First Insights.

JANUARY 2016 – A quarterly publication from the Economic and Market Research team

Welcome to the January 2016 edition of First Insights, the quarterly publication from the Economic and Market Research (EMR) team.

In this edition of First Insights, we discuss key themes for the year ahead and reflect on the year that was.

Much of the year 2015 was dominated by the ongoing debate around the timing of the US Federal Reserve first rate hike. Coupled with financial market volatility, fears over a slowdown of the Chinese economy and the dramatic fall in the oil price, equity markets didn't perform as well as expected throughout the year.

2016 will see a continuation of market concerns over Chinese growth, speculation over how often and by how much the US Fed will raise rates as well as geo-political tensions that have the potential to disrupt financial markets. While we explore key themes for 2016 we also analyse the implications of these trends for major economies such as the US, China, Europe, Japan and Australia.

Given recent market volatility, we have provided our views in a Q&A style format to address common investor concerns regarding China, the fall in the oil price and general trends in the equity market amongst others.

In our revamped Market Watch, we provide an updated chart pack on page 10 as well as our updated forecasts for the major developed economies on page 18. Lastly, we provide a list of our research reports for the quarter on page 21.

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

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Section 1

2016: 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.

In January 2015, we highlighted the following as themes for investors to focus on:

- "Ongoing US economic recovery."
- "The start of the US Federal Reserve (the Fed) monetary policy normalisation in June 2015."
- "Significant policy divergences as the European Central Bank (ECB) and Bank of Japan (BoJ) continue and enhance their aggressive quantitative easing (QE) programs."
- "The impact of the falling oil price on global growth and growth divergence."
- "Global inflation to remain modest on the back of lower oil prices, economic spare capacity and rising productivity on the back of better use of technology and information."
- "Slower economic growth in China, but with more balance and no crisis."
- "Ongoing strengthening in the US dollar (USD), especially against the euro (EUR) and Japanese yen (JPY)."
- "Long dated bond yields to remain relatively low – yield curves to flatten."
- "Some equity markets to be supported by the good growth-low inflation combination in the US."
- "Increased financial market volatility."

While we got the timing of the first US Fed rate hike wrong (ie. it was December 2015, not June) and equity markets did not perform as well as we expected, it would be fair to say that our expectations for 2015 were largely fulfilled.

In addition, our risks for 2015 included:

- Further falls in the price of oil.
- Political risks, especially in Greece and Russia.
- Ongoing concerns over deflation.
- Lower for longer bond yields.
- Liquidity concerns and
- Weakness in global trade.

Clearly, some of these risks were also important influencers of the 2015 outcomes and, at times, dominated market performance.

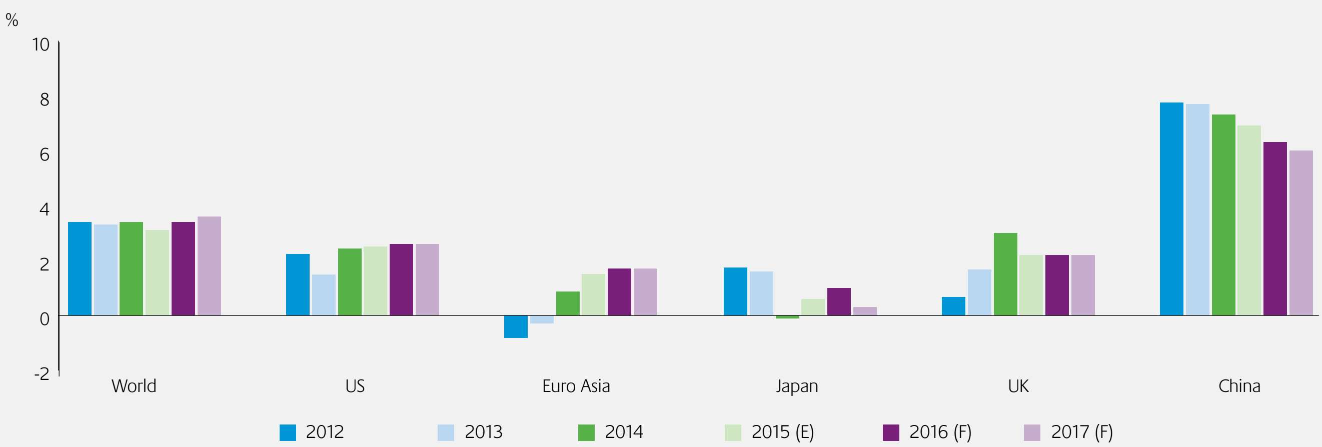
With this in mind, we present our key themes for 2016, a closer look at all the key countries we cover and our list of risks for the year ahead, some of which remain the same as 2015.

2016 key themes

The dominating factors for financial markets in 2016 are expected to be:

- Global economic growth to improve a little in 2016, but remain well below trend at around 3.4% – according to the International Monetary Fund (IMF). This will be up from expected growth of 3.1% in 2015, but it is worth noting that the IMF spent much of 2015 and early 2016 revising down their growth forecasts.
- Markets have started the year with concern that the pace of global economic growth will decline, led lower by China and a less accommodative US Fed.
- The real concern is more likely around the ability of the Chinese authorities to manage the 'triple-threat' coming from a 1. a slower economy, 2. financial market volatility and 3. capital outflows and a weaker currency through a lack of policy coordination and communication.
- These concerns are likely to remain in place for the better part of H1 16. However, China's presidency of the G20 this year and inclusion in the IMF's Special Drawing Rights (SDR) basket should give the Chinese authorities added incentive to stabilise markets into H2 16.

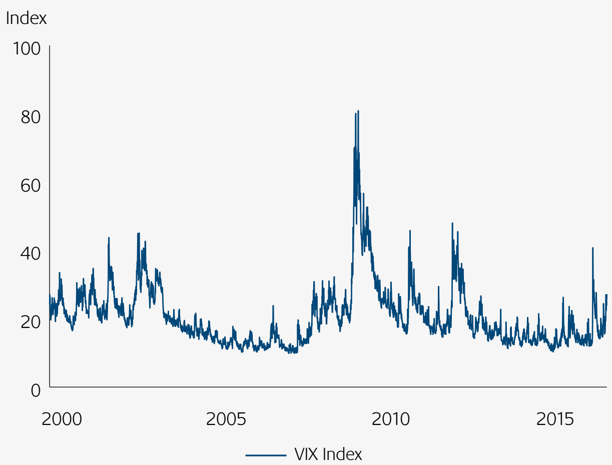
Chart 1 – Global GDP growth chart



Source: IMF. Data as at January 2016.

- 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.
- 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.
- Low returns on safe financial assist will persist, which will remain problematic for investors, corporations and governments.
- Global trade growth to improve only very gradually, which will be problematic for many emerging markets countries.
- US Fed monetary policy normalisation to continue gradually in 2016, with three rate hikes expected this year.
- Gradual Fed monetary policy and only modestly higher US inflation should limit the extent of any sell-off in the US bond market and flatten the yield curve.
- 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.
- Monetary policy divergence to remain a key influence. Policy tightening in the US and, eventually, the UK could be more than offset by further policy easing in China, Japan, Europe and other smaller nations, such as New Zealand.
- The overall stance of monetary policy for the global economy could be easier at the end of 2016 than at the start.
- This should be supportive for the USD (especially against the EUR and JPY) and for risk markets such as equities and credit.
- The significant monetary policy divergence should continue to see an increase in financial market volatility as seen below in the Chicago Board Options Exchange Volatility Index (VIX) chart – a measure of market estimated future volatility.

Chart 2 – Market volatility as measured by the VIX



Source: Bloomberg. Data to 12 January 2016.

- Technology developments and the application of information will continue to disrupt business models. Trust will be essential.
- 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 European Union (EU) membership, will also be important political events this year.

The United States

The US economy is expected to maintain its moderate growth path in 2016, with GDP expanding by around 2.5% for the year. See our forecast section for more detail. Attention in the US in 2016 will likely focus on the pace of normalisation of monetary policy by the US Fed and the Presidential Election.

A modest growth/low inflation outlook is consistent with the Fed's plan to normalise interest rates only very gradually through 2016 and the years ahead.

Not only will the Fed's monetary policy path in 2016 be gradual, but it will also not be pre-determined. The actual path of the Fed Funds rate will likely depend on the data flow and financial market developments.

Our view on the Fed is anchored around Chair Yellen's observation that the neutral real Fed Funds rate is currently close to zero and will increase only gradually over time.

With the core personal consumption expenditures (PCE) rate at 1.3%, we expect the Fed Funds target rate to rise from 0.25%-0.5% currently to 1%-1.25% by year-end 2016.

We, therefore, expect three rate hikes in 2016 – most likely in March, June and December. However, as noted, the specific timing is not pre-determined and could alter throughout the year.

As the core PCE then increases towards 2% by 2018, we expect the Fed to continue to gradually increase the Fed Funds rate target, peaking at 2.5% in 2018.

Put another way, we expect that it will take the US Fed around three years to lift official interest rates from near-zero to 2.5%.

With both the rate of inflation and monetary policy only expected to increase very gradually in 2016, the upside risk to US bond yields should be marginal.

While we do expect US bond yields to rise in 2016, the biggest increase is more likely to be in the short-end of the yield curve, especially given that we expect three rate hikes from the Fed in 2016, while the market is priced for only two rate moves.

This should see the US yield curve continue to flatten throughout 2016.

Based on our view of the Fed, we also expect the USD continues to appreciate through 2016, especially against the currencies of countries that are likely to see further monetary policy easing, including China, Japan and the EU.

US and global equity markets have had a challenging start to the year, which is not surprising, given the central bank policy divergence that is underway and the concerns around developments in China. However, the US economic fundamentals should remain generally supportive for the US equity market this year, with a gradual Fed, a solid labour market, low inflation and a relatively good pace of economic growth.

One of the other big events for the US later in 2016 will be the Presidential Election. Before the actual vote (Tuesday 8 November), there will be a series of 'primaries' to determine the two Presidential candidates.

At this stage, it looks like Hillary Clinton (aged 68, former Secretary of State) will win the Democratic nomination. She is likely to move to the centre of the policy debate ahead of the election and campaign hard on her record of 'getting things done' as well as the opportunity for the US to elect the first female President.

On the Republican side, the anti-establishment candidates are being dominated by Donald Trump. However, most political commentators continue to downplay his chances of winning the nomination.

The most likely Republican candidates, at this stage, are Marco Rubio (aged just 44, Senator from Florida) or Ted Cruz (aged 45, Senator from Texas). Both Jeb Bush (aged 62, former Governor of Florida) and Chris Christie (aged 55, Governor of New Jersey) remain in the race – but are longer shots.

Opinion polls and political commentary suggests that at this stage, Hillary Clinton could win the election, but there is a long way to go.

