Economic Update

SEP 2016

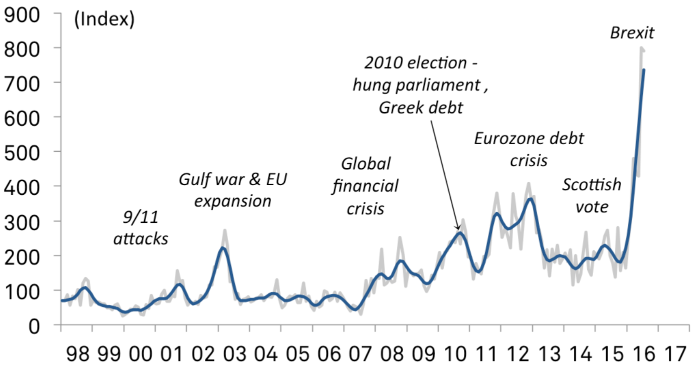
More stimulus for the UK, Europe and Japan

Recent months have brought further monetary policy stimulus in Japan and the UK, and the European Central Bank (ECB) is also favoured to continue to add to monetary policy accommodation over the course of this year.

With interest rates already negative, the Bank of Japan (BoJ) and the ECB are pushing further into unconventional quantitative measures in an effort to support growth and reinvigorate inflation. This is occurring even as the effectiveness of ever looser monetary policy, zero and negative interest rates and unconventional policy settings are increasingly being questioned.

The Bank of England (BoE) has its own unique set of problems. This is due to the 'Brexit' vote that will see the UK leave the European Union. Before the vote on 23 June, the BoE had been favoured as the second major global central bank to begin to remove policy stimulus, after the US. It has now been forced to reverse course. At the same time a heightened degree of uncertainty is impeding economic activity and politicians are now scrambling to come to an agreement on a way forward.

UK: Policy uncertainty
The post-Brexit environment will remain challenging



Source: IFM Investors, www.PolicyUncertainty.com

For economic policymakers, the task is to attempt to reduce the impact on the economy, which is now broadly expected to enter recession. In August, the BoE cut rates 25 bps to just 0.25% and increased its government bond buying program from £375bn to £435bn. It also committed to start purchasing corporate bonds. Monetary conditions more broadly have eased as the GBP continues to trade around 11.0% lower than before the Brexit vote.

Fiscal policy will also play a part, with an aggressive cut in corporate taxation rates touted as one measure to support investment. This is deemed appropriate as much of the expected deceleration in growth stems from the delay or cancellation of business investment plans. Unfortunately it also appears that infrastructure spending has declined markedly and this will only continue as European funding is potentially withdrawn. This will put additional pressure on the government to make infrastructure investment a key fiscal policy to support growth in aftermath of the Brexit vote.

The US struggles to remove it

The US is not adding further monetary policy stimulus but it is struggling to remove it. The timeline for the Federal Reserve to tighten further has been continually pushed back. This comes after a solitary 0.25% hike in the federal funds rate back in December last year. The Federal Open Market Committee (FOMC) was expected to lift rates twice more in 2016. However, its recent communications have been relatively dovish due to inconsistent domestic data flow and global financial market volatility despite improvements in unemployment and inflation.

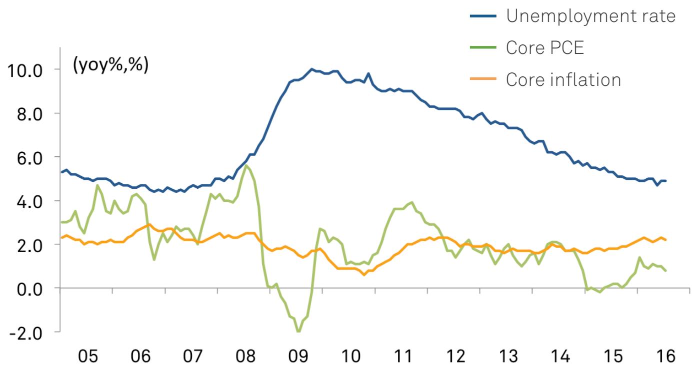
As a consequence, most economists remain cautious that the FOMC will raise rates more than once this year; and even that is highly uncertain with financial markets currently pricing in only around a 50% likelihood of a hike by December. So what is happening in the US economy that makes this the case?

Economic growth has been soft in the US in the first half of 2016, slowing to an annualised seasonally-adjusted rate of just 1.2% (primarily due to weakness in private and public investment and despite a very solid contribution from consumers). However, a rebound in GDP growth is expected in the second half of 2016 to around 2.25%, seasonally adjusted.

Progress also continues to be made on the FOMC's other two key mandates – unemployment and inflation. Despite some volatility in payroll data in recent months, they have on average been strong enough to keep the unemployment rate edging lower and it is now just below 5.0%. This is in line with the expectations of the FOMC and under what is generally accepted to be a level of 'full employment'.

