WEEKLY MARKET UPDATE

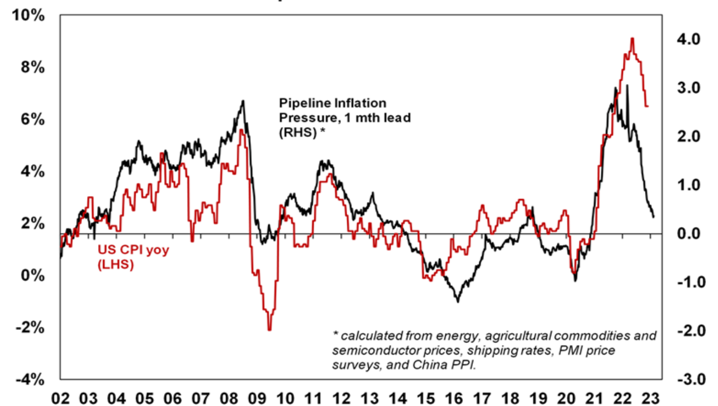
10 FEBRUARY 2023

Investment markets and key developments

Global share markets mostly fell over the last week on hawkish comments from the Fed, higher bond yields and recession concerns. For the week US shares fell 1.1%, Eurozone shares fell 1.3% and Chinese shares fell 0.9% but Japanese shares gained 0.6%. Australian shares also fell 1.6% not helped by more hawkish than expected interest rate guidance from the RBA with falls led by property, health, utility and IT stocks. Bond yields mostly rose on increased interest rate expectations. Oil prices rose with Russia announcing a 500,000/day cut to oil production, iron ore prices were little changed but metal prices fell. The $A was little changed despite a rise in the $US.

We remain reasonably upbeat on the outlook for investment markets this year as inflation falls and central banks get off the brake, but it won't be smooth sailing. And after a very strong start to the year shares are vulnerable to a pullback. Till their highs last week global shares were up 8.6% year to date and Australian shares were up 7.4%. This was above or roughly in line with our expected gains for the whole year. But we still expect that it will be a volatile year given that: the process of getting inflation back down won't be smooth; the topping process in central bank rates will take time with setbacks along the way as we have seen for both the Fed and the RBA over the last week; recession risks are high; raising the US debt ceiling around the September quarter won't be smooth; and geopolitical risks around Ukraine, China (as highlighted by the balloon over the US) and Iran are significant. With shares getting overbought after the new year rally and seasonality turning less positive (February can often be a bit messy after a December/January bounce), shares both globally and in Australia are vulnerable to more of a pull back in the short term.

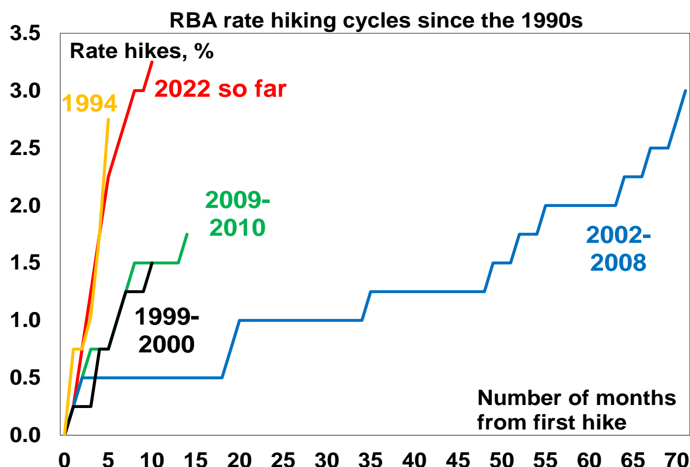
Fed pushing back against the market getting too dovish and expecting rate cuts later this year. Following the prior week's stronger than expected jobs data Fed officials struck a somewhat more hawkish tone over the last week. Fed Chair Powell emphasised the Fed's expectation for two more rate hikes but arguably wasn't as hawkish as feared. However, other Fed officials were more hawkish stressing the need for rates to be higher for longer. We continue to expect another 0.25% hike in March and since we expect inflation to fall faster than the Fed does – as suggested by our Pipeline Inflation Indicator which is continuing to fall – we expect this to be the peak for the Fed ahead of rate cuts later this year. The stronger than expected January payroll report in the US added a bit of upside risk to this, although jobs are always a lagging indicator.



