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Global economic perspectives
July 2017

A world not yet in sync

European elections in focus

Geopolitical factors continued to dominate much of the market commentary as the second quarter drew to a close. The defeat of far right parties in the Netherlands and France and a swing to the left in the UK election appear to have laid to rest prophesies about the rise of populism taking over the western world which followed the Brexit referendum and the US election. However, we would highlight that overly sweeping generalisations between countries and continents are always too simplistic.

In the UK, where sitting Prime Minister Theresa May overplayed her hand in calling an election three years early, there were factors beyond the Brexit referendum and the decision to leave Europe that impacted the election result. These include a frustration at going to the polls for the third time in three years and disappointment in the Prime Minister's uninspiring campaign run. Next up, in September is the German election as well as the possibility of an early election in Italy.

As we mentioned in our previous update, our view remains that the swing to the populist parties in the far right of European politics was limited to the anti-EU message of the Brexit campaign and is not one that would be repeated, particularly while economic activity is picking up in the Eurozone.

Paris climate agreement

The Trump administration's decision during the quarter to withdraw the US from the Paris climate agreement drew much attention. The Paris agreement was struck in April of 2016 and it came into effect in November of 2016. The removal of the US from the agreement makes them one of only three nations, along with Syria and Nicaragua that have not signed the agreement. Nicaragua, believe the agreement does not do enough to address climate change.

The long-term implications this decision will have on the US and global renewable energy investment is yet to be played out but early indications point to US states going it alone and participating in large scale renewable projects irrespective of the stance of the US Federal Government. It is also worth pointing out that the US cannot withdraw from the agreement before 4 November 2020 which is one day after the 2020 US presidential election.

Until the withdrawal takes effect the US may be obliged to maintain its commitments however there are legal doubts about the enforceability provisions of the agreement.

Greece debt

Another escalation of the Greek debt crisis was averted in early June when the IMF stepped in along with Euro area ministers to allow Greece to make more than €7bn of debt repayments it faces in July. The IMF had been a reluctant participant in a further Greek bailout without reform assurances, noting that the budget surplus targets set by Euro area ministers in 2015 "were punishingly ambitious and unlikely to be met."[1]

Instead, the IMF focused on a primary budget surplus and asked the Greek government to widen its income tax base and cut pensions. The measures, which were adopted in May, are estimated to increase Greece's GDP by approximately 2%. The IMF's participation is key, because its confidence in the path of recovery for the Greek economy is seen as the major stumbling block to be cleared before the ECB will begin buying Greek sovereign debt as part of its stimulus package, something that will have a material impact on the cost of funding for the Greek government.

Moody's downgrades China debt

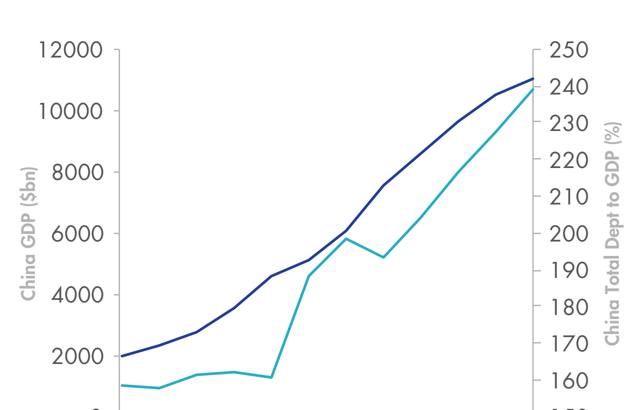
During May, Moody's sounded the alarm bell on the Chinese economy when it downgraded China's credit ratings for the first time in nearly 30 years, casting doubts over the financial strength of the economy. Its major concern is that the strength of the Chinese financial system will erode in coming years as growth slows and debt continues to rise.

The one-notch downgrade in long-term local and foreign currency issuer ratings, to A1 from Aa3, comes as the Chinese Government works to stave off the potential risks posed by a credit fuelled stimulus over the last 6 years aimed at maintaining their target GDP growth rate. "The downgrade reflects Moody's expectation that China's financial strength will erode somewhat over the coming years, with economy-wide debt continuing to rise as potential growth slows," the ratings agency said in a statement, changing its outlook for China from stable to negative.

1 Financial Times, "Greece bailout deal met with relief as default is averted", June 2017

The Chinese Government is well aware of the threats posed by the ballooning debt the country has seen since the end of 2011 and in an effort to maintain the strength of the currency and minimise any potential issues of runaway inflation has been tightening the money supply since early 2016 as evidenced by the month-on-month M2 velocity of money (chart below).

