MOVING MARKETS AND POLICIES

SEPTEMBER 2015

Global markets faced a number of challenges across August and into September. This was largely related to the ongoing volatility of the Chinese share market and the decision to devalue China's currency. The resulting sharp declines in global equity prices and pressures on various countries relying on China as a trading partner meant that central banks continued to keep monetary policy on hold, and in some cases, lay the path for further stimulus to bolster their economies.

AUSTRALIA

The Reserve Bank of Australia (RBA) kept rates on hold during August. While there was little additional commentary from the RBA that was 'new', it continues to note that the growth outlook remains below trend with excess capacity still prevalent across the economy. We continue to see further downside in regard to consumer and business confidence on the back of the weaker outlook for commodity prices coupled with the ongoing economic slowdown in China. The sharp fall in the equity market over the month highlights the increased level of market volatility.

US

All eyes remain firmly on the US Federal Reserve (Fed). And while there was little news coming from the Fed's two day meeting at Jackson Hole during the month, it is clear that a decision on increasing cash rates remains a matter of 'when' and not 'if'. Unfortunately for the Fed, the potential negative impact of tightening cash rates on other economies and currencies, particularly emerging markets, resulted in the Fed holding tight. However, in our view the upward trajectory of the US economy remains in place, highlighted by a strong labour market, improving consumer and business confidence and an improving housing market.

JAPAN

The turnaround in Japan continues to move in fits and starts. While the PMI surveys reflect ongoing expansion, industrial production along with business conditions paint a more sombre outlook near term. Additionally, the Bank of Japan's (BOJ) goal of seeing inflation move up towards its target of 2.0% seems further away than ever with the consumer price index coming in at 0.1%. And despite the fall in the yen, export led growth continues to remain relatively modest.

EUROZONE

The outlook for the Eurozone continues to slowly improve, with PMI surveys stabilising above 50, highlighting continued expansion across the manufacturing and service sectors of the economy. Greece remained challenging for Europe during the month as Prime Minister Tsipras called a mid-September election (he has since been re-elected as Prime Minister). So while an in-principle agreement was reached with its creditors during July, the ability for Greece to once again be front page news will ensure that financial market volatility remains elevated.

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UK

The UK economy continues to show solid growth. Along with the US, we see the UK economy as being one of the strongest developed market economies. To this end, we envisage that the Bank of England will look to move on cash rates through the first quarter of 2016 with multiple indicators (employment, housing consumer and business confidence etc) all pointing to further economic growth through the second half of 2015.

CHINA

Chinese economic data continues to highlight a further slowdown in the economy. The decision by the People's Bank of China (PBOC) to devalue the renminbi over the month caught many in financial markets by surprise and resulted in increased currency volatility across other emerging market regions. With China now effectively moving away from its peg with the US dollar, the potential for a further devaluation of the renminbi as a means to protect its growth outlook cannot be discounted. While the government and PBOC have a number of tools to tackle slowing economic growth, the flow on impact to other regions (via a further devaluation of the renminbi) will be closely watched should the Fed move on rates in the near term.

How has the Australian economy performed over the past year?

The economy only grew by 2% over the past year, its slowest pace since the third quarter of 2013 and well below trend of 3.5%. The first quarter of 2015 had offered stronger growth of 0.9% quarter on quarter compared to 0.2% in the second quarter. The stronger growth in the first quarter was partly related to unseasonably good weather, whereas the key sources of growth in the second quarter were household consumption and government spending. These were offset by falls in dwelling and business investment and exports.

This is in line with the RBA's forecasts for the economy contained in its August quarterly statement on monetary policy. In its report, the RBA indicated that the economy is operating at a moderate, below-trend pace and inflation will be subdued for some time. It is anticipated that the recent falls in the Australian dollar will continue to benefit the economy and have already had a positive influence on tourism and business services sectors.

Why did the Fed maintain its hold on interest rates in its September meeting?

In her statement to the press, Fed Chair Janet Yellen noted that the Fed believed it was appropriate to maintain the Fed funds rate at 0-0.25% for the time being given the less certain global economic outlook and recent market volatility. The Fed particularly noted global developments including the slowdown in China, which resulted in sharp drops in global equity prices, increased capital flows which put upward pressure on the US dollar and weakness in oil prices as having the potential to constrain the US.

