

ECONOMIC & MARKET REVIEW – FEBRUARY 2015

As a framework from within which to place your investment strategy, our comments on the local and global economies and securities markets are as follows:

Around the world

As we enter the 2015 calendar year, global economic growth on the whole is improving and the world's debtor nations are getting better control of their budget deficits and national debt – albeit that the actual debt pile is still growing!

The world's most important economy remains the US economy; whatever happens in the US economy and its financial markets directly affects not only our Australian markets but capital markets in every region of the world. The US economy is currently re-inventing itself due to the changing fundamentals associated with increasing energy self-reliance (due to new shale oil & gas discoveries), a rebounding housing market, relative lower wages than other developed economies, and very healthy corporate balance sheets.

Continued low US interest rates (effectively close to zero at 0.25%) together with the US Federal Reserve Bank ('the Fed') implementing 'Quantitative Easing' (versions QE1, QE2, & QE3) some 4 years ago – **which effectively printed money that was then used to repurchase US Federal government debt** – had the desired impact of injecting liquidity into the US financial system (and other parts of the world); which improved access to finance, assisted in lowering overall interest costs for home owners with mortgages, and encouraged businesses to borrow and invest. The success of this strategy has seen the Fed progressively 'unwind' the bond buying program from a maximum \$US\$85 Billion PER MONTH at the beginning of 2014 to the point where the program ceased completely as at the end of October 2014.

In what has been a well communicated strategy by the Fed, to the surprise of many there has been very little market disruption as QE3 has been completely withdrawn – further the Fed is now being very careful to flag to markets what the circumstances will be and at what rate it will eventually begin to increase interest rates from their current very low base. We expect the beginning of interest rate increases to commence sometime in 2015 barring any unforeseen events (falling oil prices are on the whole a positive for the US economy).

One of the side effects of the Fed's Bond buying program has been to inject a fair degree of liquidity into the world's disparate economies – along with efforts by the European Central Bank, this has helped to assist the PIIGS (Portugal, Ireland, Italy, Greece & Spain) finance their economies while they restructure. The recent election of an 'anti-austerity' party in Greece has ruffled feathers amongst Eurozone members but not actually resulted in a Greek debt default or restructure as yet, the Greek economy is about 2/3 the size of the Victorian economy and has shrunk by about 25% since the onset of the GFC. Sanctions applied against Russia due to its Ukrainian incursion are having a negative impact, badly effecting Germany's economy. There is

however significant improvement in GDP growth in a number of other EU economies – particularly the UK & Ireland, the Netherlands and Poland.

China has successfully maintained its GDP growth at about 7.5% through 2012 and 2013 and has recently stated it expects GDP growth in coming years at a slightly lower 7% per annum. If Chinese growth continues at this level it should mean Australian commodity export volumes will continue to grow – but just not at the inflated prices we received for them previously. Having watched the US implement QE3 and ‘just print money’ the Japanese have implemented the same strategy – one of the objectives being to drive down the value of their currency and make its exports more price competitive in global markets.

Our Economy & Markets

At the start of the 2015 calendar year we see the Australian economy is at somewhat of a turning point.

As has been widely documented, our policy makers the Reserve Bank of Australia (RBA) & the Federal government’s Treasury Department have been attempting to ‘transition’ the economy from one where growth has been fuelled by a commodities based investment boom across to a more evenly dispersed and broader based growth ‘profile’. The commodities **investment cycle** is now going to peak significantly lower than was expected a couple of years ago while the imminent shift to the **production/export** phase of the boom will provide much longer-term benefits to the Australian economy.

The RBA has attempted to kick start this transition to broader growth by (i) lowering interest rates to historic lows, and (ii) ‘jawboning’ down the A\$. The decision on February 3rd by the RBA to cut overnight interest rates once more from 2.50% pa to 2.25% is one more attempt to put a fire under the domestic economy. In anticipation of the interest rate announcement – and then subsequent to it, the Australian share market has traded at its highest level since prior to the GFC (i.e. the last 7 and a half years) and 10 year Australian Government Bonds are now trading a record low yield of 2.292% per annum!

The fall in the price of Iron ore together with the rise of the US\$ because of the strengthening US economy and the ending of QE3 has done what the RBA couldn’t and has seen the A\$ fall about 8.5% for the 2014 calendar year – but a more dramatic 13.4% for the last the three months ending on 31st December 2014 – and now down to about US\$0.78 cents.

While much of this recent fall in the A\$ and Australia’s Terms of Trade could be foreseen, the sudden fall in the US\$ price of oil – more than 50% from June through to the end of 2014 – could not. Australia currently imports about 92% of its refined petroleum product requirements, so the significant drop in petrol prices (even after adjusting for the falling A\$) will be boost for consumers – equivalent to about a 3% wage rise or a 0.15% cut in mortgage interest rates!

The Federal government is projecting the Australian economy to grow at 2.75% for 2014-15 and 3% for 2015-16. This is similar to the International Monetary Fund who forecast growth rising to 3% per annum over the next 3 years. The risks to these forecasts are mostly external, that is, what happens in China, the rest of Asia, the US etc. matters. Any weakening of global growth from here (China particularly) would have a detrimental impact on Australia.

Conclusion

We are still the 'Lucky country'. At the same time as a lower A\$ is increasing our global competitiveness, the unrelated fall in global oil prices has more than offset the A\$ rise in the price of oil that would normally occur – effectively reducing one of Australian businesses' major input costs as well as a cost born by every consumer.

From the perspective of the Australian economy and share market all the ingredients are now in place to assist in getting real growth happening. The lower A\$ makes our goods and services more price competitive globally & help local manufacturers compete against imports, lower interest rates assist businesses in financing new investment, lower oil prices are a shot in the arm for both consumers and businesses, and the recent swag of new Free-Trade Agreements (South Korea, Japan, & China) will provide an impetus for more value added exports – not just bulk commodities. Having nearly completed the largest capital investment phase in Australian history the economy is again well placed to continue its upward growth path.

In summary, now that the unwinding of the US Federal Reserves' bond buying program has been completed, the focus will now move to when it is that the US Fed will begin to raise US interest rates – a much more sensitive issue for both global equity and bond markets. With regional risks also remaining high (China, the Eurozone, Japan) we expect a volatile period ahead for global markets - with the volatility itself more reflective of markets adjusting to a 'return of normality' rather than a fundamental weakening of company profits or significant weakening of global economic growth prospects.

For further information, please contact Banksia Partners on (03) 9458 4588 or clientservices@banksiapartners.com.au