Economic Snapshot

March - April 2016

In summary

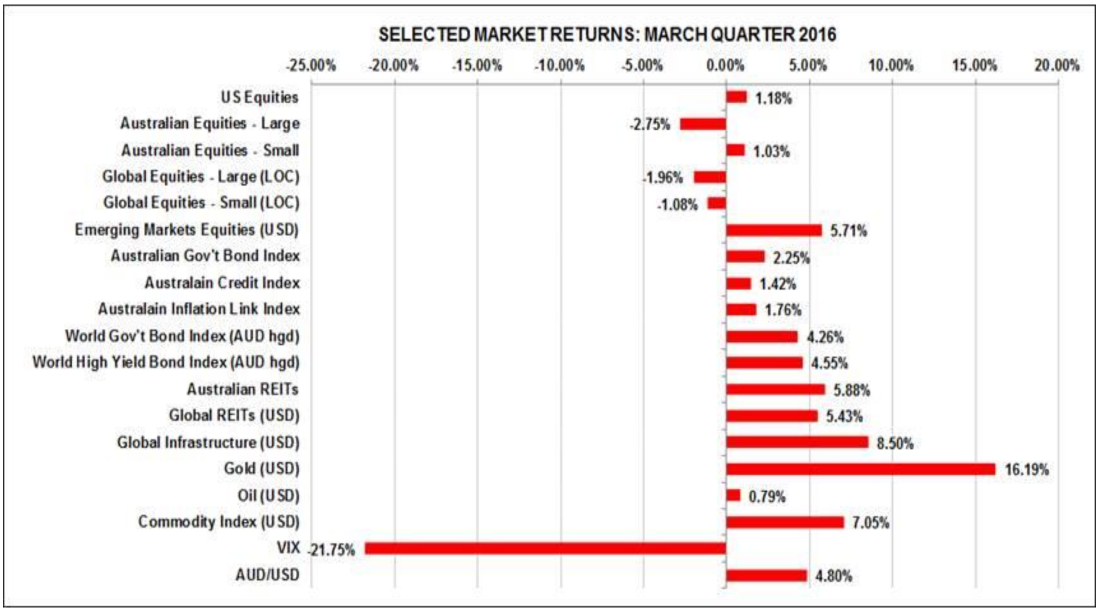
Portfolios in March saw further improvement in global investor sentiment as fears of a recession faded due to better news on key economic data and some stability returning to the oil market. Equities recorded a positive return for the month, with emerging equity markets outperforming particularly well after their recent difficult months. The normal monthly graph looks significantly different to the 3 month equivalent for the first quarter of the year and as such we have included the latter for a better perspective. US equities for example have now achieved a moderate return of 1.18% for the quarter but this is due to a strong rebound of over 6% in March. This is a poignant reminder that when we take into account a minimum 5 year time horizon the graphs are merely snapshots of a point in time.

In the US, there were further signs of labour market strength and some welcome improvement in the pace of manufacturing activity. Core inflation also continued to edge higher. However, the Federal Reserve again reiterated its preference to move cautiously with further interest rate increases. This inevitably undermined the US$ and resulted in speculative trading and volatility.

There were also encouraging signs of improving economic conditions in China, with the manufacturing index rising to its best level since June 2014. This reflects the impact of further monetary and fiscal stimulus from the Chinese authorities in recent months.

The latest figures for a number of key Australian economic indicators imply some moderation from the stronger than expected pace of growth seen in 2015. The A$ rose further on the back of higher commodity prices, including oil and iron ore. This led to increasing speculation about the Reserve Bank cutting the cash rate again to weaken the currency. However, the Bank remained content to leave the cash rate at 2% at the March meeting.

