The roads to recovery

October 2013

ADVANCE

As we enter the final quarter of 2013, we ask Felix Stephen, Head of Strategy and Research at Advance to reflect on the roads to recovery for key global economies, to share his thoughts on recent world events and the outlook for these economies and financial asset markets.

Australia

With the full effect of the Reserve Bank's decision to lower the cash rate by 25 basis points to 2.5 per cent, effective 7 August 2013 still working their way through the economy and an early post-election confidence boost, the Reserve Bank of Australia (RBA) kept monetary policy unchanged suggesting this will remain so unless domestic economic conditions deteriorate or the Australian dollar apppreciates further.

US

A surprise decision by the US Federal Reserve (Fed) to hold off on tapering its quantitative easing program, contrary to telegraphed intensions, resulted in a sharp rally in both the US share and bond markets. Any tapering is now highly dependent on the trajectory of the US economy and a resolution to their fiscal crisis.

Japan

A sharper than expected upward revision to Japan's June quarter GDP growth was challenged by more recent data showing a slowdown from rising inflation and consumption tax uncertainty.

The government has since announced the tax mechanics and we anticipate any resulting intermediary fiscal drag should be followed in resumption in growth momentum.

Eurozone

Angela Merkel won a historic third term in the German elections, but she must form a coalition, which brings new challenges and uncertainties for the region's strongest economy. The European Central Bank's (ECB) kept policy unchanged as expected, reiterating a degree of cautious optimism on the ongoing economic recovery.

UK

Solid activity over the September quarter led the Bank of England (BOE) to upgrade its near term economic outlook. The October monetary policy meeting is imminent, but the September meeting minutes showed a clear upbeat assessment from the Monetary Policy Committee, which along with recent data, implies an on-hold policy stance.

China

Growing optimism that the worst of the slowdown is over for China was supported by continued positive data surprises over the month. Significant unresolved underlying issues remain however and these are likely to weigh on growth over the longer term.

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.

How is the housing market supporting Australia's economy through diminishing mining investment?

Continued positive signs from the housing market are supporting the economy at a time when other sectors are soft. Over the year, all capital cities showed positive price growth except for Hobart, as latest data suggests that house price stability/appreciation might continue with the support of low interest rates and pent up demand from investors and upgraders. However, there is still a degree of cautiousness amongst potential buyers given the prospect of rising unemployment. Evidence that housing construction may gather pace is reflected in the solid increase in finance commitments for new dwelling construction, which will generate a higher supply of homes and temper excessive price gains. Construction activity will also generate jobs and demand in the broader economy, which should help soften the blow to the economy from contracting mining investment.

What was behind the Fed's surprise decision to hold off on tapering its quantitative easing program and what does it mean for the US?

The Fed's commitment to maximum employment with price stability was conflicted by the current economic, market and political indicators. Weaker than expected August payroll, evidence that the housing recovery is wavering under the recent rise in mortgage rates and softness in consumer spending, may have underpinned this decision. Remaining with the status quo appears to be deemed more appropriate given ongoing economic and fiscal challenges. The immediate upshot was a sharp rally in both the US share and bond markets. The Fed's credibility and its communications process are likely to questioned by markets, creating more uncertainty and volatility. Indications suggest tapering is still on the near term agenda, but dependent on economic progression and fiscal resolutions. There are only two opportunities remaining in 2013 for tapering to commence, but given the current political situation, it seems unlikely. The labour market recovery is crucial for any Fed tapering decision and this has been hampered by the recent government shutdown.

How crucial is the US debt ceiling issue?

The debt ceiling and the subsequent government shutdown has been the most critical issue facing the US economy today. The US Senate finally passed legislation raising the Treasury Department's borrowing authority, which would end the government shutdown that has crippled the country since October 1. The general expectation throughout the shutdown, was that the ceiling would eventually be raised, but what wasn't expected was that it would eventuate at the eleventh hour. The eleventh hour compromise came just hours before the point where the US Treasury simply would have been unable to borrow money to meet its very big debt obligations.

