ifm investors

Economic Update

OCT 2017

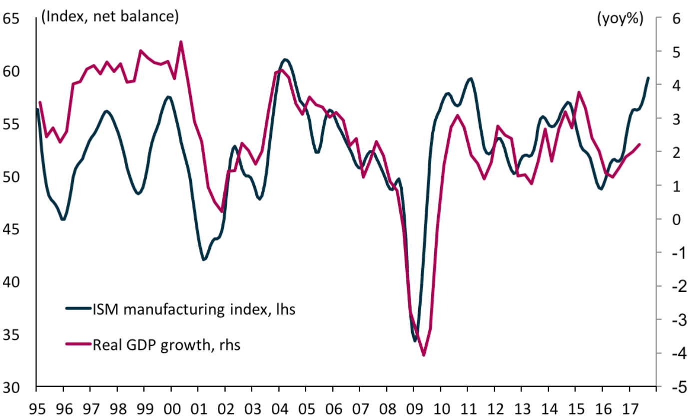
United States

The US economy continues to perform well as we move into the last quarter of 2017, building on momentum from the June quarter as the third estimate of GDP growth was again revised higher, up 0.1pp, to 3.1%yoy saar. This growth remains heavily reliant on the US household sector that contributed 1.9pp to the 2.2%yoy rate of growth in real GDP. However, pleasingly, private investment also made a solid contribution through the year and is set to improve further. Government demand nonetheless remains flat and net exports and inventories are weighing on growth.

The current rate of growth is just shy of the Federal Reserve's (Fed) expectation of 2.4%yoy by year's end but activity indicators suggest it is accelerating towards this target. Recent ISM data underscore this assertion. The manufacturing index hit 60.8 in September – the highest level since May 2004. Similarly, the ISM non-manufacturing index (largely services sectors) rose to 59.8, the highest level since February 1998. Both auger well for an acceleration of real GDP growth.

US: ISM manufacturing and real GDP growth

ISM indexes point to growth upside



Source: IFM Investors, ISM, Bloomberg

Such an acceleration would suggest some cyclical strength in the economy as it outperforms consensus estimates of potential US GDP growth at around 1¾%. We can therefore continue to expect improvements in the labour market with the current unemployment rate on track to meet the Fed's forecast of 4.3% by year's end. As such, economic conditions are supportive of further policy interest rate increases.

Consequently, recent focus from the Fed has been on the momentum of inflation rather than activity indicators, as the former is the matter within the Federal Open Market Committee's (FOMC) mandate with which it is most concerned. As a result, August's solid inflation data would have been warmly welcomed. The headline measure of inflation showed prices increasing 0.4%mom – the strongest result since January – with the annual rate of increase accelerating to 1.9%yoy. Energy prices, in particular gasoline, were a key contributor, and volatility in this space should be expected given recent severe weather events. There was also a strong contribution from 'shelter' where prices rose the most since 2005. These weather events will also likely introduce volatility into activity indicators over coming months – the seemingly already occurred with the reversal of non-farm payrolls in September's data.

Nonetheless 'core' inflation came in at 0.2%mom, breaking a four consecutive month run of 0.1%mom outcomes, a positive sign despite the annual rate remaining steady at 1.7%yoy. Yet even though annual rates of 'core' inflation are stable, the 'core' personal consumer expenditure (PCE) deflator edged lower to 1.3%yoy in August, still well below the Fed's 1.6%yoy forecast for year end.

Despite this, most economists expect that the FOMC will raise interest rates again in December to 1.25-1.5%. Both recent Fed communications, and its September statement, suggest this will be the case. Indeed the September update of the "Dot Plot" showed the vast majority of FOMC members still expect three hikes in 2017 – leaving it one to go. It also indicated the Fed is still looking for another three hikes in 2018, but now only two hikes in 2019. Further, it also lowered its long-run equilibrium rate to 2.75%, which is down from 3.0%. This may suggest that Fed is somewhat cautious as to how far it will need to take rates to remove policy accommodation.

The Fed also announced its well-telegraphed intention to commence balance sheet reduction from October. This will involve allowing US$10 billion per month of assets to mature - US$6 billion in Treasuries and US$4 billion in agency mortgage-backed securities.

