ADVANCE

A renewed outlook

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As the world's leading economies settle into the first quarter of 2013, we talk to Felix Stephen, Head of Strategy & Research at Advance about reactions to latest world events and the outlook for these key global economies and financial asset market trends.

Australia

The Reserve Bank of Australia (RBA) kept official interest rates on hold at 3%, but remain open to further cuts, particularly if evidence suggests a peak in mining investment.

US

The US continues to show encouraging signs of economic traction despite unexpectedly contracting in Q4, whilst the debt ceiling, entitlement spending and defense spending cuts remains an ongoing concern.

Japan

A sizeable loosening of monetary and fiscal policy in Japan has occurred over the past month on the back of the Liberal Democratic Party's landslide victory in the December elections.

Eurozone

An upbeat assessment from the European Central Bank (ECB) is leading a more positive tone in the Eurozone along with better than expected data, however ongoing political issues prevail and banks, consumers and businesses remain cautious.

UK

The extent of the UK's economic contraction in Q4 took many by surprise, heightening expectations of a 'triple-dip' recession to follow, but there is cause for cautious optimism that any renewed recession will be short-lived.

China

Recent evidence suggests that the Chinese economy is showing signs of recovery after slowing down for the majority of 2012.

How have global markets performed since the beginning of 2013?

Risk assets started the year strongly thanks to improved global sentiment towards Europe's sovereign debt crisis, encouraging data from China and the last minute temporary US 'fiscal cliff' resolution. These factors also saw global equities outperform for the month. Japanese equities continued their strong rally and both industrial and financials (led by banks) outperformed. Bonds have underperformed although the increase in yields remains orderly, whilst European corporate credit lost ground as investors paused after 2012's strong performance, but commodities and hedge funds performed strongly.

What were the key reasons behind the RBA's decision to keep interest rates on hold?

Firstly, the downside risks to global growth appear to have abated and secondly, sentiment in financial markets has continued to improve in recent months with risk spreads narrowing, the sharemarket making further gains, long term interest rates of highly rated sovereigns remaining at exceptionally low levels, and borrowing conditions for large companies proving very attractive. Some areas of the domestic economy like residential property and export growth have been strengthening and also there is a lag between interest rate adjustments and their full impact on the real economy. Whilst showing some early signs of support, the full impact will still take further time but there appears to be little urgency for the RBA to cut rates this month.

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What is the early outlook for growth in Australia in 2013?

Latest evidence suggests moderate growth, despite an encouraging recovery in consumer and business confidence. Consumer spending has moderated considerably based on retail sales data. Sales have fallen for the past three months with the overall effect that sales were flat in the December quarter however sales of new motor vehicles (not captured in retail sales data) have increased a sharp 17.9% over the past year, with new sales levels at an historical high, thanks to the strong AUD and internet sales. The business sector also rebounded strongly and the business conditions index (a measure of hiring, sales and profits) improved. At current levels both confidence and conditions remain well below long-term average levels and businesses remain very concerned, with the weakest sectors being wholesale, manufacturing, retail and construction.

What is the status of the US economy post the 2012 'fiscal cliff' negotiations?

Recent data is positive except for consumer confidence, which showed significant weakness in December and January. Given the services sector is the largest employer, the labour market should continue to strengthen. Recent housing data has been positive, suggesting a sustained moderate recovery. The risk of a government default has been reduced for now with Congress voting to suspend the debt limit for three months but the next looming crisis is 1 March when sequestration is set to take effect, meaning broad and automatic across-the-board cuts to most categories of government spending, with military and entitlements bearing the brunt.

How has the new Japanese government been addressing its fiscal issues?

The government announced a fresh stimulus package worth $220bn and likely to add 2% to Japan's GDP growth rate and boost employment by 600,000. It comprises increased spending on public works, disaster recovery and increased aid to small business. Military spending of around 100bn yen has also been announced, the first increase in a decade as territorial tensions between Japan and China intensifies. It is uncertain how quickly such measures will flow through to stronger domestic activity and the recent weakness in the yen is important to support stronger export growth whilst domestic demand remains subdued.

