First State Investments
Colonial First State
Global Asset Management

First Insights.

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

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

As is the case each January, in this edition of First Insights, we discuss the key themes and risks for the year ahead.

2017 looks set to be dominated by President Trump and his plans for significant fiscal policy easing in the US. The real issue for markets will be whether Trump's policies will permanently raise the US's potential GDP growth rate. If so, then markets are right to be bullish. But the risks remain for a boom-bust cycle that leads to higher inflation and higher interest rates.

Geopolitics are likely to dominate elsewhere, including in the UK, Europe and China. I discuss these themes and risks in this edition of First Insights.

In addition, we provide our regular Market Watch and charts pack, as well as our forecasts for the key economies we cover and a summary of our research publications through Q4 16.

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

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Section 1

2017: Key Themes and Risks

By Stephen Halmarick

Key Themes and Risks

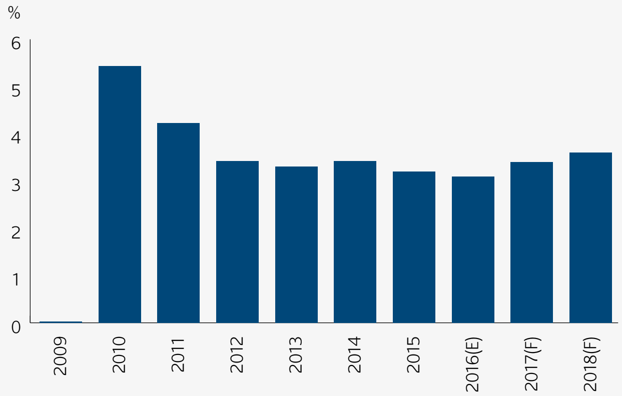
In January each year we spend some time discussing our key themes for the year ahead and the risks surrounding these themes.

A review of our 2016 calls:

In January 2016 we highlighted the following as themes for investors to focus on in the year just completed (with a comment on how accurate, or not, our views proved to be).

- Global economic growth to improve a little in 2016, but remain well below trend at around 3.4%. (This was pretty good, with global growth now estimated at 3.1% for 2016, little changed from previous years).

Chart 1: Global economic growth and outlook



Source: IMF data as at January 2017.

- Concern around the ability of the Chinese authorities to manage the 'triple-threat' coming from; 1. A slower economy, 2. Financial market volatility and 3. Capital outflows and a weaker currency through a lack of policy coordination and communication. (This proved critical for markets over H1 16, but with a significant response from Chinese officials, growth proved more resilient than expected in 2016, while the currency depreciated modestly).
- The global disinflationary pulse will remain a key driver of markets, driven by low commodity prices, disruptive technology and lower wages from excess labour capacity. (Low and declining inflation proved critical for many economies, such as the EU, UK, Japan, Australia and NZ in 2016, with central banks in these jurisdictions easing policy further. Inflation in the US, however, began to creep higher).
- Global commodity prices to remain under pressure as there is more than enough supply of most commodities, including money, for the expected level of global economic growth. (In fact, commodity prices moved higher in H2 16 on the back of some supply response and stronger-than-expected demand).
- Low returns on safe financial assets will persist, which will remain problematic for investors, corporations and governments. (While equity market beat expectations, post Trump's election win, bond yields jumped higher).
- Global trade growth to improve only very gradually which will be problematic for many emerging markets countries. (Correct).
- US Fed monetary policy normalisation to continue gradually in 2016, with three rate hikes expected this year. (The Fed was very gradual in 2016, increasing interest rates only once).
- A gradual Fed and only modestly higher US inflation should limit the extent of any sell-off in the US bond market and flatten the yield curve. (Bond yields found new cyclical lows around mid-year, but then were higher into year-end on the Trump factor).
- The US Presidential Election could come down to Hillary Clinton v Ted Cruz or Marco Rubio. At this stage, a Clinton victory looks the most likely outcome. (The biggest miss for the year – Donald Trump defied all expectations, including our own, to not only become the Republican nominee, but the President-elect).
- Monetary policy divergence to remain a key influence. The overall stance of monetary policy for the global economy could, therefore, be easier at the end of 2016 than at the start. (This proved correct, with only one rate hike from the US Fed, but easier monetary policy in the EU, UK, Japan, Australia and NZ).
- This should be supportive for the USD (especially against the EUR and JPY) and for risk markets such as equities and credit. (Again correct, especially at year-end after the Trump election win).
- Geo-political developments will likely remain potential risks for financial markets, especially in the Middle East, but also the ongoing threat of acts of terrorism and the refugee crisis in Europe. The US Presidential Election and, possibly, the UK referendum on EU membership will also be important political events this year. (This proved the most accurate forecast of all – from Brexit to the US election, to the Italian referendum, the ongoing disaster in Syria and even the Australian election – geopolitics had a significant impact on global markets in 2016).

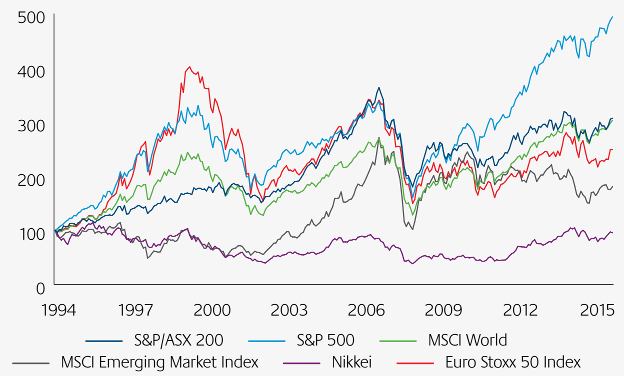
2017 Key Themes:

Now for this year! Key factors for global financial markets in 2017 are expected to be:

- **The biggest event for global financial markets in 2017 is likely to have taken place on 20 January** – when Donald Trump was sworn in as the 45th President of the United States.
- **How the Trump Presidency unfolds will clearly have a significant impact not just on the US** (see below for details), **but on global markets in 2017 and beyond.**
- Which Donald Trump turns up for work each day – pragmatic Trump, or populist Trump? Does he tweet at 3am in the morning on a consistent basis and how do markets respond?
- What foreign policies events/concerns/disasters will be created and/or averted?
- In terms of the global economic outlook in 2017 – the US is also likely to dominate. A large scale US fiscal policy easing is expected to support growth, so that global economic growth in the year ahead should be a little faster than recent years. **This is likely to see global economic growth in 2017 close to 3.5%/yr, from nearer 3%/yr in 2016.**
- **The big question is, however, will the pace of trend or potential GDP growth in the US be raised permanently by Trump's policies,** outstripping the cost of higher US debt and the rising cost of capital.

- **If so, then the rally being enjoyed by 'risk' assets will become more entrenched.**
- **If not, then we are in for a multi-year 'boom-bust' cycle. As indicated by our Fed view, we see more risk of the latter, rather than the former.**
- Another key theme for 2017 is likely to be, once again, inflation.
- **But the main focus for this year is likely to be a trend to higher headline inflation,** given the recent increase in key commodity prices – especially oil.
- **Underlying, or core inflation, is likely, however, to remain relatively subdued in 2017,** although the direction of change is more likely to be up than down – especially given the ongoing improvements in most major economies labour markets.
- **Global monetary policy settings are unlikely to be eased much further in 2017.** We expect further tightening/normalisation of monetary policy in the US and no change in monetary policy by the other major central banks in 2017, ie. the ECB, the BoJ and the BoE. The RBA and RBNZ are also expected to be on hold in 2017.
- **Another major theme for 2017 is expected to be the interplay between fiscal and monetary policy.** A fiscal policy easing in the US is expected to lead to further monetary policy tightening. This trend may also become evident elsewhere, especially in the UK and Japan and perhaps even Europe.
- **Key risks remain in Europe, especially around political and policy developments.**
- The French Presidential election (April-May), the German general election (likely September-October), political uncertainties in Italy and the start of Brexit negotiations in the UK will also likely be key factors for global markets in the year ahead.
- Concerns about a sharp slow-down in the pace of growth in China proved (once again) to be unfounded in 2016. Government investment spending and a depreciating currency both helped China grow by an estimated 6.7% last year.
- For 2017, slower growth expectations still dominate, as government stimulus is likely to be reduced significantly. This should see growth moderate to around 6.5% in 2017.
- **The biggest risk in China in 2017 likely revolves around the political machinations of the five yearly reshuffle of China's political leadership late in the year.**
- Other key developments to watch in China include capital outflows and/or capital controls and any tightening in financial conditions – especially around the property market.
- **No doubt concerns around the debt levels in China, especially at the local government and SOE level, will still linger in 2017.**
- **China's relationship with US President Trump will also be critical to watch.**
- In Japan, the focus is likely to be on the BoJ's target of capping 10yr JGB yields at 0% and the expectations of further weakness on the Yen.
- Prime Minister Abe is also expected to call an election in H1 2017, which he is expected to win. This should then see Abe remain in the top job all the way out to 2021 – ensuring he is Prime Minister for the 2020 Tokyo Olympic Games.
- **The Australian economy will likely continue to see growth average around 2.5%-2.75% in the year ahead,** with housing, infrastructure and net exports (of both resources and services) more than offsetting weakness in business investment.
- Concerns around Australian household debt levels will likely be raised (yet again) in 2017. But household balance sheets remain in relatively good shape and with the RBA expected to be on hold we do not see significant downside risks to the Australian housing market in the year ahead.
- **For financial markets, one of the dominant themes is likely to be further strengthening of the US dollar in 2017.** This will have big implications for not only the US, but other developed and key emerging markets.
- For global bond markets, the return of (some) inflation, especially in the US, could be a major theme. Higher inflation could pose a major risk to both US and global bond markets. Most of the increase seen in global bond in yields so far appears to be driven by term-premium (which could still move further), **but if inflation begins to increase meaningfully, then yields could have a lot further to go.**
- This is expected to lead to **a steepening in yield curves** in the major bond markets through 2017.
- **For global equity markets, stronger economic growth in the US and a better global economy should be supportive** – especially if there is a noticeable increase in nominal GDP growth (ie. a bit of inflation pressure).
- Equity markets will, however, likely also have to deal with higher interest rates and an increase in the labour (ie. wages) share of the economy relative to the profit share.

Chart 2: Global equity markets – lots of 'good' news priced in



Source: Bloomberg as at 18 January 2017.

The United States:

As noted, the biggest event for global financial markets in 2017 is likely to have taken place on 20 January – when Donald Trump was sworn in as the 45th President of the United States.

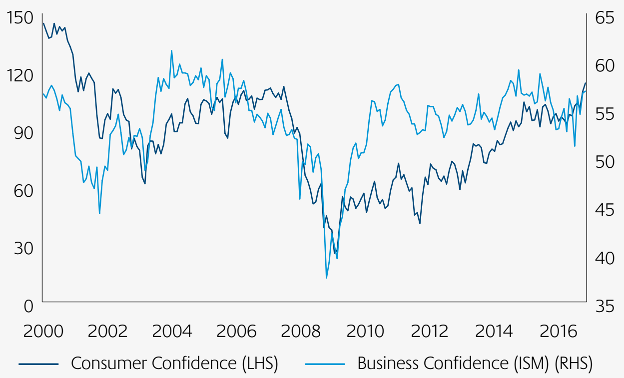
In our view the implications for the US economy and financial markets from President Trump is likely to involve three phases.

Phase one was 'risk off', with the unexpected election victory by Trump seeing the US equity market and the US dollar sell-off and US bond yields rally. This phase, however, lasted less than 24 hours, with the market quickly moving into the second phase.

The second phase, which we expect to be the dominant factor throughout 2017, is supported by the view that Trump's policies will be expansionary and stimulatory – especially his company and income tax cuts, increased infrastructure spending and reduced regulatory environment (see below for details).

