

## ➤ Economic Update August 2017



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*"If you have one economist on your team it's likely that you have one more than you'll need."*

Warren Buffett

## The Global Economy



*China and the US recently faced off regarding trade talks. It did not go well. Will the Chinese give in to Donald Trump?*

**Black Swans.** "Black swan" is the usual term given to monumental events of the serious and negative nature. This type of talk usually captures the attention of prudent and educated citizens looking to manage risk. Any one of these black swan type events when it unfolds does have serious implications for the global economy, investors, businesses large and small and at times even mum and dads who have little interest in such information usually. The global financial crisis in 2008 would be a good recent example.

**Trade wars.** That's what the image at the start of this letter is all about. Recent talks between China and the US failed to reach agreement on trade, casting doubt over future trade relations between the two countries. America for its part (Donald Trump) is threatening to impose steel and aluminum tariffs on Beijing. Interestingly, after the meeting the US cancelled their press conference, then China followed suit. Obviously there was nothing good to talk about so they didn't bother. At the heart of the discussion is the USD\$340 billion trade deficit that America has with China along with restrictions on access to Chinese markets. The bottom line here is

that New Zealand would likely be caught up in the crossfire should a serious trade war between the US, China or any other major nation emerge. New Zealand's economy, whilst tracking nicely at the moment all things considered, is a narrow economy (e.g. tourism and agriculture) and therefore remains vulnerable.

**Shadow banking in China.** Basically this is the substantial amount of lending that is being carried out in China off balance sheet outside of the Chinese banking regulatory system. The two main issues are firstly the poor quality of this type of lending. Should these loans not be repaid and a large number of debt holders default then that could potentially unravel the whole shadow banking system in China. This brings us to the second point which is that the sheer size of this banking problem is significant. Big enough indeed to unsettle global markets in a way that we would all notice.

**Deflation rules for a long time.** We only need to look at the Japanese economy that has been held within the tight grip of deflation for around 25 years. Interestingly that is about how long interest rates have been declining, helping to prop up residential property prices in New Zealand and other economies but that's by the way. The point here is that the Chinese economy, the European economy, the Japanese economy and the US economy all matter to the global economy. There are other economies that matter too, however with the US economy struggling to achieve real economic growth sustainably beyond 4% (which by the way I don't see happening any time soon) where will the growth come from and why? There is always more central bank intervention including the numerous macro prudential tools that have been at play strongly since the Global Financial Crisis in 2008.

**There are some positive signs** coming out of the US however by my estimation they do not suggest economic growth at 4% per annum sustainably long term. Some argue this level of economic growth could well be impossible for the foreseeable future. The debt servicing alone for the US economy is already biting a reasonable chunk out of annual tax receipts in the US. If I was an economist (I'm an investor not an economist) I could easily argue that deflation is a black swan happily floating confidently in a global economy awash with debt.

**North Korea successfully sending missiles to the US or another country.** The immediate impact apart from the loss of lives and panic from an economic perspective at least would be the damage to international trade which would be immediate. I struggle to calculate the impact of this and have left it to one side as an outlier event and a real black swan should it ever eventuate. It occurs to me that North Korea has already been implicated in malware attacks using hackers to send malicious code around the world and to some extent has been successful. I wonder how long it might take for them to disrupt the defence system in the US so that they can buy enough time to send a volley of missiles their way so that the US shield defence system does not have time to respond? It sounds a bit far fetched but then is it really? I vote we put this outlier to one side and focus on what we can do.

**Regardless of black swans,** the global economy generally remains stable with economic growth predicted to run at around 2.5% or so for the global economy over 2017. Not a bad result actually for an economy that is largely in the grip of deflation still.

**The US Fed has successfully increased** interest rates twice and is looking for a third increase soon which looks quite likely.

**Brexit** continues to unfold and as I have previously suggested, remains a slow burn that is yet to give up too much in the way of clear direction as to how things will unfold for Europe and the UK. More recently Donald Trump signaled that he was keen to undertake serious discussions on trade with the UK, which sounds good on the surface. However, the sceptics note that striking a good deal with the US is far from easy.

**The Chinese economy** continues to grow at slightly under 7% based on official data which some speculate is more likely around 4% in real terms which is still strong growth for an economy the size of China. Although the shadow banking issue alluded to earlier is potentially a significant problem, general debt in China also continues to rise but at this stage is manageable. The much needed reforms in China continue which is good news.

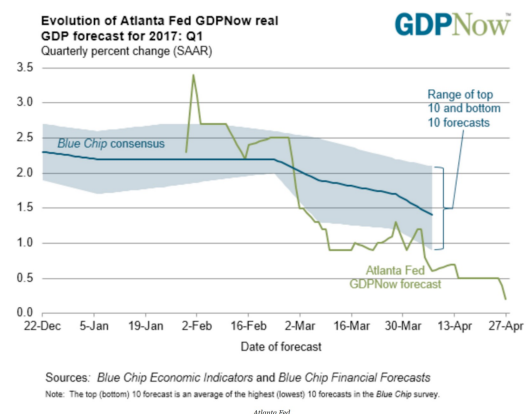
**Japan's economy continues to stumble** along, achieving limited growth but nonetheless remains

stable although of course the significant increase in debt due to the so-called printing machine is a good part of the reason why.

**Closer to home both** New Zealand and Australian economies are performing satisfactorily, particularly against the backdrop of a fragile global economy.

**All things considered,** the global economy remains stable and whilst it is supported by a significant amount of debt, the debt at this stage is manageable and at least until the next unexpected event it really is ... *"steady as we go for now"* for the global economy.

## The United States of America



*Growth in the US economy exists but remains fragile and subdued.*

**By some accounts, the US economy virtually ground to a halt** in the first quarter of 2017. One quarter's data does not an economy make, however it is symptomatic of what I refer to often as "the lingering grip of deflation". Frankly, the US economy whilst it appears to be heading in the right direction continues to struggle to shake free of the shackles of deflation. Consumer spending appears to be partly to blame which, adjusted for inflation, saw its weakest February since 2009 – that's eight years ago. For example the slowdown in motor vehicle sales also impacted on retail sales over March. Interestingly, the gross domestic product number increased at a rate of 1.4% annual rate which is well below the 3% to 4% that Donald Trump has talked about in the past.

