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Global economic perspectives

March 2017

Global recovery gains traction amid political risk

Since the start of the year there has been by a stream of positive macroeconomic indicators. These support our view that the global economy is gradually recovering from its long period of stagnation following the 2008 credit crisis and eventsin the years following.

In the US and Europe, inflation readings and expectations have risen and are now at or about 2% indicating these economies are strengthening. US manufacturing figures have been generally strong, unemployment remains low and there has been an uptick in the US labour force participation rate. The participation rate had been long held as the indicator demonstrating the US labour market wasn't as strong as the unemployment rate suggested so its rise was viewed positively by the market.

Europe has also seen a pickup in manufacturing however unemployment remains at 8.10%, well above that of other developed markets. In China, the US$1 trillion decrease in foreign reserves over the last three years reversed in February, increasing for the first time since June 2014. There has also been a rebound in manufacturing and producer prices indicating stronger export demand. This supports our view that the People's Bank of China (PBoC) has been able to reduce the amount of foreign reserves it needs to sell to support the renminbi.

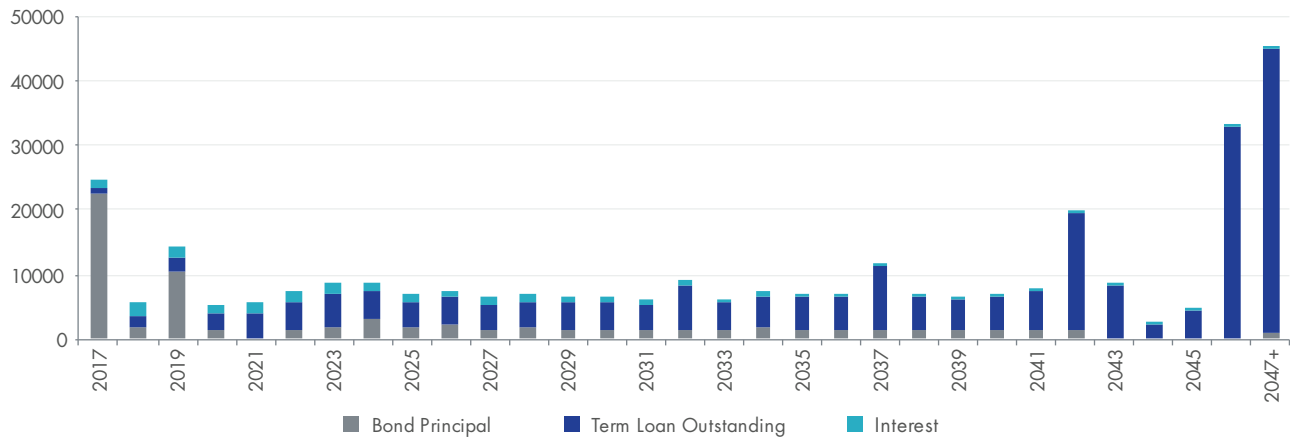
This notwithstanding, the level of foreign reserves should not be the only measure investors watch to review the level of intervention from the PBoC. The PBoC can, and probably does, intervene through other measures such as the overnight repo rate. The overnight repo rate is widely seen now as the de facto policy rate.

In commodities, crude oil prices rose into the mid US$50s per barrel but came under pressure in early March despite production cuts from OPEC countries. There were concerns over the inventories being held by US shale produces which saw the price drop back below US$50 a barrel. We are not surprised by oil's price decline given that markets often experience a period of meaningful profit taking after a strong year of performance as we had in 2016. Memories are short so it may be surprising to recall that oil was US$29 per barrel back in January 2016. Despite recently strong US drilling activity and production, most other macro and industry wide fundamental indicators continue to suggest that supply imbalances remain ahead. We expect that a continuation of steady demand will easily offset today's short term oversupply.

Despite these positive developments, political uncertainty remains the driving force of economic conversation with the impact of policies from the new Trump administration at the forefront of many investor's minds. For now, it appears that the fiscally stimulative tax reform and infrastructure investment that was expected after the election, has taken a back seat to healthcare reform. That has proven problematic, with Trump blaming both Republicans and Democrats for failing to support the first attempt to wind back Obamacare. The result is US markets are looking like retreating from expectations around tax reform and infrastructure which may not now come until late 2017 at the earliest, if at all.

