



The Big Issues of 2016

BIG ISSUES OF 2016

Will we need to worry about inflation again?

China: Hard landing or soft landing?

How aggressive will the US be in lifting interest rates?

What is 'normal' economic growth in Australia?

When will 'animal spirits' return?

Housing: Hard landing or soft landing?

What will our tax system look like in five years' time?

Will oil prices ever see US\$100 a barrel again?

The Big Issues of 2016

- For the past 12 years we have produced “*The Big Issues*” report – a report that has sought to highlight the issues that are expected to influence the economy over the forthcoming 12 months.
- Now this is no crystal ball gazing exercise. The aim is not just to forecast where certain economic variables are likely to be in a year’s time. Rather the focus has been to highlight trends, issues and ‘big picture’ influences that act as threats or opportunities for consumers, investors and businesses alike.
- The aim has been to produce a highly readable, relatively jargon-free document. Probably today we could call this a blog. But the intention over time has been to produce commentary that causes people to think and ask the ‘so what’ question – that is, to determine what this means for their own circumstances.
- And we undertake this analysis by providing a healthy amount of graphs and pictures in addition to the text to best highlight the issues we think will prove important in 2016. Certainly one of the great innovations over recent years has been the infographic and other developments that have sought to bring subject matter ‘alive’. They say that a picture should tell a thousand words, and that should be the basis for all economic and financial commentaries – make the subject matter more alive and relevant to readers. The real value of economics is when people say ‘so what?’ and relate the commentary and forecasts to their own situation.

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...But First...The Economic 'State of Play'

Review of the Past Year

- In addition to our 'Big Picture' analysis of key economic issues we feature a recap of the past year's economic performance together with an outlook for the economy for the coming twelve months.
- This economic assessment largely sets the scene for the discussion of the *Big Issues*. Because there are themes and trends that have evolved over the past year or years to affect economic performance. And clearly each one of us wants to know whether the same factors or indeed new factors are likely to dominate in the coming year.
- Last year we wrote the following: *"The past year has been characterised by cautious consumers and businesses. Spending, investing and employment have been relatively unremarkable. As a result, the economy has grown near, or slightly below the 'normal' pace."*
- Sound familiar? The difference in the past year is that economic growth has been below 'normal' – in the words of the Reserve Bank Governor, the economy is growing, but *"not as fast as we would like"*. In response, rates were cut twice – in February and May. Both our forecasts and the forecasts of the Reserve Bank weren't met over the past year. Economic growth disappointed; inflation was lower than forecast; and as a result our forecasts for the sharemarket and Aussie dollar proved too high. Only unemployment looks to have fallen in the target band.

The Year Ahead

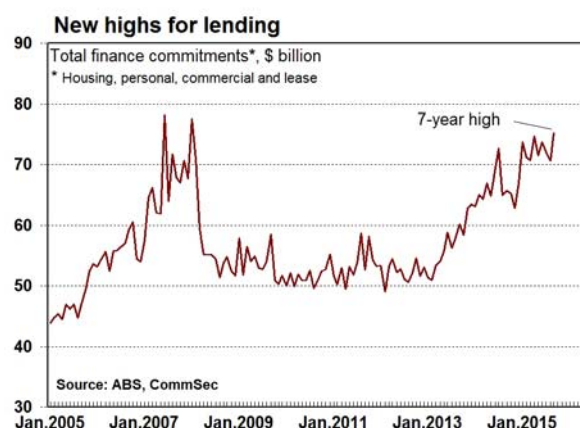
- In recent months the economy has gathered momentum, led by home building and home purchase activity. Building approvals are at record highs as are tourist arrivals and new vehicle sales. Retail spending is growing around the 'normal' pace; businesses are reporting favourable business conditions, they are hiring more workers and are starting to borrow again.
- If momentum continues into 2016 then economic growth should lift closer to the longer-term average pace. But much will depend on a continuation of solid home building activity. Businesses will need to start investing again, and early indications are cautiously optimistic. Certainly businesses appear to be borrowing again.
- Inflation shouldn't be a problem over 2016 although the main issue that the Reserve Bank is monitoring is the "pass-through" of a lower Aussie dollar into higher prices for imported goods. So far, the "pass-through" has been weak with retailers preferring to cut costs and margins to stay competitive especially against foreign retailers.
- At present we think the Reserve Bank will stay on the interest rate sidelines over 2016. But the Reserve Bank has made it clear that it has the ability to cut rates should it become necessary given that underlying inflation is at the low end of target band.
- Unemployment is expected to gradually improve over the year, easing towards 5.50 per cent, especially if economic growth improves as we expect.
- The Australian dollar has fallen US 9 cents over 2015 and the pressure is unlikely to let up in 2016. The US Federal Reserve is tipped to lift rates over the year while our analysts remain negative on prospects for commodity prices.

RECAP: LAST YEAR'S FORECASTS

	2014	2015
Economic Growth	2.75-3.25%	2.75-3.25%
Underlying inflation	2.25-2.75%	2.25-2.75%
Unemployment	5.75-6.25%	5.50-6.00%
	mid 2015	end 2015
Cash rate	2.25-2.75%	2.50-3.00%
Sharemarket (All Ords)	5,800-6,000	6,000-6,200
Australian dollar	US80-87c	US79-86c