US fiscal policy also came back into focus this month with the administration re-outlining a potential tax package. For corporate tax, this would entail reducing the top rate from 35% to 20%; allowing immediate full expensing; a one-off tax reduction for companies to repatriate offshore profits and tax credits for R&D, and low-income housing. For individuals, seven tax brackets are collapsed into three: 12%; 25%; and 35%, although the income thresholds are left ambiguous. The proposal would also double standard deductions and eliminate estate tax. Although markets welcomed the news as broadly positive, scepticism remains as to whether it can be passed into legislation. This is because the cuts remain politically contentious due to their highly regressive nature and cost to the US federal budget. It is far too soon to expect any strong resumption of the 'Trump Trade', nor increased optimism around the US economy.

Europe & UK

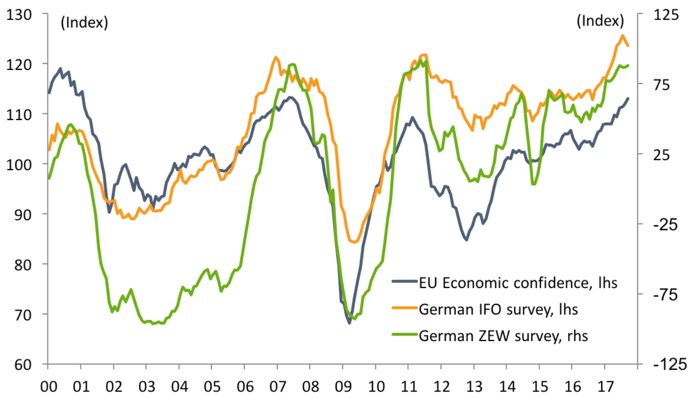
The buoyant economic environment in the Eurozone continues. This is evident in recent sentiment measures remaining elevated. Notably, the European Commission's Economic Sentiment Indicator rose to 113 in September from 111.9 in August – its best result since July 2007. The increase was driven by improved sentiment in the manufacturing, retail trade and construction sectors. In contrast, confidence in the services sector edged higher but remains by far the most optimistic sector. Also positive within these data was that consumer confidence improved again in August to -1.2 – the highest level since April 2001, and a trend being driven by ongoing improvements in the labour market. Nonetheless, retail sales volumes in the Eurozone declined 0.3%mom in July, the first reversal since December 2016. Setbacks in larger economies such as Germany (-1.2%mom) and Spain (-0.3%mom) drove the decline. However, through the year growth remains a solid 2.6% and should underpin GDP growth going forward.

Elevated sentiment is not just confined to consumers. The ZEW survey of financial market participants edged higher to 87.9 in September – just off recent highs – and continues to suggest a level of optimism around the German economy. Similarly, the German IFO company survey, much focused on by markets and economists, dipped modestly in September to 123.6 but remains elevated and a full 9.0pp higher than this time last year. Both monthly reversals may have been driven by uncertainty heading in to the German election.

Hopefully the political uncertainty will not continue, but the German general election's complicated outcome means it will likely be months until the country has a new government. Despite Chancellor Angela Merkel holding onto power and the centre-right parties, the CDU/CSU, winning the largest number of seats, it will not be re-forming a "Grand Coalition" with the centre-left SPD. Following historic losses for the latter, the party has stated it will instead form the main opposition in the German parliament. This makes Merkel's task harder, leaving her to either form a minority government or attempt to form a coalition government with the liberal FDP and the Greens. Another vote of concern is the referendum outcome on Catalonian secession from Spain. Uncertainty may stem from lack of stability with ongoing protests in the region and the consequent potential for the Spanish government not to be able to pass its budget without support of the Basque region's PNV party. Further, Catalonia makes up 20% of the Spanish economy, and around 16% of Spain's population. As a result, disruption – let alone secession – may pose some significant downside risks to the broader economy.

Eurozone: EU economic confidence, German ZEW & IFO

Confidence is high across Europe



Source: IFM Investors, Bloomberg

The European Central Bank (ECB) kept monetary policy unchanged in September, and asset purchases continuing as scheduled until at least December. With speculation around any potential 'tapering' of policy continuing, ECB president Mario Draghi suggested that decisions regarding the future of the quantitative easing (QE) program would be made in October. He also noted that an appreciation of the euro had "unquestionably" tightened financial conditions and was a source of forecast "uncertainty", arguably to temper speculation that a tapering of QE is imminent or will be overly aggressive.

