

# Economic Snapshot

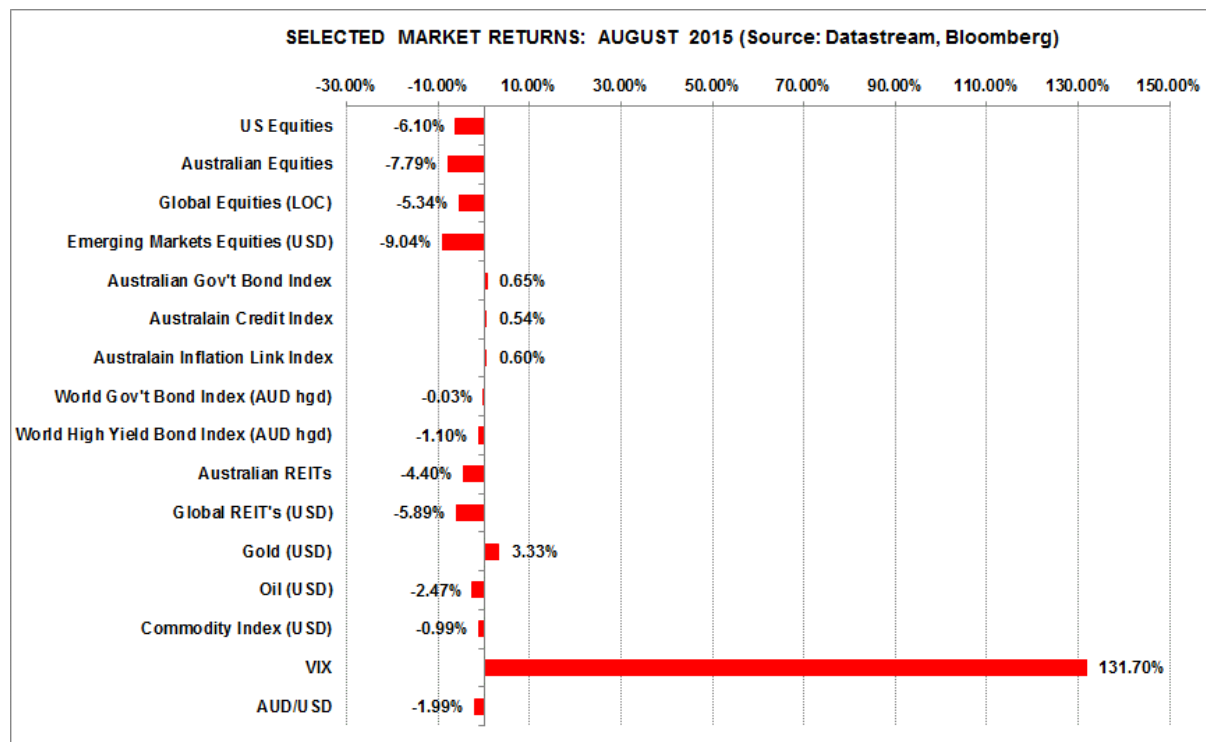
August 2015

## In summary

August was the worst month for global financial markets in several years as sentiment was hit by a conjunction of factors which the markets collectively interpreted as a global deflationary shock. These events included the renewed decline in the price of oil and other commodities, the surprise currency move by China, plus some soft economic statistics from that country, and ongoing nervousness about when the Fed will lift interest rates.

Equity markets fell across the board, especially among the emerging markets, and volatility spiked sharply higher. The extreme volatility and dramatic reactions to economic news suggest the markets are pricing more off fear than off fundamentals. Economic data from the US released in August confirmed ongoing modest economic recovery with low inflation. The Australian economy recorded modestly positive real GDP growth in the second quarter driven by consumer spending. The Reserve Bank left the cash rate unchanged at 2% at its Board Meeting on 2 September.