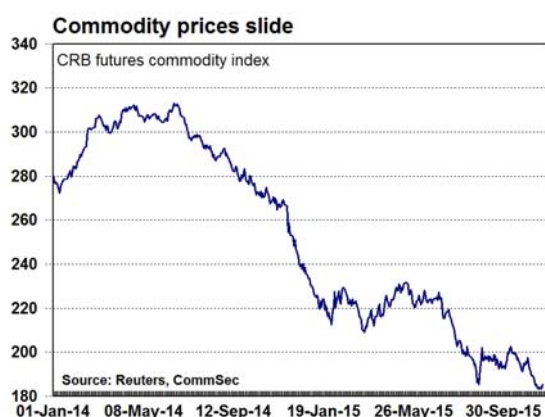
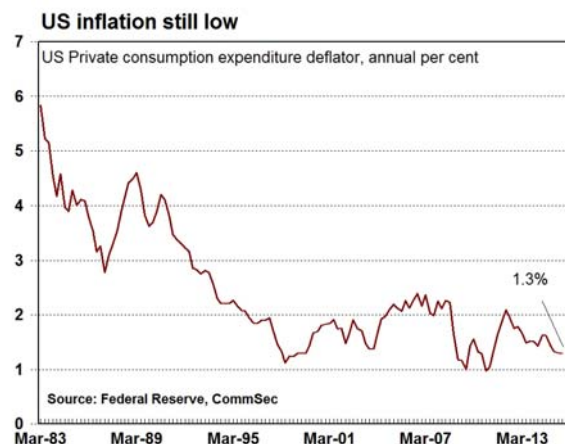
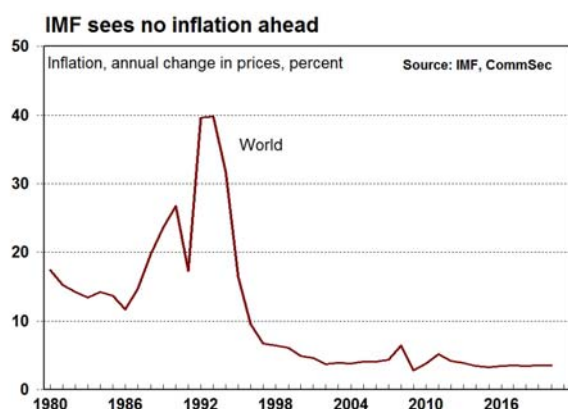
FORECASTS

	2015	2016
Economic Growth	2.00-2.50%	2.50-3.00%
Underlying inflation	2.25-2.75%	2.50-3.00%
Unemployment	5.50-6.00%	5.50-6.00%
	mid 2016	end 2016
Cash rate	1.75-2.00%	1.75-2.00%
Sharemarket (All Ords)	5,200-5,400	5,500-5,700
Australian dollar	US64-72c	US68-75c



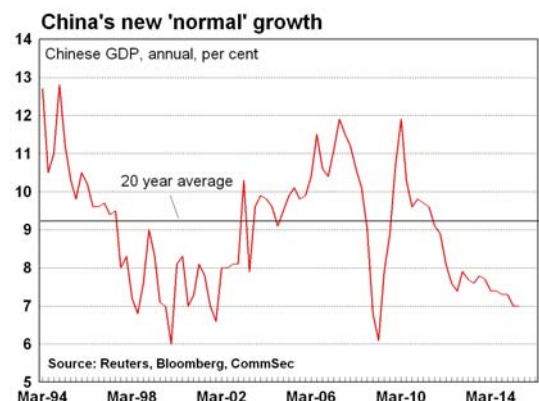
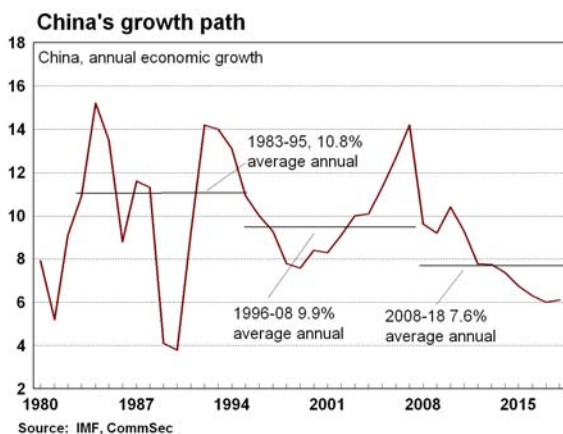
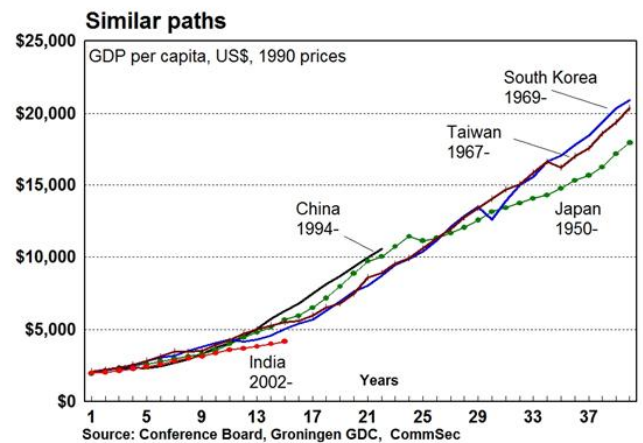
Will we need to worry about inflation again?

- Inflation has featured in our *Big Issues* for a number of years. Last year we asked ‘*Is Inflation dead?*’ – clearly tempting fate. And in the previous year’s *Big Issues* we also included a similar item: “*Inflation or Deflation?*”
- We continue to find it remarkable, that with interest rates close to zero across many parts of the world and some central banks still injecting stimulus via bond buying, that concerns about deflation still abound.
- It may be reasonable to expect deflationary concerns in under-performing economies like Europe and Japan. But in the United States, consumer prices are up just 0.2 per cent over the year. Excluding food and energy, prices are up 1.9 per cent over the year. And the Federal Reserve’s favoured measure – the personal consumption expenditure deflator (price index), excluding food and energy – was up just 1.3 per cent over the year. The Fed target is 2 per cent.
- Certainly inflationary pressures are being capped by low and falling commodity prices like oil. While central banks generally strip out oil when monitoring inflation, falling energy prices are keeping downward pressure on broader measures of goods and services prices.
- But commodity prices rise and fall and economies speed up and slow down over time. The question we raise is ‘*Will we need to worry about inflation again?*’ That is a bigger question and it relates to the fact that businesses are increasingly facing greater global competition through lower trade barriers, the ability to sell goods over the internet, and especially the growing consumer acceptability to purchase goods from abroad through electronic payment methods. But there is also the advance of technology through 3D printing, adding a further imperative on businesses to accept a new lower ‘normal range’ for margins. The jury is still out, but there are few signs of inflation reviving any time soon.



