Global repercussions as US regains its health

- DON STAMMER
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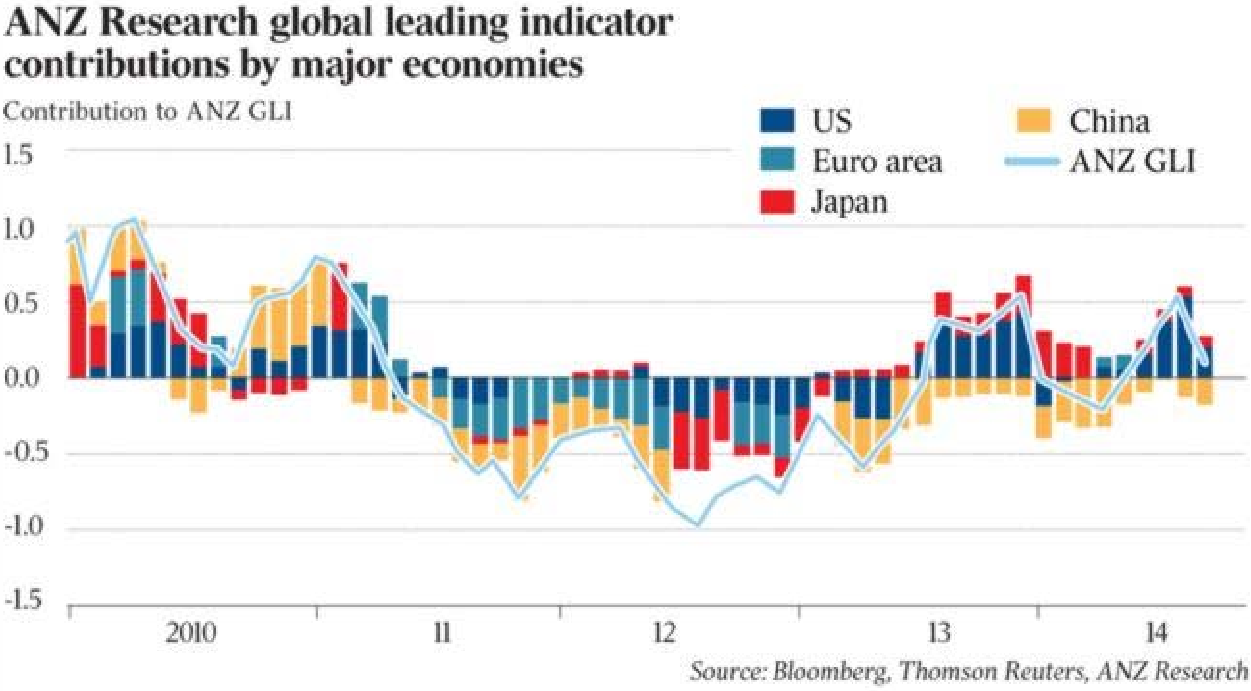

Leading indicator contributions *Source:* TheAustralian

INVESTMENT markets have turned jumpy again, with investor sentiment, particularly in sharemarkets, swinging widely from day to day. There's widespread worry that growth outside the US is slowing; but with the US economy picking up speed, there's heightening uncertainty as to when the US cash rate will be raised from the near-zero level where it's been for six years.

Views on the US economy are becoming decidedly more upbeat. In the March quarter, GDP contracted by 2.9 per cent (US growth figures are annualised) on early estimates and by 2.1 per cent on revised numbers. The marked dip in business activity, caused by the polar vortex and harsh winter, helped to lower yields on US government bonds and left many share investors concerned about the outlook for corporate earnings.

The US economy has more than made up for the bad start. In the June quarter, US growth quickened to 4.6 per cent. In the current half year, with confidence of households and businesses recovering, banks recapitalised and cheaper energy from shale oil and gas, US real GDP could rise by 3-3.5 per cent.

Of course, not all economic statistics will be pointing in the same direction. But it looks as though the US economy will stay in better health — even if growth rates slow a bit further in Europe, China, Japan. The International Monetary Fund sees upside risks to forecasts for the US economy and downside risks to growth elsewhere.

Here are four possible effects on investment markets from the improving US economy.

If US job numbers continue to strengthen (at or above the net gain of 245,000 jobs a month they have averaged since late March), investors will probably focus on the Fed beginning its program of normalising the cash rate in the first half of 2015; that's six to 12 months earlier than was generally inferred from the forward guidance provided last week by the Fed.

The rebound in the US economy would probably also underpin a rise in US bond yields. The Fed has argued, often and strongly, that the marked fall in the number of Americans with jobs or looking for work (the US labour force participation rate has declined to 62.7 per cent, its lowest since 1978) is mainly cyclical in nature and will reverse as the economy strengthens — and will keep inflation low.

Should the low participation rate turn out, instead, to reflect structural influences, such as ageing population and skills imbalances, inflationary expectations could re-emerge in the US, quickly and powerfully. (Ten-year US bonds yielded 2.3 per cent at time of writing, and US inflation has been running a little below 2 per cent.)

Positive news on US economic growth would probably also be accompanied by upgrades to the quarterly profits of most leading US companies. US share prices, which usually set the direction for sharemarkets in other countries, would be challenged by somewhat higher interest rates. But there would be improving earnings to factor in.

The relative strength of the US economy is likely also to help deliver a further lift in the value of the US dollar (which rose by 7.7 per cent against the currencies of its trading partners in the September quarter) against the yen, euro and Australian dollar — even if there's pressure from US politicians and business for the Fed to resist further appreciation.

As Ben Levishon points out in Barron's, the US investment weekly: "Currency is a relative game, and to buy the greenback, people must sell something else, say the euro or the yen.

"And for the most part, two factors determine what (currency) people want to buy or sell: the strength of an economy and the direction of its interest rates."

don.stammer@gmail.com

Don Stammer chairs QV Equities, is a director of IPE, and is an adviser to the Third Link Growth Fund, Altius Asset Management, Philo Capital and Centric Wealth. The views are his alone.