Economic Snapshot

Market update 25th August 2015

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MARKET UPDATE

The current volatility in global financial markets, while unwelcome, is not a repeat of the GFC. The underlying economic conditions between the immediate pre-GFC years and now are quite different.

Pre-GFC we had:

- Overheating economies operating above trend rates of growth;
- Booming commodity prices;
- Asset prices (equities and in the US, housing) trading at highly overvalued levels;
- Rising inflation;
- Central banks tightening monetary policy around the world.

The GFC started as a worse than usual, but nevertheless fairly standard, cyclical downturn triggered by central banks raising interest rates to head off inflation. It was the decision to let Lehman Brothers go that turned this situation into the GFC. That is the event that froze the worlds' global financial markets and produced the massive dislocations that followed.

Now we have pretty much the reverse conditions:

- Economies are operating with significant spare capacity;
- Commodity prices are weak;
- Asset prices around the world are trading at much more realistic levels;
- Inflation is low and showing little sign of becoming a problem in a hurry;
- The Federal Reserve and the Bank of England are the only major central banks thinking of lifting interest rates and they are going to be very slow and cautious about it;
- Nearly every other central bank continues to run the loosest monetary policies in their history.

Not only are we not facing rising interest rates to head off inflation, we are not facing a re-run of the Lehman episode. The world economy is in a protracted phase of slow recovery with subdued inflation and historically low interest rates. We expect this situation will last for some time yet and that the Fed's moves to gradually start lifting interest rates will not upset this path.

The markets at the moment have been caught out by a conjunction of events which are being collectively interpreted as a deflationary shock to the world economy. These events are:

- The renewed decline in the price of oil and other commodities;
- The surprise currency move by China at the same time as a poor "flash PMI" figure was released suggesting China is heading for a "hard landing';
- Nervousness about when the Federal Reserve will lift interest rates.

These events are regarded as a deflationary shock because they adversely affect the emerging economies:

- Many emerging economies are commodity exporters;
- The Asian economies which compete with China have just lost some competitiveness to China which will hurt their exports;
- A higher US dollar will follow from both China's move and the Fed lifting interest rates and this will cause more commodity price weakness, further hurting commodity exporters.

These concerns are similar to what we saw earlier in the year when the oil price fell sharply. They are now compounded by China's currency move. Fund Managers believe these fears are overdone:

- Although the world economy is operating at historically modest rates of growth it is nevertheless recovering and we expect this to continue;
- So far modelling of the growth outlook for the world as a whole and the US and Australian economies in particular has been reassuringly accurate;

  It is clear the Federal Reserve will be very careful about lifting interest rates with a view to not disrupting markets
- Economists do not think China is about to embark on "currency wars" or extended depreciations; we may see some further modest depreciation of the Chinese currency in coming months, but aggressive moves seem unlikely;
- The Chinese economy, while slowing down, is not the basket case so many commentators seem to think; positive signs include a strong services sector, robust consumer confidence, improving house prices and still respectable official PMI readings of manufacturing activity;
- We expect further monetary and fiscal policy stimulus in China in coming months to support growth near the government's 7% target;
- It is generally accepted that the balance of effects between oil exporting (emerging) nations and oil importing (developed) nations when the oil price falls is positive for global growth, not negative as the markets are currently implying.

Overall, we do not feel recent developments are as negative as the markets seem to think. A 12-month outlook continues to suggest meaningful positive returns to equities over bonds. These expected excess returns are even greater now that equity markets have declined as much as they have.

It is very important when managing portfolios at times like this to be very objective about what is happening and to stick with processes which have proved successful over time. A chopping and changing portfolio position in response to market volatility is almost guaranteed to be unsuccessful.