

# Colonial First State

## Market View – December 2016

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### Summary

The Reserve Bank of Australia (RBA), as widely expected, left the cash rate unchanged at 1.5% at the December 2016 Board meeting.

The Australian dollar was weaker against the strengthening USD throughout December. The AUD ended the month down 2.4% against the USD at \$US0.7208. The AUD was also weaker against the other major currencies.

The S&P/ASX 200 Accumulation Index continued its strong momentum in December, rising 4.1% to hit 12-month highs, with all market sectors finishing the month in positive territory.

US (and global) financial markets continued to be driven through December by the Presidential election victory for Donald Trump in early November. Financial markets focused on the stimulatory policies expected under President Trump, including significant company and income tax cuts, increased infrastructure spending and reduced regulation.

Most commodity prices remained well supported in December, helped by both the OPEC deal to try and limit oil supply and positive expectations. The price of West Texas Intermediate (WTI) Crude oil finished the month at \$US53.72 per barrel, up 8.7% per month, while the price of Brent Crude oil was up 12.6% to \$US56.82 per barrel.

### Australia

The Reserve Bank of Australia (RBA), as widely expected, left the cash rate unchanged at 1.5% at the December 2016 Board meeting. The signals from the RBA continue to suggest that the hurdle to another rate hike is high and the most likely outcome will be rates on hold for all of 2017. As per usual, there was no Board meeting in January 2017.

The big news for Australia in December was that GDP growth for Q3 2016 printed -0.5% per quarter, well down from the revised +0.6% per quarter growth of Q2 2016. This was only the fourth quarterly negative print in the last 25 years and took the annual rate of growth down sharply to 1.8% per year from 3.1% per year in Q2 2016.

The only bright spots in the data were an increase in household consumption and inventories. All other key sectors of the economy, including net exports, private investment and public investment, contracted in Q3 2016.

Importantly, there was a 4.5% per quarter increase in Australia's terms of trade over Q3 2016. As a result, real net disposable income rose a solid 0.8% per quarter in Q3 2016, taking the annual rate of increase to a strong 3.2% per year.

The November labour market report showed the unemployment rate up marginally at 5.7%, from 5.6%, but with total employment up 39.1k (+39.3k full-time, -0.2k part-time).

Australia's Mid-Year Economic and Fiscal Outlook (MYEFO) showed a small improvement in the projected 2016/17 Budget (deficit now estimated at \$A36.5 billion, -2.1% of GDP, vs the pre-election estimate of \$A37.1 billion, -2.2% of GDP), but an accumulated \$A10.4 billion widening of the budget deficit out to 2019/20. The government still maintains that the budget will be back in (small) surplus by 2020/21.

The deterioration in the budget position in the out-years was due to parameter changes – with policy decisions taken by the government since the election improving the budget position by around \$A2.5 billion over the four year forecast period.

The major rating agencies reconfirmed Australia's credit rating at AAA/Aaa after the MYEFO. But no doubt they will be watching closely for further improvements in the May 2017 Budget. At the moment the position of the AAA feels more like a stay of execution, rather than a reprieve.

### US

US (and global) financial markets continued to be driven through December by the Presidential election victory for Donald Trump in early November. Financial markets focused on the stimulatory policies expected under President Trump, including significant company and income tax cuts, increased infrastructure spending and reduced regulation. The more concerning policies around trade, immigration and climate change

look to be considered secondary factors at this stage.

The other big news impacting on markets in December was the Federal Reserve's 15 December meeting. As widely expected, the Fed raised the Fed Funds target rate by 25 bps to a 0.5% to 0.75% range. This was the second rate hike from the Fed since December 2015 and indeed, only the second rate hike in 10 years. The Fed's policy decision was unanimous.

The surprise in the Fed's decision was a slight upward drift in the FOMC's median projection for the Fed Funds rate in the years ahead, ie. the 'dots', with three rate hikes now expected for 2017 (as opposed to two) and a small increase in the long-run 'dot' to 3.0% (from 2.9%).

These moves came despite only very modest changes to the key economic forecasts. In her press conference, Fed Chair Yellen went out of her way to emphasise that the changes to the 'dots' were only very minor. The Fed Chair also made the point that the raising of interest rates was a sign of the confidence in the economy.

Asked about the potential of a significant fiscal policy easing under President Trump, the Fed Chair refused to be drawn on the implications for monetary policy – as she did not want to pre-empt what that fiscal policy easing would look like and/or what impact it would have on the economy. Clearly this will be a big part of the Fed's reaction function in the coming years.

We have made some major changes to our expectations for the Fed Funds rate – to reflect the expansionary, stimulatory and, ultimately, inflationary policy of the Trump administration.

