Economic Snapshot

September – October 2015

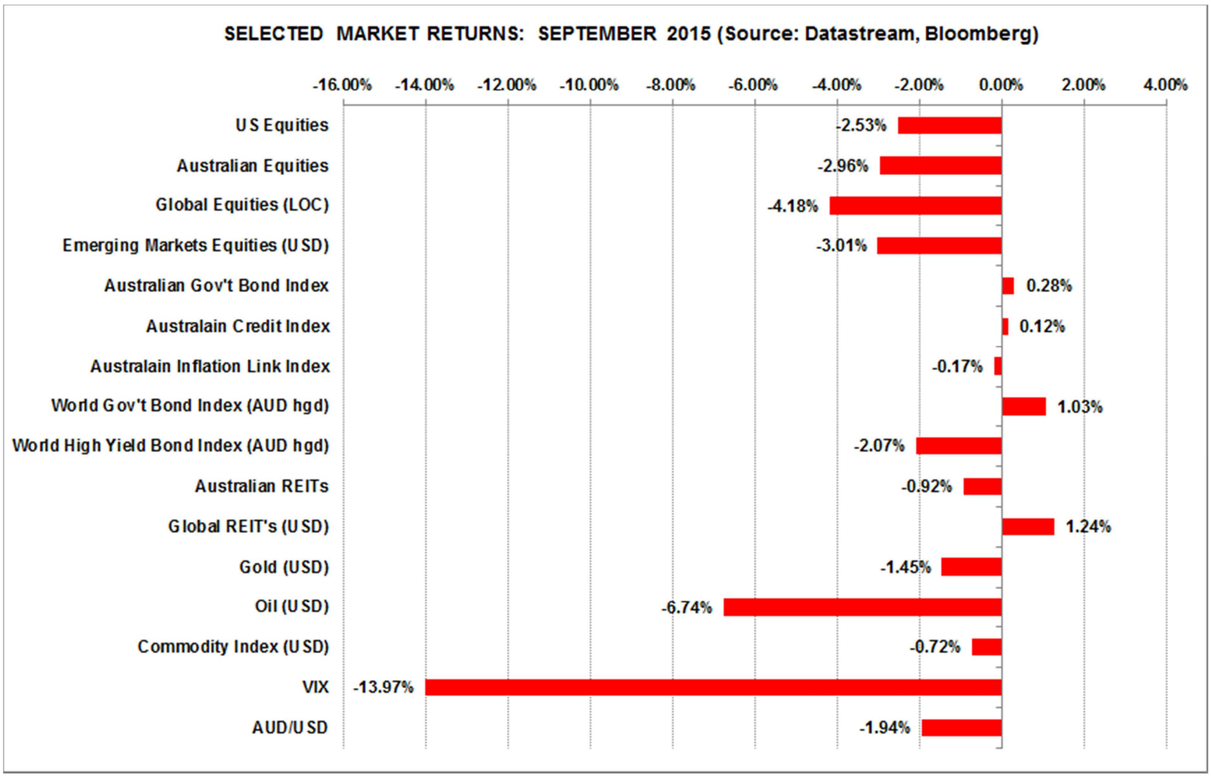
In summary

September was another difficult month for the global financial markets as calendar year 2015 reflects an eerie resemblance to 2014 with a strong first quarter, falling away towards the latter part of the year. A combination of concerns about a slowing world economy (connected to China) and uncertainty about what the US Federal Reserve will do with interest rates drove a general sell-off in risk assets. These two issues appear to be dominating sentiment***. However in pragmatic terms, economists continue to argue that the macro environment of the world's economies is relatively healthy*** – But in terms of sentiment, markets are extremely sensitive to perceived bad news and they are not linked to economic output.

Financial markets were already nervous after August's very poor performance and although data in September showing further improvement in the US household sector, other figures showing a slower pace of employment growth and manufacturing activity contributed to underlying concern about the US economy heading towards recession. Soft data about the Chinese manufacturing sector added to these fears even though there was more positive news from other parts of the economy.

In the face of the markets' somewhat overdone uncertainty about economic conditions and the general volatility, the Federal Reserve then compounded the problem by deciding to leave interest rates unchanged in September. This merely fuelled more uncertainty and renewed volatility. ***Domestically, the Board of the Reserve Bank left the cash rate unchanged at 2% in both September and October***.

