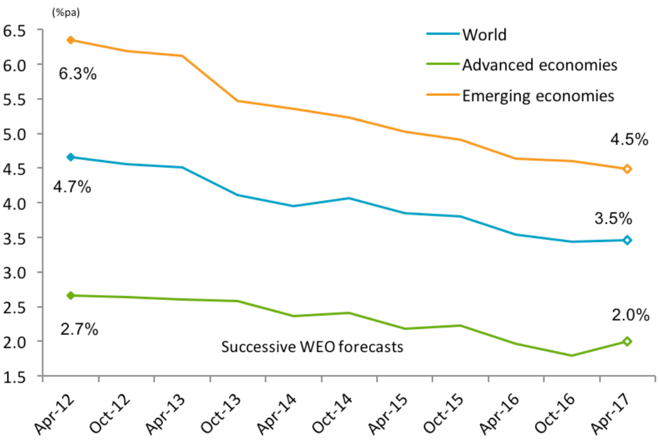
Economic Update

MAY
2017

Global Economy: recovery still expected

The International Monetary Fund's (IMF) biannual World Economic Outlook (WEO) was released in April. And the forecasts contained therein reinforced the increasingly broad-based expectation that global economic growth prospects will improve in 2017 and beyond. The IMF now expects global growth to accelerate from the estimated 3.1% recorded in 2016 to 3.5% in 2017 and 3.6% in 2018. And both the 2017 and 2018 forecasts were revised up fractionally since the WEO's last major release in October. It is an upward revision to advanced economy growth forecasts, by 0.2pp to 2.0%, which has led to the improved global outlook in 2017. This marks the end of a long period in which the IMF had consistently downgraded its expectations.

Global: Economic forecast revisions for 2017 real GDP
Advanced economy prospects revised materially higher



Source: IFM Investors, IMF

The IMF justified the improvements in its forecasts by noting that "buoyant" financial markets and a long-awaited cyclical recovery in both manufacturing and trade are now underway. But equally, it cautioned that more persistent structural problems including low productivity growth, high income inequality and pressures for inward-looking policies meant risks to growth are still to the downside.

It should also be noted that despite better prospects in advanced economies it is the developing economies still accounting for much of global growth. This comes despite growth forecasts for this bloc being revised down 0.1pp to 4.5%. Developing economies are expected to account for around 60% of global growth in 2017 – with China a key driver accounting for over a third of this by itself.
A notable revision to the IMF's forecasts was its more positive outlook for China. April's WEO now has growth at 6.6% and 6.2% for 2017 and 2018, respectively – up 0.4pp and 0.2pp since October's forecasts. This was based on an anticipation of "continued policy support in the form of strong credit growth and reliance on public investment to achieve growth targets".

The better prospects in China have in part led to the upward revision to the IMF's forecasts for Australian real GDP growth in 2017. This forecast now sits at 3.1% - up a material 0.5pp since October. This is also driven by "accommodative, monetary policies, supportive fiscal policies or infrastructure investment", according to the IMF, which has further noted the benefits from improving commodity prices and reduced impact of slower investment in the commodity sector. While these arguments are in part true, the IMF's forecasts seem too optimistic, as the year's forecast of 3.4%yoy to the December quarter would require quarterly outcomes of around 0.85%qoq for four consecutive quarters – a feat not witnessed since 2007. Further both the Reserve Bank of Australia (RBA), in its May Statement on Monetary Policy and the federal Treasury in the Budget, have more conservative and realistic expectations.

US: Looking through temporary softness

At a time when Australian growth forecasts seem too strong, US authorities have argued that those for its economy are too weak. While US growth forecasts for 2017 and 2018 were upgraded by the IMF to 2.3% and 2.5% (by 0.1pp and 0.5pp, respectively) US Treasury Secretary Steven Mnuchin suggested that the IMF's outlook for the US economy was a "little conservative". He described post-recession growth as "sub-optimal", suggesting the "US economy is now well positioned" to achieve "3% or more sustainable economic growth". Such growth is clearly factoring in the fiscal stimulus policies of the new administration not as yet enshrined in legislation.

The monetary policy implications for the US Federal Reserve's policy stance of the new administration achieving such a cyclical growth spurt are clear. Interest rates would need to be potentially raised more quickly to head off any risk of an inflationary outbreak. The latter would be a risk because a 3% growth rate would be both: materially above the Federal Reserve Bank of St Louis own forecasts for potential growth at around 1.5-1.75%; and further tighten a labour market that is already edging towards full employment.

