Economic Snapshot

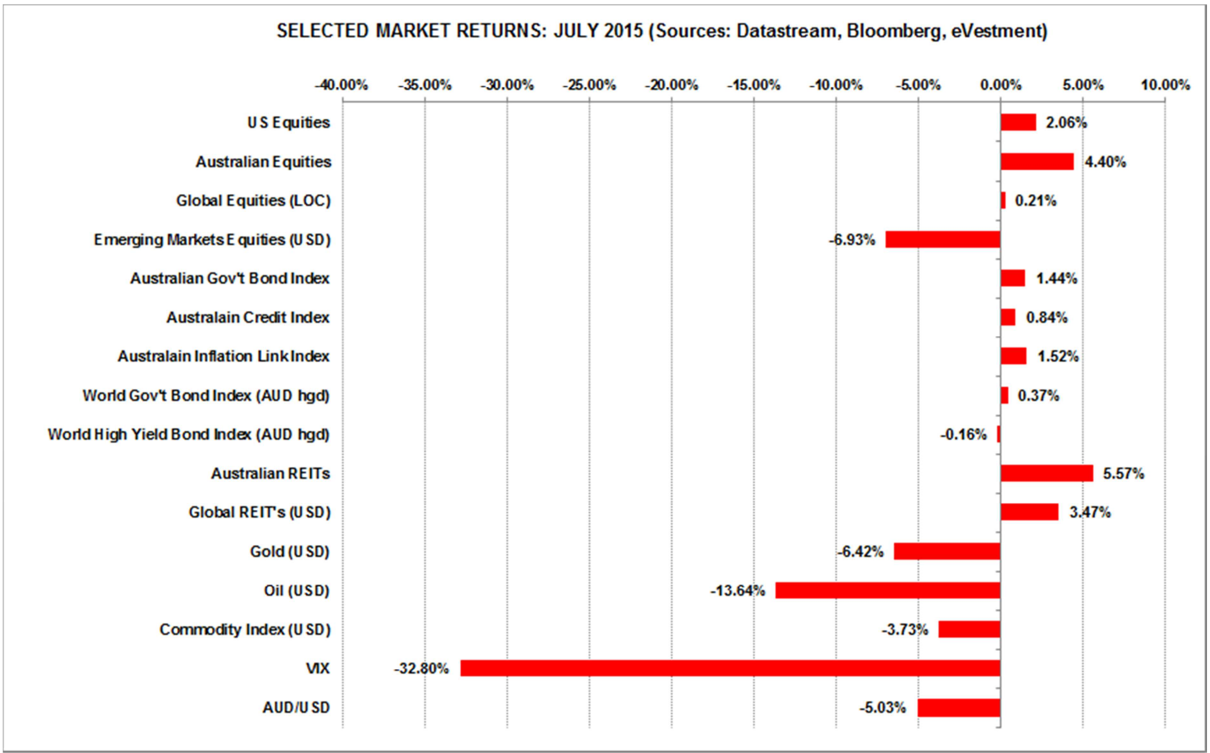
July – August 2015

In summary

With the ending of the financial year in June in Australia, July proved to be a turbulent month for the world's financial markets. We witnessed the resolution (for now) of the Greek crisis which settled nerves but no sooner had this happened we experienced significant volatility in the Chinese equity market which had/has a contagion effect on Australian shares. After flirting with departure from the Eurozone, the Greek Prime Minister suddenly capitulated to the demand of the country's creditors in a deal that was harsher than he was rejecting a few days before. Greece will now get the financial support it needs, but at a cost as the political landscape has been changed and new elections are likely before the end of the year as voters feel duped by the new government.

The dramatic falls in Chinese equities raised concerns about the country's economic health, but in reality the stock market has little connection with the economy. Likewise Chinese shares doubled in the corresponding period over the space of a slightly more than a year. Of greater importance is the continued improvement of the US economy and the Federal Reserve's much publicized signal that it is likely to lift interest rates this year. Markets remain jittery on how this will play out.

Figure 1: Emerging markets was an underperformers in July but overall shares were strong



Australia

In Australia the labour market figures continued to confound the expectations of the pessimists with the unemployment rate rising only very slightly to 6.0% in June. There have been further signs that the unemployment rate may be stabilising around these levels rather than the significantly higher levels expected by a number of commentators. Even so, the unemployment rate is still not expected to decline in a hurry.

