A cautionary quarter

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With the debt crisis exacerbating in Europe and new economic strategies and budgets announced for the UK, Japan and China, we talk to Felix Stephen, Head of Strategy & Research at Advance about reactions to the latest world events and the outlook for key global economies and financial asset markets.

Australia

The Reserve Bank kept interest rates on hold at 3% suggesting an easing bias if the non-mining sector lacks momentum to support the economy. The housing sector provides the clearest indication that previous interest rate cuts are starting to flow through although private consumption and business investment are lagging.

US

Recent US economic releases suggest the growth momentum has again slowed, expected with sequester spending cuts and debt ceiling negotiations. Uncertainty continues to weigh on investment and spending decisions however positive fundamentals are expected to see the growth momentum pick up later in 2013.

Japan

The new Bank of Japan Governor announced an aggressive plan to remove deflation. The scale was much larger than expected, immediately showing a positive impact on the sharemarket and pushing the Yen lower. This formally begins the new joint approach between the BOJ and the new government to reflate the economy.

Eurozone

The bailout plans for Cyprus was finally reached but not before markets and confidence had suffered. The ECB monetary policy meeting kept policy unchanged. Downside risks to the economy were highlighted with the hint that the ECB would act to ease policy further if recovery was limited in the coming months.

UK

Subdued economic activity and bad weather were significant factors impacting the UK economy and the 2013 Budget outlined various tax cuts and spending measures aimed at helping businesses, families and homebuyers in order to stem the decline in economic traction. Fiscal deficit will not be reduced as quickly as hoped but the Chancellor's measures aim for economic growth to raise revenue and reduce deficit.

China

China's economy data releases indicate a reasonable pace of growth. The economy should expand by around 7.5% in 2013 but inflationary pressures will pose a challenge to the new government as it aims to transform the economy from investment and export to a consumer driven economy.

How did the global markets fare at the end of Q.1 2013?

Risk assets mostly gained in March, extending year-to-date gains. Global equities outperformed other asset classes while domestic equities were up +8.0%. Global REITs and bonds outperformed domestic equivalents while most commodity prices were negative . Japan was the strongest regional equity market although the Cypriot banking problems tested global investor sentiment. Emerging market equities underperformed developed market equities while fixed income markets also generally underperformed. Credit was the best performing sector while commodities lagged, with the exception of natural gas because of adverse Northern Hemisphere weather conditions. Energy outperformed, precious metals and agriculture underperformed and industrial metals fell heavily.

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What is key to stronger domestic economic activity in Australia?

Ensuring conditions remain accommodative is crucial. Sectors heavily exposed to the AUD like manufacturing and tourism will be slower to gather momentum, but the housing sector continues to show signs of benefiting from easier financial conditions, improving affordability and market confidence. Consumer confidence is increasing and labour market data was very encouraging, indicating stronger employment growth, but conditions remain difficult for industries like manufacturing and construction. At least one further cut in interest rates from the Reserve Bank is likely in this cycle but we question whether this will be enough to offset a significant slowdown in mining. Overall credit growth remains very weak compared to prior to the GFC and whilst the 3% cash rate may be at historical lows, current lending rates are not therefore the Reserve Bank may need to reduce rates further to lower lending rates.

How is the US economy faring so far in 2013 after a tumultuous 2012?

The housing market recovery is on track although recent data has been below expectations, and the manufacturing sector continued to expand but at a slower pace with uncertainty related to government spending and policies hampering activity levels. Slower growth was shown in new orders and production, but the employment index and export orders climbed. The services sector also slowed and although still growing, there is concern about economic uncertainty. The labour market continued to improve at a very slow pace. Unemployment did manage to decline but because of a fall in the labour market participation rate, it's lowest since May 1979. The consumer sector is holding up despite the rise in payroll tax, with spending, which makes up about 70 per cent of the economy, having its strongest gain in five months, reflecting stronger income growth. Lower fuel prices, a stronger equity market and the housing recovery are all supporting the consumer.

What is predicted for the US economy over the coming months?

Latest spending numbers are encouraging but consumers still appear to be holding back and the pace of growth is much less than prior to the GFC. Spending should gain stronger momentum once fiscal issues dissipate and business becomes more inclined to invest and hire. The headwinds from fiscal tightening will obviously have a near term negative impact but the fundamentals are good for a stronger growth trajectory. The Federal Reserve's key objective is to achieve a substantial improvement in the labour market so the unexpected slowdown in employment growth and the impact of sequester cuts suggest it may be well into 2013 before consistent improvement is seen in labour market numbers with no variation in asset purchases until then.

What does the new Bank of Japan Governor's economic plan entail?

