Ausbil Investment Markets

Report

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International economic review

Economic Review

The US Federal Open Markets Committee (FOMC) April minutes released on May 18th reinstated rate hike expectations, provided key economic conditions are satisfied at the upcoming meetings for 2016. This was a hawkish surprise for markets and subsequent speeches by various Federal Reserve officials reinforced the rate hike message. Chair Janet Yellen told a Harvard University audience “It’s appropriate and I’ve said this in the past, for the Fed to gradually and cautiously increase our overnight interest rate over time. Probably in the coming months such a move would be appropriate.”

Consequently the US dollar appreciated, bond yields rose, gold fell and oil prices pushed higher to US$50 per barrel. Other commodity prices eased with the US dollar strengthening and China’s economic momentum slowed in April. Iron ore prices tested US$70 per tonne before falling back to US$50.

In the **United States**, March quarter GDP grew by a (revised) higher 0.8%, as transitory drags subtracted a total of 1.2 percentage points from the headline GDP number. Residential investment, state and local government and consumer spending were positive contributors, while inventories, exports, federal defence spending and business investment were negative contributors. Real disposable income growth rose to 4%, after rising a revised 3.3% in Q4 and the saving rate rose to 5.7%. The Atlanta Federal Reserve’s real-time GDPNow model (as at May 26th) is estimating Q2 GDP at 2.9%. Non-farm payrolls increased in April by a less-than-expected 160,000 persons. Most of the weakness can be attributed to the wholesale and retail trade sectors, following a robust March quarter. Consumer prices spiked in the month of April, boosted by the 3.4% surge in energy prices. 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. Federal Reserve Chair Yellen is prepared to accept the low risk that inflation will overshoot the 2% target as unemployment trends lower.

In **Europe** the economy sustained a solid pace of growth in Q1, expanding by 0.5% (2.1% quarter annualised). Growth was boosted by an acceleration in domestic demand, while exports slowed significantly. The economy has transitioned from recovery to expansion, with the level of GDP climbing above the pre-GFC peak set in Q1 2008. An expansion driven by domestic demand should drive employment growth, which in turn supports wage growth and consumer confidence. Brexit uncertainty is impacting UK activity, however bookmaker odds currently favour no exit with 75% indicating stay and 25% leave. Bank of England Governor Carney warns that Brexit could lead to a ‘technical recession’.

In **China** the “person of authority” warning regarding high leverage was not intended as an opinion against further stimulus or in favour of tightening policy. Instead the comments were meant to highlight the risks related to excessive credit growth. Economic momentum slowed in the month of April following the previous month’s sharp rebound. The property market recovery strengthened further on easing credit standards on mortgage loans and lower borrowing costs. Foreign exchange reserves rose for the second consecutive month to USD3,219.7 billion, reflecting stricter enforcement of capital controls.

GDP grew 0.4% in the March quarter in **Japan** driven by domestic demand in private household consumption and government spending, public investment and net exports. Private business investment and residential investment were detractors. The Kumamoto earthquakes in a key manufacturing region, is having a negative effect on production. The Bank of Japan (BoJ) defied strong market expectations of an easing move including QE into equities. The BoJ’s April outlook downgraded GDP and inflation projections for 2016 and 2017. However, they remained optimistic that inflation would accelerate towards 2% by 2017. Speculation is building that the planned 2017 consumption tax hike maybe delayed to support GDP and inflation in the near term. Structural reform is required to sustain higher aggregate consumption by both households and the business sectors.

The Reserve Bank of Australia (RBA) reduced rates by 25 basis points to a record low 1.75% on May 3rd. The AUD/USD exchange rate quickly fell to 0.72 cents from the recent high of 0.78. RBA Governor Stevens said the AUD is responding broadly as expected given the current circumstances and highlighted both adherence to, and flexibility within, the 2-3% inflation target,

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stating that it had served the economy well. The meeting minutes released on May 17th revealed no easing bias and suggested that further interest rate cuts will be conditional on (a) continued undershooting of the core inflation rate and (b) re-appreciation of the AUD to the US78 level. Non-tradable prices (a proxy for domestic inflation) is running at 1.7% below the growth rate in nominal wages at 2.1%. Factors driving the rate cut decision highlighted that the inflation outlook had been revised lower, however, the outlook remained unchanged for activity and unemployment. Developments in the housing market were carefully assessed and emphasis was placed on APRA's supervisory measures, which saw strengthening lending standards. The potential risks of lowering interest rates were therefore less than they had been a year earlier.

