PERENNIAL INVESTMENT PARTNERS

Economic and Market Review

Monthly Report as at 31 August 2015

Markets focus on events in China despite solid data readings in the US and Europe.

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Economic and Policy Trends: Heightened angst about the underlying health of the Chinese economy unleashed a brutal bout of volatility on financial markets already fretting about the timing and size of the upcoming US Fed tightening cycle.

Earlier falls in developing Chinese mainland equity markets had sensitised markets and steps by Chinese authorities to devalue the currency mid-month by 3% were seen more through the prism of proof that economy was excessively weak rather than through the prism of ongoing reform designed to open up the country's capital account and allow a greater role for markets to determine prices. While the 3% devaluation did remove some build up in the real effective exchange rate, the move to make the fixing mechanism more market based seems more about the Renminbi meeting the "freely useable" criteria for inclusion in the IMFs SDR (or currency weighted) basket.

That said, financial markets went into the release of Chinese PMI anxious and August's preliminary Caixin PMI reading of 47.1 was a major disappointment to markets that were looking for a lift from 47.8 in July to 48.2. This data triggered a broader global sell-off in equities that saw markets ignore better readings from the US and European economies. Chinese authorities responded to heightened growth concerns by easing monetary conditions via a 0.25% cut in lending and deposit rates (the fifth move this cycle) and a 0.5% cut in the reserve requirement ratio to 18%.

Heightened volatility has also made the Fed's job more difficult and reduced, but not completely ruled out, the likelihood of lift-off occurring mid-September. Much will depend on incoming data on the Fed's two pre-conditions for lift-off; namely further labour market improvement and confidence in achieving its medium term inflation objective. Commentary from the Fed's Fisher at the Jackson Hole summit suggests that the Fed is close to action "…because monetary policy influences real activity with a substantial lag, we should not wait until inflation is back to 2 percent to begin tightening". We still expect the Fed to commence tightening before years end and that the upcoming tightening cycle will be gradual and that until the last of legacies of the financial crisis have been worked through, the US cash rate was likely to remain lower than would otherwise be the case given the Fed's longer term growth and inflation forecasts.

The Australian economy continued to generate mixed readings over the month with these reflecting the diverse range of forces at work. Retail sales for June showed signs of responding to earlier rate cuts and the May Budget, rising a stronger than expected 0.7% over the month and 0.8% over the quarter in real terms. The labour market was mixed over July with employment, the participation and unemployment rate, all rising more than expected. Labour force data suggest that there have been solid gains in the numbers employed and the Reserve Bank of Australia (RBA) suggest that low wage gains had a role to play. The wage price index for the June quarter rose by a modest 0.6% for a yearly rate of 2.3%. Consumer sentiment rebounded in August with most of the forward looking components improving.

After sharp rises in business conditions and confidence in June, there was some retracement in July's data with business concerned about China's prospects. Weakness was concentrated in the mining sector but there was some slippage in the forward orders and employment intentions categories. The June quarter capital expenditure survey highlighted the extent of the transition the economy faces as the resources boom moves from the investment to production phase. Real private capital expenditure fell a greater than expected 4% over the June quarter and this follows on from a 4.7% fall over the previous quarter. For 2014-15, total capital expenditure was $150.6bn and this is expected to fall $35.8bn to $114.8bn over 2015-16. The decline is made up of a $22bn fall in mining, $0.7bn fall in manufacturing and $13bn fall in “other”. The only bright spot in the survey was a lift in expectations in manufacturing and “other” and this may suggest early signs of a response to a lower currency.

The RBA left the cash rate unchanged in early August and appeared to have a neutral bias on the cash rate. In it’s Statement of Monetary Policy (SMOP) earlier in the month, the RBA revised down its near term growth forecasts, largely reflecting a downward adjustment for the rate of population growth and the pushing back of a lift in non-mining investment. They expect the economy to grow by 2.5% over 2015-16 and 3% over the following year. Underlying inflation is forecast to track 2.5% over the outlook period and while they didn’t expect the unemployment rate to spike as much as in the May SMOP, they don’t see the unemployment rate falling to below 6% until mid-2017. Given such an outlook, we expect them to leave the cash rate unchanged at 2% until mid-2017.

Equity Market Trends: Offshore equity markets swooned on fears that steps by Chinese authorities to support growth were not enough. Despite solid data readings in the US and Europe, the S&P 500 and Euro STOXX 50 fell 6.3% and 9.2% over August. In Japan, the Nikkei fell 8.2% while in China, the Shanghai Composite fell 12.5%. The MSCI World ex-Australia Accumulation Index in Australian dollars fell 3.1% over August with a weaker Australian currency cushioning falls. In Australia, a lacklustre reporting season and offshore weakness led to a 7.7% fall in S&P/ASX 300 Accumulation Index.

Bond Market Trends: Mixed local and weaker Chinese data, along with sharp falls in the equity markets, underpinned a fall in Australian yields over the month. Three and ten year government bonds ended the month 12 and 10 basis points lower at 1.78% and 2.66%. These moves meant that the Bloomberg AusBond Composite Index experienced capital gains and ended the month 0.64% higher. The cash sector, as measured by the Bloomberg AusBond Bank Bill Index, rose by 0.18% over month.