

Ausbil Investment Markets

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Report

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International economic review

Economic Review

During April, the International Monetary Fund (IMF) lowered global growth forecasts for this year and next, while major oil exporters meeting in Doha, Qatar failed to reach a deal to freeze oil production at current levels.

The IMF lowered growth forecasts by 20bps to 3.2% for 2016 (in-line with 2015) and by 10bps to 3.5% for 2017. Recovery is projected to strengthen in 2017 and beyond, driven primarily by emerging market and developing economies, while conditions in stressed economies start to gradually normalise. But uncertainty has increased and risks of weaker growth scenarios are becoming more tangible. The fragility has increased the urgency of a broad-based policy response to raise growth and manage vulnerabilities, while participants were relieved to see some normalisation in financial conditions in the last two months on reduced concerns about a global recession. The IMF is trying to convince policymakers that concerted action was needed to safeguard the global economic recovery.

The Doha oil meeting concluded with no agreement, because Saudi Arabia reasserted a demand that Iran should also agree to cap its oil production. An agreement would have marked a new level of cooperation between OPEC members and non-members.

Elsewhere, the St Louis financial stress index is improving back at levels prior to the panic onset of January and February. The US Federal Reserve is looking for clear evidence that the recent acceleration in core inflation is not temporary and there is growing realisation that Advanced Central Bank interventions on monetary policy could be failing in their quest to revitalise growth. One third of the Developed Market sovereign bonds are trading at negative yields, including German bunds with maturities less than 10 years and the 10-year JGB.

We expect the **US Federal Reserve** to delay and reduce the number of rate increases in 2016. The Fed is yet to be convinced that the recent acceleration in core inflation is sustainable. The new easier policy stance accepts the risk that core inflation will overshoot the 2% target and that the labour market will tighten further. This allows markets to consolidate with limited impact on the real economy. Chair Janet Yellen adopted an explicitly 'dovish stance' and proceeded cautiously given the disinflationary impact from the appreciating USD. We were also reminded that the Fed still has options to ease, including a return to QE, however, the FOMC minutes revealed a difference in opinions on the inflation and the outlook for monetary policy.

The European Central Bank (ECB) eased monetary policy with the emphasis on credit as the preferred transmission channel instead of currency depreciation. QE has seen German 10-yr bond yields decline to below of 0.10%. Brexit uncertainty is impacting activity and resulting in volatility for the Pound Sterling.

China is targeting fiscal policy. The growth target was lowered to the range 6.5-7% for 2016 and expansionary fiscal policy was adopted as the deficit expands to 3% from 2.3%, the highest since 2010. March saw a rebound in activity for industrial production, fixed asset investment and retail sales.

Japanese sovereign bond yields are negative for maturities to 10-years. The Yen has appreciated, sparking speculation of fiscal stimulus and additional QE, possibly in equities. There is growing speculation that the planned 2017 consumption tax hike may be delayed to ensure GDP growth remains at 1%. Structural reform is required to sustain higher aggregate consumption by both households and the business sectors.

The **Reserve Bank of Australia (RBA)** left policy on hold at 2% on April 5th with a strong conditional easing bias as low inflation provided scope if needed. The RBA also jawboned the currency noting it has appreciated recently, reflecting some increase in commodity prices, but highlights monetary developments elsewhere in the world. New information introduced "under present circumstances, an appreciating exchange rate could complicate the adjustment underway in the economy". Employment is out-performing with the unemployment rate lower at 5.7% against a rising participation rate. Annual employment growth at 2% is trending back to its long term sustainable trend.

Global Economic Outlook

Global monetary policy divergence is in progress as the United States sets about normalising interest rates over a number of years. The concept of the 'neutral federal funds rate' (estimated to be at 0% real and 2% in nominal terms) will be an important guidepost for driving policy. The offset from lower oil and commodity

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prices is temporary and will fade, while the measures of core inflation are expected to return to the 2% target level. We expect the US Federal Reserve to hike rates by 50 basis points in 2016. But if activity and inflationary pressures re-accelerated, then the Fed could act more aggressively in 2017 and play catch up against an improving global environment. In Europe and Japan, negative deposit rates will continue as QE programmes are modified and extended beyond their originally intended time frames. Most advanced economies are oil importers, so the price fall is equivalent to a large permanent income tax cut.