Further complicating the ability of the Trump administration to enact its budget agenda are concerns from within the Republican Party about the US government debt ceiling, with house leader Paul Ryan confessing that any adjustment will not be "clean".

Greek Government outstanding debt maturities

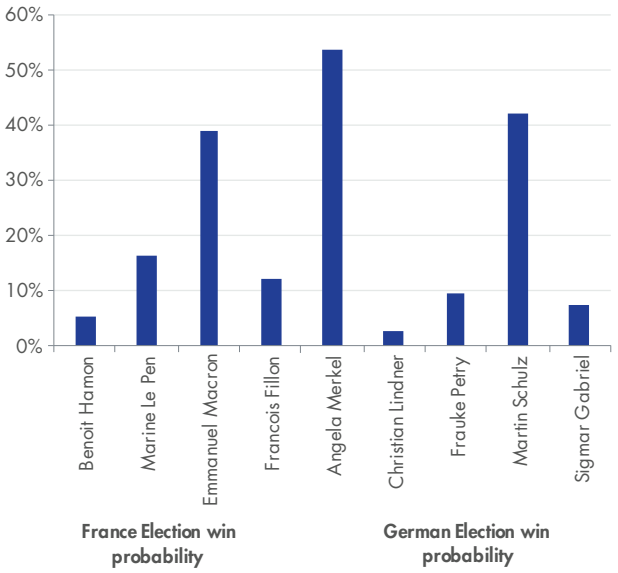


Source: Bloomberg 29 March 2017

In Europe, 2017 could be an inflection point for future of the EU. The Greek debt crisis will rear its head again as around €25bn comes due in 2017 and there are still concerns about the strength of Italian banks after the government bailout of Monte dei Paschi.

Investors will also be watching the upcoming elections in France and Germany to see if there is a continuation of the populist outcomes of the Brexit referendum and US Presidential election. Our belief is that the far right National Front party of Marine Le Pen in France and the Alternative for Germany party of Frauke Petry will be unable to repeat the successes of populist forces in the Brexit and US election outcomes. This primarily comes down to the majority of the population in France and Germany, unlike the UK, being in favour of remaining in the EU.

French & German election probabilities



Source: Bloomberg 29 March 2017

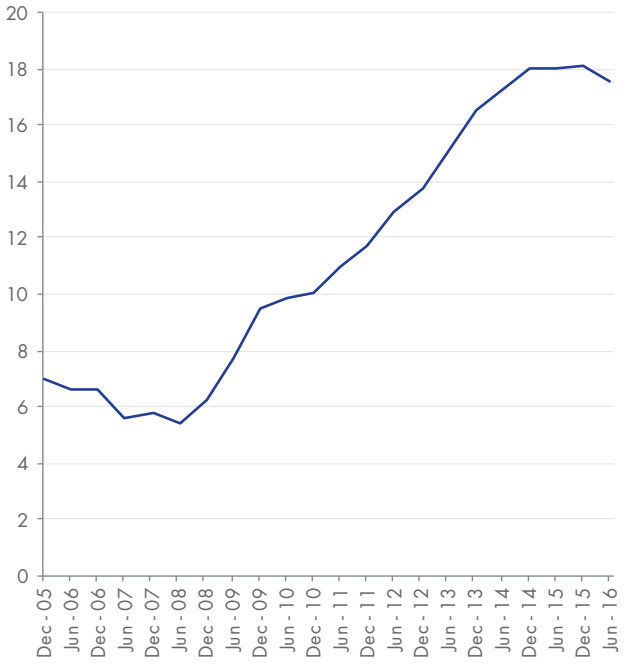
In the Netherlands the debunking of the populist movement materialised in the March election. There were fears of a victory to the far right "Party for Freedom" but it didn't eventuate. The existing centre-right Prime Minister, Mark Rutte, was returned to power, albeit after having appropriated some of the populist viewpoints of the Party for Freedom.

