WEEKLY ECONOMIC BRIEF

Chief Economist's View, 9 February 2018

The death of Goldilocks?

Volatility returns to global markets

After a prolonged period of subdued volatility in 2017, volatility returned in February with the VIX jumping to its highest level since August 2015. Equity markets tumbled, with the S&P 500 falling more than 8% over the first week of the month.

The catalyst for the correction was stronger-than-expected wage growth data in the US, which caused investors to fear a sharp move higher in interest rates. US 10-year government bond yields surged by 18bps to 2.88% following the data, the highest yield since early 2014. The swift rise in interest rates caused investors to reassess the lofty valuations in the US equity market, which have fallen by over 8% this week, returning the S&P 500 to its level of November last year.

The correction in equity markets has been broad, extending to all major markets. European markets are down around 5% over the week (and will likely open lower on European markets tonight as they play catch up to the S&P 500), the Nikkei is down 8% and the Hong Kong and Chinese markets are down around 10%. The Australian market is currently down just under 5% for the week, outperforming its US counterpart, finding support from the RBA, who continue to signal their intent to keep monetary policy on hold, and a 3% fall in the AUD; outcomes mirrored in Canada, whose stock market is also outperforming the US.

So how worried should we be? To begin, let's reflect on what most market commentators, including QIC, had been expecting to happen over the course of 2018. The consensus had been that: (i) inflation would gradually rise, as tight labour markets finally begin to generate wage growth, leading central banks continue to tighten monetary policy; (ii) tighter monetary policy would lead to higher bond yields; (iii) higher bond yields would lead to a retracement of equity prices to fair value; and (iv) the equity market correction would lift market volatility from historical lows. The consensus view was the 'Goldilocks' assumption: that the correction in asset valuations would be orderly.

Market moves this week have all been in line with the above expectations, except for the Goldilocks assumption that market adjustments would be orderly. But of all the above assumptions, this was probably the assumption at most risk as we know that corrections in financial markets are often abrupt rather than orderly.

However, to move from 'abrupt' to 'calamity' requires some form of contagion. That is, some form of negative feedback loop either from financial markets to the real economy. As mentioned, the genesis of this week's market turmoil was last Friday's US labour market data, which showed wage growth rose to 2.9% in January.

This was a sharp step higher from the originally reported 2.5% (since revised to 2.7%) growth rate in December. However, the other data in the labour report showed continuing strong growth in employment and preceded data earlier in the week showing strong and rising business sentiment (a leading indicator of business capex spending).

More generally, the run of economic data, business and consumer sentiment measures and forward-looking indicators of economic growth are strong and rising across all major economies and economic regions. From the point-of-view of economic fundamentals, the backdrop to any market correction is supportive – if ever there was macroeconomic backdrop that could cushion the impact of a correction in an overvalued equity market, now is the time.

A key factor linking the economic backdrop to equity markets is the outlook for corporate earnings. In the US, earnings in the S&P 500 are expected to rise 12.8% over 2017 and are projected to rise by around 18% over 2018 (according to IBES estimates). Although current forward earnings estimates may prove to be overly optimistic, it is difficult to forecast a weak corporate earnings outlook over the coming year. Earnings momentum into 2018 is strong, given the robust earnings outcomes currently being reported for the last quarter of 2017 (with 78% of companies reporting earnings above expectations), while the favourable macroeconomic backdrop and the recent corporate tax cuts enacted by the US Congress should ensure at least double-digit earnings growth this year.

In a world of robust earnings growth and supportive global macroeconomic backdrop, it is difficult to envisage a calamitous correction in equity markets. However, with inflation on the rise and central banks continuing to tighten monetary policy gradually, the era of low financial market volatility is drawing to a close.

Table 1: Financial market movements, 1 - 8 February 2018

Equity index	Level	Change	10-yr government bond	Yield	Change	Foreign exchange	Rate	Change
S&P 500	2,581.0	-8.5%	US	2.82%	3.4 bps	US Dollar Index (DXY)	90.31	1.9%
Nikkei 225	21,890.9	-6.8%	Japan	0.08%	-1.9 bps	USD-JPY	108.74	-0.6%
FTSE 100	7,170.7	-4.3%	UK	1.62%	8.6 bps	GBP-USD	1.391	-2.5%
DAX	12,260.3	-5.7%	Germany	0.76%	4.1 bps	EUR-USD	1.225	-2.1%
S&P/ASX 200	5,890.7	-3.3%	Australia	2.89%	8.6 bps	AUD-USD	0.778	-3.2%

