A timely reflection

ADVANCE

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As we look ahead to the second half of 2013, we ask Felix Stephen, Head of Strategy & Research at Advance to reflect on the year to date, and discuss the latest world events and the outlook for key global economies and financial asset markets.

Australia

The Reserve Bank left interest rates unchanged in June and although a further rate cut is possible, recent RBA minutes have now tempered its easing bias given the decline in the Australian dollar and accommodative financial conditions. The Federal Government's 2013/14 Budget was announced, indicating a softening in the government's commitment towards fiscal consolidation due to challenges faced by the economy due to the decline in mining activity.

US

There are concerns and speculation regarding the possibility of the Federal Reserve tapering its quantitative easing (QE) program by gradually reducing the monthly purchase of fixed income securities, just when the US economy faces uncertainties due to the impact of the sequester and increased volatility in financial markets.

Japan

The positive boost from stronger than expected GDP growth in Q1 in Japan was offset by continuing deflation, raising doubts that the Bank of Japan will achieve its 2% inflation target by 2015, a commitment that they have however publicly reaffirmed.

Eurozone

The Eurozone experienced a sixth consecutive quarter of negative GDP growth with the currency bloc contracting by -1.0%, a tenth of a percentage point more than the contraction recorded in the final quarter of last year.

UK

As anticipated by the market, the second estimate of the UK's first quarter GDP report came in unchanged, avoiding an unprecedented triple dip recession, however its economic recovery since the crash of 2008 has been the slowest since 1921.

China

With China's economy losing momentum, officials suggest that long overdue structural reforms will support a more balanced and sustained future growth path. However, this is likely to result in a growth trajectory that is well below the elevated ten-year average, placing the nation on a slower and bumpy growth path.

Felix Stephen
Head of Strategy & Research
Advance Asset Management

How did Australia's economy perform over the March quarter?

The March quarter was Australia's slowest pace of growth since December 2011 when the Reserve Bank (RBA) began its monetary easing cycle. Soft domestic demand was caused by weaker than expected growth in household consumption and business investment and a decline in motor vehicle spending (the key source of spending in Q4). Activity in the consumer, transport and health services eased slightly, while manufacturing, utilities and construction witnessed more significant contractions. Although dwelling investment was flat over the quarter, this sector grew at its strongest yearly pace since mid-2011, thanks to a series of interest rate reductions. Latest partial housing data suggests building approvals are up, indicating a positive outlook for construction. We anticipate prices will trend higher but the softer economic outlook is likely to limit the potential of a house price bubble emerging in the near term. The external sector was by far the biggest contributor to growth, adding 1%, reflected by a surge in exports.

Why did the RBA keep interest rates on hold and what does it mean for the economy?

Interest rates were left unchanged as Australia's economy struggles to cope with a declining mining sector. RBA Governor Stevens said that the below trend growth was likely to continue but "...the easier financial conditions now in place will contribute to a strengthening in growth over time, consistent with achieving the inflation target." The Australian dollar has borne the brunt of this adjustment process but could be a supportive factor in 2014. August will be the earliest likely timing of another rate cut should it occur, but the question remains as to whether it is required? Stevens said policy easing over the past 18 months has helped support activity and "...further effects can be expected over time." Against this, the Government's 2013/14 Federal Budget was announced suggesting a softening in the government's commitment to fiscal consolidation due to challenges faced by the economy from a decline in mining activity and as the economy transits towards non-mining led growth.

We expect a challenging year that experiences more subdued growth in the near term being replaced with a gradual and bumpy recovery supported by easing financial conditions and tailwind support of a relatively weaker Australian dollar. However, uncertainty and weakness in the global economy and a more adverse deterioration in the labour market have the potential to significantly dampen business and consumer activity.

With the US economy heading into uncertain territory, what is the forecast?

