

ECONOMICS & MARKETS

Market Update 24 June 2022

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By Dr Shane Oliver

Head of Investment Strategy and Economics and Chief Economist, AMP Sydney, Australia.

Investment markets & key developments

Share markets managed to stabilise and, in most major markets, bounce from oversold levels over the last week as there were no new hawkish surprises from central banks and weak economic data saw bond yields fall taking pressure of share market valuations despite increasing worries about recession. For the week (to date) US shares are up just over 3% and Australian shares rose by just over 1% led by IT, property and health stocks. Growth downturn fears pushed bond yields down (with 10-year yields down 0.4% and 0.5% from their recent highs in the US and Australia respectively) and also drove oil, metal and iron ore prices lower. The \$A remained around \$US0.69 as the \$US fell slightly.

After 10% plus falls over the previous two weeks shares were due for a bounce which we saw in the last week. Increasing signs of capitulation in the last few weeks – with indiscriminate selling of shares are a positive sign in terms of capitulation - and the bounce may have further to go. But it's still hard to be confident from a technical perspective that we have seen the bottom – both put/call option ratios and VIX have yet to reach extremes seen at past major bottoms.

And the macro story remains the same with more higher inflation readings in the past week (in the UK where it rose to 9.1%yoy and in Canada where it rose to 7.7%), more hawkish comments from central banks (the Fed, ECB and RBA and a 0.5% rate hike in Norway) and ongoing fears of recession. **We remain of the view that a global recession can be avoided but with central banks hiking rates aggressively the risks have increased to the point that its now a close call.** This is reflected in the breakdown in the growth sensitive copper price and the Korean share market (often referred to Dr Copper and Dr Kospi). And if a recession eventuates shares likely have more downside, because so far the falls in markets mainly reflect a valuation adjustment (ie lower PE's) in

response to higher bond yields. Either way – given the uncertainties it's still too early to say that shares have bottomed.

The Fed remains hawkish – but maybe a bit less so than markets had been allowing for. While Fed Chair Powell's Congressional testimony reiterated the Fed's commitment to bring inflation down, it did not signal a further leg up in hawkishness from what markets were already expecting. That said he did note that achieving a soft landing will be “very challenging” and recession is “certainly a possibility”. This along with falls in US business conditions PMIs saw market expectations for the Fed Funds rate at year end wound back by around 0.25% to 3.45%.

