WEEKLY MARKET UPDATE

06 APRIL 2023

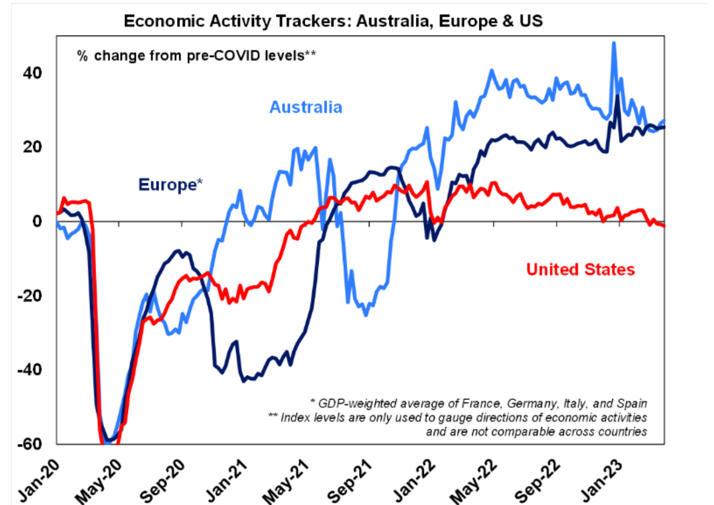
Investment markets and key developments

Sharemarkets fell over the week on growth concerns as data showed a declaration in economic momentum (particularly in the US). US shares were 0.5% lower (driven by tech which was down by 1.8% after a strong rally in recent weeks), Australian shares were down by 0.3%, Eurozone -0.4%, Japan -1.7% but Chinese shares managed to rise by 1.2% (although the Chinese sharemarket was closed on Wednesday). **Bond yields declined** on growth worries with the US 10-year yield down to 3.3% (well down on its early March levels of 4%). Commodity prices were mixed with aluminium, copper, iron ore and nickel prices down, gold prices continuing to rally and oil higher. Oil prices rose to $85USD/barrel after OPEC+ announced a surprise cut to oil production of 1.15 million barrels/day (which is ~1.1% of global supply) in May and June which is on top of Russia also cutting production until the end of the year and reflects the bloc attempting to lift oil prices after issues in the banking sector led to lower oil prices on recession concerns. Higher oil prices add to inflation but are also negative for growth. The $A was marginally higher over the week, now at 0.67US dollars.

After recent concern around a wages breakout in Australia, the Victorian public sector wage cap has been lifted from 1.5% to 3% which will add to wages growth but is not in line with a wages breakout. The Fair Work Commission will make its decision about minimum and award wages in June. Public sector wages growth will increase from here but has been lower than the private sector (public sector wages were up by 2.5% over the year to December versus 3.6% for the private sector) while private sector wages growth will be constrained by a slowing labour market.

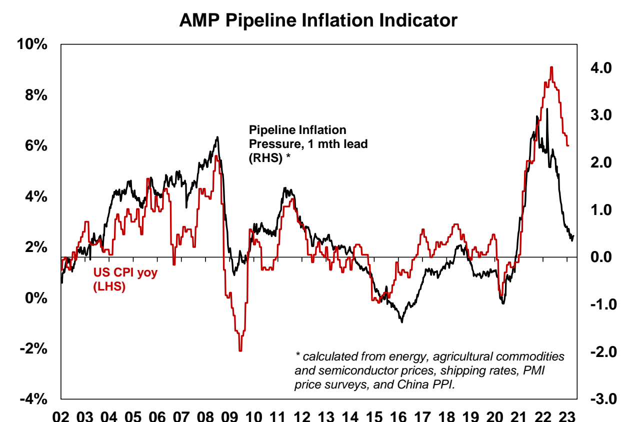
Economic activity trackers

Our weekly Economic Activity trackers fell in the US (from a decline in confidence, lower job ads and a decline in mortgage applications), rose in Australia (from better credit card spending and job advertisements) and was flat in the Eurozone (see the chart below).



