Economic Update

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Market Highlights – October 2014

Share markets were generally lower in September, with global, Australian and emerging market shares all declining in local currency terms. However, the sharp fall in the Australian dollar in the month helped boost returns for unhedged investors in global shares.

The decline in share markets in September primarily reflected three factors. First were continued geopolitical concerns in Eastern Europe and the Middle East and the growing threat of terrorism in developed economies. Also, significant weakness in the housing sector and soft Chinese industrial production growth, now at its weakest pace since the global financial crisis, increased concerns over the Chinese growth story. Finally, and most significantly, was the increased focus on the likelihood of US interest rate increases in 2015 following the US Federal Reserve's (Fed) most recent meeting.

The latter saw a marked waning in investors' appetite for higher income generating assets (often referred to as the search for yield). In particular, the Australian dollar (AUD) fell by 6.4% in September versus the US dollar (USD), taking the AUD down to US87.5c, close to January's low. This move largely reflected a strengthening in the USD as investors re-allocated money back to the US on the expectation of higher cash rates versus other economies given the continued relative strength in the US economy. While the AUD also fell against other major currencies such as the Pound, Euro and the Japanese Yen, the extent of the declines were much smaller than against the USD.

Emerging market shares also fell, having previously been supported by the search for yield theme, as capital flowed from these markets back to major developed economies, especially the US. Emerging market shares fell by 4.2% on a local currency basis, though a fall in the AUD against emerging market currencies meant that on an unhedged AUD basis they fell by a more modest 1.0%. While the weakness was fairly broad based, there was particular weakness in Brazil which unwound the significant strength in August as optimism over the political situation gave way to renewed concerns over weaker growth in China and the impact of falling commodity prices, especially for iron ore. The MSCI China Share Index also performed poorly, dropping 6.6% in local currency terms, as concerns over the economy and the state of the housing market intensified.

Similarly, Australian shares performed poorly in September, falling 5.4%, as the waning of the search for yield theme saw investors exit the Australian market. The weakness in Australian shares was accentuated by increased concerns over the Chinese economy and the resulting sharp decline in bulk commodity prices. Though the drop in Australian shares was broad based, the resources sector underperformed the remainder of the market by posting a 7.5% decline.

Global developed market shares outperformed other share markets while still posting a negative return of 0.7% in hedged AUD terms. Having held up for most of the month, US shares retreated from their recent highs, posting a 1.6% fall, while the UK market fell almost 3%. Weakness in these countries was partly offset by a continuation of recent strength in the Japanese market which rose 3.8% as investors saw the continued decline in the Yen as being a positive for Japanese corporate earnings. The sharp decline in the AUD in the month meant that on an unhedged basis global shares posted a very strong return of 4.3%.

Fixed interest markets performed relatively poorly in September with most markets underperforming cash returns. This was particularly the case for the Australian market, where credit spreads and longer dated bond yields rose as investors shunned higher yielding local bonds in favour of US dollar assets. The Australian fixed income market returned negative 0.3% in the month.

Global fixed interest markets recorded a negative return of 0.1% in the month. The increased focus on the potential rise of US short-term interest rates weighed on US bonds, pushing 10-year bond yields up by 15 basis points (bps) to just below 2.5%. European and Japanese bond yields rose by less, however, while peripheral European yields fell (prices rose) as the European Central Bank lowered interest rates modestly and continued to signal the possibility of its own quantitative easing program.

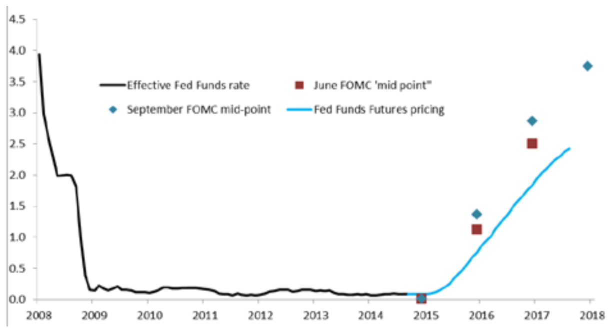
Economic highlights by region

US

It was a mixed month for US data during September. On the positive front, our favoured partial indicators of growth, the new orders indices within the Institute Supply of Management surveys, rose further from an already strong level. At the same time, consumer spending growth rebounded as softer prices, in part reflecting lower fuel prices, helped support consumer purchasing power. This was offset, however, by signs of weakness in existing home sales and resulting softening in house prices alongside a fall in consumer confidence. At the same time, employment growth disappointed following its recent strength, leaving the unemployment rate unchanged at 6.1%.

The latest Fed meeting was the main focus for markets. The Fed continued to slow the pace of new asset purchases to just $15 billion a month, and is expected to end new purchases at its next meeting in late-October. The Fed also continued to note it would be a considerable period before it commenced raising rates. However, a modest increase in the median Fed member's expectations for rate rises alongside signs of dissent from some members saw the market increase its expectations for rates rises in 2015.

