What to watch in 2018

Here are ten things that I expect I'll be talking about at conferences and events over the course of the coming year.

1. *Central banks.* The era of ultra-cheap money, which began during the global financial crisis, is drawing to a close. Already, the US Federal Reserve has raised its key policy interest rate target four times since the end of 2015, and has begun to wind back its bloated balance sheet (something which will take a very long time to complete). The Bank of Canada has raised its policy rate three times, and the Bank of England once, since the middle of last year. The European Central Bank and the Bank of Japan are maintaining their negative overnight interest rates for the time being, but both of them have recently foreshadowed an eventual end to their bond-buying programs. All of this is happening in response to growing evidence that the major 'advanced' economies are finally throwing off the lingering effects of the financial crisis. Business and consumer confidence are back to pre-crisis levels; capital spending is rising, and unemployment is falling. Inflation remains unusually low (more on that later). But central banks are becoming more concerned about the risks to financial stability of persisting with monetary policy settings that were designed to deal with the consequences of the financial crisis. Some of them also want to create some 'headroom' to be able to lower rates again in the event of another shock, or downturn. So investors should expect further interest rate rises from those central banks who have already started, and initial increases from those who haven't. The ECB will likely end its bond-buying program this year; and the BoJ will probably be more forthcoming about when it will terminate its program.

2. *Market reactions to central bank actions*. Financial markets have thus far been remarkably sanguine about the impending end to the era of ultra-cheap money. Although bond yields are off their all-time lows of mid-2016, they are still very low by historical standards. Credit spreads are tighter than at any time since the financial crisis. Equity markets have gone on to new highs. And most surprisingly of all, volatility in all financial markets (except crypto-currencies) has remained unusually low. All of this could be a tribute to the clarity of central banks' communications. Or, alternatively, it could be an indication of complacency about risk among financial market participants. Whether for one of those or some other reason, it's hard to believe that the actions central banks are likely to undertake over the course of this year won't have some significant, and (as yet) unanticipated) ramifications for financial markets.

3. *Inflation*. Another reason for the resilience of global financial markets to the prospect of a gradual return to more 'normal' monetary policy settings could be that market participants expect that inflation will continue to surprise on the downside, thus limiting the scope for central banks to raise interest rates. And there's no denying that inflation has for the most part continued to surprise on the downside in most major economies during 2017, as it has done for most of the past decade. But, as they say, 'past performance is no guarantee of future behaviour'. With unemployment in the four largest 'advanced' economies now well below the levels traditionally regarded as consistent with 'full employment',

labour force growth increasingly constrained by demographic change, and overall economic growth running at an 'above trend' pace in an increasing proportion of economies, the risk of a positive 'inflation surprise' must surely be rising. Central banks aren't going to seek to pre-empt that risk – but if it eventuates, they will certainly react to it.

4. *Trump Administration economic policies*. One very important unknown is the economic consequences of the large cuts in US corporate and personal income taxes enacted at the end of last year. Many market participants appear to believe that their impact will be similar to that of the tax cuts (and increased defence spending) implemented by the Reagan Administration in the early 1980s. But the economic context today is very different from back then. When Reagan's measures were put in place, unemployment was at a post-war high, the labour force was still growing rapidly, interest rates were on their way down from Paul Volcker's peak, and US debt was still relatively low. Trump's tax cuts, by contrast, will be taking effect when unemployment is less than 5%, the labour force growing by only ¼ pc per annum, interest rates are on their way up, and US government debt is over 80% of GDP. If the tax cuts *do* stimulate demand, the result is more likely to be some combination of higher inflation and a larger current account deficit than increased supply (economic growth). And if the tax cuts do result in widening US external deficits, then the risk that the Trump Administration will actually implement some of the protectionist measures that featured so prominently in Donald Trump's election campaign, could increase dramatically.

5. *Political risks*. Political developments within and between individual countries captured a lot of attention and time during 2017 but rarely moved markets. 2018 may bring more of the same – or maybe not. At the time of writing, the risk of another US budget shutdown appeared to be weighing heavily on the US dollar, when 'fundamentals' should have had it higher. The next test of the (comforting) idea that the populist wave has peaked comes on 4th March, when Italians go to the polls. The other major scheduled political event of interest will be the US mid-term Congressional elections on 6th November – where, on present indications, the Democrats could regain control of the House (a prospect which would have seemed unthinkable a year ago) but face an uphill task to retake the Senate. Brexit negotiations between the UK and the EU will continue throughout the year. Tensions between China and the US may continue to escalate, with the former seeking to assert its primacy in the Asian region and to alter the international geo-political order established by the US after World War II, while the latter vacates its traditional leadership role. It's unclear what any of this means for markets, which is probably why they continue to ignore it. But a sudden change in 'facts on the ground' (resulting, for example, from actions by North Korea) could prompt abrupt shifts in markets.