The September decision did not rule out the prospect for an increase later in the year. The key drivers for a rate rise later will include ongoing activity for the global economy and continued strengthening of the US labour market. If economic conditions in China and Europe continue to remain volatile, or worsen, then it is likely that the Fed will maintain the hold on interest rates for the remainder of 2015. On the side of the US labour market, August payroll numbers were slightly below expectations and the three month trends indicate gains in the numbers are below that required to reduce the unemployment rate.

Will the BOJ increase monetary stimulus?

Second quarter data indicated 0.4% quarter on quarter contraction in the Japanese economy. However the BOJ has some reasons to expect the weakness is temporary. It believes the economy will continue to recover moderately, supported by highly accommodative financial conditions, a marked improvement in corporate profitability, and further steady improvement in the employment and income situation of households.

There is some evidence to indicate this may be correct. The labour market continues to show signs of improvement with unemployment falling to a 20 year low of 3.3% in July. But this hasn't translated to wages growth yet, which may indicate that business confidence is low given an uncertain and volatile global environment.

Wages growth will be a key factor in driving improved household income and this may mean the BOJ will need to reassess its view of the economy. The challenging global environment may also force the BOJ to consider further stimulus, particularly given the slowdown in China – Japan's largest trading partner.

What are the signs that the European Central Bank (ECB) may increase its bond purchasing program?

There were a number of indications to suggest the ECB may increase its bond purchasing program. First, the ECB reduced its GDP and inflation forecasts, with GDP in 2016 anticipated to be 1.7% (previously 1.9%) and inflation tipped to be 1.1% (previously 1.3%). This

reflected increased concerns over risks to the global economy including the slowdown in China, difficulties facing other emerging markets and the pronounced fall in oil prices recently.

Secondly, the ECB raised the limits of bonds that central banks can buy from 25% to 33%, which would ensure that technical aspects don't prevent commitment to and completion of the €60bn asset purchase program. Based on increased market volatility and global growth concerns since the September policy meeting, many economists expect an announcement of increased bond purchasing in December.

Performance in the UK was somewhat weaker in August. What were the key affected areas?

The most recent August Purchasing Managers Index (PMI) was weaker than anticipated with the manufacturing sector quite sluggish. While output and new domestic orders indices moved higher, new export orders volumes disappointed due to the stronger British pound and subdued sales growth to the Eurozone and China. There were also job losses in the sector for the first time in 26 months.

Data for the services sector was also disappointing in August and dropped to a 27-month low. Despite the decline, growth in the sector remains strong overall and is consistent broadly with its long run average. It also saw increased job creation during August.

Inflation also fell back to zero in August, from 0.1% in July. This was largely a result of lower oil prices.

Why did the PBOC devalue the yuan?

The PBOC devalued the yuan on 11 August with fixing now based on how it closes in a previous trading session rather than a midpoint against the US dollar set by the PBOC. This means the market sets the midpoint and the value more accurately reflects market outlook on the prospects for China's economy and currency.

When making this decision, the PBOC noted that the yuan's midpoint had diverged substantially from the market rate and it was time to move to a market based midpoint. Its decision was based on two key reasons. Firstly, allowing the yuan to depreciate will help the flagging export sector by improving the competitive value of Chinese goods. Secondly, it is a further step by China to deregulate its financial system and improve the yuan's prospects of being included in the International Monetary Fund's SDR, which would amount to declaring the yuan a global reserve currency on par with the US dollar, euro, yen and British pound.

While this assists in managing China's deflationary pressures, the result has created challenges and uncertainty for global markets.

What does this mean for investment strategies?

The current market volatility reflects heightened uncertainty about the outlook for the global economy, and how policy makers in China and developed economies will respond. We expect the next few months will see a range of policy responses that will quell these concerns. Chinese authorities have already reduced interest rates, eased restrictions on banks and allowed local governments more access to finance, and more measures are likely to follow. The ECB and BOJ are both likely to announce some extension of quantitative easing by the end of the year. These measures, along with more clarity from the US Federal Reserve, are likely to stabilise confidence then lead to some recovery in equity markets.

The current turmoil in markets is creating opportunities that we will look to take advantage of. We have been adding to our positions in growth assets and will continue to do so as opportunities arise. In the mean time, we continue to monitor these developments closely.

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