Source: Bloomberg, AMP

The RBA starts the year more hawkish. While its latest 0.25% hike – which makes the current rate hiking cycle the biggest since the late 1980s – was not surprising after the December quarter CPI, the RBA's commentary was far more hawkish than expected with more definitive commentary about expecting further increases in interest rates, leaving less room for a pause and the insertion into its statements of more commentary about the dangers of high inflation and high inflation expectations. The RBA in its Quarterly Statement on Monetary Policy made no major changes to its growth and unemployment forecasts seeing growth slowing to around 1.5% this year and unemployment rising to 3.75%. But it revised up its wage growth forecast to 4.2% for this year (from 3.9%) noting increased wages growth in liaison with business. And while it still expects inflation to have peaked last quarter it revised up its near-term forecasts for underlying and headline inflation, albeit it still sees a decline to around 3% next year. It also estimated that supply side pressures have accounted for about half or three quarters (depending on how its estimated) of the rise in inflation but noted that while a central bank can look through supply side pressures that are short lived, recently they have been persistent leading to concerns about rising inflation expectations.

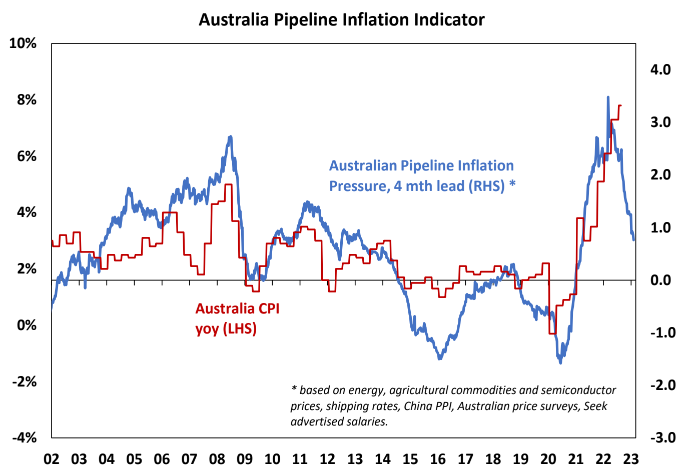
Based on the SOMP the main driver of the RBA's more hawkish turn appears to have been the stronger than expected level of underlying inflation last quarter and increased wages pressure which has led to a further increase in its near-term inflation and wages forecasts even though it expects that inflation has peaked. After significant tightening already, this is dangerous as inflation is a lagging indicator. As we saw with the "no rate hike expected before 2024" comments, RBA guidance is not always the best guide to what actually happens and there is probably a bit of "jawboning" here (to dampen wage claims, price hikes and household spending). But the stridency of the RBA's comments has caused us to now expect another 0.25% rate hike next month with a very high the risk of more to come beyond that. Market expectations for the cash rate peak have now pushed back up above 4% for the September quarter.



Source: Bloomberg, AMP

Cash rate near the top, albeit with near term risks still skewed to the upside. While we have been too dovish in terms of how far the cash rate would rise, our base case remains that we are near the top: as inflationary pressures are easing globally and showing signs of doing so here too (as evident in our Australian Pipeline Inflation Indicator); given the three fold increase in household debt to income ratios over the last 30 years mortgage rates around 6% now are already pushing above the equivalent of the 17% level that helped tip the economy into the early 1990s recession and risking a sharper rise in mortgage stress than we have been allowing for; and there is increasing evidence that rate hikes are getting traction, with for example real retail sales falling last quarter. **We continue to see inflation falling faster this year (to around 4%) than the RBA is expecting (to 4.75%)**.

We are getting more concerned though that the RBA is raising rates too far in response to inflation which is a lagging indicator and is not paying enough attention to the lagged flow through of rate hikes to the economy and signs of slowing demand and improving supply which will push inflation down. This is increasing the risk of a recession that we don't have to have and with that a bigger rise in unemployment and a bigger fall in home prices (although we already expect them to fall 15-20% top to bottom). Hopefully RBA jawboning will be successful on the inflation front so it doesn't raise rates much more such that its bite won't be as bad as its bark. **However, by year end or early next year we continue to anticipate cash rate cuts as the RBA moves to respond to the slowdown in the economy**.