It is worth noting that whoever wins the election will not be sworn in as President until January 2017.

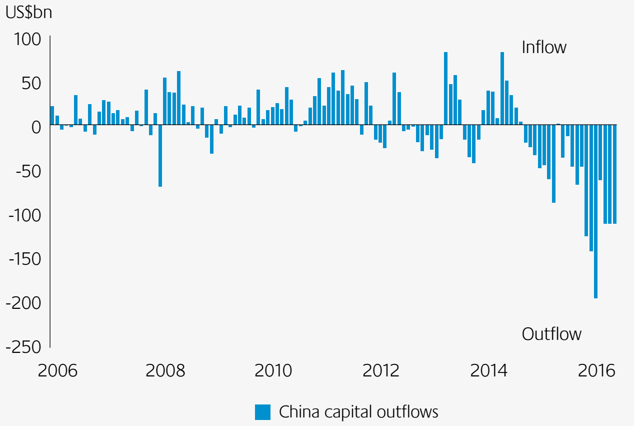
In addition, opinion polls also point towards the Republican Party retaining their majority in the House of Representatives. In the Senate there is expected to be a swing to the Democrats, but likely not enough for the Republicans to lose their majority.

China

Chinese financial markets started 2016 in a very volatile fashion, especially the equity and foreign exchange (FX) markets. This reflects both structural factors associated with the slowing pace of economic growth and speculation around further policy easing, as well as technical factors around regulations imposed by the China Securities Regulatory Commission (CSRC).

As noted, the Chinese authorities are managing three challenges which are proving difficult to coordinate: 1. the economy is slowing, 2. there is increased financial market volatility and 3. capital outflows and the pressure to depreciate the currency.

Chart 3 – China capital outflows



Source: Bloomberg. Chinese capital outflow includes FX purchases by banks, FX deposits, monthly trade and direct investment balances. Data to 30 November 2015.

For 2016, we expect economic growth in China to slow to around 6.5%, ie. the government's floor, from just under 7% in 2015. To achieve this growth, the Chinese authorities will need to ease policy further.

This policy easing is likely to take many forms, including interest rate cuts and reductions in the Reserve Requirement Ratio (RRR) which will allow the banks to lend more money, some targeted fiscal spending and further depreciation in the renminbi (RMB).

We would also highlight that China will hold the Presidency of the G20 through 2016. The G20 Leaders meeting will be held in China in early September 2016. The RMB will also be included in the IMF's Special Drawing Rights (SDR) basket on 1 October 2016 with stability of the RMB expected around this time.

It is likely that the Chinese authorities will strive for 'stability' in China's economic data and financial markets around the time of the G20 Leaders meeting and inclusion in the SDR. This would imply more aggressive policy action in H1 16 and less ahead of September and October.

Over the medium-term, we would highlight that China's demographics imply a decline in labour force growth, while labour productivity is also softening. Both of these factors point to a slower potential GDP growth rate for China in coming years, which is something the Chinese and global economy will need to adjust to.

Europe

Inflation is still way below the ECB's target level, with headline inflation at just 0.2%/yr and the core Consumer Price Index (CPI) at 0.9%/yr. With limited gains expected over 2016 due to recent commodity price falls, we expect the ECB to maintain its aggressive QE program through 2016. Although the market was disappointed with the additional easing measures put in place by the ECB in late 2015, the reduction in the deposit rate to -0.3% and the extension in the asset purchase program (APP) out to March 2017 imply a significant further increase in the ECB's balance sheet.

We would expect that during 2016 and even as early as March, the ECB could increase its monthly APP from the current €60bn per month (to perhaps €70bn) and contemplate a further cut in interest rates to enable the purchase of shorter dated bonds, even at a negative yield.

See the Forecast section for our 2016 outlook for EU GDP growth. Political risks are likely to remain apparent in the EU through 2016. This could include Portugal (with another general election likely in coming months), Spain (where the Catalan separatists remain a concern and no government has yet to be formed post the December general election) and Greece (where program implementation could remain an issue). The build-up to the 2017 French Presidential Election could also increasingly become a focus, as will the ongoing refugee crisis.

The UK

As with most major economies in 2016, the pace of economic growth in the UK is expected to remain modest this year at around 2.4%. Inflation is expected to remain low and could see the Bank of England (BoE) delay lifting the Bank Rate until H2 16 (see the Forecast section for more details). We expect two rate hikes in the UK before year end, taking the base rate to 1.0%, and a further two hikes in 2017, making this a very modest 'tightening' cycle.

One of the biggest risk factors for the UK (and also for the EU) is the upcoming UK referendum on whether to stay within the EU. While the vote was originally slated for 2017, it could occur late this year.

Much work remains to be done by Prime Minister David Cameron to secure a number of reforms of the EU that he wants put in place ahead of the vote. The latest opinion polls have the vote at around 55% to stay versus 45% to leave, but the outcome is far from certain.

Prime Minister Cameron has stated that he will campaign for the UK to remain in the EU, though after he has secured some key reforms. So a vote to leave the EU has the potential to be politically destabilising.

Japan

Despite ongoing stimulus from 'Abenomics', which has included zero interest rates, large scale quantitative and qualitative easing (QQE), fiscal reform, regulatory changes and a weaker JPY, the Japanese economy continues to grow at a very modest pace. After expected growth of 0.7%/yr in 2015, the Japanese economy is expected to grow by around 1.0%/yr in 2016.

However, given the demographics of Japan, where the population is now actually declining, it is difficult to imagine substantially higher growth. To put this another way, at around 1.0%/yr GDP growth, the Japanese economy is likely growing close to its long-term potential and GDP per capita is indeed rising.

The BoJ has pledged that inflation will rise to 2% in coming years, but averaged just 0.8%/yr in 2015, with a similar outcome expected for 2016. Headline inflation will be higher in 2017, but mainly on the back of the next scheduled increase in the Consumption Tax rate from 8% to 10% on 1 April 2017.

As a result, after an underwhelming tinkering with QQE program in late 2015, we expect the BoJ to ramp up its policy easing through 2016.

This could involve a further increase in the targeted expansion of the Japanese money supply (up from the current ¥80trn), which would imply a further increase in the pace of monthly bond purchases (currently at ¥8trn-¥10trn per month) and even a possible move into negative interest rates.

One of the most important factors for Japan and the BoJ is recent developments in the JPY. After weakening from around US$/¥80 in 2012 to a peak (low) near US$/¥125 in mid-2015, the JPY has recently strengthened back to levels around US$/¥117.

For Japan, this is bad news for both their efforts to increase inflation and to stimulate the economy through supporting the export sector. Indeed, the BoJ could be the first major central bank to ease monetary policy in the face of the significant developments in China at the start of 2016.

Some political factors may also surface as important considerations for financial markets in Japan in 2016, especially if Prime Minister Abe was to call an early election for the Lower House and/or he wins a two-thirds majority in the scheduled Upper House election.

A two-thirds majority in both Houses could enable Prime Minister Abe to focus his attention on constitutional reform and international developments rather than the domestic economy. This would likely have a negative impact on Japanese financial markets.

Australia

Economic growth in Australia is expected to remain below its long-term trend in 2016, at around 2.6%, but (once again) talk of a collapse in the Australian economy will prove to be too pessimistic.

While the pace of economic growth in Australia is far from optimal and income growth, in particular, has slowed significantly, the Australian economy proved itself to be more resilient and more flexible than most people imagined through 2015. This should further help the economy through 2016.

Please refer to our Forecast section for further details on our 2016 Australian economic outlook.

It is likely the Reserve Bank of Australia (RBA) will hold the cash rate steady at 2% throughout 2016. The risk to this view is that the RBA acts on its current soft easing bias and lowers the cash rate further.

It is also worth noting that Glenn Stevens' term as RBA Governor expires in September 2016 and his replacement is expected to be announced around mid-year. The overwhelming favourite to replace Stevens is current Deputy Governor, Phillip Lowe. His appointment would be warmly received by markets.

2016 will be an important year for Prime Minister Malcolm Turnbull and his government. Having taken over in mid-September 2015, the Prime Minister and Treasurer Scott Morrison will want to stamp their policy priorities in the May 2016 Budget.

The Prime Minister is expected to take a number of significant structural policy reforms, especially around taxation, industrial relations and competition policy, to the late 2016 Federal election.

Current opinion polls point to a victory for the government in the election that must be held between August 2016 and January 2017, but is likely to be held in the September- November 2016 window.

With the RBA expected to be on hold throughout 2016, Australian bond yields could outperform any US-led bond market sell-off, while the Australian dollar (AUD) is expected to depreciate further through 2016. The Australian equity market is likely to continue to find domestic economic and global commodity price conditions challenging.

New Zealand

If it were not for strong tourist activity in 2016, the New Zealand economy would be in a vulnerable position as the country deals with a dairy sector downturn. Economic growth is likely to moderate back to its underlying rate of around 2.5% through 2016. We do expect growth to pick up a little over 2017, but this is contingent on further rate cuts by the Reserve Bank of New Zealand (RBNZ) over the course of this year.

Our view is the circumstances will indeed warrant further Official Cash Rate cuts this year and we expect a move to 2% by September 2016.

Key risks in 2016

In addition to our key themes, there are a number of risks to global financial markets that remain in place for 2016. These include:

- A further collapse in the price of oil towards US$20/barrel (bbl) and other key commodities. This would likely see headline inflation rates fall below zero in a number of major nations (US, EU, Japan) and would be bad news for many oil exporting nations.
- Further volatility in Chinese financial markets and a sharp depreciation of the RMB that increases concerns around the Chinese authorities' ability to manage their economy. This could be accelerated if Chinese authorities do not improve their policy communication.
- Higher inflation would be the most surprising and damaging risk for the global economy and markets in 2016.
- This would likely see the US Fed accelerate its policy normalisation, as markets may worry the Fed is 'behind the curve.' Apart from raising interest rates faster, the Fed would likely also start reducing their holdings of bonds on balance sheet, thereby tightening policy through this mechanism as well.
- This would then potentially initiate a significant sell-off in bond markets and, eventually, a big sell-off in equity markets. In contrast, the USD would likely be substantially stronger.
- At the other end of the risk spectrum is that the US economy falters and the Fed reverses its late 2015 rate hike and contemplates the start of QE4 and/or a negative Fed Funds rate. This would see bonds yields rally hard, likely down to new lows, and a substantially weaker USD. A recession in the US would be a negative for equities.
- Another major risk for the US and the global economy/geo-political environment would be if Donald Trump were to win the US Presidential Election. At this point, this outcome remains a low risk event.
- The US election does pose a risk to the outlook during 2016 if the focus in the US turns more to personalities rather than policies.
- As has increasingly been the case in recent years, geopolitical risks are likely to be heightened during 2016. This is especially so in the Middle East, but would also include Europe, the UK and Russia.

