Economic Snapshot

2016 Full year review - and a 2017 outlook

In summary

In hindsight 2015/16 proved to be a volatile year of repeating mini crisis'. Despite the erratic political and economic news, we still enjoyed modest growth in most of the traditional main stream asset classes. This ended up coupling nicely with some surprisingly buoyant returns in bonds, small cap equities and listed property. Although this was an impossible task to foreshadow at the beginning of the year, diversification into what is traditionally the more volatile areas proved beneficial for investors.

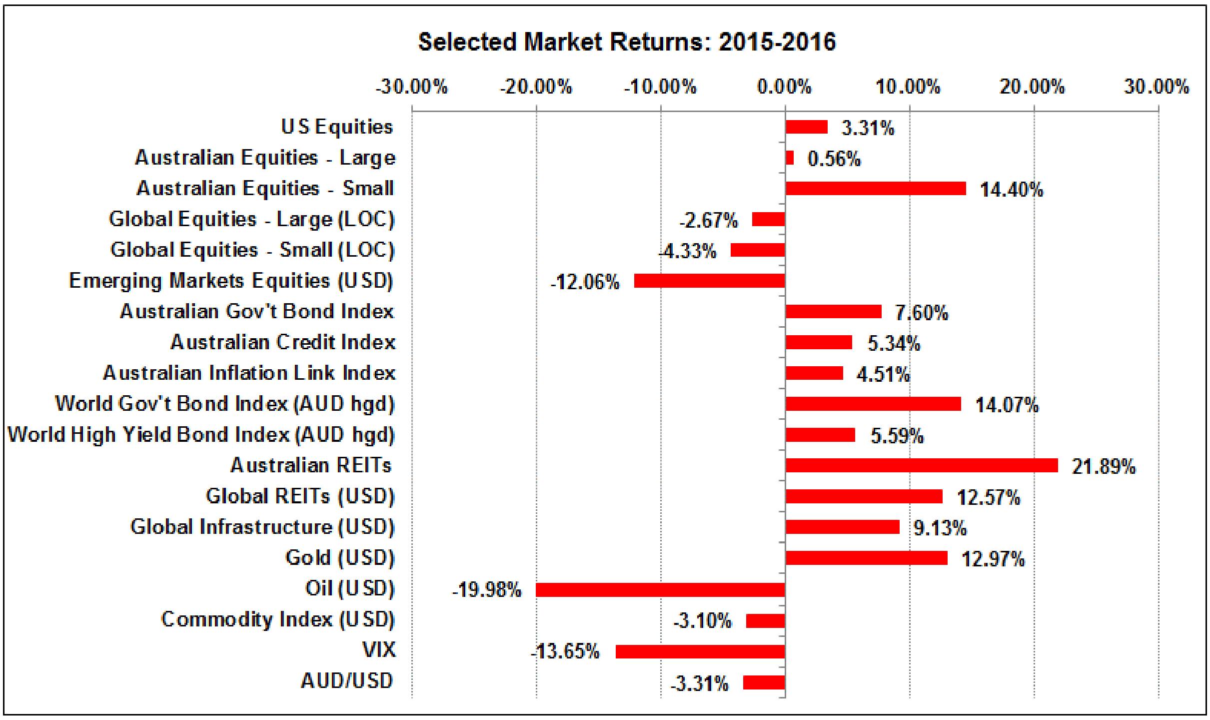
Overall the year seemed to be full of new surprises, triggering bouts of volatility in equity markets and ever lower sovereign bond yields. It started with China's devaluation in August 2015, shortly followed with OPEC's decision to push the price of oil down to regain lost market share, and then extenuated with the Federal Reserve [Fed] in the USA generating on-off again messages about lifting interest rates. Finally, we had the surprising Brexit vote with the UK referendum deciding to withdraw from the European Union. Not surprisingly, this all undermined investors' confidence in the global economy. However fears of imminent recession proved overdone as global growth slowed and resilience emerged in keeping with economic fundamentals. Some would say a victory for the economists.

