Economic Update

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Market Highlights – September 2014

Geopolitical concerns persisted in the month of August. US President Barack Obama authorised air strikes in Northern Iraq while reports of a build-up in Russian military presence in the Ukraine dominated headlines.

Meanwhile, the macro picture appeared mixed as disappointing data from the euro zone contrasted with the solid readings from the US. Italy's Gross Domestic Product (GDP) contacted 0.2% year on year in the second quarter, sending the euro zone's second largest economy back into a recession. During the month, Europe's woes were further compounded by the bailout of Banco Espirito Santo SA in Portugal as well as by the resignation of the French government after feuding over the country's economic policy.

While this backdrop initially weighed on share markets earlier in the month, positive economic readings from the US and prospects of further monetary easing in the euro zone ultimately buoyed investor sentiment, and led share markets in aggregate to turn in a positive performance in August. Developed market shares ended the month up 2.9% in hedged Australian dollar (AUD) terms. US shares led the gains, up 3.8% in USD terms, with the S&P 500 index flirting with a new record high. European shares rose 1.8% in local currency terms but Japan fell 1.3% in yen terms as poor macro data raised investor scepticism over the effectiveness of the Abe government's policies.

Australian equities underperformed their global counterparts, however, still gained 0.6% on an accumulation basis for the month. The market was weighed down by the resource sector which declined 2.8% as the downward trend in commodity prices continued due to weaker economic data from China. However, this was partially offset by stronger corporate results, which to date, have slightly exceeded market expectations and added some gloss to the market towards the end of the month. Meanwhile, Australian listed property performed well as investors still favoured higher yielding assets in this low interest rate environment.

Emerging markets gained 1.6% in AUD terms. The Brazilian share market rallied 9.8% in local currency terms on rising expectations that President Dilma Rousseff could lose her bid for re-election in October. President Rousseff has been widely criticised by investors for mismanaging the economy and latest polls showed increasing prospects of a regime change. Elsewhere in Emerging Markets, Asia's performance was relatively flat, as the slowdown in China's economic momentum kept investor sentiment in check.

Global fixed interest markets continued to perform well in August, with the Barclays Global Aggregate Bond benchmark up 1.4% on a hedged AUD basis. Despite positive macro data, US bond yields continued to trend lower (prices higher). Although US Federal Reserve (Fed) Chair Janet Yellen presented a more balanced view on the state of the US labour market at the Jackson Hole conference, the path of interest rate hikes by the Fed is likely to be muted.

Instead, it was European Central Bank's (ECB) President Mario Draghi who stole the show at Jackson Hole. Draghi's comments on the recent slide in inflationary expectations in the euro zone were interpreted by markets as a step along the road to a quantitative easing programme, resulting in a sizeable rally across European bond markets. The decline in yields was especially pronounced in the peripheral markets, with the 10-year bond yield falling to new lows of 2.38% in Italy and 2.14% in Spain. In Germany, the 10-year bund yields fell to a low of 0.87% while the 2-year bund had a negative yield of 0.039%.

Australian fixed income performed in line with its global counterparts and returned 1.0% for the month. Both the 10-year and 3-year government bonds rallied on weaker unemployment data which rose to 6.4% in July and up 0.4% from June. This was partially offset by a string of more positive data releases towards the end of the month including stronger business conditions, rising consumer sentiment and stronger capital expenditure intentions. Latest comments from the Reserve Bank of Australia (RBA) governor still point to an ongoing re-balancing of the economy towards non-mining sectors and for monetary policy to be accommodative in assisting with this transition.

Despite disappointing Chinese data and falling iron ore prices, the AUD was surprisingly resilient, finishing the month at US93.4c, up 0.5% from the previous month. The tug-of-war on the AUD continues with weak commodity prices offset by the continuation of the search for yield.

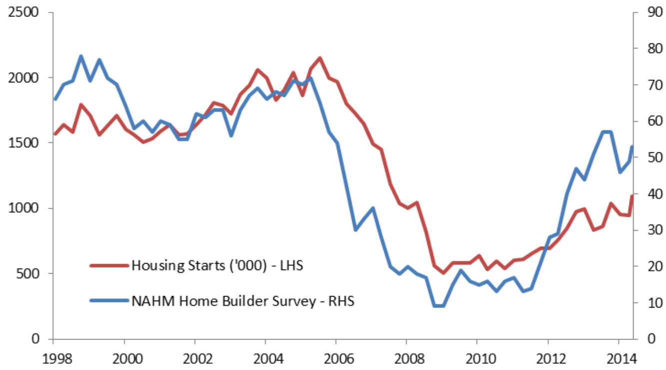
Economic highlights by region

US

Apart from the weak retail sales reading, the data from the US was largely positive. The second reading of US Q2 GDP was revised up slightly to an annualised rate of 4.2% quarter on quarter (q/q) from 4.0% q/q. Housing starts surged in July, marking the second-highest level in this recovery. The strength in housing starts appears consistent with the message from the latest NAHB homebuilder survey, a measure of homebuilder sentiment. At the same time, the expansion in industrial production in July, coupled with the tick up in capacity utilisation to 79.2% are consistent with healthy momentum in the industrial sector. Looking through the volatile headline durable goods order, the growth in core orders in July points to an uplift in business investment in the near term.

