Economic and Market Review

Monthly Report as at 28 February 2015

Central bankers continue to top up the punch bowl with the Australian and Chinese central banks joining the party.

Economic and Policy Trends: Central bankers continue to top up the punch bowl with the Australian and Chinese central banks joining the party. In Australia, the Reserve Bank of Australia (RBA) cut the cash rate from 2.5% to a new historical low of 2.25% early in the month. Towards the end of the month, Chinese authorities announced that the official one-year lending rate would be reduced from 5.6% to 5.35% while the deposit rate would be reduced from 2.75% to 2.5%.

Central bank actions taken since the start of the year have certainly lifted asset values with equity markets performing strongly and while nascent, growth momentum appears to be improving in Europe. Political risk also declined when the Eurogroup of Eurozone finance ministers agreed to extend Greece's bailout, which was due to expire at the end of February, to the end of June.

In the US, the recovery continues to expand and deepen. US Fed staff forecasts have the US economy growing at an above trend rate with sufficient improvement in the labour market to eventually push core inflation back towards the 2% level. Their latest forecast included the boost from lower oil prices and the drag from a stronger currency. We continue to expect the Fed to commence a long drawn out tightening cycle commencing in the second half of the year.

The Australian economy continues to grow at a sub trend rate and the lack of a convincing sign of a rebound in non-mining investment appears to have been one of the main factors behind the RBA's decision to ease in February. Towards the end of the month, the release of the December quarter capital expenditure survey vindicated that decision. The first estimates for 2015/16 non-mining capital expenditure point to a small fall in the level of spending compared to 2014/15. Given that mining capital expenditure is poised to fall by around $20bn, business investment will be a drag on economic growth this financial year and the next.

Labour force data for January was also weaker than expected with employment falling by 12,200 and the unemployment rate jumping to 6.4% from 6.1%. While volatile, the unemployment rate has already spiked at the RBA's upwardly revised peak in its latest set of published forecasts. Reflecting sluggish labour market conditions, wages growth remains subdued with the wage price index rising by 0.6% over the December quarter. While business conditions eased slightly in January according to the NAB survey, there was a slight lift in confidence. There was a strong lift in consumer sentiment in February following the RBA easing with the index lifting from 93.2 in January to 100.7. Credit growth rose by 0.6% in January with housing up 0.6% and business lending up 0.8%.

Against the backdrop of near term sluggish domestic demand and subdued inflation pressures, we still see room for a front end loaded burst of "insurance easing" to underpin activity levels in the interest rate sensitive sectors of the economy. Thereafter we look for the RBA to step back and wait for the economy to respond to the impetus of lower interest rates and a lower exchange rate.

Equity Market Trends: Ultra accommodative monetary settings by major central banks and signs of improving economic momentum buoyed equity markets. In the US, the S&P500 gained 5.5%. Equity markets were even stronger in those countries where central banks are running quantitative programs; in Europe the Euro STOXX 50 rose 7.4%, while in Japan, the Nikkei rose 6.4%. The MSCI World ex-Australia Accumulation Index in Australian dollars rose 5.3% over February, with moves in the Australian currency the slightest of drags on returns. In Australia, the S&P/ASX 300 Accumulation Index weathered the reporting season and gained a vigorous 6.9% over the month. Over the first two months of the year, the Australian equity market has returned 10.4%, not far off the sectors annual long run return.

Bond Market Trends: The yield curve steepened over the month as the shorter end moved to factor in further monetary easing. The yield on a three year government bond fell by 15 basis points to end the month at 1.79% against the current cash rate of 2.25%. At the longer end of the curve, the yield on a ten year government bond crept up by 2 basis points to end the month at 2.46%. Reflecting these moves, the Bloomberg AusBond Composite Index gained a modest 0.28% over February. The cash sector, as measured by the Bloomberg AusBond Bank Bill Index, rose by 0.21%.

Frank Uhlenbruch, Investment Strategist