WEEKLY MARKET UPDATE

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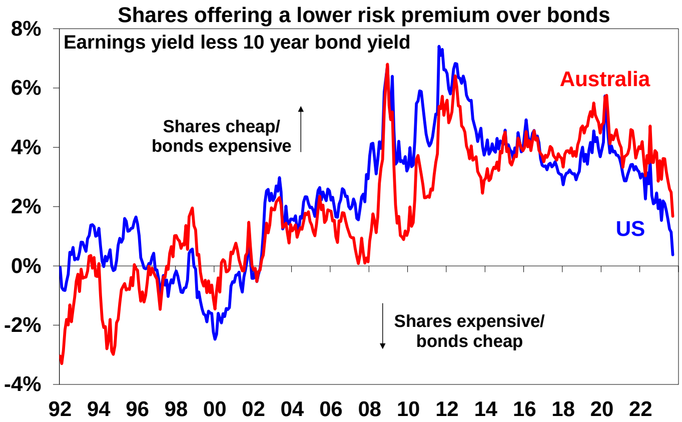
Investment markets and key developments

Global share markets fell over the last week on worries about an escalation of the war in Israel that would disrupt oil supplies and as bond yields pushed even higher. The poor global lead saw Australian shares fall around 2.2% for the week taking them back to their lows of earlier this month with falls led by IT, retail, health, industrial and property shares. Only energy shares rose. Some solid US data and comments from Fed speakers including Chair Powell saw bond yields push higher with the US 10 year bond yield rising to 4.99%, a new post 2007 high and the Australian 10 year bond yield rising to a new post 2011 high. Oil prices rose further on the back of uncertainties around the war in Israel and metal and iron ore prices also rose. The $A rose slightly as the $US fell slightly.

The conflict in Israel presents a dilemma for central banks. On the one hand if it escalates (contrary to the efforts of the US to prevent a "folly" driven by the desire for vengeance by Israel) and drives a further sharp rise in oil and hence petrol prices it will add directly to inflation which could further boost inflation expectations making it even harder to return inflation to target (which is something RBA Governor Bullock highlighted in the last week), unfortunately, the war in Israel providing even more parallels to the high inflation 1970s. On the other hand, when monetary policy is already tight as it is now and household budgets are stretched higher, oil prices will act as a tax on spending and hence damage economic activity adding to the already high risk of recession and ultimately driving lower inflation. Our leaning is more to the latter and so, in the words of Fed Chair Powell, central banks including the RBA should proceed "carefully" and stay in wait and see mode.

Fed Chair Powell's comments in the last week were balanced but they still pushed bond yields higher. Powell indicated that the Fed is "attentive" to stronger growth but also to the tightening in financial conditions flowing from higher bond yields and so it can proceed "carefully" – implying no hike in November. But because he didn't pushback against higher bond yields and said the Fed should let it "play out" and that the neutral rate of interest may now be higher it provided a green light for a further lift in the US 10-year bond yield, which rose to around 5%.

The risk of a further leg down in global and Australian shares remains high. The new highs in bond yields are putting increasing pressure on share market valuations which are already stretched; central banks are continuing to signal high for longer interest rates; the risk of recession remains high; the risk of an escalation to involve Iran in the Israeli conflict which would directly threaten oil supplies is high; this would add to inflation and recession fears; uncertainty remains high around the China's economy and property markets; and the US remains at high risk of a shutdown next month. So, the ride for shares is likely to remain volatile.



Source: Bloomberg, AMP

But several things should help shares by year end: seasonality will become positive in the next two months; inflation is likely to continue to fall which should take pressure of central banks allowing them to ease through next year; and any recession is likely to be mild. So, while near term uncertainties remain high our 12-month view on shares remains positive.

