ECONOMICS & MARKETS

Market Update 27 August

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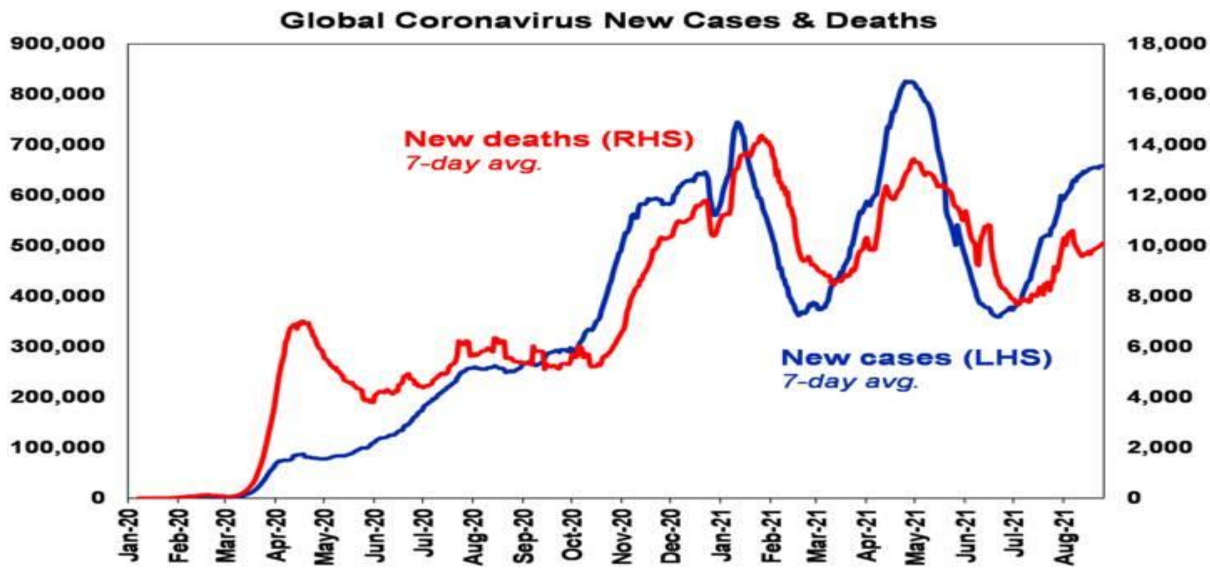
Investment markets and key developments over the past week

Global share markets rebounded over the last week with US shares making a new record high helped by signs that the Delta wave may be slowing in the US, before a bit of caution pared gains later in the week ahead of the central bankers Jackson Hole meeting. Reflecting the positive global lead Australian shares also rose over the week but rising local coronavirus cases and mixed earnings results constrained the gains with strong increases in resources and IT stocks but weakness in consumer staples, telcos and utilities. Consistent with the risk on tone bond yields rose, as did oil, metal and iron ore prices. The $A rose slightly as the $US slipped.

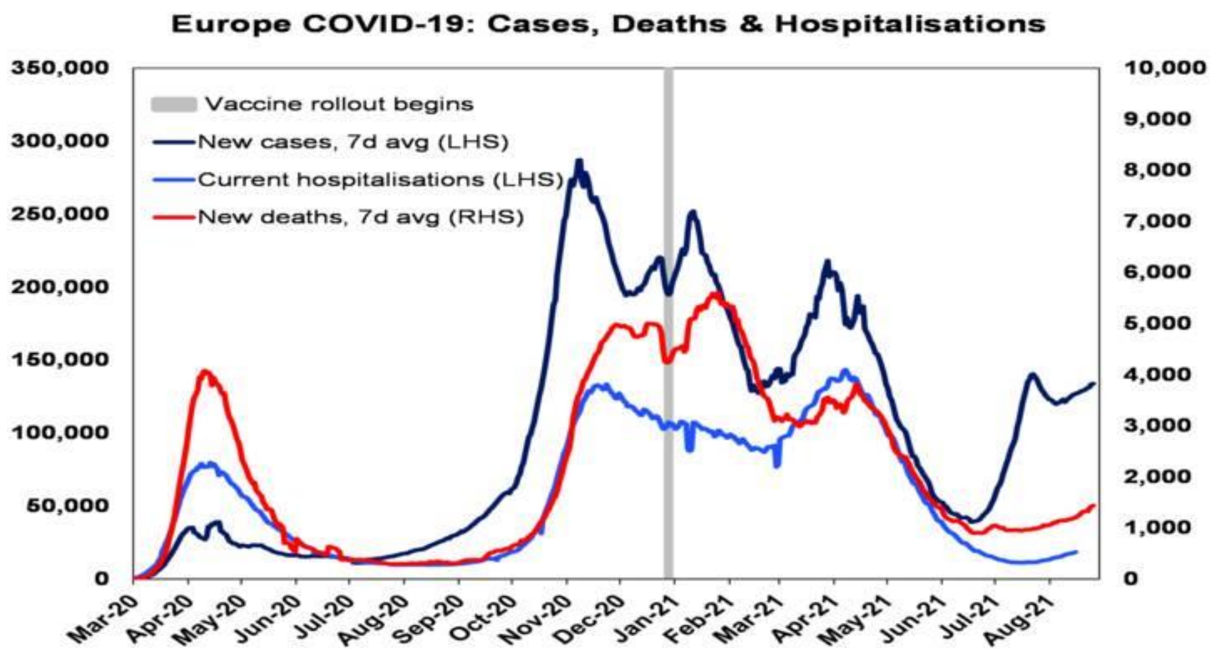
Share markets remain vulnerable to a short-term correction – as coronavirus remains a threat, Fed tapering gradually approaches, supply constraints impact growth and as the next six weeks is often seasonally weak for shares. However, the combination of a likely continuation of the economic recovery beyond a near term interruption, vaccines ultimately allowing a more sustained reopening and still low interest rates with tight monetary policy being a long way off augurs well for shares over the next 12 months.

Some good news on the coronavirus front - the rate of increase in new global coronavirus cases slowed further over the last week as Asia rolled over – albeit with Japan and Malaysia continuing to surge – and South America continuing to trend down. China has also seen its Delta outbreak recede.