While outright victory for far right parties is unlikely in our view, the result in the Netherlands proved that electoral victory is likely going to require a shift in political policy to the right. This means that populist forces in these countries will continue to influence political policy and agenda over the coming years.

With this view as our base case, we believe the most likely trigger of a breakup of the EU remains Italy. There is certainly less evidence of the recovery in the Eurozone economy in aggregate in terms of Italy's own economic data.

Opinion polls also show declining popular support for the euro in Italy which is only to be expected after so many years of economic stagnation. The potential for a banking crisis in Italy is a significant development to watch for in 2017.

Italian Bank Non Performing loans (%)



Source: IMF Bloomberg, 2005 to 2017

Gold seeking a price catalyst

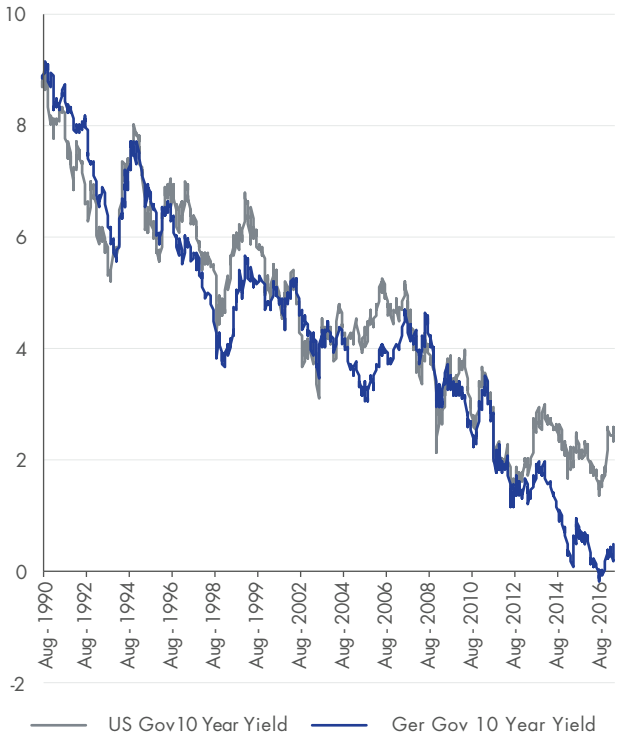
So far in 2017, gold has lacked a catalyst that would move the price significantly higher. We believe such a catalyst is likely, but the source and timing are impossible to predict. In the coming months or years, it is our opinion, that a geopolitical, economic, or financial event that motivates investors to seek safe haven investments is likely.

Given the easy monetary policies globally, recent expectations for growth and the potential for trade protectionism, we understand those who see inflation as the next gold catalyst. The popular reflation theme relies on growth and government spending that may not be as strong as expected, as we have already seen the difficulties President Trump may face passing his agenda through Congress. It is for this reason we believe the catalyst for a move higher in gold is more likely to be geopolitical instability than inflation.

All eyes on the Fed

European yields have climbed with 10-year French and German bond yields increasing over 50% and over 100%, respectively so far in 2017. At the same time US 10-year yields have remained relatively flat.

US versus German 10 year yields



Source: Bloomberg, 1990 to 2017

The market in the US appears to still be waiting to determine if President Trump can achieve the pro-growth tax reforms and fiscal programs promised during his campaign. Infrastructure spending which was such a large part of the pre-election rhetoric, has not received much attention in the administration's busy first weeks and was not even mentioned in the President's inaugural speech. Investors now believe that the promised investment could come in the form of tax cuts as part of a broader tax policy.

How much of a multiplier effect this will have on broader economic growth is debatable but given the economy is already operating at or near full capacity the stimulating effect of direct fiscal investment may have an overwhelming inflationary impact. All this has given Federal Reserve Chair Janet Yellen enough scope for the gradual monetary tightening that has been forecast for the past 24 months.

