Economic Snapshot

PARAGEM

Sept-Oct 2017

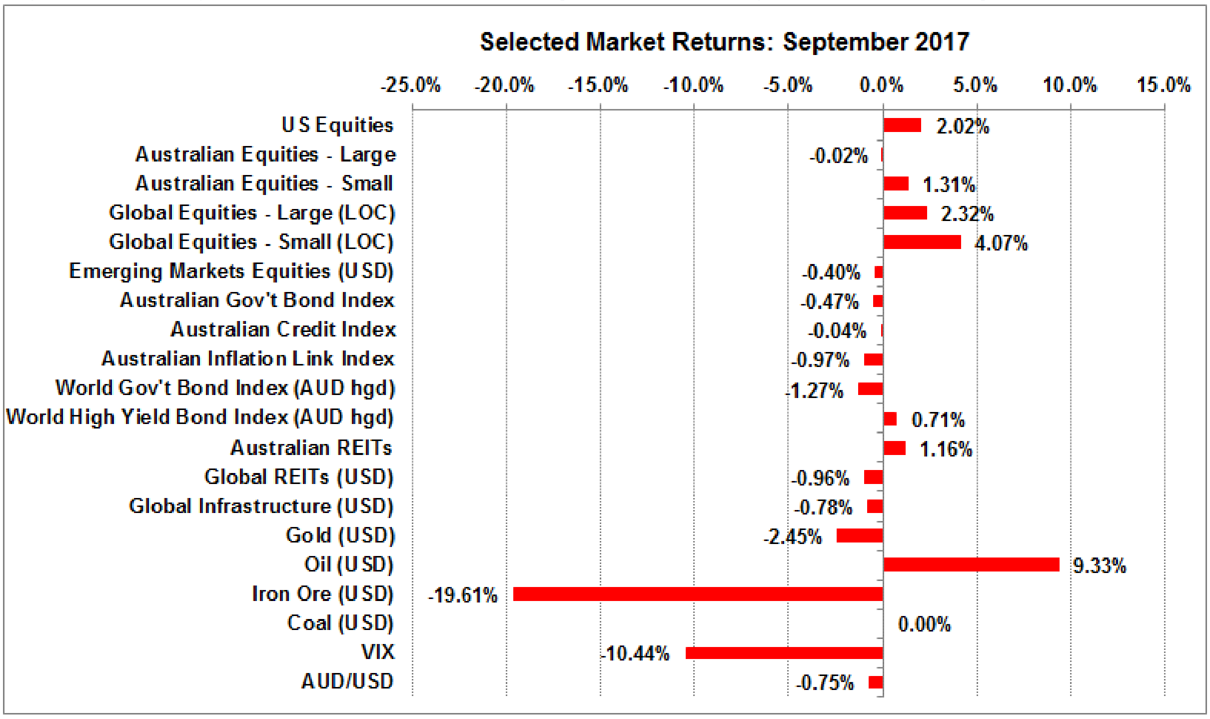
In summary

September saw some significant developments for global financial markets: After months of hesitating the US Federal Reserve [Fed] finally made it clear that US interest rates will rise, even if inflation remains below their 2% target; The Fed also said it will start unwinding the massive post-GFC expansion of its balance sheet; President Trump announced a plan for major tax cuts in the USA;

Meanwhile developed equity markets (ex-Australia) enjoyed modest rises while emerging markets took a breather following some good months. Part of this was because the higher US$ pushed down the prices of commodities exported by many emerging economies. Bond markets faltered however as the implications of the Fed's decisions were assessed. At this stage, the reaction of equities versus bonds suggests the markets do not think the interest rate moves will threaten the economy and profits.

As to be expected the US$ immediately rose after the announcement, causing the A$ to break its rally. This coupled with the sharp fall in the iron ore price, which analysts had been expecting for some time, added to the selling pressure on the A$. Economists have noted and commented that the US cash futures suggest financial markets are still underestimating how far the USA is likely to lift their cash rate next year, in which case the recent rise in bond yields and the US$ would not be finished. That in turn could make equity markets more nervous. The Reserve Bank has left the Australian cash rate unchanged at 1.5%.