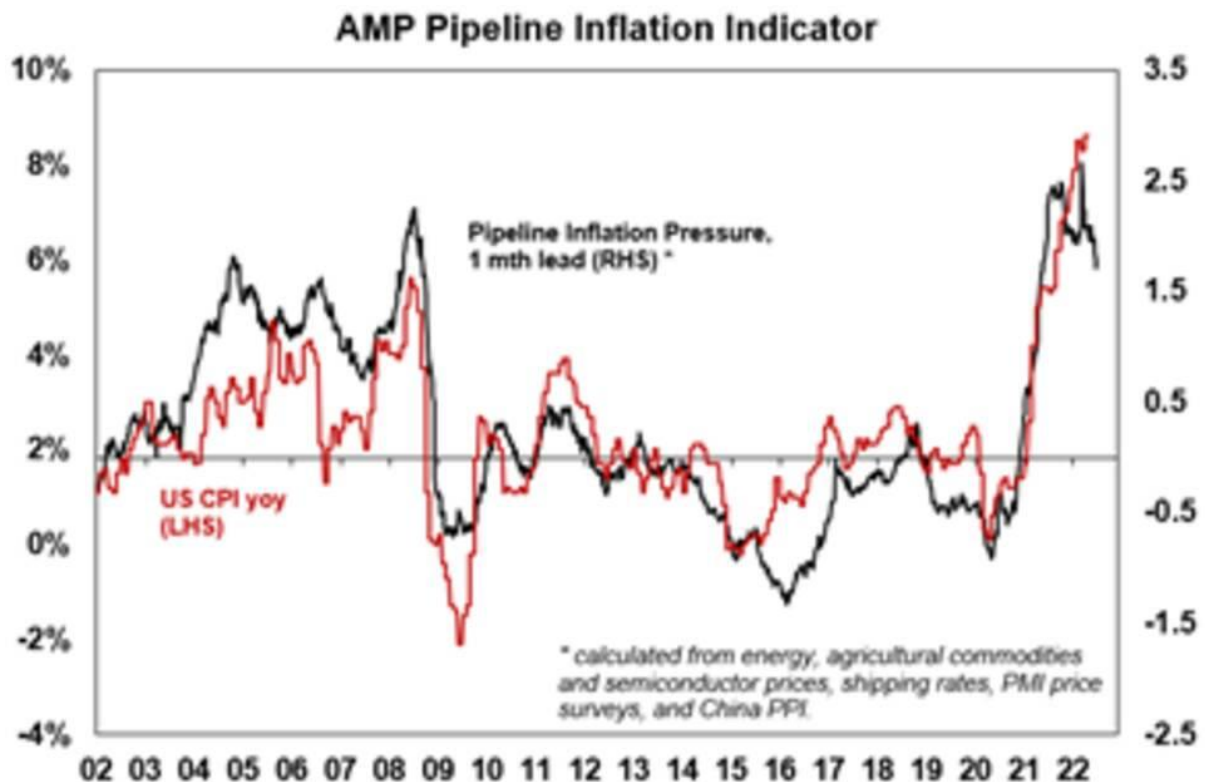
The RBA is also hawkish - but like the Fed was a bit less hawkish than many perceived to be the case. The key messages from Governor Lowe were that: the RBA will do what is necessary to return inflation to target but is not seeking to do so immediately; it is very focussed on keeping inflation expectations down (and hence wants to see wages growth with a 3 in front of it, but not a 5); more rate hikes are on the way; it does not see a recession; and is not on a pre-set path but will be guided by data. The overall impression was bit less hawkish than some might have been expecting – particularly with: Lowe indicating that a hike of 0.25% or 0.5% (and not 0.75%) is on the table for July; the comment in the minutes that implied that the RBA can move by less than other central banks at each meeting because it meets more frequently; and Lowe's push back against hawkish money market expectations for the cash rate to rise to above 4% over the next year. Governor Lowe's dismissal of the risk of a recession should be taken with a grain of salt - he would say that and its hard to deny that falling real incomes and rate hikes have not significantly increased the risk of recession – and the money market has given a better lead on rate hikes than the RBA has. However, **our assessment remains that the next hike will be 0.5%, the cash rate will “only” rise to 2.1% by year end and will peak around 2.6% in the first half next year.**

While money market expectations for the RBA cash rate have fallen sharply over the last week (from 3.86% for year end to 3.22%) over the last week in response Lowe's comments and recession fears, at 3.9% in a year's time they still look too high. Taking cash rates to around 3.9% will mean variable mortgage rates of 7.5% or so and more than a doubling of household interest payments which would push house prices down by 20-30% and knock the economy into recession given cost of living pressures hitting at the same time. Very weak consumer confidence and slowing credit and debit card transactions as reported by various banks so far this month suggest that

consumer spending is starting to slow significantly already. Which all means that the scale of interest rate hikes expected by the money market is unlikely to happen.

Maybe it sounds perverse – but the best outcome for share markets would be if economic data starts to slow sharply now. This would take pressure off inflation and enable central banks to ease up on tightening before driving a recession. And on this front the cooling evident in global business conditions PMIs over the last week (see below) is a positive sign.

As is the continuing decline in our Pipeline Inflation Indicator. Business survey components relating to prices, work backlogs and delivery times are continuing to show signs of improvement. Shipping and cargo costs look to have peaked. And the recent pullback in oil prices – which are now down 10% from their high early this month helps support the idea that inflation may have peaked. Of course, its still too early get too confident on this front given the ongoing risks around Ukraine – with Russian gas being increasingly cut off to Europe and Russia threatening Lithuania over its enforcement of a blockade of EU goods into Kaliningrad. And the process of inflation peaking can always be messy and drawn out.



The Inflation Pipeline Indicator is based on commodity prices, shipping rates and PMI price components. Source: Macrobond, AMP

