Confidence and uncertainty

ADVANCE

With an impending Australian election and as we look ahead to the last quarter 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

Uncertainty surrounding the Federal election date impacted confidence, spending, and investment decisions, resulting in subdued economic growth. Stability in inflation and intense pressure on authorities to act to support growth saw the Reserve Bank of Australia (RBA) cut official interest rates by a further 25bps to a record low of 2.5%.

US

Mixed economic data has not provided clarity on the likelihood of the Federal Reserve tapering quantitative easing but there is consensus that September is a possibility. Unexpected weakness in July payrolls data, subdued inflation and continued fiscal uncertainty does suggest policy may remain at its current level.

Japan

Latest Japanese data suggests that initial euphoria about Abenomics and the Bank of Japan's (BoJ) aggressive monetary easing may be beginning to wane. A period of slower growth is likely despite Abe's majority win in the Upper House elections ensuring a stronger mandate to push through with his three pronged economic revival plan.

Eurozone

On the back of more encouraging Eurozone economic data, the European Central Bank (ECB) left policy unchanged at its August policy meeting with an announcement reinforcing formal guidance on interest rates and a more upbeat assessment of the outlook for the second half of 2013.

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

Encouraging signs suggest that momentum in the UK economy is slowly building. Second quarter growth was twice the pace of Q1, and Q3 looks promising. The Bank of England (BoE) left policy unchanged in August but it is set to continue pursuing a highly accommodative policy stance, and is looking at providing forward guidance.

China

The growth pulse in China continues to weaken so the government's challenge continues to be managing an orderly slowdown whilst pushing ahead with structural reforms to stabilise long-term growth. There is growing expectation that the financial system will risk a crisis risk similar to that faced by major developed economies.

HOW IS THE AUSTRALIAN ECONOMY DEALING WITH UNCERTAINTIES OF THE IMPENDING ELECTION?

The weeks of uncertainty around when the Federal election would take place had a significant impact resulting in overall subdued economic growth. The Australian economy is at a critical juncture as the resources boom nears its peak and the non-mining sector struggles to gain momentum. The risk of substantial slowing in growth is significantly increasing and the pressure on authorities to act to support growth is at its most intense in recent years. Against this background, the Federal Government announced that it will not achieve its budget surplus until 2016/17, and has downgraded its near-term economic outlook. RBA.

ARE THERE LIKELY TO BE MORE RATE CUTS BY THE RBA THIS YEAR?

June quarter inflation data was a clear consideration for the RBA's latest decision to cut official interest rates in August to a new record low of 2.5%. Given the rising prospect of fiscal consolidation in the coming year, this latest rate cut is unlikely to be the last in this cycle. However whilst lower rates will be supportive for growth, at the same time they could stoke asset prices and thus create potential financial stability problems down the track. RBA Governor Stevens announced that the RBA have left the door open for a further cut in rates, and our expectation is that unless we see a marked turnaround in sentiment post rate cuts and the election, and/or further weakness in the AUD, a further cut in rates cannot be ruled out before year end.

WHEN WILL THE US FEDERAL RESERVE BEGIN TO TAPER ITS QUANTITATIVE EASING PROGRAM?

There is a general expectation that the Fed will start tapering quantitative easing in September and Q2 GDP figures were quite supportive, although mixed economic data gave rise to uncertainty. The housing sector continues to show the most visible signs of sustainable recovery and may add to the case for the near term. It does needs to be emphasised that tapering is just a gradual reduction in the amount of accommodation and Fed Chairman Bernanke suggested that there needs to be some form of balance between promoting stable economic growth through monetary policy while maintaining financial stability.

HOW IS JAPAN'S ABENOMICS POLICY FARING?

Latest data suggests the Japanese economy looks to be heading for a period of slower growth with consumer spending and confidence weakening slightly. The sharpest decline was in employment, interesting given that employment growth is still growing and the unemployment rate of 3.9% is at a five year low, most likely due to proposed labour market reforms as part of Abe's policy. Weaker June retail sales numbers could see Q3 GDP growth quite soft and a high majority of consumers surveyed said they expect inflation to rise over the coming year and may tighten their purse strings even further. This recent weakness does add to the challenges facing the Abe government, including his calls for higher wages to bolster reflation efforts and the government's proposed doubling of the consumption tax from five to ten per cent. This is scheduled to occur in two stages – April 2014 and October 2015. There is speculation that the government may backtrack and not go ahead with it, given the poor voter turnout for the recent elections. If it does not, then this would question Abe's credibility and resolve to tackle Japan's huge fiscal deficit. Financial markets are likely to be unforgiving in their reaction.

