Economic Snapshot

October – November 2017

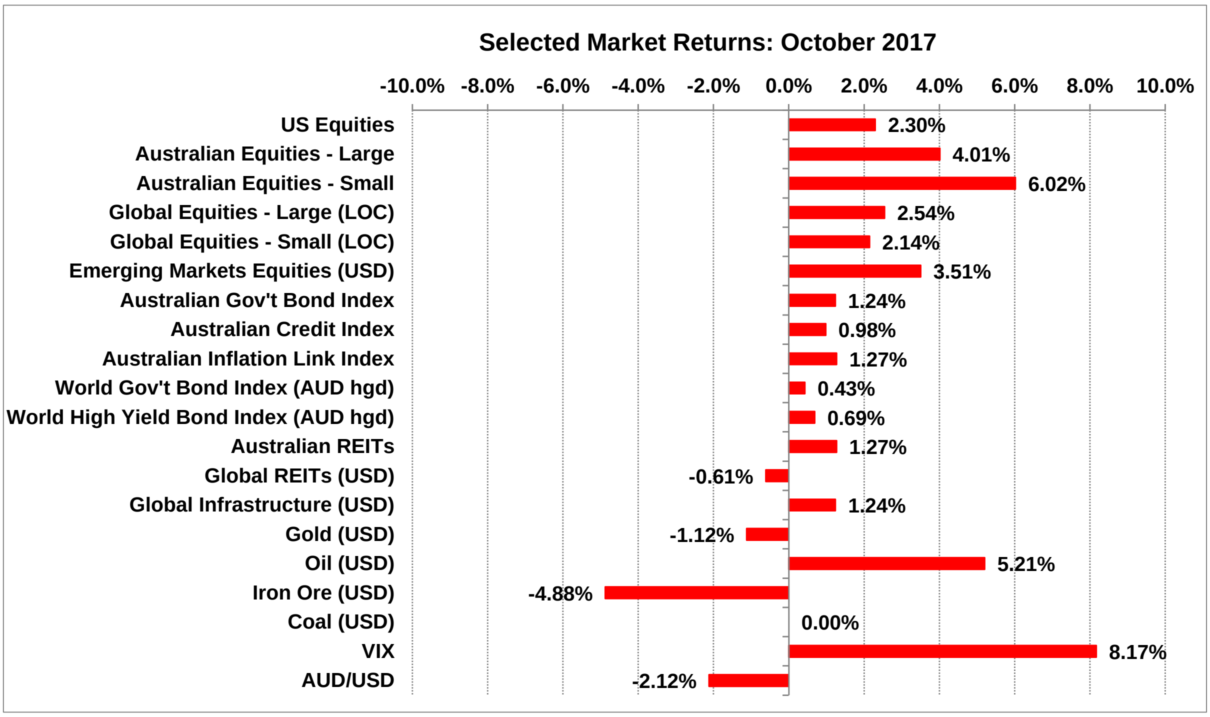
In summary

As we move into the 2nd quarter of the fiscal year, the Australian equity market has moved out of its relatively benign sideways move of recent months and has started to catch up with the rally in global equity markets. The rally has been good for portfolios holding global and domestic equities. In fact, domestic equities, especially small caps, easily outperformed their international counterparts. The A$ also continued a mild retreat from its recent highs as iron ore prices fell further and a softer than expected CPI report undermined expectations of an imminent rate hike by the Reserve Bank. All of this has helped diversified portfolios move toward double digit returns year on year.

Ongoing strength in the US economy, combined with low inflation and interest rates, as well as the popularity of the leading tech stocks, has also helped push the US equity market to new highs. A pause in the war of words between the US and North Korea may have also contributed to a better mood in the markets. However, as the rally in global markets continues, institutional investors are becoming increasingly concerned that the major asset classes will not be able to deliver much more than very low returns over the next year or so and the flow of cash into markets may slow as a result.

