Economic Snapshot

PARAGEM

2016 & outlook for 2017

In summary

2016 was a dramatic year for the world's financial markets. The year started with collapsing oil prices, fears of recession and deflation, equity markets falling sharply and investors favouring bonds and what might be termed "expensive defensives".

By the end of the year, we had rising oil prices, renewed optimism about US growth and inflation, cyclical equities rallying, bonds selling off and defensives falling out of favour. In between we had on then off again OPEC deals, we had Brexit and we had the USA Trump victory which threw most fund managers. In summary despite all the noise and surprise political outcomes, we had a good year for diversified portfolios with positive returns recorded by a number of asset classes in 2016. This end result rewarded patient investors and masked the considerable within-year volatility.

2017 looks like being another year of volatility (the new normal) although somewhat surprisingly, forward looking expectations for asset classes have more upside room than at the beginning of 2016. This is an encouraging scenario built on economic rationale not geo political activities and market sentiment which, of course has a history of overturning expected outcomes in the short term. Snapshot comments cautiously on the outlook in the second half of this update given the interest of many readers for asset class outlooks.

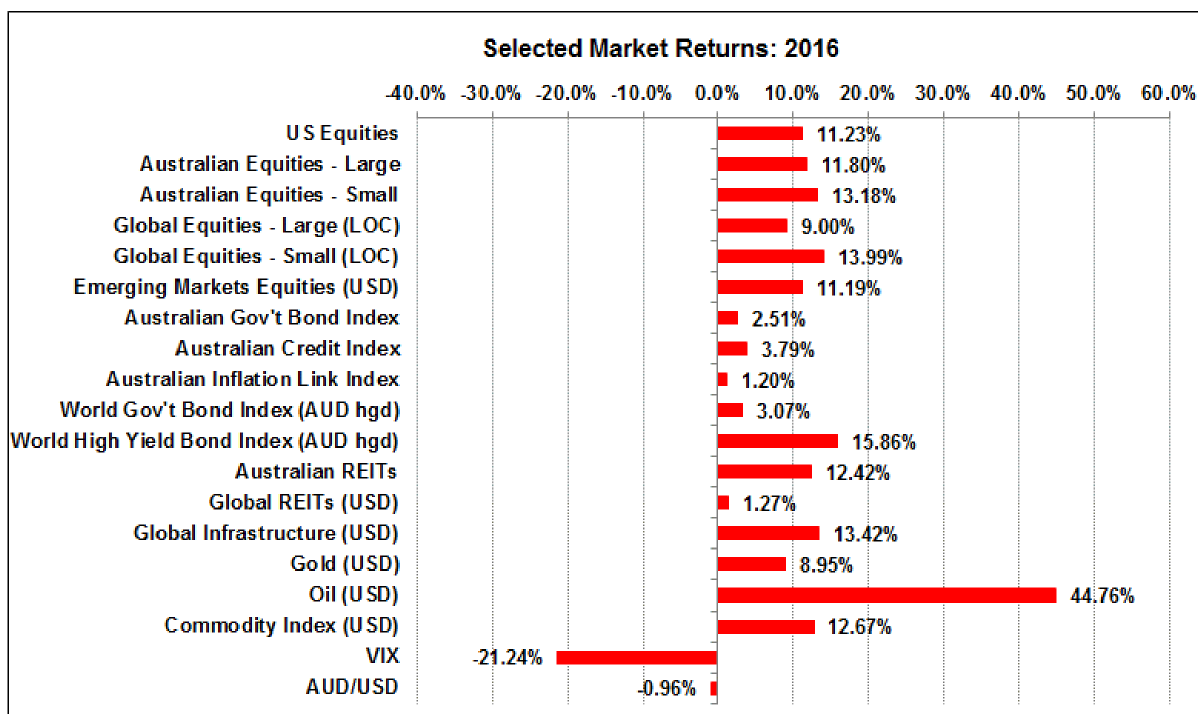
Statistical data update

Conditions in the Australian economy softened in 2016 with weaker business conditions and little improvement in the unemployment rate. Both wage growth and consumer price inflation reached new historical lows and the Reserve Bank cut the cash rate to a record low 1.5%. Perhaps this is best described as a sanguine atmosphere although equity markets have performed.