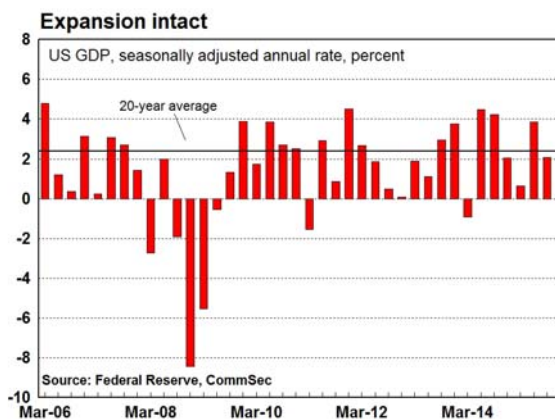
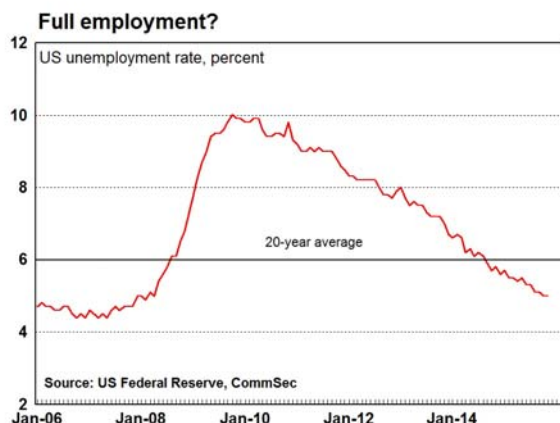
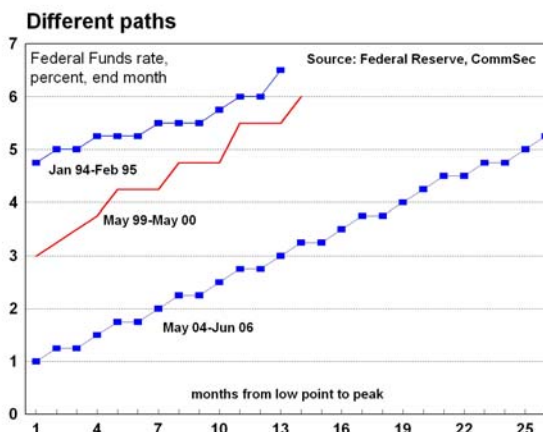
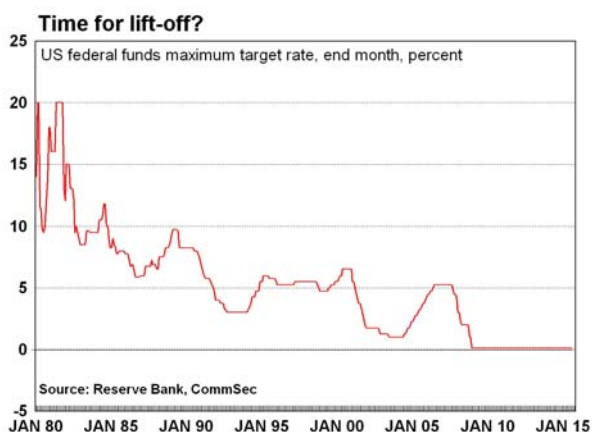
Will China face a hard landing or soft landing?

- China is Australia’s largest trading partner. Further, recently the number of tourists to Australia from greater China (mainland China and Hong Kong) outnumbered those from New Zealand. China is also providing the biggest contribution to global economic growth of any nation. China may still only be the second largest economy on the planet but with growth rates near 7 per cent rather than 2 per cent in the US, it is expected to contribute 1 percentage point of the expected 3.6 per cent growth of the global economy in 2016.
- But China is transforming. Whereas the industrial sector drove growth in past years, in future years it will be services and household spending that is expected to lead the way.
- This is hardly a remarkable situation. All major industrialised economies have followed the same path. It has happened more recently in South Korea, Taiwan and even Japan. And the US and Australia have also trekked the same path. Rural and mining sectors initially drive economies, and infrastructure is put in place. But as incomes rise and businesses are priced out of markets, they move on to more elaborately-transformed manufactures and services industries.
- Chinese authorities have made no secret of the fact that growth drivers are changing and that growth rates will slow. Chinese authorities refer to it as the “new normal”. Economic growth rates are more likely to be in a range of 6.0-7.0 per cent.
- Such transformations are by no means easy. Some businesses will need to close as industries retreat in importance while other businesses will take their place. And the impact is by no means local. Australian resource providers will need to get used to lower prices and will need to adjust supply to the slower pace of expected demand. Commodity prices have trended lower for a century, interspersed with relatively short-lived upturns as new economies industrialise – like Japan and China.
- While there will be some pain in Australian mining and energy sectors, there are other businesses and industries that will benefit from rising Chinese incomes, as well as the rising middle class in Asia. Business such as those in food production, tourism, education, health and financial services.
- We expect China to experience a relatively soft landing. But that doesn’t mean that there won’t be bumps along the way as Chinese authorities attempt to transform the nation from a developing economy into a developed economy.



How aggressive will the US Federal Reserve be in lifting interest rates?