## IHS Markit Composite PMI and U.S. GDP



Sources: IHS Markit, U.S. Bureau of Economic Analysis.

The above chart shows the relationship between economic growth in the US (the grey shaded bars) and manufacturing (the blue line).

**Recent data suggests further acceleration** in business activity growth across the US private sector, which is good news. In June the number was 53.9 and recent data suggests this number has moved up to 54.2 (the number over 50 means growth). Manufacturing production appears to be driving the increase in activity; meanwhile recent data on service providers suggest growth remains unchanged from that sector.

Interestingly private sector payroll numbers also expanded at a solid pace in July, with the rate of job creation the fastest so far in 2017.



Although the unemployment rate in the US recently spiked up a tad, the trend is definitely in a downward direction.

**Employment is considered a key indicator of** economic growth or recession. High unemployment generally indicates recession and low unemployment generally indicates economic growth. Interestingly, unemployment claims have now been below 300,000 for 125 straight weeks, the longest such stretch since 1970. Although there is debate around how the number is actually calculated, nonetheless that is a positive number for the US economy.



Interest rates in the US rise and the Fed is on track for another increase soon.

**The US Federal Reserve is watching** the labour market which continues to strengthen as well as economic activity which has been improving although modestly so far this year. The jobless number (unemployment) continues to perform strongly with the jobless number continuing to decline from already low levels. Household spending and business fixed investment also continue to expand. However, inflation (excluding food and energy prices) has declined and is running below 2%. Indeed inflation remains stubbornly low.



Since January this year near term inflation has peaked and appears to be on the decline – not ideal.

**Consumer prices in the US** have increased at an average annual rate of 1.6% over the 12 month period ended June 2017. This rate continues to decline and will be an indicator that the US Fed is watching closely. Indeed, it is the lowest inflation rate since October 2016 when petrol prices declined. This is ongoing evidence that whilst we have some inflation, deflation remains strong.



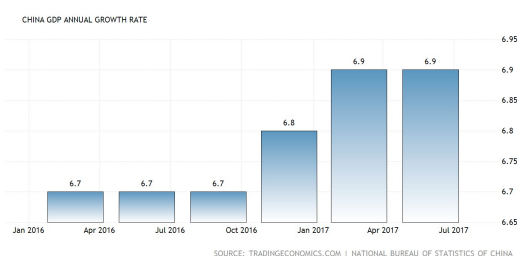
Consumer spending continues to rise which is useful at least in the short term.

**Consumer spending in the US is important** because over 60% of economic growth in the US

economy is based on consumption. Whilst we won't get into the discussion around how much of consumer spending is based on debt, at least for now, consumer spending is helping to support growth in the US economy.

**The US economy continues to grow although at a fragile and modest pace.** Donald Trump in my view will be a neutral impact on the US economy, particularly in the long term. He is pro growth and in the short term his impact may even be positive although I will be surprised if economic growth stays much beyond 3% for long. Trade with China and other economies will prove interesting.

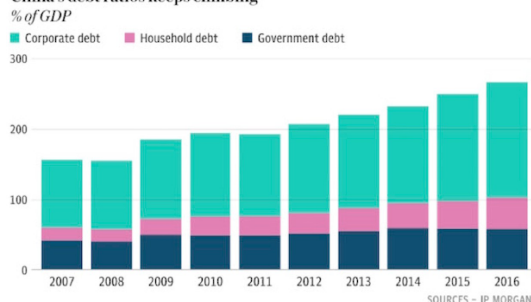
## China



Official figures from China show economic growth stable.

**The Chinese government in my opinion is vigorously** supporting economic growth in China. We know this because of their ongoing efforts on several fronts across the economy. Although it is difficult to know for sure, some estimates suggest that real economic growth sits at around 4% or so (difficult to know for sure) which is still remarkable given the size of the Chinese economy. The challenge for China and the rest of the world is to maintain economic balance and stability in order to avoid a rapid slowdown in the Chinese economy which would worry and impact on the global economy. It is common knowledge but worth mentioning that the increase in debt is an indication that stimulus is an important component of economic growth and stability and so the question becomes, how far can they go?

### China's debt ratios keeps climbing



China's debt continues to grow although currently it remains at a manageable level but for how long?

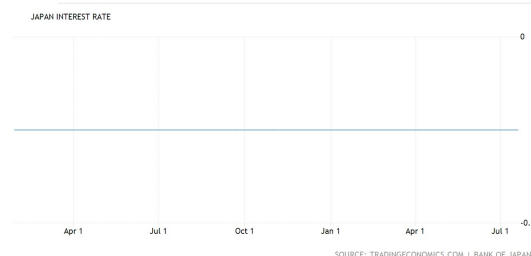
**China's debt continues to grow and whilst it remains at manageable levels** at some point (a bit like what the US economy is confronting now and in the future) the servicing of the debt becomes a drag on economic growth. Note in the chart at bottom left that household debt and even government debt is much less than corporate debt.

## Japan



Economic growth in Japan is actually quite good – at least for Japan.

**Japan's economy is now the fourth largest in the world** and is considered reasonably diversified and technologically advanced. Services in Japan account for around 62% of economic growth (as measured by GDP). Within services the most important are wholesale and retail trade (around 7% of GDP) and real estate (around 6% of GDP). Manufacturing is the engine of the Japanese economy and accounts for around 22% of economic growth.



What an interesting chart – notice the blue line and notice the top right hand corner, the number zero. Interest rates in Japan remain at a negative 0.1%.

