

WEEKLY MARKET UPDATE

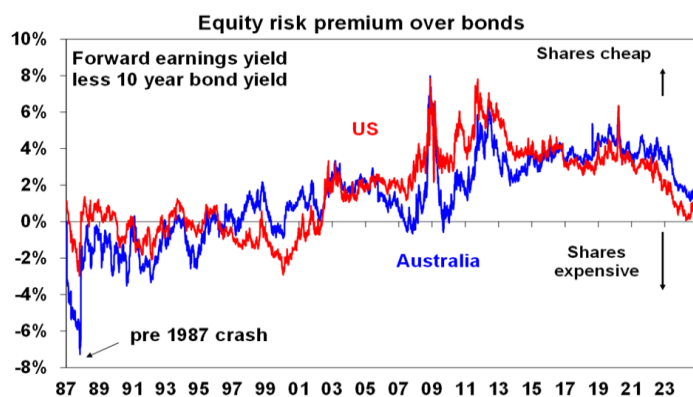


DR SHANE OLIVER
Head of Investment Strategy
and Chief Economist, AMP

Investment markets and key developments

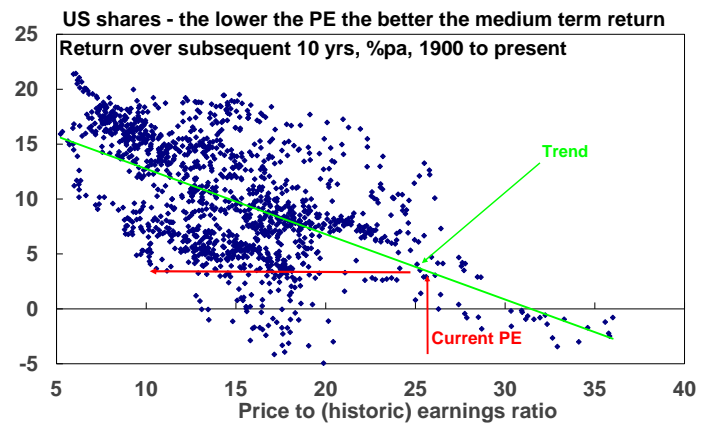
Global share markets hit a rough patch over the last week on concerns about valuations amidst rising bond yields even though economic and earnings data was mostly okay. For the week US shares fell 1%, Eurozone shares fell 1.2% and Japanese shares fell 2.7%, but Chinese shares rose 0.8%. Reflecting the weak global lead Australian shares fell 0.9% for the week, with falls in IT, property, industrials and retail shares leading the falls. Oil prices rose but remain well down from recent highs. Metal and iron ore prices fell but gold made it to a record high on the back of falling interest rates lowering the opportunity cost of holding it. The \$A fell as the \$US rose.

Rising bond yields and share valuations. The past week has seen a further rise in long term bond yields as investors reduce expectations for how much central banks, notably the Fed, will cut rates and price in potentially higher US budget deficits if Trump wins the presidential election. This is potentially a threat to share markets because high price to earnings multiples mean that the risk premium shares offer over bonds (measured by the earnings yield less the 10-year bond yield) is already very narrow compared to what it's been since the GFC. See the next chart.