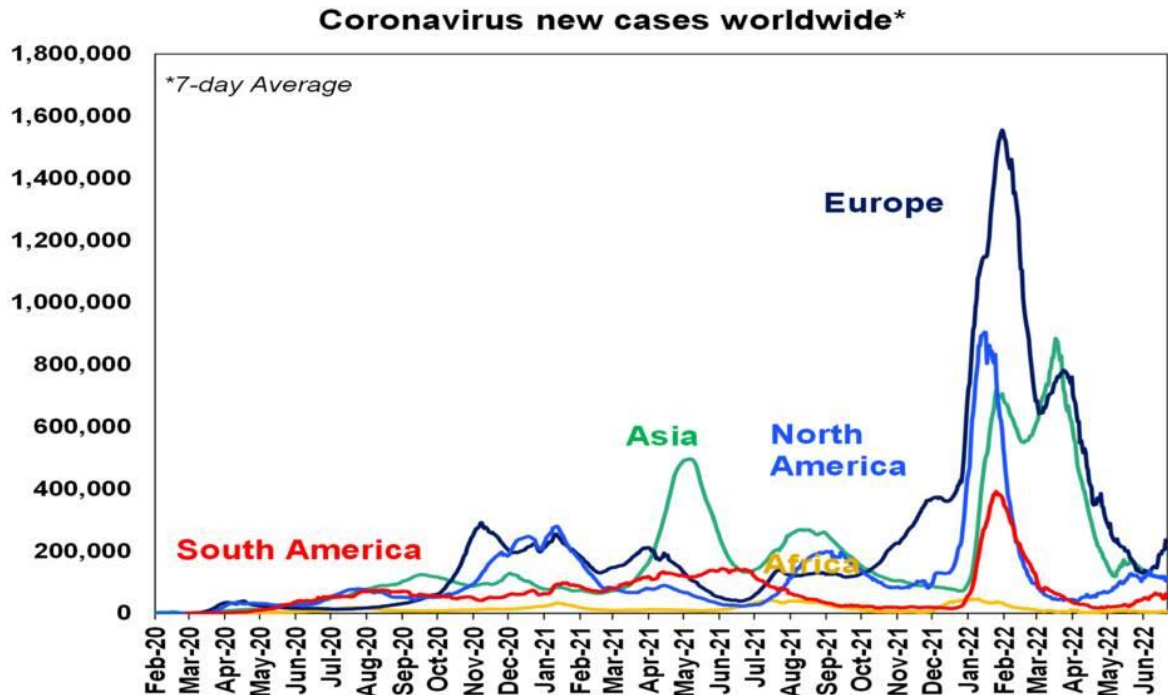
The RBA's review of its aborted yield target (which targeted 0.25% initially and then 0.1% for the 3-year bond yield) provided few surprises. Yes, it helped lower funding costs and head off the worst-case downside risks at the height of the pandemic lockdowns. But it contributed to the RBA's forward guidance ('no rate hike expected to 2024') debacle and so caused reputational damage in money markets and in the wider community. Its hard to see the RBA going down that path again.

NSW starts stamp duty reform, but it is disappointingly narrow and so far looks like yet another flawed demand side "solution" to housing affordability. The good news is NSW that is finally giving some buyers the option of paying stamp duty or an annual land tax from January next year so this is a great move in the direction of a long needed reform. The bad news is that it only applies to first home buyers on properties worth less than \$1.5million. As such it brings forward first home buyer demand without boosting sales by downsizers and so runs the risk of simply boosting demand and resulting in higher than otherwise prices in the sub \$1.5million section of the market. The barrier to more fundamental stamp duty reform is that stamp duty accounts for something like 20% of NSW government revenue. The baby step comes as NSW introduced another demand side measure with a shared equity housing scheme for essential workers. Demand side schemes may be popular, but they just make the housing affordability problem worse. Rising interest rates will be the dominant driver of NSW property prices over the next 18 months and so we continue to expect a 15% fall in prices with the risk that it may be greater. The extra demand side measures announced by the NSW Government may help place a fall under property prices and will mean higher than other prices over the long term though.

Two head kandy music classics. Having a catchy tune stuck in your head at times of stress – maybe due to the turmoil being seen in investment markets – is a bit like meditation or chanting in helping to quiet the brain. Here are two of my favourites at moment. Nick Lowe's [Cruel To Be Kind](#) some reason popped into my U Tube "feed" recently and its been stuck in my head ever since. And The New Radicals [You Get What You Give](#) is one of the best feel-good songs. This one never fails to uplift – "don't give up you got a reason to live". I wouldn't mind going to Staten Island Mall just to imagine I was there for the video.

Coronavirus update

New global Covid cases remain low but edged up a bit further over the last week with a further increase in Europe. New deaths globally are continuing to trend down.

