Economic Snapshot

July - August 2016

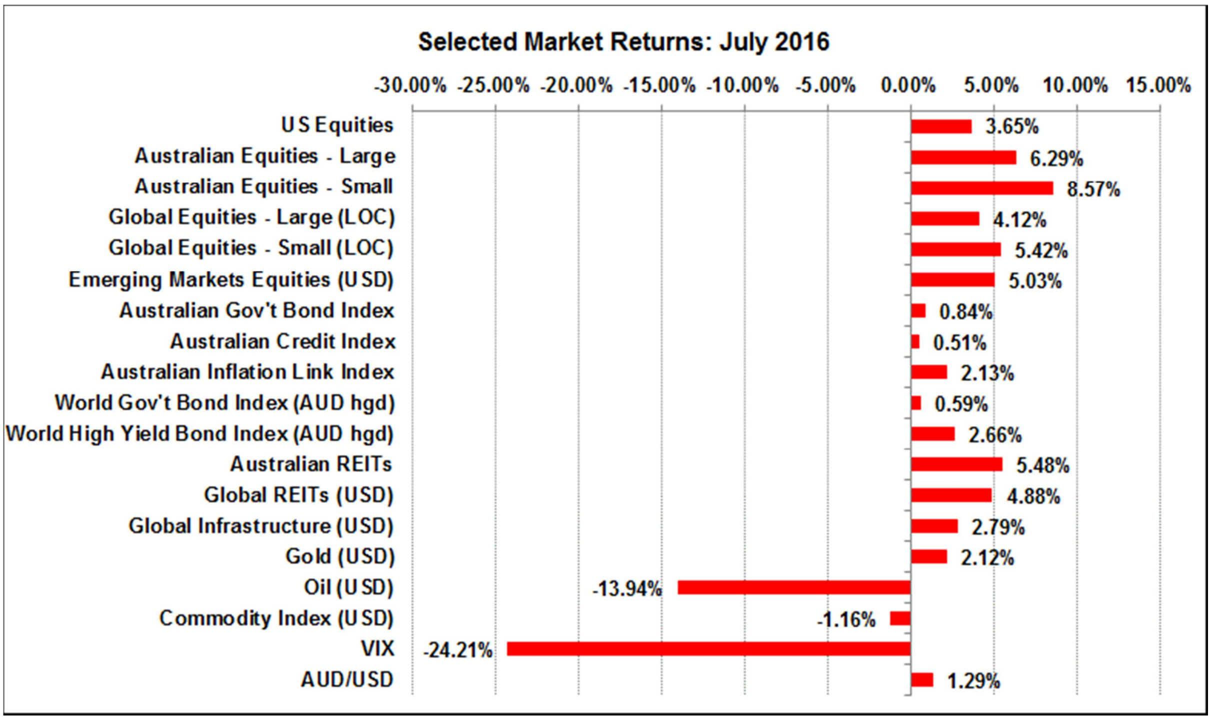
In summary

The turbulence world financial markets unleashed by the surprise Brexit vote at the end of June quickly disappeared in July as it became apparent that any immediate negative impact would more than likely be restricted to the UK. The issue of sorting out the actual exit has also been realised as a long term programme meaning there's no need to overreact.

What markets did do, is turn their attention back to the pace of economic growth and its implications for central bank policy. In general, the latest data show no signs of imminent recession in major key economies like the US and China. Equally there's not enough US growth to clearly compel the Federal Reserve to lift interest rates in a hurry. Combined with expectations of further monetary stimulus in the UK, Europe and Japan, the markets were happy to resume buying both equities and government bonds.

After holding the cash rate steady in June, the Reserve Bank cut to a new record low of 1.5% on August 3rd. This came in the wake of the inflation report for the second quarter which, as expected, showed inflation remaining below the bottom of the Reserve Bank's target range.

Figure 1: July was a better month for risk assets (Equities) , with volatility falling sharply



Source: Thomson Reuters

Equity markets performed well in July despite the price of oil falling steadily throughout the month. At the start of the year, equity markets rose and fell with the price of oil, but this link appears to have broken in July as markets focused more on economic news and prospects for further monetary stimulus. Nevertheless, it is worth noting that the fall in the oil price from just over US$50 a barrel to just under US$40 a barrel partly reflects increased production from the US as marginal oil rigs became profitable again at the higher price. The oil market still has a way to go before it finds a more stable balance between supply and demand.

