1st October 2016

Woodhall's Wrap

Ron Bewley PhD, FASSA

Federal Reserve dictates market moves

US Fed unlikely to rock the boat
Australian economic growth shows positive signs
China bears submit

The Big Picture

In December 2015, the US Federal Reserve (Fed) hiked rates for the first time in nearly a decade. At that time they predicted four more hikes during 2016. So far there have been none!

Some held out hope for a hike in September but this group have been disappointed at each meeting. December this year is their last chance for 2016. They might just do it to save face but there is no legitimate reason.

After two years of solid job growth, 2016 has been a fizzer so far. New jobs are positive but about 25% down on 2015 data. The new Fed economic growth forecasts are 2% each for the next two years – and then 1.8% for 2019.

Central Banks raise rates to slow growth and curb inflation. US growth is at best moderate, inflation is anaemic and wage growth is on life support. We think that there will be at most three rate hikes before 2019. There is just no case for chancing the impact of more hikes than that.

If the Fed does as we think, stock markets will have another couple of good years. But what about Australia? World markets have done well while we have limped along.

Our economy posted strong growth for the second quarter of 2016. Over the year our economy grew at 3.3% and that's better than moderate! On top of that we note a turnaround in what households have to spend after inflation and after allowing for population changes. After four bad years of growth in that indicator, the latest number was strong.

But the labour force data is still not out of the woods. The basic issue is that part-time jobs have been growing quite nicely but the full-time jobs are down on the year to date. As a result, the unemployment rate looks a bit better than it is.

The Reserve Bank of Australia (RBA) kept rates on hold in September at 1.5%. With six central banks having negative rates, and the Fed rate only a bit above zero, our 1.5% is quite large by international standards.

Dr Philip Lowe took over the governor's position at the RBA in September. There is no urgent need for a cut at home and so the new governor might not want to start his career with a cut. But we think we will get at least one more over the next few months.

September got a boost near the end of the month after it looks like OPEC might strike a deal on cutting the supply of oil and, hence, lift oil prices. But Deutsche Bank dominated the close of the month. There is talk that Germany might have to support its huge international bank to pay a fine to the US for GFC events. A few hedge funds have withdrawn some of its business so that caused a little volatility.

But will it turn into a big problem? That doesn't look likely at this stage. Angela Merkel goes to the polls next year and here party suffered some big losses this year over the refugee immigration policy. She has to support the bank if need be. And a rumour has just started the Deutsche has just cut a good deal with the US.

With the US just posting its best consumer confidence read in nine years, its citizens either think they know who will win the presidential election in November or they don't care who wins.

The world economy continues to improve – albeit slowly. The doomsayers have gone into hibernation for the northern winter – the China bears are asleep.

Asset Classes

Australian Equities

The ASX 200 did end a long losing run in September but it is still up +3.9% for the current financial year to date (FY16). A lot of that gain is due to the Materials sector gaining +11%, Consumer Staples +11% and Financials +4%.

But for the calendar year to date, the so-called 'yield sectors' (Financials, Property, Telcos and Utilities) have lost ground wiping out the dividends received. The other sectors have been going gangbusters.

We see plenty of opportunity for good fund managers to see out FY16 on a high note but the broader index might struggle to get through 6,000.

Foreign Equities

Wall Street is off its all-time August highs but not by much. It is largely trading sideways. The London FTSE shows no sign of struggling after the July Brexit referendum. The Shanghai Composite market is also largely trading sideways.

The world seems to be waiting for a signal for the next leg up in markets but volatility measures suggest there is no imminent downtown from known sources – and, by definition, no one can predict the unknown!

Bonds and Interest Rates

Central bank activity, or lack thereof, held the markets' attention again during September. It looks like low rates will last for even longer than most thought at the beginning of 2016.

There is an obvious split in the Fed decision makers. One or two say that they are already behind the curve but there is some support for no rate hikes before 2018!

The Bank of Japan (BoJ) kept rates on hold in September but pledged to do some more on stimulating its economy using less transparent means. Markets liked that.

Of course none of these rate forecasts make it any easier for retirees who choose to rely on term deposits and government bonds.

Other Assets

Oil prices jumped up after OPEC made a preliminary statement about cutting supply. The decision will be put before a formal OPEC meeting in November. Oil prices are about 75% above the low of 2016 and they don't look like retuning there any time soon.

Iron ore prices seem to have stabilised at just under $60 / tonne which is about 40% up from their lows of 2016.

And the VIX 'fear' index that measures expected volatility on Wall Street is down about 50% from the 2016 high.

In other words – as we tried to explain earlier in the year – commodity and stock markets were going through a temporary but painful wobble. The longer term looked fine then and now.

Regional Analysis

Australia

Our headline unemployment rate fell to 5.6% but that doesn't tell the full story because of the continuing switch from full time to part time work.

Economic growth reported last month was strong and if that continues we would expect some real improvement in the labour force statistics.

Our business and consumer confidence indexes were up in the month but business conditions fell.

China

The emphasis has moved away from watching China statistics because broad opinion is that the China economy is settled.

The main problems with China relate to its position over territorial claims in the South China Seas. China is moving positively on ratifying global warming action.

USA

Anyone – other than possibly US voters – watching the lead up to the November presidential elections on TV must be amazed by the goings on. It makes the Sarah Palin era look tame.

Clearly there are unusually strong negative views about both candidates. But we think we should not dismiss the chance that Trump will win. He may not have typical presidential credentials but the world is changing. Large numbers of people in many western countries are getting fed up with how they are being governed. People are looking for change without necessarily considering the full consequences.

Markets prefer Clinton as shown by the reaction to the first debate. But there are more votes in the Mid-West, the Deep South and elsewhere than in Manhattan! The US people will chose who they want.

If Clinton wins markets could rally into Christmas. If Trump wins there might be a little volatility but the president can do little without Congress being onside. Just look at Obama's lack of success in getting his way over the last eight years.

Europe

The UK continues to shine in the sunlight after Brexit. Its Purchasing Managers Index (PMI) came in at well above 50. The new Prime Minister, Theresa May, announced a $16 bn improvement of Heathrow. More countries need good infrastructure spending – Australia included.

Europe is slowly dealing with the refugee situation. M. Hollande, the French President, seems committed to dismantling the Calais 'jungle' camp. The backlash against the German political policies makes it more likely that all EU governments will want to act to resolve the situation without too much downside for the general population.

Rest of the World

Iran declined to deal with OPEC over supply cuts but the next day OPEC flagged it was going to move anyway. Japan's data show no signs yet that suggest further stimulus will not be provided.