ANZ Global Wealth Chief Investment Office Investment Spotlight

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Spotlight: Step up

Central bank rate cuts, government bond purchases from the European Central Bank (ECB), plunging oil prices and falling bond yields have given many the jitters over the economic outlook. In this month's spotlight we argue that while there may be some merit in the gloomy view, there are forces at play which may help a step up stronger economic growth and slightly higher inflation down the track.

2015 has seen a busy start to the year for central banks. A raft of central banks from the Bank of Canada to the Singapore Monetary Authority to the People's Bank of China and the Reserve Bank of Australia have cut rates in response to a combination of a softer growth outlook and weak inflation trend. The collapse in oil prices and broader commodity prices intensified an already weak inflation trend, driving headline inflation at the end of 2014 to levels seen during the global financial crisis. In Switzerland and Denmark official rates have now turned negative. Critically, responding to softer growth and weaker inflation, the ECB added to existing stimulus measures by announcing an extension to its quantitative easing (QE) program to include the purchase of euro zone government bonds.

Global Annual Headline Inflation (%)

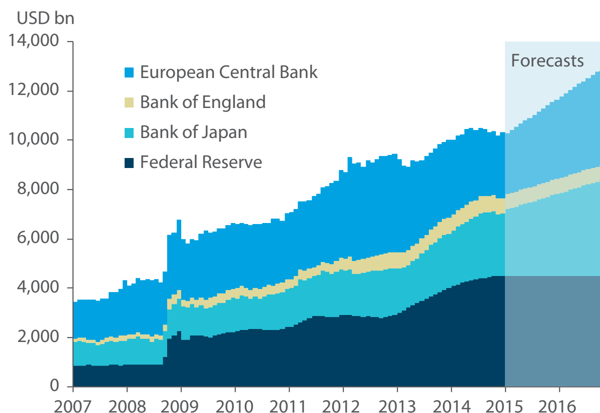
Source: Thomson Reuters Datastream, ANZ Global Wealth

ECB announces open-ended QE

The ECB's QE program is aimed at boosting the struggling euro zone economies and lifting inflation. The €60 billion a month program is scheduled to commence in March 2015 and is expected to run to September 2016. Interestingly though, the QE program is effectively open-ended as it is tied to the achievement of the ECB's inflation objective of below, but close to, 2% over the medium term. The expectation is if inflation is well short of this level through 2016, the program will be extended and perhaps even increased.

The ECB's action follows the Bank of Japan's decision to significantly expand its own QE program late last year. The result of these combined actions is that despite the end of QE in the US and UK, the balance sheets of the major central banks will expand at a rapid US$1.5 trillion annually. This is greater than the pace of expansion in the past two years under the US Federal Reserve's (Fed) QE program.

Major central bank balance sheets

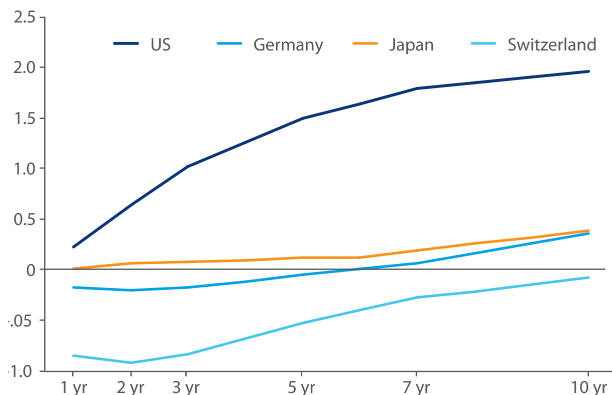


Source: Thomson Reuters Datastream, Bloomberg, ANZ Global Wealth

Taken together, the combination of central bank policy cuts, ECB QE, lower oil prices and weaker inflation has driven government bond yields sharply lower. In an increasing number of cases, this has resulted in negative yields. Most notable here is Germany, where government bond yields are currently negative out to 5 years duration, and Switzerland, where 10 year government yields are now negative. In total, approximately US$3 trillion in bonds globally are now trading with a negative yield.

Financial markets are grappling with what the collapse in yields means for future growth, inflation and asset market returns. Views range from arguing that the collapse in yields is a temporary phenomenon that will finally lift growth and inflation across weaker economies, to pessimistic views that consider negative yields are signalling that Europe will sink into sustained deflation similar to that witnessed in Japan for the past two decades.

