Investment Spotlight
ANZ Wealth Chief Investment Office

FEBRUARY 2017

2017 – Better but late cycle risks emerge

The global economy has entered 2017 with the headwinds from the 2015-16 slowdown and price deflation falling away. Overall, we consider the outlook for stronger growth and inflation continues to favour shares over bonds. However, in this Spotlight we argue that this is not without its risks. Read on for more.

Deflation turns back the clock

Before delving into our outlook for 2017, it is important to take a step back and look at where we have come from to get a better sense of where we are heading.

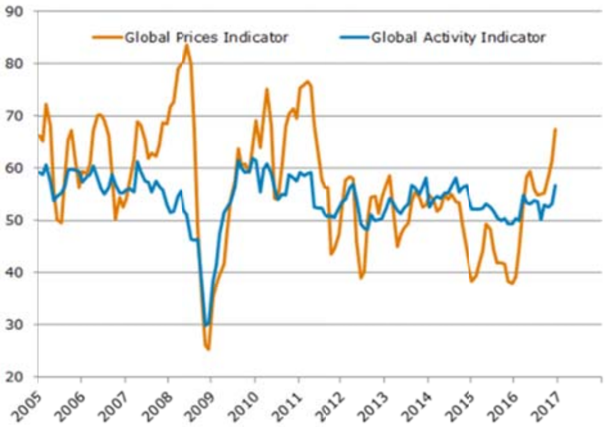
At the epicentre of the 2015-16 economic slowdown was the sharp decline in Chinese growth, particularly in the industrial sector, which spread globally. Weaker Chinese growth reflected shorter-term cyclical forces but also a longer-term structural slowing in Chinese growth. In essence, the 20-year Chinese supply side boom and double-digit growth that commenced before 2000, primarily absorbed by the increasingly indebted US households, came to an end.

Instead of an outright collapse in demand, a large supply side overhang of industrial goods and commodities eventuated, driving prices down and intensifying global deflationary pressures. Global profits fell and nominal GDP growth in the major developed economies slowed towards 2% as inflation and real growth eased. The Australian economy faced headwinds from weak commodity prices, but these were offset to an extent by the beneficial impact of lower interest rates and currency through early 2016.

Recent years have echoes of the late 1990s Asian crisis where a recession in Asia imparted a significant deflationary shock, although the activity slowdown in the developed countries was only moderate compared with prices. Profits then, and now, fell in line with the weakening in activity and prices, before staging a recovery.

While the recovery commenced before the US election, Donald Trump's victory and, more crucially, the Republicans' clean sweep of both the Presidency and Congress, created an expectation of greater fiscal spending in the US economy, further fuelling the recovery. By the close of 2016 the market looked to have reset the investment cycle clock to a much earlier point with cyclical assets like commodities preferred over defensive assets.

Chart 1: 2015's deflationary shock



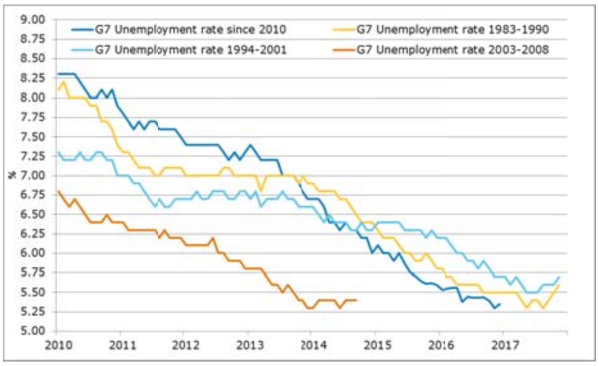
Sources: Bloomberg, ANZ Wealth

Where are we in the investment cycle?

The scene we set in the preceding section raises the question: Where are we now in the investment cycle? The rotation to cyclical assets has occurred eight years on from the end of the Global Financial Crisis (GFC), with asset markets having already posted strong returns across both growth and defensive assets. While the global economy's pace of recovery has been more moderate than typical following a recession, this has not been the case for the unemployment rate.

The unemployment rate is a key indicator of the business cycle watched by central banks, and low levels in the past have suggested moves into weaker phases of growth. As Chart 2 illustrates, the current decline has been in line with or faster than the 1990s cycle, which lasted for close to nine years, and the shorter 2000s cycle. Unemployment is now at the level of previous cycle lows.

Chart 2: Unemployment now at cyclical lows



Sources: Bloomberg, ANZ Wealth

Whether the cycle ends, or not, is critical for asset markets. We can view the investment cycle as comprised of four phases representing stages of growth in the economy and typical asset market performance;

• **Recession:** Period of shrinking economy when share markets underperform long run returns.

• **Recovery:** Shares witness higher than average returns as the economy begins to recover, and highly rated fixed income underperforms as interest rates rise.

