ECONOMICS & MARKETS

Market Update 16 September 2022

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Investment markets & key developments

Share markets fell sharply over the last week, reversing their rally from the previous week's lows as US inflation surprised on the upside adding again to Fed rate hike expectations. The poor global lead saw Australian shares fall back to their lows of the previous week with falls led by property, health, consumer staple and industrial shares. Bond yields rose as higher short term interest rates for longer were factored in. Oil, metal and iron ore prices fell not helped by recession fears. The $A fell as the $US rose.

Shares remain at high risk of further falls in the short term on the back of inflation, interest rate, recession and geopolitical risks. And as we have seen in the last week if US shares head down, Australian shares will follow even if the RBA takes a less hawkish path. There is a danger in exaggerating the mid-week plunge in share markets because it just took shares back to where they were a week ago. Nevertheless, the speed of the fall highlights the vulnerability of share markets in the short term as inflation remains high, global central banks are still hawkish, recession risks are high, geopolitical tensions remain high and the period out to mid-October is known for share market weakness.

In particular, on the inflation front US core inflation came in far higher than expected at 6.3%yoy as the breadth of high inflation continued to increase and it was a similar story in the UK with core inflation there also rising further to 6.3%. This along with hawkish Fed comments and a still strong US jobs market likely keeps the Fed on track for another 0.75%

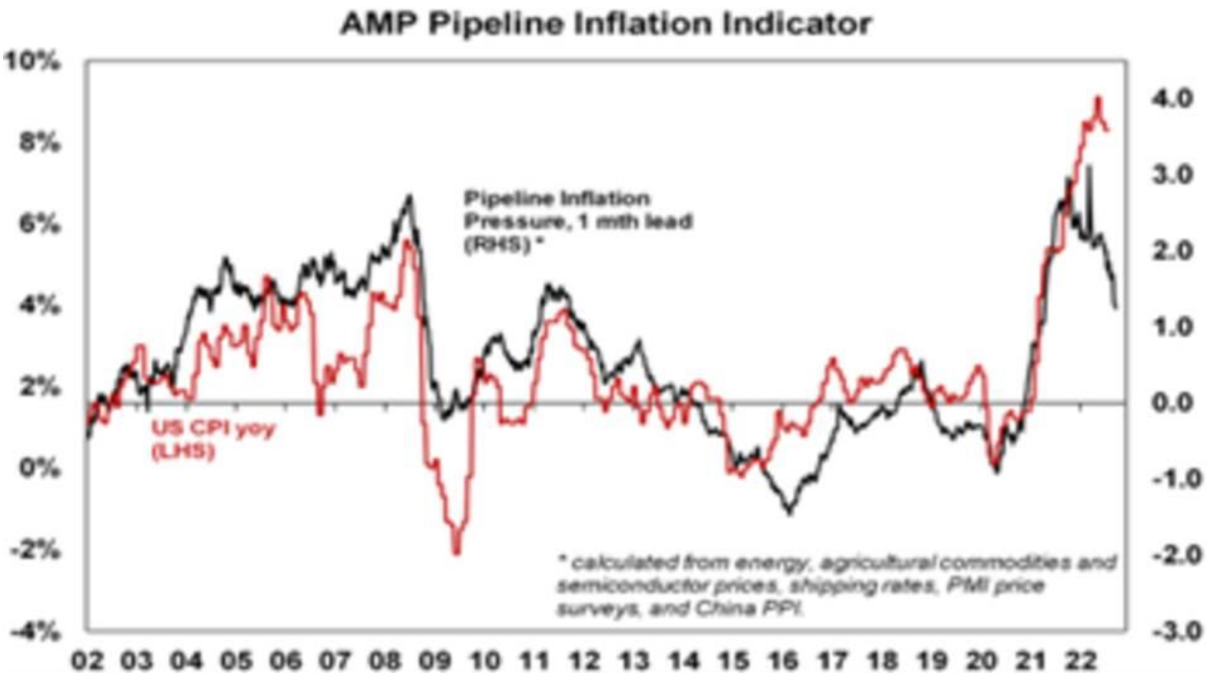
hike in the week ahead and keeps the BoE on track for another 0.5% hike in the week ahead too. The danger is that the Fed and other central banks have become locked into supersized rate hikes based on backward looking data and a loss of confidence in their ability to forecast inflation at a time when they should really be giving more attention to monetary policy lags and slowing the pace of hikes. This increases the risk of recession/deep recession as it may make it hard to slow down rate hikes when they should be.

