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First Insights.

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

Welcome to the April 2016 edition of First Insights, the quarterly publication from the Economic and Market Research (EMR) team.

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Continuing the trend of late-2015, the first quarter of 2016 was once again dominated by market volatility. After the first interest rate hike by the US Federal Reserve in December 2015, markets began 2016 weaker, fuelled by global growth concerns, particularly in emerging markets and China and the effectiveness of central bank policy to deal with this. As a result, government bond yields finished the quarter lower, while equities were mixed.

Global central bank easing was also a theme during the March quarter, with the Bank of Japan moving interest rates into negative territory, the European Central Bank easing monetary policy across multiple fronts and the Fed's FOMC revising its 'dot plot' downwards. Other central banks to also ease interest rates over the quarter were the People's Bank of China, Reserve Bank of New Zealand and Sweden's Riksbank.

Despite ongoing concerns over the medium-term outlook, there is something interesting now happening in China. Since 2014, median economic growth rates have been falling, however in the last few weeks, several economists have begun to upgrade their growth forecasts. In the research essay this quarter, James White discusses the outlook for China and the drivers of this growth. He also considers how the country has been addressing the various structural challenges it has faced, including the property markets, debt and capital flows.

You will find all of our usual analysis via our chart packs and updated forecasts which I trust will provide you with some useful insights into the global economic outlook. If you have any questions or feedback, please do not hesitate to get in touch.

Stephen Halmarick
Head of Economic and Market Research

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Section 1

China Policy and Growth Outlook

In our October 2015 edition of First Insights, we highlighted the consistent tightening of monetary policy from 2011. Policy was tightened through relatively conventional means, interest rates, the exchange rate and the reserve requirement ratio (RRR). It was also tightened by less conventional means, such as market interest rates, the corruption crackdown and changes to environmental policy.

The data, as shown in chart 1, indicates consistent tightening through 2014 until the emergence of a shift in the middle of 2015. The big question now is what happens next?

Chart 1: Monetary Conditions Index (MCI) points towards pick-up in growth

Source: Bloomberg. GDP to 31 December 2016, MCI to 31 March 2016.

The relationship would suggest a pick-up in nominal economic growth in China as easing begins to work. Such a growth pick-up would be positive for the economy, particularly debt- servicing. This research essay looks at the growth outlook for China.

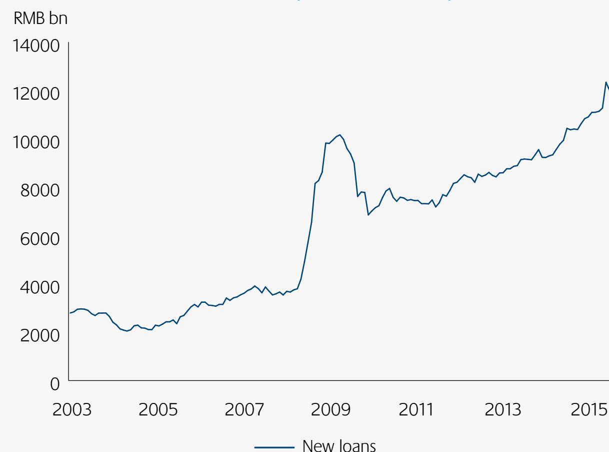
Growth upgrades

Something strange happened at the start of this year with economic growth forecasts for China upgraded. Since 2014, the median forecast for Chinese economic growth has been, generally, falling. At the start of 2014, the year-end 2016 forecast for China real GDP was 7.25%. In the period since, it has fallen to 6.55%. But in recent weeks a number of economists have forecast an improvement in conditions. Not a lot, but certainly there has been a shift.

The drivers of growth upgrades

The primary drivers of economic growth upgrades are expected changes in infrastructure spending as a consequence of increasing monetary stimulus and improving approvals speed. The removal of bureaucratic obstacles is obvious in the increase in new loans seen in chart 2. In particular, new loans in February 2016 reached a record high of over RMB3 trillion.

Chart 2: New loans growth (12 month sum)



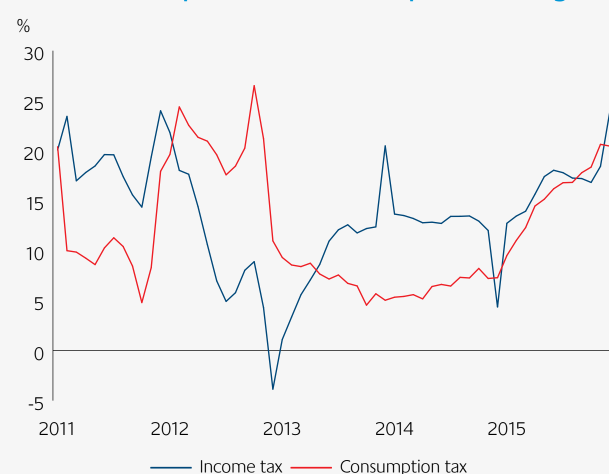
Source: CEIC. Data to 29 February 2016.

But it may also be evident in other drivers.

The shift in Chinese economic activity from heavy industrial towards the service sector has become a cliché, as true as it may be. One important way of observing this shift is through taxes paid by consumers.

Income and consumption tax paid by households is rising rapidly, though this is still a small part of the Chinese tax base.

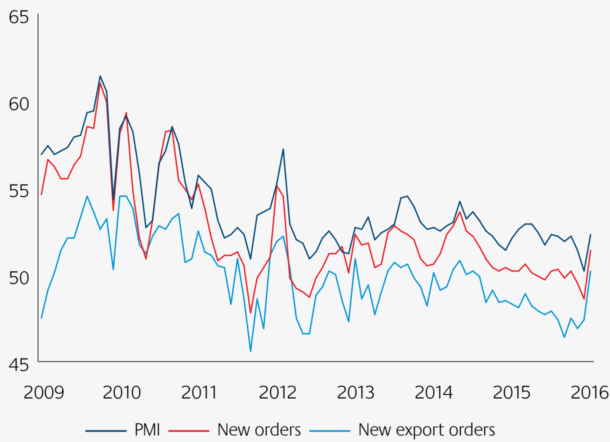
Chart 3: Consumption and income tax paid increasing



Source: CEIC. Data to 29 February 2016.

It is also seen in the purchasing managers index (PMI) data. China's PMI data surprised markets in April. This may have been due to such idiosyncrasies as a flower show (which has reportedly brought forward some economic activity) but is in line with the broader sentiment that some change, though potentially small, is underway.

Chart 4: PMIs showing some signs of improvement



Source: CEIC. Data to 31 March 2016.

Such an improvement in growth offers some opportunity for a fundamental improvement in the Chinese economy, but scepticism remains high.

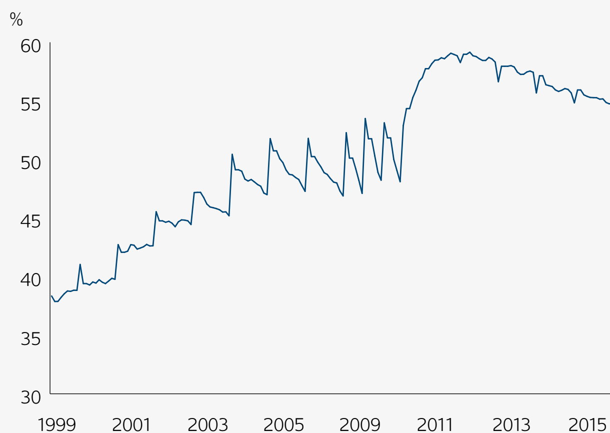
China's structural problems

Global markets have long identified a myriad of problems for policy makers in China to deal with. In particular, debt, property and capital flow seem most important.

China's debt problems have been well-documented. However, it is useful to look at a few important counters to this analysis.

First, China's companies hold a lot of cash. This is most likely to be a function of the policy tightening highlighted above. The limited and expensive availability of credit through 2015 encouraged firms to hoard cash. This is seen in the data below using 4,000 Chinese companies. Alternatively, a measure of government account balances, shows RMB30 trillion on deposit.

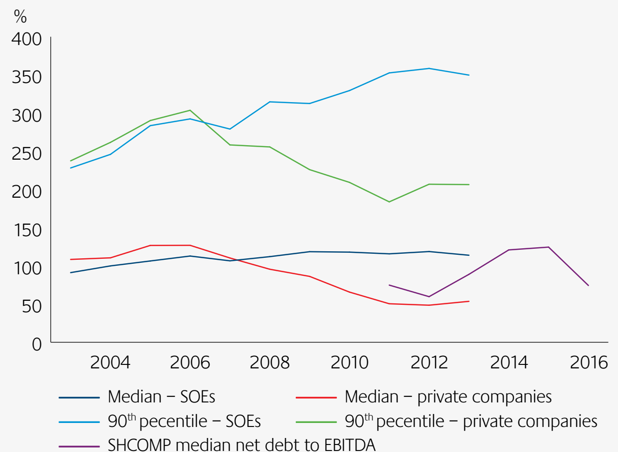
Chart 5: Cash as a share of total liabilities



Source: CEIC. Data to 31 December 2015.

