First State Investments

Colonial First State Global Asset Management

First Insights.

APRIL 2017 – A quarterly publication from the Economic and Market Research team

Welcome to the April 2017 edition of First Insights, the quarterly publication from the Economic and Market Research (EMR) team.

In this edition of First Insights we look at the risks and opportunities developing in the UK and Europe. In the UK, the Brexit negotiations and the decision by Prime Minister May to call a snap election will be a clear focus for markets. In Europe, the focus will be on both the French and German elections, as well as the path of policy from the European Central Bank.

In addition, we provide our regular Market Watch and chart pack, as well as our forecasts for the key economies we cover and a summary of our research publications through Q1 2017.

If you have any comments or questions, please get in touch.

Stephen Halmarick
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Section 1

The UK and Europe: Risks and Opportunities

First Insights.

The UK and Europe

Each year since 2009, at least one member of the Economic and Market Research (EMR) team has produced a Travelling Economist report. These reports have covered countries as diverse as China, India, Japan, New Zealand, the UK and Europe and the US. Since 2014 one of the Travelling Economist report each year has been on the US – focussing on developments in the world's largest economy, the policy outlook for the Federal Reserve and the impact on financial markets.

For 2017 the plan is to go back to the UK and Europe. The focus will be to better understand the progress and implications of Brexit, the UK election and the outlook for the UK economy. In Europe, the focus will be on the implications of the French Presidential and parliamentary elections and the outlook for elections in Germany. The outlook for the banking system, especially in places like Italy, and the ongoing financing needs of Greece will also be important.

Of course, the most important issue is likely to be the path of monetary policy from the European Central Bank (ECB) and the implications of this for global financial markets.

This essay is to serve as a primer for the planned Travelling Economist trip later in the year and highlight the key developments that could impact on financial markets and that should be on the minds of investors.

The UK

Brexit

On 29 March, the British Prime Minister, Theresa May, wrote a letter to Donald Tusk, the President of the European Council, formally advising the UK's intention to leave the European Union (EU).

This official activation of Article 50 of the Lisbon Treaty sets in play a two year negotiation process to decide the terms and conditions of the UK's departure from the EU and, it is hoped, to decide on the new relationship between an independent UK and the EU. However, some EU leaders, especially Germany's Angela Merkel, have stated that they want the terms of conditions of the separation, including the exit bill to be paid by the UK, decided upon before negotiations on the new, post-exit, relationship take place.

That is, the UK wants the current and future negotiations to run parallel, while the EU wants them to run sequentially.

Rhetoric around the negotiations from the UK has been strong, including a threat to turn the UK into a tax haven if a good deal is not forthcoming and the "no deal is better than a bad deal" stance of many MPs. PM May did, however, go out of her way to stress that the decision to leave the EU was "no rejection of the values we share as fellow Europeans. Nor was it an attempt to harm" the EU. She also stated that "we are leaving the EU, but we are not leaving Europe – and we want to remain committed partners and allies to our friends across the continent."

PM May also set forth a list of proposed principles for discussion:

i. We should engage with one another constructively and respectfully, in the spirit of sincere cooperation.

ii. We should always put our citizens first.

iii. We should work towards securing a comprehensive agreement.

iv. We should work together to minimise disruption and give as much certainty as possible.

v. In particular, we must pay attention to the UK's unique relationship with the Republic of Ireland and the importance of the peace process in Northern Ireland.

vi. We should begin technical talks on detailed policy areas as soon as possible, but we should prioritise the biggest challenges.

vii. We should continue to work together to advance and protect our shared European values.

This is, of course, a large and significant list. Negotiating an agreement on separation and the future UK-EU relationship within two years looks like a very challenging task. And as described in the two break-out boxes below – there are areas of significant uncertainty.

In our regular research work and our proposed Travelling Economist trip later this year, we will be paying close attention to the progress of these negotiations and the implications for the UK economy, financial markets and policy.

For now, the next step in the process should be the 29 April European Council summit to agree on the negotiation guidelines. This will be followed in June by a summit between the UK and the 27 members of the EU to agree the process of negotiation. Then between June and November the European Council will agree on a negotiation mandate and begin formal negotiations with the UK – aiming to hit the March 2019 deadline.

EU citizens living in the UK

Currently there are 3.3 million EU citizens living in the UK. Their residential status is now unclear, with the UK Parliament refusing to act unilaterally to protect the residential rights of EU citizens currently living in the UK.

PM May has pledged to resolve the issue "at an early stage" of the negotiations – so long as the 27 EU members grant the same rights to UK citizens now living in the EU (of which there is approx. 1.2 million). The Mayor of London, Sadiq Khan, has stated that the EU citizens "need some reassurance about their future going forward and I was hoping that the government would give them guarantees that the future is secure. I'm looking forward to them having those reassurances sooner rather than later."

There seems a general sense within the UK and EU that the UK government is underestimating the concerns and potential impact on the labour market of the fate of EU citizens in the UK. As an example, Pret a Manger (the sandwich and coffee chain) report that only 1 in 50 of all job applicants in the UK are British. Not all of the non-Brits will be from the EU of course, but a large share would be. In addition, universities as prestigious as Oxford have expressed concerns that they may lose valued lecturers and researchers.

The fate of EU citizens living in the UK (and vice versa) will no doubt be a key part of the Brexit negotiation process.

UK Airlines operating in the EU

Aviation experts from the EU have warned that UK based airlines will no longer be able to fly between cities within the EU (ie. Rome to Frankfurt) once the UK leaves the EU. This is based on the view that to operate intra-EU routes, an airline must have a significant base on EU territory and be majority owned by EU members.

This means that airlines that are currently UK owned, may need to establish EU majority owned subsidiaries to continue flying intra-EU routes. This is likely to lead to job losses within the UK.

The 2017 Election

On 18 April PM May made the unexpected decision to call a snap election for 8 June 2017, well ahead of the scheduled end of her term in 2020 and despite an earlier promise to not call an early election. In calling the election May is hoping to capitalise on the double digit lead in the polls the Conservatives currently hold over Labour which is likely to lead to a stronger majority in the House of Commons. She is also seeking a strong mandate as she negotiates Britain's exit from the EU, strengthening her hand and shoring up support for her Brexit plan. Further, the early election pushes back the next scheduled election to 2022 (as opposed to 2020) extending the potential negotiating window with the EU and giving her more time to reach an agreement on the UK's new relationship with the EU without the pressure of an election.

While the election outcome is largely expected to be another strong showing for the Conservative party it does represent another political risk for Europe in an already crowded calender.

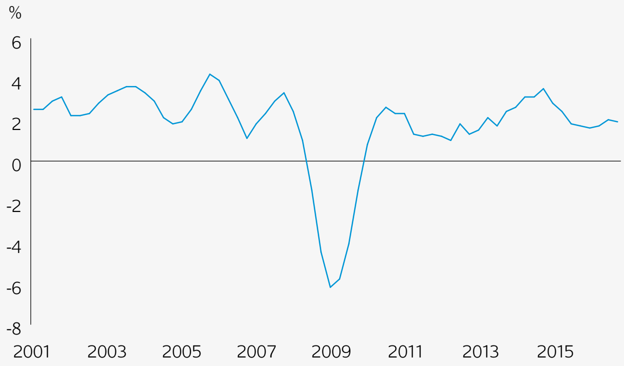
The UK Economy and Markets

The economic data in the UK has generally outperformed expectations in the months since the unexpected Brexit vote. 2016 GDP growth came in at a respectable 1.9%/yr.

We expect GDP growth to remain around 1.8%/yr in 2017, before a slowdown to around 1.5%/yr growth in 2018. A further slowdown to 1.25%/yr growth is expected in 2019 as the Brexit negotiation process weighs on economic activity.

However, downside risks for the out-years remain if negotiations around Brexit fail to come up with a solid new model for the UK's trading relationship with the EU.

Chart 1: UK GDP growth



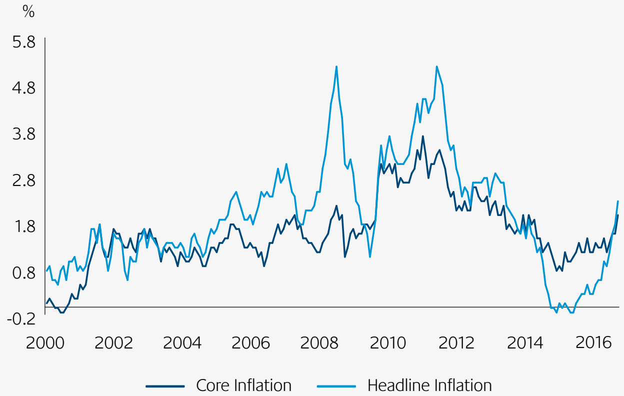
Source: Bloomberg, as at 31 December 2016.

The pace of inflation in the UK has accelerated in recent months, driven largely by the sharp weakening in the GBP and fluctuating oil prices.

From an average of 0.7%/yr in 2016, CPI inflation has jumped to 2.3%/yr as at March 2017. Inflation is expected to be above the BoE's 2% target in 2017 (f/c 2.5%) and 2018 (f/c 2.5%), before returning closer to target in 2019 (f/c 2.25%).

The BoE has signalled that monetary policy is likely to remain on hold for the foreseeable future, with the base rate at 0.25% and a £425bn annual pace of QE. We expect these monetary policy conditions to be retained through 2017, with some minor normalisation of policy in 2018 and 2019.

Chart 2: UK inflation



Source: Bloomberg, as at 31 March 2017.

Europe

Geo-politics

The biggest sources of risk in the EU this year are likely to be found in the political (and banking) sectors.

On the political front, three events are expected to dominate – the French Presidential election, the German general election and the negotiation strategy with the UK on Brexit (see above).