This phase has already seen a strong rally in equity markets, the US dollar, a sell-off in bond markets and is expected to be the primary factor driving markets throughout 2017. A noticeable increase in both business and consumer confidence has taken place since the election.

Chart 3: US Business and Consumer confidence



Source: Bloomberg as at 31 December 2016.

Further out, however, phase three may not be as positive. Although the timing for phase three is very difficult to determine, it could be anywhere between 2018-2020, this phase is likely to involve an increase in inflation and a more aggressive monetary policy tightening cycle from the US Federal Reserve.

Higher inflation, higher interest rates and the risks associated with Trump's anti-trade policies could sow the seeds for an economic downturn late in Trump's Presidency, seeing equity markets and the US dollar sell-off and bond yields rally again. As mentioned, however, the timing of phase three remains very uncertain and is unlikely to occur in 2017.

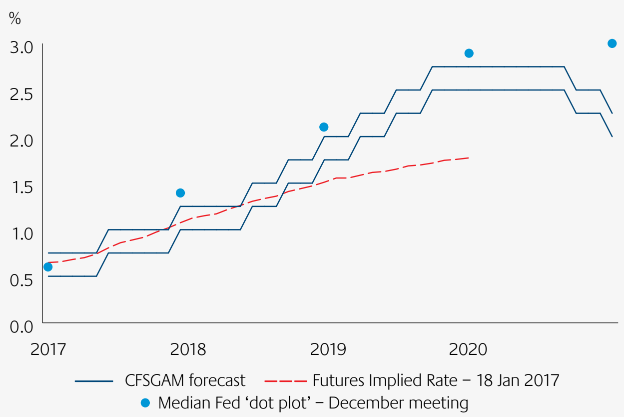
Indeed, after raising interest rates on 15 December 2016 by 25 bps, to a new range of 0.5%-0.75%, **we expect the US Federal Reserve to remain on a gradual tightening path in 2017.** With the Fed unlikely to pre-empt the impact of Trump's fiscal policy easing, we expect only two further Fed rate hikes in 2017.

However, we have recently made some significant changes to our Fed view – to reflect the expansionary, stimulatory and, ultimately, inflationary policy of the Trump administration.

Given that we expect the US economy to experience a significant easing of fiscal policy from late 2017 onwards, which pushes inflation higher than previously expected and brings forth the need for more tightening from the Fed, **we now expect the two rate hikes in 2017 to be followed by three rate hikes in 2018 (previously two) and a further three rate hikes in 2019 (previously two).** This will give a peak in the Fed Funds target rate in 2019 of 2.5%-2.75%, ie. 50 bps higher than our previous peak forecast.

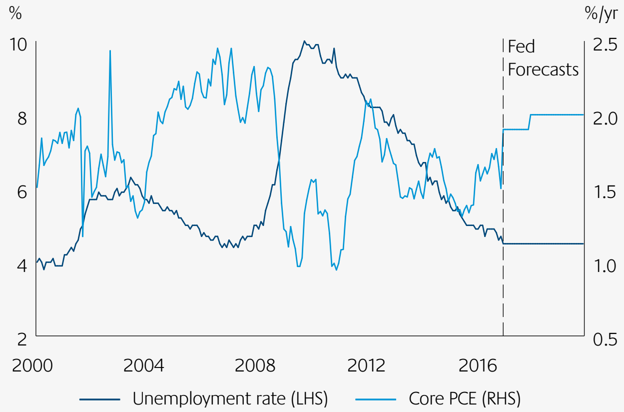
We now expect, however, two rate cuts in 2020 (previously no change) as the significant tightening of financial conditions over 2018-2019 (from a higher USD, higher bond yields and a higher Fed Funds rate), combines with President Trump's anti-trade and anti-immigration policies to bring about a (significant) economic downturn.

Chart 4: Fed rate expectations



Source: Bloomberg, data to 17 January 2017. Fed 'dots' as at December 2016. CFSGAM forecasts as at 15 December 2016.

Chart 5: US Unemployment rate and Core PCE rate – Actual and forecasts



Source: Bloomberg and Federal Reserve. Unemployment rate as at December 2016. Core PCE to November 2016. Fed projections from December 2016 FOMC meeting.

In terms of the main policy agenda for President Trump, we expect the following (with the **+**, **–** and **?** symbols indicating the direction of impact on the economy and markets).

- **+** Significant fiscal stimulus through:
- **+** large income tax cuts (three rates 12%, 25% & 33%),
- **+** company tax cuts (to 15% or 20% or 25% from 35%) and
- **+** a 10% repatriation tax for cash currently held off-shore.
- **+** Increase in Infrastructure spending, ie. $US300bn government money, with private sector involvement potentially up to $US1 trillion.
- **+** Increase in Military spending – current and veterans.
- **+** Reduce regulatory burden – especially on energy to achieve "complete American energy independence".
- **–** Strongly protectionist stance – name China as a 'currency manipulator' and impose 45% tariffs on selected imported goods.
- **–** No support for TPP and change/withdraw from NAFTA.
- **–** Scale back climate change regulations.
- **–** Critical of Fed policy, pro-audit, Chair Yellen to be replaced in early 2018.
- **–** Isolationist stance of foreign policy – critical of NATO/some allies and China. Closer to Russia.
- **–** Tough stance on immigration – build a wall.
- **?** Repeal and replace Obamacare.

It has been estimated that Trump's policy agenda will increase the level of US government debt by around 20% of GDP over the coming decade – as shown in the chart below. Other estimates put the cost of the Trump tax policies at between $US2.4tr - $US5.3tr.

The key question for markets over 2017, and beyond, is: will this be money well spent? Will President Trump's policies lead to a permanent shift higher in the US's potential economic growth rate?

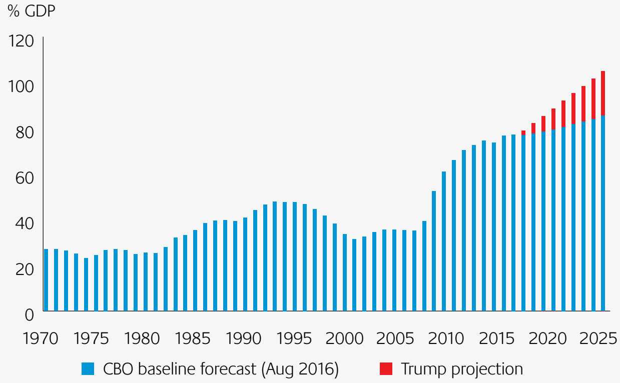
The optimists are saying 'yes' – that the suite of expansionary fiscal policy actions will lead to an increase in business investment, a rise in productivity and an increase in the wages share of the economy that drives growth higher.

This would then lead to an increase in the neutral level of interest rates, ie. R* would rise, and an increase in the rate of return on investments.

The pessimists are much more skeptical and fear a 'boom-bust' cycle over coming years.

As detailed in our revised Fed view above, **we are more on the skeptical side than the opportunistic side.**

Chart 6: US Debt expectations



Source: CBO as at August 2016. CRFB as at October 2016. CFSGAM.

In this regard it is interesting to note recent comments from Fed Chair Janet Yellen about the labour market.[1] The Fed Chair stated that the **two biggest factors impacting on the US labour market were technology and globalisation.**

Perhaps in an effort to push back against those who are looking to turn the clock back against both the advancements of technology and globalisation, the Fed Chair stated that "while globalisation will likely continue and technology will continue to advance, we don't know how fast the economy will grow, what new technologies will develop, or how quickly and consistently employment will expand. What is considerably more certain, however, is that success will continue to be tied to education, in part because a good education enhances one's ability to adapt to a changing economy."

The other factor that markets will need to consider in 2017 is the leadership of the Federal Reserve.

President Trump will get to nominate people to fill two Governor vacancies at the Fed in 2017 and, most critically, find a replacement for Chair Yellen in early 2018 – assuming that he will not reappoint Dr Yellen.

In terms of Janet Yellen's possible replacement as Chair in early 2018, **neither President Trump nor the new Treasury Secretary** (Steven Mnuchin) **are likely to be looking for a monetary policy hawk.**

Given the extent of fiscal policy easing that is planned, the new Fed Chair will more than likely be somebody that favours a conservative approach to monetary policy and would be less inclined to hike rates substantially. From the list of names below, this likely rules out John Taylor.

Possible new members of the Fed and specific candidates for Chair include:

- Martin Feldstein: Former Chair of the Council of Economic Advisors (CEA – 1982-84 President Reagan). Former CEO of National Bureau of Economic Research. Currently at Harvard.
- Richard Fisher: Former President of Dallas Federal Reserve.
- Thomas Hoenig: Vice Chair FDIC (2012 – current). Ex-President of the Kansas City Fed (1991-2011).

1 Chair Janet Yellen, University of Baltimore, December 19, 2016.

- Glenn Hubbard: Deputy Assistant Secretary to the Treasury (1991-1993). Chair CEA (2001-2003 for George W). Currently at Columbia University.
- John Taylor: Stanford University and established the "Taylor Rule" for monetary policy. Under Secretary International Affairs – Treasury (under George W. Bush). Member of the CEA (President George W. Bush).
- Kevin Warsh: Currently at Stanford Uni. Former Special Assistant to President George W. Bush on Economic Policy (2002-06). Former member of the FOMC (2006-2011) - acted as a special advisor to Wall St and the Fed through the GFC. At the time of his appointment to the Fed in 2006 he was the youngest appointment in the history of the Fed, at just 35yrs of age.
- Richard Clarida: Currently at Columbia University and strategic advisor to PIMCO. Former Assistant Secretary of the Treasury for Economic Policy and winner of the Treasury medal for outstanding service to the Treasury Department.

China:

Economic growth in China could also moderate in 2017, perhaps down to around 6.5%/yr, as government investment spending slows and the official focus remains on medium-term structural changes to the Chinese economy.

But as shown in the chart below, the high-frequency data in China has been very solid through H2 16 and so some slowdown from this strong pace of growth should be expected in 2017.

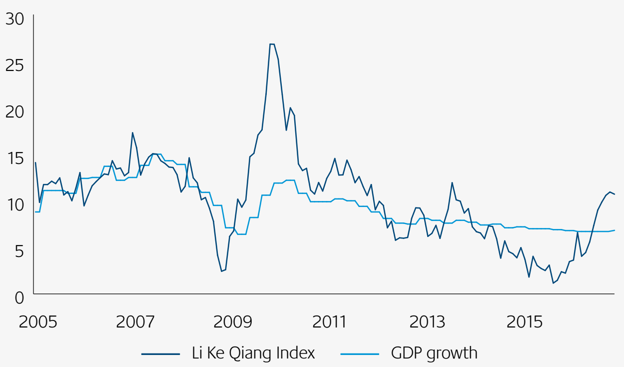
One of the bigger risk factors in China in 2017 revolves around the political machinations – with the five yearly reshuffle of China's political leadership in late 2017.

No doubt the political leadership will be looking for economic stability ahead of the political changes in late 2017. This could imply a growth target for the year of "around 6.5%", as opposed to the 6.5%-7% target on 2016.

Inflation in China could trend a little higher through 2017, especially given the accelerating in the PPI evident over H2 2016.

Other key developments to watch in China include capital outflows and/or capital controls and any tightening in financial conditions – especially around the property market.

Chart 7: China GDP growth and Premier Li index



Source: Bloomberg. GDP data to 31 December 2016. Li Keqiang Index data to 31 December 2016.

No doubt concerns around the debt levels in China, especially at the local government and SOE level, will still linger in 2017. **But we doubt that 2017 will be the year that these debt concerns come to a head.** This is especially so given the strong desire there will be for 'stability' in 2017 ahead of the political changes towards the end of the year.

