PERENNIAL INVESTMENT PARTNERS

Economic and Market Review

Monthly Report as at 31 January 2015

Central bankers continue to treat their economies with kid gloves.

Economic and Policy Trends: Central bankers continue to treat their economies with kid gloves. Sub trend recoveries and general labour market slack, along with the risk that the transitory effects of lower oil prices become entrenched in longer term inflation expectations, led a number of central banks to ease over the month.

The highest profile mover was the European Central Bank (ECB) which announced a significant expansion of its unconventional monetary policy programme to include the purchase of sovereign bonds. Under the expanded programme, the ECB will purchase €60bn of public and private sector securities per month until end-September 2016. The programme will stay in place until the ECB is confident that the path of inflation is consistent with its objective achieving inflation rates below, but close to 2% over the medium term. Monetary conditions were also eased in Canada and Singapore.

In the US, recovery continues along with further labour market improvement. The US Federal Reserve (Fed) appears on track to commence "lift-off" in the second half of the year provided the outlook unfolds as they expect. In their FOMC press release, they added readings on financial and international developments to the range of factors shaping their views.

These policy moves, combined with the overall pro-cyclical pulse from lower oil prices and a lessening in fiscal drag, should help underpin growth momentum over the year ahead. Weak levels of investment remain a significant headwind and a factor behind the International Monetary Fund nudging their global growth forecasts lower. The latest update to their World Economic Outlook has the world economy growing 3.5% in 2015 after estimated growth of 3.3% in 2014. For 2016, they expect the global economy to grow by 3.7%.

In Australia, sentiment remains fragile while the economy continues to generate mixed readings. Both building approval and labour force data were much stronger than expected. Approvals rose 7.5% over November while employment rose by 37,400 with full-time gaining 41,600. The unemployment rate fell to 6.1% with participation edging up. In contrast, retail sales rose by a weaker than expected 0.1% over November. Inflation data was mixed and didn't provide the Reserve Bank of Australia (RBA) with the smoking gun needed to "lock in" a February easing. The headline rate rose by 0.2% over the quarter with falling fuel prices playing a major role. In contrast, the average of the RBA's statistical measures rose by 0.7% against expectations for a 0.5% gain. Private sector credit growth for December was 0.5% with the yearly rate of growth running at just under 6%.

Following offshore central bank moves, expectations for another burst of RBA monetary easing have risen. We have changed our base case view and factored in a round of "insurance easing" over the first half of 2015. Before the RBA actually cuts we look for the RBA to move towards an easing bias first, most likely at its February board meeting. Against the backdrop of a sluggish labour market, fragile sentiment and patchy domestic demand conditions, a further burst of easing should help consolidate exchange rate falls and lift flagging "animal spirits". We continue to look for a tightening cycle to commence mid-2016.

Equity Market Trends: In Europe, the Euro STOXX 50 rose 6.5% buoyed by ECB policy actions. In the US, the S&P500 fell by 3.1% on mixed corporate data and expectations that the Fed was on track to raise the federal funds rate later in the year. In Japan, the Nikkei rose 1.3%. The MSCI World ex-Australia Accumulation Index in Australian dollars rose 3.2% over January, with a weakening Australian currency boosting sector returns. In Australia, the S&P/ASX 300 Accumulation Index gained 3.2% over the month.

Bond Market Trends: Yields fell over the month as markets became more confident that the RBA would follow the lead of a number of offshore central banks and provide a burst of "insurance easing" to underwrite growth and employment at a time when inflation was subdued. The longer end of the curve benefitted the ECB's larger than expected quantitative easing programme. Three and ten year government bond yields ended the month 18 and 30 basis points lower at 1.95% and 2.44% respectively. As a result of these moves, the sector experienced strong capital gain with the Bloomberg AusBond Composite Index gaining 1.61%. The cash sector, as measured by the Bloomberg AusBond Bank Bill Index, rose by 0.25%.

Frank Uhlenbruch, Investment Strategist