Is the Bank of Japan's (BOJ) 2013 monetary policy realistic and measurable?

The BOJ introduced a 'price stability target' (inflation) of 2% y/y to pursue monetary easing as soon as possible, and an 'open-ended asset purchasing method' through a virtually zero interest rate policy and purchases of financial assets for as long as appropriate. This will start in January 2014 for an indefinite period, involving monthly asset purchases of 13trillion yen. With current inflation at -0.1%, it will be some time before the 2% target is reached and the new forecasts suggest it will not be met in the next two years.

What was the ECB's analysis of the Eurozone performance in January?

The European Central Bank (ECB) surprised the market with an upbeat assessment, saying there has been "...a significant improvement in financial market conditions and a broad stabilisation of cyclical indicators..." These include sharply lower bond yields and credit default swaps, higher equity prices and lower volatility, strong capital inflows into the Euro area and a recovery in bank deposits. In light of these developments, a unanimous decision was made to not cut interest rates despite the support in December for a rate cut, implying a more optimistic outlook.

What are the most serious risks to recovery in the Eurozone?

At the forefront is political instability, notably the impending Italian elections and allegations of corruption in Spain. Another risk is that geopolitical issues are intensifying thereby threatening global confidence and potentially destabilising financial markets.

What is the British Government's response to the UK's negative growth patterns?

The unwinding of the Olympic effect had a negative impact as did a slump in mining production. Services sector output, which makes up around 75% of GDP, was also flat in the quarter therefore it is unsurprising that latest growth figures have increased calls for the government to ease up on austerity measures to help restore confidence and activity. The government has said it will continue to press ahead with fiscal consolidation to "...ultimately deliver stronger growth in the next few years."

Is the UK likely to fall into a 'triple dip' recession in Q1?

Despite its resolve there is a growing expectation that the UK will lose its 'AAA' rating. However, there are reasons for cautious optimism with credit conditions appearing to have improved and expected to gather further momentum in Q1. This easing was a factor in the Bank of England's (BOE) January decision to keep policy unchanged and partial data released has been encouraging. January's manufacturing PMI survey showed moderate growth for the second consecutive month, but the services sector PMI survey is a more reliable guide, with results suggesting a reasonably good start to 2013. These results together suggest the UK may indeed escape falling into a 'triple dip' recession this quarter.

Has China's Q4 growth followed through into 2013?

Fourth quarter GDP data revealed that China's economic growth rate increased for the first time since December 2010, reflecting acceleration in industrial production and exports, and stronger growth in consumer spending and housing. This is on the back of the government's efforts and incentives to stimulate growth such as encouraging consumer spending on energy-efficient home appliances to spur retail sales. The improved trend in growth looks to have continued with the latest manufacturing PMI data showing expansion at its fastest pace in two years. The most positive aspect was new orders (mainly domestic) increased to 53.7 — the highest level since January 2011 and the fourth consecutive increase; whilst new export orders also increased and are now sitting above the crucial 50-level.

What will be the focus of the new Chinese government in 2013?

The latest data is encouraging but comes as inflation has edged up again headlined by a sharp jump in food prices. Sustaining the recovery without igniting inflation will continue to be the focus. Underlying this is a medium term aim to re-balance the economy to consumption and away from investment and exports, the key drivers of growth over the past 10 years. The ongoing territorial dispute with Japan has already had a dampening impact on trade and will do so until resolved. To successfully transition the economy to a consumer-led one, the government must address the factors hampering consumption like low income levels, lack of a social security system and the widening gap between the rich and poor. Overcoming these issues will take time however.

What does this mean for investment strategies?

We had been optimistic that central bankers will do what ever it takes to hold global growth from spiraling lower and this would benefit risky assets. However, it now appears that risky assets have priced-in quite a lot of positive news and are therefore vulnerable to unanticipated shocks such as political uncertainties and turmoil. We would suggest that investors should gradually lighten their risky asset holdings and move into a defensive position until there is more clarity and certainty about future geopolitical developments. The reward is presently not sufficient enough for taking on additional risk.

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