First State Investments

Colonial First State
Global Asset Management

First Insights.

OCTOBER 2016 – A quarterly publication from the Economic and Market Research team

Welcome to the October 2016 edition of First Insights, the quarterly publication from the Economic and Market Research team.

This edition begins by analysing the current economic landscape. Since the Global Financial Crisis in 2008, many of the major global economies have experienced recession and despite the extraordinary amount of policy easing, economic growth appears stuck at 3% pa. In the essay for this quarter, I examine the cyclical and structural reasons behind this and why the environment of low growth, low inflation and low interest rates is likely to persist for the foreseeable future. If you are interested in further information on this topic, it is discussed at length in our recently published 2016 Investment Report – Investing in a low growth environment.

You will find all of our usual economic analysis via our chart pack and updated forecasts in Sections 2 to 4, which I trust will provide you with some useful insights. Please get in touch if you have any questions or feedback.

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Section 1

The Current Economic Landscape

By Stephen Halmarick

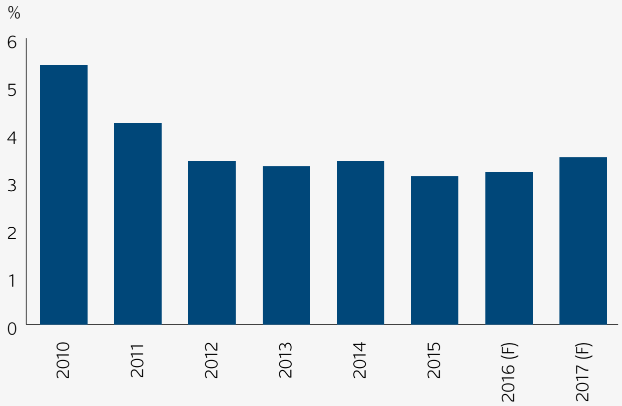
Nothing is changing

When the Global Financial Crisis (GFC) spread across the world through 2007-2008, the economic impact was deep and significant, leading to recession in many of the world's major economies. This recession was then followed by a solid recovery in 2010 (see Chart 1), as both fiscal and monetary policy action was taken to restore growth.

However, as also demonstrated in Chart 1, since 2012 global economic growth has been stuck at around 3% pa each year. 2016 and 2017 look like they will see growth very close to this level, despite the extraordinary amount of policy easing currently in the global economy.

In many ways, the current economic environment is nothing new. The world seems trapped in a low growth; low inflation; low interest rates environment. We expect this situation to persist.

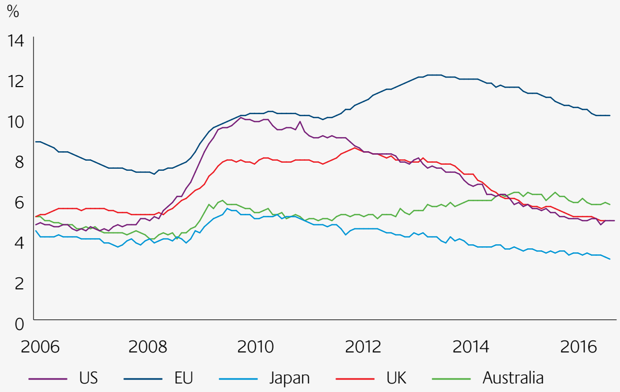
Chart 1: Global economic growth 2007-2017



Source: IMF data as at October 2016.

One important feature of the world economy that is worth remembering is that although 3% pa global economic growth is well below the pre-GFC trend (which was a little over 4%), it is far from a disaster. Indeed, as shown in Chart 2, 3% pa global gross domestic product (GDP) growth is evidently enough to support the labour market, with the unemployment rate trending down in all major economies. Importantly, this improvement in the labour market is not associated with rising wages pressure.

Chart 2: Major economy unemployment rates



Bloomberg. Data to 12 October 2016.

Low inflation almost everywhere

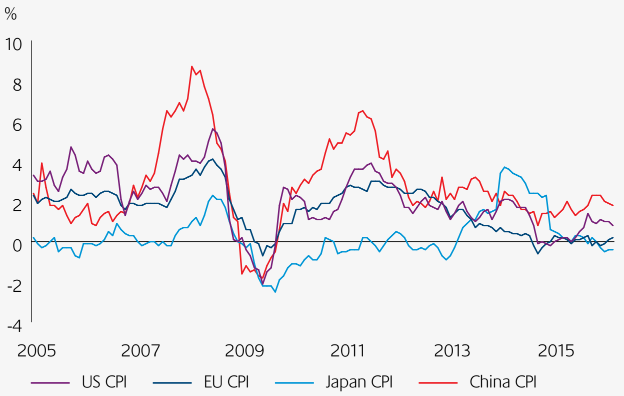
One of the major features of the post-GFC world is the fact that inflation is low almost everywhere. In our view, there are a number of reasons for this global low inflation environment; some cyclical and some structural.

In cyclical terms, inflation is being held down by the modest level of global economic growth as well as the low level of wages growth, which is partly a result of the large increase in the global supply of labour coming from countries such as China and India. Lower commodity prices, especially oil, have also had a noticeable impact on inflation and inflation expectations.

These cyclical developments have been aided by two major structural trends; demographics and technology. It is our view that demographics are playing a key role in subduing inflation, where aging populations in some of the world's major economies, especially Japan, are putting downward pressure on prices.

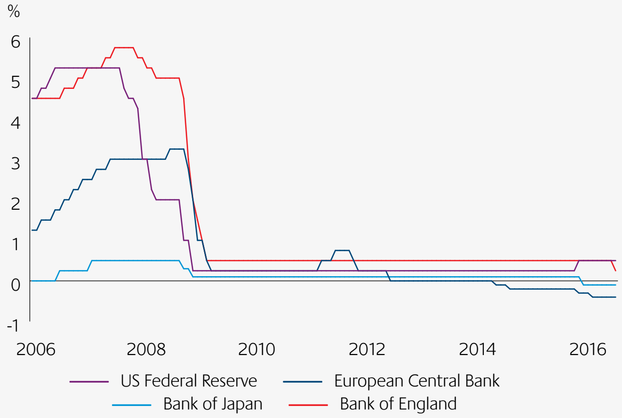
Technology has played a crucial role. With the rise of online shopping and the availability of an 'app' for everything, technology has enabled the supplier of any good or service to get much closer to the buyer, thereby removing many layers of 'middle-men' and significantly lowering costs and prices.

Chart 3: Inflation is low almost everywhere



Source: Bloomberg. Data to 12 October 2016.

Chart 4: Major central bank policy rates



Source: Bloomberg. Data as at 12 October 2016.

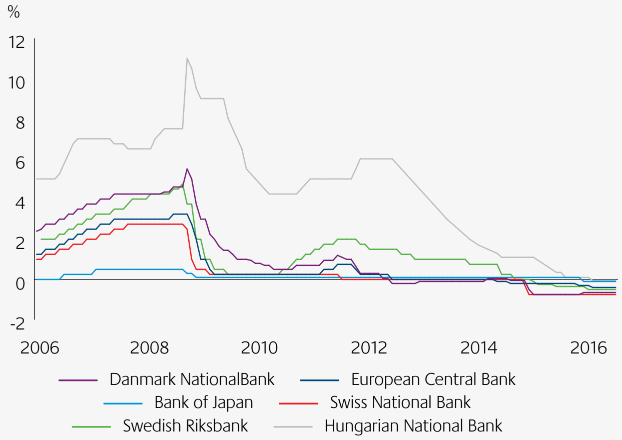
Monetary policy

The low inflation environment is critical to the outlook for financial markets, as it is having a significant impact on global monetary policy. As is well known, most major central banks target inflation at 2% ie. US Federal Reserve (Fed), Bank of England (BoE), European Central Bank (ECB), Bank of Japan (BoJ) and the Bank of Canada (BoC). The Reserve Bank of Australia (RBA) and the Reserve Bank of New Zealand (RBNZ) have more flexible arrangements, targeting 2-3% and 1-3% respectively. For much of the time, these central banks have worked with a 2% inflation target, the primary goal was to get inflation down to 2%. Now the challenge is to get inflation up to 2%.

This desire to increase inflation to the 2% target has led to the implementation of extraordinary monetary policy measures across most of the world's major economies. Quantitative easing ie. central bank balance sheet expansion by asset purchase programs, has become common-place in the US, UK, Europe and Japan.

Official interest rates have been cut dramatically across nearly all major central banks, while six central banks currently have their official interest rate set in negative territory ie. in Europe, Japan, Denmark, Switzerland, Sweden and Hungary. For further details on the impact of negative interest rates, please see our report published in July 2016, Negative Rates: Are there any positives?

Chart 5: Six central banks have gone negative



Source: Bloomberg. Data as at 12 October 2016.

Negative interest rates

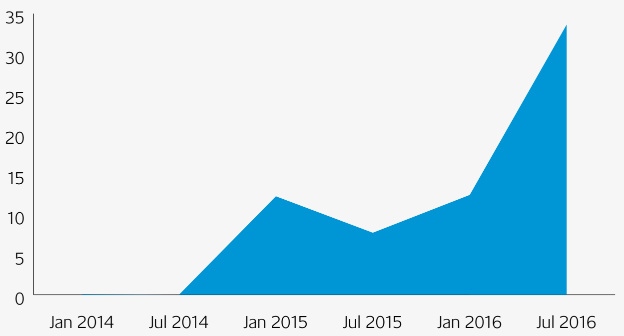
It is also interesting to note the impact of negative interest rates in places where they have been implemented.

One initial response of negative interest rates was an increase in the cost of funding for many banks around the world, with considerable uncertainty over what impact negative interest rates would have on the profitability of many banking models. This was especially the case in Japan and the European Union (EU).

