Economic Update

JUN 2017

Global markets: mixed signals

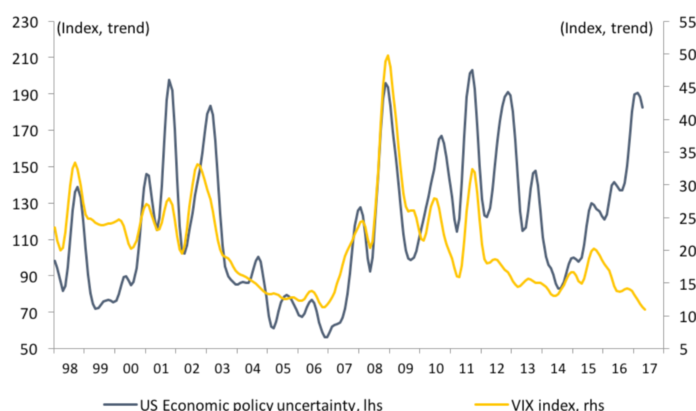
Global financial markets continued to edge cautiously higher through May. Equities in the US rose overall but had a choppy month as the focus on political risks intensified. The UK's equity market made a strong gain, to touch a record high on the FSTE 100, due primarily to the weaker GBP. In Europe, increases were more modest but nonetheless held on to some post-French election optimism. And it is to be expected that continued optimism around the Eurozone economy should be supportive.

Indeed it was the Australian equity market that fared worst over the past month, declining markedly – led lower by the banking sector. A confluence of factors drove this result, including: a weakening outlook for the Australian economy; heightened risks in the domestic property market; a credit downgrade for smaller non-government guaranteed banks; and the introduction of a 6bp 'bank tax' in the federal budget. Lower commodity prices also weighed on resources stocks.

What is notable in global equity markets is the divergence of measured uncertainty and implied market volatility. The former is near historical highs and the latter near pre-financial crisis lows (despite a brief spike in May due to US political uncertainty that has since rapidly retraced). Historically, the relationship between the two has been relatively strong and at least has had some degree, and often a high degree, of correlation. Since around 2015 this has broken down completely. The low level of volatility is not just characteristic of equity markets; levels are low in bond and exchange rate markets also. And it is being reflected in very narrow spreads in investment grade credit that reflect, in part, a low level of perceived risk.

Global: measured policy uncertainty and financial market volatility

Material policy uncertainty is not being reflected in markets



Source: IFM Investors, Bloomberg, Policyuncertainty.com

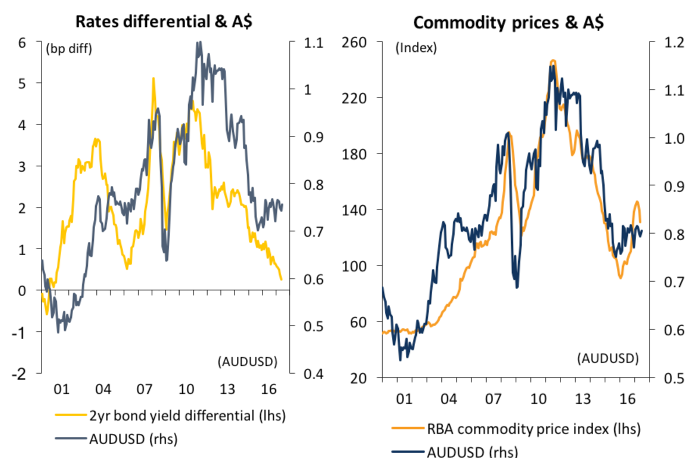
This divergence likely has no single explanation. In terms of the bigger picture it may reflect the difficulty markets are having trading a more upbeat global economic outlook that remains beset by still simmering geopolitical tensions and political uncertainty. The former being supported by still accommodative monetary policy setting of major central banks. Also, market specific factors such as the flow of funds from active to passive investment may be having an influence.

Bond markets have continued to rally globally. US ten-year bond yields have fallen approximately 25bp since March and are at around 2.1%. Australian government bond yields have likewise fallen by around 60bp to 2.4%, after briefly looking to breach 3% back in February. However, what is more notable is the narrowing of the spread between the two, which has come in to as little as 16bp over recent weeks. This has not been seen since early 2001 and reflects the market's expectation that while the US economy is performing relatively well, the outlook for the Australian economy has deteriorated.

