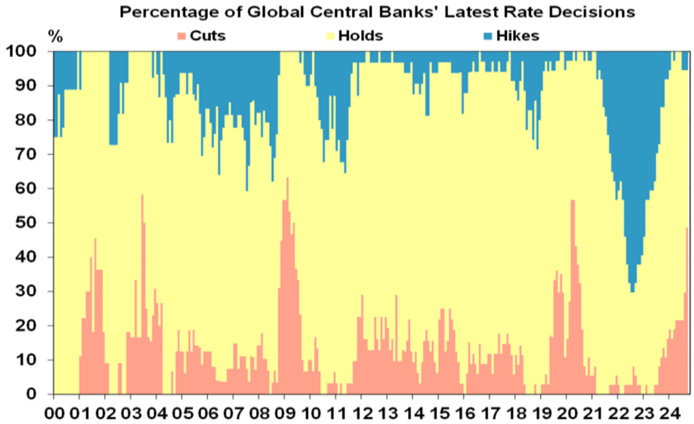
WEEKLY MARKET UPDATE

27 SEPTEMBER 2024

Investment markets and key developments

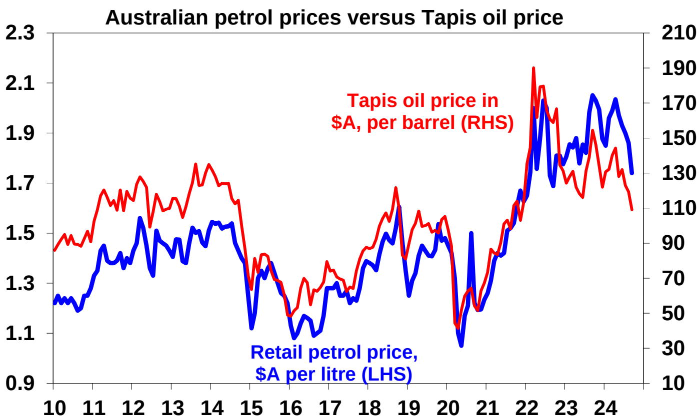
Global share markets rose again over the last week on expectations for a continuation of a "goldilocks" macro outlook on the back of central bank rate cuts reinforced by news of aggressive Chinese policy stimulus. This saw US and global shares make new record highs and Chinese shares surge around 15.7%. For the week US shares rose 0.6%, Eurozone shares rose 3.6% and Japanese shares rose 5.6%. Australian shares made it to a new record high above 8200 but rose less than 0.1% for the week with a 9% surge in mining shares on the back of Chinese stimulus measures offset by a correction in bank shares after their strong run. Bond yields were mixed with slight increases in the US, UK, Japan and Australia but falls in Europe. Despite an escalation in the Israel/Hezbollah conflict oil prices fell with Saudi Arabia set to increase production and Libyan production returning. Consistent with the "risk on" sentiment, metal prices surged higher, the iron ore price rose, the $A rose to $0.69 and the $US fell.

The risk of a near term pullback remains high for shares, but increasing policy stimulus globally as we move into a more positive seasonal period for shares is very supportive. The risk of another correction in shares remains high given: stretched valuations; optimistic investor sentiment; the still high risk of recession in the US and Australia; and geopolitical risk around the US election (if Trump looks like winning or their looks like being a Democrat clean sweep) and in the Middle East with the expansion of the Israel/Gaza war to Hezbollah. However, the success in getting global inflation down, ramping up central bank policy stimulus (with nearly 50% of global central banks now cutting rates and the RBA getting closer to joining in) and China seemingly moving to "whatever it takes" policy stimulus are all very positive for shares on a 6-12 month horizon particularly if we continue to avoid recession. We are also now coming into a positive time of the year for shares from a seasonal perspective after they performed surprisingly well through the normally weak months of August and September.



Source: Bloomberg, AMP

Oil prices sliding = lower petrol prices. While the expanding war around Israel is a big worry, the key from an investment perspective is whether global oil supplies are impacted (say if Iran which accounts for around 3% of liquid global fuel production is directly drawn in) and so far this has not happened. In the meantime, Saudi Arabia is moving to increase production in December, Libyan oil production (1% of global supply) is set to resume, non OPEC production is rising and demand growth has been cooling. So oil prices have been trending below $US70 a barrel. If sustained this is positive for growth and inflation. And it means that petrol prices in Australia may continue to trend down (abstracting from the weekly/monthly cycles in each city – which eg has just turned up again in Sydney). There is a close relationship between the Asian Tapis oil price in Australian dollars and average petrol prices – and both are trending down.

