IFM Investors Economic Update

The volatility that characterised global investment markets in February and March has continued into April.

At the time of writing the VIX index is hovering in the low 20s, after averaging, for the last three months of 2017, just below 10. US equities have been swinging between losses and gains on news flow, but remain around 9% off the peaks seen in late January.

Market concerns in the US have been shifting from anxiety induced by the prospect of higher bond yields impacting valuations to fears of an escalating trade war between the US and China. The former was a reflection of improved economic conditions, while the latter came about from speculation around what could be a material negative impact on these two economies and, by implication, the global economy and its financial markets. The headlines suggest the scope for rising tariffs on a broader range of Chinese goods imported to the US will possibly be met with retaliatory action from China’s government. As yet, we do know where this potential escalation will end, given the players involved, nor how greatly markets and investor confidence will be impacted. For now there seems potential for both further escalation and for tensions to dissipate if a bargaining position could be reached. Economists and investors are clearly contemplating the downside risks to the global economy should the situation deteriorate – whilst hoping a détente is reached.

What is clearer to the vast majority of economists is that protectionists have too readily discounted the benefits of global trade for consumers and businesses alike over an extended period. This policy course is being pursued as they seek the expedient political benefit of protecting domestic labour forces and industry, which have more often than not proven themselves less than competitive in the face of global competition.

In a worst-case scenario of damaging escalation, the fallout for Australia could come via two channels: financial markets and potentially a direct external shock from a weaker Chinese economy. This is despite, at this stage, it being unlikely that direct sanctions on the US by China will have a material impact on Australian industry.

The fallout from global financial markets is likely from volatile and weaker asset markets, prompting economic instability and investor caution. This could impact not only investors, but also households, who may see a reduction in wealth as asset prices decline.

It would also impact the broader economy, companies and governments via weaker commodity prices. Indeed, the opening round of tariffs on steel from the US has seen a pronounced selloff in iron ore prices. Further, the rise in uncertainty both globally and in Australia will do nothing to improve the outlook for much-needed business investment.

The risk of a direct impact on the Australian economy from an exogenous source will come largely from any material slowdown in the Chinese economy rather than the US (which will clearly have an indirect impact). As is well known, the Australian economy is exposed to China like no other. In 2016-17 China accounted for 23.7% of two-way trade more than the next three countries combined – Japan (9.3%), Korea (5.3%) and the US (9.0%). What is less well known, however, is that it is not just key resources exports but services that define Australia’s exposure. China was Australia’s top goods exports destination by far in 2016-17, accounting for 32.8% of our export trade (or 37.2% if Hong Kong is included). Japan is a distant second, taking 14.5%. Yet China is also our top services export destination by far, accounting for 18.0% of this trade. In this category, the US is second at 10.4%.

Australia: Goods and services exports to China

While goods exports have stabilised, services have exploded

Source: IFM Investors, DFAT

Of these services, the massive increase in tourists and students consuming education services has been a material source of direct economic growth for Australia. Much of this has been due to the emergence of the Chinese economy and rising incomes of its households. Whilst also clearly being assisted by a weaker Australian dollar.
Indeed the growth of services exports in recent years has reshaped the list of Australia’s top five exports. Iron ore and coal are still first and second, and liquid natural gas is fourth (and is rising rapidly as exports come on-stream), accounting for 16.8%, 14.5% and 6.0% respectively. But education-related travel services and personal travel services are now third and fifth, accounting for 7.5% and 5.8% respectively, placing them well ahead of the manufacturing sector and agricultural products.

Aside from this readily quantifiable trade exposure, we can also observe increased foreign – and largely Chinese – investment into residential property, which at the margin is a material and significant driver of new development and ownership. This factor potentially creates another less definable, but still material, risk to the economy via this sector.

Concerns of an exogenous negative shock from a Chinese economic hard landing on the Australian economy have, to date, been characterised as a high impact but low probability event. Chinese corporate debt, financial liberalisation and economic transition have driven this argument. Now, with the prospect of ‘trade wars’ being added to the list, it unarguably increases the probability.