China credit fuelled GDP growth



Source: Bloomberg Intelligence

Tightening money supply

China M2 Money Supply (%)
USD/CNY

China M2 Money Supply — USD/CNY

Source: Bloomberg, People's Bank of China

Amid these concerns the Chinese economy has continued to release positive economic data. The late May official PMI release in China (manufacturing PMI steady and above consensus at 51.2, services PMI rebounding to 54.5 in May) indicated that growth moderation looks manageable for now with clear signs of external support and some domestic rebalancing. The new export orders PMI inched up in May. The PMIs for small and medium companies also showed improvement rising to multi-year highs. These trends create a supportive background for CNY; along with tighter liquidity conditions as factors pushing CNY stronger at the moment.

MSCI includes China A shares in EM Index

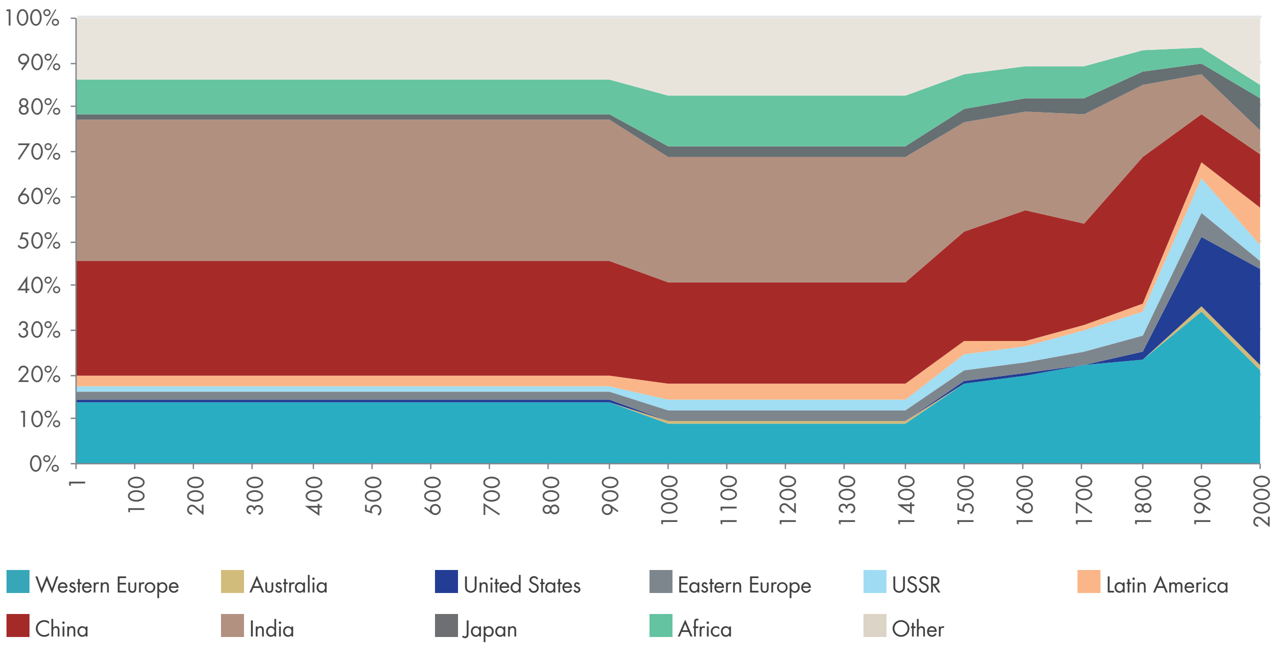
On the 20th of June, MSCI announced plans to add mainland Chinese shares (China A shares) to its benchmark emerging markets index, at a weight of 0.73%. This came after MSCI had previously considered but ultimately decided against adding China due to concerns around transparency in the market place and corporate governance issues. The index giant will add 222 China A large-cap stocks on a gradual basis beginning in May 2018. China is the second largest equity market in the world and the small weight is reflective of the ongoing concerns around market operations.

Our view is that this is an important step for China in becoming the global player in financial markets that it desires to be. The Chinese government has been actively seeking reform initiatives since Xi Jinping took the reins of power in 2012.

The crackdown on corruption that was rife in corporate China has led to the arrest of senior executives from at least 34 Chinese companies during 2015 and early 2016[2]. With the anti-globalist agenda pushed by the Trump Government since being elected in November of 2016, China sees this current US regime as its opportunity to step forward and take its place as the world's dominant power.