In addition, negative official interest rates have had a significant impact on global bond markets. As shown in Chart 6, over the past year or so, there has been a surge higher in the shareof the world's sovereign bond markets that are trading with a negative yield.

Bonds with negative yields now represent around 30% of the World Government Bond Index – which is over US$10 trillion (trn) worth of sovereign bonds – with most of these in Japan or the EU.

Chart 6: Share of WGBI in negative yield



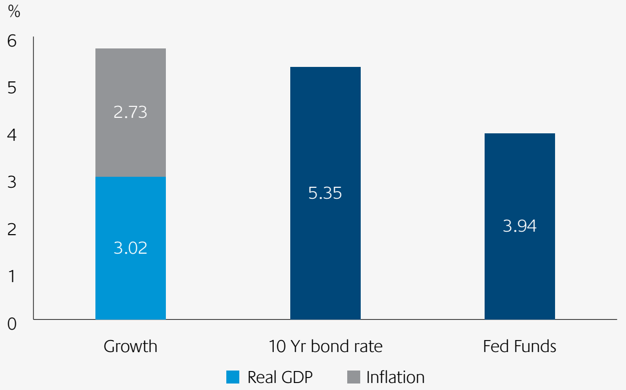
Source: Citigroup as at July 2016.

It is also interesting to observe human behaviour due to the effects of negative interest rates. Over the past year, the value of high-denomination bank notes in circulation in the EU, Switzerland and Japan has increased sharply. Data from Japan also shows a surge in the number of household safes being sold in order for individuals to keep high denomination notes at home and consequently earn a return greater than negative, ie. zero.

The 'new normal'

In this environment of very low and negative interest rates, there is a lot of talk of the 'new normal'. One way to represent this view is through Charts 7 and 8. From 1992 to 2008, the US economy averaged nominal economic growth each year of approximately 5.75% pa (split between real growth of around 3% and inflation of approximately 2.75%). Ten year bond yields averaged a little below this rate at approximately 5.35%, while the Fed Funds rate averaged just under 4%.

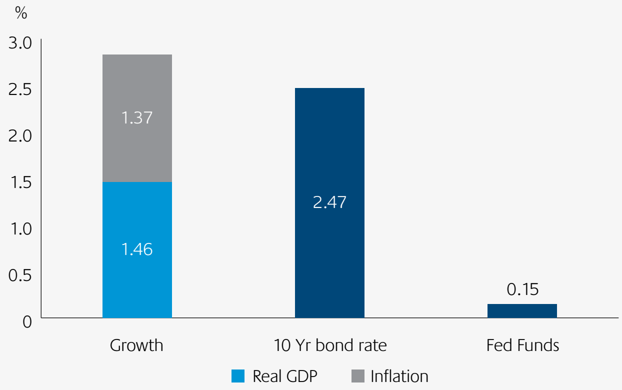
Chart 7: The 'new normal' US 1992-2008



Source: Bloomberg. Data as at 12 October 2016.

Since the GFC, however, this situation has changed significantly. Nominal economic growth in the US has averaged closer to just 2.8% pa (split between real growth of 1.5% and inflation a little lower than 1.4%). Ten year bond yields have average just under 2.5%, while the Fed Funds rate has barely been above zero.

Chart 8: The 'new normal' US 2009 – present



Source: Bloomberg. Data as at 30 September 2016.

To our mind, the 'new normal' represents the fact that whatever the given level of economic growth, the inflation rate and interest rates, and therefore the return on investments associated with that economic growth, is now likely to be much lower than in the past.

Another way to put this is that the 'new normal' is not a period of below-potential economic growth, but that potential growth itself has declined.

This is the defining issue for the post-GFC world and does not look like changing anytime soon.

We remain in a low growth, low inflation, low interest rate global environment.

Everything is changing

One area that is subject to constant change however, is global politics.

As we have written about previously (see First Insights, July 2016), there is a strong anti-globalisation trend underway in the political landscape of many countries. This is clearly demonstrated in the run-up to the US Presidential election and the 'Brexit' result in the UK Referendum, but also evidentin recent elections in Europe and Australia.

While there are some justifiable concerns that the benefits of globalisation have not been evenly shared across nations and within nations, the political promise to either 'solve' these concerns or somehow turn-back time on globalisation carries with it great risks.

In our view, any implementation of anti-globalisation policies could lead to:

- Less global trade – which would be bad for global growth.
- Less immigration – which would be bad for the demographics of many countries.

- Governments are likely to become more interventionist and short-term in nature.
- Government resources could then be 'wasted' on less productive spending and attempts to 'protect' some economic sectors, rather than encourage the development of new sectors.
- Larger budget deficits and more government debt could result.
- Productivity enhancing micro-economic reform is less likely to be undertaken.
- This could further reinforce the recent trend towards more of the heavy lifting to create economic growth being put on central banks.
- This could exacerbate the trend to lower interest rates.
- This could also create increased volatility in global FX markets as countries try and 'borrow' economic growth from others, rather than create more economic growth.

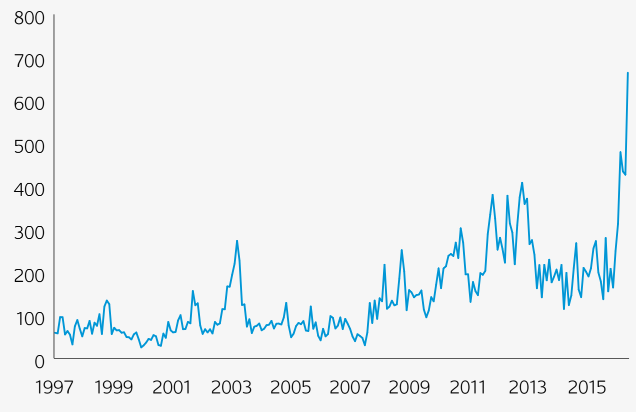
Upside risks

One potential source of upside risk for the global economy and markets could be developments in fiscal policy. We are now seeing the beginnings of a debate that suggests, with monetary policy potentially reaching the limits of its effectiveness, fiscal policy should play a greater role in helping to create economic growth.

With interest rates and government bond yields near historically low levels, the idea would be for governments to borrow and invest in productivity-enhancing assets, especially infrastructure. We have already seen this type of policy implemented in Japan and Canada, while the new UK Prime Minister and both Presidential candidates in the US have talked about using such policy and/or increasing infrastructure spending. Some jurisdictions in Australia have also been increasing infrastructure spending and this proved to be a solid source of support for the economy in the recent Q2 2016 National Accounts.

As illustrated in Chart 9, after a number of years of a declining trend in government capital spending, plenty of upside remains.

Chart 9: Government fixed capital spending – % of GDP



Source: CBA as at February 2016.

Conclusion: Implications of low nominal GDP

It would appear that not much is likely to change in the economic outlook for the remainder of 2016 and into 2017. Over the year ahead, we are expecting the situation of low economic growth, low inflation, and low interest to persist.

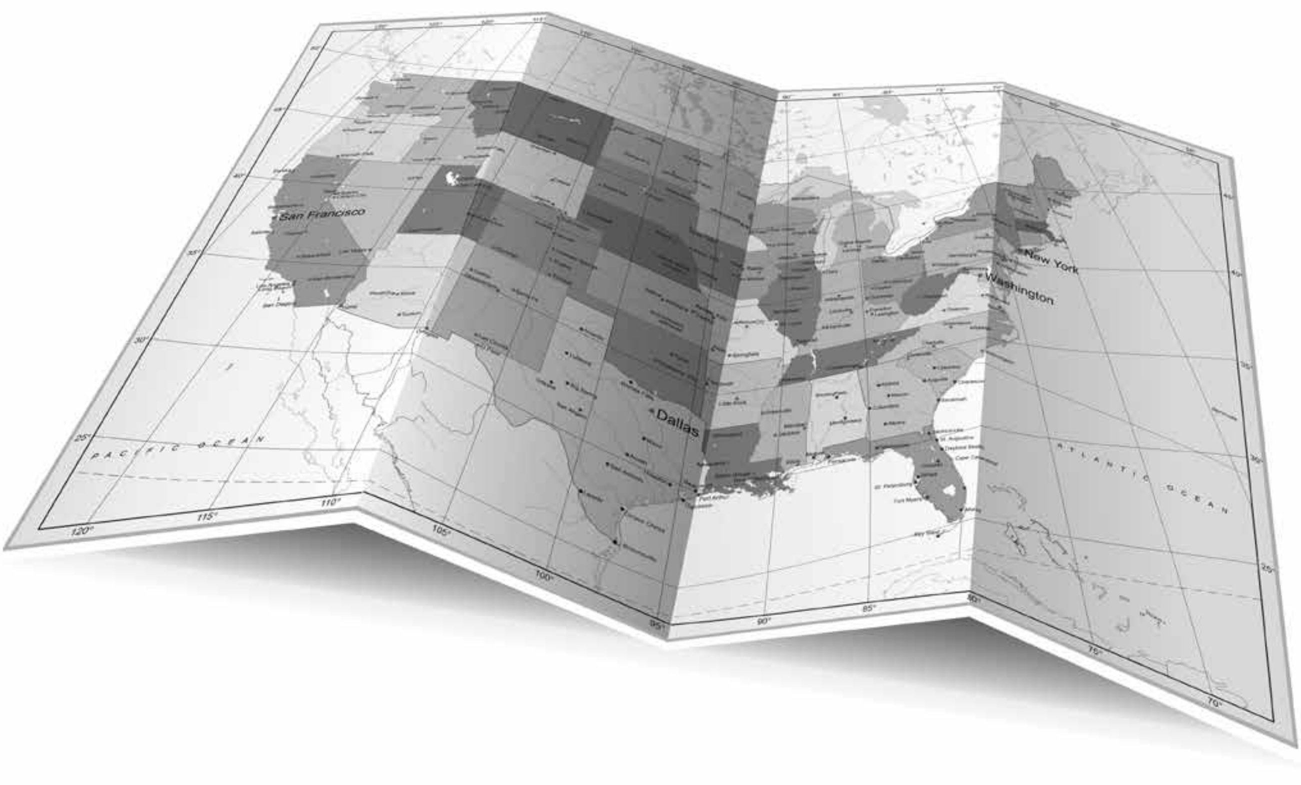
This in turn is expected to keep the pressure on central banks to maintain, or even increase, the amount of monetary policy easing applied to support growth. The US Fed is expected to raise interest rates only very gradually, including a rate hike in December 2016 and two more in each of 2017, 2018 and 2019 to reach a peak of around 2%.