Figure 1: steady returns from markets in September although Australia was quiet



Sources: Thomson Reuters, Bloomberg

Australia

Latest data showed further signs of improvement in parts of the Australian economy. The NAB business survey reported business conditions held up very well in August, although business confidence slipped again. Reasons for the decline in business confidence are unclear, but the North Korean situation and on-going local policy uncertainty, especially over energy, are likely to have been contributing factors. Conditions in the retail sector remain noticeably weak compared to other parts of the economy and this mirrors the more subdued state of household confidence. Nevertheless, the employment conditions component of the NAB survey improved in August, implying the likelihood of further gains in job creation in coming months. The ABS reported 54,200 new jobs in August, of which 40,100 were full-time. The unemployment rate held steady at 5.6%, which is still well above the 5.0% rate, beyond which the Reserve Bank would expect to see wage inflation starting to pick up.

The Governor of the RBA flagged that the next move in local interest rates is likely to be up rather than down. Phil Lowe suggested that cutting the cash rate any further would be unnecessary and likely counterproductive. By default, the next move will be to lift the cash rate, but the RBA is in no hurry to do so, despite what overseas central banks may be doing. RBA Board member Ian Harper put this into context by noting the remaining slack in the labour market and saying “why would anyone be suggesting tightening monetary policy…”

USA

The big news in the USA included the Fed’s newfound resolve to lift the cash rate despite low inflation, President Trump’s announcement of tax cuts, and the hurricanes on the southern coast of the USA. The on-going tensions with North Korea also stayed in the headlines. The economy remains robust with key indicators of manufacturing activity picking up again in September and over 150,000 new jobs added in the month. Inflation is still relatively low, with core inflation running at around 1.7%.

The Fed’s policy position is a very welcome and important development. The Fed correctly sees low inflation as an opportunity to normalise the real cash rate while inflation is low and the economy is reasonably strong. With inflation lower rather than higher, the less the Fed has to lift the cash rate to achieve its goals. This, plus starting to unwind the emergency post-GFC bond purchases, is necessary and prudent steps towards reining in monetary conditions that are looser than the economy needs. The Fed’s delay in getting to this point was a major reason why the US$ kept falling and thereby pushing up other currencies, including the A$. As long as the Fed holds its nerve and delivers on its policy, then the US$ is likely to keep rising and the A$ to fall further. This is very beneficial for countries like Australia which have been feeling the disinflationary impact of an over-valued currency.
International Equities that are unhedged would benefit from this scenario.

The proposed US tax cuts include a corporate tax rate of 20%, cuts in personal tax rates, increased deductability for companies' investment spending but elimination of a number of personal deductions, and cancelation of the estate tax (death duties). Given the complexity and cost of the proposed package – more than US$5 trillion over ten years – as well as the toxic state of US politics, it seems unlikely the package will get through unscathed. Exactly when something might be implemented remains unclear. The equity market, especially small cap stocks, initially responded favourably to the package.

China

China posted some more good economic figures with the manufacturing index rising again in September, and some signs of higher inflation. Authorities in several more cities announced new rules banning the re-sale of homes within two to three years of purchase in order to curb speculative price rises. So far, 44 cities across China have imposed restrictions like this. The government also announced it will curb steel production over the winter months to ease pollution. This contributed to the fall in the iron ore price.

Europe

In Europe Angela Merkel's election victory has proved more problematic than expected and she now faces the challenge of putting together a coalition government. Meanwhile, Catalonia held its referendum on independence from Spain, despite government measures to prevent the ballot even happening. This comes at tricky time when the EU is trying to deal with Brexit and Theresa May hopes the Scottish independents do not feel inspired to have another referendum themselves. Also in the UK, Jeremy Corbyn continues to strengthen his grip on the Labour Party while staking his claim to be the next Prime Minister. Markets have been unfazed by all the geo political posturing.