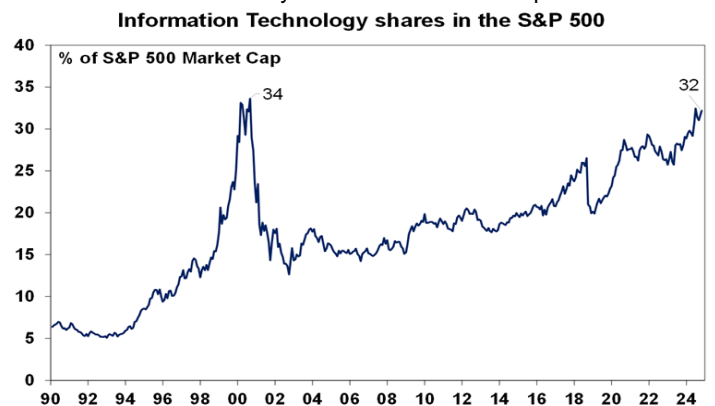
Source: Bloomberg, AMP

From a longer-term perspective it's hard to avoid the conclusion that rich valuations - with US shares trading on a PE of 26 times current earnings and nearing 40 times trailing 10-year average earnings - point to a period of lower returns over the next decade or so in the US. This was highlighted in a Goldman Sachs report but is also evident in a casual observation of the relationship between PEs and subsequent share market returns – see the next chart – with the current US PE pointing to an average return over the next decade of around 3% pa (although as can be seen in the next chart there's been a big range around this).



Source: Bloomberg, AMP

US share market concentration in IT is a concern. The Goldman's analysis added in a variable to account for high US share market concentration, which is again a big issue with the surge in IT shares to the point where they are now nearly as big a share of the market as they were at the tech boom peak in 2000.



Source: Bloomberg, AMP

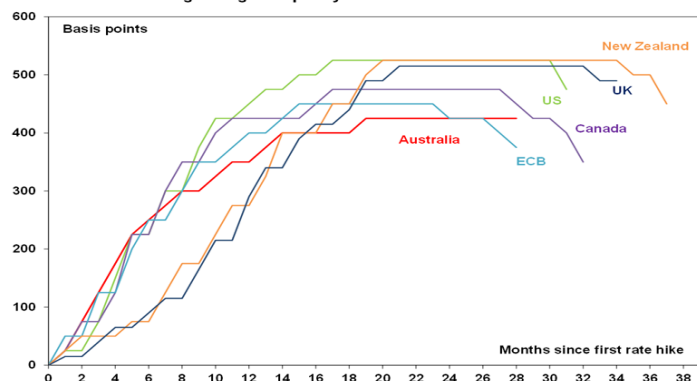
Fortunately, valuations for other share markets including Australian shares are not as stretched, but this has several implications for investors. First, stretched valuations for the key US share market leave shares vulnerable to another correction particularly given that the risk of recession still remains high, the expansion of the war in the Middle East threatens to impact oil supplies (with Israel still likely to retaliate against Iran's missile attack) and a Trump victory in the US election will likely spark fears of another trade war. Second, it provides a reminder that share market returns won't be sustained at double digit levels. Third, poor medium term return prospects are often resolved via sharp share market falls that then reset the market's return potential such that it provides a decent risk premium. Fourth, given the relatively stretched nature of the US share market and tech stocks in particular there is a case to consider a reduced allocation to US shares in global portfolios. But finally, it's worth bearing in mind that getting the timing of this right is likely to prove very difficult. Worries about the US sharemarket's increasing dependence on tech stocks are not new – remember the term FAANG stocks which gained

popularity a decade ago only to morph into the Magnificent 7 - and they have kept going for longer than many thought.

While the near term risk of a correction and more volatility is high, on a 6-12 month view though shares are still likely to trend higher on the back of the success in getting global inflation down, central bank rate cuts (with the RBA getting closer) and China ramping up policy stimulus. October can often see high levels of share market volatility, but beyond this we are coming into a positive time of the year for shares from a seasonal perspective.

The past week saw more good news on interest rates. The Bank of Canada cut its key policy rate by 0.5% taking it to 3.75%, with Governor Macklem noting that "if the economy continues to evolve in line with our forecasts, we will be cutting rates further". Another cut is likely in December. ECB President Lagarde and other ECB speakers were also generally dovish.