Both the ECB and BoJ are predicted to retain their extraordinary easy monetary policy conditions for some time to come.

Both the RBA and RBNZ are expected to ease monetary policy further.

Upside risks to growth could come from a greater focus on fiscal policy, with governments using the historic low level of interest rates and bond yields to borrow and invest in productivity-enhancing infrastructure.

A source of risk, however, is the concerning anti-globalisation trend now evident in the politics of many countries and the temptation for governments to 'intervene' or attempt to turn back the clock. Such policies are more likely to slow global growth and potentially harm those that they proclaim to support.


San Francisco
Dallas
New York
Washington

Section 2

Market Watch – Our Quarterly Market Review

After the political uncertainty that dominated markets over the second quarter, central banks were once again the focus for the third quarter. Markets were still processing the impact of the 'Brexit' vote as the third quarter began, with most equity indices rebounding back to pre-'Brexit' levels over July. Improving sentiment was driven by better than expected earnings in the US, along with less concern around the UK referendum and strong signs of support for global central banks. Markets largely took a break through August with volatility remaining subdued in the seasonally quiet northern hemisphere summer. However, volatility returned in September as markets focused on the uncertainty of central banks' policy, with the European Central Bank (ECB), Bank of Japan (BoJ), Bank of England (BoE) and US Federal Reserve (Fed) all meeting over the month.

As mentioned, central bank meetings were the main driver of markets in the second half of the quarter. In the US, the outcome of the Federal Reserve Open Market Committee (FOMC) was as expected and did not raise rates in the period. However, the continued speculation and uncertainty around the timing of the next rate move kept markets jumpy. August delivered the anticipated easing from the BoE; after a tentative hold in July, it cut the bank rate from 0.50% to 0.25%. Additional bond purchases were also announced. The BoJ announced its 'yield curve control' extension to the current 'quantitative and qualitative easing' (QQE) in September. This extension aimed to lower short-term rates and stabilise or increase long-term interest rates, with the BoJ leaving the short-term rate at -0.1% and 10 year yields now capped at 0%. The market reaction to this announcement was somewhat muted following the sharp rise in 10 year Japanese government bond yields in early August, when the focus on the curve was first announced. The ECB disappointed markets by announcing no additional stimulus in the quarter. In Australia, the Reserve Bank of Australia (RBA) delivered the highly anticipated cut to the cash rate on 2 August, taking rates to a new low of 1.5%.

Commodity prices were stable to higher over the quarter with individual commodities driven by specific factors. The price of West Texas Crude initially weakened on signs of continued oversupply and increasing rig counts in the US, before news of a potential Organization of Petroleum Exporting Countries (OPEC) production cut drove prices higher in late September to close at US$48.2 per barrel, down 0.2% over the quarter. While the OPEC agreement was announced, no cuts will occur until the 30 November OPEC meeting where individual quotas and supply reductions will be decided. Given the pressure on OPEC budgets and the desire to increase supply by several members (including Iraq, Iran, Nigeria, Venezuela and Libya), a sustainable agreement to reduce production seems unlikely. The iron ore price, as measured by the benchmark price delivered to Qingdao China – 62% Ferrous Content, rose 0.4% over the quarter to US$55.9 / metric tonne. Coal prices, as measured at the Newcastle Coal Terminal, also increased by 26.8% and continued to rise further at the start of Q4. The increase has been driven by a pick-up in Chinese demand as they cut their own production. Base metals were up, with zinc (+12.9%), nickel (+12.0%), aluminium (+1.5%), lead (+18.8%) and copper (+0.4%) all higher. Gold advanced to US$1,317.8 an ounce, up 0.1%.

Global equity markets continued their post-'Brexit' recovery in early July, before settling into a holding pattern from late July to early September as they sought any signs of a post-'Brexit' slowdown and awaited central bank action. While volatility increased in September, markets closed the month relatively unchanged, to end the period up significantly from the post-'Brexit' lows. The MSCI World Index rose 4.4% in US dollar terms and 1.4% in Australian dollar terms, given the 2.9% appreciation of the Australian dollar against the US dollar over the quarter.

The Chicago Board Options Exchange SPX Volatility Index (VIX), a market estimate of future volatility, fell and remained low through the quarter till early September. The VIX Index started at 15.6 and finished at 13.3, but reached an intra-quarter high of 18.14 in the lead up to the Fed and BoJ meetings. Overall it averaged 13.3, compared to 15.6 in the prior quarter.

In the US, the S&P500 Index rose 3.3%, reaching new all-time highs through July and August. The Dow Jones (+2.1%) and NASDAQ (+9.7%) also rose. On a sector basis, MSCI Utilities fell 4.1% as bond yields rose as expectations of Fed interest rate hikes increased. Information Technology (+12.7%) was the best performing sector, driven by significant earnings beats and new product launches. Materials (+9.2%) and Financials (+6.3%) also performed strongly, rising with commodity prices and yields respectively.

European equities recovered from the 'Brexit' weakness, with broad-based performance across all markets. The currency strengthened with the Euro up 1.8% against the US dollar and 3.8% against the British Pound. Overall, the Euro Stoxx 50 Index rose 4.8%, recovering almost all the losses of the second quarter. In other equity markets, Germany (+8.6%), France (+5.0%) and Spain (+7.5%) outperformed the European index while the Netherlands (+3.8%) and Italy (+1.3%) underperformed. During the period, news of the US Department of Justice proposal that Deutsche Bank AG pay US$14 billion to settle a set of high-profile mortgage-securities probes stemming from the financial crisis, raised concerns around the bank's solvency and for Germany and European banks generally.

UK equity markets continued their strong post-'Brexit' performance with the FTSE100 rising 6.1%. The domestically-focused, mid-cap FTSE250 index also recovered from the post-vote slump to end the quarter up 9.8%. The British Pound depreciated further against the USD and EUR, ending the period 2.3% and 3.7% lower respectively and down 15%-17% from the pre-vote level. The smooth political transition, monetary policy support from the BoE, rebounds in business and consumer surveys and better than expected economic data provided market support. The timing of the UK's exit from the EU was also firmed up with Prime Minister (PM) May confirming that Article 50 will be invoked before the end of March 2017, starting the two year negotiation process. PM May also offered more details on the likely deal, confirming that the UK would seek to take back control of immigration, even at the cost of access to the single market.

The Japanese equity markets were stronger over the quarter, with the Nikkei and Topix indices up 5.6% and 6.2% respectively. Markets reacted positively to the BoJ's policy review and move to 'QQE with yield curve control' with Financials performing particularly well over the month. The Japanese yen appreciated 1.8% against the USD despite further easing.

The MSCI EM (Emerging Markets) Index was one of the best performers in in Q3 closing up 8.3%. EM markets saw strong inflows over the quarter as global investors continued their search for returns and looked for markets insulated from the political uncertainty impacting the west. Increasing commodity prices and a stable US dollar also supported markets. All regions performed well with the MSCI Asia ex-Japan the best performer up 9.4% while the MSCI EM Latin America rose 4.9% and the MSCI EM Europe, Middle East & Africa finishing up 4.6%. Key performers were Argentina (+11.2%), Brazil (+13.3%) and Indonesia (+8.3%) while the Shanghai Composite Index rose 2.6%.

The ASX/S&P ASX 200 Accumulation Index returned 5.1% during the quarter. There were a number of potentially market-sensitive events during the period, including concerns around the financial stability of German banking giant Deutsche Bank, interest rate deliberations of various central banks, oil price volatility and the progress of the US Presidential election campaign. For the most part, financial markets took these events in their stride. Favourable commodity prices over the period, including iron ore and industrial metals, helped support margins and profitability for companies in Australia's large Materials sector. Bond proxy sectors, such as REITs and Utilities, fell during the quarter, as the market reacted to rising bond yields and US Fed comments on a potential rise in interest rates.

Overall, government bond yields traded in modest ranges of 28-50 basis points (bps), but ended relatively muted around the low level of yields. The biggest falls in 10 year yields were in the UK (-12 bps to 0.75% due to initial 'Brexit' reaction) and Australia (-7 bps to 1.91% due to the RBA rate cut). An increase in yields was seen in the US (+12 bps to 1.59%), Japan (+13 bps to -0.09%) and Germany (+1 bp to-0.12%).