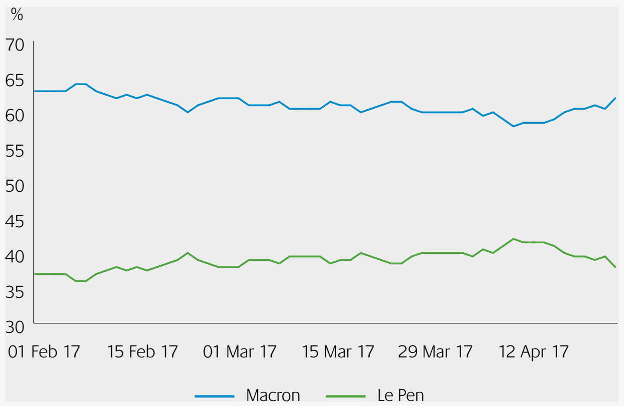
The French Presidential election will be held over two rounds. The first round of the election was held on 23 April, with 11 presidential candidates fighting it out.

Consistent with our expectations and opinion polls ahead of the vote, the two candidates who received the highest number of votes in the first round were Emmanuel Macron, the centre-left independent candidate and Marine Le Pen, from the far-right National Front. These two will now face off against each other in the second round on 7 May.

In terms of the first round results, Macron received just under 24% of the votes, with Le Pen at just under 22%. The other main candidates were: Fillon – Republican Party 19.5%, Melenchon from the socialist left 19.5% and Hamon from the Socialist Party at just 6.3%.

As shown in the chart below, the opinion polls show that Macron holds a substantial lead of 62% to 38% ahead of the second round vote to be held on 7 May.

Chart 3: French Presidential 2nd round election opinion poll



Source: Bloomberg as at 24 April 2017.

If the opinion polls are to be believed, Emmanuel Macron will be the next President of France.

This will be quite an achievement given that Macron is just 39 years old and only broke away from the Socialist government (where he was Minister for the Economy, Industry and Digital Affairs) in 2016 to set up his En Marche! movement.

Macron could best be described as a conventional pro-market, pro-trade, pro-EU politician from the centre-left part of the political spectrum. Macron has proposed to relax the 35-hour work week restrictions, convert President Hollande's temporary reduction of social security costs for firms into a permanent cut and significantly reduce the corporate tax rate from the current 33.5% to 25%.

In terms of social policy, Macron has promised to raise the minimum wage by €100 per month and increase public investment/infrastructure spending by around €50bn (equivalent to 2.25% of GDP). Macron has also proposed reducing France's budget deficit in support of the EU's demands for medium-term fiscal consolidation – mostly through a €60bn reduction in government expenditure. Macron has based his economic policies on expected growth of around 1.75%/yr during his 5 year term.

Marine Le Pen is the leader of National Front – the far right wing political movement. Perhaps Le Pen's most well-known policy, and the one that attracts the most concern is her push to hold a referendum on France leaving the EU – known as "Frexit".

Le Pen is also opposed to free trade, advocates protectionism for French industry and is against privatisation of government assets. She has also campaigned on an anti-immigration and socially conservative platform.

Generally, she is interested in turning France inwards, protecting industry and increasing spending on a number of groups within traditional French society – 'Make France Great Again', if you will. She is also very vocal on the supremacy of French law over EU law.

Her policies would likely cause significant financial risk in markets, a blow-out in France's budget deficit and lower structural economic growth.

In addition to the second round Presidential election on 7 May, France will hold Legislative elections for the 577-seat National Assembly on 11 and 18 June.

With both Macron and Le Pen from outside the major political parties, it will be critical to see how a National Assembly, dominated by traditional political parties, deals with one of these 'independent' Presidents.

The German general election will take place on 24 September 2017. Chancellor Angela Merkel (leader of the centre-right Christian Democratic Union, CDU) is running for a fourth term – a very difficult achievement.

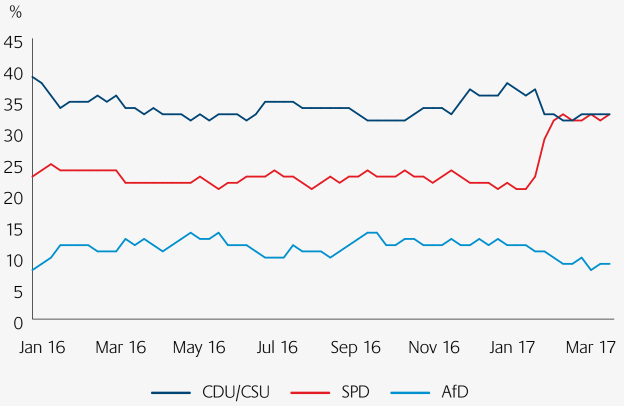
In March 2017 the centre-left Social Democratic Party (SPD) chose Martin Schulz as their leader and candidate for Chancellor. Martin Schulz is a former President of the European Parliament.

As shown in the chart below, the latest opinion polls have the CDU (Merkel) and the SPD (Schulz) neck-and-neck around 32%. At this stage, therefore, either Merkel or Schulz could be Chancellor post the election – although both would need to govern in some form of coalition.

Markets, however, seem relatively comfortable with either prospect – as both Merkel and Schulz would likely retain Germany's strong commitment to the EU and pro-market economic policies.

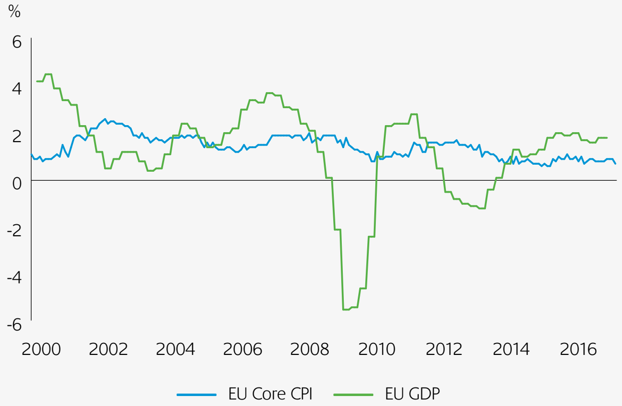
Opinion polls also show that the far-right Alternative for Germany (AfD) are currently polling around 10%, down from their peak in 2016 of closer to 15%.

Chart 4: German opinion polls



Source: Bloomberg. As at 22 March 2017.

Chart 5: EU GDP growth and Core inflation



Source: Bloomberg. GDP data to 31 December 2016. CPI data to 31 March 2017.

The Economy

As detailed in our forecasts, we expect the EU economy to continue to grow modestly in 2017, with growth of around 1.5%/yr, compared with the 1.9%/yr outcome for 2016.

Growth should be supported by the very easy stance of monetary policy, and some minor support, if not neutral, from fiscal policy. This is helping see a recovery in domestic spending, while business investment is also picking up. The weaker EUR should also help those EU countries that are heavily export orientated, ie. Germany.

Importantly, downside risks to the economic outlook look to have faded a little (excluding the political risks mentioned above) and this is leading to a more balanced outlook for the EU economy this year.

Some downside risks do remain, however, such as any anti-trade rhetoric from the US, Brexit developments and the fragile nature of the banking system in some EU nations.

Headline inflation in the EU is likely to rise to around 1.5%/yr in 2017, well up from 0.3%/yr in 2016. The biggest swing factor here is the changing price of oil/energy.

Core inflation is still likely to rise in 2017, but to a much lesser extent – keeping the ECB on the sidelines. The key factor behind the expected upward drift in core inflation is the gradual tightening of the labour market underway and some signs of wages pressures.

The ECB

After adjusting its monetary policy stance in late 2016, we expect the European Central Bank (ECB) to maintain the current stance of monetary policy in 2017 – with €60bn of asset purchases per month planned until December 2017 and a deposit facility rate of -0.4%.

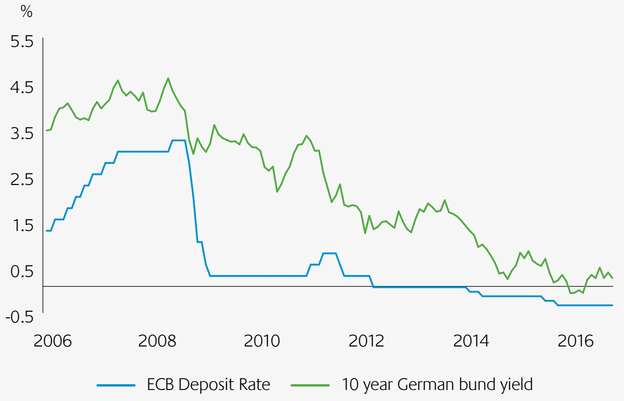
What could change in the months ahead, however, is a shift in the ECB's bias – with the ECB likely to alter its bias from downside risks to a balanced assessment, perhaps around mid-year.

This could then set up the ECB, assuming the modest growth path persists, to further 'taper' its QE program in 2018 and signal a potential increase in the deposit facility rate to 0%.

This should help limit the sell-off in the EU bond market from any pressure for higher bond yields – especially coming from the US. A widening interest rate spread with the US should also put further downward pressure on the EUR – something the ECB is unlikely to resist.

Ongoing low interest rates and a weaker EUR over 2017 should act to support the European equity markets and the economy more generally. However as detailed above a number of geopolitical risks could increase volatility in EU financial markets over 2017.

Chart 6: German bund 10yr yield and ECB Deposit Facility rate



Source: Bloomberg, data to 12 April 2017.

