ADVANCE
ASSET MANAGEMENT

2015: A YEAR OF DEFLATION AND RISING ASSET MARKET VOLATILITY

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The US economy has gone from strength to strength and appears to be a stand out for the global economy for the first time since the GFC. However China, Europe and Japan are struggling with economic growth challenges while attempting to fend off deflation.

AUSTRALIA

Economic momentum has eased, falling business and consumer confidence are weighing on spending and investment, housing has cooled off and will likely soften further, while the Government unsurprisingly revealed a budget deficit blowout. Against all this, the Reserve Bank of Australia (RBA) continues to weigh all the information when looking at potential rate cuts; preferring to talk down the Australian dollar to boost the economy and soften increasing headwinds.

US

The US ended 2014 on a reasonably solid footing with both household and business sectors remaining relatively robust despite a slight easing. Solid job gains offset by subdued wages imply the US Federal Reserve (Fed) can continue to push out potential rate hikes until it becomes clearer that its twin goals of employment and inflation are moving toward target levels.

JAPAN

Following his sweeping victory in the snap elections in December, Japanese Prime Minister Shinzo Abe has not wasted any time in attempting to prop up his recession-hit economy, approving an emergency stimulus package and vowing to push ahead with structural reform, the 'third arrow' of his 'Abenomics' program, to reflate the economy.

EUROZONE

Inflation fell in the Eurozone for the first time in five years adding pressure on the European Central Bank (ECB) to up the ante in its fight against deflation. Recent comments indicate policymakers are ready to undertake a more substantive quantitative easing program in an effort to break the deflationary spiral and spur economic activity.

UK

As we move into 2015, expectations that the Bank of England (BOE) is close to raising interest rates for the first time since July 2007 have been pared right back. This is largely due to growth in the UK being softer than originally thought, inflation being quite weak, and the uncertainty created by the upcoming general elections.

CHINA

Weakening growth in China will continue to pressure prices and add to the disinflation environment. There are widespread opinions about whether or not the authorities will step up stimulus measures to offset this risk but it is anticipated the People's Bank of China (PBOC) will be inclined to cut interest rates again, especially if 2014's final quarter GDP is weaker than target.

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.

Key points

- Australian growth is predicted to be below potential and has been dragged down by the fall in mining investment. A currency weakness is expected to mitigate softer economic activity, while household spending could get a moderate uplift from lower petrol prices, lower interest rates and the positive wealth effect of higher house prices.
- In the US, inflation will likely come in below target due to a stronger currency and lower energy prices but stronger growth could see inflation start to emerge and prompt the need for interest rate normalisation.
- The fragile and uncertain Japanese economy fell into a recession in the third quarter of 2014 but is improving. The recovery could be supported by delaying the proposed consumption tax hike, lower oil prices, and potentially additional monetary and fiscal stimulus.
- Consumer prices have remained below the ECB's target rate of 2% for 22 consecutive months. The Eurozone faces a further fall in prices and weakening growth that will lead to higher unemployment and delays in spending and investment.
- Higher imports and lower than expected Government and business investment have caused UK growth to slow down, while consumer spending appears to have held steady. The recent plunge in oil prices, while good for households would be negative for capital investment and Government revenues. In addition, the prospect of a hung parliament means political uncertainty will continue to have a significant negative impact.
- The continuing disinflation trend in China means the PBOC will be inclined to cut interest rates again. There are calls for further stimulus to offset the slower pace of growth and increase jobs which will help to mitigate social instability.

What is the forecast for the Australian economy over 2015?

Consumer confidence recently fell to its lowest level since August 2011, while business confidence also plummeted to its lowest level since July 2013, which leads us to believe the Australian economy is likely to function well below potential this year. Growth will be dragged down by the fall in mining investment and weakness in the economies of our key trading partners. Stronger non-mining activity will be crucial for improved economic prospects in the future but will not be sufficient enough to be significant in the short term to replace the sharp contraction in the resources sector activity. Improvement in non-mining investment intentions are encouraging and could provide tailwind support through a weaker exchange rate. Consumers are likely to remain cautious due to job uncertainty but we expect a moderate strengthening in spending on the back of lower petrol prices, possible lower interest rates and the wealth effect of higher house prices. The RBA prefers at this stage to see continued depreciation in the Australian dollar stimulate the economy rather than cut interest rates further but will continue to evaluate this based on available information.

When is the Fed expected to raise the US funds rate and what will drive it?

