A new beginning

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ADVANCE

As we enter a new year, we ask Felix Stephen, Head of Strategy and Research at Advance to reflect on how key global economies performed in 2013 and share his thoughts on recent world events and the outlook for these economies and financial asset markets in 2014.

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Australia

GDP growth for the 12 months ending September 2013 was 2.6%. The Federal Treasury revised the anticipated 3% economic growth outlook for 2014 down to 2.5% and their assessment now reveals a 'substantial deterioration in the domestic outlook' and a more significant fall predicted for mining investment.

US

GDP growth for the 12 months ending September 2013 was 1.95%. The final revision to the US September quarter GDP report showed stronger growth at 4.1% annualised, a notable increase and the strongest expansion rate in two years. Consumer spending also showed solid growth for the year and business investment was revised higher to begin to show consistent momentum.

Japan

GDP growth for the 12 months ending September 2013 was 0.85%. The most recent quarter showed a slowing from the initial burst of growth when Shinzo Abe came to power in December 2012 and introduced his three-pronged economic stimulus initiative, 'Abenomics'.

Eurozone

GDP growth for the 12 months ending September 2013 declined 0.78%. The Eurozone's mid-December Industrial Production report was anticipated to contain payback from September's contraction and the forecast estimate of a 0.3 per cent bounce back over October was consistent with expectations of a gradually strengthening of the currency bloc into 2014.

UK

GDP growth for the 12 months ending September 2013 was 1.20%. The three latest surveys covering manufacturing, construction and services have been robust. More significantly, the UK Office for Budgetary Responsibility is about to upgrade its forecast of GDP growth for 2013 from 0.6 per cent to 1.4 per cent and from 1.8 per cent to 2.4 per cent for 2014.

China

GDP growth for the 12 months ending September 2013 was 7.68%. Consumer prices in China increased by just 3% in November (down on October's 3.2% increase) and there is a strong possibility that the Government's 3.5% inflation target may come under renewed pressure in 2014. Leaders have pledged to give market forces a 'decisive role' in setting resources prices.

How is the uncertain future of Australia's automotive industry impacting economic sentiment?

Despite a brief spurt of expansion immediately following the Federal Election, latest manufacturing data shows a second consecutive month of contractionary activity. Businesses surveyed in December attribute the decline to decreased consumer and business confidence in Australia's automotive industry in the wake of Holden's recent decision to cease manufacturing production. This sentiment was also captured in the November Employment Report with unemployment rates increasing by 0.2% to 6.8% and 6.2% respectively in both hubs of the automotive industry, South Australia and Victoria.

Despite its decline, can the resources industry continue to underpin growth in Australia?

Morgan Stanley recently predicted that Liquefied Natural Gas (LNG) exports will help Australia eliminate its current account deficit for the first time in four decades. It suggests that mobilising LNG exports could transform the national economy and that Australia could quite conceivably overtake Qatar to become the world's premier exporter of LNG as soon as 2017 rather than by 2030 (as currently assumed). The US also has an excess of natural gas from shale sources but it is estimated to take between five to ten years before they have the necessary infrastructure and export terminals to sell significant amounts internationally. This lag provides Australia with a golden opportunity. According to the investment bank's analysis: *"...the ramp-up would be enough to see Australia record a current account surplus in 2015, the first time since the second quarter of 1975. It is difficult to overestimate the long-term structural importance of this industry to Australia."*

What does the quantitative easing (QE) tapering announcement mean for the US?

In light of the recent strengthening of the labour market, the US Federal Reserve (Fed) announced it would begin to taper asset purchases from January 2014. The QE program will still continue at a slightly slower pace of US$75 billion per month (down from US$85 billion). Asset purchases will also continue for most of 2014. The Federal Open Market Committee (FOMC) simultaneously announced they would keep short-term interest rates at current record low levels until well after the unemployment rate falls through the 6.5% threshold. While the FOMC went to great lengths to stress that this may be a tapering; it is not a tightening of monetary policy and Fed officials now predict inflation will remain weak over the next three years with the 2% target not anticipated to be threatened.

Can the Abenomics stimulus initiative support the Japanese economy through 2014?

The Japanese economy has cooled significantly since Abenomics was introduced 12 months ago. Corporate investment did not expand over the third quarter suggesting Japan's corporate titans are not convinced of the long-term effectiveness of Abenomics. Although the estimate of private consumption growth effectively doubled (albeit to a still rather modest 0.8%), it is most likely due to consumer 'front loading' – purchasing big-ticket items ahead of the national sales tax hike in April. The November core consumer price index (which includes oil products but excludes the volatile cost of fresh foods) increased by 1.2% in the year giving confidence to the Government and the Bank of Japan (BOJ) as the monetary impetus of Abenomics endeavours to raise inflation to 2% by 2015. Authorities have also welcomed developing price pressures but the sustainability of these pressures is doubtful. Most are the result of the Yen's depreciation by more than one-fifth (due to the BOJ's enormous expansion of the money supply) and represent an increase in the cost of imported energy rather than growing demand for products at a higher cost. The real test will come in the northern spring with the annual shunto ('spring struggle') negotiations between unions and management. For BOJ to meet its inflation target, wages will also need to rise in line with the rising prices.