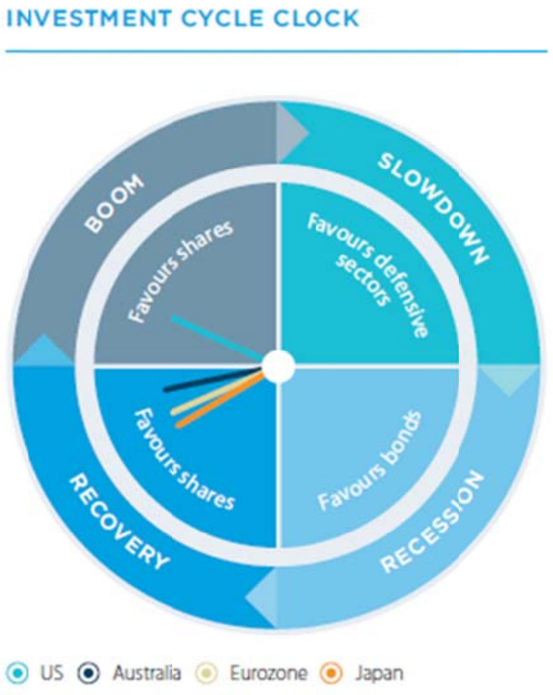
• **Boom:** Mature phase of the economic cycle. Capacity constraints begin to emerge where fixed income returns lag the cycle and share returns moderate but remain somewhat above average.

•**Slowdown:** The economy begins to slow and moves below trend, shares underperform while highly rated fixed income returns move above average.

So what typically brings an end to an economic cycle? According to the late, famous MIT economist Rudi Dornbusch, "none of the post-war expansions died of old age. They were all murdered by the Fed"! The motive for this 'crime' is usually the threat or reality of inflation as the economy's growth reaches full capacity, driving the US Federal Reserve (Fed) to raise interest rates, which ultimately triggers a recession.

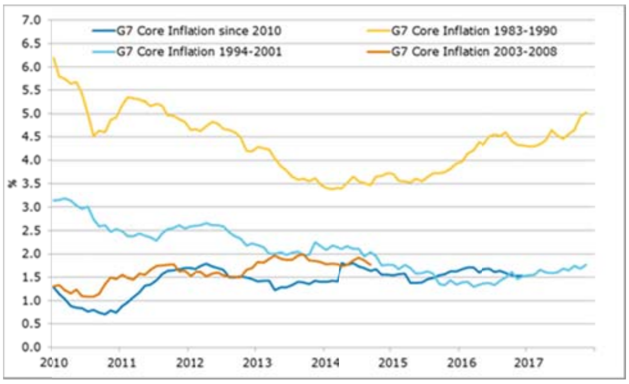
We believe the developed economies are on the cusp of moving from the recovery to the boom cycle, led by the US (refer to Investment cycle clock, right).

But every cycle is different in some way. This time the concern has been that inflation is too low, rather than too high. Hence, compared with previous cycles, monetary policy remains very accommodative, with official interest rates still negative in Europe and Japan and less than 1% in the United States. While core inflation is modestly tracking higher (Chart 3), it nevertheless remains below the 2% target of most central banks. All major central banks are still encouraging the recovery, not trying to slow it. We assess that there is still some way to go.



Source: ANZ Wealth

Chart 3: Inflation in line with recent cycles



Sources: Bloomberg, ANZ Wealth

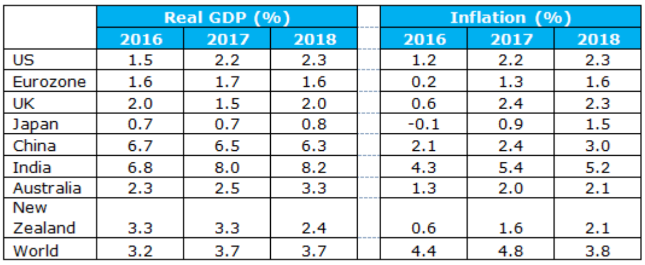
Global recovery to have legs

The post-GFC environment has been characterised by a number of start-stop recoveries – signs of recovery emerge, markets respond, but something arises to short-circuit the improvement.

In our view, however, there is little on the economic horizon to short-circuit the current recovery. For 2017, financial conditions and monetary and fiscal policies are all looking supportive for growth in the major economies. After a couple of years of running at a 3.2% pace, we expect growth to accelerate by around 0.5% with stronger growth in both the developed and emerging market economies. Overall, we start 2017 with more optimism than last year (Table 1).

We consider potential growth to now be much slower as compared to recent decades as population growth falls. As such, we expect that most developed market economies will grow above this new lower trend pace in the coming year and this will drive unemployment rates lower and wages and inflation gradually higher, but not dramatically so. Of the major three developed market economies only the US is likely to have inflation around target of 2%, with Japan and the eurozone still around 1% in 2017.