And technically, the rebound in shares from their June lows has lacked the cyclical leadership normally seen in new bull markets and earnings revisions remain negative.

Source: Bloomberg, AMP

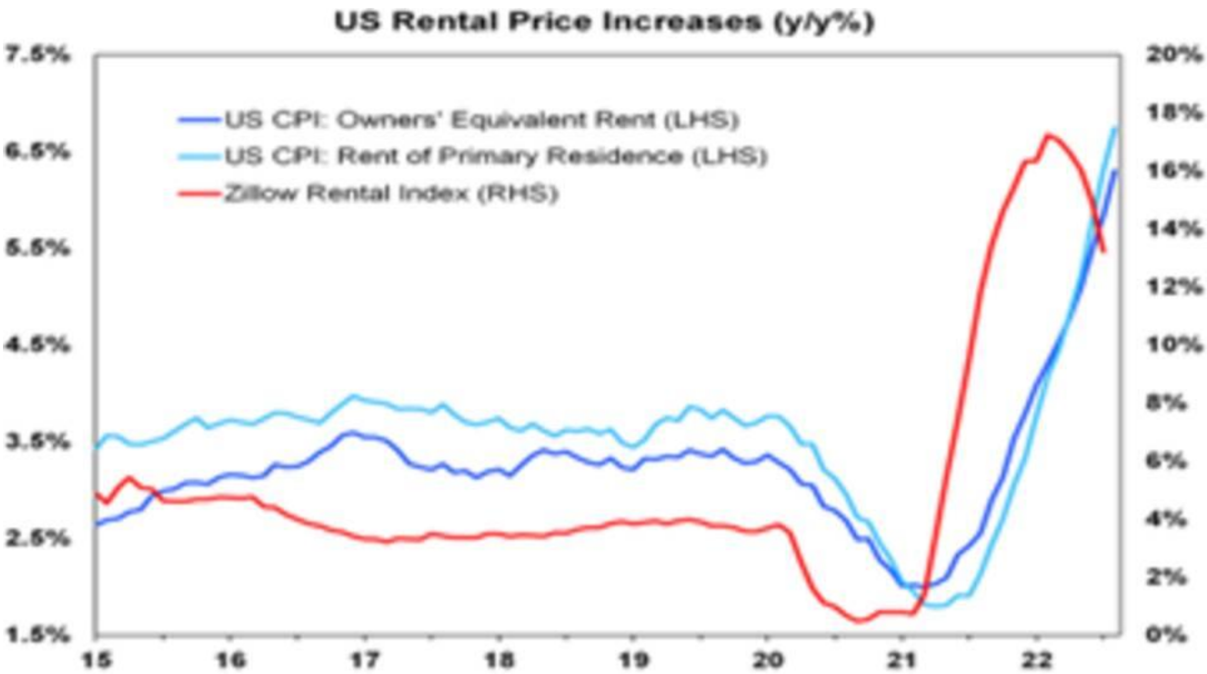
However, while short term risks remain high there are several reasons for optimism:

- Producer price inflation is slowing and looks to have peaked in the US, UK, China and Japan.
- This is consistent with our Pipeline Inflation Indicator which is continuing to trend down given falling price and cost components in business surveys, falling freight rates and lower commodity prices (outside of gas and coal).



