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ASSET MANAGEMENT

BALANCING THE SCALES OF STABILITY

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Global political turmoil has escalated in recent times, which continues to challenge ongoing economic recovery. Economic results have been mixed with some regions continuing to show signs of positive and sustainable growth while others face deflationary pressures. Felix Stephen, Head of Strategy and Research at Advance, considers these results and discusses what these mean for countries facing the prospect of interest rate rises and inflation, to disinflation and economic stagnation.

AUSTRALIA

Interest rates are anticipated to remain on hold due to June's underlying inflation lift, soft economic activity and the persistent strength of the Australian dollar. While uncertainty around the transition of economic growth from mining towards non-mining sectors continues, a cut to interest rates is unlikely. However, sharp deterioration in the global environment and/or a further appreciation in the Australian dollar could change this outlook.

US

We expect the first increase in the Federal funds rate to be around mid-2015. However, the US economy has shown a positive lift from weakness witnessed earlier in the year, with the June employment and GDP data providing policy makers with some level of comfort that they are closer to meeting their dual mandate of optimal labour participation and price stability.

JAPAN

Disappointing data suggests the Japanese economy is struggling to regain momentum following the slowdown induced by the consumption tax hike. Despite this, the Bank of Japan remains optimistic that it is on track to meet its 2015 and 2016 inflation targets and have not indicated a need for further stimulus.

EUROZONE

The European Central Bank's decision to lower rates to record low levels was justified and timely given the prospect of deflation in the region. July inflation surprised with a year-on-year gain of just 0.4% with even weaker readings expected in August and September before price pressures gradually pick up.

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.

UK

The UK continued its stellar recovery overtaking its pre-recession peak in June. However, more timely data has shown mixed results, heightening uncertainty for the economic and interest rate outlooks. While the Bank of England kept policy on hold. we expect interest rate rises are unlikely to be moved higher until there is evidence of an absence of economic slack particularly in the form of stronger wages growth.

CHINA

Stimulus measures introduced to address weak GDP growth appear to be starting to work. July's official Purchasing Managers' Index report recorded its most robust monthly performance since April 2012, and the Q2 year-on-year GDP increased to 7.5% (coincidentally this is the nation's annual growth target

Key points

> Australian inflation is likely to be impacted in the future by the repeal of the carbon tax, tobacco excise increases, the strength of the Australian dollar, wage pressures and any US interest rate rises. At this point, growth is expected to be moderate.

> US data has been more positive than anticipated with some signs of growth in wages. While the Fed has indicated the risk of a sooner than expected rate rise, we believe this would be around mid-2015

> The Eurozone continues to face the prospect of deflation and it's anticipated that Germany is likely to take a continued and strong leadership role in determining future economic policy.

> Economic data from the UK continues to be positive and looks to be largely sustainable though the BOE is likely to wait for a while and analyse wage growth trends before considering any interest rates rise.

> Stimulus measures in China appear to be having the desired impact with the IMF supporting the approach taken by Chinese authorities.

What is the outlook for inflation and interest rates in Australia?

Headline inflation eased in the second quarter and was driven by health insurance, tobacco, new housing and furniture. However, underlying inflation increased during this period. Various factors are likely to impact on inflation in the future. The most significant is the repeal of the carbon tax which will subtract from headline inflation while tobacco excise increases will add to it.

Underlying inflation is likely to be influenced by the Australian dollar and wage pressures even though the strength of the Australian dollar appears to have had no material impact on dampening prices at this point. The closer the US moves to raising interest rates, the stronger the potential for weakness in the Australian dollar which would in turn add to underlying inflation. Until that point, the Australian dollar is likely to remain at current levels with neutral impact to underlying inflation.

In terms of wage pressures, moderate employment growth makes it difficult to see strong upward momentum in wages to the extent that it would materially impact underlying inflation. The Reserve Bank of Asutralia (RBA) is unlikely to change its interest rate policy until it has evidence the economy is gaining stronger momentum. Current data and market uncertainty suggests only moderate growth going forward

What are the likely timings for a funds rate hike in the US?

