WEEKLY MARKET UPDATE

AMP

09 DECEMBER 2022

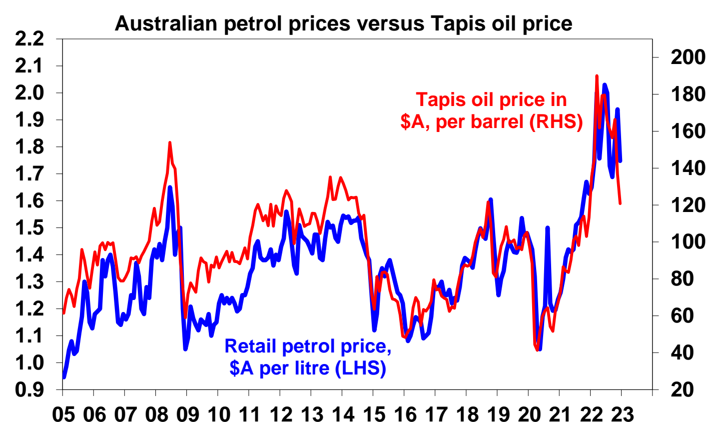
Investment markets and key developments

After strong gains since September/October lows US and European share markets pulled back in the last week on the back of interest rate fears ahead of this week's Fed meeting and recession worries. This saw US shares fall 3.4% for the week and Eurozone shares fall 1%. Japanese rose 0.4% though and Chinese shares gained 3.3% with the latter helped by optimism about reopening in China. The negative US lead saw Australian shares pull back by 1.2% for the week, with the falls led by IT, energy, financial and industrial shares. Bond yields mostly rose, but fell in Australia. Commodity prices were mixed with oil down 11%, but metals and iron ore up. The $A fell slightly, but remains around $US0.68, as the $US rose slightly.

The RBA hiked by another 0.25%, but we think they are at or close to the top. Thanks to the surge in inflation, this year has seen the cash rate rise far more than we were expecting at the start of the year. In hiking to 3.1% the RBA cited high and still rising inflation, solid growth, the tight labour market and a pickup in wages growth. And its bias remains hawkish expecting to raise rates further, although it added a qualifier to its post meeting Statement that it "is not on a pre-set course" making it sound a little bit less hawkish. However, we see the RBA as being at or close to the top as supply bottlenecks have largely dissipated, the lagged impact of the surge in mortgage rates and costs will hit many households very hard in the next year, there is increasing evidence demand is slowing (with now bank card and merchant transaction facility data suggesting a weak start to holiday spending) and the global outlook is deteriorating all of which will likely push inflation down faster than expected next year. Government moves to lower energy prices will likely also help, resulting in an estimated 0.5% reduction in inflation. Fortunately, the RBA does not meet in January but by February/March there is likely to be clear evidence of a sharp slowing in demand and easing in inflation pressures enabling it to leave the cash rate at 3.1% (which is our base case), or hike just once more to 3.35% (which is a high risk), followed by an extended pause ahead of rate cuts at the end of 2023 or start of 2024.

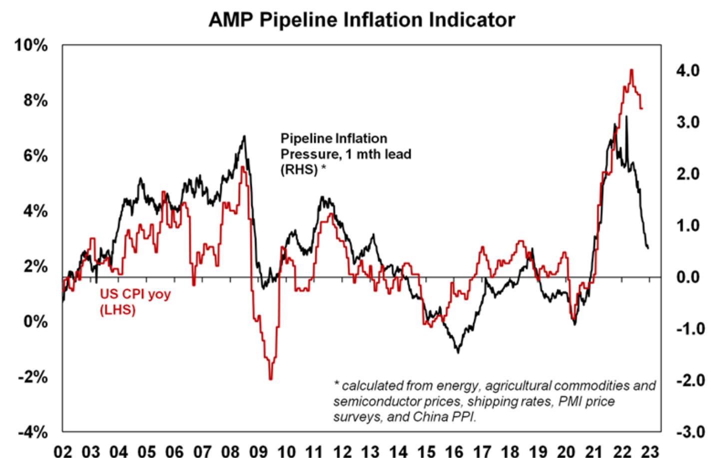
The Bank of Canada added to the pattern of major central banks moving incrementally less hawkish. It hiked by another 0.5%, the same as in October, which was a step down from 0.75% in September. But its commentary was dovish noting signs that "price pressures may be losing momentum" and that "there is growing evidence that tighter monetary policy is restraining domestic demand" and indicating that it "will be considering whether the policy interest rate needs to rise further". The latter suggests that it may pause rate hikes at its next meeting in late January.