**Figure 1: Massive equity volatility spike in August**



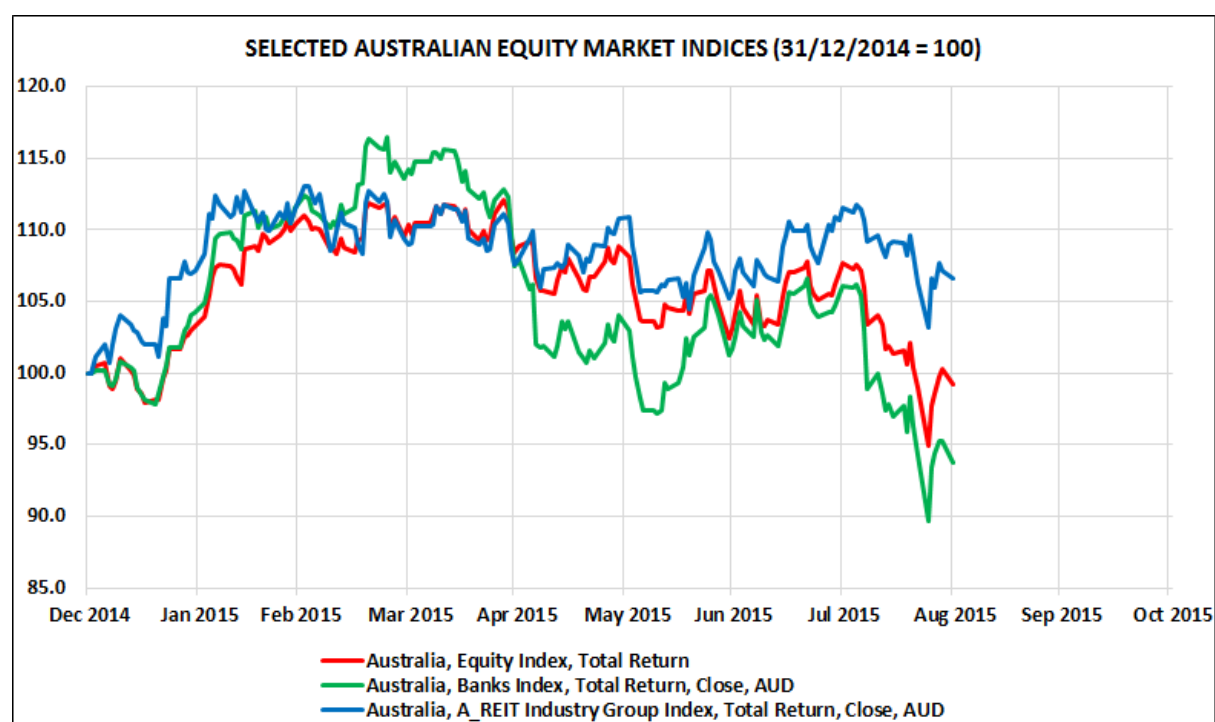
Employment growth improved further in [Australia](#) in July with an extra 38,500 jobs being created, although nearly two thirds of this was part-time employment. The unemployment rate picked up to 6.3% in August from 6.1% the previous month. Retail sales were a bit better than expected but the investment statistics still paint a mixed picture with large declines in resource sector investment still offsetting capital expenditure in other sectors.

Second quarter GDP figures came in on the soft side but still better than the pessimistic commentators' expectations of a negative reading. Real GDP grew by just 0.2% in June quarter with consumption (+0.9%) a major contributor to this result. Investment spending rose 0.4% in the quarter but was still 3.3% lower than a year earlier. The terms of trade fell

3.4% in the June quarter and contributed to a 0.9% decline in real net national disposable income.

Weaker global commodity prices and concerns about China undermined resource stocks in the Australian equity market, while the banking sector was adversely affected by capital raisings and signs that moves by the regulator to tighten lending for dwelling purchases may be starting to bite. Although the local equity market recovered some of its losses towards the end of the month, it still fell nearly 8% overall. The Australian dollar also continued to decline and finished the month around US\$ 0.715.

**Figure 2: Australian bank stocks underperformed in August**



The Reserve Bank noted some softening of economic conditions in China and East Asia recently offset by stronger US growth. The Board left the cash rate unchanged at 2% at its meeting on 2 September.

The all-important ISM index<sup>1</sup> in the **United States** fell in August to 51.1 from 51.7 in July. This was slightly worse than expected by the market, however other statistics confirmed ongoing improvement in the US economy. For example, factory orders rose nearly 2% in June with durable goods orders up 3.4%. House prices, sales and starts all continued to improve in recent months. House starts are now at their highest level since October 2007. Non-farm payroll employment rose by 215,000 in July with the unemployment rate steady at 5.3%, but wages growth remains subdued as does inflation. Retail spending and industrial production both increased in July and consumer sentiment rose in August. Revised figures showed real GDP growth increased by 3.7% at an annualised rate in the second quarter, well ahead of the initial estimate of 2.3% and above the market's expectations.

