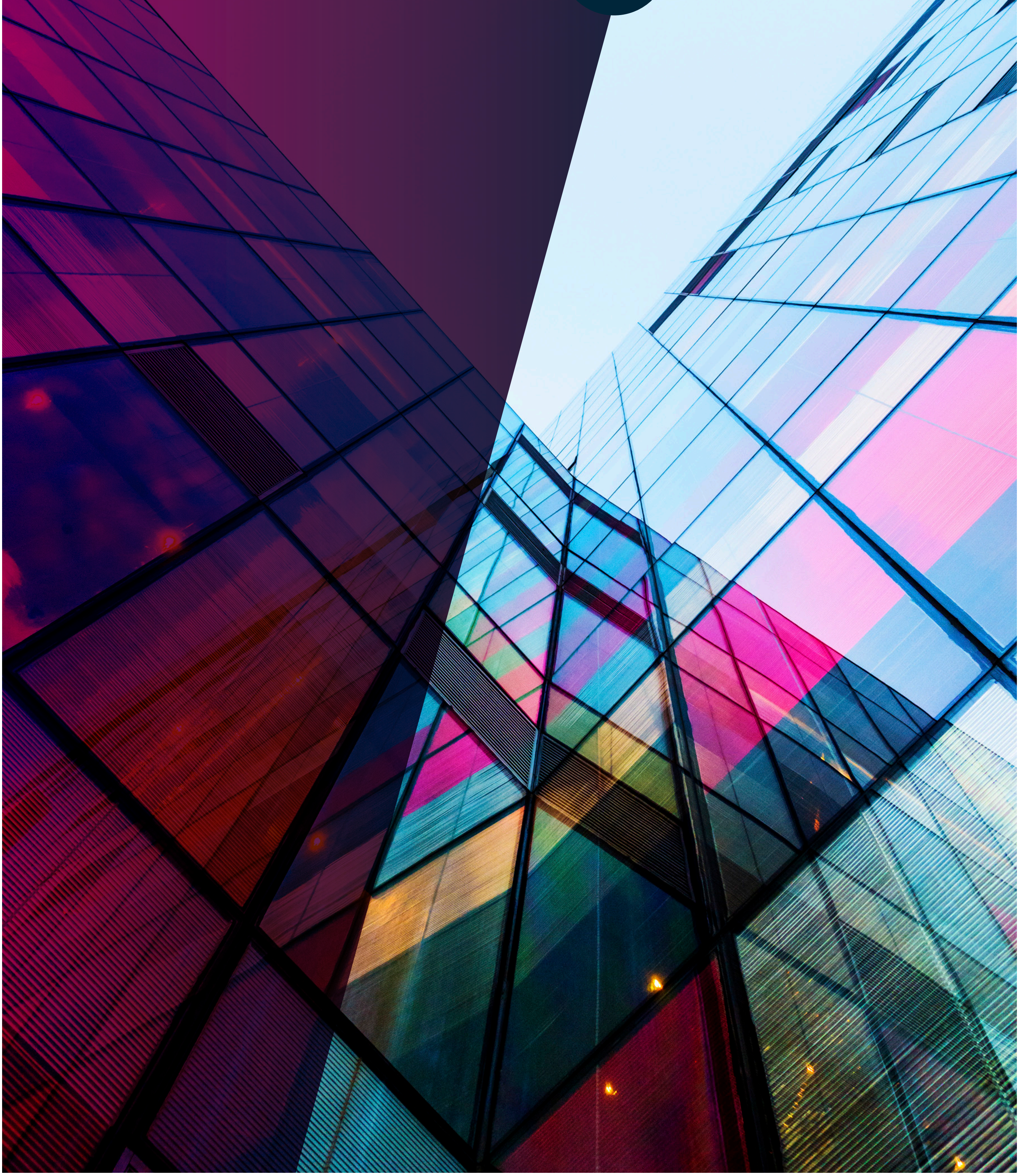
ifm investors

Economic Update

DEC 2016



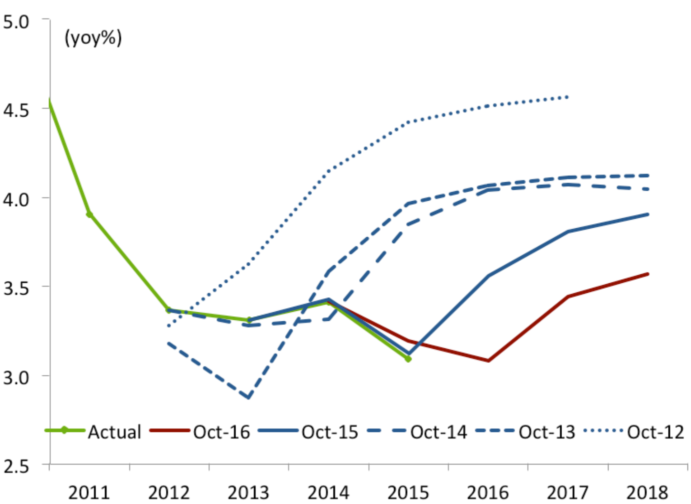
What will 2017 bring?

The global economic environment can be described as lukewarm in 2016. There was no marked deterioration in the performance of advanced economies, but any signs of sustainable improvements were few and far between. And clearly overshadowing economic developments this year were key political events, particularly in the UK and US, and more recently the Italian referendum. These, and yet more political events, will likely define economic outcomes in 2017 and beyond.

Nonetheless, we expect that economic activity will improve modestly in developed and emerging economies alike in the coming year. The problem is that this expectation has been in place at this time of year for much of the post-financial crisis period. And to date these expectations have disappointed, with extraordinary policy accommodation required to support rates of economic growth that are in the main below trend.

This is evident in the International Monetary Fund (IMF) having to consistently downgrade its global real GDP growth forecasts. Indeed its forecasts over the past five years have consistently looked for a significant rebound in GDP growth toward 4.0% pa, which has failed to materialise. The IMF's latest round of forecasts, contained in the October release of the bi-annual World Economic Outlook, are significantly more circumspect. Economic growth is expected to accelerate from an estimated 3.0% in 2016 to 3½% in 2017 (see following chart). Emerging markets are anticipated to expand by 4½%, whereas developed economies are forecast to grow at just 1¾%. This underscores the ongoing importance of developing markets to global growth. For example, China's economy will have been responsible to just over a third of global economic growth in 2016. By contrast, the US economy contributed less than 20%.

Global growth: successive IMF real GDP forecasts
Will 2017 be any different?



Source: IFM Investors, IMF October 2016.