Table 1: Global Economic Forecasts



	Real GDP (%)			Inflation (%)		
	2016	2017	2018	2016	2017	2018
US	1.5	2.2	2.3	1.2	2.2	2.3
Eurozone	1.6	1.7	1.6	0.2	1.3	1.6
UK	2.0	1.5	2.0	0.6	2.4	2.3
Japan	0.7	0.7	0.8	-0.1	0.9	1.5
China	6.7	6.5	6.3	2.1	2.4	3.0
India	6.8	8.0	8.2	4.3	5.4	5.2
Australia	2.3	2.5	3.3	1.3	2.0	2.1
New Zealand	3.3	3.3	2.4	0.6	1.6	2.1
World	3.2	3.7	3.7	4.4	4.8	3.8

Source: ANZ Research

The net result of this mix of forces, which might best be characterised as 'better but not great', is that easing cycles have ended in virtually all of our key markets of interest. We believe the timing of the European Central Bank's (ECB) taper will be important for bond markets generally. If we start to see a pickup in wage growth which is anywhere close to the rates historically consistent with near capacity levels of employment, then interest rates seem to be too low.

We expect growth to be led by the **US,** where growth has not just accelerated in the second half of 2016, but become more broadly based with a rebound in dwelling construction and a waning in the sizeable drag from weaker oil and gas investment supporting growth. There are also signs building of a solid recovery in US capital goods spending.

Alongside improved growth has been a lift in overall inflation and we expect a further gradual pickup in coming months given the economy is close to full employment and growth is above trend.

The more positive US growth outlook had been building in advance of the election of Donald Trump as US President. The initial financial market reaction to the prospect of a Trump presidency was consistent with the view that he will be pro-growth and pro-inflation. On the positive side of the growth ledger, President Trump has spoken of spending US$1 trillion on infrastructure, boosting military spending and cutting corporate and personal tax rates. On the negative side of the growth ledger are Trump's trade and immigration policies. In sum, while we expect a Trump presidency to result in a modest fiscal stimulus to the US economy from 2018 onwards, considerable risks exist.

This year marks the fourth year of recovery for the **eurozone** economy but the region appears to still be hampered by slow growth, high unemployment, low core inflation and negative interest rates. The ECB is expected to continue with its policy of generous monetary accommodation as there is little evidence of a sustainable pickup in core inflation and wage pressures. Politics will be a key focus in the year ahead with elections in the Netherlands (March), France (April/May) and Germany (September).

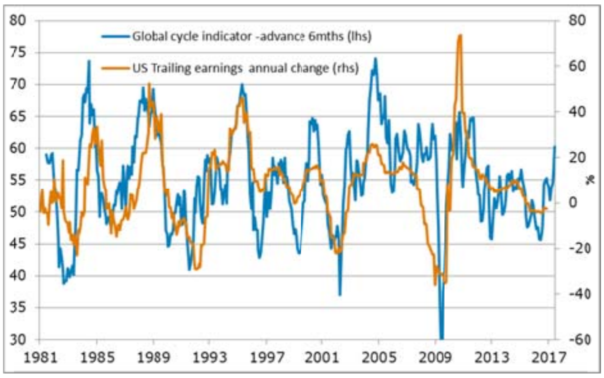
Emerging market growth is expected to accelerate this year to around 4.75%. A further slowdown in **China** is expected with GDP growth of 6.5%. A large part of China's economic vibrancy is now coming from the services industries and domestic consumption instead of low-level manufacturing and investment. Elsewhere, **Russia** and **Brazil** emerge from recession and **India** adjusts to demonetisation. However, despite an improved outlook for growth, emerging market economies may still face challenges in 2017.

In 2017, we expect to see the **Australian** economy to almost completely shake off the drag from the wind-back in mining investment. Non-mining business investment is likely to grow modestly although housing construction is likely to level off after a period of strong growth. Export growth is set to remain solid as LNG export capacity comes on stream and services exports continue to benefit from the lower Australian dollar (AUD) and rising household incomes in China. Inflation is expected to remain well below the Reserve Bank of Australia's (RBA's) 2-3% target, which should keep the cash rate on hold at the record low of 1.5%.