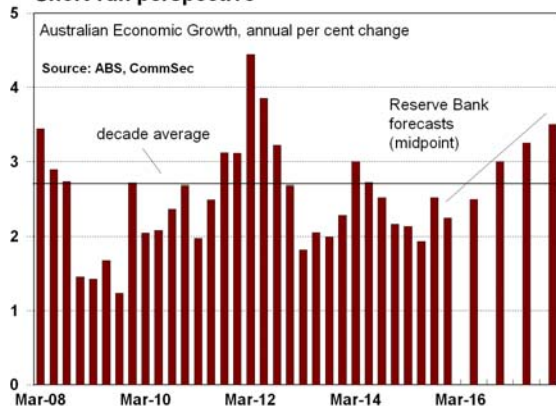
- Last year we posed the question *“When will the US start lifting interest rates?”* We rationalised that all the ingredients seemed to be in place for the Federal Reserve to start the ‘normalisation’ process – that is, lift rates to more ‘normal’ levels. And our advice was that *“investors need to stay alert to the timing and size of US rate hikes over 2015.”*
- Well it’s taken longer than we, and most other analysts, thought. But at the time of writing it looks like rates will start rising on December 17. Given that it is a sign of how much the economy has recovered, Federal Reserve chief Janet Yellen recently said *“it is a day that I expect we all are looking forward to.”*
- The question now is what form will the ‘normalisation’ process take? As you would hope and expect, the Fed chief has indicated that the central bank won’t be in a rush to lift interest rates. Much will depend on the flow of economic data, as to whether the process needs to be quickened or moderated. And certainly with inflation still below the Fed’s target, there is no need to rush.
- Janet Yellen noted in her recent speech: *“Given the persistent shortfall in inflation from our 2 per cent objective, the Committee will, of course, carefully monitor actual progress toward our inflation goal as we make decisions over time on the appropriate path for the federal funds rate.”*
- The path of interest rate increases is one thing investors will be watching over 2016. The other issue is the end-point. That is, at what point will the Federal Reserve be satisfied that interest rates have risen enough?
- Back in the 1994-1995 period, the Federal Reserve lifted the federal funds target rate from 3.00 per cent in February 1994 to 6.00 per cent in February 1995. In the 1999-2000 period, the fed funds rate lifted from 4.75 per cent in May 1999 to 6.50 per cent in May 2000. And between 2004 and 2006, fed funds rose from 1.00 per cent in May 2004 to 5.25 per cent in June 2006.
- All Janet Yellen can say at present is that the ‘neutral’ federal funds rate is historically low – that may suggest that rates of 2-3 per cent would cause the Fed to pause in its rate-hiking process.



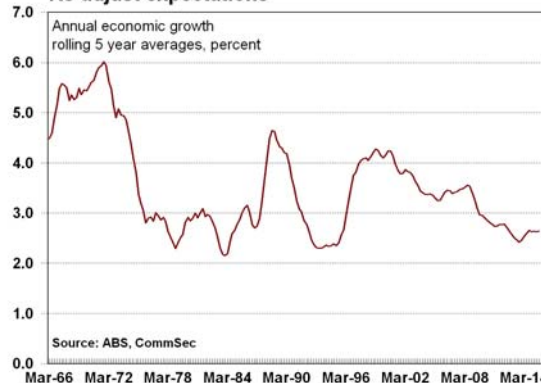
What is “normal” economic growth in Australia?

- This has been one of the more interesting questions raised in 2015. And it is a question that will be posed more and more over 2016. Certainly it is an issue that CommSec has been focussing on for some time, so we are pleased to see that it is being discussed more widely by analysts, investors and policymakers alike.
- The general assumption had been that the Australian economy can grow around 3 per cent without sparking inflation. That ‘speed limit’ is broadly the by-product of population growth of around 1.5 per cent and productivity growth of around 1.5 per cent. And it is generally assumed that the economy needs to be growing broadly around 3 per cent or higher to create enough job opportunities to cause the unemployment rate to fall.
- Over the past five years annual economic growth has averaged 2.6 per cent, down from a decade average of 2.7 per cent and 15-year average of 2.9 per cent. So the growth rate has been trending lower. And indeed Federal Treasury has now locked in 2.75 per cent for the new ‘normal’ growth rate.
- The Reserve Bank expects that the long-term trend or ‘normal’ pace of the economy has come down, but it is keeping an open mind on the issue. Perhaps lower wage growth accounts for the stronger job market. And the low wage growth on top of stronger productivity growth may have also enticed employers to take on extra staff rather than work existing staff more intensively.
- But the good news is that jobs are being created; inflation remains low; and economic growth, while low, is starting to lift.
- Still, if the ‘speed limit’ has come down, then this has broader implications. It may be that the Reserve Bank starts worrying about a lift in inflation when the annual economic growth rate approaches 2.75 per cent rather than 3.00 or 3.25 per cent – and that’s not far below the current 2.5 per cent growth rate. Further, companies may need to factor in slightly slower ‘normal’ profit growth if growth in the broader economy has ratcheted lower.
- As noted, the Reserve Bank hasn’t yet locked in new lower estimates for ‘trend’ or ‘normal’ economic growth, but certainly it will be an issue it will watch carefully over 2016.