A plunge in oil prices to January levels is supportive of peak inflation and central banks becoming less hawkish. The combination of the plunge in oil prices and the rise in the Australian dollar suggests Australian petrol prices should be averaging around $1.6 a litre.



Source: Bloomberg, AMP

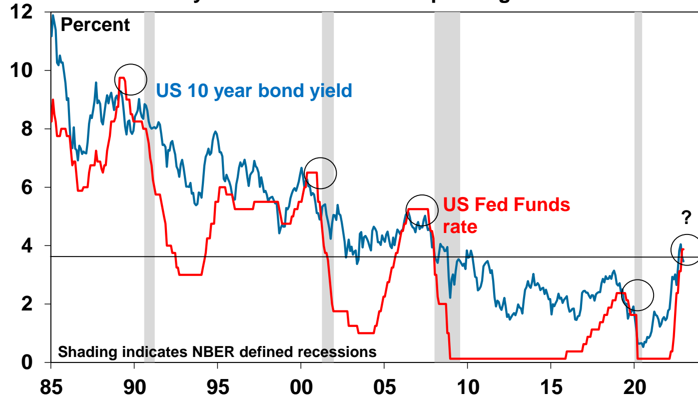
Our Pipeline Inflation Indicator rose slightly in the last week, with a rise in some commodity prices, but remains in a downtrend.



Source: Bloomberg, AMP

After rallying up to resistance, shares have pulled back in the last week on recession fears and this remains the main risk now. However, if inflationary pressures continue to show signs of easing allowing a peak soon in interest rates this will boost confidence that recession can be avoided or if not that it will be mild. With the Fed Funds rate now well above the US 10-year bond yield the Fed should now be considering pausing as it has on prior occasions when this occurred. See the circles in the next chart. It's unlikely to pause in the week ahead, but there is a good chance that it will be forced to early next year. Another offset to the global recession risk next year is a likely rebound in Chinese growth as it progressively exits its zero-Covid policy allowing a reopening boost

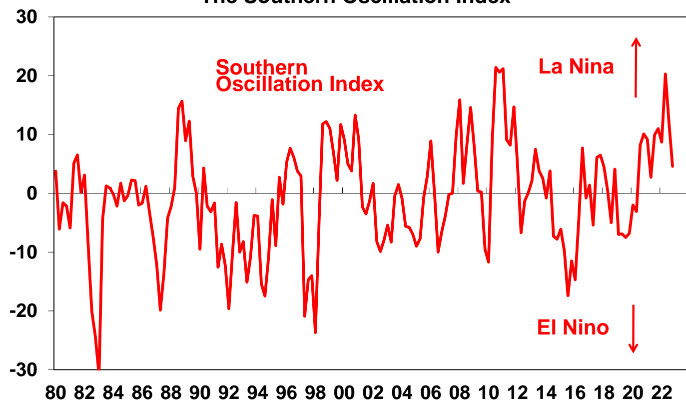
fuelled by policy stimulus, which in turn should provide an offset to slower conditions in the US & Europe and providing support for Australia.



Source: Bloomberg, AMP

The bottom line for investment markets is that short term risks remain high and could keep share markets erratic – with the main risk being a US/global recession – but providing any recession is mild we remain of the view that the combination of improved valuations, central banks easing up on the brakes and anticipation of stronger growth in 2024 will enable share markets to rise on a 12-month view. We are now in a seasonally strong time of the year for shares (particularly from mid-December) – so a playout to watch would be for shares to rally into January after the Fed meeting in the week ahead, pull back into February/March probably on recession and earnings concerns possibly entailing a re-test of the October low and then for the rally to resume.

Is La Nina losing its grip? The Southern Oscillation Index fell to 4.6 in November (shown in the chart, whereas prior observations are quarterly averages). This is well down from recent highs suggesting that La Nina may be weakening. But the SOI can be quite volatile and we have seen several dips in the past couple of years only for La Nina to remain/resume.

