Economic Update

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Market highlights

Financial markets rose strongly in May. The key driver was the continuation of the global search for yield, supported by both low and stable inflation across the developed world and the success of central banks in these countries in anchoring cash rates expectations. These combined resulted in an unusually high correlation between US Treasury yields and other asset classes, with both fixed income and equity markets performing well. The strong equity returns in the month made a mockery of the adage “sell in May and go away”.

Two additional factors further propelled this search for yield in May. First, expectations have risen that the European Central Bank (ECB) would soon provide more stimulus to avoid unwanted disinflation, with President Draghi indicating the ECB is considering implementing its own form of quantitative easing. Second, anecdotal evidence suggests that several large pension funds, especially in Japan, have sought to diversify their investment allocation away from low yielding assets. This was potentially a factor behind the strong 3.4% gain in the Japanese equity market, the first rise this year.

Overall, developed market equities posted a strong gain of 2.5% in hedged Australian dollar (AUD) terms in May. Aside from Japan, the strongest gain was seen in the US, which was buoyed by low interest rate expectations and also improved economic data following the winter soft patch. The improvement in equity markets was broad based, with European and UK markets both up by 1.0% or more.

The Australian equity market posted a more modest return of 0.6% in the month. The Australian market was held back by weakness in the resources sector as iron ore prices fell further to below $100 a tonne. By contrast, defensive, higher yielding sectors such as utilities continued to outperform the broader index posting robust gains.

Emerging markets outperformed developed markets in May, posting a strong 3.0% return in AUD terms. Along with the global search for yield, several other factors saw continued inflows into emerging markets. First and foremost was an apparent reallocation of risk among investors from global small cap stocks towards emerging markets. Global small cap stocks have been the strongest performing market sector over the prior year and are now seen as being expensive on a valuation basis. Emerging markets’ valuations, on the other hand, are seen as being more supportive. Also, signs of stabilisation in Chinese economic activity helped drive a rebound in Chinese shares. Finally, emerging market shares were supported by the election of a pro-market Government in India with a clear mandate to pursue much needed economic reforms along with a rebound in the Russian market following the sharp decline in April.

Global fixed interest markets performed well in May, with the Barclays Global Aggregate Bond benchmark up by 1.2% on a hedged AUD basis. Since the start of the year, global fixed interest has risen by 5.2%, exceeding its expected annual return. US 10-year bond yields fell 17 basis points (bps) in May to 2.46%. This is the lowest level since the US Federal Reserve (Fed) first raised the prospect of winding back its asset purchases last June. The latest fall in yields came as markets further pushed back expectations for US rate hikes despite improved economic data and a stabilisation in inflation. Another factor supporting the decline in US yields is that, despite Fed tapering, the sharp reduction in the Federal deficit has seen the Fed become the dominant purchaser of new Treasury issuance. Since the start of the year, Fed bond purchases have accounted for more than 100% of new issuance. Meanwhile, the prospect of further stimulus in Europe saw European Government bond yields fall by around 10bps in the month.

The Australian fixed interest market also performed strongly, rising 1.4%. Australian government bond yields fell by a greater extent than its global counterparts, with 10-year yields dropping by almost 30bps to 3.66%, a 10 month low. In addition to global factors, the Australian market was driven by negative consumer reactions to cuts to a range of welfare programs and several tax rises in the Commonwealth Budget. This saw expectations for rate rises by the Reserve Bank of Australia pushed back to late next year.

Despite the change in perceptions on Australian monetary policy and falling iron ore prices, the AUD remained elevated, finishing the month slightly higher against the US dollar at US93.1c. The AUD appears to have been supported by the continuation of the search for yield, which has seen ongoing strong demand for higher yielding AUD assets.