**United States: Fed consider the upside**

Despite the turbulence in financial markets, the real economy in the US continues to perform well. Economic growth has been even better than first thought, with the third read of the US GDP figures showing a 2.9% expansion, (or 2.6%yoy). This was an upwards revision from the previously estimated 2.5% saar. Stronger growth in household spending on services and a smaller drag on growth from inventories drove the improvement. Non-residential investment was solid and residential investment was strong, after weakness in the previous two quarters.

Headline CPI inflation decelerated in monthly terms in February coming in at 0.2%mom, yet ticked 0.1 pp higher to 2.2% in annual terms. Within these data, apparel and motor vehicle insurance prices both saw a second month of outsized gains, rising 1.5%mom and 1.7%mom respectively. Core inflation was also more modest, at a softer 0.2%mom, and remained unchanged in annual terms at 1.8%yoy.

Economic growth above potential, combined with a weaker US$ since late 2017 and some important partial indicators, suggest there is some upside risk to headline inflation at least. This was observed in March’s ISM manufacturing data, with the Prices paid index climbing to its highest level since April 2011, in part due to the US government’s tariff announcements, but also broader capacity utilisation. The Institute for Supply Management noted, “Demand remains robust, but the nation’s employment resources and supply chains are still struggling to keep up.” This came as the headline index eased to 59.3 from 60.8, as important forward orders and employment sub-indexes also declined.

Inflation may also be supported by another modest acceleration of wages growth, which ticked up 0.1 pp to 2.7%yoy in March. This was despite a weaker than expected non-farm payrolls outcome, in part attributable to poor weather.

**US: Headline inflation and manufacturing prices paid**

*Potential upside to inflation if price increases passed through*

Source: IFM Investors, ISM, BLS

Nonetheless, the US Federal Reserve (Fed) gave no indication it believes materially stronger inflation will emerge at the recent Federal Open Market Committee (FOMC) meeting or in its subsequent press conference, in which Chairman Jerome Powell suggested there’s “no sense in the data we’re on the cusp of an acceleration of inflation”. The Fed did note, however, that “the economic outlook has strengthened in recent months” and this warranted “further gradual adjustments” in policy rates. As was broadly expected by financial markets, it raised the federal funds rate by 0.25% to an upper bound of 1.75%. However, by a narrow margin, the median expectation in the ‘dot plot’ for policy rate hikes in 2017 remained at three, despite some market expectation of an upgrade. The number of hikes FOMC members expect to transpire in 2019 was increased from two to three, which would take the funds rate to 3.0% by the end of 2019. This was seemingly a reflection of an improved economic outlook that prompted the FOMC to increase its GDP forecasts and
lower its unemployment rate forecasts materially. Core inflation forecasts were also adjusted upwards, albeit more modestly, by 0.1pp to 2.1% in both 2019 and 2020.

Europe: Growth with little inflation

In its March meeting the European Central Bank (ECB) gave some recognition to the improved economic outlook for the region and the now significantly diminished downside risks to inflation. It had opened the year noting that “some members expressed a preference for dropping the easing bias regarding the asset purchase program”. In March it did indeed drop its easing bias, which suggests it no longer “stands ready” to add further stimulus – the implication being it feels stimulus is no longer necessary. Real GDP forecasts for the Eurozone were increased by 0.1pp in 2018 to 2.4% and growth expectations in 2017 were also revised higher to 2.5%. The regional economy was confirmed to be expanding by 2.7%yoy in Q4.

While economic activity in the Eurozone is expected to be solid and above trend, inflation forecasts are more conservative. This was highlighted by President Mario Draghi, as he played down the shift in language at the press conference following the March ECB meeting. Indeed, headline and core inflation forecasts remain at just 1.4% and 1.1% respectively for 2018. These are still well below the ECB's target of being below but “close to” 2% over the medium term.

February’s data confirmed the inflation pulse is modest in the Eurozone economy, with headline inflation decelerating to 1.1%yoy from 1.3%yoy in the month prior, and core inflation unchanged at 1.0%yoy. March's advance read on inflation did show an acceleration in the headline measure to 1.4%yoy, due to a base effect. But this may be reversed in April, due to a base impact from gasoline prices. The core measure was unchanged at 1.0%yoy.

