

ECONOMICS & MARKETS

Market Update 28 August 2020

28 Aug, 2020



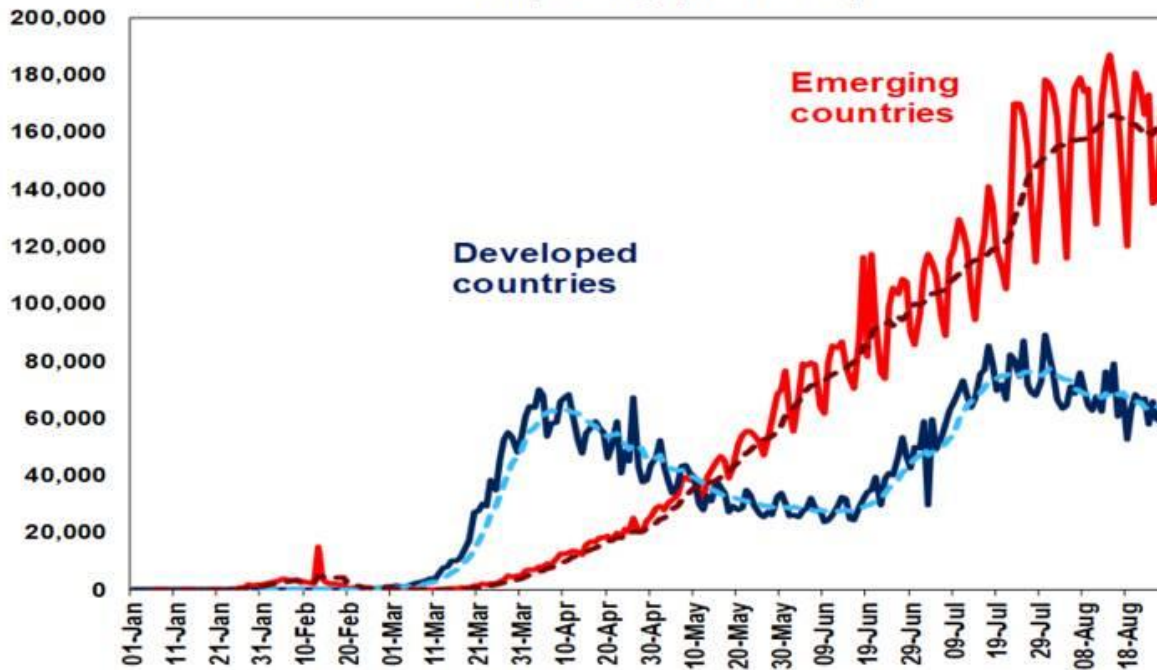
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Investment markets and key developments over the past week

Global share markets rose over the past week helped by continuing signs of economic recovery, positive coronavirus vaccine and treatment news and anticipation of the Fed's shift to inflation average targeting. Australian shares fell slightly though over the past week reflecting poor earnings results with weakness in utilities, energy, health, telco and material shares. Bond yields rose helped by the Fed's more dovish approach to inflation targeting. The iron ore price fell slightly, but metal and oil prices rose as the \$US fell and this also saw the \$A rise to around \$US0.73 its highest since December 2018.

The better news flow on coronavirus continues. New global coronavirus cases have been trending flat for a month now. Emerging countries may be rolling over with better trends in Brazil, South Africa (which has gone from 13,000 new cases a day down to around 2000), Pakistan, Mexico and Saudi Arabia.

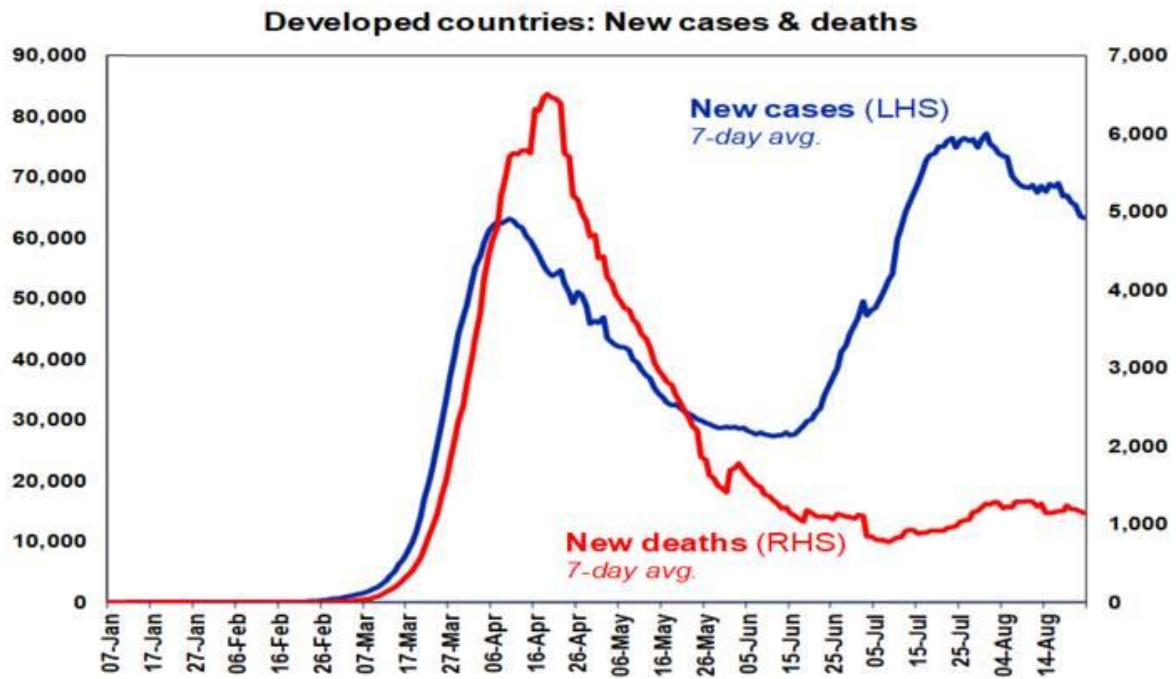
Coronavirus confirmed cases worldwide Daily Change (new cases)