In contrast, the US economy improved through the year and more recently has shown further encouragement with labour market figures. Both the manufacturing and services sectors registered stronger activity, there was further robust overall employment growth and the unemployment rate fell to 4.6%. Wage inflation and consumer price inflation picked up a bit, but still remained relatively subdued. The Federal Reserve also lifted the cash rate by 0.25% in December reflecting the positive outlook but a full year after its previous increase.

China saw a significant pickup in economic activity in the second half of the year in response to government stimulus programs. However, other parts of the world are still struggling to generate better economic conditions. In particular, Japan has not been able to deliver sustained growth and inflation despite further aggressive monetary policies from the Bank of Japan. After some improvement in 2016, peripheral Europe now looks vulnerable to weaker growth and employment.

Figure 1: Every asset class finished strongly in 2016 with many ending in double digits.



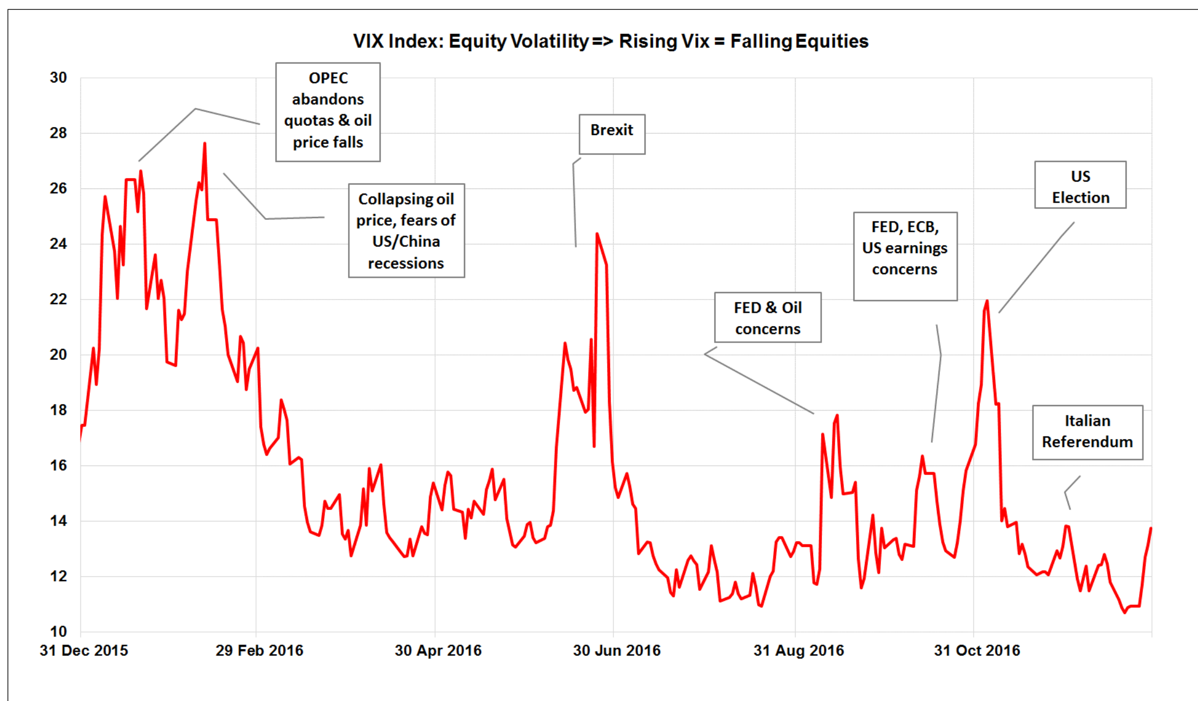
Source: Thomson Reuters

2016 in retrospect showing the volatility saga

Figure 2 overleaf illustrates some of the volatility seen in 2016 and flags key events associated with the bouts of volatility. The falling oil prices seen at the start of the year really undermined equity markets (see Figure 3) because of the negative impact on the US energy sector as well as the downward pressure on inflation. Many investors were surprised by this because weak oil prices have traditionally been positive for household spending and hence economic growth, but this time households seem to have saved rather than spent the gains from lower fuel prices.

However, the mood changed by mid-February as the oil price recovered and central banks reiterated their commitment to providing liquidity and support. This encouraged investors to keep buying government bonds. The yields on these bonds fell to new lows (see Figure 4) by the middle of the year. In the case of Australia, the fall in bond yields was supported by expectations the Reserve Bank would cut the cash rate, partly driven by the renewed strength in the A$ (see Figure 5). The A$ was supported by higher commodity prices, including higher iron ore as demand for steel in China picked up in response to the government's stimulatory spending program.