Given the current outlooks for both economies, there is a strong possibility that policy rates, and possibly bond yields as well, will 'invert'. That is to say, the Federal Reserve in the US will continue to raise policy interest rates beyond the 1.5% level the RBA will likely keep rates at for an extended period. This will likely weigh further on the Australian dollar, which consensus still expects to depreciate over the coming year.

Markets: RBA commodity price index, rates differentials and $A

Both interest rates and commodity prices to weigh on AUD



Source: IFM Investors, Bloomberg, RBA

Another drag on the Australian dollar has been the broader sell off in the commodities complex – in particular bulk commodities. Most notable amongst these was Australia's single largest commodity export, iron, that fell 17% in May alone to US$58 per tonne. This represents a very sharp 39% decline from the highs of the recent cyclical upswing to US$95 per tonne back in February. Driving this decline has been ongoing increases in supply, reduced speculative pressure, ample inventories in China and ongoing fears of a slowdown in growth in that economy.

Spot thermal coal prices have also receded from recent peaks, down from US$110 per tonne in late 2016 to US$74 currently. Similarly, metallurgical coal prices have halved over the same time frame, from US$309 per tonne to US$150, with a spike in the aftermath of Cyclone Debbie (that interrupted supply in Queensland) retracing rapidly. These trends in commodity prices will likely persist. Consequently, the sharp increase in Australia's terms of trade in recent quarters will continue to pull back. This will not only weigh on resources sector profits and government taxation revenues but nominal GDP and income growth as well.

US: uncertainty rising

The aforementioned political risk that is characterising the global environment has now largely shifted from Europe to the US. This is centred on domestic politics but is occasionally punctuated by geo-political concerns with regard to North Korea and Russia in particular. Domestic political distractions have beset the Trump Administration over recent months. These include high profile dismissal and appointment of key staff, ongoing accusations of election interference and ongoing unorthodox communication. This, along with lack of strong consensus on policy priorities and ongoing consideration of the Administration's Healthcare plan, threaten to further delay the legislative agenda.

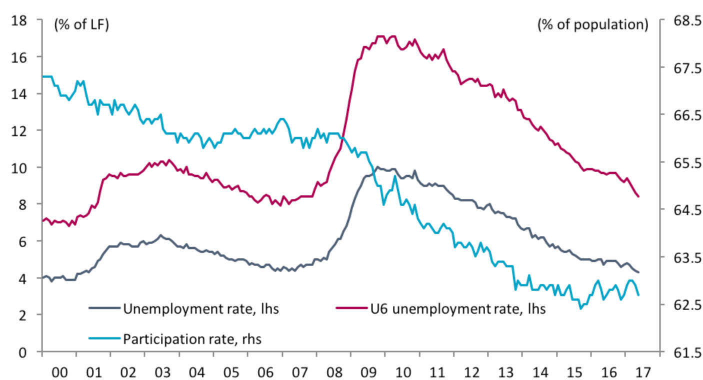
This is particularly true of tax reform and potentially true of ambitious infrastructure plans. Indeed the clear risk is that tax reforms become more modest in terms of scope and scale. This would suggest that they may meet less opposition from Democrats and fiscally conservative Republicans alike. And there seems little doubt that the Administration will be endeavouring to push some sort of tax measures through as soon as possible to have some legislative track record heading into mid-term elections in November 2018. The risk here for the Administration seems to be that historically incumbent Federal governments lose seats in the House. If this pattern repeats itself, the loss of 24 Republican seats would see the Democrats take a majority. And if this eventuates it may become even more difficult to pass legislation. We are more hopeful on infrastructure, which has more potential for bipartisan Federal support and the involvement of state governments. What seems to be clear is that the fiscal impulse that some were expecting early in the Administration will be smaller and more delayed than first thought.

Despite these concerns, consensus is still expecting 2.0% real GDP growth in 2017 and marginally better in 2018. However, what is clear is that any optimism in some of their forecasts due to aggressive fiscal policies has been increasingly revised out. And risks around these forecasts are now balanced rather than to the upside. It is arguable that this may be a good outcome as many questioned the rationale for adding stimulus to the US economy as it already approaches full employment.