The risk of another rate hike in Australia is high with the RBA getting nervous about the upside risks to inflation. The RBA was out with a somewhat more hawkish message in the last week via the minutes from the last meeting and a "fireside chat" with Governor Bullock. The key messages are that:

- monetary policy is working to slow spending & ease inflation;
- there are few signs of a wage price spiral;
- but services inflation is sticky, with the rise in petrol prices, potentially made worse by the war in Israel adding to the risks;
- the rise in house prices might support household spending and may suggest monetary policy is not as tight as assumed;
- upside risks to inflation are a concern given how long inflation is likely to be above target, as the longer its above target the more long-term inflation expectations may rise making it even harder to get inflation back to target; so
- the RBA has a "low tolerance" for a slower fall in inflation than expected and if its higher than expected then it would respond.

Of course, the RBA has long been flagging that "some further tightening in monetary policy may be required" but it's communications over the last week are somewhat more hawkish than flagged in the statement following its last board meeting. This may just be jawboning and an effort by the new Governor to highlight that she is just as determined to get inflation down as Governor Lowe and so is all aimed at keeping long term inflation expectations down. But the clear message is that the risk of another rate hike is high and the RBA has flagged that it will be looking at things very closely at its November meeting after the latest run of data on jobs, economic activity and inflation along with revised RBA forecasts.

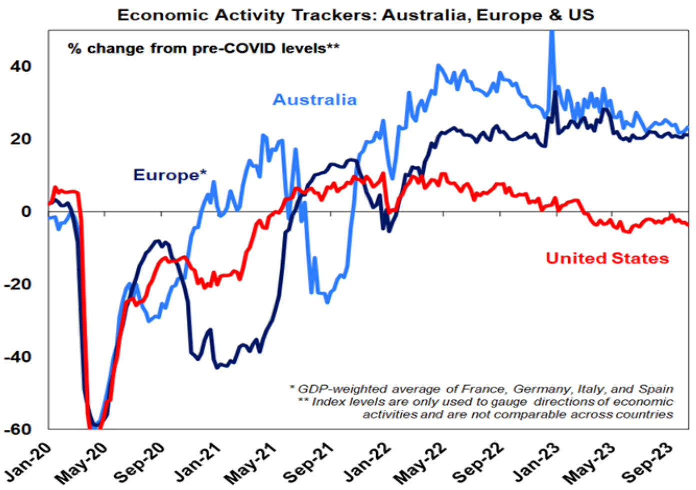
We had put the risk of another rate hike at 40% but following the RBA's latest communications now see it as being close to 50%. Jobs data in the past week was mixed – with slowing jobs growth but still low unemployment – leaving the September quarter inflation data due Wednesday as key to whether the RBA hikes again in November. We think the inflation data will come in roughly in line with RBA forecasts and so no change from the RBA on rates remains our base case, but the risk is on the upside leaving the rates call a very close one. The money market has priced in a 25% chance of a rate hike in November (up from just 6% a week ago) & an 88% chance by March (up from 40% a week ago).

Given the lags with which monetary policy impacts the economy we would see another rate hike as dangerously adding to the risk of recession next year, particularly with the RBA's own analysis showing that around 1 in 7 households with a mortgage were already cashflow negative in July (where essential expenses including private health insurance and school fees and mortgage payments) exceed their income.

Anyway enough of this gloomy stuff - watching the David Beckham documentary, I was reminded what a great song The Spencer Davis Group's Gimme Some Lovin is. Apparently, they came up with it in less than half an hour. I particularly like Steve Winwood's organ sound. Even The Blues Brothers did a cover of it, replacing the organ with horns though!