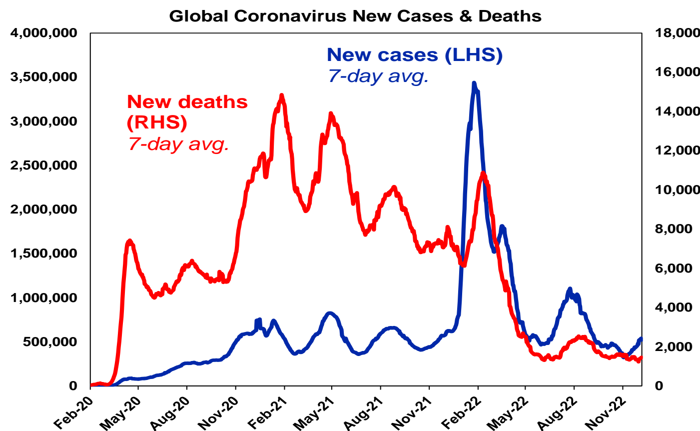


Source: Bureau of Meteorology, AMP

Valerie. For some reason I missed this song and video when it came out. It was originally by the Zutons in 2006 then Mark Ronson covered it in 2007 with Amy Winehouse providing lead vocals. It's a real upbeat song and the karaoke style video (where the women are lip syncing to Amy's vocals) adds to the feelgood factor.

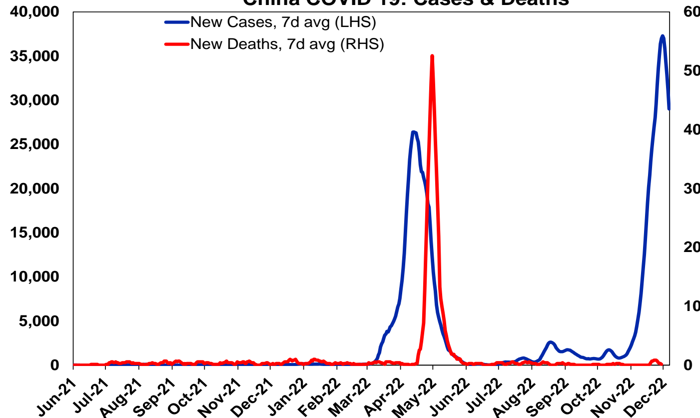
Coronavirus update

New global Covid cases are still rising, albeit from a low level.



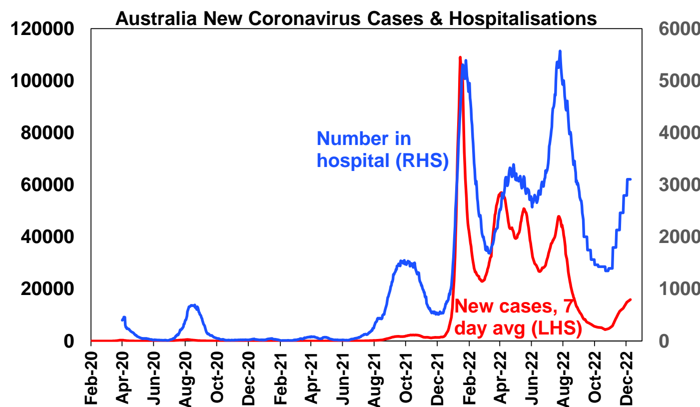
Source: ourworldindata.org, AMP

China has seen new Covid cases roll over (although this may be due to less testing) and has sped up the relaxation of its Covid rules. In particular the Government announced 10 measures to further ease Covid rules – and these included allowing home quarantine for close contacts and mild cases, easing testing requirements and incentives to speed up vaccination of the elderly. And it made no mention of "Zero Covid." As Australia saw this year, reopening will inevitably have a bumps on the way causing economic disruption (with cases in China likely to surge before things settle down), but its increasingly clear that China is heading down the path to reopening.



Source: ourworldindata.org, AMP

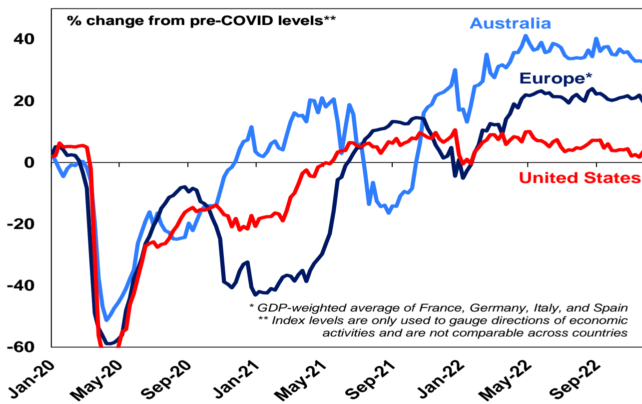
New cases and hospitalisations are still rising in Australia.