In this very unusual environment investors continued to seek yield (Real Estate Investment Trusts and Infrastructure) while avoiding riskier growth assets (Emerging Markets). The US cash futures market ended the year pricing in no further move from the Fed for the better part of the next two years. Many commentators feel this is overly pessimistic and believe it's likely that the Fed will have to take some cautious tightening steps in the coming year.

A weaker US$ on the back of reduced cash rate expectations, then combined with modest resurgence in the price of iron ore helped drive the A$ off its lows around US$0.69 to finish the year closer to US$0.74. However traditional thinking suggests lower Australian inflation and cash rates should undermine the strength of the A$ in the coming year.

On all accounts 2016/17 is set to be another year of slow growth and low inflation as business investment languishes and excess capacity persists. Geo-politics is also likely to provide more potential volatility, of which the US Presidential election is the most prominent at this stage. In simple terms if the polls suggest or imply an improbable Trump victory, the more worried the markets will be and after the Brexit surprise, everyone is on alert for unknowns. Further to this the aftermath of the Brexit vote is still unclear and is also likely to cause periodic volatility.

Figure 1: 2015/16 was a struggle for mainstream listed equities, but proved positive for bonds, AREITs and Australian small caps. As is often in volatile times, gold was also favoured and did well.

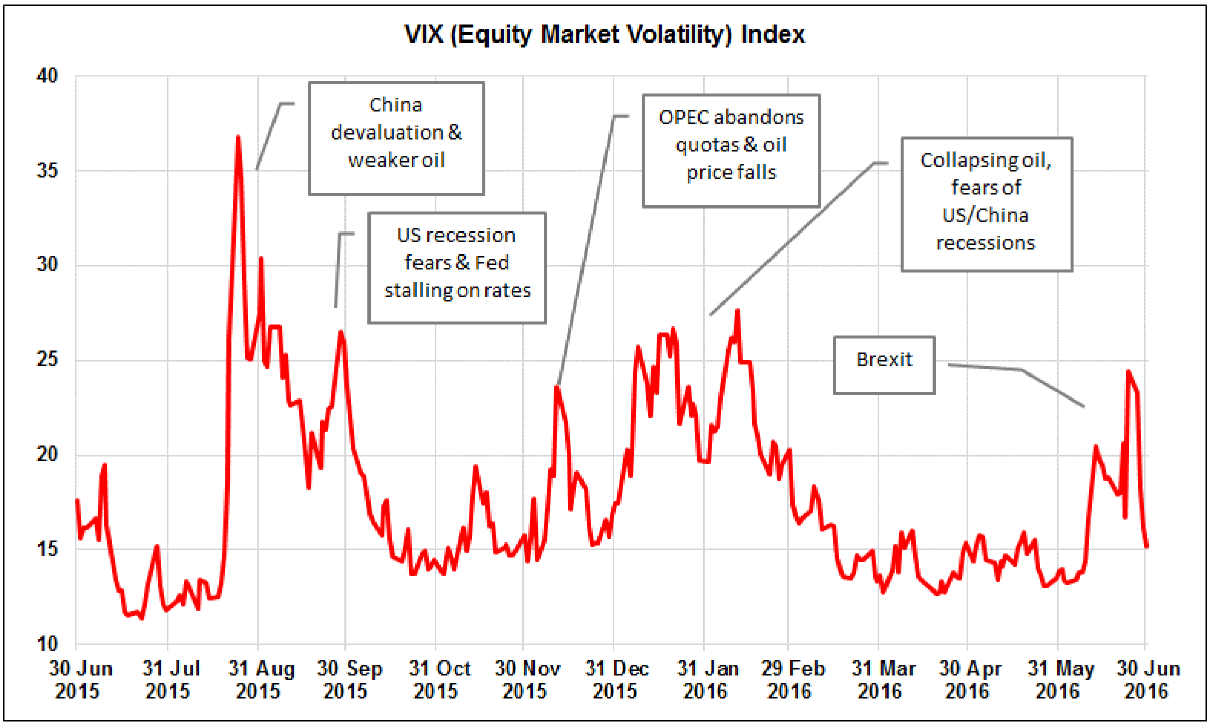


Source: Thomson Reuters

As Figure 2 [overleaf] shows, there was plenty of equity market volatility throughout the year driven by a succession of crisis events. Shortly after the volatility associated with Greece had eased, weakness in the price of oil plus China's currency devaluation in August triggered a new bout of equity selling. Markets were particularly concerned that China's move was the start of a round of competitive devaluations to gain export market share from its regional neighbours and potentially lead to another Asia Crisis.