Longer-run issues[1]:

Over the coming decade we see a number of issues that investors should focus on and that could potentially impact on global economic performance:

- Slower GDP growth across most major economies driven mainly by slower population growth.
- The pace of economic growth in China will continue to slow, but China's financial weight will continue to grow. This will include the impact of the RMB's inclusion in the SDR basket and increased use in global capital outflow.
- Demographics and economic reform (hopefully) will see India become a more important part of the global economy.
- The US will remain the leading source of innovation and dynamism.
- The share of most economies and employment accounted for by services (especially health, aged care and household) will continue to rise.
- Demographic challenges in many countries imply a shortage of appropriately skilled workers, not a shortage of jobs.
- Digital disruption of many business models will continue, therefore trust will be key.
- Cyber-security will become even more prominent as the consequences of an attack grow.
- Global interest rates are likely to remain very low by historical standards, especially in Europe and Japan.
- The problems of providing sufficient/adequate retirement income will grow for people, organisations and governments.
- Investors and companies will either need to accept a lower return on savings/investments or increase their risk appetite.

1 Many of these factors are discussed in a speech by the RBA Governor, Glenn Stevens, "The Long Run", 24 November 2015.

Q&A

Given recent market volatility, we have provided our views on some common investor concerns regarding the economic and market outlook.

1. What is your take on the recent market movements in Chinese equities and FX markets? What impact is this having on global financial markets?

Global stock markets have fallen heavily in the first few weeks of 2016. Falls came on the back of some weaker manufacturing data in China and the US, concerns over the changing regulatory environment for Chinese equities with the failed introduction of a circuit breaker and a lower fixing rate for the Chinese currency against the USD. Increased political tensions between Saudi Arabia and Iran, as well as provocative action by North Korea also impacted on markets.

As discussed in detail earlier in this section, China continues to face three challenges (a slowing economy, ongoing sharemarket volatility, and currency depreciation and capital outflow). In dealing with these challenges, financial markets have become concerned with the ability of Chinese policy makers to manage these challenges in a positive way and communicate them effectively. This was especially the case with equity market regulation, where some regulations that were designed to reduce volatility, actually increased it.

These challenges are likely to remain in place for the weeks and months ahead. For 2016, we expect economic growth in China to slow to around 6.5%, ie. the government's floor, from just under 7% in 2015. To achieve this growth, however, the Chinese authorities will need to ease policy further.

Apart from China, so far in 2016 there does not appear to be signs of renewed economic weakness in US (ie. very strong payrolls data, albeit some weaker manufacturing data), Europe or other countries such as Australia.

As a result, any signs of stability in financial markets in China and a more effective policy response, should see global asset markets stabilise somewhat and begin to focus more on economic fundamentals – rather than concerns over China-specific events.

2. Will the US growth outlook be affected by the volatility? How will the Fed's policy plan be affected?

The recent volatility in global financial markets is unlikely to have a major impact on the US economy and/or the Fed's policy plan. A slower Chinese economy is likely already in the Fed's forecast, as would be increased financial market volatility.

The biggest influence on the US economy from China, particularly inflation, as well as the Fed's policy plan, would likely be via the USD. If there is substantial further weakness in the RMB and the Chinese economy, one result could be a further strengthening of the USD. A stronger USD would, all other things equal, likely lead to a lower-than-expected US inflation outcome, which in turn would slow the path of interest rate increases by the Fed.

Currently, the Fed is signalling that they expect to raise interest rates four times in 2016. Our own forecast is for three rate hikes, while the markets are only priced for two rate increases. A stronger USD and/or sharply weaker commodity prices from here would see our own view move closer to current market expectations.

3. Which currencies do you think can continue to outperform against the USD in the year ahead?

Our monetary policy expectations would imply further strengthening in the USD, especially as we expect three interest rate hikes from the US Fed this year, rather than the two rate hikes priced into markets.

The strength of the USD should be felt most acutely against the currencies of those central banks that are easing monetary policy further, including the EUR, JPY and RMB. Other Asian currencies are also expected to weaken against the stronger USD, but by a lesser amount than those currencies where monetary policy is eased aggressively.

At the start of 2016, however, these expectations have been unsettled by the sharp increase in global financial market volatility that has seen a 'flight to quality' rally in currencies such as the JPY and weakness in commodity based currencies such as the AUD and Canadian dollar.

Indeed, increased financial market volatility is expected to be a feature of global financial markets through 2016 and this could see many currencies trade in a wider range than those experienced in recent years.

4. How do you see sharemarkets shaping up in the next six months to a year?

The global environment for equity markets is expected to be mixed in 2016. A 'below-trend' economic environment is unlikely to support significant gains in global equity markets, but equally is not an environment that would push equity markets sharply lower.

Nonetheless, equity markets have started the year with concern that the pace of global economic growth will decline, led lower by China and a less accommodative US Fed. The real concern is around the ability of the Chinese authorities to manage the 'triple-threat' mentioned previously. These concerns are likely to remain in place for the better part of H1 16, but China's presidency of the G20 this year should give the authorities added incentive to stabilise markets into H2 16.

While there will, no doubt, continue to be country-specific factors that weigh on equity markets, the global economic environment is one that would argue for modest gains for equities through much of 2016.

5. Can you explain the downward moves in the oil price and the outlook for 2016? What is the outlook for the other major commodities?

The spot Brent crude oil price has fallen to as low as US$28.76/bbl since the start of December 2015, levels not seen since 2004. This extends the drop from its peak on 27 April 2011 at US$109.2/bbl. The price of West Texas Crude has suffered a similar fate, after reaching its peak on 29 April 2011 at US$113.9/bbl, it has now fallen to US$28/bbl, with the bulk of the decline occurring between July 2014 and mid-January 2016.

The most recent fall has been driven by OPEC's decision to not cut production at its meeting on 4 December, while the International Energy Agency also warned that global oil oversupply could worsen in 2016. The lifting of sanctions against Iran will add 500,000-1m barrels per day to an oil market that is already in over supply. These supply issues together with financial market volatility stemming from economic growth and currency concerns in China, have led to further falls in the oil price.

While most of the oil producers are struggling at the current price, thus far, suppliers seem reluctant to be the first to cut production. OPEC has to-date ruled out production cuts while non-OPEC and non-US producers have also been resilient to the need for lower production. There is excess supply and inventories in most markets and until there are material production declines, it is hard to see much upside in the oil price in the short-term.

Looking forward to the rest of 2016, the sharp sell-off in oil and natural gas prices is expected to increase the pace of capex reductions, setting the stage for potentially higher oil prices at some point in 2016. Though, the risk does remain that oil prices could collapse further towards US$20/bbl if limited changes are made to supply.

Weakness in other commodity prices, particularly base metals, can be attributed to various factors. Some of the metal demand slowdown in China is structural, there is cyclical weakness in the property market, weak land sales and continued anti-corruption investigations into some of the higher profile state infrastructure companies has exacerbated the slowdown and weakness in prices. There is a reasonable probability of a modest cyclical rebound in demand for 2016, supported by continuing policy stimulus measures in China.

Some of the necessary conditions for a bottoming of the mining cycle are starting to emerge. On the supply-side, production is being reduced in some copper and zinc mines globally, other mines are being shut down such as coal in the US and iron ore globally. At the company level, dividends are being cut, equity is being raised, capital spending continues to be deferred, and costs remain the key focus. In 2016, we expect to see further supply cuts, asset sales, dividend cuts, write downs, bankruptcies and equity issuance in the mining sector.

The outlook for bulk commodities (ie. iron ore and thermal coal) remains unattractive given strong supply additions, a falling cost curve and the rotation toward a consumer-led Chinese economy.

Gold continues to face macro headwinds from a strong USD, increasing US interest rates and subdued inflation outlook. This is counterbalanced by periodic bouts of risk-off demand primarily due to geo-political risks.

Section 2

Market Watch – Our Quarterly Market Review

The fourth quarter of 2015 produced predominantly positive returns on global equity markets, although this was driven primarily by strong returns in the month of October. Post these strong returns, global equity markets retreated in November and December as markets refocused on the likely and eventual first interest rate rise by the US Fed. As a result, government bond yields finished the quarter higher, with Japan the exception.

Global central bank divergence proved to be the theme of the fourth quarter. The Fed embarked on the first interest rate hike since 2006 after keeping the Fed Funds rate at zero since 2008. Throughout the quarter, there was substantial debate and market repricing of the odds of such a move that created volatility within markets. Ultimately stronger employment data pushed the Fed in lifting the Fed Funds rate by 25 basis points (bps) to a target range of 0.25%-0.5% with equity markets largely unfazed by the move after such a long build up.

With the Fed lifting interest rates, other central banks embarked on further easing measures, including the ECB, the People's Bank of China (PBoC) and the RBNZ, while the BoJ made some technical adjustments to its QQE program. This divergence is set to continue in 2016 with a set of gradual increases to the Fed Funds rate and further easing measures expected in Europe, Japan, China and some smaller economies. As a result, 2016 is set to include the first real divergence in central bank policy, since the depths of the GFC, and is expected to see financial market volatility continue.

Other key events over the quarter included further commodity price weakness, in particular, oil and iron ore. The price of West Texas Crude fell 17.9% to US$37/bbl, taking falls over 2015 to 59.4%. A large increase in oil supply from Russia, Iraq, Libya and Saudi Arabia, OPEC ruling out production cuts and weaker demand led to the sharp fall in the oil price which continued into 2016. The iron ore price, as measured by the benchmark price delivered to Qingdao China – 62% ferrous content fell 22.6% over the quarter to US$43.6 / metric tonne, taking annual losses to 44.2%. Base metal prices were also weaker, including nickel (-15.2%) and copper (-8.8%), while gold retreated to US$1064.8 an ounce, down 4.8% in the quarter.

As a result, global equity markets moved higher in October before weakening into year end. Continued concerns over the pace of growth in China and the policy response, political concerns in Europe with elections in Spain and Portugal, and the immigration crisis all impacting markets. Despite these concerns, the broader global economic outlook did not change and company earnings continue to report solid numbers, which helped propel the market forward over the quarter. The MSCI World Index rose 5.1% in the quarter in USD terms. The index rose 1.1% in AUD terms, given the 4% appreciation of the AUD over the quarter against the USD.

The Chicago Board Options Exchange SPX Volatility (VIX) Index, a market estimate of future volatility, showed less extreme moves over the fourth quarter compared to the third quarter. The VIX Index started the quarter at 24.5 and finished at 18.2. Overall, it averaged 17.2, compared to 19.3 the prior quarter with less political risk in the further quarter compared to the third quarter with the crisis in Greece largely resolved.

