Looking to rebalance

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Many major economic regions of the world showed some tentative signs of growth for the start of 2014 but challenges remain as they seek to rebalance their economies. The opportunity for ongoing growth continues to be sensitive to a range of pressures unique to each region, such as currency strength in Australia and the Eurozone, or consumer confidence in Japan. Felix Stephen, Head of Strategy and Research at Advance, considers the recent economic data and the likely ongoing outlook for recovery and growth.

Australia

GDP for the 12-months ended 31 December 2013 increased by 2.8%, slightly higher than anticipated. The result has led to cautious optimism that Australia's economy is finally starting to re-balance away from the mining sector towards non-mining, dominated by consumption and housing investment. The Reserve Bank of Australia (RBA) kept monetary policy unchanged for the sixth consecutive month and is expected to remain on hold for the short term.

US

While the impact of severe weather conditions across December and January has generated mixed messages about the underlying activity in the US, the data typically indicates softer activity compared to the end of 2013. February data has been more encouraging and suggests the economy is resuming its growth momentum. As a result, the US Federal Reserve (Fed) is likely to continue the tapering of quantitative easing, subject to ongoing economic performance.

Japan

GDP for the 12-months ended 31 December 2013 declined 0.4%. This result was weaker than expected but initial data for 2014 indicates Japanese activity is gaining momentum ahead of the 1 April sales tax increase. The Bank of Japan (BOJ) expects a surge in activity prior to the tax increase and a decrease following, with growth to resume late in the year. In light of this, the BOJ continues to maintain its approach to quantitative easing, but has also extended its special loans programs for banks which was due to expire.

Eurozone

Better than expected activity data and February inflation numbers have relieved pressure on the European Central Bank (ECB) to provide additional support for the recovery through a form of quantitative easing. As such, the ECB recently voted to continue with its existing policy.

UK

The Bank of England (BOE) provided an update on UK growth and inflation forecasts, and further clarity on its policy stance and forward guidance. Although offering a more positive outlook, the BOE still maintains that interest rates will remain on hold at least until the middle of 2015. For now, data continues to indicate the recovery is gathering momentum.

China

GDP for the 12-months ended 31 December 2013 increased 7.7%. The annual meeting of the National People's Congress saw China's leadership set the 2014 GDP growth target at 7.5% - unchanged from the 2013 target. The government also reaffirmed its commitment to rebalancing growth away from an over-reliance on investment towards consumption but more recent growth indicators suggest growth in the first quarter may be lower than this estimate.

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Is the push to non-mining investment viable and translating to growth in Australia?

There is little evidence at present to suggest that the non-mining business sector is growing fast enough to cover the rapid slowdown of the mining sector. That said, the housing sector has been a key buffer for the economy and remains well supported by low interest rates and persistent investor demand. Demand for the housing sector is expected to remain strong, bolstered by ongoing low interest rates and continued strong activity from foreign buyers.

Business sector sentiment and conditions have strengthened but this is yet to translate to stronger investment, and appears unlikely to do so this year or next as the extent and pace of the slowdown in mining investment is significant. However, the RBA noted that tentative signs of improvement in investment intentions exist. The decline of the Australian dollar will play a strong role in fostering business investment and has already aided the manufacturing, construction and retail sectors.

Gains in the retail sector have also been reflected in solid overall household spending, supported by low interest rates and the wealth effect of rising house prices. Despite this, consumer confidence has been affected by the weak labour market conditions and subdued wages growth. Recent news of job cuts at Qantas and Toyota are expected to stifle confidence in the labour market further and may in turn impact on household spending.

The RBA expects the continued decline of the Australian dollar and low interest rates to be significant drivers for the economic growth of the non-mining sectors in Australia.

How has the adverse winter weather in the US affected economic conditions?

The extreme weather in the US continued to affect housing activity and the consumer sector at the start of 2014. Existing home sales dropped to their lowest level in 18 months during January.

Consumer spending fell in January too, most notably at retail outlets and auto dealers, although spending on services, particularly home heating, was up due to the cold weather. Consumer confidence remains at a reasonably high level, although it has been mixed in recent months. Consumer sentiment surrounding expectations six months from now increased in February, while sentiment about current conditions declined.

The manufacturing sector showed better than expected data in February and is anticipated to increase further in March. New orders increased sharply, although still below December levels, and may offer a rebound in production in March. Regardless of the impact of the extreme winter weather, the US Federal Reserve expects the economy to continue to expand at a moderate pace and will continue to taper its program of quantitative easing.

