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Investment Update – January 2017

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 2016

This will be remembered as the year that Brexit was decided mid-year, Donald Trump was elected the 45th US President, John Key resigned and the US Federal Reserve finally raised its key policy interest rate for the second time late in the year. It will also be remembered as a mixed overall performance year for shares.

January and February saw large falls in share prices mainly due to lower oil prices and concerns surrounding China and its currency, the yuan. Central banks responded with greater stimulus and some moved to negative interest rates. The markets readily recovered in fits and starts for the remainder of the year, even after the surprising US election results. In 2016, greater capital volatility emerged in share markets.

The performance from bond markets was acceptable in 2016 as interest rates moved even lower during the year. That is until July when the US 10- year treasury note yield bottomed at 1.36%. Late in the year, the promises of America's President-Elect to increase spending and lower taxes lead to higher inflationary expectations and sharply higher interest rates. The 10-year note yield was 2.4% at year end.

At the beginning of the year, the New Zealand official cash rate (OCR) was sitting at 2.5% and the Reserve Bank of New Zealand (RBNZ) dropped it three times in the year to finish at 1.75%. Following rate cuts by the RBNZ in March, August and November, the OCR dropped back to historic lows of 1.75%. This took mortgage rates down with them.

New Zealand assets generally had satisfactory returns for these twelve months compared with Australia and the rest of the world.

Bonds (as measured by the NZX Corporate A Grade Index) provided a total return (income plus capital gain) of 3.74%, while shares (the NZX50 Gross Index) provided a 10.1% annual return to equity investors.

Beyond New Zealand, share markets were variable. Australia had a reasonable year in AUD, 11.8%, and the results from other major bourses in their local currencies were USA 9.5%, London 14.4% and Germany 6.9%. However, a strong New Zealand dollar over the year reduced unhedged returns from global shares – the MSCI World Index (in NZD) rose only 3.4% in the 12 months.

In 2016 nearly all 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.

The Year Ahead

In 2017, interest rates still look very likely to remain relatively low. Of the larger economies, only the US looks likely to raise rates.

Indeed, some commentators feel that deflation is still a possibility in some countries as major countries like Japan and the euro zone area are struggling to generate inflation and stimulate meaningful growth. Moreover, with divergence between the monetary policies of the major central banks, the preconditions are in place for larger currency deviations in 2017. In 2016, the UK pound depreciated by a massive 21.5% against the New Zealand dollar.

We are conscious that the bull market of the past eight years has seen significant asset price appreciation in shares and that future investment returns are likely to be more modest. It is also likely that the bull market in bonds of the last 35 years is now over.

As statistics emerge around the prospect of higher inflation and economic growth, the need for higher interest rates appears to be gaining impetus. However, further accommodative monetary policy may be required in countries like Japan and China.

A number of countries, (New Zealand included) hold elections in 2017, the results of which may provide uncertainty in the investment markets. Particularly close attention will be paid to the results that come out of the European elections.

Summary

Apart from the US, central banks look likely to continue to support markets with easy monetary policies through the first part of 2017. Inflation is still low, so interest rates need not rise sharply in the short-term, but inflationary expectations are now rising too.

This scenario still supports a constructive case for retaining existing levels of share exposure, at least until interest rates begin to rise even further to make bank term deposits and bonds more attractive. However, a diversified approach to investment, as always, remains appropriate.

Moreover, as all securities have risen strongly in value 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.