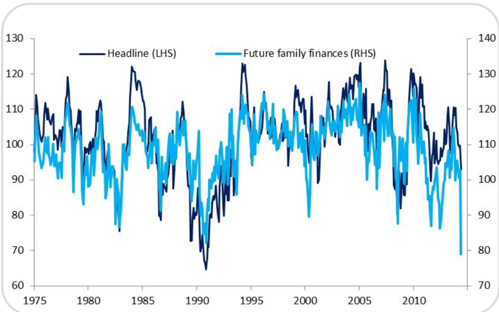
Economic highlights by region

Australia

The Abbott Government’s first Budget was handed down in May and was aimed at addressing what the Government perceived to be an unsustainable state of finances. This was achieved through a series of measures such as sweeping changes to welfare eligibility, changes to health care entitlements, an increase in the retirement age and some increases in taxes. While the direct impact on growth from the Budget is likely to be relatively moderate at only around ½ a per cent of GDP for the coming year, negative publicity about the measures has driven a sharp decline in consumer sentiment, with the key index on future family finances plunging more than 20% to a record low. This raises concerns over the potential for a more marked impact on the economy.

On a more positive note, the second estimate of business investment plans for the 2014/15 financial year showed a strong uplift in planned investment outside of the mining sector. Meanwhile, though residential building approvals have fallen from near record levels, they remain consistent with a continued pickup in residential construction activity over the coming year.

Australia – Consumer Confidence Index



Source: Bloomberg

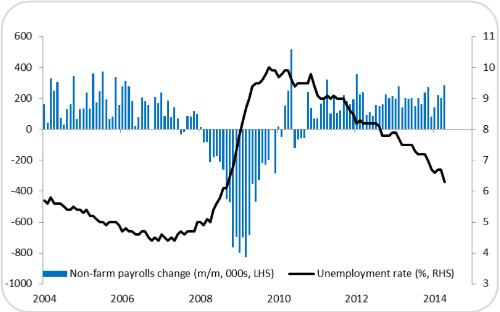
US

The US economy is now reported to have contracted by an annualised 1.0% in the March quarter. The downward revision to economic activity was entirely the result of a large drag from business inventories, which subtracted 1.5 percentage points from growth in the quarter. Despite being a negative in the March quarter, this is actually a positive for growth in coming quarters.

Activity data since the March quarter shows the economy has rebounded from the earlier weather-induced weakness, led by a pickup in business spending on both labour and capital goods.

The forward looking ISM new orders indices rebounded to a robust level, while employment growth has accelerated, with non-farm payrolls rising by 288K in April, its largest monthly gain in more than two years. The latter in turn contributed to a sharp decline in the unemployment rate to 6.3%. A trend decline in initial claims for jobless benefits suggests that this improvement in labour demand has continued into the middle of the year. At the same time, the recent decline in mortgage rates has provided a boost to the housing sector with both activity and prices showing improved momentum.

US – Employment and Unemployment



Source: Thomson Reuters

Europe

Growth across the euro zone in aggregate was unchanged in the March quarter to that experienced on average in the second half of 2013. This was despite the improvement seen in business surveys through the quarter which had pointed to a strengthening in growth momentum to something close to the region's long-run average pace. The lack of a pickup in growth momentum occurred despite growth in Germany, the largest economy in the region, accelerating to its fastest pace in four years. This was offset by a stalling in activity in France and renewed contraction in Italy and the Netherlands as industrial production fell.

At the same time, inflation failed to rebound as much as expected in April, with partial indicators pointing to a further slowing in inflation in May. Against this backdrop, ECB President Draghi gave his strongest signal to date that the ECB was prepared to provide further stimulus to support the fledgling recovery, including the use of unconventional policy measures.

Asia

Activity indicators for April slowed further in China, with fixed asset investment growth slowing to its lowest level since 2001 and nominal retail spending growth easing to a five year low. However, the purchasing manager's index for May showed signs of a stabilisation, led by a rise in the forward looking new orders component, while export growth showed signs of improvement. This provides some comfort that recent policy measures designed to support growth may be bearing fruit.

Outside of China, activity data throughout the rest of Asia has remained patchy. Growth slowed in the March quarter in Hong Kong and India while exports fell on an annual basis in South Korea, Hong Kong, Indonesia and Thailand. By contrast, exports have picked up strongly of late in Taiwan and Singapore as industrial production growth has improved.

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