It is worth pointing out that the Chinese see this as regaining their rightful place as the largest economy in the world. Research from economist Angus Maddison in 2010 highlighted that on the basis of GDP, China had the world's largest economy from around 1500 AD to 1890, and prior to 1500 China was second only to India on a GDP basis[3]. But the industrial revolution in the US saw the country's economy take off from the early 19th century to become the dominant nation for the entire 20th century.

Gross Domestic Product (GDP) 1 BCE to 2000 BCE



Source: Angus Maddison, University of Groningen; The Economist

2 CNBC, "China's disappearing billionaires – an alarming trend", February 2016

3 The Economist, "Hello America", August 2010

OPEC production cuts put a floor in price of oil

In late May, OPEC countries committed to extend oil production cuts by nine months to March 2018 in an effort to put a floor in the oil price after WTI Crude fell from a six month high of US$57.40 per barrel in early January down to US$46.19 per barrel in early May. Despite the production cuts, oil prices have continued to fall and are now at US$43 per barrel as of writing. We believe despite these falling prices, there are a number of reasons to be optimistic about the direction of the oil price for the remainder of 2017 and into 2018.

1. Supply is falling

While the fall in oil prices (now down 25% from their 2017 high in January) has been pronounced, we believe the headlines about a "widespread oil glut" are missing a long-term secular trend of tighter global oil supplies that are likely to support higher oil prices ahead.

2. Too Much Energy Spent Paying Attention to US Shale

US shale oil production accounts for a little over 5.5 million barrels (Bbl) per day (or just 5.6% of the world's daily total), yet seems to be the main focus of the market. In these past several months, markets seem to have overreacted and driven oil prices down on news of US inventory levels declining less than expected.

3. Global demand growth is remarkably healthy

Given broad expectations of improvements in global GDP, the risk is to consumption on the upside, rather than disappointment on the downside. Global oil demand growth is forecast by the IEA at 1.3 million Bbl/day in 2017. This is in comparison to the average growth of 1.4 million Bbl/day and 1.3 million Bbl/day over the last 5 and 15 years, respectively.

Weak US Dollar supports Gold Price Recovery

The gold price is up over 8.5% year to date as of writing, on the back of global political concerns and US dollar weakness. The US Dollar index is down over 4.5% year to date. Gold came off in May as the risk of a Marine Le Pen-led Eurozone break-up following the French election lessened.

The US Dollar Index fell 2.1% in May and appears to have entered a bearish downtrend since reaching multi-year highs in early January. Economies in Europe and Japan have stabilised recently and the Trump administration has indicated a desire for a weaker US dollar.

Is the US Equity Market Bubble Set to Burst?

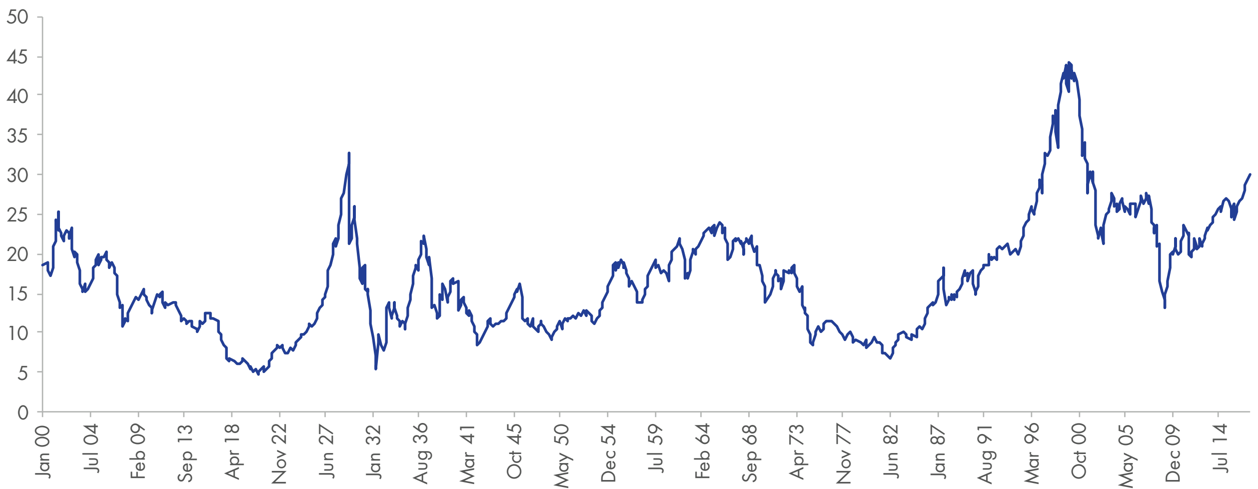
Following the November presidential election the "reflation" or "Trump" trade took the markets by storm. There was a belief that pro-growth policies would ignite animal spirits in the markets that would stimulate business and prosperity. As President Trump has struggled to implement policies and his administration has been dogged by controversy, the Trump trade has unwound. Metals such as copper and iron-ore have given up much, if not all, of their post-election price gains.