Lower potential growth rates are expected to persist, particularly in most advanced economies. Therefore, even modest improvements in cyclical economic growth will see continued improvements in labour markets and higher rates of inflation. This should reduce the pressure on monetary policy to bolster growth, which itself is fortuitous as there is the realisation that monetary accommodation has likely reached a bound of what it can constructively achieve. Ideally, at least some of this burden will shift to fiscal policy. This is as more governments' budget balances have improved enough for policy to become less restrictive.

A US inflection point?

The US economy has the greatest potential to surprise, in our view. This will hopefully be to the upside but downside risks can't be ruled out. This uncertainty is driven by the new year bringing in a new President with a set of policy unknowns.

For now, markets have decided to give President-elect Trump the benefit of the doubt that he will deliver, at least in part, some of the aggressive fiscal policies he outlined in the election campaign. Primarily this is tax cuts and infrastructure spending, but more broadly his administration is expected to be more anti-regulation and pro-domestic business. These policies are likely to be implemented early enough in the term to materially bolster economic activity in the second half of 2017.

That said, what is also expected is that a fiscally conservative Republican Party will be unlikely to pass measures that cause a blow-out in the budget deficit. Therefore, there should not be a breakout of inflation in an economy in which inflationary pressures are gradually building. The Committee for a Responsible Federal Budget (CRFB) estimates that the foreshadowed tax cuts, along with other measures, would cost the budget US$5.3 trillion. This compares with the current level of debt of more than US$14 trillion, or near 77% of GDP, the highest debt to GDP ratio of any incoming President since 1945. This will likely cap any overly ambitious fiscal spending.

