

# WEEKLY MARKET UPDATE

24 JUNE 2016



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## Investment markets and key developments over the past week

**Britain votes to Leave the European Union.** The past week has been dominated by first the anticipation that Britain would vote to Remain within the European Union followed by an abrupt reaction in financial markets as the referendum saw the Leave vote win by 52% to 48%.

**Of course there will be a fair way to go before Britain actually leaves the EU – up to two years of negotiation once Britain puts in its formal notification and this will determine the terms of its leaving and hence the ultimate economic impact on the UK.** If the UK negotiates free trade access like Switzerland or Norway has with the EU it will have to allow the free movement of people, agree to EU rules and regulations and contribute to its budget so it's unclear as to whether it will want to agree to that.

However, as we have seen already markets won't wait to see the final terms of the exit and are already reacting sharply. The main concern globally is not the impact on the UK economy but rather whether Brexit will kick off a round of contagion to exit amongst Eurozone countries which would then see the Eurozone unravel. It's doubtful that it will because the hurdle to leave the Eurozone is high as it will mean adopting a new currency, paying higher interest rates, etc. Just think of Greece despite its woes over the last few years consistently deciding to stay in the Eurozone. However, the risk is there, with Italy perhaps being most at risk, and markets will likely fear the worst in the short term.

Reflecting the worries about the impact on the UK and more significantly Europe financial markets have already reacted sharply in "risk off" fashion with the British pound (-8%), British share futures (-8%), the Euro (-3%) and Eurozone share futures (-11%) down sharply and this seeing global share markets down generally along with the Australian dollar. Safe haven assets such as bonds, the \$US, Yen and gold have all benefitted. The likelihood is that this will all have further to go in the short term as the dust settles. A concern is that a rising \$US will weigh on the Renminbi, commodity prices and emerging countries taking us back to the global growth fears we saw earlier this year.

I am not so confident about British assets given the long period of uncertainty the UK will now face both economically and politically with Scotland likely to request another independence referendum and PM Cameron weakened. However, **the global bout of "risk off" now underway is likely to provide a buying opportunity as Europe is likely to hang together as it did through its sovereign debt crisis and central banks led by the Bank of England and European Central Bank are likely to run easier monetary policies** than otherwise (led by liquidity boosting measures immediately) fearing an adverse financial and economic outcome.

**Given that a Leave victory is unlikely to plunge the UK or Europe into an immediate recession the main impact on Australia will be on financial markets.** This could affect short term confidence and may add to the case for the RBA to cut interest rates again particularly if banks increase their mortgage rates out of cycle due to higher funding costs flowing from an increase in lender caution. That said we expect the RBA to cut rates again anyway.

**The key for investors is to either look through the short term noise caused by the Brexit decision or look for investment opportunities that it throws up as investment markets become oversold.**

**Not that it got a lot of attention given the Brexit fixation, but the German constitutional court basically approved the validity of the ECB's Outright Monetary Transaction (OMT) program,** which partly underpins Draghi's 2012 commitment to do "whatever it takes" to preserve the Euro. This is a big relief because its rejection would have put a cloud over the ECB's ability to respond to any turmoil in peripheral bond markets that may flow from the Brexit vote.

Now on to other things!

**In Australia, the big event in the week ahead will be the Federal election (Saturday). Each side of politics is offering very different visions for the size of government:**

- Labor is focussed on spending more on health and education and in the process allowing the size of the public sector to increase, funded by tax increases on higher income earners (retention of the budget deficit levy and cutbacks in access to negative gearing, the capital gains tax discount and superannuation). The ALP would also undertake a royal commission into banking and intervention in the economy is likely to be higher than under a Coalition government.
- By contrast the Coalition is focussed more on containing spending, and encouraging economic growth via company

tax cuts and mild reforms. Despite the Coalition's tilt to "fairness" with its super reforms it's committed to keeping taxes down. It does plan to reinstate the Australian Building & Construction Commission but even with the double dissolution election it's unclear whether it will get enough votes to do this.

**At this stage the polls suggest the Australian election is too close to call.** But it's a big ask to see the ALP become the first opposition in 85 years to regain government after just one term as it will need to win 19 seats. As such betting agencies have the Coalition as favourite. However, the big issue may be what happens in the Senate with there being a good chance that the Greens and minority "parties" control the balance of power again acting as a huge constraint on the government, which would mean another de facto minority government, ie more of the same. Which in turn mean poor prospects for getting government spending under control over the next three years and for implementing serious productivity enhancing economic reforms.

**Over the 7 weeks since the election was called the Australian share market has tracked sideways.** The next table shows that 8 out of 12 elections since 1983 saw shares up 3 months later with an average gain of 4.8%. This may partly reflect relief at getting the election out of the way.