On the key data in the US, labour markets rebounded well, with non-farm payrolls in May and April rising 138k and 174k respectively. This comes after a temporarily weak 50k rise in March. The unemployment rate continues to trend lower, reaching just 4.3% in May. However, it continues to be for 'poor' reasons – that is, a decline in the participation rate. Inflation data remains mixed. Subsequent to the likely one-off monthly deceleration of inflation in March, headline prices rose 0.2%mom in April but decelerated through the year to 2.2%yoy. Core inflation was softer than expected, rising just 0.1%mom and decelerated in through the year terms to 1.9%. It is expected that this weakness in prices will be transitory, especially given a continuation of good labour market performance.

US: unemployment and participation rates

Spare capacity in US labour market continues to be eroded



Source: IFM Investors, Bloomberg, BLS

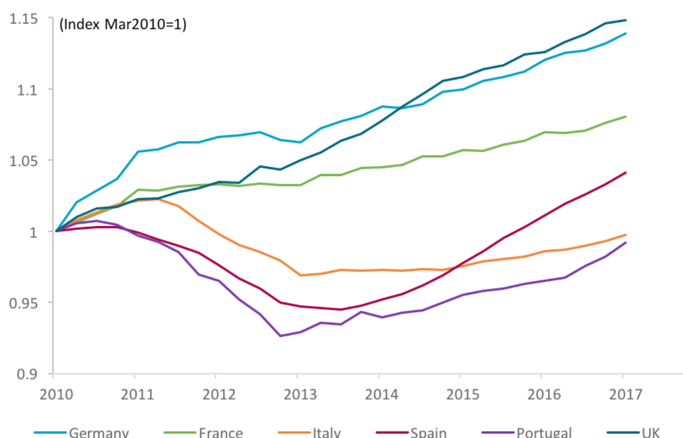
The Federal Reserve continues to have confidence in its current course, noting in its minutes that recent softness in the labour market and on inflation will prove transitory. As will the weak read for Q1 GDP that it attributes to "transitory soft consumer expenditures and inventory investment". The FOMC still appears to be on course to raise rates again in June and further elaborate on its intention to reduce the size of its balance sheet.

Europe: economic growth broad-based

The positive economic tone out of the Euro Zone continued, with real GDP growth coming in at 0.5%qoq in the March quarter and the annual growth rate decelerating only modestly by 1.7%. Growth rates of the larger economies are quite varied: the German economy expanded 1.7%yoy, France a more modest 1.0%yoy and Italy 1.2%yoy. On the periphery, Spain was a standout with 3.0%yoy growth and Portugal 2.8%yoy, while Greece continues to face challenges with just 0.4%yoy growth after contracting in the previous quarter. Solid economic performance prompted the unemployment rate across the region to edge down to 9.3% in April, the lowest since 2009. That said, despite some monthly strength in April, inflationary pressures remain inconsistent and will allow the European Central Bank to keep its accommodative policies in place for some time yet ECB president Mario Draghi reiterated that “an extraordinary amount of monetary support” is still required.

Eurozone: real GDP indexes

Real GDP growth in the Eurozone is broad-based



Source: IFM Investors, Bloomberg, EuroStat

UK: political doubts, economy good for now

Prime Minister May’s election gamble to increase her majority heading into Brexit negotiations has failed. Indeed, she didn’t succeed in getting an outright majority, let alone a larger one. The election result has the Conservatives with 318 of the 650 seats (326 votes to form a majority government), while Labour has 262, SNP 35 and Liberal Democrats 12. At this stage, May will remain Prime Minister and work with the Democratic Unionist Party of Northern Ireland (conservatives and Brexit supporters) to form a working majority in Parliament. Nonetheless, this outcome creates significant political uncertainty and draws Theresa May’s own political future into question. Further, it seems to risk fraying May’s clear vision of Brexit, as it appears there is now more potential for domestic negotiation even before taking proposals to the European Union. This will likely create further delays in the process that was already under time pressure, and significantly reduces the odds a comprehensive agreement can be reached. As a consequence, we’d be expecting further financial market volatility and persistent downside risks to the UK economy for some time.