Source: ourworldindata.org, AMP Capital

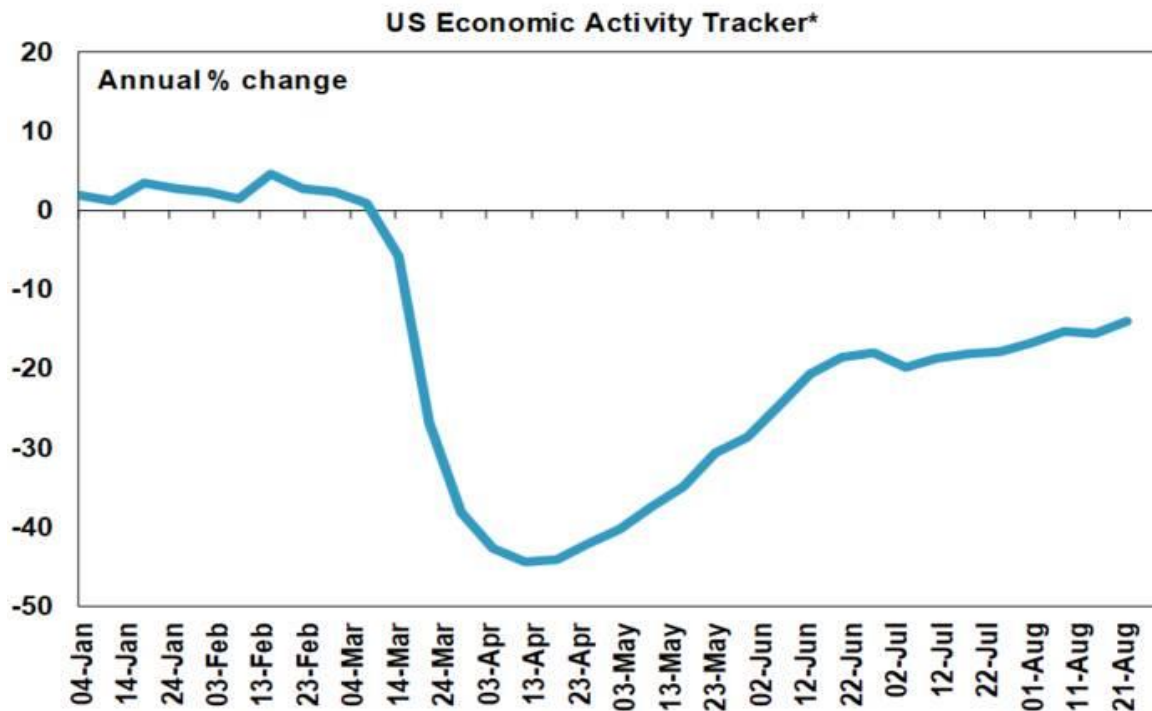
New cases are continuing to trend down in developed countries led by a sharp decline in the US and to a lesser degree in Japan offsetting a still rising trend in Europe.

The really good news remains that the second wave of new coronavirus cases in developed countries has continued to be far less deadly than the first wave with deaths running well below their April high whereas new cases have been well above. This is helping to avoid a return to generalised lockdowns in most countries – in favour of targeted measures – and helping confidence hold up.