In the UK focus has largely now shifted to when, and not if, the Bank of England (BoE) will raise official interest rates. The Monetary Policy Committee (MPC) voted seven to two to keep asset purchases and interest rates on hold at their September meeting. However, the MPC's minutes struck a hawkish tone and gave a strong indication that a rate rise in the near future is a real prospect. The minutes noted that the economy had been "slightly stronger" than anticipated and that inflation was becoming a key concern. It concluded that "some withdrawal of monetary stimulus was likely to be appropriate over the coming months in order to return inflation sustainably to target" and further that policy settings "could need to be tightened by a somewhat greater extent over the forecast period than current market expectations".

Its position comes as both key measures of inflation accelerated in August data. Headline inflation jumped to 2.9% yoy from 2.6%yoy a month earlier - well above the BoE's 2% annual inflation target and clearly testing its tolerance, and soon requiring the bank to explain the overshoot. The bank's remit requires Governor Mark Carney to write a letter to Chancellor Philip Hammond explaining a divergence of 1pp either side of its annual CPI target, and proposing remedial action when it occurs.

Eurozone: EU economic confidence, German ZEW & IFO

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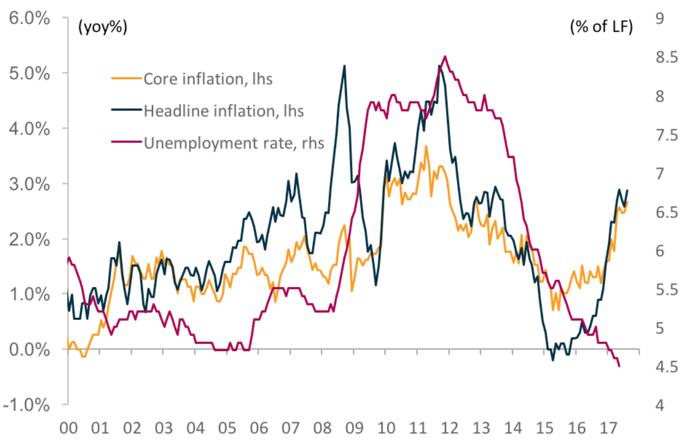


Source: IFM Investors, ONS

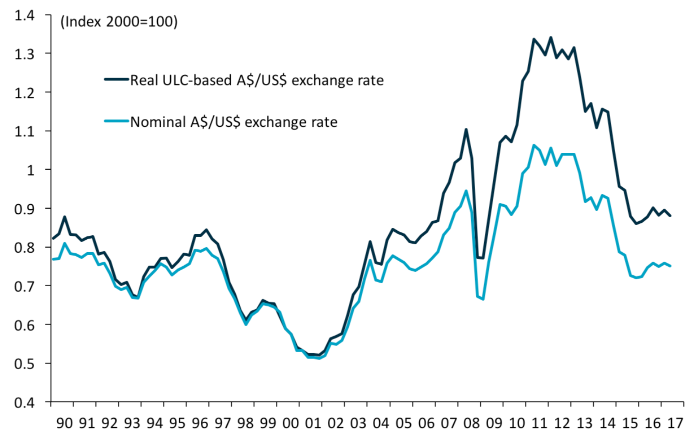
Core inflation also accelerated in the month to 2.7%yoy from 2.4%yoy – the strongest rate since December 2011. A continuation of good labour market performance may also be giving the BoE confidence to hike rates despite significant economic uncertainty around Brexit remaining. Employment in the three months to July rose 181,000, well beyond market expectations and the unemployment rate fell to 4.3% a fresh 42-year low, and below the Bank's own estimate of 4½% as a sustainable long term level.

Australia

The Australian economy continues to send mixed signals. The most positive of late has been the strong performance of the labour market. Despite below trend growth the economy has generated eleven consecutive months of jobs growth. This has translated to 326,000 more jobs, equivalent to an employment growth rate of 2.7%yoy. This has allowed the unemployment rate to edge lower, reaching 5.6% despite a marked increase in the participation rate. Yet spare capacity in the labour market remains with the underemployment rate only edging lower to a still high 8.6%. We remain sceptical that this capacity will be significantly eroded by accommodative monetary policy alone. This is, in part, because underemployment is a conscious decision by the employee. Or more concerning, one by the employer to keep a more flexible workforce. In the latter case, combined with elevated employment uncertainty it seems unlikely that wage growth will become entrenched any time soon (Q3 wage price index will be boosted by a one-off rise in the minimum wage). Indeed, it seems difficult for employers to justify higher wages in the absence of meaningful improvements in productivity. The wages boom seen through the 2000s has, in the absence of productivity growth, significantly eroded Australia's international competitiveness – a factor that will unlikely be 'fixed' by a lower nominal exchange rate depreciation alone. To do so may require an extended period of soft wages growth and/or significant improvements in productivity. The later seeming more likely than the former at this juncture.

