18 December 2020

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

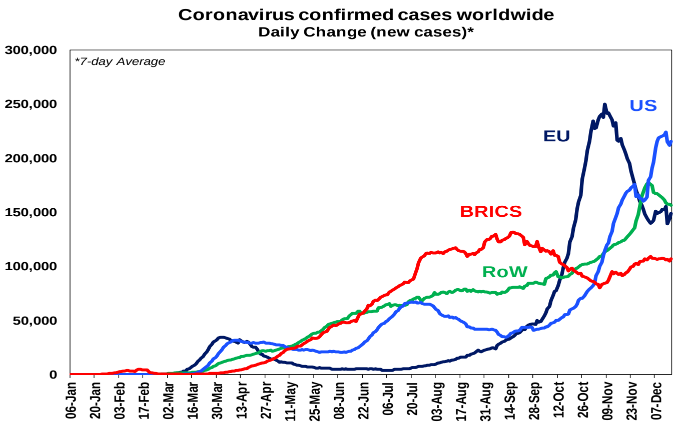
Investment markets and key developments over the past week

Global share markets pushed higher again over the last week as the roll out of vaccines and US stimulus optimism offset uncertainties about the near-term impact from lockdowns. While the latest coronavirus outbreak in Sydney weighed on Australian shares on Friday, the local share market still rose for a seventh week in a row helped by the positive global lead and stronger than expected local economic data. IT, retail and telco shares led the gains with continuing high iron ore prices helping the miners and this offset weakness in energy, consumer staples and health stocks. Bond yields were flat to up and oil and metal prices rose, but the iron ore price fell slightly albeit it remained very high. The surge in commodity prices along with a commitment by the Fed to continue with a high level of quantitative easing helped push the $A above $US0.76, with the $US remaining under pressure.

While the ongoing slide in the $US helped push commodity prices higher, it also helped drive Bitcoin decisively through its 2017 high, which in turn triggered a mass of technical buying pushing it briefly about $US23k. As I noted a few weeks ago the $US likely has more downside and bitcoin may have much more upside (eg some technical analysts have it going to $US36k-$US40k) – but its highly speculative & very hard to get a handle on what exactly its worth.

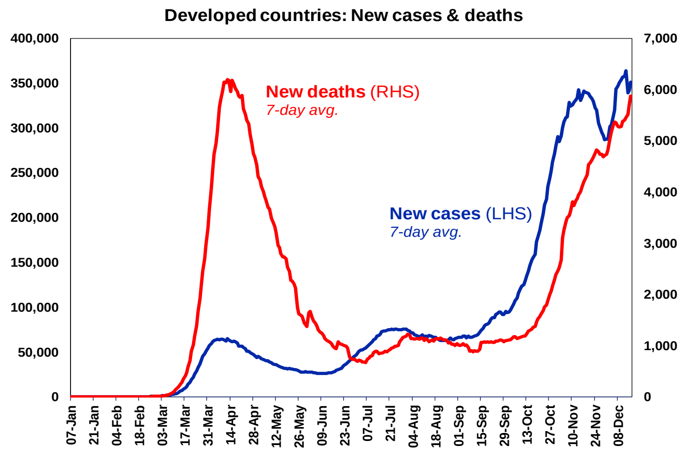
Shares are stretched and at risk of a correction after their strong run since early November. This is likely to give way to volatility in the early part of 2021. However, beyond short term noise more upside is likely as momentum is very strong, the Santa Claus seasonal rally runs from mid-December into January and investors are yet to fully discount the potential for a very strong economic and profit recovery next year as stimulus combines with vaccines and so 2021 is likely to see solid returns. Cyclical recovery shares like resources, industrials and financials are likely to be relative outperformers as the focus shifts from pandemic to recovery, and this should benefit the Australian share market over US shares. The $A is likely to continue to head higher towards our forecast of $US0.80 by end next year on the back of rising commodity prices and a falling US dollar. RBA quantitative easing will likely only be able to slow the $A's ascent as opposed to stop it.

The trend in new global coronavirus cases slowed a bit over the last week, but this could just be another blip in a still rising trend given the volatility in testing. Emerging countries and the US have slowed a bit (although some of the US data for the south looks a bit odd), but Europe seems to be trending flat to slightly up again, particularly with renewed increases in Germany, the Netherlands and the UK. And Japan, Canada and South Korea remain in rising trends.



