A mid-year reflection

July 2013

ADVANCE

As we move into the second half of 2013, we ask Felix Stephen, Head of Strategy & Research at Advance to reflect on the year to date, and share his thoughts on recent world events and the outlook for key global economies and financial asset markets.

Australia

The Reserve Bank (RBA) left official interest rates unchanged with further cuts now dependent on the economic response to previous cuts and the trajectory of the trade weighted value of the Australian dollar (AUD). With interest rates already at historic lows, a further decline in the AUD will support easier financial conditions that would in turn support domestic economic activity.

US

The US economy is facing new uncertainty with investor expectations suggesting that the US Federal Reserve (Fed) will start tapering its quantitative easing program. Mixed economic data ranges from the negative impact of sequester cuts becoming more pronounced to resilience in the housing market and consumer spending.

Japan

Shinzo Abe's reflationary strategy appears to be generating economic traction and driving corporate and consumer optimism. However several years of solid economic performance is needed to claim any success. The Bank of Japan (BoJ) did not announce any further monetary stimulus measures, but Abe did announce further structural reforms aimed at boosting economic growth.

Eurozone

Stabilising economic activity and better than anticipated economic data releases saw the European Central Bank (ECB) re-affirm its commitment to maintaining an accommodative policy stance to help support recovery in the medium term. The ECB also stated that it would keep interest rates at record lows for an extended period.

UK

Economic data was fairly unchanged from last month, confirming UK's subdued growth outlook. There appears to be hope riding on the new Bank of England (BOE) Governor, Mark Carney to provide continued monetary policy support to boost investor and consumer confidence and for the UK to recapture economic traction.

China

Despite signs of slowing growth and tightening credit conditions, authorities have defused expectations of further policy stimulus, reflecting concerns of inefficient investments and heightened fears of systemic risk within the banking sector. Short-term growth appears to be forfeited for sustainable and balanced long-term growth.

How are global markets faring at the mid way point of 2013?

Positive first half performances in a majority of financial assets were supported by central bank initiatives to stimulate the global economy. However, concerns that easy liquidity conditions may be coming to an end raised investor anxiety in May and June this year with financial market participants agonising over the prospect of the US Federal Reserve (Fed) reducing its bond-buying program and ending its era of ultra easy interest rates. Markets are also precariously positioned due to slow global growth; the possibility of the Fed's tapering of quantitative easing, and rising inflation across emerging markets leading to macro volatility. These issues will continue to dominate investor behaviour in the coming 12 months.

Felix Stephen
Head of Strategy & Research
Advance Asset Management

How has the weakening dollar impacted the Australian economy?

Having depreciated by around 10% since early April, the AUD still remains elevated on a trade weighted basis, leading RBA Governor Stevens to suggest that "...the exchange rate will depreciate further over time, which would help foster a rebalancing of growth..." The positive impact of a weaker trade weighted AUD on financial conditions should ultimately flow through to support stronger economic activity. Financial conditions should be the most accommodative for the first time since late 2009 should the RBA cut rates or the AUD decline further. The RBA acknowledges the potential inflationary impact from a weaker currency but does not expect a spike above its inflation target. This is perhaps the RBA's view of economic growth tracking below trend, and weak demand limiting the opportunity for businesses to pass on currency-induced higher prices to the end user.

What is the US Federal Reserve's policy plan in light of economic uncertainty?

The US continues to face considerable uncertainty, particularly in relation to economic policies generating higher volatility in financial asset markets due to expected tapering of quantitative easing and headwinds generated by the sequester. The Federal Open Market Committee (FOMC) has a more optimistic 2014 GDP growth forecast along with declining unemployment and marginally lower inflation. However, the Fed's policy is likely to be flexible with Chairman, Ben Bernanke stating that the pace of asset purchases could be reduced more quickly if economic conditions improve faster than expected. He also stated that tapering could also be delayed if the outlook was to become less favourable, and the pace of purchases could even be increased for a time if conditions were to deteriorate significantly.

How is the Japanese government's policy playing out?

There are encouraging signs that Shinzo Abe's push to end deflation is generating traction, with the rise in optimism in business, manufacturing, industrial production, the consumer sector and the labour market. Given inflation is still well below target, several years of solid economic performance are needed before any success can be claimed. The next iteration of Abenomics is structural reforms, which are crucial to boosting long-term growth prospects. Whilst fiscal and monetary aspects are important in driving short-term growth, they must be accompanied by structural reforms in relation to the workforce, productivity and innovation. Abe's plans include targeting annual gains of 3% or more in gross national income per capita, setting up special economic zones to attract foreign business, providing tax incentives and reviewing business regulations to create an international business environment, de-regulating the electricity retail sector, boosting the total value of infrastructure projects, tripling infrastructure exports and supporting new entrants into the health sector.

