Economic Snapshot

January – February 2017

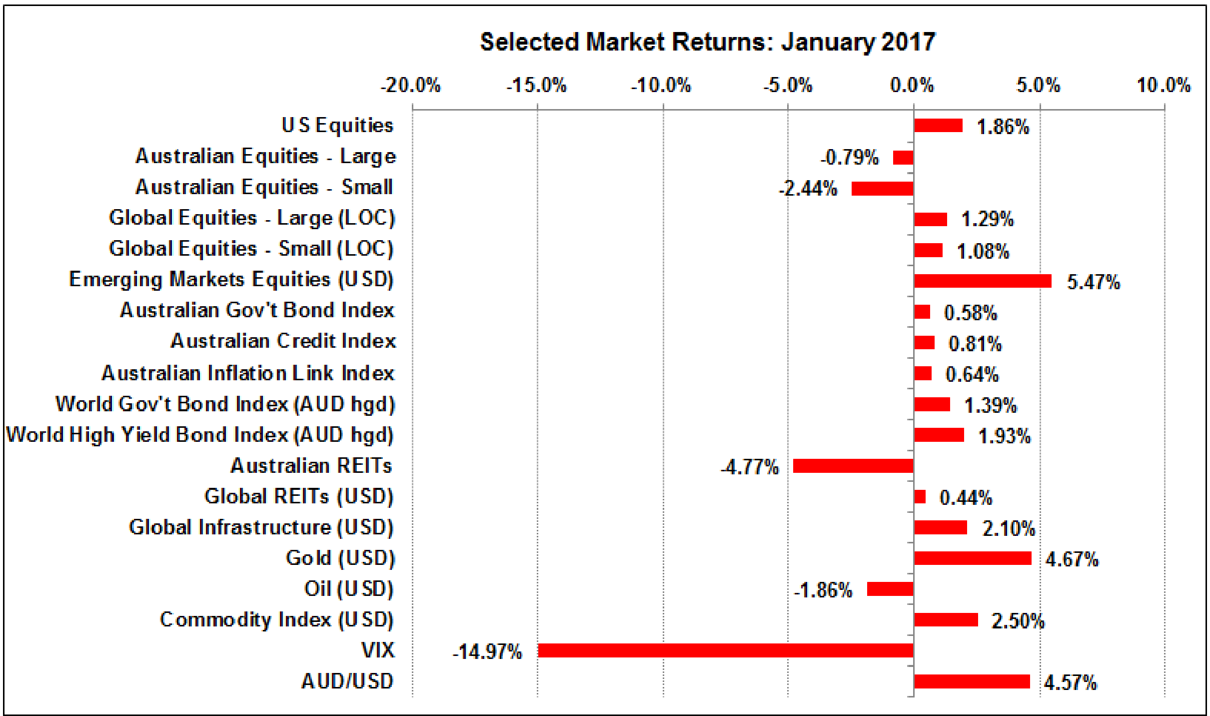
In summary

President Trump (elect at time) was the main headline in January's news with a flurry of Executive Orders, public statements and barbs at foreign governments. This caused some concern in financial markets and lead to weakness in the US dollar. In sequence with this, emerging markets and gold rose, while Australian equities underperformed in the month.

The economic news for Australia confirmed an overall picture of moderate growth with subdued inflationary pressure giving the Reserve Bank little incentive to change the cash rate in the near future. However, the ongoing strength of the A$ is damaging business conditions which may show up in a higher unemployment rate in the second of the year. If inflation is still below target at that time the RBA could be under pressure to act.

In contrast, the US economy continues to show good economic momentum with subdued inflationary pressure. In this environment the Federal Reserve should be able to pursue its objectives of lifting the cash rate further in 2017. However, the key drivers of the US growth impulse at the moment are the higher oil price and the economic stimulus program in China, which is showing up in stronger exports from the US. These forces cannot be relied on to continue indefinitely - rather, President Trump needs deliver on his promise of fiscal stimulus. At the time of writing, the Dow Jones had shot through the 20,000 barrier and appears to be on an upward trajectory through early February.

Figure 1: The A$ rose in January 2017 as did Emerging Markets and Global Equities

