Monthly Market Update

February edition 2017
By Chris Boag

Royston Capital
AFSL 438262

The global economic outlook has shown signs of momentum in January. Economic readings from the US, China and Europe were consistent with firmer GDP growth on balance, and signs continued to show that the period of very low inflation is turning and that inflationary pressure is starting to build, albeit slowly. Meanwhile in Australia, while there has been little new data over the holiday period, it seems there is still no acceleration from the recent subpar period of GDP growth—the miners have been performing very well thanks to the improved global outlook and higher commodity prices, but other assets remain dependent on a still-elusive pick-up in the pace of economic activity. There are signs that Australian GDP growth will be materially stronger when Q4 GDP is released early in March, but inflation in Australia may take some time to lift.

The US dollar has rebounded in recent weeks. This resurgence has partly reflected an easing of concerns about the president's trade and foreign policy agenda, which had intensified following his rapid fire of executive orders and highly-controversial tweets upon moving into the White House. Nerves have been soothed in particular by Trump's inability to ride roughshod over the US judiciary and by his about-face over the one-China policy and backing away from comments about a military blockade of China's artificial islands in the South China Sea. Equity markets were also buoyed by comments from Trump that his "phenomenal" tax plan would be announced within weeks.

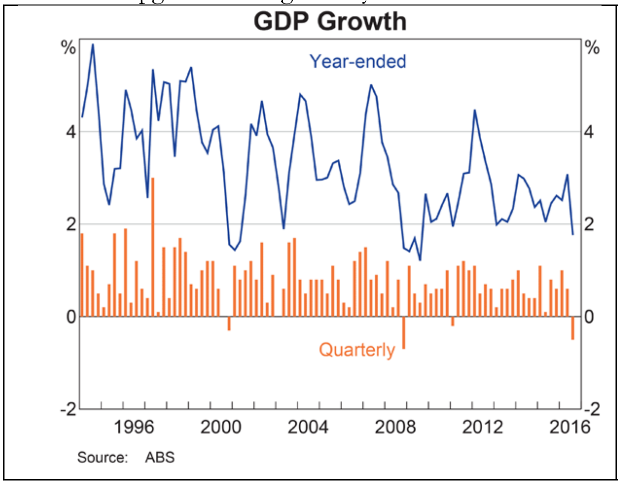
The strong sense is that President Trump's America First policies will fire up business and consumer spending, adding momentum to an economy that was already expanding quite well. Consumer confidence and sentiment were at or close to cycle highs in January, and surveys of home building activity, manufacturing and non-manufacturing businesses are pointing to strong expansion and using up spare employment capacity fast. The Federal Reserve has indicated three rate hikes through 2017, but the risk is that there will need to be more if the economy continues to gather momentum, inflation rises, and President Trump delivers fiscal stimulus to an economy already growing close to capacity. The risks seem skewed to the upside for US bond and Treasury yields. With this in mind, we expect the dollar's rise to continue along with the Federal Reserve to potentially raise rates more rapidly.

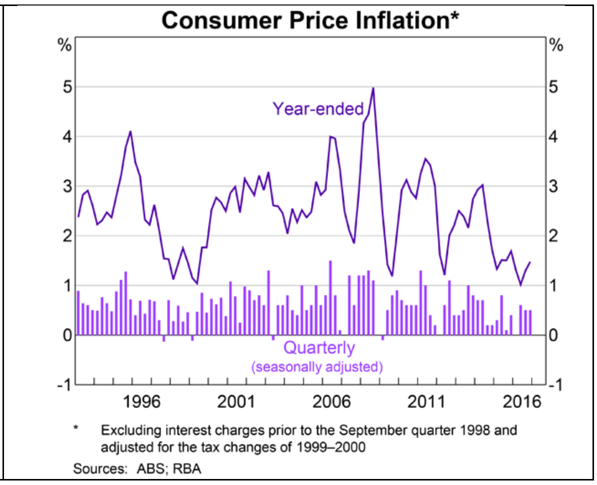
In Europe, most economic readings took a stronger turn in late 2016. Q4 GDP accelerated to 0.5% q-o-q, 1.8% y-o-y. The unemployment rate moderated to 9.6% in December, almost a full percentage point less than where it was a year earlier. Inflation is starting to lift, up on the preliminary numbers for January 2017 to 1.8% y-o-y. Government support programs have been put in place for some of the weakest banks (think Italy). Europe, especially Germany, is benefitting from the comparatively weak euro exchange rate, although this is attracting unwarranted attention from the Trump. Europe still faces difficult national elections that could throw up results capable of fracturing the European Union, with Marine Le Pen making strong indications that her agenda is for France to leave the Euro. Britain's exit from the EU is also still a negotiating nightmare. Nevertheless, the underlying economic readings are improving for the most-part, making Europe's relatively under-valued share markets tempting for investors and adding another potential pressure point to rising bond yields. Let's not forget Greece whose troubles have not dissipated let alone Italy's dire banks.

In China the monetary policy outlook is also shifting, but reflecting more of an emphasis on policy aim. Through much of 2016 monetary policy was working together with expansionary fiscal policy to support growth. That growth came, but with too much contribution from residential construction, unwanted excessive growth in house prices and further deterioration in the quality of bank lending. China continues to prop up the currency at the expense of the manufacturing sector and also continues clamp down on foreign capital flows. Other factors have been the continued supply side reform which has led to global price rises for commodities. Local governments have ceased tax incentives for manufacturing businesses which is adding further pressure to the sector. On the back of this China has been and is likely to continue to spend on infrastructure in the lead up to the congressional elections in November where 5 of the 7 party members will retire.

Later this month we will know more about the state of the economy when much of the workforce are re-employed on their 12 month contracts. Beyond this and the election in November, we see pressure building up to resolve the overbuilding of infrastructure and may lead to a pronounced economic slowdown.

Australia's international trade balance has swung from a record deficit at the end of 2015 to a record surplus in December 2016. This is the result of huge rises in commodity prices not volumes of material shipped. While this is good for the trade surplus it does not have a material impact on GDP due to the capital expenditure on delivering the volume upgrades having already been sunk.





The Statement on Monetary Policy (SMP) shows that the RBA is almost assuming that the economy performs perfectly over the next few years. This rarely happens and our view is that GDP growth and inflation could turn weaker in the later part of 2017. The economy will grow by 2-3% this year. The slower annual rate of growth highlights that there will be more spare capacity in the economy than the RBA previously thought.

The forecast for underlying inflation appears to be largely unchanged, with it expected to rise to 2% in the second half of 2018. That may not be enough to prompt further rate cuts, especially when the recent rise in demand for housing loans from investors is fuelling its financial stability concerns. Nonetheless, rates are more likely to fall this year than rise. A cooling in the housing market will give the RBA room to move if need be but we feel rates will remain on hold for the remainder of 2017.

Overall we think the outlook is picking up for four key reasons: 1. Labour market conditions should continue to improve in most economies; 2. The process of household deleveraging is now largely over; 3. Monetary conditions should remain supportive; 4. Prospects for spending in the US are improving, particularly if corporate tax rates are slashed by the Trump Administration.