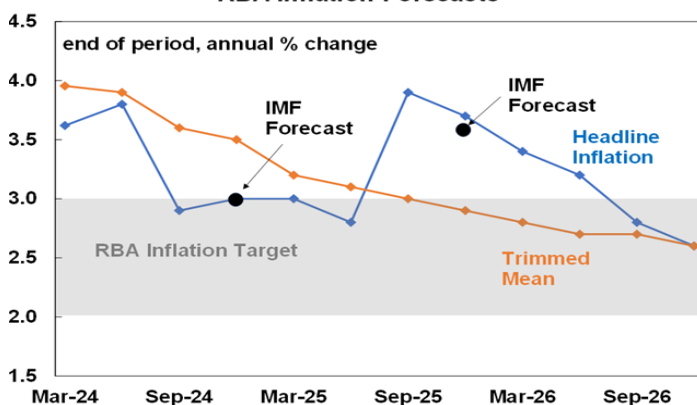
Changes in global policy rates since 2021



Source: Bloomberg, AMP

Australia lagging in getting inflation down, but it's not as bad as the IMF is portraying. Much has been made of the recent IMF World Economic Outlook forecasts for inflation that show Australia as an outlier in having relatively high inflation next year compared to other countries, consistent with the RBA's relative hawkishness in getting interest rates down. This partly reflects Australia's relatively strong jobs market and more cautious approach to raising the cash rate along with strong growth in public spending which is keeping demand stronger than expected. But its not as bad as it appears. Firstly, the rise in inflation from 3% this year to 3.6% next year that the IMF is forecasting is similar to the RBA's forecasts and reflects the ending as currently legislated of "cost of living" measures which pull headline inflation down this year and see a bounce back next year. Abstracting from this and focusing on trimmed mean underlying inflation suggests a continuing fall next year. We are a bit more optimistic than the RBA forecasts shown in the next chart.

RBA Inflation Forecasts

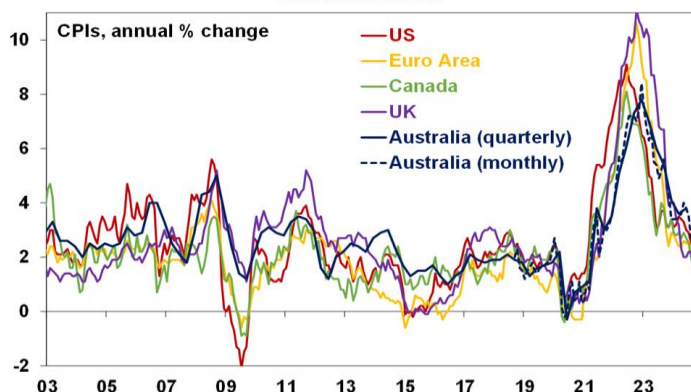


Source: ABS, RBA, IMF, AMP

Secondly, as evident in the next chart Australian inflation lagged global inflation on the way up in 2022 and so peaked a bit later so its lagging on the way down is not surprising and doesn't suggest Australia has a chronic inflation problem

compared to other countries. In fact, underlying inflation in Australia at 3.4%yoy in August is not that different to core inflation in the US at 3.3%yoy and the UK at 3.2%yoy. Finally, **we expect September quarter inflation data to be released Wednesday to show a further fall in underlying inflation to 3.4%yoy from 3.9% in the June quarter and below RBA forecasts for 3.6%yoy, and to 3.2%yoy in the month of September.** And price indicators in business surveys continue to point to falling inflation. Our base case remains for the RBA to start cutting in February next year, but a cut in December still can't be ruled out if September quarter trimmed mean inflation comes in as forecast and October monthly underlying inflation shows a further leg down. **Market expectations for just a 30% chance of a rate cut in December and 70% for February now look to have swung too pessimistic after being at 92% and more than 100% respectively in early September.**