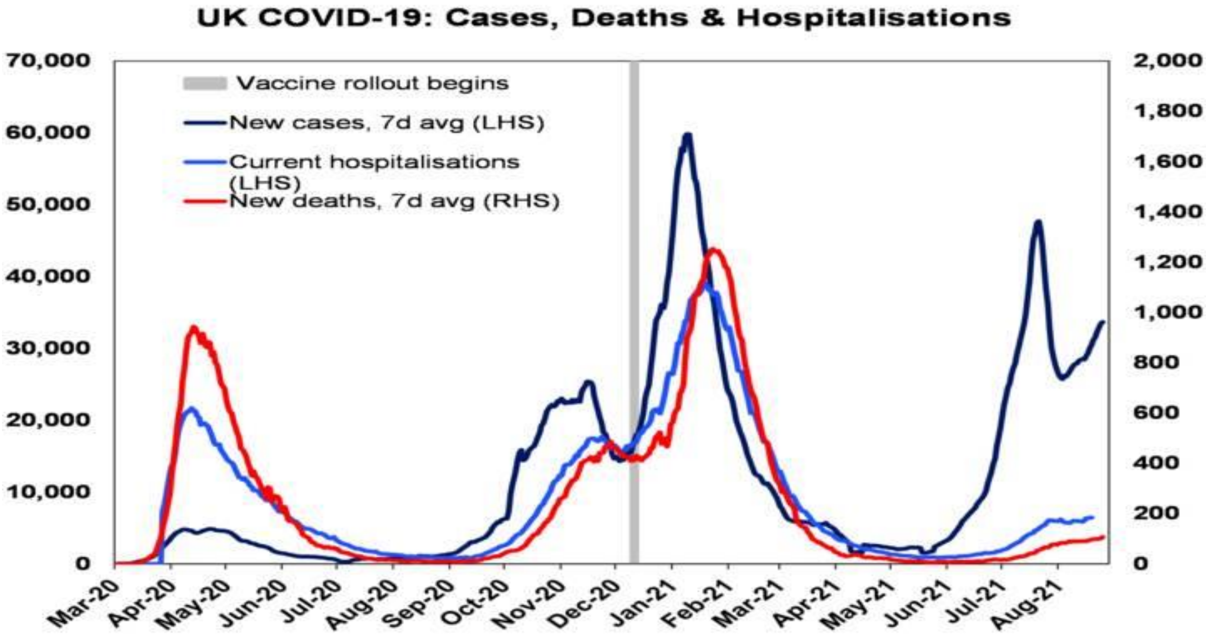


Source: ourworldindata.org, AMP Capital

The UK, Europe and Canada have seen a hook up in new cases, but hospitalisations and deaths remain low compared to the last wave as vaccines continue to work in heading off serious illness.

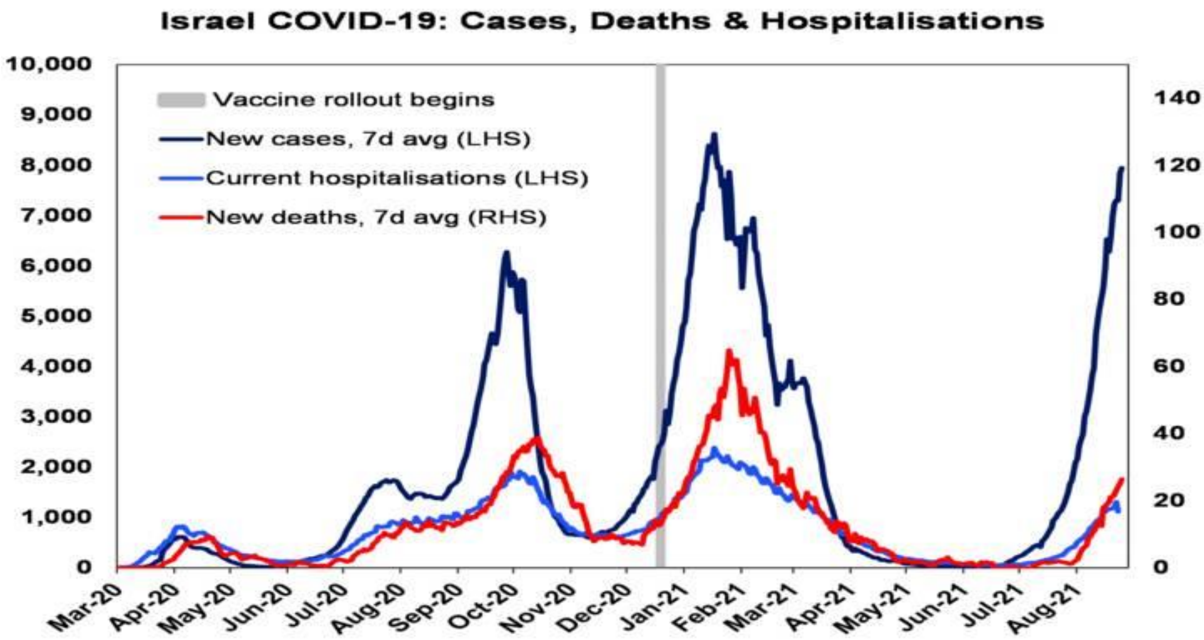


Source: ourworldindata.org, AMP Capital



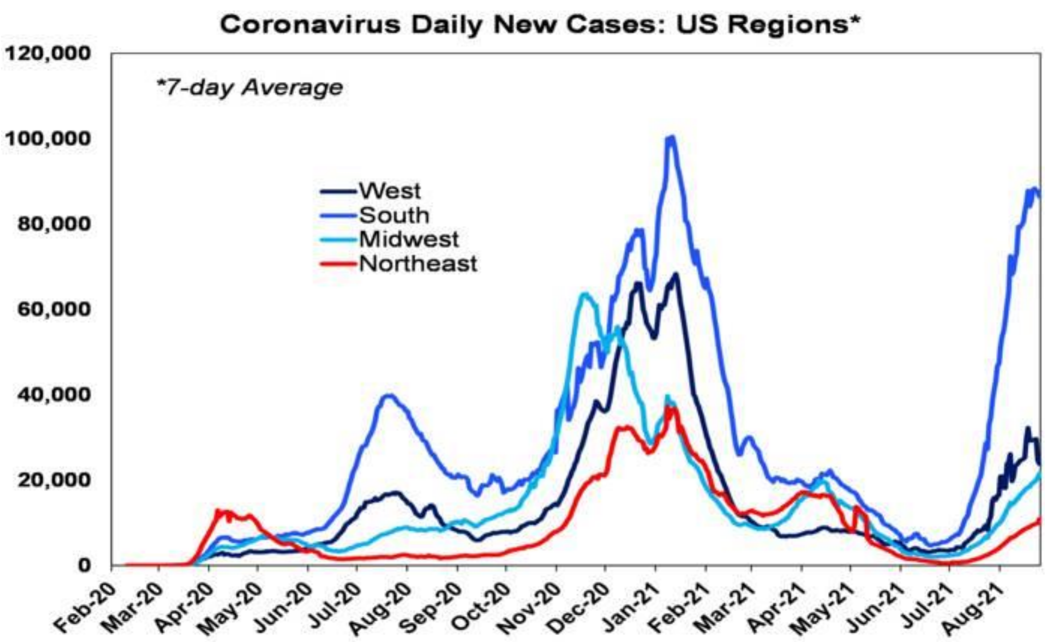
Source: ourworldindata.org, AMP Capital

Israel, which was a world leader in vaccinations, has seen a bigger problem in terms of new cases and hospitalisations. This was initially amongst the unvaccinated (which is 40% of the population) but also increasingly the vaccinated with indications that vaccine efficacy was declining for those vaccinated early in the year starting with the elderly. As a result, Israel is ramping up booster shots. The contrast with the UK, which lagged Israel by about a month in terms of vaccinations, is interesting. On the one hand Israel's experience provides a warning to the UK (and other countries) but the better UK experience may also be consistent with some studies showing that efficacy is holding up better for the AZ vaccine (which the UK relied on more) than the Pfizer vaccine which Israel used.



