Economic Update

SEP 2017

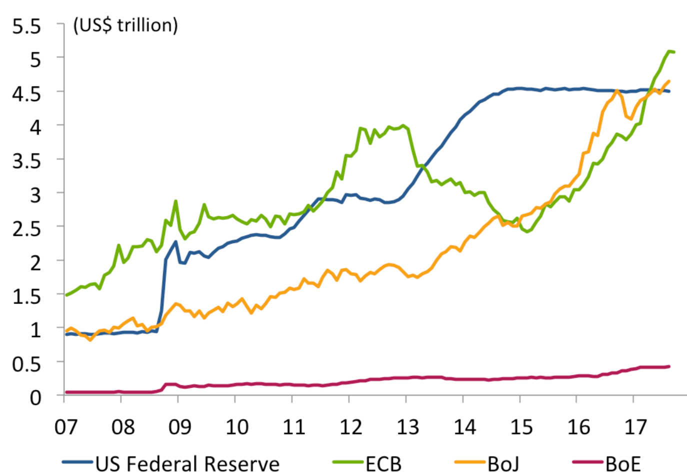
ifm investors

United States

Another watershed moment in the post-global financial crisis monetary experiment fast approaches. The moment of truth will be the US Federal Reserve's (Fed's) balance sheet reduction and normalisation process – the first major central bank to wind back the impact of its emergency quantitative easing (QE) program. It is expected to be foreshadowed as early as this month and implemented either later in the year or early 2018, with estimates of its completion around late 2021. Over the period the Fed's balance sheet is anticipated to shrink from its current level of US$4.5 trillion to around US$2½trillion – yet the exact endpoint is as yet unknown. Thus far the Federal Open Market Committee (FOMC) notes only that the final level of its assets will be "appreciably below than seen in recent years but larger than before the financial crisis; the level will reflect the banking system's demand for reserve balances and the Committee's decision about how to implement monetary policy most efficiently and effectively in the future". The process will broadly involve the Fed allowing its assets (largely Treasuries and mortgage-backed securities) to mature rather than outright selling. More detail and heavy communication around what the Fed actually intends will likely be forthcoming as it seeks to avoid causing any undue volatility in financial markets by its action (and avoid a reaction akin to that of the 'Taper tantrum' of 2013).

Global: Major central bank balance sheets

Fed to reduce balance sheet before others



Source: IFM Investors, various central banks, Bloomberg

Nonetheless it remains relatively unclear how broader financial markets will react – and whether the removal of liquidity is in practice a tightening of credit conditions. Bond markets, overall, are expected to have a modest reaction, if any, to the Fed's move, with the risk being only a marginal rise in yields. This is as many estimate that the impact of QE has been to suppress the term premium significantly and there's a chance this may reverse to some extent. However, clear communication around the unwinding, and gradual nature of the reduction, may go some way to avoiding any marginal yield rise. This outcome is certainly desirable from the Fed's perspective as rising yields would effectively represent a tightening of monetary policy. That said, if there indeed is an undue and unwelcome increase in yields the Fed can always slow the process of reduction and/or foreshadow a slower pace of raising interest rates.

The returning of cash to the private sector may also impact short-term Treasury bill markets as these funds are initially held in cash. Such downward pressure on yields is again likely to be small and should not unduly steepen the yield curve. A muted impact in rates should mean the impact on equity markets should also be modest. Indeed, the correlation between QE and equity market performance has broken down in recent years. Ideally, the Fed will be hoping that underlying economic fundamentals will continue to drive financial markets and balance sheet reduction in the most benign way possible.