Australian Economic Outlook

Australia is in a structural transition with the drivers of growth adjusting away from the previous resources boom. We expect real GDP growth to be below trend at less than 2.75%. The lower cash interest rate is providing ongoing support to aggregate demand and the lower Australian dollar is helping to drive domestic production, particularly in the services sector. Core inflation is at the low end of the 2-3% target band, with wage inflation at a series low of 2.1%. Business confidence has trended higher and consumer confidence has become more favourable in the surveys. Employment growth has been stronger than forecast with the unemployment rate expected to stabilise at 6%. The shift towards the more labour-intensive services sector has more than offset the decline in the mining and manufacturing sectors. Lower wages and greater flexibility allows businesses to expand their workforce, prior to embarking on the need for business investment.

Employment growth is supporting household income and in turn private consumption. Housing remains a key beneficiary in the near term. Construction, net exports and infrastructure spend are important drivers for growth in the year ahead. We expect the cash interest rate to remain at 2% with a strong easing bias. Against the favourable backdrop of low core inflation, if the pace of domestic growth was to falter, the Reserve Bank of Australia would cut interest rates to achieve the required rebalancing of the economy.

Fixed Interest

As measured by the Bloomberg AusBond Government Bond Index (0+ years), the debt market produced a return of 0.19% in the month of April and positive 3.47% for the 12 months. The (0-5 years) Index returned 0.30% in April and positive 2.52% for the year.

2016	US	US	Aus	Aus
Month end	April	Mar	April	Mar
2yr	0.78%	0.72%	1.86%	1.90%
10yr	1.83%	1.77%	2.52%	2.49%
2/10 yield curve	1.05%	1.05%	0.66%	0.59%
10yr indexed	0.12%	0.13%		
10yr spread to US			0.68%	0.72%

Global bond yields were range bound as the US 2-year maturity rose 6 basis points and the 10-year rose by 6 bps. The positive sloped 2/10 yield curve widened by 9bps. The inflation indexed US10-year real yield was unchanged. Australian short dated bond yields moved lower with the 2-year falling by 4bps and the 10-year increasing by 3bps, the 2/10 yield curve widened by 7bps. The 10-year spread to the US narrowed by 4bps.

Budget to have minimal impact on Australian equities market

The 2016 Budget, released in early May, was expected to have a generally neutral impact on the domestic equity market, with some positives evident for media companies and discretionary retailers, while the aged care sector looked to suffer some mild setbacks.

There were some minor tax cuts for those earning above \$80,000, which essentially addressed bracket creep, while a reduction in superannuation concessions was predominantly targeted at the wealthy. Neither of these developments will have a material impact on the share market.

The primary beneficiary of the budget was the media sector following a 25% reduction in the television licence annual fee, which is paid to government, from FY2017 onwards. The fee currently represents 4.5% of revenue and the industry had been lobbying the government to go further. While further cuts are possible, greater importance is likely to be placed on the media reform changes due later this year.

The small tax cuts were perceived as a very minor positive for retailers and the GST will be applied to low value imports of less than \$1,000 from July 1st 2017, which should provide a minor advantage for importers of electronics and cosmetics. The impact of the cut in official interest rates in early May will probably have a far more significant impact on retail spending than the aforementioned budget changes.

The Budget also included further changes to the Aged Care Funding Instrument (ACFI), where savings measures were increased from \$472 million last December to \$1.2 billion over the period FY2017 to FY 2020. This is expected to have a negative impact on earnings per share within the sector of about 3% to 5%.

Overall, the Budget avoided taking hard decisions about achieving a surplus with the path to positive territory remaining long-dated, while a lower company tax rate of 25% for all companies was ultimately targeted for the year 2026. This last point is quite pertinent for the longer term net earnings growth of domestic corporates.

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