Source: ourworldindata.org, AMP Capital

The surge in new cases and hospitalisations in the US has mainly been an issue in the low vaccinated South with hospital admissions there surpassing prior peaks. But the good news is that new cases in the South look to have peaked.



Source: ourworldindata.org, AMP Capital

34% of people globally and 65% in developed countries have now had at least one dose of vaccine. Singapore is now at 81%.

Percentage of population that's been vaccinated

	% one dose	% two doses
Global	34	26
Developed countries	65	53
Emerging countries	37	28
Rest of world	12	7
Canada	75	68
Singapore	81	77
UK	72	63
US	62	53
Europe	64	56
Japan	54	43
Australia	45	26

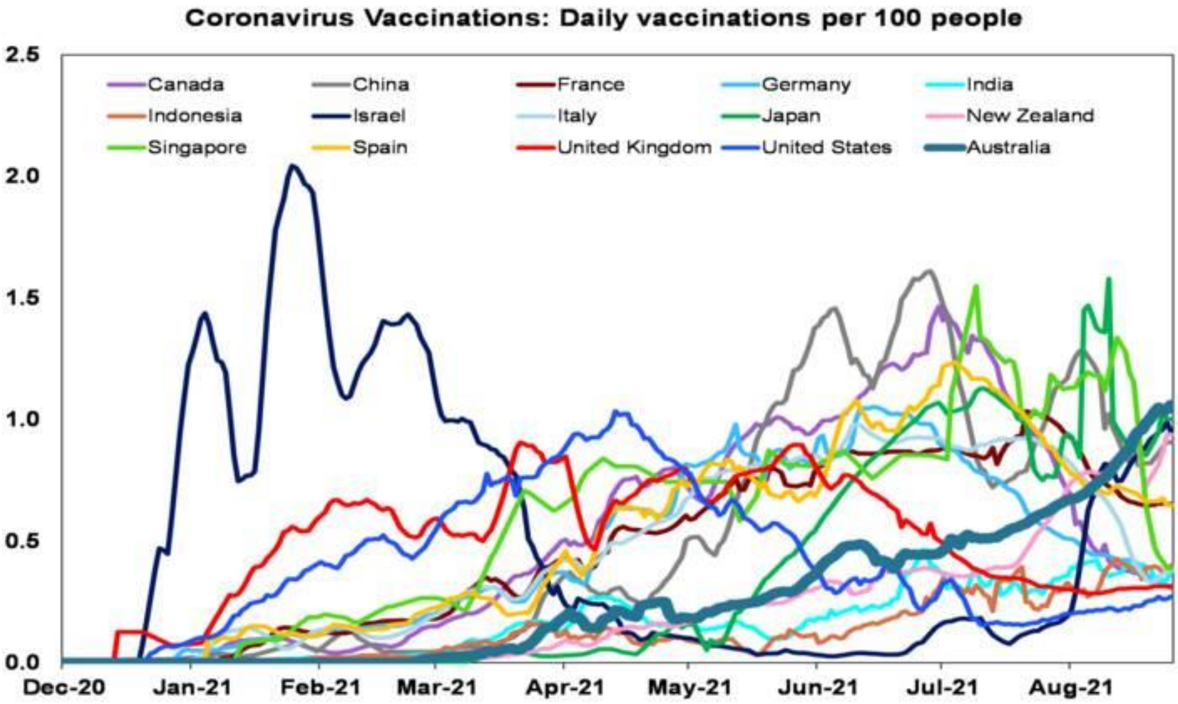
Source: ourworldindata.org, AMP Capital

While Australia has spent much of the past week debating various models regarding the safety of reopening at particular vaccination rates, the key messages from the Delta outbreaks and vaccine experience across various countries more advanced in vaccination that Australia are that:

- The vaccination program should include the whole population not just adults – as children get it, transmit and get sick from it.
- The greater transmissibility of Delta and the lower efficacy of the vaccines (60 to 80%) in preventing infection from it mean that a very high proportion of the population ideally needs to get vaccinated – leaving 40% unvaccinated as in the UK, Israel and elsewhere is risky as it means that there are lot of people who can get sick. Singapore has been right to aim for 80% and then keep going.
- To achieve higher vaccination rates above 70 to 80%, carrot and stick measures will be needed – vaccine passports (ie no job, no entry) are a key part of this and Australia looks to be going down this path.

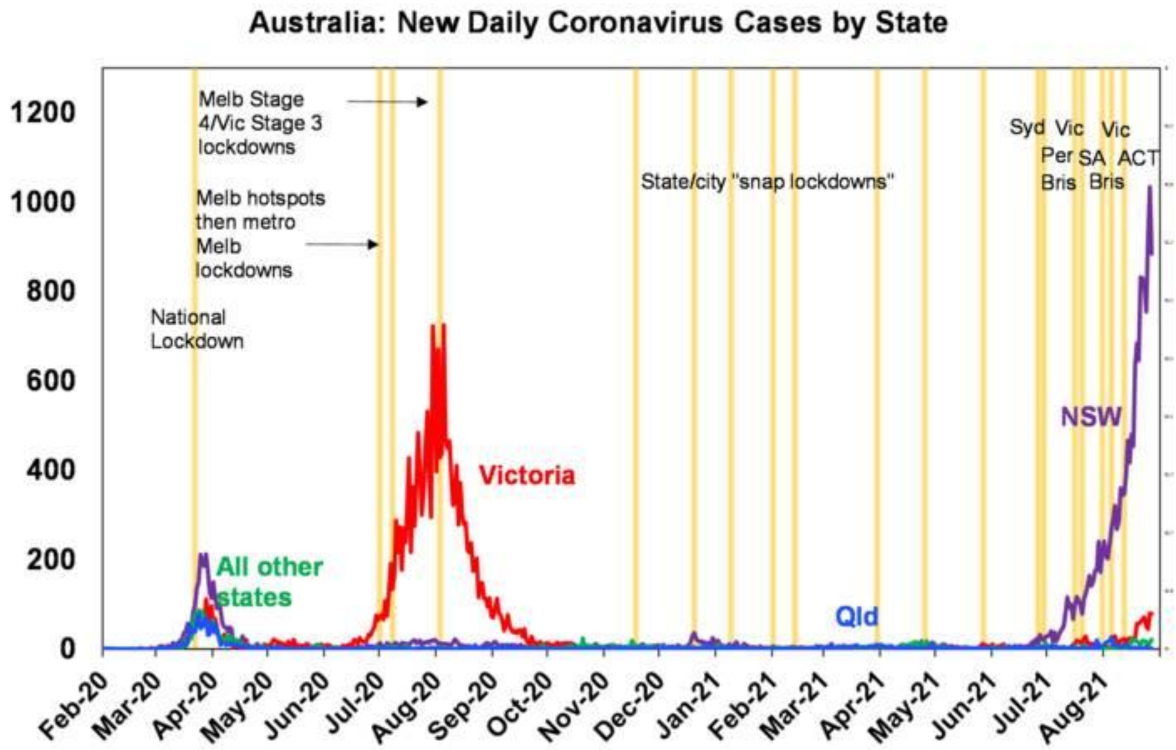
- Booster shots will be needed after about six months – although it may appear to be less the case for AZ.
- If the virus has not been suppressed prior to reopening then very high case numbers can be expected, eg the UK is seeing around 33,000 new cases a day (or about 12,000 cases a day adjusting to Australia's population). This is now the risk facing NSW and Victoria as new cases continue to rise. In Australia where there is little tolerance for high case numbers this runs the risk of causing consumer and business caution initially in the reopening phase which could in turn slow the recovery in growth compared to last year's reopening which occurred against a backdrop of covid zero or near to it. Which of course, is another argument for vaccine passports as they may help boost confidence for the already vaccinated.