China's relationship with US President Trump will also be critical to watch in 2017. Key areas of focus/concern will revolve around the currency and trade policy, as well as security issues in the South China Sea.

Europe:

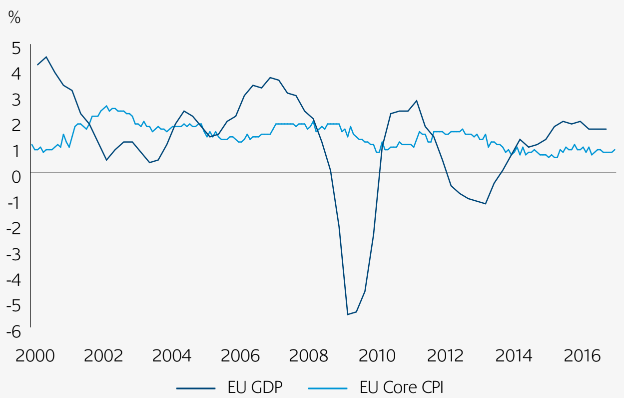
After adjusting its monetary policy stance in late 2016, **we expect the European Central Bank (ECB) to maintain the stance of monetary policy in 2017 – with €60bn of asset purchases per month planned until December 2017.**

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 narrowing interest rate spread with the US should also put **further downward pressure on the Euro – something the ECB is unlikely to resist.**

Ongoing low interest rates and a weaker Euro should act to support the European equity markets and the economy more generally.

As detailed in our forecasts, we expect the EU economy to continue to grow modestly in 2017, with growth of around 1.7%/yr, compared with the 1.6%/yr expected outcome for 2016.

Chart 8: EU GDP growth and Core inflation



Source: Bloomberg. GDP data to 30 September 2016.
CPI data to 31 December 2016.

Growth should be supported by the very easy stance of monetary policy, and some minor support, if not neutral, from fiscal policy. The weaker Euro should also help those EU countries that are heavily export orientated, ie. Germany.

The risks remain, however, to the downside, with both US and UK anti-trade developments likely to weigh on the EU and the fragile nature of the banking system limiting credit supply.

Headline inflation in the EU is likely to rise to around 1.1%/yr in 2017, well up from 0%/yr in 2015 and just 0.2%/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 with the current stance of monetary policy. 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 biggest sources of risk in the EU in 2017 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.

- The 23 April/7 May French Presidential Elections. While Marine LePen (Front National) is currently trailing in the polls behind Francois Fillon (The Republicans), as we saw last year in the UK and US, the polls are not always reliable. **The key risk if LePen is elected President would be a referendum on EU membership. If this were to occur, and be successful, the EU would likely disintegrate.** This is not our base case, but will likely keep markets on edge until the election outcome is known.
- The German general election is expected to take place around late August-late October 2017. **Chancellor Angela Merkel is running for a fourth term – a very difficult achievement.** But opinion polls continue to suggest that Merkel will be able to form some sort of coalition government and remain in place. The Alternative for Germany (AfD) could do well, however, and have a strong influence on the election and the type of government formed afterwards.
- **The expected activation of Article 50 by the UK in March will set the 2 year clock-ticking to negotiate the UK's exit from the EU.** EU negotiators have a strong incentive to drive a hard bargain with the UK and this could well be a critical factor for markets in the year ahead.

On the banking front, the Italian banking crisis is likely to continue to unfold. While the government is in the process of raising capital, it seems unlikely that it will be able to bail out the banks without support from the broader EU, which has so far signalled little appetite for this. This could be a source of tension between Italy and Germany as the Italians push further back against austerity.

The United Kingdom:

The most significant event in the UK during 2017 is likely to be the start of the Brexit negotiation process. Article 50 is expected to be invoked in March 2017, triggering the 2 year process of negotiating the terms and conditions of the UK's exit from the EU.

Not only will the terms and conditions of this exit be a source of uncertainty for financial markets in 2017, but questions still remain over the role of the UK Parliament during the negotiation phase and the final agreement.

The economic data in the UK has outperformed expectations in the months since the unexpected Brexit vote. 2016 GDP growth looks like coming in close to 1.6%/yr.

We expect GDP growth of 1.6%/yr in both 2017 and 2018. We are, therefore, more optimistic than consensus (and the Bank of England, BoE) for both years, based on the 2016 easing of monetary policy, the weaker GBP and the expected easing of fiscal policy in the years ahead.

The downside risk remains, however, if negotiations around Brexit fail to come up with a solid new model for the UK's trading relationship with the EU.

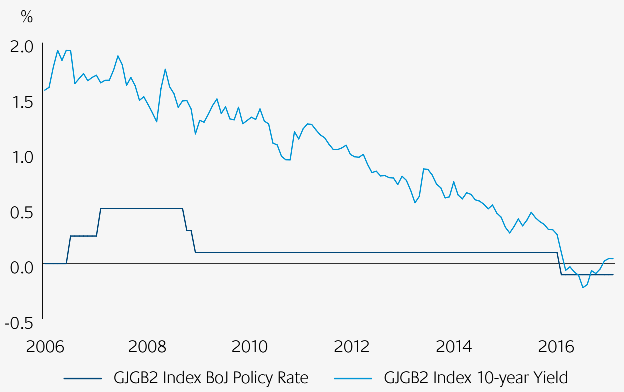
The pace of inflation in the UK has accelerated in recent months, driven largely by the sharp weakening in the GBP and rising oil prices. Inflation is expected to be above the BoE's 2% target in 2017 and 2018, before returning to target in 2019.

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.

Japan:

The big event for the year in 2016 in Japan was the "comprehensive reassessment' of monetary policy. This reassessment resulted in the decision to move away from targeting the size of balance sheet expansion to targeting the 10 year JGB yield at 0%.

Chart 9: Japan 10yr JGB and Short-end rate



Source: Bloomberg, data to 17 January 2017.

For 2017 we expect the BoJ to try and hold monetary policy steady throughout the year – with the short end rate at -0.1% and 10yr yields at 0%. The trend to higher global bond yields, especially from the US, works strongly in Japan's favour, if the BoJ can successfully hold 10yr yields down at 0%.

This would act to lower, ie. push further into negative, Japanese interest rates relative to the rest of the world, **which in turn should weaken the Yen and strengthen the Nikkei. All this should help create some inflationary pressure in Japan and support nominal GDP growth.**

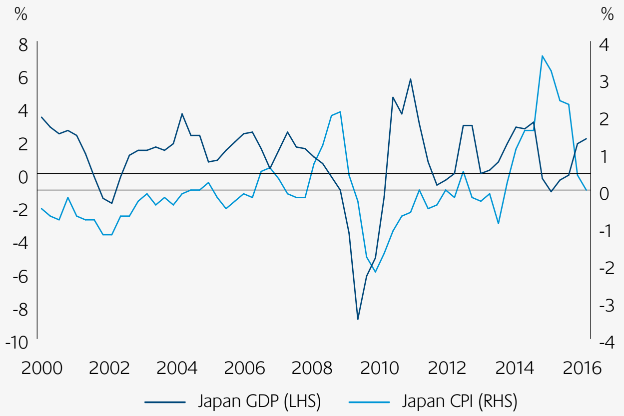
As detailed in our forecast section, however, **economic growth and inflation are both expected to remain modest in Japan in 2017.**

For 2017 we expect a little more economic growth that experienced in 2016, with an annual rate around 0.9%/yr. 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.

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.

Like elsewhere, headline inflation has shown some pick-up at the end of 2016 as energy prices rise again. Some slight improvement in underlying inflation could be seen in 2017 and 2018, but the pace of inflation is very unlikely to meet the BoJ's 2% target in the years ahead.

Chart 10: Japan GDP growth and Inflation



Source: Bloomberg. GDP data to 30 September 2016.
CPI data to 30 November 2016.

The other big event for Japan in 2017 is expected to be (another) snap Lower House election by Prime Minister Abe. This election, which could be expected before mid-year, is expected to see the re-election of Abe and the LDP – giving Abe the opportunity to remain Prime Minister until 2021 – ie. after the 2020 Tokyo Olympics Games.

Australia:

In Australia, throughout much of 2016 the economic data continued to show relatively solid growth, although there was an evident slowdown in the September quarter relative to the first half of the year. Economic growth continues to be driven by exports of both resources and services, especially tourism and education, and the strength in residential construction. Infrastructure spending also remains strong, especially in NSW, while the largest source of weakness remains business investment.

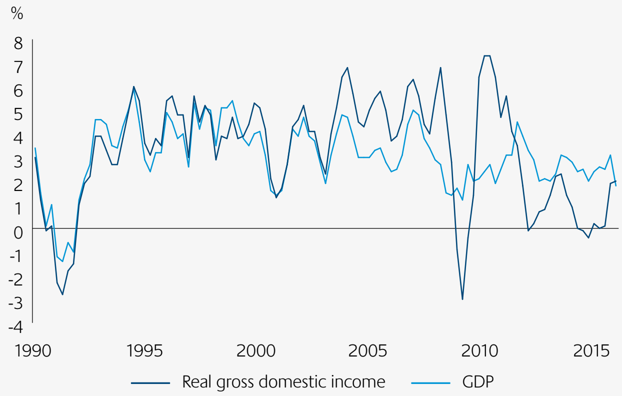
2017 is likely to bring a bit more of the same. Consumer spending growth looks set to remain relatively modest, as consumers continue to use the low interest rate environment to pay down debt, rather than increase spending.

The weak spot for the economy is expected to remain business investment – where both mining and non-mining investment continue to decline. Although it does appear that we are past the worst of this slowdown.

One of the most important development in recent months and which could dominate the discussion in 2017 is the improvement in the income side of the Australian economy.

As shown in the chart below, after running well below GDP growth for the past few years, national income growth accelerated from mid-2016 onwards (even as GDP growth slowed). A further improvement in national income growth – and nominal GDP growth – could be one of the most positive developments for Australia in 2017.

Chart 11: Australian GDP and income growth



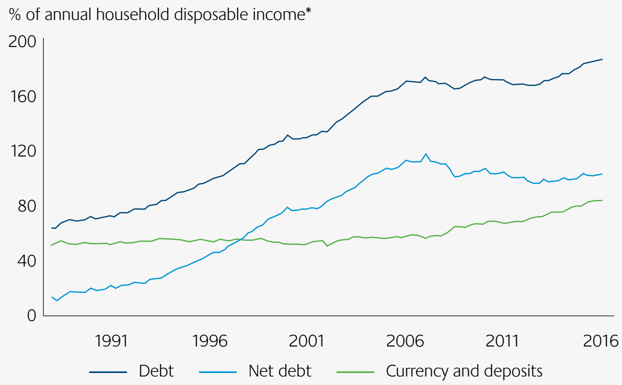
Source: ABS. GDP data to 30 September 2016.

Inflation in Australia is expected to remain low in 2017, but with the headline rate likely to drift up closer to the RBA's 2%-3% target range over the medium term.

After having cut interest rates in May and August 2016 on the back of the low inflation environment, the Reserve Bank of Australia, under the new leadership of Dr Phil Lowe, is signalling a reluctance to lower interest rates even further.

Indeed, after the election of Donald Trump and on concerns around the level of household debt in Australia, the markets are now expecting that Australia's cash rate has bottomed and the 1.5% interest rate will be the low in this cycle. Indeed, **we expect no change in the 1.5% cash rate throughout 2017.**

Chart 12: Australian household debt levels



* Household sector includes unincorporated enterprises; disposable income is before the deduction of interest payments.

Source: ABS; RBA Governor CEDA speech, 17 November 2016.

We would note that concerns that Australia is experiencing an unsustainable house 'bubble' are likely to linger in 2017 – but remain, in our view, unfounded (as they have for the past 20 years or so).

