Ausbil Investment Markets

Report

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Economic Review

Sovereign long dated bond yields in the advanced economies rose sharply (prices fell) and yield curves steepened during October. The key driver being Central Bank willingness to let inflation overshoot as economies pushed the limits of sustainable trend growth rates. There was also discussion advocating fiscal stimulus to help sustain the global recovery in growth.

In the **United States** Federal Reserve Chair Janet Yellen is running a 'high pressure economy' to help repair the damage done by the years of sub-par growth since the GFC. The aim would be to boost labour market participation rates and drive the unemployment rate lower, producing an upward drift in wages growth and then inflation. Vice Chair Stanley Fisher also warned that historically low levels of interest rates may threaten financial stability. The conditions fit with expectations for a December rate hike and shallow overall tightening cycle.

The ISM surveys recovered in September and Q3 GDP expanded by 2.9%, the fastest quarterly pace in two years. The Beige Book report saw growth continuing to expand late August to early October at a 'modest to moderate' pace. Activity levels and the outlook continue to improve, while labour market conditions remain 'tight'. The upcoming US Presidential election was viewed as a potential source of economic uncertainty. The core private consumption expenditure deflator, (the Fed's preferred measure of core inflation), accelerated to 1.7% in August, compared to 1.4% a year ago. Diminishing labour market slack, the fading effects of the USD appreciation and declining energy prices will push core and overall PCE inflation up towards 2%.

In **Europe** the European Central Bank (ECB) left monetary policy unchanged and maintained its easing bias, while the QE monthly asset target will remain at €80 billion until March 2017, or beyond, until the ECB sees a sustained adjustment higher in the path of inflation. ECB President Mario Draghi said tapering was not discussed nor the intended horizon of the program, and highlighted that it is "unlikely to abruptly stop bond purchases". Draghi confirmed that the upcoming December meeting would include new staff macro forecasts which should give better guidance on the future path for QE.

In the **UK**, Prime Minister Theresa May is planning to invoke Article 50 of the Lisbon Treaty 2009 by the end of Q1 2017. Consequently a 'flash crash' in Sterling happened on 7 October, where the Financial Times noted comments from French President Francois Hollande, who believed the UK may have opted for a 'hard Brexit' and therefore the EU must follow through on its willingness to leave. Sterling against the USD has fallen 18% since 23 June and 15% against the Euro.

In China Q3 GDP grew 6.7%, matching expectations and in-line with the average pace over first half of 2016. By sector, agriculture grew 3.7% from 6.5% in Q2, manufacturing grew 5.4% from 3.5% in Q2, and services grew 10.9% from 10.6% in Q2. Private investment continues to decelerate growing by a mere 2.5%, while the focus on infrastructure grows, where investment via State owned Enterprises increased by 21.1%. Sharp and rapid gains in property prices has led multiple cities to implement tighter curbs on property purchases. The pace of house price growth (average prices of new homes in 70 Chinese cities) has accelerated to an annual rate of 11.2% in September.

In **Japan**, Former US Federal Reserve Governor Bernanke, commented favourably on the Bank of Japan's new policy framework of Yield Curve Control. Bernanke cited US precedent where "the Federal Reserve targeted long-term yields during and immediately after World War II in an effort to hold down the costs of war finance". The Bank of Japan's (BoJ) action amounts to monetary finance or helicopter money by indefinitely keeping the government's borrowing rate at a fixed price instead of quantity. The aim is to steepen the flat yield curve by targeting the price of the 10- year bond at a 0% yield. The BoJ also committed to over-shooting on the 2% inflation target by expanding the monetary base, without limit.

In **Australia**, the Reserve Bank of Australia Financial Stability Review, concluded that local banks are in good shape, where household-related risks have "lessened a little" since April 2016. Risks have increased for property development, particularly given the

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huge increase in the supply of apartments in Brisbane and Melbourne, and mining-related areas. The re-drafted RBA Statement on the Conduct of Monetary Policy, placed greater emphasis on the degree of 'flexibility' in achieving the inflation target 'over time' subject to the overarching goal of financial stability. These themes were discussed in the speech on Inflation and Monetary Policy by the new Governor, Philip Lowe. He highlighted that "achieving the quickest return of inflation back to 2.5% would be unlikely to be in the public interest if it came at the cost of a weakening of balance sheets and an International economic overview Latitude Insurance Monthly Investment Report October 2016 5 unsustainable build-up of leverage in response to historically low interest rates". In explaining the two interest rate cuts earlier this year, Lowe confirmed that the cuts were not due to low growth, but rather aimed at ensuring that low inflation outcomes did not lead to falling inflation expectations. Employment has slowed with monthly gains averaging 5,600 people for calendar year to September 2016, compared to 24,830 average for 2015. Growth has been in part time with a net loss in full time positions, together with moderate hours worked. Residential building approvals, dwelling commencements and final completions are consolidating at recent cycle highs. The pipeline of residential construction work yet to be completed will remain high for the next two years.

