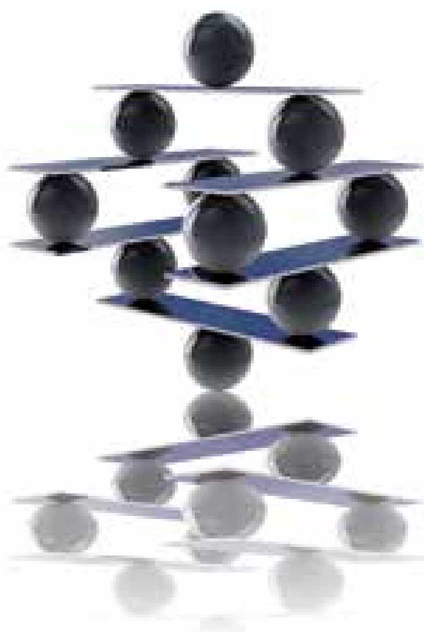
A delicate path

January 2013

As we embark on a challenging journey with the dawn of a the new year, we talk to Felix Stephen, Head of Strategy and Research at Advance about reactions to latest world events and the outlook for key global economies and financial asset markets.



Australia

To stimulate Australia's non-mining sector, the Reserve Bank of Australia (RBA) cut the official cash rate by 0.25% to a GFC low of 3%. We consider a further 0.25% cut in early 2013 to be a strong possibility. Our overall expectation is for Australia's GDP to expand below trend by 2.9% by the end of 2013 and economic growth to outpace other key developed economies.

US

With their decision to target the federal funds rate to the unemployment rate, the US Federal Reserve is inducing Americans into borrowing money with the promise not to raise rates when the recovery gains more momentum.

Japan

With the convincing return of the Liberal Democratic Party (LDP) to political power, it seems that new Prime Minister-elect Shinzo Abe is determined to end the chronic deflationary malaise.

Eurozone

Europe fell into recession again in Q3, and this is likely to extend into Q4. There are increasing calls for the European Central Bank (ECB) to cut interest rates to help support the economy, but ECB President Mario Draghi has watered down prospects of any such action in the near term. Despite encouraging progress in stabilising the debt situation, the outlook for the coming year remains precarious.

UK

Despite confirmation that the UK economy at last returned to growth in Q3, the outlook is weaker growth as the positive impact of temporary factors (Olympic Games and Queen's Jubilee) wane.

China

Current indications suggest the Chinese economy is recovering although latest international trade metrics are rather deceptive.

Felix Stephen
Head of Strategy & Research
Advance Asset Management

How did global markets close out 2012?

Equities outperformed other asset classes and risk assets broadly ended the year with positive returns despite enduring political turbulence and uncertainty. Europe was the best performing region while US 'fiscal cliff' relief brought about buying of equities on the final day of the year. Commodities underperformed as oil demand softened and growth concerns weighed on industrial metals. Bonds were generally positive but underperformed equities. Peripheral European debt was the standout asset in 2012, with Greek and Portuguese government bonds and European equities strong outperformers. Investors increasingly appeared to believe the current economic tail risks of the past few years may be abating, yet 2012 will likely deliver the slowest global growth in three years with the International Monetary Fund (IMF) forecasts predicting advanced economies would grow at just 1.3% (down from 1.6% in the prior year and 3% in 2010).

How did the Australian economy finish the year?

Despite China's slowdown and falling commodity prices, Australia's third quarter GDP increased unevenly by 0.5%. Mining investment was strong, consumption decelerated and public sector demand fell as the Government endeavored to generate a budget surplus. The RBA cut the official cash rate by 0.25% to just 3% in December stating this latest rate reduction would "...help foster sustainable growth in demand and inflation outcomes." Recent economic data releases have been unequivocally supportive and the RBA also revealed that inflation was currently in line with their desired target level but there may be some short term volatility ahead due to the carbon tax.

How did the US economy react to the lead up to the 'fiscal cliff' negotiations?

December's FOMC meeting resolved to keep short term interest rates almost at zero until the jobless rate falls below 6.5% (a move without precedent), and whilst the unemployment was reported at 7.8%, the immense concerns ahead of the 'fiscal cliff', meant this report was better than it looked. There was a welcome degree of health within the economy with job creation spread across healthcare, restaurants , manufacturing and construction , which was indicative of the strong housing market recovery. The government sector however shed 13,000 jobs in December as austerity bit into both state and local government treasuries. The increase in the December ISM non-manufacturing report to a ten-month high also tends to infer that the looming fiscal cliff had only a limited impact upon service sector activity at year's end.

What are the early indications for economic recovery in the US in 2013?

As expected the increase in the debt ceiling was not part of the 'fiscal cliff' bill and this lack of progress coupled with the lack of agreement over the much discussed spending cuts means that fiscal uncertainty will remain for at least a further two months. This has the potential to undermine the lacklustre US economic recovery.

Did the recent Japanese general election ignite any global economic interest?

The Japanese general election of 16 December attracted plenty of international attention due to the opposition Liberal Democratic Party's (LDP) promise to force an entirely new monetary strategy upon the Bank of Japan (BOJ), which has potential repercussions upon the yen, and equity and government bond markets.

