RBC Investor & Treasury Services

Chief Economists Forum

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2017 Chief Economists Forum

In its 11th year, the Financial Standard Chief Economists Forum arguably produced its most valuable presentations, entertaining thoughts and forecasts about an economic environment that includes Brexit and Donald Trump.

It may well be Rainmaker's 25th anniversary in 2017, but this year also marks the anniversary of several historic and global economic turning points. Renowned economist and Forum master of ceremonies Saul Eslake reminded guests it is the 30th anniversary of the 1987 stock market crash; the 20th anniversary of the Asian financial crisis that began in Thailand; and it's also arguably the 10th anniversary of the Global Financial Crisis.

Hopefully this doesn't mean that 2017 will feature some other crash, Eslake joked. More seriously the annual Chief Economists Forum explored Trump's impact on the US economy, the global economy and financial markets; it also mentioned the potential impact of several European elections to be held this year; central bank policy; commodity and property prices; and the outlook for China and Australia.

Global growth steady

In front of 900 guests at events in Sydney and Melbourne, J.P. Morgan chief economist Sally Auld said global economic growth will struggle to break out of its current rate unless 2017 sees a meaningful lift in productivity growth.

Auld said she expects the global economy to grow at 2.9% in 2017 - a modest uptick from 2016, and on the back of inflation growth over the past couple of quarters.

"When we look at a chart of global growth you can see it's been trapped between a two and 3% range. We think we're going to get close to the top of that range this year but we feel like there are significant structural headwinds, which mean the chances of breaking above that are pretty limited," Auld said.

"What would make it a whole lot better is a meaningful lift in productivity growth across the world.

That said, the J.P. Morgan chief economist and head of fixed income and FX strategy for Australia and New Zealand added the firm was on every asset class except sovereign bonds, where returns will be negative in 2017. This was reflected in the first half of the 2016-17 financial year, Auld said.

Auld said the US, given its market is important for the global story, is predicted to grow at about 2% this year. She did warn that J.P. Morgan's modeling shows recession probabilities in the US, but this is beyond the next two to three years.

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She said China has stabilised with policy support and its economy will grow 6.5% in 2017. The Euro area is continuing to do well with about 2% growth and above trend for the region - an outstanding outcome considering Brexit, according to Auld.

Adding his thoughts to the discussion, RBC's economist Michael Turner said the firm has tended to be more upbeat on both the US and European economies.

"The health of US household balance sheets has been improving for some time now, while the unemployment rate in Europe has been falling steadily since early 2013. Our US economists expect the shift in fiscal policies there to help growth pick up over the next few years, and our equity strategists expect the S&P to be 10% higher by year end," Turner said.

What's actually happening

If you want to understand the US and global economies and where they're going, you've got to think outside the box because sometimes the most obvious realities are the hardest to see.

That was the key message from Principal Global Investors' chief global economist Bob Baur. He told Forum attendees there are currently four fading trends which had a detrimental impact on the global economy over the past decade. He said the world is transitioning to a new era which will create significant financial implications and opportunities.

Labeling the trends as 'four funerals and a wedding,' Baur highlighted how the investment boom in China alongside global debt financing demand, the belief that economic stagnation was permanent and wage and salary stagnation is declining, is paving the way for a happy marriage between growth and mild inflation.

Baur believes the world is in a synchronised upturn with reflation and profits returning, a surging confidence and rising interest rates, and the next bull market being in salary and wages.

"That global upturn is spreading, we're seeing some great shoots of capital spending and the populism that is in the United States and parts of Europe is actually reflationary, so we say long live the happy couple of growth and trifling inflation," Baur said.

Baur said that markets need to adjust to the weighty implications of such change, saying that while stocks can continue to rally for some time they will eventually get so high as to become a drag on the stock market and then a drag on the economy.

"When this happens there will be a correction of some significance, maybe 30% or more, likely after mid-year or maybe early next. The key will be the level of 10-year US Treasury yields - we think somewhere between three and 3.5% on treasury bonds," Baur explained.

Baur warned that this is transition from economic mess to a better era is not going to occur without disruption.

"The key risk we see when interest rates in the US start to rise will be in China, because money will want out of China and China will need to raise interest rates to compensate, which isn't what it needs today," Baur said.

"Secondly, if we're entering an era where macro-economic events cease being the major cause of movement in financial markets, then its idiosyncratic risk in securities has become paramount, and the move toward passive investment that we see today may not be the right trend and active management may be where we find the returns."