Opecs decision in late 2015 to abandon its output quotas was a very significant development, effectively leaving member nations free to supply as much oil as they want. This was partly motivated by a desire to regain market share from the growing US domestic oil industry and partly by Saudi Arabia's desire to punish Iran and its ally Russia for the trouble they have been causing in the Middle East conflicts. The result was the price of oil fell below US$30 a barrel to its lowest levels in more than a decade.

Figure 2: 2015/16 succinctly shows events causing most of the volatility



Source: Thomson Reuters

Markets incorrectly interpreted the lower oil price as a sign of global economic weakness rather than the result of increased supply. Equities were sold off heavily in January and the first half of February as markets began to worry about a potential global recession. Seasonal thinness of markets impacted further by severe weather patterns in the USA, coupled with aggressive activity from hedge funds, exacerbated the volatility. By the middle of February 2016, the panic had subsided and equities set about recovering much of their losses. Such is the challenge of short termism in equity investing.

Nevertheless, such a dramatic fall in the price of an important commodity such as oil in such a short space of time inevitably has an impact on the global economy. Apart from temporary downward pressure on headline inflation, there are redistribution effects away from oil producers towards oil consumers. This operates both within and between nations, but one of the surprises of the past year has been how muted the response of household spending has been to lower oil prices. As the year ended there were some signs from the US that this delayed response might be starting to emerge, which if maintained, will be a positive factor in the coming year.

The final big event of 2015/16 was the Brexit vote on 23 June. Despite the late polls and the betting markets tipping a 'Remain' win, the 'Leave' camp prevailed. Once again markets responded by selling off equities on fears the UK's departure would signal the start of a broader unravelling of the Eurozone.

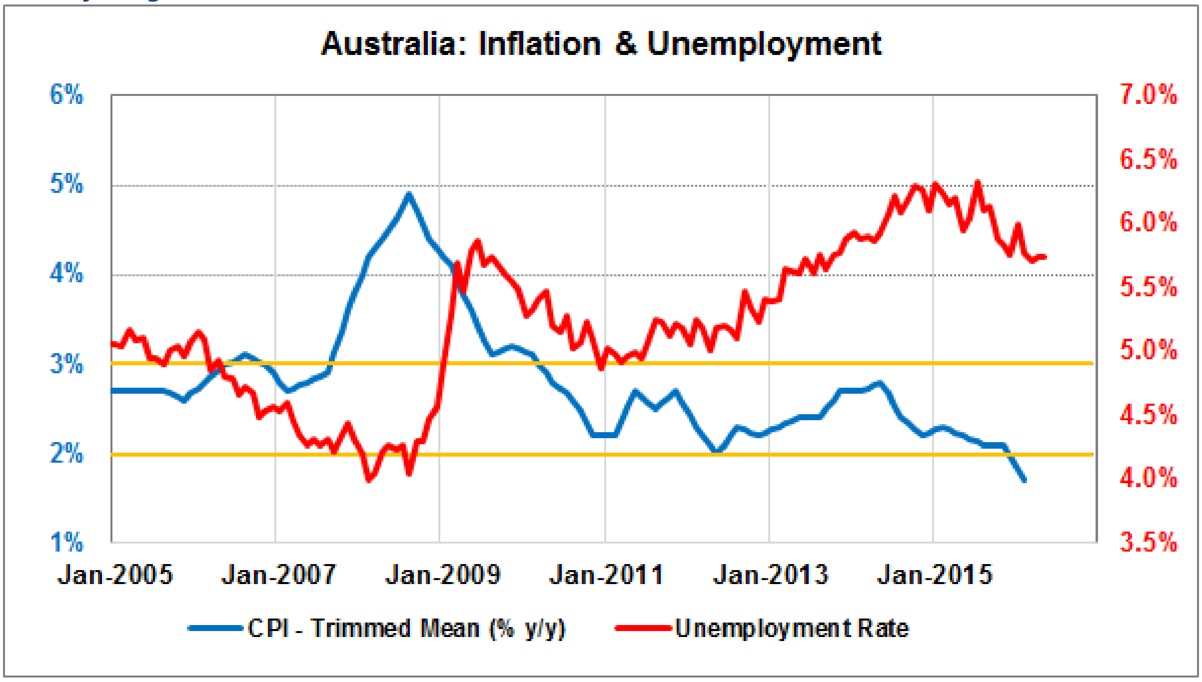
As things turned out, however, after only a few days markets quickly stabilised to recover as it became more apparent that there's still a long way to go before the UK actually leaves (some would say if at all) and that central banks have the will and the means to support economies and markets.