In the US, the S&P 500 Index rose 6.5% in the quarter, after falling 6.9% in Q3 15, the worst since Q3 11. There were sharp gains in October before falling into year end. On the whole, US equity markets reacted in a smooth fashion to the first US interest rate hike since 2006 in late December. The Dow Jones (+7.0%) and NASDAQ (+8.4%) both rose. On a sector basis, MSCI Energy fell 1.4% in the quarter while IT was the strongest performer, up 8.6%.

European equities were mixed over the quarter, with each market impacted by country specific issues as well as further stimulus efforts by the ECB. The German DAX outperformed other European markets, rising 11.2% over the quarter. Expectations of further aggressive ECB easing helped propel the German market, although when the package was delivered in December it did disappoint the high expectations in the market. The deposit rate was cut by 10 bps to -0.3% and the APP was extended by a further six months to at least March 2017. Elsewhere, France rose 4.4% while dealing with the tragic terrorism attacks and fell 0.2% on the uncertain outcome from its December General Election and continued push from the Catalan Region to separate from the rest of Spain. Overall the Euro Stoxx 50 Index rose 5.4% to finish 2015 up 3.8%. The EUR fell 2.9% against the USD, with divergence between the Fed and ECB escalating over the quarter. The EUR is down 16.3% over 12 months against the USD.

In the UK, FTSE 100 rose 3.0% over the quarter to finish 2015, down 4.9%. Sterling fell 2.7% against the USD over the quarter and 10% over 2015. The UK economy continues to perform moderately, although expectations of the first BoE rate hike have been pushed out to mid-2016 despite the US Fed lifting rates in December 2015.

The Japanese equity market rose 9.5% in Q4 15, after falling 14.1% in Q3 15. The Japanese economy is performing moderately and the BoJ made some technical adjustments to its QQE program but did not expand it as some market participants had expected. The JPY depreciated just 0.2% in the quarter, and fell 9.5% for the year.

The MSCI EM (Emerging Markets) Index rose 0.3%, experiencing significant volatility in reaction to both country specific issues and as a reaction to economic growth concerns, falling commodity prices and the potential rate hikes in the US and a rising USD. The MSCI EM Index significantly underperformed the broader global equity market index and was held back by MSCI EM Europe, Middle East & Africa (-8.6%/qtr) and Latin America (-3.4%/qtr). The Shanghai Composite Index rose 15.9% in the quarter, despite ongoing concerns over the pace of devaluation of the RMB and the pace of economic growth. Despite falls in Q3 15, the market is still up 49.7% over 2015.

Other key performers included the Argentina Burcap Index, which rose 21.6% over the quarter, although was still down 10.5% over 2015. Argentina lifted capital controls in December and let the Argentine Peso depreciate freely, with the Peso falling 34% against the USD in the month of December.

Australian shares rallied in the final quarter of 2015, offsetting weakness from the September quarter and ensuring the S&P/ASX 200 Accumulation Index closed the year in positive territory (+2.6%). The Index was led higher by financial stocks, which registered an 11%+ gain. All four of the major banks raised home loan rates by between 0.15% and 0.20% during the period, which is expected to support margins and boost profitability.

At the other end of the scale, materials stocks generated disappointing returns, capping off a miserable 2015 in which the sector declined in value by nearly 20%. Bulk commodity prices continued to decline, reflecting concerns over economic growth rates in China and increased supply. During November, sector heavyweight BHP Billiton also had to contend with a serious incident in Brazil at a mine operated by Samarco, a 50% owned joint venture.

Bond markets in the final quarter of 2015 were largely driven by central bank policy, specifically by the actions and rhetoric from the US Fed (with the first rate rise since 2006) and the ECB (with further easing measures announced in December). Government bond yields in the major bond markets rose over the December quarter, with the exception of Japan, where yields fell modestly. The US 10-year treasury yield ended the quarter at 2.27%, an increase of 23 bps; the 10-year German bund yield rose by 4 bps to 0.63%, whilst the yield on the UK 10-year gilt rose 28 bps, ending the quarter at 1.96%. The 10-year Japanese government bond (JGB) fell by 9 bps to 0.26%.

Longer dated Australian bond yields mirrored the direction of global yields and rose during the quarter. The yield on the benchmark 10-year government bond increased by 28 bps to 2.88%. Throughout the quarter, the RBA left the official cash rate unchanged at 2% with the most recent minutes leaning toward a mild easing bias.

United States

The US Federal Reserve – first rate hike

- The US Federal Open Market Committee (FOMC) met on 15-16 December and unanimously agreed to begin the monetary policy normalisation process by announcing a 25 bps increase in the Fed Funds target range from 0%-0.25% to 0.25%-0.5%. See chart 1.
- This is the first increase in the Fed Funds rate since 2006, after leaving the target rate at zero since December 2008.
- The statement accompanying the policy decision highlighted the improvement in the US economy, noting that "there has been considerable improvement in labour market conditions |this year." Overall, however, the Fed notes that "economic activity has been expanding at a moderate pace", with household and business investment "increasing at solid rates", housing improving further, but net exports 'soft'.
- As widely expected, in the statement the Fed emphasised (twice) that the pace of further rate hikes will be gradual, stating that "the Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate" and that "the Committee expects that, with further gradual adjustments in the stance of monetary policy, economic activity will continue to expand at a moderate pace and labour market indicators will continue to strengthen."
- The Fed statement also reinforced the 'data-dependent' nature of the policy outlook, stating that "the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data."
- However, despite reinforcing the gradual nature of rate hikes, the Fed did not lower their end 2016 'dot' plot estimate of the Fed Funds rate, which remains at 1.4% (ie. a 1.25%-1.5% range) and implies four rate hikes in 2016. This is more aggressive than the approximately two rate hikes currently priced into markets. See chart 2.

Strong employment gains but still no wages growth:

- The US Fed drew confidence to lift rates in December 2015 from stronger employment numbers, particularly for October 2015 and November 2015 that were released prior to the December 2015 rate hike meeting.
- Over the quarter, 851,000 jobs were added, compared to 521,000 in Q3 15 and the unemployment rate fell to 5% at end of December 2015, compared to 5.1% at the end of September 2015. See chart 3.
- Strong jobs growth in the construction, education, health services and retail sector helped propel the creation of 2.65m jobs over 2015.
- Despite the fall in the unemployment rate and strong employment numbers, there has been to date limited signs of wages pressure emerging.
- Average Hourly Earnings rose to 2.5%/yr in December 2015, up from 2.3%/yr in September 2015, albeit a rise but still slower than what would be expected at this point in the employment cycle.

Economy records moderate growth, inflation still low.

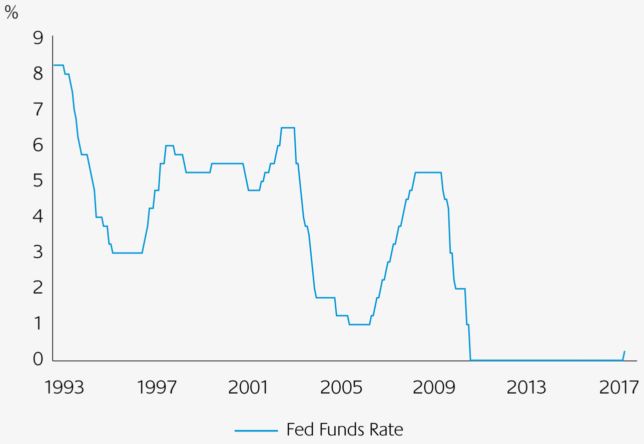
- GDP growth slowed to 2% on a seasonally-adjusted-annualised-rate (SAAR) in Q3 15, down from the strong 3.9% SAAR recorded in Q2 15. See chart 4. Consumer spending was a clear outperformer, helped by strong employment growth and low gasoline prices. The slowdown in growth was driven by inventory drawdown on weak external demand.
- Inflation remained low, headline inflation was just 0.5%/yr in November 2015 (compared to 0.2%/yr in August 2015), while the Fed's preferred measure, the Core PCE was unchanged throughout the past three months at 1.3%/yr. See chart 5.

Government funding deal achieved

- Early in the quarter, a deal was achieved to suspend the US$18.1trn debt ceiling until 15 March 2017. See chart 6. This deal was facilitated by Republican Paul Ryan, a former Vice-President candidate who was confirmed as the new Speaker of the House after John Boehner's retirement. A deal for government funding through September 2016 was also achieved.
- The suspension off the debt ceiling till March 2017 will see this become a non-issue for the 8 November 2016 Presidential Election which should dominate headlines in 2016.

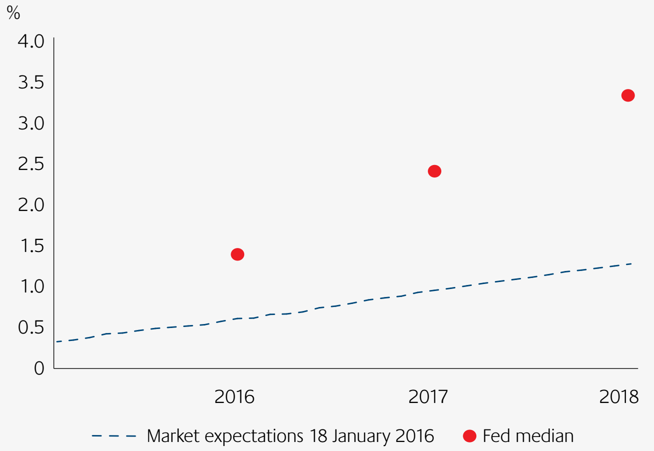
Chart 1 – US: Fed Funds rate

First rise since 2006



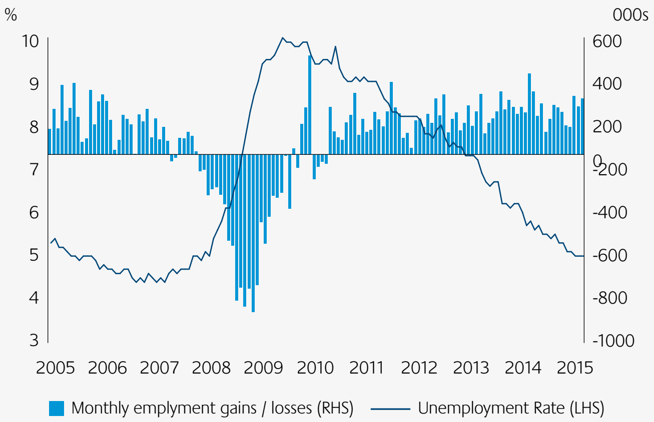
Source: Data to 31 December 2015.

