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ADVANCE
ASSET MANAGEMENT

THE SWING OF THE PENDULUM

MAY 2015

As the weaker US dollar reverses its recent upward trend against major currencies and China's GDP slows to its weakest pace in six years, which itself will likely see the broader global economy feeling a deflationary draught – the global economic pendulum continues to swing. Sharing the spotlight in May was the continuing Greek debt crisis, the Conservative Party being returned to power in the UK, and the further rate cut to historical lows in Australia. Against this backdrop, we ask Patrick Farrell, BT Financial Group's Chief Investment Officer to advise how continued volatility and quantitative easing (QE) programs will impact key global economies and financial asset markets as we move towards the half-year mark. He will also discuss the key global economic and financial market issues being considered by the Advance investment team.

AUSTRALIA

In what is likely the last such move for some time, the Reserve Bank of Australia (RBA) cut official interest rates by a further 25 basis points in May. The cash rate yet again finds itself at a new historical low of two per cent with a distinctly dovish RBA saying it will "...continue to assess the outlook and adjust policy as needed to foster sustainable growth in demand..."

US

We saw official confirmation that the US economy barely grew in the first quarter of 2015 being effectively hamstrung by the combination of bad weather, the strike of Californian Dockers and the rather ebullient strength of the US dollar. As such – stagnant first quarter GDP growth coupled with a stalling labour market increased the expectation that the US Federal Reserve (Fed) will delay any rate hike until at least Q3, although the Fed opines these factors are but "transitory".

JAPAN

Amid growing signs of recovery in Japan and despite the likelihood of further delays in achieving its two per cent inflation target, the Bank of Japan (BOJ) voted to maintain its massive quantitative easing (QE) program while simultaneously cutting forecasts for both growth and inflation.

EUROZONE

Continued signs of improvement in the Eurozone were driven by the European Central Bank's (ECB) substantial QE program, which saw the declining euro and weaker oil prices also assist the Eurozone's recovery, which is fairly tentative and in its early stages. Although there are some rumours that the ECB may taper or exit its asset purchasing program before the planned culmination in September 2016 this seems highly unlikely given the program only began in March. Although the currency bloc did receive a boost from QE, nonetheless the seemingly interminable Greek debt crisis keeps it highly vulnerable to potential negative shocks.

PATRICK
FARRELL

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

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What impact will the Conservatives retaining power in the UK have on their economy?

The Conservative UK government went into the election against a backdrop of rising consumer confidence, solid employment growth, rising real wages, and increased house prices; and activity appears to have regained positive momentum with the potential to strengthen now that the election is over. This result removes uncertainty and boosts business confidence, especially reflected in the continued acceleration of activity in the services sector, which accounts for around 75 per cent of the UK economy. The BOE is likely to continue to provide positive support but with inflation remaining at zero in March, (well below its two per cent target) there is no immediate prospect of interest rates being raised in the near future. However, despite a range of views over their most likely near future path there is a somewhat tacit agreement amongst BOE monetary mandarins that it is more likely than not that rates will be higher in three years' time.

With China slowing to its weakest pace of economic growth since 2009, what is Beijing's most likely response?

There is increased pressure on the ruling communist party to deploy further stimulus in light of the clear downward shift in growth momentum. Indeed, there is mounting speculation that the PBOC may be considering implementing its own QE or asset purchase program. Whilst there has been no official response from the authorities with regards to such rumours – tellingly downside risks to the economy appear to be gaining much greater traction than just a few months ago. Consequently, further policy responses are highly likely in the near term, which is not only in the interests of China, but also for the broader global economy feeling the deflationary impact of China's slowdown to date. Although it is worth noting that the major developed nations such as the US, Europe, UK and Japan only resorted to such asset purchasing measures when more conventional approaches were exhausted – for example when interest rates reached the zero bound – nonetheless the likelihood of a potentially looming Sino-credit crunch emanating from the shadow banking system just may necessitate the authorities taking unexpectedly strong and innovative action.

What does this mean for investment strategies?

In the current macro environment where global growth is subdued, inflation remains benign and central bank stimulus measures are having little effect, this suggests that interest rates will remain lower for a while yet.

We believe interest rate sensitive sectors will benefit in the near term, particularly in countries such as Australia and New Zealand whereby the RBA stands ready to cut interest rates further if the need arises. As a result the focus on yield is likely to continue, which remains supportive for fixed interest property and dividend paying stocks.

In addition, the likelihood that the Australian dollar falls further, given the outlook for interest rates and commodity prices means international assets will look more attractive on an unhedged basis. In particular, international equities, even though they are expensive, can produce further capital appreciation for Australian investors if the Australian dollar depreciates against the major currencies.

The key risk facing investors is the Fed's timing on interest rate hikes.

If the Fed implements a series of rate hikes, then equity markets around the world are likely to correct as many exporting countries rely on US growth to maintain their own growth prospects.

Another key risk remains around Greece and its sovereign debt servicing program.

If the European Finance Ministers, European Central Bank and International Monetary Fund cannot come to an agreement with the Greek Government this could lead to market volatility and a flight to safer assets such as developed world Government bonds. A risk which we are closely monitoring.

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