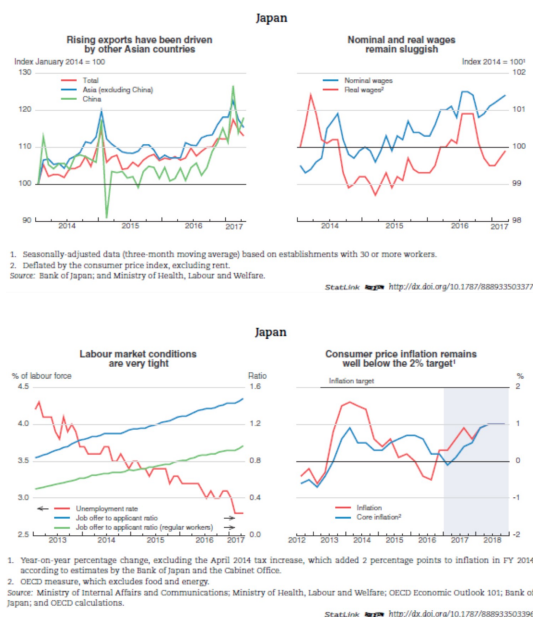
**The above chart is** quite self-explanatory and highlights the fact that deflation still has a strong grip on the Japanese economy although economic growth has improved of late.





*Inflation not surprisingly in Japan remains subdued.*

**Inflation in Japan is** running at about 0.4%, which is actually not bad when you consider that deflation remains very strong, even after 25 years of it. Japan is a good example of the fact that deflation is difficult for an economy to shake off. Japan has been increasing levels of debt in an attempt to stimulate the economy (otherwise known as “printing money”) which is possibly showing signs of having some impact but of course far too early to know whether or not it will indeed generate the desired outcome – hopefully it will! Otherwise Japan has a world of debt and little wriggle room because of already massive levels of debt.



*Economic growth has been supported by strong international trade in Asia along with significant fiscal stimulus. Consumer price inflation however remains sluggish.*

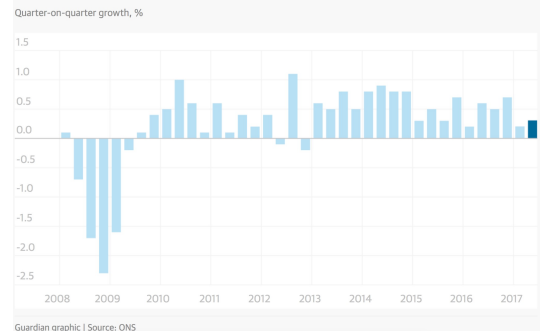
**Japan remains** a mixed bag although economic growth as measured by GDP has been increasing albeit at a modest pace. Looking bigger picture, Japan has been a strong player not only with its trading partners in Asia but in other countries around the world. Indeed Japan has become an increasingly integrated component in global value chains, especially in Asia. The benefits of international trade are largely concentrated in

the bigger firms in Japan although the number of smaller businesses that are starting to export is rising gradually.

Interestingly Japan still has a high level of support for farmers which could be reduced in part by lowering trade barriers which may also help to deepen Japan's integration in the world economy. Anyway, growth generally remains sluggish however the economy remains stable.

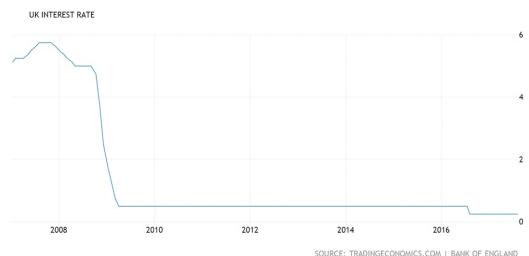
## The UK

Britain's economy expanded by 0.3% in the second quarter of 2017



*Although economic growth is underway it remains decidedly sluggish.*

**Economic growth in Britain is slower than preferred and looking more sluggish** when we compare it to France who grew 0.5% in both the first and second quarter of 2017, Spain who grew by 0.8% in the first quarter and 0.9% in the second quarter of 2017. Sweden grew 0.6% in the first quarter of this year and a significant 1.7% in the second quarter of 2017. Further, at the time of writing Ireland's central bank has increased its growth forecast for this year, expecting economic growth as measured by GDP to reach 4.5% up from the previously expected 3.5% it was predicting back in April. However, it mentioned that Brexit does pose a potentially significant contingent threat.



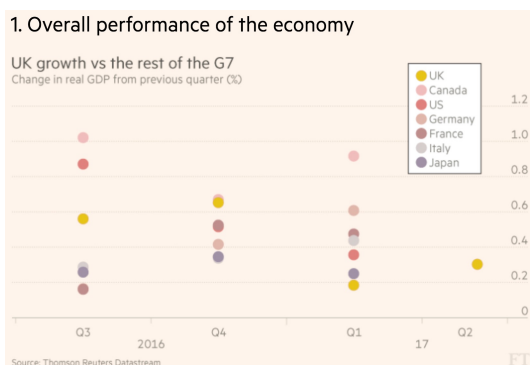
*Low interest rates tell the story ... there is lots of work to be done yet before the UK economy is “normalised”.*

**In June this year the Bank of England** voted by five to three to keep the bank rate at the record low of 0.25% as widely expected. That's because the economy in Britain whilst

having had a decent run over the last few years, does rely on central bank intervention to maintain economic stability and then there is Brexit ...

**Interestingly, Britain's economy** in its first year since the Brexit vote has in some ways been a tale of two stories. On the one hand the strong economic performance towards the end of 2016 has been followed up with weaker growth this year. It appears that households accelerated their spending before Christmas last year by possibly saving less and borrowing more. However as prices of goods and services rose faster than wages, consumers appear to have increasingly struggled in 2017 to cope with the squeeze on their finances. The result is that spending growth has slowed down a lot. The business sector remains mixed.

**Although many commentators and economists have been** more pessimistic since the Brexit vote, it appears that the weakness is more a reflection of recent economic activity as opposed to an appraisal of future prospects as a result of Brexit. Therefore the current weakness is not necessarily a locked in trend but could potentially be a shorter term "blip".



*Britain's economic growth has slipped compared to other members of the so-called G7.*

**Although the growth rate in Britain was** slightly improved at 0.3% in the second quarter of this year, it still remains "tepid" to paraphrase the International Monetary Fund, and quite a bit lower than the average of 0.5% that the UK has achieved since 2010.

