Economic Snapshot

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November – December 2016

In summary

November was a dramatic month for the world's financial markets with Donald Trump's surprise victory in America precipitating significant market volatility but with positive outcomes.

Unexpectedly for economists and fund managers, markets responded positively while contradicting main stream media's expectations. We are all impacted by media, and in some respects, this momentous occasion in the change of world politics highlights the irrelevance of media speculation when investing for the long term. Forecasts got the wrong candidate and also got the wrong market outcome.

After selling risk assets [equities] aggressively as the vote count proceeded, financial markets quickly changed their mind and cyclical equities moved back into favour at cost of defensive assets.

Some of the price movement has been the most significant we have experienced for a while and the charts following illustrate some of this story. Positive returns of 5.6% were experienced for small cap global equities, the USA market rose 3.6% and Australia's large cap (often classified as blue chips) rose 3%. Bonds however fell in value such that investors holding defensive assets with high bond weightings will have had a poor month.

Bearing in mind 12 month term deposits are slightly below the above equity returns ***it's a salutary reminder that despite volatility, diversification including equities is essential for longer term wealth creation alongside income generation.***

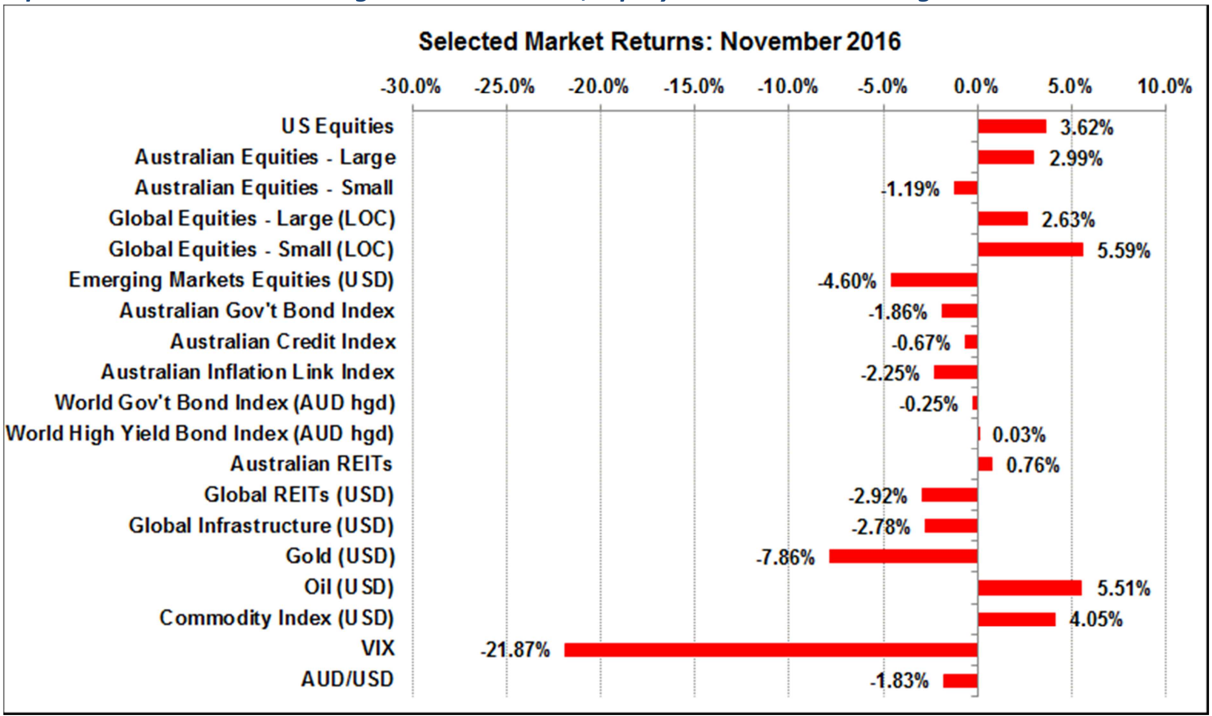
Domestically, the Australian economic news showed on-going softness with patchy labour market figures and soft inflation. One remarkable feature is wages growth has fallen to the lowest pace on record. Business conditions and confidence slipped further, partly under the weight of a firm A$. Unsurprisingly, the Reserve Bank left the cash rate at 1.5%.

Despite a record high stock market in the USA, economic conditions continue to improve with stronger manufacturing activity and employment growth. However, both wage and consumer price inflation remained subdued.

In China, economic activity has also continued to improve. The latest indices for both manufacturing and services rose, while inflation picked up with higher commodity prices and the weaker local currency. Stronger economic activity helped push the price of iron ore upwards, but analysts mostly believe this cannot account for the entire increase and assume that speculative activity is the driver.