Source: covidlive.com.au, AMP

Economic activity trackers

Our Australian, US and European Economic Activity Trackers fell over the last week, with economic momentum now showing clear signs of slowing.



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

It was a quiet week for US economic data, but the ISM services index confused things. For November it surprisingly rose to a strong 56.5 fuelling concerns about a more aggressive Fed. But given most other indicators are going the other way, including the services PMI (which is the same thing but with a bigger survey and fell to a 46.2) we are inclined to see the service ISM as a bit of an aberration. Meanwhile, initial jobless claims rose only slightly and remain low, but continuing claims continue to rise more sharply suggesting hiring is slowing. Consumer sentiment rose slightly but remains weak. Producer price inflation was higher than expected but still fell to 7.4%yoy from 8.1% and consumers' long term inflation expectations were unchanged at 3%, in line with where it's been since the mid-1990s and well down from near 10% in 1980.

The Democrat's win in the Georgia run-off election has been complicated by Kyrsten Sinema's move to be an independent. But it doesn't really change things as she has indicated she will not caucus with the GOP. The new Senate doesn't make life easier for the Democrats in passing laws (as the GOP will control the House from January and they still need some GOP senators) but it does make it easier procedurally and in doing things like appointing judges. Attention may now shift to passing a full year bill to fund the Government ahead of the new Congress in January – if its left to next year the GOP could force a Government shutdown.

German industrial production and factory orders for October were stronger than expected adding to signs that Europe is proving more resilient than initially thought.

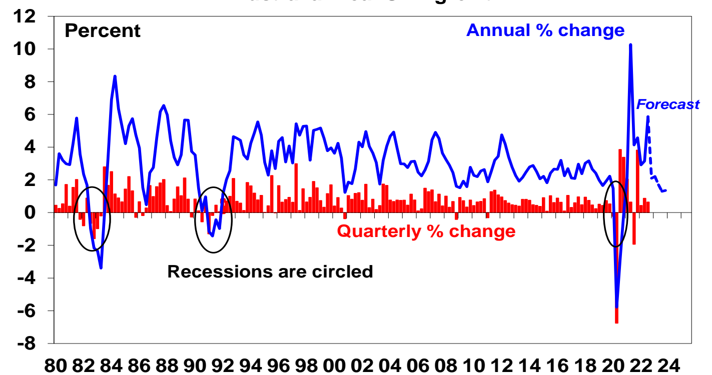
Japanese household spending rose more than expected in October, but economic sentiment softened, and nominal wages growth slowed back to 1.8%yoy and remains too low for the BoJ.

Chinese export and import growth both fell more than expected reflecting slower global activity and the surge in Chinese Covid cases. CPI inflation fell to just 1.6%yoy in November with producer prices remaining down -1.3%yoy reflecting weak demand. Moves to ease Covid rules and a likely transition to living with Covid early next year along with the December Politburo meeting signalling a more growth stance point to stronger growth next year.

Australian economic events and implications

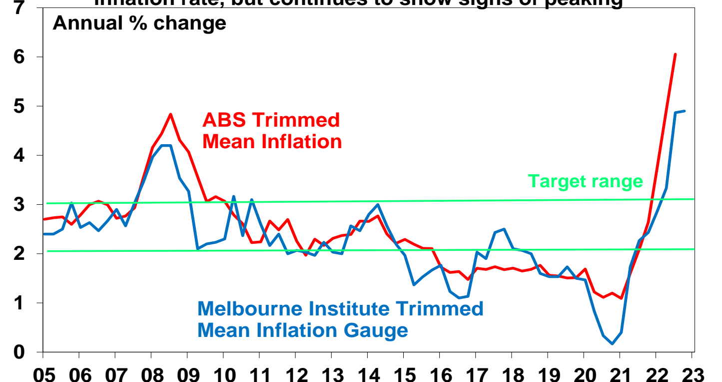
Price caps, subsidies and other market interventions don't have a great track record of success, but Government moves to cap gas and coal prices and provide subsidies to lower power bills (relative to what they would otherwise be) should help take some pressure off inflation next year by keeping household and business energy prices lower than otherwise. Any near-term cost to the Federal budget will likely be offset by the greater than forecast surge in corporate tax revenue, which itself is in large part due to higher coal and gas prices. So, electricity bill subsidies are not really a fiscal stimulus as some are saying.