Source: Bloomberg, AMP

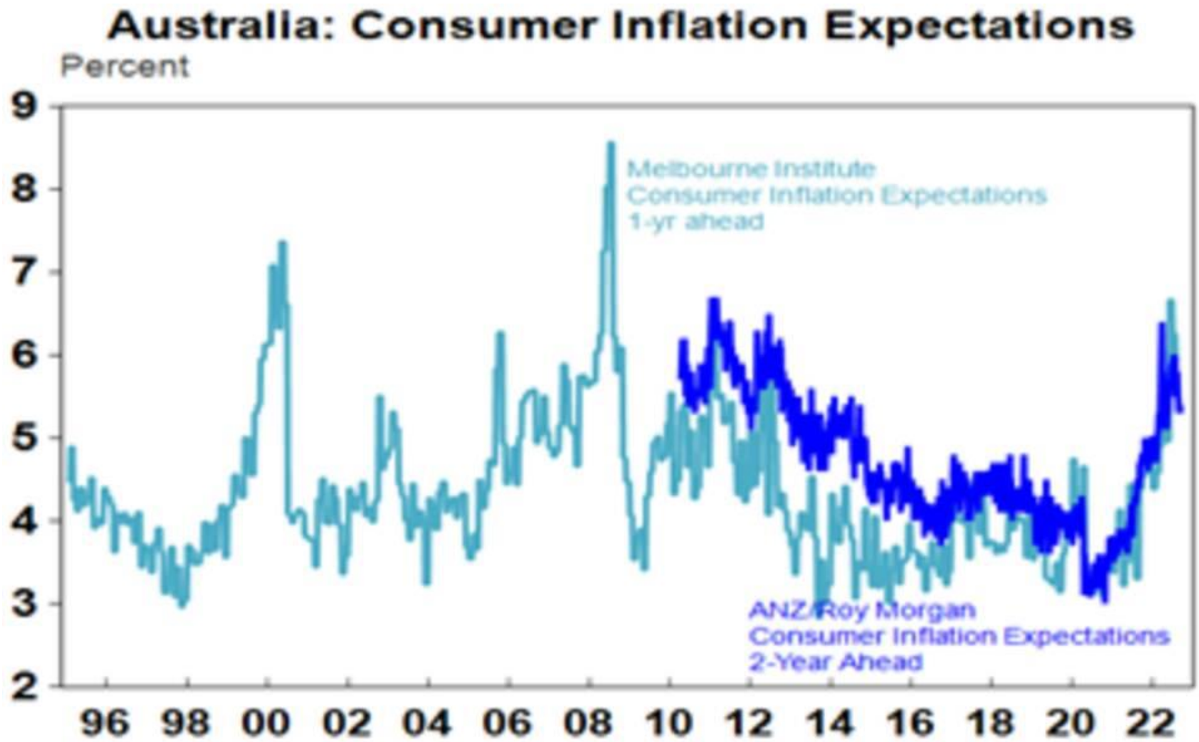
- Market reported rents as measured by Zillow in the US point to a slowing in US “shelter” inflation ahead. As this reflects new leases it impacts with a lag. This is significant because the shelter component is 33% of the US CPI and is dominated by rent and owners’ equivalent rent.



Source: Bloomberg, AMP

- Consumer inflation expectations have fallen in the US and Australia, helped be aggressive central bank moves and falling petrol prices. This should make it easier for central banks to get inflation back down without having to take interest rates to exorbitant levels.

Source: Macrobond, AMP



Source: Macrobond, AMP

- Finally, money supply growth has slowed from its 2020 surge, and this is likely to contribute to lower inflation ahead.

The bottom line is that while short term inflation remains high, these considerations are consistent with the US having reached peak inflation and point to lower inflation ahead which should enable central banks to slowdown the pace of hiking by year end in time to avoid a severe recession. If this applies in the US, then Australia should follow as its lagging the US by about six months with respect to inflation. For this reason, while short term risks around shares remain high, we remain optimistic on shares on a 12 month horizon.

In Australia, the RBA has flagged that it will consider scaling back to a 0.25% hike in October – this makes good sense. Reserve Bank Governor Lowe in his appearance before the House of Representatives Economics Committee reiterated his recent messages that: high inflation damages the economy; the RBA will do what is necessary to return inflation to target; more rate hikes are likely; but the RBA is aware monetary policy operates with a lag; and there is case to consider slowing the pace of tightening. The still tight jobs market and still high price and cost pressures evident in the latest NAB business survey point to the RBA hiking again next month. Governor Lowe has indicated that the RBA will consider a 0.25% or 0.5% hike at that meeting dependent on incoming data and we expect the RBA to scale back to a 0.25% hike with the peak at 2.85%. However, given the strength in lagged data and RBA worries about inflation the risk is on the upside to our interest rate forecasts. And Governor Lowe's reference to slowing the pace of hikes "at some point" suggests it's not necessarily imminent. But just because the Fed is likely to hike by another 0.75% in the next week does not mean that the RBA will have to keep going with 0.5% or greater hikes. The RBA sets interest rates for Australia, not the US; it would only need to match the US if its worried about a crash in the $A boosting Australian inflation but so far there is no sign of that (and the Fed hiked from 2015 to 2018 while the RBA cut without the $A crashing); and wages growth in Australia is running well below where it is in the US giving the RBA a bit more flexibility to allow for monetary policy lags.

