# Economic Update

OCT
2016

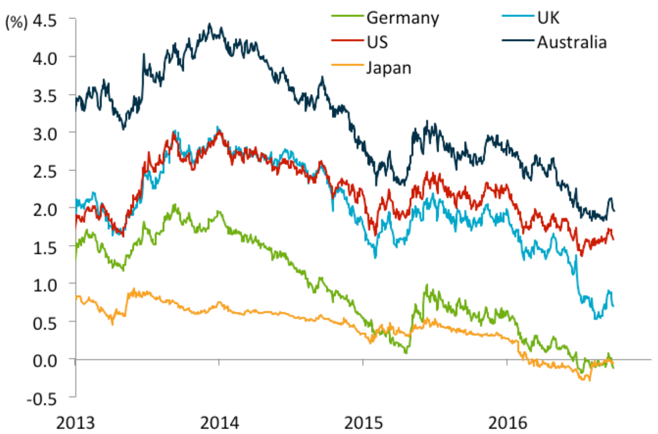
## Central banks the focus of market attention

Recent market focus has squarely been on the advanced economy central banks, as meetings of the European Central Bank (ECB), the Bank of Japan (BoJ) and the US Federal Reserve (the Fed) kept markets watchful. As it turned out, statements of intent characterised these meetings rather than any formal shift in policy. Importantly, further policy accommodation was not ruled out by central banks as they endeavour to spur inflation and growth.

The ECB met early in September. Policy rates remained unchanged, with the main refinancing rate and deposit rate left at 0.0% and -0.4%, respectively. The ECB also reaffirmed that it would continue to purchase €80 billion per month of assets "until the end of March 2017, or beyond, if necessary" in order to drive inflation towards its target.

However, despite a commitment to an ongoing accommodative policy stance, ECB President Mario Draghi's comment that additional stimulus may not be necessary "for the time being" garnered a significant market reaction. Bond yields rose relatively sharply as a result, with German 10-year bond yields moving into positive territory for the first time since declining below zero in the wake of the Brexit vote. Despite proving to be short-lived, this move reverberated around global markets, with US and Australian bonds selling off. This underscores how sensitive markets have become to even the slightest suggestion that additional monetary policy accommodation may not be implemented.

**Developed market's 10-year bond yields**
*Bonds sell-off marginally*




Source: IFM Investors, Bloomberg

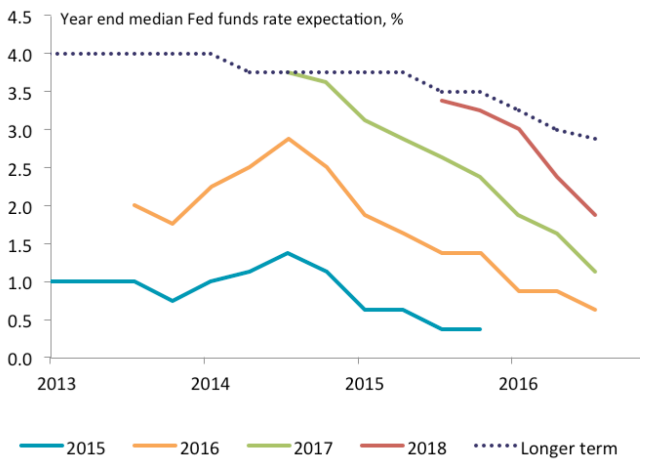
The BoJ met late in September and was expected to deliver additional support to the goal of achieving its 2.0% year-on-year inflation target. While policy rates were unchanged at -0.1%, the BoJ altered its policy framework. The previous monetary base target was abandoned in favour of "yield curve control". Effectively, the BoJ will target a 10-year bond rate of 0.0% and adjust the degree of monetary stimulus accordingly. This is designed to boost growth, support the function of the financial system and drive inflation to overshoot its 2.0% target. These measures will be in place until this final condition is met.

The key focus of the month was on the Fed. Despite some speculation that a rate move was an outside chance, the FOMC (Federal Open Market Committee) left policy rates on hold at September's meeting. Nonetheless, it became apparent that three of the ten FOMC members favoured an immediate increase in interest rates.

The language and economic forecasts from the Fed's meeting were instructive, with two important changes. First, the Fed assessed the risks to the economic outlook as "roughly balanced". This represented an upgrade from downside risks being described as having "diminished" in the July statement. Second, the Fed asserted that the case for raising interest rates "has strengthened", but it "decided, for the time being, to wait for further evidence of continued progress towards its objectives". These statements support the argument that the FOMC is looking towards a December hike.

Despite the chance of a near-term hike having increased, the FOMC became more cautious around the medium-term outlook. This was reflected in the median of the "Dot Plot" – a graphical representation of the FOMC's policy rate expectations. For 2016, the FOMC now expects one hike after previously expecting two, and for 2017 it now expects two hikes after previously expecting three. This came as no surprise as the FOMC has been continually revising down its expectations for policy tightening for some time (see following chart). This supports the case that policy rates will be lower for longer.