The market appeared convinced in January and early February that the Fed would keep rates on hold until the middle of the year. A pickup in macroeconomic data out of the US in the middle of February, particularly when a string of strong data came out beating expectations, reversed this. There were positive small business surveys, lower than expected initial jobless claims, an increase in housing starts and building permits, and the Philadelphia Federal Reserve business outlook survey reached levels not seen since the start of the global financial crisis.

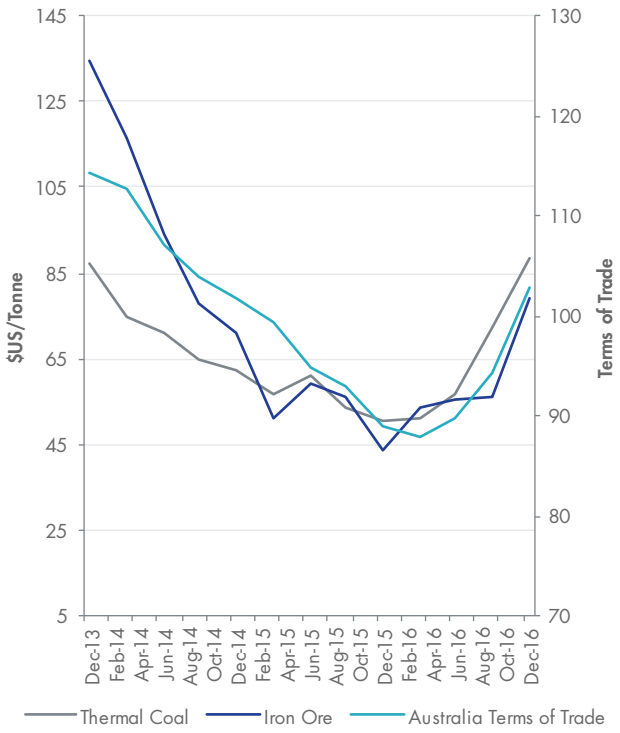
These all gave the Federal Reserve enough confidence that, having reached its employment targets, inflation was close enough to its target band to justify another rate rise. The most recent rise notwithstanding, the Fed has maintained the notion that a slow, gradual normalisation is likely. As we go to print, the market is pricing in another 0.50% in interest rate rises during 2017. Although there are expectations of two or three rate hikes this year, a couple of dynamics bear watching.

Firstly, no one knows if Trump will stand by quietly as Yellen tightens rates, which could slow down growth and strengthen the US dollar. With two open seats remaining on the FOMC, Trump has the ability to fill the vacancies with members who are going to be sympathetic to his views on the US dollar. Secondly, it is unclear what the Fed will do with its massive mortgage backed securities and treasury portfolios and what will the impact be on market yields if it stops reinvesting principal payments.

Australian terms of trade improves

The Australian economy avoided slipping into a technical recession in Q4 of 2016 with GDP growing at 1.1% quarter on quarter, rebounding from the 0.5% decrease in the third quarter. The rebound in growth was predominantly due to a rebound in commodity prices, with the price of thermal coal and iron ore up 22% and 41% respectively for the quarter. This improved export conditions for Australian miners and also saw Australia's terms of trade improve by over 9% for the quarter. However, we believe the surge in commodity prices to be unsustainable, particularly given the previously mentioned slowdown in the growth rate of the Chinese economy.