As it stands this inflationary risk in the US economy has not yet materialised. Indeed the inability of the new administration to progress with its legislative agenda continues to take the exuberance out of markets as it seems that the implementation of stimulatory fiscal reforms may become increasingly delayed and complex. Markets have also remained tentative due to a recent bout of soft activity data. However, these setbacks in recent activity indicators can to at least some extent be explained away. And the broad expectation is that these outcomes will prove temporary, rather than the beginning of a softer trend, with recoveries expected. This is important as the most notable examples of this occurrence have been in payrolls, inflation and GDP data – three key tenets of the Fed's policy mandate.

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March's non-farm payrolls disappointed expectations materially rising just 98,000. The unemployment rate declined in the month to 4.5% but this was driven by a fall in participation. However, the weakness in these data was attributed to warmer weather in January and February pulling forward jobs growth. And the rogue March outcome was all but rectified with a strong rebound in April with a 211,000 in payrolls. Further the unemployment rate ticked down another 0.1pp to 4.4% and also positive was that the underemployment rate dropped 0.3pp to 8.6% - suggesting the US labour market continues to tighten.

Headline CPI inflation reversed 0.3%mom in March (the first decline in prices since February 2016) and decelerated to 2.4%yoy from 2.7%yoy. Lower energy prices and a one off decline in wireless telephone service prices (as unlimited data plans were introduced) further contributed to the fall. Core CPI also disappointed, contracting 0.1%mom, resulting in a deceleration in the through the year increase to 2.0%yoy from 2.2%. These one-off factors, better growth and a tighter labour market leave us comfortable that the trajectory of inflation is still towards the Fed's mandate.

Lastly the March quarter GDP report showed that the US economy expanded at a relatively weak 0.7% qoq saar (0.2%qoq and 1.9%yoy) disappointing even the market's modest expectation of a 1.0%qoq saar growth. This has become a familiar pattern in US GDP data and can in part be attributed to what the Bureau of Economic Analysis (BEA) labels "residual seasonality" - a difficulty in appropriately seasonally adjusting the data.

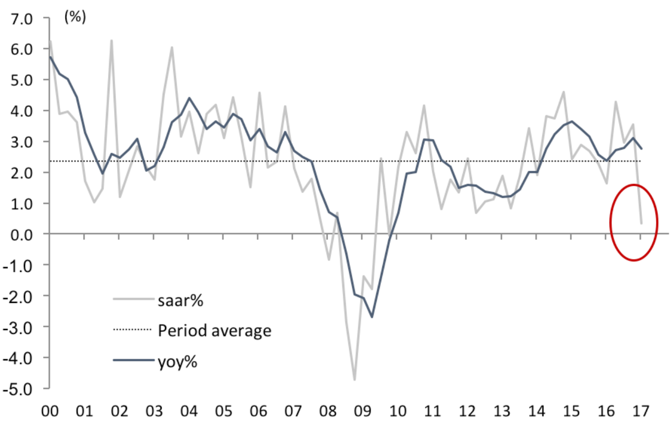
Weakness in March quarter was largely due to a marked deceleration in consumer spending growth to 0.3%qoq saar from 3.5%qoq saar in December quarter and the worst outcome since the December quarter 2009. Further, inventories detracted 0.9pp from GDP growth, an outcome that will likely at least in part be reversed in the June quarter. These negatives largely outweighed what were some significant positives in the data.

Business investment increased by 9.4%qoq saar after falling 0.1% in 2016, in what was one of the weaker years of investment outside a formal recession. Residential investment also posted a second consecutive strong quarter with growth of 13.7%qoq saar in March after a 9.6%saar expansion in the December quarter. This came despite issues around low inventories and other supply side constraints to the building sector.

With this strong foundation and the consumer expected to rebound from what where likely one-off impacts on spending in the March quarter (including weak car sales, sharp falls in utilities and to some extent clothing spend due to warmer winter, services seasonality and tax refund delays) June quarter GDP growth is expected to recover. And indeed there is still a strong expectation that the Fed's forecast of a 2.1% expansion in the US economy is achievable.

US: Real consumer spending growth

Consumers set to bounce back after a soft March quarter



Source: IFM Investors, BEA

Indeed the Federal Open Market Committee's (FOMC) May meeting statement reflected a willingness to look through some of the recent setbacks in the data. Particularly that on GDP growth which it assessed as being "transitory". And importantly, on household spending it noted that the "fundamentals underpinning continued growth in consumption" remained solid. Despite this the FOMC's statement did not contain any strong indication that a near-term rate hike was imminent. Nonetheless after the strong rebound in payrolls data economists expect another hike from the Fed at its upcoming meeting on 13-14 June, and markets are now fully pricing this outcome.