Figure 2: Event-driven volatility spikes were common in 2016



Source: Thomson Reuters

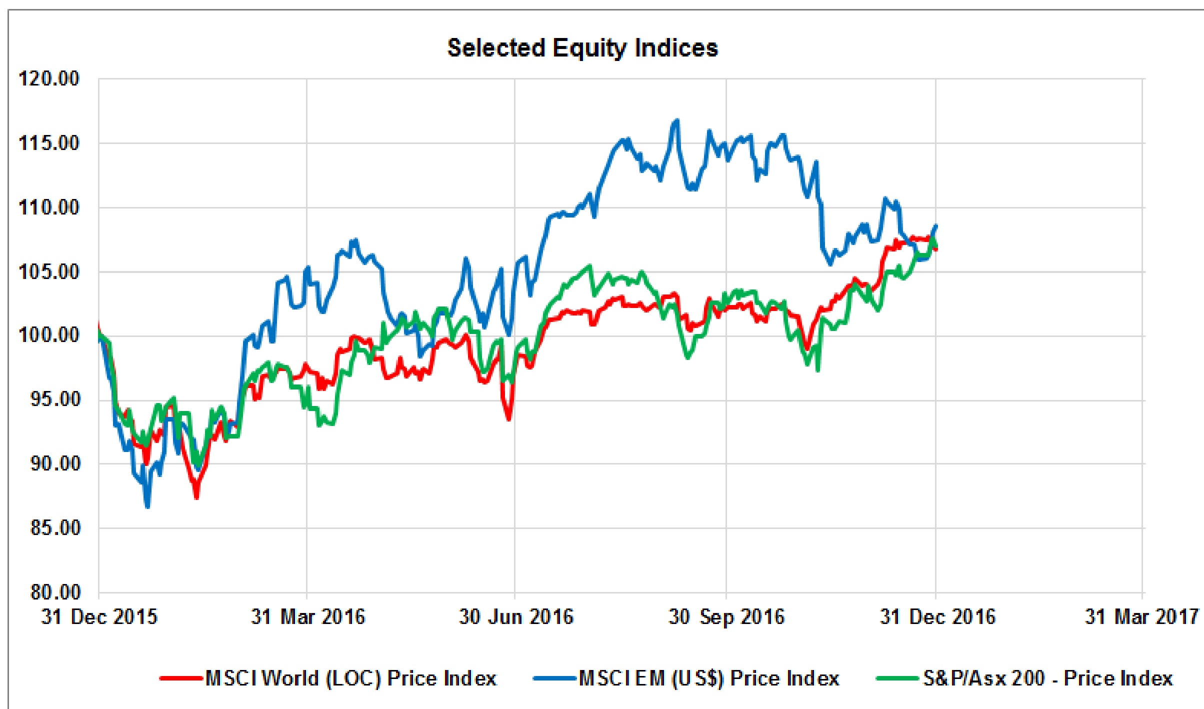
The next big event to rile markets was the UK's Brexit vote on 23 June. Contrary to the accepted wisdom and expectations 52% of voters chose to leave the EU. Markets were getting jittery in the weeks leading up to the vote, but when the result was announced equities and the pound immediately dropped, while bond yields fell even further as investors sought safe-haven assets. However, within a few days market sentiment swung to a more positive mood, with fears of the EU unravelling being put into proper perspective. Markets also realised that Brexit would take years rather than months to implement and Equities rallied (Figure 3) and bond yields started to rise from levels that marked the lows of the year (Figure 4). Although not really apparent at the time, this was later seen as the "beginning of the end" of the multi-decade bond market rally. By the end of the year this went further and was described by managers and economists as the start of the "great rotation" from bonds to equities.

However, it was still not plain sailing for markets. In September and October there were renewed concerns about stability in the oil market, combined with fears of the Federal Reserve and the European Central Bank starting to unwind their stimulus programs while their economies might not be strong enough to withstand such a move. Markets still believed the Reserve would not be able to lift the cash rate much at all in 2017. Then just as these concerns started to settle down, along came Donald Trump's surprise election victory – contrary to the accepted wisdom and expectations.