**US: FOMC interest rate expectations, the "Dot Plot"**
*US policy rates to rise at a slower pace*




Source: IFM Investors, US Federal Reserve

The FOMC's forecast for real US GDP growth for 2016 was also revised downwards, from 2.0% previously to 1.8%. Forecasts for 2017 and 2018 US GDP growth were unchanged at an unspectacular 2.0%. The Fed, along with other central banks, will likely continue to encourage governments to engage fiscal policy support to growth, as this would facilitate central banks weaning economies off the huge amount of monetary stimulus in the system. However, the fiscal outlook in the US has become increasingly uncertain as the Presidential election looms.

## Politics, politics, politics

In the short term, focus may come off US monetary policy as momentum builds up to the Presidential election to be held on 8 November. While difficult to predict, the establishment Democratic candidate Hilary Clinton is still expected to claim victory over the populist Republican candidate Donald Trump. As the campaign moves into its final stages, we are starting to get a better idea of the candidates' stance on fiscal policy. Both are expansionary and should, to some degree, reduce the US economy's reliance on monetary policy.

On the Republican side, Trump's policies are more aggressive and, in the event of his victory, more likely to pass into legislation as such an election result would likely see both the House and Senate remain in Republican hands.

The centrepiece of Trump's fiscal policies thus far is large tax cuts. The rate of federal corporate tax would be reduced from 35.0% to 15.0%. In addition, corporations would be allowed a one-time 10% tax rate to incentivise them to repatriate foreign profits. Further, the household marginal income tax rate would be reduced and three brackets would be created, with a top rate of 33.0%, down from the current 39.6%.

On the spending side, Trump has outlined increases in both military and infrastructure spending, at the expense of decreasing "non-safety net" spending by 1.0% per year over the next 10 years. He has also put forward a proposal to aggressively reduce government debt, which is difficult to reconcile with the expansionary fiscal policy outlined above. Should it get to the point that Congress needed to pass these measures, they would likely be scaled back to some extent.

Trump's populist anti-globalisation measures include introducing heavy trade tariffs on China and Mexico in particular, withdrawing from the Trans-Pacific Partnership Agreement and renegotiating the North American Free Trade Agreement, amongst other measures that would likely be disruptive to global growth.

On the Democrat side, Clinton's policy measures are more measured yet would still be reflective of modestly expansionary fiscal policy. Broadly they would reflect a similar policy direction to that of the Obama administration. However, they would arguably have a more difficult path through both Houses, unless she was to win the election by a large margin. On corporate tax, Clinton has proposed reforming the treatment of business income, although there are no clear details as yet. Proceeds from this would fund a US$275 billion, five-year infrastructure spending program (including a US$25 billion infrastructure bank) to spur much needed public investment. Clinton also favours household income tax increases that would largely impact higher income earners.

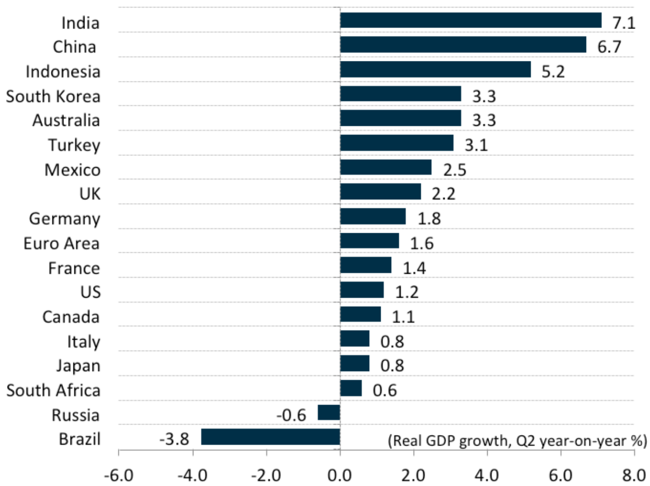
Overall, the fiscal impulse imparted by a Clinton administration would be significantly less than one led by Trump. It is also clear that a Clinton victory would impart much less volatility and uncertainty into the global economy and financial markets. As such, this is a preferable situation for both the US and global economies.

## It remains a low growth world

Recent months have seen the release of a raft of global real GDP data for the June quarter. Broadly these results continue to underscore how difficult it is for monetary policy alone to generate solid and sustainable expansions in real economic activity.