US - Fed Funds Rate and FOMC projections (%)



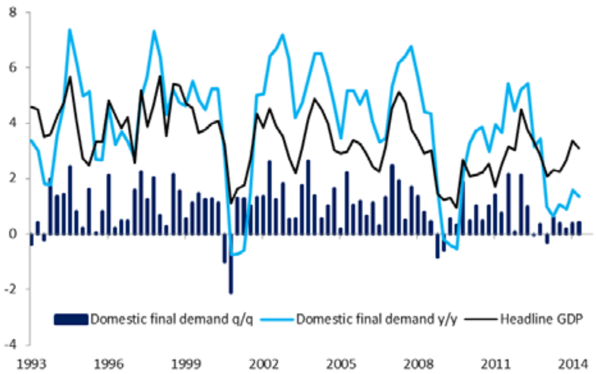
Source: Bloomberg, US Federal Reserve & ANZ Global Wealth

Australia

Growth in the Australian economy was reported to have slowed in the June quarter from the strong pace recorded in March. The softer pace of growth primarily reflected weaker exports after it had contributed significantly to growth in the prior quarter. Domestic final demand growth was unchanged at a fairly modest 0.4% rate suggesting that the transition in the economy towards non-mining sectors remains a work-in-progress. Recent signs of a renewed softening in consumer spending in the September quarter also suggest this transition remains fragile, though this is offset by continued strength in housing activity and a trend improvement in business conditions.

The challenge increasingly for the Reserve Bank of Australia (RBA) is to continue to support the economy's transition without creating a bubble in the housing market. The RBA continues to point to rates remaining at their current stimulatory level for some time. However, it has increasingly hinted at the potential use of macro-prudential regulations to limit excessive lending to housing investors.

Australia – GDP growth (%)

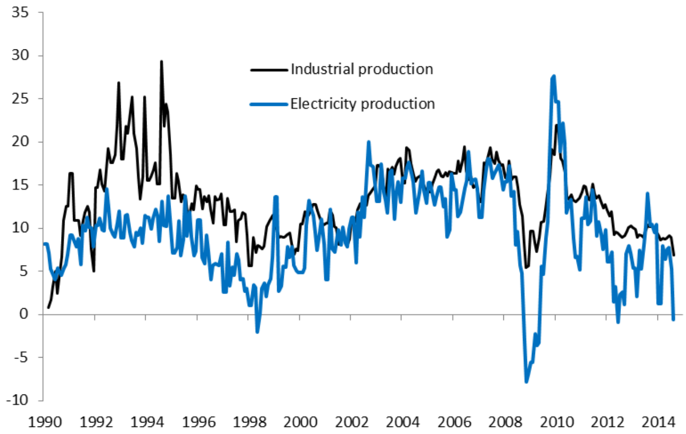


Source: ABS & ANZ Global Wealth

Asia

Economic growth worries over China intensified in September. This reflected concerns over the deteriorating housing sector, with 68 of 70 cities now reporting falling prices, and a marked weakening in key activity indicators. In particular, annual growth in industrial production slowed to its weakest pace outside of the global financial crisis since 1991 (excluding distortions from Lunar New Year holidays) as electricity production growth turned negative. Meanwhile, the pace of growth in fixed asset investment fell to a 13 year low. Though Chinese policymakers loosened policy at the margin to support growth, and have taken several steps to help cushion the adverse impact from the unwinding housing sector, the lack of any broad based measures to support activity increases the likelihood that underlying growth will be clearly weaker than the government's 7.5% target. Pro-democracy protests in Hong Kong have also worked to unsettle markets of late.

China – Annual growth in industrial and electricity production (%)



Source: Thomson Reuters & ANZ Global Wealth

Europe

Recent activity indicators across the euro zone have become less encouraging after the economy surprisingly failed to grow in the June quarter. Key business survey indicators have continued to turn lower, with the expectations component of the German IFO Business Conditions Index falling to a 21 month low to a level which is consistent with almost no growth in the economy in the second half of 2014. This downturn is concerning given the already low level of inflation of 0.3% (Italy has slipped into modest deflation at present). Worryingly, the concerns over growth appear to be weighing on the already fragile consumer sector, with confidence declining recently.

Against this backdrop, the European Central Bank (ECB) moved to further lower interest rates modestly in September. In addition, the ECB announced it will commence purchases of covered bonds and asset-backed securities starting in late October. While the initial intention is to return the ECB's balance sheet to the levels seen in early 2012 (an increase of up to €1 trillion from its current level), ECB President Draghi's comments clearly state the willingness of the ECB to continue asset purchases until inflation rises in line with its target.