It is also interesting to look at net debt levels using other data sources. According to the IMF, the leverage ratio of Chinese firms is substantially bifurcated. The largest debt burden is held by state-owned enterprises (SOE's). The median Chinese firm has relatively low leverage, most specifically the private companies. Data from the Shanghai Composite also shows relatively subdued leverage.

Chart 6: Leverage ratios across sectors

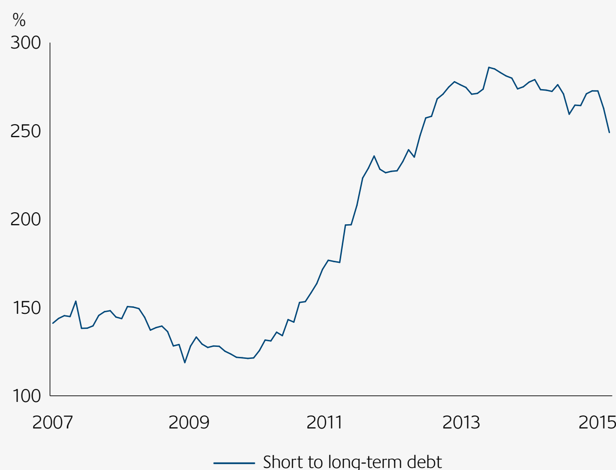


Source: CEIC. Data to 31 March 2016.

This highlights a couple of points about China's debt dynamics. First, it shows that from a median perspective, Chinese firms are not particularly leveraged once cash is netted out. This reflects the inability to access capital as described previously. Second, the outlier in Chinese debt dynamics is the SOE sector, which has substantial leverage. This poses a risk but it also begs the question: would the state default on its own assets, in scale, given the consequences for economic stability?

Second, there are definitely areas of concern. Most obvious are the high capacity sectors such as steel and coal. Here there seems to be a more concerted effort to remove capacity and resolve the debt issues which began five years ago. Chart 7 shows loans to steel firms have been predominantly short-term, most likely backed by inventory. Less long-term finance has made expansion less likely and is the first step in slowing capacity growth. Now banks are becoming incrementally tougher. For instance, it would seem that working capital to start up blast furnaces is not being extended. This is making seasonal capacity shutdowns a little more permanent than previously thought.

Chart 7: Short to long-term debt ratio

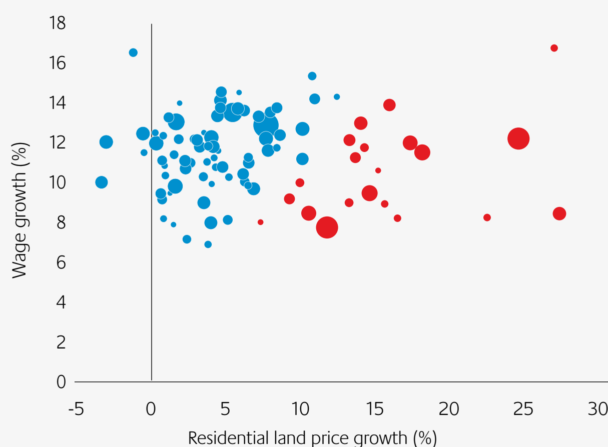


Source: CEIC. Data to 31 January 2016.

The property market is linked to China's debt position. It is estimated that around 70% of China's debt is collateralised or linked to property in some way. As such, property prices matter. In the last 12 months, property prices have accelerated, especially in 'Tier One' cities. It has also been particularly rapid in the cities of Hebei province. Despite the gloom surrounding the steel industry, the province's biggest industry, the likelihood of infrastructure investment as part of Jing Jin Ji has led to a rise in speculation.

More importantly, it is not clear that property prices are rising unreasonably in China. Chart 8 takes wage and residential land price data from 105 cities across China over five years. It shows, on average, property prices have been growing at a slower pace than wages in 81 of 105 cities. China's productivity is driving wage growth and this has supported property price growth. The cities with stronger land price growth reflect Hebei and the land-constrained coastal provinces.

Chart 8: Property price growth and wages



Source: CEIC. Data to 31 December 2015.

The final concern is capital outflow. During the course of 2015, capital outflow from China rose startlingly. This raised serious concerns that internal investment opportunities in China were insufficient to encourage capital to stay. There are a number of important comments to make on this issue.

First, China's participation in global capital flows is tiny, relative to its role in trade. According to the Bank of England, China accounts for 20% of trade flows, but just 2% of financial flows. Over time, this proportion is likely to increase further, regardless of internal investment opportunities.

Second, balance of payments data point to a less dangerous driver of capital outflows. Payments data show Chinese firms were taking capital offshore in order to pre-pay offshore lending obligations. Chinese firms were acting in advance of expectations of a depreciating currency and taking advantage of better financing rates onshore.

The next three years

China's problems, despite the doomsayers, seem relatively manageable, particularly in the near term as growth accelerates or at least stabilises. The bigger question is the sustainability of this improvement in the medium-term.

Here it is useful to focus on two broad issues: the infrastructure multiplier and balance sheet repair.

China's observed infrastructure multiplier is high. According to S&P, it is $2.50 for each dollar of infrastructure spend and according to the St Louis Federal Reserve, it is $2.00 for each dollar of government expenditure. The deceleration in infrastructure spending through 2015 has likely slowed private sector investment. Without improved land, private investment in China is likely to be less profitable. An infrastructure improvement is likely to lead to a more sustained period of investment by the private sector than currently assumed.

Balance sheet repair is an issue China also seems more willing to address at present. An emerging solution to China's debt is equity though equity has long been very expensive for firms to issue. But in recent months equity has increased from around 1% of total social financing to 5.4%. In turn, China has undertaken around RMB1 trillion in debt to equity swaps. This begins a process of lowering the gross debt burden in China.

The change in capacity is also likely to lead to greater profitability. Indeed, margins are already rising for steel makers. As a consequence, improved profitability is likely to improve debt positioning.

Section 2
Market Watch and Chart Pack

The first quarter of 2016 was a volatile period for global financial markets. After the first interest rate hike by the US Federal Reserve (Fed) in December 2015, markets began 2016 weaker, fuelled by global growth concerns, particularly in emerging markets and China and the effectiveness of central bank policy to deal with this. Markets recovered somewhat in March with easier than expected central bank policy and improvements in the underlying economic data. As a result, government bond yields finished the quarter lower, while equities were mixed.

Global central bank easing proved to be the theme of the first quarter. The Bank of Japan (BoJ) was the first to act, surprising markets by moving interest rates into negative territory at their January 2016 meeting. The BoJ labelled the change "Quantitative and Qualitative Monetary Easing (QQE) with a Negative Interest Rate" and demonstrated that it has plenty of easing opportunities up its sleeve, despite sentiment that it was running out of tools.

The European Central Bank (ECB) followed suit in March, announcing further monetary policy easing across multiple fronts in response to downward revisions to inflation and inflation expectations. ECB President Mario Draghi once again proved his commitment to "do whatever it takes" with an easing package that exceeded market expectations.

With increased financial market volatility and a softer global outlook, the market's reduced expectations of the Fed hiking rates this year proved to be well founded with rates unchanged over the quarter. The March Federal Open Market Committee (FOMC) meeting saw a significantly softening in both the rhetoric and the outlook for further rate hikes in 2016, with the US Fed's internal forecast on the path of normalisation (known as the 'dot plot') revised downward. Overall, commentary from the Fed over the quarter suggested a slow and gradual return to normalisation dependent on supporting economic data, but with careful consideration given to international developments and market sentiment and volatility. The quarter also saw further easing from other global central banks, including the People's Bank of China (PBOC), the Reserve Bank of New Zealand (RBNZ) and Sweden's Riksbank.

The International Monetary Fund (IMF) downgraded its forecasts for global growth in January and again in April. Global economic growth of 3.2% is now expected in 2016, down from its previous forecast of 3.6%. In 2017 growth of 3.5% is forecast, down from 3.8%. Weakness in emerging economies was the main cause of the downgrades.