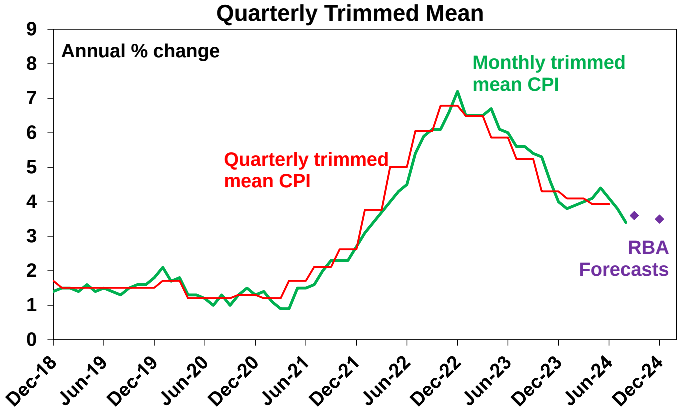


Source: Bloomberg, AMP

RBA on hold and still hawkish but pivoting to be a bit less so – at least it didn't consider another rate hike! As widely expected, the RBA left rates on hold at 4.35% and its post meeting statement continued to lean hawkish with warnings about too high inflation, excess demand, low productivity and a still tight labour market. However, while Governor Bullock repeated that "in the near term [the RBA] does not see interest rate cuts" there was a step in a dovish direction with the Board not explicitly considering a rate hike after months of considering one, against the background of still "not ruling anything in or or out" which means that despite the guidance against cutting in the near term it may still do so if circumstances warrant!

In this regard, Australian inflation data for August provided good news. Not so much because electricity rebates pushed headline inflation down to 2.7%yoy, to be back in the target range for the first time in three years, which the RBA regards as temporary. But because underlying inflation measures – which the RBA focusses on - all fell. Excluding the electricity rebates inflation fell to around 3.1%yoy from 3.5%, inflation excluding volatile items fell to 3%yoy from 3.7% and trimmed mean inflation fell to 3.4%yoy from 3.8%. And the annualised rate of trimmed mean inflation over the last three months fell to 2.8%, way down from 6.4% in the three months to May. Sure, the Monthly CPI needs to be treated with caution, but further falls in underlying inflation provide confidence that disinflation has resumed after stalling earlier this year. In fact, the trimmed mean is now tracking slightly below RBA forecasts.

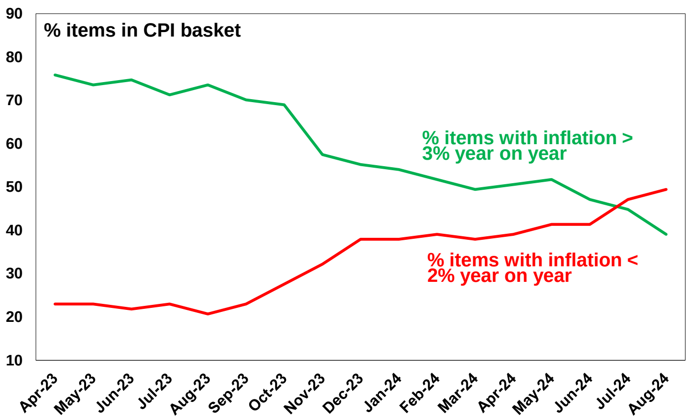
Monthly Trimmed Mean CPI Indicator versus Quarterly Trimmed Mean



Source: ABS, AMP

Consistent with this there are now more CPI basket items with inflation less than 2%yoy than there are with inflation above 3%yoy.

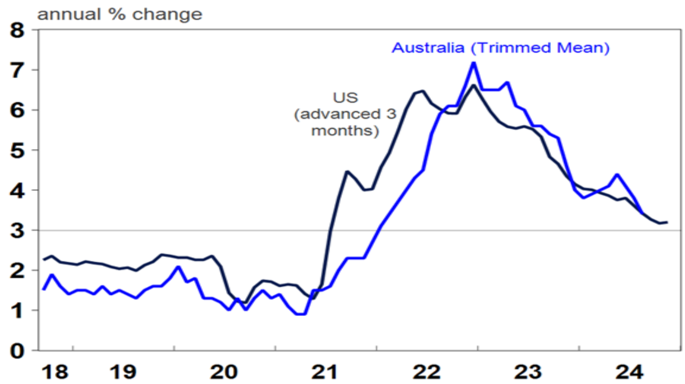
Australia Monthly CPI Breadth



Source: ABS, AMP

Australian inflation continues to look like it's just "lagging" the US and not "different", ie, more sticky, as some have claimed. As can be seen in the next chart trimmed mean inflation in Australia is just following US core inflation down with a 3-month lag. Maybe all the inflation angst in Australia over the last few months has been much ado about nothing.