Economic activity trackers

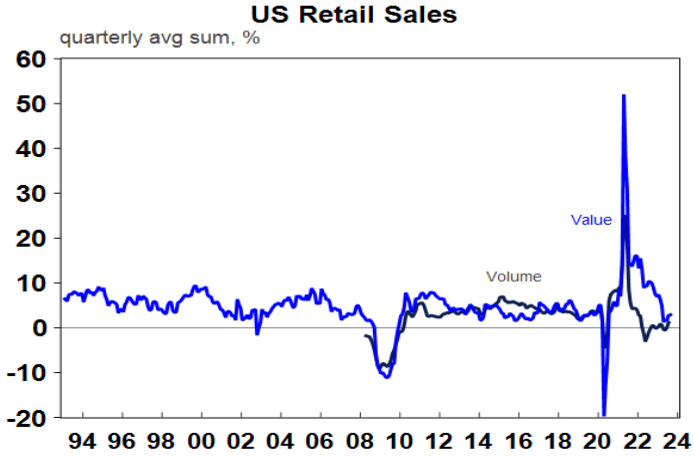
Our Economic Activity Trackers are still not showing anything decisive in terms of the direction of economic activity.



Levels are not really comparable across countries. Based on weekly data for eg job ads, restaurant bookings, confidence and credit & debit card transactions. Source: AMP

Major global economic events and implications

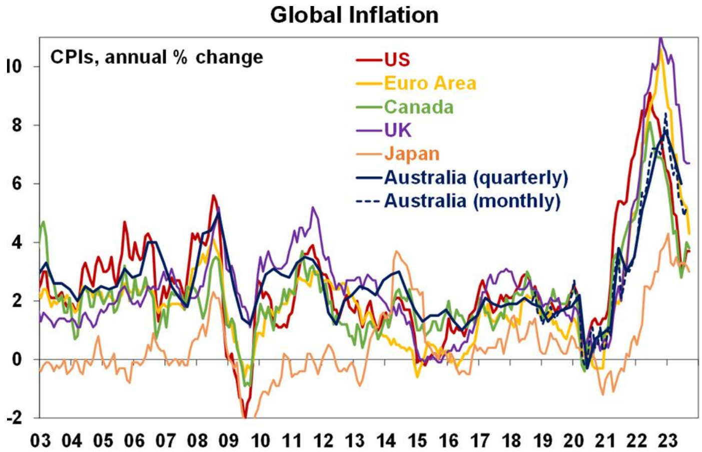
US data was a mixed bag over the last week. Retail sales rose solidly in September pointing to strong September quarter consumer spending, industrial production also came in better than expected and jobless claims remained low. But against this the volatile Philadelphia Fed and New York regional manufacturing indexes were mixed with one up and one down and the average remaining soft. Housing starts rose sharply in September, but this only partly reversed a sharp fall in August, the trend remains down and falls in mortgage applications and home builder conditions on the back of a surge in mortgage rates point to falls ahead in starts. Existing home sales also fell as did the index of leading indicators. And the Fed's Beige Book suggested a soft take on economic conditions with "little to no change in activity", labour market conditions continuing to ease and prices continuing to "increase at a modest pace".



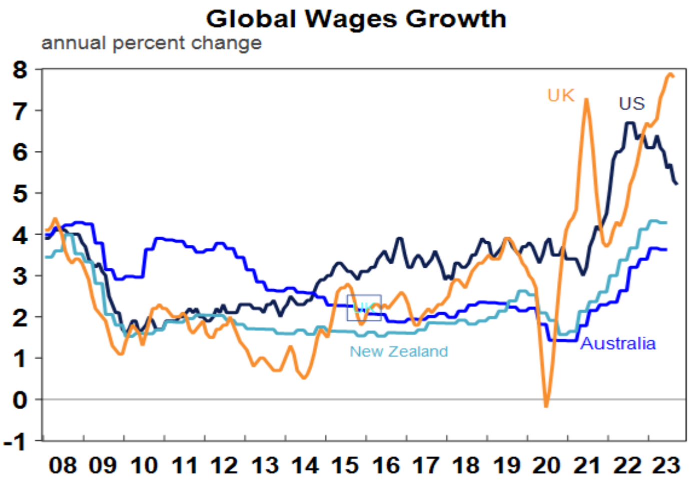
Source: Macrobond, AMP

It's still only early days in the US September quarter earrings reporting season with only 16% of S&P 500 companies having reported with 75% coming in better than expected.