The commodity price decline that has characterised much of the past two years appeared to have found a bottom over the quarter, with most commodities recovering somewhat after reaching lows in February. The price of West Texas Crude reached a low of $US26.20 before closing at $US38.30 per barrel, up 3.5% over the quarter. The recovery was led by increased global demand, falling non-OPEC supply and a potential production freeze agreement between OPEC and non-OPEC producers. The iron ore price, as measured by the benchmark price delivered to Qingdao China – 62% Ferrous Content, rose 23.4% over the quarter to $US53.80 / metric tonne on signs of excess supply beginning to leave the market and improving sentiment around China's economy. Base metal prices were mixed, with nickel (-3.7%) and lead (-4.9%) down, while copper (+3.0%), zinc (+12.9%) and aluminium (+0.3%) rose, gold advanced to $US1232.40 an ounce, up 16.0% in the quarter.

The Chicago Board Options Exchange SPX Volatility Index (VIX), a market estimate of future volatility, showed more extreme moves over the first quarter compared to the fourth quarter despite ending the quarter lower. The VIX Index started the quarter at 18.2 and finished at 14.0. Overall it averaged 20.4, compared to 17.2 the prior quarter.

In the US, the S&P500 Index rose 0.8% in the quarter, after the worst start to the year ever, at one stage being down 10.5% from the Q4 2015 close. The Dow Jones (+1.5%) rose, while the NASDAQ (-2.7%) fell. On a sector basis, MSCI Healthcare fell 7.4% in the quarter while Utilities was the strongest performer, up 8.0%.

European equities were down over the quarter, despite further stimulus efforts by the ECB. Overall the Euro Stoxx 50 Index fell 8.0%, while the Euro was up 4.7% against the US dollar (USD). In other equity markets, Germany (-7.2%) and France (-5.4%) outperformed the European index, while Spain (-8.6%) and Italy (-15.4%) underperformed.

In the UK, FTSE100 fell 1.1% over the quarter. The announcement by UK Prime Minster David Cameron of the referendum on the UK's EU membership scheduled for 23 June 2016 and the close polling weighed on the currency, with the Sterling down 2.3% against the USD over the quarter.

The Japanese equity market was one of the worst performers globally, falling 12.0% in Q1 16. The Japanese economy has disappointed with inflation and growth both falling. Despite the introduction of negative rates by the BoJ, the Japanese yen (JPY) appreciated 6.4% against the USD over the quarter.

The MSCI EM (Emerging Markets) Index rose 5.4% driven by the commodity price recovery, a falling USD and signs of more accommodative monetary policy. The MSCI EM Index significantly outperformed the broader global equity market index led by MSCI EM Latin America (+18.5%/qtr) and MSCI EM Europe, Middle East and Africa (+12.1%/qtr). The Shanghai Composite Index fell 15.1%, driven ongoing growth concerns and the expectation of a Yuan devaluation. The Brazilian IBOVESPA Index was a key performer, up 15.5% over the quarter, despite the worsening political crisis. The expanding corruption investigations and potential impeachment of President Rousseff have been seen as positive by markets and a sign of Brazil's strengthening institutions and rule of law.

Australian equities struggled in early 2016, declining in value in nine of the first 10 trading days of the year. This set the tone for the remainder of the quarter. In spite of a recovery during March, the S&P/ASX 200 Accumulation Index closed the quarter 2.75% lower. The Index was led lower by stocks in the Financial sector, while the Materials sector typically performed relatively well, rebounding from a low base.

Bond markets in the first quarter of 2016 continued to be largely driven by central bank policy. The easier monetary policy stance from global central banks drove yields lower. Globally, bond yields traded in volatile ranges and fell notably over the first two months of the quarter, but started to rise towards the end of the period as the environment turned from 'risk-off' to 'risk-on'. The US 10-year treasury yield ended the quarter at 1.77%, a decrease of 50 basis points (bp); the 10-year German bund yield fell by 48bp to 0.15%, whilst the yield on the UK 10-year gilt fell 55bp ending the quarter at 1.42%. The 10-year Japanese Government Bond (JGB) fell by 30bp to -0.04%.

Longer dated Australian bond yields mirrored the direction of global yields and fell notably during the quarter. Specifically, the yield on the benchmark 10-year government bond fell by 39bp to 2.49%. Throughout the quarter, the Reserve Bank of Australia (RBA) left the official cash rate unchanged at 2% with the most recent minutes leaning toward a mild easing bias.

United States

The US Federal Reserve – gradual

- The FOMC, as widely expected, held the Fed Funds target rate unchanged at 0.25%-0.5% in Q1 16 – the rate set in December 2015.
- The Fed remains of the view that the economy will expand at a "moderate pace", but has also highlighted the risks coming from "global economic and financial developments."
- While the Fed continues to expect the process of monetary policy normalisation to proceed in 2016, the Fed's own 'dot' forecasts now imply only two rate hikes this year, well down from the previous expectation of four moves, but above the market expectations of less than one hike in 2016 (see chart 2). Further out, the Fed has lowered their long-term Fed Funds target forecast from 3.5% to 3.25%.
- The Fed's economic forecasts were altered a little. The unemployment rate forecast for 2016 remains at 4.7%, but has been lowered to 4.6% for 2017 and 4.5% for 2018. Economic growth is now forecast at 2.2% in 2016, down from 2.4% previously, then moderating to 2.1% in 2017 and 2.0% for 2018. Underlying inflation is expected to drift higher from 1.6% in 2016, 1.8% (down from 1.9%) in 2017 and 2.0% in 2018.

Strong employment gains but still no wages growth

- The strong employment numbers that encouraged the Fed to lift rates in December 2015, continued in the first quarter of 2016.
- Over the quarter, 628,000 jobs were added, compared to 851,000 in Q4 15. The unemployment rate fell to 4.9% in January, before returning to 5% in March, driven by an increase in the labour force, to finish the quarter unchanged. See chart 1.
- The participation rate has continued to improve and is now at the highest level in two years having increased 0.6%, to 63.0%, in the last six months. This has led to a 3.1% annualised increase in the labour force, which has limited the continued decline in the unemployment rate.
- Despite the continued strength in the labour market, there has been, to date, limited signs of wages pressure emerging. Average Hourly Earnings fell to 2.3%/yr in March, from 2.6%/yr in December.

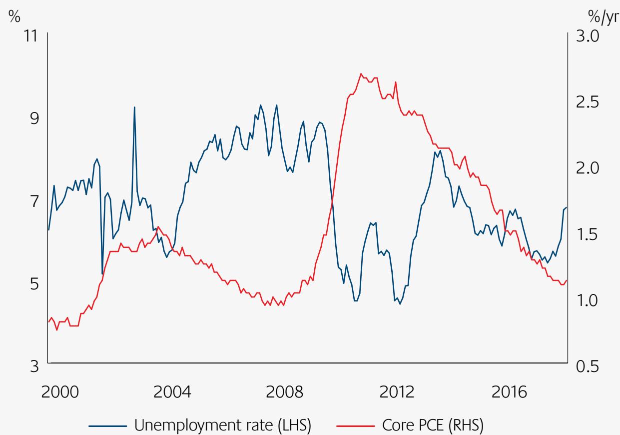
Economy records moderate growth, inflation increasing

- GDP growth slowed to 1.4% on a seasonally-adjusted-annualised-rate (SAAR) in Q4 15, down from the 2% SAAR recorded in Q3 15. Once again, consumer spending was a clear outperformer, helped by strong employment growth and low gasoline prices. For all of 2015, growth in the US was 2.0%, compared to 2.5% in 2014.
- Inflation showed some signs of recovery as the temporary impact of energy prices and the strong dollar faded. Headline inflation increased 1.0%/yr in February 2016 (compared to 0.5%/yr in November 2015), while the Fed's preferred measure, the Core Personal Consumption Expenditure Index (Core PCE) increased to 1.7%/yr from 1.4%/yr in Q4 2015. See chart 1.

US Presidential election – establishment vs outsider

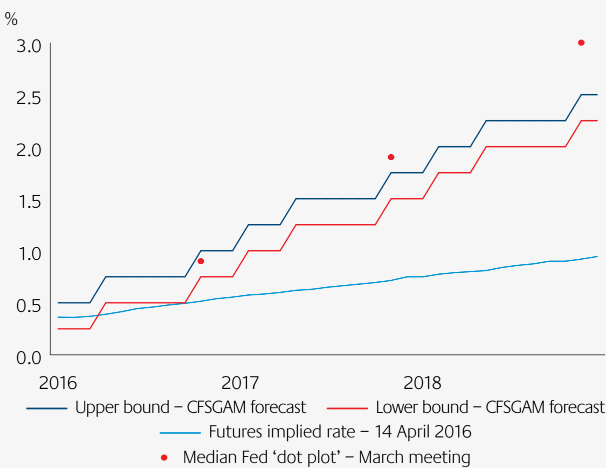
- Over the quarter, the Republican and Democratic Party Primaries kicked into full swing, with results that have surprised both pundits and party elites.
- Against all expectations, Donald Trump has emerged as the front runner for the Republican nomination. There is, however, still the possibility of a rare contested convention which could see runner-up Ted Cruz or another candidate emerge victorious.
- On the Democratic side, as expected, Hillary Clinton remains the strong favourite, though outsider candidate Bernie Sanders has been building momentum in recent weeks as the race tightens.
- Recent polling suggests a Democratic victory is likely if either Trump or Cruz face off against Clinton (see chart 4) however this outcome is far from certain.
- While markets have yet to react much to the Presidential election, volatility is likely to increase closer to the November 2016 election.

