A question of inflation

May 2016

Inflation has become the key concern of our time for central banks, with disappointing results for some economies in the first quarter of 2016. This continues to create challenges globally, with questions over the effectiveness of previous stimulus or the direction of future monetary policy. For some, it is early days still and time will tell whether more action is required. Tim Rocks, Head of Market Research and Strategy, considers the activity of the past month.

Australia

The Reserve Bank of Australia (RBA) made the decision to cut official interest rates by 25 basis points to a record low of 1.75% at its May meeting. This was off the back of extremely weak inflation data from March, which saw headline CPI falling 0.2% q/q to 1.3%, its lowest level since 2012. Underlying inflation rose by just 0.15% q/q, taking the annual underlying rate to 1.55%, its lowest on record.

US

The US economy grew by just 0.1% q/q and 0.5% annualised in the first quarter of this year. Consumption, housing and government sectors were all positive contributors to growth in the quarter, while business investment, net exports and inventories detracted from growth. On the inflation front, the core Personal Consumption Expenditures deflator grew by just 0.1%m/m in March, easing back to 1.6% y/y – well below the Fed's 2% target.

Japan

The Bank of Japan (BoJ) left monetary policy unchanged at its April meeting but sharply downgraded its growth and inflation forecasts. GDP growth is now expected to be 1.2% y/y for financial year 2016, compared to the 1.5% forecast from January. Inflation is now forecast to be 0.5%, compared to previous forecasts of 0.8%. The BoJ also pushed out its expected timings to achieve its 2% inflation target to across the 2017 financial year rather than in the first half of 2017 as previously forecast.

Eurozone

The European economy grew faster than expected in the first quarter of 2016; however, inflation has fallen back into negative territory. GDP increased by 0.5% q/q with annualised growth at 2.1% – its fastest pace in a year. Inflation dropped to -0.2% in April, down from the previous rate of 0% in March. This primarily reflected a drop in oil prices.

Tim Rocks

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UK

UK economic growth slowed in the first quarter of 2016, with slowdowns in construction and industrial output. GDP grew by 0.4% for the quarter and annualised growth was 2.1%. Construction dropped 0.9% in the quarter and industrial output declined by 0.4%. However, the services sector was a positive contributor to the economy and grew by 0.6%.

China

Data released in April was weaker than expected, with softness in industrial production, retail sales, fixed asset investments, exports and imports. By contrast, the Chinese stimulus measures appear to be having a positive impact on the property sector with rising house prices, and growth in real estate investment and property construction, in March and April.

What are the key risks/ uncertainties to the RBA's outlook for the Australian Economy?

The RBA indicated a significant downgrade in its outlook for inflation and a more moderate reassessment of its outlook for economic growth in its Quarterly Statement on Monetary Policy. It highlighted some key areas with the potential to destabilise the outlook.

+ There are concerns surrounding the People's Bank of China's (PBoC) current prioritisation of short-term growth over longer term objectives to deleverage and drive growth through consumption.
+ The current stimulus efforts in China may see commodity prices pose an upside risk to forecasts for Australian terms of trade.
+ Persistent weak wages growth against a backdrop of tight labour markets in some countries has helped keep inflation and inflationary expectations very subdued resulting in easy monetary policy. If inflationary pressures build more rapidly, this could create a significant change in the expected path of monetary policy with flow-on effects to exchange rates – risking further depreciation in the Australian dollar.
+ The RBA views both upside and downside risk to wages growth and inflation as the economy continues to transition from its dependence on mining to non-mining sectors.

Are markets right to push out the probability of a Fed rate hike until much later in the year?

Based on current futures pricing, there is an increased probability the US Federal Reserve (Fed) will raise the Federal Funds Rate in September. The chance of a hike before then appears much smaller now compared to views a few months ago.

The most recent data provides mixed signals on the economy. The April labour market data was quite disappointing, with non-farm payrolls growing by just 160,000 – the weakest gain since September last year. The three-month moving average pace of gains has dropped back to 200,000 compared with 282,000 back in December. The unemployment rate held steady at 5%, where it has more or less been since October last year. The Fed will likely be keen to see payroll's pick up the pace in the near term before raising rates for a second time in this cycle. Similarly, although average hourly earnings increased 0.3% m/m in April, yearly growth of just 2.5% is still too low to raise concerns regarding the inflation outlook for the Fed.

Data supportive of the Fed hiking sooner rather than later includes April retail sales, consumer confidence, and services ISM survey – all of which posted better than expected results. But even in light of this encouraging data, unless we see a rebound in payroll numbers and some significant signs of price pressures in the economy over the next few months, the Fed is unlikely to raise rates in the near term. It will opt to tread carefully, especially given the initial negative impact the December hike had on markets and ultimately, the US economy.

Given inflation has fallen again in Europe, will the European Central Bank (ECB) go further into negative territory on interest rates?

The April inflation results were disappointing, but not entirely unexpected. Mario Draghi, ECB President, had stated inflation could turn negative again, with risks to economic growth remaining towards the downside. However, his view was for inflation to start rising before the end of the year and pick up further in 2017. On that basis, it is unlikely the recent inflation data would force the Bank to cut interest rates in the near term, especially given that policy was already loosened further in March. The latest data on the economy also supports this view, with activity continuing at around reasonably solid levels, with no sign of excessive weakness in the data. Importantly, the ECB would be pleased that its policy measures to date are starting to show some traction, with bank lending to non-financial corporates up at around 2% y/y.

Will China add even further stimulus given the latest run of weaker than expected data?

The PBoC has already pumped extensive stimulus into the economy over the past year to help stabilise growth. Despite the recent weakness in some activity indicators, it is likely authorities will remain cautious in implementing further measures. Based on a recent research trip to China, the stimulus measures are still working through the economy. Our view is for economic growth to be fairly solid into 2017, even without more measures. The property sector appears to have significant upside with developers only buying land now. This implies projects will not be started until the second half of the year and a peak in steel demand is still to come. Moreover, recently announced large scale infrastructure projects will take some years, further supporting growth. There are other developments likely to be positive drivers in the longer term. Rapid and continuing improvements in healthcare, pensions and social security are likely to reduce the need for precautionary saving and support consumption growth. The creation of new industries such as solar, pharmaceutical, medical and ecommerce are also likely to support the economy. Finally, the expansion of domestic and international tourism indicates an improvement in consumption and is likely to continue to support long-term growth prospects.

What does this mean for investment strategies?

The Australian sharemarket may see some uncertainty in the short term as a result of the upcoming federal election given the potential impact of policies from either of the major parties, particularly in relation to property. In the immediate term though, the recent decrease in official interest rates should assist sharemarkets and property through business investment and consumption.

China and the US have a strong influence on global markets. Despite poor data recently, if stimulus measures continue to play through in China, there may be some benefits to sharemarkets, especially commodities, and this in turn will benefit the Australian resources sector. Ongoing recovery in the US – followed by a rate hike in September – should also help drive confidence in global sharemarkets.

On the whole, the ongoing low inflation should continue to assist sharemarkets through low costs to business investment – also benefiting property markets for similar reasons. On the flip side, the low inflationary environment can make it more difficult to drive returns through fixed interest or cash investments, though these are still an important component of a diversified investment portfolio.

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

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