Global treasury yield curves – major markets

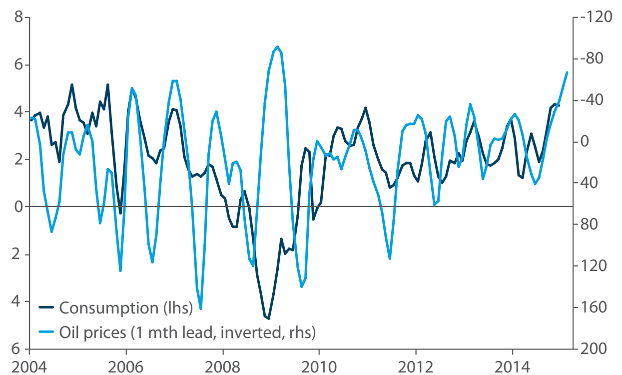


Source: Bloomberg, ANZ Global Wealth (Data as at 10 February 2015)

Are lower oil prices and yields part of the solution?

While we see some merit in the gloomy view, on balance we consider that historically low yields form part of the solution to the weaker growth and resulting disinflationary trend of recent years. These low yields have been engineered by central banks through the combination of zero short-term interest rates, and in the case of Switzerland and Denmark, negative cash rates. Further, unprecedented bond buying programs and forward guidance on policy which have indicated that these policy settings will continue for as long as is necessary have played a role. We think that when you couple this with low oil prices, which helps put more money in the back pocket of consumers across the developed world as well as China, these forces are expected to help the shift to stronger economic growth and slightly higher inflation down the track.

US consumption and oil prices (3m/3m annualised %)



Source: US Department of Energy, Thomson Reuters Datastream, ANZ Global Wealth

US growth should remain solid in 2015

Central to our view is the belief that the US should maintain solid growth through 2015, supported by both lower yields and oil prices. The chart above shows that the impact of lower oil prices can be quite quick, and is already occurring, with consumer spending up in the latter part of 2014 at its fastest pace since the Global Financial Crisis (GFC). Additionally the US economy has made good progress in combatting the excessive debt burden of households and financial institutions which led to the GFC so the domestic economy is fundamentally strong, as illustrated by the current rapid pace of employment gains. We believe this opens the door for the Fed to modestly lift rates later this year.

The concern for some is that against the backdrop of weak growth across the rest of the developed world, this may drive a further rise in the US Dollar (USD), which would weaken the US recovery. While a stronger USD would likely cause some softening in US growth and limit US earnings, given the strength in domestic demand and the relatively closed nature of the US economy we don't think that it will significantly eat into the current recovery. A stronger USD should support some recovery in growth and profits for the more troubled economies outside of the US, in particular Europe. Furthermore, even assuming the Fed tightens policy, as they have indicated, we would not expect a meaningful rise in US bonds yields as easier policy outside of the US should act to cap yields.

Growth markets currently agree with our positive growth view in the main. For example, share market returns remain buoyant and share market price to earnings multiples sit around or above historical averages as shown in the global share valuations chart below. But, risks have risen in recent months. Realistically, bond yields would only stay at their current extremely low levels over the long-term if both real growth and inflation were also extremely low (markedly lower than they are now) across the developed world. Such a scenario would be likely to have a negative impact on share markets.

Global share valuations – MSCI World Forward PE Ratio

Source: Thomson Reuters Datastream, ANZ Global Wealth

Holding the course – our preference for growth assets

While we're mindful of the risk of deflation, we believe the outlook still supports our view that growth assets should continue to outperform defensive assets. As the Fed starts to move its policy settings to more normal levels, and with shares fairly valued, we expect returns are likely to be lower and more volatile than the past two years. We continue to focus on limiting our exposure to higher risk and less liquid assets such as emerging market shares and the AUD.

Our preference remains for largely unhedged global developed market shares as currency movements provide insulation for AUD and NZD investors against any spike in growth concerns which would harm share market returns. This allows us to maintain a moderate overweight to growth assets while managing overall portfolio risk.

Within a moderate overweight to global developed market shares we have shifted our preference towards the euro zone and away from the US. A combination of a weaker Euro and more aggressive ECB policy action may suggest that euro zone growth and earnings are likely to lift during 2015. In contrast the stronger US dollar will likely start to curtail the robust growth in US earnings.

View the full ANZ 2015 Global Market Outlook publication at wealth.anz.com/marketwrap to gain more in-depth insights about what to expect in investment markets around the world in 2015.

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