6. *China*. Perhaps the most notable thing about China's economy in 2017 was how *little* happened. Reported economic growth was steady; policy interest rates were unchanged (although market-sensitive rates rose a bit); the yuan was fairly steady in trade-weighted terms (but rose a bit against the US$); the 2015-16 upsurge in 'shadow financing' seems to have been curtailed without any serious

consequences; property prices slowed but didn't tumble. Under Xi Jinping's leadership, cemented at the 19th Communist Party Congress in October, China is reverting to a more tightly controlled economy (and society), with 'market forces' playing a lesser role than had seemed likely a few years ago. That could mean that China's economy becomes less prone to the cyclical swings which have been one of its features over the past twenty years. The 'Chinese authorities' appear to be de-emphasizing economic growth in favour of 'stability' and a range of other, non-economic objectives. For Australia, this could all mean less volatility in key export commodity prices. However, Australia will also need to watch carefully the various ways in which China is asserting its growing economic and military power in our part of the world.

7. *The Australian economy*. The Australian economy enters 2018 in better shape than many had expected this time last year. Business and consumer confidence are both at above-average levels; employment has grown more strongly than at any time since the financial crisis; housing activity is holding up at historically high levels; public infrastructure spending is rising strongly (at least in Victoria and New South Wales); and there are clearer signs of the long-awaited pick-up in non-mining business investment. The one remaining significant weak spot is household spending, weighed down by the high level of household debt and persistently weak growth in household income (especially wages). High household debt isn't going to 'go away'; and wages growth is likely to remain subdued for some time yet, given the extent of 'spare capacity' still evident in the labour market, despite the recent strong growth in employment. Nonetheless, both wage and price inflation have likely bottomed, and should be gradually heading back towards where the Reserve Bank wants them do be over the course of this year.

8. *The Australian property market*. Australian residential property prices look to have peaked in the past six months or so (with the exceptions of Perth and Darwin, where they peaked in 2014, and Hobart, where they're still rising, albeit from a low base). Foreign investor interest is waning in the face of higher taxes and capital controls on outflows from China, while tighter Australian regulations appear to have dampened lending to domestic property investors. This has created some room for first-time buyers to come back into the market. A property 'crash' of the sort repeatedly told by foreign observers (often the same ones) remains unlikely, given that most of Australia's household debt is owed by high-income households and interest rates are unlikely to rise sharply in the near- or even medium-term. But a more subdued housing market may also add to the caution being shown by Australian consumers.

9. *Local elections*. There will be elections in three states this year – South Australia and Tasmania in March, and Victoria in November. The South Australian election will attract interest for the challenge posed by independent Nick Xenophon, whose team could attract more than one-third of the vote. In both Tasmania and Victoria, first-term governments who have presided over much-improved state economies are seeking second terms – but in neither case is a second term necessarily the most likely outcome. At the federal level there could be a few more by-elections stemming from last year's dual citizenship imbroglio. And although a federal election isn't due until June next year, this year's Budget

could well be the last before the next federal election, in which case there will be keen interest in whether the Government provides more detail about the personal income tax cuts it intends to dangle before the voters in 2019.

10. *The RBA*. The Reserve Bank will likely set a new record for inactivity on 22nd March this year. On that date, it will have gone 596 days without changing its cash rate, surpassing the previous record set between 14th December 1994 and 31st July 1996. The RBA will be in no hurry to follow other central banks in embarking upon the journey of returning interest rates towards more 'normal' levels – especially while both wage and price inflation remain below, and unemployment and 'under-employment' remain above, where it wants them to be. Nor, however, given how far the cash rate is currently below 'normal', will the RBA be waiting until inflation hits 2½%, or unemployment reaches 5%, before lifting rates a first time. While it's never all that exciting to be sitting with the consensus, August looks the most likely month for 'lift off', but that decision will be dictated by the flow of data, not by the calendar. And the currency could play a role in the timing too. If, contrary to my expectations, the A$ is still in the high 70s (or even higher) against the US$, then the first rate hike could be delayed until much later this year.

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19th January 2018.