United States

The US Fed – December is a go, gradual thereafter

- The FOMC held the Fed Funds target rate unchanged at 0.25%-0.5% over the quarter.
- In detailing the policy decision, the Fed judged "that the case for an increase in the Federal Funds rate has strengthened but decided for the time being to wait for further evidence of continued progress towards its objectives".
- Interestingly the FOMC decision was not unanimous with three members of the committee, Esther George, Loretta Mester and Eric Rosengren, who dissented and called for a 0.25% increase in the Federal Funds rate. While their dissent was not a surprise, it further reinforces the case for an increase in December.
- One of the key developments in September's statement from the Fed was the addition of 2019 to the Fed's forecast horizon. The extended forecast horizon has given the Fed the opportunity to both lengthen and flatten its monetary policy tightening expectations. The majority of the FOMC members now believe there will be just one rate hike this year (down from two) and two in 2017 (down from three). Further out, the Fed continues to expect three rate hikes in 2018 and 2019. The expected long-term rate was also lowered from 3% to 2.9%. See Chart 1.

Labour market slack gradually reducing

- The US labour market continued to expand with an average of 192,000 jobs per month created over the third quarter compared to 146,000 in the second.
- Despite this pick-up in employment growth, the unemployment rate increased to 5% in September from 4.9% in June. The increase was driven by a 0.2% pick-up in the participation rate to 62.9%, a sign that discouraged workers are beginning to re-enter the labour market.
- Average Hourly Earnings were stable over the quarter at 2.6%/yr in September, the same level seen in June. See Chart 3.
- The continued reduction of labour market slack and subdued wage gains are likely to give the Fed confidence in running the economy a little hotter.

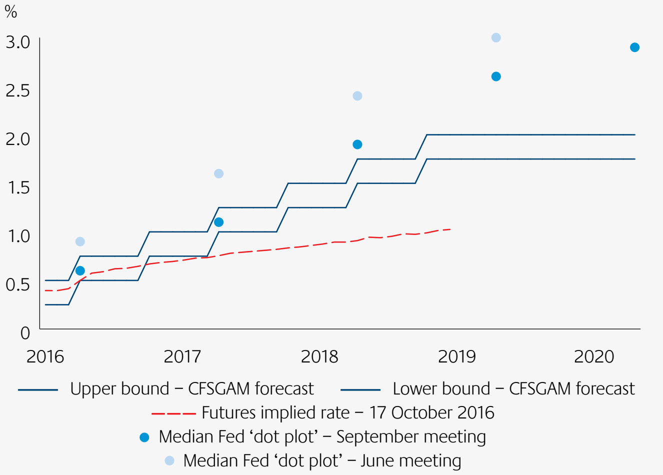
Growth continues to disappoint

- GDP growth remained weak during Q2 2016, printing at 1.4% on a seasonally-adjusted-annualised-rate (SAAR) significantly below the 2.5% expected, but up from the 0.8% SAAR recorded in Q1. The disappointing print was largely driven by a fall in inventories which subtracted 1.2% from the headline number.
- Growth in Q2 was driven by improvements in consumer spending (+4.2%) while weak business investment (-2.2%) and government spending (-0.9%) were the laggards.
- Inflation is beginning to trend higher as the impact of the commodity price decline diminishes. Headline CPI was up 0.3%/mth in September with the annual rate increasing to 1.5%/yr. Core CPI increased 0.1%/mth with the annual rate at 2.2%/yr, around the level it has remained for most of 2016. Inflation continues to be driven by rents (+3.7%/yr) and medical services (+4.8%/yr).
- The Fed's preferred measure of underlying inflation, the Core Personal Consumption Expenditure (PCE), increased to 1.7%/yr in August, the cyclical high it last reached in February 2016.

US Presidential election – Clinton v Trump

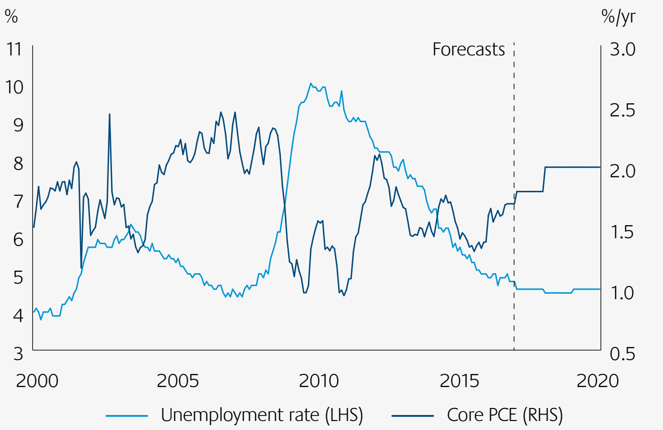
- The third quarter saw the US Presidential election get into full swing with the party conventions and first debates taking place.
- Polls remained volatile over the quarter with significant moves around the conventions and debates. Poor debate performances and other issues have damaged the Trump campaign, with polls showing Clinton ahead with a 3-6 point lead and most election forecasts consistently showing an 80%+ probability of a Clinton victory on November 8. See Chart 4.
- Trumps polarising rhetoric and poor polling has increased concerns for down ballot races and raised the probability of the Democrats taking back control of the Senate (currently held by Republicans 54:44) and making inroads in the House (currently held by Republicans 247:188).

Chart 1: US monetary policy normalisation will be even more gradual



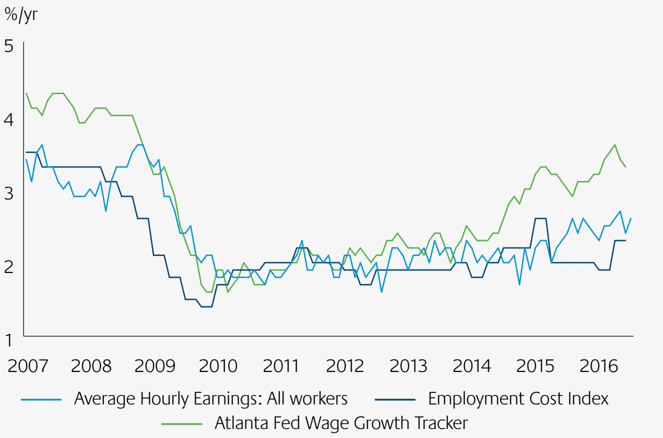
Source: CFSGAM and Federal Reserve – September FOMC meeting.

Chart 2: The US Fed is achieving its dual mandate



Source: Bloomberg. Data to 17 October 2016.

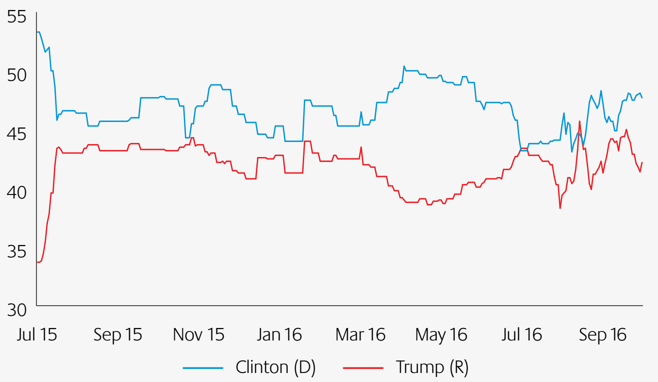
Chart 3: Signs of tighter labour market leading to wage growth



Source: Bloomberg. Data to 17 October 2016.

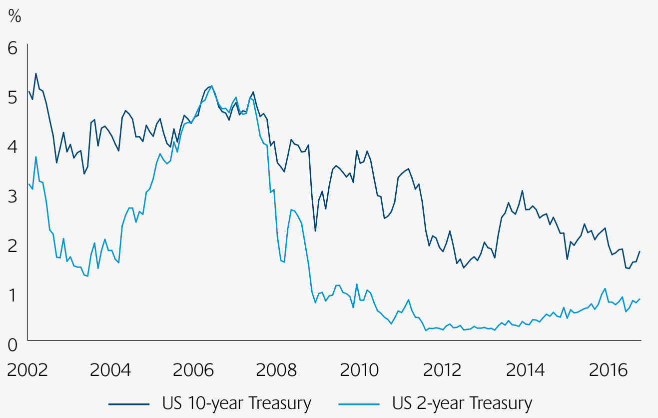
Chart 4: Clinton maintains lead over Trump

RealClearPolitics Poll average



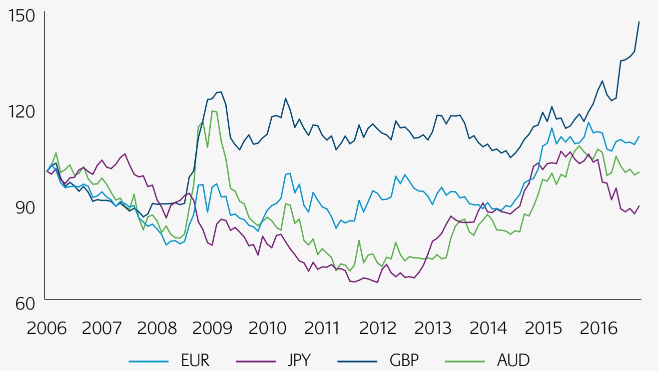
Source: RealClearPolitics, 18 October 2016.

Chart 5: Bond yields rise on rate hike expectations



Source: Bloomberg. Data to 17 October 2016.

Chart 6: USD strength stabilising



Source: Bloomberg. Data to 17 October 2016.

Europe

European Central Bank remains on hold

- The ECB met on 8 September 2016 and left monetary policy unchanged while the market expected an extension of the ECB's quantitative easing (QE) program due to end in March 2017.
- The only concrete thing that came from the meeting was to task "the relevant committees to evaluate the options that ensure a smooth implementation of our purchase programme." During the Q&A, ECB President Draghi said that the committees have a full mandate to redesign the programme and look at all policy options including QE, interest rates and targeted long-term refinancing operations (TLTROs). While no timeframe was given, any decisions appear likely to be made at the December meeting.
- This is possibly a response to the constraints the ECB is facing in the implementation of its QE program. We currently believe it is likely the ECB will loosen the 33% issuer limit and deposit rate floor but leave the capital key unchanged.