Source: Bloomberg

Matthew Peter	Drew Klease	Nathan Cotton	Lynda Bourke	Sophie Willgoose
Chief Economist	**Principal Economist**	**Economist**	**Economist**	**Graduate**
m.peter@qic.com	d.klease@qic.com	n.cotton@qic.com	l.bourke@qic.com	s.willgoose@qic.com

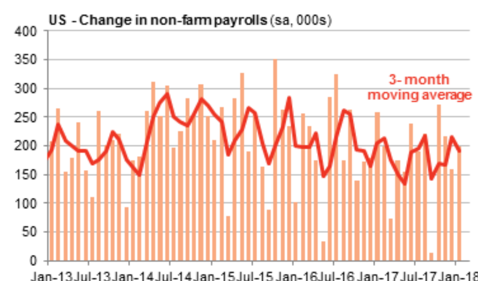
The Weekly Economic Brief is issued by QIC Limited ACN 130 539 123 ("QIC") and is compiled by QIC's Economics & Research Team. For further information regarding QIC's investment solutions, please contact Andrew Arkell (Director, Business Development - Queensland) on +61 7 3360 3856 or a.arkell@qic.com

Economic Update

United States

Surprise strength in wage growth in the US

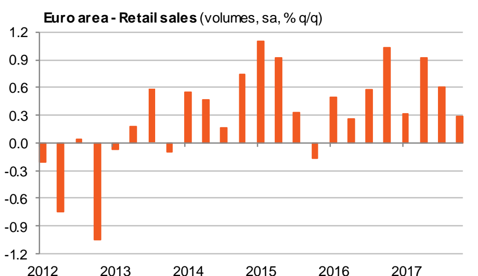
- The US had strong labour market results released for the month of January. Non-farm payrolls increased by 200,000 up from 148,000 in December and higher than market expectations of 180,000. Unemployment remained low, unchanged at 4.1%.
- Importantly, average hourly earnings increased a stronger-than-expected 0.3% over the month. The report also included significant upward revisions, causing year-ended wage growth to rise to 2.9% in January. This was substantially above market expectations for a 2.6% gain and the previously reported 2.5% rate in December (now 2.7%). Part of the increase in average hourly earnings in January was likely due to poor weather, causing a drop in average weekly hours from 34.5 to 34.3 and a resultant increase in average hourly earnings for those on fixed salaries. Nonetheless, the latest data reveal a clear pick-up in wage growth in the US, a trend which was previously absent in 2017, and helps dismiss market speculation that the Phillips curve (i.e the relationship between unemployment and wage growth) is broken.
- The final estimate for consumer sentiment as measured by the University of Michigan was higher than the preliminary estimate of 94.4 at 95.7 for January. Sentiment was boosted by the recent tax cuts and expectations of continued solid job and wage.
- Business conditions remain strong in the US. The non-manufacturing ISM jumped 3.9pts to 59.9, its highest level since 2005, while factory orders rose a stronger-than-expected 1.7% in December.
- The threat of another federal government shutdown looms in the US, with the US Senate still debating a bill to extend federal government spending. The deadline for a deal is midnight (US EST) Thursday 8th February.

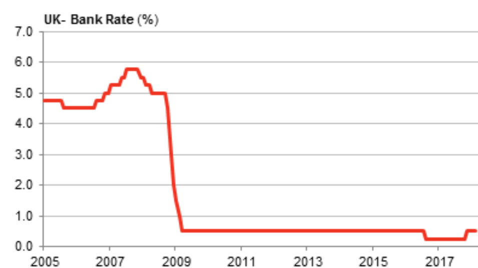


Euro area / United Kingdom

Bank of England keeps rates unchanged, but provides hawkish guidance

- Retail sales volumes in the euro area declined by 1.1% in December, with almost all categories declining over the month. While sales have been very volatile over recent months, they have still trended higher, with sales up 0.3% in the December quarter. Nonetheless, there appears to be some softening in consumer momentum in Europe, with quarterly sales growth easing from a 0.6% pace in the September quarter and a 0.9% pace in the June quarter.
- The Bank of England (BoE) kept rates at 0.5% in their February meeting. However, the February inflation report was hawkish and indicated that rates would need to be increased earlier and more significantly than projected in the November report. This comes as the BoE upgraded their forecasts of UK GDP (from 1.6% to 1.8% in 2018 and unchanged at 1.7% in 2019) and inflation (from 2.5% to 2.6% in 2018 and unchanged at 2.2% in 2019) and indicated that the amount of slack in the labour market was now very limited as opposed to limited in November. The signals from the BoE are consistent with a likely rate hike in August, and potentially as early as May if BREXIT risks subside or inflation surprises to the upside.





