New horizons

September 2013

ADVANCE

September brings a new Australian government, the announcement by the US Federal Reserve about their quantitative easing program and the move out of recession in the Eurozone.

Against the backdrop of these new horizons, 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 new Government is tasked with supporting an economy performing well below its long-term potential whilst attempting to bring finances back under control. The Reserve Bank of Australia (RBA) are concerned about the growth trajectory, are saying they are prepared to cut official interest rates further if necessary. Our fairly subdued outlook is for growth around 2.5% by the end of September 2014.

US

Stronger than expected upward revisions to growth in Q2 and evidence that labour market conditions are continuing to improve suggest that the US Federal Reserve (Fed) could soon start tapering its quantitative easing program. However, inflationary pressures remain subdued and early evidence that the housing market recovery may be wavering implies a need for policy to remain quite accommodative.

Japan

A slowdown in activity has heightened concerns about the potential negative impact of the proposed consumption tax, which is due to commence in April 2014. It appears authorities are looking to stagger a rollout or implement stimulus policies to help negate this. If a stimulus strategy is successful, we anticipate growth to be up from the current pace and trend.

Eurozone

Optimism in the Eurozone improved in light of some positive data and the fact that it emerged from recession in Q2. There are still significant factors that will limit the potential for a sharp upturn over the coming year so we anticipate growth by 1.0% over the year to September 2014, with risks weighted to the downside.

Felix Stephen has over 40 years of experience in international banking, treasury, fixed income, foreign exchange and portfolio management and has served on asset allocation and investment strategy committees at funds management institutions in Australia and overseas.
Felix has also been a consultant to institutions in Australia and overseas on strategic developments in funds management and financial markets.

UK

The Bank of England (BOE) announced its explicit forward guidance for the stance of future monetary policy. Better than expected data suggest the economy is gathering strong upward momentum, although the recovery is very weak by historical standards. We expect growth to be around 1.8%, an improvement, yet below trend.

China

Despite some improvement, underlying structural problems will limit China's growth potential. It is encouraging to see some stabilisation but downside risks remain. We are very cautious on China's growth prospects and expect growth will be likely to be around 7%, however has the potential to remain in the vicinity of 7.5% in the short-term.

How will the RBA support the Australian economy as it transitions to non-mining investment?

The RBA still has ammunition to support the economy through this tumultuous period and minutes to the August 6th meeting suggest it is still prepared to cut official interest rates later in the year if necessary. For now they would be hoping that the AUD drops further to support our exports sector and work harder for the economy. Given activity is already below trend and near term prospects are for more of the same, we expect another cut in rates as likely, although with interest rates already at historical lows, this would not be the RBA's preferred option due to potential risks inherent in ultra easy monetary policy.

What is the outlook for Australia?

A subdued outlook positions growth to remain around its current pace of 2.5% and below trend of 3.5%. The economy is facing its biggest challenge as mining investment drops off while non-mining sectors are still struggling to gain momentum. Weaker growth in China, potential post election fiscal tightening, and the possibility of a still relatively high AUD mean prospects are dim. We expect a gradual recovery in business sentiment as the global outlook improves and the post-election sentiment fosters confidence, improved investment sentiment should follow. The consumer and housing sectors will be supported by lower interest rates, but rising unemployment rate will cause strain.

Were there signs to suggest the US Federal Reserve would continue quantitative easing?

Although it came as a surprise, August payroll and unemployment rate data would have been crucial to the decision, whilst the July Federal Open Market Committee (FOMC) minutes showed some members were still concerned about the labour market recovery. Softer data also implied a need to delay tapering. Monetary policy outlook is dependent not only on economic data, but on the risks associated with keeping policy at its current very accommodative stance for a long time.

What does this mean for the US economy as we look towards 2014?

With tapering largely factored into the financial markets, the decision to actually delay tapering could see significant volatility in asset markets, which would ultimately pose risk to financial stability. In 2014 we expect fiscal austerity will be less of a hindrance on growth and the Federal Reserve will succeed in transitioning monetary policy to a less accommodative stance, meaning two key uncertainties impinging activity will be removed. The debt ceiling issue could persist as a risk but a likely higher degree of certainty regarding policy should support growth. The housing and consumer sectors will contribute more positively and improved business sector profitability will support stronger investment.

How will a consumption tax affect the Japanese economy?

It is increasingly likely that a consumption tax will be introduced into Japan with growing support for short-term fiscal stimulus to offset the initial impact. Proposed measures include a cut in the corporate tax rate and tax breaks for capital spending, which should encourage stronger investment. Once the decision is announced the reduction in uncertainty over the tax could support stronger business investment. Much will depend on how the tax is implemented and the potential impact on consumption. Already facing rising price pressures but still to see significant offsetting wage rises as a result of Abenomics, consumers will be the biggest losers as the tax will add to household income burden, and potentially cause a short-term plunge in consumption.

