Economic Snapshot

January / February 2016

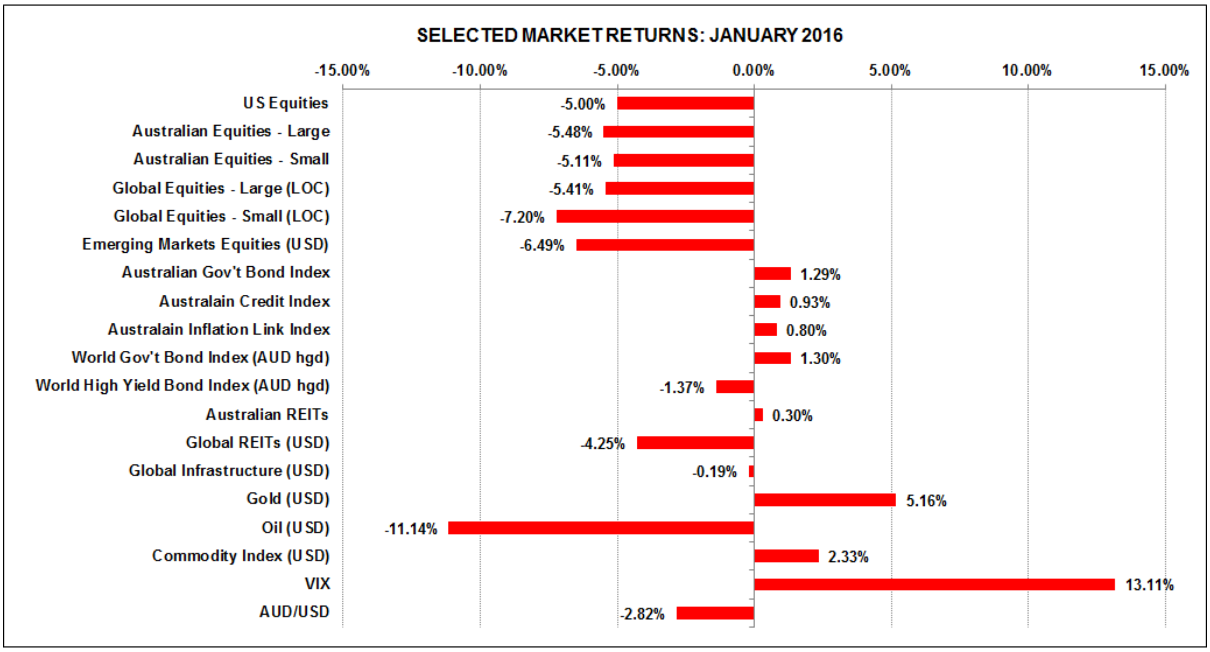
In summary

January was an extremely difficult month for the world's financial markets with very sharp falls in the price of equities and commodities. Price volatility both within and between days was exceptionally high. These conditions were attributed to the surprisingly large fall in the price of oil, economic data from China, the US Federal Reserve [Fed] lifting interest rates and concerns about the state of emerging economies. All this led to speculation about an imminent recession and even "the next leg of the GFC" with some extraordinary statements issued from a Bank Of Scotland analyst saying it is "time to sell everything".

In reality these comments appear more colourful than constructive, with the economic data revealing nothing to support that much pessimism. The markets continued to selectively misinterpret the data from China, and although the US manufacturing sector showed further signs of slowing, the household sector remains robust. In Australia, the latest data confirmed recent improvements in the labour market, while inflation remained at the lower end of the Reserve Bank's target range.

While the Fed reiterated its intention to gradually lift the cash rate this year, the Bank of Japan announced a negative cash rate policy which sparked a rally in equities at the end of the month. The European Central Bank also flagged plans for further policy easing with Mario Draghi saying there are "no limits" to what they can do. In Australia monetary policy remained unchanged at 2%.