Section 2

Market Watch – Our Quarterly Market Review

Political concerns remained front and centre over the first quarter of the year, with no shortage of headlines around the globe. In the US, markets in the first two months of the quarter were boosted by Present Trump's aggressive legislative agenda post his inauguration on 20 January 2017. There was hope that tax reform, infrastructure spending and changes to the health care system would lift potential economic growth in the US. However once the difficult reality of passing legislation and the partisan political environment sunk in, markets took a breather in March. Elsewhere elections in the Netherlands and the upcoming Presidential elections in France saw volatility in European markets, particularly through government bond yields. In the UK, Article 50 was activated late in the quarter. In Asia, markets largely reacted to global events, with concerns over potential trade and economic policy changes in the US front of mind, while Chinese economic data continued to show stability ahead of key political changes in November.

In a widely anticipated move, the Federal Reserve Open Market Committee (FOMC) delivered its third rate hike, increasing the Fed Funds rate by 25bps to 0.75%-1.00%. This follows moves in December 2015 and December 2016 and shows a new, more active phase to monetary policy by the Federal Reserve. Given this move was highly signalled by the FOMC there was limited reaction in financial markets. The move did reignite debate on the number of interest rate hikes expected in 2017 and the timing of measures to unwind the $US4.5tr balance sheet. The European Central Bank (ECB) remained committed to its ultra-accommodative policy stance despite some improvements in the economic data. The Bank of England (BOE) meanwhile held policy unchanged although there was one dissenter at its March meeting who called for rates to move higher. The Bank of Japan (BoJ) held the cash rate steady at -0.1% in the quarter and defended the 10yr JGB target rate at 0.0% over the quarter. While in Australia, the Reserve Bank of Australia (RBA), as widely expected, left the cash rate unchanged at 1.5%. The signals from the RBA continue to suggest that the hurdle to another rate cut is high with increasing risks in the housing market a rising concern; the most likely outcome will be rates on hold for all of 2017.

Commodity prices were mixed over the quarter with oil prices down from their recent highs while bulk commodity and precious metal prices rose over the quarter. The price of West Texas Crude was relatively steady in January and February before large falls in March. There were reports that OPEC compliance of production cuts had slipped in March and there were further signs of an increase in US oil inventories, while the US oil rig count, as measured by Baker Hughes, increased 26% in the quarter to 665. The price of West Texas Intermediate fell 5.8% to $US 50.6/bbl while the price of Brent Crude fell 8.4% to $US53.5/bbl. US gas prices as measured by the Henry Hub spot price fell 15.8% as expectations rose that President Trump would rewind some environmental regulations put in place by his predecessor, this was confirmed late in the quarter. The iron ore price, as measured by the benchmark price delivered to Qingdao China – 62% Ferrous Content rose 1.9% over the quarter to $US80.39/metric tonne, although this hides sharp gains in February and then reversal in March. Coal prices, as measured at the Newcastle Coal Terminal, also fell over the quarter by 8.7% to close at $US 80.8/metric tonne. Base metals were predominantly stronger, apart from tin (-4.5%) with copper (+5.5%), zinc (+7.6%), lead (+16.0%) and aluminium (+15.9%) all higher. Gold rose 8.4% to $US1,249.4 an ounce and Silver was one of the strongest performers, up 14.7% in the quarter.

With the economic environment favourable to risk assets and volatility low, global equity markets rose sharply in January and February before steadying in March. The catalyst was the failure of Republicans to agree on a bill to repeal the Affordable Care Act with the proposed bill pulled from the House of Representatives before a vote could take place. President Trump and Congress will now turn their attention to tax reform which could take till early 2018 to enact and where equity market expectations for corporate tax cuts are high. As a result doubts emerged about the reflation trade priced in to markets post President Trump's election. Sentiment in Emerging Markets improved with a weaker US dollar and higher commodity prices, while potential for anti-trade policies did not emerge from President Trump. The MSCI World Index rose 5.9% in the quarter in US dollar terms and fell 0.1% in Australian dollar terms, given the 6.0% appreciation of the Australian dollar over the quarter against the US dollar.

The Chicago Board Options Exchange SPX Volatility Index, a market estimate of future volatility, remained low over the quarter after last spiking around the US Election in early November. The VIX Index started the quarter at 14.0 and finished at 12.4 and averaged 11.7 over the quarter. This was the lowest quarter average since Q4 2006.

In the US, the S&P500 Index rose 5.5% in the quarter, once again reaching new all-time highs on 1 March 2016 before retreating into quarter-end. The Dow Jones rose +4.6% while the NASDAQ performed strongly, rising 9.8%. The Dow Jones continued to outperform other indices as sentiment towards industrials improved with the prospect of tax cuts and infrastructure spending. On a sector basis, MSCI Information Technology (+12.0%) was the star performer while MSCI Health Care (+7.8%) performed well despite the political uncertainty surrounding the sector. MSCI Energy (-5.6%) was the weakest performer, moving lower with the fall in oil prices over the quarter.

European equities followed US equities higher over the quarter despite the geopolitical risks in the region. The economic backdrop continued to improve with leading indicators such as the Purchasing Managers Index for both Manufacturing and the Services sector improving significantly, while monetary policy remains extremely accommodative. Overall the Euro Stoxx 50 Index rose 6.4%, banks drove much of this increase with the EURO Stoxx Bank index rising 8.7% in the quarter following a sharp 27% increase in the December 2016 quarter. In other equity markets, Spain was the top performer, rising 11.9% while Germany (+7.2%), France (+5.4%), Italy (+6.5%) and the Netherlands (+6.9%) all rose. While the Dutch elections loomed as a threat, the far-right party led by Geert Wilders failed to draw as much support as expected, meanwhile in France the lead-up to the first round Presidential vote on 23 April appeared to be a race between Marine Le Pen from the National Front and Emmanuel Macron from the centrist En Marche party.

UK equity markets also rose over the quarter although gains were muted compared to other regions. The FTSE100 rose 2.5% in Q1 2017 with Prime Minister Theresa May officially activating Article 50 in the quarter starting the clock on the two-year time frame to negotiate the exit from the European Union. The Japanese equity market retreated over the quarter, with the Nikkei down 1.1%, the Japanese yen appreciated 4.8% against the USD to end the quarter at JPY111.39.

Emerging markets recovered over Q1 17 after falling sharply post US election in November. The MSCI EM (Emerging Markets) Index rose 11.2% in US dollar terms and 4.9% in Australian dollar terms. Improvements in commodity prices, a weaker US dollar and less rhetoric on trade policy from incoming US President Donald Trump helped Emerging Markets recover. On a regional basis the MSCI EM Europe, Middle East & Africa underperformed, rising 2.1% with falls in Russia holding the region back. The MSCI EM Asia (+13.2%) and MSCI EM Latin America (+11.6%) both rose.

The S&P/ASX 200 Accumulation Index posted healthy gains in the March quarter, rising 4.8% to finish at its highest level for almost two years. In sharp contrast to the previous quarter, Health Care (+14.8%) was the best performing sector in the Australian share market. Performance was mostly driven by biotechnology company CSL, which comprises around half of the Health Care sector by market capitalisation. CSL added more than 25% during the quarter after posting a profit upgrade in January and strong results in February. Sirtex Medical enjoyed similar strong performance, recovering some of the sharp losses experienced in December 2016. Telcos (-4.6%) was the market's laggard by some margin. Healthy gains from mid-cap Vocus Group wasn't enough to offset losses from sector giant Telstra. Property Trusts also struggled, as bond proxy sectors lagged in an environment of rising bond yields and interest rates.

The movement in government bond yields differed by regions as differing political back drops and central bank moves were at play. Bond yields in Europe moved the most in the quarter with 10-year German bunds up 12 bps to 0.33% with geopolitical risks and improving economic data helping to drive yields up. UK 10-year gilts were 10 bps down to 1.14%, US yields were 6 bps down to 2.39% despite the US Federal Reserve lifting official rates whilst Japanese bond yields rose 2 bps in the quarter as they continue to trade notably range bound. In Australia yields largely followed the direction of US yields with the RBA firmly on hold, yields (whilst trading in a 35 bps range) ultimately ended the quarter only marginally lower, with the 10-year yield down 6 bps to 2.70%. Global investment grade credit spreads ground tighter overall in the quarter amidst but continued to be resilient to the unfolding political events.

United States

The US Fed – a new more active phase in policy

- On 15 March 2017, the US Federal Reserve Open Market Committee (FOMC) raised the official Fed Funds target rate to 0.75%-1.00%, a lift of 25 basis points and was widely expected by financial markets.
- After a very slow start to its monetary policy normalisation process, with one rate hike in both 2015 and 2016, this latest hike signals a new more active phase for monetary policy.
- There was little change to the accompanying statement, highlighting continued strengthening in the labour market and moderate expansion in economic growth.
- The Fed's own expectation for the future path of monetary policy, the "dot plot" for 2017 remained at three rate hikes in total, so two more expected this year.
- This new phase represents a desire to have monetary policy return to a more normal setting in an environment where the Fed is much more confident of achieving its dual mandate. In addition, while it remains very unclear what policies President Trump will be able to implement, it does seem possible that fiscal policy easing is in prospect, although the exact timing of this and its impact on the economy is very much still up in the air.
- As Chart 1 shows, the market has priced in the chance of more rate rises this year, compared to early 2017. Our own expectation is for two further rate hikes in 2017 (most likely June and September).
- At the March FOMC meeting, it was noted in a discussion around the future of the balance sheet "most participants anticipated that gradual increases in the federal funds rate would continue and judged that a change to the Committee's reinvestment policy would likely be appropriate later this year."
- As Chart 2 shows, the Fed's balance sheet has risen from just under $US1tr pre GFC to $US4.5 tr, owning $US2.4tr of Treasury securities and $US1.8tr of mortgage-backed securities. Our expectation is that the Fed will begin to taper reinvestments late 2017, most likely at its December 2017 meeting, with Chair Yellen likely to want a plan in place and started before her term expires in February 2018.