As shown in the above chart, while gross household debt to income continues to rise to very high levels, the unique nature of Australia's mortgage market (ie. variable mortgages that can be pre-paid) means that the net debt of Australian households has remained almost unchanged over the past decade.

Essentially, Australian households have been using the historically low interest rates to pay down debt – rather than leverage consumer spending, and this means that household balance sheets remain in relatively good shape. This should remain the case throughout 2017.

In terms of Australian markets, the end of the monetary policy easing cycle and global developments are **likely to see Australian bond yields drift higher throughout the year ahead.**

Over the second half of 2016 the Australian dollar traded in a relatively tight range around $US0.72 – $US0.77, but is starting the new-year at the lower end of that range. **Some further modest depreciation of the Australian dollar could be expected in 2017 against a stronger US dollar.**

One of the key risks for Australia in 2017 will be ongoing concerns over the budget position and Australia's AAA credit rating. While the credit rating agencies expressed some confidence in the budget after the late 2016 Mid-Year Update, this seems more like a delay in a potential downgrade, rather than a reprieve.

We see a greater than 50% risk of a credit rating downgrade, most likely by S&P, during 2017. However, a AA+ credit rating is still high by international standards and we see little impact on the cost of borrowing for the Australian treasury. A greater impact could be felt by the States and the banks, as their credit ratings would also be affected by a lower sovereign rating.

New Zealand:

The biggest news in New Zealand at the end of 2016 was the shock announcement by Prime Minister John Key that he was resigning. Key had been Prime Minister since November 2008 and was widely regarded as very successful.

He was replaced by former Finance Minister (and previous National Party leader) Bill English as Prime Minister, who then announced some significant ministerial reshuffling.

2017 is likely, therefore, to bring some political changes in NZ, but no doubt Bill English and the National Party will be keen to maintain the major policy initiatives of the Key government.

The next general election in New Zealand is due late in 2017. At this stage the opinion polls are showing the National Party well ahead at around 47% of the vote. The other major parties are well behind at 28% for Labour, 12% for the Greens and 9% for NZ First. A returned National Party government remains, therefore, the most likely option – unless the other three major parties can find some way to form a coalition if that opportunity arises.

In terms of the economic outlook, the **groundwork looks to have been laid for the NZ economy to shift back into higher gear in 2017.**

Strong population growth and low interest rates have fuelled construction demand. A tourism boom has the retail sector humming. The labour market has tightened and NZ households feel more confident.

After cutting the official cash rate three times in 2016, down to 1.75%, we expect, therefore, no further rate cuts from the RBNZ through 2017.

The RBNZ has, however, retained an easing bias, stating in November that "policy settings ... will see growth strong enough to have inflation settle near the middle of the target range. Numerous uncertainties remain...and policy may need to adjust accordingly."

Risks:

In addition to our key themes, there are a number of risks to the global economy and financial markets in 2017. These include:

- Substantially higher bond yields, ie. US 10yr above 3.5%, as a result of market concerns that the US Fed is 'behind the curve' on a President Trump-fiscal policy inspired inflation surge.
- An associated risk would be that the US Fed has to raise official interest rates more than three times in 2017.
- Audit the Fed: A number of Republicans in Congress, plus President Trump, have publically criticised the Fed and supported "Audit the Fed" legislation (as proposed in both 2014 and 2015). This legislation would take away flexibility from the Fed and impose policy rules, ie. the Taylor Rule. This would likely imply much higher interest rates in the US – which is probably one good reason why it won't happen, but the risk remains.
- New Fed Chair. Janet Yellen's terms as Chair of the Fed ends in February 2018. As noted earlier, President Trump will get to nominate a new Chair and this could be a focus for markets in 2017. We would also note that although Janet Yellen's term of Chair expires early next year, her term as a Governor extends all the way until 2024!
- US President Trump is true to some of his pre-election rhetoric and imposes significant trade restrictions and tariffs on the US's major trading partners, ie. China, Mexico and Canada, and initiates a trade war.
- China is named as a 'currency manipulator' and trade restrictions imposed lead to a significant break-down in US-China trade.
- US President Trump initiates a break-down in some of the major geopolitical structures, ie. NATO, the US relationship with China, the IMF/World Bank and the US relationship with Russia.
- Marinne Le Pen and the National Front win the French Presidential election and initiate Frexit.
- Angela Merkel loses the Germany general election and the AfD can either form government or be part of a larger coalition government.
- Brexit negotiations start off badly with negative implications for the UK's trade with the EU and doubts over London's position as a global financial centre.
- China's political leadership loses control of the economy and concerns over debt levels at the local government and SOE level spill-over into a wider financial crisis that leads to significant capital outflow from China.
- The security situation in the Middle East (specifically Syria) continues to spiral downwards – worsening the refugee crisis in Europe and escalating the risk of terrorist activities in major western nations.
- Other potential geopolitical flashpoints in 2017 would include the South China Sea and Eastern Europe/Russia.

Section 2

Market Watch – Our Quarterly Market Review

Political concerns were once again the primary focus of markets over the fourth quarter with the US Presidential Election and Italian referendum (and resignation of Matteo Renzi) occurring over the quarter. Markets started the quarter weaker as concerns around the US Election outcome and the prospect of a Fed rate hike in December sapped sentiment. Investors were clearly skittish in the lead-up to the election as Twitter and FBI revelations drove markets on a daily basis. The surprise election result and ensuing risk-off sentiment in Asian markets proved short lived as investors shifted focus to the potential of significant fiscal stimulus. On the back of this perceived pro-growth environment, inflation expectations and equities resumed their move higher and subsequently bond yields rose sharply.

While politics may have taken centre stage, not all central bankers sat on the side lines. In the US the Federal Open Market Committee (FOMC) delivered it's much anticipated rate hike increasing the cash rate by 25 bps to 0.50%-0.75%. This was the second rate hike from the Fed since December 2015 and indeed, only the second rate hike in 10 years. The surprise in the Fed's decision was a slight upward drift in the FOMC's median projection for the Fed Funds rate in the years ahead, with three rate hikes now expected for 2017 (as opposed to two) and a small increase in the long-run 'dot' to 3.0% (from 2.9%). In early December, the European Central Bank (ECB) announced a longer-than-expected extension of its asset-purchase/quantitative easing (QE) program out to December 2017, well beyond the previous time-frame of March 2017. However, the QE program will, from April 2017 onwards be reduced to a monthly pace of €60bn, rather than the current pace of €80bn/mth. The Bank of England meanwhile held policy unchanged. The bank signalled that while policy is unlikely to be changed in the period ahead, they have the ability to respond in either direction. The Bank of Japan (BoJ) held the cash rate steady at -0.1% in December 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 hike is high and the most likely outcome will be rates on hold for all of 2017.

Commodity prices were mostly stronger over the fourth quarter with energy and industrial metals performing well while precious metals were weaker. The price of West Texas Crude rose and fell over October and November along with sentiment and expectations around the potential OPEC production cut. Crude prices rose close to 10% on the 30th of November as the 6 month, 1.2mbbl cut to oil production starting January 2017 was announced. Oil continued to perform well into year and quarter end to close at $US53.7 per barrel up 11.4% over the quarter and 45% over the year. US Oil Rig counts as measured by Baker Hughes have continued to rise along with prices, up 66% from the lows reach in May and 24% over the quarter to 526, suggesting that the production cut may be less effective in reducing oversupply and increasing prices than expected. The iron ore price, as measured by the benchmark price delivered to Qingdao China – 62% Ferrous Content rose 41.2% over the quarter to $US78.87/metric tonne, driven by increased demand from China as property sales and construction pick-up and positive sentiment around increasing infrastructure spending in the US. Coal prices, as measured at the Newcastle Coal Terminal, also increased over the quarter rising 22.4% to close at $US 88.4/metric tonne after peaking at $US115 in early November. Base metals were mixed, with copper (+13.8%), zinc (+8.40%) and aluminium (+1.2%) all higher while nickel (-5.2%) and lead (-5.0%) were weaker. Precious metals fell as yields rose with gold down 12.6% in the quarter and platinum down 12.1%.

Global equity markets had a volatile quarter with the US Election, the OPEC deal and the Fed rate hike impacting sentiment. Markets weakened through October before reversing in early November as risk-off sentiment turned to risk-on. In the wake of the US election equity markets continued to perform as developed market investors focused on the pro-growth and potentially inflationary policy proposals of President Elect Donald Trump. Sentiment in Emerging markets was however weaker as investors grew concerned with the potential for anti-trade policies and the impact of the rising US dollar and yield environment. The MSCI World Index rose 1.5% in the quarter in US dollar terms and 7.5% in Australian dollar terms, given the 6.0% depreciation 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 relatively low over the quarter after spiking sharply higher around the US Election in early November. The VIX Index started the quarter at 13.3 and finished at 14.0 but reached an intra-quarter high of 22.51 in the lead up to the US Election. Overall it averaged 14.1, compared to 13.3 the prior quarter.

In the US, the S&P500 Index rose 3.3% in the quarter, once again reaching new all-time highs. The Dow Jones (+7.9%) and NASDAQ (+1.3%) also rose with the Dow Jones outperforming other indices as sentiment towards industrials improved with the prospect of tax cuts and infrastructure spending. On a sector basis, MSCI Financials (+14.09%) was the star performer as rising bond yields and the promise of looser regulation drove positive sentiment, Energy (+6.68%) also performed well with rising oil prices. Consumer Staples (-6.01%) were the worst performer as rising yields reduced the sectors attractiveness and concerns around a rising US dollar and trade impacted sentiment.

European equities followed US equities higher over the quarter, with broad-based performance across all markets aided by the depreciation of the Euro which was down 6.4% against the US dollar. Overall the Euro Stoxx 50 Index rose 9.6%, banks drove much of this increase with the EURO Stoxx Bank index rising 27% over the quarter with rising yields and signs that monetary policy easing has peaked. In other equity markets, German (+9.2%), France (+9.3%), Spain (+6.5%) and the Netherlands (+6.8%) all rose but underperformed the broader index while Italy rose +17.3% with much of the performance coming in the days following the failed Italian Referendum, despite the resignation of Prime Minister Renzi.

UK equity markets also rose over the quarter as the economy continued to outperform post-Brexit expectations with growth coming in above forecast and inflation rising. The FTSE100 rose 3.5% in Q4 while the British pound depreciated further against the US dollar ending the quarter 4.9% lower but rising 1.6% against the Euro.

The Japanese equity market was one of the best performing markets over the quarter with the Nikkei up 16.2%, driven by weaker yen. The Japanese yen depreciated 13.4% against the US dollar to end the quarter at 116.96.

Emerging markets underperformed developed markets over the quarter with the MSCI Emerging Markets Index closing down 4.6% in US dollar terms, but up 1.3% in Australian dollar terms. Strong inflows to Emerging markets reversed over the quarter, despite the continued strength in commodity prices, as global investors moved back to traditional safe havens. Concerns around the future of US trade policy and an environment of rising yields and a stronger US dollar also weighed on Emerging markets. On a regional basis the MSCI Emerging Markets Europe, Middle East & Africa was the best performer up 1.4% driven by strength in European markets such as Russia (+12.9%) and Hungary (+15.7%). The MSCI Asia ex Japan (-6.64%) and MSCI Emerging Markets Latin America (-1.69%) both fell while the Shanghai Composite Index rose 3.3%.

The S&P/ASX 200 Accumulation Index posted healthy gains in the December quarter, rising 4.4% to hit one-year highs at quarter-end. Financials (+12.8%) was the best performing sector in the Australian share market, as rising interest rates improved sentiment towards the large banks. Materials (+7.9%) performed well, supported by rising commodity prices. Iron ore was particularly strong, adding more than 40%. Energy (+7.5%) rose, as companies in the sector benefitted from a rising oil price. Health Care (-8.8%) was the laggard by some margin, as companies in the sector posted downbeat earnings forecasts. This was capped off in December by Sirtex Medical, which halved in value after posting a negative trading update.