Prospects for wages growth in Europe, which would underscore inflation momentum, seems some way away, with labour costs rising just 1.5%yoy. Employment growth is currently running at a solid 1.6%yoy but this is only gradually bringing down the unemployment rate which is at 8.5% as of February’s data.

It is notable, however, that labour market tightness varies greatly across the region and there is a large range of unemployment rates prevailing across the Eurozone and Europe more broadly.

Europe: Unemployment rate

Labour market strength remains disparate across countries

Source: IFM Investors, Eurostat

UK: a hike coming amidst uncertainty

The case for a near-term rate hike, which is likely as early as May, continues to build. This comes despite overall UK economic growth being mired at just 1.4%yoy growth and characterised by weak business investment and soggy household spending. Where the surprise has been, given the modest activity data, has been in the labour market.

In the three months to January, employment has increased by a very solid 168,000 positions, a rebound after some weaker growth late last year. This was enough to push the unemployment rate back down 0.1pp to 4.3%, and that was despite an increase in the participation rate of 0.1pp to 63.7% (data re three month rolling values). Importantly, the unemployment rate is forecast to continue declining through the Bank of England’s (BoE) current estimate of full employment at 4.2%. Already, the proximity of the unemployment rate to full employment has seen wages growth accelerate through much of 2017.

Wages growth continued in January’s data, with private average weekly earnings accelerating to 2.8%yoy – a rate not seen since September 2015. This threat that wage growth will support inflation is likely key in the BoE signalling to remove, very gradually, policy accommodation. That said, in data to February the rate of inflation decelerated to 2.7%yoy, after peaking at 3.1%yoy in late 2017.
Similarly, core inflation decelerated to 2.4% y/y as the impact of the weaker GBP fades. Notably, both rates are still above the Bank’s target rate and, therefore, the gradual removal of accommodative policy is viewed as a prudent course, given aforementioned wage pressures that may start to underpin inflation.

The Brexit process took a positive turn in March, with the EU and the UK governments agreeing to a 21-month transition period that will extend to December 2020. This comes after limited progress in broader negotiations. Through this period the UK government has agreed to guarantee EU citizens rights for those arriving before the Brexit vote and during the transition period. Importantly, the UK will stay within the EU single market and customs union until the end of the transition, providing important time and economic certainty, at least in the short term, whilst further Brexit details are negotiated. Further, the UK can negotiate trade agreements with third parties during the transition but not implement them until after it has passed. The UK also has no vote in EU policy-making in the period but would be consulted major policy issues and direction.

**UK: Unemployment and inflation rates**

*Inflation remains elevated and this still may persist*

Source: IFM Investors, ONS

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**Japan: BoJ to stay the course**

The Bank of Japan (BoJ) maintained its course at its March meeting. The board voted eight to one to keep interest rates unchanged at -0.1% and retain its quantitative and qualitative monetary easing (QQE) with yield curve control (YCC) program. The dissenting Board Member, Goushi Katatoka, was more dovish, favouring additional policy easing. Within the decision, the BoJ reaffirmed the ongoing purchase of Japanese government bonds at “more or less the current pace” of ¥80 trillion per year, which is designed to keep the 10-year JGB yield anchored at or around 0%. This was despite having to purchase significantly lower amounts of JGBs in recent months to achieve this.

The BoJ continues to assess that the Japanese economy is “expanding moderately”. However, there is some concern that the residential construction cycle may be “weakening somewhat”, in contrast to its previous view that it was “more or less flat”. This comes after residential construction subtracted modestly from real GDP growth in both Q3 and Q4. Indeed, the outlook for real GDP growth in fiscal 2018 is now for growth to decelerate to 1.4%, with some slowdown anticipated. The more modest growth outlook is still above the BoJ’s estimate of potential growth at 0.5-1.0% y/y rate, so is expected to generate inflationary pressures. And what is notable is the significantly more intense use of capital and labour input required to ensure an ongoing positive output gap and this should also be supportive of inflation.