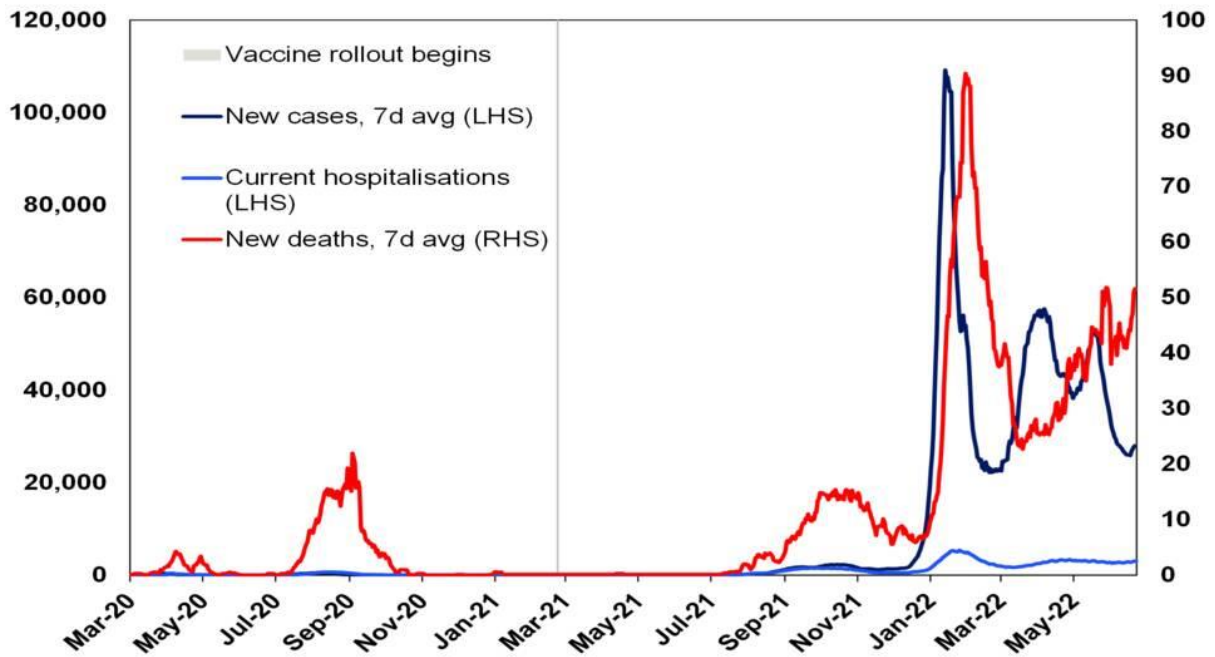


Source: ourworldindata.org, AMP

New cases are remaining low in China – which given its zero covid policy and the absence of more effective vaccines has pushed down a path of mass regular testing/isolating to hopefully avoid lockdowns – time will tell but the risk of lock downs remains high given the high transmissibility of Omicron.

New covid cases appear to be edging up again in Australia. While the rate of deaths with covid (deaths/cases) remains low compared to earlier last year we are still seeing around 50 deaths a day with covid. Booster shots – which are important in terms of protecting against serious illness from Omicron - appear to be stalling at around 54% of the population. This is something to watch as the more transmissible Omicron BA4 and BA5 variants come to dominate in the months ahead against which prior Omicron variant exposure offers little protection against infection. Fortunately, South Africa's experience with BA4 and BA5 in April/May augurs well.

