

Market Update

View from the Investment Team

July 2024

Summary

Global share markets experienced mixed performance in July. Market indices returned around 1% globally, whilst some previously lagging areas of the market outperformed, including Australia. Bond markets rallied as yields and rate expectations came down.

US jobs data continues to soften, with unemployment rising to 4.3% and jobless claims also rising more than expected. The SAHM rule, a jobs-related recession indicator, has been triggered.

The US earnings season continued, with overall earnings growth likely to be around 11%, which is higher than expected at the start of the financial year.

MARKETS

Global equity markets rose by approximately 1% (in local currency terms) in July. Rotation was the key development, with previously very strong performing areas such as the Nasdaq, Japan's Nikkei, and momentum indices falling by a couple of percent, whilst defensive sectors such as utilities performed very well. Volatility as measured by the VIX index also started to rise after a period of relative calm.

Bond markets and high-quality corporate debt were beneficiaries of slower data. US investment grade bond prices gained over 3% and long-term US treasury prices gained over 5%, reflecting a strong shift toward pricing a rate easing cycle

US chair Powell noted that "a reduction in our policy rate could be on the table as soon as the next meeting in September", paving the way for rate cuts to be priced more aggressively. The number of interest rate cuts in the US priced for the rest of 2024 was around two at the start of July; this jumped to three by the end of that month then continued into August towards four.

The change in interest rate cycles also affected currencies. The Japanese Yen gained almost 7% in July, as US rate expectations fell. The gap between US and Japan 2-year bond yields moved over 0.5% in July, triggering the unwinding of many 'carry' trades that benefitted from the yield-gain between the two countries.

DATA AND EVENTS

US data continues to soften, with results generally coming in below expectations. This is not yet indicative a recession is imminent, but it is impacting forecasts. Fears have increased due to employment numbers, where initial jobless claims continued to come in above expectations, payrolls have been weaker than expected (but still positive), and the unemployment rate rose to 4.3% early August, which was above expectations of 4.1%.

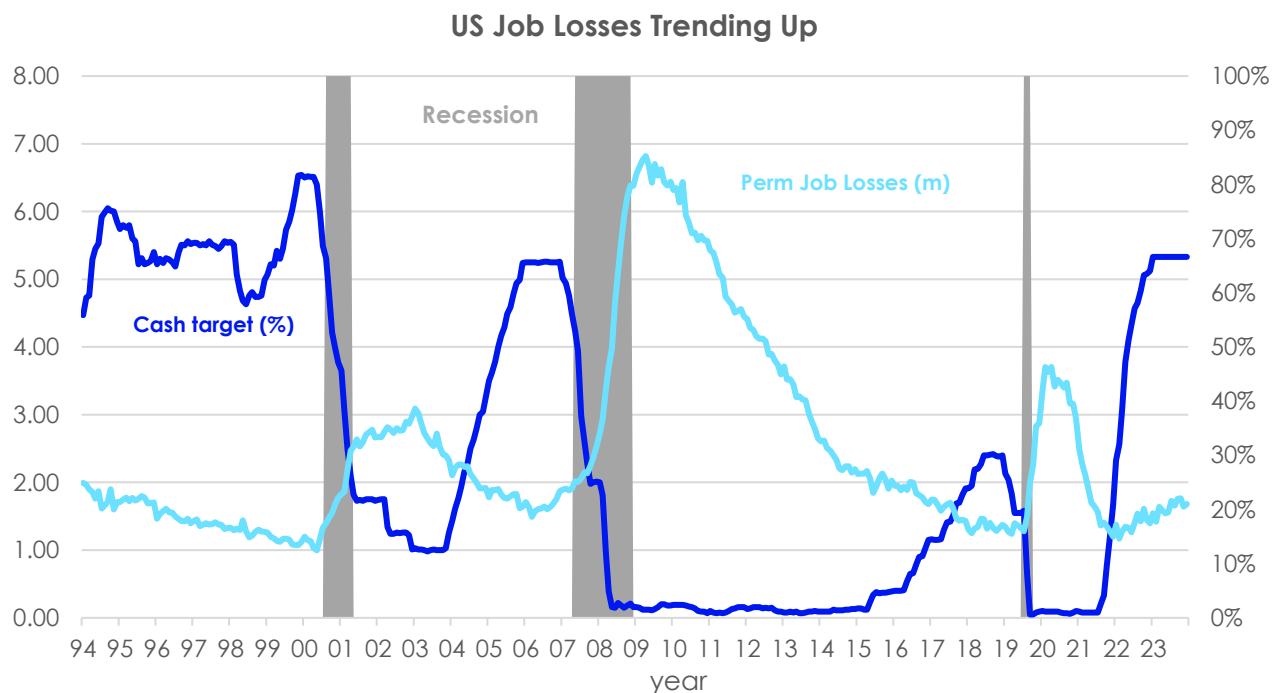
Chinese data continues to weaken. GDP growth has dropped to 4.7%, below the government's target of 5%. House prices are continuing to fall, with the 70-city new house price index down 4.5% yoy. Excess capacity continues to increase, reflecting the government's commitment to higher production. Retail sales were up 2% yoy, well below expectations of 3.7%. Chinese policies are not working.

Australia continues to experience generally weak data and stickier inflation than desired. PMI surveys (>50 equals expansion) saw manufacturing drop further to 47.4 and services weaken from 51.2 to 50.8. Our composite PMI (combination of the two) is just above 50 and weaker than the global composite of 53.

Australian inflation remains above global averages. One reason for this is the inflation basket components that are 'government influenced or indexed', such as health, utilities and education, are falling more slowly than areas that don't have those controls.