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

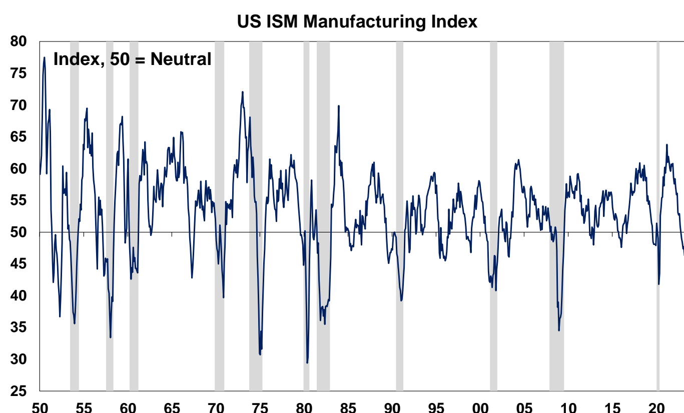
Our inflation indicator was largely unchanged this week however is still indicating that headline inflation should fall significantly in coming months (see the chart below).



Source: Bloomberg, AMP

Major global economic events and implications

The US ISM manufacturing index disappointed in March, with the index down by 1.4pts to 46.3 which is close to recession-like levels (see the chart below) and the prices paid and employment sub-indices both fell. The **services ISM index** for March also surprised lower, falling to 51.2 from 55.1.



Source: Bloomberg, AMP

Construction spending, factory orders and job openings all fell in February. The ratio of job openings to unemployed has declined to 1.7, down from a high of 2 which is a sign that (so far) job openings are being reduced without an increase in the unemployment rate. **March ADP employment rose less than expected**, another sign that the US labour market is turning.

Source: Bloomberg, AMP

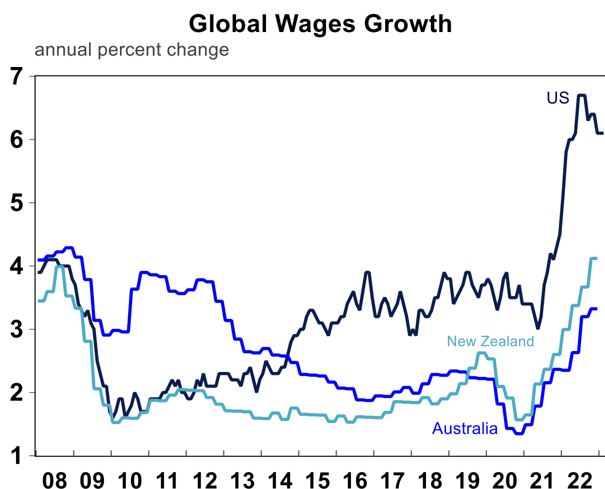
Fed speakers remained hawkish with Cleveland President Mester saying that interest rates should be kept above 5% this year, pushing back on market pricing of rate cuts in late 2023. The US **March quarter earnings season has started**, with 3% of S&P500 companies reporting earnings so far for the third quarter and have mostly been positive, beating expectations. Total earnings are likely to be down 6% over the year to March.

Japan's Tankan manufacturing business survey was weaker than expected in the March quarter, but non-manufacturing was better.

The Chinese Caixin manufacturing PMI fell in March, declining to an index level of 50 (from 51.6 last month) which indicates that the economic reopening is looking some momentum. However, the Caixin services PMI improved to 57.8, beating expectations.

Eurozone producer prices were down by 0.5% in February, or 13.2% higher compared to a year ago.

The Reserve Bank of New Zealand surprised markets and increased the Overnight Cash Rate by 0.50% to 5.25% which was higher than expectations of a 0.25% lift (only 1 out of 22 economist surveyed by Bloomberg expected this outcome). The RBNZ cited inflation and employment as still being too high. Recent weather events will also add to near-term CPI inflation and risk adding to inflation expectations (although I would have thought that the central bank could see through this). Now the question turns to whether Australia needs similar rate settings to NZ given that the RBNZ has lifted rates by 500 basis points (or 5.00%) and the RBA has done "only" 350 basis points (or 3.50%). While inflation was running at similar levels in Australia and New Zealand over 2022, wages growth in New Zealand is higher (see the chart below). There is an increasing risk that New Zealand is overdoing the tightening and engineering an unnecessary recession, with this week's quarterly survey of business opinion showed that trading activity over the next 3 months was likely to be in line with negative GDP growth (or a recession) and that there was a clear deceleration in price pressures.



