A year of change

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At the end of 2013, Felix Stephen, Head of Strategy and Research at Advance Asset Management shares his insights on the performance of key global economies and important world events as well as his outlook for these economies and financial asset markets in 2014.

Australia

The Australian economy continues below trend as the mining sector slows and non-mining sectors (except housing) struggle to gain momentum. September quarter GDP was disappointing, and the Reserve Bank of Australia (RBA) is counting on a weaker AUD for support. The economy should continue to grow below trend with fairly even risks.

US

Focus continues to be on the variables of, if, and when the US Federal Reserve (Fed) will begin to pare back quantitative easing (QE). Mixed economic data from the US shows that it will be a challenge for the Fed to clearly distinguish and differentiate its intention to taper from an intention to hike interest rates. If the Fed can do this, the fallout from tapering should essentially be minimal when it does begin.

Japan

After outperforming the major developed countries in the first half of the year, Japan's GDP growth slowed considerably in Q3. This was not unexpected given the previous strength shown earlier in the year was fairly unsustainable, however we predict that activity will gather momentum again as spending picks up ahead of the impending consumption tax increase in 2014.

Eurozone

The Eurozone's September quarter GDP dropped after exiting the recession in June. This event, and continued subdued inflation, vindicates the European Central Bank's (ECB) November rate cut. We expect the ECB will continue to 'do what it takes' to support the economy. Moderate growth, with risks firmly to the downside, is forecast for 2014.

UK

Continued positivity was supported by the Bank of England's (BOE) forecast upgrade. The bank also unexpectedly announced a re-focus on its 'Funding for Lending Scheme' (FLS) to be now used for business loans only. The BOE took the accelerator off housing stimulus, easing the risk of a housing bubble emerging, and will keep policy on hold.

China

China's medium term blueprint of policy reforms will have a major impact over the next five years. Export growth and measures to boost consumption should be offset by slower infrastructure investment, tough housing regulations and dampening activity. Easing growth and unclear debt levels will leave the economy open to negativity.

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What is the RBA's secret weapon to drive economic recovery and growth?

The RBA's focus is to use the AUD to stimulate the economy, whilst intonating that the AUD is currently overvalued and even going so far as to suggest that the RBA could actively intervene in the currency market to help bring the price down to an appropriate level if necessary. The AUD has continued to fall in response to the weaker Q3 GDP and the increasing likelihood of the US Fed tapering policy.

The recent softness looks likely to continue, which will help instill business sector confidence after its tumble, following a post-election boost and growth.

Are Australian consumers still showing signs of confidence in the economy?

Yes, consumer confidence has held, driven by the housing market's price increases. Stronger sentiment and the AUD's softening also flowed through to spending with domestic retail sales rising in recent months. Consumer spending should continue to improve although further weakness in the labour market could hamper this, but with interest rates expected to remain at current low levels, housing and consumer spending will be integral to growth.

How is the uncertainty surrounding QE tapering impacting the US economy?

This is the biggest risk currently facing the US economy. That tapering will occur is as a given but the challenge is for the Fed to clearly distinguish its intention to taper from an intention to hike interest rates. If it can do this, the fallout should be minimal. The sharp tightening in financial conditions that occurred when tapering was first mentioned in May and the resulting easing in activity shows how tough this will be. It is thought that the the Fed will succeed without unintended side effects, with growth improving slightly above trend. When they do make the announcement they are likely to enhance forward guidance on interest rates in an effort to dampen expectations that it means an imminent rate hike and should be able to manage a smooth tapering process, with limited negative consequences.

Will Japan's consumption tax hike in 2014 support economic growth?

Yes, evidence is already emerging that activity has stepped up in anticipation of the April 2014 consumption tax hike with retail sales rising 2.3 per cent, led by increases in car sales. The fact that spending didn't actually fall given the sharp plunge in consumer sentiment largely reflects October's official announcement. The reality of rising prices (with more to come as the tax is increased) in addition to stagnant wages growth does not bode well for real household disposable income, even with the labour market continuing to improve. Spending should surge in the near term as consumers try to get in ahead of the tax, but once implemented in Q2, a sharp fall back in consumption is possible. Much will depend on how consumers and businesses react to the planned stimulus packages, of which the finer details are to be announced. The government is hopeful that its Yen 1 trillion tax breaks for businesses and homebuyers will encourage increased wages as this would create a cycle of higher incomes and consumption, bigger profits and eventually stronger investment and employment – all key factors necessary to end deflation.

