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Saul Eslake - What to watch in 2016

1. *China.* China is now the world's biggest economy (almost 9% larger than the US this year, according to the IMF) and has accounted for almost one-third of the growth in the world economy since the onset of the global financial crisis. It accounts for one-seventh of world trade in goods – including almost one-third of Australia's exports. And it accounts for one-quarter of the world's savings. What happens in China matters. No-one doubts that China's economy is slowing, or that the mix of growth in China is changing. What's not at all clear is how sharply growth will slow, how quickly the mix of growth will change, what Chinese policy-makers will try do in response, and how effective whatever they decide to do will turn out to be. Most likely, the slowdown in growth will continue to be gradual. But China's financial system could be a source of significant volatility, not just within China itself but for the entire global financial system. What happens to the currency will be especially important. A large devaluation of the yuan would add renewed impetus to the deflationary pressures that policy-makers in advanced economies are hoping will ebb this year.

2. *The Fed.* Having finally taken the first step just before Christmas, the Fed would really like to continue down the path of returning US monetary policy settings towards 'normal' over the course of this year, by raising the target for the Fed funds rate another three or four times. Whether they can actually accomplish that will depend on whether the US economy continues to grow at a pace sufficient to keep the unemployment rate around 5% and broader measures of under-employment on a downward trajectory; whether its preferred measure of 'core' inflation continues heading back towards 2%; and on the stability or otherwise of US and global financial markets. The first of these is reasonably likely; the second is probable but by no means guaranteed; but the third is anyone's guess. A large and sustained fall in equity markets, or a large and sustained (further) rise in the US dollar, would likely see the Fed putting its hopes of a 'return to normalcy' on hold.

3. *Commodity prices.* Oil still matters for the global economy. The huge fall in oil prices over the past 15 months has done less to stimulate growth in oil-importing countries than expected, whilst also pushing some oil-exporting economies (notably Russia) into recession and adding to lingering global deflationary pressures. It's also given rise to some credit market concerns in the US. Oil prices could well have further to fall, as the contest for long-term shares of the oil market continues. Prices of other key commodities, including iron ore and base metals, appear to have stabilized for now but may resume their decline if China slows further or devalues its currency aggressively. Not only would that provide a renewed 'headwind' for the Australian economy to contend with, but together

with higher US interest rates and a stronger US dollar it could also be a lethal combination for some emerging economies.

4. *Emerging market debt*. Debt owed by households, businesses and governments in emerging markets has increased by more than US$25 trillion since the onset of the financial crisis (of which China accounts for US$20 trillion), or 184%. By contrast, non-financial sector debt outstanding in advanced economies has risen by 'only' US$16 trillion (or 21%) over the same interval (of which more than half was US government debt). While most of China's debt is owed to Chinese financial institutions, China still has cross-border liabilities of nearly US$600 billion. And other emerging economies have cross-border liabilities of more than US$2¼ trillion, most of which (like China's) are unhedged. Higher US interest rates and a stronger US dollar could undermine the capacity of some emerging market economies to service their existing debts, especially in the context of weak domestic growth and (for commodity exporters) lower commodity prices.

5. *US elections*. The long grind that constitutes a US presidential election kicks off at the beginning of February with primaries in New Hampshire and caucuses in February, and runs all the way through to polling day on 8th November. It still seems hard to conceive that Donald Trump could be a serious contender for what used to be called 'Leader of the Free World', but at this stage he looks odds-on to be the Republican nominee. And while that also makes it more likely that Hilary Clinton, the presumptive Democratic nominee, will end up taking the oath of office as the 45th President of the United States on 20th January 2017, if by some chance opinion polls start to suggest that Donald and Melania Trump could be moving into the White House, financial markets around the world may well take fright (it's even scarier than the thought of Barnaby Joyce as Deputy Prime Minister of Australia). A close-looking election could also provide yet another complication for the Fed in its scheduling of US interest rate increases.

6. *Europe*. The euro zone economy does now seem to be experiencing a gradual recovery, which should provide some 'breathing space' for the most heavily-indebted countries to pursue much-needed economic and fiscal reforms. Greece has to deliver on politically challenging pension reforms early this year but its debt refinancing schedule is now less demanding than it was last year, and the probability of a renewed European 'debt crisis' is quite low. However the European Central Bank is likely to remain concerned at the downside risks to inflation, implying that more 'quantitative easing' and a further decline in the euro could be on the cards. Apart from the continuing threat to European integration posed by demands for greater 'border security', the other key issue for Europe will be the prospect of British withdrawal from the EU. The referendum promised by David Cameron before last year's general election has to be held

before the end of next year: but if the UK is able to procure what it regards as a 'reasonable' outcome from its negotiations with EU leaders such that a 'Yes' vote (to remaining in the EU) seems more likely, then the poll could be brought forward to this year. A 'no' vote would be a major shock to financial markets.