Gold has rebounded from its post-election losses. Interest rates have subsided and the US dollar Index has fallen to pre-election levels. The one asset class that appears to still believe in the reflation trade is US equities, which on valuations remain at elevated levels.

The CAPE Shiller Price-to-Earnings measure ended May at 29.52. We have seen US equity valuations at levels beyond this twice before in history, in the lead up to the Great Depression and in the lead up to the Dot-Com Crash.

On a valuations basis, a view that US equity markets are expensive, cannot be argued against. But investing is a relative game. The decision is what can be earned with savings relative to holding that money in cash. In an environment where Government bonds yield close to zero, paying a higher price for US$1 of corporate earnings could be justified. Add to this that stocks can stay disconnected from their average historical valuations for long periods of time and that in the past investors have proved very poor at picking where the top of the market is, all leads us to believe it is foolish to say that now is a time to avoid US equities.

Cyclically Adjusted Price Earnings Ratio (CAPE Shiller Ratio)



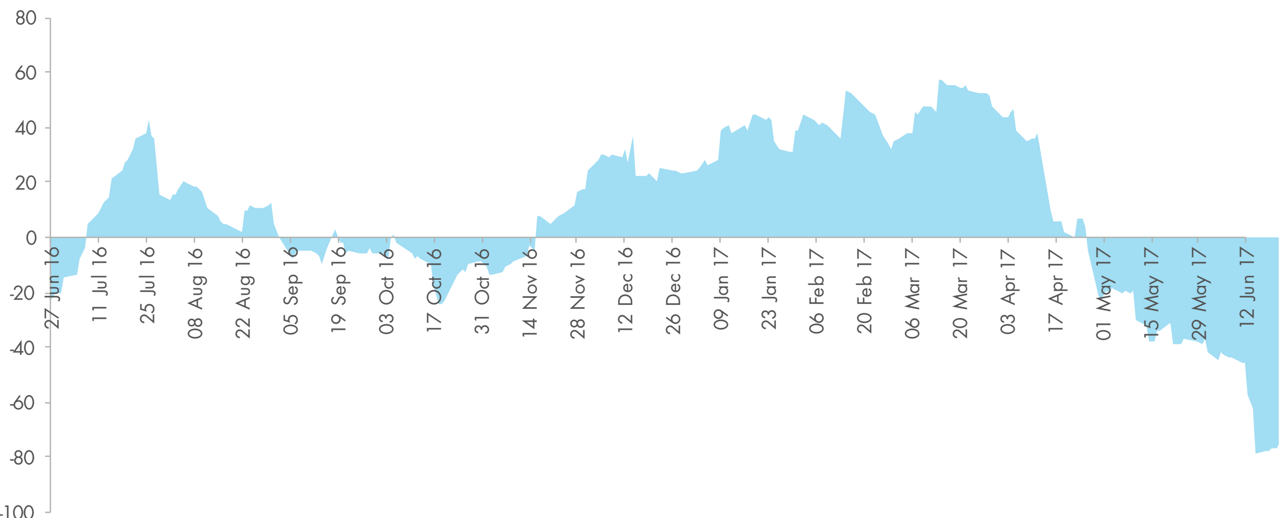
Source: Yale University

The Fed continues to tighten

In the US, a hawkish Federal Reserve seems to be at odds with the flow of economic data being released. As June began, data released indicated that both headline and core inflation continue to moderate in May undershooting consensus at 1.9% and 1.7% year-on-year, respectively. Retail sales were also weak (the year-on-year growth decelerated to 3.8% in May), together with the underwhelming wage statistics, the University of Michigan survey, the labour market conditions index and housing starts all indicating that there are very few upside inflation pressures in the pipeline for now.