WHAT IS FUELLING THE INCREASED CONFIDENCE IN THE EUROZONE?

The pickup in PMI survey data has led positivity with both manufacturing and services industries laying the foundations for improved economic growth. The July manufacturing survey signalled the sector moved moving back into expansionary territory for the first time in two years and production and new orders both increased at the fastest pace since mid-2011, as new export business expanded and a number of domestic markets moved closer to stabilisation. Germany, the region's main growth driver, saw its manufacturing sector move moving back into expansionary territory due to improved domestic demand. In France industrial output is still contracting, but is at a stronger pace less so thanks to a solid increase in new export orders. Output also expanded again in Italy, Ireland and the Netherlands.

Although consumer activity remains fairly subdued, recent sentiment surveys and spending data indicate a cautious improvement, May retail sales data were quite strong, and there has been a modest improvement in the credit multiplier process, which has previously one of the many factors inhibiting recovery.

IS THE UK ECONOMY SHOWING SIGNS OF IMPROVEMENT?

Yes. Growth in the second quarter was twice the pace of Q1, the strongest in almost two years. Encouragingly, growth was fairly broad with all key sectors contributing to quarterly growth. The services sector, which accounts for 70 per cent of GDP, was the key growth source, and the latest PMI survey data was overwhelmingly strong, suggesting the economy has solid momentum going to into Q3. The most significant news was the expansion in the services sector in July at its fastest pace in six and a half years.

The upturn in UK manufacturing market has been building for the past five months and reflects the strongest growth in production and new orders since February 2011. Domestic new orders were the key source of strength but there has been a very solid increase in new export orders in more recent months. There were similar improvements in the construction sector with solid increase in construction employment levels and the strongest degree of positive sentiment about future output since May 2010. Improved consumer sentiment implies that consumer spending, which accounts for two-thirds of all spending, will boost the economy in Q3.

WILL THE CHINESE ECONOMY MEET THE GOVERNMENT'S TARGET FOR GROWTH IN 2013?

The growth pulse in China continues to weaken and it is looking increasingly unlikely that the economy will grow at the 7.5% target set by the government for the end of 2013. GDP growth has slowed down in nine out of the last ten quarters, manufacturing output declined for the second consecutive month, and at a faster pace; however the services sector surprised in its resilience in July. The normal or expected policy course of action under such subdued growth would be for the People's Bank of China to cut interest rates and/or bank reserve requirement rates, or for the government to embark on huge fiscal stimulus, however the 'new normal' course of action being adopted by the authorities is structural reform. Policy is now about stabilising growth so that it is more sustainable in the longer term and the crux of this is transforming the economy to a consumer led one from an investment and export driven one.

In line with that there have been various announcements in recent months to help achieve this, including the removal of administrative approval procedures, expanding VAT tax reforms, deregulating to attract private sector investment, progressively improving the basic medical insurance system nationwide, setting minimum living standards and improving employment assistance.

WHAT DOES THIS MEAN FOR INVESTMENT STRATEGIES?

While the outlook for aggregate global economic growth has improved, there are many lingering geopolitical risks together with the risk of the US Fed acting to gradually reduce the quantity of unconventional policy stimulus in the financial system because they fear the unintended consequences of easy monetary policy could trigger a crisis that they will not be able to manage.

Investors should always pay close attention to the risks and rewards when they make investment decisions because of the heightened level of social, political and market volatility that presently prevails.

ADVANCE

Who we are

Advance is a specialist asset management business within the Westpac Group. Our focus is on asset allocation and risk management, implemented through a multi-manager process, providing investment opportunities across a range of asset classes, including shares, property, fixed interest and cash.

Why Advance?

- We offer investors a wide choice of quality investments and the security of ongoing monitoring and analysis.
- 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.

With a dedicated team of skilled and experienced professionals performing an ongoing investigation into the funds, investors can spend less time worrying about market and manager fluctuations and more time enjoying the more important things in life.

Award winning

Our investment process is tried and tested, and acknowledged by our peers as best practice.

Advance is *Money* magazine's **Best Fund Manager** for 2012 and 2013.

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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