Pressure remains on the Bank of England. UK inflation was unchanged at 6.7%yoy in September and while core inflation fell to 6.1%yoy it was slightly higher than expected and services inflation rose further to 6.9%. What's more wages growth remained elevated at around 8%yoy. Combined this maintains pressure on the BoE for a further rate hike. The risks are high though because payrolls are now falling. Fortunately for global markets, the UK is at the high end in global comparisons of inflation and wages growth. See the next two charts.



Source: Macrobond, AMP



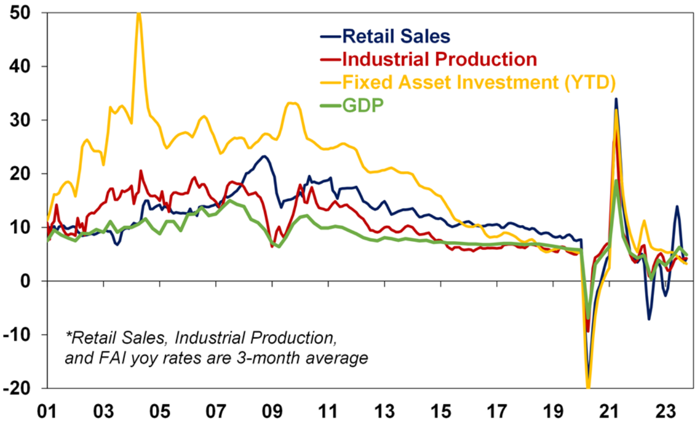
Source: Macrobond, AMP

Both Canada and New Zealand saw inflation fall further in September. Canadian inflation fell to 3.8%yoy (from 4%) with underlying inflation measures also down and NZ inflation fell to 5.6%yoy (from 6%). This should help keep both central banks on hold regarding interest rates.

Japanese inflation also fell in September to 3%yoy, from 3.2% with core (excluding food and energy) inflation falling to 2.6%yoy.

More signs that Chinese growth has bottomed with economic activity data stronger than expected. GDP slowed to 4.9%yoy in the September quarter, but this was stronger than expected with quarterly GDP growth of 1.3%qoq up from 0.5%. Growth in industrial production and retail sales also surprised on the upside in September and unemployment fell. This followed stronger than expected import, export and credit data. Policy stimulus seems to be helping but so far the trend in key data still remains soft (see the next chart) and property related risks remain high - with property sales and investment down and home prices continuing to fall in September - and policy stimulus announcements have stopped short of what may still ultimately be required.

China Activity Indicators, annual growth (%)

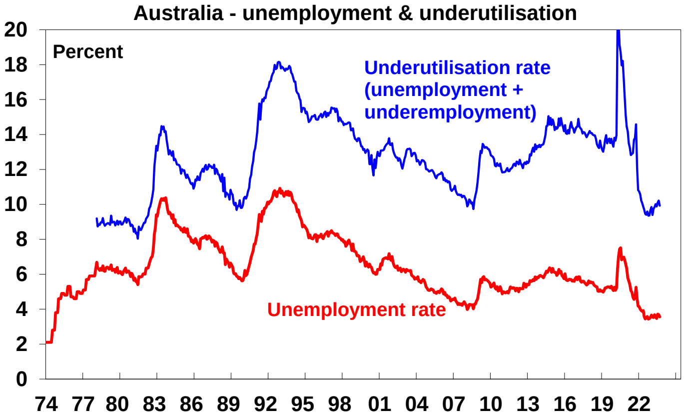


Source: Bloomberg, AMP

Australian economic events and implications

Another messy Australian jobs report for September. The jobs market is still tight with unemployment at just 3.6% and labour underutilisation at 9.9% is well below the average of the last four decades. But its continuing to cool with employment up a less than expected 6700, full time jobs down by 53,000 over the last three months, hours worked continuing to slow and job vacancies down for five quarters in a rose. And without a fall in the participation rate (which may be due to "discouraged workers", statistical noise or both) unemployment would have increased to 3.9%.

