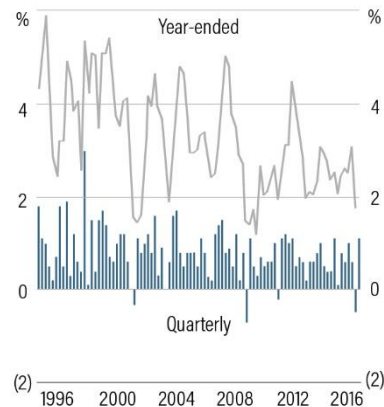




DR DAVID SOKULSKY  
CHIEF INVESTMENT OFFICER

## Australian GDP growth over the last 25 years



Source: Australian Bureau of Statistics

## Australia is not an economic island

Many people think that Australia is an island, not only in the geographic sense, but also with respect to economics and financial markets. On both fronts they are mistaken.

As described in the *Encyclopaedia Britannica*, an island is a mass of land that is both “entirely surrounded by water” and “smaller than a continent.” Therefore, Australia can’t be an island as it is commonly referred to, as it is already a continent. Similarly, we are not an economic island operating independently of global trends. This is despite us enjoying economic expansion for 25 years straight, and avoiding global events such as the Asian financial crisis, the global recession in the 1990s following the dot-com bubble, and the great recession following the sub-prime crisis in 2008.

This year has been a great example of how we follow the lead from offshore markets. Our domestic financial markets have been almost entirely driven by offshore events—particularly those in the US. This is why, at Crestone, we spend so much time and effort analysing global economics, politics and risks.

In this month’s update, we consider some of the major global risks, why we are not immune to them, and how they might impact the domestic economy and markets going forward.

### Why we’re not an island

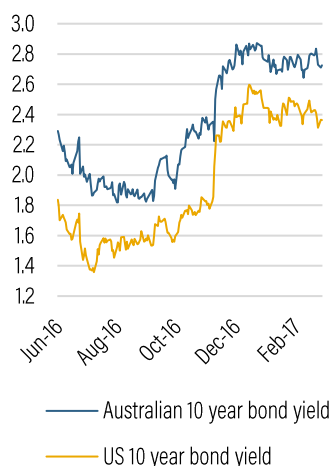
Despite our recent stellar economic performance, Australia is not an economic island—quite the opposite. Our economic growth over the last two and a half decades has been primarily the result of us being a critical part of the supply chain for one of the largest economic expansions mankind has ever seen—China. China’s unprecedented growth and its demand for natural resources, housing, clean air, education and tourist destinations has been the primary reason for Australia’s continued prosperity in the face of global volatility and recessions.

What happens in the global financial markets flows directly into the prosperity of the local economy and our equity and fixed income markets. The US dollar, US 10-year government bond yield and commodity prices are the key global variables which impact Australia.

As mentioned above, domestic financial markets have been almost entirely driven by offshore events this year with the domestic economy having little relevance:

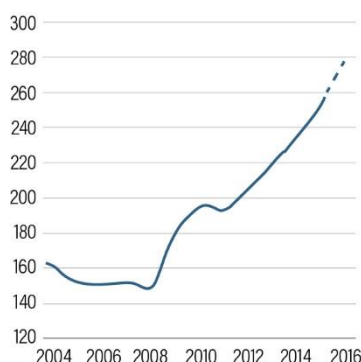
- The Australian equity market has tracked global markets upwards following the US election and experienced a strong rally;
- domestic fixed income markets have been almost entirely driven by the US market, which has seen our 10-year government bond yield increase sharply despite domestic inflation teetering at record lows;

### Australian and US 10-year bond yields (%)



Source: Bloomberg

### Chinese non-financial debt as a percentage of GDP



Source: CEIC, UBS estimates

- commodity prices have continued to rally on the back of strong Chinese demand and the expectation that global growth and infrastructure spending will increase; and
- the Australian dollar has been volatile responding to both commodity prices and expectations around US interest rate policy.

### Why are we so interested in Trump?

The first thing to consider about President Trump is that there is great uncertainty about his policy mix and what it will ultimately look like, so it is hard to be definitive in our outlook. Thankfully, the US political system has several 'checks and balances' in place which gives us confidence that Trump's more 'controversial' policies will be heavily watered down.

Trump's policy mix can, however, still have a major impact on financial markets, geo-political risk and global trade. As such, as a nation we are vulnerable, particularly with regards to his trade policies. China is our largest trading partner, and the potential for Trump to impose tariffs on Chinese exports creates a major risk for the Chinese economy and hence Australia's economic prosperity. A meaningful slowdown in China will almost certainly see demand for our exports including iron ore decrease, demand for Australian housing fall, and tourism shrink which will impact the services part of our economy.

