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ASSET MANAGEMENT

THE SPLIT IN THE ROAD

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Monetary policies have slowly started to diverge, with the US looking at tighter policies while other countries are still focusing on further easing. Of these, Japan took the unexpected decision to move to negative rates while the Eurozone is anticipated to offer further quantitative easing in coming months. Currencies have also been a focus for the year after China depreciated the yuan pegging it to a basket of currencies rather than its historic peg to the US dollar.

AUSTRALIA

Recent reports offered mixed data for the Australian economy. The fourth quarter CPI report indicated headline consumer prices had risen by 0.4%, bringing the annual rate to 1.7%, with nine of the 11 indices measured showing gains. The six month annualised rate of core inflation also reached 1.7%, below the Reserve Bank of Australia's (RBA) desired target band of 2-3%.

US

The advance estimate of the US fourth quarter GDP report came in slightly below expectation at 0.7% compared to the anticipated 0.8%. Personal consumption grew, with robust growth in consumer durable goods, and residential investment growth beat expectations. Unfortunately, the strong US dollar and weak global demand saw the US trade deficit widen over the quarter. Private business investment was also sluggish with some drag from the energy sector. Government spending was higher driven by gains in national defence spending.

JAPAN

The Bank of Japan (BOJ) surprised global markets in January by cutting the official interest rate from 0 to -0.1%, passed by a 5-4 vote. This was part of its response to poor data from 2015 indicating falls across most areas, from household spending to industrial production and exports. Initially, the decision saw stock prices in Japan rise and the yen fall as the BOJ had hoped; however, this has since reversed.

EUROZONE

The January headline CPI print matched forecast estimates by reporting a 0.4% annual gain, with strength in domestic demand outweighing weakness in emerging markets and US demand. Despite this, low oil prices and the recent strength of the euro is likely to cause ongoing challenges for the Eurozone, which may see the European Central Bank (ECB) reduce the already negative benchmark interest rate further.

UK

The fourth quarter GDP report saw quarterly growth underperform expectation, with growth in annual terms declining to 1.9% – the weakest rate of expansion since a 1.4% gain recorded in 2013. Growth in the quarter was driven by the services sector, expanding by its fastest pace in over 12 months, with notable gains in business and financial services. Industrial output, as in the US, recorded its first decline since 2012 impacted by weak foreign demand and the strength of the British pound.

While growth has been weaker than 2014 for the UK, the International Monetary Fund (IMF) has forecast

TIM
ROCKS

Tim is Head of Market Research and Strategy, BT Investment Solutions.

expansion by 2.2% in 2016 and 2017, placing it above the averages anticipated for other developed nations.

CHINA

Reports from China showed its GDP growth rate slowed to a 25-year low of 6.9% last year, with indications that efforts to rebalance the economy are beginning to gain traction. The services sector expanded by 8.3% over 2015, while manufacturing declined to 6%. In the latter part of 2015, fiscal spending had jumped by around 30% and broad credit gained 14%.

As signalled in December, will the US Federal Reserve (Fed) raise its short-term interest rates four times this year?

The Fed has previously indicated its plans to increase interest rates by 25 basis points each quarter in 2016; however, this will depend on a variety of factors. Any increase in the interest rate will reflect the Fed's expectation of rising inflation from wages and stabilisation in oil prices. Given the sharp fall in oil prices at the start of 2016, it seems less likely inflation will increase and in turn, the Fed will need to review its policy expectations. In addition, the Fed is likely to be monitoring the elevated market volatility that has impacted markets since the start of the year, with particular concern over the impact of China on markets and global demand. Based on these factors, it seems unlikely the Fed will increase interest rates at the original pace, and it may not even increase rates at all in 2016.

Given the outlook, some may question why the Fed elected to increase rates in December at all. But the decision reflects the Fed's belief in the Phillips Curve. This concept suggests that as employment levels rise, companies are required to offer higher wages to attract the smaller pool of unemployed candidates (or alternatively to attract employees from other companies) and in turn, increasing wages will result in increases to inflation. This was a central theory in the 1960s and 1970s, but may have reflected the greater political power organised labour and the union movement had at that point in time. The question arises whether the GFC has now created a new social contract based on fear of job loss – whereby employees do not ask for pay rises in the hope of just retaining their jobs so companies are not required to battle to retain them with higher wages.

How do the US interest rates impact on Australia?

Increases in the US interest rate were expected to drive increasing strength in the US dollar, and in turn see the Australian dollar and other currencies gradually weaken over the year. This would have benefited the Australian economy by supporting both exports and tourism markets. If the Fed keeps US interest rates on hold, the Australian dollar and Australian interest rates are likely to be attractive to international investors, and result in an increase in the value of the Australian dollar against the US dollar.

If the Australian dollar increases, this will put pressure on Australia's inflation rate, and impact both exports and the tourism sector by making both more expensive internationally. Any impact to the exports and tourism sectors may have a flow on effect to the unemployment rate, and may see the RBA reduce its cash rate further from its already record low level of 2%.

What are negative interest rates and why did Japan decrease its interest rate below zero?

Central banks can act as a cash reserve for financial institutions in a country, and the official cash rate it sets reflects the rate it charges financial institutions to borrow from it, or the rate it pays to those institutions who deposit cash with it. A negative interest rate effectively means a financial institution would need to pay the central bank to hold its money, instead of earning interest on it.

A central bank may choose to do this to encourage financial institutions to use their money in other ways instead of holding it in a central bank. This may mean lending money to companies or consumers as an example, and this is expected to help invigorate the economy by injecting more cash into it.

The ECB elected to do this with the Eurozone and now Japan has done the same.

Japan has struggled with deflationary pressure and reports from 2015 indicated ongoing falls across sectors like household spending or industrial production. The 'Abenomics' policies have not been sufficient in supporting the economy to date and the BOJ has therefore moved to more dramatic measures. In electing to move to negative interest rates, Japan hopes to stop the ongoing downward pressures and support spending to boost the economy.

While initially the decision saw stock prices rise and the yen fall (a boost for exports), this has since reversed. The likelihood of success from Japan's decision is uncertain. Domestic consumption demand is low and this has also meant demand for loans from companies and consumers is low, challenging the concept of a cash injection into the economy from banks moving their money elsewhere.

Would the RBA adopt a negative interest rate like Japan and the Eurozone?

Australia is almost unique among the developed nations of the world in that its official cash rate is higher than most other countries at 2%. This means the RBA has room to reduce interest rates from current levels to manage heightened levels of financial market volatility, a stronger Australian dollar or other perceived threats to the economy if needed. At this stage, it is unlikely the RBA would need to resort to negative interest rates.

What does this mean for investment strategies?

The environment of low inflation and low interest rates has a variety of implications for investment strategies. While there may be some possibility of enhanced returns from US fixed interest, negative interest in the Eurozone and Japan indicate that Australian fixed interest may continue to offer better returns for investors compared to international fixed interest.

Given central banks are likely to continue to offer supportive monetary policy, which is beneficial for investment markets, we maintain a positive outlook for shares. Although market volatility has impacted on markets, as a whole, this can also create opportunities. The easy monetary policy in the form of low interest rates is also beneficial to property and sharemarkets as it encourages business investment at a lower cost for debt repayment.

Sharemarkets may also benefit from ongoing falls in energy prices, as a lower cost of transportation not only benefits costs of goods and services but also leaves consumers with more disposable income from cheaper petrol costs.

For more information on the Advance Multi-Blend Funds, please speak to your adviser or call Client Services on 1800 819 935.

Advance Asset Management, GPO Box B87, Perth WA

Client Services 1800 819 935 Adviser Services 1300 361 864

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