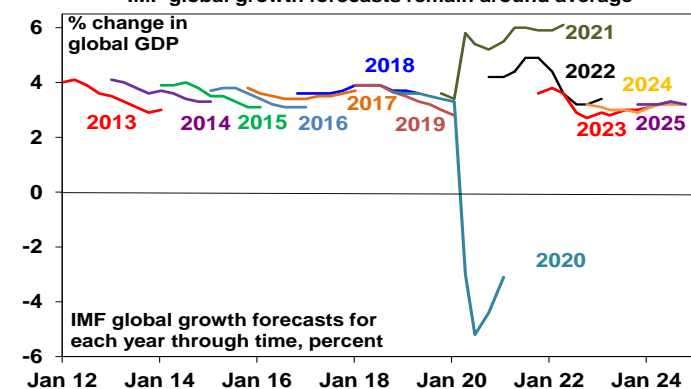
Global Inflation



Source: Bloomberg, AMP

While the IMF's latest Global Economic Outlook noted rising downside risks – around regional conflicts, too tight monetary policy, possible financial market volatility, China and rising protectionism – risks always seem to be high and it had some good news in its assessment that the battle against inflation has almost been won. And its global growth forecasts for this year and next of 3.2% are around the average seen pre-Covid.

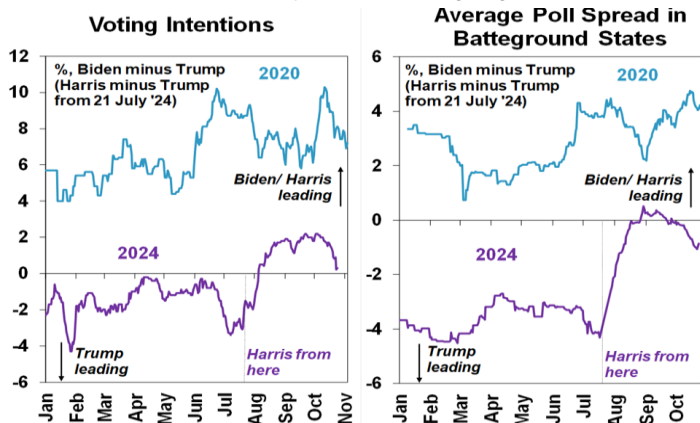
IMF global growth forecasts remain around average



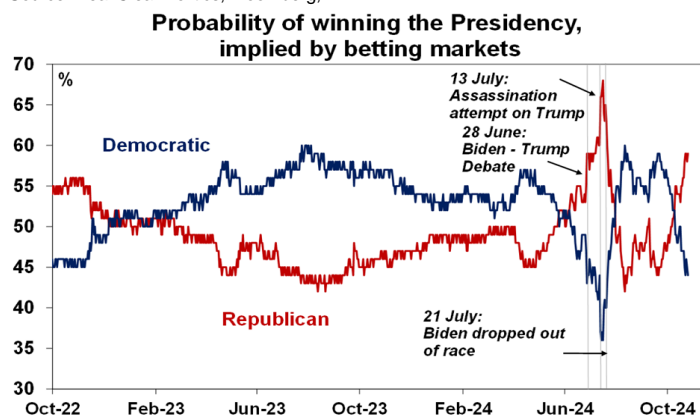
Source: ABS, Bloomberg, AMP

Markets starting to pay more attention to the US election with Trump pushing further ahead. Historically a rising share market over the 3 months prior to a US election has coincided with a win by the incumbent party and vice versa for a fall with 83% accuracy. Since 5th August US shares are up 12% which should be a positive sign for Harris but this is not foolproof and polling and betting markets are increasingly pointing to a Trump victory. Harris' lead in the RCP average of national voting intentions polls has fallen to just 0.1%, whereas Biden was ahead by around 7% at this point in 2020, the RCP poll averages show her now behind in all the battle ground states and betting market odds have Trump ahead by around 59 to 43. And investment markets appear to be starting to take notice with bond yields up partly on concerns that Trump's

policies will add to the huge US budget deficit, with this starting to weigh on shares and the \$US rising as might be expected if Trump kicks off another trade war. Trump's policies to cut taxes and regulation are positive for shares (as we saw in 2017) but his tariff policies would be negative (as we saw in 2018). Of course, which policies he runs with first could have a big impact on how shares respond. But market volatility could pick up going the election.