The persistent disconnect between the Fed's narrative (hawkish) and the recent data flow (sluggish) supports market expectations of the Fed's staying on hold until March 2018 versus one more hike in 2017 signalled by the Fed "dots". The Citi US Economic Surprise Index, which measures the degree to which economic releases undershoot consensus, has fallen off a cliff since the beginning of April. It is our view that the US Federal reserve is walking a tight line between giving themselves room for monetary easing in the event of the next economic downturn and also putting at risk the current economic recovery at a time when it appears to be running out of steam.

Citi US Economic Surprise Index



Source: Bloomberg, Citigroup Global Markets Inc.

Bear flattening yield curve

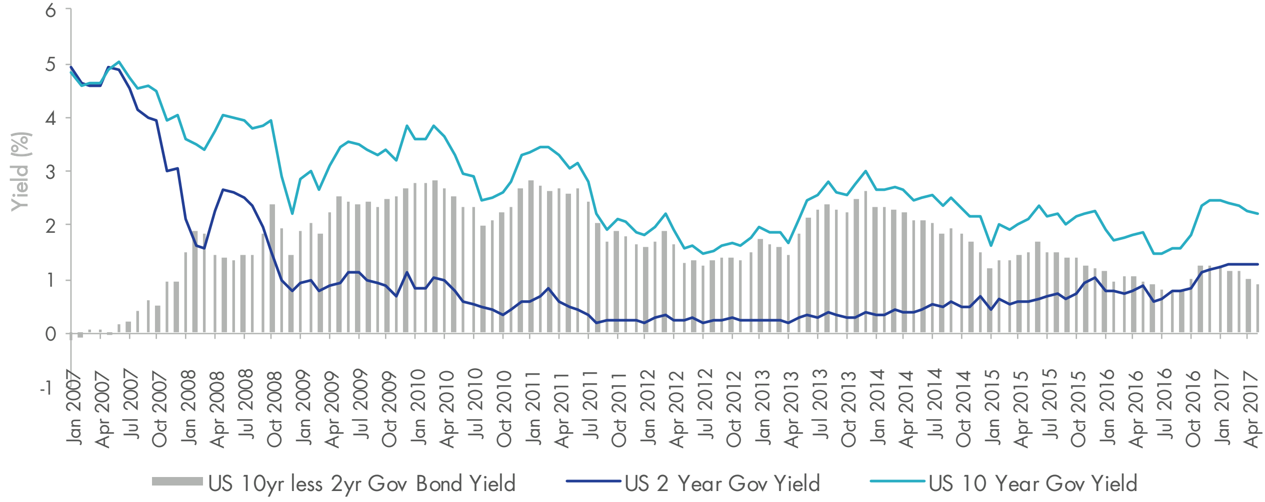
Fed Chairwoman Janet Yellen is an expert at labour market economics, having completed her dissertation titled "Employment, Output and Capital Accumulation in an Open Economy: a disequilibrium approach". At a hearing before the Committee on Banking, Housing and Urban affairs in 2010, then as Vice Chair of the Federal Reserve Board of Governors, Yellen said, "The modern version of the Phillips curve model—**relating movements in inflation to the degree of slack in the economy**—has solid theoretical and empirical support."[4]

This remains the foundation of Yellen's views on the economy and how broad US monetary policy is shaped. Famously dovish, Yellen and the Fed have been increasing the overnight fed funds rate since December 2015 when the Fed funds rate upper bound was raised from 0.25% to 0.50%.

Their belief that the strong employment market in the US will lead to the continuation of a rise in inflation appears to be under threat at present. US personal consumption expenditure, the Fed's preferred measure of inflation, appears to have topped out at 1.79% in January having fallen in the three consecutive months since then.

The greater concern however for those looking at the US economy more broadly is the bear flattening of the forward rate curve. As short term rates are rising, the long end of the curve has been falling, an outcome referred to as "bear flattening". Long term interest rates are reflective of the expectation of future short term rates. If there is a belief that future economic growth will be lower, investors are happier to lock in a lower long-term interest rate.

