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Woodhall's Wrap

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The world economy is getting stronger

- **US economy recovers from snowbound quarter one**
- **China economy on track for its controlled economic stabilisation**
- **Australia labour market continues to flummox the pundits**

The Big Picture

Surprisingly, markets rallied after the US reported that economic growth fell by -2.9% (annualised) in quarter one. Everyone had already worked out that the worst winter in 30 years damaged growth. The rally was inspired by the Federal Reserve comments that they were feeling upbeat. Further, the Fed subtracted another $10bn from its bond-buying stimulus bringing it down to $35bn per month from $85bn at the start of the year. That is confidence.

A few days later US house home sales were reported to have risen a staggering +18.6% on the month – the best result since January 1992. US consumer price inflation also pleased and the all-important labour force data – the so-called nonfarm payrolls – again beat +200,000 new jobs and unemployment rate is 6.3% which is not that far above our number (of 5.8%) after the US experienced double digit unemployment at the height of 'The Great Recession' as they refer to the GFC.

It seems like being quite a while off before the Fed will raise rates and that supports the US stock market continuing to rally.

China data also pleased. Having experienced a planned dip in production earlier in the year some pundits questioned whether they were still in control. But the Purchasing Managers Index (PMI) that measures business expectations about growth started June at 50.8 which was a five month high and well above the all-important 50 level. The provisional PMI number later in the month shocked markets by being well above expectations. Today's official number was 51.0 further indicating strengthening growth.

Other China data was a little mixed but its government came out with some strong comments that spurred on resource stocks. JP Morgan reportedly just stated that Chain's growth is at the 'Goldilocks' level – which I would agree with. In fact we have been predicting this sort of result since last year.

At home, unemployment again came in at 5.8% and below the peak of 6.0% some months ago. 22,200 new full-time jobs were created but -27,000 part-time jobs were lost. That is, employers on average are prepared to commit to full-time work in this switch. Given that full-time is defined as working 35 hours or more per week while part-time only requires one hour of work, the impact on total hours worked was positive.

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Australia's economic growth came in at +1.1% for the quarter or +3.5% for the year. Good numbers! Job vacancies were also up +2.1% but people are still worried – as measured by consumer confidence indexes. Unfortunately, the political turmoil of the previous government that I attributed then to the poor confidence reads seems to be carrying on with the new government. And maybe it is now even worse. If political parties continue this race to the bottom, Australians will not be as well off as they should.

The Reserve Bank kept rates on hold at the start of June and again today but they do seem to be worried about economic conditions. The Australian dollar is not where they had anticipated.

Europe is dragging its feet far less these days. They are worried about deflation – that is consumer prices falling – as that does not encourage current purchases because goods will become cheaper. As a result, the ECB cut rates and that is bringing with it renewed confidence. This activity has brought 10 year bond yields down. Spain's yield was slightly lower than the US rate a couple of weeks ago despite the difference in ratings!

So the world economy is mending nicely but rosy is too strong a word. Wall Street is expected to rally into Christmas. We have of FY15 forecast for the ASX 200 to be 5,900 in 12 months time. That isn't a very bullish forecast but the implicit 9% capital gain with dividends of around 4.7% plus franking credits makes our prospects 'solid'. Volatility is low but only around where it was during the really good bull runs of the early 1990s and the mid 2000's. Volatility usually rises before corrections take place – unless there is some external event.

It does seem that the Ukraine problems will not get worse but the unrest in Iraq and Syria could spill over. So far markets are not worried but stuff sometimes comes out of the blue.

Asset Classes

Australian Equities

The ASX 200 was flat over quarter two but the month of June was negative at -1.8%. This behaviour is very much in line with our comments in April 1st newsletter. Our Jan 1 forecast for the end of 2014 was 5,850 but that figure has slipped a little to now be 5,650. However, much of the downward pressure on forecasts came from weakening resources earnings' forecasts from the brokers that are surveyed by Thomson-Reuters.

We suspect the earnings revisions were the result of too pessimistic a view of China's growth prospects. With iron ore prices possibly having bottomed and China's PMI stronger, the August reporting season of company accounts could see upgrades in earnings forecasts that would flow on to lift our forecasts for the index. Only the Property sector index rose in June.

The big banks are coming under pressure from all sides. Not only are there complaints of poor and bad financial advice, the Bank of International Settlements just reported our banks were the most profitable in the developed world. With David Murray's inquiry into the financial system due out on July 15th we might know soon if there will be new government intervention into the system.

Foreign Equities

The S&P 500 keeps making new highs – fuelled by government stimulus and a strengthening economy. While we lost -1.8% in June while the S&P 500 rose +1.9%. The FTSE and the German DAX both fell but Emerging markets rose +1.5%.

We only have the S&P 500 slightly overpriced and the VIX 'fear index' is in a place consistent with the rally continuing.

Bonds

Fitch, the ratings agency, has estimated the probability of European default has fallen over both the year and the month. Finding good yields is now the problem.

Interest Rates

The Reserve Bank has questioned whether rates are low enough to help the transformation from mining exploration to the rest of the economy. But it didn't drop rates on June 3rd or today. It doesn't look like rates will go up anytime soon. There is likely to be an extended period of stable low rates here too.

Other Assets

Gold (+5.8%) and silver (+9.8%) prices rose strongly in June but copper prices were flat.

Oil prices were up a little on the Iraq situation and our dollar was up +1.1%.

Iron ore prices are up about 4% from the low during June.

Regional Analysis

Australia

It is almost impossible to keep up with what from the budget might get through – and with that comes business uncertainty. And Malcolm Turnbull hasn't helped things by having dinner with Clive Palmer and the Head of Treasury – only to follow that in this week's newspapers pointing out the obvious. He said that the government has failed to sell the budget to the people.

China

China Industrial Production came in at +8.8% in June which was ahead of expectations. Retail Sales were up +12.5% and inflation was +2.5% which was well below the comfort level of +3.5%.

USA

US inflation was welcomed at +0.4% and Fed-speak is still 'lower for longer' on rates.

Nonfarm payrolls came in at +217,000 which is the fourth straight month above +200,000 – the best result since the start of the millennium.

Most analysts are claiming that the unemployment rate of 6.3% does not reflect true market conditions. There are increasing numbers of long-term unemployed that will find it very difficult to get a job. Moreover, many who get jobs are slipping down the scale to minimum-wage jobs. At $7.25 per hour and 35 hours in a week equates to about $A14,000 pa – less than our aged pension for full time work. And now I can get a part aged pension for England I just found out that the maximum pension is $10,400 pa so my take should only be less than $2,000 pa! We in the lucky country are better off than many think – especially as the UK pension gets taxed if you earn on top of that!

Europe

The ECB cut rates such that the deposit rate for banks is now negative! Banks have to pay to park money with the Central Bank. As a result banks are being encouraged to lend.

Inflation in Europe is said to be dangerously low. The ECB is apparently ready to act again if necessary.

The UK tried to block the new President of the EU being elected as Cameron claims the new President is very unlikely to push through the reforms that are needed. Could the UK leave Europe? It seems possible if the Conservatives are re-elected next year but that is apparently not too likely.

Rest of the World

While much of the world is focused on Brazil and the World Cup, less is being heard about the Ukraine and Iraq. Markets are coping.

At least Australia can take pride in having tried hard in Brazil and they put up three very good performances. England also had to pack their bags but they had their heads held low after a pathetic tournament. As one wag put it, he thought the Italy and Uruguay (who each beat England) sides were strong until he realised England was so bad (after their draw with Cost Rica).