Australia

By some metrics the Australian economy performed reasonably well over 2015/16. Real GDP was around 2.5% - 3.0%, which was pretty good by global standards. Business conditions indicators remained steady/positive after the improvement seen in the previous year, but business confidence slipped, partly due to concerns about the deteriorating political situation. Generally flatter business conditions were mirrored in a slowing pace of employment growth and the unemployment rate settling around 5.7%.

However, perhaps the most significant economic news came with the first quarter CPI report which showed inflation falling at both the headline and underlying levels. The measure of inflation watched by the Reserve Bank is now below the lower level of the RBA's target range (Figure 3). This news surprised the markets and led the RBA to cut the cash rate in May to a new record low of 1.75%. Leading indicators suggest the inflation rate will remain low well into 2017, leading to speculation of another one or even two rate cuts from the RBA.

Figure 3: Australian unemployment still relatively high, but core inflation the lowest ever recorded and still falling

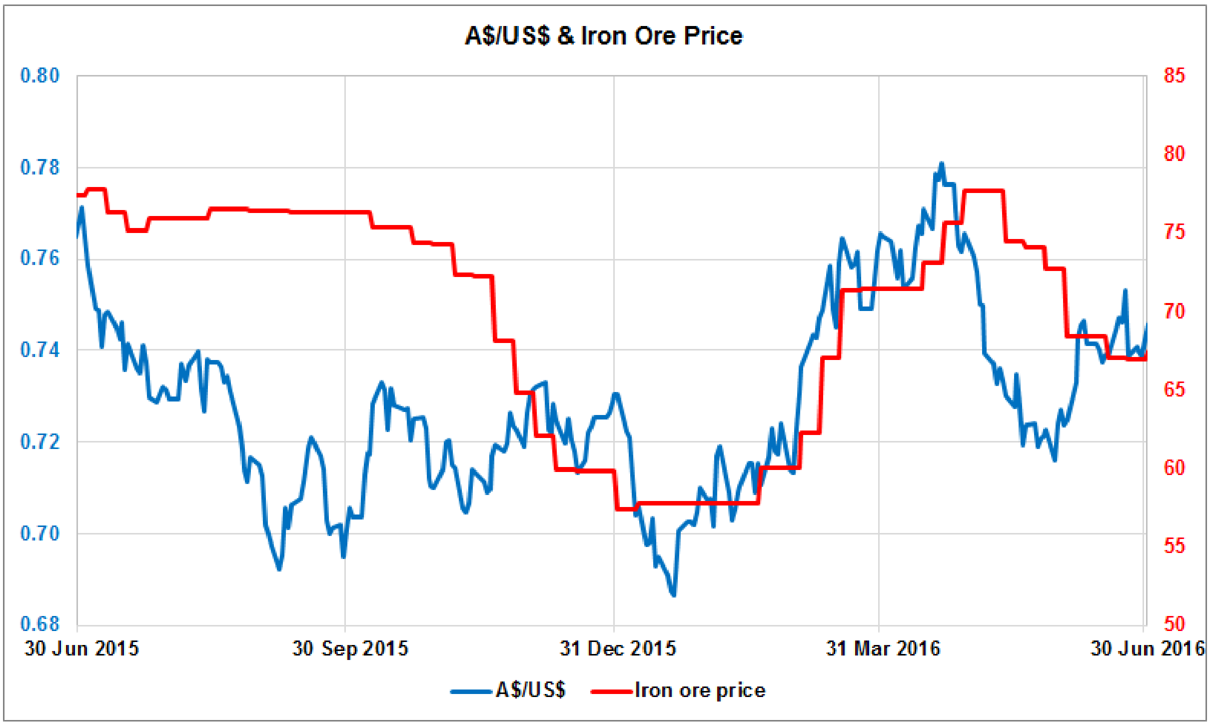


Source: Thomson Reuters

Australia is now clearly part of the global low inflation story. Although the risk of deflation seems remote, there appears to be insufficient growth occurring here or overseas and economists feel the RBA will need to cut the cash rate further to stop real interest rates and the A$ rising, both of which would adversely impact growth. A lower A$ would also help support the inflation rate.

The A$/US$ rate began a slow downward trend through the second half of 2015 but found itself retracing back in the first half of 2016 to finish the year not much below where it started. This was despite a rate hike by the Fed and a rate cut by the RBA leading to an overall reduction in the interest differential against the US$. Commodity prices particularly iron ore and oil, contributed to the resurgence of the A$ (Figure 4). However, at current levels the A$ is well above traditional valuations implied by the interest differentials. The likelihood the Fed will tighten more than the markets currently think, combined with further cuts from the RBA and seasonal weakness in the iron ore price, all suggest the A$ is at more risk of falling than rising in the coming year.

Figure 4: The A$/US$ recovered in 2016 on higher iron ore prices



Source: Thomson Reuters

USA

