Economic and Market Review

Monthly Report as at 30 September 2015

Global linkages and policy spill overs took centre stage as central banks fretted about growth prospects for emerging market economies and the implications of a second, but more modest wave of lower oil prices.

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Economic and Policy Trends: Global linkages and policy spill overs took centre stage as central banks fretted about growth prospects for emerging market economies and the implications of a second, but more modest wave of lower oil prices.

In Europe, the European Central Bank (ECB) revised its growth forecasts for the region down slightly from its June forecast run. For 2015, the ECB are now looking for growth of 1.4% lifting to 1.7% in 2016 and 1.8% in 2017. Lower oil prices led them to revise their inflation forecasts lower, but the profile still remains for a period of above trend growth and the dissipation of the impact of lower oil prices to lift inflation from 0.1% in 2015 to 1.1% in 2016 and 1.7% in 2017. ECB commentary remains dovish and speculation several months ago that the ECB may end its quantitative easing program early was premature.

In the US, the Fed left monetary policy unchanged at its most recent meeting but the tone of its commentary confused markets as to the relative importance of offshore factors in its decision-making process. Rather than reassure markets by holding ‘lift off’ until it saw further labour market improvement and had greater confidence that its medium inflation target would be met, it spurred volatility.

The Fed’s Chair Yellen tried to address this uncertainty in a post FOMC speech entitled ‘Inflation Dynamics and Monetary Policy’ where she stated “that my colleagues and I anticipate that it will likely be appropriate to raise the target range for the federal funds rate sometime later this year and to continue boosting short-term rates at a gradual pace thereafter as the labour market improves further and inflation moves back to our 2 percent objective”. International factors got less “air time” with Yellen stating that while the Fed was watching developments abroad, they anticipated that these would not prove large enough to have a significant effect on the path of US policy. The US fixed interest market continues to factor in less tightening than the Fed, which leaves it vulnerable in the medium term to a lift in yields.

Local data releases out over the month were mixed but there was tentative evidence in business and tourism data, that the economy may be responding to the pro-cyclical pulse from a lower exchange rate. Indeed, data from the Nab survey and PMI readings from the construction, manufacturing and services sectors pointed to improving levels of activity in August with export orders lifting. These trends were corroborated by August labour force data which had total employment gaining by 17,400 over the month and 235,000 over the last 12 months.

Nevertheless recent financial market volatility has taken its toll on confidence with business confidence slipping in August despite stronger activity levels and consumer sentiment fell sharply in September with the forward looking measures falling as well. While most likely a reaction to poor headlines, there is a risk that rising uncertainty will see consumers pare back spending. While more backward looking, the June quarter national accounts had the economy growing by only 0.2% after a gain of 0.9% over the previous quarter. In terms of the drivers of growth, positive contributions from consumption and the public sector were just enough to offset minor drags from housing, business investment, stocks and a larger drag from net exports.

The Reserve Bank of Australia (RBA) left the cash rate unchanged in early September and subsequent commentary suggests that while they are watching offshore developments and further easing remains a possibility, they are “content where we are right now” (September 18 comment made to House of Representatives). We continue to look for an extended period of sub trend growth as the various sectors of the economy grow at an uneven rate and for the RBA to keep the cash rate on hold until the second half of 2017.

Equity Market Trends: Offshore equity markets struggled to find their mojo, not helped by dovish and at times unclear communications from central banks and developments at VW and Glencore. Despite relatively solid data readings in the US and Europe, the S&P 500 and Euro STOXX 50 fell 2.6% and 5.2% respectively over September. In Japan the Nikkei fell 8%, while in China the Shanghai Composite fell 4.8%. The MSCI World ex-Australia Accumulation Index in Australian dollars fell 2.8% over September with a weaker Australian currency cushioning falls. In Australia, S&P/ASX 300 Accumulation Index was down 2.9%.

Bond Market Trends: Yields rose over the first half of the month, reflecting constructive business sector and labour market data and a perception that if the Fed didn’t commence lift-off at its FOMC meeting, it would lay the groundwork for a near term move. Instead, the Fed appeared to elevate offshore concerns and created some confusion about its objectives. This triggered a period of broader uncertainty and weaker equity markets which led to longer term bonds benefitting from flight to quality flows towards the end of the month. Against this backdrop, the yield on the three year government bond ended the month 5 basis points higher at 1.80%. At the longer end of the curve, the yield on a ten year government bond ended the month 6 basis points lower at 2.61%. These moves meant that the Bloomberg AusBond Composite Index gained 0.25% over September. The cash sector, as measured by the Bloomberg AusBond Bank Bill Index, ended the month 0.18% higher.