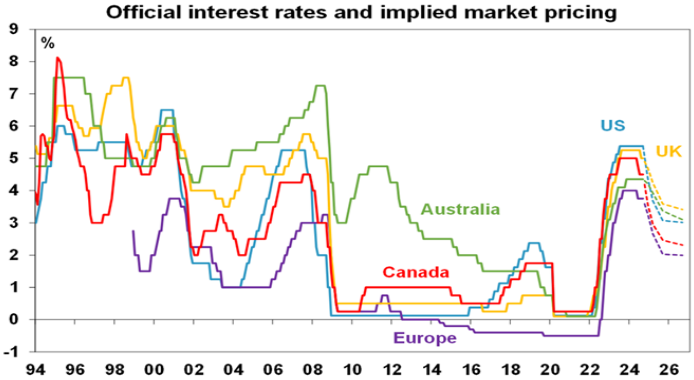
Australia and US Core Inflation



Source: Macrobond, AMP

The resumption of the downswing in underlying inflation provides confidence that rate cuts are getting closer. Our base case is that the RBA won't cut until its seen lower underlying inflation in both the September and December quarters and so won't start cutting until February next year. However, with inflation starting to follow a similar profile to that seen in the US – which led it to pivot to a 0.5% rate cut in September – a similar pivot in Australia is a high risk resulting in a December cut if underlying inflation continues to fall as it did in August. We remain of the view that while the RBA won't automatically follow other central banks in cutting, easing global inflation pressures are good news for Australian inflation and so the rate cuts now underway in other central banks including the Fed are a pointer of things to come in Australia.

Official interest rates and implied market pricing



Source: Bloomberg, AMP

The Government should ditch the proposal to split the RBA Board. There has been much angst around this reform over the last few weeks with the RBA becoming a bit of a political football and the Green's demanding rate cuts before supporting the reform which would severely dent the RBA's credibility. However, the reality is that there is no evidence that the RBA Review's proposal to set up a separate interest rate setting board will lead to better outcomes or that its world's best practice, but it could reduce RBA accountability (as egotistical external economists could outvote the RBA) and create confusion. The reform is not critical to success of the RBA going forward and the best approach is to simply forget about it and work in a bi-partisan way to improve the process of selecting members for the current board.

Here we go again – with the Government considering changes to negative gearing and the capital gains tax discount. This and the deflection of blame to the RBA for the slump in economic growth is a clear sign we are getting close to the next election! The case for curtailing these tax concessions is that:

- it would provide a budget boost (eg negative gearing cost the budget $2.7bn in 2020-21 and likely much more now with higher mortgage rates and the capital gains tax discount looks to have cost it $9.3bn although that relates to all assets);
- the concessions benefit mainly the rich in terms of dollar value;

- reducing the tax benefit to investors may lower house prices;
- it could be seen as doing something about poor housing affordability; and
- some take excessive advantage of negative gearing with multiple properties and the capital gains tax discount is very generous.

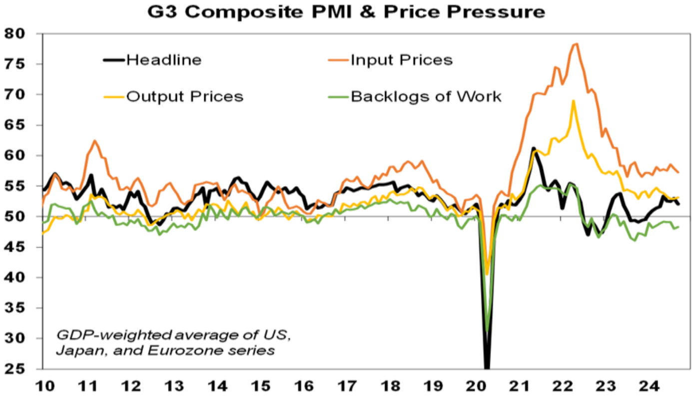
Against this though:

- the ability to offset the cost of an investment (including interest costs) against its income & set that against other income for tax purposes is a fundamental and sensible aspect of our tax system;
- the concessions mainly benefit the rich because they pay more tax, but the Australian tax system is already very progressive (with the top 10% paying nearly 50% of the income tax revenue going to Canberra) and over 2 million taxpayers have an investment property and most of these are ordinary income earners;
- reducing the after-tax return for investors may lower house prices in the near term as investor demand falls but will likely boost them over the long term as less investors will mean less rental property supply putting upwards pressure on rents and prices;
- these tax concessions are only a tiny fraction if any of the reason we have expensive housing in Australia with the shortfall in the supply of housing relative to underlying demand from population growth being the main driver, eg given the surge in population over the last year we should have built around 250,000 new homes but only managed around 170,000. Fixing this ongoing imbalance (with more homes and lower immigration) is the main issue with debate about tax concessions just a sideshow.
- Yes there is a case to curtail excessive use of negative gearing (eg to reduce the number of properties or the dollar value an investor can claim a tax loss for) and the capital gains tax discount should be reduced (as it's a major distortion in the tax system) but any changes should occur as part of an overall tax reform to lower marginal income tax rates otherwise it will just result in an even more progressive tax system which will reduce incentive to work.

See here for a broader assessment of the problems with our tax system and issues around tax concessions.

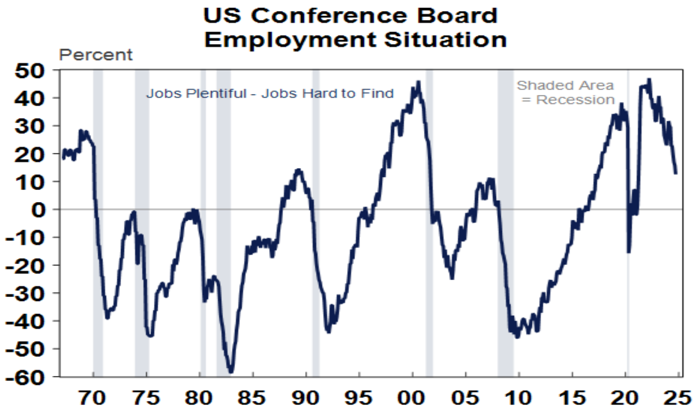
Major global economic events and implications

Business conditions PMIs for September 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 Europe, the UK and Australia with manufacturing weakening further including in the US, but remain okay thanks to services. The weakness in manufacturing is worth keeping an eye on though as it may lead to weaker services. Input prices remain elevated, but output prices remain near their pre-covid range and order backlogs continue to fall.



Source: Bloomberg, AMP

The US PMI for September remained solid, except in manufacturing and saw price components rise but output prices remaining around their pre-covid range. Other US economic data released over the last week was mixed, consistent with still okay growth. Consumer confidence fell in September with a further deterioration in labour market perceptions (jobs plentiful less jobs hard to find – see the chart below), home price growth continues to slow and new home sales fell and underlying capital goods orders remain flattish. Against this, personal income and spending saw modest growth in August, jobless claims remain low, mortgage refinancing is on the rise as lower mortgage rates feed though which will boost homebuilding and the Atlanta Fed's GDPNow estimate of current quarter GDP growth suggests growth is tracking around 3.1%. Meanwhile, core final PCE inflation came in slightly weaker than expected in August at 0.13%mom/2.68%yoy leaving the Fed on track to cut again in November and possibly by another 0.5%.



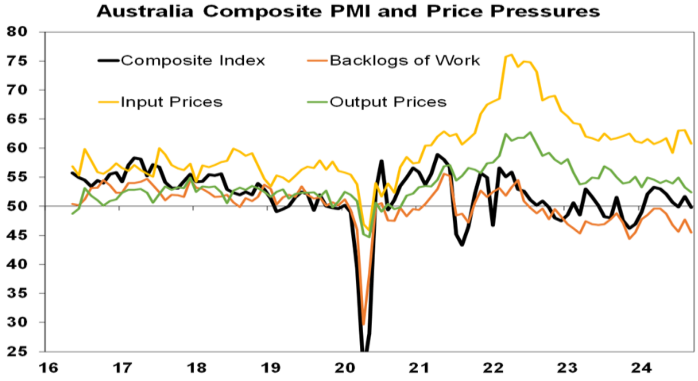
Source: Macrobond, AMP

Along with weakness in European PMIs, Germany's IFO business conditions index weakened further in September. And the Swedish and Swiss central banks both cut interest rates by another 0.25% and signalled likely more cuts ahead, with the possibility of a 0.5% cut before year end in Sweden. Softer than expected September inflation data in France and Spain point to another ECB rate cut next month and possibly by 0.5%.

