ifm investors

Economic Update

AUG 2017

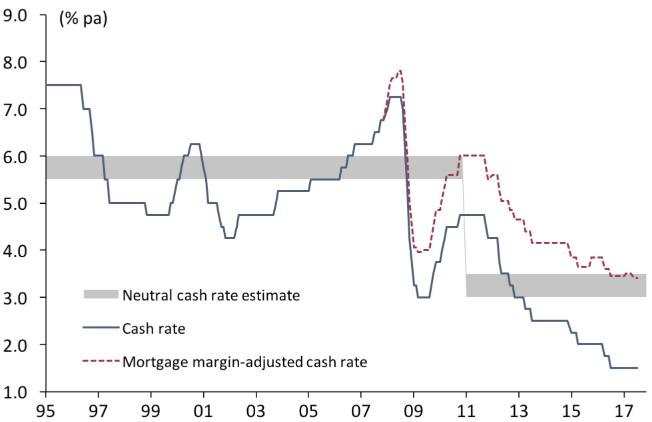
Global economy: what is neutral?

The Reserve Bank of Australia (RBA) had markets moving this month, particularly the Australian dollar. It inadvertently did this when it put a number on the neutral rate of interest in Australia (the point at which policy is judged from being expansionary to contractionary, or vice-versa) in its June Board meeting minutes. The number itself was of no surprise to economists, but given the demand from markets for hawkish fodder, as other central banks move to remove policy stimulus, this was interpreted somewhat as a statement of intent. It turned out to be a mis-interpretation as the RBA qualified the discussion as being a theoretical one, with no implications for short-term policy settings.

Nonetheless, it did highlight a narrative that has recently emanated from several global central banks, as they contemplate removing policy accommodation. Indeed, the nominated neutral interest rate is now lower than it was previously and will be so for the foreseeable future. The RBA itself noted in its minutes that its estimate of the neutral rate is around 3½%. The Reserve Bank of New Zealand followed up relatively quickly in a statement supporting this level in its context. The Bank of Canada has been discussing the neutral rate for some time and re-iterated in its July 2017 Monetary Policy Report that "The neutral nominal policy rate in Canada is estimated to be between 2½ and 3½%." The US Federal Reserve (the Fed) also subscribes to this view in its quarterly longer-run forecasts that, given it assumes the economy will be running at potential over the longer run, can be interpreted this way.

Australia: neutral cash rate

Economic trends and lenders costs push neutral rate lower



Source: IFM Investors, RBA

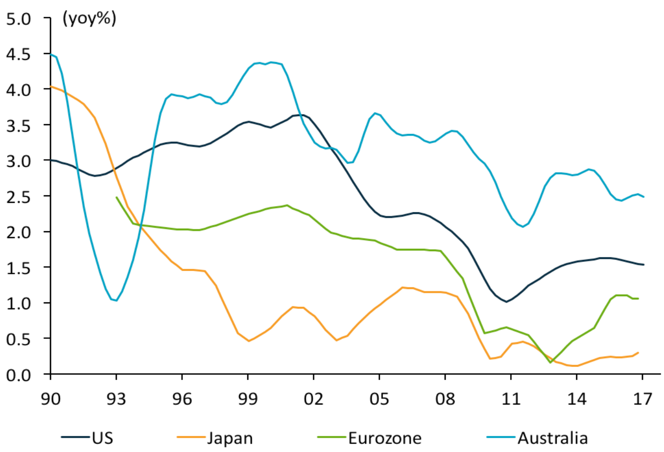
All central banks have arrived at this approximate estimate from levels that were significantly higher. For example, in the January 2012 minutes of the Federal Open Market Committee (FOMC), it noted that "longer-run nominal levels [of the neutral rate] were in a range from 3¾ to 4½%". And the RBA itself estimated the neutral rate above 5% in the pre-financial crisis, pre-resources bust period. Nonetheless, all of these estimates from central banks are just that: theoretical estimates. No central bank knows what the neutral interest rate is – not until they reach it. Until then, they will be feeling the way with monetary policy as they remove stimulus. This potentially creates a risk to the economy should they overshoot. That is why we should expect that all central banks will remove current policy accommodation extraordinarily gradually – we are not in a 'normal' tightening cycle.

It is apparent an inflection point for this cycle has been reached in global monetary policy, with implications for bond yields and, significantly, risk-free rates. But lower neutral rates mean we clearly should not expect mean reversion. This is important for investors in terms of asset valuations, particularly those of longer duration.

Central banks note that it is lower potential rates of real GDP growth that are a key driver of a lower neutral rate outlook. This is as lower productivity growth, reduced labour supply (via deteriorating demographics) and reduced growth in capital inputs all weigh in this space. Indeed, neutral rates of interest and potential economic growth have likely declined in lock-step. Advanced economy potential growth, as estimated by central banks, has been in decline for the past two decades.