Chart 1: The US Fed is achieving its dual mandate



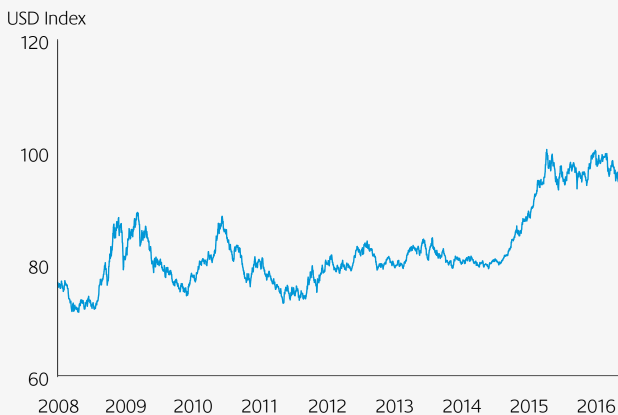
Source: Bloomberg. Data to 31 March 2016.

Chart 2: But US monetary policy normalisation to be very gradual



Source: CFSGAM and the US Federal Reserve – March FOMC meeting.

Chart 3: USD strength runs out of momentum



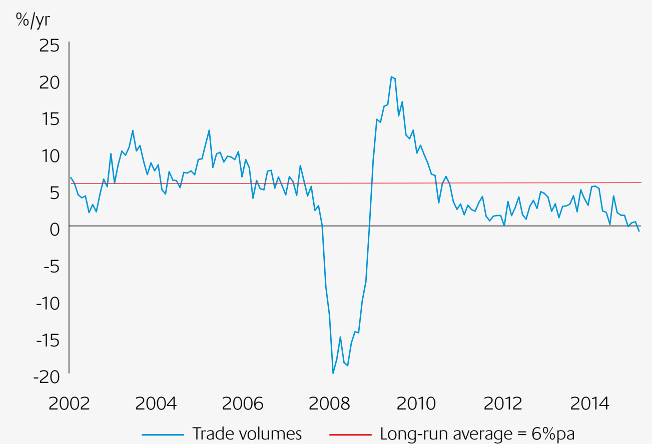
Source: Bloomberg. Data to 14 April 2016.

Chart 4: US Presidential election becoming a risk for markets

	Clinton v Trump	Clinton v Cruz	Clinton v Kasich	Sanders v Trump	Sanders v Cruz	Sanders v Kasich
18 Apr '16	9.3	2.3	-7.8	15.2	11.2	4
1 Apr '16	10.6	2.8	-6.2	15.8	9.4	1
1 Mar '16	3	-1.5	--	8	--	
1 Feb '16	3.5	-1.7	--	8.7	--	
1 Jan '16	5	0.6	--	2	--	
1 Dec '15	3.5	1.3	--	--	--	
1 Nov '15	2.5	8.3	--	--	--	
1 Oct '15	3.6	7.7	--	--	--	

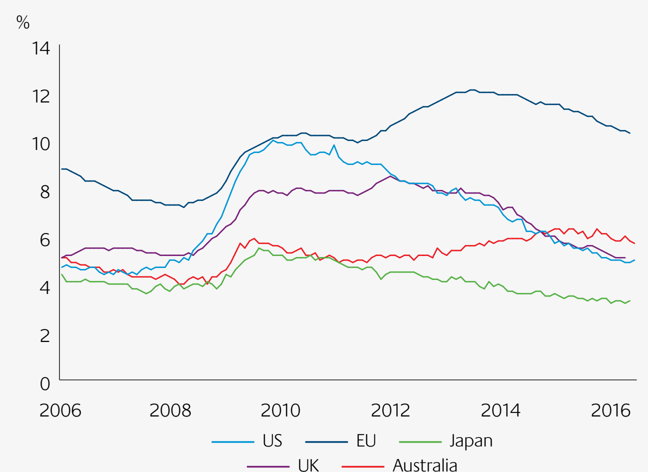
Source: RealClearPolitics.

Chart 5: Global trade continues to be weak



Source: Bloomberg. Data to 31 January 2016.

Chart 6: But unemployment rates are falling globally



Source: Bloomberg. Data to 14 April 2016.

Europe

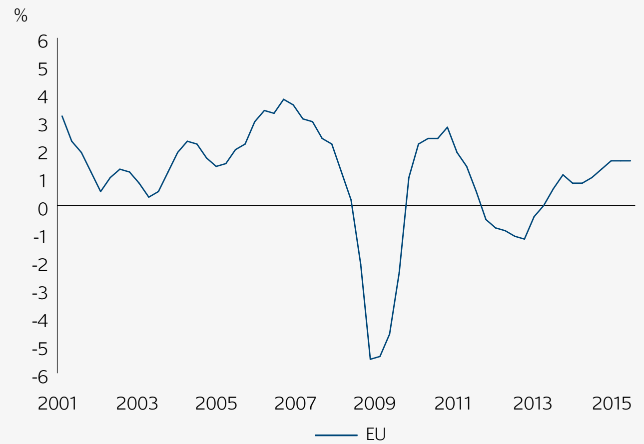
European Central Bank eases

- The ECB met on 10 March 2016 and announced further monetary policy easing across multiple fronts in response to downward revisions in inflation and inflation expectations. The easing, which exceeded the markets expectations, once again put into practice ECB President Mario Draghi's promise to "do whatever it takes".
- The ECB's monetary policy easing has taken multiple forms:
  - The rate on the deposit facility was lowered by 10bps to -0.40%;
  - The main refinancing rate and marginal lending facility rate were lowered by 5bps to 0.00% and 0.25% respectively;
  - The monthly purchases under the asset purchase programme were increased from €60bn to €80bn per month;
  - The asset purchase programme will now include investment grade bonds issued by non-bank corporations;
  - A new series of four targeted longer-term refinancing operations (TLTRO II) will be launched, starting in June 2016.
- The ECB's economic forecasts were lowered slightly. Headline inflation is now expected to be just 0.1%/yr at the end of 2016, 1.3%/yr at the end of 2017 and 1.8%/yr at the end of 2018. Annual real GDP is now forecast to increase by 1.4% in 2016, 1.7% in 2017 and 1.8% in 2018.
- ECB President Mario Draghi offered some forward guidance on rates stating that "the Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases."

Growth stable, inflation nowhere to be seen

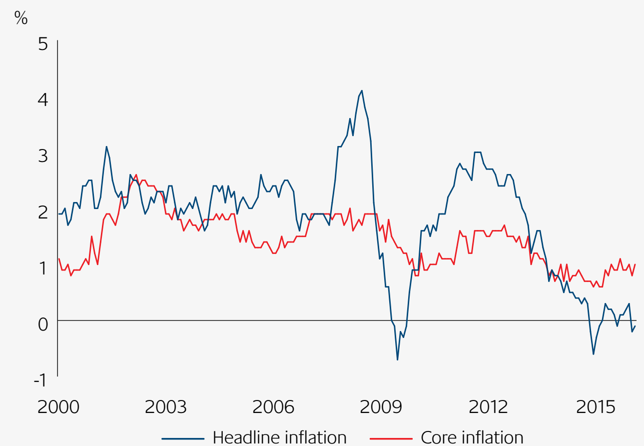
- Q4 2015 GDP data for the Euro area released over the quarter showed growth at 0.3%/qtr, enough to keep the annual rate at 1.6%/yr.
- Despite stable growth and increase stimulus from the ECB, inflation still remains elusive. Headline inflation for the Eurozone decreased to -0.1%/yr in March from 0.2%/yr in December while core CPI has increased to just 1.0% in March from 0.9% in December. Weak inflation continues to be driven by energy and food price weakness.