**Japan: Output gap & potential growth**

*A greater degree of capacity utilisation needed to drive growth*

Source: IFM Investors, Bank of Japan

Utilization index is comprised of capital and labour inputs
Nonetheless for now the acceleration of inflation is still occurring at an almost glacial pace. Headline inflation ticked higher to 1.5% y/y in February data and the focused measure ex-fresh food did likewise to 1.0% y/y. But it will need to maintain this momentum to reach the 1.4% y/y the BoJ expects by the end of the year, which is also still well short of the central bank’s 2.0% y/y target. However, there seems little underlying pressure for this to occur, with the ex-fresh food and energy measure – consistent with the core measure in the US – running at just 0.5% y/y.

An uplift in labour cash earnings to 1.3% y/y in February may help to avoid any undue disinflation. However, this may be offset by the recent strength of the Japanese yen, which has appreciated by 6% since the start of the year and will act as a headwind to inflation’s momentum. Indeed the BoJ noted, if this persists, there will be a “risk of a delay” in achieving its inflation target and may pose downside risk to the economic outlook.

**Australia: growth steady but yet to be convincing**

In Australia, the economic outlook shows signs of modest improvement. Yet it is employment growth and business confidence metrics that have remained the standout performers in the data flow. Both are expected to continue to be positive, yet current strength and momentum is unlikely to be maintained over the course of the year.

Labour market data has continued to demonstrate improvement, with February’s data delivering another 17,500 jobs and extending the record run of consecutive monthly increases. Nonetheless, spare capacity remains, with the unemployment rate ticking higher to 5.6% after another increase in the participation rate. Also notable was the underemployment rate, which ticked higher as a consequence to 8.4%.

Business survey data showed that conditions in February have never been better, with the index rising to 21 – a record high since the survey started in March 1997. This was a result of strong reads on trading and profitability, combined with a sharp improvement in the employment outlook, which appears anomalous and may reverse in the coming month. Business confidence slipped in February, although still remains elevated.

The strength of surveyed business conditions can lead to two conclusions. The first is that there is upside risk to economic growth, given the historic strength of the relationship between the survey and underlying activity. Or that if this relationship is weaker and the survey has peaked then economic conditions may soften. The outperformance of the survey may also be in part due to the extraordinarily accommodative monetary policy settings in place, amidst soft wages growth, abundant labour supply and cyclical highs in surveyed profitability.

Although weaker than business sentiment, consumer sentiment has held on to gains in recent months and remains in slightly optimistic territory. This, along with exceptionally strong employment and elevated tourist arrivals supported a surprise rise in retail sales in February. Sales rose 0.6% in the month and accelerated to 3.0% y/y – a growth rate not seen since July last year.

The news was less positive for households in terms of dwelling prices, which declined again across capital cities in March. Weakness was led by Sydney, Melbourne and Adelaide markets, with other cities recording monthly gains. Overall, median house prices are now only 0.8% higher through the year. During the quarter, prices were actually 0.5% q/q lower and this combined with a simultaneous 5% sell off in equities markets suggests household wealth may have declined in the March quarter. This is a trend that, if continued, will weigh on household consumption growth going forward.
For the Reserve Bank of Australia (RBA) it seems much of its April Board meeting was spent focussing on developments overseas. The Bank noted the aforementioned decline in equity markets due to concerns about “trade policy in the United States”. It also focused on rates markets. Firstly, it considered long-term yields rising as inflation rates rise globally and other central banks removing stimulus. And secondly, discussions were around developments in short term rates markets, which warranted a comment in the RBA release due to the material rise in rates in that space due to “reasons other than the increase in the federal funds rate”. This has flowed through to short-end rates in Australia and may pose somewhat of a cost challenge to domestic banks, although implications for domestic monetary policy at this stage are likely few.

Overall, there was little change in the RBA’s assessment of domestic conditions. These remained broadly in line with its expectations of only “gradual” progress to unemployment and inflation objectives. Indeed, there seems little prospect of any near-term change in course from the RBA, particularly in the absence of any upside surprise to its forecast for inflation or wages. For any prospect of this we will have to wait until 24 April for March quarter consumer price data.

Dr Alex Joiner
Chief Economist
@IFM_Economist