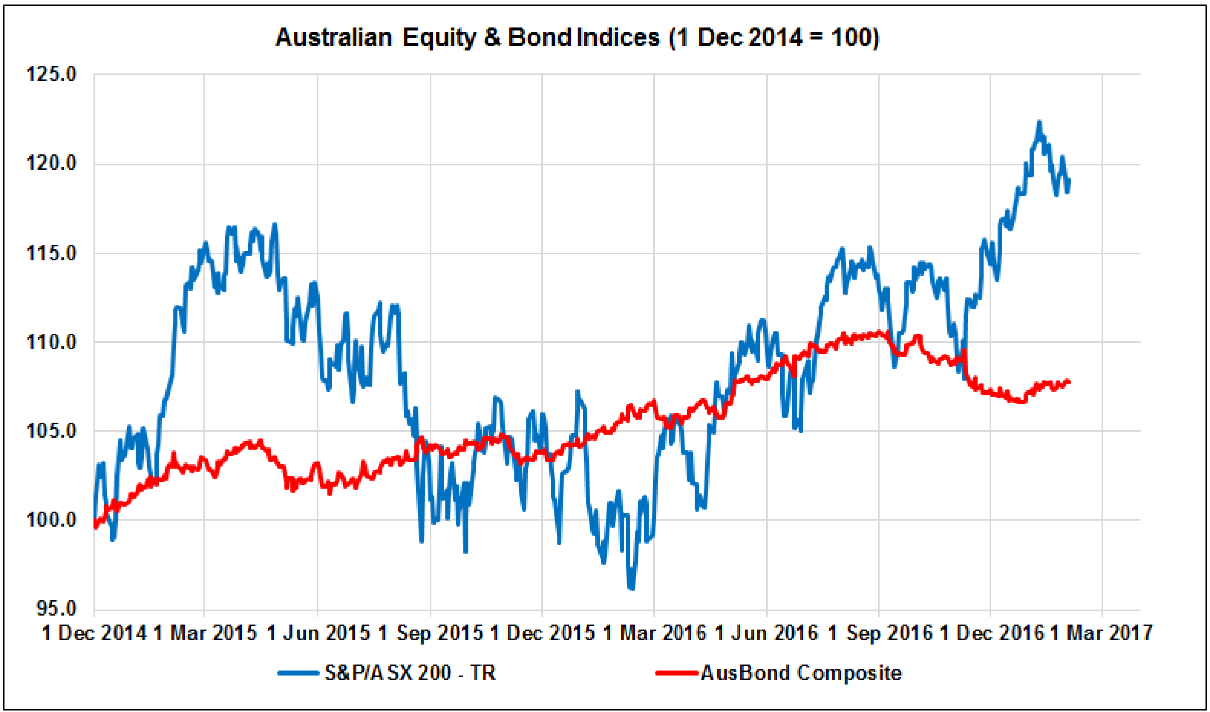


Source: Thomson Reuters

January 2017 was a better month for global assets than for Australian assets. Emerging equity markets were the best performer in the month, reflecting weakness in the US$ triggered by concerns arising from President Trump's first weeks in office. The A$ also rose in response to the pressure on the US$ and contributed to the underperformance of the local equity market.

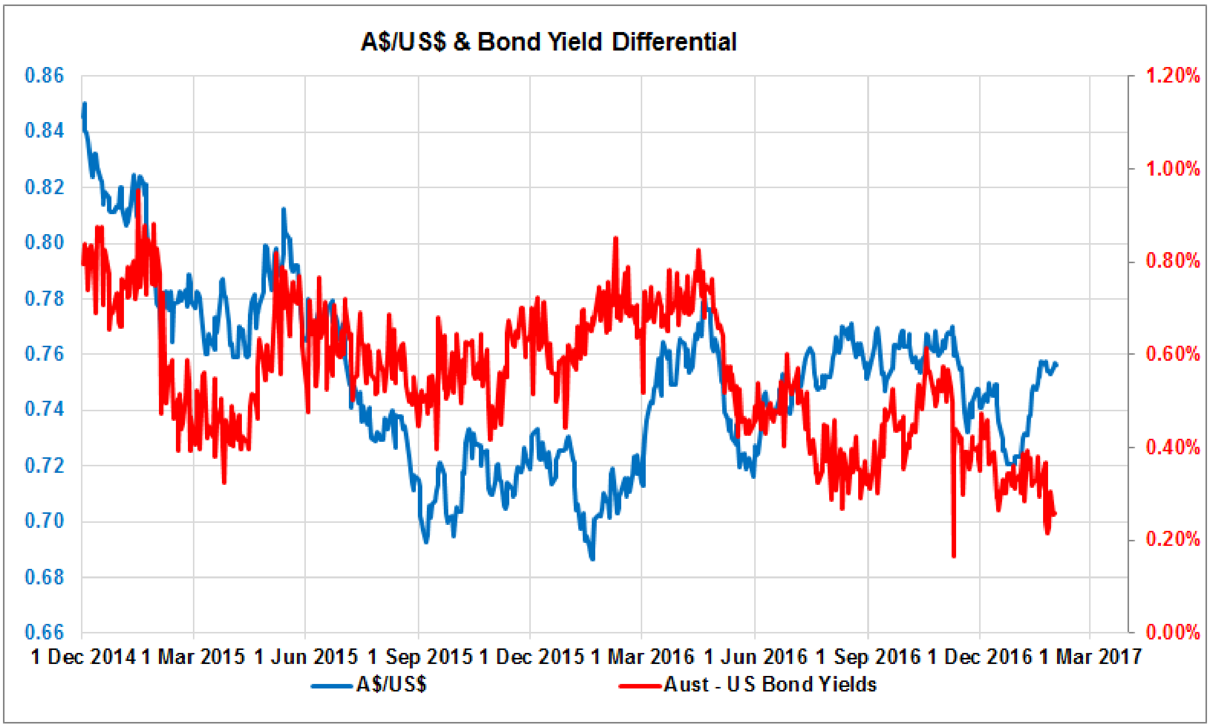
AREIT's fell nearly 5% despite the local bond market having its best performance since Q3 2016.
In some respects this may have been a simple issue reflecting the stellar annual performance of AREITS in 2016 when they got ahead of forecast. Global bond markets had a better month, with high yield in particular benefiting from signs of firmer economic growth in the US. The VIX volatility index fell further in January and is now at its lowest levels seen in the past few years. Gold also benefited from the weaker US dollar and concerns about President Trump.