In some of the biggest single day volatility seen for a long time, equities fell sharply and gold rallied as the vote count unfolded, only to reverse just as dramatically when the President-Elect delivered a conciliatory acceptance speech. Equity markets then commenced a sustained rally in which cyclical equities, such as resources, have soundly beaten bonds and bond-sensitive equities, such as AREIT's. Bank stocks also improved as prospects for steeper yield curves improved the outlook for bank profitability. This was in stark contrast to the pressure on Australian bank stocks at the start of the year amid sensationalist claims that Australia was heading for a US-style housing crash.

The key factor behind these end-year moves in markets has been the expectation that President Trump will use fiscal policy, including a combination of tax cut and spending initiatives, as well as de-regulation to boost economic growth. This is in turn has been seen as lifting the risk of inflation in the US economy and giving the Fed more room to lift the cash rate. All of this contributed to the further sell-off in bonds and the resurgence of the US$, which helped push the A$/US$ back down towards US$0.72, breaking the link with commodity prices, including iron ore (Figure 5).

Figure 3: Equity markets recovered from a terrible start to the year to finish strongly



Source: Thomson Reuters

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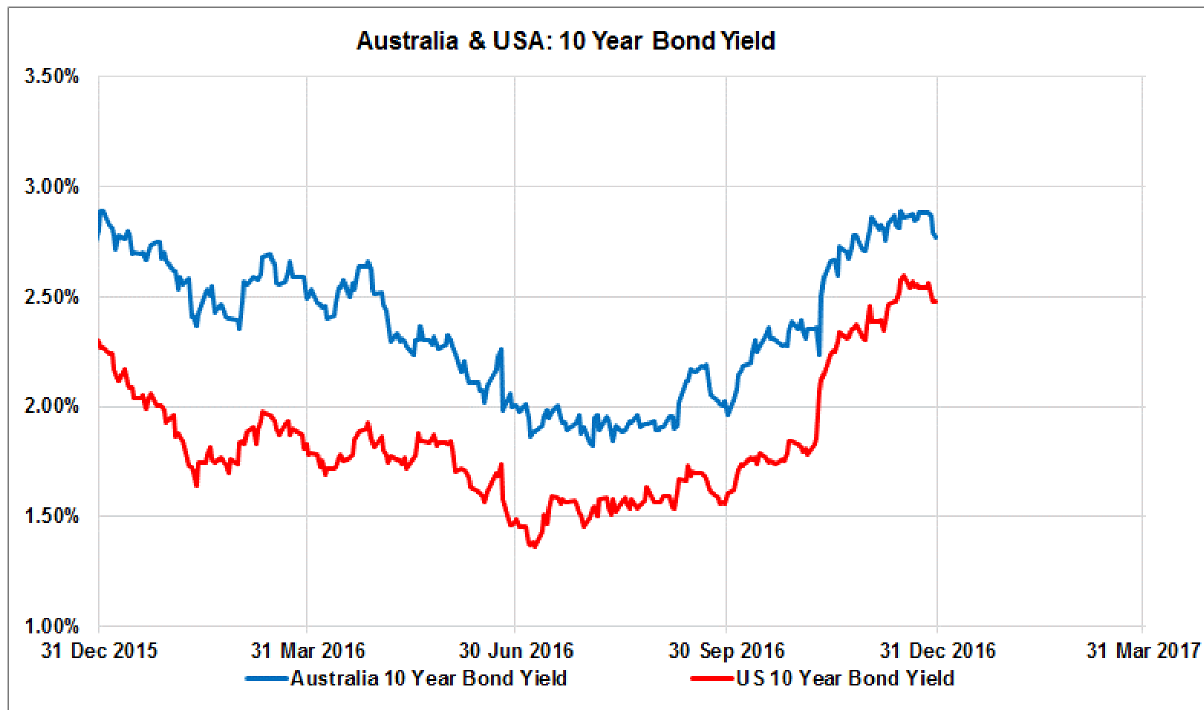
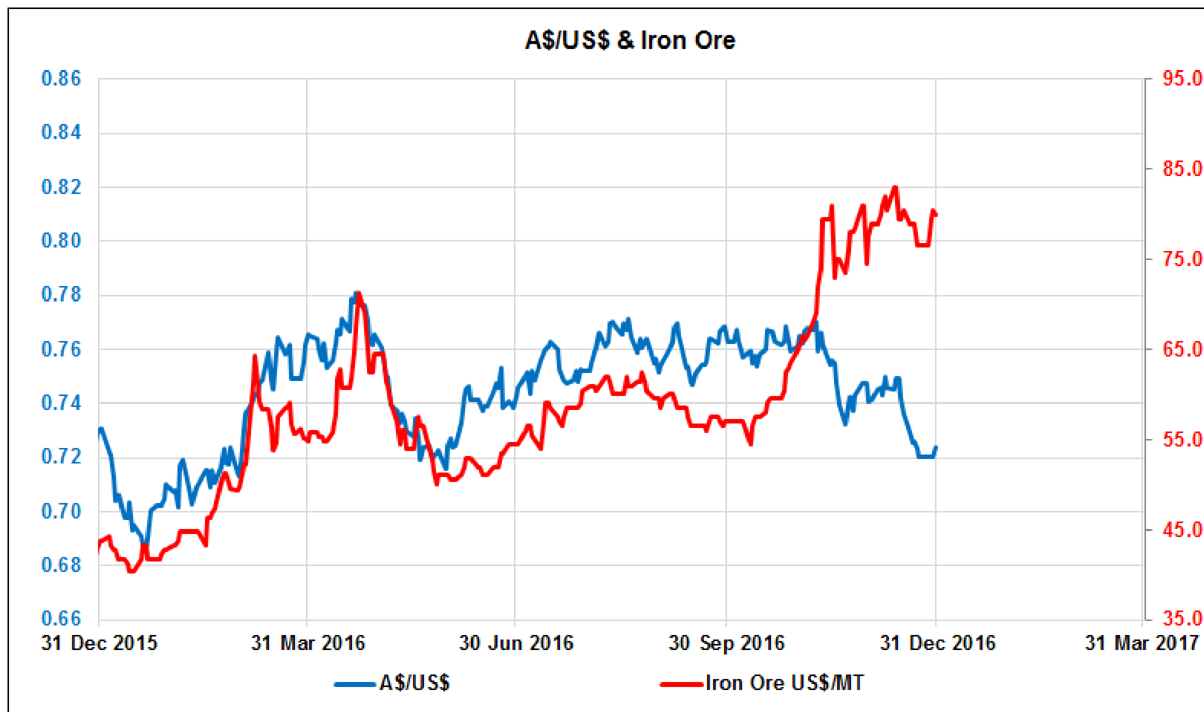
Figure 4: Bond yields fell steadily in the first half of 2016



