The path to sustainable growth

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The global economy continues to show signs of recovery though questions remain over the sustainability of this trend. Ongoing concerns such as the Russia-Ukraine crisis, tapering of quantitative easing by the Fed and the slowing growth in China will have an impact on the favorable outlook for ongoing global economic growth. Felix Stephen, Head of Strategy and Research at Advance discusses these issues in light of recent data releases.

Australia

Latest evidence pointing to Australia's transition to non-mining sector growth is progressing and inflationary pressures remain subdued. This implies that the Reserve Bank of Australia (RBA) could maintain a stable interest rate policy, especially with the tighter fiscal policy, a more resilient AUD and slowing growth in China. Upcoming data releases will have a critical bearing on their stance to potentially even ease policy in the future.

US

March quarter GDP data confirmed the heavy impact of adverse weather conditions early in 2014 but more recent data signals a rebound from the earlier lull. However housing activity looks to be more than just weather-related and suggests the sector may not provide as much support to overall economic growth as it did in 2013.

Japan

The first signs of a decline in Japan's economic activity following the three per cent sales tax increase on April 1st are emerging with motor vehicle sales contracting sharply along with manufacturing activity. Any easing in policy is unlikely until the second half of 2014 when the extent of the negative impact on the economy arising from the tax hike will be clearer.

Eurozone

Despite signs that the Eurozone economy continues its gentle recovery, key challenges remain. Deflationary pressures persist, accentuated by a stronger currency, while banks remain reluctant to lend. However, the European Central Bank (ECB) appears ready to act in order to alleviate economic headwinds by introducing negative deposit rates for banks or potentially undertaking some form of quantitative easing.

UK

Continued positive economic recovery in the UK suggests activity will remain fairly solid over 2014 but increased speculation that the Bank of England (BOE) may bring forward its first interest rate hike to early 2015 may be a headwind to any further strength in economic trajectory. However, once the excess slack in the economy is absorbed, this could lead to the emergence of inflationary pressures which will be the trigger for the BOE to increase rates. However, in the immediate future, policy is likely to remain unchanged.

China

The slowdown in Chinese growth to 7.4% is now at its slowest pace in over a year, and there are fears that it is heading for a hard landing. Although there are repeated calls for the authorities to shore up activity while the economy is still drowning under excess capacity brought on by the economic stimulus package that was implemented following the 2008 global financial crisis, the Chinese leadership is focused on introducing structural reforms that are are integral for China to achieve a more sustainable and balanced economic growth path in the future.

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.

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Key points to note:

Recent data in the US has been encouraging and the US Fed is expected to continue with the current pace of tapering of the quantitative easing program and the market will need to adjust to a new equilibrium.

There are early signs of the expected fall back in spending post Japan's sales tax increase but this is expected to stabilise over the year and it will take time to assess the full impact of this.

Overall Eurozone data is encouraging however as deflationary pressures and the strong Euro persist, the ECB may need to inject further stimulus at its meeting in early June.

Encouraging data from UK indicates that the BOE may bring forward its interest rate hike to bolster the ongoing growth and recovery of the UK.

While growth in China slowed, Chinese authorities have announced a number of stimulatory measures to manage this, more so to smooth the potential economic measures of longer term policy initiatives.

Impact for investors

Recovery continues to be slow but there have been positive indications in recent data for a number of economies, however different regions are coping with different issues which could result in increased volatility. Ensuring a broad diversification across asset classes and regions may help assist in managing these risks.

Will the US Federal Reserve (Fed) continue its tapering program?

Recent US data signals a rebound from the earlier lull, with April's labour market report one of the most encouraging data releases for some time. As long as economic activity continues to look promising from its first quarter weather-hampered weakness, the Fed should continue its tapering program.

Encouraging signs from both the business and consumer sectors should help offset any lack of activity in the housing sector. It is likely that only a fairly negative shock to the economy might make the Fed pause its current policy.

If growth does begin to pick up pace more strongly than expected, the Fed may lean towards increasing the federal funds rate earlier than the mid-2015 timeframe currently estimated, however the outlook is uncertain with the US economy prone to domestic and external risks, particularly as geopolitical tensions mount and global growth remains lacklustre.

What has been the early fallout of Japan's April 1st sales tax hike?

Motor vehicle sales have declined sharply and expectations are that May numbers will also show weakness as buyers baulk at the tax hike.

Manufacturing activity also fell in April, marking the first contraction in activity since February 2013 and the biggest monthly decline on record. In a sign of further contraction, both new domestic and new export orders dropped, with firms clear in their view that the tax hike was to blame. On the positive side, payroll numbers increased at a greater pace and employment growth was the sharpest since February 2007, however signs that price pressures continue to build was also evident. April consumer price inflation data is only available for the Tokyo area at the time of writing, however it is a good guide to national trends.