Otherwise, the UK economy remains sound for now despite GDP growth being relatively soft at 0.2%qoq in the March quarter – growth is still a solid 2.0% rate through the year. Quarterly weakness was attributed largely to the household sector, but retail sales rebounded since in April’s data. Despite softer growth outcomes, labour market conditions remain robust with 122k jobs added in the quarter to March and the unemployment rate edging 0.1pp lower to 4.6%. Headline inflation data for April saw a 0.5%mom increase in prices driving a material acceleration of the through the year rate to 2.7%yoy from 2.3%yoy. The weaker exchange rate and solid economic performance are driving inflation higher. Price pressures seem broad-based, with core inflation also picking up from 1.8%yoy to 2.4%yoy. The BoE continue to assert that “Monetary policy can respond in either direction to changes to the economic outlook as they unfold” but if its central projections unfold as expected it may shift to a tightening bias.

Australia: RBA on hold despite weak GDP

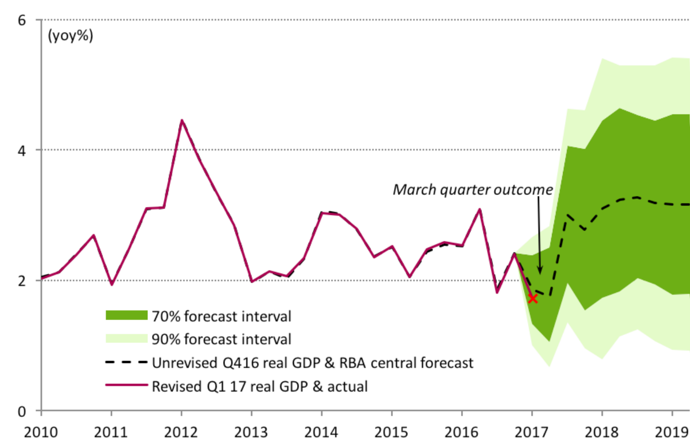
In Australia, it remains clear that the RBA has little appetite to move official interest rates in either direction. In its June press release accompanying its policy decision, the RBA continued to carry a relatively positive, glass-half-full tone. It noted that “Business investment has picked up”; recently “Employment growth has been stronger” and that “inflation is expected to increase gradually as the economy strengthens”. On this basis, it seems the RBA sees no immediate justification to even consider lowering rates further. And in terms of a hike that had been considered by some earlier this year, the RBA noted that dwelling “Prices have been rising briskly in some markets, although there are some signs that these conditions are starting to ease”. It also seems confident that the prudential regulator’s tightening of conditions “should help address the risks associated with high and rising levels of indebtedness”. Both of these factors suggest a rate hike to address these issues is far from warranted.

March quarter GDP figures were released and the outcome was disappointingly soft but more than likely transitory. Real GDP growth was a modest 0.3%qoq and through the year growth decelerated to just 1.7%yoy – the lowest rate of growth since 2009. One-off impacts from weather-related interruptions to dwelling construction and exports were to blame, as was the drag from engineering investment. Residential construction should rebound next quarter, yet exports are likely to be interrupted still

as Cyclone Debbie impacted Queensland coal production (in late March). Consumers continue to be prudent with spending up a modest 0.5%qoq to be 2.3%yoy higher – well below the longer term average of 3½%. Strength in services spending offset weak retail growth in the quarter. And it is the services sectors driving the vast majority of growth in the broader economy. However, even this level of spending is reliant on a run down in the savings ratio that edged down to 4.7% from 5.1%. Therefore, in the absence of wages growth, spending is likely to stay subdued. The RBA to some extent expected this slowdown, foreshadowing the previous day that "GDP growth is expected to have slowed in the March quarter". On our estimates, the quarterly forecast miss was modest and a ¾% qoq rebound in the June quarter will see the RBA's forecast come to fruition. This may not come to fruition, although partial domestic data to date has been supportive.

Australia: RBA real GDP forecasts

RBA forecast a slight miss in March quarter



Source: IFM Investors, RBA, ABS

Higher frequency and more timely economic data showed a welcome rebound in retail sales of 1.0%mom in April. This comes despite unimpressive consumer sentiment and soft wages growth. The NAB business survey continues to be strong and points to ongoing solid labour market performance. This was evidenced by the unemployment rate falling 0.2pp to 5.7% in April. And the economy adding 106,000 jobs this year, prompting a stabilisation of employment growth. Building approvals were sharply lower in April and, although volatile, continue a downward trend that is expected. House prices in Sydney and Melbourne also softened in May after their recent strength. However, this was likely due to seasonal factors and we await further evidence to confidently conclude the market has peaked.

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