Chart 2 – US: Market expectations for Fed Funds rate and Fed 'dots'



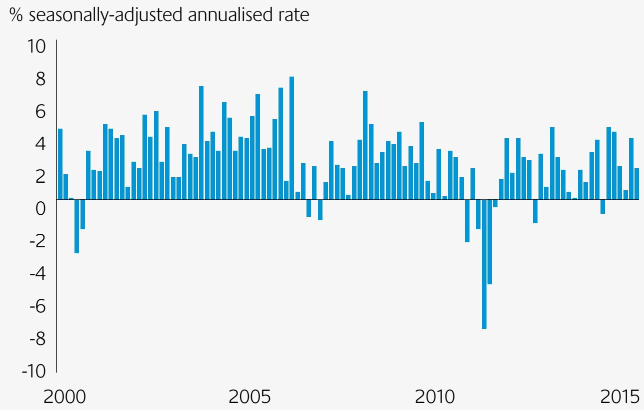
Source: Bloomberg. Data to 18 January 2016. Fed dot plot as at December 2015 meeting.

Chart 3 – Employment strong in late 2015



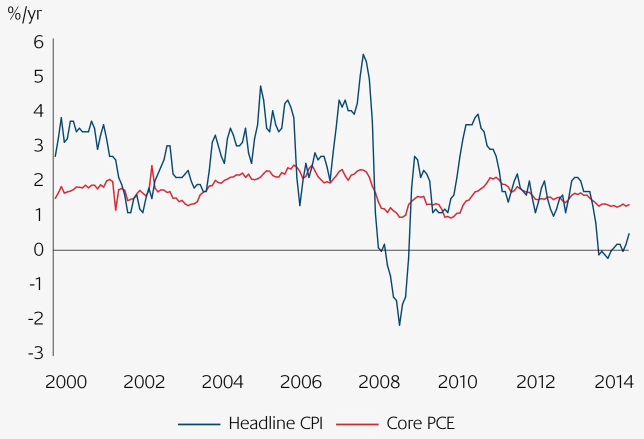
Source: Bloomberg. Data to 31 December 2015.

Chart 4 – US: Economic growth resilient but slower



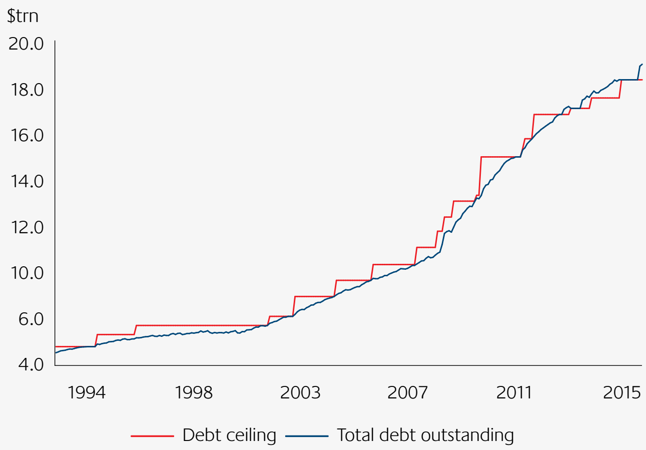
Source: Bloomberg. Data to 30 September 2015.

Chart 5 – US: Inflation still low



Source: Bloomberg. Data to 30 November 2015.

Chart 6 – US: Debt ceiling suspended till March 2017



Source: Bloomberg. Data to 31 December 2015.

Europe

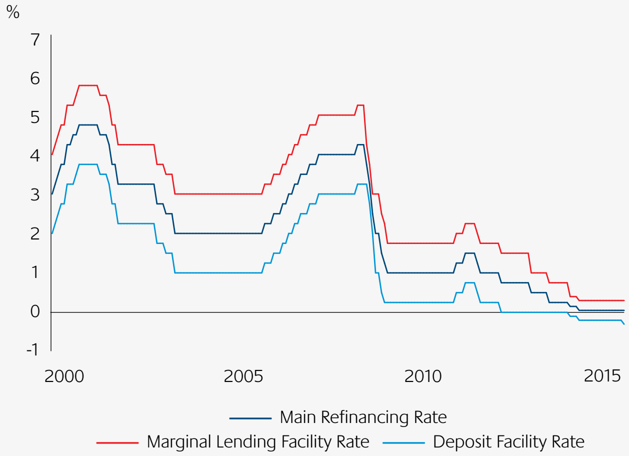
European Central Bank eases again

- The ECB met on 3 December 2015 and announced a number of decisions to ease monetary policy further. The interest rate on the deposit facility was cut by 10 bps to -0.30%, effective from 9 December 2015.
- The interest rate on the main refinancing operations and the interest rate on the marginal lending facility remained unchanged at 0.05% and 0.30% respectively. See chart 7.
- In relation to non-standard monetary policy measures, the APP was extended until the end of March 2017, from its current September 2016 end-date or beyond if necessary until the path of inflation is adjusted to just under 2%. As at end of December 2015, headline inflation was just 0.2%/yr and core inflation was 0.9%/yr. See chart 8 and 9.
- Other announcements included the decision to reinvest principal payments on the securities purchased under the APP and to include a wider selection of securities that could be purchased. EUR-denominated marketable debt instruments issued by regional and local governments located in the EU area will now be included.

Political troubles in Spain

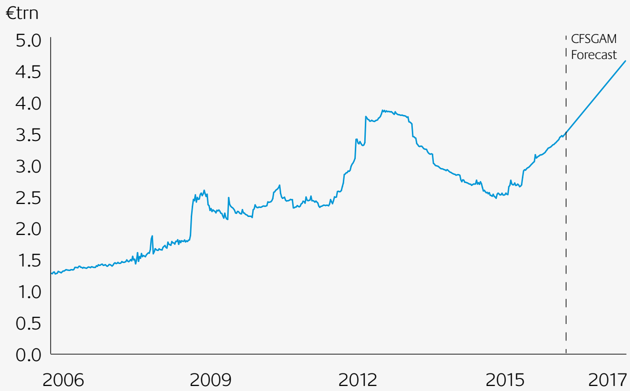
- The Spanish general election was held on 20 December 2015 with no consensus reached on whom will form government. Incumbent Prime Minister, Mariano Rajoy is acting in the role until a solution is found or a new election is called. At the election, the ruling People's Party recorded the largest number of votes, although not enough to form government. The opposition Spanish Socialist Worker's Party scored second although recorded its lowest vote in history. Left-wing anti-austerity party Podemos gained support winning around 20% of votes, while the Citizens Party ran fourth.
- The push by the Catalan region for independence continued over the quarter with political instability occurring in Spain despite improvements in economic growth. Q3 15 GDP growth was recorded at 3.4%/yr and the unemployment rate fell to 21.2% for Q3 15 down from a peak of 26.9% in Q1 13.

Chart 7 – Europe: Key ECB interest rates
Deposit rate further in negative territory



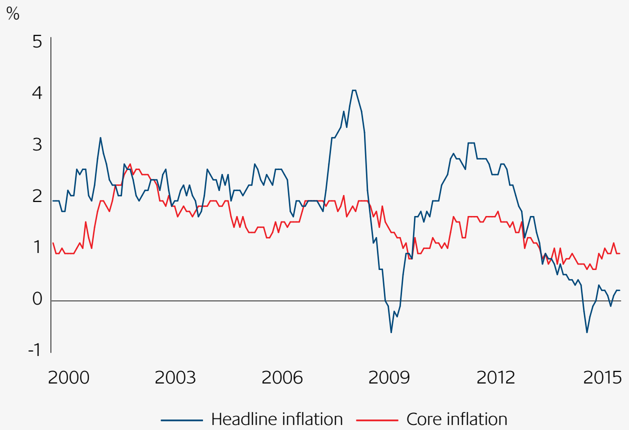
Source: Bloomberg. Data to 31 December 2015.

Chart 8 – Europe: ECB balance sheet set to keep expanding to March 2017
Forecasts till March 2017



Source: Bloomberg and ECB. CFSGAM forecasts to March 2017. Actual data to 31 December 2015.

Chart 9 – Europe: Headline and core inflation still muted



Source: Bloomberg. Data to 31 December 2015.

United Kingdom

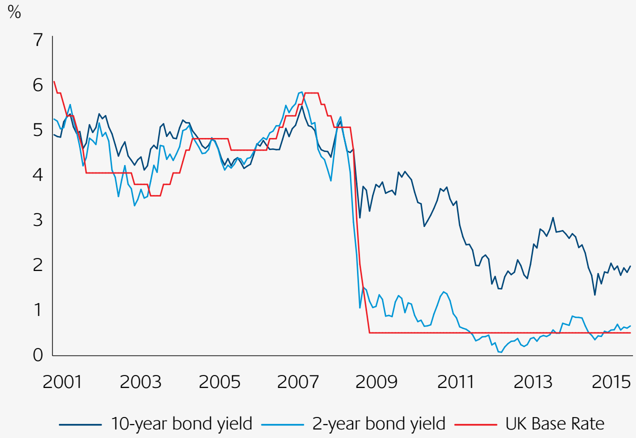
Bank of England – no signs of rate rise

- The BoE remained on hold over the December 2015 quarter, maintaining the Bank Rate at 0.5% and the APP at £375bn. See chart 10.
- There continues to be one dissent on the nine member board where there has been since the August 2015 meeting. Ian McCafferty continues to prefer to increase the Bank Rate by 25 bps, based on a view that domestic cost pressures were more likely to lead to inflation exceeding the target in the medium term.
- In November 2015, the BoE released its latest Inflation Report, and downgraded its forecasts for inflation. CPI inflation is projected to rise to 0.4%/yr in December 2015 and 0.7%/yr in March 2016, largely due to further falls in the oil price, weaker prices for clothing and footwear and lower household gas prices. Inflation is expected to remain below 1% until the second-half of 2016.
- Currently, the BoE expects inflation will return to the 2% target in around two years as domestic cost growth picks up and the drag from past falls in import prices wanes.
- Commentary from the BoE remains cautious, in terms of further rate rises, despite the US Fed starting the normalisation process and a subdued market reaction. Any discussion around Bank Rate increases from the BoE focus on the gradual and shallow nature of any possible rate rises.
- Actual Inflation remains low in the UK, with headline inflation at 0.1% /yr to November 2015, compared to flat at end of August 2015. Core inflation is creeping higher, 1.2%/yr at end of November 2015, compared to 1.0% at end of August 2015. See chart 11.

