

A QUESTION OF EMPLOYMENT AND INFLATION

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Global markets have continued to be challenged by both economic and geopolitical events in the past few months. Inflation and employment data are universal concerns for central banks in determining policy - be it the US considering timing for an increase in the official cash rate or Australia evaluating the need for further rate cuts.

AUSTRALIA

The Reserve Bank of Australia (RBA) maintained its hold on the official cash rate in October and November citing moderate expansion in the economy. This view is supported by stronger employment growth and a steady rate of unemployment over the last year. Statements from the RBA indicate that rates are likely to continue to remain at current levels going forward, unless there is a shock to the global system or signs of a more protracted slowdown in global demand.

US

There are indications that the US Federal Reserve (Fed) would like to increase rates at the scheduled December Federal Open Market Committee meeting but this is dependent on a number of factors. While the Fed has met its mandated unemployment target, it is far from meeting its inflation target of 2% with annual CPI posting zero or flat growth in September.

JAPAN

The Bank of Japan (BOJ) is under pressure to intensify efforts to support its economy. The unemployment rate has stayed steady, drifting between 3.25% and 3.5% since the start of the year but latest annual CPI data recorded zero annual prices growth and annualised GDP growth declined by 1.2%.

EUROZONE

The Eurozone continues to be challenged by low inflation, but unlike Australia, the US and Japan, also faces an elevated unemployment rate. While latest reports saw unemployment decline by 0.1% to 10.9%, an aggregate number is not a complete picture with peripheral nations like Spain and Greece facing

unemployment rates of 20% and youth unemployment at least double this.

UK

While final estimates of GDP from July indicated annual growth of 2.4%, the UK faced an unforeseen collapse of 0.8% in its manufacturing production report suggesting that recovery is being driven by consumer spending. This is also reflected in the current account deficit of 5.5% of GDP. As a result, it looks unlikely the official cash rate will increase before 2017.

CHINA

Releases from September indicated that the elevated volatility seen in previous months has started to decrease. Data suggested that the recent string of weak PMI readings had levelled off and were likely to improve due to the imminent government stimulus initiatives.



TIM

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What are the drivers of employment growth in Australia?

Employment growth has benefited from a shift towards the services sector and declining wages growth. The lower wages growth may have encouraged employers to employ more workers for a lower rate than may have been possible previously. While there has been an increase in labour supply, this has been offset by increased demand and has meant unemployment has remained stable at 6-6.25% over the past year.

The increase in demand in the services sector has been driven by a number of factors such as increasing demand for aged and home-based care services and recovery in the tourism sector due to a decline in the Australian dollar.

Will the Fed raise the official cash rate in December?

The Fed have reinforced that any increase in the official cash rate is data dependent. At this point, it is meeting its employment targets but not its inflation targets. Statements indicate that the Fed believes in an inverse relationship between unemployment and inflation which would mean that current low levels of unemployment (and in turn decreasing supply of available workers) would lead to increased wages growth. This would finally lead to a pickup in inflation. Added to this, the Fed is becoming concerned over the potential damage that the low cash rate may have to financial markets so it is looking increasingly likely that rates may increase in December.

What is the impact of an increase in the US official cash rate to emerging markets?

Emerging market corporate entities have borrowed extensively in US dollars on the expectation their home currencies would strengthen against the US dollar. This activity can be compared to that in the lead up to the Asian financial crisis in the 1990s where government debt of many emerging markets was denominated in US dollars. In turn, when the US increased interest rates, many currencies plummeted against the US dollar and in turn, many debt repayments failed.

Though the situation is somewhat different in this case as it faces corporations rather than government, many corporate entities will face challenges from the US overexposure if interest rates rise, even gradually. Many of these entities may face bankruptcy and create further challenges within their home countries.

What is influencing inflation levels in the UK?

Reports in September showed 12 month CPI inflation at -0.1% with much of this reflected in falls in energy prices, food and other imported goods prices. Inflation has been negatively impacted by increases in the sterling exchange rate, low world export prices and demand, and increases in domestic cost growth. This is buffered by robust private domestic demand and an anticipated pickup in wages growth due to growth in productivity.

How is China managing its slowdown?

Though some slowdown in China was inevitable given the most aggressive phases of its development are complete, the Chinese government has implemented a number of measures to ensure ongoing measured growth. The government acted to stabilise the share market earlier in the year and depreciated its currency to offer short- and medium-term support but also acted on more long-term measures. It changed local government financing rules to support infrastructure funding, fast tracked a number of large-scale infrastructure projects and decreased benchmark interest rates to reduce financing costs and support lending.

It also looked at measures specific to the housing and auto markets. This included relaxing restrictions on home purchases to reduce deposits for first home buyers to 25% from 30% and lifting restrictions on foreign purchases on Chinese property, while supporting the auto market by reducing the sales tax on small cars. As these measures start to take effect, there should be noticeable support for the economy in 2016.

What does this mean for investment strategies?

Inflation is likely to continue to remain low globally. Easy monetary policy will continue to manage the problem for most countries. This will offer continued support for most asset classes, such as property that benefits from the low cost of investment. Government policies in China should see some recovery which will alleviate some of the market volatility that it has driven in share markets.

If the US does increase its official cash rates in December, this will create some short-term volatility in markets, particularly fixed interest but also equity markets given the exposure of emerging market corporations to the US dollar.

The ongoing uncertainty in markets offers opportunities for investors and we have been adding to growth assets in our portfolios as these opportunities arise. We are also monitoring market developments closely to continue to adjust the portfolios as market conditions require to preserve and grow investors' money.

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