Ausbil Investment Markets

Report

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ausbil

International economic review

Economic Review

Contained in the release of its quarterly World Economic Outlook, the International Monetary Fund lowered its global growth forecasts following the UK referendum. Prior to the unexpected Brexit outcome, the IMF were likely to revise upwards their global forecasts. Year 2016 was reduced to 3.1% from 3.2% and Year 2017 to 3.4% from 3.5%. The UK outlook was slashed one percent on the assumption that the European Union and UK would negotiate a deal that does not lead to a large increase in economic barriers. A more severe scenario (where talks break down) could see global growth slow to 2.8% in both years.

Brexit will likely turn out to be a regional (may be country specific) rather than global economic event. Bank of England Governor Carney warned of heightened economic uncertainty leading to an adverse hit to the economy. The impact has seen the currency depreciate and the BoE's Agent Summary of Business Conditions reported that uncertainty had increased, but a majority of firms did not foresee an impact on their capital spending or hiring plans in the near term. A special, one-off edition of the UK PMI saw the July flash composite fall to its lowest level since mid-2009. Ongoing uncertainty pre- and post-Brexit impacted service providers more than manufacturers given services are a large share of the UK's exports. In the Eurozone and in Germany, the post Brexit ZEW business expectations survey turned sharply negative. Given the geo-political uncertainty and concerned expressed by BoE policy members, we expect an interest rate cut at the upcoming meeting on August 4th (since confirmed). Further stimulus measures may be announced, combining additional QE and a special supplementary fiscal package.

United States - June's 287,000 surge in non-farm payrolls relative to consensus 180,000, was a welcomed relief that the labour market is not in sharp slowdown. June's outcome confirmed that May's poor result was most likely a one-off. Q2 GDP grew at just 1.2%, lower than expected due to an outsized drag from inventories. Encouragingly, private household consumption is running at a solid pace pointing to real consumer spending at a 4.2% annual rate. Momentum in industrial production picked-up in the six-months to June. The housing sector is strengthening, but there are growing supply constraints with a lack of skilled labour and available land lots. The various measures of core inflation have accelerated and are seen as sustainable as the rises have become broad based. The Federal Reserve is looking for unambiguous evidence that the acceleration in core inflation is permanent, given the ongoing disinflationary impact from the strength in the USD. Chair Yellen is prepared to accept the low risk that, inflation will overshoot the 2% target as the unemployment rate moves below the Fed's estimate of full employment.

Europe - European Central Bank President Mario Draghi described the euro area economic recovery as continuing, but noted it was subject to geopolitical uncertainties. He stressed the ability to act if needed, but wanted to evaluate incoming data to assess underlying conditions. Brexit was estimated to have a minor impact on activity, with the ECB's first estimate of potential GDP loss somewhere between 0.2% and 0.5% over the next three years. The growth outlook sees risks to the downside; with the "sluggish pace of implementation of structural reforms" as a new risk. The Flash July PMI surveys proved resilient in the core countries and showed no sign of a significant UK Brexit impact on Eurozone business sentiment yet.

China - The Permanent Court of Arbitration in The Hague ruled China's claim to the South China Sea (an area covering 3.6 million square kilometres) to be invalid. Land-reclamation activity, turning reefs into artificial islands with airstrips or other facilities, confers no new rights to the surrounding waters or any authority to exclude others passing nearby. Q2 GDP grew 6.7% due to targeted fiscal stimulus and monetary easing earlier in 2016. The outcome was above the market expectations of 6.6%, and at the same pace as Q1. The pace of house price growth continues as new home prices increased at an annual rate of 7.3% in June compared to the previous corresponding period of negative 4.9% in June 2015.

