Economic and Market Review

Monthly Report as at 30 May 2015

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Economic and Policy Trends: The global economy continues to expand at an uneven pace, fanned by ultra-accommodative monetary settings, lessening fiscal drag and the net boost from lower oil prices. Central banks continue to hold a strong pro-cyclical mindset. In China, sluggish demand conditions and easing inflation led the Chinese central bank to ease monetary conditions further when they cut the one year RMB benchmark loan interest rate and deposit rate by 25 basis points to 5.1% and 2.25% respectively. Chinese authorities are likely to dip into the policy toolbox again to support the Government's 2015 growth target of close to 7%.

In the US, the economy appears to be regaining some momentum after poor weather and port strikes held activity back in the first quarter. While the Fed's Yellen has made it very clear that the US cash rate will lift, the timing remains data dependent with the added caveat that the Fed will also consider the implications of its actions on offshore economies. The most likely timing for "lift off" remains in the window between the September and December FOMC meetings. By then, the Fed's two conditions of further labour market improvement and confidence in achieving its medium term inflation objective should be met. On the offshore aspect, the cyclical recovery currently underway in Europe should be more entrenched and the Chinese economy should be showing signs of responding to the ongoing stimulus it has received over recent months.

Demand conditions remain uneven across the Australian economy as it continues to adjust to the end of the investment phase of the mining boom. The transition to other sources of demand has been made more difficult by cautious consumers and weak public demand. It does appear as though there has been some lift in activity, particularly in housing, and sentiment following the RBA's February rate cut. The RBA's early May cut in the cash rate to 2% seeks to build on this momentum and foster the conditions for a broadening in the sources of demand, particularly in non-mining investment.

The Government appears to have learnt its lessons from the 2014 Budget and presented a well signalled more upbeat package with a focus on lifting workforce participation and boosting small business. The Government has the deficit heading towards balance at a slightly slower rate and over a longer period implying some easing in the fiscal stance since the December mid-year economic and fiscal outlook (MYEFO). Both Treasury and the RBA updated their forecasts for the economy and both have sub-trend rates of growth persisting until 2016/17 when a significant lift in gas exports will boost the headline GDP number.

Data releases over the month highlighted the unevenness of conditions, with building approvals up a stronger than expected 2.8% in March. Retail sales gained 0.3% over March, while real sales were up 0.7% over the quarter. The labour market took a breather in April, with total employment down 2,900 after a quarter of strong gains. The unemployment rate edged up from 6.1% to 6.2% in April. Wages growth remains subdued with the wage price index edging ahead by a weaker than expected 0.5% over the March quarter. Consumer sentiment rebounded in May following the Budget and RBA rate cut.

The most disappointing data release over the month was the March quarter capital expenditure survey. Apart from showing a sharper than expected 4.4% fall over the quarter, the second estimate for the total amount of capital expenditure for 2016/17 showed little improvement in non-mining investment intentions. With a large fall expected in mining capex, total capital expenditure is expected to fall significantly over the year ahead and highlights the need for other parts of the economy to offset the drag from growth that will come from business investment.

Equity Market Trends: Offshore equity markets were mixed over the month. In Europe, the Euro STOXX 50 fell 1.2% with ongoing concerns about Greece's solvency weighing on sentiment. In contrast, both the US and Japanese equity markets benefitted from supportive central banks and ended the month 1.0% and 5.3% higher respectively. The MSCI World ex-Australia Accumulation Index in Australian dollars rose 3.5% over May. In Australia, the S&P/ASX 300 Accumulation Index ended the month 0.43% higher.

Bond Market Trends: Domestic yields lifted across the curve over the first part of the month, only to reverse direction over the second half on a combination of weaker domestic data and flight to quality flows at the longer end on heightened fears that Greece would be unable to broker a deal with its creditors. Three and ten year government bonds peaked at 2.19% and 3.04% before ending the month at 1.88% and 2.73%. These moves meant that the Bloomberg AusBond Composite Index edged ahead by 0.04% over May. The cash sector, as measured by the Bloomberg AusBond Bank Bill Index, rose by 0.20% over the month.