Terms of trade and key commodity prices



Source: Bloomberg, 2013 to 2017

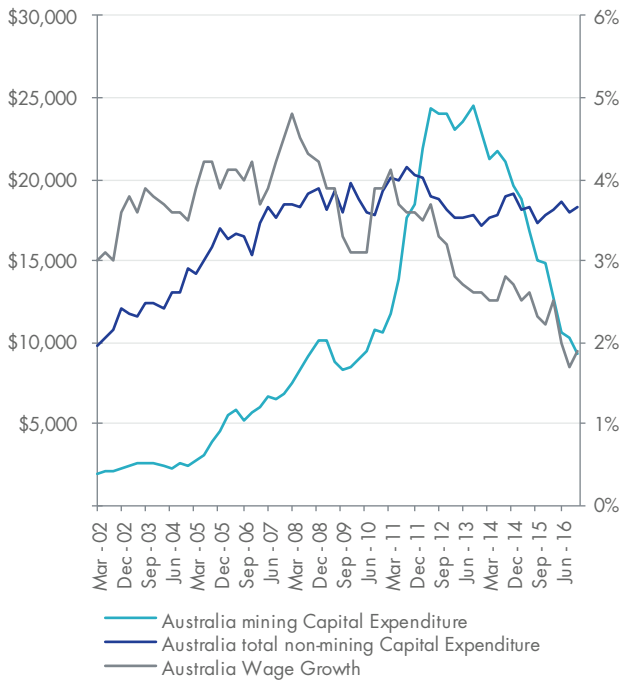
While wage growth increased slightly in the fourth quarter it remains at historic lows. With excess capacity remaining in the labour market, the ability of employees to drive wages higher appears to be non-existent. This is because with unemployment hovering around 5.7% the Australian economy is not operating at full employment. Since September 2015 the Australian unemployment rate has come in at 5.8%, 5.8%, 5.73%, 5.67%, and 5.7% for each repsective quarter.

There has also been a slowdown in construction spending, the great economic driver since the end of the resources boom. Factoring in a reduced growth rate of the Chinese economy and the transitioning of Australia towards an innovative, services led economy the real GDP growth of 3% which the Federal Government hopes for, we believe, still remains a few years away.

The earnings reported by S&P/ASX 200 companies during February 2017 were generally better than expected. This was mainly due to strong earnings growth, particularly from the miners that benefitted from resurgent commodity prices in 2H 2016. Of the companies in the S&P/ASX 200 reporting earnings, average EPS was up by 19% and aggregate dividends rose by 6.7%. Aggregate cash rose 12% from June 2016 levels. The question now is when are companies going to turn positive earnings results into investment?

Both mining and non-mining capital investments remain below their pre-GFC levels. Despite the recent windfall for mining companies we think it is likely that these companies will use this opportunity to shore up their balance sheets rather than pour money into capital investment. Without capital investment into new mining projects it is not likely there will be a drop in the unemployment rate. This will keep wage growth at the historic lows mentioned above.

Australia Capital Investment and Wages



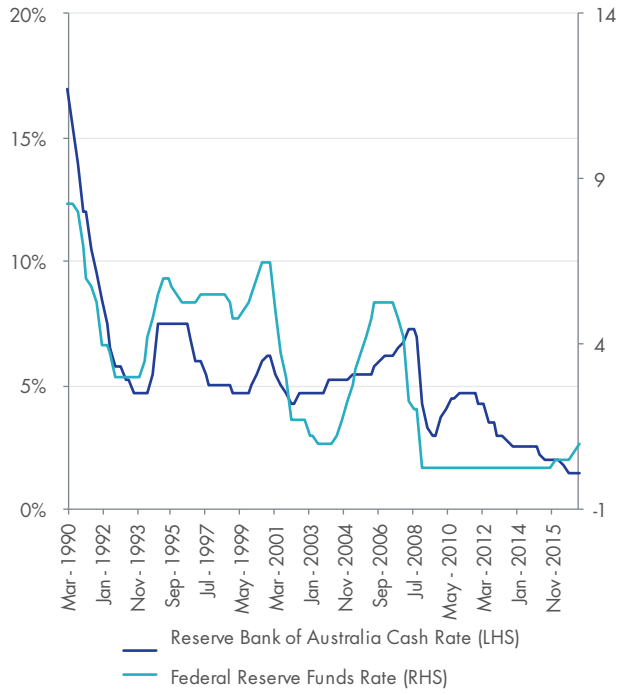
Source: Bloomberg, 2013 to 2017

Rate divergence to take the steam out of housing

With the growth rate of the Chinese economy expected to continue to slow during 2017, the possibility of Australia being able to "import" inflation in the form of increased foreign demand appears to be limited. This points to inflation in Australia remaining below the RBA target inflation band of 2 to 3% and the next interest rate move being a cut rather than an increase.

