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Despite political risks featuring prominently through the year, the financial year has been very positive for investors. The rare and recent synchronised growth of global economies has found itself under threat from escalating trade tensions, European political risks and a slowing Chinese economy. These risks emerge in the context of tightening monetary policy around the world as inflation slowly moves higher in line with central bank targets. Despite labour market tightness, wage growth is not yet sustainable and household sectors remain exposed to cost of living price increases.

US markets perform well but trade risks persist

While President Trump's $1.5 trillion tax cuts have provided a boost to US consumer spending in the June quarter, the tariff war with major trading partners—including China, Canada, Mexico and the European Union —could prove a drag on growth longer term, putting pressure on supply chains and possibly undercutting business investment. US inflation rose from 1.8% to 2.0% and is now sitting at the Federal Reserve's inflation target for the first time since April 2012.

Economic activity grew at a solid rate and strong jobs growth has seen unemployment decline to just 3.75%, a 48 year low. Manufacturing rose again with a shortage of skilled labour and materials failing to put a dent in production.

Chinese economy slowing and trade tariffs

China's economy continues to show signs of fatigue, with slowing credit growth and infrastructure spending pointing to softer economic growth. Chinese firms have felt the pinch from the Government's measures to curb risky lending, resulting in higher borrowing costs and reduced access to funds for smaller companies. The People's Bank of China responded by cutting reserve requirements for the major state-owned banks—the third such move in 2018.

On 6 July 2018, US tariffs on US$50 billion worth of Chinese goods came into effect, with China responding in kind with tariffs on American soybeans, pork and electric vehicles. The major fear for markets is that these tit-for-tat tariff rises will result in a prolonged trade conflict. The value of goods and services subject to the recent tariffs represent only a small percentage of total trade value at this stage. However, Trump's threat to impose tariffs on another US$100 billion of imports suggests trade tensions will remain a risk for financial markets.

European political issues continue

While the European Central Bank announced an end to its bond-buying programme by the end of 2018, monetary policy is likely to remain very accommodative. In the ongoing trade saga, the US has threatened to impose higher tariffs on European automakers, with President Trump accusing the EU of unfairly targeting US car makers. German Chancellor, Angela Merkel signalled her willingness to lower auto tariffs, contingent on agreement from Germany's 'big five' car makers.

In Italy, the governing coalition of right-wing parties has solidified its economic programme. Adding both tax cuts and universal basic income in its first budget, they have shown both voters and markets that it is not backing down from its agenda. Meanwhile, UK Prime Minister May's attempt to work out a Brexit negotiation plan has resulted in high political drama with the resignation of pro-leave ministers.

Australia's economic growth

Australian economic growth is on a sound footing, supported by a bounce in global growth, a strong commodities sector and improved public sector investment. However, while there has been a surge in employment and hours worked over the past year, momentum has slowed from last year's pace and wage growth remains subdued at around 2.0%.

The unemployment rate fell to 5.4%, the lowest reading since 2012. However, considerable spare capacity remains in the labour market as the underemployment rate, which measures part-time workers wanting to work more hours, remains high at 8.5%. Combined with those unemployed, having nearly 14% of the workforce underutilised has constrained annual wages growth to just 1.9%, a 20 year low.

Prudential controls and tighter bank lending practices, partly in response to the Royal Commission into Financial Services, have already underpinned a slowdown in household credit and house prices. The potential oversupply of apartments in Brisbane, Sydney and Melbourne has cooled the pace of residential construction after years of substantial construction activity. Allowing for the current pipeline of planned construction still to be done, the housing sector is a key downside risk for the economy over coming years.

With low wages growth, high household debt and sharply higher utilities costs, many Australian households are under pressure. Household spending is likely to be constrained going forward, with savings rates already low, while consumer sentiment appears to be improving but is still relatively subdued. Business conditions remain buoyant, driven by the pickup in investment construction, but the retail sector continues to struggle.

Investment issues looking ahead

Notwithstanding the recent moderation, the outlook for global growth continues to be positive. Business surveys in most major economies indicate confidence and that continued economic expansion can be expected. With GDP growth now exceeding long term potential growth in many economies, capacity in labour and other markets is tightening, so that inflation is generally expected to edge up through 2018. Against this backdrop, whilst monetary conditions have been slowly tightened, policy responses have remained muted and key advanced economy central banks are indicating preparedness to retain supportive monetary conditions.

If you have any questions or wish to discuss anything, please call us on 03 9544 1004.

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