ADVANCE
ASSET MANAGEMENT

THE TIPPING POINT

September 2014

Interest and inflation rates continue to offer a key concern for long-term sustainable growth in global financial markets with interest rates still on hold in many economies. Alongside this, escalating global geopolitical crises and continued labour market instability tie into concerns about the ongoing recovery of the market. Investment markets may be reaching a tipping point with its associated opportunities and risks.

AUSTRALIA

The Reserve Bank of Australia (RBA) indicated that official interest rates would remain on hold for the foreseeable future with the high Australian dollar, rising unemployment and/or a sharp deterioration in global tensions unlikely to prompt a cut. The focus has shifted to the potential negative consequences of extremely low interest rates.

US

The US Federal Reserve (Fed) has still not provided clarity on the timing of the first funds rate hike since 2006. It has highlighted continued uncertainty surrounding the degree of slack in the economy with August labour market indicators softer than expected but heading in the right direction.

JAPAN

Japan's economy contracted sharply in Q2 with latest data suggesting that an expected Q3 rebound will not be strong enough to support the Bank of Japan's (BOJ) goal for 2% inflation by FY2016. Both the government and BOJ officials reiterated their commitment to continue with highly accommodative monetary policy.

EUROZONE

The European Central Bank (ECB) surprised markets by announcing a further cut in interest rates and plans to start buying asset-backed securities and covered bonds from Eurozone banks. This move was prompted by signs that the region's economic momentum has weakened and mounting disinflationary pressures.

UK

The release of the Bank of England's (BOE) Quarterly Inflation Report did not provide insight into when the first official interest rates hike will be implemented but implied that it would be "gradual and limited". Conflicting signals mean the BOE is content to leave policy unchanged with market expectations of a hike most likely in Q1 2015.

FELIX STEPHEN

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CHINA

China announced new measures to support the economy on the back of April's fiscal and monetary stimulus plans. These measures may help to stabilise short-term growth but over the longer term, structural reform remains crucial to sustainable growth. Declining property market prices and stresses in the shadow banking sector are headwinds faced by the Chinese economy.

Key points

- The RBA has turned to a focus on managing the risks of a low interest rate environment, holding interest rates at the current level to avoid potential negative risks to the financial sector.
- US economic indicators continue to suggest recovery, although this may be threatened by the prospect of an excess capacity in the labour market and geopolitical concerns dampening consumer confidence.
- Real wages growth in Japan remains negative but there are initial signs of recovery in consumer sentiment and spending, along with the manufacturing sector.
- The ECB has introduced some measures to alleviate the situation in the Eurozone but will hold off decisions on a full program of quantitative easing pending the outcomes of these measures.
- The BOE is likely to leave interest rates in the UK on hold for the remainder of 2014 given conflicting market signals and uncertainty across the region.
- Chinese authorities have reaffirmed a commitment to structural reform and announced a number of new stimulus projects, ranging from pollution prevention to public service buildings like hospitals, and increased support to farming.

Why is the RBA continuing to keep interest rates on hold?

The RBA indicated the primary focus is now the potential negative consequences of extremely low interest rates when announcing a hold on rates for the foreseeable future. It believes monetary policy has done as much as possible to support the economy's transition to non-mining sector growth. The RBA articulated potential negative risks of cutting rates further and the resulting negative consequences to the financial sector should residential house prices, which surged as a result of the low interest rates, decline sharply. Additional concerns included uncertainty fuelled by the Federal budget, global geopolitical issues, historically high household debt and poor consumer sentiment. Spending is likely to continue to be moderate, although if business investment and hiring intentions start to trend higher, household spending could gain momentum in 2015.

What potential risks could derail economic recovery in the US?

Labour market indicators, albeit softer, are still heading in the right direction for the Fed to consider looking towards raising interest rates. That said, a number of factors might impact on the ongoing recovery.

The Fed believes the continuing lag in wages growth is a result of a large amount of excess capacity in the labour market. Aside from this, geopolitical concerns in the Middle East and Europe may negatively impact on confidence and activity if they escalate. The actions of the Fed itself may also be sensitive in that increasing rates too late may result in an inflation surge or increasing too early may thwart the current pace of growth.

Given market uncertainty is a challenge to effective policy, a best case scenario would be continued moderate growth for the economy, with it now being in a better position to withstand some policy adjustment.

What are the initial signs of growth for Japan in Q3?

The partial data for Q3 has been mixed. The manufacturing sector has started to show some promise while the new export sub-index also showed a marked increase. There are welcome signs that consumer sentiment and spending are slowly returning as wages growth continues to gradually pick up. That said, after adjusting for inflation, real wages growth remains negative.

