Economic Snapshot

2015 In review - What happened, Why and the Outlook for 2016

In summary

The start of share markets in 2015 replicated the start of 2014 with strong gains in the first quarter which drifted away through volatile movements over the remaining 8 months. Media focussed on a bad year for markets and investors but despite this ***returns in many diversified portfolios still managed to outperform cash and term deposits illustrating the benefits of long term investing and diversification.***

Historically January tends to be a good month as we start a new year with investments, but 2016 has started differently with losses allegedly linked to the Chinese market and the incessant media commentary on China's economic slowdown however ***the discipline of looking at economic fundamentals is the only long term way to invest with confidence and as at January 2016 the fundamentals are pretty good.***

Although economic reports often focussed on the USA increasing rates and exiting the Quantitive Easing [QE] programme, the things that really changed 2015's outlook turned out to be developments in the emerging markets, [notably OPEC and China] coupled with the fall in the price of oil which was a major shock to the global economy. This spearheaded the collapse of the Chinese equity market [from record highs] and then the depreciation of the Yuan provoked fears of spreading recession. These events introduced significant volatility.

Interestingly, the Australian economy actually had a better year than envisaged at the end of 2014. Business conditions improved, as did the labour market and arguably the change in Prime Minister helped improve the national mood. The expected depreciation of the A$ also contributed to stronger business conditions and noticeably helped international investments in portfolios. Nevertheless, the transition of growth outside and away from the resources sector remained slow and prospects of a budget surplus have been pushed out even further. ***From the perspective of overall wealth creation, the housing market performed very strongly in 2015***, leading to the introduction of macro-prudential measures to cool speculative activity.

The US economy improved enough for the Federal Reserve to finally lift the cash rate by 0.25% on the 16th December, incredibly this was the first tightening since mid-2004. However, by the end of the year the slowdown in the US manufacturing sector, driven by energy and exports, had cast a shadow over equity and debt markets.

Monetary policy was eased in a number of countries around the world, including Australia, Europe, Japan and China. In Australia, the cash rate started the year at 2.5% but by May was at 2.0% where it remained for the rest of the year. The A$/US$ fell nearly 11% to finish the year at US$0.731, although for many economists this appears to be overvalued when compared with interest rates in commodity prices.

The year 2015 in graphical retrospect

While Figure 1 below neatly summarises the movement of major asset prices over 2015, it does not really show the degree to which market volatility fluctuated through the year. Figure 2 illustrates this.

Figure 1: Diversification proved a winner and offset some of the effects of falling oil prices.

