Ausbil Investment Markets

Report

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International economic review

Economic Review

The dominant factor affecting global economies in the June quarter was the lead up to the UK Referendum, which was held on June 23rd, and the volatile aftermath following the unexpected outcome. In Australia, speculation about the Federal Election on July 2nd was also prevalent because of the lengthy eight week campaign.

More than 30 million people voted to decide whether the UK should leave or remain in the European Union (EU) and the Leave vote won by a margin of 52% to 48%. England voted strongly for Leave (53.4% to 46.6%) as did Wales, but Scotland and Northern Ireland both voted to Remain. The EU is an economic and political partnership involving 28 European countries. It began after World War Two to foster economic co-operation, essentially as a way to encourage trading among the nations instead of war.

For the UK to leave the EU, it has to invoke an agreement called Article 50 of the Lisbon Treaty. Prime Minister Cameron's successor will need to decide when to invoke Article 50, which will start the legal process and give the UK two years to negotiate its withdrawal.

The Leave campaigners argued that Britain was being held back by the EU, claiming it imposed too many rules on business and charged exorbitant membership fees for little in return. The Leave vote also had reservations about the 'free movement' of EU members, which means you don't need a visa to go and live in another EU country.

Governor Carney of the Bank of England warned that a vote to leave would likely lead to lower growth and higher inflation for the UK economy. Against these major developments, as risk-off dominated capital flows, global bond yields fell with the German 10 year bund turning negative, the US dollar depreciating and gold surging through US$1,300 per ounce.

After an extended eight-week official campaign period, the Australian Federal Election was held on Saturday July 2nd. It was the first double dissolution election since the 1987 election. No party initially won enough seats in the Australian House of Representatives to form Government. At the time of this report, there was still no clear outcome.

Elsewhere, the US Federal Open Markets Committee (FOMC) meeting on June 15th, left policy unchanged despite last month's re-instatement and Federal Reserve member comments of heightened rate hike expectations for 2016. The statement observed that "the pace of improvement in the labour market has slowed while growth in activity appears to have picked up". Chair Janet Yellen's outlook remains cautious, and rate hikes will be gradual in an environment with global uncertainties in the near term. She said: "I continue to think that the federal funds rate will probably need to rise gradually over time."

United States. The FOMC's June macroeconomic projections were revised lower for real GDP, higher for both headline and core inflation and were unchanged for the unemployment rate. Median projections for the nominal federal funds rate were lowered by a sizeable 30 to 60 basis points. More importantly, the long run equilibrium rate was reduced to 3% from 3.25%. The Atlanta Federal Reserve's real-time GDPNow model (as at June 17th) is estimating Q2 GDP higher at 2.8% from last month's estimate of 2.5%. Private household consumption started Q2 at a solid pace pointing to real consumer spending at a 4% annual rate. May's non-farm payrolls increased by a disappointing 38,000 persons (the lowest since September 2010) versus the consensus estimate of 160,000. The unemployment rate fell to 4.7% from 5% for the wrong reason, as the participation rate fell to 62.6% from 62.8%. The various measures of core inflation are accelerating and signs are pointing to this being sustainable as price rises are becoming 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 and lower commodity prices. Chair Yellen is prepared to accept the low risk that inflation will overshoot the 2% target as unemployment trends lower.

Europe. The European Central Bank (ECB) commenced buying investment grade corporate bonds on June 8th and on the 22nd provided longer term credit at rates as low as negative 0.4%. The ECB left monetary policy unchanged and macroeconomic projections were updated with growth and headline inflation revised higher, while the core inflation rate was lowered. The expansion will be driven by domestic demand on private household consumption, investment and some fiscal easing. The global environment is expected to strengthen gradually, which will support exports particularly

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to the emerging market economies as they recover. The economy sustained a solid pace of growth in Q1, expanding by 0.6%, taking the annual rate to 1.7%. The major regions gained momentum with Spain growing at 0.8%, Germany at 0.7%, France at 0.6% and Italy at 0.3% for the quarter.

China. The MSCI will delay including China A-shares in the MSCI Emerging Markets Index until the next review due in June 2017. The international arbitration court in The Hague will soon rule on a territorial and sovereignty dispute between the Philippines and China. This is over an area covering 3.6 million square kilometres in the South China Sea, including the countries of Vietnam, Malaysia, Brunei and Taiwan. The disputed area is a commercial waterway for a large portion of the world's merchant shipping, in particular, for Japan and South Korea. Economic momentum appears to have stabilised in the month of May following the sharp slowing in the previous month. Fixed asset investment spiked for State owned enterprises and real estate. The property market recovery strengthened further on easing credit standards on mortgage loans and lower borrowing costs. After falling by over US$500 billion in 2015 and US$100 billion in January, foreign exchange reserves have recently stabilised in part due to tighter capital controls. In May this fell by US$28 billion due to the strengthening USD. Securities held in other major currencies fell in value when expressed in USD nominal terms.

Japan. Prime Minister Shinzo Abe announced on June 1st that the consumption tax increase (from 8% to 10%) scheduled for April 2017 would be delayed 2½ years to October 2019. PM Abe also stated that the Government would be implementing comprehensive economic stimulus measures in the second half of 2016. 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. Fitch Ratings agency re-affirmed Japan's credit rating at "A" and revised the outlook to negative from neutral. Fitch cited the delay in the consumption tax hike and a lack of confidence in the authorities' commitment to fiscal consolidation.

