12 February 2018

AUSTRALIAN MARKETS WEEKLY

Stocks, bonds & Australia – still optimistic growth!

In this issue

- **Recent market volatility is largely equity specific – a mix of hefty valuations being impacted by rising bond yields and, somewhat separately, an unwind of leveraged "inverse volatility" products.**
- **The rise in global bond yields appears a durable trend, reflecting the ever-improving global growth outlook. It's natural that the asset markets that benefited most from very low bond yields in recent years – and that is just about all assets – will need to adjust to this new reality.**
- **In Australia, the RBA left the cash rate at 1½% last week, a record 18th consecutive month, and in a speech Governor Lowe said the Bank's Board "does not see a strong case for a near-term adjustment in monetary policy".**
- **The case for rate hikes will be stronger when the unemployment rate is at or below the "full employment" unemployment rate near 5% and wage growth is more clearly rising. NAB currently forecasts hikes from the second half of 2018 – forward indicators for employment and wages are positive but there is nonetheless a risk our forecast hikes are delayed.**
- **NAB expects Thursday's December labour force report to show employment grew +35k (Consensus +15k) and the unemployment rate fell to 5.4% (Consensus 5.5%). For the reasons outlined above, the market is likely to focus closely on the track of the unemployment rate in coming months.**
- **The US CPI on Wednesday night is also an important release, given much of the recent equity market weakness ultimately sourced from concerns about US inflation, wages and Fed action.**
- **We'll also be watching the NAB survey to see if the RBA's increased confidence on the growth outlook continues to be mirrored in our survey (watch business conditions in particular) and importantly whether there is any progress on reducing spare capacity in the labour market (watch the capacity utilization rate, which is a good lead indicator) and returning inflation to the midpoint of the target band (watch the wages and prices indicators).**

To contact NAB's market experts, please click on one of the following links:

Ask the Economists

Ask the FX Strategists

Ask the Interest Rate Strategists

In early October, Warren Buffett told CNBC that *stock market valuations make sense with interest rates where they are*.

So perhaps a bigger surprise than the past week's weakness in global share markets was the prior 13% run-up in the S&P500 since Buffet's comment, even as the US 10-year bond yield rose 50bps.

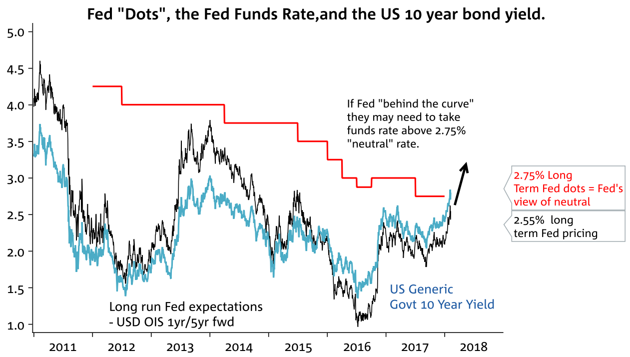
Higher stock prices and higher bond yields can coexist if expectations for the economy and earnings are also improving – as they have been. But there will be a flinching point when either: 1) higher bond yields start to make heftily priced stocks unattractive (see chart 2), or; 2) the lift in bond yields has been so great the economic outlook is threatened.

Key markets over the past week

	Last	% chg week		Last	bp / % chg week
AUD	0.7807	-1.6	RBA cash	1.50	0
AUD/CNY	4.93	-1.5	3y swap	2.16	-6
AUD/JPY	85.0	-2.7	ASX 200	5,808	-4.6
AUD/EUR	0.637	0.2	Iron ore	76.5	2.8
AUD/NZD	1.076	-0.7	WTI oil	59.2	-9.5

Source: Bloomberg

Chart 1: Market pricing above Fed Dots!