CHART OF THE MONTH

Historically, once job losses start rising, policy easing has usually started. This is not the case presently.



Source: Bloomberg

KEY THEMES

1. Earnings trends

The US market is approximately 75% through earnings season and results have been solid so far. Earnings growth expectations for the **next 12 months** remain at around 11%. Earnings growth as of 30 June (for the **last 12 months**) is expected to be around 11-12%. Earnings revisions, or the ratio between rises and falls, is positive. Concerns remain around weaker growth in sales (at around 5-6%) and the historically high level in profit margins.

Best areas of growth are in communications, technology, financials and utilities (all above 15% over the last year). Worst are in materials and industrials (all negative). Large companies are still fundamentally doing better than smaller ones.

2. Corrections and rebounds

We have observed over recent months that some areas of the market were becoming crowded and vulnerable to a pullback. These included momentum strategies (where investors buy things that have been going up), but also 'carry trades' (where investors borrow in a low yield currency like the yen and buy into a higher yielding one like the US or Australian dollar). When something goes wrong or changes, these positions often have to be sold. (In this case, US and Japanese monetary policies are changing - in opposite directions). As a result (typically):

- A. Investors are forced out of trades to stem losses, as the buy signal (prices rising) has gone. If levered, they may have to sell other things to pay for losses.
- B. This tends to overwhelm market liquidity, as everyone is doing the same thing, and market makers widen spreads when volatility goes up.
- C. Other investors must sell as volatility is rising, as they have risk triggers that require them to reduce exposure when this occurs.

This creates a feedback loop that eventually runs its course, and that can have additional steps depending on how many are forced to sell and who wants to take the other side. Typically, when there is a large (e.g. 10%) correction, there has been a relief rally before a retest of the low and then a recovery. A key question to follow is 'what if there is a recession?'. This is a different question; and one where the odds just rose slightly.

3. US employment and recession

The US Federal Reserve (Fed) requires two things to cut or normalise interest rates: 1) lower inflation and 2) a rebalanced employment market. If the employment market were to deteriorate quickly, then the Fed would cut faster. Given that tighter policy works with a variable lag, waiting for both conditions to be met means there is always a risk of overcooking it. At present the Fed has been patient, as they want to be sure that inflation is tamed. If they can achieve the inflation goal without a recession, they will have achieved a 'soft landing'. The challenge, of course, is the downward momentum from tight policy remains even when inflation has reached its target. If employment is falling, then policy must be eased ahead of time to stop any downward momentum.

Unemployment in the US has been trickling upward for a few months. The *Chart of the Month* shows permanent worker job-losses, along with recession indicators and Fed cash rate levels. Typically, when job losses are growing a recession is on its way and rates are already being cut. Today, cash rates are unchanged and likely to remain so until at least September's Fed meeting (unless things really deteriorate). We believe any weakening in jobs is likely to have gained momentum by then (hence indicators like the SAHM rule being triggered), and policy is likely to come down faster and harder than what appears likely now. In our view, this makes bonds ultimately defensive again and, given higher yields, an important part of a balanced portfolio.

4. Housing prices

House prices and house building are always important drivers in an economy. Australia clearly has a housing affordability problem (depending on your circumstances), that has been exacerbated by high recent population growth, high building costs and government policies. The issue however extends further back and is, at its simplest level, largely due to a lack of construction.

Over the last 15 years, Australia has developed a shortfall of approximately 200,000 houses that would be required to satisfy current demand. That problem requires concrete building programs by the states, which is currently not the case. It also won't be addressed by first home buyer grants, or other support measures.

The challenge of demand and supply is not uniform, however. It varies across the states and is cumulatively the worst in Queensland and NSW, whilst Victoria is the only state with clear oversupply. Migration from NSW to Queensland will help shift the burden to Queensland, but not address the overall problem.

Undersupply means higher prices and high rents. Lower population growth may alleviate some of this imbalance - but only some, whilst lower eventual interest rates will probably create more price pressures in key undersupplied markets.

5. Is AI a good investment?

We have noted how large investment levels into AI models have been, with this having large benefits for the winners (like Nvidia). An important question of course, is what are the products that use all this AI infrastructure? If Nvidia's revenue from chips and data centre's is in the order of \$150b by 2025, the data centre's cost twice this to build and run, and the owners require a margin on top of that, we can get to numbers north of \$500b required in sales for AI products or applications **per annum**. Open AI currently has around a few billion in revenue. Even if all the tech majors generate more than this and collectively got to \$100b, there is still a large hole to fill.

In addition, new Nvidia chips are in the pipeline (not mentioning other potential providers). New technology like AI is exciting, but there will be some big winners and losers as it develops.

MARKET RETURN SUMMARY

Asset class (% change)	1 month %	3 months %	1 year %	3 years (% p.a.)
Australian shares	4.2	6.2	13.5	7.4
Smaller companies	3.5	2.0	9.3	-0.6
International shares UH	4.1	7.9	22.7	11.2
International shares H	1.2	7.7	18.3	6.8
Emerging markets UH	2.6	4.3	9.7	1.2
Property – Australian listed	6.8	9.3	28.3	8.0
Property – global listed	5.7	10.3	6.1	-4.5
Infrastructure - global listed	6.7	9.1	8.1	3.0
Australian fixed interest	1.5	2.7	4.7	-2.2
International fixed interest	1.9	3.5	4.7	-2.5

Source: Bloomberg. Returns are shown on a total return basis as at 31 July 2024. Past performance is not a reliable indicator of future performance.

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