Economic and Market Review

Monthly Report as at 31 December 2014

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Economic and Policy Trends: The global economy finished the year on an uneven footing with concerns about ongoing momentum reflected in declining commodity prices, particularly oil. The announcement in late December of a snap poll in Greece added another ingredient to the simmering pot of geo-political uncertainties.

In the US, recovery continues to broaden and deepen with ongoing labour market improvement bringing the Fed closer to conventional tightening. According to the final estimate for the September quarter national accounts, the US economy expanded by a thumping 1.2% over the quarter and by 2.7% over a year ago. Partial data suggests that solid momentum has carried over to the fourth quarter. According to projections released by the Fed at its December FOMC meeting, US growth is expected to lift from around 2.4% in 2014 to 2.8% in 2015 and 2.75% in 2016. These growth rates are above trend estimates so by 2017, the Fed see the unemployment rate falling to below trend levels. While lingering financial crisis effects have given the Fed the space to delay tightening, Fed members are looking for a Fed funds rate of around 1% by the end of 2015 and around 2.5% by the end of 2016.

While the US economy has a strong footing, the same cannot be said of Europe where conditions are more fragile and the ECB is fighting to ensure that near term cyclical deflation does not become entrenched in longer term expectations. To that end, the ECB has signalled that it remains open to further non-conventional policy measures, like purchasing sovereign bonds, to supplement its current programmes designed to improve credit and liquidity conditions.

In Japan, the Tankan survey and labour force data support the BOJ's view that a moderate recovery is underway; notwithstanding a 0.5% fall in Q3 GDP, which partly reflected payback for the bringing forward of spending ahead of a VAT rise earlier in the year. In China, the Central Economic Work Conference made growth stabilization a top priority for 2015 with fiscal and monetary policy to have an easing bias. The final growth target will be announced in March's National People's Congress and is likely to be around 7%.

In Australia, data readings were again mixed and consistent with the ongoing narrative of a re-balancing economy. The September quarter national accounts were weaker than expected with GDP rising by only 0.3%. Both public and private sector investment fell and offset positive contributions from net exports and consumption. Partial data for the December quarter points to improving momentum, with both dwelling approvals and retail trade data for October coming in stronger than expected. Labour force data also surprised on the upside with total employment lifting by 42,700 over November, though most of the gains were for part-time jobs. The unemployment rate edged up to 6.3%.

On the fiscal side, the budget position deteriorated by $43.7bn over the forward estimates, a function of weaker than expected growth and the difficulty the Government is facing in getting spending cuts through the Senate. While the RBA left the cash rate at 2.5%, commentary from the RBA Governor hints that if the currency does not fall enough, there may be room to ease further if required.

Equity Market Trends: In Europe, the Euro STOXX 50 fell 3.2% on heightened political risks and sluggish data. In Japan, the Nikkei was unchanged over the month. While in the US, despite better economic and corporate data, the S&P500 edged 0.4% lower. The MSCI World ex-Australia Accumulation Index in Australian dollars rose 2.6% over December, with a weakening Australian currency boosting sector returns. In Australia, the S&P/ASX 300 Accumulation Index gained 2.0% over the month and ended the calendar year 5.3% higher.

Bond Market Trends: Yields fell over the month as markets became more confident that sluggish demand conditions and subdued near term inflation were creating the conditions for further monetary easing in 2015. Yields also benefitted from flight to quality flows late in the month as markets fretted about the implications of the snap Greek election. Three and ten year government bond yields ended the month 27 and 28 basis points lower at 2.14% and 2.81% respectively. As a result of these moves, the sector experienced strong capital gain with the Bloomberg AusBond Composite Index rising 1.69%. The cash sector, as measured by the Bloomberg AusBond Bank Bill Index, rose by 0.23%.

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