Forget China — it’s the US that we must watch

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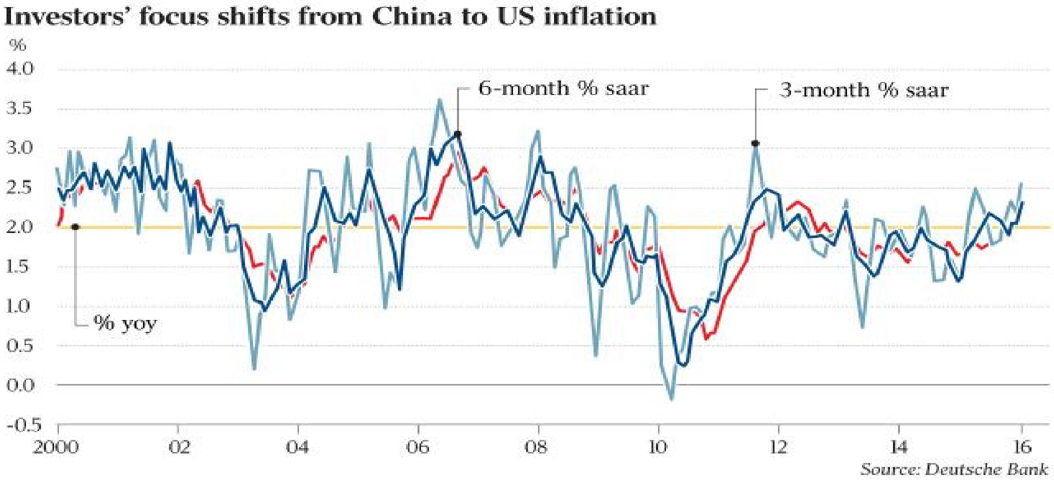

Investor focus

The powerful forces acting on our economy and investment markets mainly originate abroad. Australian investors need to keep watch for major changes in expectations for business conditions and asset markets overseas, particularly in China and the US.

China takes a third of our exports and has a strong influence on our economy. The pricing of Australian shares and longer-dated bonds largely follow leads from US markets. Economic conditions in both China and the US affect the Australian dollar. Housing is the one asset category where average prices are “made in Australia”.

There are many times (including the present, I’d claim) when market sentiment towards China (particularly) and the US become oversimplified — and a sudden and powerful change in market sentiment follows.

Recently, fear of a hard landing for the Chinese economy has been the major preoccupation of investors around the world. It’s contributed to heightened volatility, depressed commodity prices, fears of global deflation, and some big punts being taken for a significant devaluation of the yuan.

In my view, investors’ extreme concerns about an early recession in China are likely to ease over the coming 12 months — though occasional periods of extreme stress will be experienced — and investors’ centre of attention will shift to the risks from US interest rates.

China certainly faces many problems — including slowing trend growth, a shrinking workforce, high levels of debt, inefficient state-owned businesses, challenges from deregulation of a controlled economy, and increasing inequality. Even then, China seems likely to avoid recession in the next year or two. Deutsche Bank assesses the China outlook this way: “Macro data … (confirm) growth is slowing gradually — not a rosy picture but far from the feared sharp slowdown.” Moderation of growth in manufacturing and fixed asset investment is being partially offset by strengthening in services and retail sales.

It’s the US outlook that’s becoming more challenging. In January and early February concerns built up that the US would slip back into recession; these fears reflected and fuelled the sharp drop in global share prices. Fortunately, there’s been little forewarning of a downturn from the traditional indicators of a US recession — such as increased job-shedding or a big build-up in inventories.

Overall, prospects for the US economy are currently brighter than those for other economies. Measured unemployment has halved; consumer spending (always the mainstay of the US economy) seems to be picking up and will be boosted by the low oil price; most banks have recapitalised; and wealth has rebuilt. The US economy seems likely to expand by 2.5 per cent this year and next.

But there are stresses in the US economy and investment markets that investors need take into account. They include:

• The financial excesses growing out of seven years of near-zero interest rates.

• The impact of the rise in the US dollar.

• Severe pain in the energy sector from the low price of oil.

• Concerns the Fed will be too aggressive in raising its cash rate.

The US is the only major country tightening monetary policy — and is likely to consider raising its cash rate even though cash rates are negative in Europe and Japan. The US central bank has the twin mandate of maintaining a high level of employment in the US and maintaining US inflation at 2 per cent. The Fed’s primary concern lies with the US economy, not running monetary policy for the rest of the world.

In December, the senior people at the Fed were anticipating four increases in the US cash rate this year. After the sharp drop in share prices in January, and some weak economic numbers, market expectations reverted to the view that the cash rate would be left unchanged or, at most, raised only once.

Investors should allow for changes in expectations for the US cash rate being a major source of volatility in investment markets, as fears ease of a hard landing in China. Much will depend on what happens to US inflation — and the January figures were a bit of a worry.

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