Australian GDP growth slowed in the September quarter, and is set to slow further in the year ahead. While annual GDP growth was very strong at 5.9%yoy, this mainly reflected the rebound from the Delta lockdowns and the slump a year ago with growth slowing to 0.6%qoq in the September quarter. Consumer spending was strong – boosted in particular by travel on the back of reopening – as was construction, but trade detracted – partly due to a surge in Australians' travelling overseas. While September quarter growth was still okay it does not reflect the full impact of rate hikes given the 2-3 month lag from an RBA hike to when the borrower sees an increase in their payments and since the September quarter there have been three more rate hikes. The national accounts show that household savings built up through the pandemic remain high but the household savings rate has now almost fallen back to pre-Covid levels. With the reopening boost now behind us, the combination of the lagged impact of rate hikes including the "fixed mortgage rate cliff", cost of living pressures and consumer confidence at recessionary levels are expected to see GDP growth slow down to around 1.5% over the year ahead.



Source: ABS, AMP

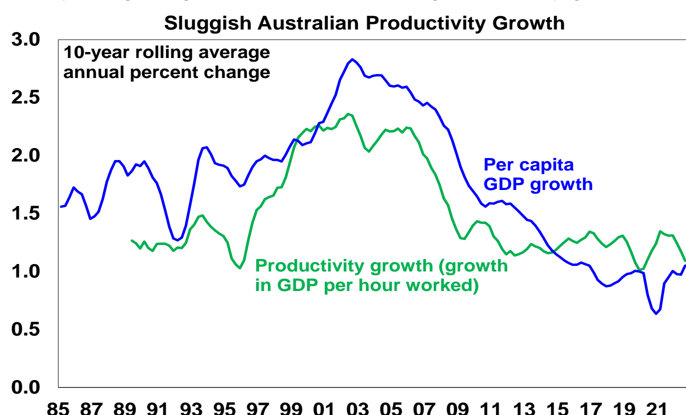
High inflation pressures confirmed, but they should slow next year. The September quarter national accounts also confirmed the inflationary pressures impacting the economy - with the consumption deflator up 6%yoy and average wages up 2.5%qoq or 4.8%yoy (albeit the latter was boosted by the increase in the Super contribution, the minimum wage rise and compositional change). But slower growth, a loosening of the labour market particularly as foreign workers return and falling global inflation pressures will likely see inflation fall next year. The Melbourne Institute's Inflation Gauge points to a bounce back in the ABS Inflation Indicator for November, but like the latter it's also showing signs of peaking. The main risk now though is of excessive wages growth.



Source: Melbourne Institute, AMP

Australian productivity growth was negative over the last year leaving its trend growth rate subdued & well below the level seen in

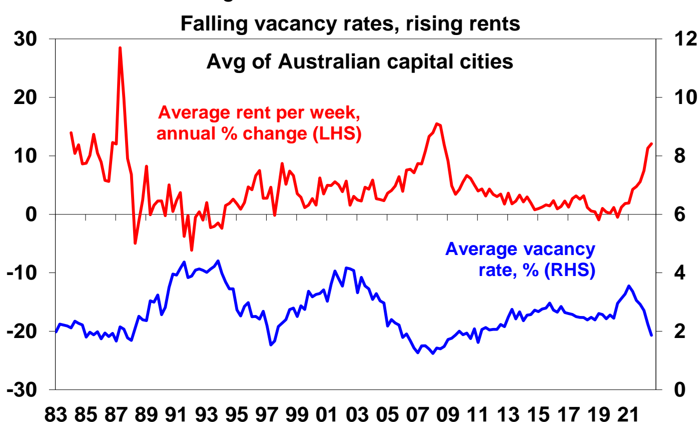
the late 1990s/early 2000s which flowed from significant economic reforms. The only way to sustain strong real wages growth and rapidly rising living standards is with strong productivity growth.