Source: Macrobond, AMP

Australian economic events and implications

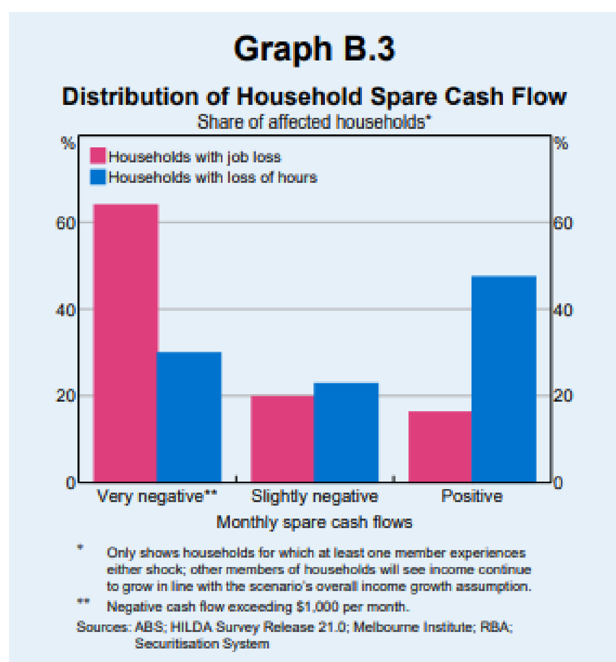
The RBA left the cash rate unchanged at 3.6% at its April Board meeting after 10 consecutive increases. The RBA's decision to keep interest rates unchanged today was justified because of the lags involved with monetary policy changes, with the RBA noting that the full effect of rate hikes is yet to be felt and that it needs additional time to assess the impact of higher interest rates. We think that this is the right decision. The data flow over recent months has showed some moderation in economic activity (slowing in consumer spending, poor lending growth, low levels of housing construction, deteriorating business surveys and low consumer sentiment) along with a downtrend in inflation. Another interest rate hike would risk sending the economy into a deeper slowdown and risk a recession which is not necessary to get inflation down (as it is already slowing). The RBA retained its tightening bias noting that "the Board expects that some further tightening of monetary policy may well be needed to ensure that inflation returns to target" although this is softer than last month's statement "the Board expects that further tightening of monetary policy will be needed". It makes sense for the RBA to maintain its tightening bias, as it needs to sound tough on inflation (which is still way too high, running at 6.8% year on year to February) because it does not want to risk a significant rebound in economic activity off the back of a pause in interest rates. However, our view is that the data flow will continue to disappoint to the downside in coming months and further rate rises won't be justified. Further financial contagion from the banking sector issues also can't be ruled out which would also justify keeping interest rates steady. By the end of the year we expect the RBA to start cutting the cash rate.

Governor Lowe spoke a day after the Board meeting at the National Press Club on "Monetary Policy, Demand and Supply" explaining in detail why the RBA left the cash rate unchanged at its April Board meeting, noting that "it is increasingly clear that the

higher interest rates are having an impact on aggregate household spending". The most interesting takeout in our view was a comment in the Q&A about why Australia may not see the same level of higher interest rates as our global peers which came down to three reasons: 1/ Australia has had lower wages growth than our peers which will keep inflation lower than otherwise 2/ the pass through to households from rate hikes as been faster given the larger share of variable and short-term fixed rates and 3/ the RBA is happier to tolerate higher inflation for longer compared to other central banks, to preserve jobs growth.

