TCorp Local Government Services

Economic Commentary – February 2016

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The Month in Review

Economic and Market Trends

Chinese manufacturing remains soft. The official manufacturing PMI weakened marginally further in January to 49.4 (recall that a reading of 50 indicates steady output). There are signs, however, that looser monetary conditions are beginning to flow through the economy. This was evident in a sharp jump in new lending, which leapt to 2.5 trillion Yuan in January compared with expectations of 1.9 trillion Yuan. Furthermore, money supply growth (which is often correlated with overall spending) increased to 14% y/y from 13.3% y/y previously.

Fears about the Chinese economy have weighed on markets for a couple of years now, but concerns about the US economy have been a new development in 2016. Recent data, however, have been reassuring. While the overall ISM manufacturing index remained becalmed at 48.2 in January, the new orders component (which usually leads the broader index) jumped to 51.5. Unemployment fell to 4.9% in January while monthly jobs growth continued to average above 200,000. The second estimate of Q4 GDP growth was upgraded from 0.7% to 1.0% annualised.

The Bank of Japan (BoJ) surprised markets by announcing that it was going to charge banks for keeping excess reserves in some accounts held at the BoJ. By moving to 'negative interest rates', the BoJ was following in the footsteps of a number of European central banks. The need for further policy support in Japan was later confirmed by news that the economy shrank by 0.4% in Q4.

In Australia, employment fell for the second consecutive month in January, and unemployment rose to 6%, from 5.8% previously. While the employment data have been very erratic over the last year, the Reserve Bank of Australia (RBA) has tended to place more credence on trends in the unemployment rate which is meant to look through the statistical noise. The RBA won't be too concerned with unemployment at 6%, but if it were to move up towards 6¼% over the next few months, it would increase the odds of a rate cut in 2016.

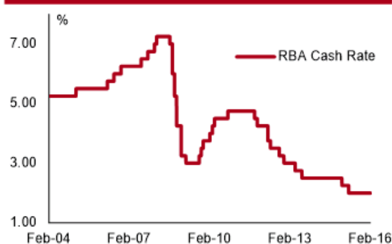
Most of the other economic data released over the month tended to be on the weaker side, but has not been sufficiently soft to shift views on the economy's underlying momentum. Retail trade was flat in December, compared with expectations of a 0.4% rise. The trade deficit widened to $3.5 billion in December from $2.7 billion previously and the NAB business survey for January reported weaker conditions and a dip in confidence. Meanwhile, the private capital expenditure survey for Q4 suggests that business investment would fall around 15% in 2016/17, after a likely decline of 19% in 2015/16.

One area of the Australian economy that has proven more resilient so far in 2016 has been the housing market. Auction clearance rates in Sydney have bounced back to around 75%, after weakening in late 2015. Similarly, new home sales, building approvals and mortgage lending have all proven stronger than expected. Stronger housing activity has been the key factor supporting Australian growth as mining investment has retreated. And the longer that housing activity remains at a high level, the better the chances that the economy will successfully negotiate the downturn in resources investment.

Global bond yields moved lower in February. The move reflected a number of factors, including weaker US manufacturing activity, falling inflation expectations, a safe-haven bid as investors retreated from equity and credit markets, as well as the BoJ's decision to adopt negative interest rates. In Australia, the 10-year yield fell from 2.90% at the start of 2016, to 2.40% in February. TCorp bonds also rallied sharply with the 2024 bond dropping 50 bps to 2.48%.