#### Australian shares before and after elections

| Election        | Winner    | Aust shares, %<br>chg 8 weeks up<br>to election | Aust shares. %<br>chg 3 mths after<br>election |
|-----------------|-----------|---|--|
| Mar 1983        | ALP       | -0.6  | 19.8   |
| Dec 1984        | ALP       | 0.0   | 5.4  |
| Jul 1987        | ALP       | 3.7   | 15.9   |
| Mar 1990        | ALP       | -7.0  | -3.5   |
| Mar 1993        | ALP       | 9.0   | 3.2  |
| Mar 1996        | Coalition | 2.3   | -2.0   |
| Oct 1998        | Coalition | -2.6  | 11.1   |
| Nov 2001        | Coalition | 5.9   | 5.4  |
| Oct 2004        | Coalition | 5.9   | 9.9  |
| Nov 2007        | ALP       | -2.9  | -11.7  |
| Aug 2010        | ALP       | 0.5   | 5.7  |
| Sep 2013        | Coalition | 4.6   | -1.0   |
| <b>Average</b>  |           | <b>1.6</b>                                      | <b>4.8</b>                                     |
| <b>Jul 2016</b> | <b>?</b>  | <b>-3.1*</b>                                    | <b>?</b>                                       |

\* Last 7 weeks. Based on All Ords index. Source: Bloomberg, AMP Capital

### Major global economic events and implications

**Fed Chair Janet Yellen's congressional testimony didn't really add much.** The key is that the Fed is "proceeding cautiously" to give it time to assess whether the US economy and inflation is on track with its expectations and given global uncertainties. There was certainly no attempt by Yellen to push up market expectations for Fed hikes. Uncertainty and market turmoil flowing from the Brexit outcome is likely to further delay the Fed in terms of raising rates again. US economic data was good with the June manufacturing PMI rising, home prices up, existing home sales at their highest since 2007 and new home sales down but after a very strong result in April, jobless claims falling sharply and home prices continuing to rise. And the US's top 33 banks passed a Fed stress test indicating that they have enough capital to withstand a severe economic shock (involving unemployment doubling to 10%.)

**The Eurozone composite business conditions PMI fell slightly in June** with a decline in services (on Brexit fears?) offsetting a gain in manufacturing. It remains at a level consistent with moderate growth though.

Japan's manufacturing conditions PMI rose just 0.1pt to a still weak 47.8 in June indicating that growth in June quarter is still struggling.

A couple of Chinese business conditions surveys moved in opposite directions for June with one up solidly and a small business PMI weakening. So bit of a wash there.

### Australian economic events and implications

**In Australia, the minutes from the last RBA Board meeting added little that was new with the RBA neutral and on the sidelines for now.** However, our view remains that lower inflation and a too high \$A on ongoing Fed delays will still see more easing ahead with the next cut likely in August. Meanwhile Australian economic data over the last week was uneventful. March quarter house prices fell slightly according to the ABS but more timely private sector data suggests a renewed pick up since then particularly in Sydney. While population growth has slowed from its 2% peak late last decade to 1.4% last year it's still contributing to solid underlying demand for housing. NSW and Victoria are the top states for population growth, and flowing partly from this house price growth. Which in turn partly explains the good state of their budgets. Finally, skilled vacancies continue to see reasonable growth telling us that the labour market remains solid.

### What to watch over the next week?

**The focus in the week ahead will no doubt see continued reaction to the Brexit referendum and then of course in Australia on the Federal election to be held on Saturday.**

In the US, expect to see a further gain in home prices and a slight rise in consumer confidence (Tuesday), solid growth in personal spending and a slight rise in the core private consumption deflator to 1.7% for the year to May, but a slight fall in pending home sales (all Wednesday) and a slight rise in the ISM manufacturing conditions index (Friday) to around 51.5 (Friday).

In the Eurozone expect bank lending (Monday) and economic confidence readings for June (Wednesday) to remain around levels consistent with continued moderate economic growth. Core inflation data for June (Thursday) and unemployment data (both Friday) will also be released. The outcome of the Spanish election on Sunday may also add to short term uncertainties regarding the Eurozone.

In Japan, expect a slight fall in industrial production (Thursday), a deterioration in the June quarter Tankan survey reflecting the recent earthquake and continued softness in household spending but the jobs market (all Friday) is likely to remain solid helped by the falling workforce. Core inflation (also Friday) is expected to fall to 0.6% yoy in May.

In Australia, expect the trend in new home sales (Wednesday) to remain modestly down, ABS job vacancies for the 3 months to May to rise consistent with monthly vacancy data and continued moderate credit growth (Thursday) and a slight softening in home price momentum in June (Friday) according to CoreLogic. The AIG's manufacturing conditions PMI (Friday) will also be released.

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## Outlook for markets

**The aftermath of the Brexit vote could see more downside in shares in the short term. However, beyond near term uncertainties, we still see shares trending higher this year** helped by relatively attractive valuations, ultra easy global monetary conditions and continuing moderate global economic growth.

**Lower and lower bond yields point to a soft medium term return potential from them, but it's hard to get too bearish** in a world of fragile growth, spare capacity and low inflation. That said, the recent bond rally has taken bond yields to ridiculously low levels leaving them at risk of a sharp snapback at some point.

Commercial property and infrastructure are likely to continue benefitting from the ongoing search for yield by investors.

Capital city dwelling price gains are expected to slow to around 3% over the year ahead, as the heat comes out of Sydney and Melbourne thanks to toughening lending standards and pockets of oversupply. Prices are likely to continue to fall in Perth and Darwin, but price growth may be picking up in Brisbane.

Cash and bank deposits offer poor returns.

**While the Brexit outcome has knocked the \$A lower, its still higher than it should be and the longer term downtrend looks likely to continue** as the interest rate differential in favour of Australia narrows as the RBA continues cutting and the Fed eventually resumes hiking, commodity prices remain in a secular downswing and the \$A sees its usual undershoot of fair value. The \$A is still likely to fall to around \$US0.60 in the years ahead.