Source: National Australia Bank, Macrobond.
Terminal Funds rate is 1yr rate, 5 years forward from OIS curve

Peter Jolly, Global Head of Research

"Inverse Volatility" products prove human nature hasn't changed

We expect the recent correction in stocks owes almost entirely to the former. Especially as it seems that added to this cocktail of hefty stockmarket valuations and rising bond yields were large amounts of money invested in leveraged equity products that relied on the low volatility we have seen in recent years continuing – so called "Inverse Volatility" products. The apparent popularity of these products highlights that human nature doesn't change. While regulators have been more alert to systemic risks since the GFC, the recent mix of super low – even negative – interest rates and the related "bull market in everything" (as the Economist newspaper described it last year) means there is likely a good amount of hidden risk and leverage in markets.

So while it's only sensible to be alert to the likelihood of more volatility ahead – especially if bond yields rise further - our judgement is that recent days' volatility is a fairly equity-specific event/correction related to stronger growth and the prospect of higher interest rates (as in 1994) rather than indicative of some new systemic crisis in the global financial system.

Evidence of this is that while some other financial products that we think of as being "risky" have also weakened, it hasn't been by much – commodities have held most of their gains, corporate credit spreads have widened only modestly, and Emerging Market currencies have held firm.

When did you last hear someone say the Fed "was behind the curve"?

NAB will release updated economic forecasts this week. The improving global economy – and not last week's volatility – is expected to have the more durable impact on businesses with interest rate and FX exposures.

Until recent weeks, the rise in global bond yields that began 18 months ago could be described as gentle, a bit stop start, but far from scary. This is because this Fed rate hike cycle itself has been gentle, a bit stop start, and far from scary. Benign inflation and wage data underpinned the calm at the Fed and in the bond market.

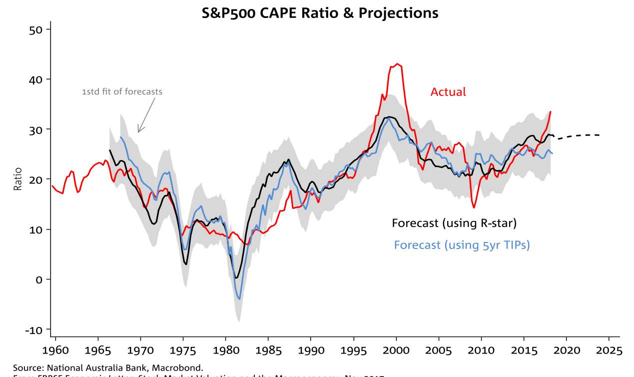
This calm is being challenged by the uptick in US wage data reported two Fridays ago (Chart 3). Talk of higher inflation and wage growth seemed old world thinking only a few months ago – weren't globalisation and automation going to suppress wages and inflation forever. Now, with a US unemployment rate of 4.1% – well below most estimates of the "full employment" unemployment rate near 5% (the NAIRU) – and wage growth lifting this no longer seems fanciful.

Bond and interest rates markets have to account for this new uncertainty.

If this wage growth rise is sustained, this will validate the three US rate hikes that NAB is forecasting and the median Fed Dots expect. Market pricing now has 62bps of tightening by year-end.

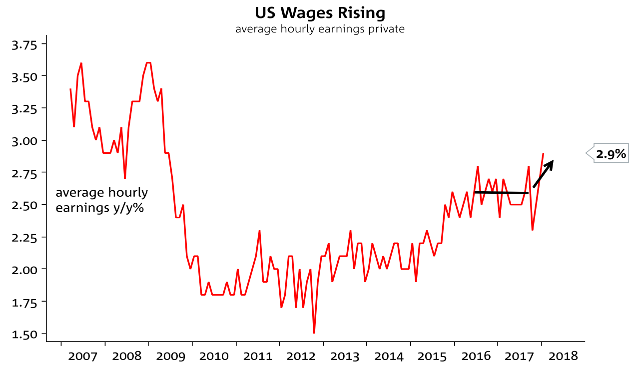
If wage growth continues to accelerate it's possible to see more than three Fed hikes in 2018 and a higher terminal funds rate – as Chart 1 shows, at no point since the Fed began hiking in late 2015 has the market priced the terminal Fed funds rate above where most Fed officials think is the "neutral or equilibrium funds rate near 2¾-3%.