China / Japan

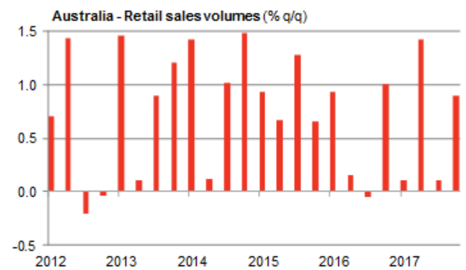
China's trade balance falls sharply in January

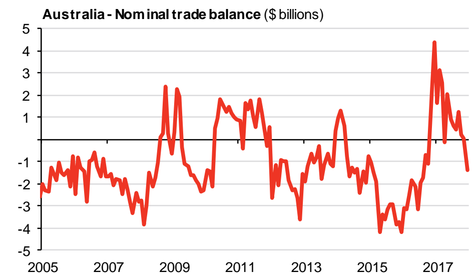
- China's trade balance fell more-than-expected in January, dropping to US$20.3b. Export growth remained solid, rising 11.1% over the year. However, the deterioration in the trade balance was due to annual import growth surging to 36.9% in January, more than three time the market's expectations for 10.6% growth. The strength in imports likely reflected strong domestic demand, colder temperatures which increased the demand for coal imports, and distortions from the timing of the Lunar New Year.

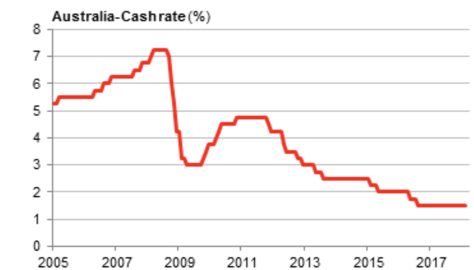
Australia / New Zealand

RBA keeps rates unchanged and sees no strong case for near-term hikes

- Australian retail sales decreased 0.5% over the month of December, a larger fall than the 0.2% expected by the market. This figure comes after a particularly strong November growth of 1.3% due to Black Friday sales and the release of the latest iPhone.
- Looking through the monthly volatility, retail sales values rose a solid 1.1% in the December quarter, a significant turnaround from the 0.2% drop experienced in the September quarter. Most of the improvement reflected a pick-up in retail sales volumes, which advanced 0.9% in the quarter compared to a 0.1% gain in the September quarter. While retail prices also edged up 0.2% in the quarter (compared to -0.3% in Q3), annual retail price inflation remains very weak at -0.1%.
- Solid sales volumes were seen in most categories during the quarter, led by household goods retailing (+3.4%), department store sales (+2.3%), clothing, footwear and personal accessory retailing (+2.1%), and café, restaurant and takeaway food services (+1.6%). Only food retailing (-1.2%) and other retailing (-0.6%) experienced a drop in sales volumes over the quarter.
- Australia's trade balance disappointed in December, falling to a $1.4 billion deficit from an upwardly revised +$36 million in November. Exports grew 2% in seasonally adjusted terms, while imports experienced broad-based growth of 6% over the month of December reflecting the impact of the high Australian dollar and improved domestic demand. Overall, the trade data is consistent with net exports subtracting around a ½ ppt from real GDP growth in the December quarter.
- As widely anticipated, the RBA left the cash rate unchanged at 1.5% at their meeting on Tuesday. Further details behind the Bank's decision were released on Friday in the RBA's quarterly Statement on Monetary Policy. The RBA's forecasts remained largely unchanged from those released in November; real GDP growth projections remain at 3% in 2018 and 3¼% in 2019 and underlying inflation projections remained at 1¾% through 2018, before edging up to 2% in 2019, with a new June 2020 forecast revealing underlying inflation improving to 2¼% by the end of the forecast horizon. Furthermore, the Bank also lowered its unemployment rate forecasts by 25bps to 5¼% over the next 18 months.
- While the RBA continues to sound more optimistic on the global economy, the domestic outlook remains broadly unchanged with significant uncertainty around the outlook for the household sector as well as wages and inflation. With only a gradual improvement in inflation forecast, Governor Lowe has highlighted that the RBA "does not see a strong case for a near-term adjustment in monetary policy."
- The Reserve Bank of New Zealand left the cash rate at 1.75% on Thursday and issued a relatively dovish outlook by downgrading its inflation forecasts. The RBNZ projections are for the cash rate to remain unchanged until mid-2019 before gradually lifting rates.







Sources: Thomson Reuters, ABS.

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