Given that we now expect the US economy to experience a significant easing of fiscal policy from late 2017 onwards, which pushes inflation higher than previously expected and brings forth the need for more tightening from the Fed, we now expect two rate hikes in 2017 to be followed by three rate hikes in 2018 (previously two) and three rate hikes in 2019 (previously two). This will give a peak in the Fed Funds target rate in 2019 of 2.5% to 2.75%, i.e. 50 bps higher than our previous peak forecast.

We now expect, however, two rate cuts in 2020 (previously no change) as the tightening of financial conditions over 2018-2019 (from a higher USD, higher bond yields and a higher Fed Funds rate), combines with President Trump's anti-trade and anti-immigration policies to bring about an economic downturn.

Employment was solid again in November, increasing by 178k (from a revised 142k in October). The unemployment rate dropped to a new low in the cycle of 4.6% (from 4.9%). However, average hourly earnings declined -0.1% per month, taking the annual rate down to 2.5% per year from 2.8% per year.

Inflation continued to increase at a moderate pace with headline CPI up just 0.2% per month in November and the annual rate increasing to 1.7% per year (from 1.6%). The core CPI also increased by 0.2% per month, with the annual rate unchanged at 2.1% per year.

The Fed's preferred measure of underlying inflation, the core Personal Consumption Expenditure (PCE), edged down to 1.6% per year in November, from 1.7% previously.

## Europe

In early December the European Central Bank (ECB) announced a longer-than-expected extension of its asset-purchase/quantitative easing (QE) program out to December 2017, well beyond the previous time-frame of March 2017. However, the QE program will, from April 2017 onwards be reduced to a monthly pace of €60 billion, rather than the current pace of €80 billion per month.

The ECB also made changes to the operations of its QE program that will allow it to continue to purchase assets for a longer period – if that should prove necessary. All official interest rates were held unchanged, with the Deposit Facility at -0.4%. In announcing the changes the ECB President, Mario Draghi, delivered a dovish message, strenuously denying that a 'tapering' of monetary policy easing was in place.

European data continued to show modest improvement in December, but with low inflation and concerns over the banking system remaining. Indeed, the oldest bank in the world, Monte dei Paschi di Siena – founded 1472 – had to request a bailout from the Italian government.

The EU unemployment rate dropped to 9.8% in October, from 9.9%, the lowest rate since mid-2009. GDP growth for Q3 2016 was 0.3% per quarter, with the annual rate up marginally to 1.7% per year.

CPI inflation was unchanged at 0.6% per year in November, with the core inflation rate also unchanged at 0.8% per year.

In politics, the focus in December was on the failed referendum in Italy that was designed to

make it easier for the government to implement (much needed) economic reforms. The failure of the referendum saw Prime Minister Renzi resign – to be replaced by former Foreign Affairs Minister Paolo Gentiloni.

## UK

Data in the UK continued to show an economy outperforming post-Brexit expectations. The Bank of England (BoE) held the cash rate steady at 0.25% in mid-December and maintained the pace of their QE program at GBP435 billion. The BoE continues to signal that policy is unlikely to be changed in the period ahead.

The annual rate of inflation rose to 1.2% per year in November (from 0.9%), with the core CPI up 1.4% per year in November (from 1.2%). The unemployment rate stayed at 4.8% in October, with average weekly earnings up to 2.5% per year in October from 2.4%. GDP for Q3 2016 came in at a final reading of 0.6% per quarter, taking the annual pace of growth to 2.2% per year.

## NZ

The biggest news in New Zealand in December was the shock resignation by Prime Minister John Key. Key had been PM since November 2008 and was widely regarded as very successful. He was replaced by former Finance Minister Bill English as Prime Minister.

Data in New Zealand continued to show an economy doing well given the global circumstances. House prices were up 12.4% per year in November (from 12.7%), while building permits jumped 2.6% per month in October (from -0.2% per month in September). Q3 2016 GDP showed strong growth of 1.1% per quarter, taking the annual pace to 3.5% per year (from 3.4%).

## Japan

The Bank of Japan (BoJ) held the cash rate steady at -0.1% in December and the 10yr JGB target rate at 0.0%.

GDP growth was 0.3% per quarter in Q3 2016, giving an annualised rate of 1.3% per year. The Tankan large manufacturing index rose to +10 in Q4 2016 (from +6), with the large non-manufacturing index steady at +16. The annual rate of headline inflation jumped to 0.5% per year in November (from 0.1% per year), but with the core pace of inflation down marginally to 0.1% per year from 0.2% per year previously.

