Balancing growth and risk

March 2013

With political turbulence in Europe, new governments in power in Asia and sequestration to hit the US, we talk to Felix Stephen, Head of Strategy and Research at Advance about reactions to the latest world events and the outlook for key global economies and financial asset markets.

Australia

Official interest rates were kept on hold at 3% with the easing bias dependent on the non-mining sector's capability to offset the expected slowdown in mining investment.

US

In a gradually strengthening economy, investors are weighing up a potential imminent wind down of current policy settings.

Japan

Despite Japan's economy contracting for the third consecutive quarter, the outlook is positive with growth supported by the new government's aggressive fiscal and monetary policy, and the strengthening global economy.

Eurozone

The Italian election result has dampened any positive sentiment that had been emerging about the Eurozone economic/political outlook and heightens the risk of the debt crisis flaring up once again.

UK

Amid a still weak UK economy, the latest Bank of England Inflation Report suggests a more flexible approach to monetary policy, calling for the government to focus more on structural reform.

China

China's Lunar New Year holiday in February made it difficult to accurately gauge its current economic performance but most major indicators suggest a stronger momentum, except the February PMI survey.

Why did the RBA keep interest rates on hold?

Better than expected economic data meant official interest rates remained at 3%. The key driver was a more positive assessment on the investment outlook as suggested by the December Quarter Private Capital Expenditure Survey, which showed a downgrade to investment plans for 2012/13, but indicated a positive increase in plans for 2013/14, especially for mining. This implies that investment in the sector will remain supportive of growth for longer and is unlikely to collapse sharply but rather gradually slow. Governor Stevens noted that the AUD remains higher than expected given recent falls in export prices, and information from the Central Bank suggested it is overvalued by around 5%. The RBA does not see a need to directly intervene to lower it, but would lower interest rates if the AUD continues to be a significant drag on the economy.

What is the economic forecast for Australia for the remainder of 2013?

Resources sector growth is expected to peak later in 2013 then gradually decline. Investment intentions outside resources show little improvement and we expect the RBA to cut rates by at least a further 25bp to help soften the blow. Although encouraging, the uncertain jobs market and continued aversion to household debt will limit the strength of the upturn. Our expectation for inflation to stay within the RBA's target band of 2-3% will make the decision to ease monetary policy more acceptable and the positive influences will ensure growth remains solid but risks tilted to the downside stem from China's growth and a significant deterioration in the Eurozone or the US. Our 1-year outlook is for growth to slow below trend to 2.6%y/y to end March 2014.

Felix Stephen
Head of Strategy & Research
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How will the 1 March sequestration impact US economic confidence?

Creating a sustained economic recovery is challenging given the tightening of the fiscal policy due to sequestration. Downside risks are potentially big with the fallout from sequestration and high debt ceiling. The government has taken extraordinary measures to meet financial obligations since the limit was hit on 31 December suspending the debt ceiling until 19 May. If Congress don't raise the limit by that date there is a detrimental economic risk that the government could default on financial commitments, impacting military salaries, social security, Medicare payments and unemployment benefits. General consensus is outright default will be avoided but uncertainty will impact spending and investments. Reasons for cautious optimism include financial conditions remaining easy and overall rates remaining near historical lows, a clear indication that the stimulatory policy is working, particularly in housing. Positive employment numbers have also helped despite higher taxes in January and imminent cuts to spending. Business confidence showed a much stronger improvement in February and augurs well for a moderate recovery in the economy against impending fiscal cutbacks.

We expect growth to come in at 2.4%, with a softer first half as fiscal austerity and the debt ceiling uncertainty weighs on confidence and activity but from late 2013 we expect stronger investment, employment and solid consumer spending. Fiscal deadlock is the key risk, followed by the European debt crisis.

What does the third consecutive contraction of the Japanese economy suggest?

Despite contracting for the third consecutive quarter, the outlook for Japan is positive. We expect GDP to grow by 0.9%y/y to end March 2014, marginally below trend but up on the current pace. Risks are weighted to the downside stemming from uncertainty surrounding key export growth. Should global growth navigate positively through the next six months, there is reasonable risk that Japan's growth could surprise. The overall 1-year outlook for Japan is that growth will gather momentum as domestic demand picks up on the back of government and central bank stimulus efforts and exports garner support from expected continue weakness in the yen and strengthening global demand. There is a risk to exports but stronger domestic demand should be able to partly offset this impact.