Unemployment falling and moderate economic growth

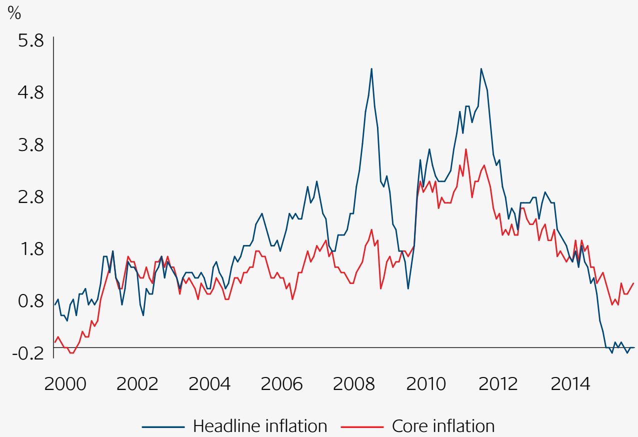
- The UK labour market continues to improve, with the unemployment rate falling to 5.2% in the three months to October 2015. Employment gains have been decent with 207,000 jobs added over the three month period. See chart 12.
- GDP growth has slowed, with growth in Q3 15 of 2.1%/yr, down from 2.3% in Q2 15. The trade sector is dragging on growth while consumption and services are the main source of growth.

Chart 10 – UK: Base rate, 2-year and 10-year bond yields



Source: Bloomberg. Data as at 18 January 2016.

Chart 11 – UK: Inflation pressures remain subdued



Source: Bloomberg. Data to 31 December 2015.

Chart 12 – UK: Unemployment rate heading lower

Source: Bloomberg. Data to 31 October 2015.

Japan

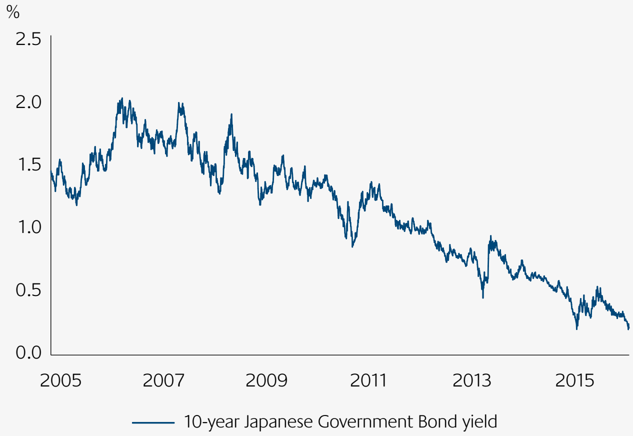
Technical adjustment by the Bank of Japan

- The BoJ policy board left its QQE program at an annual increase of ¥80trn to its monetary base over the quarter. However, at its December 2015 meeting, made some technical adjustments to its program.
- This included lengthening the maturity of bonds purchased in the QQE program to 7-12 years duration from 7-10 years. This should help improve the functioning of the program with some short maturity bonds becoming scarce.
- The BoJ is also increasing the maximum share of each JREIT that the BoJ can buy. The current cap is 5% per REIT, but the BoJ will now allow itself to own as much as 10% per REIT. This move surprised market and saw Japanese government bond yields fall in the quarter, with 10 year yields down from 0.36% at end of September 2015 to 0.27% at end of December 2015. See chart 13.
- This technical adjustment to the QQE did leave some disappointment in the market that further stimulus would not be forthcoming.
- Currently, headline inflation is just 0.3%/yr to November 2015 and core inflation (ex food and energy) is just 0.9%/yr, albeit slightly higher than three months earlier. See chart 14.

Economic growth moderate and the JPY starts appreciating late in the quarter

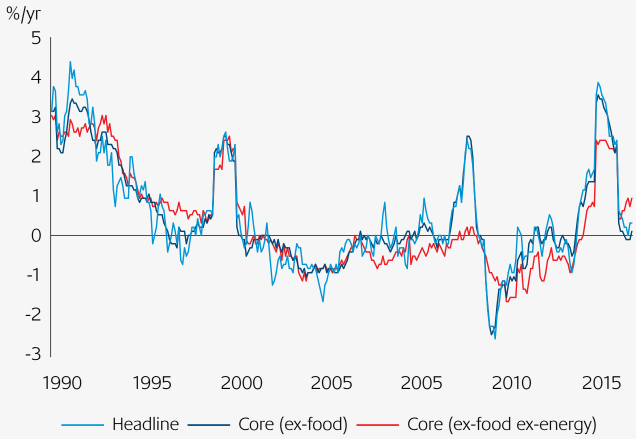
- The Japanese economy grew by 0.3%/qtr in Q3 15, stronger than expected and up from the disappointing -0.1/qtr recorded in Q2 15. Stronger private investment and consumption were both positive, while public investment was weak. Annual growth rose to 1.6%/yr in December 2015, up from 0.7%/yr in September 2015. See chart 15.
- Over the course of 2015, the JPY depreciated by 0.3% against the USD, although at one point in early June 2015, the JPY had fallen 4.9% against the USD. This compares to a 13.6% depreciation in 2014. The stagnating depreciation comes despite the US Fed lifting interest rates for the first time in December 2015 and despite expectations of more easing at some point in 2016 by the BoJ.

Chart 13 – Japan: 10-year Japanese Government Bond yields
Drifting lower



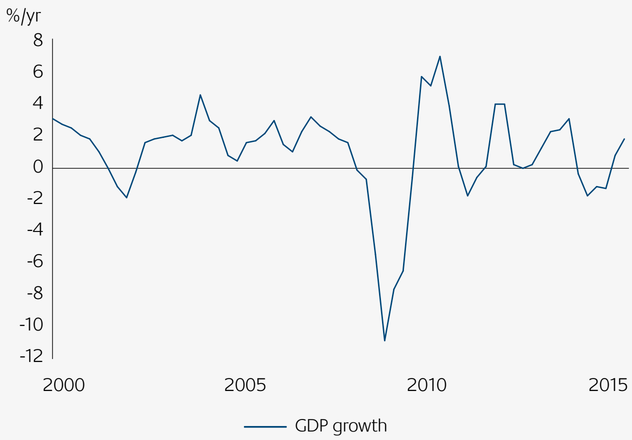
Source: Bloomberg. Data to 31 December 2015.

Chart 14 – Inflation measures – three ways



Source: Bloomberg. Data to 30 November 2015.

Chart 15 – Japan: Economic growth moving higher



Source: Bloomberg. Data to 30 September 2015.

China

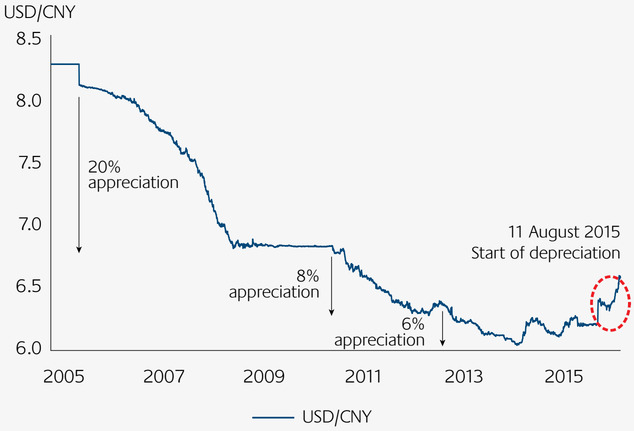
Renminbi further depreciation and to be included in the IMF reserve currency basket

- It was announced on 30 November 2015 that the RMB will be included in the IMF's SDR basket as of 1 October 2016. This is a clear step forward for the RMB becoming an international reserve currency.
- The RMB will join the USD, EUR, JPY and GBP in the basket and should prompt further depreciation of the RMB and capital account liberalisation.
- The initial weight for the RMB was set at 10.92%, while the remaining weights are: USD (41.73%), EUR (30.93%), JPY (8.33%) and GBP (8.09%).
- Over the December quarter, then onshore RMB continued to depreciate versus the USD after the initial devaluation on 11 August 2015.
- The CNY/USD depreciated 2.2% against the USD over the quarter (see chart 16), while capital outflows increased rapidly under the new currency regime. As a result, the PBoC continued to use its FX reserves to manage the currencies moves, with the depreciation increasing rapidly in early 2016, leading to extreme global financial market volatility.
- Capital outflows were at a record high over the quarter, as changes to the currency regime and desire for diversification accelerated. One measure of capital flows showed US$366bn over the three months to November 2015, compared to US$313bn in the three months prior. This must be seen in context of the over US$3trn FX reserves held by China.

Economic growth slows, albeit in a transition phase

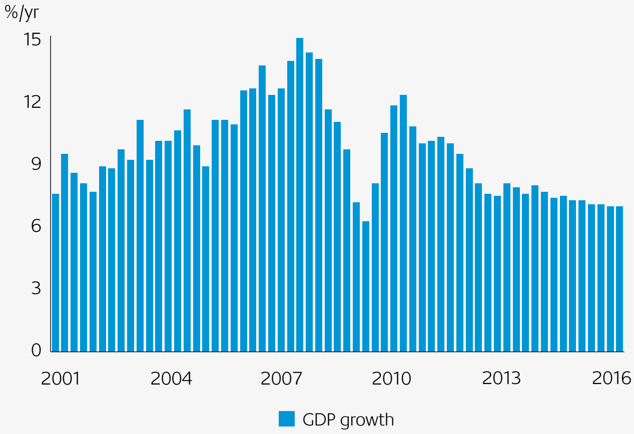
- Q3 15 GDP data showed annual growth recorded at 6.9%/yr, down from the 7% recorded in both Q1 15 and Q2 15. This was above consensus estimates of 6.8%/yr, but below the current target of 7%. See chart 17. The services sector continued to perform well, accelerating to 8.6%/yr, while the manufacturing sector slowed to 5.8%/yr. This is also being reflected in weaker industrial production and fixed asset investment numbers while retail sales have been helped by strong vehicles sales due to tax changes. See chart 18.

Chart 16 – RMB liberalisation with SDR inclusion the aim
USD/CNY exchange rate – depreciation stepped up



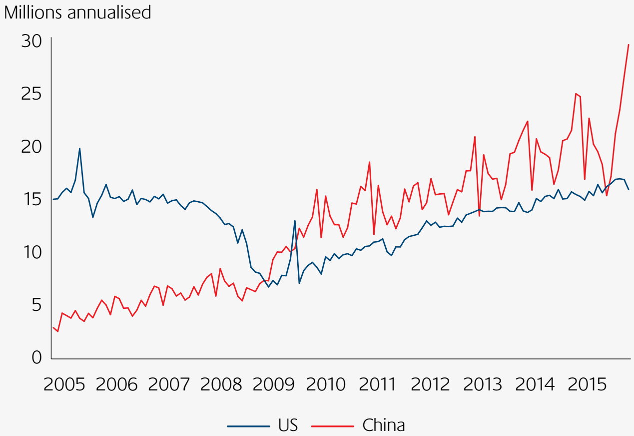
Source: Bloomberg. Data to 19 January 2016.