## China

Activity data in China was relatively stable over the month. Industrial production was at 6.2% per year for November (from 6.1%), while Fixed Asset Investment was steady at 8.3% per year. Retail sales were stronger, rising to 10.8% per year in November from 10.0% per year in October.

Inflation continued to increase in November, rising to 2.3% from 2.1% per year. China's PPI increased by a very solid 3.3% per year in November, well up from 1.2% in October and the highest level since December 2011.

New Yuan lending rose by Y794.6 billion in November, from Y651.3 billion in October, while aggregate financing jumped to Y1,740 billion in November, from Y886.5 billion in October.

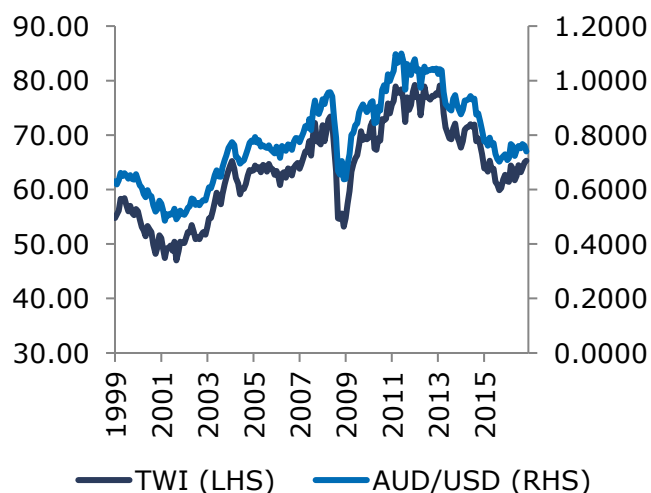
## Australian dollar

The Australian dollar was weaker against the strengthening USD throughout December. The AUD ended the month down 2.4% against the USD at \$US0.7208.

The AUD was also weaker against the other major currencies: down -1.1% against the GBP, -0.1% against NZD, -1.9% against the EUR and -0.4% vs the Yen. The TWI ended the month down 2.1% at 63.9.

The AUD continues to be driven by its relative position against the stronger USD, but supported by improvements in commodity prices and general expectations that the RBA interest rate cutting cycle is at an end.

## USD STRENGTH TRUMPS INCREASING COMMODITY PRICES



Source: Bloomberg as at 31 December 2016

## Commodities

Most commodity prices remained well supported in December, helped by both the OPEC deal to try and limit oil supply and positive expectations, especially on infrastructure spending, from a Trump Presidency.

The price of West Texas Intermediate (WTI) Crude oil finished the month at \$US53.72 per barrel, up 8.7% per month, while the price of Brent Crude oil was up 12.6% to \$US56.82 per barrel.

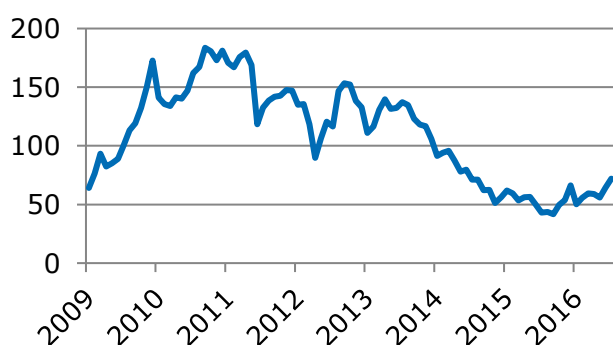
Gas prices were also stronger, with the US natural gas Henry Hub futures price up 11.1% to \$US3.72/MMBtu.

Iron ore prices were stronger (again) over December on increased demand from China and the expectation of infrastructure spending in the US. The spot iron ore contract (Qingdao 62% Fe fines) rose by 9.4% to US\$78.87/t in December.

Base metals decreased with the London Metals Exchange (LME) Index falling by 5.0%. Lead (-14.7%), nickel (-10.9%), copper (-5.0%), zinc (-4.7%) and aluminium (-2.3%) all lost momentum. Tin increased slightly by 0.4%.

Precious metals prices, which are generally more sensitive to changes in US interest rate policy, declined in December. The spot gold price fell by 1.8% to end the year at US\$1,152.27/oz.

### IRON ORE RISES WITH INFRASTRUCTURE EXPECTATIONS



Source: Bloomberg as at 31 December 2016

## Australian shares

The S&P/ASX 200 Accumulation Index continued its strong momentum in December, rising 4.1% to hit 12-month highs, with all market sectors finishing the month in positive territory.

In contrast to recent months, bond proxy sectors, including Utilities (+8.7%) and A-REITs (+6.8%), were among the market's leading performers. The Utilities sector was led higher by Hong Kong-based Cheung Kong Infrastructure's \$A7.3 billion cash bid for DUET Group.