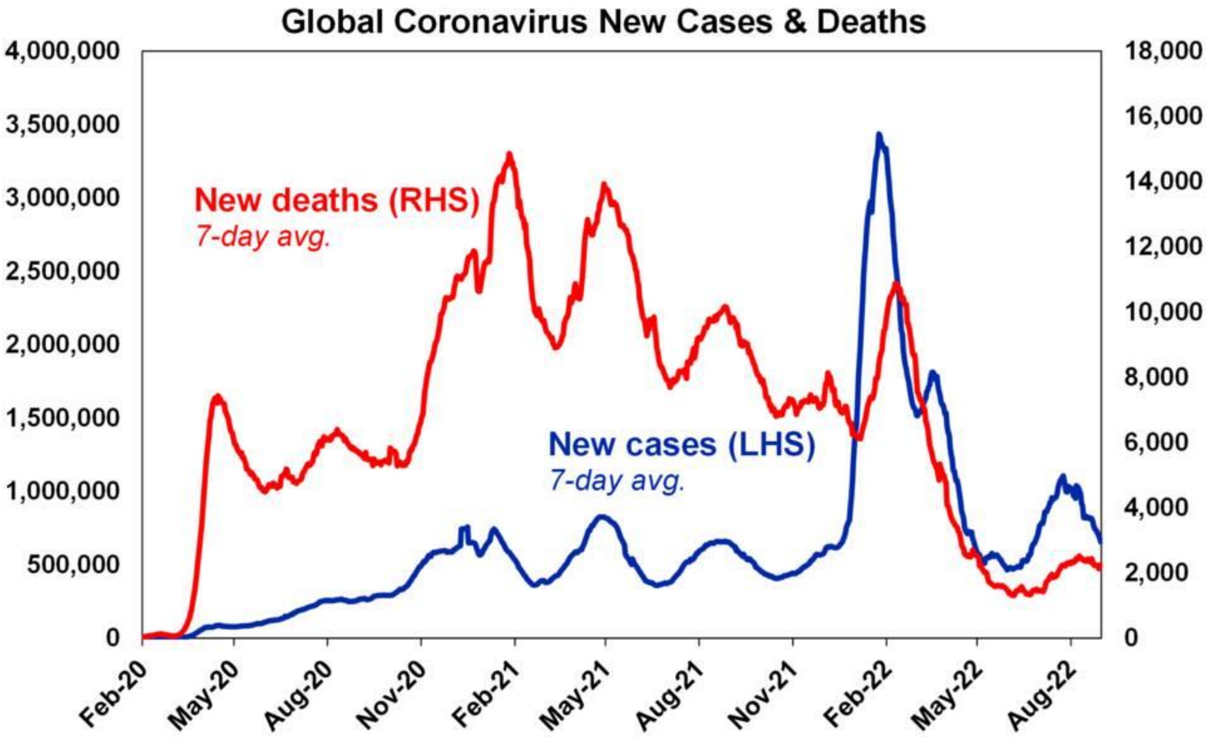
Recent Ukraine success in retaking territory from reportedly disorganised Russian forces have the potential to impact markets positively, but it could also prove to a

false dawn. On the one hand President Putin could decide to look for paths to wind down the war. This would likely be taken positively by investment markets as it could eventually take pressure off commodities, inflation and the risk of recession in Europe. But on the other hand, backed into a corner he may decide to take even more risks and further escalate. At this stage it's too early to tell which way it goes. Chinese President Xi's maintenance of distance from Russia in relation to its invasion of Ukraine in meetings with President Putin may be seen as good news for investment markets though as it suggests China won't be drawn into further support for Russia .

She and Him are back with Melt Away - A Tribute to Brian Wilson. When my daughter introduced me to Zooey Deschanel (of (500) Days of Summer) and Matt Ward it was impossible to miss the Brian Wilson/Beach Boys influence with bright pop songs, rich orchestrations and layered voices. They had already done some covers of Beach Boys songs and sung with Brian. Their latest album takes it to another level with some well known Beach Boy's songs like Don't Worry Baby and Wouldn't It Be Nice but some others that only dedicated fans might know such as Darlin, This Whole World, and Melt Away. So if you want to hear some cool upbeat reinterpretations of Brian Wilson/Beach Boy classics, do yourself a favour and check it out. And Brian is in there too with vocals on Do It Again.

