Investment Spotlight

ANZ Wealth Chief Investment Office

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Economic and markets mid-year report card

The Australian economy has now entered record-breaking territory in terms of years without a recession. What has been behind these trends, and how do we rate the economy and markets now that we're halfway through 2017? Read on for more.

Overview

Before delivering a mid-year report card, there are two key economic themes to explore.

The first theme is around the Australian economy and its now record-breaking uninterrupted expansion; it has now been growing since the bottom of the last recession in June 1991.

Secondly, there has been an ongoing global economic recovery since 2009, with signs of better growth this year. There is strong growth well beyond US shares and the influence of so-called 'Trump trade'.

The never-ending recovery

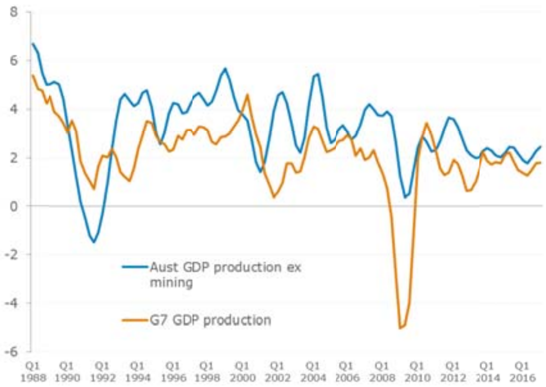
Generally, economists refer to a 'recession' as a period of two consecutive quarters of negative economic growth, which only focuses on the volume (i.e. price adjusted) of demand or production.

This is a fairly simplistic definition and may not cover all bases in terms of 'real' measurement of the economy. Other approaches may focus on trends in unemployment or measures of national income that account for swings in commodity prices.

Nevertheless, no matter which way you look at it, the past 27 years has been an extraordinary period for the Australian economy. This is particularly meaningful after the shocks, high inflation and volatility of the 1970s and 1980s.

According to our calculations Australia reached record expansion territory in Q1 2017. We have now equalled the Dutch expansion which ended due to the GFC.

Chart 1: What has Australia got right?



Source: ABS and OECD

This uninterrupted period of growth reflects Australia as a highly flexible and adaptable economy that has been adept at sustaining growth, a 'rolling recovery'.

Chart 1 shows growth in Australian GDP (ex-mining output) versus that of the major developed economies – the G7 or Group of 7 (US, Japan, Germany, France, Italy, UK and Canada). Removing mining from the picture eliminates a certain amount of volatility; albeit volatility that has ultimately led to a sector that now forms almost 10% of GDP.

Outside of the early 1990s, Australia has consistently been growing faster than the G7 countries except on three occasions (1994, 2000 and 2010). Nevertheless, in all of these instances it was still tracking at a reasonable pace. This has happened in large part due to a 'rolling recovery' style – as one sector slows another picks up

Typically, construction has been one of these rolling sectors; mining, housing and non-residential construction switch places as the key driver of growth at different times. This is the case at the moment, where mining investment has fallen from 9% to only 4% of GDP in the past four years. Heavy construction has picked up quite a bit of the slack.

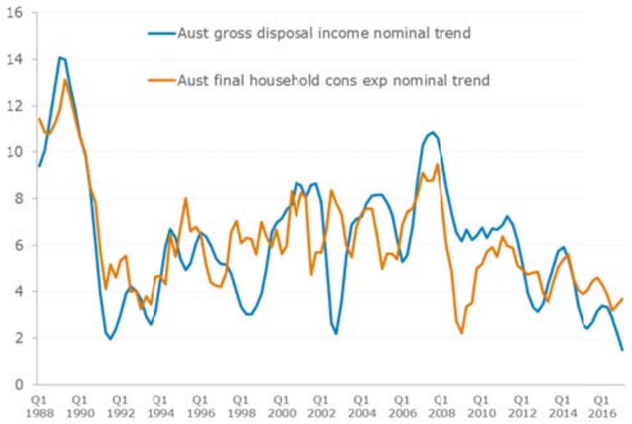
Australia has also seen periods of a weak AUD (now, 2008 and early 2000s), which have helped the export sector and further boosted growth. Rising house prices have also helped to indirectly boost consumption via a wealth effect at times as well.

As such, despite the collapse in commodity prices and investment in the mining sector, the economy has been remarkably stable in recent years.

What could go wrong?

Currently, the Australian household sector is under pressure, with income growth the weakest since 1991. With debt elevated and dwelling construction falling, consumption could soon start to feel even more pressure.

Chart 2: What could go wrong in Australia?



Source: ABS

So far, consumption has held up better than income data would suggest, as the savings rate has fallen. People are spending the money they ordinarily would have saved, and this isn't sustainable.

Employment data for May was strong with 2% employment growth, and there was also a fall in the unemployment rate, but wages growth still shows no signs of recovery and is currently at 1.9%.

On the plus side—as per the record of the past 27 years—as one sector rolls over, another picks up. Australia now seems to be benefiting from the long-awaited recovery in non-mining business investment. So, while income growth of households is weak, company profits are benefitting from rising profits due to the relatively tepid cost of labour.

Additionally, Chart 1 demonstrates the close correlation between Australia and the world's major economies. This suggests the backdrop of a strong global economy may indeed support domestic growth.