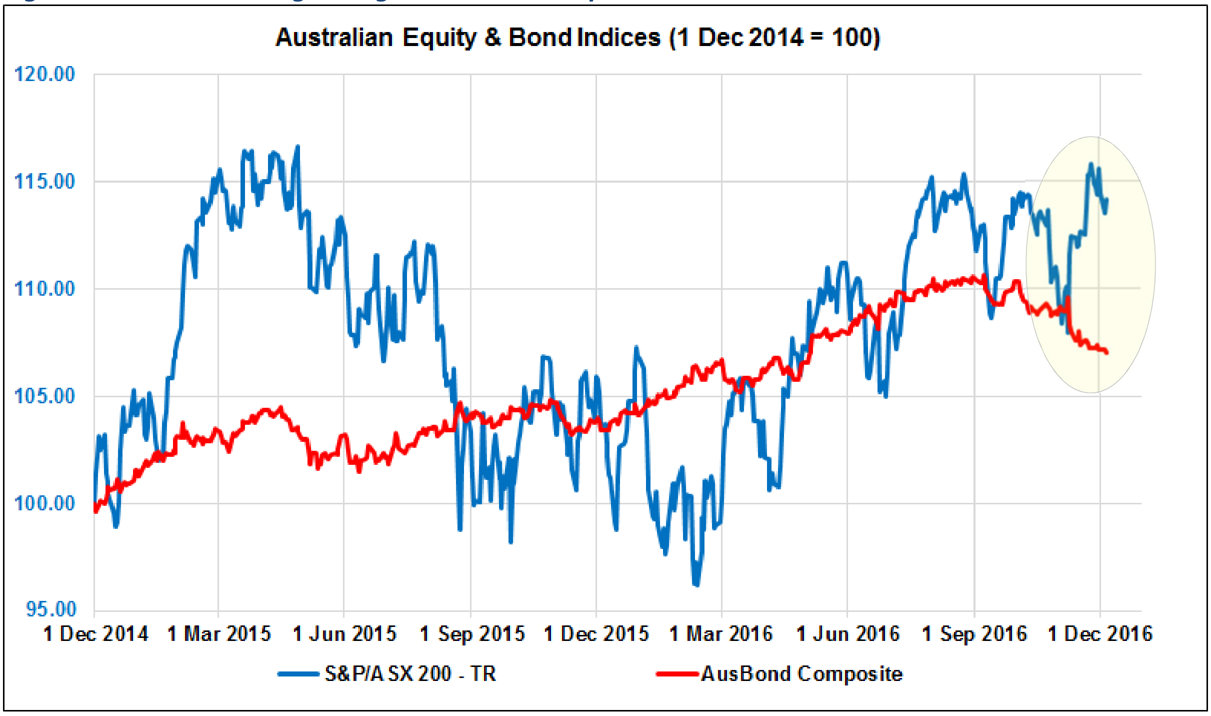
Oil producing nations agreed to reduce output in 2017 but the oil price has struggled to hold its gains in the wake of this because markets doubt the deal will be effective and believe that further cuts in production will be necessary to stabilise the oil market.

Figure 1: Equities outperformed post Trump vote, Bonds went negative and emerging market equities were volatile and negative. On balance, equity markets were strong.