This tightening of the labour market is supportive of only stable wages growth of around 2.0% year-on-year, but, due to limited productivity gains, unit labour costs are picking up. This will put upward pressure on consumer price inflation, especially as the deflationary impact of the stronger US dollar and lower oil price wanes. Headline inflation is expected to accelerate to around 2.25% year-on-year by the first quarter of 2017 from the current 0.8%. Yet core inflation is already around 2.25%, therefore upward pressure on the core PCE deflator (personal consumption expenditure deflator, the FOMC's preferred inflation target) is expected. Indeed, it is forecast to approach the FOMC's target of 2.0% year-on-year as we move into 2017.

US: Unemployment rate and inflation measures
Economic indicators converging to Federal Reserve targets



Source: IFM Investors, Bloomberg

Despite all this, the FOMC remains cautious as it does not want to make a policy mistake. That is, raising rates too early and prematurely choking off growth, as this would likely put pressure on it to reverse course and cut rates again and/or have to contemplate even more quantitative measures. By contrast, raising rates too late and inflation getting above the target is much less of a problem as the FOMC can simply move rates higher more quickly.

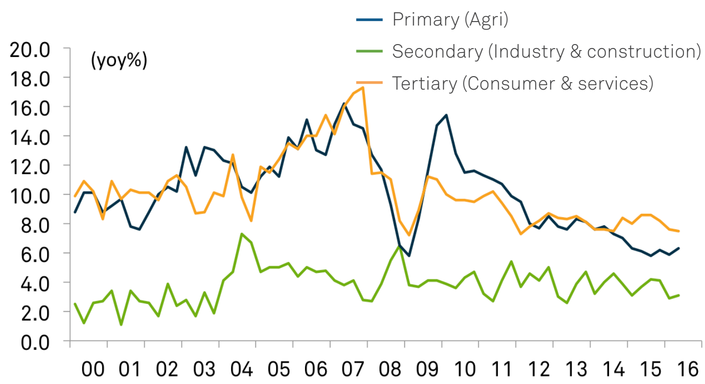
Interestingly, some are also suggesting there is potential for some modest fiscal stimulus now the need for austerity has abated. Both potential future Presidents have promised to do more. The Democrat's proposal is clearer and involves a US$275bn spending plan over the next five years. The need for this spending in the US is driven by under-investment over a long period of time and the ageing of existing assets. But it also has potential to lift growth rates and allow the FOMC to be more confident with its interest rate settings.

China: Steady...with risks

Chinese economic growth continues to be relatively solid, running at 6.7% year-on-year. This has been supported by stimulus from both monetary and fiscal policy. On the former, the People's Bank of China (PBoC) continues to keep interest rates and the reserve ratio requirement low, and continues to facilitate liquidity in the financial system. These measures have allowed for improvements in the residential space, a welcome development for Chinese and Australian economies alike. Yet whether these improvements can be sustained going forward remains an open question. Although emphasising exchange rate stability, the PBoC also seems comfortable with some further modest depreciation to support the export sector. Fiscal policy has also been proactive and is likely to continue to be so, with government authorities emphasising infrastructure spending as a primary means of stimulating growth.

Nonetheless, the rate of GDP growth is still expected to decelerate modestly to around 6.25% year-on-year over coming quarters. Further, much has been made of the gradually shifting composition of growth in China, from resource intensive investment to services and household spending. Australia is benefitting from both factors as commodity demand has held up well and growth in services (in the form of Chinese tourists and students) continues to add materially to GDP growth, especially since the depreciation of the Australian dollar since 2013.

China: Real GDP growth by sector
Services sectors driving growth as economy transitions



Source: IFM Investors, Bloomberg

Australia is exposed to China's economy more than any other developed nation. Therefore, any marked setback in China's economy is a key risk domestically. Two key concerns arise – high corporate indebtedness and the ability of policymakers to transition the economy and liberalise financial markets. These issues will be ongoing and as such represent a low probability but high impact risk to the Australian economy.

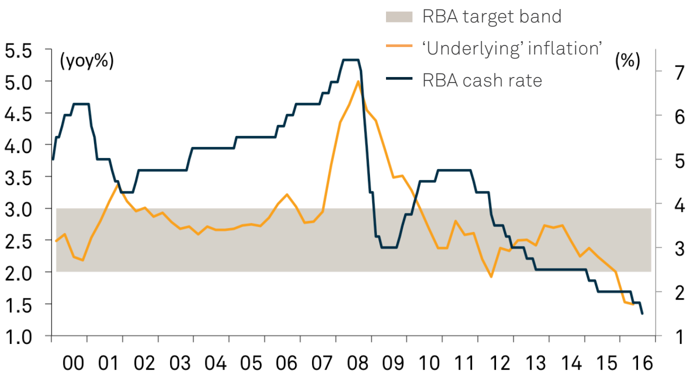
Australia: Joining the race but to what end?

