

A MID-YEAR REVIEW

July 2014

With subdued activity in Australia and the Eurozone, mixed results in the United States, Japan and China, and positive signs in the UK as we reach mid-year, we ask Felix Stephen, Head of Strategy and Research, to share his thoughts on how economic recovery is really tracking in key global economies. We also ask him to identify why labour, manufacturing, housing and property are so critical over the next six months to help build consumer and business confidence and support long-term sustainable growth.

AUSTRALIA

Subdued corporate and household confidence leading to modest economic activity is hampering Australia's transition towards non-mining sector led economic growth. This level of uncertainty saw the Reserve Bank of Australia (RBA) keep official interest rates at their historic low of 2.5% and we expect this to continue over the year, although weakening sentiment and further strengthening of the AUD may prompt the authorities to consider one further official rate cut sometime during this cycle.

UNITED STATES

Despite unexpected softness in consumer spending, the US economy continues its modest recovery from the sharp weakness witnessed earlier in the year. The Federal Open Market Committee continues to taper its bond purchases while keeping the official funds rate steady at 0-0.25%.

JAPAN

Details about the 'third arrow' of Abenomics – structural reform were released following 18 months of monetary and fiscal stimulus contributing to sustainable short-term growth. However it is too early to conclude if these policies have successfully pulled Japan out of the deflationary rut it has been in for more than a decade.

EUROZONE

Eurozone recovery is losing momentum with inflation remaining subdued, vindicating the European Central Bank's (ECB) unprecedented monetary policy stimulus

measures. With pressure to do more, a quantitative easing (QE) program is being investigated but is unlikely to be implemented until the impact of current measures are known.

UK

Market speculation as to when the Bank of England (BOE) may raise interest rates is founded on continued positive economic data releases from the UK. Inflation has remained below target for the past five months suggesting the possibility of excess capacity in the economy remains. Notwithstanding recent strong economic growth, a near term rate rise is very unlikely.



FELIX
STEPHEN

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.

Signs of an over-heating housing market has elevated risks of future financial instability, prompting the BOE to pursue macro-prudential policy initiatives to address these risks.

CHINA

Evidence that recent stimulatory policies are helping stabilise China's economy has finally appeared with manufacturing surprising on the upside, and a positive response from markets that the 7.5% GDP growth target is looking more achievable. Markets seem to be ignoring the underlying risks associated with elevated residential property prices and the rapid ascension of the shadow banking system.

Key points:

Subdued corporate and household confidence leading to modest economic activity is hampering Australia's transition towards non-mining sector led economic growth. The RBA is keeping official interest rates on hold and we can expect this to continue over the year, however further strengthening of the AUD and weakening sentiment may prompt them to consider a further rate cut sometime during this cycle.

Details of Japan's structural reforms (the 'third arrow' of Abenomics) have been released, with cutting the corporate tax rate at its crux, from 36% to less than 30% in a move to entice businesses to invest and encourage foreign direct investment. Japan's corporate tax rate is one of the world's highest and a key impediment to stronger business investment.

The UK's high levels of household debt and an over-heating housing market are the biggest threats to its future financial stability, prompting the BOE to pursue macro-prudential policy initiatives to address these risks. Inflation has remained below target for the past five months suggesting the possibility of excess capacity in the economy. In spite of recent strong economic growth, a near term rate rise is very unlikely. Signs of an over-heating housing market has elevated risks of future financial instability.

Evidence has appeared in China to suggest that recent stimulatory policies are helping to stabilize the Chinese economy with manufacturing on the upside and a positive response from markets that the 7.5% GDP growth target is looking more achievable.

What is the biggest threat to the non-mining sector supporting Australia's economy?

The persistent strength of the AUD and dwindling corporate and household sentiment are the biggest concerns. Business credit is gradually picking up but the Australian dollar's resurgence may temper stronger

momentum while continuing softness in sentiment, particularly in respect of household finances could thwart corporate confidence and prompt corporate executives to shelve or pare back investment plans. If the consumer sector continues to struggle and the currency keeps defying expectations, it will be harder for the trade-impacted non-mining sectors, (manufacturing, retail, wholesale, tourism) to grow as mining investment fades. The RBA will be closely monitoring these factors (given inflationary pressures remain contained) and may be able to reduce official interest rates if the economy shows any further weakness. The authorities are also aware of the potential imbalances generated by the buoyant residential property markets and the negative spillover impact this could have on the broader economy. They are likely to favour regulatory policies to address those risks rather than rely on monetary policy to trigger the adjustment, similar to the stance taken by the Bank of England.

What is driving the continuance of measured tapering in the United States?

The Fed continued to wind-down its asset purchase program and should persist with this strategy if there is ongoing improvement in labour market conditions and if projected inflation drifts towards their longer-run goal. June employment numbers beat even the most optimistic of expectations, bumping the three-month average gain up to its strongest pace since February 2012 (which was boosted by the government census). With wage growth remaining subdued and slack in the economy evident, it's likely that the Fed will stick to its current policy stance, while official interest rates are likely to remain lower for longer.

What does the 'third arrow' of Japan's Abenomics program entail?