Bonds markets were driven by political events and central bank action over the quarter. Overall government bond yields traded in wide ranges of 20-111 bps to end the quarter notably higher. The biggest gains in ten-year yields were in Australia (+86 bps) and the US (+85 bps), yields in Germany and UK were also up notably by 33 bps and 49 bps respectively. Yields in Japan rose by a less notable 14 bps in the quarter reflecting the cap at 0% at the ten year part of the curve that the BoJ implemented as part of its yield-curve focused monetary policy strategy.

United States

The US Fed – Restarting normalisation after a long pause:

- As widely expected, the Fed raised the Fed Funds target rate by 25 bps to a 0.5%-0.75% range at their 15 December meeting. This was the second rate hike from the Fed since December 2015 and indeed, only the second rate hike in 10 years.
- The surprise in the Fed's decision was a slight upward drift in the FOMC's median projection for the Fed Funds rate in the years ahead, ie. the 'dots', with three rate hikes now expected for 2017 (as opposed to two) and a small increase in the long-run 'dot' to 3.0% (from 2.9%).
- Asked about the potential of a significant fiscal policy easing under President Trump, the Fed Chair refused to be drawn on the implications for monetary policy – as she did not want to pre-empt what that fiscal policy easing would look like and/or what impact it would have on the economy. Clearly this will be a big part of the Fed's reaction function in the coming years.
- We have made some major changes to our expectations for the Fed Funds rate – to reflect the expansionary, stimulatory and, ultimately, inflationary policy of the Trump administration.
- Given that we now expect the US economy to experience a significant easing of fiscal policy from late 2017 onwards, which pushes inflation higher than previously expected and brings forth the need for more tightening from the Fed, we now expect two rate hikes in 2017 to be followed by three rate hikes in 2018 (previously two) and three rate hikes in 2019 (previously two). This will give a peak in the Fed Funds target rate in 2019 of 2.5%-2.75%, ie. 50 bps higher than our previous peak forecast.
- We now expect, however, two rate cuts in 2020 (previously no change) as the tightening of financial conditions over 2018-2019 (from a higher US dollar, higher bond yields and a higher Fed Funds rate), combines with President Trump's anti-trade and anti-immigration policies to bring about an economic downturn. See Chart 1.

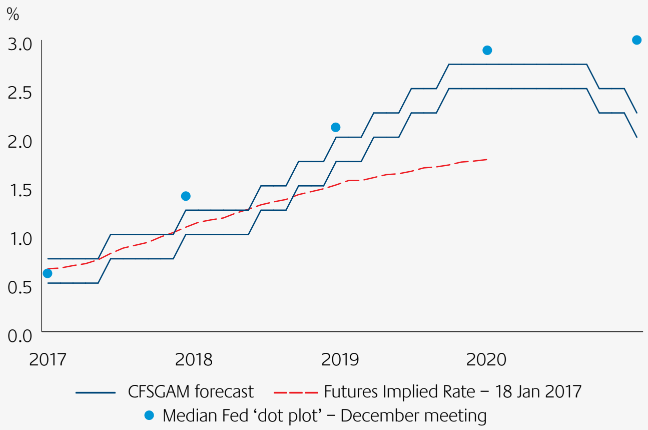
Fed achieving its mandate as a tighter labour market leads to wage growth and inflation

- Inflation continues to gradually increase with headline CPI up 0.3%/mth in December and the annual rate increasing to 2.1%/yr (from 1.5%/yr in September), the highest level since mid-2014. The core CPI also increased by 0.2%/mth, with the annual rate edging up to 2.2%/yr, around where it has remained for most of 2016.
- The Fed's preferred measure of underlying inflation, the core Personal Consumption Expenditure (PCE), edged down to 1.6%/yr in November, from 1.7% previously.
- The unemployment rate dropped to a new low in the cycle of 4.6% in November before increasingly slightly to 4.7% in December. See Chart 2.
- Average hourly earnings increased 0.4%/mth in December, taking the annual rate to a new cycle high of 2.9%/yr.
- Rising wage pressure can also been seen in the Atlanta Fed's Wage Growth Tracker measure which increased to 3.9%/yr for November. See Chart 3.

President Trump – what to expect?

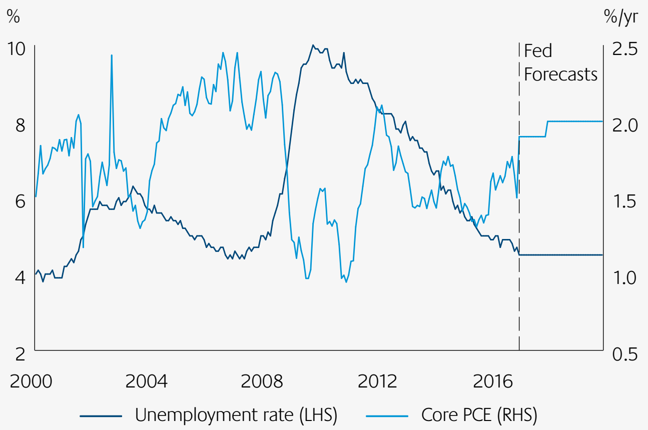
- US (and global) financial markets continued to be driven through December by the Presidential election victory for Donald Trump in early November. Financial markets focused on the stimulatory policies expected under President Trump, including significant company and income tax cuts, increased infrastructure spending and reduced regulation. The more concerning policies around trade, immigration and climate change look to be considered secondary factors at this stage.
- However there is some uncertainty around exactly what tax policies will be implemented given the differences between Trump's proposals and the GOP's own. Of particular concern for markets is the GOP proposal to introduce so called "border adjustments" which would effectively tax imports at the new corporate tax rate (20%) while offering exporters tax credits, this policy would likely create many winners and losers and has the potential to lead to a sharp appreciation in the US dollar.
- Estimates from the Committee for a Responsible Federal Budget (CRFB) suggest that President Trump's policies would lead to a significant increase in the Federal deficit and debt to 105% of GDP by 2026, above existing Congressional Budget Office (CBO) estimates of 86% of GDP. See Chart 4.

Chart 1: US monetary policy now on a new cycle



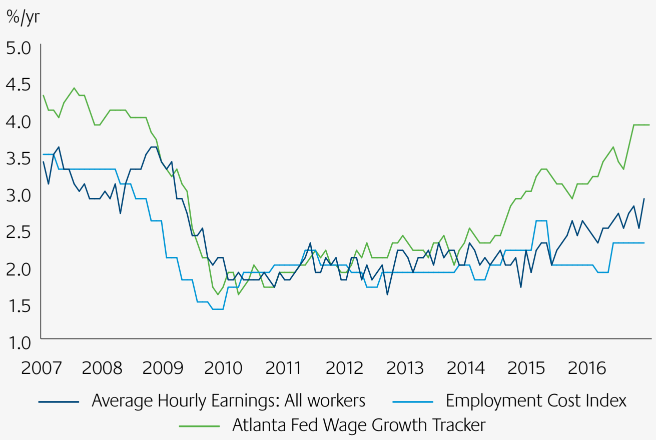
Source: Bloomberg, data to 17 January 2017. Fed 'dots' as at December 2016. CFSGAM forecasts as at 15 December 2016.

Chart 2: The US Fed is achieving its dual mandate



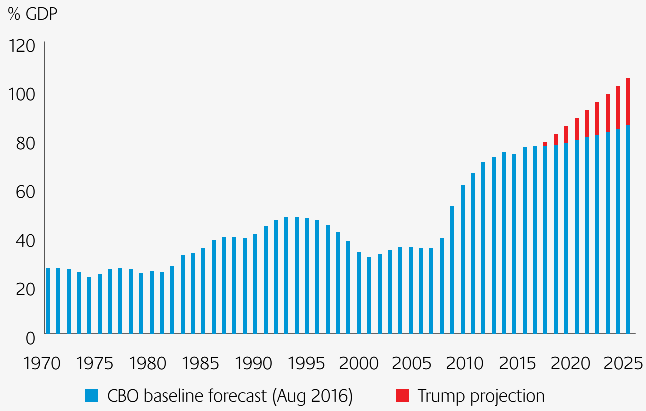
Source: Bloomberg. Data to 18 January 2016.

Chart 3: Signs of tighter labour market leading to wage growth



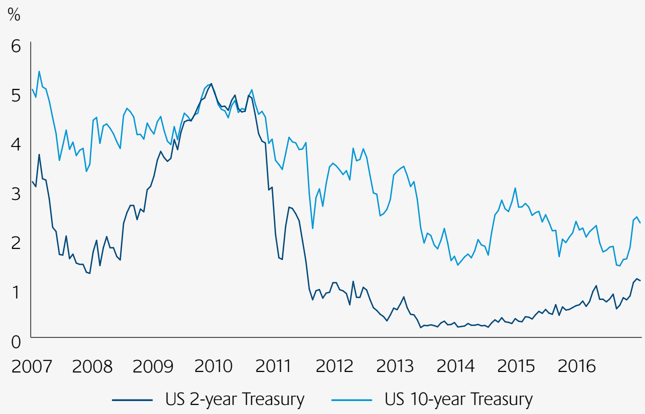
Source: Bloomberg. Data to 17 January 2017.

Chart 4: Large debt increase coming under President Trump



Source: CBO as at August 2016. CRFB as at October 2016. CFSGAM.

Chart 5: Bond yields rise on rate hike expectations



Source: Bloomberg. Data to 17 January 2017.

Chart 6: USD rally likely to continue

Source: Bloomberg. Data to 17 January 2017.

Europe

European Central Bank tweaks policy

- In early December the European Central Bank (ECB) announced a longer-than-expected extension of its asset-purchase/ quantitative easing (QE) program out to December 2017, well beyond the previous time-frame of March 2017 and longer than anticipated by markets. However, the QE program will, from April 2017 onwards be reduced to a monthly pace of €60bn, rather than the current pace of €80bn/mth. All official interest rates were held unchanged, with the Deposit Facility at -0.4%.
- The ECB also made changes to the operations of its QE program that will allow it to continue to purchase assets for a longer period, including the removal of the deposit rate floor.
- In announcing the changes the ECB President, Mario Draghi, delivered a dovish message, strenuously denying that a 'tapering' of monetary policy easing was in place.
- Despite Draghi's insistence it is important to note that the removal of the deposited rate floor acts as a form of tapering as it will allow the ECB to buy shorter dated bonds (previously below the floor) reducing the total duration of asset purchases.

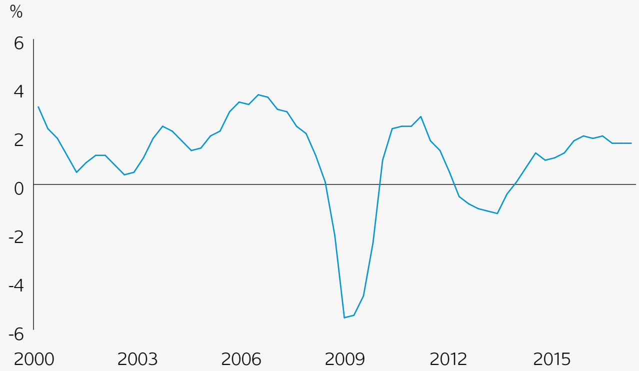
Growth remains steady through H2 16

- GDP data released for the Euro area confirmed Q3 16 growth at 0.3%/qtr, in line with expectations. Annual growth for Q3 2016 remained at 1.7%/yr where it has remained for the last three quarters. See Chart 7.
- Growth was broad based with consumption (+0.3%/qtr), government spending (+0.5%/qtr) and investment (+0.2%/qtr) all growing while net trade was a negative with imports (+0.2%/qtr) rising faster than exports (+0.1%/qtr).
- The stable aggregate growth figures do however continue to hide significant divergence between countries, Spain (+3.2%/yr) remains the best performing of the major economies, Germany (+1.7%/yr) is growing at the Eurozone average while France (+1.1%/yr) and Italy (+1%/yr) continue to underperform.

