Economic Snapshot

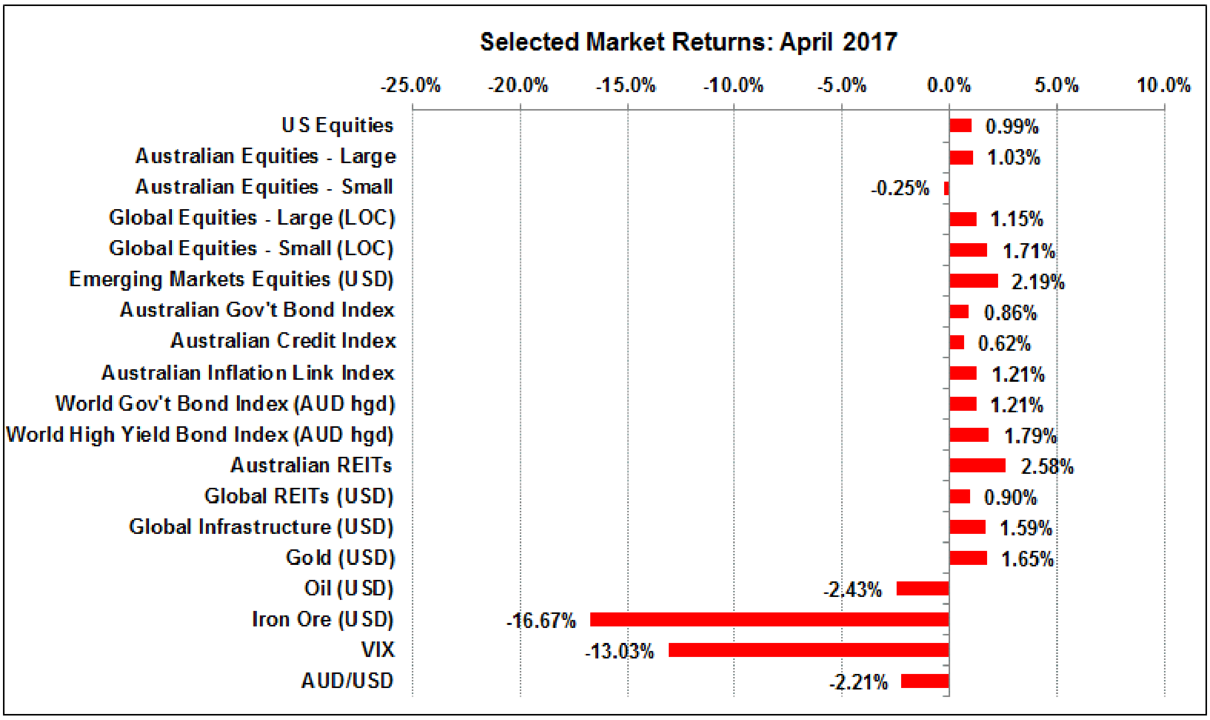
April – May 2017

In summary

Equity markets continued to improve through April, although it was with less conviction than in recent months. The stronger economic growth seen in a number of countries since late last year now appears to be rolling over- and this, combined with higher equity valuations and low levels of equity volatility, suggests equity markets are vulnerable to some retracement in coming months. If true, Bonds would be a natural beneficiary of this, especially as inflation in the US looks likely to be lower than markets had previously expected. ***Diversification is central to capital protection and growth***.

Geopolitics remains an ongoing primary risk factor for markets. Commentators argue equities have been 'relieved' at the outcome of the first round of the French Presidential election, but even the expected victory for Mr Macron over Ms Le Pen would likely lead to little in the way of necessary economic reform and it is this which determines long term outcomes. In the UK, prime minister May seems to be in a position to win a sufficient majority to manage the UK exit from Europe as she wishes over the next few years. Meanwhile in Asia, political pressure from the US may finally be leading the Chinese to mediate the North Koreans to modify their military aggressiveness with nuclear arms.

April was another good/steady month for all asset classes – exceptions being iron and the A$



Source: Thomson Reuters

Equity markets have enjoyed a great run since late 2016. In the past six months the S&P500 and the ASX200 have risen approximately 14%. This substantially outpaced the bond markets given their fairly lacklustre performance. ***The main reason equities have done well is that markets have embraced the "reflation trade" in the wake of Donald Trump's electoral success***.