The good news is that Australia's vaccination rate reached around 1.9 million doses over the last week or 1.1% of the population a day, which is up from 1 million a week six weeks ago. At the current rate of vaccination, we will reach the national objective of 70% of adults being vaccinated in October and 80% of adults in November. The precise date will vary depending on lags between jabs. 80% of the whole population being vaccinated could now be reached in December and 90% (which would be ideal in January). While the vaccine hesitant may cause problems in terms of the achievement of the higher vaccination rates, community pressure from the majority of vaccinated people wanting to get on with their lives will likely force the issue, with vaccine passports on the way.



Source: covid19data.com.au

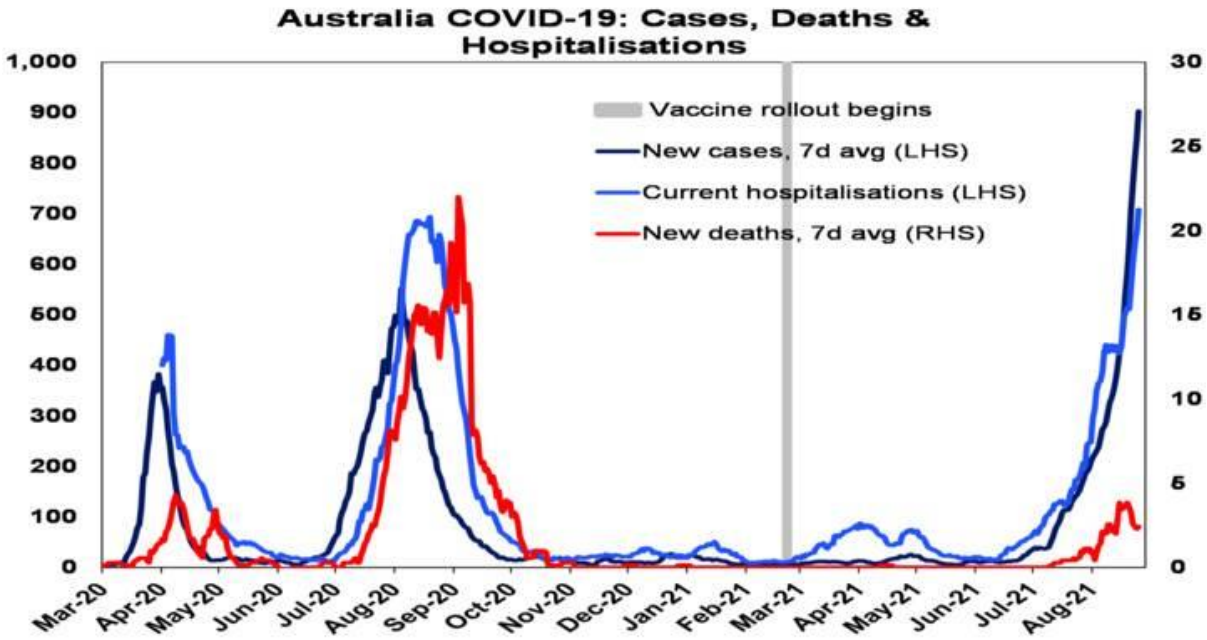
The bad news of course in Australia is that new cases have continued to surge in NSW and Victoria.



Source: covid19data.com.au, AMP Capital

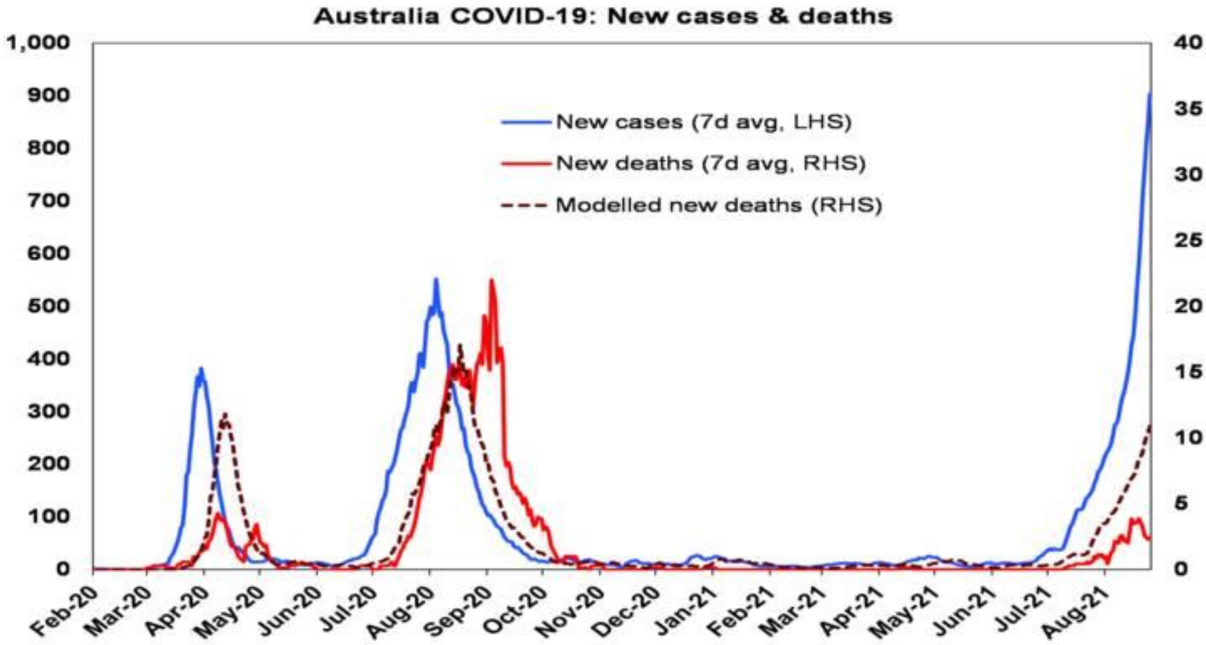
But apart from the massive surge in vaccinations there is some other good news in Australia in that the level of deaths relative to new cases is very

subdued compared to the situation in last year's case waves (particularly relative to the Victorian wave) – suggesting that the program to vaccinate the elderly and at risk has helped. The level of hospitalisations is also low relative to new cases compared to last year – but less significantly.