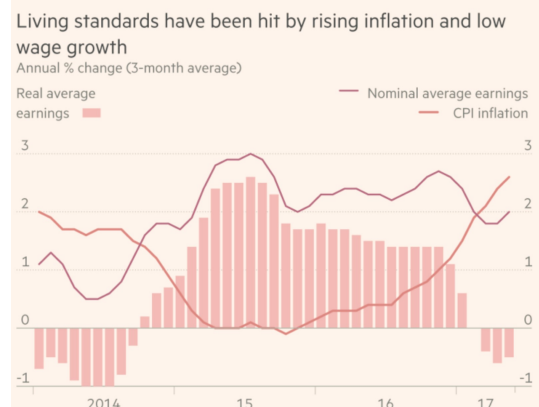
## 2. Household savings ratio



*Household savings have declined in favour of borrowing to fund consumption – not ideal.*

**Although it turns out there were** some anomalies in the numbers that helped make up the above chart, even taking those into account it appears that the overall finding remains unchanged and that spending by saving less after the Brexit vote could well be a trend, and one that cannot continue forever.

## 3. Living standards



*Increased expenses and costs since Brexit is contributing to a decline in living standards for households across the UK.*

**After adjusting for inflation,** household earnings have fallen from 1.5% in the three months before the EU referendum to negative in recent months. Recent data shows real wages falling at an annual rate of 0.5%. It seems that the decline in living standards for Brits is linked more closely to the rise in costs rather than a fall in the average wage. However both have played a part.

#### 4. Jobs

Unemployment is at a 40-year low  
Unemployment rate (% of labour force)



*Unemployment is low and continues to track lower.*

**Unemployment which has fallen from 4.9% to 4.5% in the past year** has reached its lowest point since 1975. Traditional economic thinking is puzzled to understand why when there is a reasonably high demand for employees and their skills that this has not translated into increased wages and growth in living standards.

**By the way** this is also a puzzle in the US economy too.

#### 5. Value of the pound

Sterling fell sharply after the Brexit referendum  
Sterling vs dollar and euro, rebased (23 Jun 2016 = 100)



*A lower pound means increased inflation for Brits and potentially a lower living standard.*

**The pound has plunged more than 10%** since the Brexit vote against both the US dollar and the Euro. So far recovery has not taken place. The sterling remains 11% down against the US dollar and 18% down against the Euro. Basically this change has caused the squeeze on household incomes across Britain but has yet to show any evidence of a pickup in British exports.

**Britain's economy whilst stable** is struggling to maintain sustainable growth. Interest rates remain low, supported by ongoing central bank intervention however unemployment still remains low with inflation moderate and the possibility of an uptake in exports to countries other than those in the Eurozone possible with a lower pound.

## The Euro Area

#### Euro area | Economic Indicators

Overview	Last	Reference	Previous	Range	Frequency
GDP Growth Rate	0.6 %	Mar/17	0.5	-3 : 1.3	Quarterly
Unemployment Rate	9.3 %	May/17	9.3	7.3 : 12.1	Monthly
Inflation Rate	1.3 %	Jun/17	1.4	-0.7 : 5	Monthly
Interest Rate	0 %	Jul/17	0	0 : 4.75	Daily
Balance of Trade	21418 EUR Billion	May/17	16831	-18510 : 30092	Monthly
Government Debt to GDP	89.2 %	Dec/16	90.3	65 : 92	Yearly

Markets	Last	Reference	Previous	Range	Frequency
Currency	1.17	Jul/17	1.17	0.7 : 1.87	Daily
Stock Market	3468 points	Jul/17	3493	1810 : 4558	Daily
Government Bond 10y	-0.42 %	Jul/17	-0.44	-0.5 : 2.57	Daily

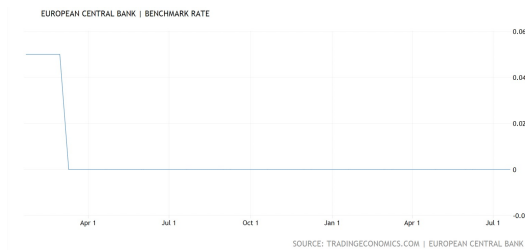
GDP	Last	Reference	Previous	Range	Frequency
GDP Growth Rate	0.6 %	Mar/17	0.5	-3 : 1.3	Quarterly
GDP Annual Growth Rate	1.9 %	Mar/17	1.8	-5.5 : 5	Quarterly
GDP	11886 USD Billion	Dec/16	11616	245 : 14115	Yearly
GDP Constant Prices	2548 EUR Billion	Mar/17	2533	1769 : 2548	Quarterly
Gross Fixed Capital Formation	532 EUR Billion	Mar/17	525	382 : 571	Quarterly
GDP per capita	39105 USD	Dec/16	38588	10807 : 39105	Yearly
GDP per capita PPP	38235 USD	Dec/16	37722	28126 : 38235	Yearly

Labour	Last	Reference	Previous	Range	Frequency
Unemployment Rate	9.3 %	May/17	9.3	7.3 : 12.1	Monthly
Employed Persons	155 Million	Mar/17	154	117 : 155	Quarterly
Unemployed Persons	14904 Thousand	May/17	14930	11368 : 19174	Monthly
Long Term Unemployment Rate	4.8 %	Dec/16	4.8	2.7 : 6.3	Quarterly
Youth Unemployment Rate	18.9 %	Mar/17	18.9	14.8 : 24.7	Monthly
Labour Costs	100 Index Points	Mar/17	112	85.1 : 112	Quarterly
Productivity	104 Index Points	Mar/17	104	82.6 : 104	Quarterly
Wages	1681 EUR/Month	Mar/16	1676	1302 : 1681	Quarterly
Wage Growth	1.4 %	Mar/17	1.6	0.8 : 3.4	Quarterly

*Economic growth whilst low remains steady. Interest rates remain at 0%.*

**The Eurozone economy expanded 0.6% for the first three months of 2017**, which is slightly better than the 0.5% in the previous period. This represents the strongest growth since the first quarter of 2015, boosted mainly by household consumption and fixed investment (investment in fixed assets such as machinery and buildings). This translates into economic growth of 1.9% over the year ending the first quarter of 2017. GDP annual growth in the Euro area averaged 1.63% from 1995 until 2017, reaching an all time high of 5% in the first quarter of 1995 and a record low of -5.50% in the first quarter of 2009.