US 10yr - 2yr Government Yields



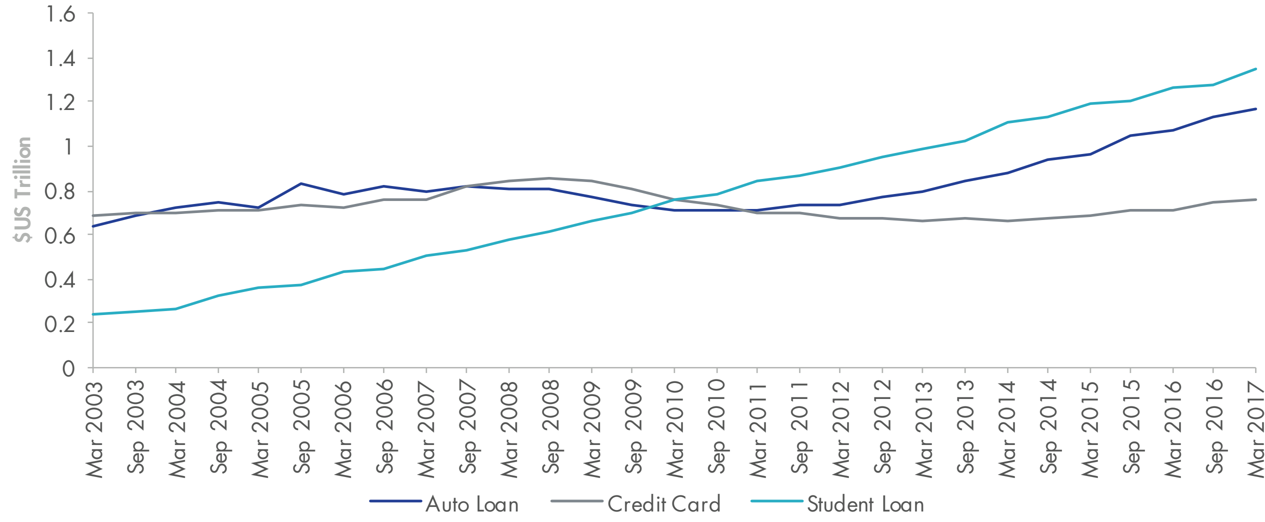
Source: Bloomberg, VanEck

4 U.S. Government Publishing Office, "Nominations of: Janet L. Yellen, Peter A. Diamond, Sarah Bloom Raskin, Osvaldo Lui Gratacos Munet, and Steve A. Linick", July 2010

Subprime US Auto loan bubble

The US auto loan market came into focus during May as fears grew that a version of the 2008 mortgage crisis could repeat itself in the form of subprime auto loans. The US$1.1trillion debt market has seen rising delinquencies since 2015 with the value of vehicle loans delinquent for at least 30 days swelling to US$23.27 billion in December, a 14 % jump from a year earlier[5]. This comes as auto loans have become a larger segment of US household liabilities, up to 9.2% as of December 2016. With wage growth continuing to be stagnant, the rising cost of US auto loans impacting on US household's disposable income we believe is a large reason behind the stalling retail sales numbers.

$US Trillion Debt outstanding



Source: Federal Reserve Bank of New York

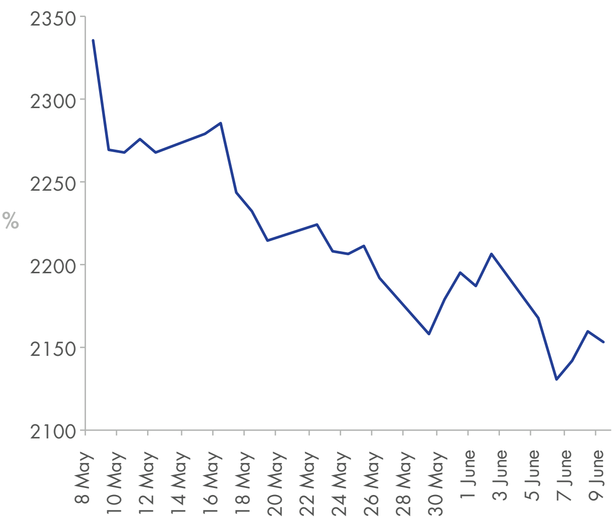
5 Bloomberg Markets, "Why America's Auto Debt Boom Fuels Bubble Talk:Quick Take Q&A", March 2017

Australia Bank levy adds to woes

When the Australian Federal Budget was handed down on May 9th by Treasurer Scott Morrison there was an unexpected penalty awaiting Australia's largest banks. The 0.06% levy imposed by the Federal Government on banks with liabilities greater than A$100 billion, impacting Australia's five biggest banks, CBA, Westpac, ANZ, NAB and Macquarie Bank, is forecast to net the Federal Government $6.2bn in revenue over the next four years.

Since the announcement we have seen a drastic sell-off in banking stocks, with the MVIS Australia Banks Index falling 9% since the announcement. South Australia has just added its own 0.015% levy forecast to raise another $370 million over the same four year period.