Chart 7: EU economic growth starting to improve



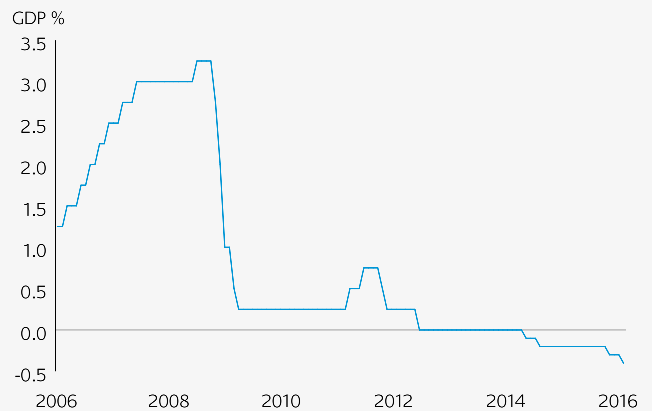
Source: Bloomberg. Data to 31 December 2015.

Chart 8: But the EU is struggling to generate inflation



Source: Bloomberg. Data to 31 March 2016.

Chart 9: As a result the ECB goes negative



Source: Bloomberg. Data to 14 April 2016.

United Kingdom

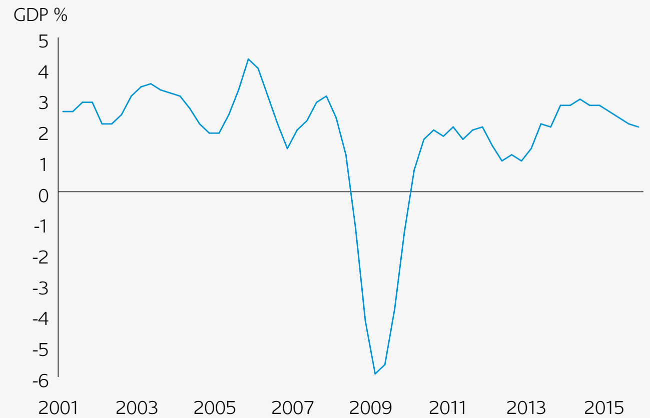
UK struggling to generate growth and inflation

- The latest growth data for the UK showed Q4 2015 GDP increased 0.6%/qtr, with the annual rate edging down to 2.1%/yr from 2.2%/yr in Q3. Over the past year, growth has declined from 2.8% at end 2014. See chart 10.
- Growth continues to be driven by consumer spending with construction and services also contributing, while exports and business investment have been a drag.
- CPI data showed inflation increased to 0.5%/yr in March from 0.2%/yr in December 2015, still well below the Bank of England's target. Core inflation also increased slightly over the quarter, up to 1.5%/yr from 1.4%/yr in December. See chart 11.
- Inflation continues to be held down by continued weakness in food and energy prices and weak wages growth.
- After some improvement in the middle of 2015 wage growth has remained weak, up just 2.2%/yr in January compared to 2%/yr 3 months earlier.

Brexit fears weigh on Sterling

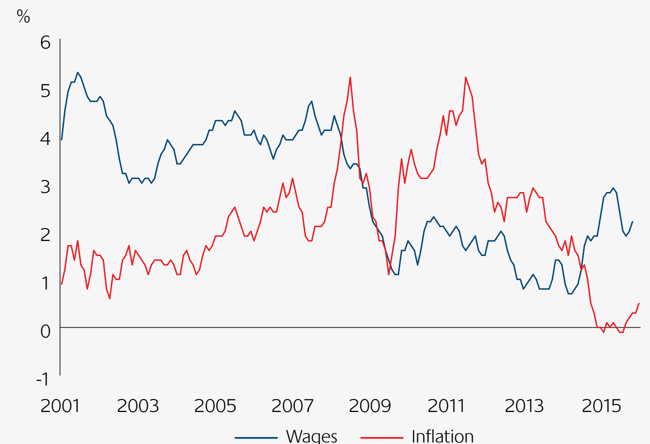
- During the month, Prime Minster David Cameron formally announced a referendum on the UK's EU membership, scheduled for 23 June 2016. The vote to 'Leave', if successful, will have long-term implications for both the UK and EU that remain far from clear.
- After the announcement, several high profile Conservative politicians including the Mayor of London Boris Johnson and Justice Secretary Michael Gove threw their support behind the 'Leave' vote.
- Current polling suggests a close race with a significant proportion of undecided voters still to be won.
- The uncertainty associated with the referendum has already had an impact on the currency, with the Sterling depreciating 2.3% against a weakening USD and 6.7% against the Euro over the quarter.
- Additionally, there is the possibility that the UK vote fuels further global financial market volatility with the risk that this could see the Fed continue to pause when they consider raising interest rate at the 14-15 June 2016 FOMC meeting.

Chart 10: UK growth is losing momentum



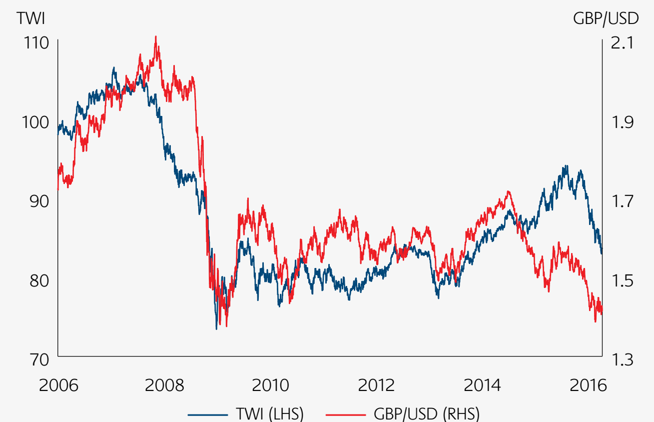
Source: Bloomberg. Data to 31 December 2015.

Chart 11: UK is struggling to generate inflation



Source: Bloomberg. Inflation as at 31 March 2016. Wages as at 31 January 2016.

Chart 12: GBP weakening sharply on Brexit fears



Source: Bloomberg. Data to 14 April 2016.

Japan

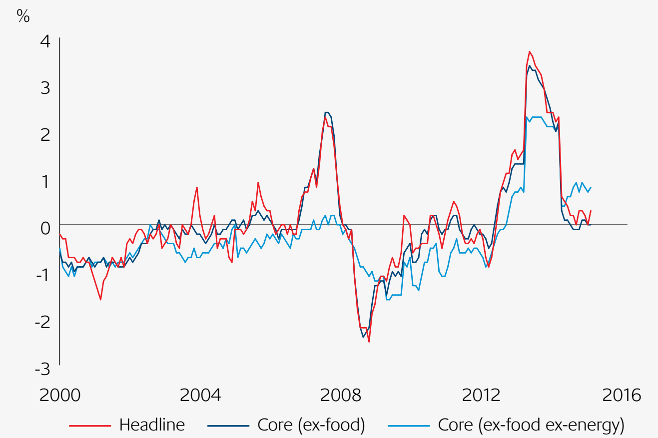
The BoJ goes negative to combat deflation and currency

- The BoJ's policy board convened on 29 January 2016 and added a new dimension to their policy armoury by lowering by 20bp one of its new three-tiered policy rates to -0.1%. This policy action was labelled "Quantitative and Qualitative Monetary Easing (QQE) with a 'Negative Interest Rate'.
- The BoJ, led by Governor Kuroda, was likely prompted into action in response to weaker inflation data and recent JPY strength.
- The introduction of negative interest rates saw bond yields move into negative out to 10 years across the curve. See chart 15.
- CPI remained weak over the quarter rising to just 0.3%/yr in February from 0.2%/yr in December. While the core measure, excluding food and energy, was unchanged at 0.8%/yr, both well below the BoJ's 2% target. See chart 13.
- Wage inflation also remains weak. The latest Shunto wage round is expected to miss expectations with union workers estimated to receive an average wage increase of just +1.7% this year compared to +2.4% last year.
- Despite the policy easing and the expectation of more to come, the JPY strengthened 6.8% against the USD over the quarter. This goes against the BoJ's goal and raises the possibility of further monetary policy easing over coming months.

Economic growth may lead to fiscal stimulus

- The Japanese economy contracted by 0.3%/qtr in Q4 15, weaker than expected and down from +0.3%/qtr recorded in Q3 15. While investment and net trade contributed to growth they were not enough to counter the weaker consumption and government spending. Annual growth fell to 0.7%/yr, down from 1.7%/yr in Q3 2015.
- The weaker than expected growth has increased the expectation of a large stimulus package from the Government, potentially to be announced as early as May, and the possibility of delaying the second consumption tax hike, scheduled for April 2017.

