Economic Snapshot

PARAGEM

July –August 2017

In summary

Overall returns in the month from markets were positive with above average returns from Emerging Markets. Figure 1 on the next page highlights the returns from all sectors. An extraordinary and largely unexpected rise in the Australian $ to US$0.80 alongside a sharp rise in iron ore was the major highlight of the month.

The strengthening currency reduced returns from international investments in unhedged portfolios but investors shouldn’t worry about the short term nature of this. The rise was driven by expectations that the Reserve Bank here in Australia would start to lift the cash rate sooner than previously expected and that the US Federal Reserve would not be able to lift the cash rate again until late next year. Currency often moves with perception and can't really be forecast.

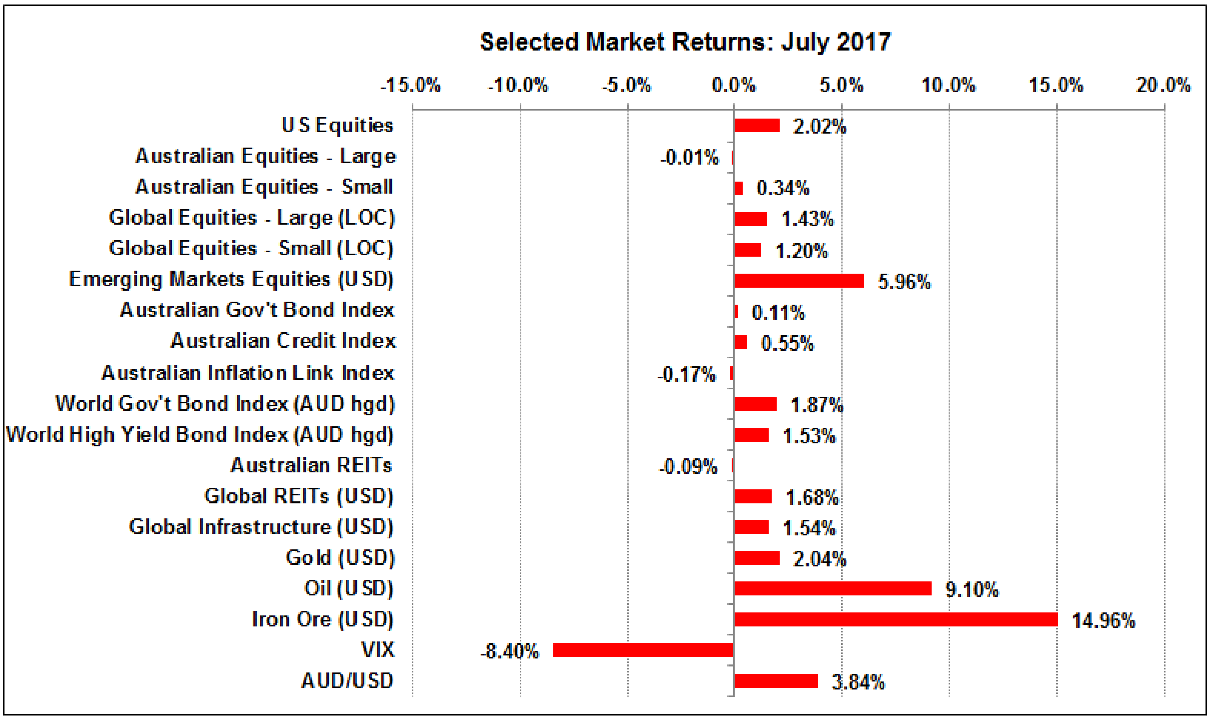
Markets then had to contend with two further issues: Perceptions of political risk associated with President Trump weakening the US dollar, while a 15% gain in the price of iron ore helped the $A.

For investors, a closer look at the fundamentals suggests markets are misreading both the Reserve Bank and the Federal Reserve, leaving the A$/US$ looking increasingly out of step with both current and prospective interest differentials between Australia and the US. Also, many economists doubt the iron ore price can sustain its current rally.

In world markets, US company earnings reports were enough to support the S&P 500, although some of this was mitigated by nervousness about overvalued tech stocks. The Australian equity market again underperformed the rest of the world, with some significant day-to-day volatility in the ASX 200 index. The emerging markets complex was a standout performer among global equities in July, gaining good support from the weaker US dollar.

The Australian bond market underperformed global bond markets, with yields here rising a bit more than overseas as the markets priced a more bearish view of domestic interest rates. US credit spreads remained tight, partly helped by the higher oil price.

