Economic Update

APR
2017

US: Making America confident again

For much of the last month or so the upward momentum in US financial markets has begun to wane. This is particularly true in equities markets - in which significant optimism was being priced in around fiscal stimulus being introduced by the new administration in its first 100 days in office. But its recent unsuccessful bid to push through policy reform on healthcare (at least to date) and ongoing negotiation around tax reform has shaken market confidence. This pause in market gains is now reflective of a more measured outlook including delays to fiscal stimulus.

Consequently, many have speculated that the "Trump trade" – and reflation thematic – has run its course. While the former may be true to some extent, we think the latter has only just begun. The "Trump trade" merely enhanced market confidence that the US was recovering – a trend that had emerged before the election of President Donald Trump.

Ongoing positive signs of US recovery leave us comfortable that the reflation theme will continue.

That said, bond yields may not push materially higher for structural reasons. However, the retracing of massively accommodative monetary policy should not allow them to plunge to historic lows again.

This recovery should allow the US Federal Reserve to continue raising official interest rates with confidence. Indeed last month came the first of the three rate hikes the Fed expects to implement in 2017. The increase saw the target range for the Fed funds rate move higher by 25bps to 0.75-1.00%. Fed members' communications since that decision would suggest they think more tightening of policy will be warranted in the relatively short term. Added to this the Fed is now communicating around the shrinking of its balance sheet (as bonds mature but no reinvestment takes place). This gradual winding down is not likely imminent, but the Fed is seeking to condition the market well ahead of time as to not introduce undue volatility when it does occur.

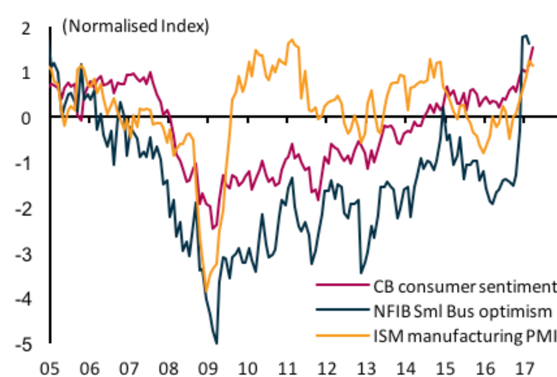
Despite this the Federal Open Market Committee (FOMC) is clearly proceeding with some caution, March's hawkish posture unchanged from the beginning of the year. Indeed markets had priced in a more hawkish FOMC communication and sold off when it failed to materialise with most concluding it was a 'dovish' hike. Its stance was also underscored by one FOMC member dissenting on the hike, with Minneapolis Federal Reserve Bank President Neel Kashkari voting to leave the rate unchanged. His dissent continued into the commentary by FOMC Chair Janet Yellen, who cautioned in the post-meeting press conference that "...the Fed Funds rate does not need to rise much to get to neutral" and that "the economic outlook is highly uncertain". Nonetheless, risks to the economy are still being judged to "appear roughly balanced". Consequently there were no material changes to the FOMC's forecast outlook. Importantly core PCE inflation was still expected to reach 2% by 2018; the median long run unemployment rate projection was taken down 0.1pp to 4.7%; and 2018 GDP growth was revised slightly higher 0.1pp to 2.1%. All other forecasts were unchanged.

Despite the FOMC still reckoning the economic outlook is highly uncertain U.S. consumers and businesses seem much more confident.

Improved confidence has been reflected in spades in recent survey data. And it is seemingly the political environment that has, to date, been responsible for this uplift.

Consumer confidence (the Conference Board measure) had been trending higher over a number of years, since it troughed during the 'great recession'. Yet it stagnated through much of 2015 16 only to be revitalised after the US election - climbing 25% since October, and hitting a 16-year high in the March data (this is in stark contrast to sentiment in Australia that has been stuck below average since the global financial crisis and punctuated by reversals caused by the political environment).

US: Consumer & business sentiment
The new administration has bolstered confidence



Source: IFM Investors, ISM, Conference Board, NFIB

Similar trends are also observable in key business surveys. The manufacturing and non-manufacturing PMI indexes (Purchasing manufacturing Index) both hit multi-year highs in recent months' data – pushing deep into expansionary territory. Small businesses are also sharing in the optimism with the National Federation of Independent Business (NFIB) Small Business Optimism index rising 11% since the election to reach a level in March not seen since November 2004.