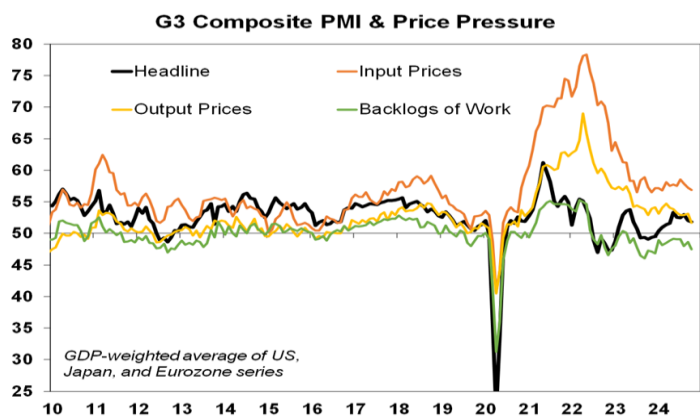
Source: Real Clear Politics, Bloomberg, AMP



Source: Bloomberg, AMP

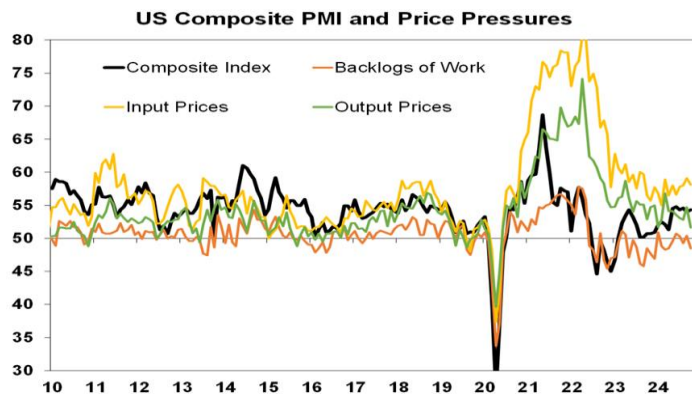
Major global economic events and implications

Business conditions PMIs for October overall suggest global growth is okay and inflation still falling – consistent with ongoing “Goldilocks” (not too hot but not too cold) conditions. Composite PMIs softened slightly in September, particularly in Japan and the UK and remain soft in Europe and Australia with manufacturing remaining weak and services strong. Input prices fell and output prices remain around levels seen pre-covid with order backlogs continuing to fall. All of which is consistent with further central bank rate cuts.



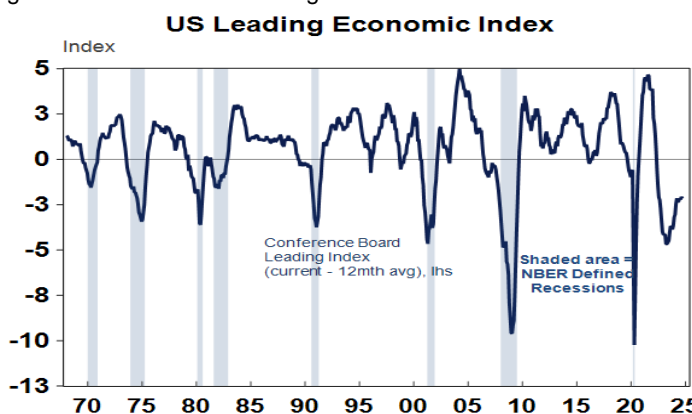
Source: Bloomberg, AMP

The US composite PMI remained strong in October with output prices falling and at pre covid levels, consistent with more Fed rate cuts.



