Ausbil Investment Markets

Report

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Ausbil Investment
Management Limited
ABN 26 076 316 473
ACN 076 316 473
AFSL 229722

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Economic Review

The post US election 'reflation' investment positioning continued into the month of December. The US 10-year bond rose to a peak yield of 2.63% before settling lower into the close. The US dollar appreciated further and equity markets outperformed, with the Dow Jones Industrial Average fast approaching the key 20,000 level on the index. On the political front, US President Obama imposed sanctions against Russia, citing cyber-related activities intended to interfere with the US election process. Chinese warships led by their sole aircraft carrier entered the South China Sea for a routine military exercise. The European Central Bank determined that Italy's oldest and third largest commercial and retail bank, Banca Monte dei Paschi di Siena 1472, needs to fill a capital shortfall of €8.8bn under an adverse stress testing scenario. The European Union's President Dijsselbloem cleared Europe's Stability Fund to provide necessary short term debt funding measures to Greece.

The Organization of Petroleum Exporting Countries (OPEC) persuaded non-members to cut oil production by 558,000 barrels per day (bblpd). These are additional cuts to the decision on 30 November to reduce member output by 1.2 million bblpd. Saudi Arabia suggested that it will cut output even more than it is required to do so next year. About 1.8% of global oil supply will be removed from early 2017. Markets are likely to come into balance by early as 2Q17 and keep prices sustainably above US$50/bbl in 2017.

United States

The US Federal Reserve hiked rates by 25 basis points, taking the target range from 0.5% to 0.75%. According to the committee's median staff projections, the expected rate path has been raised by 25bps in each year for 2017, 2018 and 2019. The long run equilibrium rate was raised to 3% from 2.9%. Macroeconomic projections were revised slightly higher across the 3-year forecast horizon for GDP, while lowering the unemployment rate below its long run normal rate. The long run potential for GDP was left unchanged at 1.8%. Chair Yellen highlighted the high degree of prevailing fiscal policy uncertainty at the moment.

The Fed's preferred measure of core inflation has accelerated to 1.7% in October, compared to 1.3% a year ago. The post-Trump rebound in confidence levels, surging business surveys and a solid labour market are driving activity at a robust pace. The economic outlook continues to trend higher as the Conference Board's composite leading index is pointing to year average growth well above potential for 2017, in the range of 2 to 2.3%.

Europe

The European Central Bank announced they would taper somewhat and extend the QE programme by nine months, leading to sharply steeper yield curves. From April 2017, the pace reduces from €80bn to €60bn to end date December 2017 "or beyond" if necessary. There were no material changes to the December staff macro forecasts. GDP is estimated at 1.7% in 2016, 1.7% in 2017 (1.6% previously) and 1.6% in 2018 and 2019. Inflation is expected remain below its 2% target over the three year forecast horizon to 2019.

The euro area grew at a 0.3% pace in Q3, taking the annual rate to 1.7%. The PMI's released since Brexit on 23 June 2016 have re-accelerated in the core countries and the German Ifo and ZEW business expectations survey continue to trend higher.

In the UK Autumn Statement on Fiscal Policy, the Chancellor of the Exchequer announced new pro-growth fiscal stimulus measures totalling £122bn over the next five years and abandoned the goal of achieving surplus by 2020. This is equivalent to a fiscal expansion of around 6% of GDP over the next five years.

China

Government authorities are stepping up their fight against capital outflows disguised through outbound investment. The State Administration of Foreign Exchange, The Peoples Bank of China and the State Council have collectively announced new measures subjecting many overseas deals to more stringent reviews. The Financial Times noted that several European companies in China have been unable to remit dividends abroad

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following the recent introduction of new exchange controls.

Economic momentum accelerated in the December quarter with inflation rising. The official government and private sector measured November PMI surveys moved further into expansionary territory. The improvement is also independently corroborated by the Spaceknow Satellite Manufacturing Index. Headline consumer prices increased to 2.3% in November from 2.1% in October. The core inflation rate (ex food and energy) moved higher to 1.8%. Producer input prices are accelerating further into positive territory to 3.3% from 1.2% from the extreme negative 6% in December 2015.

Japan

The Bank of Japan (BoJ) kept rates unchanged at its December policy meeting. While the BoJ will continue with QE, it upgraded its assessment of the economic outlook. As the economy continues on its moderate expansionary trend, the BoJ noted a pickup in exports and industrial production, an improvement in business sentiment and highlighted policy support from highly accommodative financial conditions and large fiscal stimulus.

BoJ Governor Kuroda provided a positive outlook for 2017. The global economy has finally moved out of its adjustment phase following the Global Financial Crisis and is entering a new upward phase. At the post meeting press conference Kuroda made the following comments: (1) the BoJ was not considering a yield target increase on the 10-year bond; (2) it was satisfied with the current shape of the curve; (3) it would continue to acquire bonds irrespective of duration; (4) Yen currency weakness is due to US dollar strength; and will assess its impact at their next Outlook report due in April 2017; and (5) judged it not appropriate to reduce ETF purchases at this point in time.

