Economic Update

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By Ron Bewley*. Brought to you by PATRON

Within this month's update, we share with you a snapshot of economic occurrences both nationally and from around the globe.

It's been all growth on Wall Street

- United States (US) tax reform

- Australian economy is warm at best

- Japan economy is on fire

We hope you find this month's Economic Update as informative as always. If you have any feedback or would like to discuss any aspect of this report, please contact your Financial Adviser.

The Big Picture

The third quarter of 2017 just ended with Wall Street's S&P 500 index not only posting a positive return – but it posted the eighth successive quarter of growth! Indeed, the last six months were also all positive.

So where did we go wrong? Out market has moved sideways since May in a very tight range. Basically, expected earnings for companies on the ASX 200 just aren't cutting the mustard. But the growth in earnings on Wall Street has been sufficient to justify their index returns over the last two years.

On top of that, Trump has started to articulate his tax reform package. The details are sketchy at this point but the right noises are being made both in politics and in business.

Our GDP growth came in at a moderate 1.8% for the year which was more or less in line with expectations. We had more strong jobs data but what will come next? The Reserve Bank (RBA) is upbeat. The worry is that they will get too enthusiastic and pull the trigger for a rate hike making the wheels fall off.

Turnbull at least got one win on the energy policy but we need more.

We reported last month that Japan's economic growth was strong at 4%. This month, Japan export growth ran into double digits for the second month in succession. So good is it that Shinzo Abe has called a snap election. He wants to usher in a big stimulus package and make a more concerted stand against North Korea.

China data over September was a little softer than the previous month but still strong. The new politburo will be ushered in this month for its five year term. The infrastructure highway across Asia and into Europe will put massive demands on steel production – and we are in a position to help. BHP was very vocal and positive last week!

Angela Merkel was returned as Chancellor in the Germany elections – but with a different blend of coalition. Not a resounding success! New Zealand elections were even more wishy-washy.

The one to watch is the UK. Its inflation read came in at a lofty 2.9% - well above the pack. The Bank of England will start tightening soon.

October is going to be very special indeed for central bank watchers. The US Fed has announced that it will no longer buy back all of the bonds that mature. In a sensible and staged fashion, they will very gradually reduce the 4.5 trillion dollar debt to about half of that over a few years.

Most commentators believe that will put upward pressure on long bond rates. There has already been some impact in this direction on the expectation of this 'balance sheet repair'. That's all good and necessary. But what will happen at the short end? Will the Fed still hike its fund rate?

It surprised many – including us – that in the latest minutes, the Fed is still planning on one more hike this year (December), three next year and two the year after – down from three. We do not think it wise to hike rates while it is commencing budget repair.

The current chair – Janet Yellen – has her term up in February and Trump has signalled he will announce the next chair in the next 2-3 weeks. Depending on the views of the new chair (or Yellen if reappointed) we could be in for a bit extra volatility to go down with the Christmas turkey. But US growth and tax reform should steer us through any bumps along the way.

Asset Classes

Australian Equities

The ASX 200 was down slightly (-0.6%) for the month but the index is up only +0.3% for 2017 to date (plus dividends makes a total return of +3.9% including franking credits).

So being in equities for 2017 would have been better than cash but there is a sense of frustration among investors.

Since May we have had the tightest range on record for the index. Of course it will break one day but there are a lot of factors at work. Some have suggested that local super funds buy in strongly at around 5,650 but foreign funds sell at above 5,800.

Such behaviour means that we are living off our rather lucrative franked dividends. Not bad if you can get it.

We think we need three things to change before our market takes another 'leg up'. First, we need our political system to engage on tax reform and infrastructure. Second, we need the US Fed to clearly articulate its plan for the next year or so. Third, we need the soon-to-be-sworn-in China leadership team to announce its new plans. On this basis it is hard to get excited about potential gains in October but we could get a really good Santa rally – and not because it is that time of year. It is that confluence of events.

Foreign Equities

The S&P 500 was up 1.9% over September. The German DAX was up 6.4% and the Tokyo Nikkei was up 3.6%. So there was a lot of action but it is hard being in the right markets at the right time.

Going forward, it is probably smart to be weighted a little out of Australia and towards Europe and Emerging Markets with a healthy – but not overweight – stake in the USA

Bonds and Interest Rates

The RBA was on hold in September and will hopefully not raise rates until at least 2019. But some commentators are calling for a hike in early 2018. They must use a different crystal ball supplier.

We expect some volatility towards the end of 2017 as the Fed sorts out its new direction. And there is pressure on the UK to hike.

While we expect volatility, we do not expect a long-run impact on our markets. We have lived in a low volatility regime for much of 2017. If volatility goes back to normal levels, so what?

Other Assets

Oil prices were up about 10% while iron ore was down about 20% over the month. In both cases, these changes are not establishing new trends but correcting previous moves.

Regional Analysis

Australia

While economic data last month came in reasonably positively, the data were not strong. The future could go either way. Recessions and the like are way out of line but slow to moderate growth is possible.

On the other hand, a concerted effort by the government and the RBA could make things happen. But our media seems centred on causing conflict. We need a circuit breaker and one isn't stepping up to the plate!

China

The China data in September was a bit light on but nothing to worry about. There is always statistical variation. In October there will be a new leadership team to run the second biggest economy in the world.

The Purchasing Managers' Indexes (PMI) which look forward, were very strong. The manufacturing index came in at well above the '50 mark' that indicates strengthening expectations. At 52.4 it was actually at a five year high. The services PMI was even stronger at 55.4 which was a three year high. Not much to worry about there!

China debt was downgraded in September (but so was UK debt). The new massive infrastructure programme is likely to change the world order and we should benefit. But it might take a while for the flow on to take hold.

US

Trump has had no real wins this year but the tax plan might make it. So far there is no real plan but there is enough at least to get his own team on side. To cut the corporate tax rate from 35% to close to 20% would have a massive positive impact. It has to be funded (at some point) but there is lots of wiggle room.

The jobs data were a little bit soft in September but one month does not make a trend. The average for 2017 job creation is the same as the 2016 average.

Europe

Brexit dominates but the noise seems to be subsiding. Naysayers seem to want the UK to fail but the leaders are being measured.

Europe is now so far from the basket case it was a few years ago, it can work its way through this. With the all-important German and French elections behind us we can look to the future. The European Central Bank is unlikely to upset the balance.

Rest of the World

North Korea has seemingly gone quiet after China closed ranks with the West on the recalcitrant North Korea. That will help markets.

But the big 'Rest of the World' news must be that Saudi Arabia is now allowing women to drive cars. Hopefully no one thinks that women shouldn't be allowed to drive but when half of the population suddenly gets a learners permit after many years in the passenger seat, what chaos can follow? Robot-driven cars are needed quick-time.

*Ron Bewley (PhD,FASSA) – Director, Woodhall Investment Research