Economic News January 2017

As we welcome in the new year, we reflect back on another year of solid returns despite 2016 being an unusual and challenging year on several fronts for investors.

The health of China's economy and its share market stability were significant concerns at the beginning of 2016, though these concerns dissipated as the year progressed. Central banks' attempts to stimulate growth continued to be a key influence on markets, distorting the prices of many assets whilst politics delivered some big surprises.

Britain's surprising decision to exit the European Union (EU) in June and Donald Trump's success in the US presidential election in November caused considerable turbulence in financial markets. Global share markets now appear to have taken those events in their stride, recovering initial lost ground. However, global bond yields have risen sharply in anticipation of significant budget stimulus under a Trump presidency and the US Federal Reserve raising interest rates in 2017.

A year of mixed returns on global share markets

Share market returns varied widely this year around the world. There was modest evidence of economic recovery in Europe but not all share markets reflected that positive news due to heightened anxiety over regional politics. Share markets in Germany and France were up 6.9% and 4.9% respectively in the 12 months to 31 December 2016. Italy's 10.2% fall reflected concerns about the stability of its banks and the potential for more political instability following the Prime Minister's resignation after the failure of the constitutional referendum.

Japan's share market continued to disappoint, with the Nikkei 225 Index rising just 0.4% in the 12 months to 31 December 2016 as the yen rose and investors began to lose faith in both monetary policy and economic reforms. China's share market fell 12.3% over the same period, despite recovering from heavy losses early in the year. By contrast, growth in the US economy helped push the US share market up 9.5%.

The Australian share market delivered a strong return of 11.8% for the year, outperforming most of the world's major share markets. This was despite the dampening impact of weak resource prices early in 2016, low energy prices at the beginning of the year and minimal earnings growth for the vast majority of companies.

Central bank policies remained a key influence on markets

At a time of minimal earnings growth for companies, widespread monetary stimulus helped support share markets again this year.

The US ended its quantitative easing program in 2014 and began to raise interest rates late in 2015. During 2016, monetary authorities elsewhere around the world continued to take measures designed to help stimulate economic growth and ward off concerns about deflation. Interest rates in Europe and

Japan remained at or near historic lows and their central banks continued to provide much needed stimulus through a range of actions, including substantial bond purchase programs.

Bonds rallied, with yields continuing to fall as prices rose, resulting in good returns for investors. Falling expectations about inflation and global growth and investors' preference for 'safe' investments were factors that drove prices higher and yields lower.

In Australia, the Reserve Bank of Australia reduced the cash rate by 0.25% in both May and August 2016, sending the rate to a record low of 1.50%. However, by year's end, markets had become increasingly sceptical about how effective central banks' monetary stimulus policies and very low interest rates were, in helping to generate healthy rates of growth and inflation. There is now concern that monetary policy has reached the end of its usefulness and that there are few options for providing further stimulus other than higher government spending. The measures that policy makers take in future to promote growth and manage inflation remains a key uncertainty.

Politics becoming a big issue for investment markets

The election in November of Donald Trump as the next US President was largely unexpected. The market's behaviour since the election result suggests that his assertive fiscal policies, such as spending US$1 trillion on infrastructure and lower taxes, will be favourable for the economy and American businesses. However, this optimism may prove misplaced. If these policies are implemented, his stimulus program could provoke the US Federal Reserve to raise interest rates more aggressively than they did in 2016 and cause a blowout in the US budget deficit.

The Brexit vote and the election of Donald Trump have raised concerns that populist and separatist parties in Europe, many of which are either anti-immigration or against EU membership, could gain power and sponsor a referendum similar to the UK's on EU membership. Important elections are due in The Netherlands, France and Germany in 2017. Electoral success for these parties with their narrow, nationalist agendas, would be far more serious for the stability and continuity of the EU and the euro than Brexit.

Many Australian retirees were also impacted by major changes to the Centrelink age pension assets tests. The government made it more difficult to qualify for a part age pension meaning many individuals had their payments reduced or cut off altogether.

Despite recent positive returns, we remain cautious

Overall, the year ended better for the global economy than it began. In January, China's economic slowdown looked worse than the market had expected and the outlook for global growth was more uncertain. Adding to market concerns were weakness in commodity markets, especially oil, where prices fell to levels not seen for over a decade and the risk of deflation in Japan and Europe.

As the year progressed, global economic conditions generally improved at a modest pace, although there are parts of the world (particularly Europe and Japan) where growth was slow. China's economy picked up during the year due to increased infrastructure spending and an exuberant property market and the US economy continued to perform strongly.

In Australia, our economy has performed well, despite the substantial contraction in mining related spending. In the first half of 2016, the Australian economy expanded at a rate of 3.2%. However, our economy recorded a rare contraction in the September quarter, with real gross domestic product falling 0.5%, bringing Australia's annual economic growth rate back to 1.8% in 2016.

A 'defensive' portfolio stance is still justified

The outlook for the global economy remains uncertain. There are still numerous risks and uncertainties, which justifies a cautious investment stance. Public and private debt levels remain high and investment by companies is lower than it should be, reflecting a general lack of confidence. Ultra-low interest rates and monetary stimulus have distorted the prices of many assets. The effectiveness of monetary policy with record low interest rates, seems to be reaching its limits and policy makers have limited firepower to respond to another crisis. Possible electoral success by populist parties in Europe could unsettle the eurozone and the practical implications of a Trump presidency aren't clear.

In the current investment environment, it remains challenging to find asset classes that can offer strong potential returns without unacceptably increasing a portfolio's risk. We remain concerned that the very loose monetary policy that has been pursued in many parts of the world has been the main driver of markets, rather than economic fundamentals. This has distorted the pricing of many assets, which we consider to be stretched and expensive.

Our defensive position means portfolios currently hold more cash and alternative investments than usual. In addition, portfolios have been very selective about the fixed income positions. Portfolios are widely diversified, risk aware and positioned for different market and economic eventualities.

If you have any questions or wish to discuss anything please call us on 03 9544 1004.

Wishing you a very happy 2017,

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