Economic Snapshot

September – October 2016

In summary

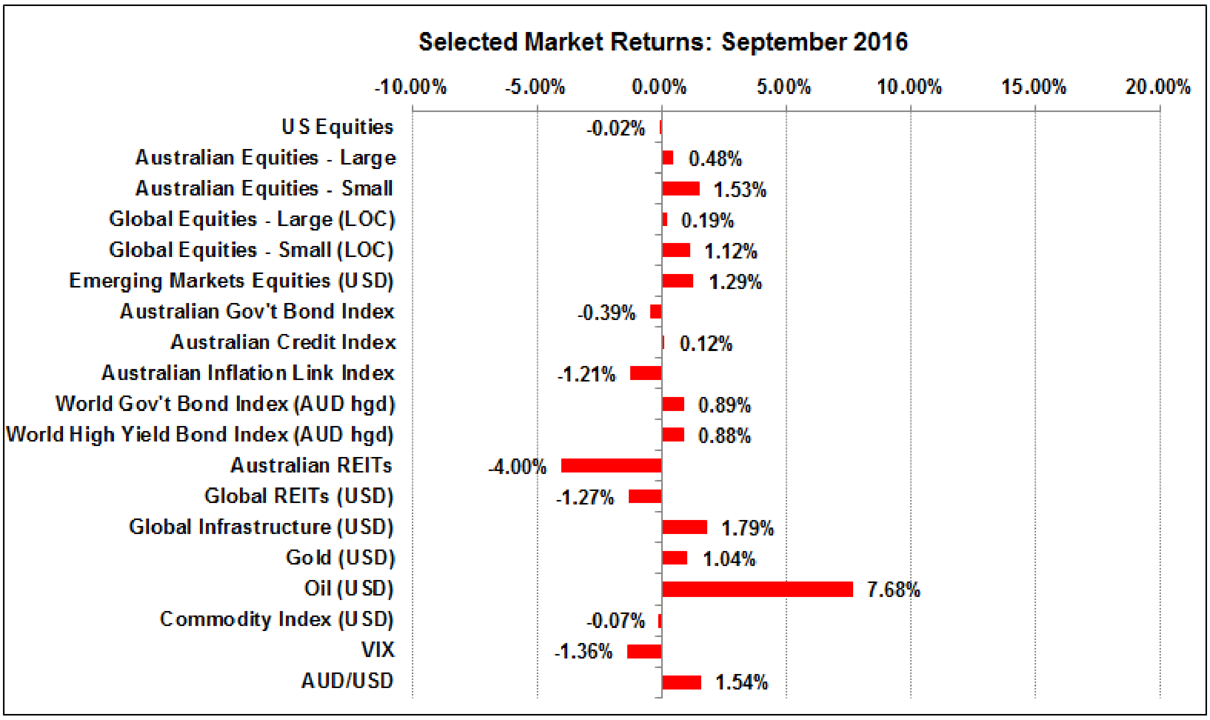
September was a frustrating month for investors in global financial markets. The first half of the month saw both bonds and equities retreat on concerns the Federal Reserve would lift interest rates at its meeting on the 20th - 21st. As things turned out, the Reserve left the cash rate unchanged and revised down its forward profile of interest rates. The markets were reassured by this, leading bonds and equities to recover ground lost earlier in the month. This see -saw effect is now a recurring theme as markets dance to the tune of the interest rate outlook.

Here in Australia the Reserve Bank has maintained the cash rate at 1.5%, noting the economy is growing at a moderate pace but inflation is low and likely to remain so for some time. Once again, the Reserve Bank noted that an appreciating A$ could complicate the adjustments the economy needs to make.

The Bank of Japan announced a new dimension to its QE program aimed at generating a positive yield curve. Despite the commentary it appears markets remain sceptical about this move.

Meanwhile in Europe the European Central Bank [ECB] left its monetary policy stance unchanged at its meeting in early September. Financial markets interpreted the accompanying statement as a signal the ECB would start to wind back its QE programme. This contributed to nervousness and volatility, as did speculation about the solvency of Deutsche Bank later in the month.

Figure 1: Muted returns for September masked much bigger swings within the month and Property retreated following strong yearly returns.