Source: ourworldindata.org, AMP Capital

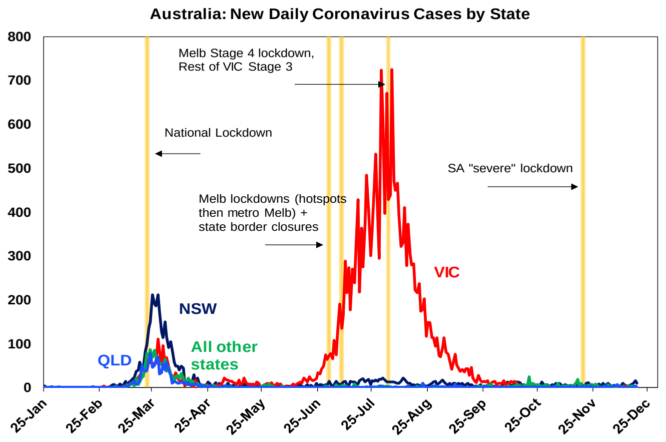
The good news is that thanks to more testing and better treatment the measured mortality rate in developed countries has fallen from 8.5% early this year to around 2%. In may even prove to be lower if everyone was getting tested. But the bad news is that deaths are approaching their April highs and hospitals remain under pressure which in turn is driving more severe lockdowns (eg in Germany and London) or the threat of the same (eg in Korea and New York).



Source: ourworldindata.org

Vaccines are starting to be deployed. They won't deal with the current waves in many countries, although they will help significantly from second half next year with a good chance of the US reaching herd immunity in the September quarter and globally by the end of 2021 or early 2022. This is continuing to help share markets look through the current problems with the virus and its economic impact.

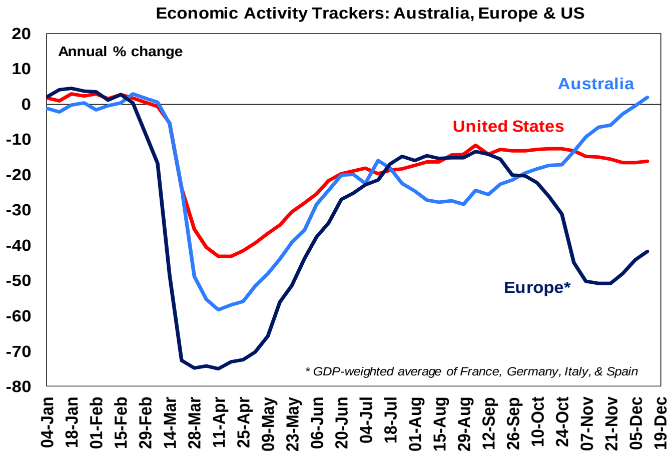
Just when it seemed coronavirus was under control in Australia – its flared up again in Sydney with a new cluster of cases on Sydney's Northern Beaches. The origin of the covid strain has been confirmed as being overseas but how it got into the community is unclear. So far, the Northern Beaches cluster has been averaging around 10 new cases a day which is not out of line with NSW's experience around July/August – see the chart below. That said it could still get worse before it gets better. Several factors provide reason for optimism that it can be brought under control relatively quickly: Northern Beaches sewage analysis indicates it was not present as at December 10 so it may be relatively new and hopefully has not spread so far; testing is far more available and widespread than earlier this year making quarantining infected people easier and faster; it should be easier to contain in summer than was the case in Melbourne when everyone was inside in close contact; and the NSW authorities are moving quickly to try and contain it and have a good track record as evident in the containment of several clusters in NSW over the last six months.



Source: covid19data.com.au, AMP Capital

What would be the economic impact of a Sydney/NSW lockdown? So far all 250,000 Northern Beaches residents have been asked to stay at home for three days. If this enables contact tracers to get on top of it then the economic impact will be trivial. If alternatively, a Victorian style lockdown is ultimately required for Sydney and NSW then it could knock 2.5% (or $12.5bn) or so off national GDP mainly in the March quarter. But as noted above there are reasons for optimism that this will be avoided and that if there is a lockdown it will be much shorter than the three months or so seen in Melbourne. As such the economic impact will be much smaller and not enough to derail the Australian economic recovery. It should also be noted that the situation is far less uncertain than going into the March lockdowns given the presence of government support measures, the bank payment holiday and the approaching deployment of vaccines.

Our weekly Economic Activity Trackers remain divergent. In Europe they have continued to move up from their lows and are likely to improve more significantly if lockdowns are eased but that's still a fair way off yet. Our US tracker edged slightly higher but is still down from recent highs pointing to some slowing in economic conditions.