The new Bank of Japan (BOJ) Governor, Haruhiko Kuroda's aggressive plan to rid the economy of deflation had an immediate positive impact on the sharemarket and pushed the Yen lower. The crux is to double the money supply and amounts outstanding of government bonds (JGB's), and more than double the average remaining maturity of JGB purchases. Some estimate it will expand the bank's balance sheet by 1% of GDP each month this year and 1.1% per month in 2014. Money supply will be the main policy target and the BOJ will purchase JGB's so that their amount outstanding increases at an annual pace of $50trn and the length of maturity will be extended to seven years with all maturities eligible for purchase. There will also be increases in purchases of ETF and Japanese real estate investments and monetary easing outlines will continue. The asset purchase program to buy short-term debt will be scrapped and all bond purchases consolidated.

What has been the response to this new program?

Early reaction has been very positive with bond yields declining that would perhaps encourage business and households to invest and spend. The equity market has strengthened while the Yen tumbled against the USD, helping exporters. The question is will this initial confidence be sustainable to achieve what previous authorities and policies have been unable to for the past 15 years? It appears so with unity between the government and the BOJ driving optimism, but there will be hurdles.

How has the Cypriot banking collapse impeded Eurozone recovery plans?

An agreement between Cyprus officials and the EU was reached but not before markets and confidence suffered. A key repercussion was concerns about the safety of bank deposits following comments by the Dutch Finance Minister that the Cypriot deal could serve as a "template" for other European bank re-capitalisations. He has since retracted his comments with ECB President, Mario Draghi stating: "Cyprus is no template". It resulted in nervousness amongst depositors, particularly in weaker banks and should other indebted nations seek bailout, the prospect of bank runs now looks increasingly likely. Against this and further regional economic weakness the ECB kept policy unchanged hinting they would ease policy further if activity failed to show some recovery in the coming months.

What are other key concerns hampering economic recover in the Eurozone?

The manufacturing sector contracted for the 20th consecutive month in March, with declines in factories in Germany and Ireland, which previously had held up well. The services sector contracted at its fastest pace since late last year and combined with the manufacturing PMI results shows an accelerated rate of decline in overall activity indicating the downturn shows no sign of abating. Businesses are increasingly concerned about the debt crisis and ongoing political instability, whilst unemployment reached another record high in February of 12% including 3.6 million people aged under 25.

What did the 2013 UK Budget delivered on March 20 announce?

Various tax cuts were announced including to the Employers National Insurance Tax and Corporate Tax rate (now the lowest business tax of any major world economy). Significant spending measures helping businesses, families and potential homebuyers were also announced including the controversial 'Help to Buy' scheme to help people buy their own homes. This enables purchasers to put down a 5% deposit on a newly built home with up to 20% being funded by a shared equity loan, interest free for the first five years. This effectively means the government takes a stake in the value of borrowers' homes. A new mortgage guarantee scheme to increase availability of loans to all homebuyers and easing the deposit required was also announced. There are concerns however that this all may create another housing bubble. The Budget shows the fiscal deficit will not be reduced as quickly as many believe it should, but the new growth measures are integral to raising revenue and reducing deficit. Economic forecasts were sharply cut and inflation forecast to remain above 2%.

How is the Chinese economy faring post the Lunar New Year holiday?

Latest indications show China's economy is growing at a reasonable pace but inflationary pressures will pose challenges to the new government's focus on transforming the economy from investment and export focused to consumer-driven. Recent news is mixed but may still be influenced by the Lunar New Year holiday. Industrial production and retail sales came in below expectations in February but manufacturing and services are continuing to moderately expand whilst the sharp improvement in new domestic orders and export orders to the US and Asia is encouraging. Signs of inflationary pressures are building in consumer prices, food prices and property, with authorities announcing stricter implementation of a capital gains tax on second home transactions, strengthening restrictions on home buying and increasing loan rates for those buying a second home. Authorities in individual cities announced even further measures.

What does this mean for investment strategies?

The world is a highly complex and challenging place and investment decisions must be made in a multi-disciplinary framework in order to ensure capital protection and enhancement. While central banks try their best to stimulate growth and stronger economic traction, elevated levels of geopolitical uncertainty continues to weigh heavily on global economic activity. This is why with so much liquidity channeled into the global financial system, global growth trajectory continues to be so anemic. The risk to investors is that with so many unresolved issues simmering beneath the surface, global financial markets are highly vulnerable to unanticipated shocks and spikes in volatility. Given our philosophy that one should only take on risk if sufficiently rewarded, we believe that investors should remain cautious because global equity markets appear to be quite mature, after four years of price appreciation.