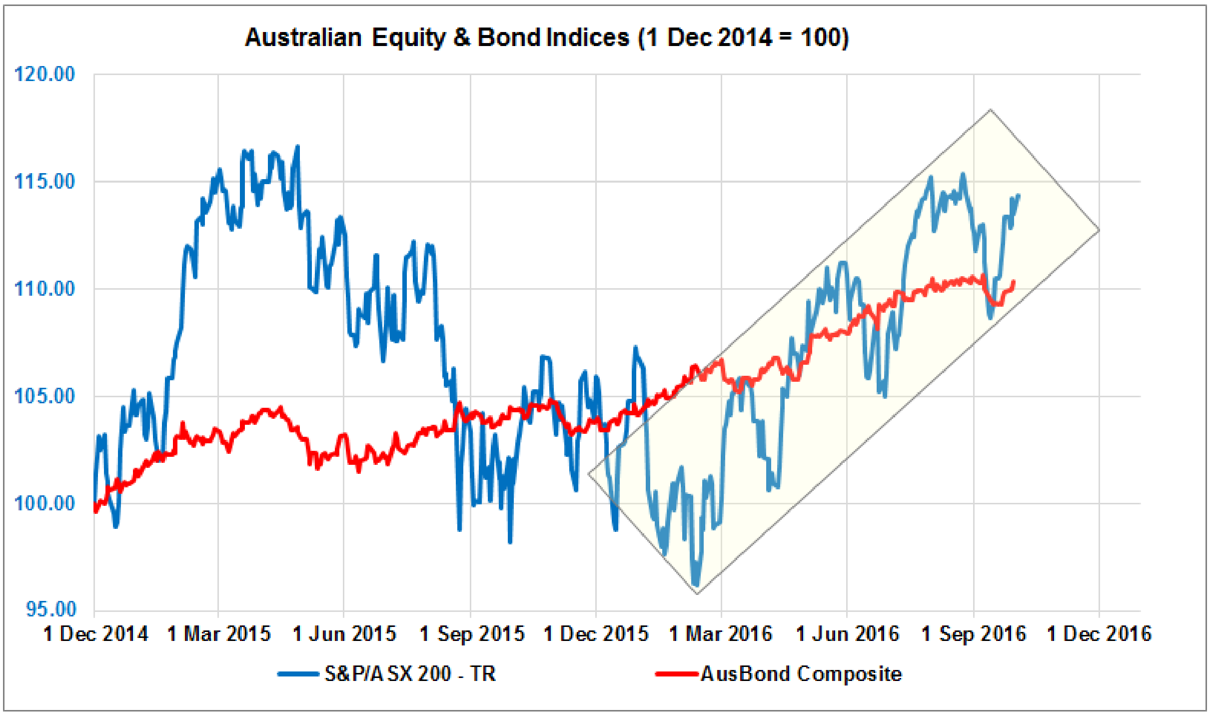
Source: Thomson Reuters

Developments in the oil market were also an enabler to broader financial market volatility. The International Energy Agency released a report predicting lower demand will increase oversupply in the market into 2017 and push down the price of oil. In addition, OPEC revised up its projections for supply from non-OPEC nations in 2017. ***By the middle of September the price of West Texas Intermediate oil [benchmark for crude oil] had fallen nearly 4% to US$43/barrel, but by the end of the month was back up to US$48/barrel on reports of a deal between Saudi Arabia and Russia to cap production***. Iran continues to demand that it be allowed to increase production back to its pre-sanction levels. The volatility of the oil price fed into volatility in emerging market equities, as well as dragging down energy shares in the US market.

Australia

In Australia Figure 2 illustrates the volatility in local markets within September, with the decline in equity and bond prices in the first half of the month followed by some recovery towards the end of the month. So far, neither bonds nor equities have recovered to the highs seen in August. Interestingly, the S&P ASX 200 has continued to trade within the broad upwards trend it has established since the lows in February this year.

Figure 2: S&P ASX 200 remains within its broad upward-trend range as seen over 2 years.



Source: Thomson Reuters

Footnote: The June quarter national accounts showed economic growth decelerating in the quarter, but still 3.3% over a year ago, which is a very respectable result in global terms. Indeed, this marked an unbroken 25 years without a recession, something very few countries have ever been able to boast.

Nevertheless, growth was skewed towards public sector spending and dwelling investment, with consumer spending making a smaller contribution and business investment detracting from growth.

Net exports made a positive contribution, however there are signs the stronger A$ is hurting business conditions, which may show up in a broader range of economic indicators in the near term.

Total employment was reported to have declined by 4,000 in August, driven by a 15,400 decline in part-time jobs only partly offset by an 11,500 increase in full-time jobs. The unemployment rate slipped from 5.7% to 5.6%.

USA

In the USA, data released early in the month suggested the economy was slowing down. For example, the manufacturing index fell from 52.6 in July to 49.4 in August while the non-manufacturing index fell from 55.4 to 49.6. In the market's mind, this did not gel with the more upbeat tone emanating from the Federal's Reserve's somewhat Beige Book report on the economy and ongoing comments from the Governors suggesting an interest rate increase could be imminent. This undermined sentiment in both the bond and equity markets.

Bond-sensitive, defensive equities such as utilities and consumer staples performed particularly poorly. However other Governors advocated caution in moving on interest rates, citing low inflation and transmission effects through foreign markets as reasons for delay. As things turned out, the Reserve made no move at its meeting on 20-21 September and markets recovered some lost ground - although speculation then focused on a rate hike in December after the Presidential election.

Nervousness ahead of the first Presidential Candidates' debate, fuelled by opinion polls suggesting the race is too close to call, added to the equity markets' worries. Trump's poor showing both during and after the debate provided a bit of a boost for the equity market.

Interestingly, consumer confidence in the US remains quite robust with the Conference Board's index rising 2.3% in September - economists had expected the index to fall.

Europe

In Europe, the ECB said it would leave monetary policy settings (both cash rate and bond buying) unchanged for the time being, and that "key ECB interest rates to remain at present or lower levels for an extended period of time" and "monthly asset purchases of 80 billion euros are intended to run until the end of March 2017, or beyond, if necessary, and in any case until it sees a sustained adjustment in the path of inflation consistent with its inflation aim."

The markets interpreted this to mean the ECB would soon start to reduce the amount of stimulus it is providing, however in the minds of many this seems an overly pessimistic interpretation.

Intriguingly, the ECB also suggested fiscal policy may need provide the stimulus monetary policy cannot. This echoes comments made in the US and here in Australia by the new RBA Governor Phil Lowe.

Although it is far too early to be expecting meaningful developments on the fiscal front, such a move would have significant implications for bond markets by allowing central banks to start unwinding their stimulus programs sooner rather than later.

Towards the end of the month, reports on concern about the solvency of Deutsche Bank in the wake of a massive fine from US authorities contributed to some renewed volatility in equity markets. Internet gossip suggested Deutsche Bank could be a “Lehman’s moment” in the making which could precipitate another global liquidity crisis. These concerns were based more on fear and speculation that on fact.

The reported fine was never going to be as large as suggested and for many the notion that the authorities would simply let Deutsche Bank fail seems very hard to believe. By the end of the month markets had bounced back from these initial reports, although some questions still remain.