

# GAME CHANGERS IN PLAY

APRIL 2015

After the instability experienced across the globe in the first quarter of 2015, April has seen the price of crude oil finally stabilise, China ease monetary policy, the announcement of a quantitative easing (QE) program in the Eurozone and potential for more of the same in Japan. In contrast, a turnaround in the US saw economic data persistently undershoot market expectations in light of a looming interest rate hike, rates remained on hold in Australia, a stance that also surprised, whilst the UK saw inflation instability ahead of forthcoming general elections. We ask Patrick Farrell, Head of Advance Asset Management and BT Financial Group's Chief Investment Officer, to discuss the key global economic and financial market issues being considered by the Advance investment team and advise how these game changers will impact key global economies and financial asset markets in the second quarter of 2015.

## AUSTRALIA

The Reserve Bank of Australia (RBA) surprised markets by keeping interest rates unchanged at 2.25% and maintaining an easing bias. We expect the cash rate to be cut by a further 25bps in the next cycle although timing is uncertain given the path of the Australian dollar, policy of the US Federal Reserve (Fed), housing market concerns, business sector challenges, May's Federal Budget, plus impending inflation data. Our outlook for Australia's economy over the coming year remains subdued.

## US

The release of weaker than expected US payroll data in March was another key surprise for markets and dampened anticipation of the Fed raising interest rates in June. This, along with other signs of weaknesses since the beginning of the year, suggests the US economy has hit a soft patch thus warranting a delay in normalising monetary policy.

## JAPAN

Despite evidence of subdued growth and weak inflation, the Bank of Japan (BOJ) kept policy unchanged in April and reaffirmed it is on track to meet the 2% inflation target by March 2016. Markets are more skeptical and still expect the BOJ to increase its QE program during the year. We believe its bias will be to ease further in light of disappointing inflation.

## EUROZONE

The final estimate of the Eurozone's Q4 GDP report confirmed that on an annual basis their GDP was just 0.9% higher than 12-months earlier. Despite 2014 being a difficult year for Europe, the outlook has improved considerably due to the European Central Bank (ECB) finally instigating its much-discussed QE initiative



PATRICK

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Patrick Farrell is Head of Advance Asset Management and Chief Investment Officer for BT Financial Group.



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## What does this mean for Advance's SAA?

SAA settings normally adopt a 5 to 10 year time horizon that typically incorporates a full market cycle. However, particularly in times where extraordinary policy settings are driving the investment decision making process, a shorter to medium term outlook has to be given significant consideration. In formulating these strategic asset allocation changes we are putting more emphasis on the medium term outlook for markets which is currently dominated by mechanical influences more so than fundamental or investor sentiment at this time. These influences are driven by the extraordinarily low level of interest rates around the world forcing investors to search out higher yielding alternatives in order to meet return objectives for their portfolios going forward. As a result, credit securities, high dividend stocks and property related investments have done extremely well over the last 12 to 18 months and the conditions going forward look to remain supportive. Valuations on these securities that are based on fundamental factors show that they are expensive relative to other market securities and relative to their own historical valuations. The acronym coined at the moment in the market is YAAP (yield at any price). Demand for these securities can continue as interest rates remain low or fall further; however, limitations in potential upside do exist as valuations will anchor performance to a degree.

A key consideration in setting strategic asset allocations is in determining how long interest rates will remain low and how far these securities can extend their performance without significantly improving fundamentals behind them. In determining our previous SAA settings, we had the view that interest rates were going to rise around the world starting in the US and UK and then spreading to the rest of the world and hence removed a significant portion of interest rate sensitivity from the portfolios.

Longer term rates in the developed economies take direction from US rates and the market (and our) expectation was for the US Federal Reserve (Fed) to start raising cash rates around the beginning to the middle of 2015. This view was justified by the more significant growth momentum coming through the US economy as evidenced by the stronger employment results seen in Q3 last year. This growth was enough to get several Fed officials to talk about the prospect of more normalised rate settings, indicating cash rates would begin to rise but that monetary policy would remain stimulatory for the economy for some time to come. The inflation outlook is another key consideration for the Fed and stronger growth drive does tend to drive inflation higher but in 2014 the Fed was faced with disinflation and needed stronger growth to get the price increases back to the 2% target levels.

In 2014, the key factors working against inflation were a higher US dollar and falling energy prices. These factors have significantly extended their recent trends and have subsequently led us to change our views on the outlook for interest rates, flowing on to revising our outlook for markets overall.

The significant fall in energy prices has delayed any prospect of higher inflation emerging for another 12 months which will subsequently keep official cash rates from rising substantially in 2015. In fact, as demonstrated by several central banks around the world, including Australia, rates will go lower and in some cases even negative. This will lead to further support for longer term rates to fall even further highlighting the potential for additional capital gains to be made on fixed interest securities or at least delay capital losses for another year. This can provide a significant opportunity for our more defensive portfolios which have been positioned for higher rates. As a result we recommend moving funds from cash and our defensive yield allocation into Australian fixed interest. We prefer Australia fixed interest over international fixed interest for the following reasons.

- > Likelihood for further rate cuts from the RBA due to growth concerns and lack of inflation.
- > More sovereign exposure and less credit-government bonds have the potential to rally more than credit securities in this environment.
- > Has a higher yield than most developed nations' bonds and therefore has the potential for spread compression.
- > US rates have a greater potential to move higher if growth and inflation move higher leading the Fed to signal higher rates sooner than expected. Australian bonds may still move higher under this scenario but not as much as the US.

With the view that rates will stay lower for longer over 2015, it is likely that the mechanical decision making process will continue to force investors into risk asset classes in order to supplement returns. From a short to medium term perspective we believe equity markets will trade sideways throughout 2015 anchored by extended valuations. However, expectations of a sustained sell off in equity markets will be limited due to investors looking to buy into any dips as they have done over 2014. This is dependent on the view that the Fed will not engage in a more aggressive monetary policy strategy than expected. As a result, volatility in equity markets is likely to remain subdued which may limit some of the opportunities utilised in our Alternative Strategies Multi-Blend Fund. However, the fund does provide valuable risk mitigation/diversification benefits to the overall Diversified Multi-Blend Funds and remains as a key component in our strategy going forward.

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