Will growth continue with the Eurozone finally moving out of recession?

Signs that early recovery is gaining further momentum is based on the broad-based expansion of the manufacturing sector throughout July and August. Business and consumer confidence is also on an upward trend, with interest rates remaining at historically lows. Consumption and business investment is gathering momentum in Germany but remains subdued in other countries whilst exports are growing only modestly. Growth needs to be more balanced to ensure a stronger, more sustainable upturn but will be difficult with unemployment remaining at a historical high of 12.1%; the banking sector still holding bad debts and loath to lend; and EU leaders yet to show common agreement to forming a banking union.

What does the BOE's forward guidance for the stance of future monetary policy entail?

The key thrust is the BOE is committed to keeping its current easing bias firmly in place until unemployment reaches a minimum threshold of 7.0% - a rate it doesn't anticipate will be reached until the second half of 2016. Governor Carney stated that markets should not expect rates to automatically rise once 7.0% is reached, and it is not a target for unemployment. Importantly he added three specific caveats: low interest rates do not pose a threat to financial stability; medium term inflationary expectations do not increase; and inflation 18-24 months ahead is more likely than not to be above 2.5%. If any of these are breached, the BOE retains the power to raise interest rates and/or sell asset purchases if necessary.

What does this mean for the UK economy moving forward?

It is believed that this new approach will make current stimulatory policy more effective in three key ways: by reducing uncertainty about the future path of policy it will help avoid the risk that market interest rates rise prematurely; it provides greater clarity to the markets; and it gives policy more scope to determine the degree of slack in the economy, without putting price and financial stability at risk. In an attempt to provide more clarity and certainty the terms and conditions of the Bank's forward guidance may actually give rise to further uncertainty.

What is the biggest risk threatening the Chinese economy?

China is in the midst of a critical period as the government tries to manage high debt levels and transition the reliance on investment and exports to private consumption. Although downside risks look to have been mitigated for now, they will remain an issue because of the over-reliance on strong credit growth and investment having left the financial, property and local government sectors vulnerable. Underlying structural problems will limit China's growth potential and there is some concern that with significant overcapacity still existing, especially in the industrial sector, and economic growth running at around its slowest pace in almost four years, deflation could actually be the bigger risk.

How are the Chinese authorities managing these issues?

The Government has reiterated that it is prepared to accept lower, more sustainable growth. It introduced small, targeted measures to arrest the continuing slowdown, but stopped short of injecting massive stimulus given private and public sector debt is at extreme levels. Stronger credit growth will only fuel higher debt and stoke asset bubbles making the economy more vulnerable.

The most responsible and sustainable pathway will be a step up in its structural reform program to help drive private consumption by tackling low wages growth, lack of social security and affordable housing, and greater provision of social services. The government has reaffirmed its commitment to solving them but the transition will be a long process.

Market outlook and risks

While global economic growth appears to have recovered during this year, the future outlook remains highly uncertain because significant investment capital flow movements are causing problems for some developing economies, with large current account imbalances while ultra-easy monetary policy has been excruciatingly slow to offer significant tailwind support for developed economies.

Quantitative Easing (QE) the unconventional monetary policy tool that has been used by central banks in developed economies to prop up their ailing economies offers tailwind support while excessive regulation, political dysfunction and fragmentation, geopolitical turmoil and social unrest are factors that act as powerful economic headwinds. The added reason to be cautious and pragmatic about the future economic or financial market outlook is that there has been a serious disconnect between economic trends and financial market trends generated by QE, which is a form of financial repression that leads to a misallocation of capital that ultimately leads to global financial market and economic instability.

Who we are

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- Our investment team provides in-depth analysis of investment funds and the managers behind them, with the aim of offering broad diversification, quality risk management and access to some of the world's best investment managers – without having to do it all the investigation yourself.
- Our multi-manager approach is based on the belief that different styles, when combined, can produce a more consistent outcome for investors by minimising style and portfolio risk.
- Our blended multi-manager funds offer greater diversification, while benefiting from active investment management and the potential to achieve sustainable outperformance over the longer term.

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Advance is the 2011 *Financial Review Smart Investor* **Fund Manager of the Year**.

Advance won '**Multi-Manager of the Year**' at the 2009 Money Management Fund Manager of the Year awards, judged by research house Lonsec.

In January 2010, Lonsec also gave the Advance Multi-Blend Funds its highest rating, **Highly Recommended***. In its overall assessment, *"Lonsec has upgraded the Advance Multi-Manager Funds to 'Highly Recommended' reflecting the manager's well established and thorough manager research process, solid portfolio construction techniques, strong SAA culture and well resourced team."*

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