ADVANCE
ASSET MANAGEMENT

BALANCING THE SCALES

October 2014

The spectre of an impending global economic slowdown was heightened by negative implications resulting from tougher sanctions imposed on Russia by western nations, airstrikes in Syria, pro-democracy protests in Hong Kong, China's property slump, worsening economic conditions in Europe and Japan and the uncertainty triggered by the outbreak of Ebola. As global political leaders and heads of international agencies search for solutions that can begin to deliver a more sustainable global economic recovery, they must also take into account a variety of domestic factors such as the rising unemployment, the lack of visible economic traction (even with historically low interest rate support), the state of global financial markets and ongoing global socio-economic and geopolitical instability.

AUSTRALIA

The Reserve Bank of Australia (RBA) continues to maintain interest rates at their current low levels. It has taken comfort from the sharp depreciation of the Australian dollar while also being acutely conscious of risks to the Australian residential property sector that could pose a serious threat to future domestic economic prosperity.

US

The US Federal Reserve (Fed) renewed its pledge to keep interest rates near zero for a "considerable time" following the end of quantitative easing (QE). However, projections suggest a slightly faster pace of rate normalisation than previously thought on the back of better economic data releases.

JAPAN

There is heightened uncertainty over the strength of any economic rebound in Japanese economic activity since the initial decline following the 1 April consumption tax hike. The Japanese government continues to monitor activity and will soon have to determine whether to inject further stimulus as well as to continue with the planned second consumption tax hike due to take effect in October 2015.

EUROZONE

There has been cautious optimism for improving financial conditions as a result of currency depreciation, falling bond yields and recent stimulus measures though overall data releases point to a weak economic outlook and a serious threat of deflation. There is a consensus that the European Central Bank (ECB) must undertake a full-scale QE program but there is growing opposition within the ECB for such measures from Germany, the Netherlands and Finland.

FELIX
STEPHEN

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UK

The Bank of England (BOE) left policy unchanged at its September meeting after evidence suggesting that growth has slowed from the more robust pace in Q2. At this stage, the first hike in official interest rates remains slated for the first quarter of next year.

CHINA

Weakness in industrial output, falling housing prices/sales and the anti-corruption drive are behind the accelerated pace in the Chinese economic slowdown. This has prompted the authorities to implement further stimulus measures to limit and slow the rate of decline in growth in an effort to meet the 7.5% pace targeted by the government.

Key points

> The fall of the Australian dollar to a four-year low is likely to assist with business optimism in the export sector and tourism, while the buoyancy in the residential property market continues to raise concerns for the RBA.

> US recovery appears to have strengthened with business indicators suggesting steady to strong future growth leading to higher household income and spending.

> Data releases from Japan continue to be mixed and biased to the downside with increased public works spending and weakening of the yen supporting sentiment among large manufacturers but weakening retailers and wholesalers.

> Data releases from Europe highlight a broader contraction in economic activity and deflationary risks to the region with ECB support measures now quite likely.

> In the UK, Q3 GDP growth was driven by services and construction but consumer confidence has been dampened by the prospect of rising interest rates and negative real wages growth.

> Industrial output and housing weakness is fuelling an accelerated slowdown in China with consumer confidence levels also dropping to three year lows.

What is the impact of a weaker Australian dollar and property measures for Australia?

The RBA welcomed the fall of the Australian dollar to a four-year low (driven by the renewed strength of the US dollar) along with the decline of iron ore prices that reached multi-year lows off the back of economic weakness in China. We anticipate the impact to generate business optimism in the export sector (especially manufacturing) with expectations for further depreciation providing major stimulus to tourism.

A steady economic growth path should be supported by steady to easy monetary policy and the prospect of the RBA introducing targeted macro-prudential measures to take the heat out of the property market. The demand in housing for investment purposes, the sharp run up in prices and the rising proportion of household income that is deployed to service housing mortgage loans, are some concerns within official circles that suspect that Australians may have over-extended themselves in investments in the residential property sector and could suffer financially if prices fall sharply. This in turn would pose risk to banks and broader economic activity. The RBA is reluctant to tighten lending rules but is concerned about imbalances that have been generated through rising speculative activity and investor demand. Despite this, there is unlikely to be a change in the official interest rates in the near term.

Is the improvement in the US economy likely to continue?

Improving momentum in the US is led by solid labour market results, relatively high confidence among consumers and favourable business conditions. Annualised growth for Q2 GDP growth was at its fastest pace since December 2011, driven by business investment and net exports with consumer sentiment almost back to long-term averages. Ongoing, the business sector indicators augur well for further growth in payrolls and ultimately household income and spending, which all point to an eventual pick-up in inflation. The potential rise in inflation is likely to be tempered if the recent strength in the US dollar persists. However, US policy makers are conscious of risks to the positive domestic economic outlook posed by external shocks that have the potential to derail the present growth trajectory.