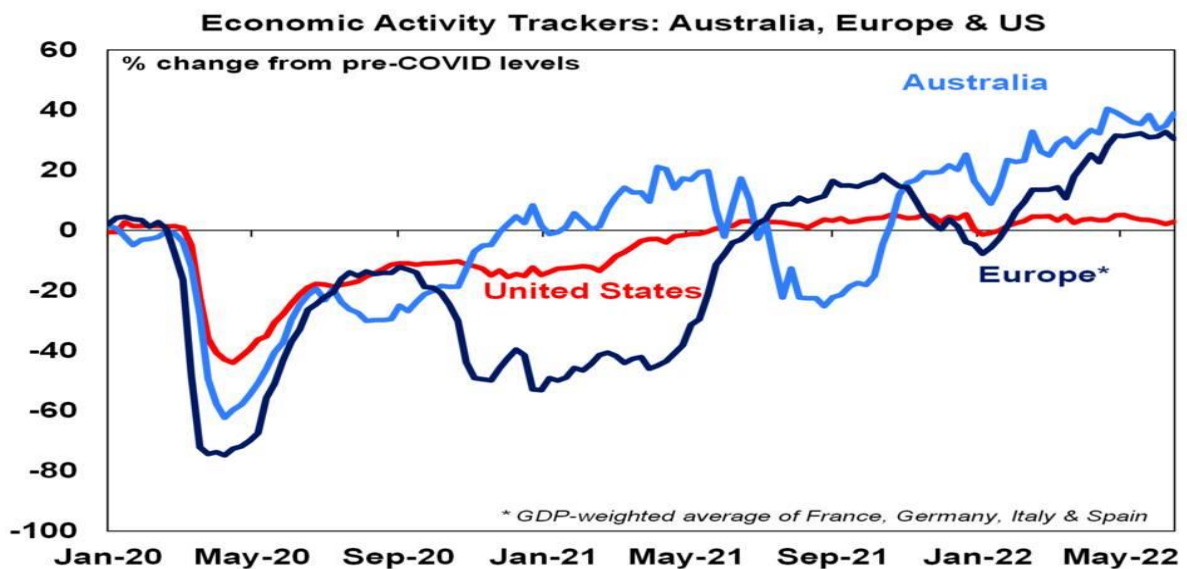
Australia COVID-19: Cases, Deaths & Hospitalisations



Source: ourworldindata.org, AMP

Economic activity trackers

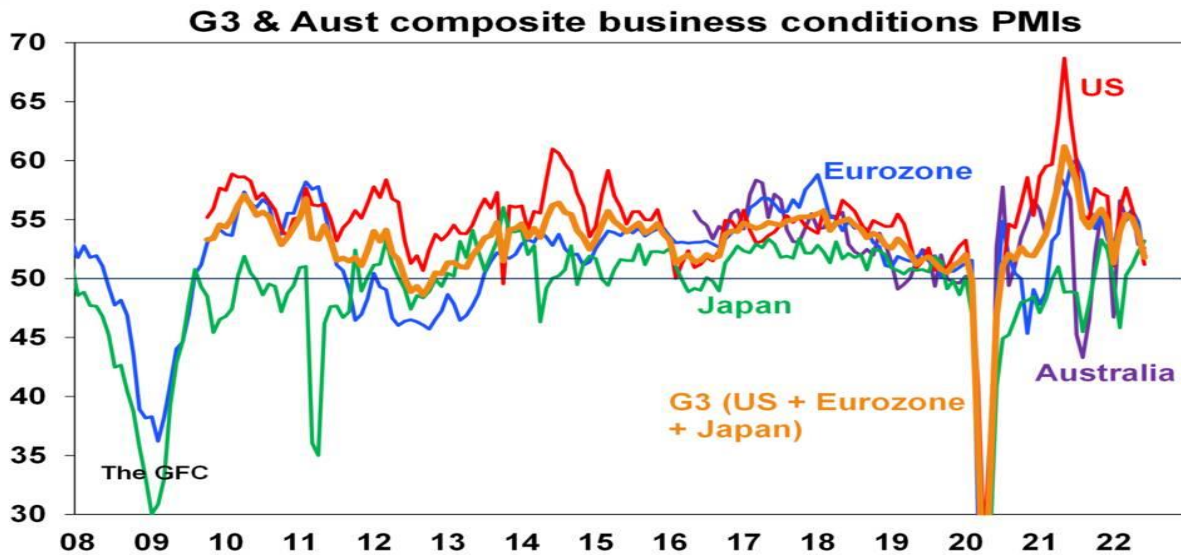
Our Australian Economic Activity Tracker rose again over the last week with transactions and mobility down but restaurant and hotel booking and shopper traffic up. It remains strong but looks like it may have peaked. Our US Tracker rose slightly but that for Europe fell. All are yet to show indications of recession.