How is political stress in the Eurozone impacting the region's economic recovery?

The divergence in economic performance between the two key Eurozone nations, Germany and France, will cause more severe political strain should it continue. France is on the cusp of a triple dip recession and President Francois Hollande has the lowest popularity ratings of any French President in modern history ahead of the forthcoming French regional and European parliament elections in late May. Hollande may succumb to Italian politician Romano Prodi's recent calls to establish a Latin Bloc of France, Italy and Spain to force a reflation policy through the European Union. The Eurozone will continue to be at risk of recession without a significant increase in global demand and thus the mandate for the European Central Bank remains disinflation and the Eurozone growth deficit. The growing austerity fatigue in the Mediterranean countries of Greece, Italy, Spain and Cyprus is likely to increasingly test resolves.

Is the seemingly positive growth seen in the UK in 2013 sustainable in 2014?

Review of the UK's third quarter GDP indicates an unbalanced and geographically skewed economy despite robust manufacturing, construction and services, an upwards revision of forecast GDP growth and the fastest third quarter growth in just over three years.

The services sector recovered most of the losses during the 2008-2009 recession but manufacturing and construction are 15% below their pre-GFC peak. Consumer spending has underwritten economic expansion since the start of 2013 due to the reticence of industrial giants to invest and restricted government spending. The Bank of England (BOE) reported the increase in consumer spending was due to the largest decline in savings for 40 years, although spending was also supported by cheap money, the BOE Funding for Lending Scheme and rising consumer confidence.

Rising consumption typically encourages investment in mature developed economies however British firms are not convinced that current consumer spending patterns are sustainable. A PWC report actually revealed that some 75% of the top 100 British stores were running heavily discounted promotions (with an average of 46% discount) in the lead up to Christmas. An increase in real wages would broaden and prolong the current rate of expansion and indicate to the corporate market that levels of consumer demand are sustainable. In turn, this would generate confidence to start building new investment capacity.

How are Chinese authorities working to transition their economy to a developed market model?

The Communist Party's Central Committee has pledged to give market forces a 'decisive role' in setting prices for natural gas, electricity, oil and water. They are also seeking to loosen restrictions over interest rates (which have been kept artificially low in the past). A rebound in production will also be crucial in transitioning China towards a developed market model. The consistent inflation in China has provided a growth cushion for authorities to create enough new jobs to counteract the economic and industrial restructures that will follow these reforms.

The Government finally ended its policy of rapid economic growth at any cost in 2013 and is ready to address the consequences of acute environmental degradation, unbalanced regional growth and social injustice. Although growth may never reach the double-digit year-on-year GDP expansion of the past few decades, the power is now decidedly shifting from the Communist Party to the markets and policies now favour the nation's embryonic private sector. Private companies can now compete on a more even playing field with state-owned banking and resource corporations. Beijing has also signaled its intent to encourage joint ventures in healthcare, infrastructure and education from public sector and privately-owned enterprises.

What does this mean for investment strategies?

Gains made in almost all financial assets over the past (almost) five years have been exceptional from a historic standpoint. These were primarily due to the artificial depression of fixed income yields by the central bank. This in turn forced retail investors to seek higher income streams and capital gains. Gains made in financial asset market prices have also cascaded into real assets, such as residential property, through improving household balance sheets and the wealth effect.

As the Fed gradually takes away 'the punchbowl of easy money', the resulting impact can be seen in emerging market assets and capital flow patterns. The impact on emerging economies is making investors who are long risky assets, re-assess their appetite for risk, irrespective of the global economic outlook or the need for a superior income stream. The tide is likely to turn against further spectacular growth asset price appreciation with evidence indicating that historically high levels of speculative investing has been predominantly financed through cheap funding.

We subscribe to the view that increasing social unrest and geopolitical events may offer the catalyst for a sea-change in investor risk appetite. This underscores our belief that investor sentiment almost always determines asset price trajectory; and increased geopolitical risk increases the vulnerability of markets because investor sentiment at present is 'euphoric'. A better risk/reward outcome based on not just economic data but a whole set of related disciplines needs to be monitored and analysed closely in order to be a successful investor in an increasingly more complex financial asset market landscape.

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