Investment Report - November 2013

There are positive, albeit uneven, signs of continued economic recovery in the major economies.

USA

The economy only added a further 148,000 jobs in September, which raises some doubts about the strength of the ongoing recovery. However, unemployment fell from 7.3% to 7.2%.

The number of Americans who signed contracts to buy homes dropped sharply in September, reflecting higher mortgage rates and home prices that have made purchases more costly.

The current Federal Reserve Chairman Ben Bernanke retires on 31 January 2014. He will be replaced with Janet Yellen, who is an advocate for aggressive action to stimulate economic growth through low interest rates and large-scale bond purchases. This continuation of the easy money policy is generally positive for markets into 2014, because a Yellen-led Federal Reserve is likely to follow closely the forward guidance on policy that has been laid out by the current Chairman.

Given the economic and financial risks being generated by the current concerns over the debt ceiling, it seems likely that the Fed's first move to taper its QE3 bond purchase programme could now come about the time of the transition of this Fed leadership next year, or later.

China

The IMF's annual report forecast China's growth to slow from 7.6% this year to 7.3% next year, consistent with the transition to a more balanced and sustainable growth path. However, for the year to 30 September, China's GDP growth actually accelerated to an annual rate of 7.8% and, in October, manufacturing activity grew at its fastest rate in 18 months.

China's property prices rose further in August with house prices now up 6% nationally and selected cities showing sharper increases. The rise in property prices is a positive in the short term for construction and real estate industry activity but it presents risks in the form of housing affordability, over-investment and excessive growth.

China's export growth posted a surprise fall for the year to September, confounding market expectations for a rise of about 6% and marking the worst performance for 3 months. Imports fared better rising 7.4% for the year to September. Analysts said weak exports underscore some worries about flagging world demand, particularly from the emerging markets, as tighter US monetary policy pushes investors away from developing countries.

Japan

Japan's industrial output rose 1.5% in September from the previous month, as stronger production of vehicles and electronic components added to the signs of recovery.

While Japan looks to have successfully engineered a short term upswing in its economy and markets, the key is whether it can generate longer term momentum. This will now come from structural things like boosting female labour participation (about 48% versus 70% for males), corporate tax reform and creditable move to longer term fiscal sustainability.

Europe

Most economic indicators continue to improve gradually for nearly all of the members of the euro area, in particular the UK. The Markit manufacturing purchasing managers' index for the currency bloc rose in October to 51.3 from 51.1 in September, above the 50 threshold that separates expansion from contraction. Only France and Greece out of the 17 members failed to enjoy the improved conditions in October.

Australia

Australian construction activity reached its highest level in almost three and a half years in September, extending the picture of a nascent recovery gaining traction. The Australian Industry Group's performance of construction index rose 3.9 points to 47.6 in September from the previous month, but remained below the 50-point level that separates contraction from expansion.

Business confidence continued its three month rise higher in September. The improvement can be attributed to a range of factors including rising equity prices, rising consumer sentiment, better economic news out of China and the recent federal election result. Overall, the results are consistent with the early stages of the forecast non-mining recovery. The September retail numbers were strong at +0.8%, double market expectations.

With mining development now detracting from growth, some commentators argue that another rate cut is possible but, in October, the unemployment surprisingly fell back to 5.6% reducing this need. As well, the RBA has indicated that it is increasingly comfortable with the current settings while headline inflation rose strongly in the third quarter by 1.2%.

The market expected a rise of only 0.8%. However, the year-on-year headline inflation of 2.2% remained comfortably near the bottom of the Reserve Bank's target band of 2 – 3%.

New Zealand

The IMF's annual report stated that New Zealand would rank among the strongest-growing of the advanced economies this year and next year. It forecasts New Zealand's growth rate this year at 2.5% and next year at 2.9%. In addition, New Zealand's expected 2014 unemployment rate of 5.3% was far better than 12.2% in the euro zone, 7.2% in the US and 6% in Australia.

Most local commentators, however, feel these New Zealand growth estimates are too low. With the stimulatory effects of elevated dairy prices and the larger contribution from the Canterbury earthquake rebuild, annual GDP growth looks increasingly likely to peak above 3.5% over the 2014 calendar year

On the monetary policy front, the backdrop of a further strengthening in domestic demand, some upward drift in inflation expectations and a broad rise in utilisation rates underlines that the bias in domestic interest rates settings remains to the upside in early 2014. In late October, the Reserve Bank left the OCR unchanged.

Summary

Central banks look likely to continue to support markets with easy monetary policies. Until underlying economic activity improves even more, capital markets will be supported by maximum liquidity.

Reasonable relative valuations, improving GDP growth and growing business and consumer confidence support this constructive view for equities. Furthermore, there are now clear signs of bond-to-equity switching on a large scale in the US and European mutual fund industries.

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