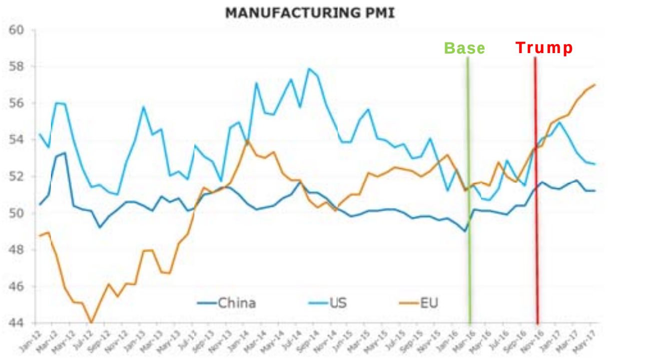
Trumping Trump

It's important to look beyond the headlines (and possibly the tweets) crediting recent share market growth in the US to the election of Donald Trump in November 2016. He was not, and is not, the sole driver of this surge.

The election certainly did provide some impetus for growth, on the back of promises of infrastructure spending, deregulation of financial institutions and corporate tax cuts.

However, a close look at data on global manufacturing shows things were turning for the better even before Trump's surprising victory.

Chart 3: Growth was getting better before Trump



Source: Bloomberg, ANZ Wealth

Chart 3 shows that the PMI survey of manufacturing in the big three economic regions (US, European Union and China) all troughed before the election and were well into their recovery by November. It was this, and the eventuating recovery in earnings that supported the strength in share markets

And while the acceleration in growth is maturing, with the US and China losing some momentum, Europe has continued to power on. We've seen synchronised growth in the global economy and it wasn't Donald Trump who delivered it

Chart 4: Shares not cheap; but not expensive either

The international equities' forward PEs have been constructed using current country/region market composition.

Source: Bloomberg, ANZ Wealth

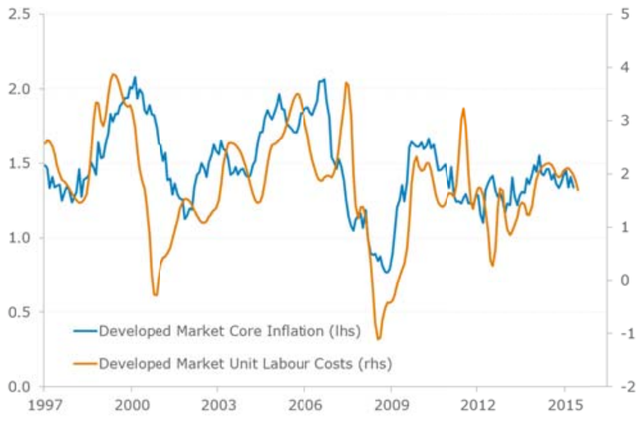
Along with a sustained economic cycle, we are now in the ninth year of a bull market for shares since the GFC. It's fair to say that markets are somewhat expensive. However, they are still well below what we saw during the early 2000s dot com tech bubble period.

Valuations are a bit more expensive than on the eve of the GFC, but for equity markets the 'bubble' then was not in valuations, but earnings. This comes back to the question of how long the economic expansion can reasonably continue. A critical variable to watch is inflation.

Where does inflation fit in?

Economic cycles normally end after a period of sustained higher interest rates to peg back inflation. Currently, this doesn't appear to be a concern for the major central banks, though it's worth keeping an eye on.

Chart 5: Inflation isn't an issue … yet



Source: Bloomberg, ANZ Wealth

Underlying inflation in the major developed economies has actually been falling a little as labour costs ease on the back of improving productivity. This means central banks can keep interest rates low for some time yet, and take their time raising them (including the Fed).

Report card

So, at the mid-point of 2017, we think the report card for the economy and markets is pretty good, as outlined in Figure 1.

Figure 1: Economic report card

*Relative returns (MSCI World hedged to AUD less the Barclays Global Aggregate Bond Index hedged to AUD) to 14.06.2017

** Relative returns (ASX 300 Accumulation Index less the Bloomberg AusBond Composite Index) to 14.06.2017

Source: Bloomberg.

Global economic growth has accelerated this year as we and many others expected to see. In turn, better growth across most regions and the related end of collapsing commodity prices (the deflation shock) has seen a recovery in earnings growth, supporting shares.

In terms of performance for shares versus bonds, it's top marks for global but Australia has been somewhat disappointing with growth softer.

While growth has picked up across nearly all economies we note the stage of cycle across economies remains divergent – the US is in late cycle, Europe and Japan are somewhat earlier, and so is Australia (though we seem to be treading water with trend growth). China is late in a cyclical sense with debt high and policy now firmer although of course still in a rapid growth phase overall.

These divergent points of economic cycles, low inflation and still-easy although tighter monetary policy in both the US and now China suggest to us that the global growth some ten years out from the global financial crisis still has some way to go.

Mark Rider, Chief Investment Officer

Mark leads ANZ Wealth's Chief Investment Office. He is responsible for delivering the overarching investment strategy, including asset allocation, investment themes, product selection and monitoring, investment compliance, risk and analytics for all client investment offerings.