On the surface, the Australian economy appears to be performing well, but the Reserve Bank of Australia (RBA) does not cut interest rates when it thinks things are going well and it has cut rates twice this year already, bringing the cash rate to just 1.5%. Why is this happening?

The RBA is easing policy rates primarily because weaker than expected 'core' measures of inflation have allowed it to. Indeed, this targeted measure of inflation has only been outside the RBA's target band of 2.0–3.0% on one other occasion in the inflation targeting period (in 2012). At just 1.5% year-on-year in the June quarter, it is the weakest in the history of the series.

A beneficial consequence of this easing has been that the RBA has kept domestic monetary policy from relatively tightening against other central banks that are still easing. In this way, the RBA has likely avoided any further material appreciation of the exchange rate that it believes would complicate the recovery of the economy.

Australia: RBA cash rate and underlying inflation
Weaker inflation prompts the RBA to ease



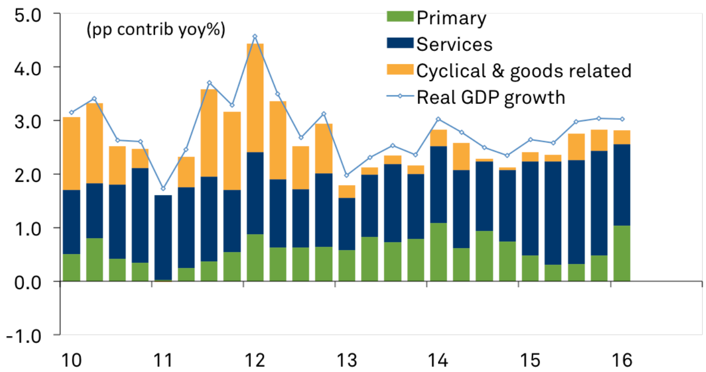
Source: IFM Investors, RBA, ABS

The RBA is also easing rates to support stronger economic growth. The economy itself, measured by real GDP, is growing at a rate above 3.0% year-on-year, but much of this is being driven by resources exports. The underlying domestic economy is still very weak. This is even abstracting the marked decline in resources sector investment, despite the record levels of residential construction.

Further, the nominal rate of GDP growth in Australia is very weak and has been running below real GDP for the better part of two years – an occurrence unprecedented going back to at least 1960. This is due to the massive decline in Australia's terms of trade as resources prices have fallen. As a result, living standards are also in decline.

But there are some positives. Services sectors are driving GDP growth, accounting for half of the growth over the past year. Demographic change and demand for services domestically has been important. Further, the lower Australian dollar has improved the comparative advantage of education and tourism sectors in particular. As a result of the latter, net services exports are supporting economic growth significantly.

Australia: Real GDP growth by sector
Services, not cyclical sectors, driving growth



Source: IFM Investors, ABS

Services sectors are also labour-intensive, and have been key in fostering employment growth and pushing the unemployment rate lower. It is unusual for the RBA to be easing rates while the unemployment rate is in modest decline, but doing so is in recognition of challenges to growth going forward.

Nonetheless, consensus is divided as to the extent to which the RBA will need to, or indeed should, ease policy further. Some believe interest rates will stay on hold at the current 1.5% for an extended period, whereas others expect two further cuts from the RBA, which would bring the cash rate to a fresh record of 1.0%.

Nonetheless, scepticism is growing as to how effective low interest rates will be in the Australian context – there are definitely diminishing marginal returns. Low rates are supportive of activity, but they are not driving a significant recovery in growth rates and they are unlikely to prompt a rapid return of inflation to the target band. Households and businesses are not changing their behaviours materially in response to ever lower rates. This is outside, of course, households continuing to leverage into the property market. However, pushing dwelling prices higher and household debt to record levels is at this stage not overly productive, and has arguably created significant imbalances and future risks.

Fiscal policy clearly has a role to play in engendering growth as monetary options become less effective. Yet it is currently contractionary as the Federal Government looks to bring the budget towards a surplus. Further, there is little confidence that the political environment, and prospect of much-needed reforms therein, have been improved by the recent Federal election. The threat of political stagnation has prompted credit ratings agencies to downgrade the outlook for the country's triple-A rating and most economists now expect that the risk of a sovereign downgrade is material.

One positive is that there have been some improvements in public infrastructure spending. New South Wales is leading the way and some better signs in Victoria have emerged, however other states continue to lag. With private sector investment soft and the residential construction cycle to decline, there is a strong case to invest significantly more in infrastructure – not only to support growth and employment but also to bolster productivity and living standards over the medium term. ■

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