The United States economy grew by around 2.0% - 2.5% with seasonal weakness over the winter months as mentioned earlier. This growth was challenged by the sharp fall in the oil price severely impacting activity in the energy sector. The key manufacturing index [ISM] fell which, combined with some softer economic data in China and pressure on emerging market economies from the lower oil price, then caused fears of a global recession. These fears were unfounded, but were enough to make the Federal Reserve further delay an expected increase in US interest rates.

The Fed has backed itself into a corner over the past twelve months by tying its decisions on interest rates to global economic and financial market conditions as much as US conditions. This is something of a departure from its long-standing practice of focussing on the domestic economy and partially reflects the greater impact of the US$ on the US economy in a post-GFC world, as well as fear of further destabilising skittish global financial markets.

In the wake of the Brexit result the markets have now in all probability priced out any increase in US interest rates for another two years. This seems rather pessimistic given the improvement in the US labour market, where the unemployment rate is now below 5% and wages growth is picking up. There is also an encouraging improvement in the housing market and consumer spending. Sooner or later the Fed will have to make a move to higher interest rates, but this will be done very gradually.

China

Conditions in China continued to be a major source of concern for markets through the year, with participants continually worried that China was about to roll over into some sort of recession. The authorities' somewhat clumsy handling of the local equity and currency markets did not help this sentiment. However the government did counter the slowing of activity in the manufacturing and construction sectors with some significant fiscal and monetary policy stimulus in the second half of 2015. This lead to improvement in key economic indicators in early 2016 and the economy appears to be on track to meet the government's new 6.5% - 7.0% growth target. However, concerns remain about the level of debt in the Chinese economy, especially poor quality debt that needs to be restructured.

Outlook – the Snapshot Crystal Ball

The coming year in all probability is likely to echo 2015/16 in some important ways: more slow growth and low inflation with further bouts of volatility generated by "crisis events", driven especially by geo-politics. Translating this outlook into expected market returns requires balancing a reasonably benign environment for returns with a potentially adverse environment for risk. Even if one could accurately forecast returns, it is impossible to forecast the specific timing and impact of events that shock the system and create the significant volatility we have come to experience in recent times.