Source: ourworldindata.org, AMP Capital

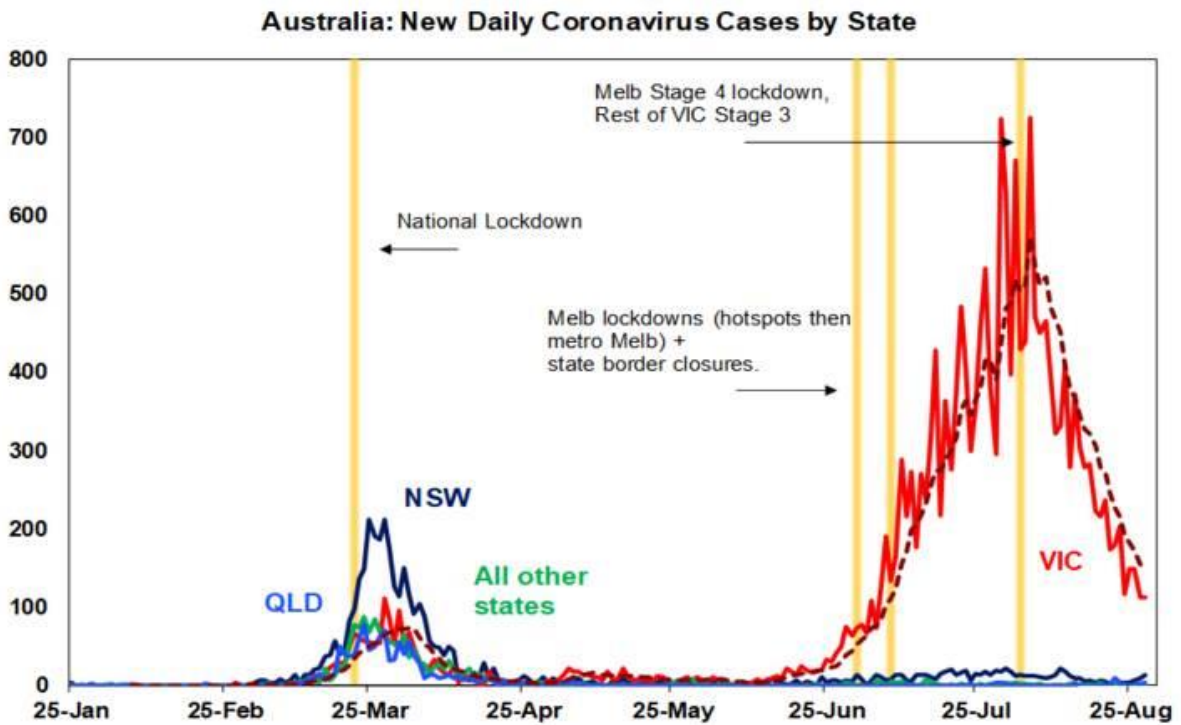
The latest downtrend in new coronavirus cases without a generalised hard lockdown adds to confidence that the economic recovery that has been seen in developed countries since April can continue. This is particularly notable in the US with our US Economic Activity Tracker resuming its upswing. The Atlanta Fed's estimate of September quarter GDP growth based on already released data is now running around 7% quarter on quarter.



* Components of the tracker include: Consumer spending, Restaurant performance, Consumer Confidence, Jobless Claims, Hours worked, Small business revenue, Rail Freight Loads, Retail Sales, Retail Foot Traffic, Apple & Google Mobility Indices, Mortgage applications, Hotel bookings and Job Ads.

Source: AMP Capital

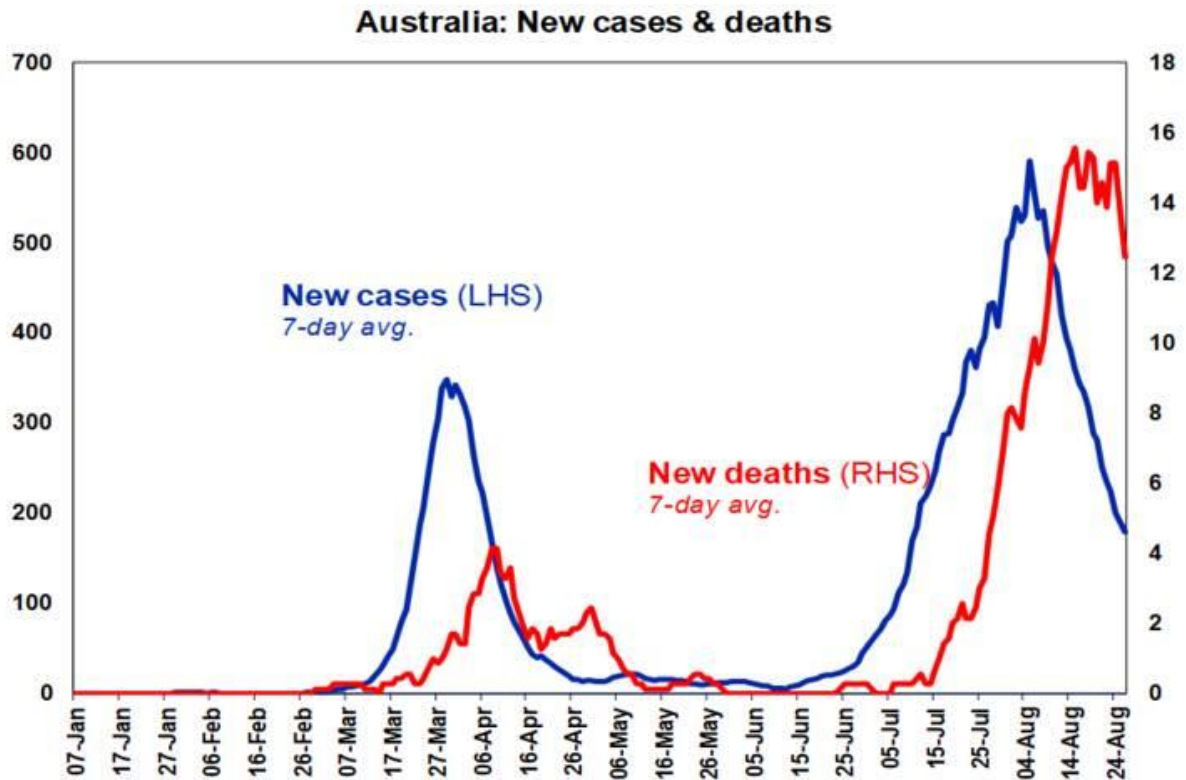
Australia has also continued to see better news on coronavirus with new cases in Victoria trending down sharply as the hard lockdown impacts and new cases remaining low in outside Victoria (suggesting that testing, tracking and quarantining programs outside Victoria are working well – albeit the risk of a break higher is still significant in NSW). Its ironic that the Stage 4 lockdown in Melbourne was announced just when new cases were peaking suggesting that the earlier Stage 3 lockdown did all the heavy lifting. The Stage 4 lockdown probably helped speed the decline though.