Chart 13: Japan failing to generate inflation

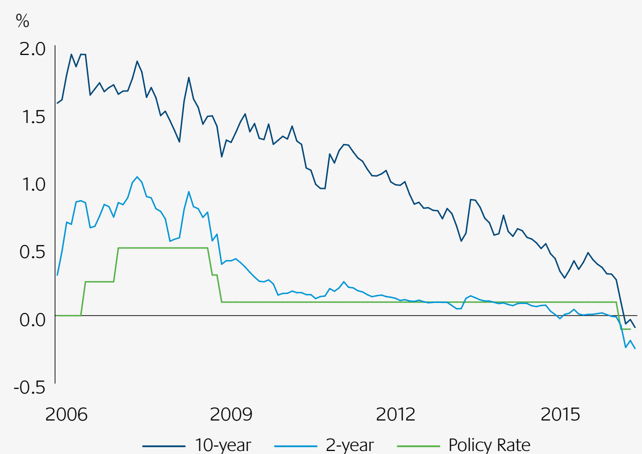


Source: Bloomberg. Data to 31 March 2016.

Chart 14: JPY has been strengthening

Source: Bloomberg. Data to 14 April 2016.

Chart 15: Interest rates go negative right across the yield curve



Source: Bloomberg. Data to 14 April 2016.

China

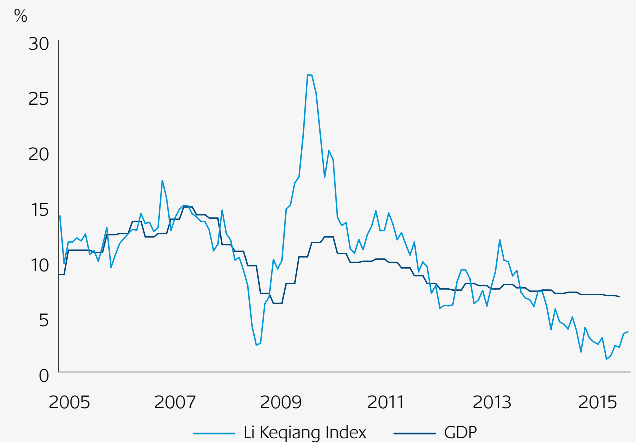
Growth stabilising but reform takes a back seat

- Fears of a hard landing in China once again proved overblown, with Q4 15 GDP released in January showing growth slowing to 6.8%/yr, down from 6.9%/yr in Q3 15. For the whole of 2015, growth of 6.9% was recorded, slightly below the 7% target and the slowest since 1990 (see chart 16). Consumption and services remains the key contributors to growth with a slowdown in real estate investment and manufacturing investment the reason for lower growth. The services sector now makes up 50.5% of the Chinese economy.
- Following the National People's Congress in March, the Chinese authorities set a growth target for 2016 of 6.5%-7.0%, down marginally from the "approximately 7%" target for 2015. The Chinese authorities stressed the focus on ensuring economic growth remained within the target in 2016 and indicated that further policy easing –both monetary and fiscal – could be implemented in the months ahead to ensure this outcome.
- While there were some supply side reforms announced over the quarter to remove excess capacity from the coal and steel industries, further reform will likely take a back seat until after the next National Congress in 2017.

A new approach to the monetary policy

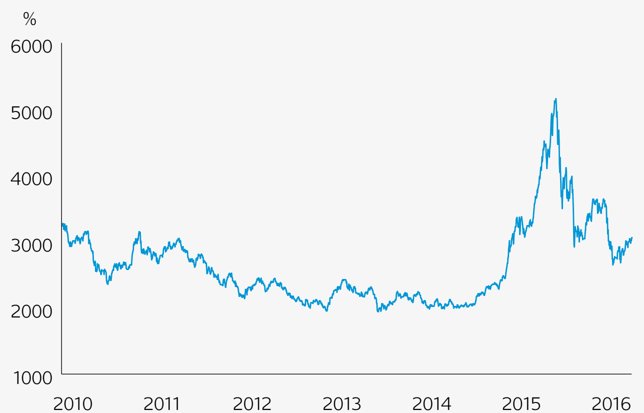
- Over the quarter the PBOC cut the Reserve Requirement Ratio by 50bps to 17.0% in February, but left benchmark interest rates unchanged.
- The PBOC halted the depreciation of the yuan against the USD, announcing a new currency regime focused on maintaining the value against a basket of currencies as opposed to a peg to the USD. Over the quarter, the yuan appreciated 1.6% against the USD, in line with broad dollar weakness.
- Over the quarter the PBOC was forced to expend significant capital reserves in an effort to defend the currency against speculation of a large depreciation and significant capital outflows. Foreign exchange reserves decreased by USD118 million to USD3.2 billion over the quarter.

Chart 16: Chinese economic data shows some stabilisation



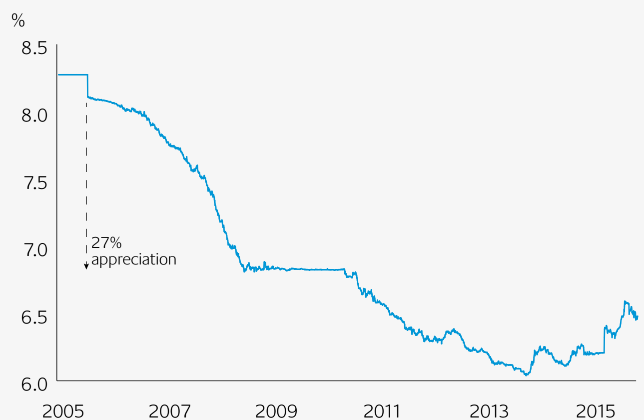
Source: Bloomberg. GDP to 31 December 2015. Li Keqiang Index to 29 February 2016.

Chart 17: Financial markets also stabilising – Equities



Source: Bloomberg. Data to 14 April 2016.

Chart 18: Financial markets also stabilising – RMB



Source: Bloomberg. Data to 14 April 2016.

Australia/New Zealand

The RBA keeps rates on hold

- The RBA kept the official cash rate on hold at 2.0% through the March quarter 2016 and where it has remained since May 2015. The RBA statement remained relatively upbeat on the domestic economy "the Board judged that there were reasonable prospects for continued growth in the economy", while maintaining a cautious easing bias. The RBA notes that "continued low inflation may provide scope for easier policy, should that be appropriate to lend support to demand."
- The statement did make reference to the recent strength in the AUD noting that it reflected both "some increase in commodity prices" and "monetary development elsewhere in the world". While they stated that the "appreciating exchange rate could complicate the adjustment under way in the economy" they avoided outright calls for a lower dollar.

GDP growth versus employment – lining up at last

- Australia's Q4 15 GDP data, which was released in early March, showed stronger than expected growth of 0.6%/qtr, increasing the annual pace to 3.0%/yr, the fastest pace of growth since Q1 14.
- Growth was driven by household consumption (+0.4%/pts), public investment and inventories (each up 0.2%/pts), while trade was flat and non-residential building was the largest drag (-0.5%).
- Capital expenditure remains a drag on growth as the economy transition from mining to the less capital intensive services sector. See chart 20.
- The income side of the Australian economy remains weak (+0.3%/yr), driven by the continued decline in the Terms of Trade (-12.1%/yr) and anaemic wages growth (+2.2%/yr). See chart 19.
- The recent improvement in growth now aligns with the robust labour market after the two measures had diverged for much of 2015.
- Over the three months to March 2016, employment growth has slowed somewhat with only 17,500 jobs added, compared to 121,900 in Q4 2015. The unemployment rate has however continued to decline finishing the quarter at 5.7%, a two and a half year low. See chart 21.

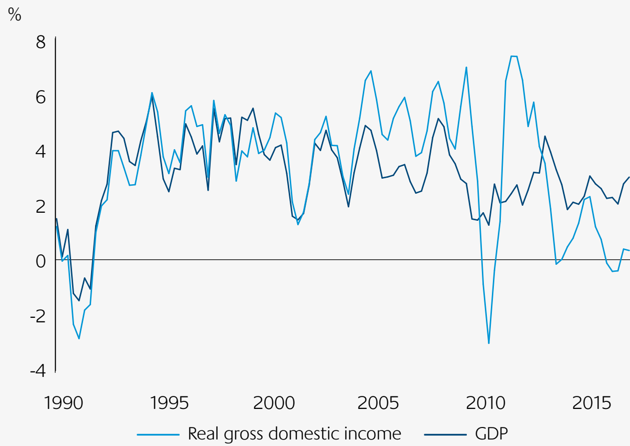
Inflation remains low in Australia and New Zealand

- Australia's Q4 15 headline CPI rose by 0.4%/qtr, slightly above expectations, with the annual rate increasing to 1.7%/yr, from 1.5%/yr. Headline inflation remains below the RBA's 2%-3% target range.
- Perhaps more importantly, both measures of underlying inflation showed a slight acceleration in the pace of price rises with underlying inflation increasing by 0.55%/qtr, which was the average of the trimmed mean and weighted median measures. This took the annual pace of underlying inflation to 2.0%, down from 2.1%. See chart 22.
- Q4 15 CPI for New Zealand was released in January. Headline CPI contracted 0.5%/qtr, taking annual headline inflation to just 0.1%/yr the lowest since September 1999. This result was much weaker than both the RBNZ and market expected.
- While higher, core inflation also remains below the RBNZ's target range at 1.6%/yr. See chart 23.