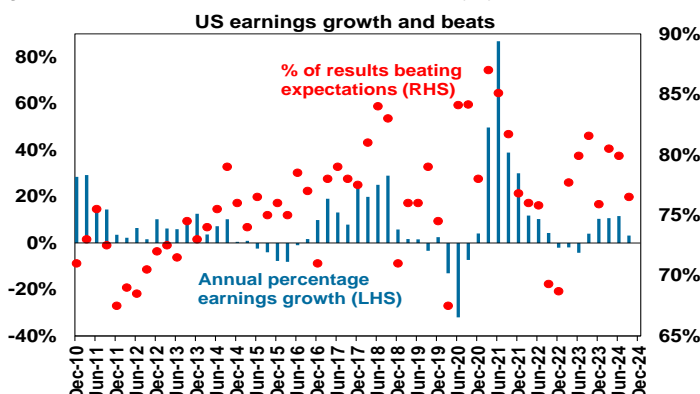
Source: Bloomberg, AMP

Other US data was mostly soft. New home sales rose slightly but existing home sales fell and remain depressed with mortgage applications to purchase a home falling again on the back of a rebound in mortgage rates. The US leading index fell another 0.5% in September and continues to point to a high risk of recession although its momentum is now less negative. Durable goods orders were soft with underlying capital goods orders and shipments trending sideways. Initial jobless claims fell but continuing claims rose suggesting its harder to find a job once lost. Meanwhile, the Fed's Beige Book of anecdotal evidence painted a picture consistent with a soft landing for the economy with references to little change to economic activity, modest to moderate wages growth and inflation continuing to moderate.



Source: Macrobond, AMP

Slower US earnings growth? 36% of US S&P companies have reported September quarter earnings and results have been okay but softer than for recent quarters. So far 76.5% of results have surprised on the upside which is just below the norm of 76% and the consensus earnings growth expectation is for just 3.2%yoy. Earnings surprise is averaging around 6% so the final earnings growth number should come in around 6.5%yoy.



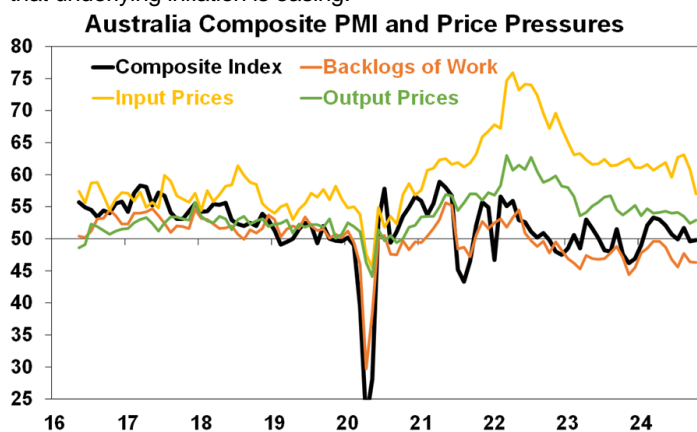
Source: Bloomberg, AMP

Continuing soft business conditions PMIs are consistent with the ECB continuing to cut rates and a fall in the Japanese PMI will keep the Bank of Japan gradual in raising interest rates.

More rate cuts from China's PBOC with 0.25% cuts to its one year and 5 year loan prime rates. This continues the policy easing seen over the last month. That said we are still waiting for the National People's Conference Standing Committee meeting (to be held on 4-8 November) to confirm the size of the fiscal stimulus package – expected to be at least 2trillion RMB (or 1.6% of GDP) - and to hopefully include significant support for consumers. Our view remains that policy stimulus will provide a short-term cyclical boost, but won't really address China's longer term structural problems.

Australian economic events and implications

Australian business conditions PMIs for October remained weak. The good news though was that input prices fell sharply presumably after the passing through of the annual National Wage Case increase. Output prices rose but remain in a similar range to that seen prior to the pandemic which is similar to the message from final product prices in the NAB survey and adds to evidence that underlying inflation is easing.



Source: Bloomberg, AMP

What to watch over the next week?