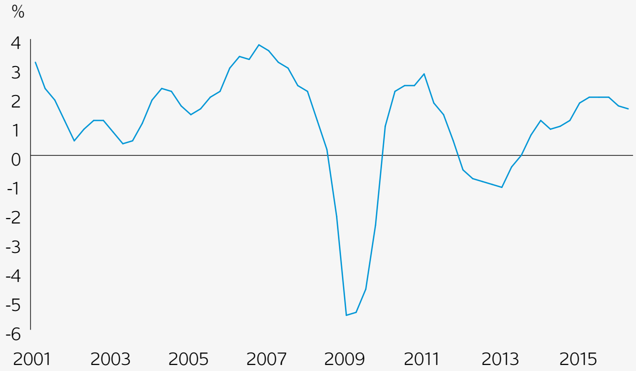
Inflation remains well below target

- September CPI for the Eurozone showed an increase of 0.4%/yr, the fastest since 2014. Core CPI was stable at 0.8%/yr, still well below the ECB's 2% target. Inflation was driven by the increase in oil prices over the month with energy prices down -3%/yr in September, compared to -5.6%/yr in August. See Chart 8.

Concerns for European banks

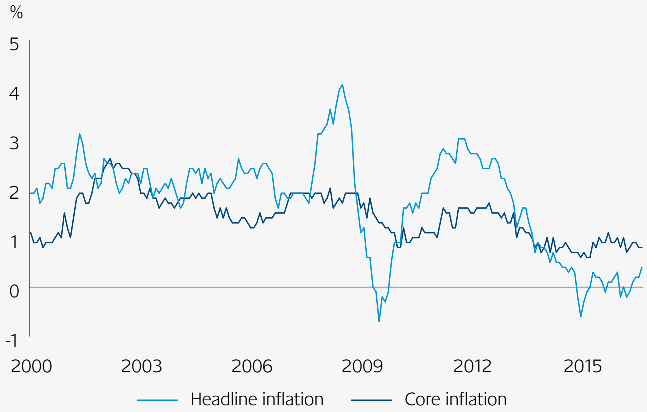
- While the market expects the final settlement between Deutsche Bank (DB) and the US Department of Justice (DoJ) to be closer to US$6 billion (bn), the potential US$14bn fine has raised concerns for its solvency and around German and European banks more generally. The value of DB has more than halved over 2016.
- DB would be the first of the European banks to settle with the DoJ on residential mortgage-backed securities (RMBS) fraud. Others that are awaiting decisions from the DoJ include Barclays, Credit Suisse, Royal Bank of Scotland and UBS
- In response, credit default swap spreads (a measure of the cost of insuring against default) for European banks increased over the quarter, see Chart 9.

Chart 7: EU Economic growth holds steady



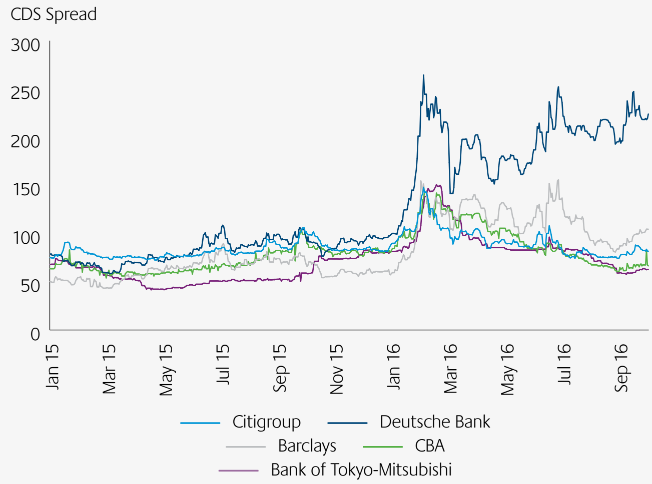
Source: Bloomberg. Data to 30 June 2016.

Chart 8: EU inflation remains elusive



Source: Bloomberg. Data to 30 September 2016.

Chart 9: Bank CDS spreads increase on solvency concerns



Source: Bloomberg. Data to 17 October 2016.

United Kingdom

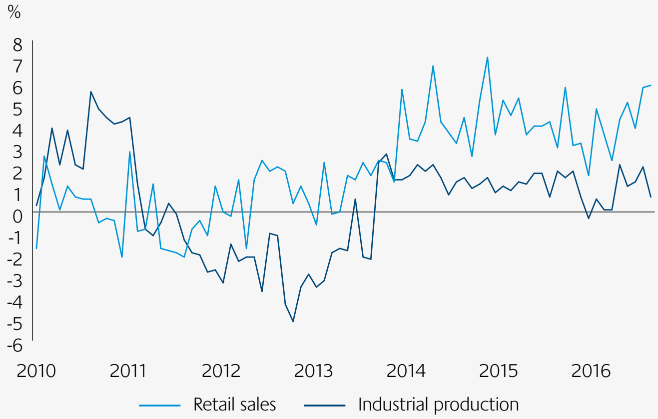
UK economy remains resilient in the face of 'Brexit' uncertainty

- Over the third quarter, initial declines in both business and consumer surveys were mostly reversed as immediate concerns around the 'Brexit' proved unfounded. Consumer confidence has increased to -1 from a post-'Brexit' low of -12 while business confidence has rebounded to 24 from a low of 6.
- The activity data released so far has been mixed, with retail sales up 1.5%/mth in July (significantly above expectations), driven by the weaker Pound (GBP) and strong holiday trading. Retail sales were up 5.9%/yr in August from 3.9%/yr in June. While industrial production has fallen to 0.7%/yr from 1.4%/yr in June. See Chart 10.
- While the confidence measures and markets have mostly recovered, the GBP has continued to depreciate, falling a further 2.3% against the USD over the quarter. See Chart 11.
- The Conservative Party conference was held during the quarter and there was confirmation from PM May that the UK would seek to take back control of immigration, even at the cost of access to the single market. The market has taken this to mean that 'Brexit' is likely to be 'harder' (leaving the single market) rather than the 'soft' exit many had hoped for.

Bank of England supports economy, prepared to do more

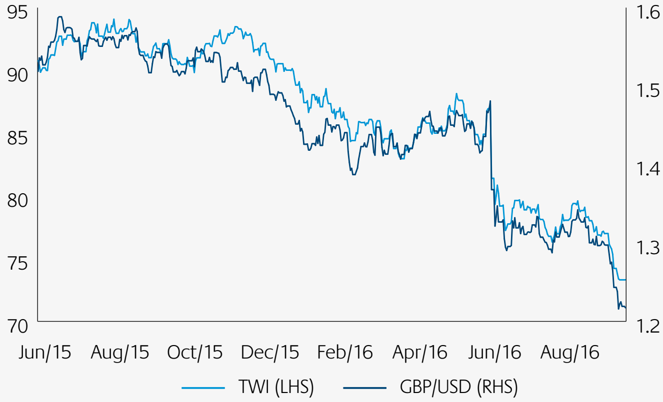
- As largely expected, the BoE cut the benchmark interest rate by 25bps to 0.25% at their meeting on 4 August 2016.
- The BoE also announced additional policy easing in the form of GBP60bn of sovereign QE over the next six months and up to GBP10bn of corporate bond purchases over the next 18 months.
- At their September meeting, the BoE recognised the outlook had improved for 2H 2016 but longer term it was still too early to draw inferences for 2017 and beyond.
- The BoE maintained their easing bias in September stating "a majority of members expect to support a further cut in Bank Rate".
- Relatively subdued inflation at just 1.0%/yr in September leaves the BoE with room to ease further if needed.

Chart 10: UK activity mixed after 'Brexit' vote



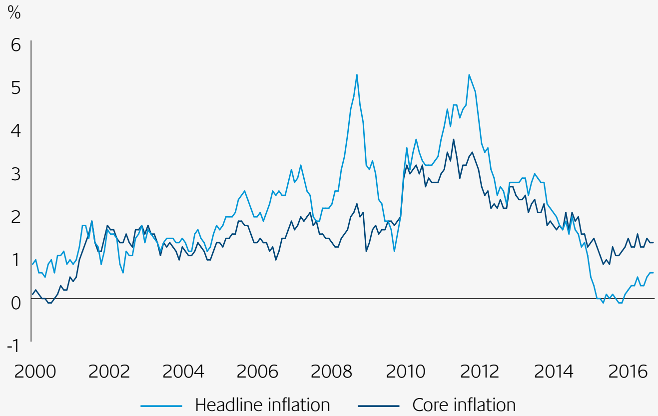
Source: Bloomberg. Data to 17 October 2016.

Chart 11: GBP depreciates further



Source: Bloomberg. Data to 17 October 2016.

Chart 12: Inflation gives BoE room to ease further



Source: Bloomberg. Inflation as at 30 September 2016.

Japan

Inflation continues to decline

- CPI remained negative over the quarter, falling to -0.5%/yr in August from -0.4%/yr in June. The core measure, excluding food and energy, was also weaker, falling to 0.2%/yr in August from 0.5%/yr in June. Both measures are well below the BoJ's 2% target. See Chart 12.
- Wage inflation remained negative with labour cash earnings printing at -0.1%/yr in July from -0.2%/yr in May.