The key challenge facing authorities is how to reach the inflation target while generating enough economic momentum so household incomes can keep pace. Latest inflation data is heading in the right direction but remains some way off desired targets.

Will the ECB move towards a program of quantitative easing?

The ECB announced further interest rate cuts and plans to buy asset-backed securities and covered bonds from Eurozone banks in an effort to generate sustainable economic recovery, and positive consumer and investor sentiment. However, some market participants feel the ECB should undertake full-scale quantitative easing with government bond purchases.

These new measures along with targeted long-term re-financing operations should, under normal circumstances, be very supportive for lending, in particular when the main re-financing rate cut forces banks to deploy excess capital elsewhere rather than place their funds with the ECB. For now, the ECB will wait to see how current measures impact activity and inflationary expectations before embarking on quantitative easing, which could place monetary policy at its limit. Sanctions imposed on and by Russia continue to have a negative impact on European economic trajectory, along with continuing regional weakness.

When will the BOE raise official interest rates in the UK?

Conflicting signals, notably the upward trend in employment, fly in the face of very weak real wages growth making it difficult to estimate the degree of slack that remains in the UK labour market. The likelihood of inflationary pressures building sooner than currently anticipated is a concern with the BOE content to leave policy unchanged for a while. Market expectations are for the rate to remain unchanged for the rest of 2014, with a hike likely in Q1 2015.

Updated wages growth forecasts are now just half of that from May and this weakness suggests the BOE may feel that there is still a reasonable amount of slack in the economy and real wages growth will remain negative till the end of 2014. There remains a reasonable degree of uncertainty surrounding the UK's economic outlook and it is expected that when rates do start to rise it will be very gradually. Given current headwinds such as geopolitical tensions, the hesitant and subdued recovery in the Eurozone, and higher household indebtedness, interest rates are more likely to remain lower than higher.

Will additional targeted measures support continued recovery in China?

Structural reform remains key to sustainability of growth, although the Chinese government appears to have had success in stabilising short-term growth with its stimulus measures. China continues to suffer the consequences of over-investment with property prices declining and vacancy rates high, leaving many banks and individuals vulnerable. In light of this, the authorities have repeatedly reaffirmed their commitment to ensure consumption rather than investment plays a more pivotal role in driving future economic growth. Structural reform that includes labour market reform, financial market reform and social reform should support household income growth that will be pivotal in driving consumption's share of GDP to drift higher.

The authorities have stated they will commence a number of new stimulus projects in areas such as air and water pollution prevention, and clean energy. They have also pledged to increase the building of public hospitals, nursing homes and fitness centres. Farming is a particularly vulnerable sector of the economy with the People's Bank of China announcing an increase in its re-lending quota to the sector with further fiscal support also pledged by the government.

Risks for investment strategies

> The search for higher yields while interest rates globally remain low has resulted in crowding and therefore higher prices based on demand in areas like high yield bonds and emerging market debt. The value of these assets may decline if interest rates start to rise again.

> Investor sentiment has historically been a powerful force in driving financial asset market prices. The latest Investors Intelligence Survey suggests that expectations for asset prices to decline are at a 25 year low (in turn, meaning expectations for continued growth are very high). Historically, this type of sentiment has been associated with market peaks having recently occurred, or being about to occur with downturns to follow. This ties in with our view that a small tipping point may be likely in the next few months. Investment strategies may consider more defensive positioning to factor for the risk of downward movement or consider short-term investments to capitalise on the movement.

> There has been a strong positive correlation across financial asset markets as well as a recent rise in volatility. Should this correlation continue, portfolios may be negatively affected across asset classes if there is a market downturn. Diversifying the portfolio to include less traditional and lower correlated strategies may assist with managing this.

Opportunities for investment strategies

> The weakness we anticipate in financial asset market prices may provide a buying opportunity for investors with a greater risk tolerance and a longer term horizon.

> It may also offer opportunities for those investors who do not track their portfolio against the market, are less sensitive to entry prices and are more comfortable with purchasing and holding assets that deliver a reasonable level of steady income.

> Investors who do track their portfolios to market and are more price-sensitive may be likely to reposition defensively, such as investing in products designed to mitigate against sharply declining sovereign bond and credit prices through floating rate bonds and shorter term investments or lower the risk of capital erosion in growth assets through alternative strategies.

> Investors may also find opportunities resulting from the current decline in the Australian dollar. If the decline continues, it will offer a good entry point to Australian assets and in turn generate upward momentum.

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