RBC Investor & Treasury Services

Chief Economists Forum

February 2016

The annual Financial Standard Chief Economists Forum invites leading economists to share their views on the year ahead.

Julie Toth, Don Stammer, Kevin Anderson, Scott Haslem, Su-Lin Ong and Bob Baur

2016 Chief Economists Forum

Hosted at the Westin in Sydney and Crown Towers in Melbourne, this year's forum presented forecasts from Kevin Anderson, head of investments for Asia Pacific at State Street Global Advisers (SSGA), as well as Principal Global Investors chief global economist Bob Baur, Australian Industry Group chief economist Julia Toth and RBC Capital Markets chief economist and head of Australian research Su-Lin Ong - with independent economist Saul Eslake taking the reins as master of ceremonies.

Over 900 financial services professionals attended the event, which addressed everything from the re-emerging prominence of the US manufacturing sector to the "sleeping giant" of the Australian economy.

Discussing the US, Bob Baur said that growth would remain stable at 2% due to resilient consumption and parity between labour costs and productivity. He contextualised the current state of global markets by saying that "in order to look ahead to make a forecast you have to start looking at today, understand why we are here and how it is we got here."

He argued that the "journey to this particular point" began 25 years ago due to the collapse of the Soviet Union in 1989 and the formation of the World Trade Organisation in 1995.

"After 1989, we doubled the number of people in the global workforce from 1.5 billion to 3 billion people. That was an enormous shock to the labour supply around the world and of course global companies tried to move in to employ those people in manufacturing. So there was a one-time relocation of global manufacturing from the West to the East," he said.

"To make that work, you had to build factories and workhouses and office buildings and infrastructure, which created an insatiable demand for commodities, which, in turn, created a tremendous economic boom the likes of which the world had never seen before. Demand seemed insatiable, and companies borrowed to keep up with that tremendous demand."

However, as demand slowed companies developed "excess capacity," losing pricing power even as labour costs continued to rise. "Then you saw a few defaults here and there, and eventually the boom was over," Baur added.

Because of the "rebalancing of global growth from emerging markets back to developed ones," though, Baur's outlook for the US economy remains positive. "The consumer spending that underpins the economy is very resilient," he said.

"Furthermore, the US manufacturing engine is actually becoming competitive again. Labour costs in the US have actually not gone up for 35 years, which sounds fantastic, but what it really means is that productivity growth has kept up with wage growth during that time, and as a result you're now seeing Chinese companies like FoxConn building manufacturing facilities there," Baur concluded.

As a result of overall diminished growth worldwide, though, Kevin Anderson argued that the core of every investor's portfolio is going to be lacklustre in 2016.

"There are numerous reasons to expect that volatility is going to remain a concern for us," he said. "In a world in which economic growth is low, we're going to have to think differently. We're going to have to look at the world through two lenses - not just targeting returns but understanding risk in more detail."

He pointed to the recent below trend performance of balanced superannuation funds as a signal of what is to come in 2016.

In developed markets Anderson expects overall equity returns to be mid-single digit with some differentiation between geographies. The US, he continued, is likely to be a laggard amid rising interest rates. In Europe Anderson said domestically focused companies would likely outperform their global peers. Japan continues to be supported by

#

The numbers

3bn

Number of people in the global workforce at one point.

FS iTV www.fsitv.com

All speaker presentations and video highlights are now available on www.fsitv.com


Su-Lin Ong, RBC Capital Markets


Su-Lin Ong and Don Stammer


Mary Murphy, First State Super

accommodative monetary policy which will serve as a tailwind to equities.

Turning to Australia, Anderson said energy and materials are still a little expensive despite recent sell-offs. Overall investors should expect mid to low single digit returns.

The investment specialist said emerging markets were clearly cheaper than last year but investors looking to pick up bargains may find themselves entering a classic value trap.

"We'll be looking at signs of stabilisation of growth in China and also the way that emerging markets are handling the hard currency debt overhang they've built up in an environment where the Fed has raised rates before we step back into emerging markets in an overweight position," he said.

While the Fed raised rates for the first time since 2006 last year, central banks worldwide will continue easing trends in a disinflationary global environment, according to Ong.

Ong noted recent sharp moves in equity markets in Asia and oil price fluctuations as having a measurable impact on global monetary policy. "Global markets in early 2016 highlighted key factors that will affect our market. Central bank action, and possibly inaction, will have its effects," she explained.

"If we start looking at the RBA, the cash rate is at 2%. It's an easing cycle that began in late 2011, even if it has been punctuated by periods of pause. Recently, markets have upped their odds of the risk of a cut, and we maintain that further cuts are likely - a 1.5% cash rate is in our profile."

Ong added that the likelihood of further cuts is precipitated by similar decisions worldwide: "We would argue that global central banks continue to err on the side of providing more rather than less accommodation due to the subpar pace of global growth and the very disinflationary global backdrop.

"With the exception of the Fed, central banks are doing more rather than less. We saw it with the Bank of Japan and we expect the ECB to move further into negative territory. Those cuts are likely. It's a consistent theme."

Despite facing significant and persistent headwinds globally, though. Australia's domestic economy has been rebalancing better than is widely appreciated, according to Scott Haslem. He said lower interest rates in Australia have helped cash-flow for consumers and supported the housing sector.

He added that it had also helped push the Australian dollar lower and the combination eased some of the import competition that Australian businesses have been facing over the last few years. The lower currency has also provided support to key export sectors like education and tourism.

"The housing sector has been in a very strong upswing and it's increasingly clear that what I would call the churn side of the housing sector, which is the 65 or 75% of Australians buying investment properties and borrowing, that has peaked. House prices have peaked and are slowing down in terms of their growth rate, we're seeing lending slowing down, we're seeing borrowing and auction clearance rates are becoming weaker," Haslem said.

"If we think about that part of the housing sector that is about new physical construction, given the lags between when we approve things and when we build them - given the much greater concentration of apartments which take much longer to build, we are going to see housing support GDP growth in this country all the way through until early 2017. That will support employment, that will support manufacturing, that will support brown goods and white goods and things we intend to put in new construction."

However Haslem said there were some reasons to be cautious about the Australian economy. He said Australia has been experiencing the most significant period of under-performance of growth since the 1990s recession.

"While Australia has typically been seen as a high-beta economy - meaning that when the world moderately improves Australia tends to outperform - this time around in the cycle there have been a lot of significant and persistent headwinds facing our economy."

This might be why Toth recommended that

> "
> *Central bank action, and possibly inaction, will have its effects.*

Australian financial institutions start taking notice of the "sleeping giant" of the economy: healthcare. She explained that healthcare in Australia employs more people than any other industry - currently up to about 13% of the workforce.

"Education and healthcare are more than 20% of our workforce and they're growing. That's where the employment growth is coming from," Toth said.

"It's not coming from mining and it's not coming from construction. On construction it appears to be the same people moving around.

"About a third of employment growth in recent years has come from health care and another chunk from education."

Toth acknowledged the economic headline numbers for Australia are okay "but they're not great." She said the theme is still "lower and slower" for many of Australia's economic measures.

She said healthcare probably would not benefit too much from the low and potentially declining Aussie dollar, but it didn't matter because the industry was rapidly growing anyway.

Toth added about two-thirds of businesses in the manufacturing and services area have told the Australian Industry Group that "they're expecting better sales in 2016 and better conditions for their own business."

"About one-third are planning to increase employment this year, so that's good news for the labour market," Toth said.

She described manufacturing as the old industrial rump of Australia and that it is "smaller than it once was but it is definitely not out for the count." **FS**