This monetary policy divergence with the US is historically unusual and should help take some of the air out of the Australian dollar which has remained stubbornly high, making the job of Australian exporters more difficult.

US & Australia benchmark cash rate divergence:



Source: Bloomberg, 1990 to 2017

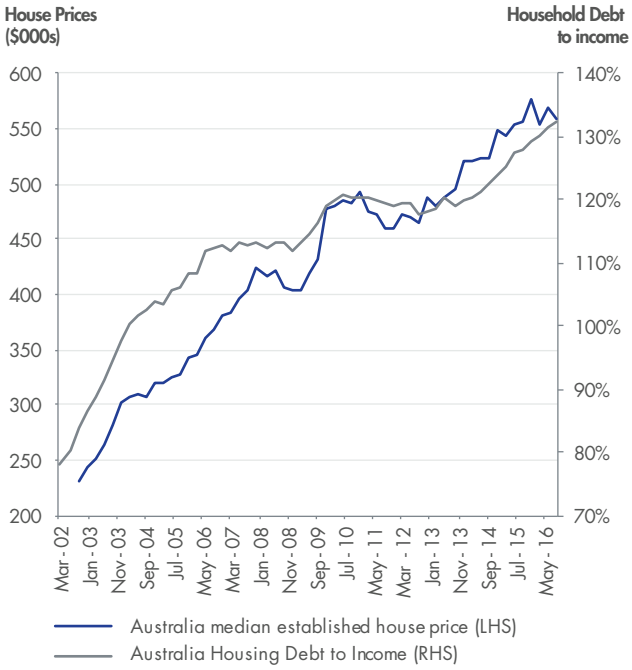
The conventional wisdom is that RBA rate cuts are good news for Australian households, whose debt to income is at an all-time high. However, we have already seen NAB, CBA, Macquarie and Westpac raise their mortgage rates without an RBA rate hike, therefore the RBA cash rate is no longer the sole determinant of mortgage rates. These rises are arguably due to wholesale funding costs increasing. Wholesale funding refers to short-term and long-term debt banks obtain to fund operations outside of deposits and equity.

Australian banks have previously benefited from increasingly lower funding costs as rates have gone down globally. However in July 2016 we saw the bottoming of the 30 year bull market in US treasury yields, effectively the global benchmark in setting rates. As yields rise this cost is reflected in new funding leading to wholesale funding costs increasing.

The RBA has noted that wholesale funding costs, which makes up approximately 30% of bank funding, has been rising for Australian banks since September 2016. Offshore wholesale funding makes up approximately 20% of the total funding provided to Australian banks. At a time when Australian households are carrying more housing debt than at any other time in history, we believe the cost of servicing this debt is going to start going up.

This leads us to believe that the 'housing bubble' is the greatest risk facing the Australian economy and the Australian share market. The median price for an established house in Australia's capital cities has risen over 127% since 2011. At the same time Australian housing debt has gone from 78% of income to 132% of income. Figures from the ABS released in March for the December quarter showed an average 4 per cent gain in overall dwelling prices, the fastest pace in five years.

Australian Median house prices



Source: Bloomberg, ABS, 2002 to 2017

The S&P/ASX 200 is wedded to the strength of its big four banks, who's combined market capitalisation make up approximately 30% of the S&P/ASX total market capitalisation. Housing lending makes up 54% of the assets on the balance sheets of the big four banks, making them vulnerable to a shock in house prices.

While there exists differences in geographic locations, it is likely that any sharp drop in house prices, particularly in Sydney or Melbourne, would spread to other parts of the country. We have already seen a drop in the median house price in Perth from its 2015 peak and the glut of supply in apartments coming online in Melbourne and Brisbane in 2017 has raised fears over the possibility of a sharp correction in those segments.

The big four domestic banks, along with the RBA, APRA, ASIC and Treasury are aware of the risks posed by runaway house prices and a possible popping of the bubble. The issue is whether there exists the political desire to make meaningful changes that would reduce the value of home prices. This is difficult given so much of the wealth of Australian voters is tied up in the value of property.

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- **vaneck.com.au**
- **02 8038 3300**
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