Politics remains a focus in EU

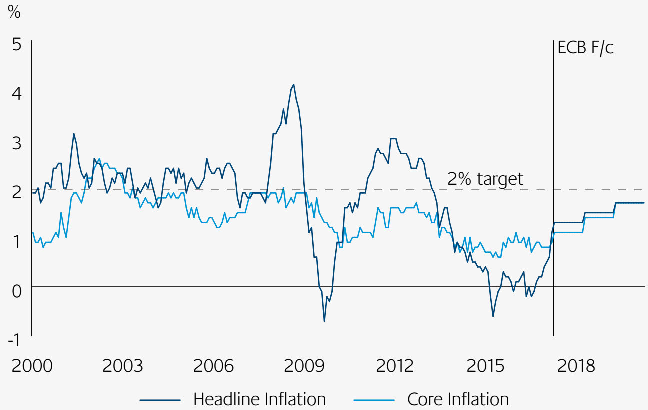
- In politics, the focus in December was on the failed referendum in Italy that was designed to make it easier for the government to implement (much needed) economic reforms. The failure of the referendum saw Prime Minister Renzi resign – to be replaced by former Foreign Affairs Minister Paolo Gentiloni.

Chart 7: EU Economic growth holds steady



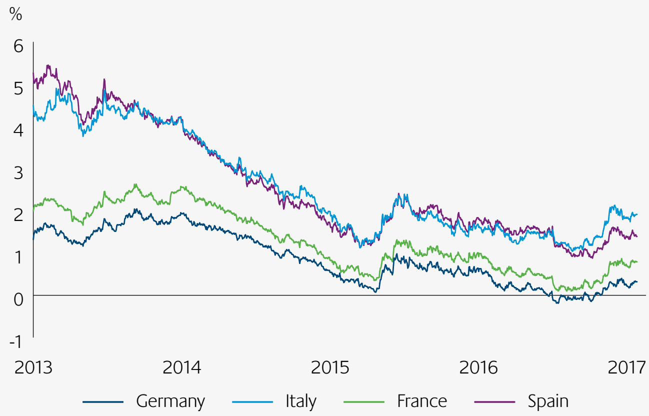
Source: Bloomberg. Data to 30 September 2016.

Chart 8: EU inflation remains elusive



Source: Bloomberg. Data to 31 December 2016.

Chart 9: EU Bond yields begin to follow the global trend (10 year bond yields)



Source: Bloomberg. Data to 18 January 2017.

United Kingdom

UK growth picks up despite Brexit uncertainty

- Q4 16 GDP came in at 0.6%/qtr, keeping the annual rate at 2.2%/yr, in-line with the BoE's revised forecasts and significantly above pre-Brexit expectations. See Chart 10.
- Services remain the driver of growth with manufacturing and construction both declining over the quarter. The best performing sectors were the distribution, hotels and restaurants sector and transport, storage and communication sector. This is consistent with the strong pick-up in consumer spending and tourism following the referendum and has likely been aided by the weaker pound.

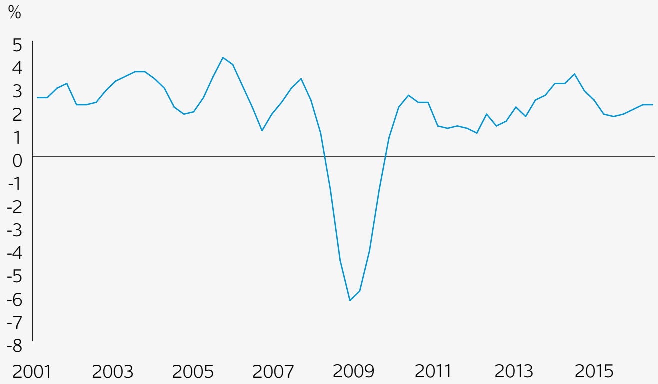
Brexit means (hard) Brexit

- Over the quarter Prime Minister Theresa May offered more insight into what the eventual exit will look like. At her highly anticipated 17 January speech she confirmed that the UK will take back control of immigration and will leave the single market but is hopeful that a free trade agreement can be reached with the EU. She was also adamant that the UK will no longer be beholden to the decisions of the European Court of Justice and pledged to give both houses of Parliament a vote on the final deal.
- Interestingly she also warned against a punitive deal suggesting that Brittan could transform itself into a corporate tax haven if the EU failed to strike a trade agreement with the country.
- Following the speech the British pound actually appreciated against most major currencies, more than reversing its depreciation on the morning following the leaking of May's talking points earlier in the week. The pound is still more than 16% weaker against the US dollar than it was before the vote. See Chart 11.

Weaker pound and higher oil drive inflation higher

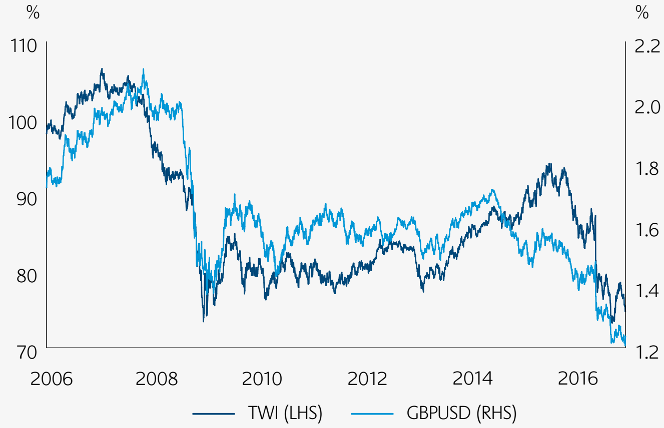
- The annual rate of inflation rose to 1.6%/yr in December (from 1% in September), with the core CPI up 1.6%/yr (from 1.5%/yr). See Chart 12.
- The lower pound (down about 16% over the last year) and higher oil price (+45% in USD since last year) have contributed significantly to the increase in inflation which is expected to continue into 2017 and 2018.

Chart 10: UK economy holding up better-than-expected post Brexit vote



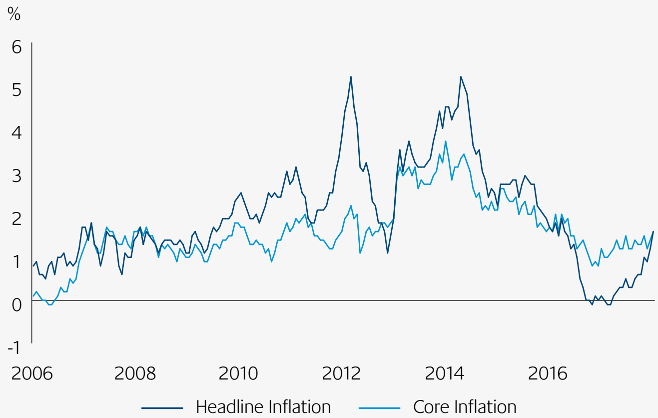
Source: Bloomberg. Data to 31 December 2016.

Chart 11: GBP maintains weakening trend



Source: Bloomberg. Data to 18 January 2016.

Chart 12: UK inflation begins to turn higher



Source: Bloomberg. Data to 31 December 2016.

Japan

Inflation turns positive as growth improves

- CPI moved back to positive territory, for the first time since February, rising to 0.5%/yr in November from to -0.5%/yr in September.
- The core measure excluding food and energy was also higher, albeit by much less given the rise in energy prices, rising to 0.1%/yr in November from 0%/yr in September. Both measures are well below the BoJ's 2% target. See Chart 13.
- GDP growth was 0.3%/qtr in Q3 16, increasing the annual rate to 1.1%/yr up from 0.9%/yr in Q2 16. The Tankan Large Manufacturing Index also rose to +10 in Q4 16 (from +6), with the large non-manufacturing index steady at +16.

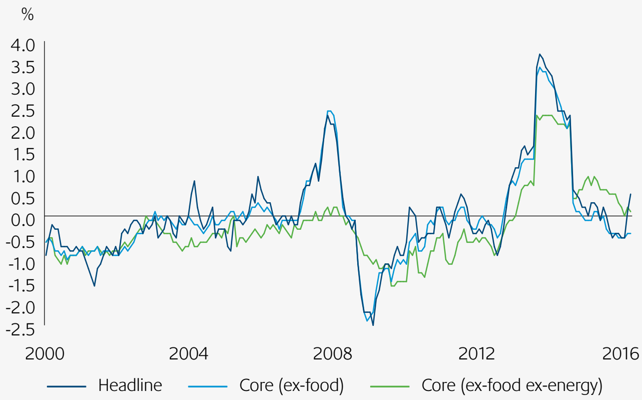
Bank of Japan (BoJ) holds policy

- 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.
- Interestingly at their 1 November 2016 meeting the BoJ finally abandoned their 2 year timeline for achieving 2% inflation as well as their unrealistic forecast of inflation reaching 2% in FY 2017. They replaced this with a more realistic, but still optimistic, forecast that inflation would "increase toward 2 per cent in the second half of the projection period", which extends into FY 2018.
- To offset this softening of rhetoric the BoJ added a commitment to expanding the balance sheet until a sustained inflation overshoot is achieved.
- These changes suggest that it would take a large adverse economic shock to the force BoJ to cut either the -0.1% overnight rate or the 0% 10yr JGB target.

The Yen weakens as global bond yields rise

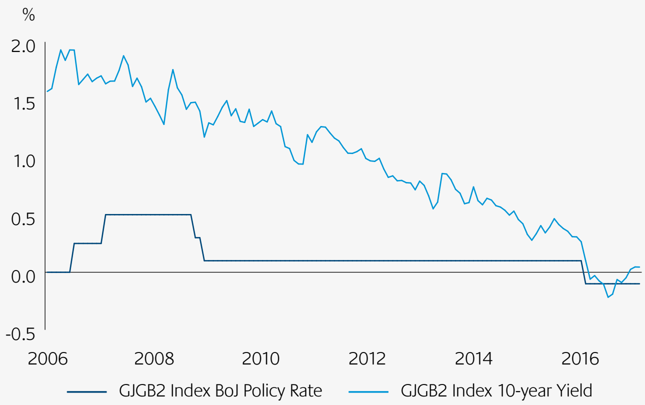
- As global bond yields rose in the wake of the US election Japanese bonds have been constrained from following suit and the Yen has depreciated as a result. See Chart 15.
- The Yen is now about 11% lower than at the end of Q3, down from a peak of 16% weaker but still an outcome that the BoJ is likely pleased with.

Chart 13: Japanese inflation remains well below target



Source: Bloomberg. Data as at 30 November 2016.

Chart 14: BoJ targets 10yr bonds at 0%



Source: Bloomberg. Data as at 18 January 2016.

Chart 15: Yen now weakening on the back of a stronger USD and JGB 0% limit

Source: Bloomberg. Data to 18 January 2017.

China

Growth picks up in H2 16

- While official GDP figures have been stable over the year other measures of economic growth suggest activity has picked up in China over the second half of 2016.
- The Li Keqiang Index, a proxy for Chinese GDP composed of growth in bank loans, electricity production and rail freight reportedly favoured by Premier Li, has increased significantly over H2 16. The index increased to 10.7%/yr in December from 5.6%/yr in June and a recent low of 4.0%/yr in April. See Chart 16.
- The rebound in the index confirms the robust growth story told by the official data but it also suggests the old energy-intensive industrial sector is recovering and driving much of it.
- Other economic data over the quarter showed further stabilisation in growth over the quarter. December data showed Industrial Production decreased to 6.0%/yr (from 6.1%/yr in September), Retail Sales were up +10.9%/yr (from 10.7%/yr in September) and Fixed Asset investment fell +8.1%/yr (from 8.2%/yr in September).