Q2 results in the US have been positive with GDP data beating even the most optimistic expectations. Expansion in consumption and the services sector, as well as the highest level of consumer confidence since October 2007, imply positive momentum for spending which is likely to be supportive for businesses and job growth. Wage growth remains a key indicator of labour health and inflationary pressures that will in turn influence the decision for a funds rate hike. Overall annual payroll growth was at its fastest since March 2012 but latest data indicates growth is still subdued, although a pick-up in line with further jobs growth is likely.

US Federal Reserve Chair, Janet Yellen, believes there is more slack in the labour market than unemployment rates suggest, which would warrant the funds rate staying lower for some time after quantitative easing; however, for the first time she identified the risk of a sooner than expected rate rise to deal with overheated asset markets. With the economy now more stable and the Fed implying it is closer to meeting its dual mandates, a rate hike looks likely to occur in mid 2015.

What is the likely role of Germany influencing Eurozone policies and the outlook for the Eurozone going forward?

The continuing diversion of the German and French economies threatens to undermine recovery across the Eurozone. France's weak economy is likely to persist unless supply side reforms are enacted or global demand increases. The combination of high levels of non-performing loans, anemic monetary aggregates, the strong euro and contracting private sector credit could push the Eurozone into outright deflation within 12 months.

Germany took an unprecedented lead role in the West's response earlier this year to the Russian annexation of the Crimea despite previously being reluctant to take on responsibilities beyond its borders. Germany could become key arbiter for EU foreign and security policy as well. In this situation, perhaps it may be more positive towards the ECB's mooted quantitative easing.

Is the stellar recovery pattern in the UK sustainable and will it effect a rate change?

Latest UK data indicates growth drivers are changing, led by services, which accounts for 75% of GDP. Construction activity was buoyed by residential construction and civil engineering at its fastest pace since mid-2007. Manufacturing expanded though, affected by concerns surrounding possible interest rate rises, continued geopolitical uncertainty and subdued exports. Data suggests the UK is continuing on a robust growth path into Q3 supported by new orders and investment. Positive employment news should also help to reduce any economic slack.

The Bank of England's (BOE) decision to keep policy unchanged was likely due to persistent weakness in wage growth despite record strong employment. It will be eager for a pickup in earnings growth before considering a rate rise. The growth of house prices at their fastest pace since prior to the GFC is supporting a rate rise though macro-prudential measures are likely to take the heat out of this. Alternatively, the persistent strength of the sterling has placed pressure on exporters and reduced the case for a rate rise.

With positive results to stimulus, will Chinese authorities continue this approach?

The stimulus measures introduced following Q1 are beginning to yield, with year-on-year price pressures recording a 28th consecutive monthly decline – a feat unmatched since the late-1990s. July's headline year-on-year CPI came in below consensus leaving no threat to the mandated 3.5% inflationary target. As a result, the authorities will not need to fear an inflationary surge if they implement additional monetary stimulus in the event of an unexpected slowdown of the economy.

The Chinese approach is supported by the International Monetary Fund (IMF) recommendation that China targets growth of less than 7% to facilitate its desired transition towards consumption, and away from investment and exports in its annual health check of the Chinese economy. The IMF affirmed its belief that the authorities are more than capable of using foreign exchange stockpile reserves to mitigate the effects of either a deposit run or the freezing up of the interbank market.

What does this mean for investment strategies?

A number of significant and serious imbalances keep developing in various global economies and the global financial system as have been highlighted by agencies such as the International Monetary Fund (IMF), the Bank for International Settlements (BIS) and the Officer of the Comptroller of the Currency (OCC). Currently, there is limited coordination and resolve globally to resolve these imbalances but history suggests that elevated risks in the market coupled with geopolitical risks will eventually force a unified response by global policy-makers.

We believe that there are elevated risks in investment markets and, regardless of trends and policy-maker responses, would advocate that investors consider balancing of the risk/reward in their portfolios carefully at this stage of the market cycle. In our portfolios, we have taken a more defensive approach to investment and decreased allocations to sectors such as equities that we perceive might be riskier at this point in time due to their sensitivity to investment market risk aversion and geopolitical events.

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