Ausbil Investment Markets

Report

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International economic review

Economic Review

United States (US) President Donald Trump withdrew the bill to overhaul the health care system due to a lack of support by Republican members. Meanwhile, sentiment surveys for businesses and consumers have surged to “euphoric” levels since the US election, consistent with accelerating activity.

The Federal Reserve (Fed) increased the target federal funds rate by 25 basis points (bps) to 1%. The 2017 median projection for three rate hikes remained unchanged, however, the consensus among the Federal Open Market Committee (FOMC) members was stronger than at the previous December meeting. The statement upgraded the outlook for business investment and emphasised the symmetric nature of the 2% inflation target. This is equivalent to the Bank of Japan’s announcement in Q4 2016, inferring that the Fed may tolerate a period of overshooting the target.

United Kingdom (UK) Prime Minister Theresa May informed the European Council that the UK would be leaving the European Union by triggering Article 50 of the Lisbon Treaty on 29 March 2017.

The **European Central Bank** (ECB) left its monetary policy unchanged. President Mario Draghi noted that the “balance of risk has improved certainly as far as growth is concerned” and “I would say that risks of deflation have largely disappeared.” The staff projections show the outlook for headline inflation has revised significantly upwards for 2017. Producer input prices are inflating and the annual headline inflation rate accelerated to 2%, meeting the ECB’s official target.

The **Peoples Bank of China** conducted mini-rate hikes, raising rates on short-dated lending facilities by a cumulative 20 bps via 10bps increments in February and March. The Government’s work reports delivered at the National Party Congress committed to a 2017 growth target of 6.5% or higher and a US$400 billion infrastructure investment in railways, roads and water as well as building six million apartments for social housing.

The **Bank of Japan** left monetary policy unchanged, repeated its commitment to overshoot the 2% inflation target and maintain yield curve control. Core inflation is likely to reach the target by the end of FY2018. All measures of consumer prices have turned positive and are inflating.

Australia’s major banks conducted out-of-cycle rate increases for investor and owner-occupier mortgages, reflecting the global cost of funds. The Reserve Bank of Australia (RBA) left the official cash rate unchanged at 1.5%, highlighting the growing risk to financial stability as “borrowing for housing by investors has picked up.” The released minutes of its meeting provided a positive global and domestic outlook with rising inflation as the backdrop and the prospect of expansionary fiscal policy. The RBA highlighted “the fact that the recent increases in commodity prices had been supported by a pick-up in global demand raising the possibility that commodity prices could be higher than expected, in which case the flow-through to the domestic economy could be larger than currently forecast.”

Although employment growth has been concentrated in the part-time category, encouragingly full-time positions have been recovering in the past six months. The NAB business survey confirmed conditions and confidence are above their long run averages.

International economic review

Global Outlook

Our investment outlook is based on the reflation trade, where global activity is accelerating, inflation is trending higher, bond yields are rising and nominal cash rates are normalising from emergency levels.

Global growth is in a synchronised upswing, which is accelerating in 2017. The US is expected to expand well beyond trend at a robust 2.3% pace, the Eurozone at 1.8%, Japan at 0.9% and China at 6.5% or higher. We expect the US Federal Reserve to hike rates up to four times this year by a maximum total of 100 basis points.

Australian Economic Outlook

Australia is benefitting from the reflation theme as our terms of trade and national income are moving higher. We expect real GDP growth to be at 2.9% in 2017. Sustainably higher commodity prices, sees the fair value for the AUD/USD exchange rate averaging US78c in 2017 and US80c in 2018. We expect the record low cash rate domestically to increase to 1.75% in November 2017.

International economic review

Fixed Interest

As measured by the Bloomberg AusBond Government Bond Index (0+ years), the debt market produced a return of positive 0.42% in March and 1.65% for the year. The (0-5 years) Index returned positive 0.25% for the month and positive 2.04% for the twelve months.

2017 **Month end**	US **Mar**	US **Feb**	Aus **Mar**	Aus **Feb**
2yr	1.25%	1.26%	1.75%	1.81%
10yr	2.39%	2.39%	2.70%	2.72%
2/10 yield curve	1.13%	1.13%	0.95%	0.92%
10yr indexed	0.40%	0.38%		
10yr spread to US			0.31%	0.33%

Global sovereign bond yields traded in a range in March to close almost unchanged. The US 2-year closed lower at 1.25% and the 10-year unchanged at 2.39%. The positive sloped 2/10 yield curve was unchanged at 113bps. The inflation indexed US10-year real yield inched higher to 0.40% from 0.38%. Australian yields drifted lower with the 2-year down 6bps to 1.75%, 10-year down 2bps to 2.70% and the yield curve widened to 95bps. The 10-year spread to the US narrowed by 2bps to 31bps.