In the US, the focus is likely to be on jobs data for October (Friday) which is expected to show a slowing in payroll growth to 120,000, unchanged unemployment at 4.1% and average hourly earnings growth unchanged at 4%yoy. September quarter GDP data (Wednesday) is expected to show that growth remains robust at around 3% annualised and core private final consumption inflation for September is likely to show a monthly rise of around 0.25%mom but with annual inflation falling to 2.6%yoy from 2.7%yoy. In other data expect to see some moderation in home price growth, little change in consumer confidence and a fall in job openings (all Tuesday), a further slowing in growth in labour costs to 4%yoy in the September quarter (Thursday) from 4.1%yoy in the June quarter and continued softness in the October ISM manufacturing conditions index (Friday). The September quarter earnings reporting season will also continue.

In Europe, September quarter GDP growth (Wednesday) is likely to have remained around 0.2%qoq or 0.8%yoy, core CPI inflation for October is likely to fall to 2.6%yoy and unemployment (both Thursday) is likely to remain unchanged at 6.4%.

The Bank of Japan (Thursday) is likely to leave rates on hold. Japanese data is likely to show continued low unemployment (Tuesday), a bounce in industrial production and continued strength in retail sales (both Thursday).

Chinese business conditions PMIs (Thursday and Friday) are likely to remain soft. The focus will remain on an expected announcement on the size of the fiscal stimulus package from the National People's Congress Standing Committee.

In Australia, September quarter CPI data is likely to show lower headline and underlying inflation. Headline inflation is likely to have slowed to just 0.3%qoq or 2.8%yoy from 3.8%yoy in the June quarter. But this will be mainly due to energy rebates and other cost of living measures along with a 6% or so fall in petrol prices all of which are volatile and unreliable guides to the trend in inflation. So, market and RBA focus will be on the trimmed mean underlying measure of inflation which is expected to show a fall to 0.7%qoq or 3.4%yoy, down from 3.9%yoy in the June quarter. Our forecasts are slightly below RBA forecasts for 2.9%yoy headline inflation and 3.6%yoy for trimmed mean inflation, but given strong jobs data and other indicators of economic resilience probably won't be enough to tip the RBA over into a rate cut in November. That said if the September Monthly CPI Indicator for trimmed mean inflation shows a further drop to 3.2%yoy from the 3.4%yoy pace recorded in August it will keep alive the possibility of a December rate cut, although our base case remains that a start to rate cuts in February is more likely.

In other data in Australia, expect a -0.1% fall in September retail sales and a 0.3% rise in real terms for the September quarter along with a 3% bounce in building approvals (all Thursday), a 1.5% rise in housing finance, a 0.2%mom and 0.9%yoy rise in the ABS' Household Spending Indicator and CoreLogic data to show a further slowing in national home price growth to 0.3%mom in October (all Friday).

Outlook for investment markets

Easing inflation pressures, central banks cutting rates, China ramping up policy stimulus and prospects for stronger growth in 2025-26 should make for reasonable investment returns over the next 6-12 months. However, with a high risk of recession, poor valuations and significant geopolitical risks particularly around the Middle East and US election, the next 12 months are likely to be more constrained and rougher compared to 2023-24.

Bonds are likely to provide returns around running yield or a bit more, as inflation slows, and central banks cut rates.

Unlisted commercial property returns are likely to remain negative due to the lagged impact of high bond yields and working from home reducing office space demand.

Australian home prices are likely to see more constrained gains over the next few months as the supply shortfall remains, but still high interest rates constrain demand and unemployment rises. Lower interest rates should help the market next year though and we see average property prices rising by around 5% in 2025.

Cash and bank deposits are expected to provide returns of over 4%, reflecting the back up in interest rates.

A rising trend in the \$A is likely taking it to \$US0.70 over the next 12 months, due to a fall in the overvalued \$US and a narrowing in the interest rate differential between the Fed and the RBA. A recession and/or a Trump victory are the main downside risks.