The RBA's Statement of Monetary Policy slashed its macroeconomic 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 upcoming July 2nd Federal Election. The three key components in the Budget were (1) Government's continual focus on jobs and growth; (2) Fixing problems in the tax system (including significant superannuation reforms and reducing tax avoidance for multinational corporation); and (3) Ensure the Government is living within its means. Employment continued to improve with the unemployment rate consolidating lower at 5.7% accompanied by a rising participation rate. Annual employment growth at 2% has returned to its sustainable trend. The forward looking components of the March quarter private capital expenditure survey expected that non-mining investment intentions for 2016-17 would be slightly higher than in 2015-16.

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 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.

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 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 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 and/or nominal wages growth is 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.

Fixed Interest

As measured by the Bloomberg AusBond Government Bond Index (0+ years), the debt market produced a return of 1.34% in the month of May and 4.89% for the year. The (0-5 years) Index returned 0.65% and 2.88% for the year.

2016 **Month end**	US **May**	US **April**	Aus **May**	Aus **Apr**
2yr	0.88%	0.78%	1.67%	1.86%
10yr	1.85%	1.83%	2.30%	2.52%
2/10 yield curve	0.97%	1.05%	0.64%	0.66%
10yr indexed	0.27%	0.12%		
10yr spread to US			0.46%	0.68%

Global bond yields were range bound until the Federal Reserve reinstated rate hike expectations, which saw US 2-years rise by 10 basis points and the 10-year rise by 2bps. The positive sloped 2/10 yield curve narrowed by 8bps. The inflation indexed US10-year real yield rose by 15bps. The Australian cash rate was reduced by 25bps, 2-year bond yields declined by 19bps, 10-year yields fell by 22bps, and the 2/10 yield curve flattened by 2bps. The 10-year spread to the US narrowed by 20bps.

Market Observer

Banking Challenges

The Australian Banking sector (inclusive of the Regional Banks) is attractive in part because of its valuation metrics and dividend yield, but troubled in other areas where growing margin pressures, rising impairments and increasing capital requirements are making it a difficult investment proposition at present.

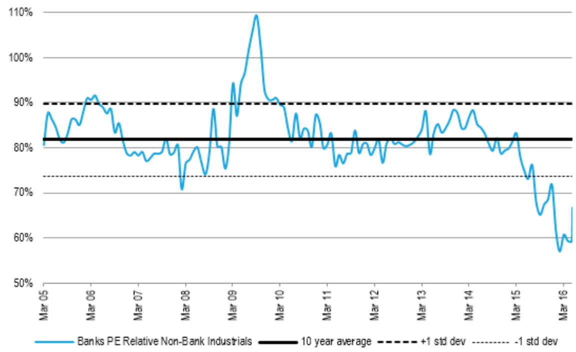
The recent May reporting season was marred by the pressure on earnings forecasts and while credit growth is tracking at a reasonable rate, margins are being impacted by rising funding costs, low interest rates and solid competition. This is, however, being tightly controlled by the management teams at the leading Banks, which have adopted repricing initiatives that are likely to continue for some time.

Within the sector there is also an intense focus on managing costs to deliver productivity gains that can then be used to help fund the necessary investment in technology and competitive positioning.

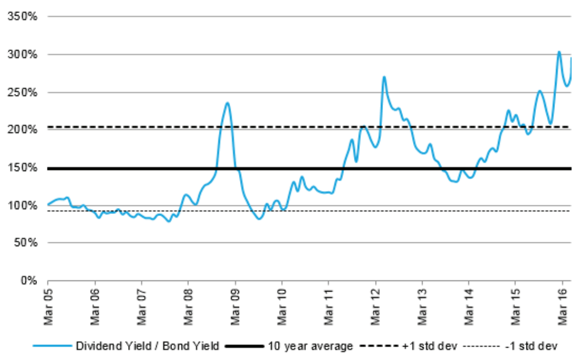
Capital levels were reported as broadly in line with our expectations, and while the trend is clearly rising, the quantum and timing of that outcome is less clear. Impairment charges are also moving up from a cyclically low base and this was exacerbated by the effects of several single name, problem corporate exposures.

In contrast to these issues, the valuation of the Banking sector relative to the 12 month forward PE of the other industrials is at a more than 10 year low, while the 12 month net dividend yield relative to the bond yield is the highest it's been in more than a decade.

12-mth forward PE relative to industrials ex-banks (IBES consensus)



12-mth forward net dividend yield / bond yield (IBES consensus)



At Ausbil Investment Management, we've assessed this problem of appealing valuation and dividend yield versus earnings pressure and moved tactically underweight the sector.

This decision was underpinned by a close examination of valuation support, margin pressure, bad debt expense, capital requirements and dividend sustainability, as well as a review of the concerns about housing prices and potential associated bad debts and the emergent threat of conduct risk.

Our in-depth research has reinforced the view that the Banking sector displays a favourable industry structure with the capacity to respond to the current challenges over time, but in the near term it is difficult to identify a catalyst that will drive a more optimistic earnings outlook.

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