Energy (+6.1%) continued its strong run, as companies in the sector benefitted from a rising oil price. The market is optimistic that a deal between OPEC and non-OPEC members to cut oil production in early 2017 will help drain the global supply glut.

Sentiment continues to improve towards banking stocks, with Financials (+5.5%) once again posting healthy gains on expectations that rising interest rates will likely improve profitability for the banks, while a steepening yield curve is benefitting insurance companies.

Rising commodity prices, particularly iron ore, helped support Australia's Materials sector (+3.9%). Lead indicators for iron ore remain positive looking ahead into 2017.

Health Care (0.9%) continues to struggle, underperforming the broader market. The sector was led lower by Sirtex Medical, which lost around half its value after posting a negative trading update.

### Listed property

The S&P ASX 200 A-REIT index rallied sharply during December, returning +6.8% as bond yields stabilised.

Gains were led by Growthpoint Properties Australia (+9.9%) and Scentre Group (+9.4%). Growthpoint Properties rose after raising its distribution guidance for the 2017 financial year by 5%. Scentre Group, which owns 34 Australian shopping centres, was supported by robust rental growth and evidence of healthy leasing demand in its key markets of Sydney and Melbourne.

Listed property markets offshore also gained in December. The FTSE EPRA/NAREIT Developed Index (TR) increased by 3.1% in US dollar terms.

### Global shares

Global developed equity markets were stronger again over December as the 'Trump rally' continued on expectation of expansionary fiscal policy, tax cuts and reduced regulation in the US. The USD was also stronger on the month with the DXY index up 0.7%. The MSCI World Index was up 2.3% in US dollar terms in the month of December and 4.8% in Australian dollar terms.

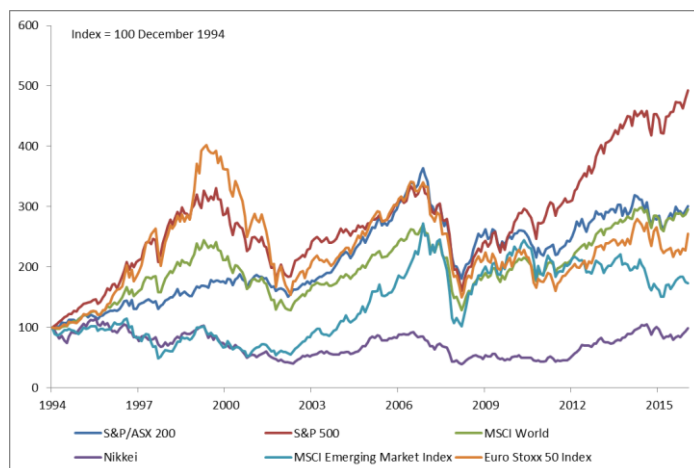
In the US, the S&P500 (+1.8%), the Dow Jones (+3.3%) and the NASDAQ (+1.1%) were all stronger.

On a sector basis, MSCI Financials (+3.9%), Utilities (+4.2%), Energy (+3.5%) and Telecommunications (+5.8%) were the best performers. MSCI Materials (+1.4%) and Industrials (+0.8%) lagged behind the gains, but were still positive on the month.

Equity markets in Europe were also stronger over the month. The large cap Euro Stoxx 50 Index put on a solid 7.8%. The best performing EU markets were; Italy (+13.6%), Spain (+7.6%), Germany (+7.9%), France (+6.2%) and the Netherlands (+5.7%). The UK FT100 was also up a solid 5.3% in December. Asia markets were mixed, with the Japanese Nikkei 225 up a strong 4.4% as the Yen depreciated 2.2% against the USD. Other gains in Asia were seen in Malaysia (+1.4%), Korea (+2.2%), Thailand (+2.2%), Indonesia (+2.9%) and the Philippines (+0.9%).

Declines in Asia were seen in; Singapore (0.8%), China (-4.5%), Hong Kong (-3.5%), India (-0.9%) and New Zealand (-0.2%). Taiwan was close to flat on the month.

## EQUITY MARKETS RALLY ON TRUMP WIN



Source: Bloomberg as at 31 December 2016

## Global emerging markets

Emerging market equities were weaker (again) over December in USD terms, with the MSCI Emerging Market Index down -0.1%, continuing the underperformance against DM equities.

USD strength, higher bond yields and concerns around US trade policy all continued to weigh on emerging markets, despite the strength in commodity prices.

MSCI EM Latin America gained 0.5% over the month, while MSCI EM Europe, Middle East and Africa actually gained 7%. MSCI EM Asia ex Japan was weaker at -2.3% on the month. The Shanghai Composite Index was also weaker, down 4.5%.