Coronavirus update

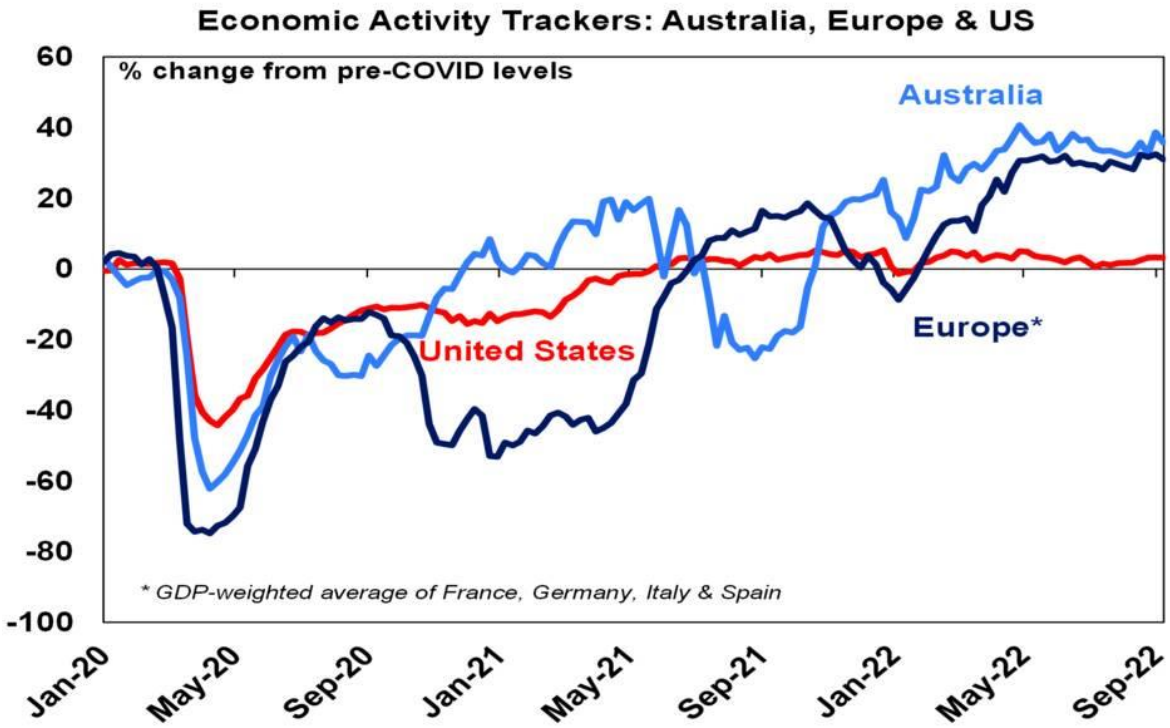
New global covid cases and deaths are continuing to fall. This includes in Australia, where data is now weekly. Cases in China are low and trending down, but high enough under its zero covid policy to pose a high risk of more lockdowns.



Source: ourworldindata.org, AMP

Economic activity trackers

Our Australian and European Economic Activity Trackers dipped in the last week whereas in the US it was little changed. Overall, they suggest that while some momentum has been lost after the recovery from the pandemic, economic activity is holding up reasonably well so far.



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

Major global economic events and implications

US economic data released over the last week was mostly soft. Unemployment claims fell again, but industrial production and retail sales were soft and business conditions surveys remained weak on average (with some improvement in small business optimism and manufacturing conditions in the New York region but a sharp fall in the Philadelphia region). On the inflation front core CPI inflation was stronger than expected but producer price inflation is continuing to fall and business surveys show still high but easing cost and price pressures.

Source: Macrobond, AMP

UK CPI inflation fell more than expected to 9.9%yoy in August owing to lower fuel prices but core inflation rose to 6.3%yoy which will keep the BoE on track for more rate hikes.

Eurozone industrial production fell more than expected in July leaving it down 2.4%yoy. Sky high electricity prices and the gas shortage will likely drive further weakness ahead.

Chinese economic activity data for August was stronger than expected with retail sales growth rising to 5.4%yoy and industrial production up 4.2%yoy. But its still soft with the risk of more lockdowns and the continuing property downturn impacting. Further policy stimulus measures are likely.

