Ausbil Investment Markets

Report

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ausbil

International economic review

Economic Review

During September, OPEC (the Organisation of the Petroleum Exporting Countries) reached an understanding to limit production to between 30 to 32.5 million barrels of oil per day (bpd) from the oil cartel. The target production cut is around 750,000 to 1.2 million bpd, primarily from Saudi Arabia. Further details, however, were scarce and a deal is not expected to be formalised until 30 November in Vienna, Austria. The oil price has settled in the range of US$45-50/barrel (bbl) and following the production cut, should climb to US$50-65 bbl.

Elsewhere, the German government denied a report of contingency planning for the troubled Deutsche Bank as Chancellor Angela Merkel ruled out assistance. A potential fine of US$14 billion from the US Department of Justice following an investigation into the Bank's selling of mortgage-backed securities, led to a loss of market confidence and a plummeting share price.

In the United States the September FOMC meeting left interest rate policy unchanged, despite the strengthening case for hiking rates. Chair Janet Yellen declined to act because the labour market had more room to run as there was no evidence of the economy overheating and the risks were viewed as 'balanced'. The FOMC is waiting for further confirmation that the labour market is near full employment and inflation (using the PCE measure of personal consumption expenditure) is moving toward the 2% target. The FOMC signalled a rate hike would most likely occur in December, since three dissenting voters preferred to raise the target range for the federal funds rate. The last time there was dissent by a Federal Reserve Governor was in 2005. The FOMC lowered its long run equilibrium fed funds rate estimate to 2.9% from 3.0% and the potential GDP growth estimate to 1.8% from 2.0%.

The ISM surveys covering the month of August unexpectedly hit an air pocket from high levels. Sector surveys for both manufacturing and services fell with no clear explanation or identifiable trigger. Something doesn't quite gel as real activity data remains resilient and supportive of the expansion. Q3 GDP is estimated to be 3% with private consumption driving growth, while housing sector starts and sales are back above pre-GFC levels. The labour market remains tight with the unemployment rate unchanged at 4.9%. Annual wage growth has accelerated as the broader employment cost index rose to 2.5% in Q2. Core measures of inflation are accelerating with consumer inflation at 2.3% and the Federal Reserve's preferred private consumption measure, which was at 1.7% in August, is expected to trend higher towards 2.0%.

On 8 September the European Central Bank left monetary policy unchanged, maintained its easing bias and reiterated that quantitative easing would continue to the scheduled end date of March 2017 or beyond. ECB President Mario Draghi revealed that further easing was not discussed at the meeting. ECB staff macroeconomic projections for September were updated with minor adjustments. Real GDP is forecast to be 1.7% in 2016 and 1.6% in 2017 and 2018. Core inflation is expected to rise as excess capacity is reduced and is forecast to average 0.9% in 2016, 1.3% in 2017 and 1.5% in 2018. An expansionary fiscal stance is forecast to provide a positive contribution in 2016 and to turn neutral in 2017 and 2018.

The euro area grew at a slower 0.3% pace in Q2, from the previous 0.5% in Q1. The annual rate rose to 1.6% for the euro area, with Germany growing at 1.8%, France at 1.4% and Spain at 3.2%. The PMI's released since Brexit on 23 June have proven to be resilient in the core countries and the impact from the vote has been negligible to date.

The Bank of England policy meeting on 15 September left rates and QE settings unchanged. The BoE highlighted that the initial impact of the aggressive August rate easing was encouraging, with near-term indicators performing better than expected. The much anticipated 2016 second half slowdown "may be less severe" than first estimated. At Ausbil we believe, Brexit will most likely turn out to be a country specific, rather than a global, economic event.

Economic momentum in China appeared to stabilise two months into the September quarter. Industrial production and retail sales increased. Fixed asset investment slowed as private investment continued to decelerate, while the focus on infrastructure grew.

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The official and private surveys on manufacturing and services are in expansionary territory. The core inflation rate is now above the headline rate for the first time since 2009 as deflationary producer input prices have decelerated to negative 0.8% from the extreme low of negative 6% at the end of 2015.

Monetary policy will remain prudent and flexible as the Peoples Bank of China viewed the earlier Q2 slowdown in credit growth as a temporary phenomenon. As expected, credit loan annual growth in August rebounded and is running at 13.4% (three month moving average) with the narrow measure of M1 money supply surging ahead.