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

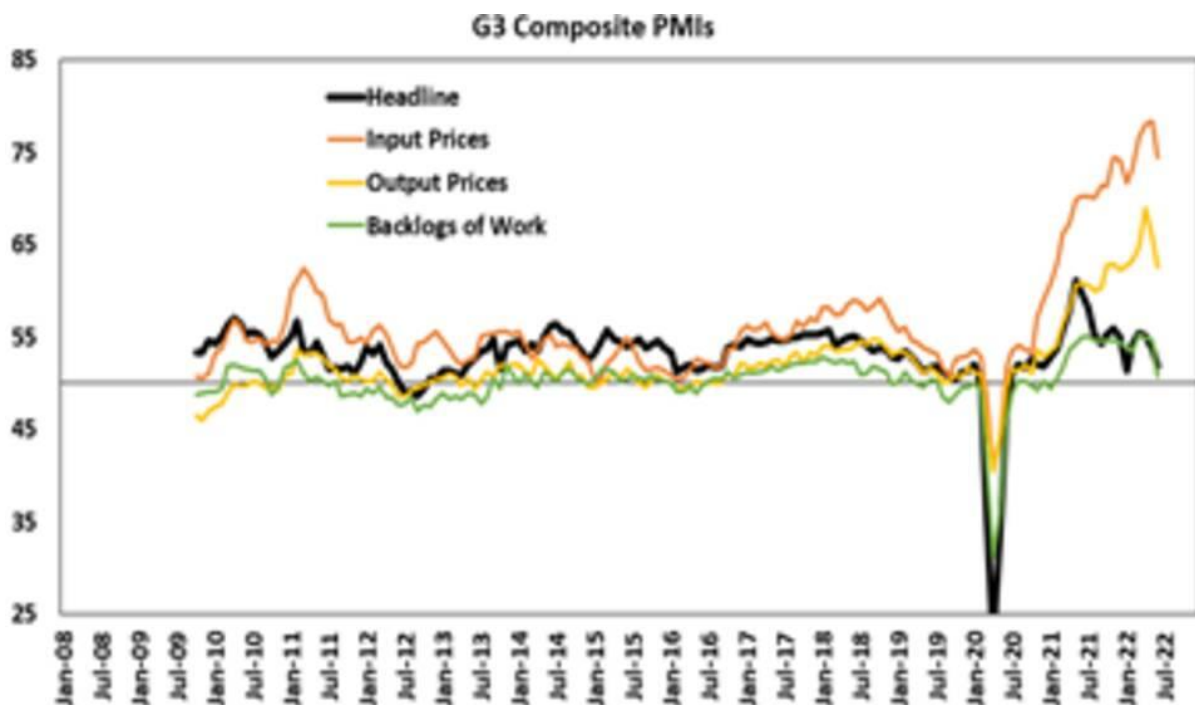
Major global economic events and implications

Business conditions PMIs fell further on average in developed countries in June. While Japan saw a rise and the UK was unchanged, they fell in Europe and the US taking the G3 (US, Europe and Japan) average composite back to around levels seen earlier this year, with the falling trend adding to concerns about recession.



Source: Markit, Bloomberg, AMP

At least price pressures appear on average in developed countries to be easing with input and output price components in the G3 continuing to fall (albeit from very high levels), work backlogs falling and delivery times falling all pointing to some easing in inflation ahead.



Source: Markit, Bloomberg, AMP

Apart from the further fall in the US PMI other US economic data was mixed with a fall in home sales but a slight fall in jobless claims (albeit the trend remains up).

UK and Canadian CPI inflation rose further in May to 9.1%yoy and 7.7%yoy, pointing to ongoing rate hikes in both countries.

Eurozone consumer confidence in June fell to near the levels seen in the early months of the pandemic.

Japanese CPI inflation was unchanged at 2.5%yoy in May with core remaining weak at 0.8%yoy, which explains why the BoJ has still not moved to start monetary tightening.

French President Macron lost his lower house parliament majority (with his LREM party and allies obtaining 246 seats out of 577). In terms of governing and his reform agenda it's likely he will be able to find some common ground with the centre-right Republicans (who took 64 seats). The impact of the result in forcing Macron into consensus building may be a good thing for Macron serving to erode his arrogant image. And in terms of fears about rising populism it's worth noting that more than two thirds of the seats went to centrist parties.

Australian economic events and implications

Australian business conditions PMIs edged down in June to still okay levels as noted above with weaker services and slightly stronger manufacturing. Price pressures remained high but slowed with improvement in backlogs and delivery times.

What to watch over the next week?

