Market in review

5 January 2015

The big picture – Our views and thoughts

US

Third quarter US economic growth has surprised on the upside. Gross Domestic Product (GDP) was revised to a very healthy 5% on an annualised basis, its highest growth rate since 2003 and up from 4.6% in the 2nd quarter. Growth was derived from a number of sources including consumer spending (which is critical for US growth and the largest contributor to the economy), business investment, housing and government spending. Increased exports added nearly 20% to the GDP figure, this will be difficult to maintain in the face of a rising $US.

Unemployment continues to improve and the current rate of 5.8% is on a lower trajectory, perhaps towards 5.3% in 2015, which is considered by some to be full employment. The US created an average of 240,000 jobs a month in 2014. A year ago the unemployment rate was 7%. We note that a high proportion of workers are in part time employment and that the long term unemployed (out of a job for at least six months) remains elevated, albeit declining. The US Federal Reserve has a focus on the underlying trends as opposed to the headline number. Average hourly earnings have crept up recently and are now up 2.1% on the year.

Taking into account 3rd quarter GDP, strong employment trends and early signs of wage growth, the Federal Reserve can be expected to increase interest rates over the coming months. Markets will not be surprised by this, however the real risk appears to be the potential for a series of increases beyond current expectations. We anticipate that rises will be gradual and measured. With respect to longer dated rates, a rise of over 1% in the coming months would not surprise. Interestingly, the US appears to be enjoying economic growth, buoyant share markets and low long term interest rates (all at the same time). This does not appear sustainable and it is our view that the bond market is susceptible, however, low bond yields are indicating that current US growth is not sustainable.

US economic strength has resulted in a resurgent $US, a trend which we think will continue, we note most currencies having been weaker against the $US, including the Euro. This will have some impact on US corporate earnings that are sourced from overseas and rising long term US interest rates will eventually impact profit margins.

The dramatic decline in oil prices towards year end will have consequences and, in our view, result in rising geopolitical tensions. More specifically for the US consumer, the event is cash flow positive as they pay less for fuel. Effectively, their spending power has increased. This is also true of China, India and other oil importing nations. Overall, we view lower oil prices as a net positive for the US economy. Increased supply coupled with slowing European and Chinese demand may see prices remain relatively low for some time.

US corporate earnings growth revisions have recently been scaled back, thus the Price Earnings Ratio has expanded as US markets reached record highs towards the end of 2014. The New Year will be a challenge for US equities if earnings growth revisions are not positive.

We think 2015 will be challenging for the US market given the probability of rising long term treasury rates, $US strength and recent cuts to the earnings outlook. Further, it is most unlikely that third quarter US GDP will be sustained. 2015 may well be a case of a strong US economy already having been factored into equity valuations.

Europe

European economic growth remains anaemic with the prospects of deflation very real. However, regardless of the negatives the German market is near record highs, not so the French market which is still well below its June 2007 highs. With Germany being the largest economy in Europe and also the largest exporter (29% of European exports), corporates will get some relief from the weakening Euro versus the $US (partially offset by Russian embargoes).

The European Central Bank (ECB) has been providing stimulus in Europe for some time. While the stimulus may have been positive for markets, it has failed to have a meaningful, positive impact on the economy. We expect major announcements early in 2015, specifically the purchases of government bonds. What is needed is for the banks to undertake more lending, a missing ingredient to the European economic recovery thus far. We do not rule out the possibility of major infrastructure spending, which would ensure the money was spent (bypassing the banks). Alternatively, a major line of funding could be provided for relevant European countries.

To keep Europe in perspective, banks that place funds with the ECB do so with a negative interest rate. The Swiss National Bank has announced it will cut the deposit rate on certain deposits to -0.25% on 22 January. The Swiss move is more about protecting its own currency from overvaluation.

While lower oil prices should benefit large parts of Europe, they will also add to the deflationary concerns.