What is being discounted is Trumps' anti-globalisation policies, which would impact trade growth and GDP growth in the medium term. Again, these are expected to be either tempered or likely deferred. Despite being growth negative, these policies also broadly point to a further acceleration of inflation. This stems from both potential tariff increases on imports and the potential acceleration of domestic wages growth as the US labour market tightens further.

The potential for better growth and inflation outcomes is likely to be supportive of further interest rate hikes from the US Federal Reserve (the Fed) in 2017. Indeed markets are more convinced that the Federal Open Markets Committee (FOMC) will deliver on the two hikes that it has foreshadowed for the coming year. This is underscored by an expectation that fiscal stimulus will be delivered at a time when the US economy is approaching full employment and may spur more inflation than the Fed is comfortable with.

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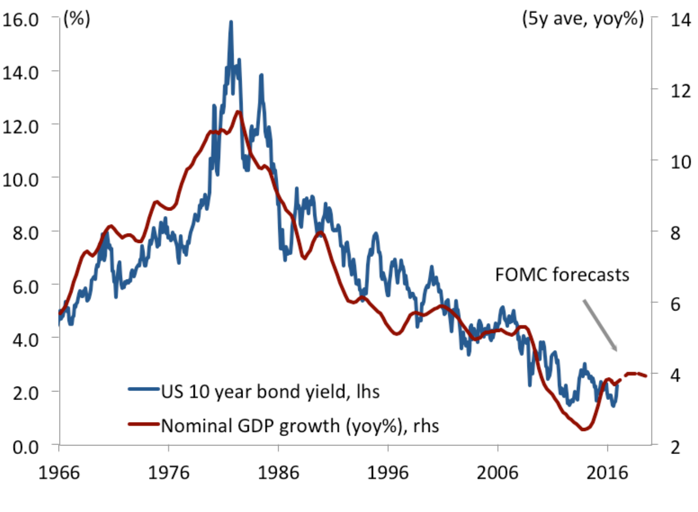
These factors combined have seen a marked recent rise in US bond yields. This is an acceleration of the 'reflation' theme that was already gathering pace. While there is a reasonable expectation that the sharp moves seen in bond markets may pull back to some extent, we are unlikely to see yields plumb new lows. This is especially true if the Fed is right in forecasting around 4.0% year-on-year nominal GDP growth. As we enter 2017, confidence seems high that this will be achieved. Therefore, markets and investors will be looking to digest just what the potential end of a 35-year long bond rally will be on asset prices in the future.

US: nominal GDP growth and 10 year bond yields
Is 2017 a turning point?



Source: IFM Investors, Bloomberg, US Federal Reserve

Accommodative policy to continue elsewhere

Potentially keeping the rise in US yields in check, to some extent, is accommodative monetary policy in other advanced economies. In Japan, real GDP growth will likely remain subdued at just 1.0% in 2017. There may be some upside risk to this expectation if the Japanese Government successfully implements fiscal stimulus early in the new year. The accommodative stance of monetary policy is likely to remain, keeping 10 year bonds at zero. Any depreciation of the Japanese yen, in the face of likely US dollar strength, should also be supportive of the economy.

In the Eurozone, growth is likely to be relatively stable at just over 1½%. Monetary policy will remain accommodative, but the prospect of further stimulus in the coming year, at this stage, seems unlikely given the growth and inflation outlook. This is true especially in light of the European Central Bank (ECB) undertaking to extend its quantitative easing program further than the initial March 2017 cut-off. This program will now run until the end of 2017, unless inflation picks up materially. Monthly asset purchases will be reduced in the extension period to €60bn from €80bn. Nonetheless, this still represents an additional €540bn of stimulus (around 5.0% of Eurozone GDP).

