Jamieson Coote Bonds

Jamieson Coote Bonds (JCB) is a
duration management specialist with **security selection expertise**,
focused on generating superior **defensive** risk-adjusted returns

---

WHAT TO WATCH IN 2017

By Saul Eslake
Jamieson Coote Bonds Advisory Board Member & Senior Economist

Over the first few weeks of the year, I've been thinking about the issues that I'm likely to find myself talking about at conferences and events in the coming year. Here are ten things that I think are likely to shape the global and Australian economies during 2017.

1. *What Donald does (or says) next.* This time last year I wrote that Donald Trump was 'odds-on' to be the Republican nominee for President of the United States, but I also found it 'hard to conceive' that he could be a 'serious contender for what used to be called Leader of the Free World'. Moreover, I thought that financial markets around the world 'may well take fright' if they began to think that he and Melania 'could be moving into the White House'. Well, Melania isn't moving (yet) – but Donald Trump is now ensconced in the White House; and although they didn't predict his victory either, they haven't been at all troubled by it (so far). Since the election, investors seem to have assumed that President Trump will only seek (or be allowed by Congress) to implement the items from his campaign platform which markets believe will boost economic growth (such as cutting taxes and boosting infrastructure spending), and that he will back away from (or Congress will block) items from his campaign platform which would harm growth (such as launching trade wars). However, Donald Trump's inaugural address casts a lot of doubt on those convenient assumptions. I think his assertion that 'protection will lead to great prosperity and strength' is complete and utter balderdash – but it's also a clear signal that he means to implement the protectionist agenda he repeatedly outlined during last year's election campaign. And, as a result, we are likely to see much more volatility in market pricing of the outlook for the US and global economies – and, eventually, if the Trump Administration is able to implement this protectionist agenda, weaker growth, higher unemployment and higher inflation.

2. *European voters.* There are a number of important elections in Europe this year – including in the Netherlands on 15th March, in France on 23rd April and on 7th May, and in Germany sometime between late September and late October. Each of these will provide some insight into the extent to which the wave of right-wing populism which gained global attention in the 'Brexit' referendum and then during the US election campaign continues to appeal to voters. The Dutch Parliamentary and French Presidential elections, in particular, could add to the number of countries seeking to exit the European Union. And then of course there are the various formal steps which Britain needs to undertake in order to give effect to last year's referendum verdict. All of these represent potential sources of market volatility.

3. *The clash between demography and economic policy.* Markets – and many policy-makers – seem to be paying scant regard to the constraints which demographic change has been having – and will increasingly have – on the rates of growth which can be sustained by advanced (and some emerging) economies. Across the OECD area, the growth rate of the 15-64 year old population has slowed from 0.75% pa in 2006-08 to just 0.2% pa in 2016-18. This largely explains why OECD area real GDP growth averaging just under 2% pa since the trough of the 'Great Recession' in early 2009 – a rate some two-thirds of a percentage point below the average between the global recessions of the early 1990s and the onset of the financial crisis – has nonetheless been sufficient to allow the average unemployment rate across the OECD area to fall by more over the past three years than over any other three-year period, bar one, in the last five decades. That fall in unemployment is of course a Good Thing. But now that the unemployment rate in the OECD's four largest economies is down to levels traditionally regarded as consistent with 'full employment' – while in those OED countries where unemployment hasn't fallen by very much, it's mostly 'structural' rather than 'cyclical' unemployment, which faster economic growth alone can't help – ongoing efforts to procure a return to pre-crisis economic growth rates are more likely to trigger higher inflation than faster growth. That's especially so if productivity growth remains as anaemic as it has, in virtually all advanced economies, since the financial crisis. And in this kind of world, protectionist policies amount to a fight over shares of a shrinking economic pie – they do nothing to make the pie bigger.

4. *The end of deflation fears*. Largely because the four major advanced economies are now effectively at full employment, the fears of falling into deflation which have periodically gripped financial markets since the financial crisis should evaporate. 'Headline' inflation rates have picked up (in some cases out of negative territory) since the middle of last year, aided by the rebound in oil prices. 'Core' inflation rates also appear to be edging higher in most advanced economies, especially in the UK (as a result of the post-referendum fall in sterling) and in the US. Producer price inflation across Asia also moved back into positive territory towards the end of last year, something which will filter into advanced economy consumer prices during 2017. This should eventually see an end to negative interest rates around the world.

5. *The Fed*. The Fed repeatedly baulked at raising interest rates last year, eventually doing so only at the last opportunity, in December. This left the Fed open to accusations from Donald Trump that it was 'artificially' holding rates down in order to favour his political opponent. As President Donald Trump is now in a position to reshape the Fed, with two vacancies on the Fed's Board of Governors able to be filled immediately, and the opportunity to appoint a new Chair and Vice-Chair early next year when Janet Yellen's and Stanley Fischer's terms in those offices expire (although they could complicate matters by electing to serve out some or all of their remaining terms as Governors). During last year's election campaign Donald Trump also appeared sympathetic to proposals to water down the Fed's independence from political interference. At its December meeting the Fed foreshadowed its intention to raise interest rates three, or possibly four, times during 2017. The Administration's reaction to such moves, as well as the calibre of its appointees to

the Fed, may have an important bearing on market perceptions of the Fed's credibility as the year unfolds.