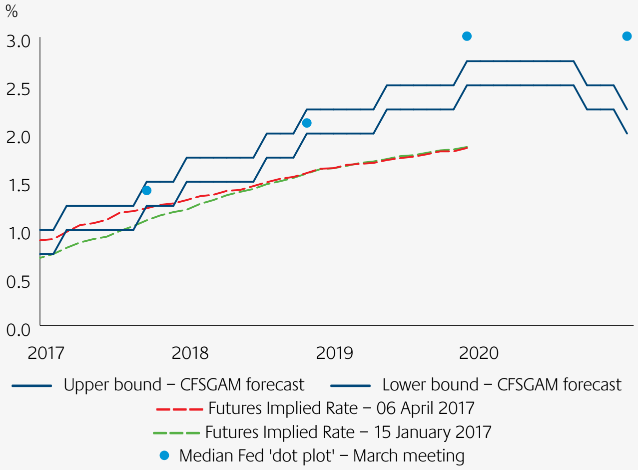
Hard data versus soft data

- Over the quarter there has been a growing disconnect between improvements in "soft" data in the US, such as consumer and business confidence readings and "hard" data, such as retail sales and durable goods orders. Just about all the improvements in economic data have been in the "soft" data, the so called "Trump" effect. To put it another way – the confidence or 'animal spirits' data in the US is showing a clear move higher, especially since the election of President Trump, but the actual real economic data is yet to move higher.
- The Conference Board Consumer Confidence Index rose 10.9% in the quarter to the highest level since December 2000. Similarly, the NFIB Small Optimism Index has risen sharply since the election, up 7%, as Chart 3 shows.
- The concern is that if President Trump can not follow through with his aggressive economic plans, particularly as the Republican and Democratic parties vote along party lines animal spirits may fade away and equity markets could reprice a more realistic outlook. As Chart 4 shows, partisan conflict has risen in recent years leading to a more challenging political outlook.
- This was demonstrated through the failure of the Republican Party to enact its much hyped health care reform.

Employment gains continue, wages increasing

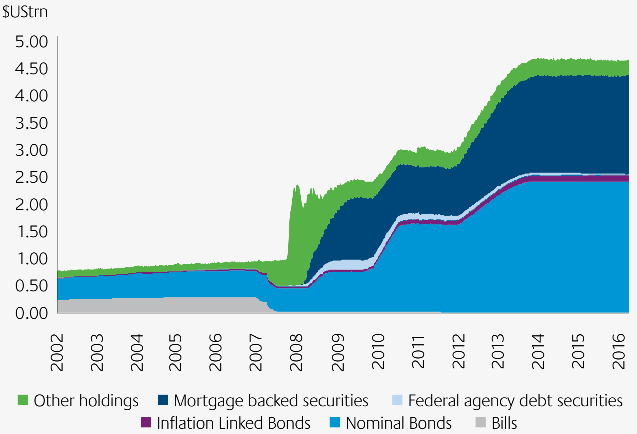
- A total of 533k jobs were added over the first quarter of 2017, with the unemployment rate also falling from 4.7% to 4.5% over the period.
- While average hourly earnings increased 0.2%/mth in March, taking the annual rate to 2.7%/yr, still below what would be expected given the gains in employment. See Chart 6, which also shows an increasing trend of job openings being hard to fill.

Chart 1: US monetary policy continues its upward path



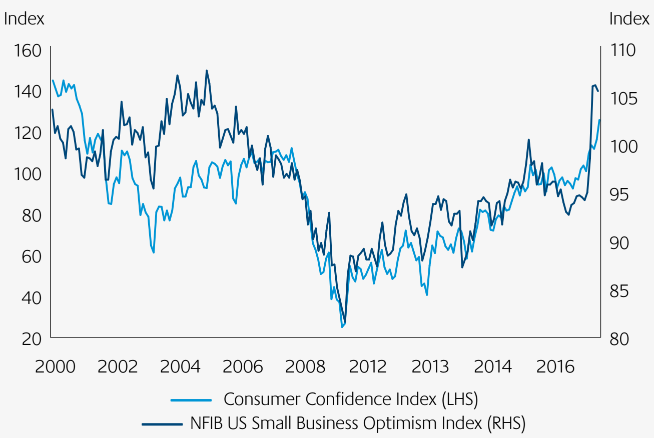
Source: Bloomberg, data to 6 April 2017. Fed 'dots' as at March 2017. CFSGAM forecasts as at 13 March 2017.

Chart 2: The Fed is likely to begin shrinking their balance sheet soon



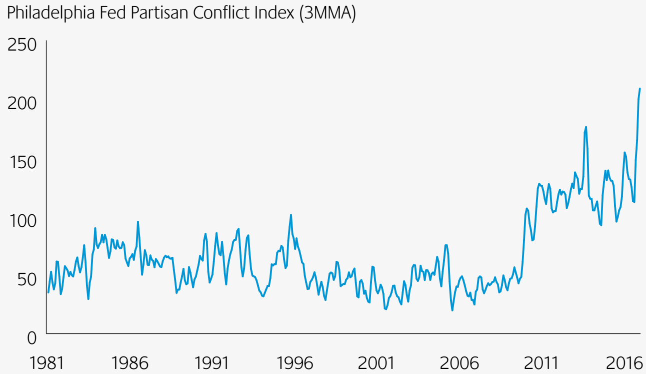
Source: Bloomberg. Data to 29 March 2017.

Chart 3: Confidence has picked up but will the real data follow



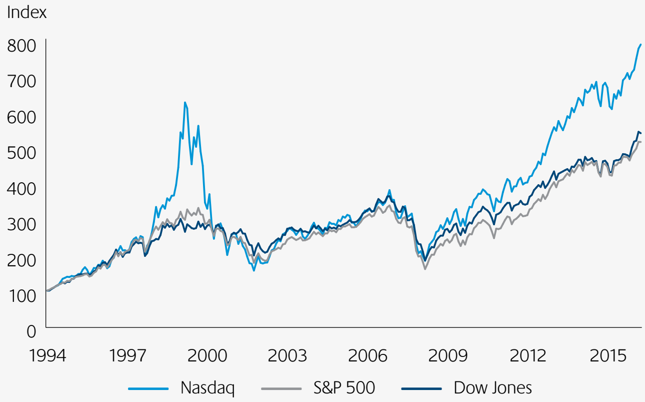
Source: Bloomberg. Data to March 2017.

Chart 4: Legislating will not be easy with partisan conflict at an all-time high



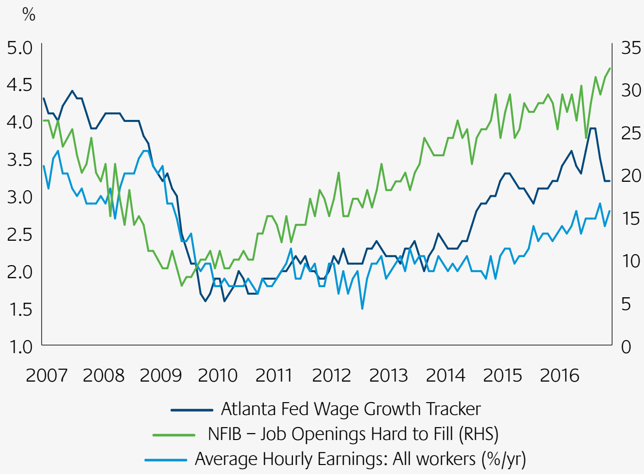
Source: Bloomberg. Data to February 2017.

Chart 5: Equity markets are pricing in a lot of good news



Source: Bloomberg. Data to 6 April 2017. Index started at 100 in 1994.

Chart 6: Wage pressure is slowly beginning to grow



Source: Bloomberg. Data to February 2017.

Europe

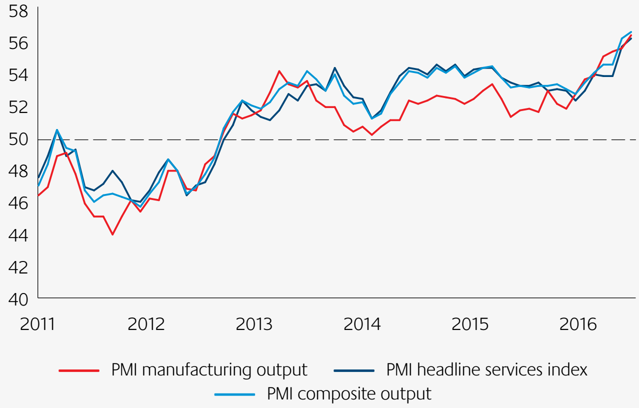
Cyclical economic upswing underway

- Outside of the geopolitical risks in Europe this year, there is a clear cyclical economic improvement underway. This can be seen in the Markit Purchasing Managers Index, with the Manufacturing Index rising to 56.2 in March 2017, from 54.9 in December 2016. The Services PMI rose to 56.0 in March 2017, up from 53.7 in December 2016. Improvements in both Germany and France helped propel the index to the highest level in at least five years. See Chart 7 for details.
- GDP figures for Q4 16 were confirmed at 0.5%/qtr and annual growth for Q4 2016 remained at 1.8%/yr where it was in Q3 16.
- The stable aggregate growth figures do however continue to hide significant divergence between countries, Spain (+3.0%/yr) remains the best performing of the major economies, Germany (+1.7%/yr) is growing at around the Eurozone average while France (+1.1%/yr) and Italy (+1%/yr) continue to underperform.
- Other economic data continues to improve as well. The unemployment rate fell to 9.5% in February 2017, down from 9.7% as of three months earlier. Inflation was recorded at 1.5%/yr in March, up from 1.1% in December 2016, with rising energy prices helping propel the inflation rate up. See Chart 8 for details.