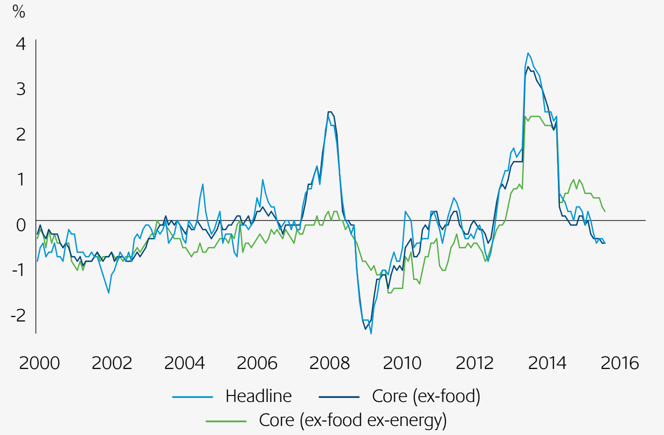
Bank of Japan (BoJ) shifts policy

- The BoJ met on 21 September 2016 and released its promised "comprehensive reassessment" of their monetary policy easing program – known as 'quantitative and qualitative easing with negative interest rates' (QQE-NIR).
- The BoJ acknowledged they had failed to achieve the 2% inflation target due to i) the fall in global oil prices, ii) the weakness in domestic demand created by the Consumption Tax hike in April 2014 and iii) the slowdown in emerging economies and volatile financial markets.
- They concluded that in order to achieve the "price stability target of 2% at the earliest possible time" the BoJ would "introduce QQE with yield curve control" by strengthening the QQE-NIR program.
- The BoJ is now aiming to undertake 'yield curve control', by controlling both short-term and long-term interest rates. The short-term rate will remain at -0.1% and 10yr JGB yields will now be targeted at around 0%.
- The BoJ has also made an 'inflation-overshooting commitment' in which the BoJ "commits itself to expanding the monetary base until the year-on-year rate of increase in the observed CPI exceeds the price stability target of 2% and stays above the target in a stable manner."

Abe initiates fiscal stimulus

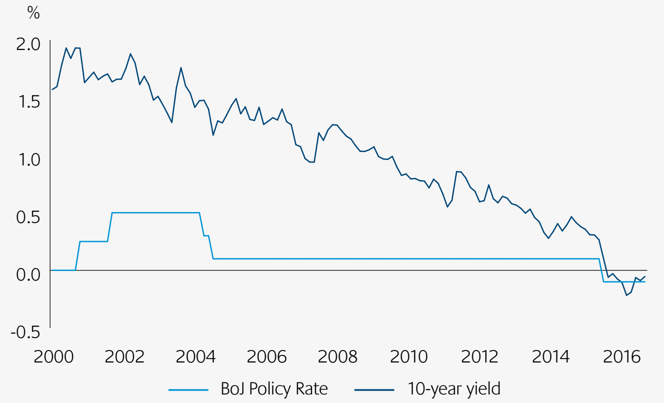
- After the strong showing in the July upper house elections, PM Abe's cabinet approved a JPY13.5 trn fiscal stimulus package which includes cash payments to low-income earners and infrastructure spending.
- The package is part of a renewed effort to coordinate policy between the Government and BoJ in an effort to boost demand and inflation.

Chart 13: Japanese inflation continues to decline



Source: Bloomberg. Data as at 31 August 2016.

Chart 14: BoJ targets 10 Yr bonds at 0%



Source: Bloomberg. Data as at 17 October 2016.

Chart 15: Yen continues to strengthen despite further easing

Source: Bloomberg. Data to 17 October 2016.

China

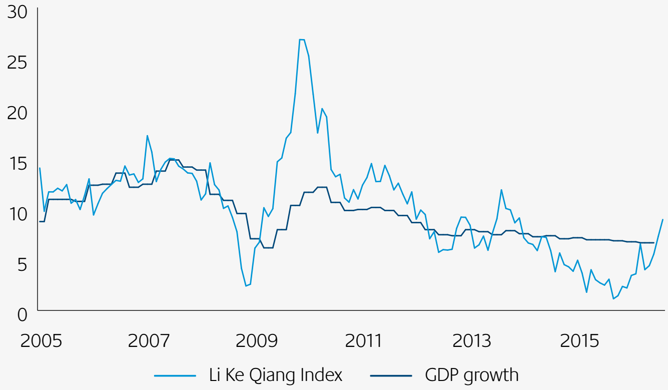
Fiscal stimulus supports growth

- Q3 2016 GDP released in October showed growth once again stable at 6.7%/yr, in the middle of the 6.5%-7% target band where it has remained for the duration of 2016. See Chart 16.
- Other economic data over the quarter showed further stabilisation in growth. September data showed industrial production increased 6.1%/yr (from 6.2%/yr in June), retail sales were up +10.7%/yr (from 10.6%/yr in June) and fixed asset investment rose +8.2%/yr (from 9.0%/yr in June).
- Growth is being supported by an increase in public infrastructure investment even as private investment continues to decline. Public investment is now up 21.1%/yr from +10.9%/yr in December 2015 while private investment has fallen from 10.1%/yr in December to 2.5%/yr in September.

Inflation shows signs of improving

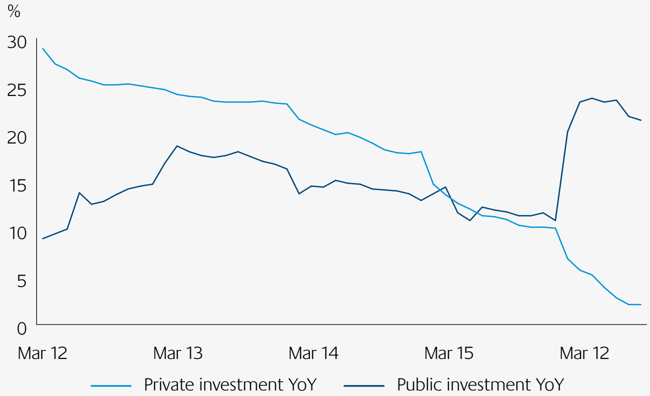
- After weakening to 1.3%/yr in August, Chinese inflation improved in September rising to 1.9%/yr the same level as June. Food price inflation continues to be the major driver of inflation, falling from 4.6%/yr in June to 1.3%/yr in August before recovering to 3.2%/yr in September.
- Core CPI increased slightly over the quarter to 1.7%/yr in September from 1.6%/yr in June. Both measures are still well inside the target rate of 3%/yr
- Producer prices, as measured by the PPI Index, continued their rapid increase over the quarter reaching +0.1%/yr in September, the first positive print since 2012 and up from -2.6%/yr in June and -5.9%/yr a year ago.
- The increase in PPI has largely been driven by increasing prices of producer goods, particularly mining (+2.1%/yr from -8.2%/yr in June) and fuels (-1.9%/yr from -7.2%/yr in June).
- The increase in factory-gate prices should begin to flow through to export prices and global markets over the coming months, removing what has been a major source of disinflationary pressure globally.
- The currency weakness also continued over the quarter with the Renminbi now down 11.5% against the USD compared to its 2014 highs. On a trade weighted basis, it is 7.7% down from its mid-2015 highs. See Chart 18.

Chart 16: Chinese economy maintains momentum



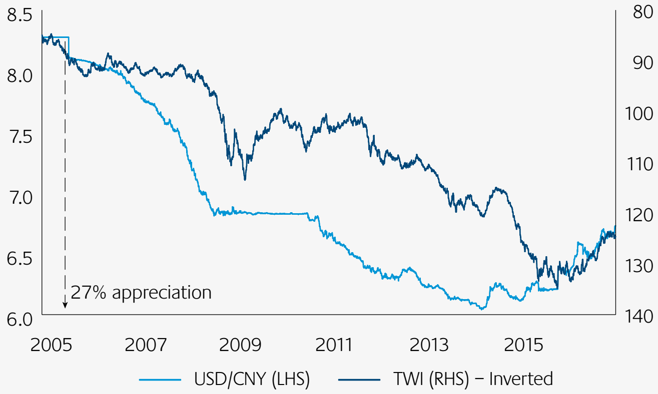
Source: Bloomberg. GDP to 30 September 2016. Li Ke Qiang index to 31 August 2016.

Chart 17: Fiscal stimulus supports investment



Source: Bloomberg. Data to 30 September 2016.

Chart 18: RMB depreciation continues



Source: Bloomberg. Data to 17 October 2016.

Australia/New Zealand

Inflation weakness drives RBA rate cut

- Q2 2016 CPI data in July showed further weakness in prices. Headline CPI rose to 0.4%/qtr but was down to 1.0%/yr from 1.3%/yr in Q1. Drivers included increases in auto fuels (+5.9%/qtr) and medical and hospital services (+4.2%/qtr) which were largely offset by declines in domestic holiday travel and accommodation (-3.7%/qtr) and telecommunications equipment and services (-1.5%/qtr).
- Underlying inflation, the RBA's preferred measure, rose to 0.5%/qtr, slightly up from 0.2% in Q1 2016. The annualised rate remained at 1.5%/yr. See Chart 19.
- Following the weak inflation data, the RBA cut the cash rate at their 2 August 2016 meeting by 25 basis points to 1.5%, a new all-time low. In their statement, they noted that "prospects for sustainable growth in the economy, with inflation returning to target over time, would be improved by easing monetary policy." See Chart 20.
- October saw the first meeting with Dr Philip Lowe as Governor. As widely expected, the cash rate was held unchanged at 1.5%.
- Also as expected, Governor Lowe has taken the opportunity to re-write some aspects of the statement. Although, critically, the words describing both the inflation and policy outlook are unchanged.
- In terms of policy guidance, there was very little, with the RBA repeating the view that "having eased monetary policy at its May and August meetings, the Board judged that holding the stance of policy unchanged at this meeting would be consistent with sustainable growth in the economy and achieving the inflation target over time."