Australia

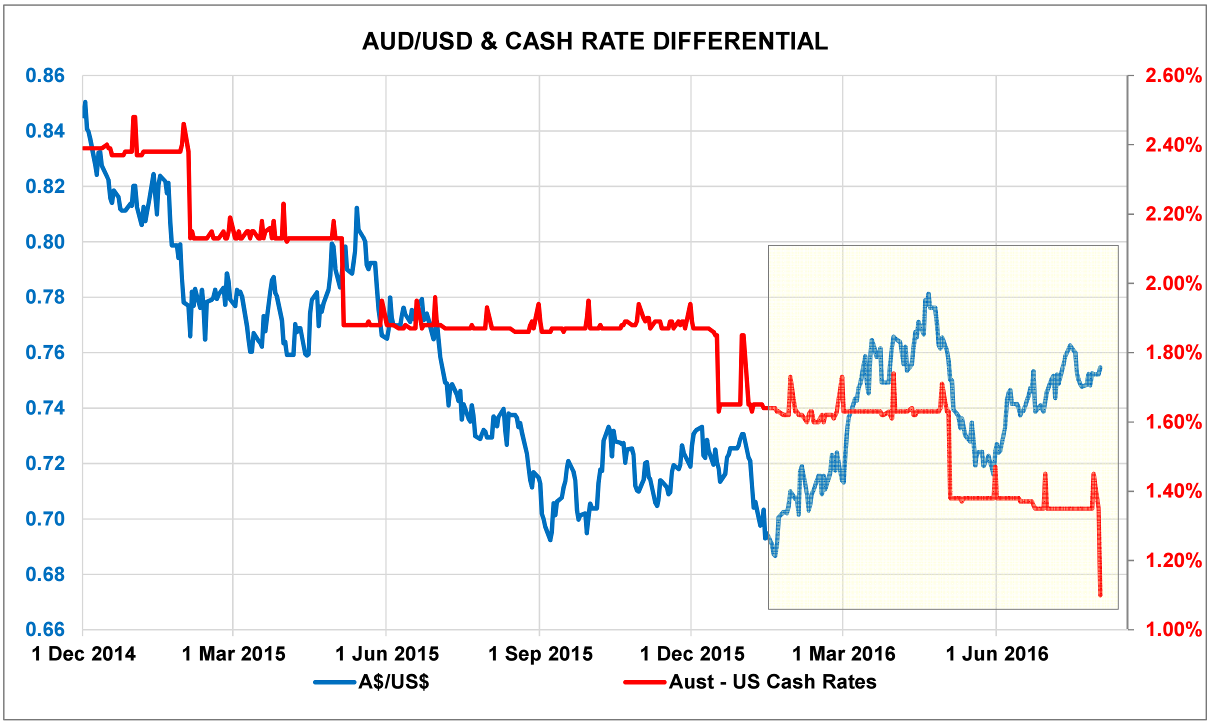
Here in Australia the June quarter Consumer Price Index report confirmed most expectations that inflation remains subdued and below the bottom of the Reserve Bank's target range. Headline inflation rose by 1% in the year to June quarter, while underlying inflation rose 1.7%. Declines in transportation and communication costs contributed significantly to the overall soft result.

Not surprisingly, the Reserve Bank [RBA] responded to the inflation news by cutting the cash rate to a new record low of 1.5% on August 3. The RBA also reiterated its view that a lower A$ would contribute to supporting both growth and inflation. Interestingly, it also flagged the housing market is not a constraint on its decisions about interest rates, believing that prudential controls on lending for housing have started to have an impact.

Other economic news on Australia released during the month showed business confidence and conditions improving slightly, but only a very small increase in employment in June combined with a slight increase in the unemployment rate to 5.8%. A survey of consumer confidence taken in the wake of the Federal election showed a 3% fall, with consumers particularly concerned about the outlook for the economy over the coming year. This may have been an impact of the electioneering.