However, the 'soft' survey data has so far not been matched by the 'hard' activity data. Indeed the disparity between the two is at a 16-year high (as measured by the

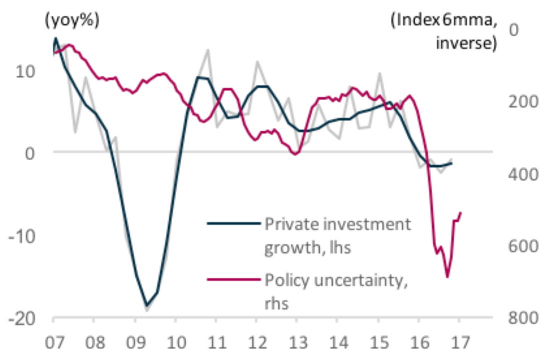
Bloomberg "Surprise index"). Yet often the soft data lead improvements in activity indicators. Intuitively that should happen again, and spending, and subsequently broader GDP growth and inflation, should be supported going forward. Thus far we have seen this more in consumer sentiment bolstering spending, rather than business sentiment bolstering private investment. We must further acknowledge that the political environment is highly uncertain and changeable, meaning any burst of optimism may be more cautious than usual. We will likely need to see some political stability in the US before a sustainable upswing in investment becomes entrenched.

UK & Europe: Brexit – it begins

Winston Churchill once famously asserted during one of Britain's other great historical challenges: "Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning." The wartime leader's sentiment neatly sums up Brexit. Finally, after months of speculation and debate following the 23 June vote, UK Prime Minister Theresa May signed a six-page letter that, when presented to European Council President Donald Tusk, formally began the two year exit process.

UK: Business investment & policy uncertainty

BREXIT uncertainty will weigh on business investment plans



Source: IFM Investors, ONS, PolicyUncertainty.com

The UK continues to desire an agreement on a comprehensive new deal with the 27-nation European Union within the two-year timeframe. However it remains a consensus view that any negotiations may risk stretching well beyond the two year deadline as complex and difficult negotiations get bogged down. Interest will lie in how willing the Europeans are to negotiate. This is because it is broadly recognised that the EU has a much stronger bargaining position than the UK government. Consequently current expectations from negotiations of UK politicians and media are somewhat optimistic. Nonetheless the transition period has now begun. On April 27th a special European Council will be convened to discuss the broad framework for the negotiations which will begin in earnest in late May or early June. The uncertainty that will characterise the transition period, and will define the course of the Bank of England's policy trajectory for some time.

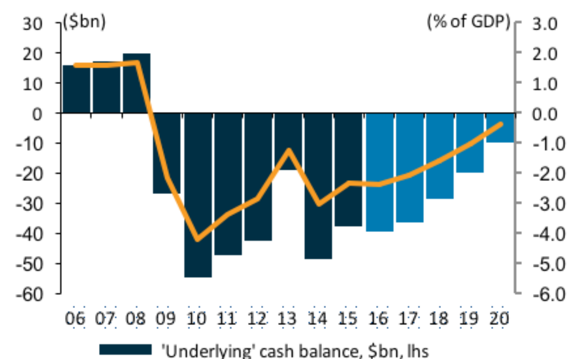
Australia: policy momentum needed

In Australia modest progress was made on economic policy over the month, a very welcome development from both a fiscal and monetary policy perspective.

This momentum will hopefully continue in the lead up to, and be incorporated into, May's Federal budget. As it stands we would expect the budget metrics to be slightly better placed than they were as foreshadowed in December's Mid Year Fiscal & Economic Outlook (MYEFO) in which the government foreshadowed a cumulative A$95bn underlying cash deficit over the next four years.

Australia: Underlying fiscal balance

May's budget will need to plot a reasonable path back to surplus



Source: IFM Investors, Commonwealth Treasury as at MYEFO 2016-17

We say 'foreshadowed' as the government will clearly be the benefactor of bulk commodity prices offering sustained growth, for longer than it had expected in recent quarters. Therefore the fiscal balance will be improved by parameter variations (that is underlying economic conditions) positively impacting corporate taxation via better than expected terms of trade and nominal GDP outcomes than were forecast.

> *But unlike the previous boom in commodity prices it will not result in an upswing of investment in the sector, nor be redistributed to households via meaningful income tax cuts.*

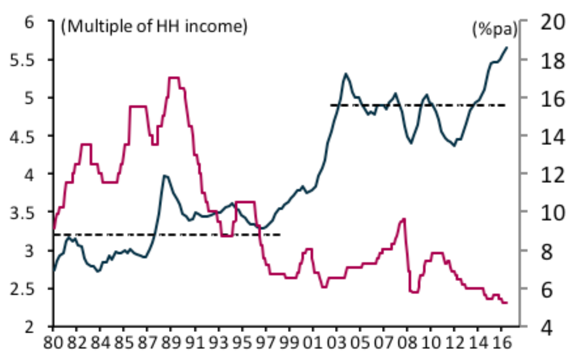
Where the government needs to proactively improve the fiscal balance is through concrete policy, if it wishes to avoid any downgrade to its AAA credit rating. This is because the credit ratings agencies will likely look through the windfall gain from commodities.

