Reflections and Predictions

June 2014

Recent data in Japan, post the April sales tax hike, points to a sharp decline in economic activity despite confidence the economy can withstand this, and in China proposed structural reforms may help drive more sustainable long term growth. Felix Stephen, Head of Strategy and Research at Advance takes a look at key global growth drivers and headwinds and what they mean for investment strategies going forward.

Australia

Australia exceeded growth expectations with the economy expanding by 1.1% in the quarter to take GDP growth year-on-year to a two-year high of 3.5%. This may have been due to the positive impact from historically low interest rates on consumption and housing, a strong export impetus and a faster transition of growth away from mining investment or could even be a statistical distortion due to poor seasonal adjustments to data.

Nevertheless, some key headwinds such as the high AUD and the declining capital investment in the mining industry, could potentially limit further growth over the coming year causing the Reserve Bank of Australia (RBA) to maintain current record low interest rate levels or even lower it.

US

Revisions to the US first quarter GDP was the first negative quarter since Q4 2011, with the economy contracting by -1.0% on an annualised basis, largely due to the impact of severe weather conditions. The outlook appears to be brighter with partial June data indicating a reasonable bounce back. It is likely that the US Federal Reserve (Fed) will continue to taper quantitative easing as planned, with a view to its completion by October this year.

Japan

Recent data post the April sales tax hike points to a sharp decline in economic activity with a possible bounce back later in 2014. Bank of Japan (BOJ) Governor Haruhiko Kuroda reaffirmed his confidence that the economy can withstand the sales tax increase while Prime Minister Shinzo Abe is due to announce the specifics of his structural reform, which will be crucial for potential economic growth later this month.

Eurozone

At its June policy meeting, the European Central Bank (ECB) announced a suite of unprecedented policy measures, with ECB President Draghi indicating that the Bank, if required, would act swiftly with further monetary policy easing. Perhaps this comes with the aim of surprising markets and lowering market interest rates and the currency, or perhaps to arrest the threat of deflation. Reaction has been mixed, with the Euro initially falling but then appreciating once again.

UK

A robust recovery continues to unfold in the UK along with a welcome ease in the pace of housing activity. Whether or not this continues is a key focus for the Bank of England (BOE) as they examine ways to ensure that the housing sector does not pose a significant financial risk to the overall economy. Against this backdrop, the BOE May Inflation Report indicated no rush to raise interest rates - a move it believes is still dependent on the degree of slack in the economy, and the prospects for its absorption.

China

China's slowdown continues, prompting the People's Bank of China (PBOC) to announce further targeted monetary stimulus to help soften the downturn.

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Felix has also been a consultant to institutions in Australia and overseas on strategic developments in funds management and financial markets.

The authorities have also stepped up rhetoric on proposed structural reforms that they believe will help drive more sustainable long term growth, yet it appears that progress is slow. We remain cautious on China, because of the potential risks to the economy from the shadow banking sector and the property market.

Key points to note:

The US economy contracted by -1.0% after revisions to the first Quarter GDP however partial June data indicated a bounce back. US Federal Reserve (Fed) will continue its quantitative easing program which is due to be completed by October 2014.

Unprecedented policy measures by the ECB were due to low May inflation data and a slowing in growth momentum over the first and second quarters. The deposit rate was cut to a negative -0.10% (a first for a world central bank), meaning banks will now be charged for leaving money overnight at the ECB. This will prompt them to lend money to other banks or the private sector, helping boost activity and economic growth.

Australia exceeded growth expectations with the economy expanding over the quarter to a two-year high of 3.5%. A key source of strength was exports, and may also be due to the positive impact from low interest rates on consumption and housing. It is unlikely that overall export growth will remain as high as it has been due to the manufactured slow down of the Chinese economy, and there is a risk that seasonal adjustments to GDP data may have distorted the end result.

Chinese government continues to recognise the likelihood and risks that economic growth will be much lower in the future with current target growth at 7.2% this year. However it is likely to be in the range of 7 to 8% rather than the average pace of 11% seen in the ten years to the end of 2011.

Impact for investors

Systemic risks from changes in Central Bank polices and developments in regional themes like China's economic rebalancing will continue to dominate the broader market risks and are likely to become more prevalent as time passes. We believe that the risks to financial market stability has risen significantly and a well-diversified portfolio across a broad range of asset classes can help manage these risks and potentially reduce exposure to market volatility.

What drove first quarter expansion in Australia and is this growth sustainable?

The key source of strength was exports, driven by increasing export volumes of bulk commodities like iron ore, with net exports adding a large 1.4 percentage points to growth over the quarter. Dwelling investment also grew, mostly reflecting a sharp rise in housing construction, as did alterations and additions, albeit modestly. Approvals look to have peaked but this positive pulse still has some way to run with commencements and construction holding out until early 2015. The multiplier effects of new home building to retail and services will also add to growth, as will exports, with volumes picking up due to increased capacity – especially in liquefied natural gas. It is unlikely that overall export growth will remain as high as it has been and the risk is that seasonal adjustments to GDP data may have distorted the end result. Other headwinds include the high Australian dollar, and the drop in consumer sentiment in response to proposed Federal Budget cuts, which may impact spending and household consumption, especially if unemployment increases.