US growth momentum keeps declining due to the impact of sequestration and increased volatility in financial markets, as speculation of a tapering of quantitative easing impacts investor confidence. Our outlook is anchored between a 40% probability of growth around trend of 2.5%, and a worst-case scenario (35% probability) of only 1.8% growth. The Federal Reserve remains flexible and any policy change will be subject to general economic performance and sustained labour market improvements. The Federal Reserve is faced with balancing sustainable growth whilst managing market expectations, but the biggest unknown is how the economy will react to heightened volatility and sequestration cuts. It is most likely that economic activity will slow, but its extent is uncertain. The risks are that financial market volatility will increase sharply not only due to tapering of quantitative easing by the Fed but also as law makers struggle to reach a bipartisan compromise for an increase in the US debt ceiling for fiscal year 2014, due sometime in late September/early October.

Are the fiscal policies driving planned growth in the Japanese economy?

The Japanese government's fiscal policy announcements are having a stimulatory effect on growth although uneven across sectors. While Q1 growth was attributed to stronger consumption and exports, business investment remained subdued. June data looks promising with industrial production rising for the fifth consecutive month but latest price data shows a slow and bumpy road towards reflating the economy. With two of the three policy pillars now in place, there is increasing focus on the third

which is structural reform, designed to encourage business investment and boost employment and wage growth. Key proposed areas include deregulation in energy, environment and healthcare, encouraging entrepreneurship, and making the labour market more flexible through immigration while encouraging women into the workforce. Structural reform will be the most difficult but most fundamental pillar to be implemented.

We expect the Japanese economy to gain stronger traction as stimulus measures are implemented but equity and bond market volatility could derail business and consumer confidence and with that, economic activity. However the Government and Bank of Japan will most likely keep pursuing their efforts to revive a stagnant and key economy given that they have found a lot of support for these new measures from the global community.

Is the Eurozone seeing any stability after a bumpy start to the year?

The decline in Q1 was the Eurozone's sixth consecutive quarter of negative growth. Germany did move back into the black in annualised terms however, its economy grew by a scant 0.9% last year. France posted a -0.2% quarterly contraction leading to a double-dip recession. The Italian economy shrank into a seventh consecutive contraction, whilst Spain and Portugal also continued relentless contractions. It is difficult to envisage a return to growth in the short term with continued contractions in overall activity likely, although the European Central Bank (ECB) remains adamant that a recovery may still emerge over the latter half of 2013.

The UK avoided an unprecedented triple dip recession, so is recovery on the cards?

Since the 2008 crash, UK economic recovery has been at its slowest pace since 1921. The UK's services sector, which accounts for two thirds of national output, was a positive contributor towards growth while trade and business investment was a negative contributor. Although the sixth consecutive increase in household expenditure is a positive outcome, they will set back the Government's plan to steer the economy away from its reliance upon consumer spending and re-balance it with manufacturing-led export growth. With inventory accumulation a substantial growth driver over the last quarter, companies may slow production until stronger demand becomes apparent. Unemployment also increased, whilst the number employed declined by the most significant amount in over a year, suggesting a slowing labour market in the future.

Is China still losing momentum and how will the Government deal with the fallout?

The Chinese economy keeps losing momentum in the absence of any central Government support or significant stimulatory measures being introduced as the new administration remains focused on reforming the economy through structural change to support a more sustained pace of growth. China is at risk of falling into a middle-income trap, resulting in several years of stagnant growth. Reform is crucial but China will struggle to achieve stronger growth prospects due to manufacturing and services suffering from weakening domestic and export demand. The services sector is also showing signs of slackening activity, with the business expectations index posting one of the weakest readings in its history. Other key data also point to subdued activity in fixed asset investments, retail sales and industrial production. Consumer inflation remains a concern with food inflation rising due to bad weather.

The new government has stepped up its commitment to transitioning China's economy to be more balanced and sustainable. A transformation of this nature and magnitude takes time and is difficult to implement because of the sheer size of the Chinese economy.

What does this mean for investment strategies?

It becomes increasingly obvious that many economies are going through a period of transition while monetary policy makers debate the effectiveness of ultra easy policy.

The best guide to investment strategies, either growth or defensive biased, is the level of financial asset market volatility. We believe that elevated volatility and turbulence is indicative of periods of transition and remain cautious about assuming portfolio risk if the reward is not satisfactory.

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

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