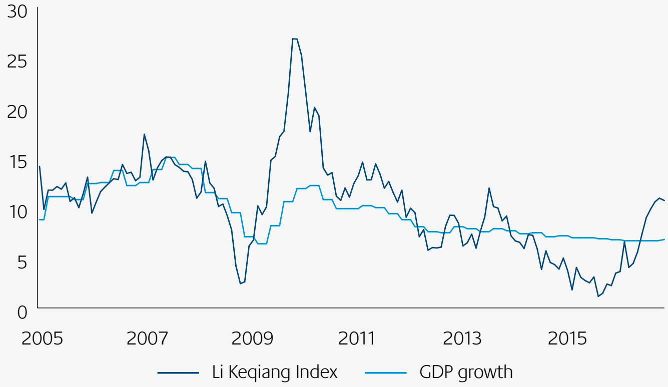
Inflation accelerates in Q4 16

- Inflation continued to increase over the quarter, rising to 2.1%/yr in December from 1.9%/yr in September.
- China's PPI continued its resurgence rising to a very solid 5.5%/yr in December, well up from 0.1%/yr in September and the highest level since September 2011.
- The increase in China PPI may suggest the beginning of a global inflationary recovery as it flows onto Chinese export prices and imported good prices in other markets.

RMB depreciating as capital outflows continue

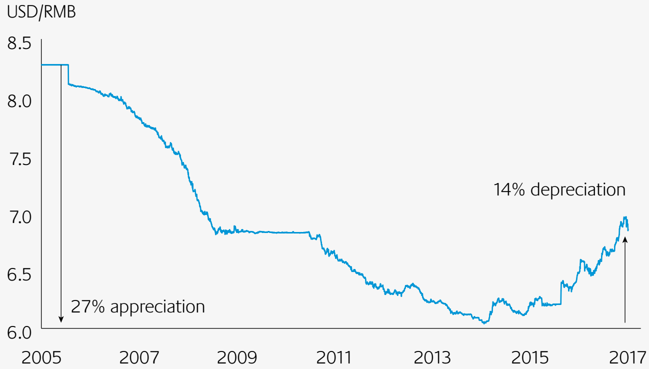
- The RMB continued its gradual depreciation against a rising USD over the quarter, falling a further 4.1% against the USD. The currency is now 14% down from its peak reach in early 2014. See Chart 17.
- However as the broad dollar DXY index has appreciated 7% over the quarter (over 25% since 2014), the Peoples Bank of China (PBoC) has been forced to expend FX reserves to support the currency. Reserves fell to $US 3.01trn in December, the lowest level since 2011. See Chart 18.

Chart 16: Chinese economy accelerates in H2 16



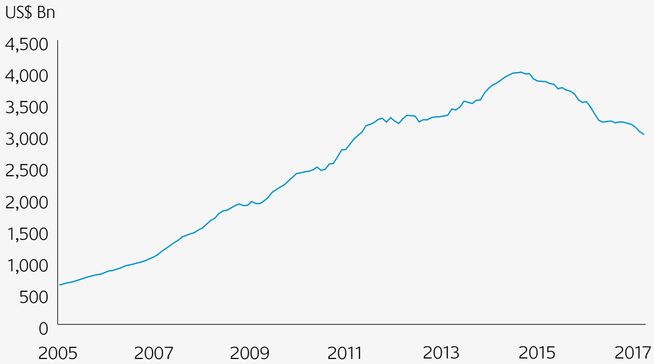
Source: Bloomberg. GDP to 31 December 2016. Li Keqiang index to 31 December 2016.

Chart 17: RMB depreciation continues



Source: Bloomberg. Data to 18 January 2017.

Chart 18: China FX Reserves being used to support currency



Source: Bloomberg. Data to 31 December 2016.

Australia/New Zealand

Australian Growth weak in Q3 16

- The big news for Australia in December was that GDP growth for Q3 16 printed -0.5%/qtr (consensus -0.1%), well down from the revised +0.6%/qtr growth of Q2 16. This was only the fourth quarterly negative print in the last 25 years and took the annual rate of growth down sharply to 1.8%/yr from 3.1%/yr in Q2 16.
- The only bright spots in the data were an increase in household consumption and inventories. All other key sectors of the economy, including net exports, private investment and public investment, contracted in Q3 16.
- Importantly, there was a 4.5%/qtr increase in Australia's terms of trade over Q3 16. As a result, real net disposable income rose a solid 0.8%/qtr in Q3 16, taking the annual rate of increase to a strong 3.2%/yr. See Chart 19.
- The household savings ratio declined to 6.7% in Q3 16 – well below the levels of 8%-9% that had prevailed since the GFC.

RBA remains on hold despite low inflation

- Q4 16 Consumer Price Inflation (CPI) data was released and was slightly below consensus estimates. Headline CPI rose 0.5%/qtr and 1.5%/yr, from 1.3%/yr in Q3. Key drivers included increases in Tobacco (+7.4%/qtr), automotive fuel (+6.7%/qtr), this was partly offset by falls in furnishings, household equipment and services (-0.8%/qtr) and communication (-0.8%/qtr). Price falls for clothing and accessories (-0.8%/qtr) and household equipment are likely related to the heavy discounting over the fourth quarter and the early start to Christmas sales.
- Underlying inflation, the RBA's preferred measure, rose to 0.4%/qtr, while the annualised rate rose slightly to 1.5%/yr from 1.3%/yr. Both measures of inflation are still below the RBA's 2-3% target band.
- Despite this continued below target inflation the RBA, as widely expected, left the cash rate unchanged at 1.5% over the December quarter. The signals from the RBA continue to suggest that the hurdle to another rate hike is high and the most likely outcome will be rates on hold for all of 2017.

AAA rating at risk as budget outlook deteriorates

- Australia's Mid-Year Economic and Fiscal Outlook (MYEFO) showed a small improvement in the projected 2016/17 Budget (deficit now estimated at $A36.5bn, -2.1% of GDP, vs the pre-election estimate of $A37.1bn, -2.2% of GDP), but an accumulated $A10.4bn widening of the budget deficit out to 2019/20. The government still maintains that the budget will be back in (small) surplus by 2020/21. See Chart 21.
- The major rating agencies reconfirmed Australia's credit rating at AAA/Aaa after the MYEFO. But no doubt they will be watching closely for further improvements in the May 2017 Budget. At the moment the position of the AAA feels more like a stay of execution, rather than a reprieve.

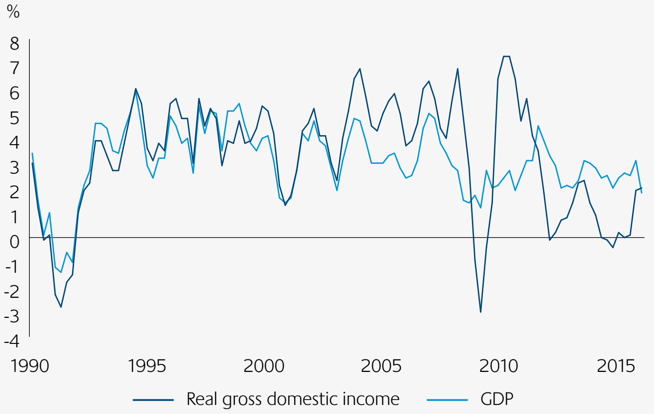
RBNZ eases one last time

- The Reserve Bank of New Zealand (RBNZ) cut interest rates 0.25% to a new all-time low of 1.75% as largely anticipated at their 10 November 2016 meeting.
- We expect no further rate cuts from the RBNZ through 2017, although the RBNZ has retained an easing bias, stating in November that "policy settings ... will see growth strong enough to have inflation settle near the middle of the target range. Numerous uncertainties remain...and policy may need to adjust accordingly."

NZ inflation and growth begin to pick up

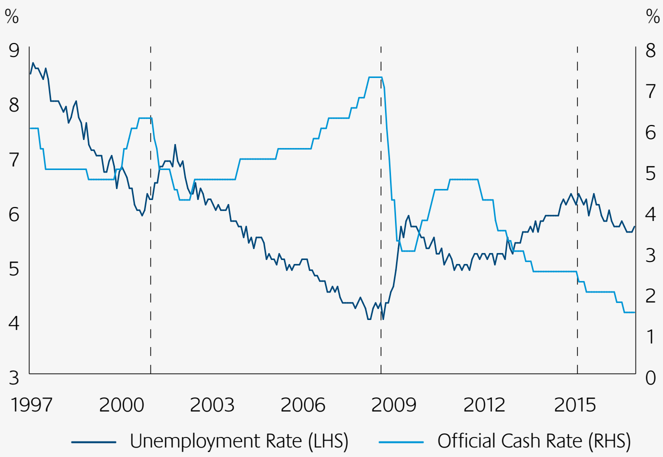
- Q4 16 CPI out in January was stronger than the 0.3%/qtr expected at 0.4%/qtr, the annual rate increased to 1.3%/yr. Inflation is now back within the RBNZ's 1-3% target band for the first time since Q3 14. See Chart 23.
- Core measures were also stronger with the trimmed 10% mean increasing to 1.7%/yr from 0.8%/yr and weighted median increasing to 2.0%/yr from 1.7%/yr which should give the RBNZ more comfort that underlying inflation is lifting.
- Economic growth for Q3 16 showed a very solid performance. Q3 16 GDP rose by 1.1%/qtr, taking the annual pace to 3.5%/yr (from 3.4%).
- Economic growth in New Zealand is running well above the 20 year average of 2.7%/yr and is being driven largely by household spending. See Chart 24.

Chart 19: As GDP softens, National income growth gains



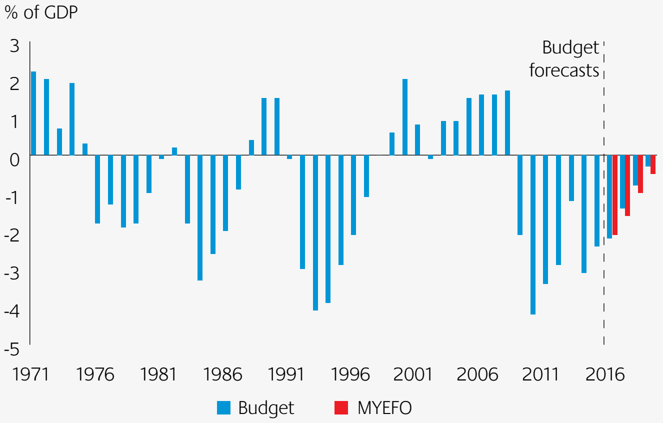
Source: Australian Bureau of Statistics (ABS). Data to 30 September 2016.

Chart 20: Despite low inflation, RBA easing cycle looks to be over



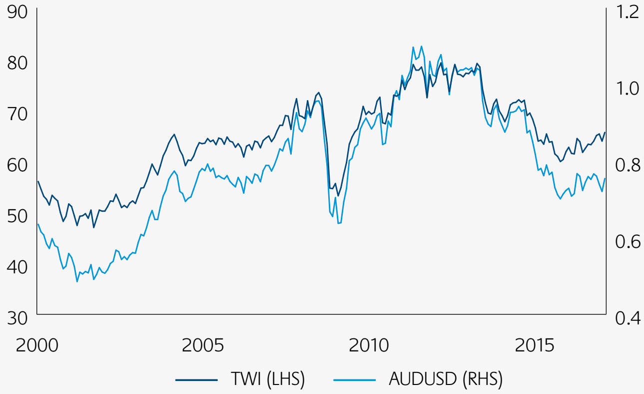
Source: RBA and Bloomberg. Official cash rate data to December 2016. Unemployment rate to 30 November 2016.