Source: ourworldindata.org, covid19data.com.au, AMP Capital

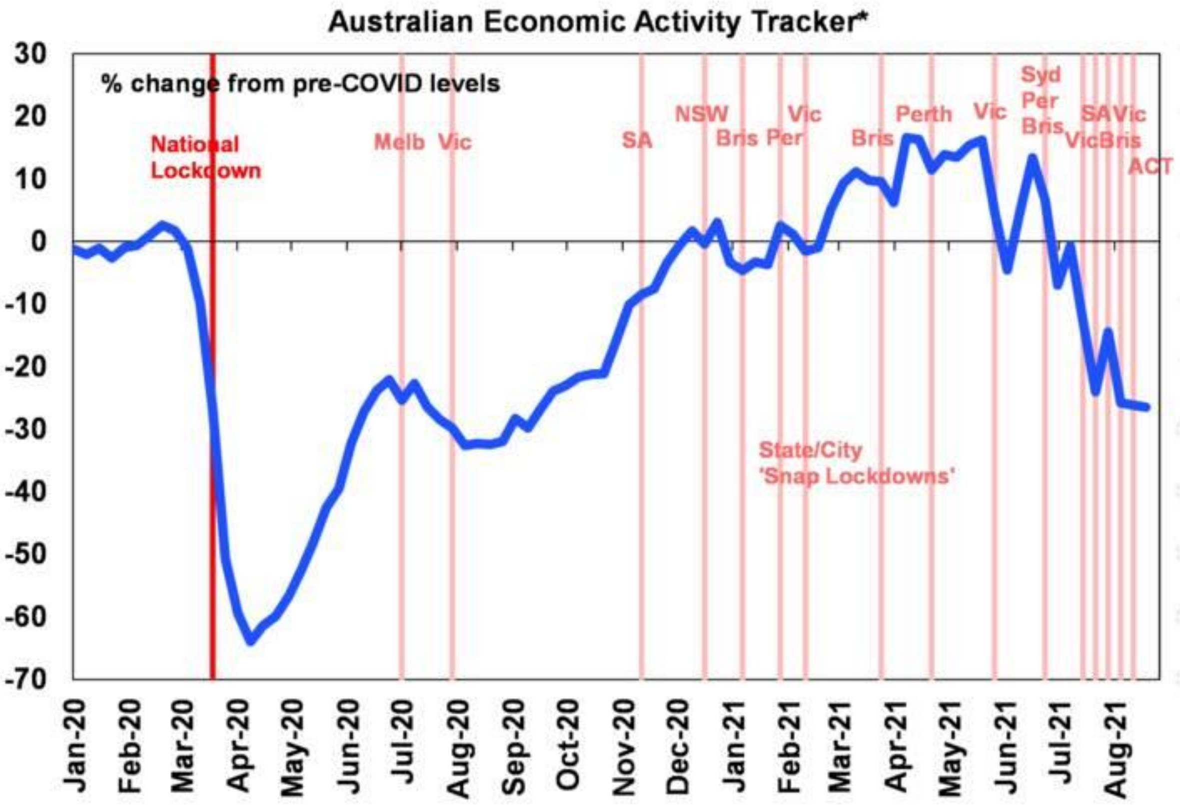
The next chart demonstrates the lower level of deaths in Australia a bit more clearly. The dashed line is a model of what would have happened with deaths based on the first two waves last year and it can be seen that in this wave the number of deaths is running well below the modelled outcome suggesting that the vaccines are helping. Of course, other factors are also be at play including how successful measures to keep covid out of nursing homes are which may explain why the first wave was less deadly than the second.



Source: ourworldindata.org, covid19data.com.au, AMP Capital

And here's another piece of good news - to get a bit technical the estimated effective reproduction rate in NSW has fallen with each new case passing it on to 1.1 people down from 1.5 people a few weeks ago. If it falls below 1 then we should see a decline in new cases over time.

The economic impact of the lockdowns is evident in a plunge in our Australian Economic Activity Tracker since June. However, while it slipped further over the last week it appears to be stabilising as it's likely that NSW and Victoria are at or close to the bottom, providing of course that other states don't enter extended hard lockdowns too.



** Components of the tracker include; Credit card data, Job ads, Traffic index, Retail foot traffic, Restaurant performance, Consumer confidence, Apple & Google Mobility Indices and Hotel bookings.*