Interest rates in the Euro area remain at 0%. The struggle continues ...

**The European Central Bank (ECB) held its benchmark refinancing rate at 0%** on July the 20<sup>th</sup> as widely expected. The bank also confirmed the ongoing asset purchases program is intended to remain in place at the current monthly rate of 60 billion Euros until the end of December 2017, or beyond if necessary. Ongoing central bank intervention remains a fact of life for the European economy "to a very substantial degree".

## The Euro Area and Brexit

### Key risks to euro area financial stability



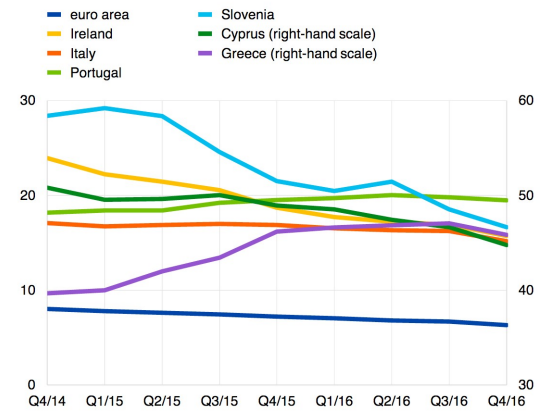
\* The colour indicates the cumulated level of risk, which is a combination of the probability of materialisation and an estimate of the likely systemic impact of the identified risk over the next 24 months, based on the judgement of the ECB's staff. The arrows indicate whether the risk has increased since the previous FSR.

*The European Central Bank has ruled out the possibility that Brexit could pose a major threat to the Euro area economy, rejecting warnings from the Bank of England that an untidy UK withdrawal could leave EU companies without vital services. Although the actual terms of Brexit have yet to be negotiated, the European Central Bank has taken the view that this will have limited implications for the Euro area economy and financial stability.*

Non-performing loans still remain high in a number of countries despite slight decreases in recent quarters

### Non-performing exposure ratios across euro area countries

(Q4 2014 – Q4 2016; percentages, euro area aggregates)



Source: ECB supervisory data.

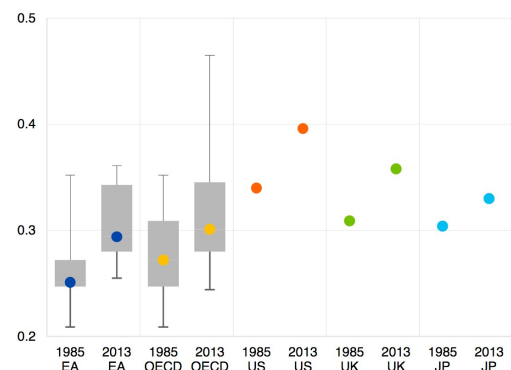
*Non-performing loans are a high risk for any economy but appear to be in hand at the moment in the Euro area.*

**Progress has been made in the Euro area** with some improvement in overall asset quality but the level of non-performing loans remains a serious problem still. It's manageable but fragile. Everything needs to go according to plan. Some of the improvement in this area is due to the writing off of some non-performing loans which helps things to look a bit better.

### Increase in income inequality over the past decades

#### Gini coefficients for selected advanced economies

(1985 and 2013; annual data, medians; for the euro area and the OECD, maximum, minimum, median and interquartile range)



Source: Organisation for Economic Co-operation and Development.

Note: The Gini coefficient is the most commonly used measure of statistical dispersion representing the income distribution in an economy. It can range between 0 and 1. Increasing values reflect higher levels of income inequality.

*Income or wealth inequality is not new but has surfaced in recent times.*

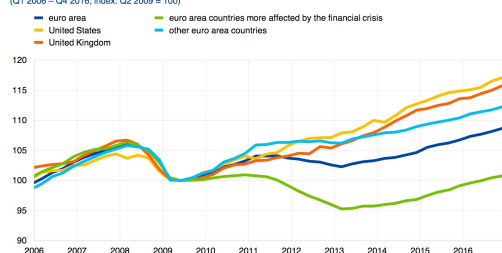
**Rising political and policy uncertainty may hinder economic growth in the future in the Euro area.** Indeed it is not just the Euro area but several countries around the world have seen increased political fragmentation and polarisation



over the last few years (e.g. Brexit, election of Donald Trump). One reason for rising political fragmentation is the increase in economic inequality that has become much more noticeable in recent times. As incomes become more dispersed, voters' preferences become more diverse with increased polarisation among electorates and the result is an increase in political fragmentation. In short, disenchanted majorities can significantly change the direction of an economy when these economies are taken down a path that is inconsistent with prudent economic stewardship.

The euro area economic recovery continues to lag that seen in international peers since the financial crisis

GDP levels in the euro area, the United States and the United Kingdom (Q1 2006 – Q4 2016; index: Q2 2009 = 100)



Sources: Eurostat and ECB calculations.

Note: Euro area countries more affected by the financial crisis include Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Spain.

Economic growth is slow and in particular the Euro area continues to lag other economies in terms of recovery from the Global Financial Crisis.

**Whilst recovery from the Global Financial Crisis across the Euro area remains slow compared** to other economies, we have seen a much more synchronised growth across the Euro area which is a promising sign.

**Economic recovery is expected** to proceed at a steady pace. A gradually improving global economy along with resilient domestic demand supported of course by very accommodative monetary policy, continued improvement in the labour market along with low oil prices and hopefully favourable economic sentiment may combine to provide sustainable economic recovery for the Euro area in the future. The Euro area is currently on track for economic growth as measured by real GDP growth of 1.8% for 2017, hopefully followed by further expansion at a similar pace in 2018 and 2019 – all things equal.

