

Ford + Scott Economic Snapshot

March-April 2018

In summary

- March into early April has been another month of significant volatility for global financial markets, with equities rising and falling in rapid succession on a daily basis. The percentage size of the swings are unprecedented and uncorrelated to meaningful economic news - but seem to be the norm for markets in today's environment. We can expect more in 2018.
- Issues driving markets were mainly political and can be attributed to concerns regarding a potential trade war following divisive remarks by the US president against China. This resulted in an immediate tariff increase by China on select imports. Overall it is envisaged talks will sooth this issue out as China has lower imports plus more to lose and that destabilisation hurts global markets including both parties.
- Overall there was a slow net downwards move with key indices like the S&P 500 testing what chartists call important technical levels. This describes levels where it is anticipated a trend downwards or upwards would occur.
- It's worth noting that despite this, markets have managed to bounce back above these levels at the time of writing. Much of the volatility appears to be related to geo politics and the impact of rapidly reducing stock prices for technology stocks that over ran valuations over the past 6 months. This includes major names like Amazon and Facebook. A stable head, a steady hand and a long term outlook is required by investors during these rapid swings.
- Towards the latter end of March, investors started to focus on more meaningful issues such as the forthcoming earnings reporting season in the USA. This is expected to remain solid enough to provide support for equities in coming months.
- Central banks in the US and Australia also behaved pretty much as envisaged with the Federal Reserve in the US lifting the cash rate by another 0.25% to 1.75%, while the Reserve Bank here in Australia left the cash rate at 1.50%. This means that for the first time since December 2000, the Australian cash rate is below the US cash rate. The Australian dollar inched down in March as a result.

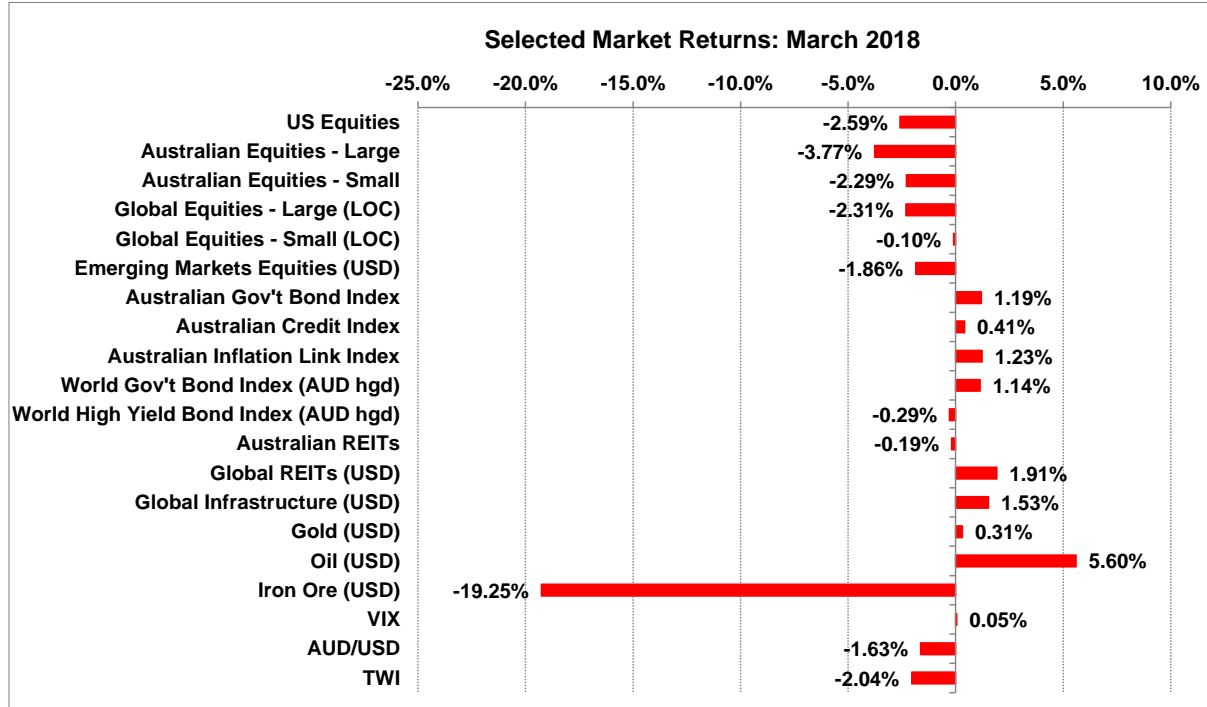
Assuming we have a bit of rhetorical chest beating and we escape trade wars, economists do feel the broader economic conditions are unlikely to remain as benign as they are now. Higher inflation and interest rates in the US will be a key development that could well trigger more bouts of volatility in financial markets as the year unfolds. As such, running well-diversified portfolios with appropriate management of equity market risk in particular, will be essential. This means managing downside risk is becoming more important as one would expect given the returns of recent years and the height of world markets.