7. *The RBA*. The RBA surprised many observers this time last year by cutting rates at its first meeting in February, having repeatedly indicated towards the end of 2014 that it was unlikely to do so. It followed up with another rate cut in May, but since then has downplayed the probability of any further move in that direction, whilst leaving the door ajar to yet lower interest rates in the event of some unforeseen negative surprise. The RBA has been pleasantly surprised by the resilience of the Australian labour market; and although it hasn't said so explicitly, it will have welcomed both the favourable impact on business confidence and the change in the tone of the government's economic narrative flowing from the change of Prime Minister in September. Compared with the experience of other commodity-dependent economies, Australia has weathered the Chinese economic slowdown reasonably well. Some parts of the non-mining sector are now clearly picking up, and it's helpful that most of these are reasonably labour-intensive. The RBA doesn't want to cut rates again, and in the absence of a major negative shock it almost certainly won't. Indeed, depending on how much further the A$ falls, financial markets are likely towards the end of this year to begin conjecturing on when the first RBA rate hike could occur.

8. *The Australian dollar*. After finally doing what the RBA had long been wishing for over the (southern hemisphere) autumn and winter, in the closing months of last year the A$ again surprised with its resilience in the face of falling commodity prices and growing expectations (followed by confirmation) of the first hike in US interest rates. It's taken a renewed bout of financial instability in China to bring the A$ back to reality, which underscores the importance of developments in China to Australia's currency. Realistically, the A$ should fall to around US65¢ over the first half of this year, at which level much of Australia's trade-exposed non-mining sectors should be reasonably internationally competitive (indeed, if they're not competitive at that level, there's not much that an even lower currency will be able to do for them). On the other hand, if the A$ stays comfortably in the 70s against the US$ while commodity prices continue to fall, then the RBA may well be forced to contemplate cutting rates again.

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9. *Australian property prices.* Many foreign commentators and investors have long forewarned of an Australian property price crash, in most cases simply by presuming that the experience of other countries where household debt and property prices have previously risen sharply must inevitably be repeated at some point in Australia. These simple extrapolative forecasts have so far not materialized. Unlike most of those other countries, Australian property prices have been supported by an ongoing shortage of housing relative to the underlying demand for it. Additionally Australian banks have for the most part avoided lending to financially vulnerable borrowers, while most households with mortgages have built up significant 'pre-payment buffers' over the past four years while mortgage interest rates have been declining. Nonetheless, the RBA and APRA have prompted lenders to tighten credit standards, particularly to property investors, and this has clearly dampened what had become an important source of upward pressure on property prices. With 'underlying' demand for housing likely to grow at a slower pace due to declining immigration, and the supply of housing now increasing more rapidly, the 'fundamentals' which have long underpinned the Australian housing market are beginning slowly to shift. The price gains of recent years thus seem unlikely to continue, although in the absence of any 'trigger' for widespread selling, a large fall in Australian property prices also seems improbable, at least for 2016. Nonetheless, a large and sustained movement in property prices (in either direction) is something that could prompt a response from the Reserve Bank.

10. *Australia's current account deficit.* Since the early 1990s, Australian financial markets have ordinarily paid scant attention to the trade and current account deficit figures with which they were obsessed in the 1980s. That's largely because Australia has been readily able to finance those deficits, as a result of declining global and Australian interest rates, the high credit ratings of the Australian banks, Australia's generally sound public finances, and (since the onset of the financial crisis) the large inflows of foreign equity capital which have financed Australia's 'resources investment boom'. However, as those inflows begin to wind down, and falling commodity prices push Australia's trade balance deeper into deficit despite the increase in resources export volumes, Australia's net debt (and the associated debt service obligations) have begun to creep up again. And Australia's public finances aren't as sound as they used to be. While Australia has been a beneficiary of 'safe haven' flows out of China in recent years, they may not be sufficient to shield Australia from a harsher spotlight in the event of a global pull-back in cross-border lending.

11. *Australia's elections.* Australians are also scheduled to go to the polls some time in September or October this year. There's some chatter about the possibility of an earlier election, although if that were to occur in the first half of the year it would have to be a double-dissolution, which would almost certainly result in even more minor parties and independents sharing the balance of power in the Senate. Most likely, Malcolm Turnbull will be able to claim a mandate in his own right: and the key uncertainty will be what reforms that mandate will empower him to implement.

What does all this mean for bonds?

Although, ordinarily, the likelihood of further increases in US interest rates over the course of 2016 would be considered bearish for bonds, many of the issues and risks discussed could present more positive opportunities if they were to materialize.

In particular, slowing growth in China and/or a weaker Chinese currency, heightened concern about emerging market debt, a stronger US dollar, further falls in commodity prices and uncertainty about the implications of the US election campaign or outcome would all likely be reflected in greater demand for high-quality government bonds. Identifying changes in the probabilities attaching to each of these risks is thus likely to be crucial to a successful investment strategy.

Some of these considerations also apply specifically to Australian Government bonds, although the likelihood of further falls in the Australian dollar (which would further reduce the prospect of any more rate cuts from the RBA) and the possible re-emergence of concerns about Australia's external deficits point to the likelihood of Australian yields trading at wider spreads over Treasuries and Bunds than in recent years.

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