Sources: Covid19data.com.au, AMP Capital

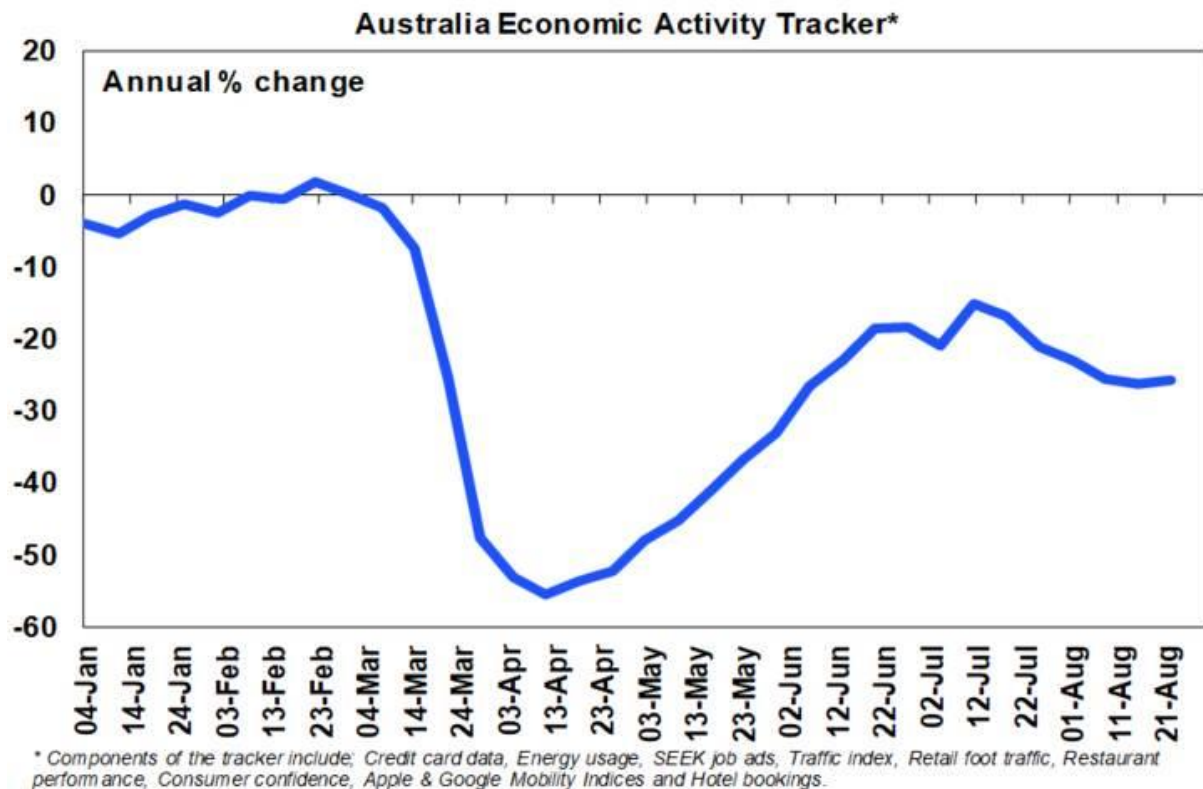
And now with new cases sliding, deaths are also starting to roll over

thankfully. Unfortunately, Australia has been hit harder in terms of deaths in the second wave because we were so successful in the first wave and because it took hold in more retirement homes in the second wave. Fortunately, the fatality rate overall in Australia remains well below that in other comparable countries.



Source: Covid19data.com.au, AMP Capital

The Victorian lockdown and bouts of uncertainty and negative headlines in NSW are continuing to weigh on economic activity in Australia with our Australian Economic Activity Tracker remaining well down from its July high. Fortunately, it has now stabilised over the last two weeks, with improvements over the last week being seen in consumer confidence, mobility and hotel bookings. Weakness in Victoria is now being offset by strength in other states. If Victoria continues to come under control and the lockdown is eased later next month then the economic recovery should resume.