Japan - The Bank of Japan (BoJ) eased monetary policy via QE by doubling the size of annual purchasers of equity listed ETF's to 6 trillion yen (~US$57 billion) from 3.3 trillion yen (~US$31 billion). As part of its announcement, the BoJ also called for a comprehensive review of its unconventional monetary policies, raising concerns about the effectiveness and limit of its existing policy tools and speculations of some form of 'helicopter money'. Prime Minister Shinzo Abe's, Liberal Democratic Party, gained a majority in the Upper House election held on Sunday July 10th. The large majority allowed Abe to implement economic reforms reflecting the change of priorities of fiscal spending towards growth enhancement. The fiscal package was announced on July 28th and is estimated at 28 trillion yen (~US$265 billion) or 5.5% of GDP. The headline fiscal figure includes public-private partnership outlays and direct government outlays. The Government will spend 13.5 trillion yen (~US$132 billion), around 3% of GDP, on cash payouts to low-income earners and infrastructure spending. The move should support consumer spending GDP and inflation in the near to medium term. More importantly structural reform is required to sustain higher aggregate consumption by both households and the business sectors.

Australia - The Liberal/National coalition was returned to Government following a 1 week count of postal votes post the Federal Election. Activity continues to pick-up in the non-mining sector. Moderate employment gains has seen the unemployment rate trend lower to 5.7%, with annual growth slowing to a sustainable 2% (around its 20-year average trend). Q2 annual headline rate eased to 1% from 1.3% in the previous quarter with the core rate averaging 1.5%. Non-tradables (a proxy for domestic inflation) edged lower to 1.6%, well below the growth rate in nominal wages.

The Reserve Bank of Australia left policy on hold at 1.75% on July 5th with an easing bias entirely data dependent. The minutes particularly highlighted that "further information on inflationary pressures, the labour market and housing market activity would be available over the following month and that the staff would provide an update of their forecasts ahead of the August Statement on Monetary Policy." Hence, a rate cut would be conditional on (a) ongoing undershooting of the core inflation rate and (b) re-appreciation of the AUD to the US78c level. With regard to Brexit, there will be a period of uncertainty for the UK and the European Union and this uncertainty was expected to have only a modest adverse effect on global economic activity. The direct effect on Australia was "likely to be quite small" given Australia's low export share with the UK at 3% and the EU at 4.5%.

Global 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 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 once by 25 basis points in Q4 2016. Should activity and inflationary pressures re-accelerate, then the Federal Reserve would act more aggressively in 2017 and play catch up against a stable and less uncertain 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 at trend, estimated at 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 undershooting the low end of the 2-3% target band, with benign wage inflation around 2%. Business confidence has trended higher and consumer confidence has become more favourable in the surveys. Employment growth, despite being moderate, would see the unemployment rate consolidate below the key 6% level. 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. The AUD/USD has traded as high as 0.78 from a low of 0.685 since January. Given we believe oil prices have bottomed and that other commodity prices are basing, we expect the fair value for the exchange rate to be 0.72. We expect the cash interest rate to be cut to 1.50% at the next RBA meeting on August 2nd (since confirmed) due to low inflation and nominal wages. Against the backdrop of extremely low core inflation, if the pace of domestic growth was to falter and/or nominal wages growth was structurally below 2%, the Reserve Bank of Australia would cut interest rates further to assist the required rebalancing of the economy and return core inflation to target.

International economic review

Fixed Interest

As measured by the Bloomberg AusBond Government Bond Index (0+ years), the debt market produced a return of 0.78% in the month of July and 6.90% for the year. The (0-5 years) Index returned 0.39% and 3.33% for the year.

2016 **Month end**	US **July**	US **June**	Aus **July**	Aus **June**
2yr	0.66%	0.58%	1.51%	1.59%
10yr	1.45%	1.47%	1.87%	1.98%
2/10 yield curve	0.80%	0.89%	0.37%	0.40%
10yr indexed	-0.04%	0.03%		
10yr spread to US			0.42%	0.51%

Global bond yields stabilised post Brexit as the US Fed left policy unchanged, while easing expectations firmed for Japan, UK and Australia. This saw US 2-years rose by 8 basis points and the 10-year fall by 2bps. The positive sloped 2/10 yield curve narrowed by 9bps. The inflation indexed US10-year real yield turned negative at minus 0.04%. Australian 2-year bond yields fell by 8bps, 10-year yields fell by 11bps, and the 2/10 yield curve narrowed by 3bps. The 10-year spread to the US narrowed by 9bps.