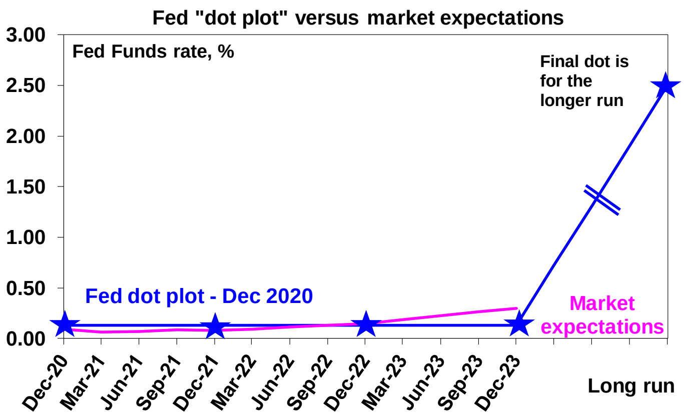


Based on weekly data for eg job ads, restaurant bookings, confidence, mobility, credit & debt card transactions, retail foot traffic, hotel bookings.

Source: AMP Capital

By contrast our Australian Economic Activity Tracker has moved higher to now be up on a year ago with a continuing broad-based improvement. Of course, this was before the latest outbreak in NSW which may cause a bit of a setback depending on how quickly its brought under control. In the meantime, it suggests that the strong rebound in the economy has continued through the current quarter.

It's been a long time coming, but US Congress appears to be closing in a stimulus plan valued at around $900bn. While contentious aspects around state aid (which is looking less necessary anyway) and liability protections for employers are excluded, it looks likely to contain additional support for small business, direct stimulus checks to households and extra unemployment benefits amongst other things providing help for the economy at a time when more lockdowns are threatening. Meanwhile, the Fed has made a very dovish change to its forward guidance on quantitative easing in committing to continue its bond buying at the pace of at least $US120bn a month until substantial further progress is made towards its full employment and inflation goals with Fed Chair Powell indicating that any tapering is some way off. Fed officials also continue to see no rate hikes out to 2023.



Source: US Federal Reserve, AMP Capital

Trump's quixotic attempt to derail the election outcome looks to have finally hit a dead end with the Electoral College voting in favour of Biden as per the election outcome and Senate Majority leader McConnell and

numerous other Republicans recognising Biden as the winner. Trump's last hope is that a member of both the House and Senate object to the Electoral College outcome at Congress' 6th January formal ratification of the result forcing each house to vote on the objection, but this looks extremely unlikely to succeed as Democrats control the House and enough Republican Senators now accept Biden's win. Trump's assault on US democracy with unsubstantiated claims that have been rejected by numerous courts over the last six weeks has done much damage. Fortunately, thousands of US election officials, judges and politicians (on both sides of politics) following the law and doing their duty have upheld US democratic values.

Tensions between Australia and China seem to be going from bad to worse with reports that China has confirmed a ban on Australian coal exports and Australia moving to take action in the World Trade Organisation – but it may not be as bad as it looks. Adding coal (worth $14bn in annual export earnings last financial year) to the list of affected agricultural products takes us from a macro economically trivial 0.3% of GDP to a more threatening 1% of GDP. And if it escalates further to cover natural gas and iron ore (worth $16bn and $85bn respectively) then a total of 6% of GDP will be impacted potentially causing serious disruption to the Australian economy. This is clearly a threat to watch for in 2021. However, there are several things worth noting. First, to the extent that less of some of our products go to China it may not necessarily mean lower production but could actually mean lower prices for Australians – there are already reports of lower prices for lobster and this could extend to wine and other products including power. Second, to the extent that China gets more of its imports from other countries it may free up new markets for Australian exports – of course this will take time. Third, China banning Australian iron ore imports would involve more of a hit to its economy as Australia accounts for 50% of iron ore exports globally so it would be impossible for China to replace all its Australian iron ore imports from other sources. Supply constraints at Brazil's Vale add to this. Australian iron ore is also higher quality lower cost iron ore. Fourthly, the downside of the dispute so far is being more than swamped by the impact of strong iron ore prices. Finally, just as Australia seemed to get sucked into tensions with China by President Trump's trade war, a likely US refocus on a diplomatic approach to resolving its issues with China under Joe Biden may provide a path to diplomatically resolving Australia's tensions with China too.

This has been a nice year for Taylor Swift fans with her second surprise album, Evermore, which I missed last Friday for some reason. Here is Willow its first single. Meanwhile its only one week to Christmas. Kelly Clarkson's Under the Tree and Mariah Carey's All I Want for Christmas is You top my list of favourite Christmas songs. Taylor had a nice one from last year too – Christmas Tree Farm.