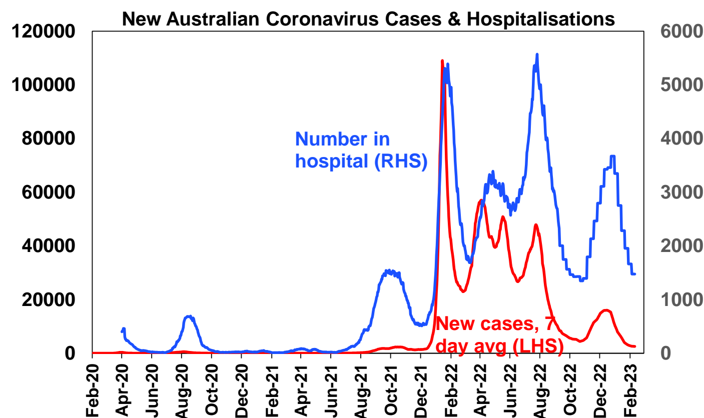
Source: Bloomberg, AMP

Farewell Burt Bacharach. He was one of the best composers. I reckon not a week goes by without one of his tunes popping into my head. What the World Needs Now is Love written with his long-time collaborator and lyricist Hal David is one of his best. He also composed the music for Casino Royale (the 1960s Bond send up) which included the classic The Look of Love. Fortunately, I got to see him a few years ago and he was the best.

Coronavirus update

New global Covid cases continue to fall and Chinese Covid deaths – the main driver of global deaths over the last few months - are still falling and are well down from the initial reopening spike.

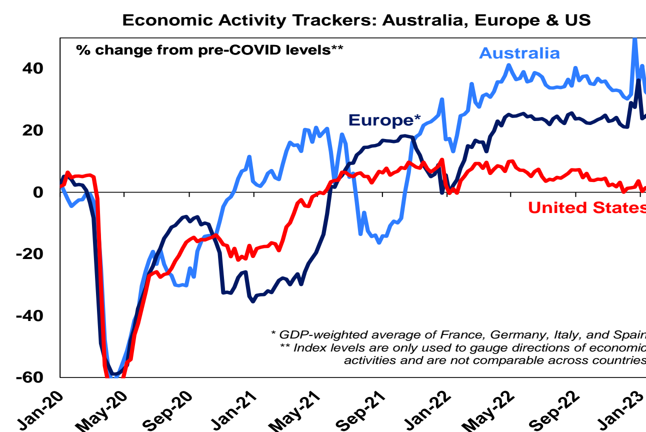
Reported new cases and hospitalisations in Australia have continued to slow.



Source: covidlive.com.au, AMP

Economic activity trackers

Our Australian Economic Activity Tracker fell last week but they rose in the US and Europe. Momentum has slowed since early last year, but there is still no sign of economic collapse.



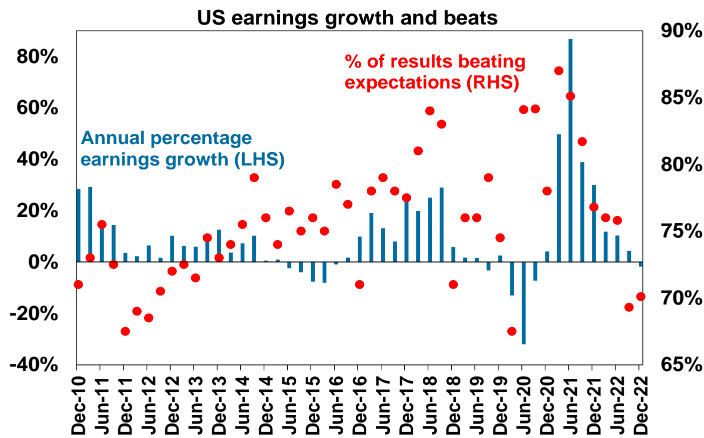
Levels are not really comparable across countries. Based on weekly data for eg job ads, restaurant bookings, confidence, credit & debit card transactions and hotel bookings. Source: AMP

Major global economic events and implications

President Biden's State of the Union address had little of relevance for markets as his spending and tax proposals have little chance of being passed into law given Republican control of the House (albeit some minor popular things might get passed). It provided a reminder though that raising the debt ceiling (necessary sometime in the September quarter) will not be smooth. On the data front, US jobless claims rose but remain low, consumer confidence rose according to the University of Michigan which also reported that 1 year ahead inflation expectations rose slightly to 4.2% but remain well down from their recent high around 5.5% and 5-10 year ahead inflation expectations were unchanged at 2.9% and in the range they have been in for the last few decades.

Delayed German inflation for January came in weaker than expected at 9.2%yoy (down from 9.6%yoy), suggesting the fall reported in Eurozone inflation for January will remain.

Around 70% of S&P 500 companies have reported December quarter earnings. 70% of results have come in better than expected which is below the norm of 76%. Consensus earnings expectations are for growth of -1.8%yoy. Energy and industrials are seeing the strongest earnings growth, but discretionary and material stocks have seen the strongest upside surprise. Non-US earnings growth is faster at +4.1%.