Source: AMP Capital

Finally, positive news on the medical front continues to flow regarding vaccines (including in relation to a vaccine being developed at the University of Queensland) and various treatments. There have also been documented cases of re-infection, but this does not necessarily mean that a vaccine won't help and its also quite possible that the ultimate solution will involve a combination of vaccines and treatments.

On the policy front, Fed Chair Powell's Jackson Hole speech has confirmed the Fed's move to inflation average targeting. This is big stuff and very dovish. Since 2012 it has had a 2% inflation target – but the objective was just 2% regardless of what had happened in the past. So, in December 2015 rates were raised even though core inflation was just 1.5% and unemployment was at 5% because the Fed “expected” inflation to rise to 2%. Inflation average targeting basically means that the Fed will tolerate a period of “moderate” inflation overshooting after a period of undershooting to achieve an average of 2% inflation “over time”. It is making this shift because the zero bound of interest rates is now closer and so binds monetary policy more frequently and because the relationship between unemployment and inflation looks to have weakened. In the current environment of undershooting this

means that it will be a lot slower to raise rates which in turn is positive for the economic recovery and investment assets. We expect the Fed to back this up with a more dovish commitment not to raise rates until the US is at or near full employment and inflation is at least 2% and with more explicit guidance around QE. This is likely next month. Of course, it does shift the dial towards higher inflation risk longer term.

In other good news the US and China reaffirmed their commitment to the Phase One trade deal signed in January, after a formal review. Despite escalating tensions between the two countries it remains clear so far that Trump does not want to do anything that threatens the US recovery and hence his re-election chances. This may change of course if Biden widens his average 7-point poll lead dramatically.

While many have argued that shares have disconnected from the real economy and profits it should be remembered that this is common at this point in the economic cycle. Just as shares led on the way down, they invariably lead on the way up. Recession and a slump in profits has been talked about for nearly six months now so its more than fully factored in but share markets are now taking their lead from good news on the medical front regarding coronavirus, declining new cases, low interest rates and signs of economic recovery at a time when there is still plenty of cash on the sidelines. **Shares are still vulnerable to further volatility, with coronavirus and US/China tensions being the main risks. But the positives should keep any volatility to being a correction in a still rising trend.** Expensive US tech and healthcare stocks could also come under pressure but if this occurs when growth is recovering then a rebound in cyclical and value stocks and non-US shares should provide an offset.

Times like this need upbeat songs. One of the best is Katrina and the Waves [Walking on Sunshine](#), which may explain why it gets so much radio airplay. I think it was a bit of a one hit wonder though. It came out about the same time in 1985 as The Beach Boy's [Getcha Back](#) which has some of my favourite vocals in a Beach Boys song.

Major global economic events and implications

US data was mostly good. Consumer confidence fell to its lowest since 2014 but home sales and durable goods orders surged again in July indicating that there is a sizeable bunch of Americans who want to get out there and spend. Reflecting the rebound in home building indicators, the US lumber price is up more than 300% from its crisis low. Jobless claims also continue to trend down.

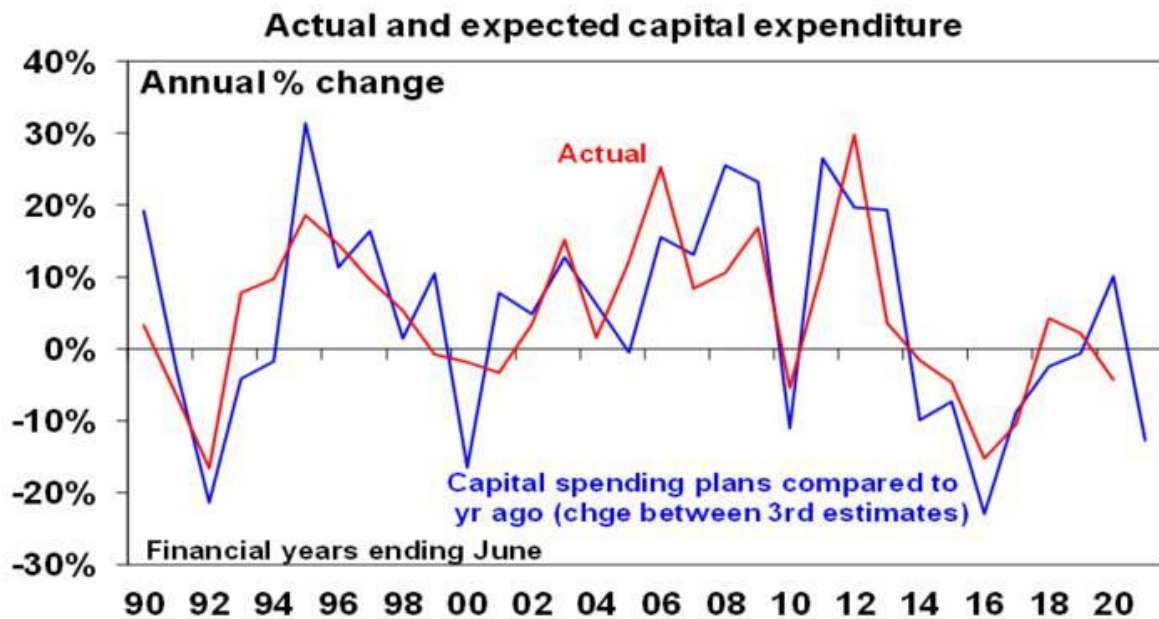
German and French business conditions and confidence readings actually improved in August.

