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Woodhall's Wrap

Ron Bewley PhD, FASSA

US rally ended with a thump

Are fears of US rate hikes justified?
Global growth still has strong prospects
Australian unemployment rate falls but inflation stays low

The Big Picture

Six consecutive months of capital gains on Wall Street were ended with a correction in October – eradicating all of the gains made in 2018. It is important to note that this correction could not have been precipitated by gloomy economic data. There wasn't any!

While everyone is entitled to nominate reasons for the correction, it is not possible to attribute it to various causes with any degree of certainty. The best we can do is focus on what hit the headlines – and then look through the noise at the fundamentals.

The downturn did start within hours of US Fed chairman, Jay Powell, making a very strong statement about being able to be aggressive on rate hikes. And he made no soothing comments even as the market fell by up to 10%.

Of course, Trump was never far from the spotlight. His repeated 'upping the ante' in the trade war couldn't have helped. The latest is that he is reportedly planning even more tariffs for China trade if China does not make progress at the table.

The US mid-term elections are due on November 6th. Pundits are forecasting the Republicans likely to keep control of the Senate but lose control of the lower house. But both reported probabilities are sufficiently woolly to allow for an upset. If Trump loses even control of just the house, his presidency will lack the support he needs for further reform.

When we look at the new economic data reported in October, we see a glowing score-card for the US. Economic growth came in at 3.5% after a 4.2% in quarter two. The IMF just reported its US forecast for 2018 of 2.5% which is already now overwhelmingly seen as far too pessimistic. Three percent plus is on the cards.

The Fed's preferred inflation measure came in at 1.6% which is well down from 2.1% in the previous quarter and the 2% Fed target. There are no apparent inflation pressures bubbling under that might require sharp rate hikes. Indeed, very gradual increases in rates seem the way to go!

The US bond market did react pushing the 10-year rate well above 3% but markets can jump at shadows. When the Fed likely raises the rate in December the key information sought from the Fed press conference by analysts will be the so-called "dot plots" indicating the most likely course of action in 2019. Given the economic data, we feel that markets and the Fed will settle by then.

Even earlier, Trump may seal a deal with China over trade. It is said by many that he wins votes from both sides of politics by looking tough with China. Whether the race is won or lost after the mid-terms, Trump can then settle the trade talks before real harm is done to the US economy. We think reasonable capital gains for 2018 on Wall Street can still be made!

The IMF did forecast world growth of 3.7% for each of 2018 and 2019. These forecasts are now the same as those from the OECD. China reported growth of 6.5%, which was a slight miss, but very good producer and consumer inflation statistics were posted.

The Australian unemployment rate fell from 5.3% to 5.0% for the latest month. Full-time jobs growth was also strong.

At times like these, it is important to remember that when people sell shares someone else is buying them! We think that those who bought in October might look very good in months to come. Reporting season for the US banks has been very strong but there were some notable misses in the rest of the company reports.

In the long run, market prices reflect the underlying strength of the economic fundamentals. In the short run, fear or hubris can take markets almost anywhere. We are reasonably confident of a continued bull-run based on fundamentals.

Asset Classes

Australian Equities

Our ASX 200 had another down month in October (-6.1%). All sectors took big losses but perhaps the biggest losers were those stocks that were priced ("to perfection") for strong growth. However, the rally at the end of October produced some gains to those same stocks.

The banking sector has projected dividends of 8.5% plus franking credits because stock prices have been sold down so strongly. With the sector proposing to divest wealth management business, capital gains for the sector are harder to predict. There is the prospect that this very large sector might soon end its poor run over recent years and start to recover – which in turn could boost the ASX 200.

Foreign Equities

The longest run of consecutive months of capital gains in recorded history for Wall Street ended with a thump in October (-6.9%). We think it is far too early for a slow-down in the US economy to be on the cards. Rather, we think October represented a case of the jitters after the US Fed chairman spoke out of turn.

Bonds and Interest Rates

The US 10-year treasuries' yield spiked at the start of October which possibly helped put equities into a spin.

The Reserve Bank of Australia was again on hold and is likely to remain so.

Other Assets

The price of oil dropped strongly in October (-8.2%) but the price of iron ore rose by +10.1%.

The price of copper (-3.0%) and the Australian dollar, against the US, (-1.9%) both fell in October.

Regional Analysis

Australia

The Wentworth by-election has put the government in a precarious position but economic data were quite strong.

Retail sales rose by 0.3% for the latest month and the unemployment rate fell to 5.0%. 20,300 full-time jobs were created.

Our CPI came in at under 2% whichever variant is used. The trimmed mean of 1.8% is below the RBA's target range of 2% to 3%.

China

October's data drop for China was slightly weaker. GDP growth missed expectations at 6.5%. Retail sales were 9.2%, factory output was 5.8% and fixed asset investment was 5.4%. The Purchasing Manufacturers' Index (PMI) was 50.2 and below the expected 50.6

While these numbers were slightly worse than expected they are still big numbers! Providing China and the US come to terms on trade soon, there seems little to impede the world's second biggest economy from continuing to grow.

US

The US recorded growth of 3.5% for the third quarter making the last two quarters as having produced the best two-quarter growth in four years.

The PCE inflation measure, preferred by the Fed, fell from 2.1% to 1.6%. With the target rate at 2%, there is plenty of wiggle room for the Fed in considering future rate hikes. The CPI inflation measure came in at 2.3% from 2.7% and the CORE inflation rate that strips out food and energy was 2.2%.

The US unemployment rate came in at 3.7% which is the lowest since 1969 when man first walked on the moon!

Europe

After 13 years at the helm, Germany's Chancellor, Angela Merkel, has announced she will not continue in politics after her term expires in 2022. She has been under intense social pressure owing to her immigration policy – particularly with regard to taking in refugees. However, she has been considered a major stabilizing influence in Europe.

EU growth slowed to 0.2% in the latest quarter and Italy came in at 0.0%!

The Brexit negotiations hit another speed bump in October. There has been a reported surge in Irish passport applications because of the way the Eire / Northern Ireland border might be handled.

Rest of the World

Brazil elected a new president in October which might help stabilize its economy.

The NAFTA trade agreement between the US, Mexico and Canada was completed. After all of the fuss, the changes are minimal in the new USMCA variant. The US is better off by only about $70m!