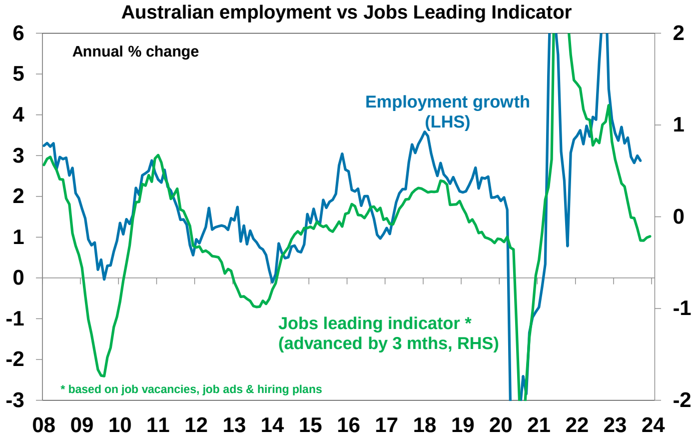
Australia - unemployment & underutilisation



Source: ABS, AMP

Leading indicators of jobs growth point to a further slowing ahead. With super strong population growth Australian needs around 35,000 new jobs a month to stop unemployment rising but our Jobs Leading Indicator (based on falling job vacancies and slowing hiring plans) points to jobs growth slowing to around 1%yoy or 12,000 new jobs a month. So we remain of the view that unemployment will head significantly higher next year. **The ongoing evidence of a slowing jobs market is consistent with our view that the RBA will leave rates on hold at its next meeting, but as noted earlier, after recent RBA commentary its now a very close call with inflation data in the week ahead being key as to whether the RBA will hike next month**.

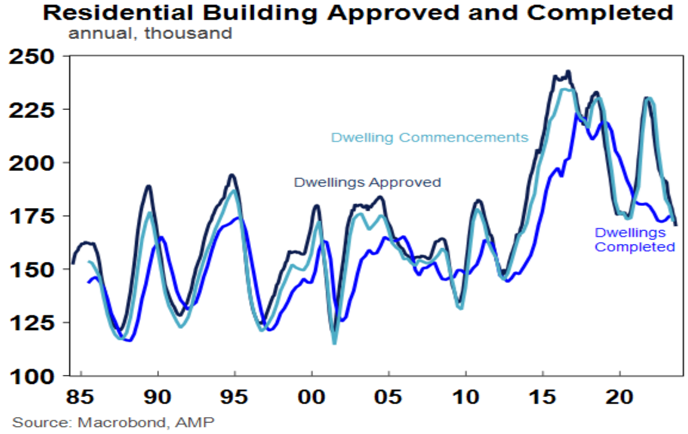
Australian employment vs Jobs Leading Indicator



Source: ABS, AMP

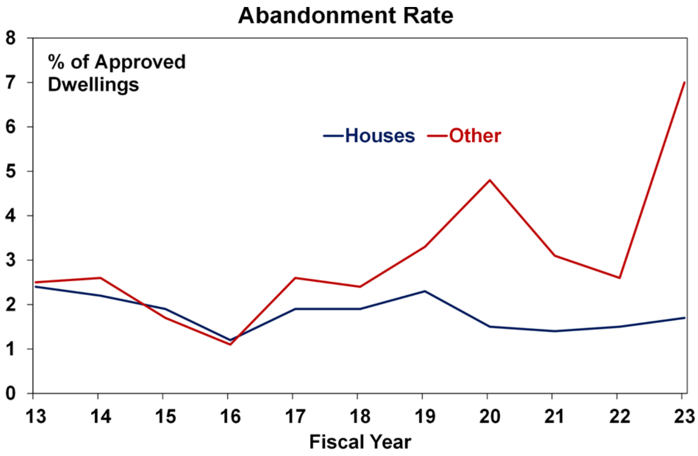
Australia's still large home building pipeline. June quarter dwelling commencements showed that they are continuing to follow approvals down. What has been unusual in the last cycle is that there was no rise in dwelling completions to match the surge in approvals and commencements in 2021 because of labour and material shortages and failures of home builders. This of course means that there is a large pipeline of construction yet to be completed which will provide some support to building activity going forward….