Source: Thomson Reuters

Figure 5: Higher iron ore prices helped lift the A$ until the Federal Reserve tightened late year



Source: Thomson Reuters

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In economic news in ***Australia***:

- the stronger A$ contributed to weaker business conditions; this plus subdued business investment helped deliver negative GDP growth in the September quarter for the first time in several years;
- employment growth slowed and the unemployment rate finished the year at pretty much the same level as a year earlier;
- growth of wages fell to the lowest levels on record as did core consumer price inflation;
- in response to these developments the RBA cut the cash rate in May and August to a new low of 1.5%;
- the housing market continued to post solid price gains, although by the end of the year some of the leading indicators of residential construction were starting to look a good deal weaker.

Meanwhile, in the ***USA***:

- after a weak start to the year, key indicators of economic growth such as the ISM manufacturing and services indices improved through the year;
- the labour market tightened even further in the face of continued robust employment growth; the unemployment rate spent most of the year just under 5%, with the latest reading at 4.6%;
- some measures of wages growth have picked up, though not dramatically, while measures of core inflation have risen to around 1.7% - 2.1% which is still a bit lower than the Fed would like to see;
- the Federal Reserve lifted the cash rate target range by 0.25% to 0.50% - 0.75% in December, its only move in the whole year; the Reserve also flagged three possible hikes in 2017.

Elsewhere in the world:

- economic activity picked up sharply in ***China*** in the second half of the year as government stimulus programs kicked in;
- there was some improvement in business conditions in ***Germany*** and ***France*** although inflation remains subdued;
- business conditions and employment prospects appear to be deteriorating in ***Spain***, ***Portugal*** and ***Italy***; the latter still has significant problems to address in its banking system;
- in the ***UK*** there has been some improvement in business conditions and core inflation has picked up slowly, but growth of employment looks set to slow down;
- in ***Japan***, the labour market has improved, with the unemployment rate now at its lowest level in 20 years; however the economy is still struggling to generate sustained growth and inflation; the Bank of Japan commenced a new policy of intervening in the bond market to hold the 10 year bond yield at 0% and manipulate the yield curve by controlling the cash rate which is still just below zero.