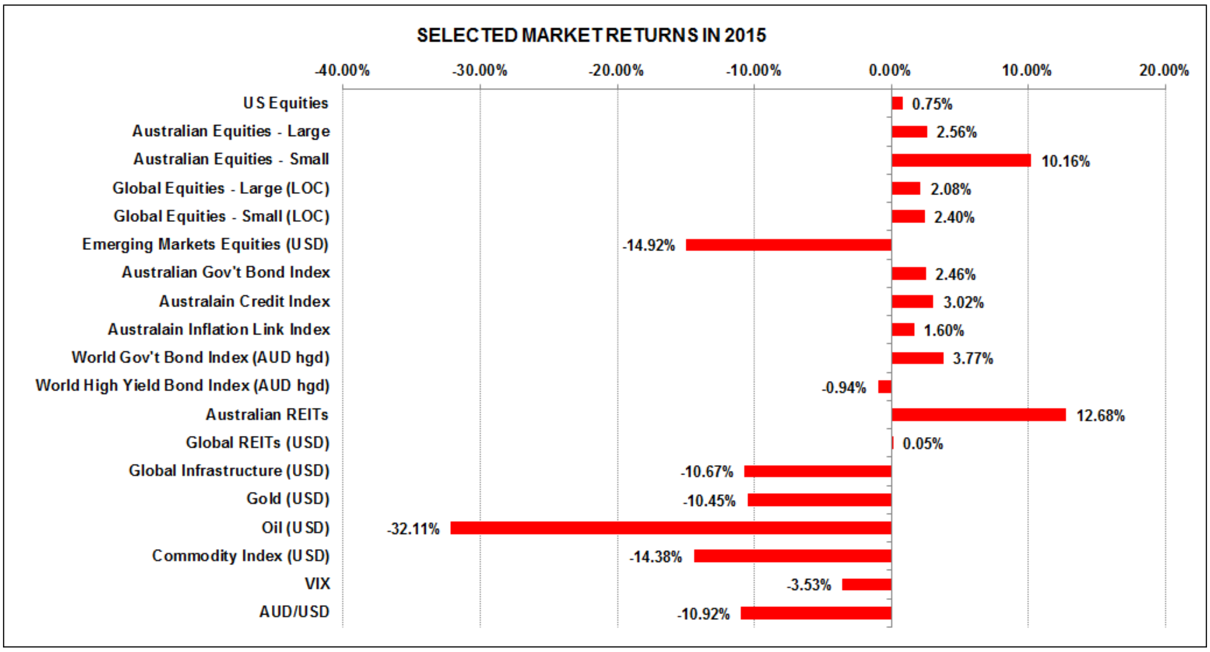
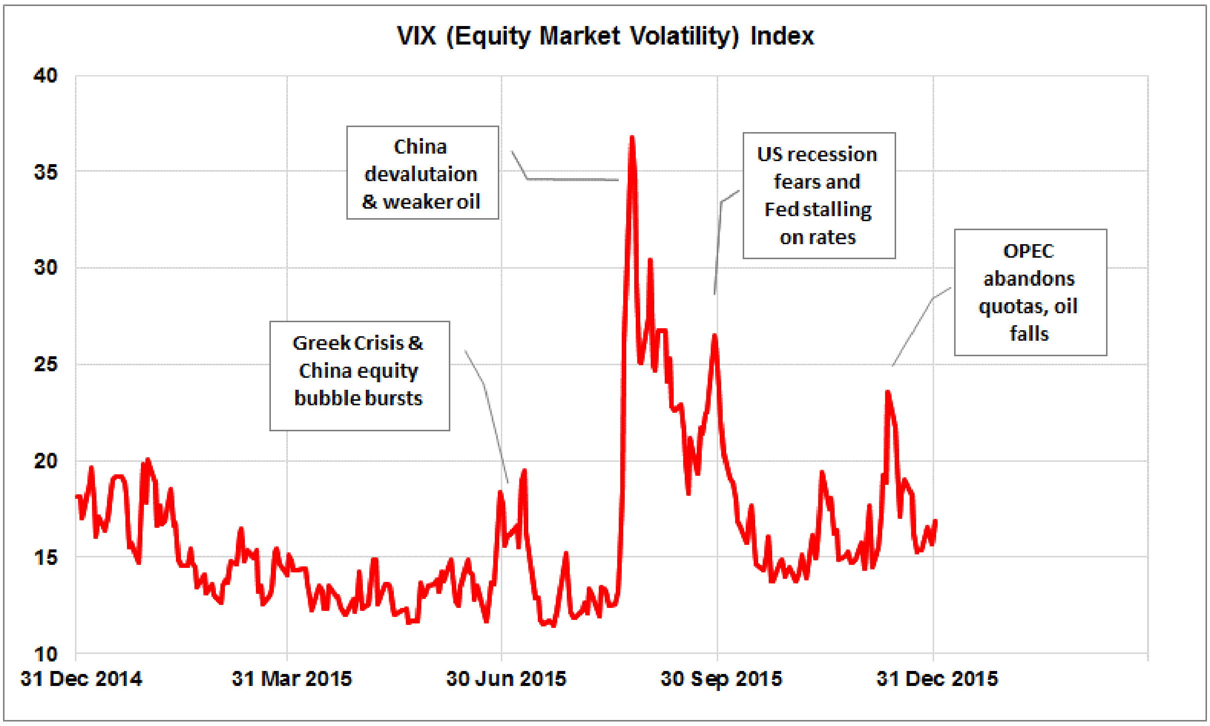