## Australia

### Australia | Economic Indicators

Overview	Last	Reference	Previous	Range	Frequency
GDP Growth Rate	0.3 %	Mar/17	1.1	-2.1 : 4.4	Quarterly
Unemployment Rate	5.6 %	Jul/17	5.6	4 : 11.2	Monthly
Inflation Rate	1.9 %	Jul/17	2.1	-1.3 : 23.9	Quarterly
Interest Rate	1.5 %	Jul/17	1.5	1.5 : 17.5	Daily
Balance of Trade	2471 AUD Million	May/17	90	-4144 : 4512	Monthly
Government Debt to GDP	41.1 %	Dec/16	37.6	9.7 : 41.1	Yearly

Markets	Last	Reference	Previous	Range	Frequency
Currency	0.8	Jul/17	0.8	0.48 : 1.1	Daily
Stock Market	5703 points	Jul/17	5785	1358 : 6829	Daily
Government Bond 10Y	2.68 %	Jul/17	2.7	1.83 : 16.5	Daily

Labour	Last	Reference	Previous	Range	Frequency
Unemployment Rate	5.6 %	Jul/17	5.6	4 : 11.2	Monthly
Employed Persons	12167 Thousand	Jul/17	12153	5996 : 12167	Monthly
Unemployed Persons	728 Thousand	Jul/17	715	364 : 958	Monthly
Full Time Employment	62000 Persons	Jul/17	63400	-80900 : 74900	Monthly
Part Time Employment	-48020 Persons	Jul/17	-15360	-72790 : 72790	Monthly
Employment Change	14000 Persons	Jul/17	38000	-74800 : 99500	Monthly
Labor Force Participation Rate	65 %	Jul/17	64.9	60.1 : 65.8	Monthly
Youth Unemployment Rate	13.1 %	Jul/17	12.7	7.61 : 20.22	Monthly
Labour Costs	99.3 Index Points	Jul/17	99.3	45.4 : 102	Quarterly
Productivity	102 Index Points	Mar/17	102	58.2 : 104	Quarterly
Job Vacancies	189 Thousand	Jul/17	186	28.4 : 190	Quarterly
Job Advertisements	175091	Jul/17	170545	69799 : 258097	Monthly
Wages	1164 AUD/Week	Dec/16	1161	59.1 : 1164	Quarterly
Minimum Wages	695 AUD/Week	Jul/17	673	544 : 695	Yearly
Wage Growth	1.9 %	Mar/17	1.9	1.9 : 4.3	Quarterly
Wages in Manufacturing	1295 AUD/Week	Dec/16	1283	333 : 1295	Quarterly
Population	24.13 Million	Dec/16	23.94	10.39 : 24.13	Yearly
Retirement Age Women	65.5	Jul/17	65	62 : 65.5	Yearly
Retirement Age Men	65.5	Jul/17	65	65 : 65.5	Yearly
Employment Rate	61.56 %	May/17	61.29	53.48 : 63.41	Monthly
Living Wage Family	2582 AUD/Month	Dec/16	2560	2550 : 2657	Quarterly
Living Wage Individual	2260 AUD/Month	Dec/16	2207	2173 : 2299	Quarterly
Wages High Skilled	5350 AUD/Month	Jul/16	6590	5000 : 6590	Quarterly

The Australian economy remains steady however economic growth sluggish of late.

**The Australian economy grew by 1.7% through the year to the end of March 2017**, which was slower than the 2.4% expansion in the prior quarter. This was the weakest annual expansion pace of growth since the September quarter of 2009. Economic expansion as measured by GDP in Australia averaged 3.47% from 1960 until 2017, reaching an all time high of 9% in the first quarter of 1967 and a record low of -3.4% in the second quarter of 1983.

AUSTRALIA GDP ANNUAL GROWTH RATE



SOURCE: TRADINGECONOMICS.COM | AUSTRALIAN BUREAU OF STATISTICS

Economic growth in Australia has been weak over the last 12 months but may not necessarily be a trend though.



Interest rates in Australia remain on hold.

**The Reserve Bank of Australia left the cash rate** unchanged at a record low of 1.5% during the recent meeting held on July 4<sup>th</sup>, which was widely expected. Policymakers have been watching the economic slowdown in the first quarter of 2017 which they regard as temporary. The Reserve Bank is looking for the economy to strengthen gradually with the transition to lower levels of mining investment following the mining investment boom coming to an end.



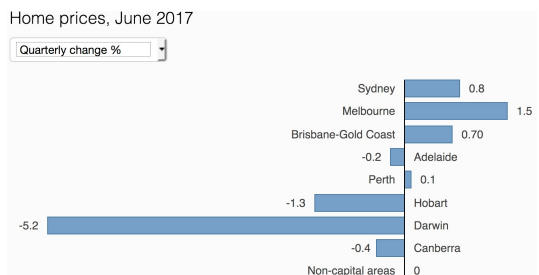
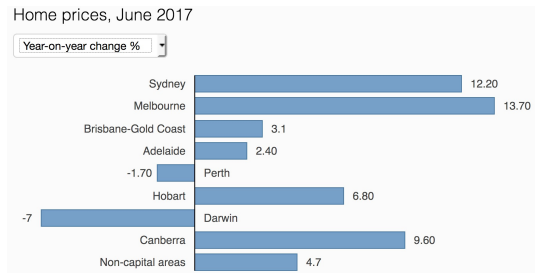
Inflation remains stable at around 1.8%.

**The core inflation rate in Australia increased** 1.8% in June 2017 over the same month in the previous year. Inflation in Australia is moderate but lower than would be preferred indicating deflationary impacts of the global economy and the absence of significant mining activity.