Source: ABS, AMP

In other data, the current account returned to a small deficit in the September quarter for the first time since 2019 with a surge in dividend payments offshore (reflecting the surge in mining profits) more than offsetting the large trade surplus. Income flows can be volatile and the trade balance remained in a large surplus in October so the current account could return to a small surplus or if not the deficit will likely remain small so this is unlikely to have any major consequences for the $A.

Residential rental property vacancy rates fell further in the September quarter (with monthly data from other data providers even lower) – with a particularly sharp fall in Melbourne. This is the main driver of the surge in rents.



Source: REIA, AMP

What to watch over the next week?

In the US, the Fed (Wednesday) is expected to slow down its rate hikes to 0.5% (from 0.75%) taking the Fed Funds rate to the range of 4.25-4.5% but with its dot plot of Fed officials' interest rate forecasts showing a higher peak rate of 5-5.25% for the end of next year as the Fed seeks to better manage the risks of inflation and recession. This has been well flagged by numerous Fed officials including Fed Chair Powell so should not really be a surprise for investors. Share markets may see the usual uncertainty going into the meeting followed by a post meeting relief rally. And of course, it doesn't mean that the Fed will end up raising rates that much (just like the dot plot was a poor guide a year ago to what happened this year).

On the data front in the US, the November CPI (Tuesday) is expected to show a further moderation in inflation to 7.3%yoy (from 7.7%) with core inflation slowing to 6.1%yoy (from 6.3%), November retail sales and industrial production are expected to be flat and the New York and Philadelphia regional manufacturing surveys for December are expected to remain weak (all due Thursday). US business conditions PMIs for December (Friday) are also likely to remain soft.

Like the Fed, the ECB (Thursday) is expected to slow its rate hikes to 0.5% (from 0.75%), taking its main refinancing rate to 2.5%, and signal more rate hikes ahead. Eurozone PMIs (Friday) are likely to remain soft.

The Bank of England (Thursday) is expected to raise rates by another 0.5% taking its policy rate to 3.5%. Inflation data for November (Wednesday) is expected to show a slight easing to 10.9% from 11.1%yoy.

The Japanese Tankan business survey for the December quarter (Wednesday) is expected to soften slightly and PMI's (Friday) are also likely to remain soft.

Chinese economic data for November (Thursday) is likely to show a further slowing on the back of the latest Covid wave with growth in industrial production falling to 3.7%yoy and retail sales falling -3.9%yoy. Unemployment is likely to have increased slightly.

In Australia, expect the Westpac/MI consumer confidence index to remain very weak and the NAB business survey to show weaker conditions and confidence (all Tuesday) and business conditions PMIs for December (Friday) to remain soft. November jobs data is expected to show a 20,000 gain in employment with unemployment unchanged at 3.4%.

Outlook for investment markets

Shares are not completely out of the woods yet as central banks continue to tighten, uncertainty about recession remains high and geopolitical risks continue. However, we are now in a favourable part of the year for shares from a seasonal perspective and 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 brakes.

With bond yields likely having peaked for now, bond returns should continue to improve.

Unlisted commercial property may see some weakness in retail & office returns & the lagged impact of higher bond yields is likely to drag down unlisted property and infrastructure returns.

Australian home prices are expected to fall 15 to 20% top to bottom into the September quarter next year as poor affordability & rising mortgage rates impact. This assumes the cash rate tops out in the low 3's but if it rises to around 4% as some are assuming then home prices will likely fall 30%.

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

The $A remains at risk of a pull back in the short term as global uncertainties persist and as the RBA remains a bit less hawkish than the Fed. However, a rising trend is likely over the medium term as commodity prices ultimately remain in a super cycle bull market.

Important note: While every care has been taken in the preparation of this document, neither National Mutual Funds Management Ltd (ABN 32 006 787 720, AFSL 234652) (NMFM), AMP Limited ABN 49 079 354 519 nor any other member of the AMP Group (AMP) makes any representations or warranties as to the accuracy or completeness of any statement in it including, without limitation, any forecasts. Past performance is not a reliable indicator of future performance. This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs. An investor should, before making any investment decisions, consider the appropriateness of the information in this document, and seek professional advice, having regard to the investor's objectives, financial situation and needs. This document is solely for the use of the party to whom it is provided. This document is not intended for distribution or use in any jurisdiction where it would be contrary to applicable laws, regulations or directives and does not constitute a recommendation, offer, solicitation or invitation to invest.