How is the new Japanese government addressing fiscal concerns?

The government is committed to kick-starting growth using all policy weapons including a stimulus package focussed on spending, estimated to add 2% to GDP growth. There is speculation that further measures may be announced and they may shelve plans to double consumption tax. This has raised concerns about the government's commitment to fiscal reform when public debt is more than twice the size of its economy, and has potential negative implications for markets via bond yields and the economy. The new BOJ governor Haruhiko Kuroda has agreed that a more proactive approach to inflation is needed.

How will the result of the Italian elections impact the Eurozone economy?

The unexpected result with no major party winning a majority in the Senate to govern properly and likely return to the polls has manifested itself in a blowout of Italian government bond yields and sharply lower equities. Italy's political deadlock means limited progress in much needed economic and fiscal reforms with concerns about renewed crisis in European debt markets threatening global markets. The possible implications for the Eurozone is weaker confidence and activity. This is concerning given the economy plunged in Q4 2012 at its fastest pace in nearly four years.

Our view is for growth to turn positive based on policy developments implemented in late 2012 (fiscal union, banking union, outright monetary transactions, stability mechanism) successfully building a safety net to match occurrences like the Italian election.

What role does Germany have to play in stabilising the Eurozone economy?

The latest data points to a growing divide between Germany and the rest of the region, one that Germany may not be able to uphold if the debt crisis escalates. As the region's largest economy with the best prospects, Germany fell 0.6%q/q on the back of declining exports and investment and sharper declines were experienced in France, Italy, Spain and Greece. Recent indications show Germany bouncing back led by manufacturing and construction with financial conditions expected to remain accommodative. Once the uncertainty of the German elections are out of the way in September this should filter through to the real economy. Our 1-year Eurozone outlook is facing downside risks. It will manage growth of +0.5%y/y to end March 2014.

Will the UK recover from its 'triple dip' recession?

Our outlook for the UK is a slow recovery with a growth rate of +0.8%y/y to the end of March 2014. Inflation is expected to continue to overshoot the Bank of England's (BOE) 2% target due to a weaker GBP and government induced price hikes. The austerity programme will continue and monetary policy will remain very accommodative with the likelihood that further quantitative easing (QE) will be implemented. Latest economic news is disappointing but may have been partly impacted by the recent extreme weather. Most concerning was the key PMI surveys showing manufacturing and construction losing considerable momentum in February. Encouragingly, housing sector activity expanded marginally and there was positive improvement in the employment index.

How has China's economy fared so far in 2013?

Latest economic releases are positive but distorted as a result of the New Year holiday, which fell in February this year and January last year. The size of strength in some indicators suggests that activity has stepped up, most notably the trade numbers, which showed a 25%y/y jump in exports and a 28.8%y/y jump in imports. As much as we can infer, China's economy is continuing to recover from the softness evident throughout most of 2012, but the pace looks to be fairly moderate. Government efforts to stimulate growth through a pickup in bank lending and government spending in 2012 are having an impact however it continues to face the challenge of finding the right balance between preventing speculative bubbles, especially in the property sector, and keeping a healthy growth rate.

What specific challenges does the new Chinese government expect in 2013?

The new leadership has recently warned of the challenges facing the economy in 2013 from a potentially unstable and weak international environment. Export growth can no longer be relied upon as the key driver of growth. We do not expect a major turnaround in monetary policy this year but some reigning in of credit growth as the People's Bank of China looks to keeping property prices in check backed up by continued restrictions on property ownership and tax changes. Our forecast is for inflation to increase to 3.3% by end March 2014, up from its current 2% pace.

What does this mean for investment strategies?

Paying sufficient attention to headwinds to economic growth and geopolitical instability are of great importance when attempting to navigate volatile and turbulent financial asset markets that continue to be dominated by forces generated by a fragmented global 'Political Economy'. Continuing to rely on tools that in the past were of tremendous help when analysing global financial asset markets is fraught with danger. The 'new world order' demands that investors ask themselves the key question, 'Is the reward sufficient enough to compensate for the risk?' when making investment decisions. We suggest that investors should be cautious when taking on risk at present levels.

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