Australian growth picks up in H1

- The Q2 2016 GDP report for Australia came in largely in-line with expectations and marks the 25th consecutive year of economic growth.
- Quarterly GDP came in at slightly below expectation at 0.5%/qtr vs 0.6%/qtr while the annual rate increased to 3.3%/yr, from 3.1%/yr in Q1, in line with market expectations and a four year high. One of the most positive signs from the report is the increase in real gross domestic income to 1.9%/yr from 0.4%/yr, largely driven by a 0.95%/qtr increase in Q2 2016 and the improvement in the terms of trade. See Chart 21.
- The biggest contributions to growth came from public investment (+0.7%), government consumption (+0.3%) and inventories (+0.3%) while non-residential building (-0.8%) and net exports (-0.2%) were the largest detractors.

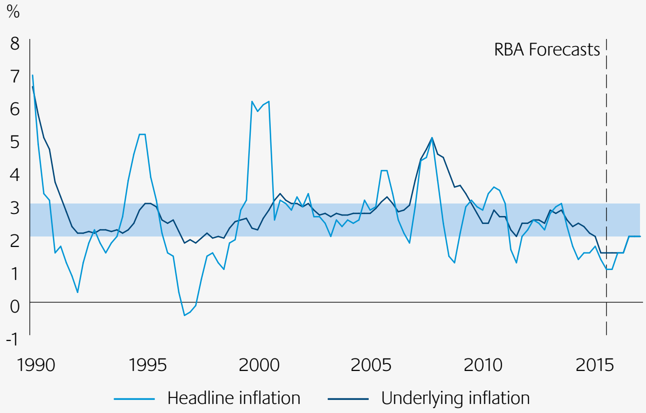
RBNZ eases, more to come

- The Reserve Bank of New Zealand (RBNZ) announced a 25bps cut in the official cash rate (OCR) to 2% at its August 2016 meeting, as largely expected by markets.
- The reasons for cutting were once again the weak inflation outlook and stubbornly strong NZD.
- The RBNZ kept the OCR on hold at their September meeting but maintained their easing bias – "Our current projections and assumptions indicate that further policy easing will be required". The market new expects a rate cut at their November meeting.
- However the bank is clearly still concerned with the housing market – "House price inflation remains excessive, posing concerns for financial stability", despite recent measures that "are having a moderating influence."

NZ inflation remains low as growth picks-up

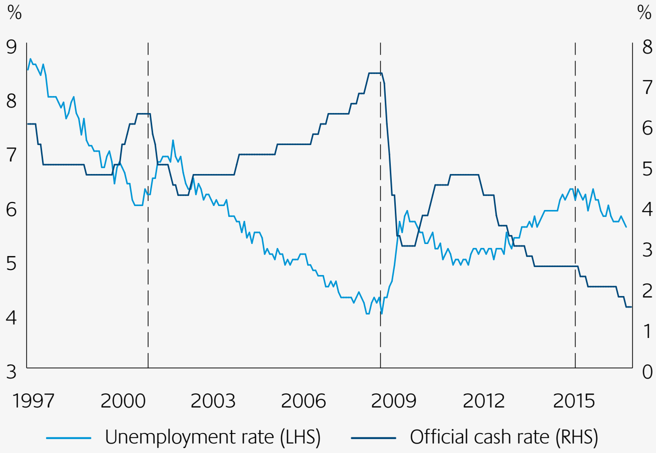
- Q2 2016 Headline CPI rose 0.2%/qtr, better than the 0.0% expected. The annual rate fell to 0.2%/yr in line with the RBNZ's forecast but well below the 2% target. See Chart 21.
- Tradable inflation was stronger than expected at 0%/qtr, despite falling petrol prices and the recent strength in the NZD. Core measures of inflation were stable over the quarter with the weighted median remaining at 1.7%/yr, which should give the RBNZ some comfort.
- Q2 GDP released in September was slightly weaker than expected at 0.9%/qtr. However Q1 GDP was revised up 0.2% to 0.9%/qtr pushing the annual rate up to 3.6%/yr, above the level the RBNZ expected in August.
- Growth was buoyed by continued strong migration, a pick-up in consumer spending (+1.9%/qtr) and continued strong residential construction (+6%/qtr).

Chart 19: Low inflation sees RBA ease further



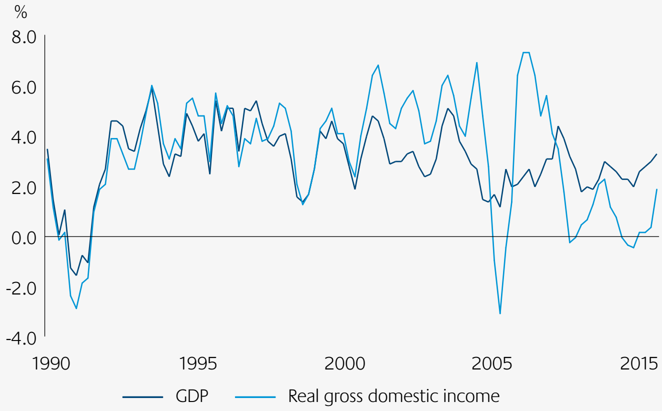
Source: Australian Bureau of Statistics (ABS). Data to 30 June 2016. RBA forecasts as at August 2016.

Chart 20: RBA eases as unemployment continues to decline



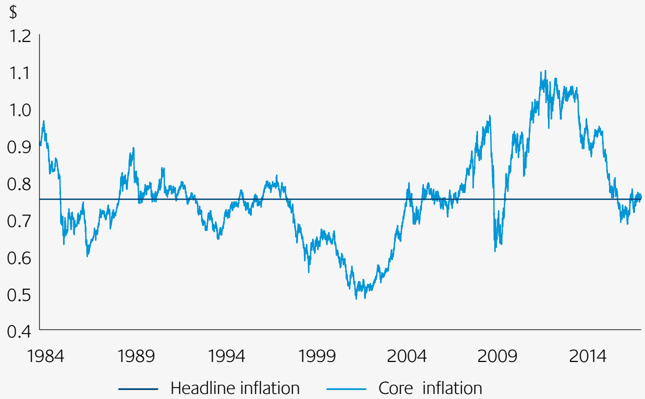
Source: RBA and Bloomberg. Official cash rate data to October 2016. Unemployment rate to 30 September 2016.

Chart 21: GDP and Income growth accelerates in first half



Source: Bloomberg. Data to 30 June 2016.

Chart 22: AUD at long-term average

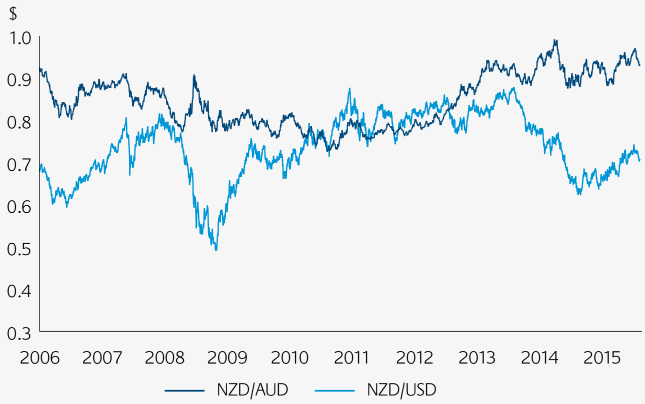


Source: Bloomberg. Data to 17 October 2016.

Chart 23: NZ inflation remains low

Source: Bloomberg and RBNZ. Data as at 30 September 2016.

Chart 24: NZD remains stubbornly high



Source: Bloomberg. Data as at 17 October 2016.

Section 3

Economic Forecasts October 2016

United States

	2016		2017		2018		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	1.5	1.9	2.2	2.2	2.1	2.0	2.0	2.0
Inflation – Core PCE	1.7	1.7	1.8	1.8	2.0	1.8	2.0	2.0
Monetary policy – Rates	0.5%	0.5%-0.75%	0.7%	1.0%-1.25%	0.85%	1.5%-1.75%	2.0%	2.0%
Monetary policy – Other	No change to balance sheet.	No change to balance sheet.	Fed unlikely to alter balance sheet.	Fed unlikely to alter balance sheet.	Coupon reinvestment may be phase out.	Coupon reinvestment may be phase out.	Balance sheet slowly returns to normal.	Balance sheet slowly returns to normal.

Source: Bloomberg.

Comments:

- GDP: Our 2016 economic growth forecast for the US has been lowered modestly to 1.9% (from 2.0% previously) – consensus is lower at 1.5%.
- Economic growth should be supported through 2016 and 2017 by the very gradual nature of the Fed's policy normalisation. Growth is also expected to be helped by the solid labour market supporting the consumer and some further improvement in the construction sector, but with softness in capital spending and net exports.
- Inflation: The Fed's favoured measure of underlying inflation, the Core PCE, has picked up again in recent months and so our end of 2016 forecast has be revised up to 1.7% (from 1.5%).
- Going forward, the rate of inflation in the US is not expected to reach the Fed's 2% target until at least 2018 on a consistent basis.
- Monetary policy: The US Fed began its monetary policy normalisation process in December 2015, lifting the Fed Funds target rate by 25bp to 0.25%-0.5%, and another rate hike, to 0.5%-0.75% is expected in December 2016.
- We expect two rate hikes from the Fed in each of 2017, 2018 and 2019 for a peak of just around 2%.
- The Fed is not expected to sell any of the bonds it holds on balance sheet, but is now expected (by us) to begin to cease reinvesting coupon income in 2019 or 2020.

United Kingdom

	2016		2017		2018		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	1.8	1.6	0.7	0.8	1.5	1.25	2.5	2.0
Inflation – CPI	0.7	0.6	2.2	1.75	2.3	2.0	2.0	2.0
Monetary policy – Rates	0.15%	0.25%	0.15%	0.25%	0.45%	0.5%	2.5%	2.0%
Monetary policy – Other	QE resumed.	QE resumed.	No clear consensus.	Ongoing QE program.	No clear consensus.	Balance sheet to stabilise.	Rates to settle around new neutral.	Rates to settle around new neutral.