Chart 2: S&P500 stretched compared to yields & growth



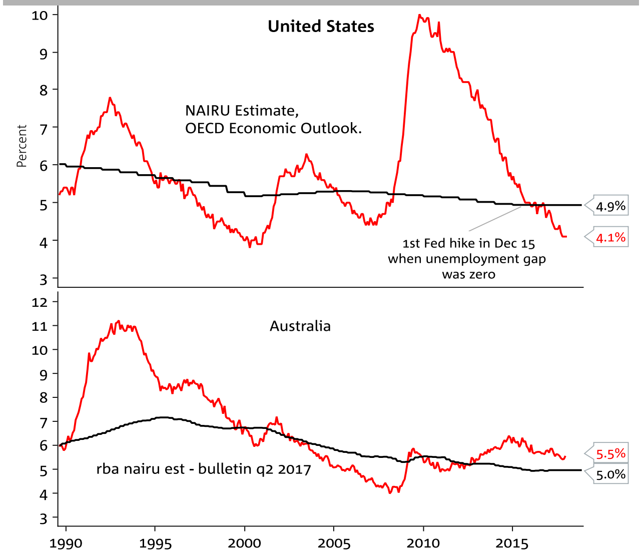
Source: National Australia Bank, Macrobond.
From FRBSF Economic Letter: Stock Market Valuation and the Macroeconomy, Nov 2017.

Chart 3: Wages growth rising again in the United States



Source: National Australia Bank, Macrobond

Chart 4: Unemployment Rates versus NAIRU



Source: National Australia Bank, Macrobond.
NAIRU is an estimate for the equlibrium or full employment rate of unemployment.

If so, US, global, and Australian bond yields will be even higher.

A higher cash rate in Australia - eventually.

The RBA left the cash rate target at 1½% last week – a record 18th consecutive month of no change in the cash rate. The post Board Statement, a mid-week speech by Governor Lowe and the Bank's updated forecasts in Friday's Statement on Monetary Policy left little doubt about the RBA's current thoughts.

The RBA expects the next move in the cash rate to be higher but for now Governor Lowe said the "Board does not see a strong case for a near-term adjustment in monetary policy". He noted the unemployment rate is still "someway from what could be considered full employment" and that inflation was forecast to remain "below the midpoint of the medium-term target range for the next couple of years."

Put another way, currently low inflation and wage growth is allowing the RBA to keep interest rates low and thereby hasten the return to full employment.

The framework looks similar to the US Fed's, where the first hike in Dec 2015 came once: 1) the unemployment rate was at the Fed's estimate for full employment near 5%; and 2) wage growth had clearly accelerated.

If the RBA is to follow the Fed roadmap, the timing for "lift-off" will be determined by how quickly the current 5.5% unemployment rate falls towards its full employment rate (in a Bulletin article last year the RBA estimated this to be near 5%) and wages turn up.

Importantly, the RBA expects "progress is likely to be only gradual" (in reducing unemployment and returning inflation to the midpoint of the inflation target).

NAB currently forecasts RBA "lift-off" in the second half of 2018, with rate hikes pencilled in for August and November. We acknowledge that unemployment/wage data will need to improve materially between now and August for them to hike by then. The good news is that the forward indicators do point to continued strong employment growth as well as some lift in wages growth in the next few quarters. NAB expects Thursday's January labour force report to show employment grew +35k (Consensus +15k) and the unemployment rate fell to 5.4% (Consensus 5.5%).

While there is a risk our forecast for RBA hikes from August may be delayed, the RBA is now considering when is the correct time to begin to reduce accommodation. Market pricing now looks too benign with a full RBA hike not priced until March 2019.

