Economic and Market Review

Monthly Report as at 31 March 2015

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Economic and Policy Trends: The world economy continues to enjoy support from highly accommodative monetary policy settings, the net stimulatory effects of lower oil prices and lessening fiscal drag. In the US, the latest set of Fed forecasts have the US economy growing at an above trend rate over 2015 and 2016 and around trend in 2017. A strengthening US currency was the main factor behind a modest downgrade from the Fed's December set of forecasts. While the Fed lowered their growth forecasts, they were more optimistic on the prospects for the labour market. The Fed now sees the unemployment rate range between 5% to 5.2% over 2015, in line with their estimates for the longer run rate. The unemployment rate falls below the longer run rate over 2016 and 2017 and helps explain why the Fed sees the inflation rate heading back towards 2% over 2016 and 2017.

Against this backdrop, the Fed changed its forward guidance dropping reference to the term 'patient'. In subsequent commentary, the Fed's Yellen indicated that the Fed was not impatient to raise rates and that two preconditions would have to be met before they would consider tightening. The first was further improvement in the labour market and the second, confidence that their inflation target would be met. These conditions should be realised towards the end of the year when yearly inflation rates are set to jump once the base effects of the fall in oil prices late in 2014 drop out.

Recovery in Europe continues to progress with the latest set of forecasts from the ECB having Euro area growth lift from 0.9% in 2014 to 1.5% in 2015, 1.9% in 2016 and 2.1% in 2017. Under these projections the ECB expect the output gap to close and inflation to lift from zero in 2015 (impact of lower oil prices) to 1.5% in 2016 and 1.8% in 2017. Such a growth and inflation profile poses a significant medium term headwind for low yielding longer dated European sovereigns, even allowing for ECB QE demand.

The Australian economy continues to grow at a sub trend rate and a sustained lift in animal spirits that drive stronger consumer spending and business investment remains elusive. Sluggish near term demand conditions are being compounded by weakness in the public sector, reflecting a combination of tightening fiscal conditions and changing State governments. Against this broader backdrop, the economy grew by 0.5% over the December quarter and by 2.5% over the last 12 months.

Partial demand indicators for the March quarter suggest that the interest rate sensitive sectors of the economy will continue to underpin activity levels. Building approvals for January surged ahead by 7.9%, well in excess of expectations and boosted by the apartment sector. Retail sales rose by 0.4% over January, in line with expectations. Consumer sentiment eased back slightly in March following February's rate cut inspired jump. Business confidence slipped in February according to the NAB survey, though conditions remained unchanged and at levels consistent with modest growth. Labour force data was in line with expectations with total employment up 15,600 while a slight fall in the unemployment rate from 6.4% to 6.3% was better than expected.

The RBA left the cash rate unchanged at its March meeting but subsequent commentary suggests that they have a strong easing bias. An easing is likely over April/May given the lack of near term inflationary pressures and slack that is building up as the economy grows below trend. As US Fed commentary suggests that lift off there is likely to happen later in the year, there is a risk that further falls in the AUD may be delayed and that the RBA may have to cut the cash rate to below 2%.

Equity Market Trends: Equity market sentiment was buoyed by perceptions that the Fed would not move until recovery was more established and that the tightening cycle would take into account the lingering effects of the financial crisis. In the US, the S&P500 fell 1.6%. Equity markets were stronger yet again in those countries where central banks are running quantitative easing programs; in Europe the Euro STOXX 50 rose 2.9%, while in Japan, the Nikkei rose 2.7%. The MSCI World ex-Australia Accumulation Index in Australian dollars rose 0.9% over March. In Australia, the S&P/ASX 300 Accumulation Index ended the month down 0.1%.

Bond Market Trends: Offshore and domestic yields trended higher earlier in the month, boosted by a strong US payrolls reports and expectations that the Fed would change its forward guidance at its mid-month FOMC meeting. Yields trended lower after the FOMC meeting as markets moved to discount a more dovish tightening cycle from the Fed. After peaking at 2.0% and 2.74%, local three and ten year government bonds ended the month at 1.70% and 2.32%. Reflecting these moves, the Bloomberg AusBond Composite Index gained 0.76% over March. The cash sector, as measured by the Bloomberg AusBond Bank Bill Index, rose by 0.21%.

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