The Bank of Japan conducted a comprehensive review of its unconventional monetary policies and declared that the economy was “no longer in deflation.” Accordingly, the BoJ changed its core monetary policy framework by adopting Yield Curve Control. The spike in long dated government bond yields was in anticipation of the BoJ seeking to steepen the flat yield curve by targeting the 10-year bond at a zero percent yield. The BoJ also committed to over-shooting on its inflation target by expanding the monetary base, without limit, until the consumer price index was above 2% on a sustainable basis. Yield curve targeting marks the beginning of the end of Quantitative Easing (with the focus on asset purchase size and balance sheet size as primary instruments of monetary policy), which other central banks in a similar position (such as the BoE or the ECB) may copy.

Q2 GDP grew to a higher revised figure of 0.2% for the quarter from the first estimate of zero growth. Growth in private consumption and residential investment was offset by the large drag from net exports and private business investment. Most measures of consumer prices turned negative in July, due to the deflationary pressure coming from lower energy input costs and the appreciating yen.

The Reserve Bank of Australia’s Statement on the Conduct of Monetary Policy was re-drafted to cover the appointment of a new Governor, Philip Lowe. The statement placed greater emphasis on the ‘flexibility’ of achieving the inflation target ‘over time’ and elevated the link of ensuring financial stability. Governor Lowe reinforced earlier comments made by Assistant Governor Christopher Kent, who signalled an explicit shift to a neutral policy stance with the cash rate remaining unchanged at 1.5%. Reflecting on the RBA’s forecasts since 2012, the easing cycle was responding to a larger-than-expected decline in mining capital expenditure and subsequently larger-than-expected decline in the terms of trade. The key development in the speech was to highlight “the abatement of those two substantial headwinds” and also to highlight that this “would be a marked change from recent years.”

Real GDP for the June quarter 2016 increased by 0.5%, taking the annual rate to 3.3%. The ongoing drag from mining investment was offset by robust public demand, the inventory cycle, modest boosts from private consumption and housing construction. Real net national disposable income accelerated 0.6% in the quarter to a positive annual rate of 2.3%, representing a significant move into positive territory after being negative for some years. The terms of trade increased 2.3% in the quarter.

Global Outlook

Global monetary policy divergence is in progress as the United States sets about normalising interest rates over the next few 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 other 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 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 intended original time frames. Most advanced economies are oil importers, so the price fall is equivalent to a large 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 at trend, which is estimated at 2.8%. 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 6%. The shift to the labour intensive services sector has more than offset the decline in employment 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 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.

Fixed Interest

As measured by the Bloomberg AusBond Government Bond Index (0+ years), the debt market produced a return of negative 0.31% in the month of September and positive 5.95% for the year. The (0-5 years) Index returned negative 0.10% and positive 2.94% for the year.

2016	US	US	Aus	Aus
Month end	**Sept**	**Aug**	**Sept**	**Aug**
2yr	0.76%	0.81%	1.55%	1.44%
10yr	1.59%	1.58%	1.91%	1.82%
2/10 yield curve	0.83%	0.77%	0.36%	0.39%
10yr indexed	-0.02%	0.11%		
10yr spread to US			0.31%	0.24%

US bond yields initially rose and then closed lower into month-end as the US Fed left rates unchanged. Adding to buying was the flight to safety on fears that global bank Deutsche Bank may be insolvent following a US$14bn damages claim by the US Department of Justice. US 2-years closed lower by 5 basis points and the 10-year rose by 1bps. The positive sloped 2/10 yield curve widened by 6bps. The inflation indexed US10-year real yield turned negative again at minus 0.02%. Meanwhile stronger Australian activity data saw yields move higher. The 2-year bond yields rise by 11bps, 10-year rise by 9bps, and the 2/10 yield curve widened by 3bps. The 10-year spread to the US widened by 7bps.

Retailing on the Rise

At Ausbil Investment Management, we believe the outlook for Australian retailing is looking positive and bodes well for the run into the key Christmas (December 2016) and clearance (January 2017) period. The first half of 2016 was less favourable for retailing with consumer confidence negatively impacted by the prospect and uncertainty of the Federal budget in May, an unprecedented protracted national election campaign and the surprise Brexit outcome. With those events having passed, interest rates at historic lows and a relatively benign, if not positive, macroeconomic environment, Australian retailers looked poised for a relatively strong end to the year.