The US Federal Reserve has signalled that the strength of the US economy gives policymakers confidence to lift the cash rate again in December. The process of selecting Janet Yellen's successor as Chair of the Federal Reserve continues, with Fed insider Jerome Powell nominated for the position. The markets see Powell as very much in the same cautious mould as Janet Yellen.

Figure 1: While all markets were strong the Australian equity markets excelled in October



Sources: Thomson Reuters, Bloomberg

Australia

In Australia the September quarter CPI report surprised markets by coming in much softer than expected. Underlying inflation rose 1.8% in the year to September, as did the headline CPI. These figures are below the bottom of the Reserve Bank's 2% - 3% target range for inflation. The main contributors to higher prices in the quarter included alcohol and tobacco, housing, health, and education. The categories of expenditure showing meaningful falls in prices were communication and clothing and footwear.

The markets have been expecting a bit more inflation than this and when the figures were released, the markets immediately priced out any expectation of a cash rate hike by the end of this year. These expectations had been building in recent months on speculation that the Reserve Bank would follow the US Federal Reserve in lifting the cash rate. Although the Reserve Bank had debunked this idea, it took the inflation figures to finally re-enforce this position. The currency market also reacted to the news, with the A$/US$ dropping from over US$0.78 to around US$0.765. This has been an enduring battle for the A$ which remains above long term trading ranges. Despite all this, the markets still expect one 25 basis point increase in the cash rate by the end of 2018.

In other local news, business confidence rose, as did consumer confidence for the first time in quite a while. However, the latest data on retail sales suggest consumer spending remains subdued. The government would be encouraged by another 20,000 jobs being created in September, of which approximately two thirds were part-time. The unemployment rate fell only very slightly to 5.5% and there is still little sign of any pick up in wages growth. This latter factor, combined with high levels of mortgage debt, and signs of a peak in the house price boom, are likely contributors to the weaker than expected retail sales figures. Surveys show that although households are getting less worried about unemployment they see reducing debt, especially mortgage debt, as a priority.

USA

The USA continued to post good economic figures during October although the major manufacturing index [ISM] slipped a little back to levels last seen in August, after a hurricane induced blip in September. This key indicator suggests real GDP growth in the US is running above 3% at the moment which is the strongest pace seen since 2004. The unemployment rate also fell to 4.2% which is the lowest it has been since 2000.

The US Federal Reserve said this economic strength gives them confidence to lift the cash rate again in December, even though inflation remains low, because it is likely inflation will pick up in coming months. Indeed, some leading indicators do suggest higher core inflation in early 2018. This confidence has flowed into both the ECB and the Bank of England which have expressed similar views about inflation and the need to gradually tighten monetary policy.

The Bank of England followed up by lifting its cash rate for the first time in ten years, but said it is in no hurry to raise rates again, while the ECB remains content to leave interest rates alone for the time being. Instead their focus will be on winding back their program of buying bonds.

Meanwhile, the process of selecting Janet Yellen's successor as Chair of the Federal Reserve continues, with Fed insider Jerome Powell nominated for the position. The markets see Powell as very much in the same cautious mould as Janet Yellen and as a result expect no aggressive moves to raise interest rates.

Europe

In Europe the dispute between Catalonia and the national government in Madrid took a more dramatic turn, with Prime Minister Rajoy declaring the independence referendum invalid, sacking the Catalan government and threatening to prosecute its President, Carles Puigdemont, for sedition. Puigdemont and some of his colleagues have fled to Belgium to escape the Spanish authorities. Madrid has made it very clear there is no way the government will accept Catalan independence and will take whatever steps necessary to keep Spain intact.

China

China completed its key Party Congress meetings at which Xi Jinping well and truly cemented his grip on power in the country. Xi is much more of an old-school Communist than his immediate predecessors and, given his new authority in the Party, his views are likely to have a significant impact on China's place in the world. Several key economic indicators are flagging a moderate slowdown in growth is now underway in China. Given how much China has contributed to the surge in global growth over the past year, a slowdown now would be expected to show up in other countries including Australia, Europe and the US. This could in turn contribute to a slower pace of growth in equity markets around the world, including resource-dependent markets such as Australia.