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The global economy continues to show reasonable prospects for improvement in 2014 despite slight slowdowns in some regions. Felix Stephen, Head of Strategy and Research at Advance Asset Management, considers recent activity in the domestic and international economies and the likely outcomes that could eventuate.

## Australia

The Reserve Bank of Australia (RBA) is likely to keep interest rates on hold at 2.5% for the remainder of 2014, unless there are dramatic changes in the economic trajectory. The economy is still vulnerable to negative shocks due to slowing growth trends in China and largely subdued business conditions, although continued solid growth in consumer spending and signs of increased strength in the business sector may buffer the economy.

## US

The outlook for US Federal Reserve (Fed) policy remains unchanged, but will now be based on more qualitative forward guidance. If the US economic recovery continues as expected after weather-induced setbacks in early 2014, the Fed will continue its measured pace of tapering quantitative easing, with a view to ending it around October.

## Japan

Activity was robust leading up to the April consumption tax hike from 5% to 8%, but a sharp decline in activity in Q2 is expected. Authorities remain confident

this will prove to be a short-term phenomenon, due to the positive offsetting influence of the government's fiscal stimulus plan, a view backed by the Bank of Japan.

## Eurozone

Inflation fell to 0.5% (a 4½ year low) but did not spur the European Central Bank (ECB) to inject further stimulus into the Eurozone. Pressure to act to counter the deflationary threat is mounting, with consistent evidence that low inflation is persisting and the nascent economic recovery is faltering.

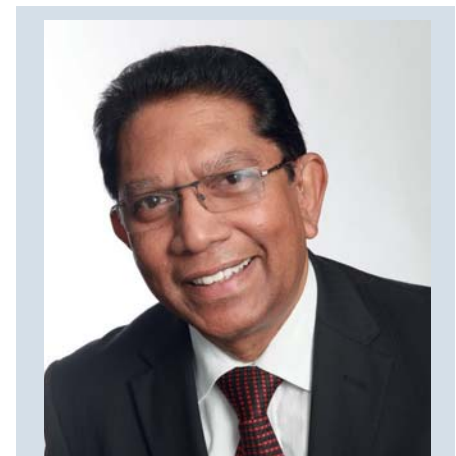
## UK

The UK continues its solid recovery, although activity has moderated slightly – welcome news for the Bank of England, concerned about the strong momentum in housing. Consumer activity is stable and although business is strengthening, more investment is needed to foster a sustainable recovery.

## China

Recent data suggests that China's economic slowdown has deepened since the start of the year; however, this may

be overstated due to the Lunar New Year. The government is fast-tracking investment and construction to ensure domestic demand expands at a stable pace to support the economy. Additional mini-fiscal stimulus includes spending on railways and tax relief.



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.

## What is the RBA forecasting for Australia's economy?

The additional capacity put in place for resources in the past few years should see export volumes continue to pick up. The transition of growth to non-mining sectors continues to be slow; however, housing construction is also expected to rise strongly.

The RBA expects economic growth to continue and potentially strengthen later in the year and into 2015. This is dependent on the impact of negative issues such as declining mining investment and fiscal drag following the May Federal Budget; and positive issues, such as the lower exchange rate and improved overseas economic conditions.

Governor Stevens reiterated expectations that inflation would be consistent with the 2-3% target over the medium term and remains confident the expected decline of the Australian dollar will assist in achieving balanced growth. He cautioned the decline may be less than anticipated in light of its recent rise but the Australian dollar is expected to weaken over time as terms of trade continue to decline.

## How will the Fed respond to the US unemployment rate reaching its target threshold?

The Fed is likely to respond to unemployment forecasts reaching the 6.5% threshold by favouring a qualitative forward guidance approach based on assessing labour market conditions, inflation pressures and expectations, and financial developments.

It is also expected to maintain current targets after quantitative easing ends. Once employment and inflation are at mandated target levels, the Fed may keep the target federal funds rate below 'normal' for a longer period.

Fed chairperson Janet Yellen indicated that the considerable slack in the economy meant the extraordinary steps taken to revive the US economy are still required. As workers in a slack labour market have little leverage, attention to trends in terms of 'quit rates', increased job openings, wages growth and hire rates provide benchmarks for the market. There has been improvement in current trends but the Fed must continue to support this to achieve sustainable employment growth and still maintain stable inflation rates.

## Will low inflation persist in the Eurozone and what are the ramifications

The ECB is not convinced that low inflation will continue, citing that factors causing downward pressure on prices should fall out of data in coming months. Annual inflation is expected to pick up in April, partly related to the volatility of service prices around Easter and is critical to determining further support.

If it does not pick up, it is likely to put upward pressure on an already strong Euro, adding to deflationary pressures and hampering exports. The threat of continued low inflation increases the risk of medium-term inflation expectations being ratcheted down. As a result, consumers and businesses would be likely to put off spending and investment in anticipation of further price and cost declines.

The falling prices of deflation also increase the real burden of debt making it more difficult for those trying to pay down debt. Should this occur, the ECB will be under pressure to act and has agreed to take a variety of measures if required to stop a deflationary spiral.

Measures discussed included a new round of cheap loans to banks, large scale purchases of financial assets, reducing the deposit rate below zero (which penalises banks for holding money at the ECB instead of lending it), and cutting the main refinancing rate.

## Why is China implementing a short-term mini-fiscal stimulus package?

Latest data was disappointing for Chinese authorities and investment markets relying on stable solid domestic growth to help drive stronger global growth. Industrial production collapsed to its weakest pace since April 2009, retail sales slowed to an eight year low, fixed asset investment (a key growth engine) slowed to a 14-year low and exports collapsed dramatically. These all contributed to China's first trade deficit since March 2013, although it is likely overstated due to the Lunar New Year holiday.

This could threaten the government's intention to create 10 million jobs over 2014 and keep unemployment down. Social instability can arise without solid employment growth and the prospect of job gains is reduced if the economy slows too much.

Authorities reiterated that the acceptable lower-bound growth rate must be enough to guarantee sufficient employment outcomes and, underpinned by the severity of activity weakness, announced stimulus to speed up investment and construction plans to grow domestic demand. They stressed that structural reform, not large short-term stimulus packages, was the key to sustainable growth.

The mini-fiscal stimulus package comprises spending to help build railways; tax relief, including extending a preferential tax policy to more small companies; and relaxing rules to allow more foreigners to invest in its share market. This comes on the back of widening the yuan's trading band to make it a global currency.

## What does this mean for investment strategies?

Financial asset markets typically discount a range of complex information, including economic data, in the present value of financial assets. This is a consequence of the historic nature, behaviour and psychology of financial market investing.

As a result, any excessive reliance on economic data and, even economic forecasts, is fraught with danger. Historic patterns of investor behaviour and financial asset market price movements can offer valuable guidance and information. In particular, financial asset market volatility is a good guide to future financial market trends at the start and towards the end of a financial market cycle.

The typical type of increased financial asset price volatility witnessed in early 2009, subsequent subdued asset price volatility and the present in increased asset price volatility in certain asset classes appears to be a reasonable guide to the five year bull market in risky assets reaching a mature stage and therefore being vulnerable to a cyclical correction.

We believe investors should be ultra cautious at this stage of the global investment cycle and not over-extend through excessive portfolio “gearing” or carry a high concentration of risky assets in their investment portfolios.

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