Over the year, Tokyo's consumer prices rose by 2.7 per cent, the fastest pace in 22 years, suggesting that companies have been able to pass on the tax to consumers, for whom the strain will be clearly felt, and will ensure that the recent burst of spending will quickly fall away. Bank of Japan (BOJ) Governor, Haruhiko Kuroda indicated continued optimism that the economy could withstand the sales tax hike, but reiterated that they would not hesitate to adjust policy if needed to support its inflation goal.

What challenges threaten the Eurozone's continued recovery?

Overall economic data out of the Eurozone has been encouraging but despite signs of a continued slow recovery, key challenges remain.

Deflationary pressures persist, accentuated by a stronger currency, and banks remain reluctant to lend.

Add to these issues the external geopolitical tensions, especially in relation to the Ukraine-Russia crisis, the downside risks to the Eurozone are growing. ECB President, Mario Draghi has reiterated that the Bank stands ready to act to help alleviate economic problems, either through the introduction of negative deposit rates for banks or undertaking some form of quantitative easing.

Levels of manufacturing output and new business increased across all countries, but this strength is yet to feed through to pricing power, with factory prices falling for a second consecutive month. Deflationary pressures therefore look to persist and the strong Euro currency is a key hindrance.

The ECB may have no choice but to inject further stimulus into the economy to avoid a deflationary trap.

How will the UK's solid economic activity elevate the risk of an early rate rise?

The UK economy accelerated in the first quarter of 2014 with the recovery broadening to show all sectors contributing positively to growth.

The consumer sector has been integral to this and latest indications are that it will continue to play a significant role. Spending continues to surprise on the upside and is supported by improved employment prospects, a pickup in wages and easing inflation.

Consumers are also beginning to borrow again with latest data showing a rise in personal loans for the first time in five years.

The BOE have been very vocal about the strength of the housing market and the potential financial risks it could pose to the recovery once interest rates rise and so the news that mortgage approvals fell for a second consecutive month in March to their lowest level since November was welcome.

The positive results have led to increasing speculation that the BOE will bring forward the timing of its first interest rate hike in expectation of the absorption of the excess slack in the economy and emerging inflationary pressures that these results inevitably bring.

With a first quarter slowdown in China, how are authorities responding?

China's growth fell to 7.4%, its slowest annual pace since September 2012, intensifying concerns that the economy is heading for a hard landing. China's structural reforms are integral to helping the economy achieve sustainable, more balanced growth. However, authorities have also announced tweaks to existing monetary and fiscal policy to help support short-term growth.

The slowdown is a result of various factors, the most significant being the deliberate tightening in credit conditions as policy makers have endeavoured to rein in credit growth, which will hamper economic activity going forward.

There is potential for further defaults within both the shadow banking sector and the banking sector raising serious systemic risks for the economy. For now the authorities remain confident that they can manage the slowdown and ease the economy off credit without posing a significant threat to long term growth prospects.

Both the People's Bank of China (PBOC) and the government remain steadfast that they will not consider more significant stimulus measures to support what they appear to consider "temporary fluctuations" in the economy.

What does this mean for investment strategies?

While the trajectory of global economic growth, the normalisation of Fed policy, anticipated stimulatory action by the European Central Bank to spur economic growth, policy settings in China and Japan get a lot of airplay and grabs the attention of retail investors and the popular press, they are only few of a multitude of factors that need constant review and deep analysis by both retail and institutional investors when assessing future price trajectory and risks inherent in financial assets.

In an increasingly complex and challenging financial asset market environment, investors also need to pay heed to the re-emergence of nationalism, social awaking in emerging and frontier economies, the prevailing fragmented and dysfunctional global geopolitical setting and the backdrop of the multi-polarity in the global political system, to name a few.

It is now obvious to many monetary authorities (who relied on their misplaced belief that ultra easy monetary policy, in its many forms and shapes, was the ultimate panacea to the ills of the world), that they have increased risks to financial stability in the global financial system when they forced traditionally risk averse investors to seek superior income streams in a low interest returning environment while encouraging leveraged and speculative activity in many global asset classes.

They acknowledge that there are many "bubbles" that need to be diffused in order to prevent the world from spiralling into a recession or depression.

However, the most crucial indicator of future asset market trends and risk is the psychology and behavior of investors.

The increase in sub-sector asset volatility, significant country, sector and sub sector asset rotations, the breaking down in sector and asset class correlations and the allocation of capital towards safe assets by long term institutional investors are some good indicators (amongst many such indicators) that global risk asset prices are very close to a cyclical price adjustment, irrespective of what anecdotal and/or future economic data may indicate.

Investors must pay close attention to these factors in order to protect their capital.