ADVANCE
ASSET MANAGEMENT

THE LONG AND WINDY ROAD

JUNE 2015

In the aftermath of a number of major events swamping global markets in May, the new month clearly reveals the struggles that each of the major economies face on the long road to sustainable growth. Currency was a key focus, as the US dollar rallied at the expense of weak wages growth and subdued consumer spending. European markets grew despite debt negotiations for Greece showing no resolution. Japan showed some positive signs, yet woes continued in China. We ask Patrick Farrell, BT Financial Group's Chief Investment Officer to discuss the outlook for global markets over the remainder of 2015.

AUSTRALIA

First quarter GDP growth exceeded expectations, but the underlying detail highlights the continual challenge facing Australia's economy. We are cautiously optimistic on the transition to non-mining sector led growth, which will soon gather pace. The Reserve Bank of Australia (RBA) does have a mild easing bias, which could be acted upon if the economy fails to show a meaningful broad based recovery As such we expect official interest rates to be reduced further during the later half of 2015.

US

Some data has been weak, which implies the quarter may not prove to be as strong as anticipated with some analysts pushing out interest rate expectations to 2016. Nevertheless, market consensus is that the US Federal Reserve will begin to normalise the Fed funds rate from September of this year. The pace of this normalisation will be slower than in the past.

JAPAN

Japan's economy grew at its fastest pace in a year in the first quarter but underlying momentum remains subdued with the majority of expansion from inventory buildup. The Bank of Japan (BOJ) is encouraged regardless, ruling out any plans for further stimulus in the near term. The key to stronger growth is consumption and investment recovery.

EUROZONE

The European Central Bank (ECB) appears comfortable with progress on the region's recovery and remains committed to fully implement its monetary policies. Latest data continues to be encouraging and reflects the positive impact of the central bank's policies. The outlook is good, but the Greek situation and signs of softness in global growth loom as potential threats.

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UK

Bank of England (BOE) Governor Mark Carney has announced that the bank expects GDP growth for 2015 and 2016 to come in lower than anticipated due to current headwinds facing the UK economy. This implies only a gradual upward cycle in official interest rates when they start to rise in 2016.

CHINA

The story out of China again reveals a weak economy struggling to gain momentum, even after a significant easing of monetary policy over the past six months. The authorities remain under pressure to do more to try to shore up growth.

Why is Australia's economy struggling to find its momentum?

Despite increased domestic confidence in the wake of the Federal Budget release, Australia's economy has been operating with a degree of spare capacity for some time and the issue is in fact lack of confidence – most pertinent to the business sector. This is reflected both in month-to-month business surveys and capital expenditure plans. Business confidence remains flat with conditions deteriorating, driven by soft employment, profitability and trading conditions. The transition to non-mining investment is proving tough despite conditions in place for a stronger pick up. It is especially weak in mining, transport and manufacturing, retail and wholesale. Recreation, finance, property and business services are keeping the wheels turning but it is not surprising that investment plans are very weak. Encouragingly, consumer sentiment is stronger – so the question remains as to whether it will translate into a recovery in household spending. This is where confidence could be further shaken, as Australians face subdued household income growth, labour market weakness and retrained wages growth.

Has the US economy managed to bounce back from its first quarter weakness?

The latest data appears to be inconclusive. Housing, labour and to a lesser degree consumer confidence are showing encouraging signs, yet there is weakness in business activity and consumer spending. In fact, the weakness in manufacturing combined with the strong US dollar and a slowdown in oil and gas production has translated into a sharp fall in industrial production. Should this weakness persist then it's looking like the economy may not show the decent bounce back that the Fed is hoping for in the second quarter. We remain cautiously optimistic, as despite recent volatile consumer confidence surveys, confidence levels remain well up on levels of a year ago. We expect to see a general improvement in confidence in the near term with labour market reports indicating solid job creation and a pick-up in earnings. The housing market has also responded reasonably well following a subdued start to the year.