Figure 2: The ASX200 has come off its recent peak but remains at elevated levels



Source: Thomson Reuters

Figure 3: The A$ has pushed away from levels implied by relative interest rate expectations



Source: Thomson Reuters

The stubborn 'Aussie dollar' has spiked up sharply in recent weeks despite interest rate expectations still favouring the US dollar. Although the outlook for higher US interest rates and fiscal stimulus through 2017 would typically see the US dollar moving higher, the early days of Mr Trump's Presidency have showcased his unpredictable and unconventional behaviour. This is exacerbated by his early actions which have focused on issues such as immigration and healthcare with an absence of news on economic stimulus programs, as well as his statements that the US dollar is overvalued. Financial markets have reacted by pricing a higher risk premium on the US dollar.

Australia

In economic news in Australia :

- employment rose by 30,500 in December, but the number of people unemployed rose by 14,700 so that the unemployment rate was 5.8% compared with 5.7% in November;
- consumer sentiment was little changed in January after a sharp fall in December; the subdued reading in January was attributed to higher energy prices and some increases in mortgage rates;
- the latest inflation figures showed the CPI rose by 0.5% in the December quarter and 1.5% in the year to the quarter; the corresponding figures for underlying inflation were 0.4% and 1.5%; higher petrol and tobacco prices were the main contributors to the December quarter result.

Although the employment figures were slightly better than economists had expected, there are still concerns the economy is not strong enough to see the improvement continue. In particular, the high A$ is hurting business conditions with the risk that this shows up in a higher unemployment rate later in the year. At the very least, it seems likely that historically low rates of wages growth will continue through the year.

The Inflation figures were a little softer than the market had been expecting. Although inflation remains well below the Reserve Bank's 2% - 3% policy target range, the figures were sufficiently similar to the previous quarters reading to suggest little incentive for the Reserve Bank to make any move on the cash rate soon. However, if inflation is still below target later in the year with a higher unemployment rate the RBA could be under pressure to act.

USA

Meanwhile, in the USA

- the ISM manufacturing index rose to 56.0 in January from 54.5 the previous month; the index is now at its highest level since November 2014;
- employment rose by a solid 156,000 in December, with the unemployment rate at 4.7% only a touch higher than the 4.6% in November;
- average hourly earnings of private sector employees rose by 2.9% in the year to December, which was the strongest result since May 2009;
- the private consumption deflator, which is the Federal Reserve's preferred measure of inflation, rose 1.6% in the year to December after 1.4% in the year to November; this compares with the Fed's target of 2%.

There is clearly some positive momentum to the US economy at the moment. Key factors driving this include the higher oil price, which is good for the US energy sector, and the economic stimulus program in China. As economic activity in China has picked up in recent months so have US exports to China and the effect of this can be traced through to the indicators manufacturing activity in the US. However, these factors are unlikely to continue driving US growth through the rest of the year. Rather, President Trump needs to deliver a meaningful fiscal program to sustain the momentum.

Although the labour market in America continues to tighten, with some associated upward pressure on wages, the immediate threat to inflation may be less than it seems. In particular, not all measures of wages are showing the same upward pressure as average hourly earnings. Also, when wage growth is adjusted for productivity the inflationary pressure looks much less serious. The stronger US dollar through 2016 has also been suppressing inflation. Overall, the US economy still seems set to have a good mix of reasonable growth and low inflation through 2017 with the Fed having room to nudge the cash rate up at least twice more. However, at the moment the confusion surrounding President Trump's early weeks in office is clouding this bigger picture.

China

The manufacturing index in China declined marginally from the previous month and lower than November, which was the highest level since mid-2014. The People’s Bank of China has lifted interest rates further to try to manage increasing leverage in the property and bond markets. The Chinese government has previously stated that the stimulus program in 2016, which has delivered the current surge in economic activity, cannot continue indefinitely and will be wound back in 2017. It is too early to say whether we have now seen the short-term peak in Chinese economic growth, but this will be something to watch closely because of its implications for US economic growth and commodity prices.