Source: Bloomberg, AMP

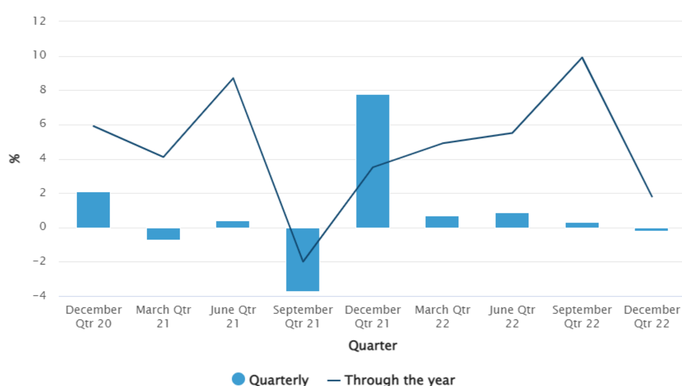
Japanese wages growth rose to 4.8%yoy in December driven by a sharp rise in bonuses, but even basic wage growth rose to its highest since 1995, adding to evidence Japan is slowly emerging from very low inflation and supporting the view that the Bank of Japan is gradually heading towards removal of monetary stimulus.

Reports suggest that academic and former Bank of Japan Board member Kazuo Ueda will be appointed as the BoJ's next Governor. When on the Board two decades ago he was mostly a dove but right now he appears to have a balanced view noting to media that the BoJ's "current policy is appropriate and monetary easing needs to be continued at this point."

Chinese CPI inflation rose to 2.1%yoy in January, from 1.8%. But this was mainly due to higher food inflation with core inflation rising to just 1%yoy and producer price inflation actually fell to -0.8%yoy. January money supply and credit growth rose far more than expected, consistent with a reopening rebound in economic growth.

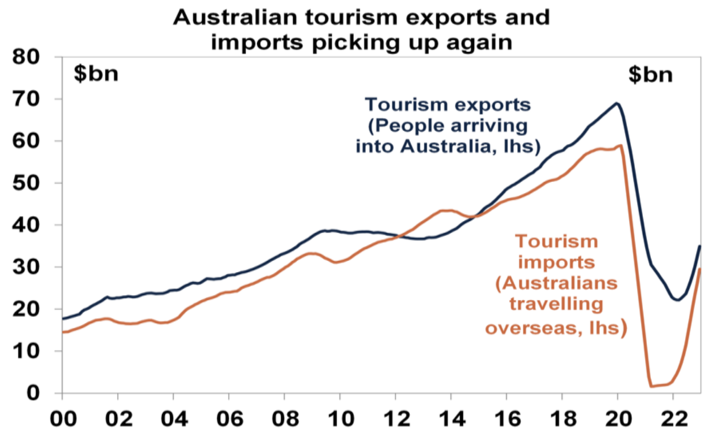
Australian economic events and implications

Real retail sales falling. While December quarter nominal retail sales were strong this was due to rising prices with real retail sales actually down 0.2%qoq and up just 1.8%yoy. Excluding food, real retail sales were down 1.6%qoq and real household goods sales were down 2%qoq. While high inflation is holding up nominal growth explaining the exuberance of retailers, the volume of actual goods sold is now being hit by rate hikes, falling real wages and the fading of the reopening surge.



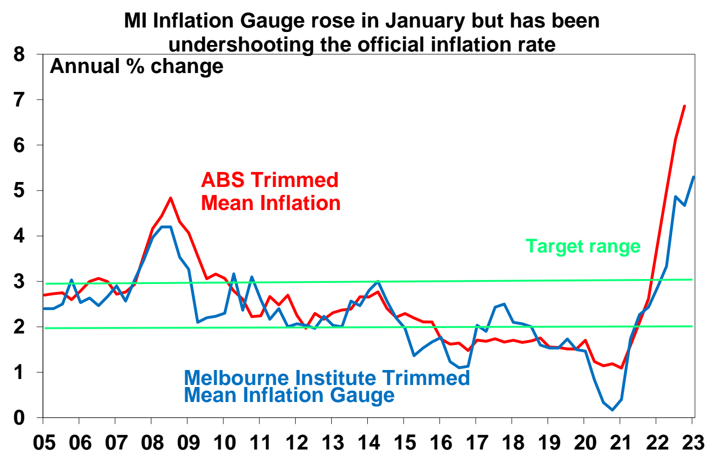
Source: ABS

Australia's trade surplus remains high. Sure it fell back to $12.2bn – due to softer exports and stronger imports including tourism imports (as Australians rush overseas faster than foreign tourists rush here) – but it remains very high historically. And net exports look like adding around 1 percentage point or so to December quarter GDP growth.