The ECB on hold, markets are focussing on the politics

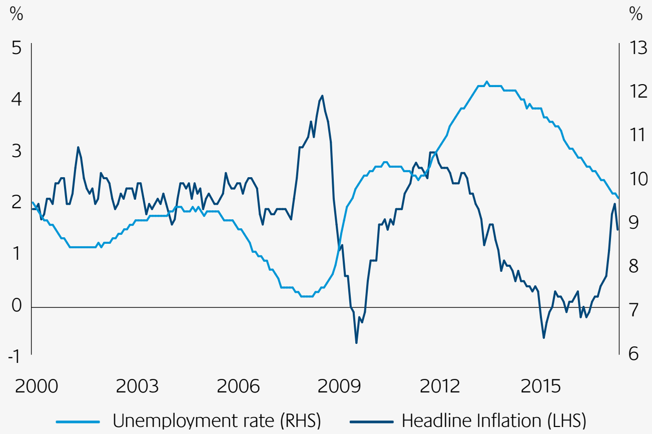
- The European Central Bank (ECB) made no changes to policy over the quarter. The Governing Council continues to expect the key ECB interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of net asset purchases.
- March is the last month of €80bn of net asset purchases, with as of April this amount falling to €60bn per month until the end of December 2017, or beyond if necessary.
- Over the quarter political risks, particularly upcoming elections in France, and the Netherlands elections over the quarter has seen bond yields for countries such as France, Italy, and a lesser degree Spain rise compared to Germany. See Chart 9 for details.

Chart 7: EU PMIs have picked up



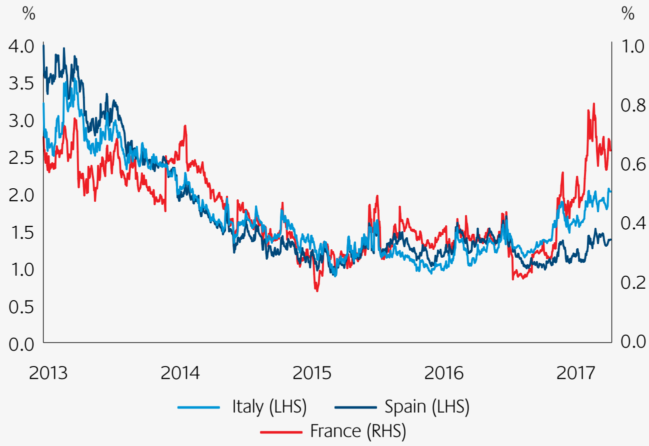
Source: Bloomberg. Data to 31 March 2017.

Chart 8: Unemployment continues to decline as inflation picks up



Source: Bloomberg. Data to 31 March 2017.

Chart 9: Spreads have reacted to political risk



Source: Bloomberg. Data to 7 April 2017.

United Kingdom

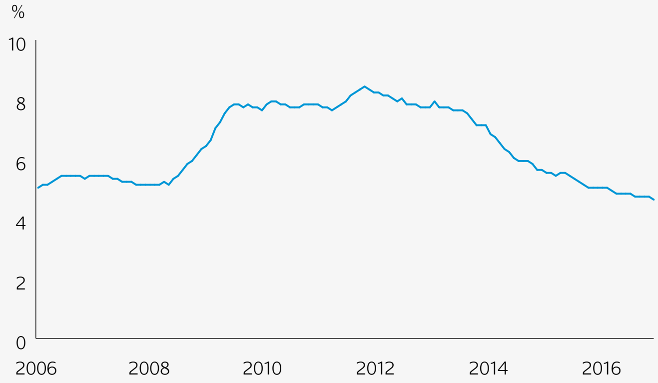
Activation of Article 50

- The key news in the UK over the quarter was Prime Minister Theresa May officially activating Article 50 on the 29 March 2017, starting the clock on the two-year timeframe to negotiate the terms of the exit and a new deal with the EU.
- As expected the UK wants to reach agreement on a comprehensive new deal with the EU27 in parallel with the terms of the exit by March 2019. The EU27 opposes this view, as detailed by EU Council President Tusk. The next steps are expected by 27 April when the EU Council will convene to determine the broad framework for the negotiations with detailed negotiation. See the main essay for more details.

Inflation picking up but bond yields lower

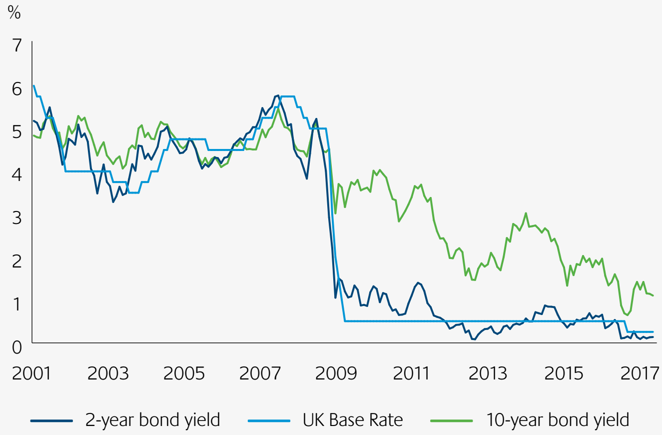
- The annual rate of inflation rose to 2.3%/yr in March 2017 (from 1.8% in December 2016 and just 0.5% in March 2016), with the core CPI up 1.8%/yr in March 2017 (from 1.5%/yr). See Chart 12 for details. The pass through from the weaker pound has led to higher inflation earlier than most expected. Against the US dollar the Great British Pound is down 12.6% for the 12 months to March 2017. This is impacting food price inflation and starting to feed through into core good inflation.
- This increase in inflation is expected to continue into 2017 and 2018. The key question is whether this will lead the Bank of England (BoE) to increase the Bank Rate.
- The BoE left the Bank Rate on hold over the quarter, as was widely expected. However one member, Kristen Forbes, did consider it appropriate to raise the Bank Rate by 25 basis.
- With the inflation rate currently at 2.3%, it is higher than the BoE forecast for Q1 17, at this stage though, bond yields, as shown in Chart 11 have not reacted, with little reason on the growth side for the BoE to hike rates, they will have to, at least for now, lift their inflation forecast for 2017.
- The unemployment rate, as seen in Chart 10 fell to 4.7% for the three months to January 2017, although wages as of yet do not show a clear upward trend adding to the on hold argument.

Chart 10: UK unemployment continues to decline



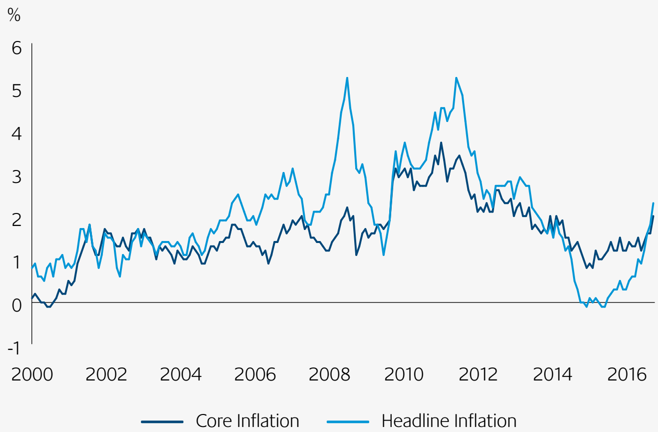
Source: Bloomberg. Data to 28 February 2017.

Chart 11: Yields remain low despite political risks



Source: Bloomberg. Data to 7 April 2017.

Chart 12: UK inflation picking up



Source: Bloomberg. Data to 28 February 2017.

Japan

Inflation remains in positive territory

- The CPI has remained in positive territory for five consecutive months, and is now up 0.3%/yr as at February 2017, down slightly from three months earlier at 0.5%/yr in November 2016.
- However the core measure excluding food and energy retreated, down to -0.1%/yr to February 2017, compared to +0.1%/yr to September 2016. Higher energy prices led to the gain in headline inflation at the expense of core inflation. Both measures are well below the BoJ's 2% target. See Chart 13.
- GDP growth was 0.3%/qtr in Q4 16, increasing the annual rate to 1.6%/yr up from 1.1%/yr in Q3 16. The Tankan large manufacturing index also rose to +12 in Q1 17 (from +10), with the large non-manufacturing index up to +20, from +18.

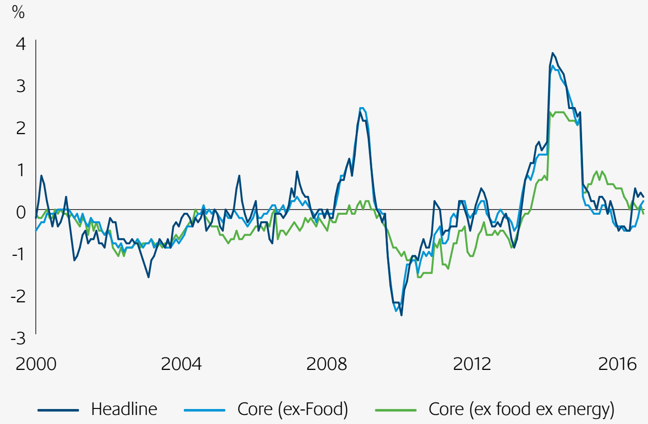
Bank of Japan (BoJ) holds policy

- The Bank of Japan (BoJ) held the cash rate steady at -0.1% and the 10yr JGB target rate at 0.0% over the quarter. See Chart 14.
- The BoJ remains focussed on the underlying inflation trend, this is based on both inflation expectations and the output gap and is unlikely to change policy and lift the 10-year JGB target until underlying inflation expectations are rising.
- At this stage one positive is the tight labour market. The unemployment rate fell to 2.8% in February 2017, down from 3.1% three months prior. This will need to flow through to wage gains for inflation to move higher. The Spring wage negotiations have to date failed to provide an acceleration on wages growth compared to 2016, especially for full-time workers.