6. *China*. The 'Chinese authorities' succeeded in shoring up China's growth rate, staunching the outflow of capital, and stabilizing the currency during 2016. Nonetheless, uncertainty about the future trajectory of the Chinese economy, and the response of the 'Chinese authorities' to the various policy dilemmas which they face, will remain throughout this year. The form taken by last year's monetary policy stimulus – whereby banks were encouraged to borrow in wholesale money markets in order to fund purchases of local government securities and loans to non-bank financial intermediaries – has introduced a new element of risk into the Chinese financial system. For the first time, the ratio of loans to deposits of Chinese banks has dropped below 100% - and is continuing to fall – implying that the Chinese banking system is starting to become exposed to liquidity risks of the sort (albeit not yet on the same scale) that were at the heart of the Asian financial crisis of 1997-98 and the global financial crisis of 2007-09. The 'Chinese authorities' may be fearful of allowing the yuan to depreciate further against an appreciating US dollar for fear of further inflaming the protectionist instincts of the Trump Administration. And of course they may have to decide whether, and if so how, to retaliate to any specific protectionist measures directed at China by the Trump Administration. Outside of the purely economic sphere, tensions between China and the US over the former's activities in the South China Sea, and the latter's relationship with Taiwan, could also prove unsettling for financial markets.

7. *Australia's on-going economic transition.* Australia's economy is continuing its hesitant and uneven transition away from growth driven by the mining investment boom (which peaked in 2013) to growth driven by a variety of other, often less visible, sources. The upswing in dwelling construction, which has accounted for more than one-third of the non-resources-exports-related increase in real GDP over the past two years, appears to have peaked – and although there is still plenty of work left in the residential building 'pipeline' this sector is unlikely to provide much further impetus to economic growth in 2017. The renewed upswing in lending to investors is potentially worrisome (since the main effect of domestic property investors is to inflate housing prices, rather than to add to housing supply), and may require further attention from APRA. There's still not much sign of any imminent pick-up in other categories of investment. Consumer spending should continue to grow at a modest pace, given subdued growth in both wages and employment, and the on-going absence of fiscal stimuli of the type that became routine during the commodities boom years.

8. *Domestic politics and the Budget*. The Turnbull Government is in a much weaker position than seemed likely this time last year – with a wafer-thin majority in the lower house, a fractious assortment of cross-benchers holding the balance of power in the Senate, and an ill-disciplined and restless backbench, all as a result of the Government's poor showing at last July's election. The Government lacks any kind of strong mandate for economic reform – with its signature initiative, the ten-year staged reduction in the company tax rate, unlikely

to gain legislative approval, and there being no readily apparent 'Plan B'. Moreover, despite Malcolm Turnbull's promise to preside over a 'thoroughly liberal government', his Government seems surprisingly beholden to protectionist and other right-wing influences, both from within and without. This tendency will only increase if Pauline Hanson's One Nation party does well in the State elections to be held in Western Australia on 11th March and Queensland most likely later this year. Another key milestone will be the Budget on 9th May – where the Government will again be under pressure to re-assure credit rating agencies and others that the budget really is on a credible path back to a sustainable surplus, and not one reliant on accounting policy changes.

9. *The RBA*. It will take a lot to get the Reserve Bank to move Australian interest rates – in either direction – this year, although no-one should doubt their willingness and ability to do so if they think it's warranted. Newly-installed Governor Phil Lowe's previous writings have prompted some to think that he places more weight on financial stability considerations than his predecessors, and hence will be less inclined to cut interest rates and further – and possibly more willing to raise them. However to date he hasn't really said or done anything to justify that conclusion. He appears to share the (sensible and pragmatic) view held by his predecessor, in his final year as Governor, that monetary policy was approaching the limits of what it could do to improve Australia's economic growth prospects, and that fiscal policy and productivity-enhancing structural reforms should play a greater role. Global developments suggest that Australia's inflation rate should edge higher, in line with the RBA's own forecasts, from its late 2016 levels – in which case there shouldn't be any need for further rate cuts. On the other hand, it's also hard to see Australia's economic growth performance picking up so strongly as to warrant one or more rate hikes this year.

10. *Property prices.* No discussion of the Australian economy, or Australian interest rates, would be complete without at least some reference to the residential property market. Actually to speak of 'the' residential property market as if it were a single homogeneous entity is even more misleading than usual under current circumstances, with Perth and Darwin prices down 8% and 6%, respectively, from their peaks but Sydney and Melbourne prices putting on more than 15% and nearly 14%, respectively, last year. There is, to be sure, a lot of new supply hitting the Melbourne, Sydney and Brisbane markets over the next few years, which in theory should put a lid on further price appreciation: but there is also quite strong population growth, particularly in Melbourne, to absorb at least some of that new supply. And there is absolutely no political will on the part of the present Government to do anything to restrict the scope for domestic investors to continue inflating existing property prices. The renewed upturn in lending to investors towards the end of last year will, if it continues, be of some concern to the RBA, but they're unlikely to raise interest rates for that reason alone, and will instead likely leave that problem to APRA. A US-, Irish- or Spanish-style 'meltdown' in Australian property prices won't happen without a specific trigger, and it's hard to see one on the near-term horizon: but the more prices keep going up, the greater the risk of either some kind of 'accident' (which could emanate from somewhere outside of Australia, such as China) or, alternatively, a growing social and political backlash against the ongoing deterioration in housing affordability.

Jamieson Coote Bonds Pty Ltd
Level 27, 101 Collins Street, Melbourne, Victoria, 3000
+61 (3) 9653 9255 | www.jamiesoncootebonds.com.au

Jamieson Coote Bonds

Saul Eslake
Jamieson Coote Bonds Advisory Board Member & Senior Economist
23rd January 2017