Economic News January 2016

Investors have enjoyed another year of positive returns in 2015, despite considerable volatility in investment markets. The first half of the year was relatively calm and enjoyed strong growth whilst the last six months proved challenging. Achieving positive returns was difficult as widespread volatility in markets mid-year resulted in some of the worst monthly returns since the global financial crisis. Causing the uncertainty was the latest instalment in the Greek debt crisis, the terrorist attacks in Paris and concerns China's economy was slowing faster than markets had anticipated which could have consequences for global economic growth.

While the global economic outlook appears modest in the current circumstances, expectations were downgraded as the year progressed and there are still major risks and issues that need to be monitored closely. Of key concern is that while stimulus measures have underpinned the performance of share markets, the flow through into the real economy has been limited.

Australia's economic performance has been less than stellar. Economic growth remains below trend. The weak third quarter capital expenditure data where expenditure fell 9.2% to be down 20.0% over the year, was a strong reminder that the transition from the mining and energy investment boom may not be smooth. Australia's substantial trade dependence on China is an ongoing issue. China is the largest or second largest export market for 8 of our 10 largest exports so the health of China's economy and its transition to a more consumer and services oriented economy is significant.

Despite these and other concerns, there are also a number of positives. The US economy continues to perform well, the eurozone continues to recover slowly, China has considerable policy firepower to respond to weaker than expected economic conditions, corporate balance sheets are generally in good shape and better value opportunities are starting to emerge following the sharp falls in investment markets which commenced in 2016.

Recent share market falls in 2016

The new calendar year has started on a particularly bleak note with widespread share market falls recorded in the first few weeks of trading. The initial trigger of the weakness and volatility in markets was further slowdown in China's manufacturing sector. The latest Chinese Manufacturing Purchasing Managers' Index (PMI) was released on Monday 4 January. It showed manufacturing activity weakened in December, albeit a small fall from 48.6 in November to 48.2 in December. However, it was the 10th consecutive month the PMI has fallen.

Rising tensions between Saudi Arabia and Iran also added to markets' uncertainty over the price of oil and contributed to the 11.3% fall in the price of oil (Brent crude) last week. In Australia, sentiment wasn't helped by new data showing new building approvals, a key source of growth for our economy in the post resources era, fell 12.7% in November.

Issues to manage in 2016

Corporations have responded to greater market scrutiny since the global financial crisis by disclosing less, not more, of their information on the basis that the less they reveal the less that can be proved misleading by regulators, investors or courts. As a result the likelihood of earnings projections being heavily relied upon becomes more challenging.

Scheduled in November 2016, is the US Federal election. Opinion polls have the Democrat's Hillary Clinton contesting the 45th US Presidential race against the Republican's Donald Trump.

There is very little prospect of the US further increasing interest rates as they did in December 2015, in the next few months. That means the value of dividend yields that have been created by this market fall becomes even greater, provided companies can maintain their dividend rates. The current earnings season in the US will be important because the US appears the best prospect of driving world economic growth.

The danger for Australia is that the current flow of money out of China into Australian property may be slowed. Chinese investors are certainly not anticipating this but with China changing their regulations constantly there is no certainty.

The big issue in late 2016, for many Australian retirees will be how changes to the Australian age pension assets test will affect them. The changes are due to take effect from 1st January 2017 and may become an election issue with Malcolm Turnbull saying to expect a Federal Election around September or October 2016.

Australian economic indicators

Australian jobs data again pleasantly surprised with employment falling just fractionally after two exceptionally strong months of jobs growth with unemployment at 5.8 per cent. Low wages growth and growth in jobs in industries like retail and construction in NSW and Victoria made up for the slump in mining related jobs in Western Australia.

Housing finance rose more than expected, but mainly due to owner occupiers. Finance to property investors rose slightly but this followed sharp falls in previous months indicating that Australian Prudential Regulatory Authority measures designed to cool lending through higher interest rates to property investors is still working.

Given the crash in oil prices including Asian Tapis grade oil in Australian dollars, petrol prices in Australian cities should be pushing down to 90 cents a litre. Energy companies are blaming high refinery margins based on Singapore as the reason petrol prices haven't decreased.

Portfolio implications

We have been assessing the potential for adverse developments in China and the implications for Australian investors for some time. We have been concerned that policy makers actions have distorted asset valuations to the point that return potential is reduced and risk is elevated. As a result, portfolios are currently managed in a very conservative manner which has resulted in reducing share market exposure and maintaining cash balances despite record low interest rates.

While this positioning creates a degree of insulation, it also positions portfolios when inevitably investment market returns rebound. Currently, the focus remains on managing risk by conservatively managing portfolios and diversifying asset bases widely.

As always, if you have any questions or wish to discuss anything please call us on 03 9544 1004.

Wishing you a very happy new year,

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