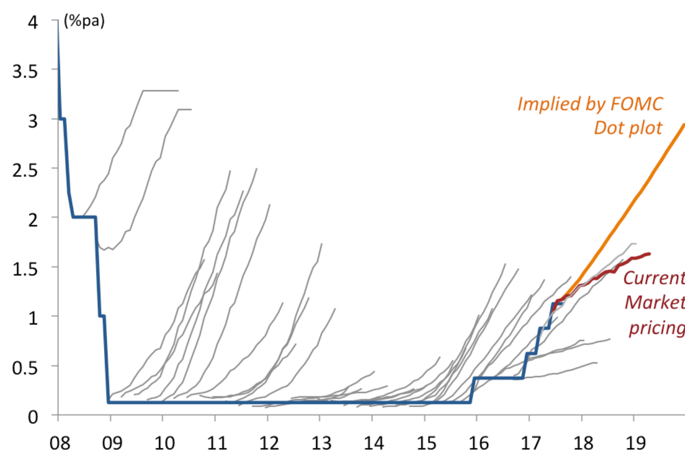
What may be interesting is just how the Fed shrinking its balance sheet will impact global capital flows. This is as the European Central Bank (ECB) and Bank of Japan (BoJ) continue to expand theirs – at least for some time yet. While the ECB may be close to at least tapering, the BoJ is not. And we therefore may see capital outflow from these markets, particularly the latter, chasing yield. And this may impact exchange rates and global bond markets alike.

With these assumptions around the US balance sheet in mind, the question becomes whether these fundamental economic drivers are strong enough to warrant further conventional policy tightening in the short term. The FOMC continues to forecast a third interest rate hike in 2017, as it has done since the start of the year, however this remains heavily dependent on the data flow. The FOMC has become more cautious around the outlook for inflation in particular, and this may provide cause for it to pause. This is despite the ongoing solid performance of the broader economy and in particular the labour market. At this stage markets are less than convinced the data will be supportive of a December hike, although for now market economists still favour this outcome.

The dovishness from markets also extends into coming years with its expectations significantly below what the FOMC expects. This may partly be attributable to the diminished optimism around the US economy in the absence of what had been a strong fiscal impulse expected from the new Administration.

US: Progressive market expectations of rate hikes

Market not convinced that Fed can hike as planned



Source: IFM Investors, US Federal Reserve, Bloomberg

Over the last month the US economic data flow has confirmed this divergence in growth-labour market performance and inflation. The US economy expanded at an annualised rate of 3.0%, according to the secondary read of June quarter data (accelerating to 2.2%yoy through the year). This was an improvement on the 2.6%saar in the preliminary estimate and was the strongest quarterly result since the March quarter 2015. Household spending and non-residential investment were even stronger contributors, with growth being revised upwards. And this more than offset the downward revisions to state and local government spending and a reversal in residential investment.

This around trend growth continues to fuel solid labour demand. Non-farm payrolls rose a relatively soft 156,000 in August, yet seasonal impacts were the driver of this likely temporary weakness. Yet had followed a 189,000 gain in payrolls in July. This ongoing improvement in employment conditions has kept the unemployment rate below 4½% since March while, importantly, the participation rate has remained relatively stable at just under 63%. Despite the erosion of spare labour market capacity, wages growth was just 0.1%mom in July – the weakest monthly result since March, and this left the annual rate of growth stagnating at 2.5%yoy.

Headline CPI inflation also disappointed markets again in monthly terms, but accelerated marginally to 1.7%yoy from 1.6% in July. Core CPI, was similarly disappointing running at just 0.1%mom, as it has done for the last four months, leaving the annual rate at 1.7%yoy (where it has been for the last four months also). Consumer and business sentiment remains elevated despite rising geopolitical concerns and domestic concerns about the debt ceiling and lack of progress on the legislative agenda. This latter point continues to delay fiscal stimulus that had been expected in early 2017.