The Yen weakens as global bond yields rise

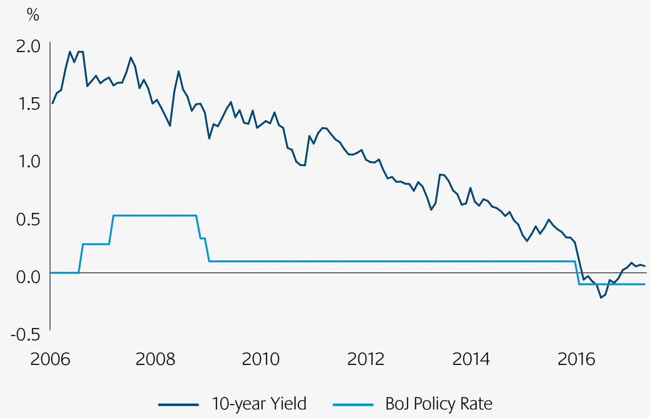
- The Yen reversed course over Q1 17, appreciating 4.8% against the US dollar, after falling around 11% In Q4 16. The US dollar was generally weaker against the major currencies in Q1 17 after such strong gains around the election of President Trump. See Chart 15 for details.
- Japanese bond yields rose 2 basis points in the quarter, a limited move given BoJ policy. Elsewhere bond yields reacted to the various politics at play.

Chart 13: Japanese inflation remains well below target



Source: Bloomberg. Data as at 28 February 2017.

Chart 14: BoJ maintains yield target



Source: Bloomberg. Data as at 7 April 2017.

Chart 15: Yen moves with USD weakness and global yields

Source: Bloomberg. Data to 7 April 2017.

China

Consumer inflation down but Producer Inflation remains strong

- One key global trend of 2017 has been expectations of reflation in the global economy. Much of this has been driven by strong gains in Producer Price Inflation (PPI) in China. PPI strengthened again in the quarter, to 7.6%/yr in March 2017, up from 5.5% in December 2016. This was slightly down on the 7.8%/yr pace recorded in February which had been the fastest since September 2008. Rising commodity prices and industrial activity have led to the gains.
- Consumer Price Inflation has been volatile, driven by movements in food prices around Lunar New Year. Inflation data released for March showed an easing of pressures that had built up at the start of the year. Inflation for the year to March was 0.9%/yr, down from 2.5%/yr to January and 2.1%/yr in December. See Chart 16 for details.

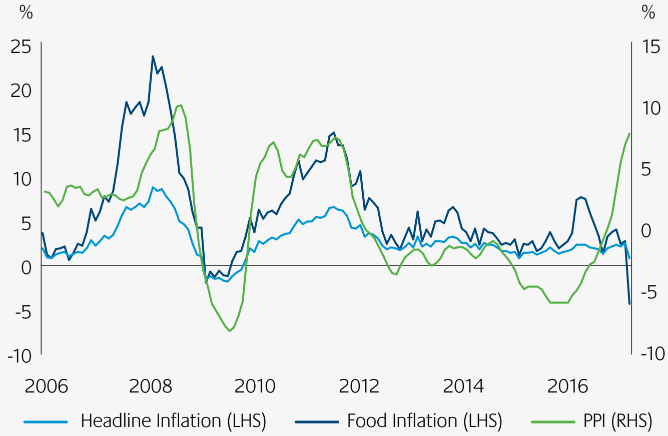
Monetary conditions tightening

- With officials watching the build-up in Producer Price Inflation, improvements in economic activity data and property data, there have been a number of movements to tighten monetary conditions in recent months. This has involved tightening in interbank liquidity, further tightening of property purchases and regulatory tightening in the shadow bank sector.
- This hasn't to date led to any increase in official benchmark interest rates, it though has led to increases in money market rates, from the 7-day repo rate to 3 months and longer. Chart 17 shows 3-month SHIBOR which has risen from 3.27% at the end of December 2016 to 4.39% at the end of March 2017.

Economic activity stable if not improving

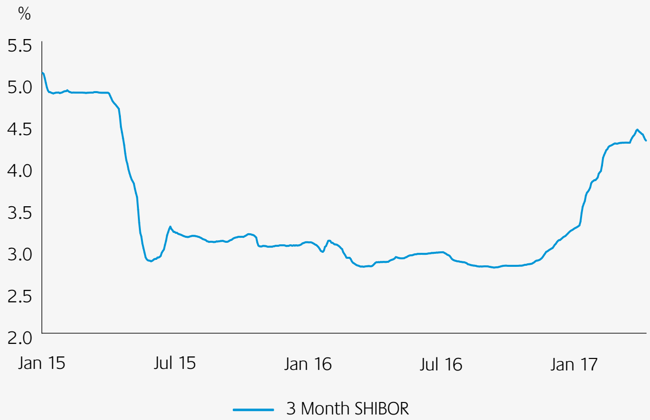
- While official GDP figures have been relatively stable over the year other measures of economic growth suggest activity has continued to pick up in China over the 2nd half of 2016 and into 2017. GDP rose to 6.9%/yr in Q1 17, up from 6.8%/yr in Q4 16.
- Other economic data over the quarter shown in Chart 18 also has stabilised, including retail sales, while industrial production and fixed asset investment have improved.

Chart 16: Inflation slumps even as PPI rockets higher



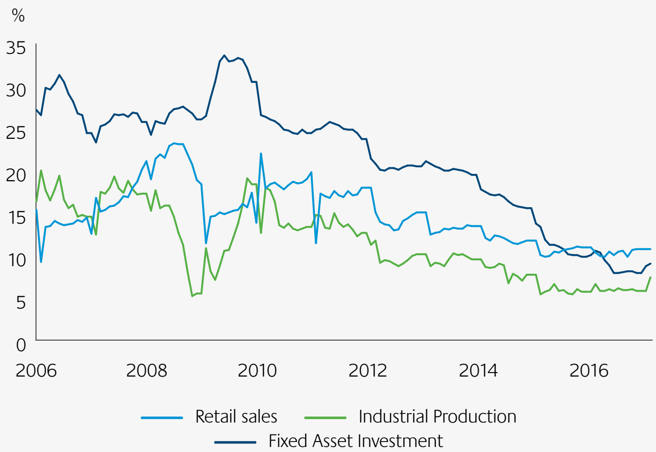
Source: Bloomberg, data to 28 February 2017.

Chart 17: Market rates have been tightened even as "official" rates remain on hold



Source: Bloomberg. Data to 7 April 2017.

Chart 18: Investment has picked up as retail sales slow



Source: Bloomberg. Data to 31 March 2017.

Australia/New Zealand

Australian Growth recovers strongly in Q4 16

- Australia's Q4 16 National Accounts showed economic growth in the quarter of a stronger-than-expected 1.1%/qtr, more than offsetting the -0.5%/qtr decline of Q3 16. The positive performance on the quarter took the annual growth rate up to 2.4%/yr from a revised 1.9%/yr as at Q3 16 and continues Australia's 26 years of uninterrupted economic growth.
- One of the major features of the Australian economy over recent years has been the lack of income growth, despite reasonable production (GDP) growth. This had meant that the economy 'felt' softer than the official data indicated and was clearly impacting on consumption growth.
- As shown in Chart 19, this has now changed dramatically, with real gross domestic income rising by 2.9%/qtr and is now running at 5.4%/yr. This significant increase in the income side of the economy has been driven by a surge in Australia's terms of trade, up 9.1%/qtr in Q4 16 and 15.6%/yr. The move to a trade surplus as seen in Chart 22 has also helped improve economic performance.

Rising risks in housing market sees additional macro prudential measures introduced

- House prices growth reaccelerated late in 2016 and into 2017. The ABS quarterly measure of house price growth (as shown in Chart 20) rose 8.9% for the year to December, led by gains in Sydney and Melbourne. More recent figures from CoreLogic showed capital city home prices rose 3.5% in Q1 17 and 12 months gains to 12.9%.
- This reacceleration prompted the RBA to confirm its view of the rising risks in the housing market and the Australian Prudential Regulation Authority (APRA) to announce in late March it was "initiating additional supervisory measures to reinforce sound residential mortgage lending practices in an environment of heightened risks".
- These additional measures include; limiting the growth of new interest-only lending to 30% of total new residential mortgage lending (currently closer to 40%), as well as placing strict internal limits on the volume of interest-only lending at loan-to-value ratios above 80% and ensure strong justification and scrutiny for those above 90%. There has been heighted discussion around the affordability of Australian housing, with new measures expected to be announced in the upcoming Commonwealth Government Budget released 9 May 2017.

RBA firmly on hold

- The RBA left the official cash rate on hold at 1.5% in Q1 17, with the last change in rates a cut of 25 basis points in August 2016.
- The RBA remains focused on three themes; inflation, wages and unemployment and the housing market.
- Inflation remains below the RBA's target band, headline inflation was 1.5%/yr to December 2016 and underlying inflation was 1.55%. The RBA does believe inflation has troughed and will gradually move higher.
- The labour market remains soft, the unemployment rate rose to 5.9% in February 2017, from 5.7% in November 2016. Wages growth remains at record low levels at 1.9%/yr to December 2016. See Chart 21.
- An argument could be made based on these two themes that official rates could be lower, however based on the RBA's view on the housing markets, the official cash rate is firmly on hold for the foreseeable future.