The 'third arrow' is structural reform to boost Japan's long-term growth and tackle structural challenges. At its crux is cutting the corporate tax rate from 36% to less than 30% to entice businesses to invest and encourage foreign direct investment. Japan's corporate tax rate is one of the world's highest and a key impediment to stronger business investment, crucial to sustainable growth. Another element, important for investors in Japanese equities, is stricter corporate governance rules. Other measures that address economic challenges relating to Japan's ageing and declining population include increasing incentives for older men and younger women to enter the labour force, raising the number of skilled foreign workers and reviewing inflexible labour market policies. The Government is also negotiating agreements with the European Union to reduce or remove tariffs on the Auto and agricultural sectors, but is facing strong domestic opposition.

What is the fallout from Japan's April consumption tax hike?

Activity seems to be recovering with investment plans, at the biggest manufacturers, surprisingly strong, which will support the adjusting economy and should filter through to stronger wages growth and consumption. Jobs growth surged in May, more than offsetting April's decline, and the job-to-applicant ratio hit a 22-year high with 109 jobs available for every 100 job seekers, and unemployment declined to its lowest since December 1997. The consumer sector is slowly improving but household spending fell four times more than expected in the year to May, reflecting the sharp pull back on housing, cars and household appliances that surged prior to April. The next few months will prove crucial in determining Japan's capacity to absorb the tax hike and whether the Government will further raise the consumption tax in 2015.

Are the European Central Bank's new stimulus measures supporting recovery in the Eurozone?

The measures are encouraging but it remains uncertain if they will stimulate lending, demand and growth. Rates have been near zero for so long with limited impact on lending, and banks are still trying to improve balance sheets with some still carrying significant bad debts. Until this is addressed, the new measures may yield little in the way of stronger lending and economic growth. Recovery remains fragile and uneven with declining manufacturing activity implying that GDP growth will remain weak in the near term. Activity in Germany and France was discouraging although peripheral growth is gathering steam, but the outlook remains subdued with softness in new domestic and export orders impacting unemployment, still at a near record high with youth levels at an unbelievable 25%. This is likely making consumers skeptical of any new policy initiatives. Price pressures remain mute with inflation still at its lowest level in more than four years, begging the question - will deflation take hold? That depends on whether current softness persists with the ECB investigating quantitative easing.

What is threatening the sustainability of the UK's recovery?

High levels of household indebtedness and an overheating housing market are the biggest threats. Household debt is around 140% of GDP, suggesting vulnerability when interest rates do rise. Much of this is directly associated with housing, as low interest rates encouraged more buyers while the share of home loan-to-income ratios reached record highs. The risk is that in the bid to pick up lending, banks may have been lax in their lending standards and borrowers may have over extended themselves. When interest rates do rise many may struggle to make repayments, potentially threatening the banking system, so the BOE have

announced further measures to mitigate the risks without raising interest rates including a new affordability test capping any lender's total number of new residential mortgages. The BOE say the measures are not intended to restrain current housing activity nor stop households who can afford mortgages from obtaining them, but will prevent lending from getting too far ahead of income growth. New macro-prudential rules to alleviate housing sector risks will allow the BOE to keep interest rates low until it determines that excess slack in the economy has been mostly used up.

Are stimulatory policies implemented in China supporting a recovery?

Evidence that recent stimulatory policies are helping stabilise the Chinese economy is finally apparent. Manufacturing data is always scrutinised as a valuable indicator of growth potential thus China is closely watched given its rising significance in the global economy. Strong June manufacturing results elicited positive market reaction indicating a bounce back from its earlier lull. New export orders also improved due to external demand and the Government's reform measures supporting growth and facilitating trade. Retail sales, fixed asset investment and industrial production also rose, supporting our view that growth is stabilising. Property remains a concern however, given continued softness, pessimistic sentiment and downward pricing pressures. For homeowners, especially those owning more than one property, further price falls could result in multiple mortgages in excess of the home's value prompting negative implications for the banking and shadow banking systems.

What does this mean for investment strategies?

As the RBA and other authorities continue to manage the transition of the domestic economy away from mining investment, investors will likely be focused on the direction of interest rates, the level of the AUD and the trajectory of Chinese growth for hints to future directions in domestic equities. More broadly, global influences that may increase volatility for investment markets continue to develop and are linked to an end to the US Federal Reserve's 'QE3' program scheduled in October this year and the implementation of the proposed further 'twin supports' for economic growth by Japan and European central banks.

As recently highlighted in the International Monetary Fund (IMF), Bank of International Settlements (BIS) and the Comptroller of Currencies (OCC), financial asset market prices have deviated away from basic and fundamental economic foundations, largely as a result of ultra-loose monetary policy. While this is quite normal, what is extremely concerning this time around is the sheer magnitude of such a deviation, prompting

the above authorities to caution central banks that their many policies have created systemic risks to the global financial system and to the global economy that may require immediate attention. We have been highlighting these risks and cautioning our investors that they also need to be mindful of how they gather and manage financial assets under these highly unusual conditions.

In order to narrow the existing gap between economic fundamentals and financial asset market prices, we need either for asset market prices to decline or rapid employment growth, accelerating manufacturing and service sector growth, higher corporate and household investments and consumption and aggregate global growth closer to potential. Given that a long period of ultra-easy monetary policy has yet to deliver this ideal outcome and instead has created multiple financial market and economic risks, investors must be cautious when taking on investment risks at this stage of the market cycle and weigh every investment decision they make being fully aware of potential risks and rewards.

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ADVANCE
ASSET MANAGEMENT

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