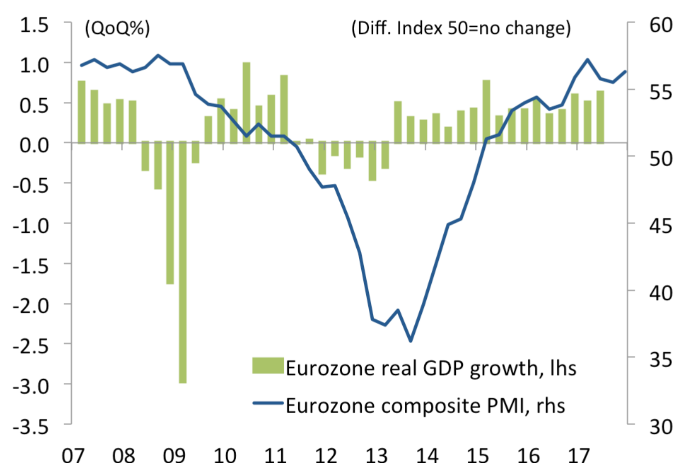
Europe and the UK

The Eurozone economy continues to perform well. This was confirmed by the release of more detailed June quarter GDP data demonstrating that the headline rate of 2.2%yoy growth, the fastest since March 2011, is broad-based across the region. This is particularly true in central and eastern Europe, with the larger economies of Germany, France, Italy and Spain recording more modest, but still solid, annual expansions of 2.1%, 1.8%, 1.5% and 3.1% respectively. This above potential growth rate is seeing a continuation of good labour market conditions, with the unemployment rate decreasing to 9.1% in July, down from 10.0% a year earlier. Solid labour market performance has been a strong driver of household consumption growth, which added 0.9pp of the 1.9%yoy real GDP growth in the year to the June quarter. This should continue as retail sales are solid at 3.0%yoy and consumer confidence remains at its higher level since 2007.

Also positive is that business indicators and manufacturing surveys all point to robust growth in coming quarters. This is particularly true of the manufacturing PMI which is at 57.4 as of August's data, a cyclical high. However, it is the services PMI that is dragging on the overall composite index (see chart), edging lower from a cyclical high of 56.4 in April to 54.7 in August.

Eurozone: Real GDP and composite PMI

Still elevated PMI data points to ongoing growth



Source: IFM Investors, Bloomberg, EuroStat

This narrative is expected to have the ECB elaborating on plans to taper its quantitative easing program in coming months – most likely in October. Indeed this month the ECB upgraded its economic growth forecasts for 2017 GDP to 2.2% from 1.9%. However, inflation forecasts were lowered slightly by 0.1pp in 2018 and 2019 to 1.2% and 1.5% respectively. And it is this persistently soft inflation pulse that suggests the ECB will outline a very measured withdrawal of QE. Also interesting from the ECB's statement from its September meeting was that

it noted with regard to its economic forecasts "recent volatility in the exchange rate represents a source of uncertainty". There is clearly some concern about the recent appreciation of the Euro so much so that it "requires monitoring". Again suggesting any move towards tightening will be very gradual.

In the UK the economy continues to send mixed messages. At one end of the scale is labour market in which a fresh 43-year low in the unemployment rate of 4.4% was recorded as of June – with ongoing solid momentum in employment. However only a modest pickup in wages as emerging a result with average weekly earnings up 2.1%yoy in the year to the June quarter. This is not enough to translate into stronger retail sales that have expanded by just 1.5% over the past year. Further business investment was flat in the June quarter as confidence remains relatively subdued. It was also flat in the year to the June quarter, not being able to recover from an overall contraction in 2016 of around 6% - this being the most visible sign of the impact of Brexit thus far on the real economy.

Real GDP growth to the June quarter was confirmed to be 0.3%qoq and 1.7%yoy in the secondary reading. Most notably, household spending was up just 0.1%qoq, decelerating markedly through the year to 2.0%yoy, reflecting the squeeze in real incomes due to the pickup of inflation over the past year. Yet there is some evidence the squeeze may begin to wane as the CPI index fell 0.1%mom in July. Nonetheless through the year headline and core inflation rates were unchanged at 2.6%yoy and 2.4%yoy respectively. While the Bank of England has become a little more cautious on the economic outlook, as a consequence of growth trends, it still cautions that if its central forecast for the economy is met then the next move in rates will be higher.