Chart 17 – China: GDP growth slowing with economy in transition



Source: Bloomberg. Data to 30 September 2015.

Chart 18 – China: Car sales rising sharply



Source: Bloomberg. Data to 31 December 2015.

Australia/New Zealand

The RBA keeps rates on hold

- The RBA kept the official cash rate on hold at 2.5% through the December 2015 quarter and where it has remained since May 2015. The RBA believes that "the prospects for an improvement in economic conditions had firmed a little over recent months and that leaving the cash rate unchanged was appropriate. Members also observed that the outlook for inflation may afford scope for further easing of policy, should that be appropriate to lend support to demand."
- While the RBA does appear comfortable with rates on hold, a slight easing bias has been maintained due to the lower-than-expected inflation data.

Government Budget – feeling the pain from lower commodity prices

- The Commonwealth government released its Mid-Year Economic and Fiscal Outlook (MYEFO) in December 2015, which showed a further deterioration in Australia's fiscal position.
- The 2015/16 Budget deficit has been revised from the May 2015 estimate of A$35.1bn (-2.1% of GDP) to A$37.4bn (-2.3% of GDP). See chart 19. Weakness in the nominal income side of the economy from falling terms of trade, lower commodity prices and soft income growth led to the revision.
- The Budget position has also deteriorated over the next four years, with the cumulative budget deficits now estimated to be around A$26bn higher than the May 2015 estimate.
- Downgrades to economic growth and a significant decline in commodity prices, particularly iron ore have led to these falls.
- As a result, net debt of the Commonwealth government is now expected to peak at 18.5% of GDP at 30 June 2018, only a little higher than the previously expected peak of 18.0%. See chart 20.
- This will take the face value of Commonwealth Government Securities (bonds and bills) to A$429bn as at 30 June 2016, up from A$369bn as at 30 June 2015.

GDP growth versus employment – the inconsistency continues

- Australia's Q3 15 GDP data was received in early December 2015 for Q3 15 and showed stronger-than-expected growth of 0.9%/qtr and 2.5%/yr. This compares to a revised 1.9%/yr in Q2 15.
- Growth on the quarter was driven by strong net exports and, to a lesser extent, household consumption. These increases were partly offset by a fall in capital investment. Real gross domestic income rose by 0.3%/qtr, to be up just 0.2%/yr. Income growth in the Australian economy remains substantially below production growth. See chart 21.
- In contrast to the sub-trend GDP numbers, Australia's employment growth has been robust. Over the three months to December 2015, 129,000 jobs were added, taking the gains over 12 months to 301,000, compared to 175,000 in 2014. There are some questions over data quality, albeit still a strong result. The unemployment rate finished the year at 5.8%. See chart 22.

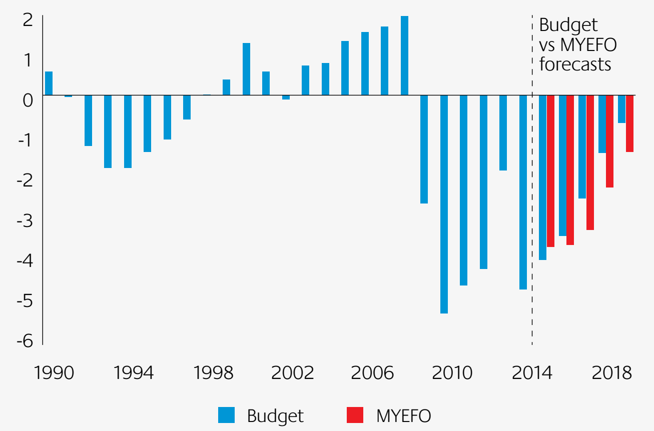
RBNZ – December 2015 rate cut takes annual total to four

- The RBNZ cut interest rates late in the December 2015 quarter, announcing a 25 bps reduction in rates at their December 2015 meeting. This was the fourth cut to the official cash rate over 2015, bringing the cash rate down from 3.5% at the start of the year to 2.5% at year end. See chart 23.
- The RBNZ noted "the rise in the exchange rate is unhelpful and further depreciation would be appropriate in order to support sustainable growth." They also noted that they expect to reach the inflation goal at current rate settings, leaving open the possibility that the monetary policy easing cycle is over. Although, RBNZ notes that the Bank will reduce rates if circumstances warrant.

NZ GDP growth slows

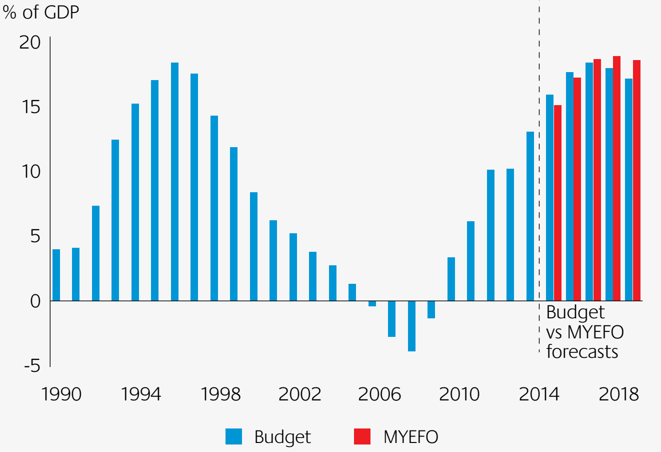
- Q3 15 GDP data released during the quarter showed growth of 0.9%/qtr and 2.3%/yr, down from its peak of 4.1% in Q4 14 but slightly stronger than market expectations. See chart 24. Leading the surprising resilience in the economy, was better-than-expected investment demand for plant and machinery, as well as strong services exports on the back of tourism activity. Also helping was stronger growth in retail, wholesale and manufacturing sectors.

Chart 19 – Australia: Budget deteriorated since May 2015



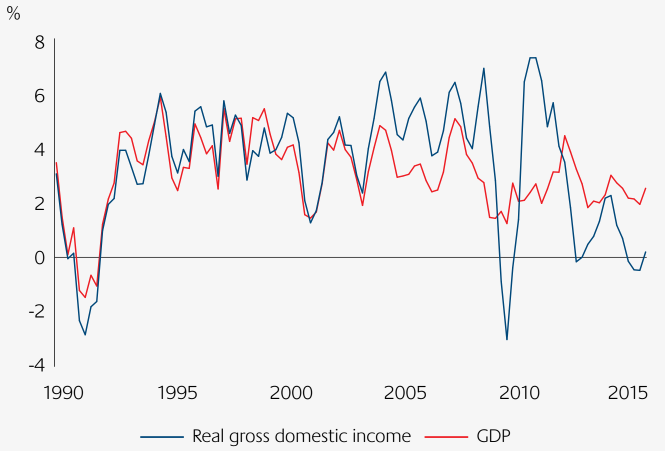
Source: Commonwealth Treasury. Data from December 2015 MYEFO.

Chart 20 – Australia: Net debt profile slightly worse



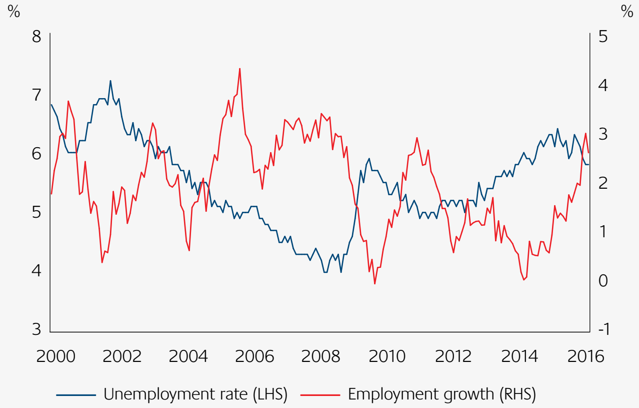
Source: Commonwealth Treasury. Data from December 2015 MYEFO.

Chart 21 – Australia: GDP growth moderate and income growth still slow



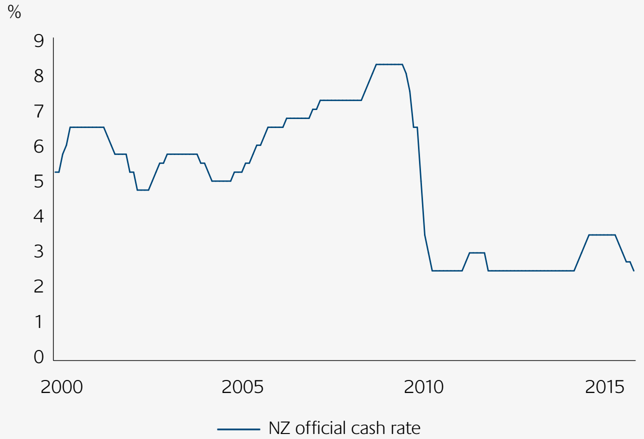
Source: Bloomberg. Data to 30 September 2015.

Chart 22 – Australia: Employment gains very strong and unemployment rate falls



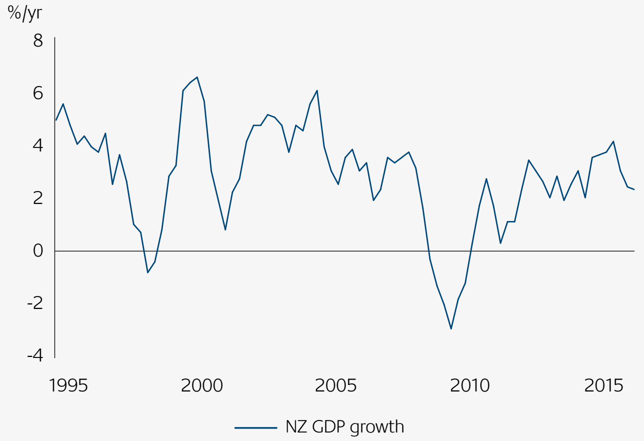
Source: Bloomberg. Data to 31 December 2015.

Chart 23 – New Zealand: RBNZ cuts the official cash rate four times in 2015



Source: Bloomberg. Data to December 2015.

Chart 24 – New Zealand: GDP growth softens over 2015



Source: Bloomberg. Data to 30 September 2015.

Section 3

Economic Forecasts January 2016

United States

	2015		2016		2017		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	2.4	2.3	2.4	2.5	2.4	2.5	2.5	2.5
Inflation – Core PCE	1.3	1.3	1.6	1.6	1.8	1.8	2.0	2.0
Monetary policy – Rates	0.25%-0.5%	0.25%-0.5%	0.75%	1.0%-1.25%	1.3%	1.75%-2.0%	3.0%	2.5%
Monetary policy – Other	No change in Fed balance sheet.	No change in Fed balance sheet.	Fed unlikely to alter balance sheet.	Fed unlikely to alter balance sheet.	Coupon reinvestment to phase out.	Coupon reinvestment to phase out.	Balance sheet slowly returns to normal.	Balance sheet slowly returns to normal.