MVIS Banks Index 8 May to 9 June 2017



Source Bloomberg: MVIS Banks Index 8 May to 9 June 2017

As soon as the Federal tax was handed down estimates of its impact began to be forecast and the banks reacted with threats to the government that they could not simply absorb this cost and it would have to be passed on to consumers in one way or another. Well, the banks were made to reassess their criticisms of the government when on the 22nd of May further heat was put on the banks by S&P downgrading the debt of every major bank in Australia outside the big 4 and Macquarie by one notch.

This put the banks on notice that they are inexplicably tied to the federal government, as S&P highlighted that the only reason Australia's five largest banks were spared ratings pain was because they had been deemed "too big to fail" which in the view of S&P "offsets the deterioration in these banks stand alone credit profiles[6]"

Despite this view from S&P, the risks to the Big 4 banks stemming from the runaway housing market and rising household debt saw Moody's downgrade the debt of the Big 4 from Aa2 to Aa3 on June 19. This will lead to further pressure on mortgage rates as cheaper funding for the banks rolls off their balance sheet and is replaced by new issuances at this lower credit rating, forcing banks to raise mortgage rates to maintain their net interest margins at a time when Australian household debt to income is at an all-time high.

Big Infrastructure spend

Lost in the focus on housing affordability and the banking tax was the Government's planned investment in infrastructure. Projects announced in the Federal budget, added to existing commitments, takes the total value of infrastructure investment by the Federal Government to $70bn[7]. At a time when borrowing costs are at historic lows for the government, investment in projects that will provide long-term economic benefits makes sense. It has long been our view that this is particularly positive for listed infrastructure companies, with those that can demonstrate a track record of successfully operating large scale assets being able to position themselves as the ideal partner for government investment.

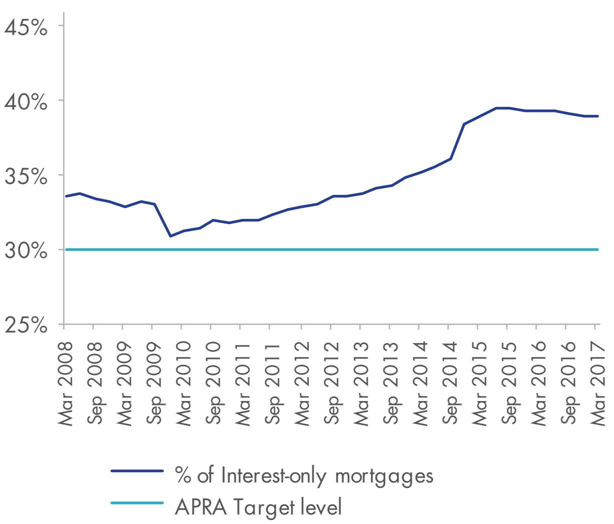
6 ABC News, "Regional bank credit downgrade backs big bank levy", May 2017

7 Budget 2017-18, "Building Australia", May 2017

Housing brakes

In March, APRA released additional macro prudential measures after chairman Wayne Byres said that APRA "views a higher proportion of interest-only lending in the current environment to be indicative of a higher risk profile[8]". The measures were aimed at limiting the flow of new interest-only lending to 30% as well as placing strict limits on the volume of interest only lending at loan-to-value ratios above 80%.

Australia Residential Interest only mortgages



Source: APRA

Following the announcement of these measures, the April Corelogic housing numbers released during May showed falling house prices are now not isolated to Perth and have spread to Melbourne and Sydney. When considering that the level of housing finance debt has continued to rise to its highest ever level, coupled with a lack of wage growth, rising mortgage rates and increased macro prudential restrictions, strong indications are that we have now reached the top of the housing cycle and a slow unwind of the recent rapid appreciation is likely.

The key factor is the Reserve Bank of Australia. If a sharp correction in housing prices occurs, it is hard to believe that the RBA would not step in to cut rates aggressively and work to reduce the slide, given that over 65%[9] of household wealth is tied up in property.