Australia

In Australia the data flow continued to be relatively positive, allowing the Reserve Bank of Australia (RBA) to continue to hold its course on policy rates while maintaining a relatively upbeat narrative. The latter was evident in its August Statement on Monetary Policy, despite a short-term downgrade to its growth forecasts. Real GDP growth forecasts were downgraded ½% to 2-3% in the year to December 2017, on a weaker than expected Q1 outcome and a raising of the Australian dollar forecast assumption to reflect its recent appreciation. However, growth is expected to pick up to an above trend rate in coming years, reaching 2¾-3¾%yoy (mid-point 3¼%) by December 2018 and 3-4% (mid-point 3½%) in the year to December 2019. These seem modestly optimistic at this stage in our view. But it is likely that growth will be enough to see the RBA's unemployment forecast at 5-6% in the forecast period be achieved.

Nonetheless the near-term economic outlook gives no justification for any further easing of policy especially given the strength of household debt accumulation and eastern capital city house prices (dwelling price growth slowed to 8.9%yoy nationally in August, yet prices were 13.0%yoy higher in Sydney and 12.7%yoy). Monthly data supports this assertion: July's labour force data brought the sixth consecutive monthly increase in employment, keeping the unemployment rate just above 5½%; retail sales have rebounded well with volumes in the June quarter rising 1.5%qoq; and building approvals have remained relatively high despite recent volatility. Surveyed business confidence and conditions also remain elevated, which is contrasted by the persistently subdued sentiment of consumers. This may in part be explained by the very weak growth in wages that is running at just 1.9%yoy to the June quarter. This is a reflection of spare capacity in the labour market, particularly via underemployment.

Two key points were abundantly clear from the RBA's forecasts and communications in the past month. They both suggest the next move in rates is higher, the question just becomes when? The first point is that it believes economic conditions will get better from here and no further easing is required on economic grounds. Yet ongoing improvements in the economy, labour market and then wages and inflation will be gradual. Many question why the RBA would not ease policy further to accelerate this process. The answer, and second key point, continues to be that it does not want to risk exacerbating already high levels of household debt. Levels that already pose a medium-term macro-economic risk. Underscoring this stance, at his parliamentary testimony in August, RBA Governor Lowe stated: "The current market pricing implies a greater probability of a rate rise than a rate reduction, I think they are reasonable assumptions and I don't want to dissuade them."

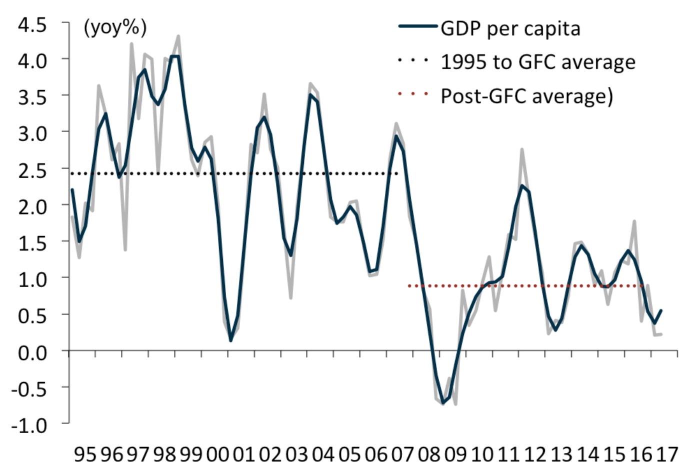
We would expect that the RBA will not consider raising rates until a pick-up in wages growth becomes entrenched and the economy can withstand a stronger Australian dollar, which continues to trade at an uncomfortably high level just around US$0.80. We subscribe to the view the economy is gradually improving and will continue to do so. This should allow the commencement of rate hikes in late 2018 as a base case – a view that is not without domestic downside risks. And further, any setback in the progress of rate rises in the US will likely have a material bearing on the timing of policy action in Australia.