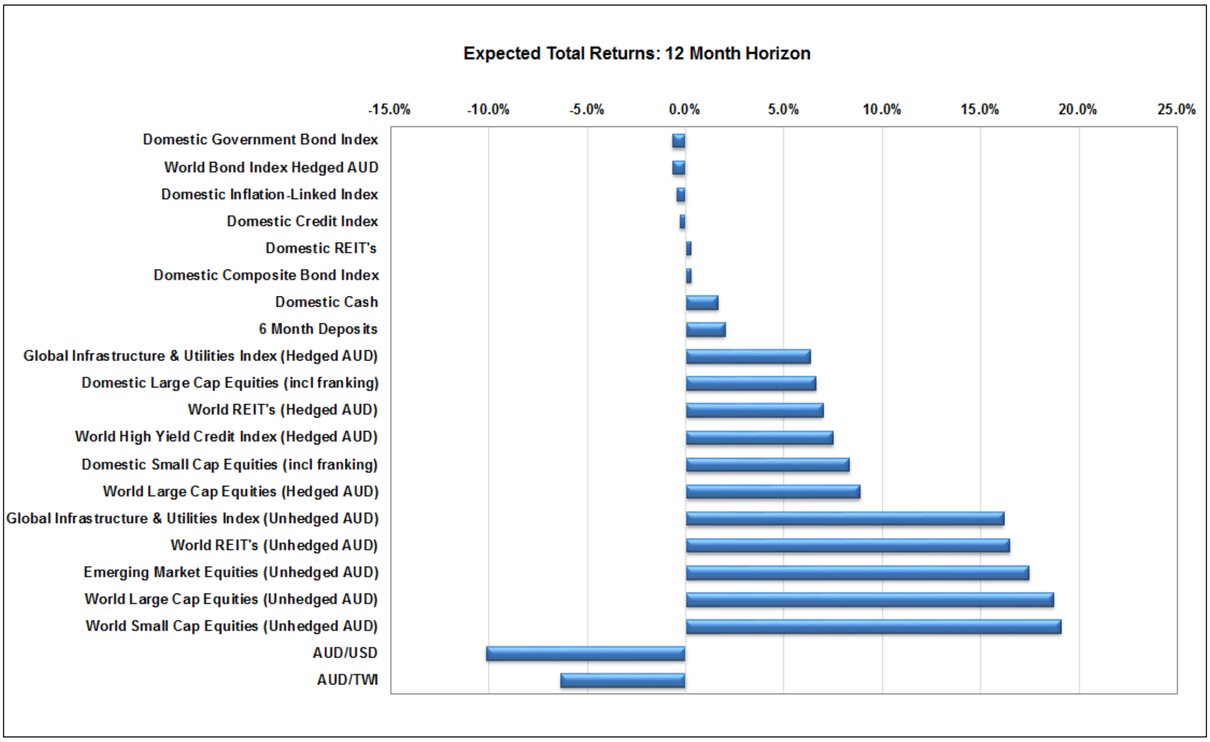
Since a global recession in the coming year is not envisaged economists do not expect to see a major pull back in equities that could signal the start of the next bear market. Equity valuations can no longer be called cheap, but the traditional precursor of equity bear markets – much higher interest rates in response to higher inflation – just does not seem likely. Indeed, the prospective environment is one in which central banks and policy makers will continue to tread carefully to avoid triggering bouts of volatility and disruption.

Domestic politics is shaping up to be of little or no benefit to local markets, apart from potentially adding weight to the case for further rate cuts. Given the sadly dysfunctional state of Australian politics at the moment, a situation in which the politicians are constrained from doing much at all may perversely be the least damaging outcome. Of course, such a situation cannot last forever and if one listens to the opposition, the possibility of another Federal election in the coming year cannot be ruled out completely.

Given all this, fund managers in general expect equities to beat government bonds and for unhedged international equities to beat domestic equities as the A$ resumes its depreciation. Government bonds look more expensive at current yields, but bouts of volatility may moderate any sell off as investors revert to perceived safe havens.

Geo-political events we all need be watching include the US election, the Brexit follow up in the UK (new PM, triggering of Article 50, Scottish independence), the response in Europe (Italian referendum in October 2016, calls for exit referenda in other countries) and the on-going conflict in the Middle East.

Figure 6: Forecast returns over 2016/17 are positive without being gregarious …(barring shocks)



Snapshot looks forward to reviewing these forecasts throughout the year and hope that the volatility envisaged proves to be in line with short term market rhetoric, rather than the economic fundamentals that we report on as drivers of markets in the longer term.