What does the consumption tax rise mean for Japan?

With supportive signs that business investment is strengthening, the Japanese Prime Minister finally announced that the proposed sales tax increase from five to eight per cent would go ahead in April 2014 with a second planned hike to ten percent in October 2015. Together they will reduce the budget deficit by around 13.5 trillion Yen. However, the overall deficit impact will be slightly diminished, because in an effort to offset the short-term negative impact the government announced a fiscal stimulus package of about five trillion Yen. The details will not be announced until early December due to a reported dispute within the ruling coalition party as to what tax cuts should be implemented.

What is the significance of Angela Merkel's historic win in the German elections?

Merkel's win was not unexpected but the extent (five seats short of an outright majority) was a big surprise and a significant sign of support from the German people about her policies and handling of the Eurozone debt crisis. With 12 out of the 17-Eurozone member governments falling as a result of discontent with the Eurozone crisis, Merkel's win reflects Germany's outperformance over its counterparts. Her focus is now on forming a coalition with an opposition party, which is unlikely to be finalised quickly, given another decision on Greece's debt issue is imminent and negotiations on forming a 'banking union' are still in full swing thus European financial markets will likely remain volatile in the near term.

Is the Eurozone economy still on the road to recovery?

Recent data suggests a moderate progression. Industrial production saw its sharpest decline in twelve months to its lowest level since April 2010. Falls were seen across most of the region, especially with production of capital goods, but this data is at odds with an improvement in business sentiment, implying soft third quarter growth if it continues. Manufacturing results were also soft but were at its strongest since June 2011 with new domestic and export orders rising, backlogs of work stabilising, and the rate of job losses easing. Consumer confidence improved to a two-year high, but remains below its long-term average. Record levels of unemployment and falling real wages highlight the fragility of recovery with little prospect of a significant turnaround in overall employment levels whilst governments continue with austerity and structural reforms, and businesses suffer from tight credit conditions.

Is the UK still showing positive growth signs?

With solid September quarter activity the BOE upgraded it's near term outlook for growth. Recovery has clearly picked up pace with consumer confidence measures increasing to their highest levels since before the GFC. Consumers are most optimistic in their outlook but real wages remain pressured from rising living costs and will inhibit spending, although should be supported by a wealth boost from the housing sector. Significant jumps in construction and employment are also encouraging and despite a slight consolidation after six consecutive months of expansion, manufacturing remains near two-year highs.

What is the current outlook for China?

Markets are optimistic with better than expected data suggesting the Chinese government's recent efforts like small business tax cuts and infrastructure spending are showing signs of success. The non-manufacturing sector, which accounts for 45 per cent of the economy and is the biggest employer, showed solid expansion. Business activity improved, industrial production increased at its fastest pace in 17 months, fixed asset investment, and August retail sales strengthened for the sixth consecutive month. China's trade surplus widened, exports accelerated and imports dipped (although are up seven per cent over the year). Data indicates the stronger demand for Chinese goods is being led by the US, and given the expected continued improvement in the US economy, exports should continue to show reasonable growth but faces headwinds from rising wage costs, a stronger Yuan and competition from low cost rivals like Bangladesh. China continues to face high debt levels and although the government has reaffirmed its commitment to address issues like low wages growth, a lack of social security and affordable housing, and greater provision of social services, the transition to a consumption-based economy will be slow.

What does this mean for investment strategies?

With the financial asset market cycle relatively mature, a visible decline in corporate earnings growth in major economies, evidence of increased levels of geared or leverages speculative investor activity in global financial markets, heighted geopolitical and a dysfunctional political backdrop etc. should be warning signs to investors that they need to be patient and carefully balance their investment portfolios in manner that adequately rewards then for investment risks they take. Trend following and/or momentum driven investment strategies have the ability to surprise investors and make them incur heavy capital losses, when they are least anticipated, prepared or expected.

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.

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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.
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