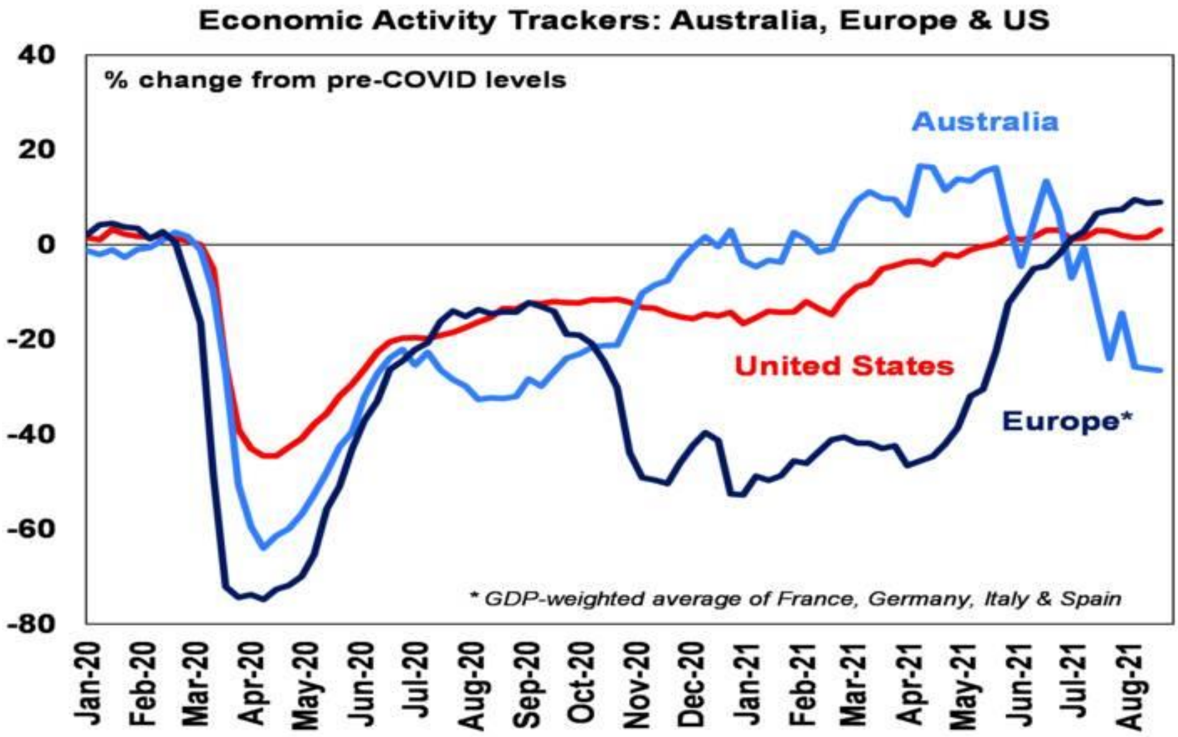
Source: AMP Capital

While it's a close call, we now expect a return to technical recession in Australia. The spread and extension of the lockdowns (which will now cost the economy an estimated $25bn since May) saw us revise down our September quarter GDP forecast to -4% a week ago. However, a combination of softer readings for some GDP components point to a small -0.1% fall in June quarter GDP as well (which is a risk we flagged 5 weeks ago). While consumer spending, plant and equipment investment and government spending will likely all add to June quarter GDP growth, this looks likely to be just offset by falls in (or flat) housing investment and non-residential building and significant detractions from growth from inventories and net exports. More data to be released early next week on trade, inventories, wages, profits and sales for the quarter could still blow our June quarter GDP estimate around and it's a close call.

But if the June quarter contracts by -0.1% as we currently expect this will mean that, with the September quarter almost certain to see a large fall, the economy will have unfortunately slipped back into recession. Of course, the "recession" concept is less meaningful than usual in relation to lockdowns as it's not a normal cyclical recession and the economy should recover more quickly than would occur after a normal recession as reopening will unleash pent up demand, even if this is constrained compared to last year as we have to learn to "live with covid". But the optics would be bad, and news of another recession would not be good for confidence.

Moreover, whether the June quarter is negative or not we remain of the view that the bigger hit to GDP from the lockdowns and an initially slower reopening due to the need to have to live with covid will result in a lower profile for GDP and a higher profile for unemployment through 2022 than the RBA has been assuming. As a result, we continue to see the RBA deciding to delay its decision to slow its bond buying from $5bn a week to $4bn at its September meeting.

While Delta outbreaks appear to have constrained our US and European Economic Activity Trackers the US ticked up over the last week and Europe remains high. The absence of lockdowns is heading off steep declines like we saw last year.

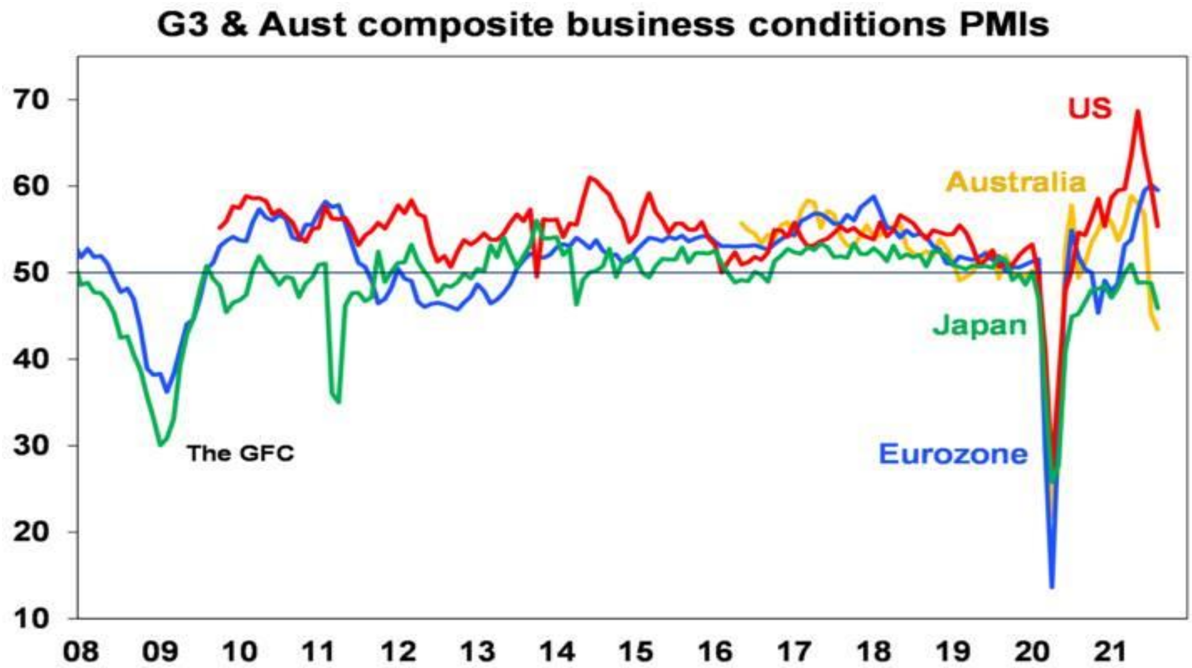


Based on weekly data for eg job ads, restaurant bookings, confidence, mobility, credit & debt card transactions, retail foot traffic, hotel bookings. Source: AMP Capital

I have always been more a Beatles than a Rolling Stones person – but I still loved the Stones' music and Charlie Watts was the backbone of it so it's really sad to hear he has left us. So here's (I Can't Get No) Satisfaction and Start Me Up – I love the look between Charlie and Bill at 2.29 in the latter. And having just re-watched The Big Chill here's the opening song You Can't Always Get What You Want – which seemed to set the tone for the whole film.

Major global economic events and implications

Business conditions PMIs fell back in August in the US, Europe, Japan and Australia reflecting Delta outbreak concerns to varying degrees. They remain strong in the US and Europe though.



Source: Bloomberg, AMP Capital

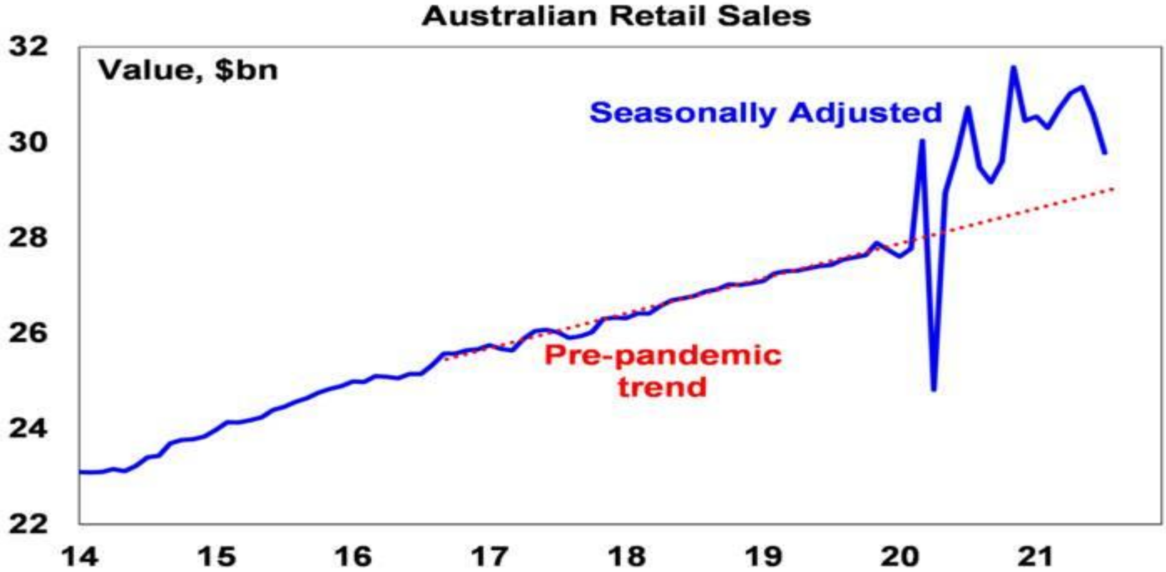
In the US, the pullback in the PMI was driven mainly by services as a resultant of the Delta outbreak. Meanwhile home sales rose, capital goods orders continued to trend up and jobless claims continue to trend down.