Market observer

Iron Ore Markets

The strength in Iron Ore prices surprised most market commentators during 2016 and was the key driver for the significant level of earnings upgrades for the major Australian producers during the year. Simply put, the key driving forces for the price strength was the combination of stronger than expected demand during a period of weaker than expected supply. Chinese Steel demand growth surprised on the back of Chinese stimulus flowing through to infrastructure and property sectors in particular. This combined with weak supply output in both Western Australia and Brazil provided significant price support.

We expect demand to remain robust during 2017 with Chinese supply side reform providing further support for Iron Ore consumption. At the same time (unlike 2016) we expect supply growth to continue, somewhat incentivised by recent high pricing. With this backdrop, we expect spot Iron Ore prices to moderate from current levels, however, consensus broker forecasts for the commodity remain too low and are likely to continue to drive earnings upgrades for the Australian Iron Ore companies.

Robust demand expected to continue through 2017

We expect commodities demand, and in particular Chinese demand, to remain robust over the course of the year. Recent economic data from China remains encouraging and suggests an ongoing recovery from a steel demand perspective. China is experiencing ongoing broad-based strength in demand in all the key steel consumption industries. Strong demand from infrastructure, machinery and whitegoods continued, and the strength in property sector continues to surprise the market to the upside despite various restrictive policies put in place. We continue to expect ongoing demand benefits to be seen through of follow-through effects on construction activity from infrastructure spending and housing market strength.

Stability targeted in the Chinese economy into the leadership changes later in the year

Over the course of the year we also expect the Chinese government to continue its focus on maintaining stability in the economy. Policy in our view is likely to be supportive of growth into the Communist Party of China's 19th Party Congress towards the end of the year where material senior leadership changes are likely. While reform is likely to be an ongoing focus during the course of the year, stability within the economy is expected to be the government's utmost priority, and as a result growth below 6.5% is unlikely to be tolerated.

Chinese supply side reform to add further to Iron Ore demand

In 2016, the Chinese government singled out the steel and coal industries for capacity reduction and they were the only two sectors with tangible targets, at 45mt and 250mt respectively. The capacity targets appear to be comfortably exceeded, with 65mt steel capacity understood to have been closed last year. For 2017, the government is targeting a further 50mt of steel mill closures. This was in-line with expectations, as part of the 150Mtpa capacity closures due before 2020. These closures are important from the perspective that they increase industry utilisation rates, enhance overall steel mill profitability and simplistically enable higher prices to be paid for raw materials (including Iron Ore).

Additional to these closures, the Chinese government is also targeting the closure of Induction Furnaces. These are unapproved furnaces that melt scrap metal to produce low quality steel as construction products. These closures are required before June 2017 and could represent up to an additional 100Mtpa of capacity reductions. This will shift operating capacity to Blast Furnace steelmaking methods which primarily consume Iron Ore (and coal) rather than scrap metal. The shift in demand as a result could be very material to the Iron Ore market.

Supply growth moderated during 2016

The weak Iron Ore market in the years leading up to 2016, resulted from a combination of weakening demand and strong supply growth. The major producers added roughly 160mt of supply over 2014 and an additional 80-100mt of low-cost supply growth was estimated to have entered the market in 2015. Rolling into 2016, weaker-than-expected supply growth was a contributing factor behind the rally in Iron Ore prices. While 2016 was expected to see material supply growth

continue, Samarco and Roy Hill issues coupled with production downgrades from BHP Billiton and Rio Tinto tightened the market materially relative to expectations; with new supply additions were understood to be only ~30mt.

High prices will see supply growth resume

Weak seasonal Iron Ore supply during the first quarter of 2017, again combined with ongoing strong demand, were the key factors driving Iron Ore prices higher in recent months. This was particularly noticeable for prices of high quality ores which traded at a premium. These seasonal supply issues are likely to resolve themselves near-term and recent high prices are likely to continue to incentivise Chinese and non-traditional suppliers to re-enter the market. This will likely be combined with continued ramp-up in the production of Vale's 90Mtpa S11D project and modest growth from the other majors.

High prices likely to moderate, but consensus broker earnings remains understated

In summary, we expect demand to remain robust with Chinese supply side reform providing further support for consumption. At the same time we expect supply growth to continue, somewhat incentivised by recent high pricing. With this backdrop we expect spot Iron Ore prices to moderate from current levels, however despite this, consensus broker forecasts for the commodity remain too low and are likely to continue to drive earnings upgrades for the major Iron Ore companies (including BHP Billiton, Rio Tinto and Fortescue Metals Group).

Notes

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