Source: ABS, AMP

The Melbourne Institute's Inflation Gauge up again in January. It rose 0.9%mom or 6.4%yoy, with its trimmed mean up 5.3%yoy but its not be a great guide to changes in the ABS' new monthly Inflation Indicator and has been undershooting the quarterly CPI.



Source: Melbourne Institute, AMP

What to watch over the next week?

In the US, the focus will be on the January CPI (Tuesday) which is expected to show a pick up in the monthly inflation rate to 0.5% partly due to higher gasoline prices but annual inflation falling again to 6.2%yoy (from 6.5%). Core inflation is expected to fall further to 5.5%yoy (from 5.7%). Producer price inflation (Friday) is also expected to slow to 5.5%yoy. On the economic activity front expect the New York and Philadelphia regional manufacturing surveys for February (due Wednesday and Thursday) to show some improvement but remain weak. January retail sales and industrial production (Wednesday) are expected to show modest bounces after weakness in December. February home builder conditions (Wednesday) are expected to remain weak with housing starts (Thursday) falling further in January. Another 70 S&P 500 companies are to report December quarter earnings.

UK CPI inflation for January (Wednesday) is likely to show a further slowing.

Japanese December quarter GDP (Tuesday) is likely to show a 0.5%qoq bounce back after -0.2% in the September quarter.

In Australia, RBA Governor Lowe will likely shed more light on the RBA's recent more hawkish turn in Senate and House Economics Committee appearances on Wednesday and Friday

respectively (sounds like overkill but Senators obviously want to get in on the action too). On the data front, expect February consumer confidence (Tuesday to remain soft, a further fall in January business conditions according the NAB business survey and January jobs data (Thursday) to show a slight rebound of +20,000 jobs after a 15,000 fall in December with unemployment unchanged at 3.5%.

The Australian December half earnings reporting season will start to ramp up with around 50 major companies reporting including JB HiFi and Lendlease (Monday), Ansell, Computershare and Dexus (Tuesday), CBA, Fortescue, Seven and Wesfarmers (Wednesday), ASX, AMP, Sonic, South32 and Telstra (Thursday) and Baby Bunting and QBE (Friday). Consensus earnings expectations for 2022-23 are for growth of 7.7%, but this is concentrated in energy, industrials, IT and utility stocks. Expect companies to generally confirm that cost and supply chain pressures have eased somewhat from last year.

Outlook for investment markets

2023 is likely to see easing inflation pressures, central banks moving to get off the brakes and economic growth weakening but probably avoiding deep recessions. This along with improved valuations should make for better returns in 2023. But there are likely to be bumps on the way – particularly regarding central banks and inflation, recession risks, geopolitical risks and raising the US debt ceiling around the September quarter.

Global shares are expected to return around 7%. The post mid-term election year normally results in above average gains in US shares, but US shares are likely to remain a relative underperformer compared to non-US shares reflecting still higher price to earnings multiples. The $US is also likely to weaken further which should benefit emerging and Asian shares.

Australian shares are likely to outperform again, helped by stronger economic growth than in other developed countries (albeit RBA rates hikes may threaten this) and ultimately stronger growth in China supporting commodity prices and as investors continue to like the grossed-up dividend yield of around 5.5%. Expect the ASX 200 to end 2023 at around 7,600. So far its looking like it might be too conservative.

Bonds are likely to provide returns a bit above running yields, as inflation slows and central banks become less hawkish.

Unlisted commercial property and infrastructure are expected to see slower returns, reflecting the lagged impact of weaker share markets and last year's rise in bond yields on valuations.

Australian home prices are likely to fall another 8% or so as rate hikes continue to impact, resulting in a top to bottom fall of 15-20%, but with prices expected to bottom around the September quarter, ahead of gains late in the year as the RBA moves toward rate cuts. Ongoing RBA rate hikes risk a bigger fall in prices though.

Cash and bank deposits are expected to provide returns of around 3.25%, reflecting the back up in interest rates through 2022.

A rising trend in the $A is likely over the next 12 months, reflecting a downtrend in the overvalued $US, the Fed moving to cut rates and solid commodity prices helped by stronger Chinese growth.

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