Are the early signs of some economic stability in the Eurozone sustainable?

Recent data releases were more positive than expected however volatility in financial asset markets saw the European Central Bank (ECB) re-affirm its commitment to accommodative policy for an extended period to help support economic recovery. Growth is still expected to remain well below potential although industrial production is showing its best improvement in three years. The manufacturing sector is still contracting (albeit at a slower pace) while there was a bigger recovery in services and an easing in the decline in new business orders. Should these trends continue, the Eurozone may return to positive growth by Q4. Most encouraging was the slowing in the decline in economic activity outside Germany and France while the continuing decline in employment is still of significant concern. Cautious optimism and near term recovery in consumer spending and investment are being tempered by rising unemployment and a lack of recovery in business lending. Fortunately inflation is fairly benign and supportive of loose policy.

What does the revised recession data in the UK indicate?

Initial optimism that the UK did not experience a double dip recession at the beginning of 2012 was short lived because revised data revealed that the 2008 recession was much deeper than estimated. The peak to trough fall of GDP during the global financial crisis was 7.2 per cent against a 6.3 per cent previously recorded. Placing today's growth in perspective now shows that Q1 2013 GDP was 3.9 per cent lower than its peak in Q1 2008, initially estimated to be only 2.6 per cent lower. The UK economy now has more ground to recover if GDP is to get anywhere near its pre-crisis peak but latest data is not supportive of such an outcome in the near term and consumer spending overall remains subdued. There is hope riding on new Bank of England (BOE) Governor, Mark Carney to provide continued monetary policy support in an effort to boost confidence and activity and his first policy meeting provided a clear signal that policy will remain accommodative for a long time.

With slowing growth, will Chinese authorities add to their policy stimulus?

Despite slowing economic growth and tightening credit conditions, Chinese authorities have not fulfilled market expectations by providing any further stimulus. This highlights the new leadership's concerns that previous lax lending practices have stoked inefficient investments and heightened fears of systemic risk within the banking sector. The overall economic and investment outlook remains subdued as short-term growth appears to be sacrificed for sustainable long-term growth. Latest data has been fairly disappointing, confirming weak economic activity.

Given the authorities are increasingly focused on financial market and structural reforms to help boost long term growth potential, the lack of policy stimulus means manufacturing and the broader economy will be subject to softer short-term growth. The new government is also focused on improving the quality of life of the Chinese population , increasing social development and improving environmental quality — the clearest signal yet that they are comfortable with slower near-term growth trajectory as China transforms from an export dependent to domestically-driven economy.

How is the banking sector restricting growth potential in China?

In June, the Shanghai Interbank Offer Rate (SHIBOR) — the rate at which banks lend to each other — jumped to a nine-year high as liquidity conditions tightened in the Chinese interbank market. The Peoples Bank of China (PBOC) normally intervene to ensure sufficient liquidity is available in the market and that the SHIBOR remains at reasonable levels. However last month, the PBOC limited the liquidity it provides to the interbank system in order to slow down the rapid pace of excessive credit creation. Furthermore the lending network outside traditional banking has expanded at such a frenetic pace that there are fears that trillions of dollars of risky assets may be concealed in the books of some of these institutions. In light of this, the PBOC has sent a clear signal to the banking system that they are keen to eliminate potential risks to the stability of the financial system even if it places downside pressure on economic growth.

What does this mean for investment strategies?

As we navigate into unchartered waters, there is an exponential rise in the 'unknowns'. This phenomenon has been clearly articulated by leading central bankers and other similar authorities. Therefore the response to many unique challenges is also unknown.

We continue to subscribe to the view that global financial asset markets have entered a period of high volatility, turbulence and uncertainty. Investors must be extra cautious when taking on risk and pay more attention to the risk/reward ratio and also be acutely aware of the multiple forces that influence financial asset market prices.

We continue to lean on our disciplines around strategic, dynamic and tactical asset allocation and in-house risk management systems to navigate challenging financial asset markets, always mindful of the risk/reward ratio.

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 July 2013. AD9923-0713rr

ADVANCE