Positive medium term outlook for Oil

At Ausbil Investment Management, we have high conviction that the outlook for the oil market will continue to improve markedly over the medium term. The oil price remains on track for an ongoing recovery, with the market balancing in 2H16 then entering deficit in 2017 through a combination of healthy demand growth, accelerating US shale output decline, underinvestment in the wider conventional oil industry and advancing natural field decline.

Demand growth remains healthy

We believe 2015 was the strongest year for demand growth since 2010 at 1.6mmb/d year on year (yoy), which was a dramatic resurgence in oil demand after a sluggish 2014. Low prices are likely to be the key driver of the uptick in demand, although Chinese oil demand also proved resilient despite growing fears of an industrial slowdown. The healthy demand environment is forecast to continue in 2016, with both the International Energy Agency (IEA) and the US Energy Information Administration (EIA) forecasting demand growth for the period at around 1.4mmb/d and a similar level continuing in 2017. Our own view is for another year of above-trend demand growth in 2016 of +1.3mmb/d, somewhat impacted by rising prices and potential macroeconomic fallout from the UK referendum.

While we are positive on the potential take up of electric and hybrid vehicles, in the medium term (before 2020) we are not of the view that there is likely to be a material impact on the oil market. Longer term, this impact will likely accelerate. Wood Mackenzie, a consultancy group, forecasts electric/hybrid vehicles will account for 2-3% of the car fleet in the US, Europe and China by 2025. If correct, this level of take up is expected to reduce global oil demand by a mere 0.35mmb/d in 2025.

OPEC to continue to target market share

While no agreement was reached earlier in the year for OPEC members and Russia to freeze production, it clearly highlighted a willingness to undertake a coordinated constructive policy. It was also a potential indication of the financial stress that low prices were inflicting upon producers. We assume that there will be no intervention from OPEC to support the oil market, instead OPEC members will continue to target market share recovery. OPEC production has increased recently following the recovery in output in Nigeria and increased output from Saudi Arabia to meet the higher seasonal domestic demand profile. While Libya and Nigeria represent a risk of increased production from OPEC, most producers lack the capacity to expand production further, with total OPEC spare capacity of 2mmb/d.

US onshore production decline to accelerate

Earnings results earlier in the year from the listed US shale companies saw announcements of 40-60% capex cuts proposed on average for 2016, which followed on from circa 40% cuts in 2015. These cuts to investment are materialising in a dramatic pullback in US drilling activity. The total number of onshore drill rigs deployed in oil plays in the US declined to a low of 316 earlier in the year, down approximately 80% since reaching a peak of 1609 rigs in early October 2014. Despite this pull back in activity over the last two years, production impacts were modest in 2015 given productivity improvements and the likely high grading of resources. 2016 will see the full impact of the collapse in the US rig count with production currently declining 100kb/d per month. Total US oil production is now down 1 mmb/d or 11.2% yoy due to this reduced Lower 48 (Contiguous US, not including Alaska and Hawaii) production.

We expect US shale production will continue to decline near term despite oil prices recovering from earlier in the year and the rig count turning up modestly. We believe that oil prices will need to strengthen further and sustain higher prices before we see a significant acceleration in drilling activity. Oil prices at these levels are not high enough in our view to stop the decline in US onshore production output.

Capex cuts industry wide to play major part in recovery

The wider global oil industry continues to slash investment. It is estimated that the major global oil companies have cut capex by 44% over 2014-16, which is equivalent to some US$500 billion in gross upstream investment. Just a handful of major upstream projects reached Final Investment Decision (FID) in 2015, totalling 1.3mmboe/d plateau production and we anticipate a similar figure this year. Next year (2017) will be the last reasonable year for conventional longer-cycle start-ups, namely those projects which were sanctioned before the oil correction in 2014. While the market continues to focus on short-cycle investment implications of US Shale, this significant underinvestment in the wider oil industry, when combined with natural field decline of 5-7% pa, compounds supply issues and will result in a significant shortfall in required supply in coming years. We believe that supply issues will be compounded by the requirement for significantly higher and stable oil prices before we start to see any material approval of major projects and even then the supply response from these long-cycle projects is unlikely to occur for many years post the investment decision.