Online shopping

Online sales growth continues to outpace Australian Bureau of Statistics (ABS) retail growth. Australian consumers spent around $20.6 billion over the 12 months to July 2016, which is equivalent to 7% of spending at traditional 'bricks and mortar' retailers. Australia, however, is still well behind its international peers with the USA estimated at 12% and the UK at 15%, where the highly competitive online retail environment has been driven by innovative retailers such as Amazon.

The Australian currency at around US76c provides a positive backdrop for domestic online retail spending, given the price arbitrage for offshore internet spending is generally uneconomic as it is generally cheaper to buy in Australia than from an overseas website.

Global entrants

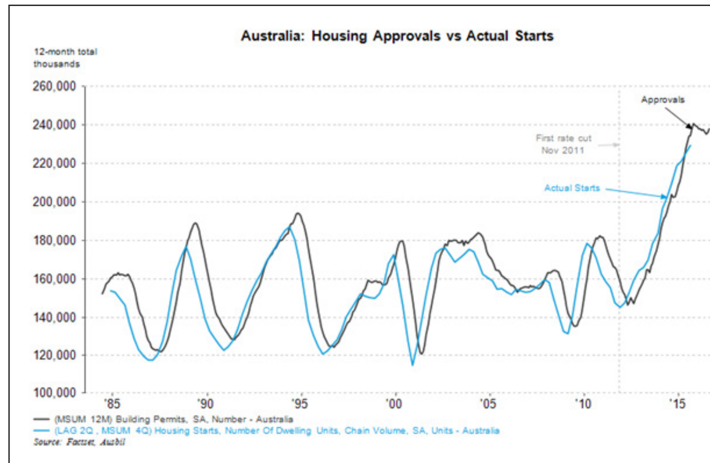
The internet and online shopping facilitated the entry of global brands into the Australian retail market. With increased competition, domestic retailers will continue to face significant challenges. The major International players continue to enter and expand in the Australian market. For example, in the last few years, fast retailing powerhouses Zara, H&M and Uniqlo entered the Australian market with 'bricks and mortar' stores, followed by cosmetics retailer Sephora. Luxury international brands are among the latest wave of global retailers expanding operations in Australia as evidenced by brands such as Cartier, Moncler, Valentino and French luxury giant Kering, which owns brands such as Alexander McQueen, Balenciaga and Gucci.

Economic drivers supporting retail spending

While mining has long been a major driver of Australian economic growth, around 80% of the economy is actually derived from services. The mean reversion in the AUD/USD to circa US76c, coupled with historic low interest rates, has underpinned a rotation back to domestic focused activity, led by housing, tourism and education. In fact, two of the key drivers of the Australian economy, residential construction and population growth, continue to provide support for retail spending.

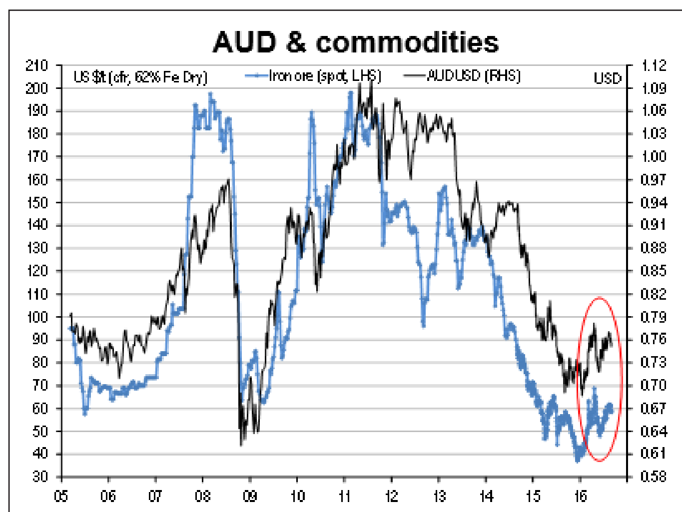
Australian housing market conditions have been responding positively to the reduction in interest rates in recent years. Population growth has also been an important driver of new dwelling construction growth and the refurbishment of existing homes. The number of newly approved dwellings has been above completions for some time, which suggests a continuation of solid housing activity, particularly in New South Wales and Victoria, where population growth is exceeding the national average for the first time in 20 years.