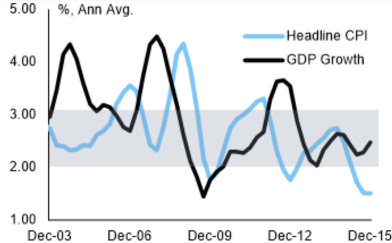
Financial/Economic Data
February 2016

RBA Cash Rate



Australia Dollar

Australian Economy

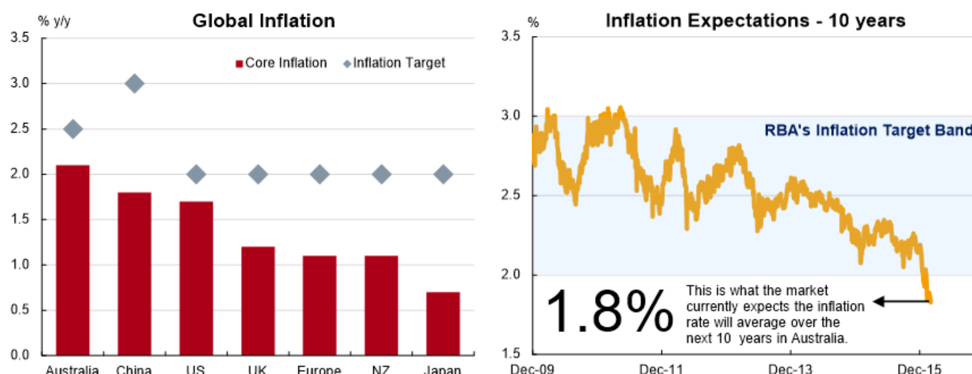


Unemployment Rate

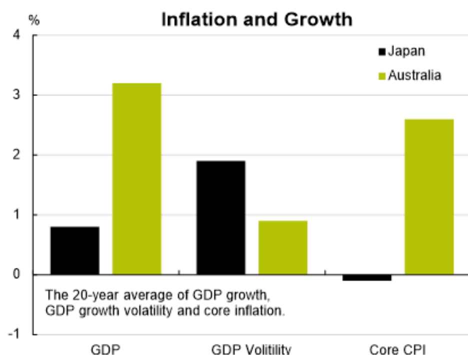
Special Report

Why do central banks fear deflation (negative inflation)?

Close watchers of global central banks would have noticed that policymakers have become especially focused on inflation – or rather, the lack of it. Most central banks are currently missing their inflation targets. The top-left chart shows that policymakers have been falling short of their inflation targets, rather than shooting above them. This has resulted in many market participants fearing prolonged periods of low inflation and even deflation (top-right chart). But there are two key questions we will need to answer to make clear why inflationary outcomes are important for the economy. First, why do central banks target inflation?



History shows that countries which target an inflation rate tend to have lower and more stable growth in consumer prices. Moreover, stable inflation rates gives households and businesses the confidence to make better informed decisions. Empirical evidence suggests that stable inflation coincides with faster GDP growth and a lower variability in growth. Second, why is low inflation or deflation a problem? To the average consumer, low, or even negative growth in consumer prices may be a positive outcome, as goods and services become cheaper. However, it seems that households tend to put-off spending if they believe prices will be cheaper in the future. And if this happens, businesses will experience a period of lower sales and profits in the meantime. If households delay their expenditure for too long, business would respond by cutting costs (e.g. reduce employee headcount and/or lower investment). This in itself would weaken demand even further.



Market Movements and Economic Data

Financial Data	29 Feb	Monthly change	
Cash Rate	2.00%	0.00	–
Corporate Bond Yield*	4.15%	-0.21	▼
Term Deposit**	2.20%	0.00	–
ASX200	4881	-2.5%	▼
S&P500	1932	-0.4%	▼
AUD/USD	0.714	0.8%	▲
Economic Data* **	**29 Feb**	**Quarterly change**	
Headline CPI	1.7%	0.2%	▲
Trimmed Mean CPI	2.1%	0.0%	–
GDP Growth	3.0%	0.3%	▲
House Prices	7.5%	-2.8%	▼
Unemployment Rate	6.0%	0.1%	▲

*A-rated 5-year rate, source: RBA **Average 90-day rate of the five largest banks for $10,000, source: RBA ***National data, y/y, source: ABS, RBA

Japan is a prime example of how a prolonged period of deflation can weigh on economic growth (bottom-left chart). Deflation is also a problem for debt holders as it eventually leads to falls in wages. If households receive less money in nominal terms, even though their outstanding debt (such as mortgages) remain unchanged in nominal terms, they will find it more difficult to pay down existing debt. Deflation will also weigh on asset prices, such as property, which could lead to lower government taxation revenues. For local governments, lower land values would likely result in lower council rates, despite the council having to maintain the same level of services to residents. To sum up, policymakers have become fixated on stabilising inflation to provide some certainty about future prices, to reduce the volatility of growth, and to control real levels of debt. It is for this reason policymakers have become especially worried about the inflationary outcomes in recent years.

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