Usually at this time of the year, financial market comments cover the performance of the year just finished and look forward to the likely prospects and outcomes for the coming year.

The Year to 31 December 2015

This will be remembered as the year that the US Federal Reserve finally raised its key policy interest rate for the first time in nearly 10 years. It will also be remembered as a mixed overall performance year for shares.

In 2015, greater capital volatility emerged in share markets. They faced a commodity price collapse, concern over the slowing Chinese economy and a sharply higher US$ so, with valuations already at high levels, the markets were more vulnerable and sensitive to bad news.

The performance from bond markets was modest in 2015 as interest rates moved even lower during the year.

At the beginning of the year, the official cash rate (OCR) was sitting at 3.5% with the Reserve Bank of New Zealand (RBNZ) having hiked it from 2.5% a year earlier. The debate was when the next increase would come and how long it would take for the OCR to move back to ‘neutral’, at around 4%.

However, falling dairy prices, much lower inflation than expected and a slowdown in domestic growth quickly saw the discussion turn to rate cuts, rather than more hikes. Following rate cuts by the RBNZ in June, July, September and December, the OCR dropped back to the historic lows of 2.5%. This has taken deposit rates to the lowest levels since 1966 and mortgage rates down with them.

Few people predicted just how much weakness we would see in the commodity sector. Crude oil prices have declined to levels not seen since the height of the financial crisis, less than half of where they were trading midway through last year.

Bonds (as measured by the NZX Corporate A Grade Index) provided a total return (income plus capital gain) of +5.8%, while shares (the NZX50 Gross Index) provided a +13.6% annual return to equity investors, the best performing market in the developed world.

Beyond New Zealand, share markets were variable. Australia had a relatively poor year in AUD, +2.6%, and the results from other major bourses in their local currencies were USA -0.7%, London -4.9% and Germany +9.6%.

However, a weak New Zealand Dollar over the year greatly enhanced unhedged returns from global shares - the MSCI World Index (in NZD) rose +11.0% in the 12 months.

The Year Ahead

In 2015, most share markets provided positive returns as dividend yields offered higher yields than bonds with the ultra-easy monetary policies and low interest rates around the world.

In 2016, interest rates still look very likely to remain low for most of the year. Of the larger economies, only the US looks likely to raise rates after its initial lift in December 2015.

Indeed, some commentators now feel that deflation is a growing possibility in some countries as major countries like Japan and the euro zone area are struggling to generate inflation and stimulate growth. Key commodity prices like dairy, oil, gold and iron ore declined sharply in 2015. Moreover, with divergence between the monetary policies of the major central banks, the preconditions are in place for larger currency deviations in 2016.

We are conscious that the bull market of the past seven years has seen significant asset price appreciation and that future investment returns are likely to be more modest.

As doubts begin to increase around the prospect of higher economic growth, the need for higher interest rates appears to be evaporating and even further accommodative monetary policy may be required in countries like Australia and China.

If US interest rates remain relatively low and global growth fails to increase, New Zealand interest rates will also remain lower for longer.

Thus, at least in the first half of 2016, the prospects for equity markets remain benign and, surprisingly, interest rates may even fall further from current levels.

Summary

Apart from the US, central banks look likely to continue to support markets with easy monetary policies through the first part of 2016. Inflation is virtually non-existent, so interest rates need not rise in the short term. This scenario still supports a constructive case for buying selected equities, at least until interest rates begin to rise to make bonds more attractive.

However, a diversified approach to investment, as always, remains appropriate. Moreover, as all share markets have risen strongly over the last few years, we encourage investors to reflect upon their portfolios which may have drifted away from their benchmark ratios due to the exceptionally strong share returns of recent years.