Chart 21: MYEFO still shows a long road back to balance



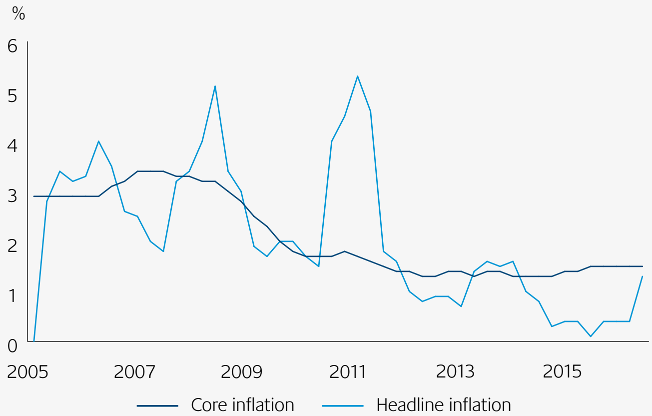
Source: Commonwealth Treasury, MYEFO December 2016.

Chart 22: AUD expected to edge lower through 2017



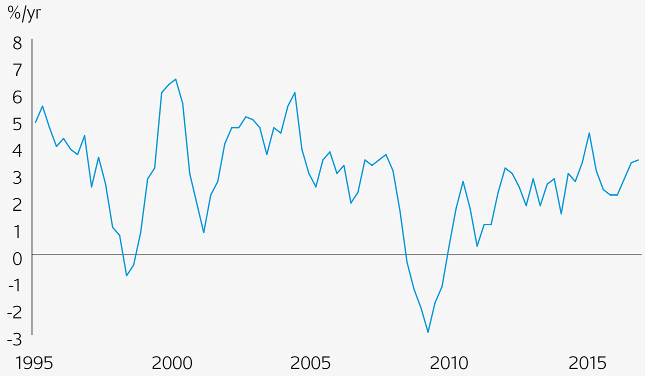
Source: Bloomberg. Data to 18 January 2017.

Chart 23: NZ inflation surprises in Q4



Source: Bloomberg and RBNZ. Data as at 31 December 2016.

Chart 24: NZ Economic growth remains solid



Source: Bloomberg. Data as at 30 September 2016.

Section 3

Economic Forecasts – January 2017

United States

	2017		2018		2019		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	2.2	2.3	2.3	2.6	2.0	2.3	2.0	2.0
Inflation – Core PCE	1.9	1.8	2.0	2.3	2.0	2.5	2.0	2.0
Monetary policy – Rates	1.2%	1.0%-1.25%	1.7%	1.75%-2.0%	2.0%	2.5%-2.75%	2.0%	2.0%
Monetary policy – Other	Fed unlikely to alter balance sheet.	Fed unlikely to alter balance sheet.	No consensus.	Coupon reinvestment may be phased out.	Coupon reinvestment may be phased out.	Coupon reinvestment may be phased out.	Balance sheet slowly returns to normal.	Balance sheet slowly returns to normal.

Source: Bloomberg.

Comments:

- **GDP:** Growth in 2016 is likely to come in lower than previously expected at around 1.6% (our latest f/c was 1.9%). For 2017 the key development will be whether there is significant fiscal policy easing. As we don't expect much of an impact from fiscal policy this year, our GDP forecast of 2.3% is close to market consensus.
- However, economic growth should be supported through 2018 and 2019 by significant fiscal policy easing and so our GDP forecasts for both years are above consensus at 2.6% and 2.3% respectively. Growth is also expected to be helped by the solid labour market and some long-awaited upward pressure in wages growth.
- **Inflation:** The Fed's favoured measure of underlying inflation, the core PCE, has picked up again in recent months and looks like ending 2016 at 1.7%.
- The significant fiscal policy easing and better growth we see is expected to put further upward pressure on inflation in the year ahead, leading us to forecast above-target inflation in both 2018 and 2019.
- **Monetary policy:** After hiking rates in December 2016, we expect the Fed to tighten twice again in 2017 – although the Fed's own 'dots' imply three rate hikes this year.
- However, we then expect to see the Fed tighten three times in both 2018 and 2019 – in response to the above-target inflation outcomes we see from President Trump's policies. But, in 2020 we expect to see the Fed ease monetary policy twice, as economic growth slows meaningfully.
- The Fed is not expected to sell any of the bonds it holds on balance sheet, but is expected (by us) to begin to cease reinvesting coupon income in 2018 or 2019.

United Kingdom

	2017		2018		2019		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	1.2	1.6	1.3	1.6	1.5	1.25	2.5	2.0
Inflation – CPI	2.4	2.2	2.5	2.5	2.0	2.0	2.0	2.0
Monetary policy – Rates	0.5%	0.25%	0.7%	0.5%	1.0%	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 outperformed expectations in the months since the unexpected Brexit vote. 2016 GDP growth looks to have come in at around 2.2%/yr, above our most recent f/c of 1.6%/yr.
- We expected GDP growth of 1.6%/yr in both 2017 and 2018. We are more optimistic than consensus for both years based on the 2016 easing of monetary policy, the weaker GBP and the expected easing of fiscal policy in the years ahead.
- The downside risk remains, however, if negotiations around Brexit fail to come up with a solid new model for the UK's trading relationship with the EU.
- **Inflation:** The pace of inflation in the UK has accelerated in recent months, driven largely by the sharp weakening in the GBP.
- Inflation is expected to be above the BoE's 2% target in 2017 and 2018, before returning to target 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	1.4	1.7	1.5	1.7	1.5	1.5	1.5	1.0
Inflation – CPI	1.3	1.1	1.5	1.4	1.5	1.5	1.5	1.0
Monetary policy – Rates	-0.18%	-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 EU showed some good stability through much of 2016 and our expectation for growth at the end of the year is 1.6%.
- For 2017 and 2018 our GDP growth forecasts are a little higher than consensus. Ongoing highly stimulatory monetary policy, neutral fiscal policy, the lower Euro and faster economic growth in the US should also support economic activity in the EU.
- However, the risks for the EU are skewed to the downside because of ongoing political concerns (ie. a new government in Italy and elections in France and Germany) and continued signs of instability in the banking system – especially in Italy.
- **Inflation:** Inflation in Europe (as elsewhere) remained very low through much of 2016 – but with headline inflation picking up towards year end on the back of higher energy prices.
- Aggressive policy action by the ECB and any further weakening of the Euro should help put upward pressure on inflation through 2017-2018. Our forecasts for 2017 and 2018 have been, therefore, raised modestly.
- However, inflation is not expected to reach the ECB's 2% target out beyond 2018.
- **Monetary policy:** In late 2016 the ECB announced that, from April 2017 onwards its monthly asset purchase program (QE) would be reduced from €80bn/mth to €60bn/mth – but extended 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	1.0	0.9	0.9	0.6	1.0	1.0	1.0	1.0
Inflation – CPI	0.6	0.4	1.0	0.8	1.0	1.0	2.0	1.0
Monetary policy – Rates	-0.1%	-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 improved a little in Japan in 2016 and looks like it will come in around 0.9%/yr.
- For 2017 we expect a little more growth, with an annual rate around 0.9%/yr. 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 at the end of 2016 as energy prices rise again. Some slight improvement in underlying inflation could be seen in 2017 and 2018, 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 has 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 to retain a very aggressive monetary policy stance for a number of years to come.

China

%/yr	2017 Consensus	2017 EMR	2018 Consensus	2018 EMR	2019 Consensus	2019 EMR	Long Term Consensus	Long Term EMR
GDP	6.5	6.8	6.1	6.6	6.0	6.2	6.0	6.0
Inflation – CPI	2.2	2.4	2.2	2.5	2.5	2.5	2.5	2.5

Source: Bloomberg.

Comments:

- **GDP:** Economic growth in China was remarkably stable through 2016 – coming in at 6.7%/yr for the first three quarters before increasing to 6.8%/yr in Q4, easily achieving the official target of 6.5%-7.0%.
- For 2017, economic growth is expected to remain relatively solid at 6.8%/yr – although the government's official target has been lowered to 'around 6.5%'. 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.
- 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 on the back of higher food and energy prices. 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

%/yr	2017 Consensus	2017 EMR	2018 Consensus	2018 EMR	2019 Consensus	2019 EMR	Long Term Consensus	Long Term EMR
GDP	2.6	2.75	2.8	2.9	N/A	2.75	3.0	2.75
Inflation – CPI	2.1	2.0	2.2	2.25	N/A	2.25	2.5	2.25
Monetary policy – Rates	1.4%	1.5%	N/A	2.0%	N/A	2.5%	No clear consensus	3.0%

Source: Bloomberg.

Comments:

- **GDP:** The Australian economy hit a pothole in Q3 16 with a -0.5%/qtr print. We expect a bounce-back in Q4 16 to give growth for the year of close to 2.5%.
- For 2017 GDP growth is now expected to average 2.75%/yr (previous f/c 3.0%), as the economy continues to transition away from growth dominated by mining capex to other sources, including housing, infrastructure spending and services. Non-mining capex spending continues to disappoint and income growth remains very soft as the terms of trade and wages growth slow.
- 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 1.3% in Q3 16 - well below the RBA's 2%-3% target range.
- For 2017 and 2018 inflation is expected to head back towards 2% on the back of slightly higher energy prices and any trend to better outcomes for wages.
- **Monetary policy:** We now expect that the RBA's easing cycle has come to an end with the cash rate at 1.5%. Better growth in the US and concerns around housing financial stability are expected to see the RBA remain on hold for all of 2017.
- We expect a very modest tightening cycle to get underway in 2018.

New Zealand

%/yr	2017 Consensus	2017 EMR	2018 Consensus	2018 EMR	2019 Consensus	2019 EMR	Long Term Consensus	Long Term EMR
GDP	2.9	3.7	2.6	3.4	N/A	3.0	2.5	2.8
Inflation – CPI	1.7	1.5	1.9	1.8	N/A	1.9	2.0	2.0
Monetary policy – Rates	1.7%	1.75%	N/A	1.75%	N/A	2.25%	N/A	3.5%

Source: Bloomberg.

Comments:

- **GDP:** The New Zealand economy pick-up in the third quarter with a 1.1%/qtr print, growth is expected to finish the year at 3.1%/yr.
- The economy looks set to continue its upswing in 2017 and 2018 supported by continued strong population growth. Construction and Tourism demand will also remain supportive, however both sectors may begin facing capacity and skilled labour shortages potentially limiting the pace of expansion going forward.
- **Inflation:** NZ headline inflation remained very low through much of 2016 but surprised on the upside to come in at 1.3%/yr in Q4 16, back within the lower bound of the RBNZ's 1-3% target band.
- The stronger economy in 2017 and 2018 is expected to lift inflation further into the target band towards the middle of the range.
- **Monetary Policy:** The RBNZ cut the cash rate by a further 25 bps in November for a total of 75 bps of rate cuts in 2016.
- We now expect the RBNZ to remain on hold for 2017 and 2018 as the impact of easy monetary policy begins to drive inflation and growth higher.

Section 4
Recent Research Reports – Q4 2016

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.

Investor Insights: How investors react to volatility and uncertainty
12 December

US Presidential Election: Outcome and Implications
10 November

The Investment Report 2016 – Investing in a low growth environment
8 November

The Travelling Economist – Japan & USA – Conclusions
4 November

The Travelling Economist – USA – Politics and the Election
2 November

The Travelling Economist – USA – The Fed and Monetary Policy
31 October

The Travelling Economist – USA – The Economy, Employment and Inflation
28 October

The Travelling Economist – The Bank of Japan and Monetary Policy
26 October

The Travelling Economist – Japan - The Economy, Inflation and Fiscal Policy
26 October

Introduction to 'The Travelling Economist' series – US and Japan
20 October

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