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CALENDAR OF ECONOMIC RELEASES

Country	Economic Indicator	Period	Forecast	Consensus	Actual	Previous	GMT	AEDT
Monday, 12 February 2018								
NZ	Card Spending Retail MoM/Total MoM	Jan	0.3/	0.5/		0.5/0.2	21.45	8.45
AU	Credit Card Purchases	Dec				27.9	0.30	11.30
CA	Bloomberg Nanos Confidence	Feb 9				59	15.00	2.00
US	Monthly Budget Statement	Jan		51		-23.2	19.00	6.00
Tuesday, 13 February 2018								
AU	RBA's Ellis Gives Speech in Sydney						21.50	8.50
AU	ANZ Roy Morgan Weekly Consumer Confidence Index	Feb 11				122.7	22.30	9.30
JN	PPI MoM/YoY	Jan		0.3/2.7	/	0.2/3.1	23.50	10.50
AU	NAB Business Conditions	Jan				13	0.30	11.30
UK	CPI MoM / YoY	Jan		-0.6/2.9	/	0.4/3	9.30	20.30
UK	CPI Core YoY	Jan		2.6		2.5	9.30	20.30
UK	PPI Output Core NSA MoM / YoY	Jan		0.2/2.3		0.3/2.5	9.30	20.30
US	NFIB Small Business Optimism	Jan		105.7		104.9	11.00	22.00
US	Fed's Mester to Discuss Monetary Policy and Economic Outlook						13.00	0.00
Wednesday, 14 February 2018								
NZ	Food Prices MoM	Jan	2.4			-0.8	21.45	8.45
AU	Westpac Consumer Conf Index/MoM	Feb		/		105.1/1.8	23.30	10.30
JN	GDP SA QoQ / Annualized QoQ	4Q P		0.2/1	/	0.6/2.5	23.50	10.50
NZ	2Yr Inflation Expectation	1Q				2.02	2.00	13.00
GE	CPI EU Harmonized MoM/YoY	Jan F		-1/1.4		-1/1.4	7.00	18.00
EC	ECB's Weidmann Speaks in Frankfurt						8.45	19.45
EC	Industrial Production SA MoM / WDA YoY	Dec		0.1/4.2		1/3.2	10.00	21.00
EC	GDP SA QoQ/YoY	4Q P		0.6/2.7	/	0.6/2.7	10.00	21.00
EC	ECB's Mersch Speaks in Frankfurt						10.20	21.20
EC	ECB's Mersch, SNB's Zurbruegg Participate in Panel Discussion						11.20	22.20
US	MBA Mortgage Applications	Feb 9				0.7	12.00	23.00
CA	Teranet/National Bank HP Index	Jan			0	217.49	13.30	0.30
CA	Teranet/National Bank HPI MoM/YoY	Jan		/		0.2/9.1	13.30	0.30
US	CPI MoM	Jan		0.3		0.1	13.30	0.30
US	CPI Ex Food and Energy MoM/YoY	Jan		0.2/1.7		0.3/1.8	13.30	0.30
US	CPI Core Index SA	Jan				254.426	13.30	0.30
US	Retail Sales Advance MoM / Retail Sales Ex Auto MoM	Jan		0.2/0.5	/	0.4/0.4	13.30	0.30
US	Real Avg Hourly Earning YoY	Jan				0.4	13.30	0.30
US	Business Inventories	Dec		0.3		0.4	15.00	2.00