Greece is again in the headlines due to political unrest, a national election on 25th January and concerns that Greece will not continue to comply with European bailout obligations. Concerns are again being reflected in the yields of Greek bonds.

China

There is no doubt the economy is slowing, however the Chinese share market staged a significant rally in the latter half of the year from undervalued levels in early 2014.

We view the China rally as one that has been influenced by recent Chinese policy initiatives. Official interest rates were unexpectedly cut during the quarter and the government has now allowed foreigners to purchase mainland China A shares. Further, with house prices having weakened in China, there may be new funds directed toward non housing related growth assets in China and abroad.

China can be expected to be a beneficiary of lower oil prices although an end to the residential construction boom is being felt across the economy with the growth rate again expected to slow. This was recognised when China reduced official borrowing rates in November 2014.

Other Emerging Markets

Countries that rely heavily on oil exports have seen major movements in their currencies and negative revisions to GDP. Russia is the more obvious example. The Russian Ruble fell 50% against the $US in the 2nd half of 2014 and interest rates rose to 17%. Russia is understood to have spent over $21 billion defending its currency. Interestingly, while $US oil prices have plunged, they have actually been offset by the fall in the Ruble. Perhaps a bigger issue for Russia is the inability of some government owned businesses to roll over maturing debt due to sanctions. This, coupled with high interest rates will place the Russian financial system under extreme stress. Russia needs to negotiate an outcome where sanctions are lifted.

The weaker oil price coupled with sanctions against Russia is placing a strain on the Russian banking sector to the extent that a Russian debt default is not out of the question should current factors prevail throughout 2015. Similarly Venezuela will almost certainly default in March 2015.

Russia's banking system is dominated by hundreds of local banks (one recently required a government bailout). Foreign banks have a limited role - the biggest are France's Societe Generale, Italy's UniCredit and Austria's Raiffeisen. We note that this has already been reflected in the currency.

For Australian investors, underperformance of emerging markets has been compounded by their currencies generally falling in tandem with the $A. The valuation gap remains wide between developed and emerging markets and we are finding it challenging to see what the rerating catalyst will be, particularly given sentiment towards Russia.

Japan

Abenomics is yet to prove successful as indicated by September quarter growth figures.

Japan's economy has again been in a technical recession after GDP shrank an annualised 1.6% in the September 2014 quarter, expectations were for growth. Underlying inflation is also tracking well below the Bank of Japan's target levels. Closer to year end, forward indicators for the first quarter were more positive than recent data.

The Yen reached an eight year low in December and on 27 December the government launched a new $29 billion round of stimulus. The stimulus target is largely the household, however wages growth would be a more permanent household benefit in our view.

Australia

Falling commodity prices have made the outlook for Australia more challenging. The price of iron ore (our largest export) averaged around $US90 in 2014, but towards the end of December was trading around $US70, the lowest since 2009. Price weakness is also impacting the federal budget, in fact the government recently slashed its price forecast for iron ore in 2015 by a third to $US63 a tonne from $US94 in September. At 6.3% in November, the unemployment rate is expected to head higher. Our present thinking is that interest rates will remain on hold in the New Year with an increasing possibility of a rate cut. Consumer sentiment remains well below ten year averages.

The above factors have been major contributors to the decline in the Australian dollar. A weak dollar should make Australia more competitive (specifically exports). However, other segments of exports will not make up for lower commodity prices. We anticipate further dollar weakness.

Equities

The US is trading on a forward price earnings ratio of around 16 times, which is above historical averages. At these levels the market is factoring in strong earnings growth due largely to strength in the US economy. We view this valuation as being on the high side and anticipate a more subdued performance from the US market in 2015, however a weakening $A would be an additional source of returns for Australian investors.

The Australian share market is trading on a forward price earnings multiple of 14.4 times and a current dividend yield of 4.5%. Australian market performance has been heavily influenced by energy (oil stocks) and commodities (resource stocks) and some of this underperformance may partially reverse in 2015.

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