Economic and market monthly update

11 August 2017

Bob Cunneen
Senior Economist and Portfolio Specialist

Bob reviews events in Australian and overseas markets during July.

How did markets perform in July?

Global shares made solid monthly gains of 1.9% in local currency terms. However the strong Australian dollar (AUD) negatively impacted unhedged global share returns with the final result being -1.2% for the month of July.

US shares achieved new record highs. Strong corporate profit reports and solid economic activity favoured US shares despite the political turbulence in Washington. Congress's failure to replace the Affordable Healthcare Act (aka 'Obamacare') and the revolving door for White House staff under President Trump had minimal impact. The US labour market continues to strengthen with robust jobs growth but wages growth remains surprisingly modest. Given this sedate inflation, the Federal Reserve (Fed) kept US interest rates steady in July but did signal the reduction of its asset holdings would occur "relatively soon".

European shares recorded mild falls in July (-1.0%, MSCI All Country Europe $A). The stronger euro currency performance against a weaker US dollar (USD) weighed on European shares. However European economic data was positive with strong business surveys, improving jobs growth and the unemployment rate falling to 9.1% - which is an eight year low.

Asian shares made solid gains. Solid Chinese business surveys and stronger industrial production and retail sales data were supportive of Chinese shares.

Australian shares were subdued in July with a flat return. There were encouraging gains for the Resources (5.0%) sector given the strong increases for key commodity prices such as iron ore, copper and oil. However this was counterbalanced by sharp falls in the Health Care (-7.5%) and Telecommunications (-4.3%) sectors given competitive pressures. Rising Australian bond yields also reduced the attractiveness of these sectors to yield-seeking investors.

Australian government bond yields rose in July even with the mild inflation result. Despite sharp price increases recorded for electricity (7.8%) and health costs (3.8%), Australia's annual inflation rate for the June quarter was only 1.9%. The key driver for rising Australian bond yields was more positive economic data. After a slow start to 2017, Australia has experienced strong jobs growth and improving retail spending in recent months.

The AUD rallied sharply to close to 0.80 against the USD. The sharp rally in commodity prices (particularly iron ore, which rose from US$65 to US$74 per tonne) and improving Australian economic activity data were the key drivers behind the AUD's strong performance.

What were the key factors driving markets?

Two major themes driving global markets in July included the debate about whether President Trump's bold stimulus promises will actually be implemented, as well as whether US and European interest rates will rise over coming years.

President Trump's promises of corporate tax cuts and higher infrastructure spending have so far been very supportive of US shares. However financial markets are still awaiting the detail and timetable for implementing the new President's policies.

While global economic activity is positive, sedate inflation results have kept central banks on hold in July and bond yields stable. Notably the central banks in Europe did **not** repeat their previous warning signals that policy interest rates are set to move higher. However the Fed did signal at the July meeting that "gradual" interest rates should be expected over the next year.

In Australia, our economic activity has encouragingly improved while our key commodity prices have risen strongly. Australia's jobs growth and retail spending has picked up speed over recent months with the unemployment rate stabilising at 5.6%. The National Australia Bank business survey also indicates strong responses for confidence and conditions.

At the time of writing, heightening geopolitical risks between the US and North Korea are causing a spike in share market volatility. While the risk is more political than economic at this stage, markets have reacted adversely.