Thursday, 15 February 2018								
NZ	REINZ House Sales YoY	Jan				-10.1	20.00	7.00
JN	Core Machine Orders MoM/YoY	Dec		-2.3/1.8		5.7/4.1	23.50	10.50
AU	Consumer Inflation Expectation	Feb				3.7	0.00	11.00
AU	Employment Change/Unemployment Rate	Jan	35/5.4	15/5.5	/	34.7/5.5	0.30	11.30
AU	Participation Rate	Jan	65.7	65.6		65.7	0.30	11.30
JN	Industrial Production MoM/YoY	Dec F		/		2.7/4.2	4.30	15.30
JN	Capacity Utilization MoM	Dec				0	4.30	15.30
EC	ECB's Mersch Speaks in Paris						6.15	17.15
EC	Trade Balance SA	Dec		22.25		22.5	10.00	21.00
EC	ECB's Praet Participates in Panel Discussion in Paris						10.45	21.45
CA	ADP Publishes January Payrolls Report						13.30	0.30
US	Empire Manufacturing	Feb		18		17.7	13.30	0.30
US	Initial Jobless Claims	Feb 3		227.5		221	13.30	0.30
US	PPI Final Demand MoM / YoY	Jan		0.4/2.5		-0.1/2.6	13.30	0.30
US	PPI Ex Food and Energy MoM / YoY	Jan		0.2/2.1		-0.1/2.3	13.30	0.30
US	PPI Ex Food, Energy, Trade MoM / YoY	Jan		0.2/		0.1/2.3	13.30	0.30
US	Philadelphia Fed Business Outlook	Feb		22		22.2	13.30	0.30
CA	Existing Home Sales MoM	Jan				4.5	14.00	1.00
US	Industrial Production MoM	Jan		0.2		0.9	14.15	1.15
US	Manufacturing (SIC) Production	Jan		0.3		0.1	14.15	1.15
US	Capacity Utilization	Jan		78		77.9	14.15	1.15
US	NAHB Housing Market Index	Feb		72		72	15.00	2.00
CA	Bank of Canada Deputy Governor Lawrence Schembri Speech						18.30	5.30
US	Total Net TIC Flows	Dec				33.8	21.00	8.00
Friday, 16 February 2018								
NZ	BusinessNZ Manufacturing PMI	Jan				51.2	21.30	8.30
AU	RBA Governor Gives Testimony to Parliamentary Committee						22.30	9.30
NZ	Non Resident Bond Holdings	Jan				61.1	2.00	13.00
EC	ECB's Coeure Speaks in Skopje, Macedonia						6.20	17.20
UK	Retail Sales Ex Auto Fuel MoM/YoY	Jan		0.6/2.4		-1.6/1.3	9.30	20.30
UK	Retail Sales Inc Auto Fuel MoM/YoY	Jan		0.6/2.5		-1.5/1.4	9.30	20.30
Upcoming Central Bank Interest Rate Announcements								
New Zealand, RBNZ		22-Mar		1.75%		1.75%		
UK BOE		22-Mar		%		0.5%		
Australia, RBA		6-Mar		1.5%		1.5%		
Canada, BoC		8-Mar		1.25%		1.25%		
Europe ECB		8-Mar		%		-0.4%		
Japan, BoJ		9-Mar		%		-0.1%		
US Federal Reserve		22-Mar		1.5-1.75%		1.25-1.5%		

