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HD **Stuck in the middle**

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Tipping point Global markets are realigning, complicating the outlook for Australia, writes Mark Mulligan.

Like most overhyped New Year's Eve celebrations, this week's monetary policy statement by the US Federal Reserve went down not with a bang but a whimper.

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It was the last chance for the central bank of the world's largest economy to spell out what it plans to do about interest rates before it winds up six years of extreme monetary expansion, yet it was universally seen as a non-event. And that was the point. The last time the Fed was too explicit tapering off a five-year bond-buying program aimed at pushing cheap credit into the real economy – known as quantitative easing – investors dumped emerging market assets en masse, driving down currencies and opening up current account deficits from Istanbul to Sao Paulo.

Known as the "temper tantrums", they stemmed from investor panic at the thought of a rapid transition from near-zero per cent interest rates in the US to a series of rate increases that would quickly reassert the greenback as the reserve currency of choice.

In the event, this is now happening, but at a more measured pace and with cautious Fed language designed to avoid global financial shocks.

"We're clearly now at the start of a US dollar bull market, which will last for a number of quarters, maybe years," says BT Investment Management's head of income and fixed interest Vimal Gor.

"And that's beneficial to all of the rest of the world's central banks, because they all want to devalue their currency."

This is never so true as in Australia, where exporters and import-exposed companies have been labouring under the price and competition pressures of a relatively high local currency for years. This was bearable when booming **mining** infrastructure investment and high commodity prices were driving the economy, but has become a drag since the end of the bonanza.

Sharply declining prices for **iron ore** and **coal**, which together account for about a third of Australia's export revenues, have eroded the country's terms of trade and national income, which means lower real spending power for households, governments and businesses. Effect on unemployment

This is weighing on consumer sentiment and spending, and holding back business investment which, in turn, means Australia's unemployment rate is likely to stay above 6 per cent for the foreseeable future.

"If you go outside **mining** exports and housing, it's still a bit hard to find some durable, consistent signs of things improving," says JPMorgan's chief economist Stephen Walters.

The fall of the Aussie dollar against the greenback in recent weeks – on a mix of softening commodity prices, jitters about the **Chinese** economy and expectations of new Fed language – will provide some relief if sustained, particularly to farmers, agribusinesses, manufacturers and services exporters such as tourism and higher education operators. Australia is caught in a pincer movement of two giant economies. On one hand the US is anticipating growth, as seen in the statements though not yet the actions of the Fed. On the other hand China is battling an economy in contraction.

As the RBA navigates these conflicting pressures, the currency's decline, to new six-month lows, also takes off some pressure. The bank has had the cash rate at a record low 2.5 per cent for more than a year and it's reluctant to ease monetary policy any further, despite concerns about the slow pace of Australia's economic diversification and the jitters about China.

The RBA's conundrum is made more complex by the risks of inflating a property bubble through even lower interest rates. In the minutes of the last RBA policy meeting, governor Glenn Stevens singled out mortgage credit and house price growth for special mention. China is by far Australia's biggest export market, with its demand for coal, iron ore and other natural resources a huge factor in global commodity prices. After years of high single-digit and low double-digit growth rates, the world's most populous country is now trying to manage an orderly transition to a more sustainable economic model.

This is making it easier for foreign investors to enter its capital markets and trade the yuan. Pimco managing director and portfolio manager Saumil H. Parikh has his doubts about the process.Cooling economy

"The current Chinese growth model of public sector directed investment and financial repression leading to a real estate boom is slowly but surely running out of steam," he says. As China tries to manage a cooling economy without unleashing domestic and global chaos, so the US Fed is carefully stage-managing its recovery the from the dark days of the global financial crisis.

China this week eased monetary policy in two separate operations, in a bid to prop up its slowing economy and counter a sharp fall in the property market.

The People's Bank of China cut the 14-day repurchase rate, which directly affects the cost of borrowing, by 20 basis points to 3.5 per cent, after moving on Wednesday to inject 500 billion yuan ($90 billion) into the banking system via short-term loans.

The rate cut came as data showed property prices tumbled across China's largest cities. These wobbles could put further pressure on commodity prices, which could hurt Australia.

"The global economic and financial backdrop is changing," says Citi's chief economist Paul Brennan in a note. "In particular, the slowdown in China is sharper than expected, but in contrast, the continued robust expansion in the US is leading the [Fed] to lift its guidance on interest rates."

US economic growth is running at about 4 per cent, meaning that, despite some patchiness in the labour market and weak wage growth, the Fed will soon need to start lifting interest rates to put a lid on inflationary pressures.

"The Fed is going to be moving to a more pronounced tightening phase in the near term," says Perpetual's head of investment markets research Matt Sherwood. Although it was cautious with its language, members of the Fed's Open Market Committee were more explicit about the pace of tightening: their bets on where US interest rates would be at the end of next year rose from 1.125 per cent to 1.375 per cent last time.Australia's place

Where Australia fits into this new world, in which the US and China are moving in different directions – while other big global players such as Europe and Japan are battling to keep economic stagnation and deflation at bay – is open to debate.

"Strong and sustained US growth historically is positive for Australia, but China's slowdown is dragging down Australia's national income," Citi's Paul Brennan says.

If early indications are a guide to the medium term, the impact of this new global dynamic on Australia's financial markets will be mixed. Despite immediately adding to recent falls with a sharp decline on the Fed's interest rate guidance on Thursday, the Australian dollar has since recovered to what many see as its new comfort level around US90¢.

Even the most bearish forecasters say the currency is unlikely to be below US88¢ at the end of this year, mainly because of the continued differential between Australian interest rates in those in the rest of the Western world.

Australian shares, too, have come under selling pressure of late, with the benchmark S&P/ASX 200 ending seven of the last 10 sessions down. "The smart money is already starting to deal with the new world," says Perpetual's Sherwood.

This is never truer than in the case of Australia's so-called "yield stocks", such as banks, utilities, consumer staples and listed real estate investment trusts, says JPMorgan**equity** strategist Paul Brunker. He puts about half the Australian sharemarket's capitalisation into this category.

"We've had a rather strange bull market, if you like, in the last three years, which has just been led by boring stocks which normally under-perform a rising market," he says. "Our view on that 50 per cent of the market is that it will lag from here, but not dramatically.

"The reason we think it will lag is improving economic growth in the US, which will **lead** to a yield pull … and that just takes some of the edge off a few of these sectors."

Many of these companies also face regulatory, macro-economic and competition headwinds, he adds.

"The tendency to treat these stock as **bonds** is questioned by what will happen to **bonds**, but also earnings – not that there's so much a huge downside, but there are question marks over upside," Brunker says.Commodity prices

The future direction of commodity prices, meanwhile, is less clear. Despite sharp falls this year, including a 30 per cent decline in price of **iron ore**, few economists are prepared to call the death of the so-called commodities super cycle. A shake-out of the least efficient **iron ore** producers should eventually help lift prices, while even tough new **Chinese** import bans on **coal** with high ash and sulphur content could eventually benefit Australia's producers, according to some industry representatives.

What Australian exporters are losing in price, they are partially making up through the greater volumes flowing from the additional capacity installed during the **mining** investment boom.

Citi's Paul Brennan is upbeat about Australia's long-term economic prospects, saying corporate cost-cutting and a strengthening US economy will benefit the country, despite faltering demand from **China**.

"While the slowdown in **China** is lowering commodity prices, the impact of lower commodity prices on **mining** investment is only gradually affecting Australia's real GDP growth," he says.

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