Will the recent stability in activity bode well for Japan's recovery?

Large firms raised business investment plans to their highest reading since September 2007. Sentiment amongst large manufacturers also increased above expectations, well supported by increased public works spending and weakening of the yen. These same factors unfortunately hamper retailers and wholesalers with increased import costs and profit pressures. Consumer data is mixed with household spending (including retail and motor vehicle sales) well down on last year but figures suggest the tax hike drop is waning with softness now attributed to heavy rains. A stronger spending pick-up remains dependent on real wages growth, which currently trails the rate of inflation, squeezing household incomes. Excluding tax hike effects, core inflation eased further away from the Bank of Japan's (BOJ) 2% target. Tentative signs of stability are encouraging but much uncertainty about the economy's underlying strength remains. Softer than expected inflation and subdued activity are likely to push the BOJ to do more to reflate the economy.

What caused further softening in the UK and how will that influence interest rates?

The latest data shows that Q3 GDP growth was driven by robust activity in the services and construction sectors while manufacturing appears to have stagnated. Consumer confidence slipped to its lowest level since March and households are less upbeat about the outlook and their personal finances as a result of negative real wages growth and speculation over the prospect of interest rate rises. This is likely to have a dampening impact on consumer spending. While retail sales growth surprised on the upside, the overall trend is softening with retailers discounting prices to reduce inventories which perhaps indicates that deflation in the sector is intensifying. From a monetary policy perspective, these trends support the view that the BOE should keep interest rates at their record low levels for some time yet with policymakers concerned with accumulating evidence of weakness in the Eurozone area. At this stage, the first hike in rates remains slated for the first quarter of next year.

What is causing China's slowdown and what are authorities doing to placate it?

The risk to Chinese policymakers' targeted 7.5% growth rate is the continued decline in industrial output and prolonged housing weaknesses. Industrial production was at its slowest since December 2008 due to declining electricity generation, soft global demand and housing sector weakness dampening demand for building products. Property accounts for around 15% of GDP, over 30% of fixed asset investment, almost 20% of outstanding bank loans and 40% of Government revenues, thus its negative multiplier effects generates significant headwinds to economic growth. Consumer confidence also fell to a three-year low reflecting heightened concerns over housing, labour and personal finances. Mounting pressure made the People's Bank of China (PBOC) announce its biggest easing in mortgage lending restrictions since the GFC, loosening property restrictions for second homebuyers. To qualify, they must pay off existing debt while banks are barred from lending to people who want a second mortgage. However, if weakness persists, the PBOC may cut reserve requirements for the whole banking system or official interest rates but be cautious of injecting massive stimulus being mindful of the negative effects of their high GFC-debt legacy.

Financial market risks

> The combination of low market yields and unconventional monetary policy has driven yield-hungry investors to seek and accumulate assets that deliver a superior return relative to fixed term deposits or cash. During this process, they have often ignored risks attached to these assets. Typically, the "herd" behaviour of investors chasing popular investment strategies causes these assets to get over-priced. History reminds us that when the "tipping point" is reached, the negative price action of crowded trades is violent, resulting in investors suffering significant capital losses. Investors need to appreciate and understand market price action and investor psychology which tends to be disconnected with economic data.

> Stringent financial market regulations have hampered financial market liquidity in certain high yielding assets, particularly when investors want to exit "crowded" trades.

> Elevated financial asset market volatility is a pre-curser to a shift in financial market price trends and investor sentiment. The recent sharp rise in volatility in almost all asset classes is perhaps a warning sign that such a shift may be underway.

Opportunities in financial asset markets

> Financial market volatility and dislocations often offer patient investors excellent opportunities to buy cheap assets when crowded trades are either voluntarily or involuntarily liquidated, be they safe or risky assets. The time to buy assets is when there is market "panic" and there are more sellers. Similarly, the time to sell assets is when there are more buyers and market "euphoria". This is particularly important for investors with long-term investment horizons who wish to adjust the risk/return in their portfolios at different stages of a financial market cycle to lock-in gains when the time is right and add risk when prudent to avoid significant capital losses and also ensure there is sufficient risk in the portfolio to deliver targeted returns over multiple financial market cycles.

> Investors should also seek and invest in strategies that are lowly correlated to traditional asset classes to diversify portfolio risk such as alternative strategies or defensive yield investments.

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