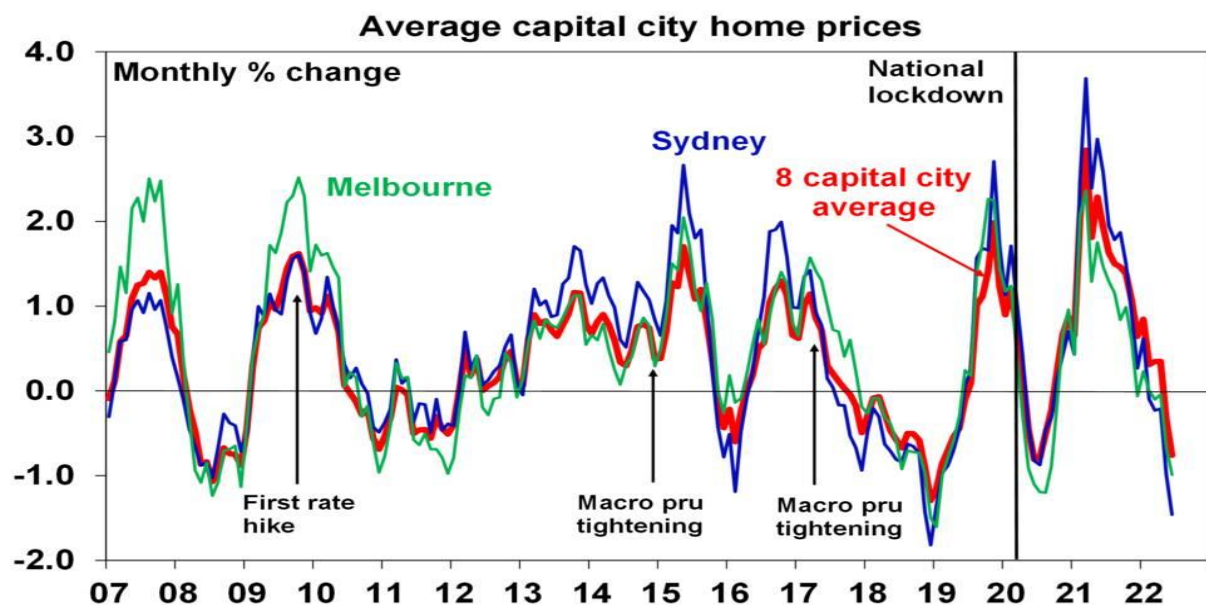
In the US, the focus is likely to be on the Fed's preferred inflation measure of the core private final consumption deflator for May (Thursday) which is expected to fall to a still very high 4.8%yoy from 4.9%. On the economic data front expect continuing modest growth in durable goods orders (Monday), a fall in consumer confidence (Tuesday) but continuing strength in home prices (also Tuesday) and a slowing in the June manufacturing conditions PMI (Friday).

Eurozone CPI inflation for June (Friday) is likely to show a further rise to 8.3%yoy. Meanwhile economic confidence for June (Wednesday) is likely to dip further and unemployment (Thursday) is likely to fall to 6.7%.

Japanese industrial production (Thursday) is likely to fall slightly and the June quarter Tankan and jobs data will be released Friday.

Chinese business conditions PMIs for June (due Thursday and Friday) may show a further improvement reflecting recovery from the covid lockdowns around March.

Australian retail sales growth for May is expected to slow to 0.3% reflecting the impact of cost-of-living pressures and the hit to confidence from rising interest rates. Further weakness is likely ahead. Job vacancies data for May is likely to have remained strong and credit growth is expected to remain strong reflecting earlier strength in housing finance (both due Thursday). CoreLogic home price data is expected to show capital city home price falls accelerating to -0.8% in June led by Sydney and Melbourne. See the next chart where the final observation relates to June month to date CoreLogic data at a monthly rate.



Source: CoreLogic, AMP

Outlook for investment markets

Shares are likely to see continued short term volatility as central banks continue to tighten to combat high inflation, the war in Ukraine continues and fears of recession remain high. However, 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 policy brakes.

The risk of a further rise in bond yields points to constrained returns from bonds.

Unlisted commercial property may see some weakness in retail and office returns (as online retail activity remains well above pre-covid levels and office occupancy remains well below pre-covid levels). Unlisted infrastructure is expected to see solid returns.

Australian home prices are expected to fall further as poor affordability and rising mortgage rates impact. Expect a 10 to 15% top to bottom fall in prices over the next 18 months but with a large variation between regions and the risk being on the downside particularly if market expectations for rate hikes prove correct. Sydney and Melbourne prices are already falling and more aggressive up front RBA rate hikes risk pushing price falls to 20%.

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

The \$A is likely to remain volatile in the short term as global uncertainties persist. However, a rising trend in the \$A is likely over the next 12 months as commodity prices ultimately remain in a super cycle bull market.

Important notes

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