Australia: AUD-US real* and nominal exchange rate

A lower nominal exchange rate has not 'fixed' our competitiveness



Source: IFM Investors, ABS, BLS, Bloomberg * based on unit labour costs rather than consumer prices.

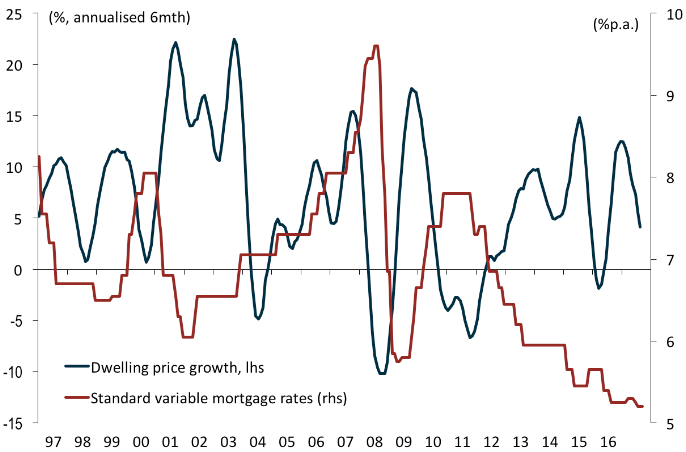
Elevated surveyed business conditions point to a continuation of solid economic and employment growth. This is particularly true in the service sectors of the economy that continues to drive the majority of growth. We would also expect the positive trend in public demand to continue given the strong pipeline of work yet to be done in the public infrastructure space.

However it is the trends emerging in the household sector that are becoming concerning, despite solid employment growth. The absence of an acceleration of wages growth, weak overall income growth and higher costs of living has seen consumer confidence remain subdued. This has driven two consecutive declines in retail sales in July and August of 0.2% and 0.6% respectively – the latter being the weakest single month result since March 2013. Combined with the annual rate of growth decelerating to 2.1%yoy, the weakest rate since June 2013, it is difficult to envisage as significant a contribution to September quarter GDP from retail spending as there was in the June quarter. This is unless the September outcome is very strong and/or these nominal monthly declines have been due to aggressive price discounting.

Also reflecting some household caution is a deceleration of dwelling price growth. Capital city median dwelling price growth decelerated to 8.5%yoy in September. Macro-prudential measures are likely to have taken the edge off the investor side of the market, but poor affordability, despite still record low interest rates, remains the key driver. Households have become ever more wary of taking on too much debt at what is increasingly appearing to be the top of a very expensive market based on any metric. It seems clear that with both structurally and now cyclically low interest rates capitalised into house prices any move to raise rates from record lows will potentially weigh heavily on price growth going forward. This is particularly true if household income growth remains so tepid. The Reserve Bank of Australia's (RBA) next tightening cycle, whenever it begins, will gradually remove the ability of households to leverage over an extended period. Therefore it would not be difficult to envisage dwelling prices over this period experiencing little to no growth, or perhaps even seeing orderly declines. How investors react to such a scenario is an open question, especially new investors that are negatively geared. There is also the dampening impact on household spending this would have via a potential negative wealth effect.

Australia: Dwelling prices and mortgage rates

Dwelling prices growth decelerating before rates have been raised



Source: IFM Investors, CoreLogic, RBA

Nonetheless for now housing credit growth remains at a solid 6.6%yoy. Updated data from the RBA show that, as this rate is still running well ahead of income growth, the household debt-to-income ratio has risen again to 193%. In our view this leaves the RBA with a hugely asymmetric policy tool. When the RBA does seek to lift rates, it will do so with caution as not to overly impact indebted households and limit spending growth. It is for this reason, amongst others, we think the RBA will not raise rates for some time to come, waiting for wage growth to pick up. It will want to be sure that household can weather the increases. The Bank will be looking for dwelling price growth to continue to decelerate to buy it the necessary time. There seems no advantage in getting ahead of itself. Inflation is not threatening to break out, and going too early would only bring unwelcome appreciation of the exchange rate. Getting behind the curve may risk debt metrics deteriorating further which is concerning, but it is seemingly a prudent course given the uncertainty of the economic outlook.

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