New Zealand's June quarter GDP rose more a more than expected 1.7%qoq but it was due to a 4.5 percentage point contribution from net expects with domestic demand falling. The RBNZ is on track for more rate hikes but the impact on growth will start to show up soon.

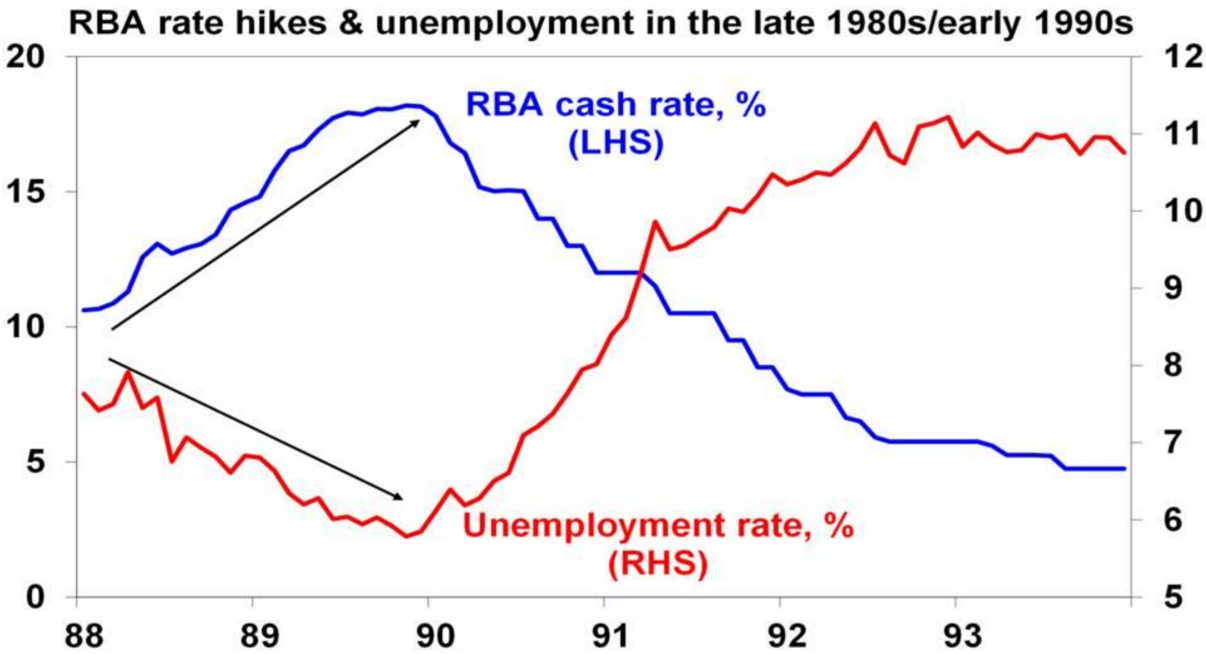
Australian economic events and implications

Australian data was mostly solid in the last week - but watch the lags. Jobs growth rebounded in August with employment, hours worked and participation up as the

holiday and flood distortions of July reversed. The unemployment rate rose slightly to 3.5% but still remains ultra low and underemployment fell leaving the labour underutilisation rate at 9.4% which is its lowest since 1982 and points to a pickup in wages growth. The level of job openings remains very high and high job vacancies still point to strong jobs growth ahead with unemployment likely to fall to around 3.2%. **Clearly the jobs market remains very tight and this will maintain pressure on the RBA for rate hikes**.