Japan has seen some uncertainty about the economic policy outlook with PM Abe reportedly planning to resign for health reasons. But there is no real alternative to Abenomics whoever takes over and Kuroda will remain at the BoJ so there will be no change to ultra-easy monetary policy.

Chinese industrial profits for July continued to accelerate consistent with recovery and are now up 19.6% year on year.

Australian economic events and implications

Australian construction activity and business investment fell in the June quarter, but the falls were much less than expected with a solid rise in engineering construction partly offsetting weakness in home building, non-residential building and investment in plant & equipment. The bad news though is that capex plans for the current financial year point to a fall of -12.9% with a rise in mining investment plans more than offset by weakness in manufacturing and other industries. With a big hit to earnings growth, an improvement in investment requires a continuing recovery in consumer spending and help from government in the form of tax breaks for investment.

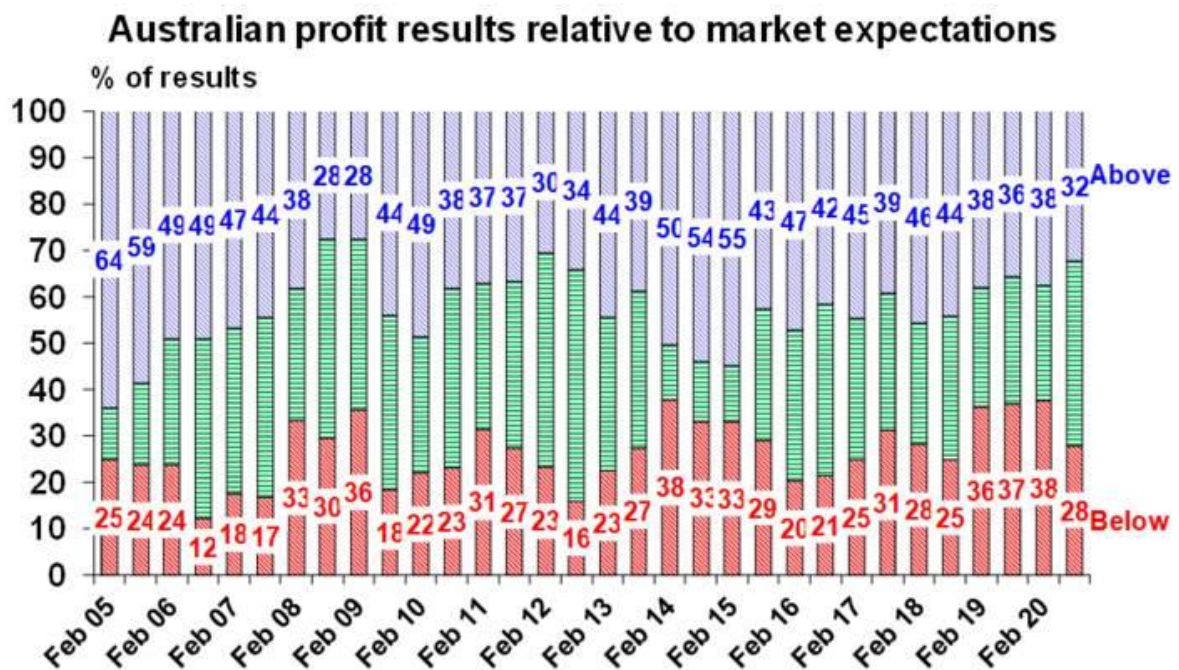


Source: ABS, AMP Capital

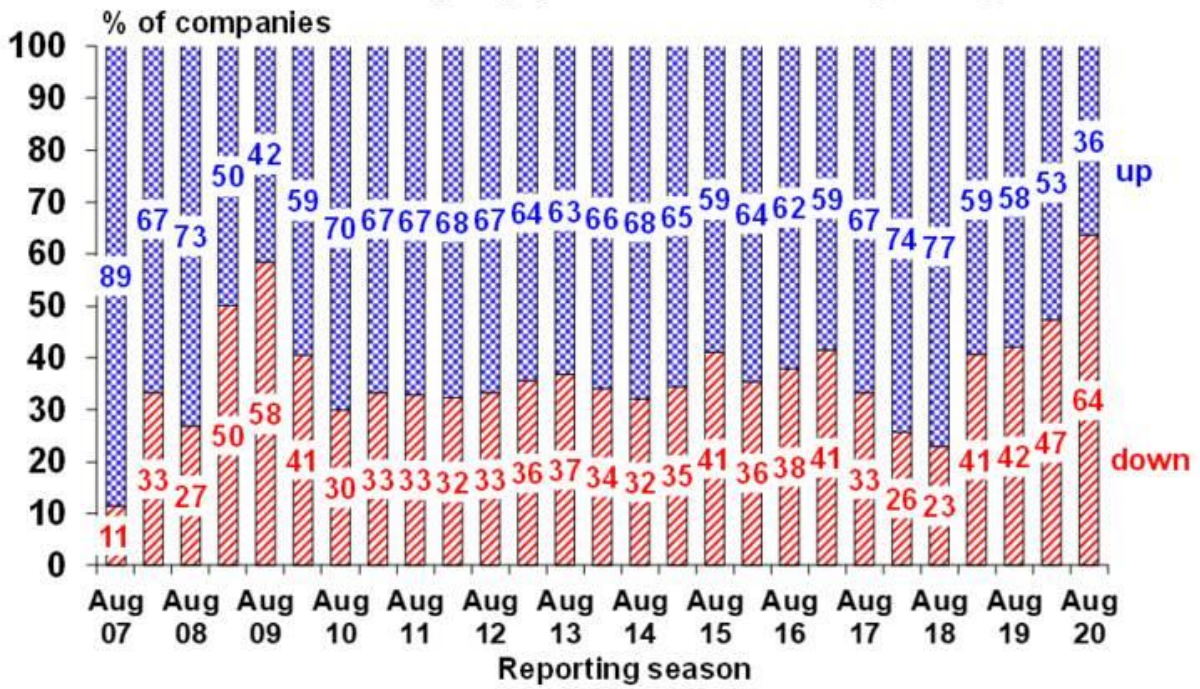
Goods trade data also showed a fall in the trade surplus in July due to a fall in iron ore exports and a surge in imports. This could prove to be a one month wonder though.

The last financial year has seen the biggest earnings slump since the early 1990s recession, but it's not been as bad as feared. The Australian June half profit reporting season is pretty much done with 92% of companies having reported accounting for 99% of market