# Watching the signs

April 2016

## There have been indications of growth for some economies while others continue to face challenges in managing deflation. Of these, there were encouraging signs Chinese stimulus measures may be having an impact while most US economic data suggested a positive outlook for growth. On the reverse, the Eurozone announced new stimulus measures and data suggested weakness in Japan.

### Australia

The Reserve Bank of Australia's (RBA) decision to keep interest rates on hold in its 5 April meeting was supported by mixed activity in the Australian economy. Consumption has slowed with retail sales data weaker than expected and jobs growth slowed sharply to 2.1% y/y in February from 2.9% y/y in November last year. By contrast, business sentiment remains reasonably positive with the NAB Monthly Business Survey for February showing a strong increase in capital expenditure for firms and a rebound in conditions for mining and wholesale businesses.

### US

The US Federal Reserve (Fed) March Federal Open Markets Committee (FOMC) meeting was a key focus last month with the decision to maintain current rates and policy. Most economic data released since the meeting has been positive for the US growth outlook, with the manufacturing Institute for Supply Management (ISM) survey indicating the sector expanded in March above expectations. This was also true of the non-farm payrolls report (for goods, construction and manufacturing companies) with the most gains for those in sectors exposed to the domestic economy.

### Japan

Latest economic data suggests Japan's economy has continued to weaken in early 2016 with slumps in consumer sentiment, job situation and household financial positions. The Bank of Japan (BOJ) March quarter Tankan Survey also showed weakness in business sentiment with the large manufacturers index dropping to 6 for the first quarter compared to 12 in the last quarter of 2015. This is its lowest level since mid-2013.

### Eurozone

The European Central Bank (ECB) revised its forecasts for inflation and GDP growth in its March policy meeting and implemented further stimulus measures. It also announced a new series of four targeted longer-term refinancing operations to start in June 2016. The revised forecasts project inflation to rise by 0.1% year-on-year (compared with December forecasts of 1%) and anticipate GDP to increase by 1.4% in 2016, 1.7% in 2017 and 1.8% in 2018.

### UK

Concerns over the European Union referendum and budget announcements impacted on confidence in the UK. Growth in the British economy was subdued in March, though the latest Markit/Cips Purchasing Managers' Index (PMI) saw the services sector rise to 53.7 (compared to 52.7 in February) and saw increases in the manufacturing and construction sectors. Growth in new business in the services sector was at its slowest pace since January 2013 according to the index.

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## China

There have been encouraging signs the stimulus measures announced by the Chinese government and the People's Bank of China (PBoC) are starting to impact on growth. The services sector continued to expand with the headline services PMI increasing to 53.8 – its highest level since December and a marked improvement on February. There were also positive increases for the official manufacturing index with new orders at their highest level since October 2014, auguring well for manufacturing activity in the near term.

### Will the recent rebound in the Australian dollar force the RBA to cut rates in the near term?

In January, the Australian dollar depreciated around 10% from its April 2015 peak but has since appreciated by approximately 8%. This would be a concern for the RBA given evidence the depreciation had been having a positive impact on the non-mining sectors of the economy – especially retail, tourism and education. RBA Governor Stevens acknowledged the increase in the Australian dollar in the April board meeting noting it reflected increases in commodity prices and monetary developments globally. It is likely the RBA will wait to assess the impact of the increase in the Australian dollar on the economy. Continued low inflation offers scope for easier policy if needed. BT Investment Solutions anticipates the RBA would focus on "pushing down" the Australian dollar if it persists around the $US0.76 level.

### What were the key outcomes of the March FOMC meeting?

The Fed highlighted potential risks for the US economy at its March meeting from recent global economic and financial activity. It lowered its expectations for the path of the Federal Funds Rate for the remainder of 2016 and now anticipates only two 25bps increases in the rate instead of the four predicted back in December 2015. The upper bound of the Federal Funds Rate is estimated to be 0.9% by the end of the year compared to the previous forecast of 1.4%. Further to this, the Fed projects the long-run neutral rate of the Federal Funds at 3.25%, 25bps lower than December 2015 projections.