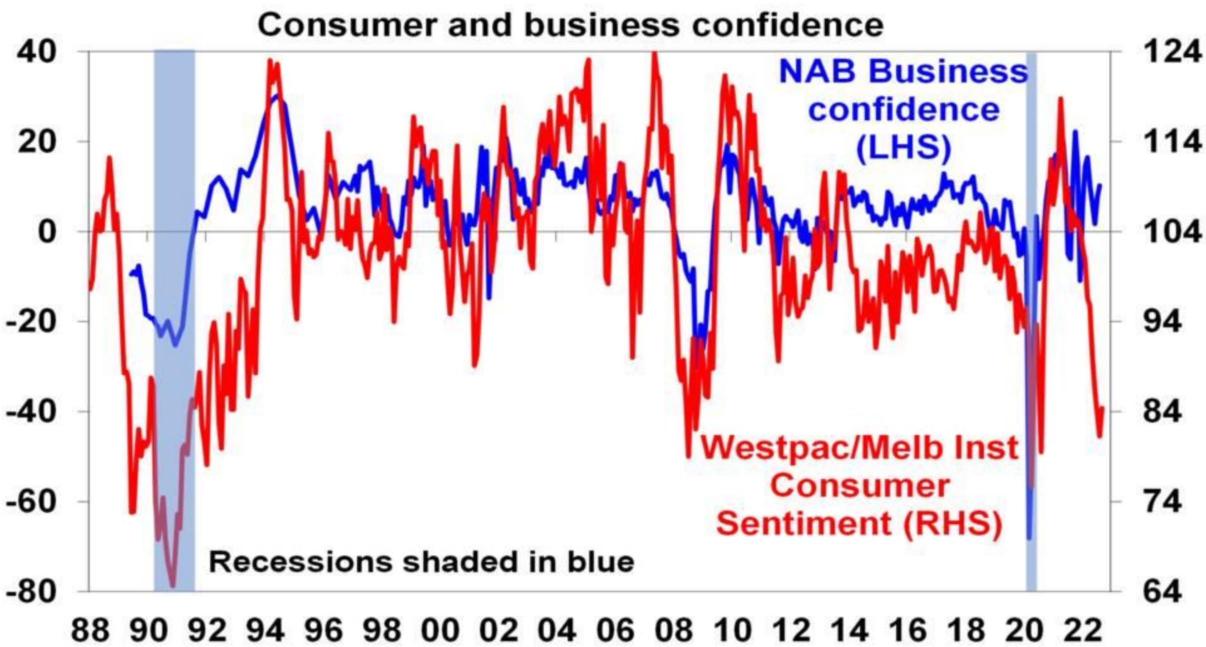
Source: ABS, AMP

However, job vacancies are starting to soften a bit and unemployment is usually one of the last things to deteriorate going into a recession. So, the RBA has to allow that interest rate hikes only impact with a lag and it is now starting to acknowledge this. The experience of the late 1980s and early 1990s highlight this clearly. Unemployment kept falling - to 5.8% which was considered low at the time after it rose above 10% in the early 1980s - as the RBA progressively hiked rates such that the cash rate reached 18% in 1989. But by then it was too late as the impact of past rate hikes hit the economy hard and it went into deep recession in 1990, with the RBA then having to rapidly reverse course as unemployment surged. Of course, things were much different back then with very low debt and very high inflation expectations resulting in much higher interest rates than are possible or needed today - but the lags are still relevant.