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 fading, 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 25 basis points in December 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 beyond their original design.

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 remain at trend, which is estimated at 2.8%. The lower cash interest rate is providing ongoing support to aggregate demand and the 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 6%. The shift to the 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 workforces, prior to embarking on 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. Given we believe oil prices have bottomed and commodity prices have based, we expect the fair value for the AUD/USD exchange rate to be 0.75 for the remainder of 2016 and average 0.78 for 2017 and average 0.80 for 2018. We expect the record low cash interest rate at 1.50% to stay unchanged for the next two years before gradual rate hikes commence in June 2018. 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 spending are important drivers for growth in the year ahead. Given we believe oil prices have bottomed and that commodity prices have based, we expect the fair value for the AUD/USD exchange rate to be 0.75 for the remainder of 2016 and average 0.78 for 2017 and average 0.80 for 2018. We expect the record low cash interest rate at 1.50% to stay unchanged for the next two years before gradual rate hikes commence in June 2018.

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Fixed Interest

As measured by the Bloomberg AusBond Government Bond Index (0+ years), the debt market produced a return of negative 1.49% in the month of October and positive 4.06% for the year. The (0-5 years) Index returned negative 0.25% and positive 2.39% for the year.

2016 **Month end**	US **Oct**	US **Sept**	Aus **Oct**	Aus **Sept**
2yr	0.84%	0.76%	1.64%	1.55%
10yr	1.83%	1.59%	2.35%	1.91%
2/10 yield curve	0.98%	0.83%	0.70%	0.36%
10yr indexed	0.09%	-0.02%		
10yr spread to US			0.52%	0.31%

Led by the US, advanced economy sovereign long dated bond yields rose sharply (prices fell) and yield curves steepened. The key driver being Central Bank willingness to let inflation overshoot as economies push the limits of sustainable trend growth rates. US 2-year yields closed higher by 8 basis points and the 10-year rose by 24bps. The positive sloped 2/10 yield curve widened by 15bps. The inflation indexed US10-year real yield turned positive again at 0.09% from minus 0.02%. Australian yields move higher with 2-year yield up 9bps, 10-year up 43bps, and the 2/10 yield curve wider by 34bps. The 10-year spread to the US widened by 21bps.

Market Observer

Grain Sector - Rural Awakening

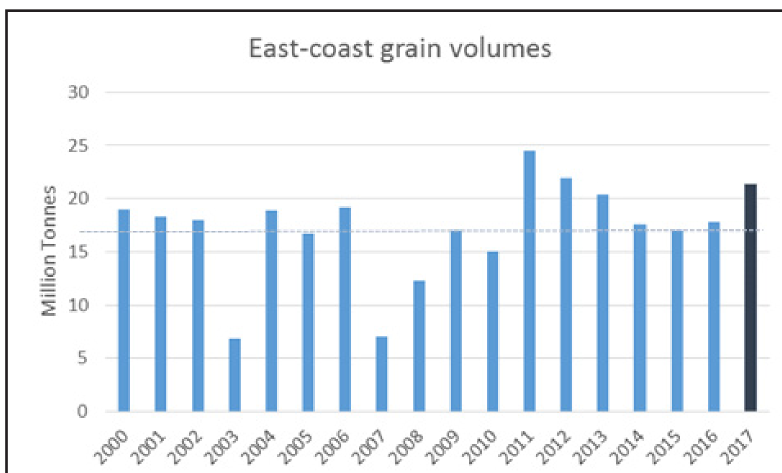
A bumper year ahead?

At Ausbil Investment Management, we believe the near-term outlook for the grain sector is increasingly positive and that participants exposed to grain handling and associated farm-inputs should be beneficiaries from a strong summer grain harvest.

