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

President Trump's inaugural address before the US Congress provided little detail on upcoming tax and infrastructure policies. There was a build-up in expectations as Trump tweeted that a phenomenal "massive tax plan" would be unveiled in the "not-too-distant future" that would lower rates "substantially" for individuals and businesses. Despite this, the financial markets liked the vision, direction and conciliatory tone expressed. The speech echoed Trump's telephone call with President Xi of China where he appeared to have toned down the aggressive election rhetoric on trade policies.

US Federal Reserve Chair Yellen has all but confirmed that markets have correctly factored in a rate hike when the Federal Open Market Committee (FOMC) next meets on 15 March. Yellen's semi-annual testimony on monetary policy to the Senate stressed that: "I noted on previous occasions, waiting too long to remove accommodation would be unwise, potentially requiring the FOMC to eventually raise rates rapidly, which could risk disrupting financial markets and pushing the economy into recession."

The ISM surveys for manufacturing and the service sectors are pointing to accelerating activity in the US. Survey commentary was positive, with many businesses noting a strong start to the year with an upbeat outlook and demand reported to be steady or rising.

Eurozone growth ended the year at a solid 1.7% annual pace. Business and confidence surveys have trended higher. The composite PMI touched a 70-month high in February. Details showed an acceleration in activity in Germany and France. There was an intensification in price pressures, with input prices across the euro-area rising at the fastest rate since mid-2011. These surveys and PMI readings signal Q1 GDP growth at a robust 0.6% (2.3% annualised).

At a hearing before the European Union Parliament, European Central Bank President Draghi said the euro is irreversible, unemployment needs to decline further, recovery has broadened in Q4, inflation is set to pick up over the coming years, acute deflation risks have disappeared and there is no clear sign of sustained inflation convergence.

Members of the United Kingdom Parliament voted in favour of the bill that gives Prime Minister May the parliamentary power to invoke the EU Treaty's Article 50 exit clause.

The Bank of England (BoE) left policy unchanged and raised GDP growth forecasts, while inflation was little changed and the unemployment rate (NAIRU) was lowered to 4.5% from 5%. The economy can grow faster and the BoE can keep monetary policy at current levels. In detail, the changes were:
(a) GDP forecast: 2017 at 2.0% (previously 1.4%), 2018 at 1.6% (previously 1.5%) and 2019 at 1.7% (previously 1.6%)
(b) Inflation forecast: 2017 lowered to 2.7% (previously 2.8%), no change for 2018 (2.6%)

The Peoples Bank of **China** (PBoC) raised its interest rate on repurchase agreements by 10 basis points and raised the lending rates on its standing lending facility short term loans (3-months). China's foreign reserves fell to just under US$3 billion in January. The release by the State administration of foreign exchange highlighted that the decline was due to the PBoC's intervention to support the yuan and seasonal factors such as demand for other currencies during the Lunar New Year holiday.

Japan's first estimate for Q4 GDP grew by 0.2%, for the fourth successive quarter of growth. On an annualised basis, GDP expanded by 1.7%. Growth was driven by private non-residential and residential investment, with the depreciation in the currency helping net exports add 0.2 percentage points to GDP. The manufacturing PMI continues to trend higher in expansionary territory reflecting the recent boost from the fall in the currency.

The Reserve Bank of **Australia** (RBA) Governor's speech on 22 February stressed that the Bank is "trying to balance multiple objectives" and ruled out further rate cuts. "We would like the economy to grow a bit more. If we were to try to achieve that through monetary policy, that would encourage people to borrow more and it probably would put more upward pressure on housing prices. At the moment, I don't think these two things are in the national interest," he said.

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Australian GDP surprised on the upside, growing by 1.1% in the December quarter to be up 2.4% for the year. The economy's recovery was broad-based, with Western Australia registering its first rise since mid-2015 and the terms of trade rising for the third successive quarter. Adding to the mix was the first rise in non-dwelling capex, equipment and building investment in more than five years. Net exports contributed to growth, led by the mining and farm sectors. The rebound in private consumption was funded by a lower saving rate and domestic growth was at its strongest in four years.

Dwelling prices, according to CoreLogic data, rose 11.7% over the past year. Over the past three months dwelling prices have risen by 3.6%, indicating a pick-up in growth. Private capital expenditure first estimate of 2017/18 spending plans implies a 5% to 12% fall in capex, due to the mining sector as non-mining improves gradually. Company operating profits surged in Q4, underpinned by the mining sector, while ex-mining profits grew at their fastest annual pace of growth in six years.

Global Outlook

Global monetary policy divergence is in progress as the US 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 2% level. We expect the US Federal Reserve to hike rates a minimum of two times to a maximum of four times in 2017. As activity and inflationary pressures build over the year, the Federal Reserve would be expected to adjust its tightening trajectory with the unveiling and implementation of President Trump's tax cuts and expansionary fiscal policies on infrastructure. In Europe and Japan, negative deposit rates are expected to continue as Quantitative Easing 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 optimism 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 most of this year before gradual rate hikes commence in November 2017.

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 achieving a budget surplus on recurrent spending, while opening up the prospects for capital investment. Whether that option is pursed will be dictated by the Government's obsession with keeping the AAA credit rating and keeping the rating agencies at bay.

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Fixed Interest

As measured by the Bloomberg AusBond Government Bond Index (0+ years), the debt market produced a return of positive 0.14% in the month of February and 0.95% for the year. The (0-5 years) Index returned positive 0.08% for the month and positive 1.62% for the twelve months.

2017 **Month end**	US **Feb**	US **Jan**	Aus **Feb**	Aus **Jan**
2yr	1.26%	1.20%	1.81%	1.78%
10yr	2.39%	2.45%	2.72%	2.71%
2/10 yield curve	1.13%	1.25%	0.92%	0.94%
10yr indexed	0.38%	0.39%		
10yr spread to US			0.33%	0.26%

Global sovereign bond yields traded within a narrow range in February, awaiting clarity on Trump's fiscal policies. The US 2-year closed higher at 1.26% and the 10-year lower at 2.39%. The positive sloped 2/10 yield curve narrowed to 113bps. The inflation indexed US10-year real yield inched lower to 0.38% from 0.39%. Australian yields drifted higher with the 2-year up 3bps to 1.81%, 10-year up 1bp to 2.72%, and the yield curve narrowing to 92bps. The 10-year spread to the US widened by 7bps to 33bps.

Notes

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

Contactus@
ausbil.com.au

ausbil