Figure 2: Falling oil prices and China concerns were key features of 2015

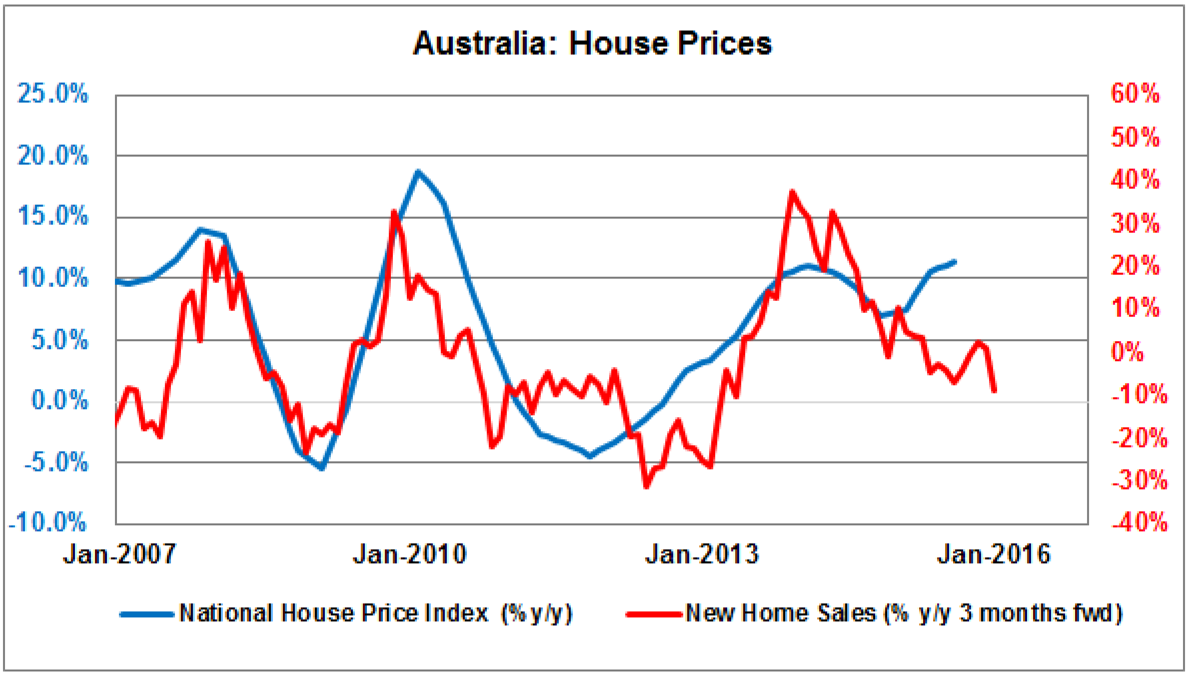


In terms of economic conditions, 2015 was a year of mixed messages. A number of developed economies and regions showed improvements in growth, while the emerging nations had a more difficult year. Oil exporting nations within the emerging markets complex, such as Russia and Brazil, experienced significant recessions. A number of countries, including the US and China, saw slowing activity in the manufacturing sector offset by stronger activity in the services sector. Inflation in both labour and goods markets generally remained low around the world.

Australia

In Australia the transition away from resource-dependent activity to other sources of growth was slow to gather pace in 2015, despite the Reserve Bank cutting the cash rate to 2%. Even at this level there was speculation the Bank would have to cut further, but they were no doubt cognisant as to whether this would in fact be counter-productive. Rather than using lower interest payments to boost consumer spending, households elected to either repay debt faster or acquire more debt in order to buy more real estate. The housing market was showing signs of overheating, leading some to believe that Australia was heading for a housing bubble bust. These developments lead to the introduction of so-called macro prudential policies under which APRA issued guidelines to curtail the pace of new lending on speculative real estate purchases. The rules governing foreign purchases of Australian real estate also attracted scrutiny, with some tightening of their enforcement. However, while anecdotal evidence suggests parts of the market are softening, the national statistics are yet to show a sustained deceleration of price growth and offshore demand, especially from China, remains strong.

Figure 3: Australian house price growth provided wealth creation but is set to slow in 2016



Labour market conditions in Australia improved more than expected through the year. At the start of the year, there was a fairly widespread expectation that the unemployment rate would approach 7% in 2015. As things turned out, the unemployment rate slipped below 6% by the end of the year and much stronger than expected employment growth offset a rise in the participation rate with more people entering the workforce. This improvement in employment mirrored a significant improvement in business conditions as reported in the NAB's surveys. The Business Conditions Index started the year at 2.4 and by the end of the year was at 10.2. Factors contributing to this improvement may have included the depreciation of the Australian dollar and the change in Prime Minister in September 2015, which also helped boost household confidence. Consumer price inflation in Australia was very subdued in 2015. The inflationary impact of the depreciating A$ was more than offset by the fall in the oil price and muted growth of wages.

USA

In the USA the economy started the year on a soft note under the impact of adverse weather conditions. However once this passed growth picked up and the unemployment rate continued to fall, reaching 5% by the end of the year. Despite this wage growth remained low. Headline inflation fell to zero under the impact of lower oil prices while core inflation rose very slightly to reach 2% by the end of the year, which is the level the Fed is comfortable with. Lower inflation helped boost household real disposable incomes and consumer confidence. This was reflected in improving retail sales and the pace of activity in the US services sector. The housing sector also continued to improve with further increases in prices and construction activity.