Market outlook

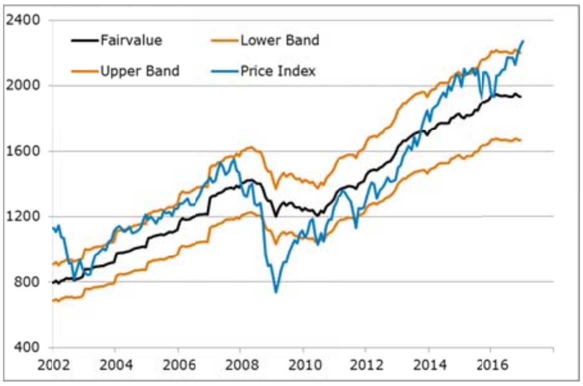
The global economy has entered 2017 with the headwinds from the 2015-16 slowdown and price deflation falling away. All regions have lifted and a synchronised upswing is emerging. However, while the upswing is synchronised we believe the stage of the business cycle varies widely from early boom in the US to mid-recovery in the eurozone and Japan. Even when we factor in the improved outlook, share market valuations across most developed markets are now moderately expensive.

Chart 4: Earnings recovery on the way



Sources: Bloomberg, ANZ Wealth

Chart 5: Market priced for recovery



Sources: Thomson Reuters Datastream, Bloomberg, ANZ Wealth

The outlook for the **US economy** has improved with the prospect for tax cuts providing further support. Headwinds for the US share market are primarily driven by current moderately expensive share valuations and the potentially higher interest rates as the economy progresses to late boom.

The outlook for **European shares** has improved supported by central bank easing and a lower exchange rate. Also, we expect economic conditions to continue to improve. That said, headwinds could re-emerge due to: 1. continued political uncertainty with upcoming French and German elections; 2. fragile European banks; and 3. the possibility that bond yields, particularly in the peripheral economies, could rise sharply as the ECB gradually shifts to further taper its quantitative easing (QE) program through the latter part of 2017. Overall, while Europe is in an earlier phase of the business cycle than the US, we believe valuations have captured the improvements and are moderately expensive. Within European shares, we expect that UK shares will continue to be supported by a lower pound as prospects for Brexit firm up.

Japanese shares have also been buoyed by a weaker exchange rate, with valuations hovering around fair value.

The recent sharp rally in **Australian shares** has resulted in moderately expensive valuations. Despite a solid recovery in corporate earnings, the uplift is primarily driven by the commodity sector, with most other sectors factoring in low to mid-single-digit earnings growth. However, stronger earnings recovery for ex-commodity earnings will likely be limited by signs that the residential construction cycle will likely peak through the first half of 2017 while the outlook for non-residential construction, including for mining, will remain soft. The outlook for **New Zealand shares** has improved with the expensive valuations now correcting and earnings and dividends set to remain solid.

Prospects across **emerging markets** will likely improve in 2017 with share valuations around fair value. Therefore we expect returns for emerging market shares to be relatively attractive, but there are headwinds. Risks include 1. US protectionism that could hurt global trade; and 2. higher US interest rates which would increase the cost of the large amount of debt denominated in US dollars (USD) across many emerging market economies. Currently these risks appear to be abating with signs that the USD is peaking; China is stabilising its currency; and the Fed is only likely to raise rates gradually.

Shares to outperform bonds

Overall, better growth and a steady lift in inflation suggest that growth assets will likely outperform defensive assets such as bonds and cash until the cycle hits late-cycle boom and transitions to slowdown. This view underpins our outlook for international, Australian and New Zealand shares, warranting a benchmark positioning in our portfolios. We expect that US bond yields will grind higher to around 3%, resulting in flat returns for international bonds in 2017. A slightly higher return for Australian and New Zealand bonds is expected.

While our shorter-term concerns regarding valuations could wash out over the next few months, our prime concern is that the US could approach late cycle boom much faster than expectations. With interest rates anchored at historic low levels for an extended period and moderately expensive valuations across many financial asset classes, a more rapid lift in rates could quickly expose latent vulnerabilities.

AUD trades in range; USD to peak

We expect the AUD to continue range trading on the back of mixed fundamentals and on expectation that the USD will level off. Valuations of fair value for the AUD are around 74 cents which is being supported by stronger bulk commodity prices, although we expect prices to moderate somewhat from their elevated peaks.

Historically, the USD tends to soften when the global outlook improves, and we expect this to eventuate. We consider the USD can stabilise through the first half of 2017 on the improved outlook but any signs that the Fed may need to lift rates faster could quickly translate to a surge in the greenback and a rotation to more defensive exposures to protect against downside risks.

PLEASE REFER TO THE 2017 ANNUAL OUTLOOK PUBLICATION FOR MORE DETAILS.

Stewart Brentnall, Chief Investment Officer

Stewart leads ANZ Wealth's Chief Investment Office. He is responsible for delivering an overarching investment strategy, including responsibility for asset allocation, investment themes, investment manager and product selection and monitoring, and investment compliance, risk and analytics.

Mark Rider, Head of Investment Strategy and Portfolio Management

Mark is responsible for driving ANZ Wealth's investment strategy and management of diversified funds within Australia and New Zealand.

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