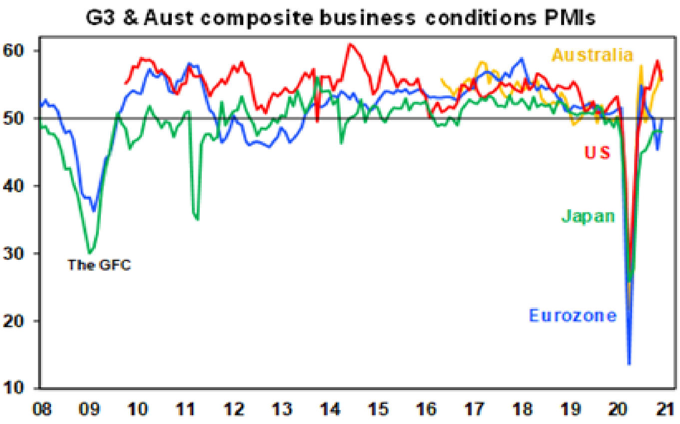
Major global economic events and implications

US data was mixed. While industrial production rose by more than expected in November and housing starts rose, retail sales, various business conditions surveys including PMIs and home builder conditions slipped. The declines were all from strong levels and each indicator remains strong, but it highlights the vulnerability of US growth to the current surge in new coronavirus cases and increasing lockdowns. This is also indicated by a further rise in jobless claims.

Eurozone business conditions PMIs rose in December albeit from low levels. This was possibly helped by a decline in new covid cases and confirms that the hit to growth this time around will be far less than seen in the first half.

Japanese data was mixed with an improvement in the December quarter Tankan business survey but a basically flat reading for the composite business conditions PMI for December and CPI deflation intensifying.

Overall business conditions PMIs across the G3 were mixed in December reflecting trends in coronavirus cases – down in the US, basically flat in Japan but up in Europe – which taken together points to a basically flat global composite PMI at around a reasonable level of 53 when data for all countries is released early next month.

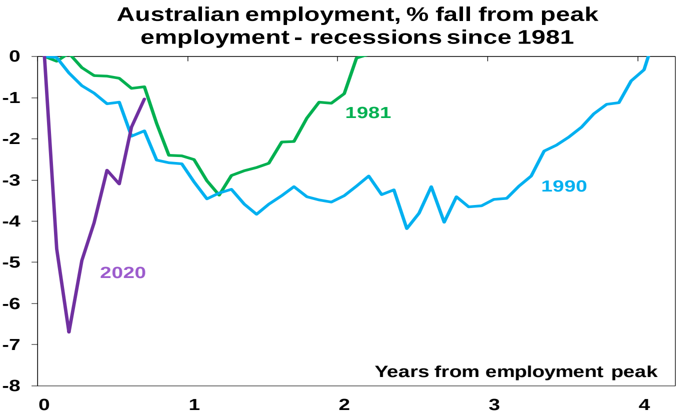


Source: Markit, AMP Capital

Chinese data continued to surprise on the upside with growth in industrial production continuing to pick up, retail sales growth catching up and investment remaining strong helped along by stimulus measures. Meanwhile house price growth remains modest but stable and unemployment fell slightly to 5.2%. Clearly the economic expansion in China is continuing.

Australian economic events and implications

Australian economic data was upbeat yet again with solid increases in business conditions PMIs (see the previous chart), new home sales and employment. The further 90,000 gain in employment in November led by Victoria's reopening means that 84% of the jobs lost earlier in the year have now been recovered, compared to only 56% in the US, and 86% of lost hours worked have been recovered. Despite a rise in participation to above its pre coronavirus level the unemployment rate has fallen to 6.8% and the effective unemployment rate which adjusted for the impact of reduced hours worked and participation has now fallen to be in line with the official unemployment rate after peaking at 14.9% in April. To be sure underemployment remains high at 9.4% as does labour underutilisation at 16.2% but at least it's been rapidly falling. A further rise in weekly payroll jobs and job ads indicates that the jobs recovery is continuing this month. Meanwhile household wealth rose to a record in the September quarter thanks to gains in house prices and shares along with high levels of saving, which in turn augurs well for future spending.



Source: Westpac/MI, AMP Capital

Reflecting the stronger than expected economic rebound in Australia along with higher iron ore prices its no surprise to see the Government revise up its growth forecasts and revise down slightly its budget deficit forecasts. The budget deficit this financial year at around 10% of GDP is huge and it will likely take more than a decade to get back to balance – but at least we have likely now seen the peak in the deficit. And were it not for all the stimulus spending the economy (and jobs) would not be recovering anywhere near as quickly and the budget deficit would be getting worse, not better!