The business tax cut that was legislated this month (reducing reducing the tax rate to 27.5% from 30% for companies with under A$50 million turnover over the next three years) will cost the budget an estimated A$5.2bn over four years. But this sum will need to be recovered elsewhere, but exactly where is unclear. One possibility is reform of the PRRT (Petroleum Resources Rent Tax). The government is also reportedly looking to tackle the tax-avoiding cash economy and illegitimate welfare, potentially recovering A$15bn in forgone revenue.

Of what we do know, as demonstrated in previous budgets, the key driver of fiscal repair over the coming four years will be 'bracket creep' – that is the increase in taxation revenues as wage growth pushes individuals into higher tax brackets. The drift is tantamount to increased personal

Australia: Dwelling price too income ratio and rates

Structurally and cyclically low rates capitalised into house prices



Source: IFM Investors, ABS, RBA

taxation by stealth, as the government lets lapse the historical adjustments that have previously rectified this issue.

> *This effective increasing of personal income taxation not only discourages work, it weighs on economic growth.*

In our view, an arguably better path to a sustainable fiscal platform would indeed be to lower personal income tax, and in doing so bolster household finances and spending. This approach could be funded by reforming taxation on speculative property investment and discretionary consumption, via the underperforming GST (goods and services tax). Yet the latter two measures, although desirable, have proven to be politically unpalatable for the government.

A policy issue getting significant attention leading up to the budget is what the government might do to address the issue of housing affordability. The debate comes as house prices in the Eastern states climb ever higher and the sheer volume of household debt now held becomes a risk for both economic and financial stability.

Unfortunately, policy measures are likely to be limited or, even worse, inappropriate. This judgment comes as initiatives floated to date, at both the Commonwealth and state level, are aimed at boosting first homebuyer purchasing power. Rather than addressing the level of dwelling prices themselves and enacting policy that would either prompt flat or negative prices growth and improve affordability for all. Clearly the latter is again less politically palatable. The positive, but less tangible, solution that will likely be highlighted is around supporting ongoing residential supply. But this is a longer term solution to balance the market in the face of strong population growth that will do little to assist with the issue in the short term.

Disappointingly, it is unlikely that the perverse tax incentives (via negative gearing and capital gains discounts) that have stimulated too much investor demand at the expense of first homebuyers will be addressed, nor will other demand-side initiatives such as putting restrictions or higher taxation on foreign purchases. Indeed, a tempering of demand by reducing population growth via a temporary slowdown in inward migration is another such solution.

Another measure that has reportedly been considered is to allow first home buyers to use their superannuation to fund a deposit on a dwelling purchase. We oppose this vehemently because in our view it pushes those who can least afford it into debt; and because it divests a professionally managed, diversified, compounding pool of savings design to provide for people in retirement – to effectively gamble on housing in a market that is clearly at the top of almost all valuation metrics.

> *On our analysis it is a dangerous assumption to believe house prices will rise indefinitely – indeed we do not think they will.*

Runaway dwelling prices – at least in the Sydney and Melbourne markets have also become a policy concern for the Reserve Bank of Australia (RBA), the Australian Prudential Regulation Authority (APRA) and the Australian Securities & Investments Commission (ASIC). The RBA is concerned due the financial stability aspect of its mandate. The re-acceleration in dwelling price growth has supported more household debt accumulation and a significant proportion of this is from housing investors, who themselves are also looking to take advantage of generous tax concessions allowed by the government. These concessions have created an imbalance in the economy and potential future risks.

In a positive development APRA stepped in to tighten macro-prudential rules, following a decision to limit investor loan growth to 10%yoy. It has now further limited borrower access to interest-only loans (that in this authour's view serve no purpose but to allow risk to be held for longer), in an effort to curb and improve the quality

of investor loan growth. Yet we doubt, in isolation, these measures will be overly effective and more will need to be done in this space. This is unless APRA purposely treads carefully in anticipation of proactive housing affordability measures in the upcoming budget that may also impact property investors.

What is clear is that the RBA needs assistance from the regulators and the government if it is to pursue its current course of monetary policy.

> *We say this as it is undesirable for dwelling prices and debt accumulation go on unchecked, but the bank does not want to raise rates to lean into dwelling price growth.*

This is because the economy and in particular inflation does not warrant such a move. And further doing so would see the Australian dollar rise materially – another undesirable outcome.

Equally if there is a downturn, or even the risk of one, the RBA may not feel free to ease policy further for fear of again reigniting dwelling price growth. With these pressures set to continue it is difficult to envisage the RBA moving rates in either direction for an extended period of time.

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*as at 31 December 2016

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