While housing market conditions overall appear to have eased since the previous year, the dwelling construction cycle remains in a strong upswing. Housing prices have risen modestly over the past year and turnover has been below average, which when coupled with supervisory measures that have strengthened lending standards in the housing market, have seen housing credit growth slow over 2016.



Household consumption

Household consumption growth is expected to be maintained around average levels. The Reserve Bank of Australia (RBA) recently noted that lower interest rates can be expected to boost overall consumption, since borrowers benefitted more from low interest rates than the offsetting opportunity cost incurred by depositors. Since the global financial crisis however, borrower households have been likely to use more of an increase in their cash flow to prepay debt with the risk that this might delay the response of consumption spending to lower interest rates.



AUD

The lower exchange rate since 2013 has continued to support activity in the traded sector of the economy. The AUD is at the top of the RBA's fair value range, which is equivalent to being about 5% overvalued.

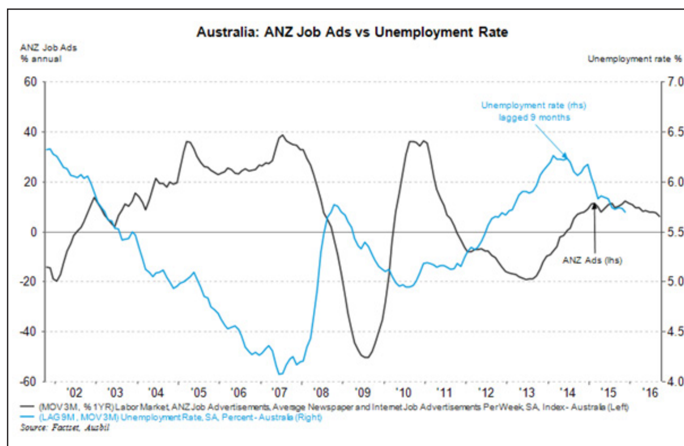
Interest rates

The Reserve Bank of Australia eased monetary policy at its May and August meetings to its current level of 1.5%, which it judges to be consistent with sustainable growth in the Australian economy and achieving its inflation target over time.

Market Observer

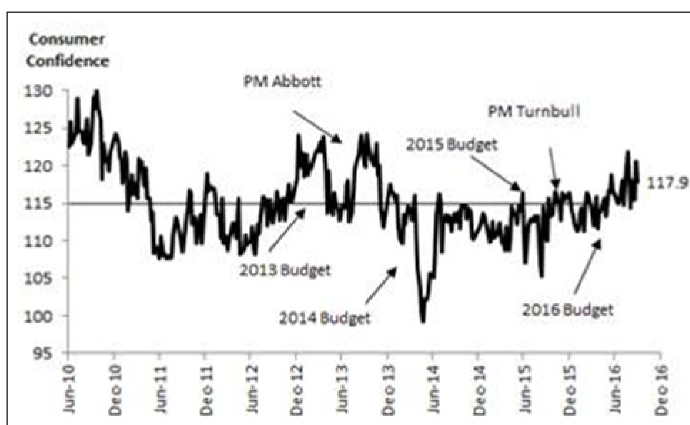
Unemployment and wages growth

The unemployment rate has been little changed at around 5.8% over 2016 and employment growth has been steady at around 2 per cent in year-end terms. Strong growth in part-time employment has been apparent in most states, while full-time employment has fallen in the mining-exposed states. Forward-looking indicators have been consistent with only a slight change in the unemployment rate in coming months. Domestic cost pressures, including wage growth, have remained low and are expected to remain so for some time.



Consumer confidence

One of the more interesting measures of consumer confidence shows the effect politics has on consumer confidence levels. Political uncertainty and perceived harsh budgets, in particular, can cause material changes in consumer confidence levels, which in turn can influence a consumers propensity to spend on discretionary items.



In conclusion, we believe the outlook for the retailing sector during the all-important Christmas and New Year shopping period looks positive as the reigning benign macroeconomic conditions should underpin consumer confidence levels.

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