Does all this mean a less easy RBA or even an earlier tightening than three years away? Maybe – particularly if things continue to improve at the current rate. But the odds are that the recovery will slow a bit in the months ahead, coronavirus uncertainties have plenty of potential to cause hiccups as we are now seeing in NSW, we still have a long way to go to get to full employment and we weren't even there before coronavirus and the RBA will remain under pressure to maintain easy money to match other central banks in order to put a brake on the rising $A. So a rate hike is unlikely until 2024 at the earliest and the risk remains that the RBA will extend its QE program beyond April.

What to watch over the next three weeks?

In the US, expect a slight rise in consumer confidence (due 22 Dec), a solid gain in durable goods orders but a slowing in personal spending and private final consumption deflator inflation remaining at 1.4%yoy (23 Dec), a fall back in the December manufacturing ISM index (5 Jan) and a 150,000 rise in payrolls with unemployment unchanged at 6.7% (8 Jan).

On the political front though the 5th January Senate elections in Georgia could see the Democrats get control of the Senate which could clear the way for tax hikes – but a victory in both Georgia seats still seems unlikely. Congress also convenes on 6th January to formally count and declare the election result but an upset from the Trump campaign is unlikely to succeed with Democrat control of the House and with numerous Republican senators acknowledging Biden's victory.

Eurozone economic confidence data (7 Jan) may show a slight recovery, but core inflation (also 7 Jan) will likely remain weak and unemployment (8 Jan) will likely rise slightly.

The outcome of Brexit talks will also be watched closely. Some progress looks to have been made on the sticking point around fair competition rules, with issues around fishing and governance still remaining. If a deal is not reached then the UK will have the much talked about hard Brexit at year end resulting in the imposition of tariffs, quotas and additional costs to trade between the two which would be far more negative for the UK as 43% of its exports go to the EU whereas less than 10% of EU exports go the UK. While much of the damage would be lost in the hit from coronavirus a hard Brexit could mean that UK growth in 2021 would be 2-3% lower than otherwise. The hit to Eurozone GDP would likely be much less at around -0.5%. A hard Brexit would also hit the British pound.

Japanese jobs data will be released on 25 December and industrial production data will be released 28 December.

China's business conditions PMIs (due 31 Dec and early Jan) will likely remain solid.

In Australia, expect preliminary November retail sales (22 Dec) to show a solid 2% gain as Victoria reopens, credit growth (31 Dec) to remain soft, CoreLogic home price data for December (4 Jan) to show another 0.6% gain in home prices and building approvals (7 Jan) to rise another 1%.

Outlook for investment markets

Shares are at risk of a short term correction after having ran up so hard recently and 2021 is likely to see a few rough patches along the way (much like we saw in 2010 after the recovery from the GFC), but looking through the inevitable short term noise, the combination of improving global growth helped by stimulus and vaccines and low interest rates augurs well for growth assets generally in 2021.

We are likely to see a continuing shift in performance away from investments that benefitted from the pandemic and lockdowns - like US shares, technology and health care stocks and bonds - to investments that will benefit from recovery - like resources, industrials, tourism stocks and financials.

Global shares are expected to return around 8%, but expect a rotation away from growth heavy US shares to more cyclical markets in Europe, Japan and emerging countries.

Australian shares are also likely to be relative outperformers helped by better virus control, enabling a stronger recovery in the near term, stronger stimulus, sectors like resources, industrials and financials benefitting from the rebound in growth and as investors continue to drive a search for year yield benefitting the share market as dividends are increased resulting in a 4.4% grossed up dividend yield. Expect the ASX 200 to end 2021 at a record high of around 7200.

Ultra-low yields and a capital loss from a 0.5-0.75% or so rise in yields are likely to result in negative returns from bonds.

Unlisted commercial property and infrastructure are ultimately likely to benefit from a resumption of the search for yield but the hit to space demand and hence rents from the virus will continue to weigh on near term returns.

Australian home prices are being boosted by record low mortgage rates, government home buyer incentives, income support measures and bank payment holidays but high unemployment, a stop to immigration and weak rental markets will likely weigh on inner city areas and units in Melbourne and Sydney. Outer suburbs, houses, smaller cities and regional areas will see stronger gains in 2021.

Cash and bank deposits are likely to provide very poor returns, given the ultra-low cash rate of just 0.1%.

Although the $A is vulnerable to bouts of uncertainty about coronavirus and China tensions and RBA bond buying will keep it lower than otherwise, a rising trend is still likely to around $US0.80 over the next 12 months helped by rising commodity prices and a cyclical decline in the US dollar.