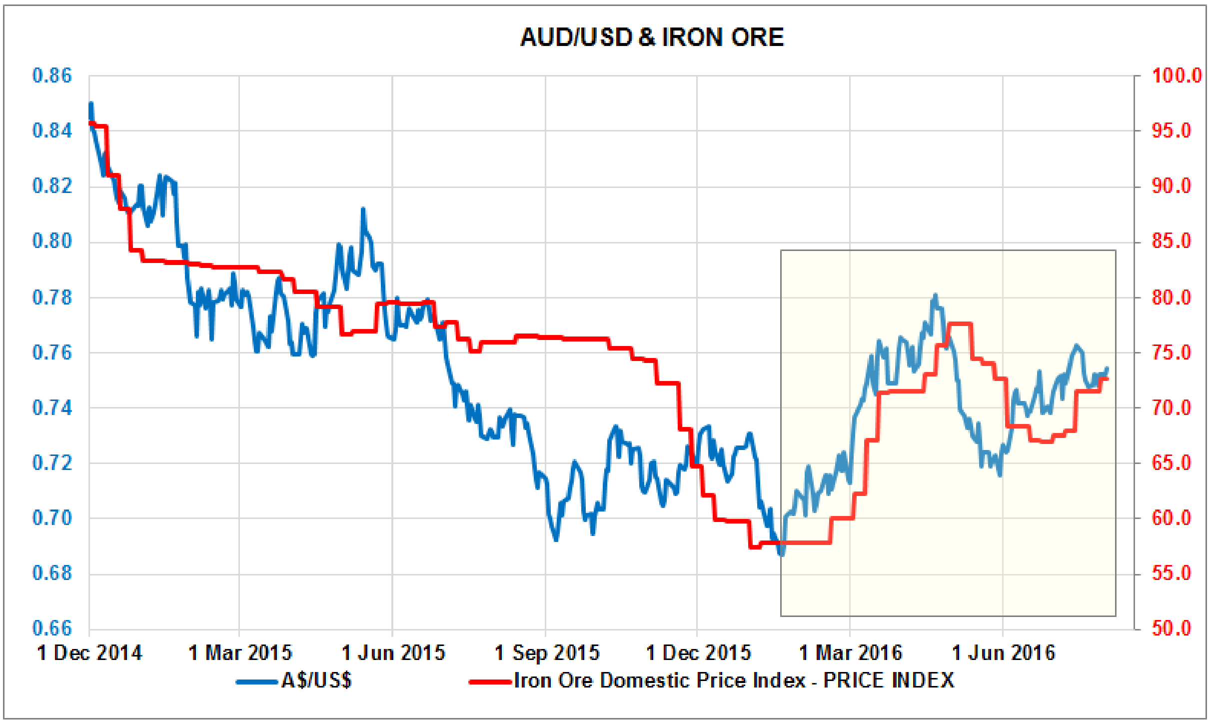
Given that a lower A$ was one of the RBA's preferred outcomes from cutting the cash rate, they must be somewhat frustrated that the currency has hardly moved since the cut on August 3rd. A key reason for this is that the currency markets are focusing more on what happens with US interest rates than with Australian interest rates. The more the markets think the US Federal Reserve will not lift the cash rate any time soon, the less inclined they are to buy US dollars. This leaves the A$ relatively high and puts further pressure on the Reserve Bank to cut interest rates more.

Figure 2: The A$ has been responding less to interest rate differentials.....



Source: Thomson Reuters

Figure 3: ...... and more to the price of iron ore.



Source: Thomson Reuters

USA

The markets remain sceptical about the Federal Reserve lifting interest rates because they believe the data still do not suggest a strong, self-sustaining recovery is under way in the United States. For example, the key ISM manufacturing and non-manufacturing surveys slipped back a bit in July, though not enough to suggest any imminent contraction in growth, while the second quarter GDP figures came in below expectations. The markets had been looking for an annualised GDP growth rate of about 2.5% in the second quarter, but the actual figure was 1.2%. However, it is important to look within the figures to get a clearer picture about what is going on. All the below-expectation softness was due to a significant rundown in inventories rather than to weakness in headline spending across the economy. In fact, consumer spending rose an annualised 4.2% in the quarter as households took advantage of better employment conditions and rising wages. If consumer demand holds up, the fall in inventories could spur increased production later in the year. Although business spending remained subdued the strength of the household sector is an encouraging sign for the momentum of economic growth. Ongoing improvement in the labour market is also a good sign, with another 287,000 jobs being created in June after the surprisingly weak result in May. The unemployment rate remains just below 5%. Inflation is still low in the US - around 0.9% for the headline rate and 1.6% for underlying inflation – but overall the economy is not doing too badly at the moment and the markets may be underestimating how much room the Federal Reserve will have to move on interest rates this year.

China

Iron ore prices have benefited from strong demand from China some of which reflects speculative activity by investors and some of which reflects increased construction spending in the wake of the government's aggressive monetary and fiscal stimulus measures in 2015. Both these sources of demand for iron ore are expected to dissipate over the rest of 2016. The authorities have been cracking down on speculative trading of commodity futures, and the stimulus program is widely expected to lose momentum by the end of the year. As a result, the recent surge in economic growth in China, to a pace around 7%, does not look sustainable. The Politburo meeting on 26 July announced further progress needs to be made in reducing unnecessary manufacturing capacity and in reforming State Owned Enterprises.

UK

Although the markets have quickly turned their attention away from Brexit, its impact is being felt in the UK. Apart from the political fallout in which Theresa May has replaced David Cameron as Prime Minister, the indicators of economic activity and sentiment are signalling that the economy is quickly slipping into recession. Although the Bank of England did not cut interest rates in July, the markets still expect it to provide further monetary stimulus in coming months.