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Equities had a poor month amid fears of trade wars - but bonds helped diversification



Sources: Thomson Reuters, Bloomberg

Australia

The latest economic news in Australia has been generally positive with business conditions remaining at record high levels - although business confidence has slipped back slightly. Importantly, both the capital expenditure and employment components of a NAB business survey were very strong.

The labour market has benefited from these developments over the past year, although it is noted the pace of improvement has slowed down in recent months. The unemployment rate was 5.6% in February, much the same as in the previous two months, but a touch higher than the 5.4% seen in November. Some of this is due to an increase in what is termed the 'participation rate' as more people move into the workforce seeking jobs.

There is still very little sign of near term inflationary pressures in Australia. The Reserve Bank has indicated that it would need to see sustainable wages growth as part of the higher consumer price inflation story before it would lift the cash rate. Given their analysis suggests this would require an unemployment rate meaningfully below 5%, we are unlikely to see such conditions this year. **This means the Reserve Bank is likely to be content with the cash rate at its current level of 1.5% for some time yet.** In turn this would protect any collapse in property which is at historical highs but remains buoyed by migration and a supply shortage in key segments.

USA

Conditions in the US are also stable to good, but there are some key differences between the USA and many other countries including Australia. Indicators of manufacturing activity remain at record highs and over 300,000 new jobs were added through February. This is all positive stuff.

Their unemployment rate is holding steady at 4% as more people enter into the workforce. However, in contrast to Australia, there are clear signs of both wage and price inflation gradually moving up. The US Federal Reserve expects this to continue through 2018 and, as a result, the Reserve is partway through a multi-year program to

lift the cash rate to around 3.5% by 2020. Theoretically, this should lead to a reduction in the A\$ which in turn would help our exports. The Aussie dollar has the capacity to surprise for sustained periods though.

Noting the above, in March the Federal Reserve lifted the cash rate by 0.25% to 1.75%. This means the Australian cash rate of 1.50% now sits below the US rate. The last time this happened was in December 2000.

Given the open communication of these hikes, the currency markets have been expecting this for some time and recognise that as the US cash rate rises even further above the Australian cash rate, so the A\$/US\$ exchange rate is likely to fall from current levels - hence the snapshot comments in the previous paragraph. At the end of March the A\$/US\$ stood at 0.767 compared with 0.779 at the end of February and 0.807 at the end of January. While this has been driven in part by movements in the cash rates, there has also been lowering of prices for iron ore, which fell a whopping 19% in March. The A\$ has been trending down since its peak near US\$0.81 at the start of the year and is now heading towards key technical levels around US\$0.76. Whether it breaks through those levels or bounces back off them will be important.

Demand for iron ore is heavily driven by developments in China. Key indicators of manufacturing activity in China fell sharply in February before bouncing back in March, reflecting the usual volatility associated with the Chinese New Year season. However, the overall picture espoused by economists is for the Chinese economy to slow down some more in coming months, especially if the central bank continues to gradually tighten monetary policy as it did in response to the US Fed's latest rate increase.

Overall, the economic conditions prevailing here and in the major economies overseas do not look too bad.

Although markets are aware of the risk, these conditions can deteriorate from here and the poor performance of equities in March really reflected a couple of other factors.

Firstly, the damage done to Facebook's reputation by the recent data privacy scandal spilled over into broader investor nervousness about tech stocks which had rallied hard for so long.

Secondly, Mr Trump's belligerent talk of imposing tariffs, especially directed at China, and the Chinese nation's equally robust response, led to fears of a global trade war. ***Although it is too early to know whether events will go down that path, if they did it would be very damaging to the world economy, including Australia.***

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