However, consumer confidence remains fragile. The Westpac–Melbourne Institute Index of Consumer Sentiment fell from 95.3 in June to 92.2 in July - the lowest level since December 2014. Within the survey, sentiment around time to purchase a dwelling fell sharply and was probably driven by concerns about housing affordability.

On the other hand, the latest Deloitte CFO survey showed some improving optimism among Australia's CFO's, while the NAB business survey showed a better than expected improvement in both business conditions and business confidence, which is now positive in all industries except mining. These are encouraging signs of some improvement in the economy which could translate into better results for unemployment and household confidence.

June quarter inflation in Australia came in pretty much as expected with a 0.5% increase in underlying inflation in the quarter and a 2.4% increase over the year to June. Headline inflation recorded only a 1.5% increase in the year to June. Overall, inflation remains under control and well within the Reserve Bank's desired range.

Also of news in Australia during the month were comments from Glenn Stevens about where Australia's medium-term potential growth path now truly lies, and moves by some lenders to start moderating the pace of funding to housing investors in response to APRA's macro prudential guidance.

The Reserve Bank left the cash rate unchanged at 2% at its Board Meetings in both July and August. The better unemployment rate figures and the renewed decline in the Australian dollar would have contributed to this. Nevertheless, the RBA has indicated it is still open to the idea of more rate cuts if necessary.

United States

National accounts figures just released for the United States showed real GDP grew by a seasonally adjusted annual rate of 2.3% in the second quarter as the economy moved beyond the weather induced weakness in the first quarter. ***On the labour market front, June saw further good gains in employment and the unemployment rate fell to 5.3%.*** Unemployment insurance claims have fallen to levels not seen in many years. The labour market has clearly improved very significantly and all eyes are now on what this means for potential wage pressures which have been relatively subdued so far.

The markets' attention continues to focus on what the Federal Reserve is going to do with interest rates. Further statements from Chair Janet Yellen and other members of the Board emphasise that decision-making will be driven by the economic data and its pace of improvement. Chair Yellen again re-iterated that an interest rate increase is likely this year as long as conditions continue to go the way the Reserve expects. In its regular guidance to the markets, the Reserve has indicated that the cash rate could be around 0.5% by the end of this year and 1.5% by the end of 2016.

However, the markets continue to price a profile of interest rate increases that is more moderate than what the Reserve is suggesting. The difference between the Reserve and the markets is not great, but there may still be scope for the markets to be adversely surprised. Looking a bit further ahead, the Reserves second move will be more important than its first move. Once the markets have three observations to work with (now plus 2 moves) they will begin extrapolating the path of future tightening and compare that to their own expectations.

Europe

The big news out of ***Europe*** was the surprise capitulation of the Greek Prime Minister to the demands of the nation's creditors. After weeks of turmoil in which Greece seemed to be heading towards an exit from the Euro, Mr Tsipras suddenly accepted a deal which was more onerous than the ones he had been consistently rejecting. This was notwithstanding the clear "No" vote in the Greek referendum. The "Greek crisis" which had been the focus of market attention in recent months effectively evaporated overnight with the way open to another bailout to help keep the Greek economy afloat. Of course Greece's problems have not evaporated and the difficult issue of debt renegotiation remains to be tackled. In addition, the Syriza has been dealt a significant blow and new elections in Greece are quite likely before the end of the year. (The Greek financial markets re-opened on 3 August and the Athens Composite equity index immediately fell nearly 20% and finished the day down a little more than 16%).

China

The equity market in China continued its roller coaster ride in July with some big daily moves. The Shanghai A shares index moved by more than 3% either way on 10 days in July including a fall of 8.5% on 27 July. The volatility in the mainland markets spilled over into other markets where Chinese shares are cross-listed, as well as exacerbating general concerns about China's growth which adversely affected equity markets in general. However, the equity market plays a much smaller role in China's economy than in other countries. This includes both as a source of funding for companies and a means of investment for households. Although speculative investor interest in the Chinese market has risen dramatically, fuelled by too much margin lending, households have a very small exposure to equites compared with housing.

There is also a strong element of "bad news sells" in this story: the same commentators now keen to talk the Chinese economy down in the face of equity market declines were not talking the economy up when the equity market was surging. The rise began in February last year with the index almost doubling over 14 months. Also we should not underestimate the authorities' resolve to contain the situation and keep the economy on track. So far the authorities have responded with a range of measures, from direct purchases to short selling bans to interest rate cuts. Whether these unusual measures bear fruit is to be seen but it does reflect the Chinese business culture of controlling outcomes through government intervention.