However, the manufacturing sector told a different tale. After starting the year around the 55 mark, the key ISM manufacturing index declined through the year to finish at 48.6 in December. This was a surprise to most commentators who had expected lower oil prices to have the traditional effect of improving corporate profitability and manufacturing activity. In the post-GFC world these dynamics have changed. For example, the US manufacturing sector is now more open to external trade than it used to be and the appreciation of the US dollar through the year, combined with slower growth from the oil exporting emerging nations, led to a sharp decline in US net exports. In addition, the domestic oil industry is now a much more significant part of the US economy than it was 10 years ago. The decline in the oil price has hurt this sector significantly leading to weaker profits, lower share prices for energy companies and stress in the high yield market.

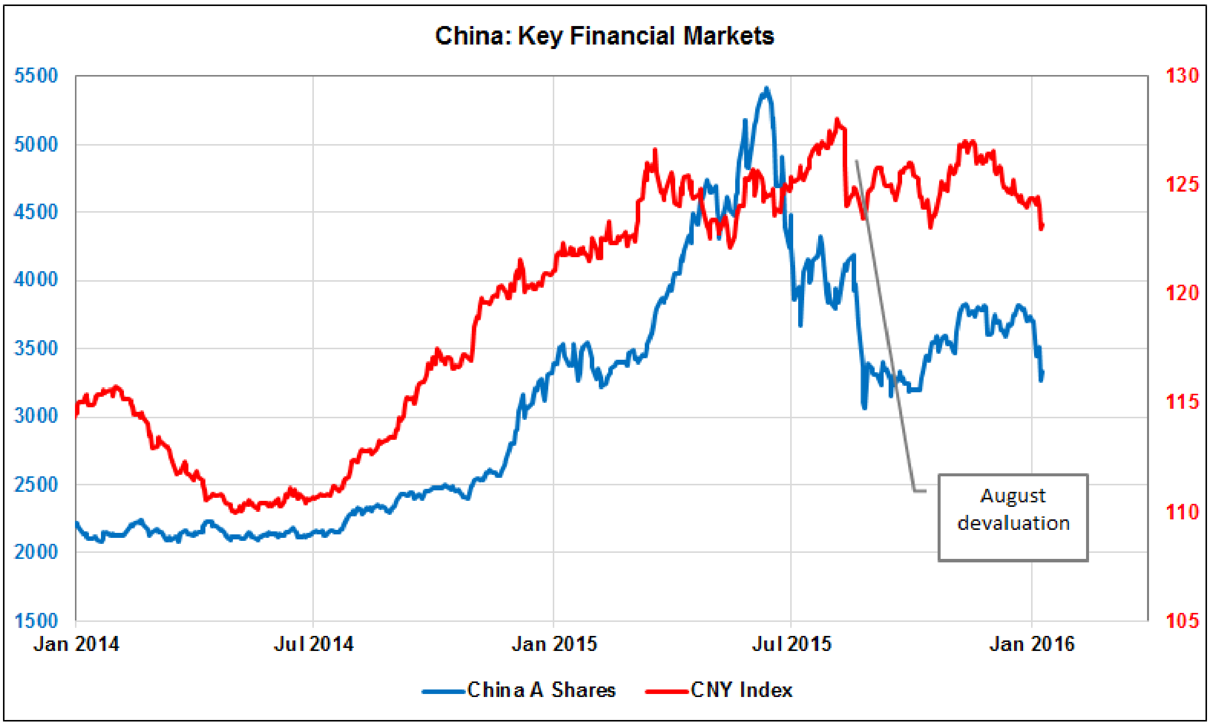
This dichotomy between the manufacturing and household/services sectors is the biggest seen in the US since the early 2000's and probably contributed to the Federal Reserve's hesitation about lifting interest rates. Worried about the impact of a stronger US dollar on other countries' economies and on US exports, the Reserve frustrated markets with its communications about monetary policy through the year. Delays in starting to lift rates were seen by the market as lacking confidence in the economy. Eventually the Reserve got on with it and lifted the cash rate target by 0.25% on 16 December. However somewhat ironically, the markets' relief at this was soon overtaken by concerns about oil and China.

China

2015 was a year of further significant transition for China's economy. Growth continued to slow through the year as the traditional drivers in manufacturing and construction were overtaken by consumer spending and the services sector. However, financial markets' attention was almost exclusively on the manufacturing sector with statistics showing any signs of weakness prompting sharp falls in equity prices around the world. The authorities took steps to support the economy through measures including new infrastructure spending and easing monetary policy to help the property market where prices had been falling. By the end of the year there were signs these measures had been having an impact. For example, house price growth was picking up across the country and some of the statistics on manufacturing were looking better. However, financial markets ignored this and remained deeply pessimistic about China.