Given most US economic indicators keep improving, the Fed may be closer to raising the funds rate by mid-year, for the first time since 2006. However, at this stage, only one of its key criteria is on track. Between full employment and 2% inflation, only the former appears to have been met. December labour data was encouraging but a reasonable amount of slack remains. This suggests the Fed can afford to wait longer before moving on rates. Growth is expected to come in on trend, driven by easing financial conditions, improving labour confidence, and more willingness by consumers to take on debt and businesses to take on investment. Inflation will likely come in below target thanks to a stronger currency and lower oil prices, but the increased prospect of a pickup in wages growth could see it rise more quickly than anticipated. Given the fragile nature of the global economy the pace of rates increases will be very gradual to ensure steady growth.

How will the re-election of Shinzo Abe impact recovery in Japan this year?

The fragile Japanese economy went into recession in the third quarter of 2014, but appears to be improving. Recovery may be supported by Abe delaying the proposed consumption tax hike until April 2017, sharply lower oil prices, and potential additional monetary and fiscal stimulus. However, Japan's outlook remains fraught with uncertainty. Abe will continue to face stiff opposition to some of his proposed reforms and the yen will weaken further, boosting inflation, which means real wages growth will remain subdued and restrain consumer spending. One of Abe's biggest challenges is inflation due to the currency translation effect that continues to outpace wages growth, which in turn limits household spending power. In light of this, his Government announced an emergency stimulus package worth ¥3.5 trillion to go towards public works infrastructure spending, and to help small businesses and households. Although positive, it adds pressure on Government finances as the administration tries to reduce the fiscal deficit.

How real is the prospect of deflation in the Eurozone and what else threatens recovery?

Inflation has remained below the ECB's target rate of 2% for 22 consecutive months, effectively meaning deflation has already taken hold. It risks a continuation of the downward spiral both in household spending and corporate investment as these crucial sectors of the economy delay spending and investment in the expectation that prices will fall further. This then naturally leads to even higher unemployment and sharply lower prices. Given growth is at a virtual standstill, a modest recovery is likely unless there are significant economic, financial or political shocks. Low household and business confidence also indicates downside risks irrespective of additional stimulus. Deflationary pressures will continue given the lower oil prices, persistent economic slack and high unemployment, but could be partly offset by the inflationary impact of a weaker currency. Inflation could turn mildly positive but remain below target, raising the question as to how long lower price expectations will persist and continue to exert a negative flow through influence on actual consumer and business sector behaviour well into the future. With its debt held by various European counterparts, financial market risks are likely to remain elevated.

What caused the surprise slowdown in growth in the UK in the past year?

Surprising markets, the UK growth slowdown was due to higher imports and lower than expected Government and business investment. The economy is now 2.9% higher than its pre-recession peak compared to an expected 3.4%. Consumer spending appears to have steadied and the recent plunge in oil prices should also help maintain consumer spending momentum, but the prospect of a hung parliament in May's general election means political uncertainty may already be having a softening impact on corporate investment intensions. Many believe the election is one of the hardest to predict in generations, causing businesses to put off investment decisions until the result. Softer growth and relatively weak inflation, along with the political uncertainty, suggest the BOE is unlikely to raise interest rates. Inflation fell to a 12-year low to half of its 2% target, largely reflecting falling oil prices bringing down travel costs and real wages showing positive growth after years of decline. The other surprise was a further blowout in the current account deficit to its highest level on record making the UK very vulnerable to sudden changes in overseas investors' appetite for their financial assets.

How will Chinese authorities address their economy's predicted further slowdown?

The deflation risk lingering in China means the PBOC will be inclined to cut interest rates again, especially if impending fourth quarter 2014 GDP data comes in weaker than the Government's 7.5% target. There are calls for further stimulus and whilst the Government may bow to pressure, it has effectively ruled out a repeat of 2008's magnitude of measures, which resulted in higher debt levels and unproductive over-investment. We expect a further slowdown with a real probability that growth will be below 7% – the weakest pace since December 2001 (except at the height of the GFC). We do not foresee a string of interest rate cuts, although authorities may favour structural reforms that could generate a more sustainable economic growth trajectory, while also opting for more targeted and measured fiscal and monetary policy. Authorities are comfortable with a slower pace of growth but one of its biggest issues will be the impact on the job market that in turn affects social stability, which is crucial to structural reform.

Advance Asset Management, GPO Box B87, Perth WA 6838

Customer Relations 1800 819 935 Adviser Services 1300 361 864 Fax (02) 9274 5211

advance.com.au

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