Europe & UK: more politics

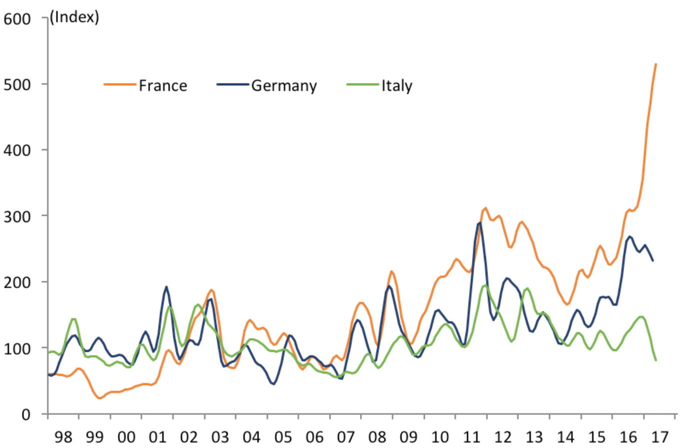
Politics has been the focus in the UK and Europe over the past month. In a surprise move UK Prime Minister Theresa May called a general election for 8 June, three years ahead of the expected May 2020 date. Her actions appear intent to capitalise on the current political weakness of the Labour opposition and to shore up support ahead of upcoming Brexit negotiations with the European Union. Indeed a larger majority could allow May to have greater flexibility when negotiating with the Europeans, who at this stage seem intent on making exit difficult. It also will take the new term of UK government well beyond the end of the two-year transition period for Brexit – advantageous should Brexit negotiations extend beyond the maximum two-year timeframe currently permitted.

In France, centrist candidate Emmanuel Macron defeated right-wing candidate Marine Le Pen in the second round of the presidential elections. It was an emphatic victory with Macron taking 66.1% of the vote. He will be sworn in as the next French president by 14 May and have a mandate for five years.

However, in order for President-elect Macron to implement the programme he set out in his election manifesto, he will need to obtain a parliamentary majority in the forthcoming legislative elections, due on 11 and 18 June. As Macron does not enjoy the backing of an established party, France could be facing a president forced to work with a broad and disparate coalition of parties to pass his agenda. So while election risk is off the table, economic risk for France still exists – this is much less an issue for markets at this time.

Europe: Economic policy uncertainty

Heightened political risks in Europe should dissipate



Source: IFM Investors, PolicyUncertainty.com

Political risks in Europe have now seemingly dissipated materially – but focus will remain on the UK election (particularly as it pertains to Brexit), German elections and Italian banking risks. These dissipating risks suggest recent spikes in economic uncertainty should retrace and that should underpin growth outcomes across the Eurozone. This will be supported by an ongoing accommodative stance from the European Central Bank which made clear this month that it has little intent to scale back policy anytime soon.

Australia: Budget focus

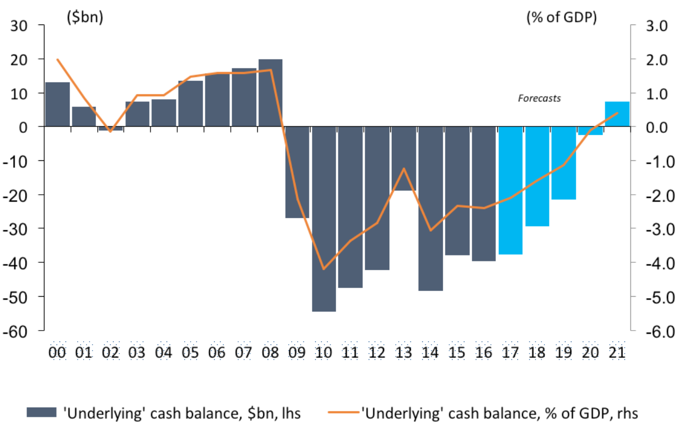
In Australia, the RBA's Statement on Monetary Policy came and went with little fanfare, as the forecasts therein were largely unchanged. Economic growth is expected to accelerate by the end of the year to 3.0%yoy. But a large contribution from net exports, as LNG production ramps up, disguises a relatively moderate domestic demand outlook. With underlying inflation forecast to slowly tracking towards the RBA's target band, and the unemployment rate to remain broadly stable around 5.5%, there is no economic justification for the Bank to be even remotely considering hiking rates.

Easing policy further is still a risk, but rekindling property market momentum remains problematic and therefore such a course is equally unpalatable. The RBA's rate will likely remain on hold for an extended period and as the Fed raises rates in the US, and the Australian dollar will resume a downward path to the benefit of the broader economy.