Figure 1: Equities bounced back in the quarter thanks to a strong March

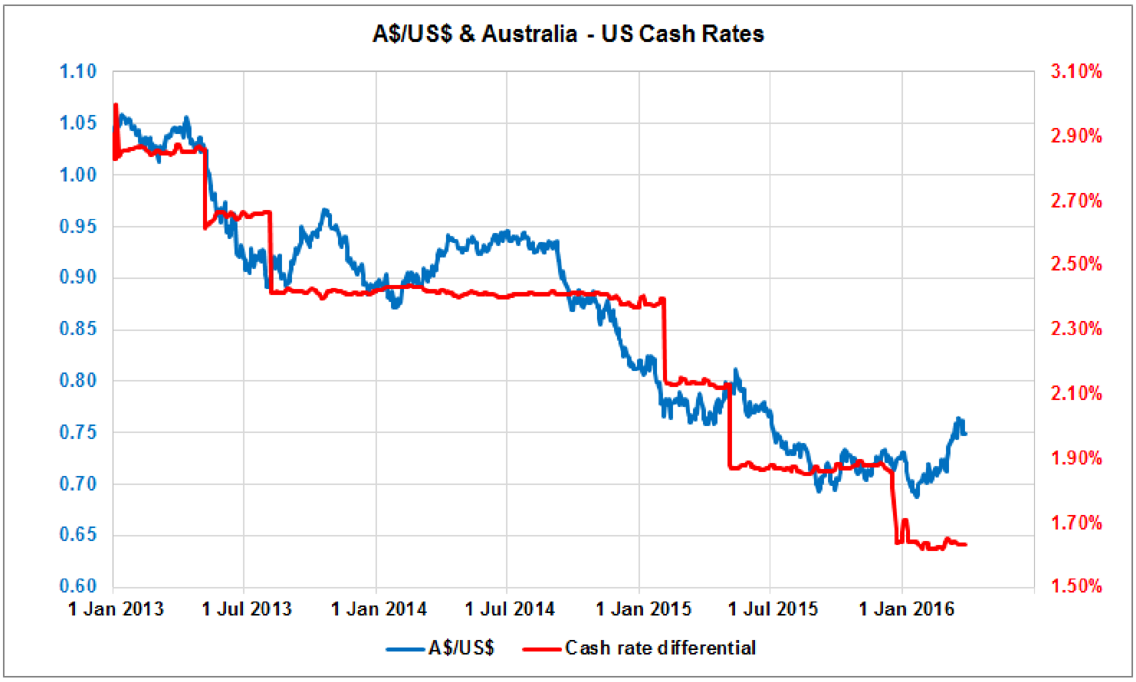


Australia

Prospects for the strength of the labour market are an important factor in the Reserve Bank's thinking about interest rates and the stronger than expected labour market figures seen in 2015 now seem to be fading. The number of employed hardly changed in February and although the unemployment rate dropped slightly to 5.8%, this was due to a fall in the number of active participants in the labour force. Figures for retail sales, vehicle sales, housing finance commitments and approvals for the construction of dwellings all painted a more subdued picture of overall economic activity.

Figure 2 shows the strength of the A$ over recent weeks to levels well above the value implied by interest differentials between Australia and the US. The A$'s rally has been driven by a rise in the iron ore price and the oil price, although some still doubt the sustainability of these commodity price increases, and observed the renewed dovish tone from Janet Yellen. Local economists expect the Reserve Bank to be actively considering further rate cuts in order to bring the A$ down before it does too much harm to economic growth. The Bank has acknowledged this in comments by senior officials, but has been content so far to leave the cash rate at 2%. Further, some commentators have suggested that the timing of the Federal Budget next month and the possibility of a double dissolution election in July could make the Reserve Bank hold off any further moves on the cash rate until August.

Figure 2: A$ strength is prompting expectations of more rate cuts from the RBA



The price of oil rose in March and briefly moved back above US$40 a barrel. However by the end of the month oil was slipping again as Saudi Arabia repeated that it expects other countries to reduce oil supply rather than cutting production itself. Iran remains a sticking point for Saudi Arabia not only because of the underlying tensions between the two countries but also because of Iran's refusal to agree to stop increasing production. In addition, US oil producers have not yet cut production anywhere near as much as the Saudis want to see.

Overall, the oil market remains fragile and vulnerable to further weakness as disputes about supply levels continue. This may in turn induce some renewed volatility in global equity and currency markets.

USA

In the USA the key indexes for the manufacturing sector showed marked improvement in March. The headline indicator rose to its highest level since June 2015. The service sector also picked up in March. Employment rose in March and the unemployment rate remained steady at 5%. Wages growth remains relatively subdued. Consumer confidence also improved. The Federal Reserve undermined the US$ by revising down its projected path for interest rates, which now implies only modest rate hikes in 2016. In subsequent comments Janet Yellen reinforced this more dovish sentiment by reiterating that she thinks the Reserve should proceed cautiously with its interest rate moves.

Europe

The European Central Bank announced further monetary stimulus through an expanded bond purchasing program as well as pushing interest rates further into negative territory. At the same time, Mario Draghi indicated that while he does not expect to see further rate cuts in Europe, interest rates will remain low for an extended period of time. The overall Euro area economy grew by 0.3% in Q4 2015 and this momentum appears to be continuing Q1 2016.

It is noticeable that in Europe, as in the United States, the household sector seems to be more confident and willing to spend than the manufacturing sector. This may reflect the beneficial impact of lower oil prices on household finances.

China

Chinese authorities announced plans to increase fiscal spending and accelerate the restructuring of impaired state-owned industries. The government remains committed to achieving 6.5% to 7.0% growth in 2016. On balance, the measures announced reveal a focus on maintaining growth rather than on managing the country’s growing debt burden. With this caveat, the measures were broadly well received by global investors. The People’s Bank of China further relaxed banks’ required reserve ratios in order to support lending – this is the reverse of the Australian banking system. The effect of these moves on bank lending is beginning to show in improved house prices. Manufacturing activity is also starting to respond to the stimulus program put in place over recent months.

Outlook – the Crystal Ball

In broad terms the world economy is working through a period of slow growth and inflation which will keep interest rates low by historic standards for some time to come. Although low interest rates are generally beneficial for financial markets, risk assets [Equities] need reassurance that growth will be robust enough to support corporate cash flows. The markets' confidence in the growth outlook has been fragile and easily tipped into fears of recession, which is what we saw in Q1 2016 triggered by the collapse in the price of oil. Economists and Fund Managers in general do not believe fears of recession are well-founded and most expect global growth to improve gradually through 2016, though still a relatively slow pace.

Although the past 12 months may not have felt like a good year for investors, Australia may continue to disappoint after better than envisaged growth throughout 2015. For many commentators, the overvalued A$ and ongoing political uncertainty will contribute to a more muted pace of growth in 2016 and the outlook for rate cuts will be determined by unemployment rate movement.

For investors with an eye to what it all means, in this environment we typically see private sector liabilities (that is, equities and credit) beating public sector liabilities (cash and bonds). However, the expected typical returns for equities have reduced as the forward growth profile has moderated.

Unfortunately the uncertainties noted above are likely to contribute to increased market volatility and in this sense what we have been experiencing the past few years could be described as the new normal - very significant equity market swings with inconclusive rationale. Investors should also bear in mind that the market indices are much higher than a decade ago and as such the percentage gain or loss is more moderate than the number of points typically reported by hungry news agencies.

The oil market is still deemed a significant source of risk with prices around US$40 a barrel looking unsustainable until US oil production falls much further than it has to date. Given the outlook and the prospective returns and risks, it would not be surprising to see 'active' fund manager portfolios rebalancing to reduce the allocation to domestic equities, in favour of international assets that are unhedged with an eye to benefitting from a possible fall in the $A.