Global: potential real GDP growth rates

Demographics and productivity weighing on potential growth



Source: IFM Investors, Federal Reserve Bank of St. Louis, European Central Bank, Bank of Japan, Australia estimated by authour using methodology in de Brouwer G (1998), 'Estimating Output Gaps', RBA Research Discussion Paper No 98-09

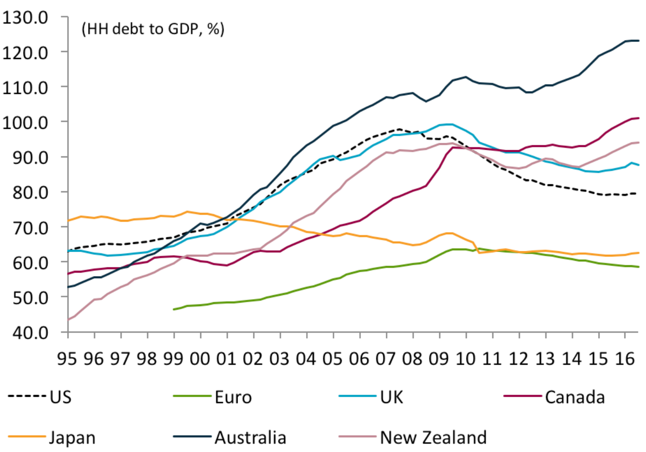
Our estimate of Australia's potential economic growth rate is around 2½% pa, slightly under the 2¾% estimate of the Commonwealth Treasury and seemingly accepted by the RBA – noticeably higher than many other advanced economies. Arguably, the reasons for this are that: (1) labour inputs have so far held up; and (2) we have had a huge run up in capital investment that is, for now, benefitting growth and flattering productivity. This is attributable to higher rates of population growth and the resources investment boom, respectively. A higher rate of potential economic growth and a higher inflation target than many advanced nations would suggest Australia's neutral rate of interest should be higher than these economies. However, this may not be so, for at least two reasons.

The first is purely mechanical. Due to cost of funds increases for lenders (due to offshore increases in costs and those arising from regulatory and prudential changes), the margin between the RBA's target cash rate and the effective rate borrowers receive is wider. In the mortgage space, this margin has widened from 180bp before the global financial crisis to around 370bp currently. For large businesses, this spread is from an average of around 230bp to now 425bp, and 132bp to 220bp on average for smaller businesses. The RBA has always said it would calibrate the level of the target cash rate to what the effective rate prevailing in the market is. This wider margin implies a lower cash rate will be required (see chart on previous page).

The second factor is largely a consequence of the actions of central banks themselves. And their maintaining aggressively accommodative monetary policies for an extended period. That is, high private debt levels and, in Australia's case, exceedingly high household debt. Monetary policy has been relied upon too much and for too long to drag forward activity, consumption and, in particular, investment in the residential sector into the current period. Consequently, Australia's household debt to GDP ratio is amongst the highest in the world. While this may be serviceable at current interest rates, it inevitably means that interest rates are a much more powerful tool than they have been in the past.

Global: housing debt to GDP ratios

Private sector debt is another factor weighing on the neutral rate



Source: IFM Investors, Bank of International Settlements (BIS)

It is also leaves monetary policymakers with a much more asymmetrical policy tool in terms of its effectiveness. Easing policy further (if needed) would likely have a limited impact on the behaviours of households (outside of property) and businesses, and serve only to weaken the exchange rate modestly. In contrast, raising rates will have a material impact on heavily indebted households, particularly on newer borrowers. Therefore, the RBA will be limited in how aggressively it can move to tighten policy (in the event this is necessary) due to the greater magnitude of the impact it will have – and also in terms of the level of the neutral rate due to the sheer amount of debt in the system. For example, household liabilities have risen from $1.3 trillion just before the financial crisis to $2.3 trillion currently (expanding in excess of GDP, population, etc.). Consequently, the level of interest rates at which these liabilities becomes more difficult to service is lower as the economic impact on household is now much larger. This factor itself should be considered in the context of a lower theoretical growth rate due to the impact of higher rates on household consumption.

In terms of the neutral rate, we may in the future be forced to consider it being lower should the current difficulties that central banks are having in generating inflation persist. That is to say, they will not have to rise as far or as rapidly to manage what could be only modest rates of inflation. This may be a consequence of ongoing weak wages growth, the rise of technology and automation, and increased competition over an extended period. And although they may not acknowledge it, central banks may become a little more circumspect about their inflation targets and focus more on growth, full employment and financial stability.