Although President Trump has not really delivered anything of substance in the way of economic reform, markets have been able to ride the surge of growth around the world since late 2016. At the same time, bond markets have been hindered by expectations of higher interest rates following on from higher expected inflation in the US and, to a lesser extent, in Europe. To some degree those expectations of higher interest rates in the US have helped push the A$/US$ down, though it should be mentioned weaker iron ore prices have also contributed.

The key question for investors of course, is where to from here?

Economists believe Equity markets have pretty much priced the growth surge seen since late last year (and recall from previous snapshots that this surge was driven largely by stimulus in China and the higher oil price). It's also worth observing that key indicators on the pace of growth, including the Manufacturing index in the US and the NAB Business Conditions index here in Australia, are already approaching levels close to long-run highs. That is, in the absence of some significant development***, it would be unusual for these indicators to move even higher and thereby support a further ongoing rally in equities.*** For further perspective on this, these indicators would have to move higher into next year, not just next month, to keep equities moving up.

Unfortunately, (at least from an economist's perspective) the latest economic data suggests a less bullish outcome than this and as such investors should anticipate lower growth all things being equal.

USA

In the USA the labour market remains in good shape: the unemployment rate of 4.5% is the lowest since just before the GFC and job gains averaged 180, 000 a month over the past quarter. But inflation is not going up as the markets had expected. In fact, the Federal Reserve's preferred measure of prices fell in March and now shows annual inflation around 1.6%. The key Manufacturing index also slipped back in March, falling to levels seen last December.

Australia

In Australia, the latest NAB Business Conditions index was very strong in March, but possibly overstated because of cyclone Debby, and Business Confidence declined. Inflation picked up a bit in the March Quarter with headline inflation at 2.1% and core inflation at 1.9%. These compare with the Reserve Bank's target range of 2% - 3%. The unemployment rate was steady in March at 5.9%. The Reserve Bank left the cash rate unchanged at 1.5% at its May Board Meeting.

China

As for China, there are signs that policy tightening undertaken by the authorities in recent months is starting to slow the pace of economic activity. The key indices for both Manufacturing and Non-manufacturing have slipped back below the levels seen at the start of the year and leading indicators suggest they are likely slip further in coming months. This is especially important because it flows directly through to the Manufacturing Index in the US, which will add to a slowing growth outlook.

The outlook for China is also important for commodities and the recent sharp fall in the iron ore price further evidences Chinas slowing growth outlook. At the margin, this will have a dampening effect on the Australian economy.

Economic Summary

Overall, the momentum of growth around the world looks like it might be peaking, which suggests it will be challenging for equities to continue rallying from here without some new factor to help markets along. President Trump may or may not deliver on this front, but whatever he does is unlikely to have much effect on the economy until next year.

The elevated level of equity valuations and the very low level of equity volatility also suggest equities may see some retracement in coming months. Bond markets would be the natural beneficiary of such a move as investors move into safe-haven assets. Bonds would also be helped by a lower than expected profile of inflation in the US - leading indicators suggests inflation in the US may be a problem for 2018 rather than 2017.

Rest Of World

Finally, onto geopolitics and rest of the world. The first round of the French presidential election has delivered the expected result of a second round run-off between Mr Macron and Ms Le Pen. At the time of writing based on exit polls it still seems likely that Mr Macron will win, but he will then face the challenge of trying to implement reforms in a Parliament he does not control. Sounds familiar?

The polls in the UK continue to show a wide lead for the Conservatives, who are likely to pick up seats across the country from Labour, UKIP and the SNP. While the possible size of the Conservative majority is prompting speculation about the future of the Labour party, the real issues is that Mrs May looks set to get the numbers she needs to have a clear run at implementing Brexit over the new few years.

North Korea has also been in the headlines with its on-going political posturing with nuclear arms. President Trump’s response has been very different from that of Obama his predecessor, not least because, left unchecked, North Korea could have a missile capable of reaching the US within Mr Trump’s time in office. His more assertive approach appears designed to stimulate the Chinese into mediation given their leverage over North Korea. It appears to be having the desired effect but whether this is sustainable without further engagement and inevitable compromise between China and America remains to be seen.