The key focus in Australia this month has been the federal government's Budget, delivering few surprises in terms of the fiscal outlook. The Budget's forecast still track a path back to surplus from a A$29.4bn (1.6% of GDP) deficit expected to be recorded in 2017-18, to a A$7.4bn (0.4% of GDP) surplus as of 2020-21. It charts is a well-worn path seen in every budget since the global financial crisis, tracking a return to surplus.

Australia: Underlying cash balance

The path back to surplus is credible but not guaranteed



Source: IFM Investors, Commonwealth Budget 2017-18

However this Budget has taken a more pro-active approach to achieving a surplus – it seeks to actively increase revenues via a combination of increased taxation and winding back some concessions. At the same time, spending in areas that the economy and community should benefit from has increased, meaning the measures will be politically less problematic. Indeed the disputed A$13bn in past savings measures not agreed with the

Senate have been scrapped. The new measures come instead of making the mistake of expecting the economy to grow back to surplus almost automatically, or run the political risk of attempting to cut back aggressively on spending – both errors of judgement made by previous Treasurers and governments.

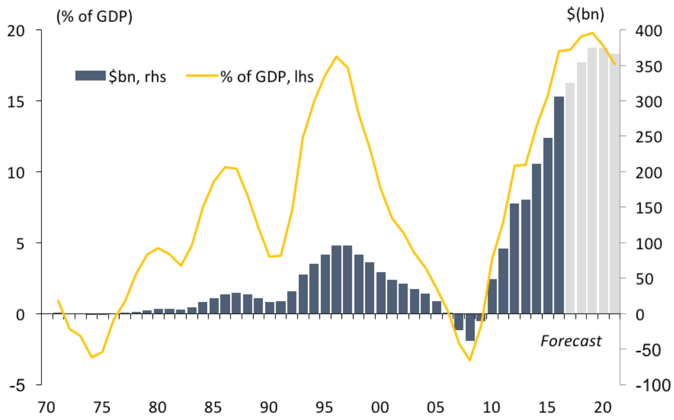
To this end key revenue raising measures include: a 0.5pp increase in the Medicare Levy to 2.5%; a 6bp levy on the liabilities of the five largest banks; a 2.5% efficiency dividend on universities and increases in student repayments; and a crackdown on the black economy, multinational tax avoidance and job search payments. Key expenditures include a significant infrastructure spend of A$75bn over the coming decade and reforms and streamlining in healthcare and education in the short term. Large outlays for these sectors occur over the medium term to fund the revised Gonski education reforms, and the National Disability Insurance Scheme.

Infrastructure measures are positive not only based on need but also to provide an economic boost. And the fact that the government is expediting the process by providing direct financing is also a positive. But this increase in infrastructure spending should be put into context. While it represents an increase in funding compared to recent years it is not as much, per year, as promised by Coalition governments in previous years. Nonetheless following pre-budget debate on what's "good" and "bad" debt it is our view that such measures fall largely into the good debt category.

Due to this debate there was some focus on an alternate measure of the deficit, in the net operating balance, contained in the budget. This should be viewed as an accounting sideshow. However, the deficit as measured there is still an increase in net debt that will peak at 19.8% of GDP in 2018-19, still remaining well short of the average debt level in advanced economies of around 90% of GDP. As the government is taking proactive steps towards surplus, this "good" debt should not attract the ire of ratings agencies and there should be no imminent threat to Australia's triple-A credit rating.

Australia: Net debt

Net debt rises again but is well constrained



Source: IFM Investors, Commonwealth Budget 2017-18

The economic forecasts put forward by the Treasury are hard to contest outright, and are suitably conservative at this point in the cycle. Indeed real GDP growth forecasts for fiscal years 16-17, 17-18 and 18-19 are 1.75%, 2.75% and 3.0% respectively. This is a 0.25pp lower than the RBA's forecasts presented just days earlier – significantly below the IMF's forecasts mentioned above.

Risks nevertheless remain in the economic projections – as they always do. The Treasury assumes 3.0% growth in real GDP for 2019-20 and 2020-21 – above its own estimate of trend growth at 2.75%. While this occurs nominal GDP growth accelerates to 4.75% and wages growth to 3.75% which are optimistic forecasts when judged by recent history. That is to say they cannot occur but they do skew risks to the downside in our opinion. And given the budget surplus relies so heavily on, and is so sensitive to, these underlying parameters, any material forecast miss would suggest the targeted surplus would not be achieved by 2020-21.

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