The Bank of Japan (BoJ) left policy unchanged ahead of the July 10th Upper House elections. Consequently, the Yen surged against the US dollar. GDP grew 0.5% in the March quarter as private capital expenditure investment was revised higher. In their updated six month outlook the BoJ reduced GDP and inflation projections for 2016 & 2017. The Kumamoto earthquakes in a key manufacturing region, has had a negative effect on production.

Australia. The Reserve Bank of Australia left policy on hold at 1.75% on June 7th with little provided in terms of policy forward guidance. The statement highlighted the near term event risk of Brexit and also rising residential dwelling prices. For foreign investors in residential and commercial real estate, State based additional surcharges including stamp duty and land taxes are being introduced in NSW, Victoria and Queensland. Real GDP for the March quarter 2016 increased by 1.1%, taking the annual rate to 3.1%., boosted by net exports with business investment lagging. The positive contributions were private household consumption on services, public consumption, residential dwellings and net exports at 1.2 percentage points. The negative contribution was in private business investment for the mining sector, as new engineering construction, detracted 0.4 percentage points

The RBA's Statement of Monetary Policy slashed their macro projections for inflation, while leaving unchanged the GDP and unemployment rate forecasts. Underlying inflation was expected to remain around 1–2% over 2016 and to pick up to 1½ - 2½% by mid-2018. The 2016-17 Federal Budget was positioned as an economic plan in the context of the July 2nd Federal Election. Employment is outperforming with the unemployment rate lower at 5.7% and a rising participation rate. Annual employment growth at 2% has returned to its sustainable trend.

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 by 50 basis points in 2016. Should activity and inflationary pressures re-accelerate, then the Federal Reserve 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.

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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 2.6%, just below trend, which is 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 wage inflation at a very low 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 to 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 in 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 remain at 1.75% with a strong easing bias. In August, the next quarterly releases for inflation and wages will determine whether the cash rate would be reduced to 1.5%. Against the backdrop of extremely low core inflation, if the pace of domestic growth was to falter (particularly around a lack of confidence around the Federal Election outcome) and/or nominal wages growth is structurally below 2%, the Reserve Bank of Australia could cut interest rates further to assist the required rebalancing of the economy and return core inflation to target.

Fixed Interest

As measured by the Bloomberg AusBond Government Bond Index (0+ years), the debt market produced a return of 0.20% in the month of June and 2.71% for the year. The (0-5 years) Index returned -0.20% and 0.71% for the year.

2016 **Month end**	US **June**	US **May**	Aus **June**	Aus **May**
2yr	0.58%	0.88%	1.59%	1.67%
10yr	1.47%	1.85%	1.98%	2.30%
2/10 yield curve	0.89%	0.97%	0.40%	0.64%
10yr indexed	0.03%	0.27%		
10yr spread to US			0.51%	0.46%

Global bond yields fell on Brexit fear, and the Federal Reserve leaving policy unchanged and lowering their projections for the cash rate. This saw US 2-years fall by 30 basis points and the 10-year fall by 38bps. The positive sloped 2/10 yield curve narrowed by 8bps. The inflation indexed US10-year real yield rose by 15bps. Australian 2-year bond fell by 8bps, 10-year yields fell by 32bps, and the 2/10 yield curve flattened by 24bps. The 10-year spread to the US widened by 5bps.

UK Referendum

The unexpected UK Referendum result has increased the level of uncertainty and volatility on global markets. Reactions have been swift and generally negative. But any concrete changes to the Law or the ultimate membership of the European Union and the subsequent trading relations within and external to that Union, will probably take considerable time to determine and enact.
Ausbil will take a measured approach to the situation.

The key international policymakers, namely the European Central Bank (ECB) and the Bank of England (BoE) have started to deal with Brexit by releasing substantial additional liquidity into the system, while the US Federal Reserve (Fed) has already stated that the risk of Brexit was one of the reasons for delaying any further interest rate hikes. There is also likely to be a more co-ordinated global effort by Central Banks to ensure liquidity remains sufficiently available.
Nevertheless, the impact will be widespread. In general, we expect global growth forecasts to be lowered and currency, bond, equity and commodity volatility to continue, while Bank funding may also be impacted and consumer sentiment would likely ease. The question is, however, to what extent? And that is impossible to answer accurately at this very early stage. What we do know is that UK growth forecasts will be lowered and therefore global growth expectations will be pared back, the US Fed will keep rates lower for longer and the thirst for yield will continue.

On a positive note, the decline in the value of the British Pound would improve the competitiveness of the UK's exports and may well be the silver lining under the latest developments. We also expect UK interest rates to move lower.

Ideally, the Brexit decision will primarily hand the ability to pass laws and set taxes back to Britain from the European Court of Justice in Luxembourg, while maintaining the overarching benefits of free trade and access to the single market. This, however, remains to be determined. Security, foreign policy and counter-terrorism considerations are also obviously paramount.

Locally, the Reserve Bank of Australia (RBA) has room to move by lowering interest rates to more accommodative levels, while any further depreciation of the Australian Dollar will also provide a buffer against international developments.

Pockets of the Australian share market have actually benefitted from the Brexit–led uncertainty, such as the high yielding domestic telecommunications, infrastructure and utilities stocks, as well as the domestically focussed REITs, while the Gold sector has also been keenly sought. We have been increasing our exposure to high yielding stocks and we have investments in a number of gold stocks across our Portfolio.

The wild gyrations in global markets have had an impact on a small number of UK exposed holdings within the Ausbil Portfolios. Needless to say, we will continue to monitor the entire situation extremely closely and our assessment of each holding may change pending further developments.

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