June quarter GDP data was the major release over the past month. Growth came in at a solid 0.8%qoq and was 1.8%yoy through the year. This was almost exactly in line with the RBA's forecast in its August Statement on Monetary Policy and therefore should not be expected to have any policy implications.

Although the June quarter outcome was solid, it was not without concerns. Most notable was still very weak GDP per capita, which is running at just 0.2%yoy for the second consecutive quarter. This suggests that monetary and government policies are not the primary drivers of growth in the economy. It is just that the economy is benefitting from strong population growth – it is people, not policy. This underscores again that monetary policy alone cannot encourage the significant and ongoing productivity gains required to drive sustainable growth – reform from government is necessary and needed.

Australia: Real GDP per capita

Growth is being driven by population not policy



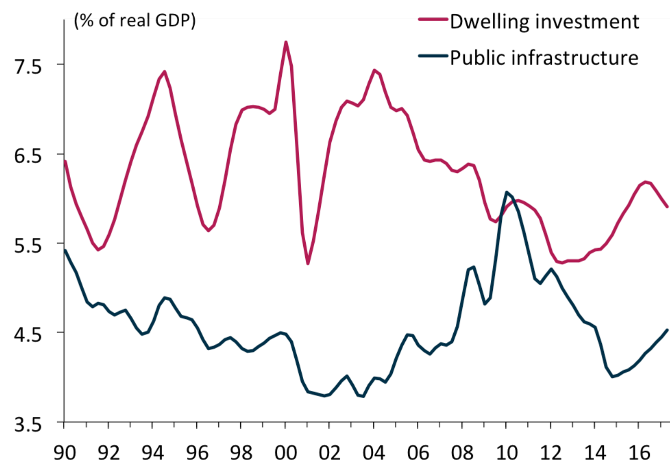
Source: IFM Investors, Australian Bureau Of Statistics (ABS)

Private demand in the economy was a solid 0.7%qoq in the quarter, accelerating to 2.0%yoy. Households were a key driver of this growth, with a 0.7%qoq expansion of spending (although this is still soft through the year at 2.3%yoy). But to do this, the rate at which households saved fell to just 4.6% of income – the lowest rate since September 2008. And with income growth still weak this rate of spending growth seems to be unsustainable.

This underscores the need for wages growth to become entrenched before the RBA considers raising interest rates. Inventories stripped 0.6pp from quarterly growth so it would be expected to give some payback next quarter. And net exports added 0.3pp. Liquefied Natural Gas (LNG) exports are driving this outcome as supply comes on-stream, whereas iron ore export volumes are decelerating and coal exports were interrupted by weather events in Queensland.

Australia: Public infrastructure and dwellings

Dwelling investment has peaked, infrastructure is rising



Source: IFM Investors, Australian Bureau Of Statistics (ABS)

Business investment (ex-transfers) was solid but it was public investment (ex-transfers) rising 4.5%qoq that contributed more to growth. It is pleasing that the ramp up in state government infrastructure spending is adding to growth. Particularly as the dwelling investment cycle has seemingly little more to contribute. Hopefully this transition of growth will be replicated in the labour market for construction workers, who would otherwise face a skills mismatch with the services driven employment growth that has characterised the labour market for some time.

That said, we would like to see both dwelling investment and infrastructure spending be key drivers of growth in the medium term – with the former unlikely and the latter needing further confirmed projects in the pipeline. It is our view that Commonwealth and state government policy should be focussed on this objective. This is because if Australia is to maintain such strong population growth then we'll need both to (1) keep an elevated level of housing supply to contain housing affordability, which is already a key concern, and (2) improve and build infrastructure to ensure the 'liveability' of our cities and to facilitate productivity growth.

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