What drove Japan to grow at its fastest pace in a year in the first quarter and is it sustainable?

Inventory build-up was the key driver, but if businesses choose to run down inventories there is a risk of reversal in the second quarter. Consumption and investment contributions were also encouraging, whilst business investment saw its first quarterly increase in a year. The 18-year low unemployment rate of 3.3%, positive nominal wages growth, and higher equity and house prices, are all positive influences on consumer confidence but real wages growth remains negative after the spike in inflation caused by the 2014 tax hike. This is due to the fall out of calculations in May impacting what should be a confidence to spend. The gap between nominal wages and inflation is closing as inflation falls, which may prove more supportive of spending going forward and the BOJ will certainly be banking on this. A pick-up in business activity is also crucial for sustained economic recovery but April data was only mildly encouraging. The next few months will be crucial in determining whether recent encouraging signs can be sustained. Expect to see increased pressure on the BOJ to inject further stimulus if that does not turn out to be the case.

With encouraging signs in the Eurozone, will the ECB still implement monetary policy measures?

Latest data out of the Eurozone continues to support the positive impact of the ECB's policies with ECB Governor, Mario Draghi stating "The full implementation of all our monetary policy measures will provide the necessary support to the economic recovery in the Euro area and lead to a sustained return of inflation rates towards levels below, but close to 2% in the medium term". He also indicated that the ECB has not discussed an exit strategy, adding there was "a long way to go" before the Bank reached its inflation target. He also said that the bank stands ready to add to its quantitative easing program if necessary and that it expects consumption to be the main short-term driver of growth and business investment becoming more prominent in 2016 and 2017. The outlook continues to be fairly positive; however, the recovery is fragile and could stall if there are any shocks to the region. The biggest potential threat continues to come from Greece – the first country to defer a payment to the International Monetary Fund since the 1980s. Signs of softness in global growth could also provide potential headwinds for the region.

What is behind the BOE's downgrading of GDP growth in the UK?

2015 GDP growth in the UK is expected to be 2.5% (down from 2.8% in 2014) with 2016 predictions also lowered to 2.3%. The main factors behind these downgrades are the impact of a stronger currency on export growth, a quicker path of interest rate rises, lower investment, weaker productivity growth and tighter fiscal policy as the government aims to move the budget back to surplus. Deflation is expected but will be short-lived, with its downward trend reflective of sharply low energy prices, lower food prices and the strong currency, these factors are considered transitory by the BOE and it expects inflation to pick up notably towards the end of the year and return to target within two years. Persistent headwinds, including weaker global demand, sustained fiscal consolidation, ongoing private deleveraging, and with time, higher financial intermediation costs, will all continue to weigh on the economy. Market expectations are that the BOE will leave policy on hold for the remainder of 2015 with official interest rates starting to rise by mid-2016.

With data continuing to disappoint in China, what challenges do the authorities face?

Chinese authorities remain in a challenging position. Key data for April was disappointing – consumer spending slowed, industrial production growth strengthened slightly but remains very weak, fixed asset investment growth slowed sharply with manufacturing, real estate investment and infrastructure investment all contributing to the slowdown. Monetary policy is playing a bigger role, but the People's Bank of China (PBOC) maintains its policy is prudent and is focused on keeping credit growth steady and maintaining appropriate liquidity. We anticipate it will have to cut rates again and possibly lower the reserve requirement ratio further. The PBOC will also push ahead with its own version of quantitative easing – that is to buy municipal bonds from regional banks as long as those banks lend money to small-to-medium-sized businesses. Transitioning from an investment and manufacturing economy to be consumption and services focused is the central goal and thus despite slow progress, the government continues to press ahead with structural reforms.

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 on the real economy, this suggests that interest rates will remain lower low for a while yet. We believe interest rate sensitive sectors will continue to 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 relatively 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 Federal Reserve's (Fed) 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 the uncertainty 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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