**Household debt** in Australia continues to rise (see chart below)...

Households Debt To Gdp by Country									
World	Europe	America	Asia	Africa	Australia	G20			
		Last	Previous	Highest	Lowest				
Switzerland		128.40	Dec/16	128	102	%	Quarterly		
Australia		123.10	Dec/16	123	125	34.2	%	Quarterly	
Netherlands		109.60	Dec/16	111	119	44.7	%	Quarterly	
Canada		101.00	Dec/16	101	101	33.2	%	Quarterly	
South Korea		92.80	Dec/16	91.6	92.8	1.4	%	Quarterly	
United Kingdom		87.60	Dec/16	87.6	97.1	29.2	%	Quarterly	
United States		79.50	Dec/16	79.4	95.5	23.4	%	Quarterly	
Spain		64.40	Dec/16	65.2	84.8	22.3	%	Quarterly	
Japan		62.50	Dec/16	62.2	74.4	20.7	%	Quarterly	
Euro Area		58.60	Dec/16	58.7	63.9	46	%	Quarterly	
France		57.40	Dec/16	57.1	57.4	18.6	%	Quarterly	
Germany		53.40	Dec/16	53.5	70.9	34.9	%	Quarterly	
China		44.40	Dec/16	43.2	44.4	11	%	Quarterly	
Italy		41.40	Dec/16	41.7	44	8.2	%	Quarterly	
Turkey		18.20	Dec/16	17.7	19.6	0.1	%	Quarterly	
Indonesia		17.00	Dec/16	16.7	17.1	6.2	%	Quarterly	
Mexico		16.40	Dec/16	16.5	16.5	8	%	Quarterly	
India		10.20	Dec/16	10.5	10.8	8.7	%	Quarterly	

Household debt to GDP is less than ideal for Australia – see chart bottom of left hand column (Australia is second from the top).



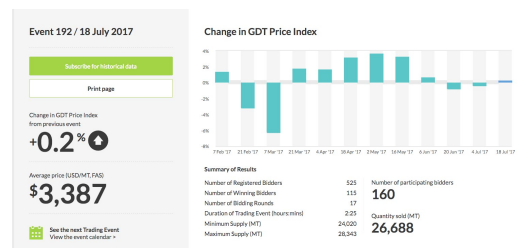
The first chart above shows the change in house prices over the 12 months ended June 2017. The second chart shows the change in house prices for the quarter ended June 2017.

**Some economists and research organisations (e.g. UBS Research) have suggested there is a high risk of a housing crash** in Australia however others point to a correction in prices and possibly a stagnation of prices for some time in the future. I am inclined to agree with the latter sentiment.

**Whilst economic growth has been soft** in Australia of late, this is likely a short-term event rather than a trend as the Australian economy remains stable and continues to grow albeit at a slower pace than it has in the past. The moderate growth outlook for Australia in the future is important of course because Australia is a major trading partner of New Zealand.

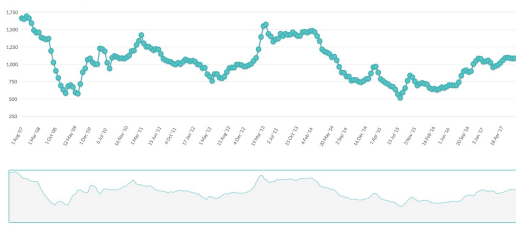
## New Zealand

### Dairy auction price



#### GDT Price Index over 10 years

The GDT Price Index is calculated from the total quantity sold in a Trading Event across all products, contract periods and sellers. For more information on the price index calculation, please go to our "New GDT Events work" page.



#### Explanatory Notes

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Quantity sold is the total quantity sold in a Trading Event across all products, contract periods and sellers. The quantity sold may be less than the minimum supply if the quantity bid on a product in the first bidding round was less than the minimum supply.

Minimum supply and maximum supply are the lower and upper bounds on the quantities the sellers wish to sell in the Trading Event. The maximum supply is also sometimes referred to as the seller's offer quantity.

Number of participating bidders is the number of bidders who entered a bid in the first round of the Trading Event.

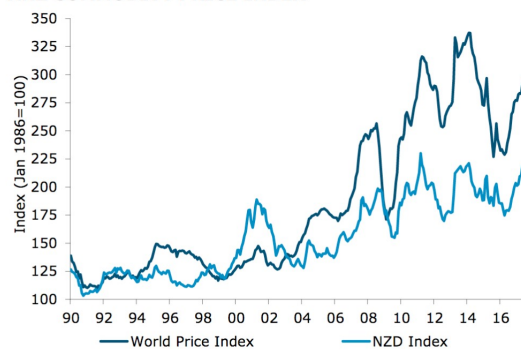
Average winning price is the quantity-weighted average of winning prices at the Trading Event. "N/A" for the winning price means that no prices were available for that contract period and therefore no average price was applicable.

"%a" for the percentage change in GDT Price Index means that no product was offered or sold, or no price was published for the last event, or on both of the two previous events. I.e. a change in GDT Price Index is only shown if there is a price available for the last event AND for at least one of the two previous events.

NZ: New Zealand, AU: Australia, US: United States, IN: India, EU: Europe, DE: Germany, SE: Sweden, UK: United Kingdom, DK: Denmark

**Milk prices remain above that all important \$3,000 breakeven level for farmers.**

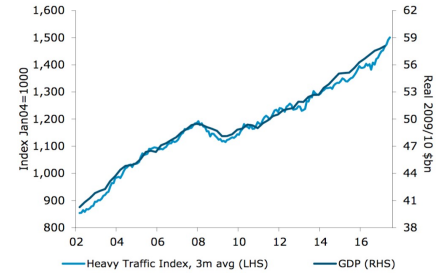
#### ANZ COMMODITY PRICE INDEX



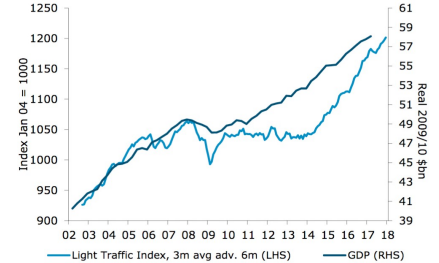
Source: ANZ

**Dairy prices increased 2.9% over the month of June when compared to the previous month and are up a significant 49% over the last 12 months. The increase was due to rises in butter, skim milk powder and cheese, and was also supported by flat production in Europe.**

#### GDP AND THE ANZ HEAVY TRAFFIC INDEX 3-MONTH AVERAGE



#### GDP AND THE ANZ LIGHT TRAFFIC INDEX 3-MONTH AVERAGE



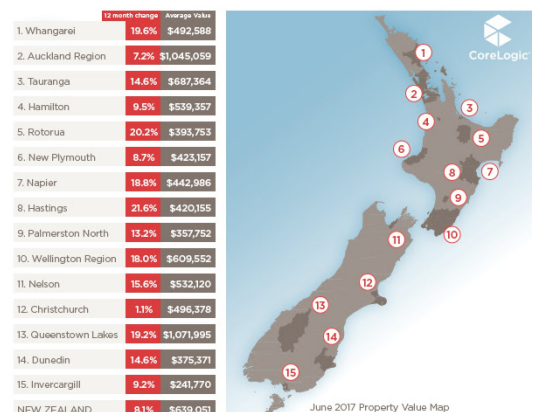
Source: ANZ, NZ Transport Agency, Statistics NZ

<sup>1</sup> The Kaikoura earthquake has seen a change in pattern of container freight at North Island ports, which has increased heavy traffic flows on State Highway 2. These impacts are likely to last for some time. We therefore make a statistical adjustment for this (2 sites).