Having come out of the recession, what is the forecast for the Eurozone after the last quarter drop?

With stalled growth, the contraction in GDP that has occurred in Germany, France and Italy, the region's three largest economies, is concerning. Weak demand in Europe, patchy global growth and a firm currency will hit exports whilst overall regional output is still smaller than at its pre-crisis peak. Recovery will continue to be slow although November manufacturing data improved to a two and a half year high. The growth rate in output and new orders both accelerated to their highest since August, and the pace of increase in export orders was highest since mid-2011. The other concern is that overall employment levels continue to fall as companies strive to become leaner and more competitive. This is a burden for spending due to record high unemployment, negligible income growth, and tight access to credit. The Eurozone should continue to recover moderately but these factors along with high private and public sector debt will limit the upside potential.

Will the UK economy continue its path to recovery?

Yes, it should continue to recover with growth expected to reach 2.3 per cent by December 2014. Risks are fairly evenly balanced, with those on the downside reflecting a persistently strong GBP and potentially weaker growth in the Eurozone. The re-focus on targeting business lending could help support a sharper recovery in investment and employment, which may generate a bigger recovery in income growth and support stronger consumer spending. The BOE also expects unemployment could hit its predicted target as early as Q4 2014 – two years earlier than expected. The lower inflation forecast (if achieved) is also good news for consumers, whose real wage growth continues to be squeezed, posing a threat for ongoing recovery in consumption. Consumer spending was the key driver of Q3 GDP growth but the constant discrepancy between wages and prices raises uncertainty as to whether this will remain the case.

Has the risk of a UK housing bubble eased since housing stimulus was eased?

As a key support for consumer spending, housing sector recovery has been crucial. Prices are still around six per cent below their pre-GFC peak. The upward trend is very encouraging but has raised concerns of bubble territory. In light of this, the BOE announced measures designed to keep a check on the housing market, including dropping financial incentives to lenders to provide home loans, imposing tougher affordability tests before granting home loans, and ensuring annual financial health checks on banks include the impact of major housing market shocks.

What does China's new economic blueprint entail?

This is the boldest package of policies seen in China in decades. Economic reforms focus on private sector involvement in allocating resources and building a unified, open, competitive and orderly market system. Political and fiscal reform involves streamlining the government and confining the administration to maintaining macro-economic stability, risk control and providing public goods and services with focus on improving the budget system whilst gradually adjusting the fiscal revenue divide through taxation reform. Financial and banking reforms aim to open up the banking sector to allow private capital to set up banks, accelerate Yuan convertibility, ease restrictions on cross border capital and financial transactions, improve risk management practices and financial infrastructure, and accelerate interest rate liberalisation. State-owned enterprise reform will promote market-orientated practices by breaking monopolies, introducing competition and improving government regulation; and social reform aims to improve income distribution, manage the ageing population, and create a stronger social safety net. The government is also seeking to promote the future development of rural areas with land reform.

Are these reforms likely to succeed?

Skeptics believe that reforms will be difficult to implement as resistance from vested interest groups is likely and will establish a National Security Committee and Central Leading Group on Reform with the power to push through reforms. The reform process will take time, with the changes and benefits unlikely to be fully visible until well into 2015. Over the medium term, many of the reforms should help lift China's potential growth rate by transitioning the economy towards consumption, services and innovation.

What does this mean for investment strategies?

There is always a visible divergence between anecdotal, coincidental or leading economic activity as opposed to financial asset market price trends. Financial asset market prices are driven by the necessity to save for the future, provide a sufficient income stream for now or the future, borrow, invest, speculate, accumulate and build wealth for oneself and for future generations and many more such needs. However, two key emotional factors that have stood the test of time are 'greed' and 'fear' that have over and over proved to be the most dominant determinants of financial asset market price trends.

We subscribe to the view that the financial asset market cycle that began in March 2009 is quite mature. Asset market returns over these years have been unusual and substantial. With headwinds such as global deflation, unfavorable demographics and volatile geopolitics beginning to dominate the global theatre, it is quite conceivable that investment returns in the future will remain low relative to the past, delivering low to mid single digits over the next year. The key to successful investing in such an environment is to be an active investor rotating portfolio risk around when needed.

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