China steps up monetary stimulus, with ramped up fiscal stimulus on the way. The PBOC announced a long list of measures to ease monetary policy including: a 0.5% cut to bank reserve ratios, modest cuts to its key policy interest rates, a 0.5% cut to outstanding mortgage rates, a cut to the minimum downpayment on 2nd homes to 15% from 25% and allowing funds and brokers to tap PBOC funds to buy shares. These moves are welcome and show the Government wants to boost growth. But the danger is that on their own they are akin to pushing on string with the cost of money already low and the key problem being the lack of demand for money. To address this fiscal stimulus is needed to boost consumer spending and directly support the property market. And this now appears to be on the way with an announcement of cash handouts to those in extreme poverty and a surprise Politburo meeting committing to increased counter-cyclical fiscal policies, necessary levels of fiscal spending and measures to halt the decline in the property sector. **This shift from cautious incremental stimulus towards "whatever it takes" is significant and very positive for cyclical assets like resources shares along with the very undervalued Chinese share market**. Whether it extends beyond providing a cyclical boost to growth and inflation to addressing China's structural problems which will require measures to clear the property overhang, put local government financing on a firmer footing and permanently boost the level of consumer spending remains to be seen.

Australian economic events and implications

Australian business conditions PMIs for September weakened again. Input and output prices fell particularly for services and work backlogs remain weak, all of which is a good sign for the RBA.



Source: Bloomberg, AMP

Australian job vacancies continue to fall, pointing to weaker jobs growth ahead. They fell 5.2% in the three months to August, have fallen for nine quarters in a row and are down 30% from their high. While they are still high the trend is likely to remain down, pointing to slower jobs growth. Its also worth noting that job vacancies as measured by Seek and ANZ/Indeed have seen similar falls but are at much lower pre-Covid levels.

Source: ABS, AMP

Australian net household wealth rose 1.5%qoq in the June quarter largely on the back of higher property prices taking it to $16.5bn. Over the last year it rose 9.3%yoy or $1.4trn. This is clearly one source of support for consumer spending.

The RBA's semi-annual Financial Stability Assessment provided a relatively benign assessment of households with arrears up but still low, the estimated share of variable rate borrowers with expenses greater than their income stabilising around 5% and set to fall going forward if cash rates fall and RBA forecasts are correct. It also seemed relatively relaxed around businesses and the banks. Some may see this as no constraint to another rate hike but note that the RBA's relatively benign view regarding households is contingent on market forecasts for rate cuts and in any case, rates will be determined by the outlook for inflation which as noted earlier is improving.

What to watch over the next week?

In the US, the focus will be back on jobs data (Friday) with September payroll growth likely to show another subdued gain of around 140,000, unemployment remaining at 4.2% and average hourly wages growth likely to slow to 3.7%yoy. After the soft August PCE inflation data, the coming week's jobs data will be important in determining whether we see another 0.5% cut from the Fed in November. In terms of other data expect a slight improvement in the manufacturing conditions ISM for September (Tuesday) to a still soft 47.6 and the services conditions ISM (Thursday) to remain around a subdued but okay 51.5. August job openings and quits (Tuesday) are likely to remain weak. Fed Chair Powell will speak Monday.

Eurozone inflation data for September (Tuesday) is likely to fall to 2.1%yoy with August unemployment Wednesday) unchanged at 6.4%.

Japanese data for jobs, industrial production and the September quarter Tankan survey will be released on Tuesday.

China's business conditions PMIs for September will be released Monday and are likely to remain soft.

In Australia, August private credit growth (Monday) is likely to remain moderate, CoreLogic data is likely to show continuing moderate home price growth of around 0.5% mom in September (Tuesday), August building approvals are likely to fall 7%mom with retail sales up 0.4%mom (both Tuesday), the trade surplus for August (Thursday) is likely to fall slightly to around $5.5bn and housing finance data for August (Friday) is likely to show a 1% rise.

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 US election, the next 12 months are likely to be more constrained and rougher compared to 2023-24.

A recession is the main threat for shares, but its now looking like our 8100 year-end target for the ASX 200 is too conservative.

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 12 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 is the main downside risk.