Technical recession avoided

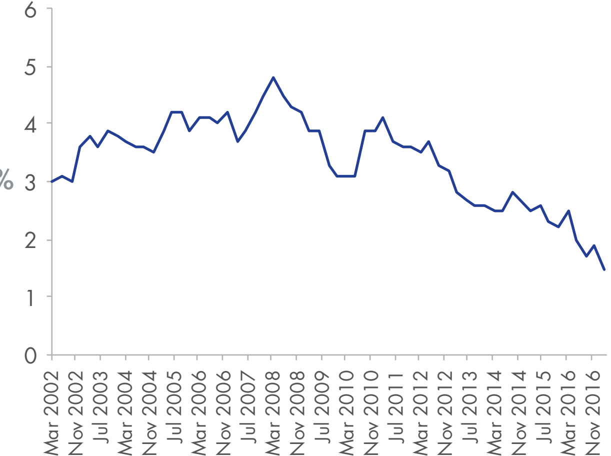
GDP data released in June for the first quarter of 2017 showed that Australia had avoided a technical recession by growing at 0.3% quarter on quarter (QoQ), but only at 1.7% on a year on year (YoY) basis. Australian GDP growth is now at its lowest level since the Global Financial Crisis without a catalyst for reversal being obvious. With the mining boom and subsequent housing construction boom appearing to have run their course, we do not expect second quarter GDP numbers to show a strong rebound.

The Australian dollar looks to be in a vulnerable position heading into FY18 for a number of reasons. The first is that the Reserve Bank of Australia appears now to be the odd man out in the developed world with Central Banks in Europe, UK and the US looking to reduce the level of monetary easing.

The second is that the spread between yield on government bonds between Australia and the US has closed significantly and holders of Australian dollar government debt are no longer earning a premium versus holding US government debt. The heavily discussed AAA rating for the Australian government debt appears safe for now with a potential housing crisis seemingly the only thing that could push the ratings agencies into downgrading the Federal Government.

Despite the strong unemployment numbers released in June, wage growth continues to be non-existent in Australia. As long as this remains the case, inflation levels will remain muted. With the Reserve Bank of Australia remaining uninterested in asset price targeting and focused solely on inflation, the cash rate will remain at the current historically low levels which will see Australian government yields remain low.

Australia Wage Growth YoY



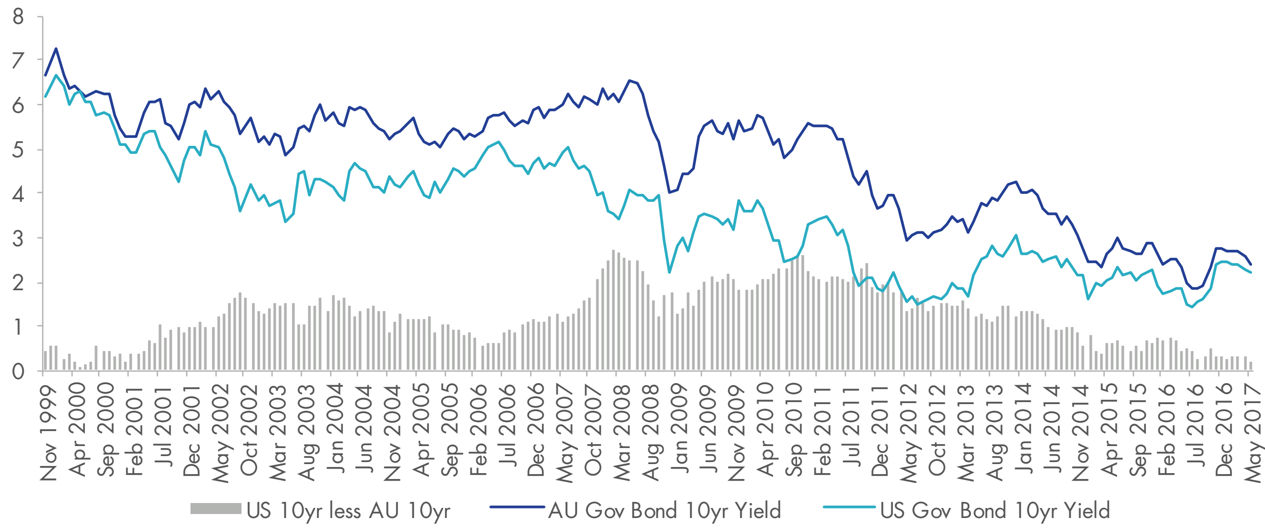
Source: Bloomberg, ABS

8 Australian Financial Review, "Apra strengthens macroprudential rules for banks", March 2017

9 Australian Bureau of Statistics - Household Income and Wealth, Australia, 2013-14

With the US Federal Reserve raising interest rates again this past meeting in June, the short term funding rates in Australia and the US are now inching towards pari passu. With the US dollar continuing to act as the world's reserve currency, short term funding rates on par with AUD will be bearish for the Australian dollar.

US & Australia 10 Year Yields



Source: Bloomberg, VanEck

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