In terms of markets, optimism is currently being priced in but this can change quickly if Trump's policies disappoint or inflation spikes higher. Higher inflation would lead to higher US interest rates, and this poses a risk for our major banks which source funding from offshore. Higher funding costs would likely be passed onto home owners via higher mortgage rates or to savers via lower term deposit rates. If this were to transpire, it would obviously be a negative for the Australian economy and housing. Conversely, the Australian dollar should depreciate in this environment, and this would help both the Australian economy and those companies with significant business exposure to the US dollar.

The greatest geo-political risk for Australia will probably be increased tension over the South China Sea. While this has been escalating for some time, and cannot be blamed on Trump, his cancellation of the Trans-Pacific Partnership opens the door for China to take a greater leadership role in the region. With this comes the potential for China to abuse its power.

### Do we catch a cold if China sneezes?

As a nation, we are very reliant on China and its ongoing economic success. Thankfully, we saw China outperform expectations last year, and it is expected that growth will remain strong this year into the 19th National Congress of the Communist Party of China due to be held later this year. However, this isn't a given, and economic risks are increasing. Some of the key risks to the Chinese economy are outlined below.

#### An increase in total debt has created a constant demand for liquidity

This appears unsustainable over the medium term given that China's debt is expected to approach 300% of GDP by the end of 2017. Much of this debt has been funnelled into the property market with residential prices in major Chinese cities rising at an annual pace of 30-40% in 2016. Unfortunately, these flows appear to be speculative in nature given that investment in fixed assets (including real estate) slowed to 8.1% in 2016 from 10.0% in 2015—the slowest in 17 years.

#### Increased capital outflows may pressure liquidity in capital markets

Foreign exchange reserves are currently just below USD3 trillion, which is still a large number, but they have been declining around USD300 billion a year. Increased capital outflows and lower reserves could pressure liquidity in global capital markets, and see the yuan depreciate further, creating inflationary pressures for China. In this environment, China would need to increasingly sell US treasuries, adding further upside pressure to global interest rates.

### French elections—second round polling



Source: National polls, the Economist as at 27 February 2016

The impact on Australia would be meaningful if China slowed significantly—especially if it coincided with higher US interest rates. This could easily lead to a situation where demand for commodities shrinks, the economy slows, house prices fall due to lower offshore demand and higher mortgage rates, and bank profit margins get squeezed due to higher offshore funding costs.

In this scenario, the Reserve Bank of Australia (**RBA**) would undoubtedly be forced to cut interest rates. In addition to weaker commodity prices, this would see the Australian dollar depreciate and provide some insulation for the economy. However, whether this would be enough to keep the economy out of recession would depend greatly on the resilience of house prices, debt affordability, employment, and the extent of any commodity price decline.

### Does it matter if Marine Le Pen wins?

The French presidential elections are due to be held in May, and the leader of the far-right Front National party, Marine Le Pen, has garnered great support. Her preference for France to be independent and exit the European Union (**EU**) has turned what is ordinarily a national election into a global event.

Polls suggest that Le Pen is on course to win the first round of the presidential election on 23 April, but she is unlikely to win 50% of the votes. As such, it will go to a second round of voting to be held on 7 May, and centrist independent Emmanuel Macron, who is pro-Europe, appears to hold a strong lead. If Le Pen were to win, there are many steps that need to be taken to exit the EU—however, as Brexit has shown, anything is possible.

The impact on Australia is expected to be minimal—this is unless Le Pen wins and global markets experience a significant sell-off. In this scenario, markets will price in the downside rapidly. European equities will likely feel the brunt of any selling, but other markets will also be affected in the short-term. Such an event could be positive for Australia as the impact on the domestic economy and businesses should be minimal. However, the Australian dollar may weaken as investors flock to ‘safe’ assets such as US treasuries and the Swiss Franc, and sell ‘risk on’ currencies such as the Australian dollar.

### Does it matter if the UK is part of the EU?

UK Prime Minister Theresa May is expected to trigger Article 50 of the Lisbon Treaty this month after close to nine months of legal challenges. While the impact on the UK and European economies is expected to be negative, the fallout is expected to be ring fenced and contained within the region. As a result, the direct impact of Brexit on Australia is likely to be minimal.

Australian equities may sell off initially if global markets take a ‘risk off’ stance—but there appears no reason why Brexit should have any lasting impact on Australian corporates or the broader economy. As such, any weakness is likely to be a buying opportunity for domestically focussed stocks. The Australian dollar may sell off initially as Brexit is considered a ‘risk off’ event, but the impact is likely to be short term in nature, and have no long-term impact. The Australian dollar should strengthen against the British pound over the medium term as the pound depreciates under the weight of its twin deficits. Fixed income markets are expected to remain responsive to US rates irrespective of how UK interest rate markets behave.

### We continue to advocate diversification

While these events are likely to impact global markets, the experience of Brexit and the US presidential election suggests that it’s increasingly difficult to predict how markets will react. Given the heightened uncertainty, we believe that it is prudent to stay close to our long-term strategic asset allocations and take little ‘tactical’ risk.

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