If you have ever tried to grow vegetables in your backyard, you will know that soil moisture, sunlight and a touch of fertiliser are the key factors to success. Large-scale grain farming is no different. In Australia, wheat accounts for the majority of east coast grain volumes and we are most familiar with wheat as the key ingredient to breads and pastas. Barley is another grain used in livestock feed, but it is increasingly diverted to higher value malting, which is used in beer, whisky and other alcoholic beverages. Canola crops are important for their seeds which are crushed into canola cooking oil. Conducive moist conditions in the April-May sowing period resulted in a solid start to the season, while adequate follow up Spring rains also increased expectations for a relatively high yielding crop. Following the initial growth phase, wheat crops typically require a period of dry, warmer weather to foster crop growth. Dry conditions also inhibit fungal diseases and allow for easier access during the upcoming harvest period.

We were initially concerned after seeing news footage of extreme wet weather in some parts of NSW and associated crop damage. In response, we visited the other key growing region in western Victoria to assess first-hand the conditions of the grain crop. We witnessed luscious green wheat and barley, contrasted with the abundant yellow canola fields. We also spoke to a number of the Victorian farmers who have substantial grain crops. They informed us that this could be the best crop on record in Victoria. We suspect that the robust crop yields in Victoria will be enough to offset the unfortunate crop losses seen in NSW from the flooding and associated diseases.

It would appear that forecaster ABARES (Australian Bureau of Agricultural and Resource Economics and Sciences) believes the same, as it recently upgraded its predictions for the east coast grain harvest from 19 million tonnes (mt) to 20mt. ABARES also expects the yield per hectare to be the highest recorded in the past three years and if this occurs, it would be the third largest crop in recent history.



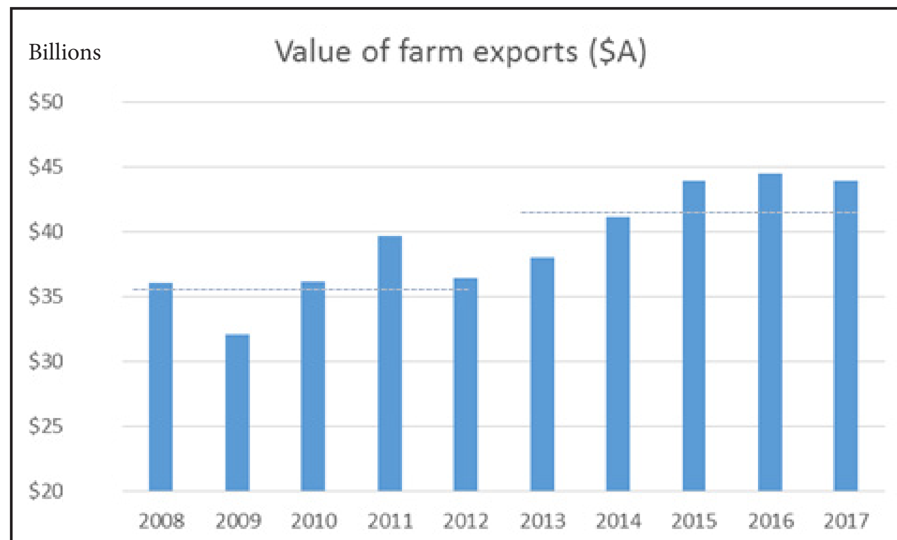
Source: Ausbil & ABARES

Agriculture is supportive of a structural transition away from resources

We know that resources investment has been in decline for a number of years. However, it is often forgotten that the outlook for the Australian agricultural sector has been very robust over this time period.

For the five years to 2017, the average value of farm exports in $A terms, was up over 17% compared to the prior 5 years. High livestock prices have provided a further boost to farmer incomes.

Importantly, the sheer scale of grain volumes currently being harvested and transported is a positive boost to rural employment, farmer incomes and the broader economy.



ABARES expects that earnings from farm exports will remain relatively stable at A$44 billion with the majority of this in the form of export earnings for crops ($23 billion).

While these farming export values are relatively small compared to resources, where iron ore exports alone are close to $50 billion, it nevertheless supports an improving trade balance for Australia.

Combined with the very positive outlook for east coast infrastructure, which is another area we are positive about, the outlook for the Australian economy is improving. The Australian economy is successfully navigating its way through a structural transition as the drivers of growth adjust away from the previous resources boom. We expect real GDP growth to remain at trend, which is estimated at 2.8%. While the lower cash interest rate is providing ongoing support to aggregate demand and the Australian dollar is helping to drive domestic production.

Notes

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