<sup>1</sup> Institute of Supply Management

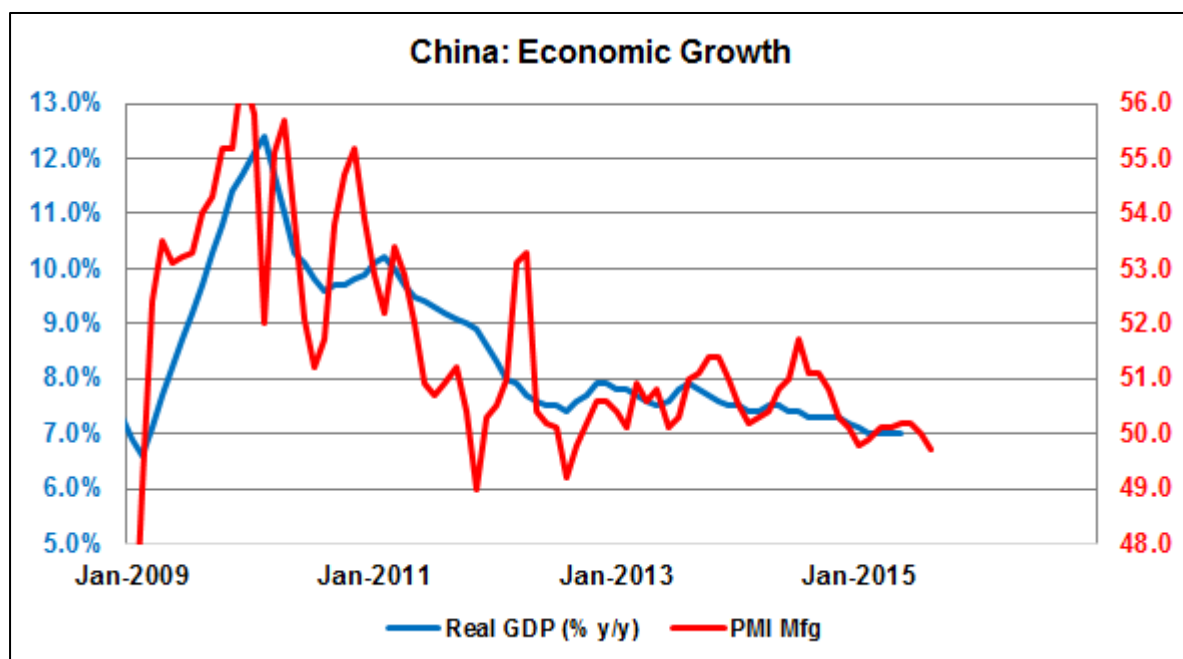
Overall, the statistics coming out of the US have been very respectable and seem odds with the pessimism of the equity markets. There is ongoing speculation about when the Fed will start to lift interest rates with many commentators suggesting that the turmoil in global financial markets will cause the Fed to postpone any move from September to December. Most likely, the Fed is taking things one day at a time and has not yet made up its mind.

**China** was the driver of a lot of the market action in August. Earlier in the month the authorities surprised everyone by changing their currency fixing arrangements and allowing a 1.9% drop in the value of the yuan's daily reference rate. This was the biggest daily fall in the currency in many years and was followed up by some further small falls in subsequent days before the central bank stepped in to stabilise the currency. Although this move was part of China's preparations for having its currency included in the IMF's SDR program, it was interpreted by the markets as an overt move to grab export growth from other countries in the region. This was seen to be a negative development because it implied that China's economy was even weaker than expected and that it might precipitate another bout of instability like the Asia crisis of 1998.

Fears of a weakening economy were exacerbated by statistics showing the official manufacturing PMI<sup>2</sup> fell to 49.7 August 50.0 in July and the non-manufacturing PMI fell from 53.9 July to 53.4 in August. However, the business activities expectations component of the PMI improved quite a bit in August and the headline PMI may have been influenced by the authorities shutting down factories to reduce air pollution ahead of WW2 celebrations in early September.

The overheated China equity market continued to decline and the authorities arrested a number of people for insider trading and for deliberately promoting adverse market sentiment through publishing false information. The Bank of China cut interest rates by a quarter of a percent and reduced bank reserve requirements by half a percent. The authorities indicated they are prepared to provide further stimulus as necessary.

**Figure 3: China PMI has the markets worried about economic growth**



<sup>2</sup> Purchasing Managers' Indices

These developments, combined with further falls in oil and other commodity prices, led markets to believe that a significant deflationary shock centred in the emerging market complex would spread to the rest of the world. These concerns are similar to what we saw earlier this year when the oil price fell sharply, and they seem somewhat overdone now as they were then. For example, it is generally accepted that the balance of effects between oil exporting (emerging) nations and oil importing (developed) nations when the oil price falls is positive for global growth, not negative as the markets are currently implying.

Also, although the Chinese economy is slowing down it does not really seem to be in as much trouble as the markets are pricing. Positive signs in China include a strong services sector, robust consumer confidence and improving house prices. The Asian economies are in much better shape now than they were in 1998 and although the region is experiencing some slower growth, it seems too pessimistic to expect a repeat of the Asian crisis. Nevertheless, financial markets are likely to remain volatile for a while longer.