Eurozone business conditions PMIs fell on the back of weaker manufacturing, but they remain strong.

Japan's business conditions PMIs were hit by weakness in services as coronavirus cases continued to surge.

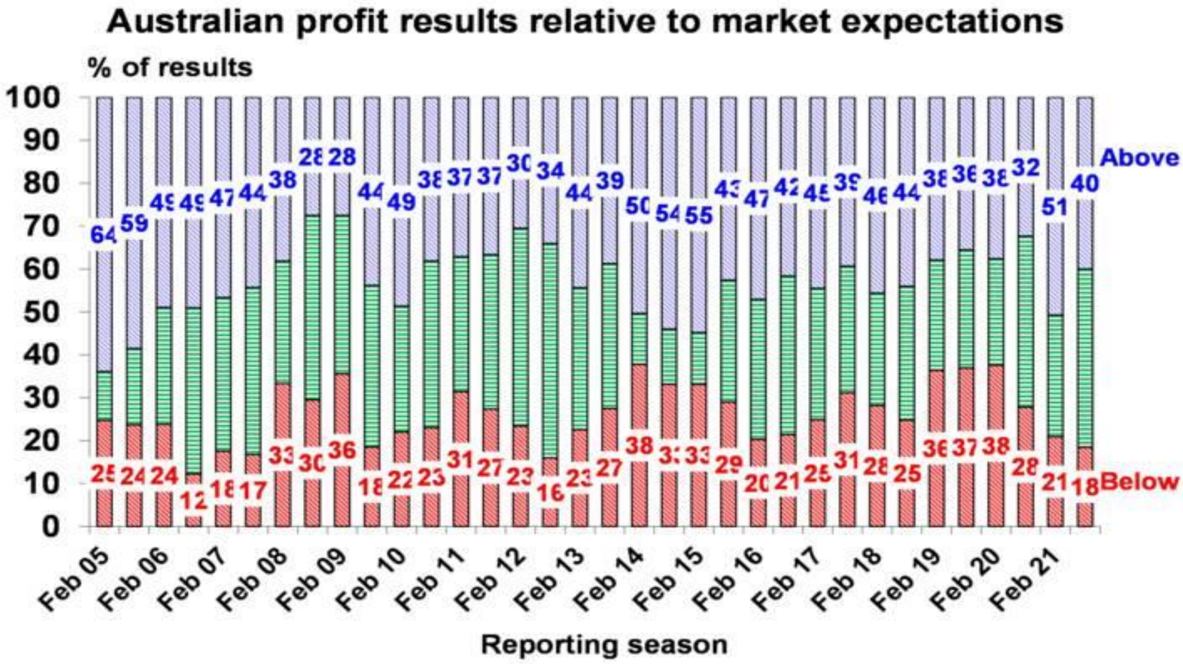
Australian economic events and implications

Australian data was a mixed bag. The good news was that business investment rose more than expected in the June quarter and investment plans for the current financial year also rose more than expected. Against this though June quarter construction was weaker than expected surprisingly due housing, payrolls jobs fell again in the second half of July led by NSW, business conditions PMIs fell further in August (see the previous chart) and retail sales fell -2.7% in July. The fall in retail sales was mainly due to NSW which saw a -8.9% decline, but a further sharp fall is likely in August as the NSW lockdown tightened and Victoria went into a hard lengthy lockdown.