RBNZ – falling inflation expectations force rate cut

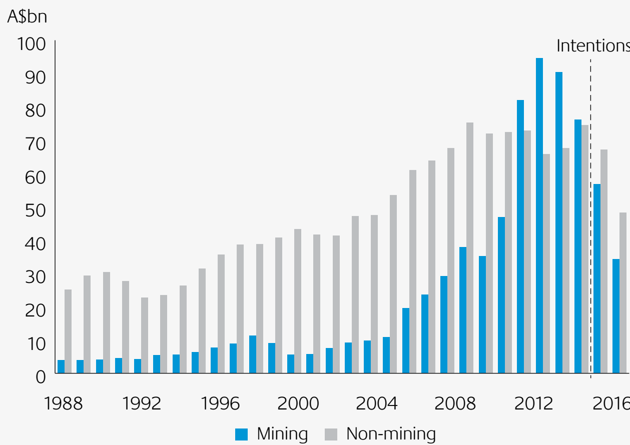
- The RBNZ surprised the market and cut interest rates by 25bps to 2.25% at its March 2016 meeting. The cash rate was last reduced in December 2015. See chart 24.
- In the accompanying statement, the RBNZ noted the weaker global outlook and domestic inflation expectations, "Given the weaker world conditions and lower inflation expectations, the Bank judges it appropriate for monetary policy to be more stimulatory than projected in December".
- The RBNZ seemed particularly concerned with the decline in headline inflation and inflation expectations increasing "the risk that the decline in expectations becomes self-fulfilling and subdues future inflation outcomes."
- The policy outlook remains biased towards further easing with the bank noting that "Further policy easing may be required".

Chart 19: Australian economy accelerates through H2 2015



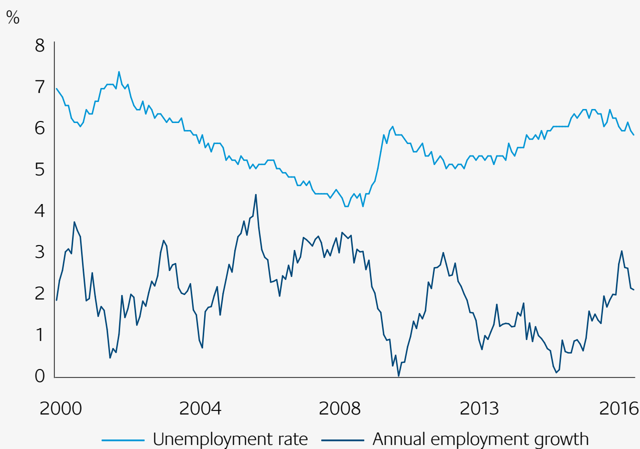
Source: Bloomberg. Data to 31 December 2015.

Chart 20: Capital spending continues to weaken



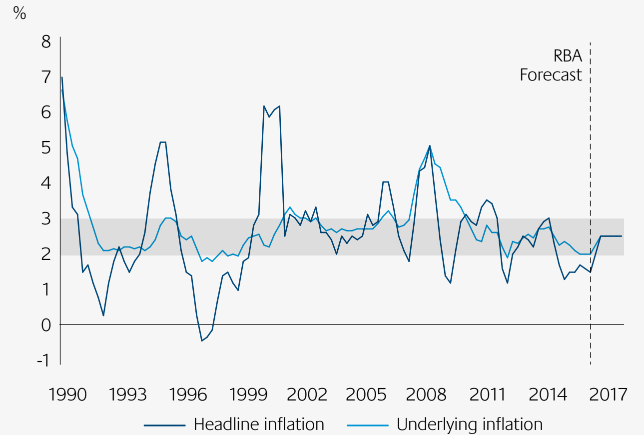
Source: Australian Bureau of Statistics (ABS). Data to 31 December 2015.

Chart 21: Employment growth surprises to the upside



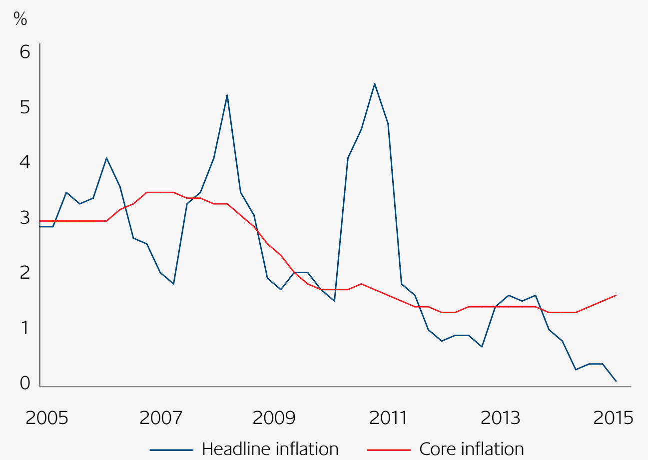
Source: ABS. Data to 31 March 2016.

Chart 22: Inflation remains low – Allowing the RBA to ease if needed



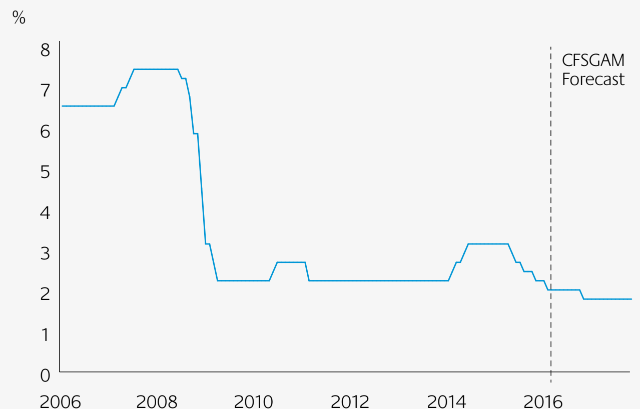
Source: ABS. Data to 31 December 2015. RBA forecasts as at February 2016.

Chart 23: New Zealand inflation remains well below RBNZ target



Source: RBNZ. Data to 31 December 2015.

Chart 24: RBNZ continues to ease policy



Source: Bloomberg and CFSGAM. Data to 31 March 2016.

Section 3

Economic Forecasts April 2016

United States

	2016		2017		2018		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	2.0	2.1	2.3	2.5	2.2	2.25	2.5	2.5
Inflation – Core PCE	1.6	1.6	1.8	1.7	1.9	1.8	2.0	2.0
Monetary policy – Rates	0.5%	0.75%-1.0%	0.66%	1.5%-1.75%	0.85%	2.25%-2.5%	3.0%	2.5%
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 to phase out.	Coupon reinvestment to phase out.	Balance sheet slowly returns to normal.	Balance sheet slowly returns to normal.

Source: Bloomberg.

Comments:

- GDP: We have revised down our 2016 economic growth forecast for the US to 2.1%, from 2.5%, reflecting the slower start to the year and recent volatility.
- Economic growth should be supported through 2016 and 2017 by the very gradual nature of the Fed's policy normalisation (see below), as well as a pull-back in the USD. Growth is also expected to be driven by the very 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, picked up in early 2016, but is expected to end the year at a modest 1.6%.
- 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%.
- Following global financial market volatility and dovish commentary from the Fed, we now expect only two rate hikes in 2016 (likely June and December) and a peak in the Fed Funds rate around 2.5% in late 2018 or early 2019. This is substantially lower than the Fed's own forecasts, but still higher than market expectations.
- 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 2018.

United Kingdom

	2016		2017		2018		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	2.0	2.0	2.2	2.3	2.2	2.5	2.5	2.0
Inflation – CPI	0.7	0.5	1.8	1.5	2.2	2.0	2.0	2.0
Monetary policy – Rates	0.6%	0.75%	0.7%	1.0%	0.85%	2.0%	2.5%	2.5%
Monetary policy – Other	No balance sheet adjustments.	No balance sheet adjustments.	No clear consensus.	No balance sheet adjustments.	No clear consensus.	Balance sheet reduction likely.	Rates to settle around new neutral.	Rates to settle around new neutral.

Source: Bloomberg.