The RBA also released its semi-annual Financial Stability Report. The key points are:

- The RBA acknowledged that financial stability risks had increased given the banking sector issues in the US and Switzerland and that a further tightening in financial conditions leading to declines in asset prices is a risk. It was noted that Australia is "not immune" from the deteriorating outlook but that it is in a strong position with banks that are well capitalised, profitable and highly liquid.
- Australian businesses that are vulnerable to rising rates includes smaller businesses (that tend to have variable debt) and volatile income and building construction firms that have come under margin pressure. Corporate insolvencies are back to pre-Covid levels but arrears are still low.
- Commercial real estate market conditions are challenging because of higher interest rates, slowing growth and a preference shift by tenants (e.g. working from home) and are a risk.
- Rate hikes are having an impact on indebted households. Mortgage arrears are increasing although are still at low levels and there has been a pick-up in borrowers who are drawing down on their repayment buffers.
- Around 40% of borrowers have less than 3 months of prepayment buffers which is largely unchanged from prior RBA analysis.
- The RBA appears more concerned about fixed-rate borrowers compared to previously (now about a quarter of borrowers) because they have larger balances and higher loan-to-valuation ratios compared to variable-rate loans.
- Renters are also in a vulnerable position as on average they tend to have lower incomes compared to home owners, are facing large increases to rent and are more vulnerable to unemployment during a downturn.
- The RBA estimates that 15% of household borrowers would have negative cash flow if the cash rate lifted to 3.75% (just above its current level of 3.6%) which is unchanged on prior analysis and would mean that these households need to make significant cuts to their non-essential spending and depleting their savings buffers.
- Job loss would result in a big negative for household cash flows. On the RBA's estimates, more than 80% of households that experience job loss would have negative spare cash flow and around 50% of households that lose a share of their hours would have negative cash flows (see the chart below).

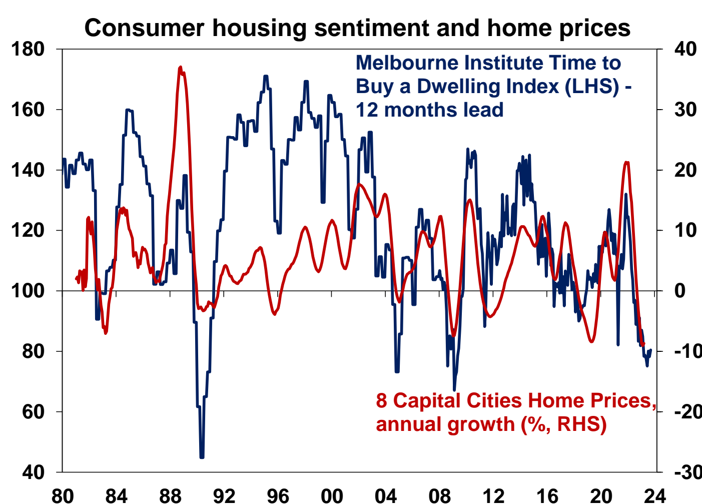


Source: RBA, AMP

There are also some positives:

- A very small share (2%) of loans have an LVR greater than 90%.
- The share of negative equity loans remains low – another 10% fall in home prices would see the share of loan balances falling into negative equity rising to 2%.

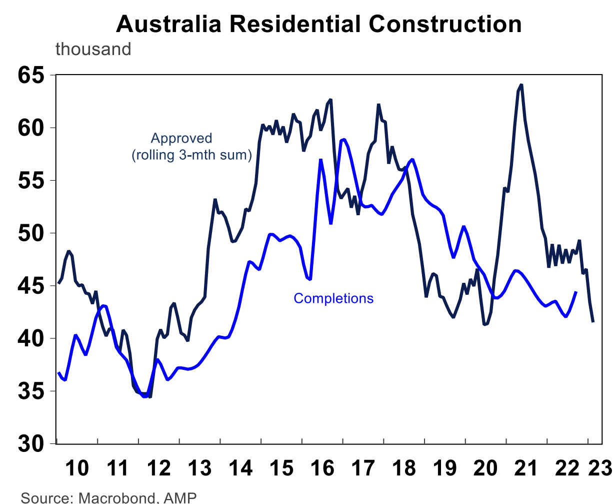
Australian national average home prices rose by a decent 0.6% in March, lifting for the first time since April 2022 (before the RBA started lifting interest rates). Capital city home prices were 0.8% higher and regional cities were up by a smaller 0.2% over the month. The main factors supporting home prices are: a rebound in immigration, an ultra-tight rental market in the capital cities and first-home buyer state government support packages (first home buyer lending rose in February). Consumer sentiment towards housing is improving which could be a sign that home prices have bottomed (see the chart below).



