Global momentum for recovery & growth

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ADVANCE

After a few months of global economic and political turbulence, we ask Felix Stephen, Head of Strategy and Research at Advance to reflect on how key global economies have performed and share his thoughts on recent world events and the outlook for these economies and financial asset markets as 2013 draws to a close.

Australia

Australia's economy is finally showing some stability, led by the housing market. The Reserve Bank of Australia (RBA) is satisfied that the current policy settings are supporting the transition to the non-mining sector and thus kept interest rates on hold. They indicated a lower AUD should support growth and expect it to depreciate in the future.

US

An eventful October in the US was headlined by the 16-day Government shutdown, affecting spending, and investment decisions, confidence and Q4 GDP growth. The labour market recovery also remains lackluster, resulting in the US Federal Reserve (Fed) keeping its quantitative easing (QE) program unchanged.

Japan

Economic activity looks to have bounced back in Japan now that the uncertainty surrounding the sales tax hike has been removed. Latest data suggests that the growth momentum is solid and as a result, the Bank of Japan (BOJ) has upgraded its near term forecasts for growth.

Eurozone

The subdued nature of the Eurozone recovery became more evident with inflation falling to its lowest level in four years. Concerns are escalating that the economy could be set for a deflationary trap, placing increasing pressure on the European Central Bank (ECB) to provide further stimulus and help lift growth momentum.

UK

Economic recovery in the UK is continuing with expectations revised up for growth this year and 2014. There is now growing speculation that the Bank of England (BOE) may bring forward its estimate of when official interest rates will start rising.

China

Recent improvements in China have continued with momentum likely to continue to gather pace. Overall growth should remain around current levels, however, the Government has re-affirmed its commitment to pursuing structural reform to help transition the economy from investment led to consumption led.

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.

Has the change of Government boosted confidence in Australia's economy?

The economy appears to be enjoying a post-election hike with most indicators improving in line with the change in Government. Perhaps the biggest boost has been to the business sector, with confidence jumping sharply to its highest level since March 2010. The lift in confidence was evident across most sectors, with weakness only seen in transport and utilities.

How crucial is housing to Australia's economic transition to non-mining investments?

A solid recovery in the housing market (particularly home construction) is crucial. Indicators continue to be quite positive, with house prices continuing to rise. Despite vendors raising price expectations with strong market conditions, and buyers becoming more price conscious, there is further upside potential for prices as interest rates look set to remain low for a long period and market fundamentals (higher pent up demand and limited supply) remain favourable. The key will be stronger building activity. At this stage the evidence looks promising with housing investment providing much needed support. Overall economic activity remains moderate despite some concerns that a housing asset price bubble may be emerging. Latest inflation data signals will allow the RBA to keep rates lower for longer to help drive the transition of growth to the non-mining sector.

Is the impending festive season looking healthy for Australia's retail sector?

September spending data was encouraging with retail sales increasing by 0.8 per cent (month on month). This was better than expectations and continues an improved trend that began in July with the recovery in consumer confidence. Department store sales were the key driver of sales growth and over the September quarter, the standout was the 3.2 per cent (quarter on quarter) increase in spending on clothing, footwear and accessories, the strongest result since mid-2009. Overall, the trend in sales is improving, and is a sign that low interest rates and the weaker AUD in more recent months (which makes online spending less attractive), are finally flowing through.

What is the economic fallout of the recent 16-day US Government shutdown?

The shutdown has undoubtedly impacted confidence and spending and investment decisions. The economy continued to expand at a moderate pace with labour market conditions showing further improvement, however unemployment rates remain elevated. The outlook for the labour market continues to rest on improved business sector activity, which in turn is determined by the pace of household spending and confidence. Despite the government shutdown, sentiment and activity amongst businesses look to have held up in October however business investment remains subdued; suggesting the pace of job hiring will continue to be lackluster. It must be noted that general economic uncertainty is also heavily weighing on plans. A sustained recovery in household confidence and spending is also crucial and the latest data indicates the Government shutdown and ongoing labour market concerns are having a dampening influence. The eleventh hour deal ensured a national debt default and financial market and economic disaster were avoided for now, but discussions must re-open in early 2014.

