Economic Update

Markets have moved aggressively higher since the beginning of the year following a pretty dismal 4th quarter of 2018. To give you a flavour of some of these movements in 2019 – Australian equities are up a little over 10%, global equities are up 10.50%, Australian and global listed property up over 15% and nearly 13% respectively, the US technology-heavy NASDAQ is now up over 14%, and even bonds are performing well with Aussie bonds up 3.4% and hedged global bonds up 2.7%.

You might be asking yourself, “why the aggressive moves” and “what’s changed to cause the turnaround”, both very valid questions.

There are effectively two answers to these questions. The first stems from the fact that the three main concerns that spooked investors in the 4th quarter of 2018 have now diminished in terms of the level of risk investors assign to them, namely US central bank tightening on “autopilot”, Chinese economic growth deceleration, and the impact of trade wars. The second answer is that we now have the US, European, Japanese, and Australian central banks turning dovish (ie. loosening), scrambling to revise down the optimistic forecasts they put out this time last year and now looking to provide additional support to their respective economies.

If central banks are turning dovish again that generally means economic conditions are no longer improving or weakening.

Australia

Australian economic growth is now slowing and will continue to slow over the year. Household consumption is too low as a result of the stretched household balance sheet, and consumption is likely to head lower as house prices continue to fall. Mining and non-mining corporate investment is anaemic as both business conditions and confidence continue to fall. In general, corporate balance sheets are in relatively good shape, but corporates won’t invest whilst the economic and political outlook is uncertain and without significant corporate tax and labour market reform.

That leaves the heavy lifting to the RBA and the government, which is why this upcoming federal election has a little extra significance. Whichever major party wins will need a clear majority (unlikely) and will need to stimulate the economy through tax and labour market reform, as well as investment. It’s fair to say the RBA wants to be done, in that they are reluctant to cut rates any further and extremely reluctant to commence quantitative easy (money printing). The only other lever the RBA could pull would be to start talking the Aussie dollar down (or force it down by intervening), thus making the economy more competitive on the global stage.

Absent some sort of stimulus or lift in corporate investment, the economy is likely to be weak for some time. At this stage, a recession is unlikely, however further housing market deterioration and a potential rise in unemployment could get us there. Now is not the time for indecisive politics nor does it make any sense reduce immigration.

US

The US economy continues to hum along at a reasonable pace, though the likely trajectory of that growth has changed a fair bit versus the last couple of years, as the impacts of trade wars, Fed (central bank) tightening (both rates and their balance sheet), and labour shortages hit home. Technically, and in light of that, a US recession is possible from here though we're highly doubtful it is this year and somewhat doubtful on next, especially given the recent Fed announcement that they're most likely done raising rates this year and unlikely to do so next year. At the same time, they announced they would be slowing the pace of their balance sheet reduction (ie. the reverse of money printing).

The household sector looks in good shape with household wealth up, debt down, unemployment at extremely low levels, and reasonable wage growth. Corporate debt has been rising at an aggressive pace, but corporate balance sheets still like in reasonable shape given significant cash on balance sheet and rising asset values. The US government is constrained with the budget deficit going in the wrong direction and divided politics. With the benefit of hindsight, it's fair to say the Fed began tightening policy too late, and then was forced to tighten too quickly following President Trump's fiscal surge, which has now meant they have had to stop policy normalisation earlier than they would've liked.

Labour shortages continue to be problem with the economy at full employment and President Trump turning off the immigration tap. Without additional labour, the economy will constrict. Given Fed tightening is done and a trade agreement imminent, we think the US economy begins to look better in the 2nd half of this year and into 2020, meaning we're not in the recession camp.

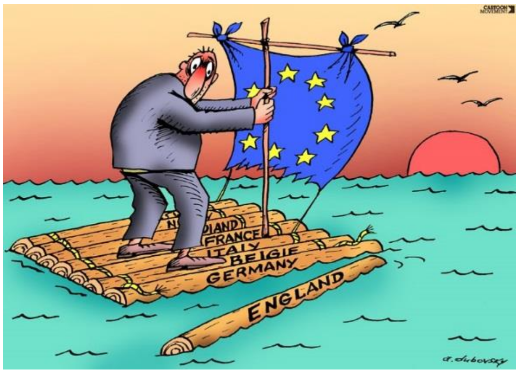
China

The Chinese economic growth rate has been decelerating for some time, and structurally this will continue given the transition to a developed market economy. This means shifting from investment-led growth (mostly fixed asset investment) and low cost manufacturing to consumption-led growth and more specialist manufacturing. This transition has been happening for some time with the government try to engineer a soft landing for the economy by pumping the brakes whilst accelerating stimulus at the same time. In the 2nd half of last year, we saw less stimulus than we've seen for some time, a function of not wanting to poke the bear (President Trump) whilst in trade negotiations and a function of changing the way they apply stimulus to the economy, that is, pump as much money as possible and hope it lands in the right places versus very targeted and specific stimulus to address weak parts of the economy or those parts that add to productive growth.

China does have a debt overhang they need to work through with both household and corporate balance sheets appearing stretched. The government balance sheet and the central bank look in good shape to continue to support the economy going forward as it transitions. Demographics remains a problem and will continue to get worse from here in light of the one-child policy, something the government will need to address at some stage as the population ages.

We're pretty comfortable with how China looks from here barring a worsening debt position or some sort of foreign policy misstep, which is highly unlikely. A trade agreement will also help boost economy and there's still some 200-300m more people to urbanise over the coming years.

Europe



Unfortunately looks messier and messier each day. Unlike the rest of the world, Europe didn't get much of a growth kick post GFC, and when data started to finally look good through 2017 and beginning of 2018, it was gone in a flash as the impact of trade wars kicked in with trade and manufacturing turning down quite sharply, and spot fires in Italy, Britain, and France not helping confidence or sentiment. Unemployment remains too high whilst economic growth and inflation have begun to fall again, forcing the ECB (central bank) to change direction from wanting to tighten into this year and next, to no tightening of policy almost indefinitely now.
A trade war agreement and resolution on Brexit will go some way to fixing the current economy downturn, in addition to continued central bank support. However, deep and meaningful structural reform is required across the Eurozone. In addition, we think individual governments will likely remove the austerity shackles from here and start to invest and spend following years of tightening. However, headlines are likely to remain negative for this year.

In light of brevity, I'll leave it there for now. All in all, even though recession probabilities have been rising around the world, we're not in the recession camp right now for this year or next, given current data at hand and likely central bank and government loosening of policy. Conditions definitely aren't clean by any means, but we think the main risks that spooked markets last year (US Fed policy, Chinese growth fears, trade war escalation) have already subsided and won't hamper growth from here. We remain in close watch.