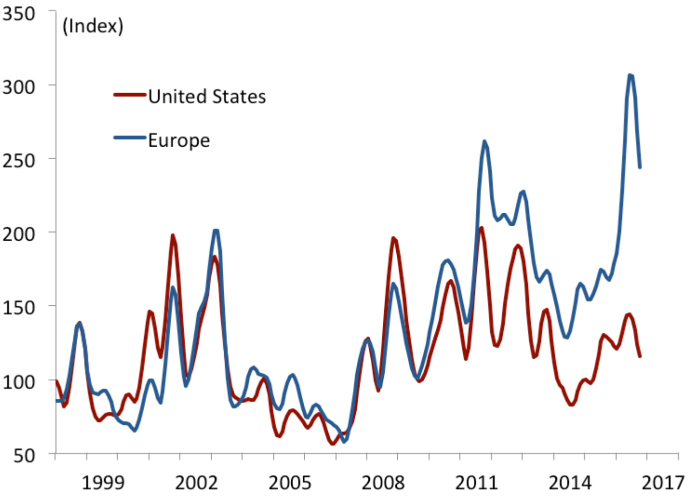
Markets will remain very watchful of any signs that the ECB may look to taper the size of its asset purchase program. However, the action taken in December underscores its strong commitment to keep policy accommodative.

The effect of restrictive Eurozone fiscal policy should continue to fade in 2017, yet there seems little hope of a concerted and significant fiscal policy push in the short term. This is especially true with political and government risks persisting in 2017. With the 'No' vote prevailing in the Italian referendum, that country expects yet another change in political leadership. Prime Minister Renzi has tendered his resignation, which raises the prospect of an interim technocrat government being installed to fill the breach until the 2018 elections. However, populist parties are calling for snap elections sooner. What seems clear is that, beset by political uncertainty, the Italian economy will again underperform the Eurozone average growth rate. In this environment, concerns over the fragility of the Italian banking sector will only intensify.

Added to this are the coming elections across the continent. These will ensure that levels of uncertainty in the Eurozone will likely persist and ultimately weigh on economic growth and policy reforms alike. On a comparative basis, policy uncertainty appears higher in Europe than even the US, even though most remain highly unsure of President-elect Trump's policy agenda.

Europe: policy uncertainty

Europeans more concerned than those in the US



Source: IFM Investors, www.PolicyUncertainty.com.

If 2016 has taught us anything, it is that political upsets can occur. So we look upon elections in 2017 with some caution as populist parties are challenging for power in key elections.

First, in the Dutch election due in March 2017, the right wing movement has gained popularity but may find it difficult to form or become part of a coalition government.

French Presidential elections follow in May, with Parliamentary elections in June. Prominent populist candidate for President, Marine Le Pen, is amongst the front-runners. Her platform would look to hold a referendum on France's European Union membership and participation in the Eurozone (although a Parliamentary vote is still required to revise the French constitution) – clearly having a destabilising impact.

Later in 2017 is the German election. Incumbent Chancellor Angela Merkel will again run as a candidate, yet recent regional elections have gone against Merkel's Christian Democratic Party and populist movements have gained support. It remains to be seen if this shift is replicated on a national scale but any marked change in government in Germany would have significant economic implication across the Eurozone.

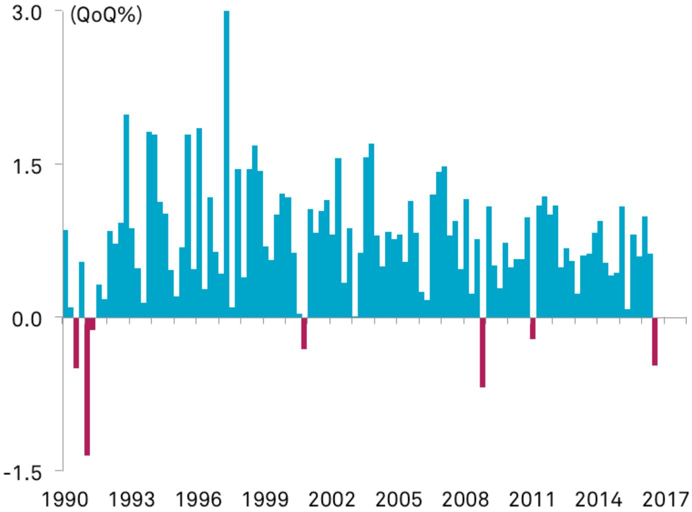
In the UK, the slow grind towards Brexit will continue. Article 50 should go to the European Union (assuming court proceedings allow) in March and the process of extricating the UK from the EU will formally begin. Uncertainty will continue and likely impact private investment, so we expect that economic growth will be subdued at around 1.0%. Further, policy easing may be forthcoming from the Bank of England and the Government as they both attempt to shield the economy from what is still likely to be a "Hard Brexit".