Will the US continue its recovery despite the slower growth in Q1?

The US economy should continue to gradually improve with GDP likely to expand above trend. The Fed's program to taper quantitative easing will continue but overall financial conditions should remain supportive along with fiscal policy. An upward momentum in business investment is also anticipated and consumer spending will also benefit from lower household debt levels and improved employment prospects. Encouragingly the proportion of consumers saying that jobs are 'hard to get' has declined to its second lowest level since the GFC and the percentage of consumers expecting their incomes to grow over the next six months is at its highest since December 2007.

The expected continued labour market recovery should ultimately support stronger income growth, which at this stage is still quite subdued. Consumer sentiment trends are encouraging and retail sales grew at their fastest pace since August 2013. Household wealth has been boosted by rising house and equity prices so may continue to be a positive contributor however the evidence on this is tentative.

What measures did the ECB announce in order to avoid a deflationary trap?

The likely triggers for the ECB's unprecedented policy measures were very low May inflation data, a slowing in the first quarter growth momentum and signs of further easing in the second quarter.

Firstly, the deposit rate was cut to negative -0.10% (a first ever by a major central bank). This means banks will now be charged for leaving money overnight at the ECB prompting them to lend their money to other banks or the private sector, helping boost activity and economic growth. It is also likely to make Euro assets less attractive to investors, effectively placing downward pressure on the currency and leading to inflationary pressures via higher import prices.

There is uncertainty about the effectiveness of this measure, as banks no longer hold much cash in reserve at the ECB. The Bank also announced a 400 billion Euro liquidity program allowing financial institutions to borrow money from the ECB equivalent to up to 7% of their outstanding loans.

This targeted longer-term refinancing operation allows banks to borrow for four years at near-zero interest rates as long as they lend it to the real economy. Those that don't pass on the money must repay it after two years. Again, the effectiveness is limited to the extent that businesses and households want to borrow additional money.

Why does the BOE consider housing "the biggest risk" to the UK economy?

BOE Governor Mark Carney warned that the housing market represents the “biggest risk” to the economy because of “...deep, deep structural problems”. He noted that they are closely monitoring bank lending procedures to ensure the banks are adequately capitalised to withstand risks.

Housing is a major source of potential financial instability because historically low mortgage rates, previous incentive schemes to entice buyers into the market, and a rapidly improving labour market has driven housing demand in recent years with prices closely following suit. With interest rates generally expected to start rising, there are concerns that some home buyers may have over-extended themselves, raising the risk of a sharp increase in loan defaults down the track. Carney also said the BOE is concerned about early signs of resurgence in high loan-to-value mortgages, and are looking at measures to counter associated risks.

He played down prospects of an early interest rate rise by outlining other means including capping the amount an individual can borrow as a multiple of their income or value of their house, or imposing some form of affordability test that would assess the ability of borrowers to cope with much higher mortgage rates once interest rates do rise. These measures are more palatable than a rate rise as the current boom is rather concentrated in London, with other parts of the country only just showing early signs of recovery.

Why is China not implementing major stimulus to combat a continued slowdown?

Although the Chinese government continues to recognise the likelihood and risks that economic growth will be much lower in the future, President Xi Jinping does not see this as a viable reason to push through large stimulus measures. He is instead supporting what he calls a “new normal” pace of economic growth for China although he has not specifically stated what the “new normal” is. Given the government’s target growth is 7.2% this year it is likely to be in the range of 7 - 8% rather than the average pace of 11% seen in the ten years to the end of 2011, just before the pace started really easing.

On the basis of this, Xi believes that the government must remain “cool-minded” when faced with this “new normal”, but at the same time, he said they must act to reduce or prevent risks in the economy, by undertaking “...timely countermeasures...” thus, the PBOC’s recent lowering of the reserve requirement ratio in a more targeted way may form part of their strategy.

What does this mean for investment strategies?

Financial markets are likely to continue to be driven by the actions of global Central Banks, with regional monetary policies now starting to move away from the current stimulatory stance. These divergences are a result of an uneven recovery post the 2007 GFC which have seen the UK and US perform better relative to Europe.

Additionally the manufactured slow down of the Chinese economy continues to raise instability concerns for growth across emerging markets and increases the downside risks for key export markets like commodities. This has repercussions for Australian investors where the domestic economy is highly sensitive to changes in Chinese growth expectations through exports of raw commodities.

Despite the current strong relative position of the Australian economy, headwinds to future growth such as a high Australian Dollar, declining capital investment in the mining industry, reduced Federal Government spending and a sluggish job market outlook, suggest more challenges are still ahead for the domestic economy and corporations.

Given these dynamics, global equity and fixed income markets are likely to experience a greater influence from these issues given the uneven growth recovery. Systemic risks from changes in Central Bank polices and developments in regional themes like China’s economic rebalancing will continue to dominate the broader market risks and are likely to become more prevalent as time passes.

A well-diversified portfolio across a broad range of asset classes can help manage these risks and assist in reducing exposure to market volatility.

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