Source: Thomson Reuters

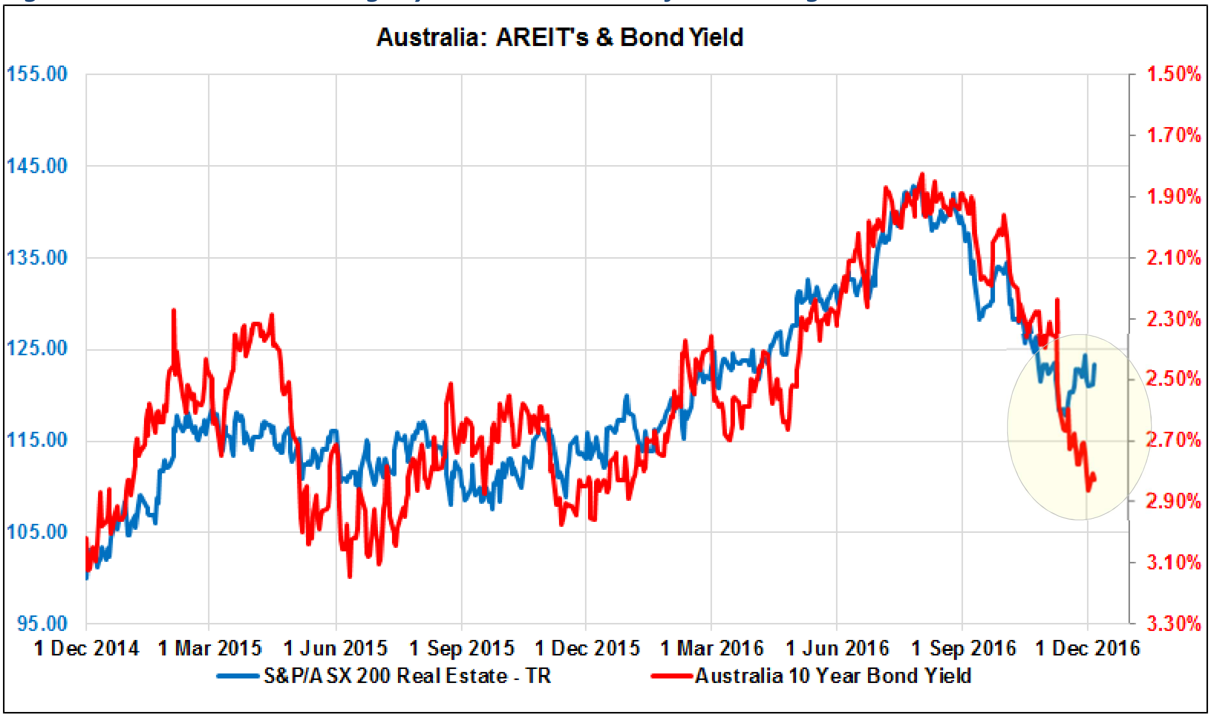
Figure 2: There was a big divergence between Equities and Bonds in Australia



Source: Thomson Reuters

The ASX200 bounced sharply in November towards the highs of the past couple of years, while the Composite Bond index continued to decline.

Figure 3: AREIT's recovered slightly in November – but for how long?



Source: Thomson Reuters

After a terrible October, property [AREIT's] recovered some ground in November. However, the growing dislocation between the bond yield and AREIT's raises the question of which might snap back to meet the other.

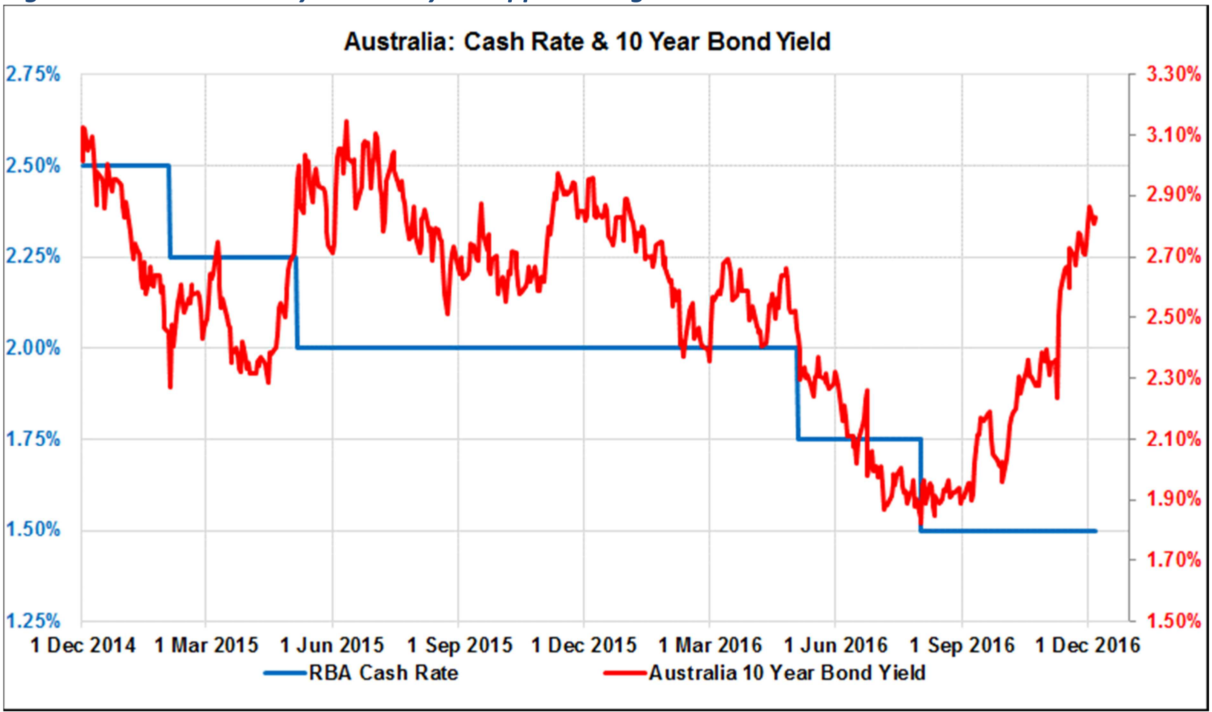
Australia

Economic news for Australia during November included:

- better-than-expected retail sales in September;
- weaker business confidence and conditions in October;
- weaker consumer confidence in November;
- weaker than expected employment growth in October, with the unemployment rate still at 5.6%;
- further slowing of wages growth – ***private sector wage inflation is now the lowest on record***.