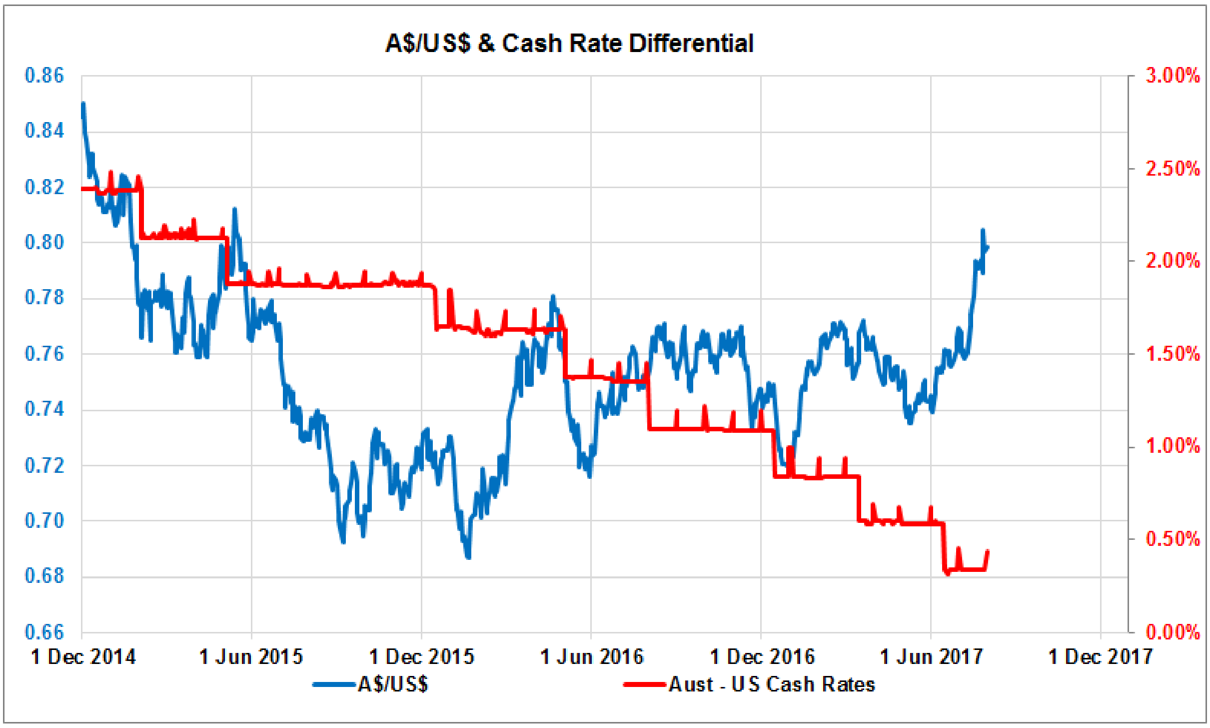
Figure 1: Higher commodity prices and a strengthening $A were key features of markets in July



Source: Thomson Reuters, Bloomberg

Central banks, interest rates and currencies were the main story for financial markets in July. In particular, market participants became convinced the Reserve Bank would start lifting interest rates sooner than previously expected, while the Federal Reserve would not be able to lift the cash rate again until late next year. This helped push the Australian dollar from A/US0.769 at the end of June to A$/US$0.799 by the end of July. This was currency's highest level since mid-2015, despite the differential between Australian and US cash rates now sitting 1.5% below where they were in mid-2015 (see figure 2 below). Furthermore, the cash rate differential is likely to narrow even further by the end of the year.

Figure 2: The A$/US$ looks increasingly out of step with a narrowing cash rate differential



Source: Thomson Reuters, Bloomberg

Several factors influenced interest rate expectations in July. First, the markets noted that the Bank of Canada had lifted its cash rate for the first time in seven years, and that the ECB had discussed when it would start reducing the amount of liquidity it is providing to the economy. The Bank of England had also been talking about these issues. The markets suddenly decided the Reserve Bank will have to follow the lead from these other central banks and that the cash rate was likely to increase sooner than previously expected.

One broker went so far as to suggest the Reserve Bank could lift the cash rate as soon as November this year, however most economists dismissed this as unlikely. Nevertheless, the idea was in the market and the Reserve Bank did not help matters when it reported that the Board had discussed a neutral rate of interest around 3.5%. The neutral rate of interest is a medium-term equilibrium rate at which the economy is running neither too hot or too cold.

The Board's discussion was theoretical rather than any indication that they see a need to get to 3.5% any time soon. Even though the Governor and Deputy Governor emphasised this in subsequent speeches, and that Australia does not need to automatically follow other central banks, the markets still felt the Reserve Bank to be leaning towards tighter monetary policy.

Australia

Having said this, the latest economic data in Australia more accurately illustrates the Reserve Bank's thinking. Inflation in the June quarter remained subdued, with core inflation rising 0.5% in the quarter and 1.8% over the year to the June quarter. Even headline inflation was only 1.9% over the same period. These figures still sit below the bottom of the Reserve Bank's 2% - 3% target range for core inflation. Labour market data for June were respectable, with 14,000 new jobs recorded and the unemployment rate steady at 5.6%. However, most new jobs are being created in the government sector rather than in the private sector and growth of wages remains low. The Governor made it clear the Reserve Bank is prepared to tolerate the declining unemployment rate as long as both wage and price inflation remained low. That is, the Bank wants to see evidence of rising inflation before it starts to think about lifting the cash rate. Most commentators do not expect these conditions to be in place until around the middle of next year.

America

Notwithstanding, the markets finished the month with a bleaker view about Australian interest rates than they had at the start of the month, and this contributed directly to pushing the A$ up. Adding to this, market views about interest rates in America became more benign through the month. Ironically, more than any other central bank, the Federal Reserve has set out the clearest and strongest path for interest rates to rise over the next couple of years, but the markets simply don't believe it. The main reason for this is that, like other central banks, the Fed has linked the path of interest rates to core inflation heading back to its target of around 2%. Despite stronger economic growth this year and further declines in the unemployment rate, both wage and price inflation remained subdued in the United States.

The broad disconnect between how the markets and the Fed view inflation and the consequence in the United States has undermined the US dollar. In addition, further erratic behaviour from President Trump, instability in his Administration, and his ongoing failure to progress his legislative agenda have made the US dollar look less attractive to global investors.

China

On top of all this, the $A got a further boost iron ore price rising nearly 15% in July on renewed demand from China. Opinions are mixed about whether the iron ore price can sustain this rally. Much depends on whether the Chinese economy slows down in coming months as has been expected for quite some time. Latest figures show some slight moderation in the pace of activity in the manufacturing sector, though this is less apparent in the construction sector where a significant part of the demand for iron ore comes from. Futures markets currently expect the iron ore price to fall by around 10% by the end of 2017 and a further 10% in 2018.