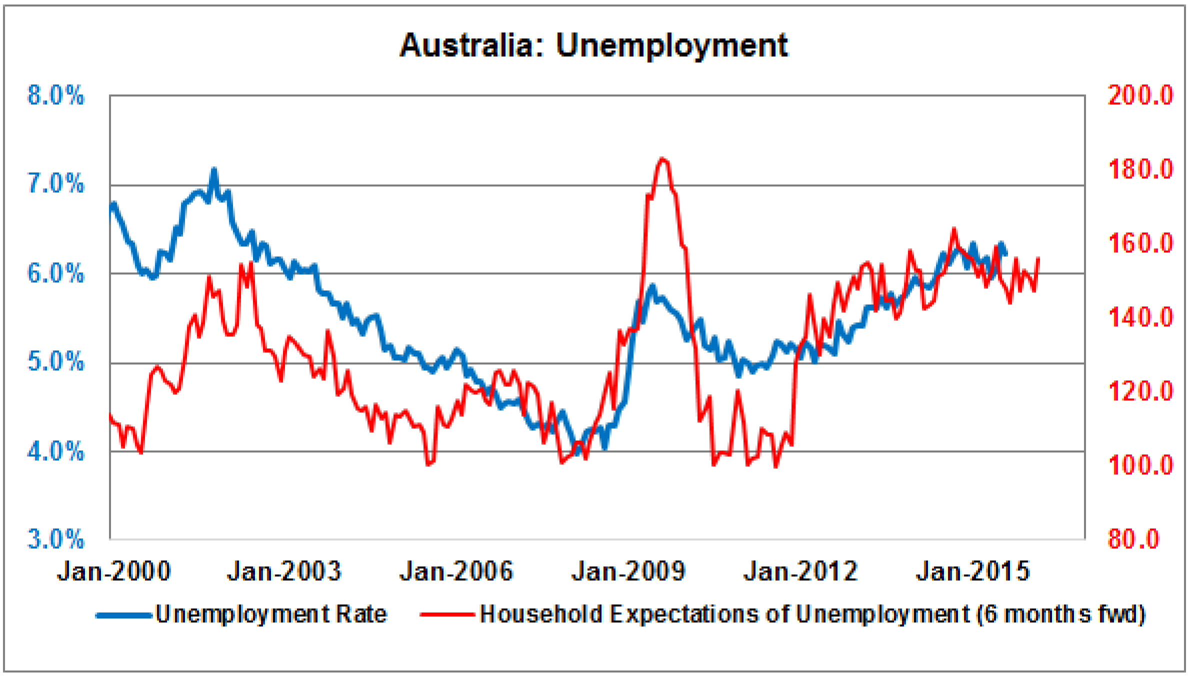
Figure 1: September saw a sell-off in risk assets with negative returns in asset classes



Australia

Employment picked up again in Australia in August figures (released Sept) with an extra 17,400 jobs being added and about one third of this being part-time employment. The unemployment rate fell slightly from 6.3% to 6.2%, although the participation rate also fell by a similar amount in the month. Figure 2 shows how the unemployment rate has remained just above 6% for some time now and that households do not expect this to improve much in the foreseeable future.

Figure 2: Unemployment in Australia remains stubbornly high



However, there was encouraging news with retail sales rising 0.4% in August compared with a decline of 0.1% in July. Compared with a year ago, retail sales growth is running around 4.5%, similar to the pace recorded for most of 2015. The number of approvals for the construction of new dwellings fell 7% in August led by an 11% decline in approvals for apartments which was partly offset by a 5% increase in approvals for houses. These statistics tend to be very volatile from month to month but do seem to reflect some impact from APRA’s tighter lending standards.

United States

The all-important ISM manufacturing index in the United States fell marginally in September alongside the ISM services index. These index’s measure output and growth. ***Despite this decline, the services sector of the US economy continues to be more robust than the manufacturing sector which has been slowing down since the middle of the year. This is a pattern which has been seen in other countries as well, notably in China, and has contributed to the nervousness in financial markets which have tended to focus on the manufacturing sector data rather than the services sector.***

Labour market conditions in the US have also softened a bit in the last couple of months. After reporting an initial increase of 173,000 new jobs in August, the figure was later revised down to 136,000 with a further 142,000 jobs being added in September. These figures are respectable but nevertheless well below the 200,000 - 250,000 new jobs per month recorded earlier in the year.

