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Woodhall's Wrap

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Markets roar back to life

Federal Reserve clarifies its position
China data were weaker than expected
Australian rate cuts on the horizon

The Big Picture

We reported last month that we had the Australian and US stocks markets as being very under-valued. Well they are much less so now after a very strong rally during January.

The turn-around in markets started straight after Christmas and gained momentum throughout January as the US Federal Reserve ("The Fed") made increasingly dovish tones – so much so that the chance of a rate hike this year is now estimated by the market to be minimal. A chance of a cut this year now has gained some support among the analyst community.

The end of January Fed meeting produced a no-change result on rates and the chairman emphasised the word "patience" in his press conference about the timing of future moves. The accent is once again firmly on "data driven" policy changes rather than following a pre-set course.

The US-China trade stoush took a few more twists and turns. The threat of more tariff increases looms large but could well be averted. The China economy is clearly in need of avoiding that situation and so some solution may come soon. China did offer to reduce the trade balance with the US to zero over the next 6 years. More needs to be done on intellectual property.

US employment data were particularly strong. A much bigger than expected 312,000 new jobs were created. Unemployment came in at 3.9% and, importantly, wage growth was a far more respectable 3.2%. The weakness in the US economy mooted by some does not seem to be showing through in the data – at least not yet.

China inflation data – both consumer and producer variants – came in weaker than expected. GDP growth was 6.6% for the year – which was on expectations – but import and export data were weaker.

The weakness in China data is nowhere as near as bad as some are making out. There is a natural progression from the double-digit growth of a decade ago to more moderate levels as any country matures. The China government is putting in place policies to combat any slowdown so we do not see this issue becoming a problem unless Trump brings the next round of tariff hikes into play.

At home, the biggest change has been the attitude towards possible rate cuts by the RBA. This was almost unheard of a month or so ago but the muttering has become louder. Indeed, one leading analyst reported a 36% chance of a rate cut this year.

One reason for a cut is that the NAB and ING just finished the out-of-cycle home loan rate increases. The second is that our CPI inflation data have been persistently lower than the target band of 2% to 3%. The latest reading was 1.8% making it 15 out of the last 17 quarters that the rate has been below the target range.

The RBA has a dual mandate. First it must try and keep full employment. At the current 5% that could be said to be have been fulfilled as there is no prescribed number. The second is to keep inflation within the target band. The RBA has failed in that regard – even in any 'average over the cycle' sense.

Our employment data was quite strong again this month but, as always, our immigration numbers helps underpin that and the more general economic growth.

In short, the Fed has learnt its lessons from making last October's ill-advised comments. If Trump can be a little more compliant, the US does not seem to be an issue – and neither then would be China. And if/when we get a rate cut (or two), we'll be doing better too. We reiterate our view that Australian and US stock markets will have an average year of returns in 2019 – if not better.

Asset Classes

Australian Equities

The ASX 200 put in a strong month in January at +3.9% with Energy stocks (+11.5%) leading the way. However, the Financials sector, under the weight of the Royal Commission, produced a capital loss of -0.2%.

We have the index only slightly under-priced at this point put our forecast of capital gains for the next 12 months has strengthened slightly as the February reporting season approaches. Brokers have been strengthening their earnings forecasts.

We do not see a return to the 2018 peak any time soon but such a figure is quite possible by the end of the year.

Foreign Equities

All the major indexes put in a strong January with Wall Street's S&P 500 gaining +7.9%. Even Emerging Markets put in over 6%.

In contrast to the ASX 200, we have the S&P 500 sufficiently under-priced to continue the January rally for a little while longer.

Our 12-month capital gains forecasts for the S&P 500 (based on broker forecasts of earnings and dividends) did start to slip a little into the end of 2018 as a pall of gloom started to collect over Wall Street. However, the Q4 reporting season, which is still underway, has given brokers the confidence to reverse some of those calls. As a result, our index forecast strengthened a little – and then stabilised.

Bonds and Interest Rates

The Fed has started 2019 on a clear path to maintain patience over any rate changes and that pleased markets. A reasonable chance of a cut this year is now being priced in.

There is now also a significant chance of a rate cut this year in Australia. Such a cut would offset the big four banks out of cycle rate hikes in recent times and possibly help promote inflation into the 2% to 3% band.

Other Assets

The prices of iron ore and oil surged by more than 15% each in January. Those increases helped support the January rallies in resources stocks

Regional Analysis

Australia

Australia is inching towards its next general election and both sides are offering sweeteners to potential electors. It is not clear that such expenditures are in the best interest of the economy's long-run growth path.

There were 21,600 new jobs reported in the last Labour Force Survey which is strong. However, all of these jobs and more were part-time. Full-time jobs shrank by 3,000.

If the RBA does cut its rate soon, that could give a small boost to housing sentiment and the general economy.

Interestingly, in the days before the Royal Commission hands down its findings, a new bank, Volt, has been given a full banking licence. With the increasing tendency towards internet-based payments systems, the big four's base will be cannibalised over time.

We again emphasise that the economy is not 'in trouble'. Rather, it is not performing as it could. We do not see a recession on the horizon in 2019.

China

China's economy is rapidly approaching the size of that for the US – and the US is not happy about that. With economic size comes political power. It is, therefore, important that the global powers assist China in transitioning to the number one slot without upsetting world order.

Trump is trying to do his bit with his trade policies. They may not be fashioned in the best way but it is a start to getting China to respect intellectual property rights and also behave in a way that fits in within a cohesive World Trade Organisation (WTO) type framework.

The near misses on the economic data front are not a major issue. It is not possible to guide any economy in a perfect trajectory. We see the China government acting in appropriate ways over 2019 to ensure a stable outcome. That is, of course, unless Trump takes the tariff war too far.

US

The stand-off between Trump and the US Congress did not make any significant gains during January. The partial shutdown is due to switch back in quite soon and the debt ceiling debate will loom large in about six months.

Whatever we think about the US political process, the hard-economic data are quite good. GDP growth has been strong and jobs growth has been even better.

It is not possible to predict what Trump will do next but he does not have a free hand – especially with this new split Congress. Some compromise on the 'wall', and a 'fig leaf' from China on trade could have a big positive impact on economic prospects for 2019.

Companies reporting quarter four earnings at the moment have been a little mixed but there have been lots of very strong results – hence the positive stock market reaction.

Europe

The Brexit issue rolls on and on. It now seems quite likely that, in effect, the March 29, 2019 deadline for the Brexit might be pushed back until later in the year.

The German economy has spluttered a bit in recent months. German car manufacturers are suffering from the US trade tariffs but the impact on Australia is muted.

Rest of the World

Kim Jong Un, the leader of North Korea, has agreed to a second summit with the US over its nuclear capabilities. The meeting is scheduled to take place in Vietnam at the end of February.