Economic Snapshot

Nov-Dec 2017

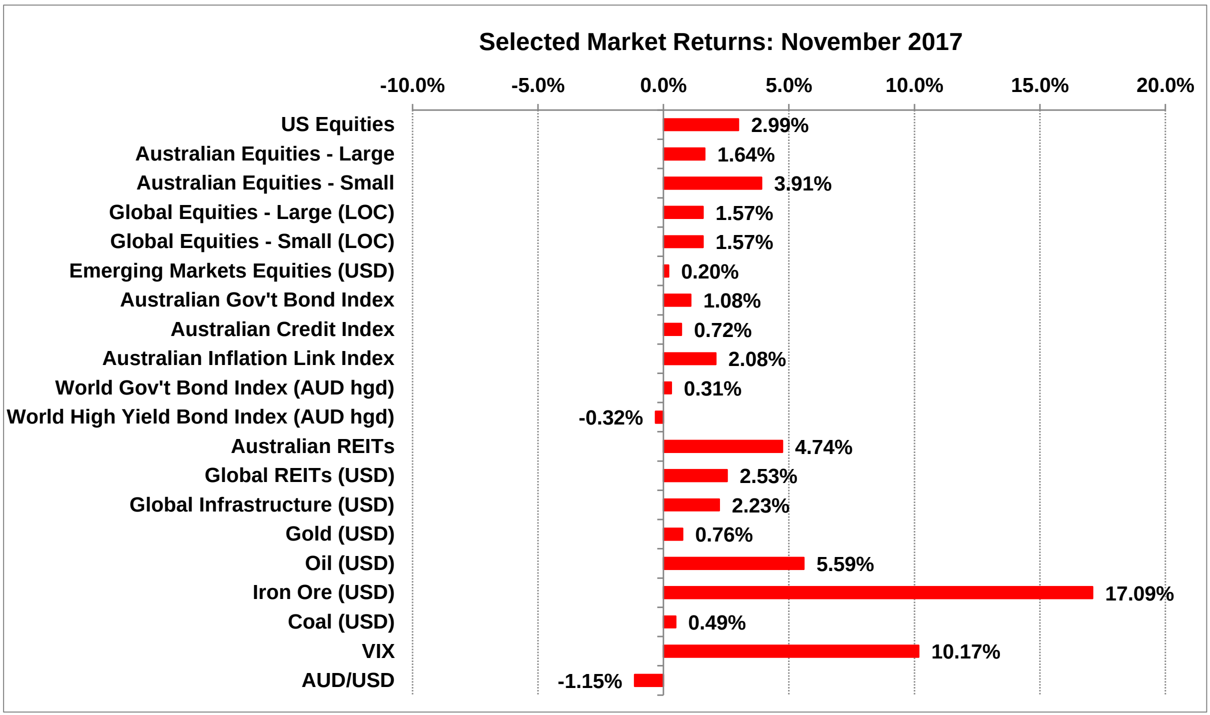
In summary

November was quite a good if not steady month for financial markets, with most asset classes performing well. In global markets the S&P500 pushed on to new highs, but here in Australia the local ASX200 was unable to hold above the 6000 mark. As we write it has inched towards 6100 though. Small cap equities outperformed again, as did AREITs with bond yields falling on lower interest rate expectations. Despite renewed debate about how soon they should start lifting the cash rate, the RBA has reiterated its view that this is not required for some time yet. Although low inflation is a key factor behind the RBA's stance, the fragility of the household sector, struggling under the impact of mortgage debt, high energy prices and weak wages growth, is another important part of the picture. Other aspects of the local economy appear more positive, with improvements in business conditions, employment and investment spending plans. Nevertheless, the A$/US$ ignored that and took its cue from interest rates to record a modest decline for the month.

The US economy continues to improve, with signs inflation has troughed. The new Fed Chair, Janet Powell has been well-received by the markets and is expected to continue the Fed's approach of recent years. US tax reform also looks likely to be enacted soon, with a positive impact on the economy. This is likely to add to the pressure on the Fed to lift the cash rate in early 2018.

