Economic News January 2018

The previous year has been a rewarding one for investors. Investment markets have performed well due to growth across the global economy, promising signs of improvement in Japan's economy and solid conditions in the US and China. These factors supported investment markets in both the developed and emerging world.

However, despite the strong market returns, some potential risks remain. Valuations in some markets look stretched and interest rates may rise further in the US in 2018, with uncertain consequences.

Overseas markets improved

After modest returns in 2016, European share markets performed well in 2017 due to the eurozone's economic upturn, employment growth and improved consumer and business confidence. The rejection of anti-eurozone parties in elections in The Netherlands and France also helped reassure markets. Although Germany's post-election political stalemate remained unresolved at year's end, its share market was up 12.5% during 2017.

In the UK, despite continuing uncertainty about Britain's withdrawal from the European Union ('Brexit') and its impact on the economy, the FTSE 100 Index provided a return of 11.9%. The implementation of the withdrawal process was complicated by the ruling Conservative Party losing its majority in the general election. This political saga still has a long way to go.

In the US, the S&P 500 Index achieved record high levels towards the end of 2017. Optimism about President Trump's significant corporate and personal tax cut reforms, which passed into law late in the year, was a significant driver of the market's performance. US economic data was also very supportive, with solid jobs growth, lower unemployment and encouraging business survey results.

Some central banks began to shift to a tightening phase

The US Federal Reserve (the Fed) raised interest rates by 0.25% three times during 2017, taking its benchmark cash rate range to 1.5%. The Fed also plans to begin a gradual reduction of its swollen balance sheet by selling its holdings of US government bonds and mortgage securities. Having upgraded its economic growth forecast for the US economy in 2018, the Fed has also signalled that it expects to raise rates three more times in 2018.

In Europe, the better economic conditions enabled the European Central Bank (ECB) to start cutting its monthly bond purchases by half to 30 billion euros for the next nine months. However, the ECB has also permitted itself the discretion to change course and increase its money printing if economic conditions deteriorate.

Late in the year the Bank of England reversed its 2016 post-Brexit rate cut of 0.25% as it attempted to bring inflation (which reached 3.1% towards year-end) back to its preferred 2% target.

The Chinese economy

China's economy continued to perform well, however, the expansion of China's economy has been accompanied by a large increase in debt levels. At 13% on an annual basis, China's debt has grown at nearly double their economy's growth rate. As a result, China's central bank implemented a number of measures to curb debt levels. These included pushing interest rates higher and increasing the interest rate at which banks lend to each other.

An important political development in 2017 was the confirmation of President Xi Jinping's second five-year term by the Chinese Communist Party Congress in November. At the Congress, policy priorities for the next five years were flagged, including greater emphasis on improving welfare, education, controlling pollution and improving the quality of life in China's cities. The Congress renewed its previous commitment to double the value of gross domestic product (GDP) and per-capita income in 2010 by 2020. To achieve these targets, China's economy will need to grow at over 6% per year for the next three years.

Political risks remain

After 2016's unexpected Brexit referendum result and election of Donald Trump as US President, market focus moved to Europe, where a string of national elections were scheduled in 2017. However, concerns that electoral success by extreme anti-European Union and anti-immigration parties could threaten the cohesion of the European Union proved misplaced.

In Germany, Angela Merkel secured a fourth term as Chancellor, though the loss of seats by her union coalition has required extensive negotiations with minority parties to try to form a government. The year concluded with no resolution in sight.

In Asia, tensions escalated as a result of North Korea's nuclear missile testing program and claims it now has the capability to strike US cities. However, markets were largely unfazed by these threats and the potential for US military action.

The Australian economy

Australia recorded mixed economic data over 2017, though the economy picked up speed as the year progressed. Substantial public sector infrastructure spending provided added stimulus. Higher mortgage interest rates for housing investors and concerns of a potential oversupply of inner city apartments caused residential construction to fall over the year.

In the housing market, action by regulatory authorities and the banks to tighten lending standards had an impact on prices by year's end. Sydney and Melbourne prices came down marginally from their previous highs and in mining-related markets such as Perth and Darwin there were more substantial declines.

The jobs market was very strong, with the creation of more than 380,000 jobs, mostly full time ones, in the year to 30 November. However, wages growth was subdued due to considerable spare capacity in the labour market. The unemployment rate remained at an elevated 5.4% and 8.3% of the Australian workforce was underemployed (working fewer hours than they would like).

Low wages growth, high debt levels and sharply higher utilities costs meant 2017 was a difficult year for many Australian households. This undermined consumer sentiment and slowed retail spending to just 2.2% annualised growth. The fall in the savings rate to 3.2% suggested that many consumers were being forced to fund their consumption by saving less.

With subdued wages growth and only mild inflationary pressures, the Reserve Bank of Australia (RBA) has left the cash rate at 1.5% for the last sixteen months.

Downsizing legislation passes

The Coalition government has passed legislation allowing individuals over age 65 to contribute some of the proceeds from the sale of their home into superannuation. Individuals will be able to contribute up to $300,000 in addition to the other superannuation caps. To be eligible, contracts need to be exchanged after 1 July 2018 and the home needs to have been owned for over 10 years. Whilst we would encourage people to stay in their own home as long as possible, this could prove an opportunity particularly for individuals where superannuation was only an option later in their working lives.

In a risky environment, a defensive portfolio stance remains justified

Some risks and uncertainties remain. After such a long period of good returns, values in both share and bond markets look high. Broad issues to be aware of in 2018 are:

1. The exuberant US share market may not last
2. State owned enterprises, local governments and banks in China may rely on their Central government to bail out the huge debts they hold, which could threaten China's growth
3. Unemployment in Europe remains at elevated levels in countries like Greece (21% unemployment), Spain (17%), Italy (11%) and France (9%).
4. It seems likely that the RBA will contemplate raising interest rates later in 2018. An increase in rates would come as a shock to borrowers carrying high levels of household debt.

We have believed for some time that where possible, it's appropriate to defensively position portfolios. At the start of 2018, given the potential risks, risk management remains important.

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

Wishing you a very happy 2018,

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