Short-run perspective



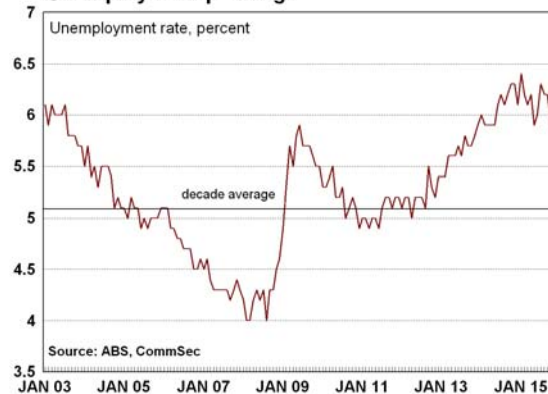
Re-adjust expectations



More productive

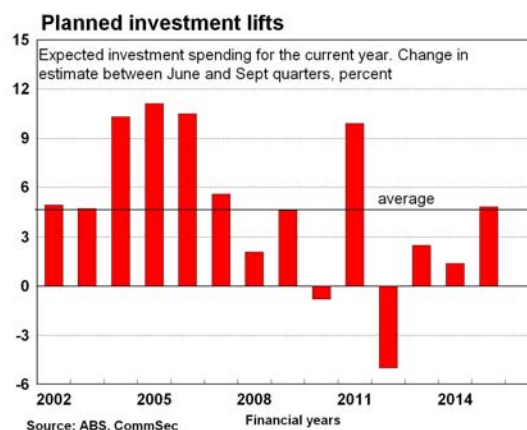
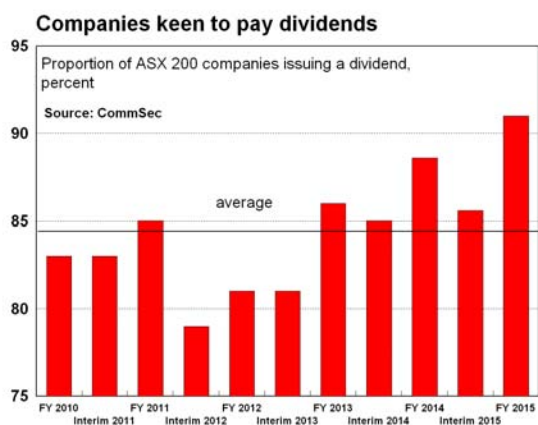
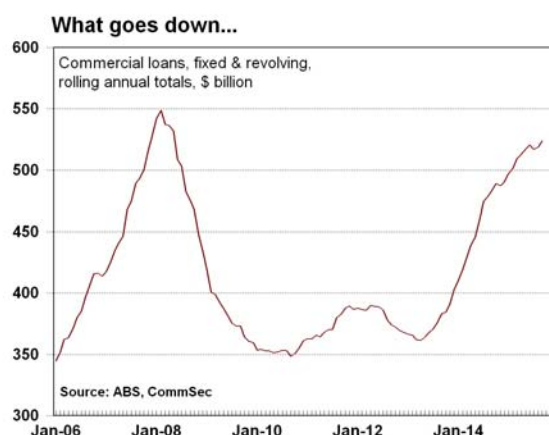
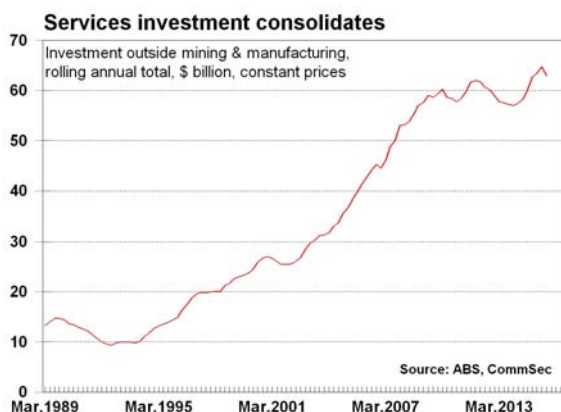


Unemployment peaking?



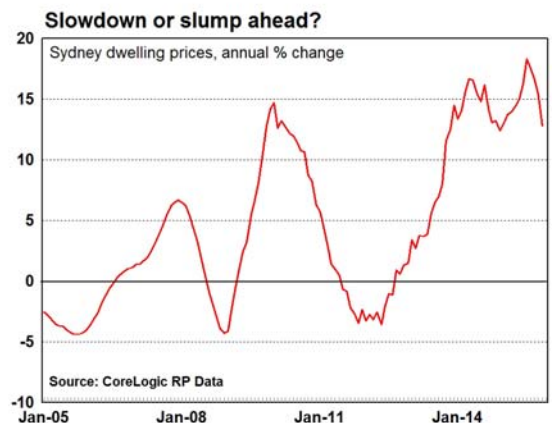
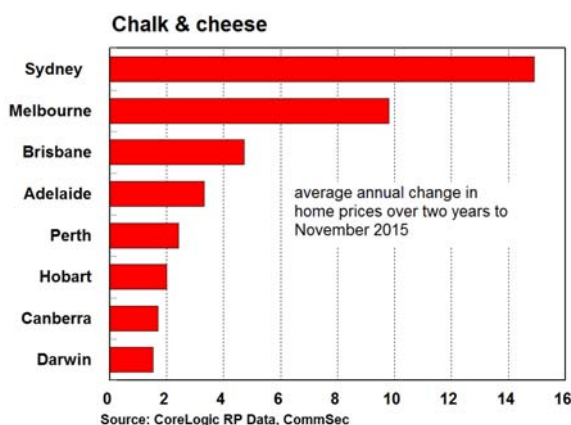
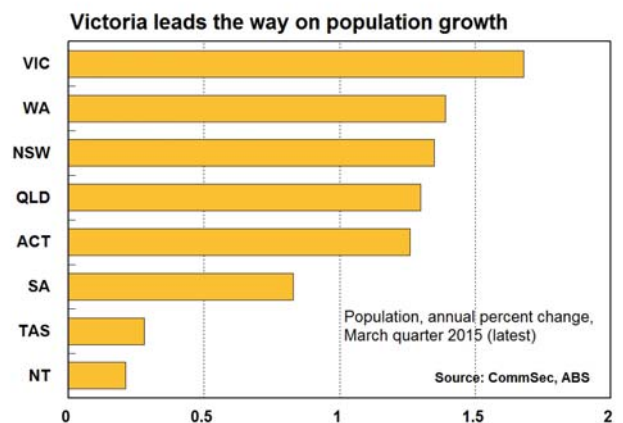
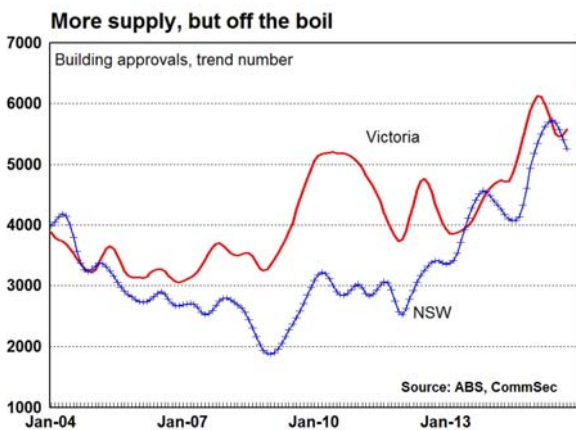
When will the ‘animal spirits’ return?