US: economy okay but inflation doubts linger

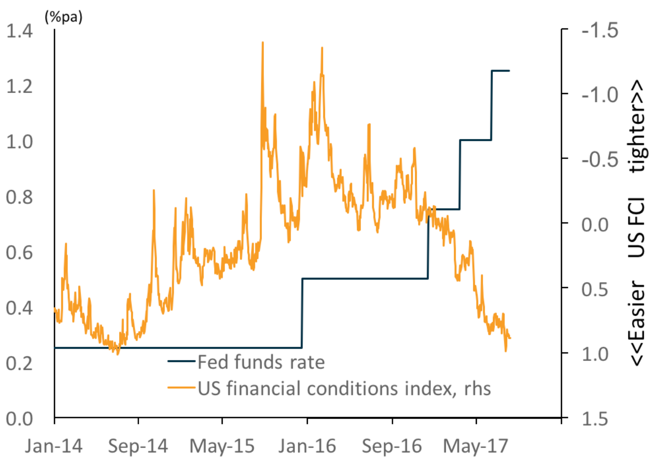
Such concerns about inflation are getting increasingly problematic for US policy-makers. This was evident at the most recent FOMC meeting. It left its policy rate unchanged at 1.25%, as expected. It also intimated that it planned to begin its balance sheet normalisation program relatively soon, which markets now expect to be in the coming month or two and likely before any future interest rate move. Yet in its accompanying communication, it was adjudged to be at least becoming more cautious, primarily on its outlook for inflation. It noted that inflation would remain below the 2% target in the "near term". This is with risks now "balanced" and developments being monitored "closely".

The FOMC's statement again underscored that future rate increases are data dependent but that it expects the US economy to "evolve in a manner that will warrant gradual increases in the federal funds rate". However, policy will remain accommodative for "some time" yet. The Fed's caution on inflation was justifiable as the data, this time for June, disappointed expectations again. The headline measure of inflation decelerated to 1.6%yoy and the core measure remained stable at 1.7%yoy. As the impact of one-off factors dissipate, focus will be on any potential reacceleration of inflation in coming data.

Indeed there is increasing market scepticism around the potential for inflation to accelerate further. And this in part stems from concerns that the US Administration will find it difficult to pass significant tax reform that would stimulate the economy. Interestingly the impact of these factors on markets is offsetting the tightening efforts of the Fed. Since the FOMC started hiking rates, financial conditions have eased materially (see chart below). This has been most notable with the US dollar selling off, but also as bonds yields have edged lower, corporate spreads have narrowed and equity markets have risen. This will come as a significant disappointment to other global central banks that have been looking for the FOMC to raise rates and strengthen the US dollar – the RBA prominent amongst them. The weaker US dollar has resulted in the Australian dollar appreciating materially (discussed further overleaf), creating downside risks to the domestic economy.

US: financial conditions and the Fed Funds rate

Financial conditions easing despite tighter monetary policy



Source: IFM Investors, Bloomberg

Outside of inflation, activity in the US economy remains robust. This is reflected in employment data remaining solid. Non-farm payrolls rose by 209,000 in July and have averaged 198,000 per month since March's anomalous slowdown. This has resulted in the unemployment rate edging back down to 4.3%, despite a slight increase in the participation rate. June quarter GDP data was also solid at 2.6%saar, driven overwhelmingly by the consumer sector and a solid lift in business equipment investment. Another modest positive in these quarterly national accounts data was that broad price measures were slightly better than expected, with the core PCE (personal consumption expenditure) deflator ticking up 0.1bp to 1.5%yoy. However, this is still well below the Fed's target.

Europe and the UK: good and mixed

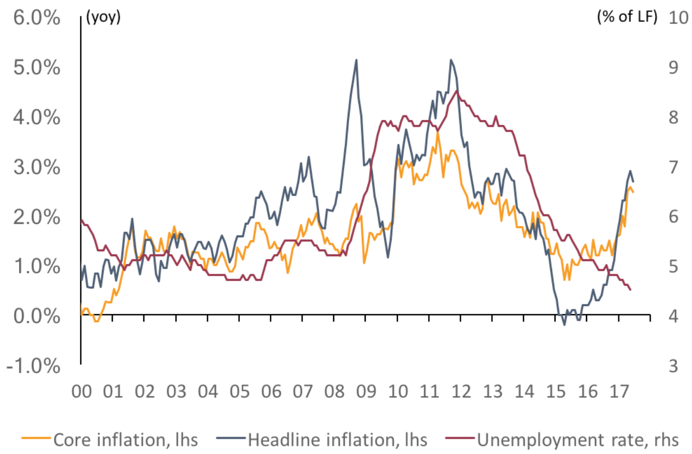
Economic activity data continues to be solid in the Eurozone, reflected in industrial production in the region growing 1.3% in May, driven by a surge in capital goods production. Growth in this space was broad-based geographically, but strong results in the larger continental economies of Germany, France and Spain were particularly pleasing. This outcome supported 0.6%qoq real GDP growth in the region in the June quarter, with the through the year rate of growth accelerating to 2.1%yoy. Nonetheless, inflationary pressures remain modest, with headline and core measures running at 1.3%yoy and 1.2%yoy respectively, underscoring that the European Central Bank will be in no hurry to remove its current accommodative policy stance.