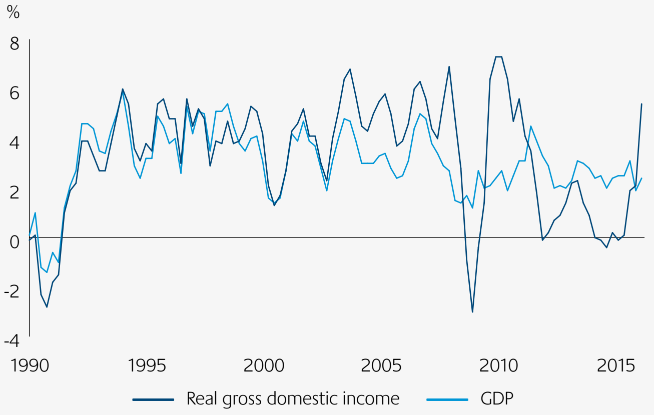
RBNZ on hold

- The Reserve Bank of New Zealand left rates on hold over Q1 17 after last cutting rates in November 2016 to 1.75%, a new record low. We expect the RBNZ to remain on hold for the foreseeable future, with recent falls in the NZ dollar welcomed by the RBNZ, although further falls would help balance growth further.
- As seen in Chart 23, the NZ dollar fell against all major currencies except the US dollar over the quarter, with dairy prices also weaker.

NZ growth slows

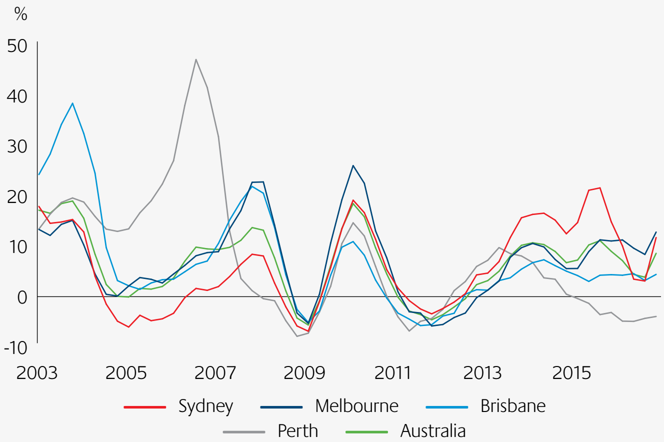
- Q4 16 GDP data was weaker than expected at 0.4%/qtr and annual growth of 2.7%/yr, down from 0.8%/qtr and 3.3%/yr respectively with the more volatile components of GDP leading to the falls. See Chart 24.

Chart 19: National income accelerates with commodity prices



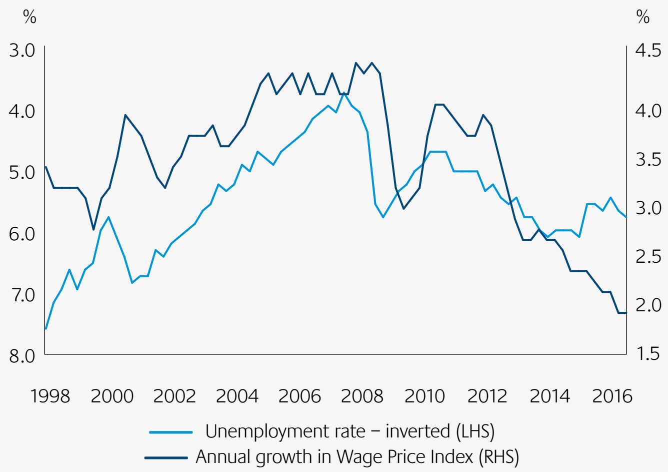
Source: Australian Bureau of Statistics (ABS). Data to 31 December 2016.

Chart 20: House price growth picks-up again, giving the RBA reason to pause



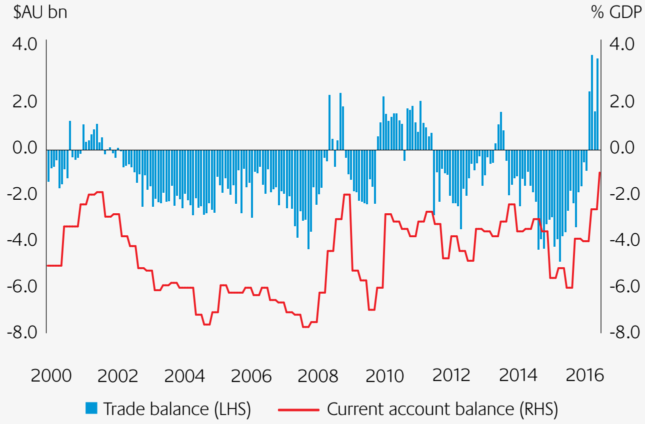
Source: ABS. Data to December 2016.

Chart 21: Wages remain weak as unemployment stagnates



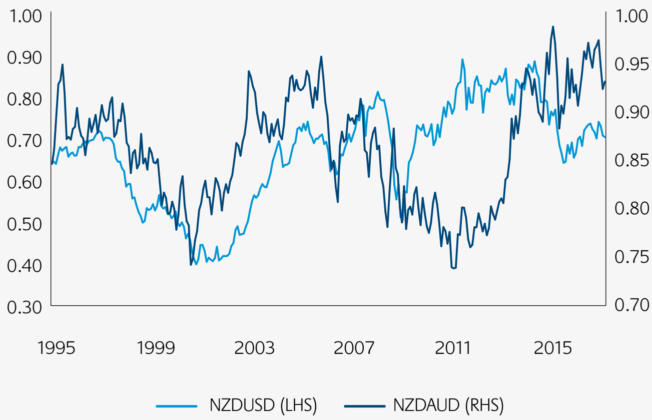
Source: Bloomberg. Data to 28 February 2017.

Chart 22: Trade balance moves into surplus with commodity price recovery



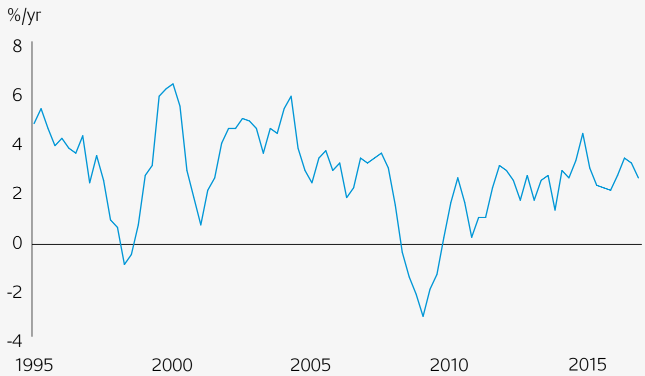
Source: Bloomberg. Data to 28 February 2017.

Chart 23: NZD weakens with dairy prices



Source: Bloomberg. Data as at 7 April 2017.

Chart 24: NZ Economic growth slows in the fourth quarter



Source: Bloomberg. Data as at 31 December 2016.

Section 3

Economic Forecasts – April 2017

United States

	2017		2018		2019		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	2.2	2.3	2.3	2.5	2.2	2.3	2.0	2.0
Inflation – Core PCE	1.8	1.8	2.0	2.0	2.0	2.2	2.0	2.0
Monetary policy – Rates	1.5%	1.25%-1.5%	1.6%	2.0%-2.25%	1.9%	2.5%-2.75%	2.0%	2.0%
Monetary policy – Other	No consensus.	Balance sheet plan likely to be announced.	No consensus.	Coupon and maturity reinvestment phased out.	No consensus.	Balance sheet slowly returns to normal.	Balance sheet slowly returns to normal.	Balance sheet slowly returns to normal.

Source: Bloomberg.

Comments:

- **GDP:** Economic growth in the US is expected to accelerate to 2.3%/yr in 2017, up from 1.6%/yr in 2016. This improvement is based on the clear cyclical upswing in the US economy, supported by ongoing strength in the employment data and generalised signs of better growth. No account has been taken of the proposed fiscal policy stimulus program of President Trump in 2017, although both business and consumer confidence have improved following the election and this should support growth.
- For 2018 and 2019, however, economic growth is expected to be supported by fiscal policy easing, especially both corporate and income tax cuts, increased infrastructure spending and some deregulation.
- We do not, however, expect these policies to permanently raise potential growth in the US economy, so some pull-back in growth is expected in 2020 and beyond.
- **Inflation:** The Fed's favoured measure of underlying inflation, the core PCE, has maintained its levels around 1.7%/yr at the start of 2017.
- The significant fiscal policy easing and better growth we see in the years ahead is expected to put further upward pressure on inflation, leading us to forecast inflation at or above the 2% target in 2018 and 2019.
- **Monetary policy:** The Fed moved to raise interest rates again in March 2017, earlier than we had expected. As a result we now expect a further two rate hikes this year (ie. three in total in 2017). By the end of this year we also expect Fed Chair Yellen to detail her plans for balance sheet normalisation – likely starting in late 2017 or early 2018 (ie. before her term as Chair comes to an end).
- In 2018 we expect a further three rate hikes from the Fed, followed by two further increases in 2019. By 2020, however, we continue to expect the Fed to be cutting interest rates, as the economic 'boom' created by President Trump's policies moves into a downturn.

United Kingdom

	2017		2018		2019		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	1.8	1.8	1.3	1.5	1.6	1.25	2.5	2.0
Inflation – CPI	2.6	2.5	2.6	2.5	2.3	2.25	2.0	2.0
Monetary policy – Rates	0.25%	0.25%	0.4%	0.5%	0.8%	0.75%	2.5%	2.0%
Monetary policy – Other	QE retained at £425bn.	QE retained at £425bn.	No clear consensus.	Balance sheet to stabilise.	No clear consensus.	Balance sheet to stabilise.	Balance sheet to stabilise.	Balance sheet to stabilise.