- The term ‘animal spirits’ is commonly attributed to luminary economist, John Maynard Keynes. Keynes wrote in his 1936 book *The General Theory of Employment, Interest and Money*:
 - *“Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits – a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.”*
- Unfortunately one of the lingering consequences of the global financial crisis is that consumers and businesses have become a little too cautious. Interest rates are historically low and policy settings generally are super-stimulatory, but spending, borrowing and investment haven’t lifted as much as policymakers had hoped.
- This criticism is generally directed more at businesses than consumers. But even Aussie consumers are more conservative than in the past. While people are borrowing to buy and build homes, borrowing for other reasons is low. And whereas home borrowers in the past would seek to reduce loan repayment and boost spending in response to rate cuts, now they are paying off debt at a faster rate.
- Still, consumers continue to spend at a ‘normal’ rate. Annual growth of household spending stands at 2.7 per cent, not far from the 2.8 per cent decade average.
- But business spending, borrowing and investing have been historically modest despite generally favourable corporate finances. The Reserve Bank has been somewhat critical of businesses for maintaining high hurdle rates of return for new investments and a desire to pay dividends in preference to ploughing funds back into the business.
- There are signs though of a “thawing out”. Business spending is lifting; borrowing levels have risen and investment plans are improving. Business investment is currently the missing ingredient in the economic uptrend and it is the issue that investors will watch carefully over 2016.



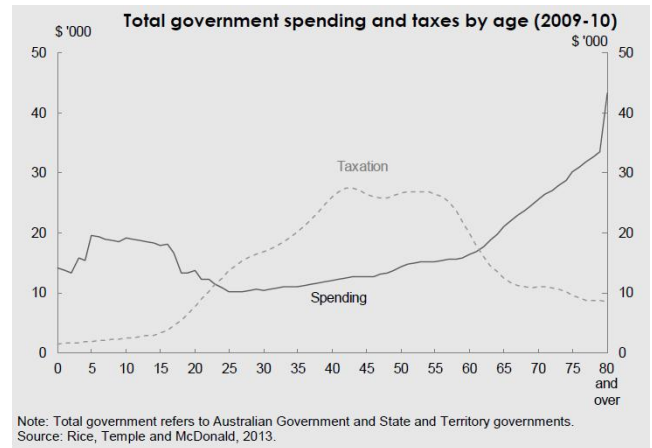
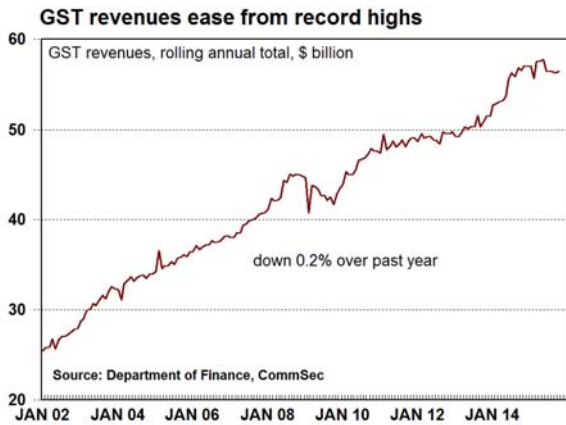
Housing: Hard landing or soft landing?

- For many parts of Australia, this issue is very much a non-issue. Why talk about a landing at all – this implies that home prices have been soaring to necessitate a landing at some point?
- Over the past two years, Sydney home prices have recorded average annual growth of almost 15 per cent. And Melbourne home prices recorded average annual growth of 10 per cent. But across the other capital cities, growth has averaged just 2.6 per cent. Growth in home prices of that magnitude has actually been lower than the average rate for the past decade.
- So the issue of ‘hard landing or soft landing?’ is primarily relevant for Sydney and Melbourne. And while the answer will be revealed over 2016, it does look as though the start of this correction process is underway. In November, CoreLogic RP Data figures showed that Sydney home prices fell by 1.4 per cent while Melbourne home prices fell by 3.5 per cent in the month.
- The drop in Sydney home prices in November was the biggest in almost five years – although it was only the second fall in prices in 18 months. And the drop in Melbourne home prices was the biggest in 18 months.
- The simple reason why Sydney and Melbourne home prices have been rising is that population growth in both capital cities has been strong and demand for homes has been outstripping supply. While population growth has eased in NSW, it still remains 7 per cent above decade averages – the only state/territory above longer-term averages. And Victorian population growth leads the nation for the first time since 1888.
- But more homes are being built – supply is rising to meet higher demand. And as noted, home prices are coming off the boil. Indeed the recent slowdown in trend building approvals in NSW and Victoria shows that supply is also easing to prevent a ‘hard landing’.
- It’s also important to note that over-supply is being prevented by lending practices – banks won’t lend to developers unless a high proportion of properties are pre-sold before building work is started. This is another factor pointing to a soft, rather than hard landing for home prices.