capitalisation. Company earnings and dividends have been hit hard by the coronavirus shock. Only 36% of companies have seen earnings rise from a year ago compared to a norm of 66% and a whopping 55% cut their dividends compared to a norm of just 16%, which attests to the severity of the hit to earnings and the uncertainty around the outlook. Consensus earnings estimates for 2019-20 based on those companies that have reported with expectations for the remainder 2019-20 have fallen to -23.2% (from -21% four weeks ago) and this will make it the worst fall in earnings since the early 1990s recession. Financials have been hit the hardest with the consensus now expecting a -30.9% slump in their earnings led by insurers and the banks, followed by industrials with a -17.8% fall in earnings and resources with -14.7%. Consumer discretionary stocks are the only sector to have seen a rise in earnings (+10.4%) as they benefitted from "at home" spending on furnishings and office equipment.

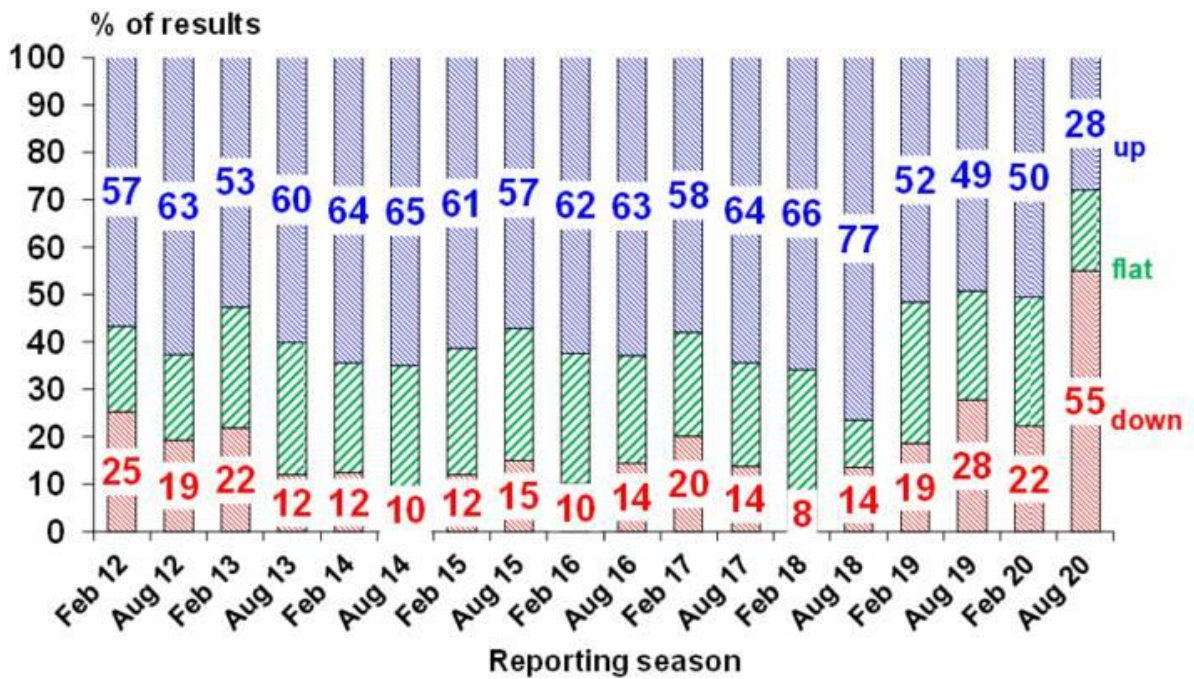
But despite the huge hit to earnings & dividends, corporate results were not as bad as feared and most companies appear to be quite resilient. Only 32% of results beat expectations compared to a norm of 44%, but beats outnumbered the 28% of companies that missed. This in turn saw 55% of companies' share prices outperform the market on the day they reported. And its also enabled the share market to rise through August so far. Earnings growth expectations for this financial year are little changed at +8.9% but they have been revised up for resources and financials and down for industrials, particularly media, general industrials and utilities.



