Economic and Market Review

Monthly Report as at 31 July 2015

Markets able to turn their attention back to fundamentals after Greece gets another bailout and Chinese authorities stabilise their stock markets.

Frank Uhlenbruch, Investment Strategist

Economic and Policy Trends: Market attention shifted back to the long game of fundamentals after being diverted by the Grexit saga and China's ambitious attempts to shore up domestic equity markets after sharp falls. On the former, a third bail-out package worth up to €86bn looks to have stopped a negative feedback loop developing that could have derailed the cyclical recovery currently underway in Europe. On the latter, steps taken by authorities appear to have placed a floor under domestic Chinese equity markets but at the cost of conditioning investors to Government support. Early steps to underpin Chinese demand appear to be bearing fruit with the Chinese economy expanding by 1.7% over the June quarter, up from the 1.4% lift experienced over the previous quarter. The Chinese economy looks set to expand by around 6.8% over 2015.

In the US, the economy's rebound from a weather and strike influenced March quarter where growth was up only 0.2%, was on the softer side of expectations. The US economy expanded by 0.6% over the June quarter with most of that growth coming from consumption. Labour market conditions appear to be firming, though readings on wages gains are mixed. The US Fed remains in a data dependent mode waiting for its two pre-conditions of further labour market improvement and confidence in achieving its medium term inflation objective to be met. The lift off window remains between September and December with most FOMC participants looking for at least one tightening by year end. The US Fed's Chair Yellen has been at pains to point out that the upcoming tightening cycle will be gradual and that until the legacies of the financial crisis have been finally worked through, the US cash rate was likely to remain lower than would otherwise be the case given their longer term growth and inflation forecasts.

Given the weaker start to the year in the US, the IMF in its July update lowered their 2015 growth forecasts from 3.5% to 3.3% while leaving their 2016 growth forecast of 3.8% unchanged. The outlook remains for a moderate uneven global expansion driven by easy financial conditions, lower fuel prices, lessening fiscal drag in Europe and improving levels of confidence and labour market conditions.

The Australian economy continues to generate mixed readings with the overall tone on the softer side. Of the interest rate sensitive sectors, the housing sector looks to be peaking with building approvals up 2.4% in May, only to fall 8.2% in June. On the consumer side, the 0.3% rise in May retail trade was less than expected and consumer sentiment fell again in July. Encouragingly, the labour market held onto recent strong gains. Total employment lifted by 7,300 in June after May's 40,000 gain. Full time jobs rose by a solid 24,500 with part time jobs falling by 17,200. The unemployment rate came in at 6.0%.

Conditions in the business sector were more vibrant with the NAB business survey recording strong lifts in business conditions and confidence in June. On the prices side, the consumer price index rose by 0.7% in the June quarter to be up 1.5% over a year ago. A rise in fuel prices was a major contributor to the quarterly result. The average of the RBA statistical measures had underlying inflation up 0.5% for a yearly rate of 2.3%.

Against this backdrop, the RBA left the cash rate unchanged at 2.0% at its July meeting. At a speech later in the month, the RBA Governor reiterated that while further rate cuts to support demand remained "on the table" the threshold for further action remained high with the Governor noting that "it is not quite good enough simply to say that evidence of continuing softness should necessarily result in further cuts in rates, without considering the longer-term risks involved". Unlike the Fed, the RBA is not yet in a position to consider removing high levels of policy accommodation. We expect the RBA to hold the cash rate steady at 2% until H1 2017.

Equity Market Trends: Offshore equity markets had a better month following the announcement of another bailout for Greece and stabilization in Chinese equity markets. The European equity market bounced the most with the Euro STOXX 50 gaining 5.2% over July. Both the United States and Japanese equity markets experienced moderate gains with the S&P 500 and Nikkei up 2.0% and 1.7% respectively.

The MSCI World ex-Australia Accumulation Index in Australian dollars rose 6.6% over July. In Australia, the S&P/ASX 300 Accumulation Index gained 4.3%, clawing back some of June's 5.3% fall.

Bond Market Trends: Sluggish local and offshore data along with periods of weakness in equity markets underpinned a fall in Australian yields over the month. Three and ten year government bonds ended the month 12 basis and 25 basis points lower at 1.90% and 2.76%. These moves meant that the Bloomberg AusBond Composite Index experienced strong capital gains and ended the month 1.30% higher. The cash sector, as measured by the Bloomberg AusBond Bank Bill Index, rose by 0.18% over month.