Recovery in price to continue into 2H16

We expect the market to balance in 2H16 and enter deficit in 2017. While 2016 prices may actually average lower than those in 2015 (Brent US$52/bbl) as the market adjusts, prices should exit the year strengthening as the market begins to balance, with further upside risk moving into 2017 and beyond, given the significant underinvestment on the supply side.
We believe the market is significantly underestimating the impact of the longer-cycle industry-wide chronic underinvestment. Ultimately this supports our high conviction that oil markets will enter a material deficit over the medium term and prices will continue to strengthen significantly. We believe a scenario can be presented where oil prices break through US$100/bbl again in periods of heightened volatility. Our base case scenario is for oil prices to increase to an average of US$60/bbl in 2017 and US$70/bbl in 2018. Both years are above consensus and likely to result in ongoing earnings upgrades and ultimately share price outperformance for listed energy companies. Given the Ausbil Investment Process primarily focusses on earnings and earnings re-visions, we have built up a significant overweight position in the Energy sector in a bid to capture any potential outperformance.

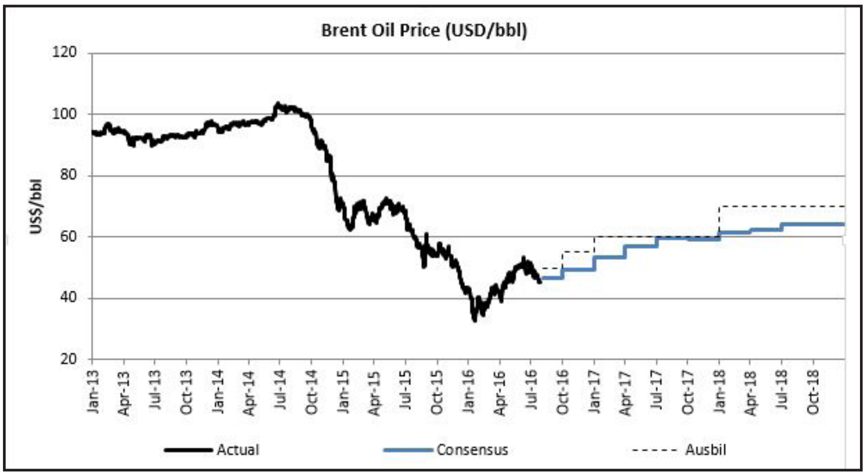

Chart 1: Brent Oil Prices (US$/t) – Actual vs Consensus

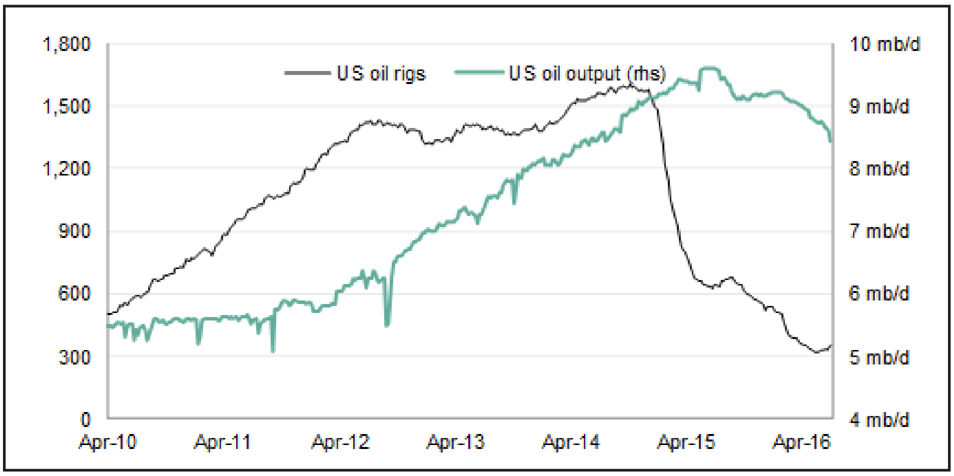

Chart 2: US Onshore Oil rig Count vs US Oil Output

Notes

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