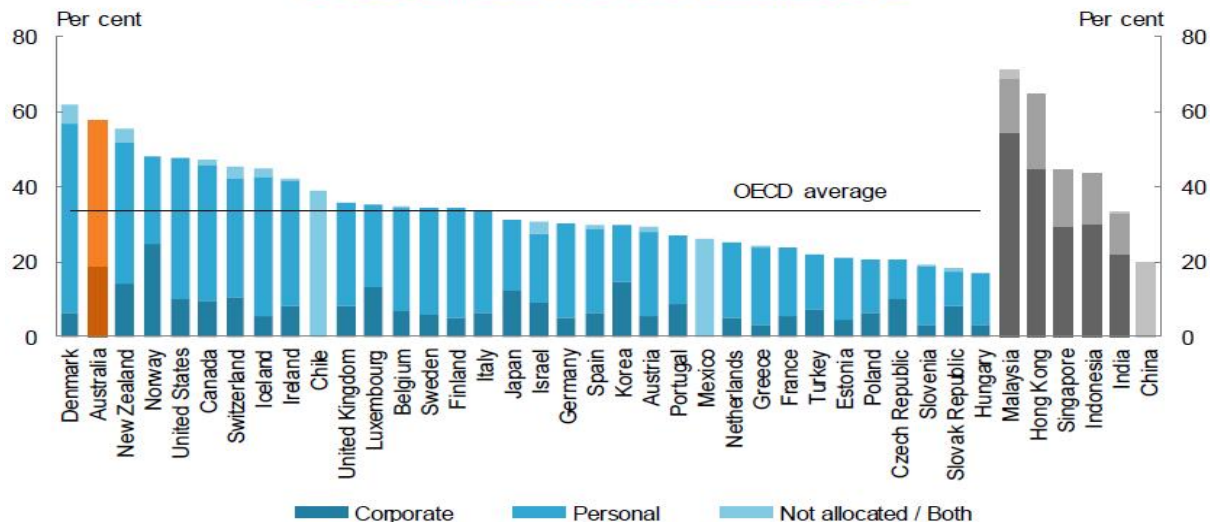


What will our tax system look like in five years' time?

- The big discussion point that emerged in late 2015 was tax reform. Almost unheralded, the NSW Premier raised the issue of raising the goods and services tax (GST) rate from 10 per cent to perhaps 12½ per cent or 15 per cent from the current level of 10 per cent. And as more voices have been added to the discussion, others have questioned the appropriateness of the tax base – the question of whether the base needs to be broadened to include food, health and/or education.
- Discussion of changes to the rate and composition of the GST isn't being conducted with the principal aim of raising more tax, rather because the tax system needs to change to meet the demands of an ageing population. Over time, a smaller proportion of the population will be in the workforce. And unless changes to the tax system are made, then those left in the workforce will take on a higher burden of generating the revenue needed for health and social security spending.
- It's important to remember that while an increase in the GST from 10 per cent to 15 per cent is being discussed, that is only part of the discussion. One aim of any change to the tax mix should be to encourage more people into the workforce or encourage them to stay in the workforce for longer. And that means lowering income tax rates or changing the tax bands.
- Also part of the discussion could be changes to business tax rates and changes to, or removal, of state government taxes and charges like stamp duty and payroll tax. Most businesses would like to see the end of payroll tax – a tax on employing more workers!
- Australia does rely on income taxes to a greater extent than most advanced countries. All political parties need to embrace change in the tax mix, with less weight on income taxation. Australia successfully implemented a GST without negative equity effects and we can do so again.

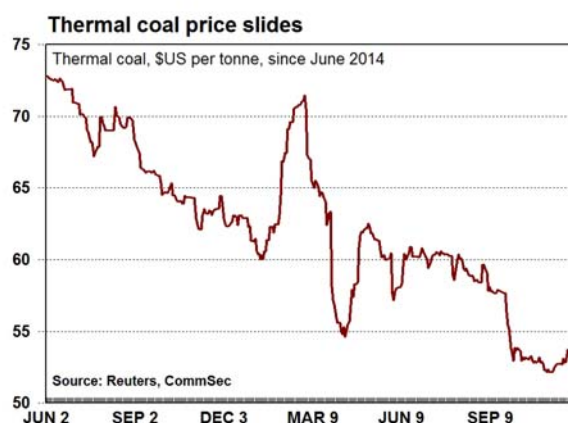
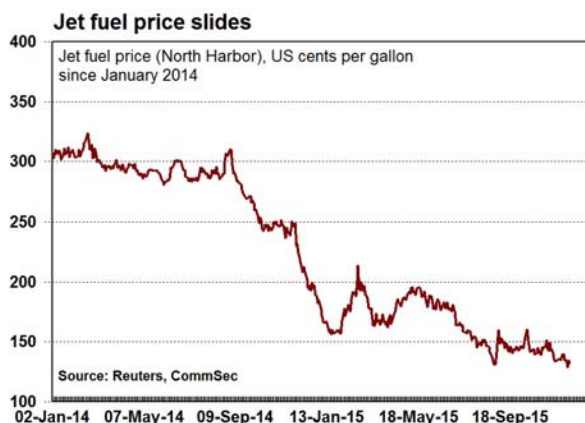
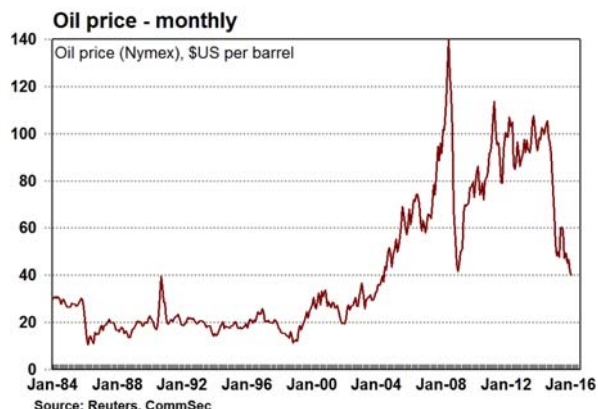
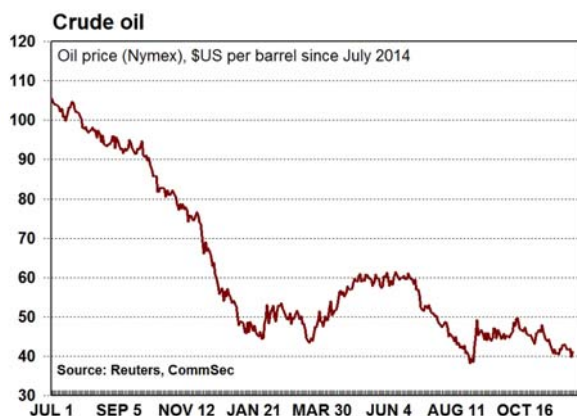


Taxes on corporate and personal income as a percentage of total taxation, for OECD and selected Asian economies, 2012



Will oil prices ever see US\$100 a barrel again?