Source: Bloomberg.

Comments:

- GDP: We have revised down our 2015 growth forecast for the US to 2.3%, a little below consensus on the back of a volatile growth pattern, the ongoing effects of the stronger USD and the inventory cycle.
- For 2016, our economic growth forecast remains at 2.5%, now in-line with consensus. Growth is expected to be driven by the very solid labour market supporting the consumer and some further improvement in the construction sector, but with softness in capital spending and net exports.
- Inflation: Expectations for inflation in the US continue to be lowered. We now expect core PCE inflation to have run at 1.3%/yr in 2015, down on the previous forecast of 1.4% – driven by the collapse in the price of oil and previous appreciation of the USD.
- For 2016, the core PCE is expected to rise only modestly to 1.6%/yr, with the 2017 forecast lowered marginally to 1.8%/yr. Both cyclical and structural forces are at play holding down US (and global) inflation.
- Monetary policy: The US Fed began the monetary policy normalisation process in December 2015, lifting the Fed Funds target rate by 25bp to 0.25%-0.5%.
- We continue to expect three rate hikes in 2016 and 2017 and a peak in the Fed Funds rate of 2.5% in 2018. This is substantially lower than the Fed's own forecasts, but still higher than market expectations.
- The Fed is not expected to sell any of the bonds it holds on balance sheet, but is now expected (by us) to begin to cease reinvesting coupon income in 2017.

United Kingdom

	2015		2016		2017		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	2.2	2.3	2.2	2.4	2.3	2.3	2.5	2.0
Inflation – CPI	0.0	0.1	1.2	1.1	1.9	1.7	2.0	2.0
Monetary policy – Rates	0.5%	0.5%	1.0%	1.0%	N/A	1.5%	2.5%	2.5%
Monetary policy – Other	No further QE.	No further QE.	No clear consensus.	No balance sheet adjustments.	No clear consensus.	No balance sheet adjustments.	Rates to settle around new neutral.	Rates to settle around new neutral.

Source: Bloomberg.

Comments:

- GDP: While economic growth in the UK held up well in 2015, we have lowered our 2015 year forecast to 2.3% (from 2.5%). For 2016 we have also lowered our economic growth forecast to 2.4% (from 2.5%) but this remains marginally above consensus expectations. Growth in 2017 is expected to moderate a little as monetary policy is adjusted through 2016.
- Inflation: The pace of inflation in the UK (as elsewhere) has slowed dramatically, largely on the sharp fall in the price of energy. Inflation in 2015 is now expected to be only 0.1%/yr. Some increase in inflation is forecast for 2016, but this has been revised down substantially to 1.1%/yr, from 1.6%/yr previously. Some further modest upward trend in inflation is expected into 2017.
- Monetary policy: With ongoing low inflation in the UK, the expected timing of the first rate hike from the BoE has been pushed back to H2 16, with just two rate hikes expected this year. For 2017, we now expect only two further rate hikes (four previously), taking the base rate to just 1.5%.

Europe

	2015		2016		2017		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	1.5	1.5	1.6	1.5	1.7	1.5	1.5	1.0
Inflation – CPI	0.0	0.1	0.8	0.7	1.5	1.5	1.5	1.0
Monetary policy – Rates	0.05%	0.05%	0.05%	0.05%	N/A	0.05%	N/A	2.0
Monetary policy – Other	QE started March 2015 and continued through the year.	QE started March 2015 and continued through the year.	QE to continue to new March 2017 target date.	QE to continue beyond March 2017 target date.	N/A	QE to remain in place.	Significant period of very easy monetary policy.	Significant period of very easy monetary policy.

Source: Bloomberg.

Comments:

- GDP: Economic data in Europe improved through H2 15 and is expected to show GDP growth of 1.5%/yr for all of 2015.
- For 2016 we continue to expect economic growth of around 1.5%/yr, supported by the weaker EUR, significant monetary policy easing, less fiscal austerity and lower energy prices
- Inflation: Inflation in Europe (as elsewhere) remained very low through 2015 and is struggling to show a positive headline reading.
- Aggressive policy action by the ECB and any further weakening of the EUR should help put upward pressure on inflation in 2016, but we have revised down our forecast to 0.7%/yr (from 1.0%/yr previously).
- Inflation is not expected to reach the ECB's 2% target out to 2017 or beyond.
- Monetary policy: ECB President, Mario Draghi, continues to deliver on his 'whatever it takes' commitment. With an official interest rate at 0.05% the ECB began its aggressive €60bn per month QE program in March 2015 and then extended its intended time frame from September 2016 to March 2017. The yield at which the ECB will purchase bonds has been cut to -0.3%.
- The very low inflation environment increases the odds that the QE program timeframe could be extended again and/or the monthly purchase amount increased, perhaps as early as March 2016.

Japan

	2015		2016		2017		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	0.6	0.7	1.0	1.0	0.6	1.0	1.0	1.0
Inflation – CPI	0.8	0.8	0.8	0.7	2.0	1.75	2.0	1.75
Monetary policy – Rates	0%	0%	0%	0%	0%	0%	0%	0%
Monetary policy – Other	QQE remains in place.	QQE remains in place.	QQE remains in place.	QQE to be expanded.	QQE remains in place.	Expanded QQE remains in place.	QQE eventually wound back.	QQE eventually wound back.

Source: Bloomberg.

Comments:

- GDP: Economic growth in Japan remained weak in H2 15, though is expected to see growth for the year coming in around 0.7%/yr.
- Previous weakening of the JPY and the ongoing QQE program from the BoJ should help support an improvement in growth in 2016, but likely still only to levels around 1.0%/yr (down from our previous forecast of 1.5%/yr).
- Inflation: As is the case elsewhere, the rate of inflation remains very low in Japan and is (once again) expected to come in at under 1%/yr in 2016. Some slight improvement in underlying inflation could be seen in 2017, but the pace of inflation is very unlikely to meet the BoJ's 2% target. Headline inflation is expected to be higher in 2017 on the back of the next rise in the Consumption Tax rate, from 8% to 10%, as at 1 April 2017.
- Monetary policy: With inflation unlikely to hit the BoJ's 2% target by September 2016, a further expansion of the BoJ's QQE program could be implemented early in 2016. The BoJ is expected to retain a very aggressive monetary policy stance for a number of years to come.

3. Economic Forecasts January 2016

China

	2015		2016		2017		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	6.9	6.9	6.5	6.6	6.3	6.25	6.3	6.0
Inflation – CPI	1.4	1.5	1.7	1.6	2.0	2.0	3.0	2.5

Source: Bloomberg.

Comments:

- GDP: Economic growth in China in 2015 is expected to come in at just below the government target of 7.0%/yr.
- For 2016, economic growth is expected to moderate further, with the government likely to set a floor for growth of around 6.5% for the year ahead. Our forecast is for growth just above this level in 2016 and lower again in 2017.
- In the next 10 years or so, China is likely to be able to maintain a growth rate around 6%/yr, consistent with the government's target of doubling GDP from 2010 to 2020.
- Inflation: As with most other nations, China's inflation rate moderated through H2 2015, with the fall in oil prices pushing annual inflation down to 1.6%/yr by year-end 2015.
- For 2016 we have revised down our inflation forecast to 1.6%/yr (from 2.0%), with a modest increase to 2.0%/yr now expected for 2017 (previously 2.5%).
- 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% now expected.

Australia

	2015		2016		2017		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	2.3	2.3	2.6	2.6	3.0	2.75	3.0	2.75
Inflation – CPI	1.5	1.5	2.2	2.25	2.5	2.5	2.5	2.5
Monetary policy – Rates	2.0%	2.0%	1.85%	2.0%	N/A	2.5%	No clear consensus	3.5%

Source: Bloomberg.

Comments:

- GDP: The Australian economy proved to be more resilient and flexible than many expected through H2 15, with economic growth accelerating to likely average 2.3%/yr.
- For 2016, growth is expected to improve further to 2.6%/yr 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.
- Inflation: As with many other nations, inflation in Australia remains very subdued, with headline inflation under the RBA's 2%-3% target band. Underlying inflation remains in the bottom-half of the RBA's target band and is expected to remain around the lower end of the range, ie. 2.25%, over the forecast horizon.
- Monetary policy: The RBA has made it clear that they now expect that the unemployment rate has peaked and with the tightness of the housing market, another rate cut is unlikely. While the RBA does still hold an easing bias, we continue to expect monetary policy to remain on-hold throughout 2016.
- The RBA could begin contemplating some normalisation in monetary policy through 2017 as US interest rates move higher and on the back of the AUD depreciation.

New Zealand

	2015		2016		2017		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	2.4	2.3	2.4	2.6	2.6	3.1	2.5	2.7
Inflation – CPI	0.3	0.4	1.4	1.2	2.0	1.6	2.0	2.0
Monetary policy – Rates	2.5%	2.5%	2.5%	2.0%	N/A	2.0%	N/A	3.5%-4.0%

Source: Bloomberg.

Comments:

- GDP: Economic growth was patchy through 2015, with some pay-back in H2 15 after a soft H1 15. For 2015 growth now looks to come in at 2.3%, down from our previous forecast of 2.5%.
- For 2016, if it were not for strong tourist activity the economy would be in a vulnerable position due to the dairy-sector downturn. Economic growth is likely to moderate back to its underlying rate of around 2.25%-2.5% through 2016. We do expect growth to pick up a little over 2017, but this is contingent on further rate cuts by the RBNZ.
- Inflation: Despite reasonable economic growth over recent years, inflation pressures in NZ have remained muted. Inflation was just 0.1%/yr in 2015.
- Inflation is expected to trend a little higher through 2016, likely coming in close to the middle of the RBNZ's target of 1%-3%.
- Monetary policy: The RBNZ cut the OCR by 25bp to 2.5% in December 2015, but at this stage, sees little need to cut the OCR further. But the RBNZ has acknowledged that it would reduce the OCR further "if circumstances warrant". Our view is the circumstances will indeed warrant further rate cuts this year. We expect a move to 2% by September 2016.

Section 4

Recent Research Reports January 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.

Travelling Economist in the United States "Open your eyes, step in the light"
http://www.cfsgam.com.au/au/insto/Insights/2015_Traveling_Economist/
1 November 2015

Investor Insights: "Investors picky on growth opportunities"
http://www.cfsgam.com.au/au/insto/Insights/Investor_Insights__Investors_picky_on_growth_opportunities/
9 December 2015

US Federal Reserve: "Feels like the first time"
http://www.cfsgam.com.au/au/insto/Insights/US_Federal_Reserve__Feels_like_the_first_time/
17 December 2015

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