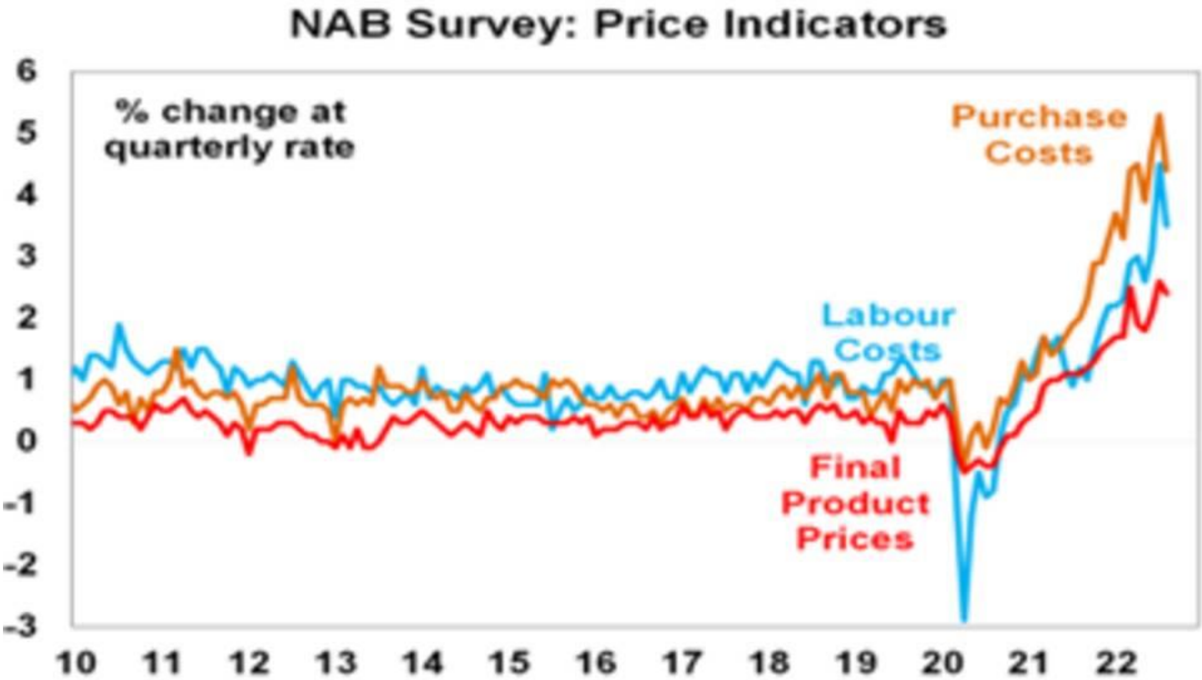
Source: ABS, AMP

Australian business conditions and confidence rose in August according to the NAB survey and consumer confidence rose in September according to the Westpac/MI survey. Clearly business conditions are still strong. But while consumer confidence rose (maybe helped by talk of slower RBA hikes) its still very low & points to weaker spending ahead.



Source: NAB, Westpac/MI, AMP

The NAB survey showed that price and cost pressures eased a bit, but still remain high consistent with a further rise in inflation.



Source: NAB, AMP

Finally, the Westpac/MI consumer survey showed that Australian's remain cautious in the use of their savings with a high proportion continuing to see paying down debt and bank deposits as the "wisest place for saving" but a low proportion favour shares, super or property.

What to watch over the next week?

In the US, the Fed (Wednesday) is expected to hike by another 0.75% taking the Fed Funds rate to a range of 3-3.25%. Headline inflation may have peaked at 9.1%yoy and inflation expectations have fallen, but guidance from Powell and other Fed officials has been hawkish and still very high inflation along with strong labour market conditions have firmed the case for another 0.75% hike. Guidance is likely to remain hawkish and the dot plot of Fed officials interest rate expectations is likely to move up to show a range of 4-4.25% by year end. This would imply some slowing in the pace of hikes across the November and December meetings.

On the data front in the US expect another slight fall in NAHB home builder conditions (Monday), a slight rise in housing starts after a big fall in July (Tuesday) a further fall in existing home sales (Wednesday) and continued softness in September business conditions PMIs (Friday) where the composite PMI was just 44.6 in August.

Eurozone business conditions PMIs for September (Friday) are also likely to remain weak with the composite at 48.9 in August.

The Bank of England (Thursday) is likely to hike by another 0.5% taking its official rate to 2.25%.

The Bank of Japan (Thursday) is likely to leave its ultra easy monetary policy unchanged reflecting ongoing very low inflation, particularly outside of food and energy. August inflation data (Tuesday) is likely to show a rise in headline CPI inflation to 2.9%yoy but with core inflation around 1.4%yoy. Business conditions PMIs for September (Friday) will also be released.

In Australia, the minutes from the last RBA Board meeting (Tuesday) are likely to reiterate that the RBA expects to raise interest rates further but is also considering slowing the pace of hikes depending on the flow of economic data. Speeches by RBA officials Kearns (Monday) and Bullock (Wednesday) will also be watched with the latter likely to reflect on lessons learned from the RBA's period of unorthodox monetary policy. On the data front, business conditions PMIs for September (Friday) are likely to remain subdued at around August's reading of 50.2 for the composite.

Outlook for investment markets

Shares remain at high risk of further falls in the months ahead as central banks continue to tighten, uncertainty about recession remains high and geopolitical risks continue. However, we see shares providing reasonable returns on a 12-month horizon as valuations have improved, global growth ultimately picks up again and inflationary pressures ease through next year allowing central banks to ease up on the monetary policy brakes.

With bond yields likely at or close to peaking for now, short-term bond returns should improve a bit further.

Unlisted commercial property may see some weakness in retail and office returns (as online retail activity remains well above pre-covid levels and office occupancy remains well below). Unlisted infrastructure is expected to see solid returns.

Australian home prices are expected to fall 15 to 20% top to bottom into the second half of next year as poor affordability & rising mortgage rates impact.

Cash and bank deposit returns remain low but are improving as RBA cash rate increases flow through.

The $A is likely to remain volatile in the short term as global uncertainties persist. However, a rising trend in the $A is likely over the medium term as commodity prices ultimately remain in a super cycle bull market.