**The ANZ truckometer indexes continue to suggest good times ahead for the New Zealand economy.**

**The ANZ heavy traffic index was** somewhat flat in June holding onto its strong 4.0% month on month May lift (seasonally adjusted). The upwards trend in the heavy traffic index looks strong. In theory the light traffic index may provide a six month lead on the direction of the economy moving forward. This index can be used to interpret the degree of momentum of economic growth. The ANZ economics department suggests economic growth above 3% year on year by the end of 2017 is a possibility.

## Residential property



**Residential property price growth appears to be slowing down somewhat.**

**Although the numbers in the above chart are historical (let's not forget that) levels of growth**

whilst mixed remain reasonably solid although it does depend where we look. Christchurch for example has basically flat lined for a year or two at less than 5% growth per annum with the most recent update showing growth over 12 months of 1.1%. Invercargill by comparison showed growth of 9.2% with Hastings coming out on top with growth in residential property prices at 21.6% for the 12 months ended June 2017.

**Although an unexpected credit crunch globally** could cause all kinds of havoc, in my view we are looking at a slowing down of price rises and potentially a period of slow or flat price increases for an undetermined period of time. Rising population in New Zealand along with still accommodative interest rates is helping to support property price increases at the moment along with property price expectations of the market.

**Interest rates are rising** and whilst those rises look likely to be slow and small, inevitably they impact on asset prices including residential property prices. Also government regulation looks like an increasing head wind for property prices in the not too distant future with restrictions in lending conditions already underway. It would appear that the next 20 years for residential property prices might look quite a bit different to the last 20 years. What do you think?

## Interest rates



*Interest rates remain on hold.*

**Interest rates are a key determinant of asset prices not just in New Zealand but worldwide.** The US Federal Reserve is in the process of raising interest rates. Here in New Zealand banks, having to fund some of their lending from offshore, are in turn having to pay higher prices for money which of course represents increased interest rates for New Zealand borrowers. This trend is likely to continue for the foreseeable future.

**Therefore we can expect** rising interest rates to place increasing pressure on assets whether it be shares or property. It is important to remember too that shares tend to be a leading indicator and property a lagging indicator.

When interest rates rise, share prices can correct quite suddenly which is nothing unusual for shares. Property on the other hand tends to be more of a lagging indicator and interest rates can take longer to impact but nonetheless will have an impact no different to shares in terms of the end result. Possibly a flattening of property price rises rather than an all out pricing crash would seem the most likely outcome from rising interest rates.



**The New Zealand economy like a number of other economies** around the world is stable and indeed tracking quite well all things considered.

Economic growth will likely be in the vicinity of 3% over the next 12 months although of course unexpected events can change that outlook in the blink of an eye. Dare I say it ... steady as we go for the New Zealand economy, at least for now.

## To Summarise ...

**The US economy remains stable** with economic growth somewhat fragile and slower than preferred with interest rates on the way up.

Donald Trump I believe will have a neutral impact on the US economy longer term and in the short term it is possible his impact could even be positive. However he is being challenged with regard to some of the reforms he campaigned on. That said whilst he may be an unusual politician, he does appear to have some underlying determination and won't be put off easily.

**Brexit** appears to be having limited impact economically at the moment however it still is too early to speculate on what might happen. My expectation is that there will be some tough negotiating between the Euro area and Britain. Interestingly Donald Trump signaled his enthusiasm for trade talks with Britain although the US is a tough bargainer when it comes to trade.

China's economic growth remains on track although undoubtedly supported by fiscal stimulus and increasing debt.

This brings us to Japan whose debt is massive and yet the economy remains stable. However, after 25 years or so of deflation, Japan has struggled to shake it off, despite significant increases in the central bank's balance sheet in order to stimulate economic activity and growth. That said there is some growth evident although it is slow and fragile.

I mentioned black swans in this update because John Mauldin, a gentleman that I have followed for probably 20 years out of the States, mentioned black swans which interestingly made the New Zealand media this month. That's why I thought I would mention it because it's in the popular media and so you may have stumbled across it?

John Mauldin as I say is someone I have followed for around 20 years because he makes sense (unlike the multitude of internet jockeys readily available whose self-interest is transparent and obvious – and their information lightweight). However John Mauldin is smart, informed and experienced however, he is someone who is looking for trouble.

To be clear, he is what is known as a "permabear" which just means that he is always looking on the dark side of things. He is very knowledgeable, smart and experienced and I know he has a significant following. For us as Value Investors, whilst he is worth a read from time to time particularly if you have the time to explore some of his material which can be quite in-depth, but we don't invest in economics, we invest in productive assets. That requires different information, different methodology and a different skill set.

**The global economy is struggling to maintain** projected growth and recently the IMF has

reduced its outlook for the global economy on at least three occasions that come to mind.

Economic growth may come in at a bit over 2% over the next 12 months as opposed to the 2.7% or so that it was predicting not so long ago. This is important because with global growth at say 2%, to expect investments to return say 10% or 12% over a lengthy period of time would appear to be unrealistic, unless economic growth and activity can rise to support increasing prices. Bear in mind that prices are already elevated.

The good news most certainly is that whilst there is always something ready to go wrong (John Mauldin can keep you entertained at length with that), the global economy nonetheless whilst growing slower than we prefer is stable and indeed is growing.

*"Democrats lead in all the polls by at least 10 points, except one ... Fox News. That is with a margin of error of plus or minus the facts."*

Stephen Colbert