Is current activity supporting plans to lift inflation in Japan in the next two years?

Economic activity looks to have bounced back in Japan now that the uncertainty surrounding the sales tax hike has been removed. The BOJ are aiming to double the monetary base by conducting asset purchases to meet its two per cent inflation target, and their updated assessment and optimistic outlook is supported by the slight upward revision to fiscal year 2014 growth and the fact they left inflation forecasts unchanged. Latest data suggests the growth momentum is solid, with most major indicators far exceeding expectations over the past month. The BOJ's higher growth expectations are based on four key assumptions: that financial conditions will become more accommodative and supportive as they continue to pursue quantitative and qualitative easing programs; that a gradual pick up in overseas economies continues, which will help support export growth, business profits and investment; that public investment remains high, especially with the impending stimulus package; and lastly that business and household medium-to-long-term growth expectations will rise moderately. The BOJ's latest outlook is reasonable but much rests on the Government's stimulus package offsetting the tax hike. However, in a world that is facing the threat of deflation, it is unlikely that Japan can attain its stated inflation target although household inflation expectations may gradually drift higher overtime.

What does the falling level of inflation in the Eurozone mean for recovery?

With the annual inflation rate falling well below target for the third consecutive month to its lowest level in four years, concerns have escalated that the Eurozone could be heading for a similar deflationary trap that engulfed Japan. There is now increasing pressure on the European Central Bank (ECB) to provide further stimulus and help lift growth momentum. Weak domestic demand and a strengthening Euro have combined to dampen price pressures. A persistent period of extremely low inflation will spell disaster for recovery as it could set in motion a vicious cycle of companies cutting prices further to re-ignite subdued demand. This in turn places revenue and profits under pressure, leading to lower jobs growth, weaker income growth and further price cutting. This appears to be a reasonable risk at the moment. The strong currency makes it hard for exporters to be competitive and keeps inflationary pressures low, whilst the region's rising unemployment is as much cause for concern.

Is the UK economy still continuing to recover and grow?

Yes, the UK economy grew at its fastest pace in more than three years in Q3, with recovery evident across all main sectors. The result was in line with expectations and the fact that it was broad based is very encouraging. The Q3 GDP data and the partial indicators released so far for Q4, suggest economic activity is continuing to head in the right direction with the International Monetary Fund (IMF) now anticipating 1.4 per cent growth this year, double the pace estimated in April. There is also now growing speculation that the Bank of England (BOE) may bring forward its estimate of when official interest rates will start rising.

What is stimulating the economic growth in China?

The majority of the growth was driven by solid investment as a result of the Government's mini-stimulus program announced earlier in the year. Investment accounted for 56 per cent of growth and private consumption 46 per cent. Infrastructure investment was significant, expanding at a strong pace of 29 per cent, with Government-backed investment accounting for about a quarter of this total. Housing investment accounted for 16 per cent however exports detracted from growth, likely reflecting a combination of subdued external demand, distortions caused by fake invoices that have yet to be eliminated from the data, and the 2.7 per cent increase in the Yuan against the USD over the past 12 months which has reduced competitiveness. Import growth in contrast has been reasonably healthy, with the majority of the demand being for products that feed directly into China's economy and more subdued growth for those used for processing and re-export.

What does this mean for investment strategies?

Financial asset prices and global economic activity have diverged overtime as investors search for higher income and returns in a low inflation, low growth and low interest rate environment. Added to this is the impact of major central banks who continue to distort financial asset market prices. Investors should be cautious when taking on portfolio risk as we continue to reiterate that the risk/reward for doing so is inadequate.

ADVANCE

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