CAUSE AND EFFECT

JULY 2015

The Greek debt crisis was the primary focus of markets in June with uncertainty causing ongoing market volatility. Falling energy prices earlier in the year are also impacting markets while the uncertainty as to when the US Federal Reserve (Fed) will raise the funds rate are key causes for caution for currencies across the major markets. We ask Tim Rocks, Head of Market Research & Strategy, BT Financial Group to discuss key global economic and financial markets.

AUSTRALIA

The Australian economy continues below trend growth amidst subdued confidence and activity with some expectations that the Reserve Bank of Australia (RBA) will need to cut interest rates again to help support stronger growth. Recent noise points to an easing bias but raises the question as to how much more traction can actually be gained from rates diving beyond their current historical lows.

US

All eyes were on the Fed for insights as to its likelihood of raising US interest rates - in fact it slightly lowered key economic projections with the anticipated path of the funds rate following suit. Despite key labour and inflation data coming in below expectations, other indicators point to renewed momentum.

JAPAN

Disappointing industrial production data reveals the struggle Japan faces in order to gain stronger economic momentum. It has given rise to expectations that the Bank of Japan (BOJ) may soon expand its monetary stimulus program to help support stronger growth despite indications showing it is comfortable with current policy.

EUROZONE

Just when we thought a sustained recovery appeared to finally be unfolding in the Eurozone, the Greek debt crisis threatens to derail it. Q2 data suggested stronger momentum but the resonating 'No' vote of the Greek people at the July referendum heightened uncertainty around the country's 'home' in the Eurozone.

UK

The UK economy continues to grow at a moderate pace supported by consumer spending and a strong services sector. Manufacturing continues to soften however as the strength in sterling and the Greece issues hamper export demand. As expected the brief bout of deflation in April was short-lived, but the Bank of England (BOE) is likely to maintain unchanged policy for the remainder of the year.

CHINA

A slumping equity market combined with continued weakness in China prompted the People's Bank of China (PBOC) to cut the cash rate to a record low and the fourth cut since November. It also slashed the deposit rate and reserve requirement ratio to give commercial banks and those servicing rural areas more capacity to lend to try to stabilise growth and enhance monetary policy efficiencies.

TIM
ROCKS

Tim is Head of Market Research and Strategy, BT Financial Group.

Despite its hesitancy, what could trigger the RBA to again cut official interest rates?

While the Australian economy is performing as expected by the RBA, there are a couple of potential triggers for further cuts. Firstly the absence of further significant depreciation in the AUD - the decline to date has helped support growth and kept inflation from falling as much as it might have and the RBA will welcome the further decline in the immediate aftermath of the Greek referendum. The unknown is whether or not a cut in interest rates would indeed send the AUD lower. US interest rates and the increased demand for the AUD as a reserve currency are also affecting its levels. A second possible trigger would be a sharp deterioration in domestic economic activity. If there were some domestic or external shock impacting negatively on confidence it would ultimately flow through to softer spending and investment and confidence, especially amongst consumers. Weak wages growth, high levels of household debt, and an uncertain jobs market are already keeping consumers cautious in their spending.

Why is the timing of the US Fed funds rate hike still up in the air?

Fed Chair Janet Yellen recently reiterated that it is not the timing that is significant rather the pace of increase in US rates. To that end, unless there is a significant shock to the global economy, we expect the Fed will increase the funds rate twice before the end of 2015 although the exact timing of the first increase will depend on incoming economic data. Momentum has improved as Q2 has progressed which should augur well for both the labour market and inflation, and keeps the likelihood of a first hike in September fairly strong. Consumers have grown more optimistic about the state of the US economy and the weakness in both headline and underlying inflation is viewed by the Fed as transitory. Lower energy prices and the impact of the stronger USD on import prices will dissipate in time and cause inflation to drift higher. The Fed remains confident that inflation will move back up towards 2% as the labour market continues to improve and this, over time, will put upward pressure on core inflation. For now however, the low level of inflation means the Fed does not need to begin raising rates just yet.

How likely is the BOJ to expand its monetary stimulus program?

Japan’s economy has struggled to gain stronger momentum on the back of the largest industrial production contraction in nearly two years. Market expectations are that the BOJ may soon expand its monetary stimulus program to help support stronger growth and meet its 2016 2% inflation target. Despite this view, BOJ Governor, Haruhiko Kuroda has indicated the Bank is comfortable that its current policy settings will help achieve its goals. Looking ahead, large manufacturing firms expect conditions to improve sharply in the next three months with the expectations index jumping to an almost eight-year high. This points to a bounce back in industrial output in Q3.

How damaging is the Greek crisis to the recovery in the Eurozone economy?

Despite all the volatility and heightened uncertainty regarding Greece and its future in the Eurozone, there are solid reasons for cautious optimism. Firstly, the region’s economy is much stronger after recording eight consecutive quarters of positive growth, whereas there were seven consecutive quarters of negative growth up to March 2013, and sentiment amongst businesses and consumers is much higher. Secondly, the European Central Bank (ECB) remains committed to reflating the economy and is prepared to add to its already huge quantitative easing program to achieve its goals. Thirdly, the depreciation of the euro over the past year and structural reforms in some countries have supported a more competitive economy. Finally, the banking sector is more solid than it was a few years ago, thanks to re-capitalisation programs and reforms.

Despite the headwinds in the Eurozone, is the UK still continuing to strengthen?

The UK economy is continuing to grow moderately, supported by consumer spending and a strong services sector. As expected, the brief bout of deflation in April was short-lived and UK consumer confidence is the highest it has been since the late 1990s. High confidence and accelerating wages growth are good omens for consumption in the months ahead. However a bigger contribution from the business sector is needed if the UK is to achieve sustainable longer-term growth. On that front, whilst the services and construction sectors are experiencing some solid growth the all important manufacturing sector is lagging due to a combination of a strong sterling and weak demand from Europe in light of continued uncertainty regarding Greece.

What caused a further easing of monetary policy in China and will it help?

On 26 June, China faced its biggest one-day slump in the equity market in five months. This was triggered by concerns that the market was overvalued having increased about 150% over the past year, and then exacerbated by traders calling in margin loans. The PBOC moved quickly to stem the fall in the market by cutting interest rates and placing restrictions on stock selling. The PBOC was concerned about confidence effects on the broader economy from the fall, and that a sharper fall in the market would close the share market to new capital raisings by cash-strapped Chinese companies. These policies appear to have worked, with the share market showing more stability in recent weeks. More broadly, the Chinese economy continues to face challenges from falling construction activity. We expect the Chinese authorities to be prepared to provide more policy support as needed as the economy continues its transition away from fixed asset investment towards consumption and services.

What does this mean for investment strategies?

The flaring up of issues in China and Greece shows that this remains a period of heightened macro risk. A number of other major global issues are also lingering, particularly pressures in emerging markets from falling commodity prices and lower export demand from the developed world

However, this month has also demonstrated the growing resilience of the global economy. The events in Greece and China had only a temporary impact on markets and it increasingly looks like there will be no permanent impact on confidence and major economic variables. This is because the global recovery is on a stronger footing and is more able to cope with small shocks. Monetary authorities are also prepared to act quickly and aggressively to address any situations that could cause instability.

Our central case scenario for the next year is one where the global economy grows more strongly than last year, inflation remains benign and monetary policy remains accommodative. We have positioned our portfolios accordingly. However we remain aware that this is a period of heightened macro risks, and we will continue to monitor developments closely and manage the portfolios to reflect this.

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