- This issue has major implications for an energy producer like Australia. And clearly the issue is multi-faceted.
- The simple reason why crude oil is trading near US\$40 a barrel than at higher levels is because the major swing producer, Saudi Arabia, is trying to protect its market share, and ultimately its income and standard of life. Higher cost producers such as the US and Canada have been taking market share from the OPEC oil cartel. In part, because production became attractive at the higher prices prevailing up to mid-2014. But also continued advances in technology have reduced the cost of extracting more marginal reserves such as oil sands, shale oil and deep-water oil.
- But, in addition, oil use itself is threatened by alternate energy resources such as Liquefied Natural Gas (LNG) and new age energy for cars such as electric power and hydrogen. So it is clear that oil producers like Saudi Arabia have threats on multiple fronts.
- Saudi Arabia will be encouraged at the cancellation of some Canadian oil sands projects; ConocoPhillips will cancel all deep-water exploration from 2017. But Saudi Arabia and other OPEC oil producers are not yet satisfied. In early December OPEC agreed to maintain the current production quota. That is despite the world remaining massively over-supplied with oil. World oil stockpiles are at record highs. The Iranian oil minister believes the market is oversupplied by 2 million barrels per day.
- When Saudi Arabia believes it has seen off the threat from marginal non OPEC oil producers then it will start to trim oil quotas. But that point still appears some way off.
- Investors clearly need to do their homework on energy producers, determining their ability to reduce costs and generate profits at sustained lower prices. Investors need to calculate (bet) how long they are prepared to wait for energy prices to recover and whether there are stocks that could provide more reliable returns in the short to medium term. Airlines, transport companies and consumer stocks will benefit in an environment of low energy prices. LNG, oil and coal companies face challenges.



Rewind: The Big Issues for 2015

- As we noted at the start of this report, we have been producing **Big Issues** for the past 14 years. And it is interesting – and perhaps even instructive – to rewind over the past year and assess what we had on the radar screen in December 2014.
- Looking ahead into 2015, we highlighted eight issues. And the first issue was “*Is Inflation dead?*” Clearly there was a big risk – the risk of Murphy’s Law – in framing the first issue. Usually when you suggest that something is dead and buried, it comes back on the screen with gusto. But not inflation.
- We actually have highlighted inflation as an issue in various guises for quite some time. And why? Because it is central to interest rates, economic growth, corporate strategy and investment returns. Indeed inflation - or the lack thereof - dominated as an issue in 2015.
- Somewhat related were the issues: “*The end of corporate pricing power?*” and “*When will the US start lifting interest rates?*” Companies have indeed found it hard to raise prices. In part because of low global inflation as well as ‘disruption’ and globalisation.
- Certainly the issue: “*Where should investors put their money?*” was amazingly relevant in 2015. Interest rates fell further, hitting record lows, and thus presenting a major problem for conservative long-term investors. Sharemarkets trended sideways, global shares were attractive because the Aussie dollar fell and the housing market was a magnet for investors, especially in Sydney and Melbourne. And while the issue doesn’t make a return for our *Big Issues in 2016*, clearly it will remain a key discussion point in 2016.
- The Aussie dollar usually is a key source of debate, but the failure of the Aussie dollar to fall in line with commodity prices was a focus of concern for the Reserve Bank and highlighted in our issue: “*What is the ‘fair value’ for the Australian dollar?*” Up until September, the Reserve Bank noted in the commentary accompanying its interest rate decisions that the Aussie had scope to fall further. With the Aussie dollar near US71 cents, the Reserve Bank dropped calls for a lower currency in announcing its September 1 rates decision. Seemingly, ‘fair value’ is in the early 70s against the greenback.
- An issue that hadn’t featured previously in our reports came on the scene in 2015: “*Does Europe still matter?*” And certainly it was a talking point over the year as people re-assessed whether it was worth worrying about Greece to the same extent as in the past. European interest rates turned negative and the European Central Bank printed more money, but importantly the world didn’t stop turning.
- Interest rates, inflation and the Aussie dollar are key talking points. But so are home prices. We questioned “*Home prices to slip or slump?*” As it turns out, prices have started to ease late in 2015 – more slip, than slump. The issue will clearly dominate discussion again in 2016.
- And finally we raised the issue: “*What shape is the job market really in?*” As it turned out, this was more of an issue than we assumed. Unemployment eased despite seemingly weak economic growth. That led to re-assessment about the true ‘normal’ rate of economic growth or the ‘speed limit’. But the improvement in the job market caused the Reserve Bank to adopt a ‘neutral policy stance. As we noted last year: “*Whether the Reserve Bank elects to cut rates again or hold rates steady, much will depend on its assessment of the job market, where it’s headed, and what it means for wages and prices; more challenging for investors.*”

BIG ISSUES OF 2015

Is Inflation dead?

The end of corporate pricing power?

When will the US start lifting interest rates?

Where should investors put their money?

What is the ‘fair value’ for the Aussie dollar?

Does Europe still matter?

Home prices to slip or slump?

What shape is the job market really in?

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