Source: Bloomberg.

Comments:

- GDP: The economic data in the UK has outperformed expectations in the months since the unexpected 'Brexit' vote. As a result we have raised our 2016 GDP growth forecast from 0.8% to 1.6%. Consensus is still now at 1.8%.
- For 2017, our growth forecast has been revised up modestly, with growth next year now forecast at 0.8%, from just 0.5%/yr previously. Some further recovery in 2018 could be expected, depending on the path of the 'Brexit' negotiations in the coming two years.
- Inflation: The pace of inflation in the UK, as elsewhere, has been benign so far in 2016. This is expected to remain the case into 2017.
- However, the substantial depreciation of the GBP post the 'Brexit' vote could see upward pressure on inflation in the UK from higher imported prices. This is expected to see CPI inflation rise from 0.6%/yr in 2016 to 1.75%/yr in 2017 and then to the BoE's target of 2% in 2018.
- Monetary policy: The economic concerns set in train by the 'Brexit' vote saw the BoE cut interest rates by 25bp to 0.25% and increase its QE program.
- With the economic data stabilising and inflation likely to be affected by the fall in the GBP, we now expect the BoE to be on hold in the year ahead.

Europe

	2016		2017		2018		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	1.5	1.5	1.3	1.5	1.5	1.5	1.5	1.0
Inflation – CPI	0.2	0.2	1.3	1.0	1.5	1.5	1.5	1.0
Monetary policy – Rates	-0.4%	-0.4%	0%	-0.4%	N/A	0%	N/A	1.0
Monetary policy – Other	QE and TLTRO to remain in place.	QE and TLTRO funding to remain in place.	Some concerns around a taper of QE.	QE to be extended and TLTRO remains in place.	N/A	Some tapering of QE. TLTRO remains in place.	Significant period of very easy monetary policy.	Significant period of very easy monetary policy.

Source: Bloomberg.

Comments:

- GDP: Economic data in the EU has shown some impressive stability through much of 2016 and our forecast for the year is unchanged at 1.5%.
- The better-than-expected data for the UK and the impact of the very easy stance of monetary policy is expected to see growth remain around 1.5% for 2017 and 2018.
- Inflation: Inflation in Europe (as elsewhere) remains very low and is struggling to show a headline reading much above zero.
- Aggressive policy action by the ECB and any further weakening of the EUR should help put upward pressure on inflation through 2017-2018. Our forecast for 2016 remains unchanged at 0.2%, with 2017 unchanged at 1.0%.
- Inflation is not expected to reach the ECB's 2% target until beyond 2018.
- Monetary policy: ECB President, Mario Draghi, continues to deliver on his 'whatever it takes' commitment. An expanded bond purchase program of €80bn/mth, including investment-grade corporate bonds, a deposit rate of -0.4% and direct funding of the banks through the TLTRO program are all providing ongoing support.
- Currently the QE program is scheduled to expire in March 2017, but we expect an extension of at least six months before any tapering of this program gets underway.

Japan

	2016		2017		2018		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	0.6	0.5	0.8	0.75	0.7	1.0	1.0	1.0
Inflation – CPI	-0.2	-0.2	0.6	0.5	1.1	1.0	2.0	1.0
Monetary policy – Rates	-0.1%	-0.1%	-0.1%	-0.1%	N/A	-0.1%	0%	0%
Monetary policy – Other	QQE, with NIRP and yield curve control.	QQE, with NIRP and yield curve control.	QQE, with NIRP and yield curve control.	QQE, with NIRP and yield curve control.	QQE, with NIRP and yield curve control.	QQE, with NIRP and yield curve control.	QQE, with NIRP and yield curve control to remain in place for foreseeable future.	QQE, with NIRP and yield curve control to remain in place for foreseeable future.

Source: Bloomberg.

Comments:

- GDP: Economic growth in Japan has improved a little in 2016, but growth for the remainder of the year is forecast to remain subdued. This is expected to see growth for the year coming in around 0.5%/yr, slightly lower than our previous forecast.
- Aggressive monetary policy easing, including the expanded QQE program, 'negative interest rates' (NIRP) and yield curve control from the BoJ should help support an improvement in growth in 2017 and beyond, but likely still only to levels around 0.75%/yr in 2017 and 1.0%/yr in 2018.
- Inflation: As is the case elsewhere, the rate of inflation remains very low in Japan and is expected to come in a little under zero in 2016. Some slight improvement in underlying inflation could be seen in 2017, but the pace of inflation is very unlikely to meet the BoJ's 2% target in the years ahead.
- Monetary policy: After its 'comprehensive reassessment' of monetary policy the BoJ has switched its focus from targeting balance sheet expansion to targeting 10yr JGB yields at 0%. The cash rate target remains at -0.1%.
- The BoJ is expected to retain a very aggressive monetary policy stance for a number of years to come.

China

	2016		2017		2018		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	6.6	6.6	6.3	6.4	6.1	6.0	6.0	6.0
Inflation – CPI	2.0	1.9	2.0	2.0	2.2	2.0	2.5	2.5

Source: Bloomberg.

Comments:

- GDP: Economic growth in China has improved a little in recent months and growth for the year looks set to hit the official target of 6.5%-7.0%.
- For 2017, economic growth is expected to moderate a little, to around 6.4%/yr (upgraded from our previous forecast of 6.1%) and then settle around 6% for 2018.
- In the next five years or so, China is likely to be able to maintain a growth rate around 6%/yr, consistent with the government's target of doubling nominal GDP from 2010 to 2020.
- Inflation: As with most other nations, China's inflation rate remains moderate, with food prices being a big swing factor. For 2016, 2017 and 2018 we expect an inflation rate around 2.0%/yr to prevail.
- In the longer-term, China has shown itself to be capable of managing inflation over the course of a cycle – with an average rate of around 2.5% now expected.

Australia

	2016		2017		2018		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	2.9	3.0	2.8	2.75	2.9	2.75	3.0	2.75
Inflation – CPI	1.2	1.3	2.0	2.0	2.4	2.25	2.5	2.25
Monetary policy – Rates	1.45%	1.25%	1.3%	1.25%	N/A	1.75%	No clear consensus	3.0%

Source: Bloomberg.

Comments:

- GDP: The Australian economy has proved to be more resilient and flexible than many expected through 2016 to date, with economic growth accelerating to 3.3%/yr in Q2.
- For 2016, GDP growth is now expected to average 3.0%/yr (previous forecast 2.8%), as the economy continues to transition away from growth dominated by mining capex to other sources, including housing, infrastructure spending and services. Non-mining capex spending continues to disappoint and income growth remains very soft as the terms of trade and wages growth slow.
- Inflation: The big surprise in Australia has been the shift lower in inflation, with headline Q2 CPI of just 1.0%/yr. Underlying inflation was also low at just 1.5%/yr – well below the RBA's 2%-3% target range.
- For 2016, inflation is expected to average just 1.3%/yr, with an increase to the bottom end of the RBA's target range expected for 2017.
- Monetary policy: The lower-than-expected inflation environment saw the RBA ease monetary policy in May and again in August (as we expected) taking the cash rate down to just 1.5%.
- We continue to expect a rate cut to 1.25% by year-end 2016. Rates are forecast to remain at this very low level through 2017, but some modest increase predicted in 2018.

New Zealand

	2016		2017		2018		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	2.7	3.2	2.6	3.8	2.4	3.3	2.5	2.8
Inflation – CPI	0.8	0.9	1.8	1.5	2.1	1.9	2.0	2.0
Monetary policy – Rates	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	N/A	3.5%

Source: Bloomberg.

Comments:

- GDP: New Zealand's economic growth accelerated over the first half of 2016, underpinned by stronger than expected construction activity. Beyond the construction sector, tourism activity also continues to grow. Improved economic demand has resulted in a stronger labour market which in turn, has helped boost NZ consumer confidence. Weak dairy incomes remain a soft spot, but the recent recovery in dairy prices has come sooner than some expected and will help boost rural confidence over the coming year.
- Inflation: NZ headline inflation remains very low. The RBNZ attributes this weakness to largely global factors (such as low oil prices). However, the fall in headline inflation had led to declines in short-term measures of inflation expectations. Over the next few years we expect inflation will gradually lift back toward the mid-point of the RBNZ's target band of 1-3%. However, we see risks that the lift in inflation will be more gradual than the RBNZ is currently expecting.
- Monetary policy: We see risk that the RBNZ will cut the OCR again in 2017, particularly as downside risks remain to the inflation outlook. We also expect the RBNZ will maintain an easing bias after November. The RBNZ is particularly sensitive to any sign of weaker tradable inflation due to strength in the NZD.

Section 4
Recent Research Reports – Q3 2016

The following is a list of the key research reports released by the Economic and Market Research team over recent months.

Australian Q2 16 CPI: Australian Low inflation will allow further RBA easing
27 July 2016

US Federal Reserve: On hold – but hopeful data will allow a further rate hike
28 July 2016

Japan Update. BoJ eases – but very disappointingly!
29 July 2016

Australian Update: RBA eases again as inflation stays well below target
2 August 2016

Investor Insights – The continuing search for growth
25 August 2016

Japan Update: BoJ moves to "Yield Curve Control" and Inflation Expectations
21 September 2016

US Federal Reserve: December is a go, gradual there after
22 September 2016

Investor Insights – The Power of Closing the Gap
26 September 2016

The Great Transition – Examining the listed sector of the US economy – Paper 3
7 October 2016