Australia

The Federal Treasury's Mid-Year Economic and Fiscal Outlook (MYEFO) for Budget 2016/17 should calm speculative fears of a possible rating downgrade to Australia's AAA status. MYEFO keeps intact the projected return to a budget surplus in 2020/21. In the nearer term, cumulative deficits over the next four years are AUD10bn higher than expected at the time of the May Budget. The average annual pace of fiscal consolidation is 0.5% of GDP over the four year period. Commonwealth net debt is expected to peak at 19% of GDP in 2018-19 and then decline over the medium term. According to ratings agencies Fitch and Moody's, the fiscal outlook is consistent with the current AAA rating. However, Standard & Poor's issued a statement implying that the next Budget in May 2017 will be a key signpost for them. An important point, the forecasting methodology for commodity prices, has changed as "the factors driving iron ore and coal prices are likely to be temporary and prices are widely expected to retrace some of their recent gains." Treasury has adopted a phased reduction in commodity prices for iron ore and metallurgical coal and suspended the decade long practice of using consensus average of the last 4 weeks leading into the budget.

The Reserve Bank of Australia left policy unchanged at 1.5% with a 'neutral' bias. There were changes to the statement, acknowledging that "slowing in the year-ended growth rate is likely, before it picks up again." The bank upgraded its global inflation outlook: "inflation is more balanced than it has been for some time" and upgraded outlook for the terms of trade as commodity prices reflect "both stronger demand and cut-backs in supply" which would boost national income. The released minutes also contained the reference to financial stability as the board discussed the easing cycle since 2011, with the balance between target-consistent inflation outcomes and potential risks to household balance sheets to be "kept under review". Assistant Governor Kent reiterated the upbeat outlook as major headwinds for the past years are subsiding for mining investment (adjustment is estimated at 80% complete) and the 4½-year negative income shock is turning positive.

Real GDP for the September quarter 2016 was unexpectedly negative 0.5%, taking the annual rate a step lower to 1.8% from 3.1%. The broad based nature of the contraction was driven by external temporary influences, particularly the un-seasonally wet weather pattern on construction activity and retail sales, and a rise in policy uncertainty associated with the 2 July 2016 Federal election. Nominal GDP reflecting wages and company profits grew at a faster annual pace of 3%, exceeding real GDP for the second consecutive quarter. The household saving ratio moved lower to 6.3% from the previous quarter. For the second consecutive quarter, real net national disposable income accelerated to 0.8% from 0.6% taking the annual rate to 3.2% from 2.3%, which was the strongest annual growth rate since 1Q2012.

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Global Outlook

Global monetary policy divergence is in progress as the United States normalises interest rates in the next few years. The concept of the 'neutral federal funds rate' (estimated to be at 0% real and 2% nominal) will be the key factor driving monetary policy. The past year's dis-inflationary offset from lower oil and commodity prices is quickly fading, and will see the various forecast core measures of inflation consolidating well above the key 2% level. We expect the US Federal Reserve to hike rates by a minimum 50 basis points in 2017. As activity and inflationary pressures build over the year, the Federal Reserve would likely adjust its tightening trajectory with the unveiling and implementation of President Trumps' tax cuts and expansionary fiscal policies on infrastructure. In Europe and Japan, negative deposit rates will continue as QE programmes are modified and tapered gradually.

Australian Economic Outlook

Australia is in an ongoing structural transition with the decline in mining investment nearing completion and exerting a significantly lesser drag on activity. We expect the modest upswing in non-mining business investment to support activity with real GDP growth around trend, estimated at 2.8%. Low nominal wages and flexibility has allowed businesses to expand their workforces to date, but we are fast approaching the point where the next stage should be to embark on private business investment. The extremely low cash rate is providing ongoing support to aggregate demand and the low Australian dollar is driving domestic production, especially in the services sector. Core inflation is undershooting the low end of the target band, with benign wage inflation outcomes at 2%. Business confidence is consolidating higher and sustaining an optimistic profile similar to the period from 2002 to 2008. Consumer confidence has sustained a favourable improvement back into optimistic territory through 2016. Employment growth, despite being slow and in the part-time category, should see the unemployment rate remain well below 6%. This in turn is supporting household income and private consumption. Housing remains the key beneficiary in the near term, but the boom seems to have peaked late last year. Construction, net exports and infrastructure spend are important drivers for growth in the near term. Given we believe in sustainably higher oil and commodity prices, we expect the fair value for the AUD/USD exchange rate to average 0.78 for 2017 and average 0.80 for 2018. We expect the record low cash rate at 1.50% to remain unchanged for this year before gradual rate hikes commence in June 2018.

At the upcoming May 2017/18 Federal Budget there is the opportunity for fiscal stimulus to be pursued through the channel of infrastructure investment. This can be achieved by the Government committing to achieve a budget surplus on recurrent spending, while opening up the prospects for capital investment. Whether that option is pursued will be dictated by the Government's obsession with keeping the AAA credit rating and the rating agencies at bay.

Notes

Ausbil Investment
Management Limited
Level 27
225 George Street
Sydney NSW 2000
Australia
Toll Free 1800 287 245

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Contactus@
ausbil.com.au

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