Figure 1: Bond markets offered a safe haven from the month's fall in equities



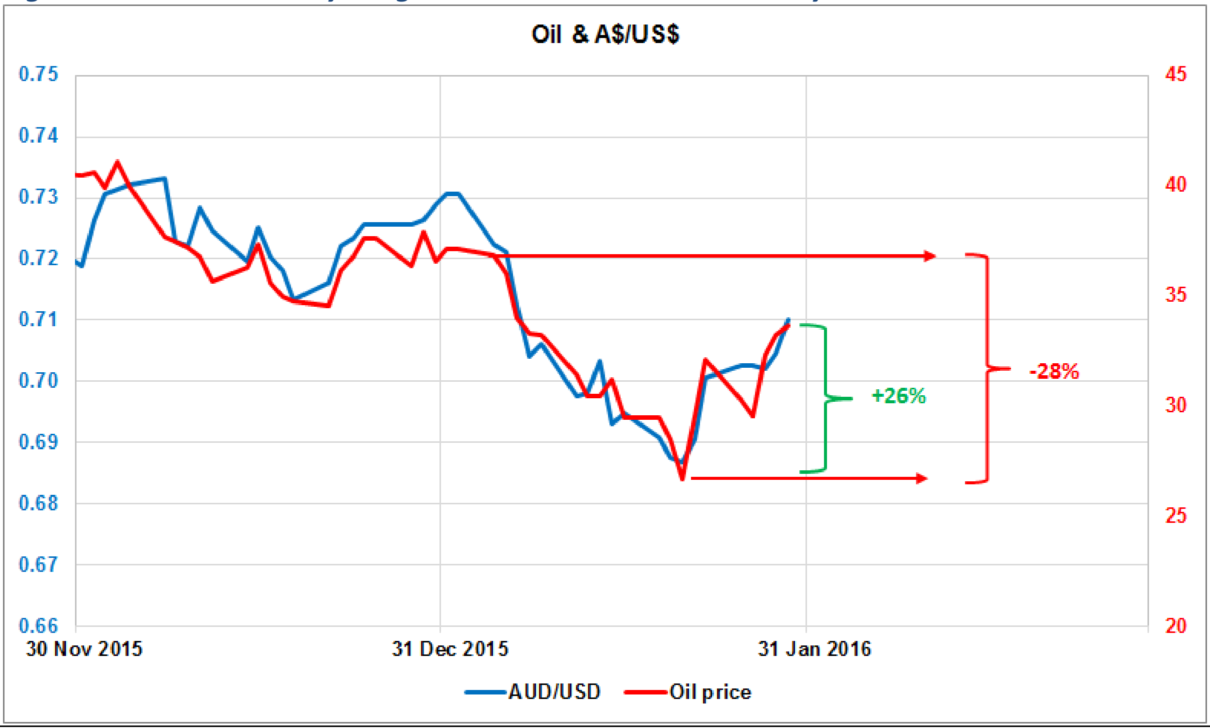
The decline in the price of oil was probably the major factor behind the turmoil in January.
From US$37 a barrel at the end of December, oil fell to just under US$27 a barrel on 20 January before bouncing back up to nearly US$34 a barrel by the end of the month. Figure 2 illustrates this volatility. The magnitude and speed of the price fall caught markets by surprise. Although further oil price softness was expected with Saudi Arabia holding the line on its supply policy and Iran coming back on line, no-one expected the price action seen in January. These conditions were likely exacerbated by seasonal market thinness and large volumes of speculative short selling.

Although the fall in the oil price has been primarily driven by supply factors as OPEC (especially Saudi Arabia) has sought to recover market share by putting its competitors out of business, the markets have read it as a sign of weak global demand and imminent recession.

In this context the manufacturing data from China released at the start of the month were seen to be important. When first released on 2 January, these figures were greeted with reasonably positive comments, but when the markets re-opened on 4 January the story was suddenly reversed and it all became very bad news. In particular, the improvement in the services PMI was ignored, as was the fact that the manufacturing PMI had stabilised with some key components showing improvements. The unofficial (and much less reliable) PMI got all the attention and was the main excuse for the heavy selling. Later in the month the authorities reported that real GDP grew by 6.8% in the year to the December quarter and 6.9% for the year as a whole, but this was greeted with the usual scepticism about the accuracy of the data.

The China PMI example illustrates how the markets were trading on fear and knee-jerk reaction rather than fundamentals. It also helps explain why nearly everything became an “oil trade” in January. If weak oil is believed to be a sign of weak growth then it follows that risk assets should be sold as the oil price goes down. The correlations of equities and commodity currencies with oil rose sharply to unusually high levels. Figure 2 illustrates the close link between the A$ and oil in recent weeks.

Figure 2: Just about everything became an oil trade in January



And yet the economic data does not support the notion of an imminent recession. Although oil producers in the US are struggling, the rest of the economy is in better shape.

USA

The key USA manufacturing index slipped a bit further in December to 48.0 but stabilised at 48.2 in January. The sub-50 reading of this reflects the sharp contraction in spending related to oil production as well as some softer demand for US exports from oil exporting nations. These factors contributed to the softer growth of real GDP reported for the December quarter. However, the household sector is still in good shape, reflecting gains in employment and real purchasing power. Payroll employment rose by 292,000 in December and the unemployment rate was steady at 5%. Real wage and salary growth is running at nearly 4% in year-on-year terms, boosted by the reduction in inflation from the lower oil price. Consumer confidence remains robust and has not been adversely impacted by financial market volatility. In this environment, the Fed still expects to lift the cash rate through 2016 but is keeping an eye on global conditions and how they affect the US economy when deciding the pace at which to proceed. Financial markets are sceptical about the Fed being able to tighten very much at all for the rest of the year.

Australia

In Australia the RBA remains content to keep the cash rate at 2% while suggesting that low inflation offers scope for easing if required. The latest CPI figures came in a bit higher than the markets expected, helping to lift the A$ back over US$0.70. Headline inflation rose 0.4% in the December quarter and 1.7% over the year. Underlying inflation was 2% over the year. These figures are at the bottom end of the RBA's target range. The level of overall employment and the unemployment rate were both steady in December, consolidating the better than expected results of previous months. There were some further signs of moderation in the housing sector, with reports of softer price growth and some reduction in building approvals.

Japan

The Bank of Japan surprised the markets late in the month by announcing the adoption of a negative interest rate policy to help support the economy. This had an immediate impact on the Yen which fell sharply against the US$.

Europe

In Europe Mario Draghi reiterated the ECB's resolve to provide sufficient monetary support and assured the markets that there are "no limits" to the measures the ECB might take. These moves by the Bank of Japan and the European Central Bank provided the catalyst for the bounce in markets at the end of the month.