Looking ahead

After an eventful 2016, the coming year is unlikely to provide much respite. Expected returns on asset classes for the next 12 months have been reduced, but expected volatility remains elevated. It would be very surprising if we did not see more volatility spikes through 2017 as we did in 2016. This less attractive trade-off between expected returns and risk makes managing portfolios even more challenging. Careful management of asset allocation and portfolio diversification will be crucial.

Although the world economy still looks quite patchy, the odds are we will see more of the low growth/low inflation environment of recent times, with the chances of recession in 2017 looking remote. This backdrop suggests there will nevertheless be enough growth for equities to beat bonds. In domestic equities, more of the total return may come from income rather than growth, while the reverse may apply for international equities. Unhedged international equities are still the favoured asset class, with further depreciation of the A$/US$ towards US$0.67 adding to expected returns. This would help unhedged emerging market equities as well, but these are not expected to beat developed market equities. Within fixed income, government bonds are expected to deliver returns little better than running yields. High yield bonds still offer a very attractive yield, with scope for some modest capital growth as well.

Overall, the outlook using mere ‘economic logic’ as base for the future suggests bond returns of only a few percent, domestic equity returns (including franking) around 7% - 8% and unhedged international equity returns around 10% - 11%. Bond-sensitive equities, such as infrastructure and REITs are expected to underperform the broader equity market, but not to post major losses.

This is a relatively benign market outlook which depends critically on some propositions about the US economy which have emerged in the wake of the November election:

- *Proposition 1: [President elect]Trump’s policies will generate inflation via higher wages in the US, leading the Federal Reserve to tighten more aggressively and pushing bond yields up:* the evidence so far is that wages growth in the US remains quite subdued even with the unemployment rate below 5%; furthermore there is still enough excess capacity in the US to act as a drag on core inflation through 2017; the market outlook above is based on a view that core inflation will be at or slightly below current levels through 2017, thereby limiting the scope for a major bond market sell-off and potentially causing the US$ to slip back;
- *Proposition 2: The Trump tax cut, infrastructure spending and de-regulation policies will add to growth both quickly and meaningfully in 2017*: the problem here is that it is still too early to say exactly what Trump’s policies will be, let alone what he will be able to get through Congress and when they will actually be implemented; the market outlook above is based on a view that there will probably be some early wins while other initiatives will be delayed, but that the overall fiscal impact in 2017 will probably be less than the markets currently seem to expect.

Financial markets have seemingly priced these propositions already – hence the rally in equities and the selling of bonds. However, the equity rally seems to have priced a lot of good news without paying much heed to the potential negatives in Trump's policies as well as the adverse feedback effects of a higher US dollar and interest rates on US growth and inflation. There is a real risk that equities pause to see what happens post-inauguration on 20 January or even slip back on disappointment that progress will be slower than expected.

Domestic financial markets are currently pricing no more interest rate cuts in Australia and the likelihood of the cash rate started to rise in late 2017/early 2018. However, if conditions in the labour market do not improve, while at the same time the inflation rate remains at or below current levels, the RBA may well consider another one or two interest rate cuts. This would be a challenge given the overt signal to the overheated property market which could well have further legs in the event of an interest rate cut. Much depends on the outcome of the A$: further depreciation of the currency would support both business conditions and inflation and reduce the need for the Reserve Bank to do anything. But renewed appreciation of the currency, for example driven by softer US interest-rate expectations and a lower US$, would increase pressure on the Reserve Bank to act.

Other key risks for 2017 include:

- US inflation does in fact rise faster than expected, pushing bond yields and the US$ up; equities could withstand some of this pressure as long as there were enough signs of growth picking up as well;
- wage inflation in the US picks up, but consumer prices do not so that profit margins are squeezed; equities and high yield bonds would not benefit from this;
- nearly half Europe's population votes in national elections this year; any sign that extremist parties from either side of the political spectrum might gain control could upset markets;
- Mr Trump's unpredictable personality may lead to tensions with China, Russia, North Korea, Iran;
- moves towards protectionist trade policies would have an adverse impact on global economic growth and inflation;
- the problems in the Middle East will persist with tension between Saudi Arabia and Iran as well as further attacks on the west by ISIS;
- the UK Prime Minister has flagged March 2017 to start the Brexit process, but legal challenges may delay this;
- on-going political paralysis in Australia will continue to hamper any meaningful economic reform;
- any signs that central banks are looking to reduce the degree of monetary accommodation;
- risks associated with an overheating Chinese economy and fragility in the financial system.