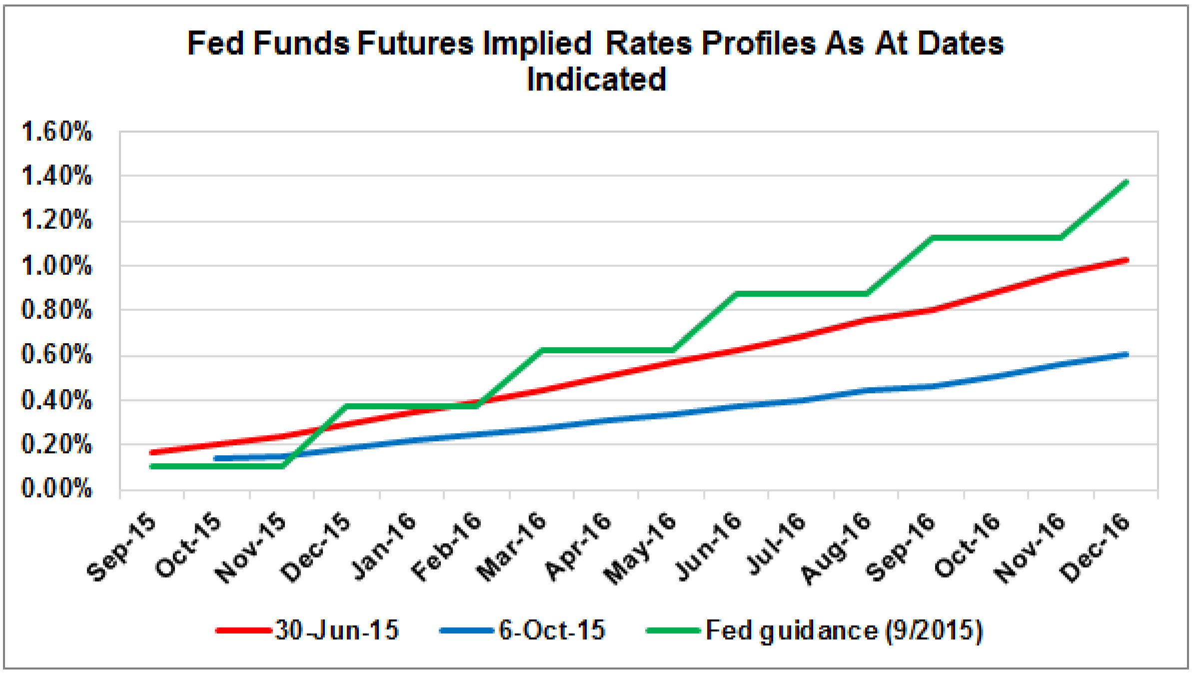
The unemployment rate has held steady at 5.1% and wages growth remains subdued at just over 2% on an annual basis. The softer than expected employment figures released at the start of September contributed to financial market nervousness about the state of the US economy and what the Reserve might do with interest rates. However, the soft employment figures released at the start of October encouraged the markets to believe the Reserve would not lift rates in a hurry and contributed to a rally in the equity market.

Other statistics on the US economy released in the month show that inflation remains under control. For example, core producer prices were little changed in August from the previous month and are still running about 2% higher than a year before. Core consumer prices paint a similar picture and are running about 1.8% higher than a year earlier. This figure is only a little below the Reserve's 2% goal, but the headline consumer price index is still considerably softer and only 0.2% in year-on-year terms. Consumer confidence improved further in September after a significant improvement in August. Survey respondents showed a clear improvement in views about current economic conditions. This was also reflected in a further increase in retail spending in both August and September.

The big news of the month was of course that the Federal Reserve decided to leave interest rates unchanged for the time being. ***The markets interpreted the caution as a sign that the central bank sees downside risks to the economy that are not yet apparent to the markets.*** This was compound by changes to the wording of the post-meeting statement which included references to economic conditions in the rest of the world (i.e. China) and the impact of the strong US dollar in suppressing US inflation. Markets were surprised by this because the Reserve typically does not refer to overseas economic conditions in its deliberations on setting interest rates. However, ***there are signs that the strong US dollar is having an increasing impact on the US economy not just through lower inflation but also through lower export orders*** which have contributed to the softer ISM manufacturing readings in recent months.

Overall, the financial markets did not take the Reserves announcement well. Apart from reading between the lines to try to validate their concerns about the economy, market participants did not like ongoing uncertainty created by the statement. The game of "will they or won't they" is starting to wear the markets down. Figure 3 shows the path of interest-rate increases implied by the futures markets (red and blue lines) compared with the Fed's guidance on interest rates (green line). Not only have the markets significantly revised down their expectations of interest rate increases over the past few months, they still do not believe the Fed will put rates up anywhere near as much as they have suggested in their statements.

Figure 3: Financial markets do not believe the Fed will tighten as much as it has said



China

Data out of China also continued to contribute to financial market volatility. Not only did the equity market decline further, but various statistics suggested the economy is slowing further. These included trade data showing larger than expected falls in both exports and imports and PMI's just below 50 indicating further modest slowdown in the manufacturing sector. Stronger figures for the services sector PMI attracted little attention although the service sector is now a larger part of the economy than manufacturing and construction. There were some signs of improvement in the housing sector with house prices rising slightly in August for the fourth month in a row. The breadth of house price increases across the country has also been improving in recent months.

The authorities in China announced further steps to support the economy including accelerating the construction of some major projects and reducing some corporate taxes. Further infrastructure spending is also expected and the central bank is likely to cut interest rates and bank reserve requirements further in order to support lending.

In Europe, there were similar steps to provide further support to the economy as the European Central Bank announced further quantitative easing in response to low inflation and the risk to growth from weaker emerging market economies.