These results highlight the mixed state of economic growth in Australia combined with ongoing low inflation. Although political uncertainty both here and overseas will have contributed to the softer business and consumer confidence readings, it is also clear that the strength of the A$ is hurting business conditions, which are now back to where they were at the start of the year. This is flowing through to the slower pace of employment growth. The Reserve Bank is of course watching all of this very closely and has noted its focus on the labour market and weak wage inflation. However, for the moment the Bank seems content to leave the cash rate at 1.5% while it awaits more information in the New Year.

Figure 4: Australian ten-year bond yield approaching 3%



Source: Thomson Reuters

The local ten-year bond yield has now risen to levels not seen since late last year. At that time the cash rate was 2% and the markets expected further easing from the Reserve Bank. The cash rate is now 1.5% and the markets expect no more rate cuts, but if the economy softens in 2017 and unemployment rises then the markets could start pricing rate cuts again.

USA

The economy has continued to show signs of improvement. The manufacturing and servicing index's rose for the third month in a row. The labour market remains tight with strong employment growth and the unemployment rate is now at 4.6%. However, both wage inflation and consumer price inflation remained subdued. The latest data showed some easing of wage inflation, while the core Consumer Price Index rose 2.1% in the year to October- this is down from 2.3% in the previous two months.

Although financial markets are concerned about the potential inflationary consequences of Donald Trump's fiscal stimulus and protectionist plans, there is little sign of ongoing inflationary pressure in the economy at the moment. Given the uncertainty surrounding exactly what the new President will be able to do, the markets may at some point feel they have jumped the gun on pricing in higher inflation. The US Federal Reserve Board meets on 13 – 14 December to decide whether or not to lift the cash rate. In the wake of the US election result and the latest economic data, financial markets now expect a 0.25% increase in the cash rate in December and have upgraded their expectations about further tightening of US monetary policy.

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Europe

In Europe financial markets turned their attention to the Italian constitutional referendum which was held on 4 December. Opinion polls suggested the referendum would be defeated, meaning markets feared the collapse of government, leading to new elections and the rise of anti-Euro political forces.

As with the American election, European assets underperformed in the days ahead of the referendum, but when it was defeated, the markets quickly lost interest and equities rallied again. Similar story… twice. The European Commission revised down its forecasts for European growth and inflation and also warned of potential instability in Europe because of Brexit.

United Kingdom

Things are getting messy with Brexit in the UK. The high court ruled that parliament must vote to approve triggering 'Article 50' of the Lisbon Treaty and start the Brexit process. Prime Minister May had previously said she would invoke the article by the end of March 2017, consequently the government has said it will appeal the High Court ruling… but understandably markets are speculating that Brexit will be delayed. The pound which has been at record lows as a result of Brexit but has recently rallied.

China

Economic news from China showed further improvement in activity. The manufacturing index rose in November, while the services index also improved slightly. The manufacturing index is now at its highest level since mid-2014. Inflation in China has also increased, driven by the weaker currency and higher commodity prices. The positive news on economic growth has contributed to a sharp spike in the iron ore price in recent weeks. However, analysts have been surprised by the strength of this and believe that this is speculative activity rather than underlying demand.

2017 and beyond…& Merry Xmas -it's been a good year despite what it may have felt like!

Fervent readers of Snapshot will recall how careful the wording is when it comes to crystal ball gazing- but as we near the end of 2016 it's worth remembering the beginning of the year and the volatile exit from 2015. Equities were shaky, but looking reasonable, bonds were looking challenged and emerging markets looked like having a breather and recovery following several hard years. Things were uneasy.

At this stage of the year and at the time of writing [mid -December] it looks like the Australian stock market will touch double digits, The USA appears to be over the line with double digits, and despite Brexit the UK is in line for double digits. Only Japan and China look like having negative years. Bond yields are minimal but positive, and Term rates are low single figures. Currency is still strong and residential property in Australia has continued to flourish. ***All in all a good year …and every reason to enjoy a Merry Xmas and safe festive season with friends and family***.