GMT: Greenwich Mean Time; AEDT: Australian Eastern Daylight Savings Time

FORECASTS

Economic Forecasts

Australia Forecasts	Annual % change				Quarterly % change 2016				2017				2018				2019			
	2016	2017	2018	2019	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Household Consumption	2.8	2.1	2.0	2.4	0.9	0.5	0.3	0.9	0.4	0.8	0.1	0.5	0.5	0.6	0.6	0.5	0.6	0.6	0.6	0.6
Underlying Business Investment	-11.9	2.9	4.8	4.8	-3.4	-2.4	-5.5	1.7	3.2	0.2	2.6	1.4	1.6	0.4	0.1	1.6	1.3	0.9	1.7	1.7
Residential Construction	8.6	-2.3	-2.2	-2.2	4.4	1.4	-0.9	2.6	-3.4	-0.5	-1.0	0.5	-0.9	-0.6	-0.8	-0.7	-0.4	-0.5	-0.3	-0.7
Underlying Public Spending	5.2	4.4	3.6	4.1	1.9	2.0	0.8	0.7	1.1	1.2	1.5	0.8	0.8	0.8	0.8	0.9	1.1	1.1	1.1	1.1
Exports	6.8	5.1	7.2	3.6	2.7	1.3	0.9	2.7	-1.6	3.3	1.9	1.6	2.2	1.5	1.1	0.9	0.8	0.8	0.6	0.8
Imports	0.2	7.4	4.1	4.2	-0.8	2.6	0.7	2.4	2.7	0.5	1.9	1.4	0.9	0.7	0.7	1.0	1.2	1.0	1.2	1.2
Net Exports (a)	1.2	-0.6	0.5	-0.2	1.1	-0.3	0.0	0.0	-0.9	0.5	0.0	0.0	0.3	0.1	0.1	0.0	-0.1	-0.1	-0.2	-0.1
Inventories (a)	0.1	-0.1	0.0	0.0	-0.1	0.3	0.1	-0.3	0.3	-0.6	0.2	-0.1	0.1	0.1	-0.1	0.1	0.0	0.0	0.0	0.0
Domestic Demand - qtr%					0.1	0.6	-0.2	1.0	0.7	0.8	0.6	0.6	0.6	0.5	0.5	0.6	0.7	0.7	0.8	0.8
Dom Demand - ann %	1.8	2.6	2.3	2.7	1.5	1.8	1.5	2.3	2.2	2.4	3.2	2.8	2.6	2.3	2.2	2.2	2.4	2.5	2.8	3.0
Real GDP - qtr %					**1.0**	**0.8**	**-0.3**	**1.1**	**0.4**	**0.9**	**0.6**	**0.6**	**1.0**	**0.7**	**0.4**	**0.7**	**0.7**	**0.6**	**0.7**	**0.7**
Real GDP - ann %	2.6	2.3	2.9	2.6	**2.7**	**3.3**	**2.1**	**2.4**	**1.8**	**1.9**	**2.8**	**2.5**	**3.1**	**2.9**	**2.7**	**2.9**	**2.6**	**2.4**	**2.6**	**2.6**
CPI headline - qtr %					-0.2	0.4	0.7	0.5	0.5	0.2	0.6	0.8	0.5	0.5	0.6	0.7	0.5	0.5	0.5	0.7
CPI headline - ann %	1.3	2.0	2.2	2.2	1.3	1.0	1.3	1.5	2.1	1.9	1.8	2.1	2.1	2.4	2.3	2.2	2.2	2.3	2.2	2.2
CPI underlying - qtr %					0.2	0.4	0.4	0.5	0.5	0.6	0.4	0.5	0.5	0.5	0.5	0.5	0.6	0.5	0.5	0.5
CPI underlying - ann %	1.5	1.8	1.9	2.1	1.5	1.5	1.5	1.5	1.7	1.9	1.9	1.9	1.9	1.7	1.9	2.0	2.1	2.1	2.1	2.2
Wages (Pvte WPI - qtr %					0.5	0.5	0.4	0.4	0.5	0.5	0.4	0.4	0.5	0.5	0.5	0.7	0.6	0.6	0.6	0.6
Wages (Pvte WPI - ann %)	1.9	1.9	1.9	2.3	2.0	2.0	1.9	1.8	2.0	2.0	1.9	1.8	1.8	1.8	1.9	2.2	2.2	2.3	2.4	2.2
Unemployment Rate (%)	5.7	5.6	5.3	5.2	5.8	5.7	5.7	5.7	5.9	5.6	5.5	5.4	5.3	5.3	5.3	5.2	5.2	5.2	5.2	5.1
Terms of trade	0.5	12.0	-1.2	-0.4	-1.9	2.5	4.1	11.2	5.5	-6.1	-0.4	-0.2	-2.9	-0.9	-0.8	-0.3	-0.4	-1.0	-0.2	0.1
G&S trade balance, $Abn	-14.3	16.3	4.9	-5.6	-8.4	-7.4	-4.1	5.7	6.8	3.4	3.1	3.1	1.6	1.5	1.1	0.7	0.0	-1.3	-2.0	-2.3
% of GDP	-0.8	0.9	0.3	-0.3	-2.0	-1.8	-1.0	1.3	1.5	0.8	0.7	0.7	0.4	0.3	0.2	0.2	0.0	-0.3	-0.4	-0.5
Current Account (% GDP)	-2.9	-1.9	-2.5	-3.0	-3.7	-3.9	-2.9	-1.1	-1.3	-2.2	-2.0	-2.0	-2.5	-2.5	-2.6	-2.6	-2.8	-3.0	-3.2	-3.2

