Investment Report – April 2016

After a volatile start to 2016 in January and February, markets steadied somewhat by March and April as fears about a U.S. recession faded to the background and gains were made in oil, iron ore and other commodity prices. Major uncertainties that could lead to a renewed increase in financial market volatility are the growth outlook for China, the apparently dwindling market impact of monetary easing and the path of monetary tightening this year in the USA.

USA

In March, the US Federal Reserve (the Fed), as widely expected, held the Fed Funds target rate range unchanged at 0.25%-0.5%. The Fed remains of the view that the economy will expand at a "moderate pace", but has also highlighted the risks coming from "global economic and financial developments". While the Fed continues to expect the process of monetary policy normalisation to proceed in 2016, the Fed's own forecasts now imply only two rate hikes this year – well down from the previous expectation of four moves.

Most recent economic statistics are still encouraging for the economy. Nonfarm payroll employment increased by 215,000 in March (versus +205,000 consensus), a slight deceleration from an upwardly revised 245,000 in February. The unemployment rate nudged higher to 5% on a higher participation rate and the employment gains were relatively broad-based, led by solid gains in service sector jobs (+199,000). Importantly, the average hourly earnings increased 0.3% from the previous month, taking the annual gain to 2.3%, slightly ahead of February's 2.2% rise. The ISM manufacturing index increased to 51.8 in March (versus consensus of 51.0), signalling the first outright expansion in the manufacturing sector since August 2015.

Japan

In March, the Bank of Japan left its benchmark interest rate on hold at -0.1% and defended negative interest rates as a useful tool against deflation.

China

The central bank is increasingly finding itself in a bind, balancing its need to continue easing credit to support economic growth against its stated goal of keeping the Chinese currency stable. In early March, the Central Bank announced that it would lower the Reserve Requirement Ratio (RRR) by 50 basis points for all financial institutions. Large and small banks now hold 17% and 15% RRR, respectively. This cut came after significant disappointment in trade data, which has been putting downward pressures on growth and equity market performance.

There is a broad consensus among private sector economists that the currency will fall further as China's economy slows, but more doubt now about whether the Central Bank can control that process without imposing outright capital controls.

China's 2016 National People's Congress commenced in Beijing on 5 March. China set a target range for 2016 real GDP growth of between 6.5% and 7.0% and it will pursue a more proactive fiscal policy, expanding its fiscal deficit ratio to 3.0% of GDP in 2016 from 2.3% in 2015.

Europe

In late February, the European Central Bank (ECB) introduced a new financial easing package, cutting rates and expanding asset buying, but undid the very stimulus it hoped to achieve by suggesting there would be no further cuts. Seeking to resurrect corporate activity and investments, the ECB said it would start buying corporate debt and even offered to pay banks for lending to companies in the ailing euro area in a bid to kick start growth and stave off the threat of deflation.

Australia

In early March, the Reserve Bank of Australia left the cash rate at its record low of 2%. Its statement read:

"In Australia, the available information suggests that the expansion in the non-mining parts of the economy strengthened during 2015 despite the contraction in spending in mining investment. This was reflected in improved labour market conditions. The pace of lending to businesses also picked up. Inflation is quite low. With growth in labour costs continuing to be quite subdued as well, and inflation restrained elsewhere in the world, inflation is likely to remain low over the next year or two. Given these conditions, it is appropriate for monetary policy to be accommodative. The Board judges that there were reasonable prospects for continued growth in the economy, with inflation close to target. The Board therefore decided that the current setting of monetary policy remained appropriate."

Australia's GDP rose 0.6% in the fourth quarter, well above most expectations. In 2015 as a whole, the economy grew by 2.5%, down only marginally from 2.6% in 2014.

New Zealand

In mid-March, Fonterra dropped its forecast payout from $4.15 to $3.90 per kilo of milk solids, after four of the last five dairy auctions saw falls in the price of milk.

Also, the Reserve Bank of New Zealand unexpectedly reduced the Official Cash Rate by 25 basis points to 2.25%. Its statement said:

"Due to weaker growth in China and other emerging markets, and slower growth in Europe. This is despite extraordinary monetary accommodation, and further declines in interest rates in several countries. Financial market volatility has increased, reflected in higher credit spreads. Commodity prices remain low.

Domestically, the dairy sector faces difficult challenges, but domestic growth is expected to be supported by strong inward migration, tourism, a pipeline of construction activity and accommodative monetary policy. The trade weighted exchange rate is more than 4% higher than projected in December, and a decline would be appropriate given the weakness in export prices. There are many risks to the outlook. Internationally, these are to the downside and relate to the prospects for global growth, particularly around China, and the outlook for global financial markets.

The main domestic risks relate to weakness in the dairy sector, the decline in inflation expectations, the possibility of continued high net immigration, and pressures in the housing market. Headline inflation remains low. While long-run inflation expectations are well-anchored at 2%, there has been a material decline in a range of inflation expectations measures. This is a concern because it increases the risk that the decline in expectations becomes self-fulfilling and subdues future inflation outcomes. Headline inflation is expected to move higher over 2016, but take longer to reach the target range.

Monetary policy will continue to be accommodative. Further policy easing may be required to ensure that future average inflation settles near the middle of the target range."

Summary

Our current investment view is that the accommodative monetary policy settings in many jurisdictions around the world will continue to be supportive of global equity markets. While a sharp correction in equity markets occurred in January and February, we do not think that a bear market is imminent. It will take signs that the global economy is actually in recession for investors to be unduly concerned.

However, we do believe that risks have increased. Global growth outside of the US and China is very weak, the effectiveness of quantitative easing is coming into question as investors, companies and more generally economies are adjusting and become accustomed to the low inflation, low return world in which they are operating. Moreover, we are now in the 7th year of the bull market in shares. Emerging markets are also under pressure from weaker commodity markets and falling currencies.

Accordingly, we are recommending to clients that their investment portfolios should be well aligned to their long-term strategic asset allocation positions and well diversified.

Information and Disclaimer: JMIS Limited is the investment consultant to the Select Wealth Management service. This report is for information purposes only. It does not take into account your investment needs or personal circumstances and so is not intended to be viewed as investment or financial advice. Should you require financial advice you should always speak to your Authorised Financial Adviser. The price, value and income derived from investments may fluctuate because values can go down as well as up and investors may get back less than originally invested. Past performance is not indicative of future results and no representation or warranty, express or implied, is made regarding future performance. Reference to taxation or the impact of taxation does not constitute tax advice. The levels and bases of taxation may change. Where an investment is denominated in a foreign currency, changes in rates of exchange may have adverse effect on the value, price or income of the investment. This report has been prepared from published information and other sources believed to be reliable, accurate and complete at the time of preparation. While every effort has been made to ensure accuracy Select Wealth Management Limited, JMIS Limited, nor any person involved in this publication, accept any liability for any errors or omission.