**G20: real GDP growth**

*Australian growth compares well to peers*




Source: IFM Investors, Bloomberg

Of the G20 countries that reported in a timely manner, growth rates of the large emerging market economies are still solid. India recorded a 7.1% year-on-year expansion of real GDP, buoyed by consumption and stimulated by easier monetary policy settings. This strong performance is expected to continue, with near 8.0% pa growth expected in 2017 and 2018. Despite ongoing concerns, especially around corporate debt levels, China recorded 6.7% year-on-year growth, supported by stimulatory monetary and fiscal policies. This growth rate is expected to decelerate marginally over coming years.

By contrast, developed economies are struggling to generate consistent growth, with expansions in real GDP remaining, for the most part, below trend. Despite huge monetary policy stimulus, businesses have been reluctant to change behaviours and private investment remains relatively subdued.

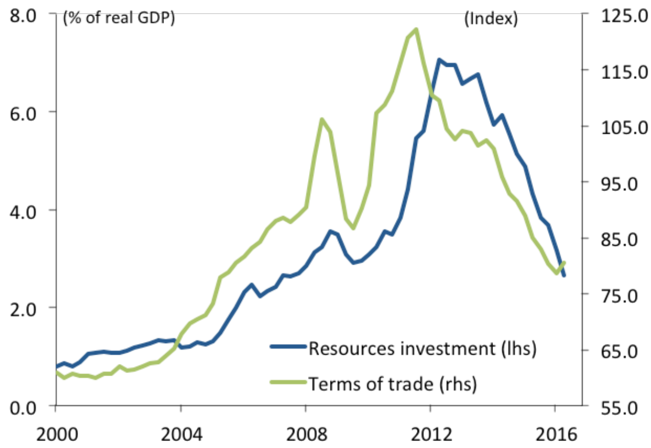
## Australia doing well, with challenges ahead

Australia's real GDP growth rate is a standout amongst the developed world, expanding by 3.3% year-on-year to the June quarter, which marked an impressive milestone of 25 years of expansion in Australia's GDP. This has been due to good management from policy-makers but also at least some measure of good luck – most notably the rise of China's economy and Australia's exposure to it. Arguably, less positive drivers were a credit boom that has driven household debt to unprecedented levels and profligate government spending of much of the windfall from the resources boom that it is now struggling to be wound back. These latter factors will continue to pose challenges to the economy and policy-makers alike in coming years.

Looking at the detail of the June quarter's national accounts, there were significant positives. Foremost among these was the above trend annual headline growth rate, despite a relatively modest 0.5% expansion in the June quarter. Arguably more important was the diminished drag on the economy and national income from the terms of trade. The latter rose 2.3% quarter-on-quarter, the first increase in twelve quarters and the largest since mid-2011. Should this stabilisation be sustained, the negative income shock that has hampered growth for some years will wane. This was also reflected in the nominal rate of GDP growth (the world in which households, businesses and governments operate), which accelerated to 3.4% year-on-year, exceeding real GDP growth for the first time since the June quarter of 2014. This may have seen the end of what has been a prolonged period of weakness, assuming commodity prices don't take another leg down in the near future.

Resources sector investment fell another 16.0% in the June quarter. This reduced investment from a peak of around 7.0% in 2012 to just 2.6% now, just above the long-term average of 1.4%. This is occurring as projects move to completion; the positive here is that the drag on the economy will start to decrease over coming quarters and will boost growth as exports come online. The diminished impact of both resource prices and investment declines are reasons for some optimism. This is certainly how the Reserve Bank of Australia (RBA) views it, with the now former Assistant Governor (Economic) Christopher Kent opining that "The abatement of those two substantial headwinds suggests that there is a reasonable prospect of sustaining growth in economic activity". The RBA has been cutting interest rates to offset these declines, so the "abatement" in this space may suggest that the pressure to reduce rates again, for this reason at least, is reduced.

**Australia: rise and fall of the resources sector**
*Is the drag from resources finally over?*




Source: IFM Investors, Australian Bureau of Statistics

At first glance the public sector made a very strong contribution to quarterly GDP growth, however much of this can be discounted due to an asset transfer. The overwhelming positive in this space was the 27.0% quarter-on-quarter spike in state-based gross fixed capital formation – that is, infrastructure investment. Indeed, this alone added more than 0.4% to quarterly growth – the largest single quarter contribution since June 1960. Such a growth rate won't be sustained, but there is further work in the pipeline, predominantly in NSW and Victoria.

However, the implication from state government budgets is that this spending will peak in late 2017 into 2018. We therefore would encourage all levels of government to facilitate further infrastructure spending beyond this point to arrest any potential decline.

This assertion is made more urgent as the national accounts again reveal a private sector in which no material uplift in investment is occurring. This is a key factor, along with below average levels of household spending growth, keeping domestic demand growth (excluding resources investment) running consistently below trend.

Furthermore, the current upswing in the residential construction sector will inevitability fade, potentially in late 2017. This will impart downward pressure on economic activity and likely involve job losses that ideally would be offset with further infrastructure investment.

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