Economic Update

financial services partners

July 2014

Market highlights

Most markets rose strongly in June as the continuation of the global search for yield thematic again saw fixed income and share markets both perform well. The search for yield was given added impetus by stimulus measures announced by the European Central Bank (ECB) in an effort to lift inflation from its current low level. While the ECB stopped short of announcing its own asset purchase program, it lowered interest rates and introduced a series of measures aimed at increasing the availability of bank credit.

While the ECB was widely anticipated to announce additional stimulus, the delivery of these measures helped shift investors' focus back to growth assets and helped the market shake off signs of a pickup in US inflation. The latter was also helped by commentary from the US Federal Reserve (Fed), which indicated it still sees inflation as remaining moderate over the coming year. Some positive signs from corporates ahead of the coming US earnings season also boosted global shares.

Overall, developed market shares posted a strong gain of 1.7% in the month in hedged Australian dollar (AUD) terms and 24.6% over the financial year to end June. Anecdotal evidence of a continued diversification of investment allocations by several large pension funds, especially in Japan, was again a potential factor behind the 5.1% gain in the Japanese share market after last month's strong rise. US shares also surged to a new record high, with improving earnings momentum assisting a rebound in global small cap shares (which are dominated by the US) after the decline in this sector in the prior three months. By contrast, European and UK markets posted declines of around 1%.

The Australian share market posted a modest negative return of 1.4% in the month. The weakness reflected concerns over the earnings outlook as many companies revised down their market guidance ahead of the end of the financial year. Consumer stocks and industrials underperformed, while resources struggled for most of the month given falling commodity prices, before getting a lift late in the month from improving Chinese activity data. By contrast, defensive, higher yielding sectors such as utilities and listed property continued to outperform the broader index, with the latter benefiting from the semi-annual distribution of dividends.

Emerging markets modestly outperformed developed markets in June, though a further rise in the AUD restrained returns on an unhedged basis to a still strong 1.2%. The global search for yield and an increase in sentiment towards share markets more generally saw continued inflows into this sector. While the rise was broad based, India remained a standout as sentiment remained particularly positive following the earlier election victory of the pro-market BJP party with a clear mandate to pursue much needed reform.

Global fixed interest markets performed well in June, with the Barclays Global Aggregate Bond benchmark up by 0.5% on a hedged AUD basis. Over the past financial year global fixed interest returned 7.8%. While US 10-year bond yields rose (prices down) modestly in June amidst stronger inflation and the Fed continuing to slow its asset purchase program, this was more than offset by a strong rally in European bond markets. German and French yields moved down towards the lows seen around the middle of last year before the bond market sell-off, while peripheral European bond yields dropped following the ECB's policy announcement and on the continued search for yield.

The Australian fixed interest market outperformed its global counterparts posting a 0.8% return. Australian government bond yields fell by more than 10 basis points (bps) across most maturities. This was driven by the search for yield and signs of weakness in domestic activity indicators, especially for the labour market, which raised questions over the recovery expected in the non-mining economy. It is especially noteworthy that the spread between Australian and US 10-year bond yields dropped to around 100bps, just above the seven year low seen last year.

Despite the weakness in Australian economic activity, falling commodity prices and a further change in perceptions of Australian monetary policy, the AUD increased 1.3% against the USD, finishing the month at US94.3c. The AUD, for now, remains supported by the continuation of the search for yield, which has seen ongoing strong demand for higher yielding AUD assets.

Economic highlights by region

United States

Downward revisions to reported spending on healthcare in the US saw GDP further revised to now show a contraction of 2.9% (annualised) in the March quarter. Weakness in healthcare spending also appears to have constrained consumption growth in the June quarter, offsetting a strong rebound in spending on goods following the weather-related weakness at the start of the year.