Australia: a hiccup on the way to 2017

The Australian economy experienced a setback in early December with the release of the September quarter GDP data. The economy shrank by 0.5% in the September quarter and growth decelerated dramatically to just 1.8%yoy down from 3.1%yoy. The last quarterly contraction in GDP was the 0.2% decline in March 2011 (largely related to floods in Queensland). Before that was 0.7%qoq detraction in the December quarter of 2008, in the aftermath of the financial crisis.

Australia: quarterly real GDP growth

Negative quarters few and far between



Source: IFM Investors, ABS

However, speculation around whether Australia is heading into recession is overblown. This is because the September quarter combined some genuine weakness (for example, the just 0.4%qoq increase in household spending) with some temporary impacts. Foremost amongst the latter was the 1.4% quarterly contraction of dwelling investment. This was unusual given we are in the midst of the largest cyclical upswing in the sector in history. Yet the statistician reported this was caused by poor weather, which also delayed project work in the non-residential space. Therefore, it can reasonably be expected that a rebound occurs across construction in the next quarter.

Also impacting investment in the September quarter was lingering uncertainty due to the 'line-ball' outcome in the Federal election. This has, to at least some extent, now faded.

Net exports detracted 0.2pp as a pullback in export volumes weighed on growth. However, strong increases in LNG export volumes should pick up the slack from bulk commodities over coming quarters. Indeed, LNG export volumes added 0.3pp to real GDP growth the quarter and 0.6pp over the last twelve months.

We would also hope that public infrastructure spending adds to growth going forward, after an inconsistent performance in recent quarters.

A key positive in the national accounts was the 4.5% quarterly rise in the terms of trade. This supported at least modest nominal GDP growth of 0.5%qoq and 3.0%yoy through the year. Unfortunately, despite expecting solid growth in the Chinese economy of 6½% in 2017, the latest commodity price rally will likely fade. Australia will need other drivers of growth in 2017 to keep the economy ticking over, as the drag from declining resources investment runs off.

It is our view that real GDP growth in Australia of around 2½% in 2017 would be a good outcome, as challenges to growth remain. Net exports will make a solid contribution but this leaves domestic demand relatively fragile. Households will not prompt growth to accelerate materially given weak income growth (due to softness in wages and employment). Also potentially weighing on households will be weaker house price growth or indeed outright falls.

Dwelling investment will likely turn from contributing to growth to potentially detracting from growth in late 2017. This will have implications for employment given the huge sectoral workforce. Public infrastructure spending should offset this modestly in terms of growth and employment, but as we continue to argue more needs to be done by governments in this space to keep projects coming online.

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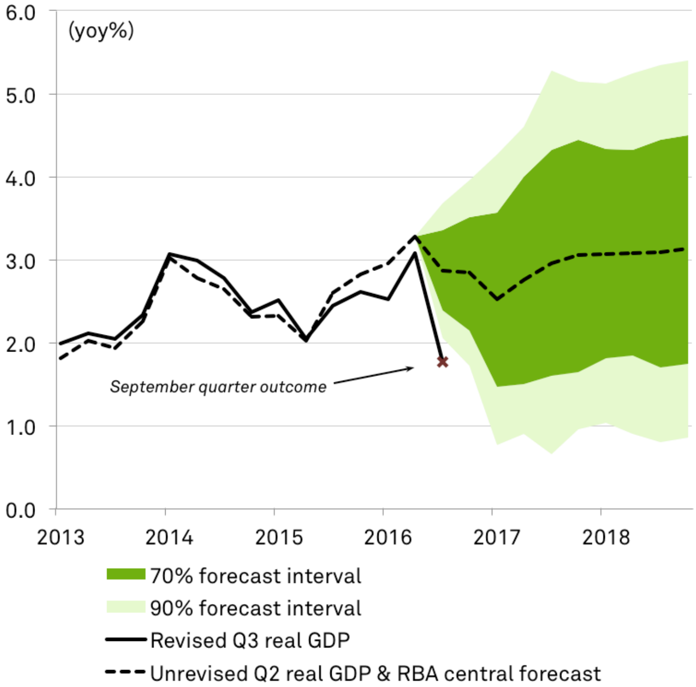
Our concern is that the now seemingly ever-present threat of a sovereign credit downgrade may discourage any additional government spending on infrastructure when it is needed most. Further, the bottom of the bond yield cycle has likely passed, meaning borrowing costs for governments will also only increase from here.