Source: Bloomberg.

Comments:

- **GDP:** The economic data in the UK has continued to outperform expectations in early 2017. We have revised up our GDP growth forecast for 2017 to 1.8% (from 1.6%).
- However, now that Article 50 has been triggered, the economic impacts of the UK leaving the EU could begin to appear in 2018, where we have revised down our growth forecast to 1.5% (down from 1.6%). By 2019 we expect growth to be lower at 1.25%.
- **Inflation:** The pace of inflation in the UK has continued to accelerate in recent months, driven largely by the sharp weakening in the GBP.
- Inflation is now expected to be above the BoE's 2% target in 2017 and 2018, before moderating slightly in 2019.
- **Monetary policy:** The BoE has recently signalled that monetary policy is likely to remain on hold for the foreseeable future, with the base rate at 0.25% and a £425bn annual pace of QE.
- We expect these monetary policy conditions to be retained through 2017, with some minor normalisation of policy in 2018 and 2019.

Europe

	2017		2018		2019		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	1.6	1.5	1.6	1.7	1.4	1.5	1.5	1.0
Inflation – CPI	1.7	1.5	1.5	1.4	1.7	1.5	1.5	1.0
Monetary policy – Rates	0%	-0.4%	0%	0%	N/A	0%	N/A	1.0
Monetary policy – Other	QE at €60/mth to Dec '17.	QE at €60/mth to Dec '17.	No consensus.	Some tapering of QE. TLTRO remains in place.	No consensus.	QE ended. TLTRO remains in place.	Significant period of very easy monetary policy.	Significant period of very easy monetary policy.

Source: Bloomberg.

Comments:

- **GDP:** Economic data in the Eurozone has continued to show some good stability through early 2017 and our expectation for growth at the end of the year is 1.5%.
- Our 2018 GDP growth forecast is a little higher at 1.7%, up from the consensus of 1.6%. Ongoing highly stimulatory monetary policy, neutral fiscal policy, the lower EUR and faster economic growth in the US should also support economic activity in the Eurozone.
- However, a key risk for the EU remains around ongoing political concerns (ie. elections in France and Germany) and continued signs of instability in the banking system – especially in Italy.
- **Inflation:** Inflation in Europe (as elsewhere) has picked up in recent months and our 2017 forecast has been revised up to 1.5% from 1.1%.
- Aggressive policy action by the ECB and any further weakening of the EUR should help put upward pressure on inflation through 2018-2019.
- However, inflation is not expected to consistently reach the ECB's 2% target over the medium-term.
- **Monetary policy:** As at 1 April 2017 the ECB's monthly asset purchase program (QE) has been reduced from €80bn/mth to €60bn/mth – out to December 2017.
- We expect this stance of monetary policy, with a cash rate of -0.4%, to be maintained throughout all of this year – before some tapering in 2018.

Japan

	2017		2018		2019		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	1.2	1.0	1.0	0.75	1.1	1.0	1.0	1.0
Inflation – CPI	0.7	0.6	1.0	1.0	1.9	1.0	2.0	1.0
Monetary policy – Rates	0%	-0.1%	0.0%	-0.1%	+0.1%	0.0%	0.0%	0.0%
Monetary policy – Other	QQE, with NIRP and yield curve control.	QQE, with NIRP and yield curve control.	QQE, with NIRP and yield curve control.	QQE, with NIRP and yield curve control.	N/A	Some increase in cash rate, but with yield curve control still in place.	Extraordinary monetary conditions to remain in place for foreseeable future.	Extraordinary monetary conditions to remain in place for foreseeable future.

Source: Bloomberg.

Comments:

- **GDP:** Economic growth for 2017 is expected to come in at 1.0%, little changed from the 2016 outcome – but likely higher than the long-term growth potential of Japan.
- Growth in 2017 should be supported by the renewed weakening of the Yen, further fiscal policy easing and the maintenance of extraordinary monetary policy easing via a -0.1% cash rate and a 0% 10 year JGB yield.
- For 2018 and 2019 we see growth remaining modest, in a 0.5%-1.0% range, with Japan's very negative demographics likely to hold the growth rate back on an ongoing basis.
- **Inflation:** Like elsewhere, headline inflation has shown some pick-up in early 2017, on higher energy prices. Some slight improvement in underlying inflation could be seen in 2018 and 2019, but the pace of inflation is very unlikely to meet the BoJ's 2% target in the years ahead.
- **Monetary policy:** After its 'comprehensive reassessment' of monetary policy in September 2016, the BoJ switched its focus from targeting balance sheet expansion to targeting 10yr JGB yields at 0%. The cash rate target remains at -0.1%.
- The BoJ is expected to retain this policy through 2017 and a very aggressive monetary policy stance for years to come.

China

	2017		2018		2019		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	6.5	6.7	6.2	6.4	6.0	6.2	6.0	6.0
Inflation – CPI	2.2	2.4	2.3	2.5	2.5	2.5	2.5	2.5

Source: Bloomberg.

Comments:

- **GDP:** For 2017, the Chinese government has set an economic growth target of at least 6.5%/yr. The consensus is at 6.5%, but we expect 6.7% as recent high-frequency economic data has shown good momentum in the Chinese economy.
- Growth should be supported by a more neutral net export performance and the political imperative of stable growth ahead of the political leadership changes in late 2017.
- For 2018 we expect some moderation in growth to around 6.4%, but still at a very solid pace.
- Over the medium-term, 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:** China's inflation rate picked up in late 2016 and early 2017, before dropping again around the time of the Chinese New Year. Volatility in food and energy prices was largely to blame. For 2017 and 2018 we expect the inflation rate to continue to edge higher and average around 2.5%/yr.
- 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% expected.

Australia

	2017		2018		2019		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	2.5	2.5	2.8	2.8	2.8	2.75	3.0	2.75
Inflation – CPI	2.1	2.0	2.2	2.25	2.5	2.25	2.5	2.5
Monetary policy – Rates	1.45%	1.5%	1.65%	1.75%	N/A	2.5%	3%-4%	3.0%

Source: Bloomberg.

Comments:

- **GDP:** The Australian economy bounced-back in Q4 16, with GDP growth of +1.1%/qtr, after the disappointing -0.5%/qtr seen in Q3 16. Overall annual growth was 2.4%.
- For 2017 GDP growth is now expected to average 2.5%/yr (previous f/c 2.75%), 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. A sharp increase in income growth has been retained in corporate profits, rather than spreading to wages.
- Growth in 2018 and beyond is expected to average around 2.75%.
- **Inflation:** Inflation in Australia remained very low through 2016, with the headline CPI at 1.5% in Q4 16 – below the RBA's 2%-3% target range.
- For 2017 and 2018 inflation is expected to head back towards 2% and above on the back of slightly higher energy prices and any indication of wage growth.
- **Monetary policy:** We expect the RBA to hold the cash rate steady at 1.5% for all of 2017. The RBA is expected to balance the risks between some softness in the labour market, low but stable inflation and growing financial instabilities in the housing market.
- We expect a very modest tightening cycle to get underway late in 2018 – especially if/when the US Fed Funds rate moves above the RBA cash rate.

New Zealand

	2017		2018		2019		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	3.1	3.7	2.8	3.4	N/A	2.8	2.5	2.8
Inflation – CPI	1.6	1.9	1.9	1.8	N/A	1.8	2.0	2.0
Monetary policy – Rates	1.75%	1.75%	1.75%	1.75%	1.9%	2.25%	N/A	3.5%

Source: Bloomberg.

Comments:

- **GDP:** The New Zealand economy hit a speed bump in the final quarter of 2016, with quarterly growth of just 0.4%/qtr. The softer Q4 16 outcome, combined with downward historical revisions, brings annual growth in at 2.7%/yr, a relatively modest result compared to expectations.
- However, the slowdown in NZ growth is expected to be temporary. Underlying indicators of growth remain robust, with firms' expectations of own activity and employment intentions remaining consistent with an acceleration in growth over 2017. We continue to expect annual NZ economic growth to hold comfortably over 3% over 2017 and 2018. However, there are two main downside risks to the growth outlook, a premature slowdown in housing construction demand and offshore geo-political events impacting business confidence and behaviours.
- **Inflation:** Headline inflation is likely to lift temporarily over H1 2017 as a result of volatility in food and oil prices. However, core inflation measures are likely to remain subdued and the RBNZ has already signalled it will look through the expected lift.
- We expect inflation to soften over H2 2017, but to remain around 1.5%-2% over the next few years, close to the RBNZ's 2% inflation target mid-point.
- **Monetary Policy:** Economic growth and inflation are still reliant on ongoing economic stimulus from the RBNZ and we continue to expect the RBNZ to hold the OCR at its current record low 1.75% until late 2018.
- The still high NZD and downside risks stemming from political uncertainties offshore remain sharply in the RBNZ's focus.

Section 4

Recent Research Reports – Q1 2017

The following is a list of the key research reports released by the Economic and Market Research team over recent months. Please click on the link to view the full report.

US Federal Reserve: Rates on Hold, but Economy Looking Better
2 February

Australian Update: RBA More Upbeat – On hold for all of 2017
10 February

Australian Update: RBA on hold for an extended period – Balancing the risks
7 March

US Federal reserve: Monetary policy enters a new, more active, phase
16 March

Australian Update: RBA remains on hold (again) – Balancing the risks and supportive of macro-prudential housing measures
4 April

French Elections 2017: It's a tight race!
19 April

French Elections 2017: Centre-Left v Far Right in the Second Round
24 April 2017

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