Does current growth mean the BOJ will change its stance on quantitative easing?

Increased retail sales and a surge in industrial production are positive indicators of growth ahead of the 1 April sales tax increase. The monthly consumer price index registered its first decline in 11 months, however annual core inflation moved to a new five-year high.

The pass-through from the weaker yen over the past year appears to have almost run its course and will in turn take the pressure off prices. Likewise, there is little price pressure from wages growth. Waning inflationary pressures will be a focus for the BOJ as it aims to reach a 2% inflation target by the end of 2015. Whether the BOJ will increase quantitative easing will depend on how the economy adjusts to the sales tax hike across the next six months.

What has been driving recent growth in the Eurozone and is it sustainable?

The Eurozone has entered 2014 on a positive note, with business, services and industrial sentiment increasing. The Purchasing Managers' Indexes (PMI) also suggested stronger momentum. The overall trend is improving despite consumer sentiment falling slightly following two consecutive monthly gains.

Growth data in Europe was better than expected, particularly in Germany and France. Other countries such as Spain, Denmark and Italy also showed encouraging growth, with Italy's quarterly growth positive for the first time in two years.

The key drivers of growth by sector were exports and business investment. Ongoing exports strength may prove unsustainable if the Euro continues to strengthen and the slowdown in emerging markets intensifies.

The ECB continues to anticipate a long period of low inflation with lower commodity prices and a strong Euro to subdue price pressures, though it should be offset by improved domestic demand.

Will current positive growth performances support a rebalance of the UK economy?

The BOE indicated that reduced uncertainty, easier credit conditions and a stimulative monetary policy should support continued solid economic growth in the UK. The BOE anticipates a surge in business and housing investment to drive higher growth.

Household consumption and wages are expected to grow while consumer confidence remains consistent at its highest level since September 2007. Housing sector activity is buoyed by improving consumer confidence, falling unemployment, low borrowing rates and improved credit availability. The combination of strong demand and a limited supply have ensured an upward pressure on prices. Manufacturing continued to improve, driven by strengthening domestic demand, as did production levels and new business, which filtered through to the labour market. This outcome was broad based with consumer, intermediate and investment goods producers all reporting robust increases in output, new orders and employment. Maintaining this positive performance is crucial to achieving a rebalance of growth away from the consumer and financial sectors, and towards investment and exports.

Will China's plan to refocus economic growth on consumption be successful?

The Chinese government re-affirmed its commitment to rebalancing growth away from an over-reliance on investment to being more consumption-driven. The ambitious nature of the plans has been viewed with some skepticism as the extent of the changes is significant.

The economy is showing signs of moderating and policy will need to reflect that. The Government's commitment to this is underscored by the lowering of its investment growth target and the increased spending target. The government has vowed to pursue structural economic reform as a top priority. The main reforms include the following.

- Greater authority for financial institutions to set interest rates.

- A new environmental protection tax to help rein in extreme pollution.

- Currency market reforms to tighten the trading band of the yuan against other currencies.

- Encouraging private sector investment in oil, power generation, railways and telecommunications.

- Reduction of government red tape.

Diplomatic tensions have increased in the past year as China has asserted sovereignty over islands and sea lanes in the Asia region, and its ongoing commitment as reflected in the expectation that defense spending will increase by 12.5% in three years.

What does this mean for investment strategies?

The maturity of the global investment cycle has left it vulnerable to heightened volatility as investors who benefited from the rally in growth assets take risk off while those who didn't participate take risk on. The frequency of this market behaviour is likely to challenge conventional investment philosophies and balancing risk relative to available rewards. The investment community continues to slavishly follow economic data, failing to recognise that these do not determine investment market trends.

Modern central bankers understand that easy financial conditions provide tailwind support while the reverse creates strong headwinds. Central bankers are now concerned the engineered easy financial conditions have failed to produce sufficient economic traction through the 'positive wealth effect'. They are gradually withdrawing the access to easy money with the view that the same policy needed to prevent the world economy from moving into depression may now create problems in financial markets that will be difficult to correct.

The adjustment, or normalisation, of policy has only begun and is likely to tighten financial conditions. The need for careful balancing of risk to rewards is extremely important at this stage of the global investment cycle. Advance continues to highlight that the biggest risk in the horizon is geopolitical instability that could have a significant negative impact on financial market trends. Active and dynamic risk/reward management is the only solution.

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