Economic News January 2020

After a sharp decline in share markets in the last quarter of 2018, it was an anxious start for investment markets in 2019. In early 2019, the Chairman of the US Federal Reserve Jerome Powell signalled that the Federal Reserve had changed from a tightening bias to a more neutral, "data-dependent" policy stance. The Federal Reserve subsequently reduced interest rates by 75 basis points to a target range of between 1.5% and 1.75%. Other Central banks followed the Federal Reserve's lead resulting in interest rates dropping sharply around the world.

The Reserve Bank of Australia (RBA) reduced interest rates by 75 basis points to a record low 0.75% in an effort to try and stimulate the Australian economy. The European Central Bank (ECB) brazenly announced that it had reduced the interest rate for bank deposits by 10 basis points to negative 0.5% and would resume net asset purchases at a monthly pace of 20 billion Euros per month. It also effectively wrote an open cheque by announcing that the asset purchase programme would remain for as long as necessary to try and stimulate the Eurozone.

Easing monetary policy comes amid deteriorating economic conditions, especially in manufacturing sectors. The Purchasing Managers' Index (PMI) suggested that the manufacturing sectors in the US, Europe and China were all experiencing recessionary conditions by the end of 2019. This has been confirmed by official economic statistics. For example, Germany's GDP grew only marginally by 0.1% in the September quarter after contracting by 0.2% in the June quarter, while Chinese GDP growth of 6.1% (year-on-year) in the September quarter was the lowest level the country has seen in 20 years.

As the tide of central banks' liquidity lifted all asset classes, investors have been richly rewarded for taking risks in 2019. Both Australian and global shares performed strongly despite concerns about economic slowdowns, lower earnings growth and expensive valuations, while emerging market shares have been a relative laggard.

The high 2019 calendar year returns masked considerable volatility in markets, which were often driven by headline news on US–China trade tensions, Brexit and developments in the Middle East. US investment markets fell by 6.8% in May 2019 and again by 5.8% in August 2019. However, in both instances, the US markets recovered strongly and quickly after those falls. One of the factors supporting the recovery is the fall in US 10-year bond yield, which started the year at close to 2.7% and was around 1.77% in November.

Australia

Australia saw growth slow to below 2% as the housing construction downturn, weak consumer and investment spending and the continued drought all weighed on the Australian economy. This in turn saw unemployment drift higher, wages growth remain weak and inflation remain below target.

The two big surprises in Australia were the re-election of the Coalition Government which provided policy continuity particularly in terms of franking credits and the rebound in the housing market from mid-year. While much of the economic news was negative, the RBA dropped interest rates and the prospect it provided for stronger growth ahead, combined with the low starting point in investment markets, resulted in strong returns for investors.

Investment markets outlook

We are cautiously optimistic in our investment outlook for 2020, which is based primarily on the easing of financial conditions by central banks. However, we acknowledge that risks are significantly skewed to the downside given the high level of geopolitical uncertainty and mixed economic data.

On the economic front, the main central banks have all eased their monetary policies and this could translate into improving economic data towards mid-2020. In the US, the level of unemployment is still low at 3.6%. Furthermore, both US households and financials have de-leveraged significantly since the global financial crisis. Importantly, US consumer price inflation remains below the Federal Reserve's target which, combined with the relatively high cash rate in the US, means the Federal Reserve has the ammunition to stimulate the economy if necessary.

Outside the US, economic prospects appear cloudier. The main source of uncertainty under this scenario is the Chinese economy, which has suffered from US tariffs on its exports. The trade war has undoubtedly made the transition of the country's economy from an exports and investment-driven economy to a consumer-oriented economy more treacherous. However, the Chinese economy is a hybrid market economy in which the authorities retain many policy levers – many of which the authorities began using in late 2017 and could continue using – such as lowering banks' reserve requirement ratios to support the Chinese economy and avoiding a hard landing.

Australian economic growth slowed in 2019 and the RBA responded by lowering its cash rate. The weaknesses in the Australian economy can be attributed to a mix of weak consumer spending, driven by low wage growth and the wealth effect from corrections in house prices, and deteriorating corporate sentiments. Economists anticipate that a more accommodative monetary policy, the reduction in income tax in July 2019 and the recovery in housing prices seen in the second half of 2019 may stabilise the economy, helping Australia maintain its record of uninterrupted economic growth since the early 1990s.

Broad issues to be aware of in 2020 are:

- The US trade wars – investment markets are assuming some sort of de-escalation in the run up to the US presidential election, but Trump doesn't always follow expectations.
- A hard Brexit looks like being avoided but there are numerous rounds of UK / European Union free trade negotiations to take place through the year.
- A continued slowing in the growth of Chinese economy would be a major concern for global growth.
- In Australia, debate could take place whether stimulus should occur from monetary (interest rate) versus fiscal (budgetary) sources – significant fiscal stimulus could reduce the need for further RBA rate cuts.
- In Australia, strength in infrastructure spending and exports will help keep the economy growing but it's likely to remain constrained due to subdued consumer spending, the drought and the impact of the devastating fires.
- Improved global growth and still easy monetary conditions should drive reasonable investment returns through 2020 but they are likely to be more modest than the double-digit gains of 2019 as the starting point of higher valuations and geopolitical risks are likely to constrain gains and create some volatility.

The paradox of investment markets can be that the stronger returns are today, the lower return expectations are for tomorrow. We must keep this in mind to maintain portfolios that are conservative and well balanced in terms of risk and return.

We hope you have a very happy and healthy new year. If you have any questions or wish to discuss anything, please call us on 03 9544 1004.

All the best,

Andrew Shaw BBus, Grad Dip SIA, CFP
Principal NAB Financial Planning Mount Waverley Pty Ltd
ACN 603 130 963, ABN 80603130963
Authorised Representatives

Suite 30, 1 Ricketts Road Mount Waverley VIC 3149
T 03 9544 1004