Despite this, the balance of data continues to point to a strong rebound in the economy, led by business spending on both labour and capital goods. Growth in capital goods orders in particular has surged in recent months. Meanwhile, there were clear signs of a rebound in housing in June, with a range of measures of home sales rising strongly. Reflecting this, our preferred summary measure of US activity, the composite ISM new orders index, has risen to a level which if sustained is consistent with US growth recovering to around a 3% pace, a rate which is comfortably above the Fed's estimate of potential growth.

US – Annual GDP Growth & ISM New Orders

Source: Thomson Reuters & ANZ Wealth

Europe

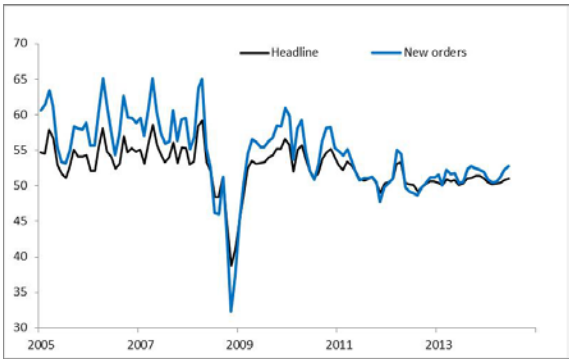
Following disappointing growth in the March quarter and a fall in inflation back to its recent low, the ECB announced a series of new stimulus measures at its meeting in June. In addition to lowering its main interest rate to 0.15%, the ECB also announced a series of measures aimed at improving the supply of credit to European households and businesses. The latter included a reduction in the rate that the ECB pays banks for excess deposits left overnight at the ECB into negative territory (that is, banks now pay the ECB for such deposits) to the provision of long-term liquidity to European banks on the proviso that the funds are used to increase lending to the private sector within the euro zone. While the ECB stopped short of announcing its own asset purchase program, it did leave open the possibility it would implement further stimulus, including a form of quantitative easing, in order to avoid a period of undesirably low inflation.

Asia

There were increasingly clear signs in China in June that recent efforts by policy authorities to support growth have begun to take hold. While fixed asset investment growth continued to ease lower, annual growth in industrial production showed signs of stabilising at its recent low levels. At the same time, the manufacturing PMI surveys have risen solidly in recent months from their recent lows. Of particular note has been the recovery in the forward looking new orders index, which rose in June to its equal highest level in just over two years. With financial conditions improving further in June, it appears increasingly likely that Chinese growth momentum will improve somewhat further in the second half of the year.

Outside of China, activity data throughout the rest of Asia has remained patchy. While exports have improved recently in Hong Kong and South Korea, they weakened again in Singapore and have remained weak elsewhere. Meanwhile, industrial production in several countries has also softened of late reflecting the earlier weakness in growth in developed economies.

China – Manufacturing PMI



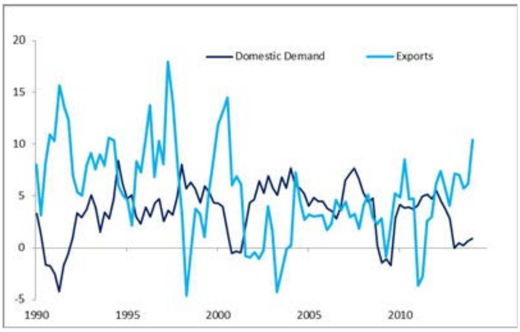
Source: Bloomberg

Australia

The Australian economy was reported to have grown strongly in the June quarter, with annual growth lifting to an above average 3.5%. Growth in the quarter was driven overwhelmingly by exports as the second stage of the mining boom (with production increasing after recent investment in new capacity) came into full swing. In fact exports accounted for all of the growth recorded in the quarter, with investment remaining weak and consumer spending soft.

Indicators of activity for the June quarter have shown a softening in momentum in both the consumer and housing sectors. This was before the hit to consumer confidence which occurred following the release of the Commonwealth Budget in May. Along with a drop in job advertisement, which reversed much of the recovery seen in the prior three months, this has again raised concerns over the strength in the non-mining economy.

Australia – Breakdown of Annual Growth in GDP (%)



Source: ABS & ANZ Wealth

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