Source: Bloomberg, Macrobond, AMP

Our view that home prices would fall by 15-20% peak-to-trough (prices are down by 8.5% since their high) may be too pessimistic given the stabilisation in home prices over the past two months but we still see some near-term downside for home prices as the full impact of RBA rate hikes is likely to see some additional selling and the increase in interest rates has led to a 27% decline in borrowing capacity.

Other housing data showed that building approvals rose by 4% in February but this was below expectations and approvals are still 31% lower compared to a year ago and risk undershooting the growth in the population which would create more affordability problems down the track. The surge in approvals over 2021 has not been matched by a concurrent lift in completions which shows that there is huge pipeline of work yet to be done, although given construction delays and cost blowouts the risk is that completions don't match the level of approvals.



An interesting report this week from the National Housing Finance and Investment Corporation about the state of housing in Australia and on their estimates there would be a 106,300 deficit of homes over the next five years (to 2027). **Housing lending** continues to fall and was down by 0.9% in February although first-home buyer lending rose**. The Melbourne Institute inflation gauge** showed a further slowing in inflation momentum in March – another sign of lower inflation. And the **February trade surplus rose to $13.9bn in February,** as imports fell by more than exports.

What to watch over the next week?

US March non-farm payrolls are released tonight and are expected to show solid jobs growth of around 240K over the month with the unemployment rate unchanged at 3.6% and average hourly earnings growth slowing to 4.3%. US markets are closed on Friday for the Good Friday holiday. Next week, the **March consumer price data** is key and is forecast to rise by 0.3% over the month, with annual growth slowing to 5.2%. In core terms, this would be a rise of 0.4% or 5.6% over the year. Other data includes initial and continuing jobless claims (tonight), the NFIB small business optimism index, FOMC March meeting minutes are released, March producer prices, March retail sales (expected to fall by 0.4% over the month), industrial production and the University of Michigan consumer sentiment. A few more companies report third quarter earnings next week, including the banks (Wells Fargo, JP Morgan and Blackrock).

China's March CPI is expected to remain low at 1% over the year to March and producer prices are expected to be 2.4% lower over the year. Unlike the major advanced economies, China clearly does not have an inflation problem. The **March trade surplus** is expected to narrow.

New Zealand data includes electronic card transactions for March (a signal of retail spending and are likely to be poor) and the February business manufacturing PMI.

Eurozone data includes February retail sales which are likely to be soft and industrial production (expected to lift modestly).

In Australia, the data releases start again on Tuesday after the Easter break, with the NAB March business survey, April consumer sentiment which is likely to show a bounce as the RBA kept the cash rate steady at its April meeting, March labour force data which we expect to show a 20K rise in employment, with the participation rate unchanged at 66.6% and the unemployment rate lifting to 3.6%. RBA Deputy Governor also Michele Bullock speaks at a panel.

The Bank of Canada meet next week rate decision after a pause at the last meeting and no change is expected at this meeting. Also watch for March employment figures and existing home sales.

Outlook for investment markets

The year ahead is likely to see easing inflation pressures, central banks moving to get off the brakes and economic growth weakening but stronger than feared. This along with improved valuations should make for better returns than in 2022. But as we are seeing there will be bumps on the way – particularly regarding interest rates, recession risks, geopolitical risks and raising the US debt ceiling in the September quarter.

Global shares are expected to return around 7% this year. The post mid-term election year normally results in above average gains in US shares, but US shares are likely to be a relative underperformer compared to non-US shares reflecting still higher price to earnings multiples versus non-US shares. 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 and stronger growth in China supporting commodity prices and as investors continue to like the grossed-up dividend yield of around 5.5%.

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). Commercial property returns are actually likely to be negative.

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.

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

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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