

# Investment Report – March 2016

There is now a growing divide in the global economy. Activity has continued to soften in China and the emerging markets, while the falls in commodity prices have resulted in sharp income falls for the commodity exporting nations. In contrast, economic conditions in the developed economies - US, EU and UK - have gradually improved.

## USA

US jobs growth remains robust, as the economy added a high 292,000 jobs in December and a lower 151,000 jobs in January, while the jobless rate fell to a new low of 4.9%.

New home sales fell by a larger than expected 9.2% month-over-month in January, reversing December's outsized gains and thus returning the series to levels prevailing through most of 2015.

The policy makers are hoping for some signs of inflation. Wholesale prices in the U.S. unexpectedly increased in January as higher food costs more than made up for the plunge in energy. The 0.1% gain in the producer price index followed a 0.2% decline in December. As the labour market strengthens, they are hoping that inflation will drift closer toward their goal. Also, manufacturing output rose in January by the most since July 2015, a sign that industry was starting to stabilize.

Further interest rate hikes by the US Federal Reserve should now be gradual or they risk hurting already fragile emerging economies, where many companies borrow in dollars. The head of the International Monetary Fund, Christine Lagarde, said a tightening in US monetary policy, which started in December with the first rate hike in a decade, should be supported by "clear evidence" of inflation in the United States. She also highlighted the negative implications of rate hikes for emerging economies. Chances are slim that the Federal Reserve would need to reverse the rate tightening cycle it began in December 2015.

## Japan

Japan's economy contracted again in the fourth quarter of 2015, shrinking by an annualised 1.4%. It grew by just 0.4% for the whole year. The central bank has embarked on a stimulus programme and, in February, the Bank of Japan cut its benchmark interest rate below zero, to -0.1%. It joined the ECB, Switzerland, Sweden and others by implementing a negative rate to attempt to stimulate the economy. Almost one-quarter of the world's GDP now comes from countries with negative interest rates and nearly 30% of the world government bond market now trades on a negative yield.

## China

In emerging market and developing economies, where activity is more heavily weighted towards trade in goods, 2015 saw GDP growth fall to its slowest pace since the financial crisis. At the heart of this slowdown is China, where GDP growth has been decelerating since 2013. Chinese demand is continuing to shift away from state-led investment in infrastructure and property, and towards private consumption and services. However, the pick-up in domestic spending to date hasn't been strong enough to offset the slowdown in manufacturing and construction. Consequently, Chinese growth is set to continue slowing over 2016.

## Europe

The progress in Europe is slow. The European Commission has cut its forecast for economic growth in the 19-country euro zone this year to 1.7% from the 1.8% it had forecast in November 2015. This figure would still mark a moderate increase from the figure of 1.6% in 2015.

## **Australia**

The Reserve Bank of Australia (RBA) retains a relatively positive view on the economy, but has recently introduced an easing bias due to the weaker inflation outlook. Still, the expected further moderate improvement in economic data should keep the RBA on hold with interest rates for the present.

The jobs numbers were disappointing in January. The market shrank by 8,000 jobs and the unemployment rate rose from 5.8% to 6%.

In this environment, returns from the share market are more likely to be derived from more cost cutting, capex reductions and merger and acquisition activity. Despite providing attractive yields, the key vulnerabilities for Australian equities include a sharp contraction in Chinese investment and another year of large equity supply.

## **New Zealand**

Benign weather arising from the El Nino weather pattern, low oil prices, surging tourism and a burgeoning construction pipeline have improved the outlook for the domestic economy over the next year or so. However, lower dairy earnings and the eventual wind-down of the Canterbury rebuild are likely to cap the pace of growth, which is becoming increasingly dependent on population growth through net migration.

We expect that low inflation will require the Reserve Bank to cut the OCR to a record low of 2.0% in 2016.

Recent developments have reinforced this view. Inflation is already below the RBNZ's target band and over the coming year it will approach historically low levels. While much of this weakness is due to falls in oil prices, there is also a more broad based softness in the prices of other goods and services.

We expect that the New Zealand dollar will fall further in the months ahead due to poor export conditions and falling local interest rates.

## **Summary**

While short-term risks in global markets feel higher, longer-term there are good reasons to be somewhat more confident. The recent sharp falls in Chinese shares arguably tells us more about regulatory issues and fears around the share market and currency in China rather than much about the economy.

A U.S. recession is unlikely; the combination of good US and euro zone indicators lately indicate the global economy is unlikely to plunge into recession. Lower oil prices and commodity prices are providing a boost to consumers and many businesses. Monetary policy remains ultra-easy. Short sharp falls in early 2016 have seen share market valuations become a little more attractive.

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.

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