By contrast, industrial production in the UK was soft again, decreasing by 0.1% in May to record the fourth monthly decline in five months. Concerns over Brexit are clearly weighing in this space, offsetting any positive production and export benefit from the lower GBP.

Nonetheless, the labour market in the UK continues to perform well, with the unemployment rate edging lower by 0.1pp to 4.5% - a 43 year low. This strength may put upward pressure on wage growth, which is running at 2.0%yoy, if continued. Yet for now, inflationary pressures have eased marginally overall. Headline inflation was dragged lower by the oil price, decelerating to 2.6%yoy in June's data, although core inflation also decelerated 0.2pp to 2.4%yoy, and this should take some pressure off the Bank of England (BoE) when considering the course of monetary policy.

UK: inflation and the unemployment rate

Inflation above BoE's target and unemployment is at a 43 year low



Source: IFM Investors, ONS

Indeed the BoE became slightly more dovish in August, as the Monetary Policy Committee voted to keep rates on hold, shifting to 6-2 majority from 5-3 previously. Further, the economic outlook was downgraded in the accompanying Inflation Report. GDP growth was taken down 0.2pp to 1.7% in 2017 and down 0.1pp to 1.6% in 2018. The BoE cited uncertainty around Brexit, business investment and household spending as key drivers of the change. Despite this increased caution, the BoE's communication makes it clear that it still believes the next move in rates in the UK will be higher. This is expected to be the case even if the economy only follows the fairly modest growth outlook outlined in its central projections.

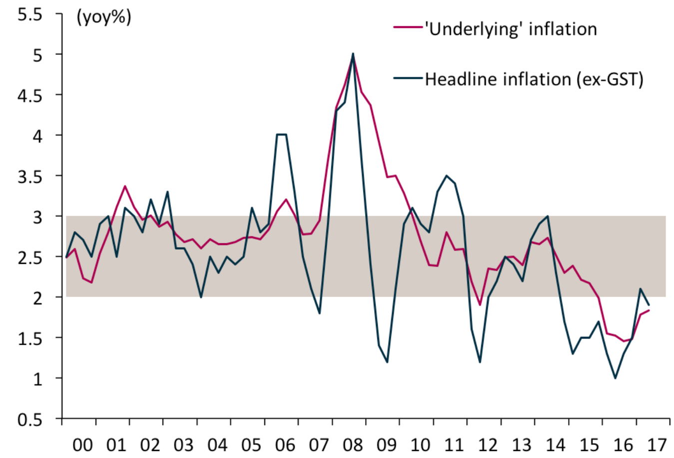
Australia: inflation and economic growth soft

In Australia, economic activity indicators and survey measures were again solid over recent months. Importantly, after some concerning weakness, retail sales posted a solid 1.9% nominal growth for the June quarter. And this was underpinned by 1.5%qoq growth in volumes, which will support real GDP growth after recent weakness. Further, the labour market recorded a solid increase in employment in trend terms and the unemployment rate remains around 5½%. By contrast, but as expected, building approvals continue to trend lower. Also as expected, they remain volatile on a seasonally adjusted month-to-month basis due to the higher than normal proportion of high rise apartments that continue to characterise the market. By contrast, dwelling prices continue to rise solidly in Sydney and Melbourne, up 12.4%yoy and 15.9%yoy for the twelve months to August. Other capital cities remain mixed.

Consumer price inflation data for the June quarter was a key focus. In headline terms prices were up a soft (and weaker than expected) 0.2%qoq to be 1.9% higher through the year. Core measures were in line with the RBA's expectations but still below the target band, running at 0.5%qoq and 1.8%yoy.

Australia: headline and core inflation

Inflation moving slowly towards target



Source: IFM Investors, ABS, RBA

Despite soft inflation data, hawkish sentiment pervaded markets as the RBA's mention of the "neutral rate" in an official communication bolstered the Australian dollar, which regularly traded over US$0.80, despite this being qualified as purely a theoretical discussion in following speeches. The RBA's dissatisfaction with the appreciation of the Australian dollar was made clear in both its post-meeting press release and in its Statement on Monetary Policy. And indeed the current level of the exchange rate was noted as already "weighing on the outlook for output and employment". The RBA downgraded its short-term GDP forecasts modestly, partly on this basis and partly due to a weaker than expected March quarter outcome. But it also went further to suggest that if the Australian dollar was to appreciate further it would "...result in a slower pick-up in economic activity and inflation than currently forecast". This underscores the RBA's disappointment with US dollar weakness, and also that it raising rates itself is still some way off.

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