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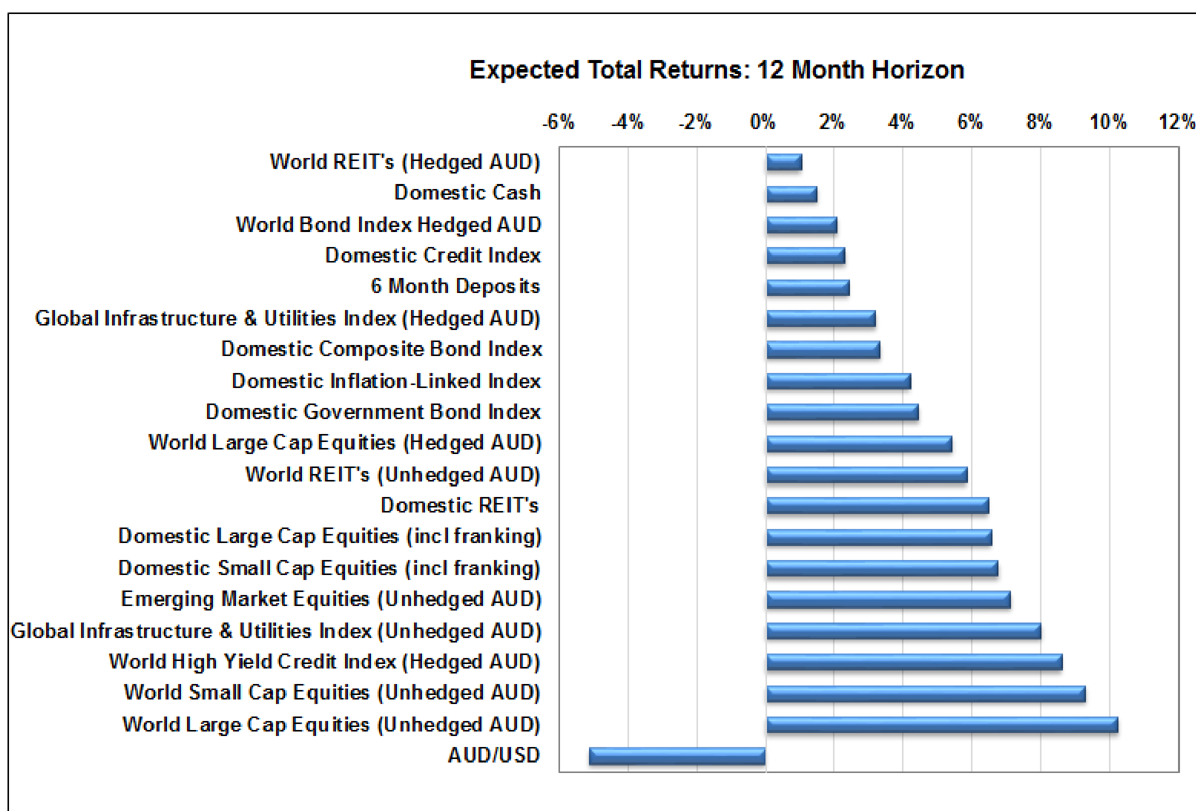
Putting all of the above into a visual picture the below crystal ball unfurls to show a possible scenario for the various asset class / sectors. The graph explicitly assumes a weaker A$ which, on an unhedged basis, throws some leverage into returns for international investments and stimulates portfolio growth. This is best illustrated by viewing the possible returns from World large Cap Equities on a hedged and unhedged basis. On an unhedged basis with a few surprises in the wings it would be feasible to see a flat year. It shows the dangers of forecasting but equally it showcases the impact of volatility and the need to have a cohesive portfolio which is diversified enough to capture the scenarios outlined under most of the key risks for 2017.

Asset Class -Sector outlooks for 2017



There are a lot of uncertainties in the above outlook and things may turn out better than expected - but the easiest forecast is that financial markets will continue to be challenging for investors in 2017… as they were in 2016. Welcome to the New Year - and happy investing!

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