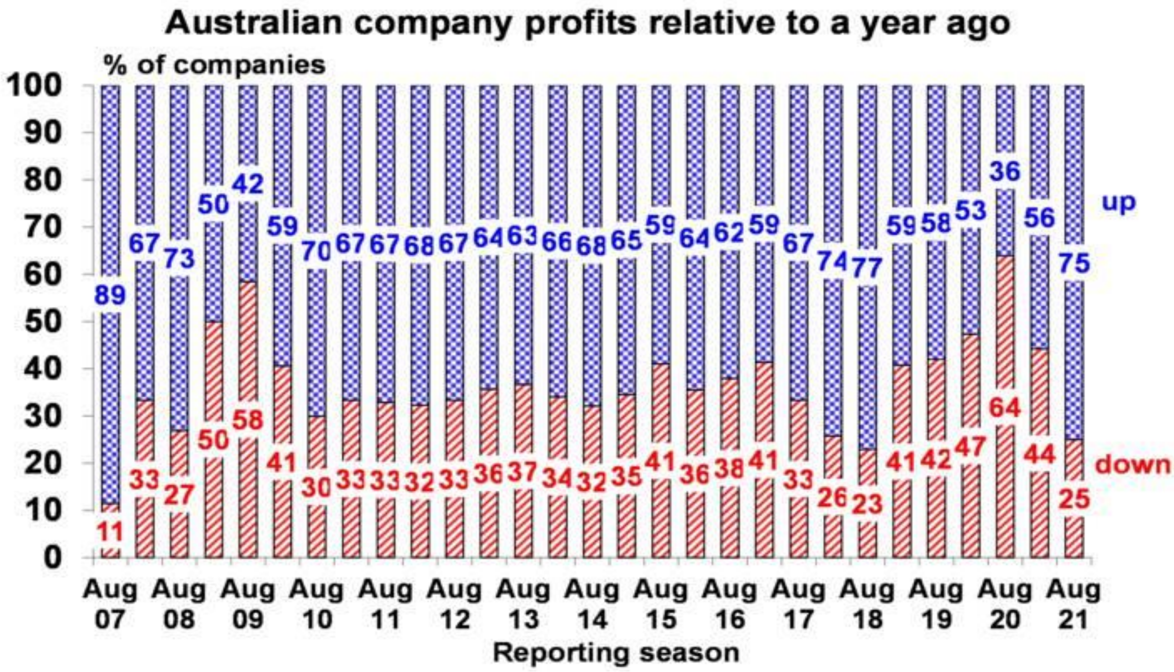


Source: ABS, AMP Capital

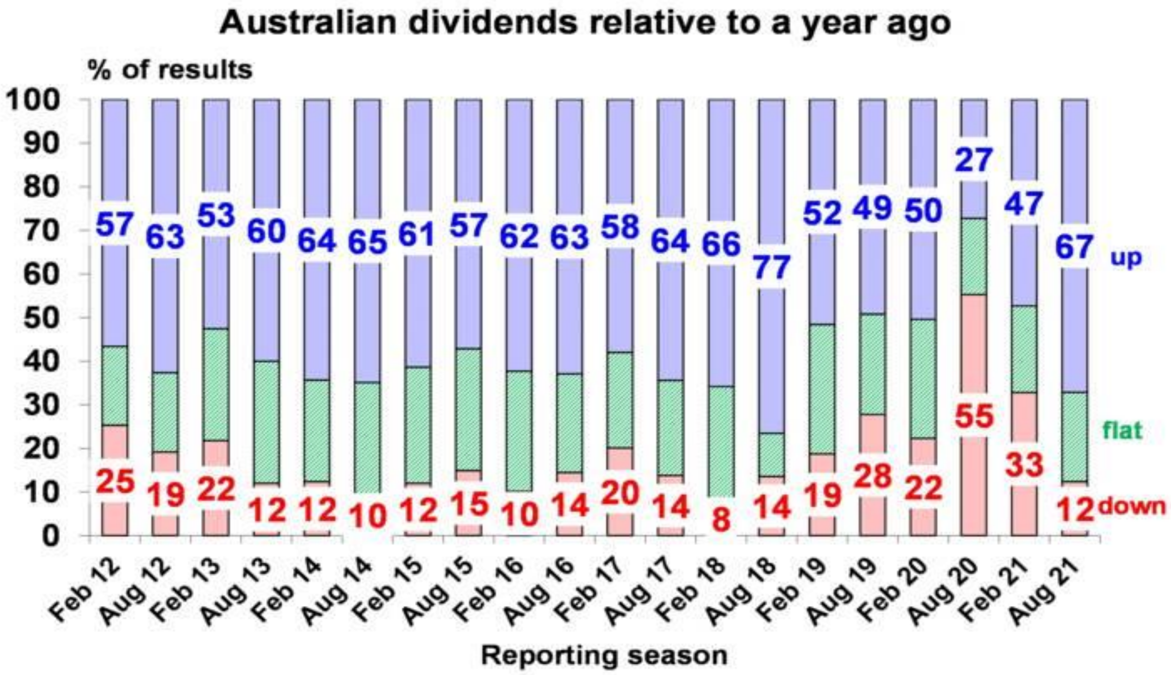
The Australian June half earnings reporting season is now around 95% complete. While the lockdowns are weighing on outlook statements with many companies providing no guidance and we have seen the usual softening as reporting season proceeds, the results have been solid. 40% of results have surprised on the upside which is just below the norm of 44% but only 18% surprised on the downside which is well below the norm of 26%, 75% have seen earnings up on a year ago & 88% have increased or maintained dividends. The return of capital to shareholders will be big with a record $30bn in dividend payments already declared (based on analysis by Richard Coppleson at Bell Potter) and over $20bn in buybacks. Consensus earnings growth expectations for the last financial year have now increased to +50.6% from +49.1% at the start of the reporting season and those for the current financial year have only fallen from +8.6% to +7.5%. Resources are seeing a 97% rise in earnings and bank profits are up by 58%. Dividend growth is coming in at around 57%.



Source: AMP Capital



Source: AMP Capital



Source: AMP Capital

What to watch over the next week?

In the US, the main focus will be on jobs data (Friday) for August which are expected to remain strong with a 775,000 gain in payrolls and unemployment falling to 5.2%. In other data, expect a small gain in pending home sales (Monday), a slight fall in consumer confidence but continuing strength on home prices (both Tuesday), a slight pull back in the manufacturing conditions ISM for August (Wednesday) to around a still strong 58.5 and similarly a slight fall in the services conditions ISM (Friday) to around a still strong 62.5.

In the Eurozone, expect economic confidence (Monday) to have fallen slightly but remain very strong, core inflation for August (Tuesday) to have risen to 1.4%yoy helped by base effects and unemployment (Wednesday) to have fallen to 7.6%.

Japanese industrial production for July is expected to have fallen and jobs data will also be released on Tuesday.

Chinese official and Caixin business conditions PMIs for August (due Tuesday, Wednesday and Friday) are expected to fall slightly.

In Australia, the focus will likely be on June quarter GDP (Wednesday) which we expect to show a -0.1% fall with increases in consumer spending, plant and equipment investment and public spending being offset by drags from housing, inventories and net exports. Of course, at -0.1% it's a close call and more data to be released on inventories, wages, profits and sales (Monday) and on trade and public spending (Tuesday) for the quarter could still blow our June quarter GDP estimate around. In other data expect to see net exports detract -1.3% from June quarter GDP, building approvals to show a 2% bounce and housing credit growth to show a further acceleration (all Tuesday), CoreLogic home price data for August to show a solid 1.5% gain led by Sydney and Adelaide, housing finance to fall 2% in July and the trade surplus to fall back to $9bn (both Thursday) and retail sales (Friday) to confirm a -2.7 decline.

The Australian June half profit reporting season will wrap up, with another 20 major companies due to report. This includes Crown, Fortescue, Harvey Norman and Freedom Foods on Monday.

Outlook for investment markets

Shares remain vulnerable to a short-term correction with possible triggers being coronavirus, the inflation scare and US taper talk, likely US tax hikes and a debt ceiling standoff and geopolitical risks. But looking through the short-term noise, the combination of improving global growth and earnings helped by more fiscal stimulus, vaccines ultimately allowing a more sustained reopening and still low interest rates augurs well for shares over the next 12 months.

Expect the rising trend in bond yields to resume as it becomes clear the global recovery is continuing resulting in capital losses and poor returns from bonds over the next 12 months.

Unlisted commercial property may still see some weakness in retail and office returns but industrial is likely to be strong. Unlisted infrastructure is expected to see solid returns.

Australian home prices look likely to rise by around 20% this year before slowing to around 5% next year, being boosted by ultra-low mortgage rates, economic recovery and FOMO, but expect a progressive slowing in the pace of gains as poor affordability impacts, government home buyer incentives are cut back, fixed mortgage rates rise, macro prudential tightening kicks in and immigration remains down relative to normal. The lockdowns have increased short term uncertainty though.

Cash and bank deposits are likely to provide very poor returns, given the ultra-low cash rate of just 0.1%. The setback from Delta coronavirus lockdowns could push the first rate hike back into 2024.

Although the $A could pull back further in response to the latest coronavirus outbreaks, the threats posed to global and Australian growth and falling iron ore prices, a rising trend is likely to remain over the next 12 months helped by strong commodity prices and a cyclical decline in the US dollar, probably taking the $A up to around $US0.80 over the next 12 months.