What does the LDP win mean for the Japanese economy in 2013?

The LDP's overwhelming victory means it has more than the two thirds majority needed to pass legislation. It appears that the initiatives of the new Prime Minister Shinzo Abe may include the BOJ purchasing construction bonds (Government debt issued to fund public works) in unlimited amounts until the required inflation rate is met; the BOJ, Ministry of Finance and private investors clubbing together to invest in foreign bonds through a public-private fund; and a large fiscal spending stimulus to make the nation's infrastructure "resilient" to natural disasters. The BOJ stated that it would wait until its next gathering in late January before discussing changes to its inflationary mandate.

After so much turmoil, how did the Eurozone economy finish up in 2012?

The Eurozone fell back into recession for the first time in three years as the economies of Greece, Italy, Spain, Portugal, Austria and Holland contracted sharply over Q3. Although better than anticipated growth in the French economy held out hopes of a flat reading for the overall pan Eurozone Q3 GDP figure, a slowing German economy coupled with a shock decline in the Dutch economy essentially erased any possibility of escaping a 'technical recession' (two consecutive quarters of economic contraction).

What's the next step for stabilising the Eurozone's precarious financial system?

In mid-December, leaders took their first tentative step towards the creation of the much mooted banking union after agreeing that Eurozone governments would hand over responsibility for approximately 200 of their largest banks to the ECB, meaning one body will be in charge of overseeing, authorising and (if need be) fining financial institutions. Although this initiative will be formally adopted by nation states by March or April, the actual change will not come into force until 2014.

What is the current status of the UK economy?

Britain's Q3 GDP report revealed that it expanded by 0.9%, the first expansion since the third quarter of 2011. More revealingly, since the beginning of 2008 the British economy has contracted by about 3% - the joint worst performance of any G7 country (bar Italy). November releases of both PMI and retail sales publications suggest that it may struggle to record positive GDP growth also in Q4. The Government is perhaps contemplating a tougher year ahead after the politically independent Office for Budget Responsibility (OBR) revised down its growth forecasts appreciably. The forecast sees the economy expanding by 2%, meanwhile it will be 2017 before we see growth approaching 2.8%.

Is the Chinese economy expected to grow in 2013?

After seven quarters of slowing economic growth, it appears that the Chinese economy is poised to regain impetus. In March, the National People's Congress will unveil its specific economic growth target, but it would appear that the desired level of economic expansion will be focused on striking a balance between 'quality' growth and 'ebullient' growth. Quality growth would see more attention on the environment and domestic sources of demand rather than the export led and infrastructure-focused development seen in the wake of Deng Xiaoping's reforms thirty years ago.

What is the current health of the Chinese export market?

November exports increased at an annualised rate of just 2.9% – a most noticeable deceleration from October's 11.6% increase, meanwhile November's import data revealed a similar tale, essentially breaking what had been generally a strong export story to the US. In the January to November period Chinese exports to the US had risen at an annualised rate of 8.2%, overtaking the European Union as China's main export destination (which saw an annualised decline of -18%). This lack of growth is explained in part by the decline in global commodity prices, although imports of both iron ore and crude oil (two commodities closely correlated to the Chinese growth story) both increased in volume terms. Although overall global demand will probably remain volatile for some time, a sustained recovery of the Chinese economy should filter through to import demand.

What does this mean for investment strategies?

We expect the global economy and financial asset markets to be highly vulnerable to continued geopolitical instability and uncertainty. Both consumption and investment are likely to suffer due to heightened levels of uncertainty and traditional support by central banks to counter negative developments are unlikely to be sufficient given that they have already used up most of the policy options available to them. Our strategy will be to continue to adjust the risk/return profile of our funds in order to protect and enhance capital during these periods of elevated uncertainly and turmoil.

Contact Centre: 1800 819 935 Adviser Services: 1800 650 498 advance.com.au

This document has been issued by Advance Asset Management Limited ABN 98 002 538 329 AFSL No. 240902 (Advance). The information provided is of a general nature only and has been prepared without taking into account the objectives, financial situation or needs of any particular person. It is not intended to constitute investment, legal or taxation advice and should not be considered or relied upon as a comprehensive statement on any such matter. Before acting on the information, a person should consider its appropriateness, having regard to their objectives, financial situation and needs. Whilst every effort has been taken to ensure that the assumptions on which the outlooks given in this document are based are reasonable, the outlooks may be based on incorrect assumptions or may not take into account known or unknown risks and uncertainties. Past performance is not a reliable indicator of future performance. Information from third parties is believed to be reliable however it has not been independently verified. While the information in this publication is given by Advance in good faith, it does not warrant that it is accurate, reliable, free from error or omission. Advance is a member of the Westpac Group.
An investment in a managed fund issued by Advance does not represent an investment in, deposit with or other liability of Westpac Banking Corporation ABN 33 007 457 141 or any other member of the Westpac Group. Subject to any terms implied by statute which cannot be excluded, neither Advance nor any other company in the Westpac Group and their directors, employees and associates accept any responsibility for errors in, or omissions from the information. Current as at January 2013. AD9923-0113jj

ADVANCE