The weak September quarter economic growth outcome is not an immediate red flag for the Reserve Bank of Australia (RBA). Interestingly, it did look to pre-empt the economic growth outcome in its board meeting press release the day before the quarterly data was published, noting that "some slowing in the year-ended growth rate is likely, before it picks up again". There was likely some disappointment as the outcome, and revisions to previous data from the statistician, conspired to undershoot even the most pessimistic expectation contained in the RBA's November Statement on Monetary Policy (see following chart).

Australia: real GDP growth revised and unrevised

Q3 outcome disappoints RBA's most pessimistic forecast



Source: IFM Investors, ABS, RBA.

Therefore we see the RBA being increasingly watchful for downside economic risks in 2017. Consequently, there is a risk of further policy easing. This would be prompted by weakness in growth, decelerating employment growth and/or weaker inflation outcomes.

The RBA will need to balance any attempt to stimulate economic activity with the clear impact that lower rates are still having in the property market and with household debt accumulation. Households in Australia are carrying, as a proportion of GDP, the most debt of any developed nation. And this will potentially be a burden on future growth.

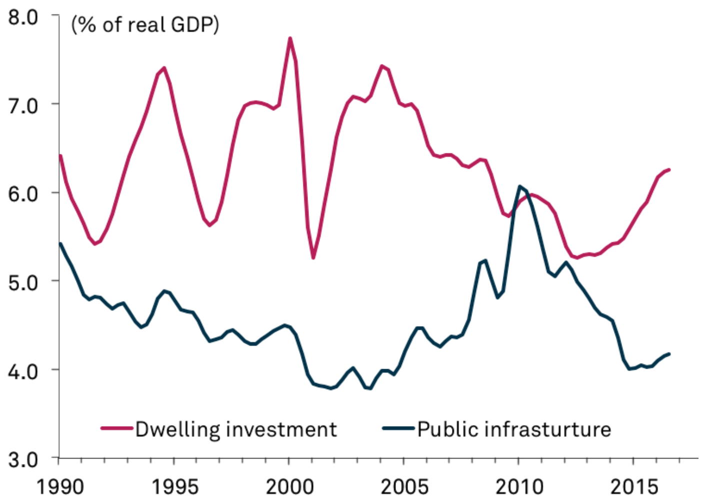
Our view is that the RBA will leave the cash rate unchanged in 2017, unless it is forced to act by materially weaker economic outcomes.

Calls for cash rates hikes in 2017 (as the OECD did in late November) are far too premature. This is based on soft growth and low inflation. However, it is difficult to envisage the RBA hiking into a declining property cycle unless the remainder of the economy is firing on all cylinders – which it is unlikely to be.

With rates on hold the RBA would very much welcome some fiscal stimulus but this does not, at this stage, appear forthcoming either. We have long argued that further infrastructure projects should now be being put in place to offset the inevitable decline in residential construction – and the job losses that will occur. It is true some progress has been made, in NSW and Victoria in particular, but more needs to be done. Failing to do so will ensure another soft year of growth in 2017. ■

Australia: dwelling and public investment cycles

Q3 outcome disappoints RBA's most pessimistic forecast



Source: IFM Investors, ABS.

Dr Alex Joiner
Chief Economist

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*as at 30 September 2016

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