On the labour front, US jobless claims continue to bounce around the 300,000 level, exhibiting a positive trend. The NFIB small business survey also showed mounting labour wage pressure, which is key to the inflation outlook. Fed Chair Janet Yellen also weighed in on the labour market in her Jackson Hole speech where she highlighted that the numerous changes in the jobs market made it difficult to determine the actual amount of slack in the economy. Nonetheless, the latest minutes of the Federal Open Market Committee meeting suggest that it is becoming increasingly focused on the timing of the Fed's first rate hike.

US - Housing Starts & Homebuilder Survey



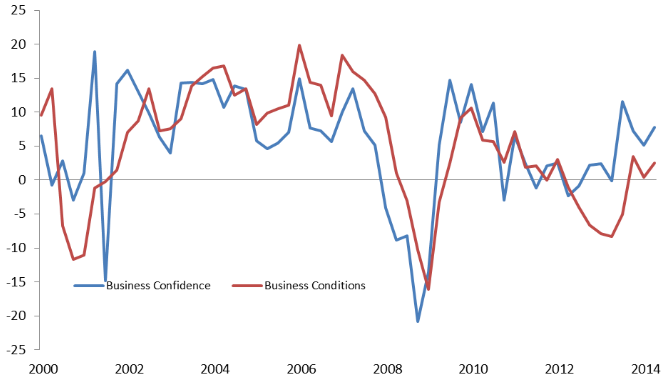
Source: Bloomberg & ANZ Global Wealth.

Australia

Recent economic data shows that the rebalancing in the Australian economy is continuing. Business conditions, as measured by NAB, rose to the highest level since March 2010. Notably, the improved business conditions were driven by the non-mining sector, especially manufacturing and construction, while conditions in the mining sector fell. The latest survey of capital spending intentions continues to point to an improvement in non-mining investment. Overall, business confidence has also improved and is now at its highest level since September 2010, barring the spike in September last year, post the Federal election.

Despite the improving economic backdrop, there appears to be little risk to inflation to date. Wages growth remains soft and the unemployment rate rose to 6.4% in July, although the rise was largely attributed to sample rotation. During the month, the RBA governor noted the fall in lending rates in Australia has made monetary conditions less restrictive, despite the cash rate being on hold. These comments further underpinned market expectations that another cut in interest rates by the RBA is likely to be off the table in the near term.

Australia – Business Confidence and Business Conditions Indices



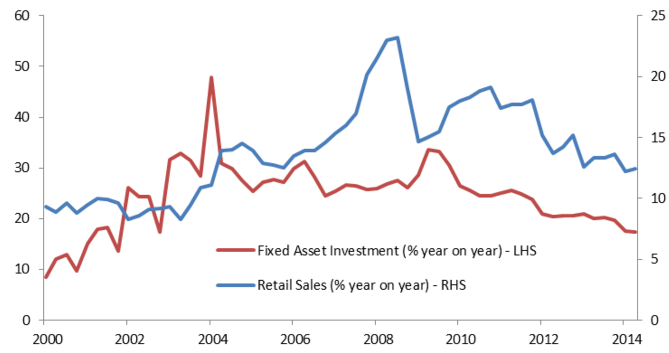
Source: Bloomberg & ANZ Global Wealth

Asia

Economic growth worries over China resurfaced following disappointing data for the month of July. Not only did China's industrial production, retail sales and fixed asset investment miss market expectations, the People's Bank of China (PBoC) also revealed lower-than-expected social financing figures (a broad measure of credit growth in the Chinese economy), with a sharp fall in new loans. The weaker-than-expected HSBC manufacturing Purchasing Managers Index (PMI) for August further exacerbated investor concerns. Meanwhile, the property market continues to cast a long shadow on the economy with property sales and new housing starts declining over the January–July period relative to the same period last year. The Chinese government would likely need to continue with its expansionary policy if it wishes to achieve its 7.5% GDP growth target for 2014.

Outside of China, the data appears patchy. Singapore's non-oil domestic exports contracted for the third consecutive month while India's industrial production missed expectations. Finally, the Bank of Korea cut interest rates in response to slowing domestic economic growth.

China – Fixed Asset Investment & Retail Sales



Source: Bloomberg & ANZ Global Wealth

Europe

There continues to be a loss of momentum in the euro zone with declines seen in both the manufacturing and services PMIs for the region, even though both indicators stayed above the 50 level. The euro zone consumer confidence index also weakened slightly in July. Over in Germany, the moderate decline in August's PMIs contrasted with the sharper-than-expected fall in the German IFO Business Confidence Index. While business sentiment appears to be affected by the geopolitical tensions in Ukraine/Russia, the economic impact is expected to be manageable, as long as tensions do not escalate further.

Country specific reasons are largely responsible for the loss in momentum in the region. Specifically, a mild winter had boosted activity in the first quarter for Germany, resulting in some payback in the second quarter. On the other hand, a lack of structural reforms is holding back further recovery in France and Italy. Notably, Mario Draghi, in his speech at Jackson Hole, emphasised the need for fiscal policy and labour market reforms to help boost economic growth, with the ECB playing a supporting role. That said, pressure is rising for the ECB to do more following the fall in consumer inflation to a five-year low of 0.3% year on year in August and the slide in inflationary expectations over the month.

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