The Fed also lowered the forecasts for GDP and inflation for 2016. GDP is now forecast at 2.2%, compared to 2.4% projected back in December. Headline Personal Consumption Expenditures (PCE) inflation is now expected to be 1.2% from 1.6% previously. The forecast for core PCE inflation remained the same as that in December, at 1.6%. There had been a recent uptick in the outlook for core inflation however Fed Chair Yellen cautioned it may be temporary and a result of transitory factors given risks to inflation on both sides. Core PCE inflation has been running at 1.7% for the past two months, and is at its highest level since July 2014.

### Are US wages a threat to inflation?

The threat of a wages growth outbreak and the impact of this on inflation has been an ongoing focus for the Fed. Though the Fed has indicated a period of faster wages growth would be welcome after many years of subdued growth, a significant acceleration would be likely to require a sharper increase in interest rates. Various Fed officials have suggested wages growth of 3-3.5% would be the acceptable level of wages growth before it risks inflation rising to or past the Fed's 2% target. The latest data indicates that we are not there yet. Average hourly earnings increased 2.3%y/y in March, below the 2.6%y/y one year high reached in December.

There are reasonable grounds to expect wages growth to gather stronger momentum over the coming year: the unemployment rate, currently at 5%, is close to its 4.7% NAIRU level (non-accelerating inflation rate of unemployment); job openings in February exceeded actual hires for the first in the past 15 years, implying that employers may need to start increasing rates of pay to attract workers; and, the share of full-time workers in the labour market is recovering well after declining sharply during the GFC. Conversely, the share of part-time workers is declining. Research shows that wages for full-time workers tend to grow faster than part-timers. As such, as long as the proportion of full-time employed continues to recover, it is likely that broad wage growth will strengthen.

### What measures did the ECB announce in its March policy meeting?

The ECB implemented further stimulus measures in its March policy meeting as follows:

+ cut the main refinancing rate by 5bps to 0%
+ reduced the deposit rate 10bps to -0.4%
+ increased the volume of quantitative easing by €20bn per month to a total €80bn
+ included investment grade euro-denominated bonds issued by non-bank corporates in the list of assets eligible for regular purchases.

This was further supported by the longer-term refinancing operations to start later this year. These operations will see banks offered attractive funding conditions in return for easing private sector credit conditions to encourage lending with more generous conditions for those offering rates below the official benchmarks. The measures exceeded expectations. Following the meeting, ECB President Draghi indicated there were limits to how much more the ECB could do, especially in relation to cutting the deposit rate even further into negative territory. He suggested future efforts would shift to more non-conventional instruments.

## What does this mean for investment strategies?

There are some short-term challenges in the market likely to impact on market performance such as speculation in Australia over the impending budget and Federal election or the referendum over membership of the European Union in the UK, which tend to create cautious behaviour from consumers and businesses alike. The higher Australian dollar also has implications. If it persists, it may create strain in the retail, tourism and education sectors – though investors in hedged shares may see some return from this while the dollar increases (though unhedged will benefit should it weaken again).

China and the US have heavy influence over global markets. The US continues to show positive signs of growth and the decision of the Fed to slow the pace of increases to the Federal Funds Rate should be supportive for US companies. Likewise, there are indications Chinese policies are starting to pay off in China. Should China continue to recover and start to offer stability, this is likely to encourage investor confidence and bolster global sharemarkets. It is also likely to benefit the Australian sharemarket with China one of the biggest importers of Australian resources and other products. Commodities markets globally would also be likely to benefit from further recovery in China.

Australian fixed interest investments may benefit from continued challenges in the Eurozone and Japan, along with the Fed decision to slow the pace of rate increases. Though low, Australian interest rates are still higher than many other markets making them an attractive prospect for some international investors.

**For more information on how market conditions impact your investments, please contact BT Financial Group.**