This mindset was exacerbated by two key financial market developments in China in 2015. The first of these was the severe downturn in the Chinese equity market at a time when global financial markets had already been put on edge by the developments in Greece. Although everyone realised there is little or no connection between the Chinese economy and stock market, when the correction did happen it provoked widespread fears that it would cause a hard landing in China. The authorities' clumsy handling of the equity market at the time also contributed to uneasiness about the country's prospects.

Figure 5: Despite the losses in Chinese markets in 2015, returns over 2 years are positive. This highlights the importance of shutting out volatility in the mind.



The second big development came soon after with the surprise devaluation of the Yuan in August at a time when the oil price had resumed its sharp decline. There are two key dimensions to this and subsequent currency moves by the Chinese authorities. First, China has been taking steps to increase the international convertibility of its currency to facilitate its inclusion in the IMF SDR basket. The measures announced in December to focus on setting the value of the Yuan against a broader basket of currencies rather than just the US dollar is another important part of this program. Second, the Yuan had been dragged up with the appreciating US dollar for some time and was contributing to slower export growth from China. Although the authorities emphasised the structural rather than cyclical motivations for the change in the currency arrangements, financial markets focused on the latter and were concerned that China would use a weaker currency to export deflation, especially to other countries in the region. Global equity markets reacted badly to these developments.

Overall though, the Chinese economy appears in better shape than one would think from looking at the markets alone. There are signs that the policy easing to date is gaining traction and there will not be a hard landing as the markets fear. It is also likely that the authorities will undertake further domestic stimulus programs in order to provide more support in 2016.

Europe

Europe was the focus of global concerns in the first half of the year. At the time, prospects for the European economy were still looking doubtful and the newly elected hard line left-wing government in Greece was making noises about abandoning its commitments on economic reform and debt servicing. The ECB announced a programme of quantitative easing to address the first of these questions while European politicians and monetary authorities along with the IMF began developing plans to address the situation in Greece. Everyone was very much aware that Greece was not an isolated situation and that if concessions were made for them, then other nations struggling with economic reform would also start seeking relief. This would be fuel on the fire for other extreme left-wing parties seeking mandates in European elections in 2015 and would seriously undermine the path of economic reform that had been pursued since the GFC. For these and other reasons Europe took a very hard line with Greece and called Syriza’s bluff about leaving the Eurozone. In the end, the Greek Prime Minister capitulated at the last minute and the crisis dissipated almost overnight. Subsequently there has been further monetary policy easing from the ECB and signs of improvement in growth and labour market conditions. The depreciation of the Euro has contributed to this through stronger net exports.

Looking ahead – the outlook

Financial markets finished 2015 on a pessimistic note with concerns about global recession and deflation stemming from the slowdown in China and weaker oil prices. These fears have continued in early 2016 with further sharp falls in equity markets around the world. How the rest of the year turns out hinges on the key question of global growth, especially in the US and China. Contributing to this will be what happens to the oil price and its effects on other commodity prices and the prospects for emerging nations.

Economic growth around the world and in Australia is expected to remain low but gradually improve by end-2016. Headline inflation will rise in 2016 but remain under control. Core inflation may be more subdued. Fears of a China hard landing seem overdone, but markets are obsessed with over-reacting to the monthly data, which often seem to be misreported and misinterpreted.

This, plus risks of further oil price declines, could disrupt markets for a while longer. Despite the Federal Reserve moving to start increasing interest rates, monetary policy around the world will remain very accommodative. Differences in monetary policy between the US and other major nations should see the US$ rise a bit more. This plus weakness of commodity prices should see the over- valued $A trade below US$0.70.

Several crystal ball gazing points to bear in mind for the coming year include:

- US bond yields will most likely - rise but not dramatically;
- The Australian bond market still seems to be pricing the chance of further rate cuts which makes this market look expensive relative to both fundamentals and the US market;
- Australian Real Estate Investment Trust's look expensive relative to the rest of the equity market and the outlook for bonds;
- Equity markets at current levels appear oversold relative to fundamentals and should be able to see some improvement once the current pressures dissipate;
- As long as Australian business conditions remain supportive, domestic small cap stocks can continue to outperform large cap stocks;
- The Australian dollar is still overvalued relative to commodities and the likely path of interest rates to 2016;
- A level of the A$ below US$0.70 looks more reasonable for 2016;
- Further appreciation of the US$ as the oil price slips a bit further and US interest rates rise relative to the rest of the world should help European equities outperform US equities;
- Emerging equity markets as a whole are unlikely to outperform developed markets until the price of oil bottoms out and/or the US dollar peaks;
- Unhedged international equities will do better than hedged international equities and domestic equities;
- Geo-political factors will continue to create bouts of volatility in the coming year with the Middle East being the biggest source of concern;