Comments:

- GDP: We have lowered our 2016 GDP growth forecast to 2.0%, from 2.4%, reflecting a loss of momentum in early 2016. For 2017 we expect growth to pick up to 2.3% and then to 2.5% in 2018.
- This improvement is based on the view that the BoE will increase interest rates only very gradually in the years ahead. We have also assumed in our forecasts that the UK will vote to remain within the EU. A vote to leave could see us revise our forecasts.
- Inflation: The pace of inflation in the UK (as elsewhere) has slowed dramatically, largely on the sharp fall in the price of energy. Inflation in 2016 is now expected to be only 0.5%/yr. Some increase in inflation is forecast for 2017, but this has been revised down to 1.5%/yr, from 1.7%/yr previously. Some further modest upward trend in inflation is expected into 2018 – consistent with the BoE target.
- Monetary policy: With ongoing low inflation in the UK and uncertainty around the referendum, the expected timing of the first rate hike from the BoE has been pushed back to very late in 2016. For 2017 we now expect only one further rate hikes, taking the base rate to just 1.0%, before further moves towards the medium-term neutral rate around 2.5% in the years ahead.

Europe

	2016		2017		2018		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	1.5	1.6	1.6	1.7	1.7	1.5	1.5	1.0
Inflation – CPI	0.3	0.2	1.4	1.1	1.7	1.5	1.5	1.0
Monetary policy – Rates	-0.4%	-0.5%	N/A	-0.5%	N/A	-0.5%	N/A	1.0
Monetary policy – Other	Expanded QE and TLTRO funding to remain in place.	Expanded QE and TLTRO funding to remain in place.	N/A	Expanded QE and TLTRO funding to remain in place.	N/A	Expanded QE and TLTRO funding to remain in place.	Significant period of very easy monetary policy.	Significant period of very easy monetary policy.

Source: Bloomberg.

Comments:

- GDP: Economic data in Europe has improved a little of late, with some good momentum in countries such as Ireland and Spain. This saw growth in 2015 accelerate to 1.6% from just 0.9% in 2014.
- For 2016, we expect economic growth of around 1.6%/yr, supported by the significant monetary policy easing now underway, as well as less fiscal austerity and lower energy prices
- Inflation: Inflation in Europe (as elsewhere) remains very low and is struggling to show a positive headline reading.
- Aggressive policy action by the ECB and any further weakening of the EUR should help put upward pressure on inflation in 2016, but we have revised down our forecast to 0.2%/yr (from 0.7%/yr previously).
- Inflation is not expected to reach the ECB's 2% target out to 2018 or beyond.
- Monetary policy: ECB President, Mario Draghi, continues to deliver on his 'whatever it takes' commitment. An expanded bond purchase program of €80 billion/mth, including investment-grade corporate bonds, a deposit rate of -0.4% and direct funding of the banks through the TLTRO program, all providing ongoing support.
- The very low inflation environment implies that the ECB will continue to implement unconventional monetary policy for a number of years to come.

Japan

	2016		2017		2018		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	0.6	0.7	0.6	0.9	0.7	1.0	1.0	1.0
Inflation – CPI	0.3	0.2	1.8	0.5	1.7	1.0	2.0	1.5
Monetary policy – Rates	0%	-0.3%	N/A	-0.5%	N/A	-0.5%	0%	0%
Monetary policy – Other	QQE remains in place, with NIRP.	QQE to be expanded, with NIRP.	QQE remains in place, with NIRP.	Expanded QQE remains in place, with NIRP.	QQE remains in place, with NIRP.	Expanded QQE remains in place, with NIRP.	QQE and NIRP to remain in place for foreseeable future.	QQE and NIRP to remain in place for foreseeable future.

Source: Bloomberg.

Comments:

- GDP: Economic growth in Japan remained weak early in 2016 and this is expected to see growth for the year coming in around 0.7%/yr.
- Aggressive monetary policy easing, including an expanded QQE program and negative interest rates (NIRP) from the BoJ, should help support an improvement in growth in 2017 and beyond, but likely still only to levels around 1.0%/yr.
- Inflation: As is the case elsewhere, the rate of inflation remains very low in Japan and is (once again) expected to come in at well under 1%/yr 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. Headline inflation is expected to be higher in 2017, if the government goes ahead with the next increase in the Consumption Tax rate, from 8% to 10% as at 1 April 2017.
- Monetary policy: With inflation unlikely to hit the BoJ's 2% target well into the future, the BoJ is expected to implement a further expansion of its QQE program in coming weeks/months and take official interest rates further into negative territory. 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	6.5	6.6	6.3	6.1	6.4	6.0	6.0	6.0
Inflation – CPI	1.7	2.0	1.9	2.0	2.1	2.0	2.5	2.5

Source: Bloomberg.

Comments:

- GDP: The Chinese authorities have set a target for economic growth in 2016 of a 6.5%-7.0% range. We expect growth for the year at the lower end of this range. Q1 16 GDP data released in mid-April showed annual GDP growth of 6.7%/yr.
- For 2017, economic growth is expected to moderate further, to around 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 higher food prices offsetting falls in producer prices. For 2016 and 2017, we expect an inflation rate around 2.0% 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	2.6	2.6	2.9	2.7	3.0	3.0	3.0	2.75
Inflation – CPI	2.0	2.0	2.5	2.3	2.5	2.5	2.5	2.5
Monetary policy – Rates	1.7%	2.0%	1.7%	2.0%	N/A	2.5%	No clear consensus	3.0%

Source: Bloomberg.

Comments:

- GDP: The Australian economy has proven to be more resilient and flexible than many expected through late 2015 and into early 2016, with economic growth accelerating to 3.0%/yr at the end of last year.
- For 2016, growth is expected to moderate a little to around 2.6%/yr, 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: As with many other nations, inflation in Australia remains very subdued, with headline inflation under the RBA's 2%-3% target band. Underlying inflation remains in the bottom-half of the RBA's target band and is expected to remain around the lower end of the range, ie. 2.0%-2.5%, over the forecast horizon.
- Monetary policy: The RBA continues to hold an easing bias, stating that the low inflation environment would give it room to cut interest rates again if that was needed to support demand. Surprising strength in the labour market and concerns around housing are seeing the RBA hold off cutting rates again.
- However, the recent strength of the AUD is 'complicating' the outlook according to the RBA and this could force the RBA's hand in the months ahead.

New Zealand

	2016		2017		2018		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	2.4	3.1	2.6	3.9	N/A	3.1	2.5	2.8
Inflation – CPI	1.3	1.4	2.0	1.3	N/A	1.9	2.0	2.0
Monetary policy – Rates	2.0%	1.75%	2.25%	1.75%	2.3%	2.75	N/A	3.5%

Source: Bloomberg.

Comments:

- GDP: For 2016, weak dairy incomes will likely remain a drag on economic demand. Business and consumer confidence remains fragile. However, lower interest rates and a weaker New Zealand dollar (NZD) will help to stimulate economic activity. We expect GDP growth to reach 3.9% by the end of 2017 on the back of increased household demand, continued residential construction growth and improved investment appetites. However, once accounting for the lift in population growth, per capita growth is likely to remain sluggish.
- Inflation: Inflation pressures remain muted and headline inflation has remained below the RBNZ's 1-3% band for 18 months. Inflation expectations have dropped to very low levels. We expect domestic inflation pressures to rise over the next few years however, further stimulus from the RBNZ will be required to sufficiently boost domestic demand. Coupled with some recovery in global oil prices over the next few years, we expect inflation to return to the 2% mid-point by 2019.
- Monetary policy: We expect the RBNZ to cut the cash rate to 1.75% over 2016. While we have pencilled in June and August Monetary Policy Statements for these rate cuts, the risks are skewed to an earlier move. At the March Monetary Policy Statement, the RBNZ signalled it is likely to cut the official cash rate (OCR) to 2% later this year. However, increased bank funding costs and the resilience of the NZD has, in our view, tipped the odds in favour of a 1.75% low in the OCR.

Section 4
Recent Research Reports

The following is a list of the key research reports prepared
by the Economic and Market Research team over the March quarter.

Australian Q4 15 CPI "Inflation remains low (again)"
27 January 2016

US Federal Reserve "Fed passes on January, but fails to mention 'balanced'"
28 January 2016

Japan Update "The BoJ goes negative – More to come if needed"
1 February 2016

RBA "On hold, with easing bias – Cautious on international developments"
5 February 2016

Some thoughts on US Fed Chair Yellen and global financial markets volatility
12 February 2016

Updating our US Fed expectations
18 February 2016

ECB Update "Draghi doesn't disappoint – More easing across multiple fronts"
11 March 2016

US Federal Reserve "Hold, hold"
17 March 2016

Dovish Yellen talks about downside risks and need for caution
30 March 2016

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