Australian company profits relative to a year ago



Australian dividends relative to a year ago



Source: AMP Capital



Source: AMP Capital

What to watch over the next week?

In the US, the focus will be on August jobs data to be released Friday which is expected to show a 1.5 million gain in payrolls and unemployment falling again to 9.9%. Meanwhile, the August manufacturing conditions ISM index is likely to remain solid at around 54.2 (Tuesday) and the services conditions ISM index (Thursday) is expected to fall back slightly to around 57.

In the Eurozone, expect August core inflation to have fallen to around 0.8% year on year and July unemployment to rise again from 7.8% with both to be released Tuesday.

Japanese data for industrial production will be released Monday and jobs data will be released Tuesday.

Expect China's official composite PMI to have remained around 54 (Monday) and its Caixin PMIs (Tuesday and Thursday) to have remained solid.

In Australia, the RBA is expected to leave monetary policy on hold for the sixth month in a row. Having provided massive monetary stimulus back in March the RBA is still in "watch and wait" mode, and the policy focus remains largely on fiscal policy. Given the uncertainty around the pace of recovery and the risks flowing from Melbourne's lockdown,

the RBA is likely to reiterate its dovish forward guidance on rates and note that it stands ready to do more if needed. Ultimately, we think it will ease further sometime in the next six months as its own forecasts have the attainment of full employment and the sustainable achievement of the inflation target as being more than two years away. In terms what it might do if it eases further it has all but ruled out negative interest rates, foreign exchange intervention and the direct monetary financing of government spending, but sees still lower but positive interest rates and the purchase of more government bonds as possible options. A rate cut to 0.1% would hardly be worth the effort which leaves more QE as the main tool for any further easing. **Maybe the RBA should also move more explicitly to inflation average targeting like the Fed.** Meanwhile, rate hikes are at least three years away.

On the data front, June quarter GDP data is expected to show a post WW2 record slump of -5.9% quarter on quarter or -5.2% year on year as a result of the hit to the economy from coronavirus. This will likely confirm a slide into recession for the first time since the early 1990s, assuming the March quarter decline of -0.3% is not revised up into positive territory (which is quite possible). However, this has been long anticipated so should not be a surprise to anyone and it's likely to have been far milder than early expectations for a -10%qoq slump and milder than the June quarter GDP slump seen in other comparable countries with the US at -9.1%, the Eurozone at -12.1%, the UK at -20.4% and Japan at -7.8%. Significant falls are likely to have been seen in consumer spending, dwelling investment and business investment but with net exports and public spending contributing positively to growth. Elsewhere, expect July credit growth (Monday) to have remained weak, August CoreLogic data to show a -0.5% fall in home prices and July building approvals to rise 2% (both due Tuesday), the July trade surplus (Thursday) to have fallen to \$3bn and July retail sales (Friday) to have increased by 3.3% in line with preliminary retail sales data.

Outlook for investment markets

After a strong rally from March lows shares remain vulnerable to short term setbacks given uncertainties around coronavirus, economic recovery, the US election and US/China

tensions. But on a 6 to 12-month view shares are expected to see good total returns helped by a pick-up in economic activity and stimulus.

Low starting point yields are likely to result in low returns from bonds once the dust settles from coronavirus.

Unlisted commercial property and infrastructure are ultimately likely to continue benefitting from a resumption of the search for yield but the hit to economic activity and hence rents from the virus will weigh heavily on near term returns.

Australian home prices at present are being protected by income support measures and bank payment holidays but higher unemployment, a stop to immigration and rent holidays will push prices lower into next year. Home prices are expected to fall by around 10%-15% from their April high. Melbourne is particularly at risk on this front as its Stage 4 lockdown pushes more businesses and households to the brink.

Cash & bank deposits are likely to provide very poor returns, given the ultra-low cash rate of just 0.25%.

Although the \$A is vulnerable to bouts of uncertainty about coronavirus, the economic recovery and US/China tensions, a continuing rising trend is likely. Particularly with the US expanding its money supply far more than Australia is via quantitative easing and with China's earlier recovery supporting demand for Australian raw materials (assuming political tensions between Australia and China are kept to a minimum).

Important notes

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