Residential Building Approved and Completed



Source: ABS, AMP

But the pipeline may not be as great as it appears because the abandonment rate (approved buildings that are never built) has spiked recently to around 7% recently for units. The previous chart also highlights the challenge Australian government's will have meeting their commitment to build 240,000 dwellings a year over the next five years. Over the last four decades completions have never come near that. Maybe there is a chance if they are tiny homes!



Source: ABS, AMP

What to watch over the next week?

In the US, September quarter GDP growth (Thursday) is expected to rebound to 4.1%annualised, after 2.1% in the June quarter, helped by solid consumer spending. September personal spending (Friday) is expected to show solid growth but with core personal consumption deflator inflation slowing further to 3.7%yoy from 3.9%. The trend in capital goods orders (Thursday) is expected to remain soft and business conditions PMIs for October (Tuesday) are likely to remain subdued. The US September quarter earnings reporting season will start to ramp up.

The Bank of Canada (Wednesday) is expected to leave interest rates on hold at 5%, helped by the lower-than-expected inflation reading for September.

The ECB (Thursday) is also expected to leave interest rates on hold at 4% for its deposit rate and 4.5% for its main refinancing rate, reiterating is "high for longer" message on rates. Eurozone business conditions PMIs for October (Tuesday) are likely to remain weak.

Japanese business conditions PMIs for October will also be released Tuesday.

In Australia, the focus will be on September quarter CPI data which is expected to show an increase of 1.1%qoq taking annual inflation down to 5.3%yoy, from 6% in the June quarter. Key drivers are expected to be a 7% increase in fuel prices and increased rent, utility and insurance prices offset partly by the child care subsidy and softer goods prices. Underlying inflation as measured by the trimmed mean is expected to be 1.1%qoq or 5%yoy, down from 5.9%. Our expectations are roughly in line with RBA forecasts and so should be consistent with it leaving interest rates on hold, but the risk is on the upside particularly for the trimmed mean.

A speech by RBA Governor Bullock (Wednesday) and her appearance before the Senate Economics Committee (Friday) will both be watched closely for clues on the interest rate outlook, particularly the latter as it will be after the CPI. But both are likely to provide a reminder that the RBA has a "low tolerance" for higher than expected inflation. In other Australian data, business conditions PMIs (Tuesday) are likely to soften a bit after the rise in September and producer price inflation for the September quarter will be released Friday.

Outlook for investment markets

The next 12 months are likely to see a further easing in inflation pressure and central banks moving to get off the brakes. This should make for reasonable share market returns, provided any recession is mild. But for the near-term shares are at high risk of a further correction given high recession and earnings risks, the risk of high for longer rates from central banks, rising bond yields which have led to poor valuations and the uncertainty around the war in Israel.

Bonds are likely to provide returns above running yields, as growth and inflation slow and central banks become dovish but given the recent rebound in yields this may be delayed a few months.

Unlisted commercial property and infrastructure are expected to see soft returns, reflecting the impact of the rise in bond yields on valuations. Commercial property returns are likely to be negative as "work from home" continues to hit space demand as leases expire.

With an increasing supply shortfall, our base case remains that home prices have bottomed with more gains likely next year as the RBA starts to cut rates. However, uncertainty around this is high given the lagged impact of interest rate hikes and the likelihood of higher unemployment.

Cash and bank deposits are expected to provide returns of around 4-5%, reflecting the back up in interest rates.

The $A is at risk of more downside in the short term on the back of a less hawkish RBA and global uncertainties, but a rising trend is likely over the next 12 months, reflecting a downtrend in the overvalued $US and the Fed moving to cut rates.