Politics remains a wild card around the world, with the backflip on the Royal Commission into financial services, Donald Trump's potential links to the Russia inquiry, Angela Merkel struggling to form a government and Theresa May struggling to conclude a Brexit deal with Europe.

Figure 1: November was a good month for most asset classes



Sources: Thomson Reuters, Bloomberg

Australia

Data on the Australian economy released over the last month paints more of the same picture: improving business conditions and employment, but with low inflation and concerns about household debt. The latter was echoed in the weakest quarterly retail spending figures in seven years. High energy prices are compounding the impact of high mortgage repayments to limit consumer spending. Add low wage growth plus Amazon to the mix, and the anecdotal evidence of more retail bankruptcies to come is not that surprising.

Inevitably there was further public debate about what the RBA should do with interest rates. Both the OECD and high-profile Canberra academic, Warwick McKibbin suggested the RBA should lift rates sooner rather than later. The OECD argued that low inflation should not be a reason for low interest rates if at the same time there are signs the economy is improving and bubbles may be forming in assets like housing. Mr McKibbin suggested that moderate disruption to the housing market now from a rate increase could prevent a bigger disruption later if current conditions are allowed to continue.

Financial markets paid little attention to these comments, which appear to be outside the RBA's thinking and ongoing communication. The RBA's statutory responsibility includes a focus on inflation, which it believes will be low for some time yet, and not the housing market, which is more APRA's responsibility through policies on lending practices.

Furthermore, many would argue the horse has bolted on the housing market. Australian lenders already have the highest proportion of real estate loans/total loans in the world, households have the second highest debt service ratio in the world (after the Netherlands) and a higher than average sensitivity to interest rate increases. If anything, this situation suggests caution about starting to lift interest rates and instead giving households more time to consolidate their debts. Signs of cooling in the housing market reinforce this approach.

As things turned out, the RBA reiterated its commitment to no further interest rate increases for the foreseeable future and has left the cash rate at 1.5%. Financial markets responded by pricing a more moderate outlook for the cash rate into next year, with both 10 year bond yields and the A$/US$ falling. The difference between Australian and US bond yields is now close to zero, with the cash rate differential not much higher. The outlook for local and US interest rates suggests these differentials will be negative in coming months, which should undermine the A$/US$. There are already signs that foreign investors, notably in Japan, are becoming concerned about A$ denominated bonds no longer having a high yield advantage.

Another consequence of these moves in local interest rate expectations was that Australian Real Estate trusts performed disproportionally well in November, easily outpacing the broader market. Bank stocks were impacted by the Government's backflip on the much hyped financial services Royal Commission. Higher oil and iron ore prices helped selected resource companies, but not the A$/US$. The ASX200 flirted with the 6000 mark, but has not been able to consolidate above that level until more recently.

USA

Tax reform in the USA made headlines in recent weeks. Although significant details still need to be sorted out, markets now see tax reform, including substantial company tax cuts and personal tax cuts, being delivered in 2018. This helped propel the S&P500 ever higher, as did economic data showing further good growth, employment gains and low inflation. However, signs are emerging that inflation has troughed and will be higher in 2018.

That would give new Fed Chair Janet Powell the ammunition to implement more rate hikes than the markets currently expect. That in turn should push the US$ up some more, but recently we have seen political risk associated with President Trump's possible links to the FBI's Russia inquiry holding the US$ back.

Europe

Political uncertainty continued in Europe with Angela Merkel struggling to put together a coalition government, and Theresa May struggling to agree a Brexit deal with Europe.

This completes the year end summaries for 2017 leaving Snapshot with the pleasant task of wishing everyone well for Xmas and the New Year. Despite ongoing concern about markets, warnings, disruptions and incredible turmoil in politics, 2017 proved to be a good year for diversified investors. As we move toward 2018 one can but request more of the same for portfolios.

A merry Xmas to all readers and we look forward to renewing with a customary outlook for asset classes in the crystal ball gazing of January 2018. Until then enjoy the festive season and the New Year festivities.