Source: NAB Group Economics; (a) Contributions to GDP growth

Exchange Rate Forecasts

	12-Feb	Mar-18	Jun-18	Sep-18	Dec-18
Majors					
AUD/USD	0.7807	0.79	0.78	0.77	0.75
NZD/USD	0.7243	0.73	0.72	0.71	0.70
USD/JPY	108.85	110	110	109	109
EUR/USD	1.2246	1.25	1.28	1.30	1.30
GBP/USD	1.3814	1.44	1.45	1.47	1.48
USD/CNY	6.3032	6.28	6.25	6.20	6.18
USD/CAD	1.2588	1.23	1.22	1.24	1.25
USD/CHF	0.9386	0.93	0.92	0.90	0.91
Australian Cross Rates					
AUD/NZD	1.0779	1.08	1.08	1.08	1.07
AUD/JPY	85.0	87	86	84	82
AUD/EUR	0.6375	0.63	0.61	0.59	0.58
AUD/GBP	0.5652	0.55	0.54	0.52	0.51
AUD/CNY	4.9209	4.96	4.88	4.77	4.64
AUD/CAD	0.9827	0.97	0.95	0.95	0.94
AUD/CHF	0.7328	0.73	0.72	0.69	0.68

Interest Rate Forecasts

	12-Feb	Mar-18	Jun-18	Sep-18	Dec-18
Australia Rates					
RBA Cash rate	1.50	1.50	1.50	1.75	2.00
3 month bill rate	1.76	1.75	2.00	2.25	2.25
3 Year Swap Rate	2.16	2.5	2.9	3.0	3.1
10 Year Swap Rate	3.00	3.3	3.6	3.7	3.7
Offshore Policy Rates					
US Fed funds	1.50	1.75	2.00	2.00	2.25
ECB deposit rate	-0.40	-0.40	-0.40	-0.40	-0.20
BoE repo rate	0.50	0.50	0.50	0.50	0.75
BoJ excess reserves rate	-0.10	-0.10	-0.10	-0.10	-0.10
RBNZ OCR	1.75	1.75	1.75	2.00	2.25
China 1yr lending rate	4.35	4.35	4.35	4.35	4.35
China Reserve Ratio	17.0	16.0	16.0	16.0	16.0
10-year Benchmark Bond Yields					
Australia	2.86	2.95	2.95	3.00	3.05
United States	2.85	2.75	2.75	2.75	2.75
New Zealand	2.94	2.95	3.10	3.15	3.40

Sources: NAB Global Markets Research; Bloomberg; ABS

Global GDP

Dec year	2014	2015	2016	2017	2018	2019	20 Yr Avge
Australia	2.6	2.5	2.6	2.3	2.9	2.6	3.4
US	2.6	2.9	1.5	2.3	2.4	2.0	2.6
Eurozone	1.4	2.0	1.8	2.4	2.2	1.9	1.5
UK	3.1	2.3	1.8	1.5	1.5	1.5	2.4
Japan	0.3	1.4	0.9	1.8	1.4	0.9	0.8
China	7.3	6.9	6.7	6.8	6.5	6.3	9.2
India	7.0	7.5	7.9	6.4	7.1	7.3	6.6
New Zealand	3.4	2.5	3.0	2.5	2.9	2.9	3.0
World	3.5	3.4	3.2	3.5	3.6	3.5	3.5
MTP Top 5	4.0	4.1	3.7	4.2	3.9	3.6	5.0

Commodity prices ($US)

	12-Feb	Mar-18	Jun-18	Dec-18	Dec-19
WTI oil	59.20	52	54	58	60
Gold	1313	1270	1280	1290	1300
Iron ore	76.5	60	62	60	60
Hard coking coal	231	140	120	100	101
Thermal coal	101	85	80	80	80
Copper	6720	6340	6280	6280	6280
Aust LNG (*)	6.41	7.9	8.0	8.5	8.8

(*) Implied Australian LNG export prices.

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