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Investment Update – December 2016

The start of 2016 was marked by nervousness about the Chinese economy, the speed of monetary tightening in the US and the risks of deflation. However, China's economy has continued to grow and the Federal Reserve has yet to push up interest rates again after its first increase in December 2015.

The end of 2016 is being dominated by lofty market valuation concerns and volatility after the result of the US election. America's president-elect has promised to increase infrastructure spending and cut taxes, leading many investors to raise forecasts for growth and inflation. Donald Trump is in effect now doing the work of the US Federal Reserve by raising inflation expectations and triggering a spike in interest rates around the world.

US

As expected, the US Federal Reserve left short-term rates unchanged in November, as Janet Yellen oversees an ultra-cautious approach in the face of firming GDP growth and a steady jobs market recovery. Although the Federal Reserve is expected to lift interest rates in December, investors are taking comfort that any further tightening in 2017 will be modest.

Nonfarm payrolls were +161,000 for October, slightly lower than expected. However, the September numbers were revised significantly higher from +156,000 to +191,000. The unemployment rate was steady at 4.9% for October.

The election of Donald Trump as US president will herald a policy shift away from monetary policy towards fiscal measures in the coming months. In particular, some members of his economic advisory team are convinced that central banks such as the US Federal Reserve have exhausted their use of super-loose monetary policy. Instead, in the coming months, they hope to announce a wave of measures such as infrastructure spending, tax reform and deregulation to boost growth.

Japan

The Japanese economy is generally expected to grow by around 0.6%pa in calendar 2016, a slight pick-up from growth of 0.5%pa in 2015. For 2017, the expectation is that growth will improve a little further, to around 0.8%-1.0%pa. Growth is being supported by the 2016 easing of both monetary and fiscal policy. This is helping see a modest recovery in private consumption and some gains in business investment. The falling yen value is now boosting competitiveness.

China

GDP rose by 6.7% in the third quarter, exactly the same pace recorded in the first and second quarters, raising questions about the accuracy of the country's national accounts. The government cited the figure as evidence that the economy is stabilising but it did hit this target by expanding credit, which is up strongly.

For the month of September, China's official factory gauge rose to its highest level since July 2014 led by new orders, suggesting that the economy's stabilisation is continuing into the fourth quarter as robust consumption underpins demand.

Europe

Mr Draghi, the President of the European Central Bank, declared victory in his bank's fight against deflation, saying the ECB had "succeeded" in removing the threat of a vicious spiral of falling prices and ever weaker demand. While inflation has risen over recent months, at 0.4% it remains well below the bank's target of just under 2%.

In Italy, the country votes in a referendum on constitutional reform on 4 December. The Prime Minister, Matteo Renzi, says that changes are needed to make the country easier to govern and he has staked his reputation on winning, whatever the result. This political uncertainty is placing pressure on the Italian banking system and, indirectly, the Eurozone.

Australia

For the third quarter, inflation was higher than expected at +0.7% (+0.4% in the June quarter), taking the annual inflation rate to +1.3%. Thus, there was no catalyst in these numbers for a rate cut and, in early October, the RBA left the official rate unchanged at 1.5% and said:

"In Australia, the economy is growing at a moderate rate. The large decline in mining investment is being offset by growth in other areas, including residential construction, public demand and exports. Household consumption has been growing at a reasonable pace, but appears to have slowed a little recently. Measures of household and business sentiment remain above average."

New Zealand

In mid-November, the Reserve Bank reduced the Official Cash Rate (OCR) by 25 basis points to 1.75%, as expected. It said:

"Domestic growth is being supported by strong population growth, construction activity, tourism, and accommodative monetary policy. Recent dairy auctions have been positive, but uncertainty remains around future outcomes. High net immigration is supporting growth in labour supply and limiting wage pressure. Headline inflation continues to be held below the target range by ongoing negative tradables inflation. Annual CPI inflation was weak in the September quarter, in part due to lower fuel prices and cuts in ACC levies. Annual inflation is expected to rise from the December quarter, reflecting the policy stimulus to date, the strength of the domestic economy, and reduced drag from tradables inflation. Monetary policy will continue to be accommodative."

The macroeconomic impact of the recent South Island earthquake (at this point) is expected to be reasonably minor, reflecting the low population density of the areas most significantly impacted.

Summary

Even after the strong rise in share values over the last 7 years and a recent sharp correction over October and November coinciding with the US presidential election, we are cautious but not bearish on shares as there is no sign of recession for 2017 and financial authorities appear prepared to do whatever is required to ensure that the financial markets are well supported. We note, however, that longer term interest rates are starting to rise, signalling the end of a very long bull market in bonds. This may well prove a headwind for shares next year.

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