RBC's Turner said there are several global economic stories that are getting plenty of airplay: short-term interest rate rises in the US which leave uncertainty around how many US-dollar borrowers will cope – particularly in parts of Asia; US fiscal policy is an open question; Europe continues to face structural headwinds; and despite all this, equity markets sit near cyclical or historical highs – making investors nervous.

Addressing the growing challenges to global trade, Turner said it is worth looking at the channels through which higher terms of trade – especially resources – can have a positive impact on the Australian economy.

"Firstly, there is the immediate cash flow impact; resource companies receive more for their exports, and in turn can pass that higher revenue on to shareholders or workers. That extra money trickles through the economy, including into household spending. This has no doubt occurred, however in a broader context, the terms of trade are still down about 30% from their peak, so this is only a modest improvement on the outlook," he said.

"Secondly, there is the potential impact on investment. If companies feel confident that prices will be sustained at levels above break-even rates for various projects, then projects will be committed to, with all the activity and demand for labour that entails. Yet, while the rise in iron ore has been stronger and lasted longer than most expected, we doubt there is much confidence around the sustainability of current prices. RBC, for example, expects a decline back from current levels above $80/t to below $70/t. Spot coal prices have already retreated significantly over the past few weeks. So we see it as unlikely that there is a meaningful boost to activity via the investment channel.

"The Australian dollar tends to rise with commodity prices, given the positive implications of the above two channels. This was a helpful dynamic to keep underlying inflationary pressures in check when the investment boom was in full swing, as a) it dampened external demand for trade exposed service sectors such as tourism and education and thus kept wage pressures somewhat lower, and b) it lowered the cost of imported goods."

Finding investment winners

Investors who try and predict macroeconomics as a source of alpha rather than focusing on long term trends will suffer in the long term.

AXA Investment Managers' head of Framlington Equities, Asia, Mark Tinker told the Chief Economists Forum that investors need to think beyond immediate geopolitical and macroeconomic risk, and take advantage of opportunities offered by the market in anti-consensus trades.

"I think it's very dangerous to stand up at the beginning of the year and say I think that X, Y and Z are going to happen, and I'm going to invest on the basis of that," Tinker said.

"All it means is that you have a portfolio of 50 to 60 stocks and you're actually only making three bets. It's like going to the casino and putting it all on red 16 - sometimes it works and you're a genius, and other times it doesn't. That isn't the way to be a long term investment strategy."

Taking aim at analysts, Tinker noted that many of the predictions made in 2016, including the collapse of China, the downturn of the RMB, oil, western equities, and commodity prices were wrong.

"We didn't talk about the potential changes which might come with political change. We didn't talk about the beginning of the end of QE which was already on the way this time one year ago. And we didn't talk about the move in China from a production and export to a consumption and import economy," Tinker said.

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Turning to the question on everyone's mind, Tinker said of Trump that "people take him literally but not seriously, but we should take him seriously and not literally." He stressed that while Trump was a man to watch, America was not the only looming political situation that investors should take note of.

"The whole of Asia doesn't sit there thinking about what Trump might do next, what he's going to tweet from the presidential bathroom. It's not just about that. I'm going to wait and see what he does, rather than listen to someone who told me what he was going to do in the first place and makes predictions based on their own analysis," Tinker said.

On emerging markets, Tinker noted that while China is due to grow by 6.5% in 2017, for a nation of the geographical size of China, investors could find data on any story that they desire.

State Street Global Advisors' head of investments for Asia-Pacific, Kevin Anderson, said achieving the 7% return targeted by most pension funds is a far more complex and riskier process than it was 10 years ago.

Anderson said the 7% target could usually be met back in 2006 with an 8.1% standard deviation via a 60/40 split between either US or global investment-grade bonds and global developed equities.

Ten years later, a far more nuanced approach is required: Anderson's example was a mix of factor-tilted equities (47.5%), index equities (15%), US bonds (17.5%), private equity (10%), emerging market bonds (10%) and high-yield bonds (10%). This portfolio also carried a higher standard deviation of 13.2%.

Anderson noted that "this isn't the only particular way to skin the cat," but what we've found that is in generating that standard 7% return, which once had an 8% standard deviation for your portfolio, now has a 13% standard deviation."

He added: "The key thing we need to think about as investors in 2017 aren't that different to usual: it's about finding yield, uncovering growth and conquering volatility appropriately." **FS**

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