Investment report – March 2013

Since the global financial crisis, central banks have done their best to rejuvenate economies with easy monetary policies called quantitative easing (QE). Now, with short term interest rates still stuck near zero, the central banks of the US, Britain and Japan are experimenting with a modified approach, i.e. to tolerate somewhat higher levels of inflation in pursuit of higher employment, output and growth. This is a significant shift in philosophy - with some risks - given the historic importance that all central banks have long given to low inflation. Bond investors have now begun to price in higher inflation expectations in many markets and this has caused the bull market in bonds to pause early in 2013.

USA

The Minutes of a recent Federal Reserve meeting discussed the daunting task of extricating the US from its lengthy QE strategy. A mere whiff of inflation could cause a sharp bond market fall, leaving the Fed nursing huge losses on its now about US$3 trillion portfolio of US government bonds. This portfolio is rising by US$85 billion each month under the QE programme. Moreover, as the average maturity of its bond portfolio is “long” at around 11 years, this would exacerbate the size of potential losses. Thus sovereign risk remains alive and well in the US and could intensify in the years ahead.

Nevertheless, for the present, Fed Chairman Bernanke has confirmed that the current QE policies are suitable, especially given the US$85 billion spending cuts now apparently entrenched in US legislation (called the sequester, which started on 1st March). He said “although a long period of low rates could encourage excessive risk-taking, and continued close attention to such developments is certainly warranted, to this point we do not see the potential costs of the increased risk-taking in some financial markets as outweighing the benefits of promoting a stronger economic recovery and more-rapid job creation”. Bernanke’s position implies a continued underpinning of the upward trend in shares.

Recent economic statistics still support a recovering US economy. Retail sales rose in January for the third consecutive month, showing that household spending is holding up even in the face of the now higher payroll taxes. Also, data from the housing sector continues to improve e.g. US home prices finished 2012 with the largest gain in over 6 years, while sales of new homes lifted strongly in January and February, a further sign that the long suffering housing market is on the mend. A separate survey showed that US consumer confidence rose much more than expected in February as Americans shrugged off worries about fiscal policy.

Europe

The Euro zone recession deepened in the last three months of 2012, as the economy of the 17 nations shrank by 0.6%, which was the sharpest contraction since 2009 and marks the first time that the region failed to grow in any quarter during a calendar year. Germany was hit by a sharp decline in exports during this last quarter. The European Commission believes that the Euro zone will record growth of -0.3% for the 2013 full year, making it very difficult for member countries to implement their respective austerity programmes.

In February, the Italian elections created heightened uncertainty in the markets over fears that a divided parliament in Italy would hamper the country’s reforms and austerity programmes as well as stability in the euro zone. Some 56% of the Italian votes went to parties that have vowed to end the EU austerity policies. Fears among investors centred on the resulting parliamentary gridlock, leading to new elections and throwing into doubt Italy's ability to pay down its debts or raise new funds at a reasonable cost.

China

Outgoing Premier Wen Jiabao outlined broad policy initiatives at the start of the National Party's Conference in March, as the government tries to sustain an economic recovery from the slowest growth rate in 13 years without triggering consumer and asset-price inflation. While the authorities have pledged to boost incomes and consumption, the earlier February decision to intensify a 3-year effort to tame the property market – higher down payments and interest rates for second homes as well as a capital gains tax – may dampen the nation's rebound in the short term. Nevertheless, the annual GDP growth rate in 2013 is still likely to be 7.5%-8% pa.

China's official purchasers' managers index (PMI) fell to 50.1% in February from 50.4% in January. Also, the HSBC PMI stood at 50.4 for the month, down from 52.3 in January. A reading above 50 indicates expansion of the economy, so the rate of expansion slowed a little in early 2013.

Australia

Australia is one of just a few countries that still have a triple-A credit rating and a stable outlook from all three of the major ratings agencies. In late February, Britain became the latest western country to lose its triple-A rating, as Moody's cited this country's commitment to its austerity policies and the likely dampening effect on its economy.

A new report from Standard and Poor's says that Australia's overall fundamentals are strong, with strong institutions, low public debt and a financial system that "appears sound", but it reiterated concerns that the country's housing market appeared vulnerable to any downturn and that high household debts could make people's finances less resilient to economic shocks. The report was more positive than past updates and praises Australia's relatively high national savings rate, which is about 25% of GDP, compared with the average for advanced countries of about 19%. They believe that the economy is likely to grow steadily, despite a forecast peak in mining investment and a related dip in activity.

Building activity slowed in the December quarter because of a decline in the engineering construction sector (-0.1%), whereas private building activity rose by +2.5%, the fourth straight month of growth. Consumer confidence jumped to a 26-month high in February, as consumers became more confident about the economy and their own finances, suggesting that past interest rate cuts may be finally lifting spirits. In March, the official cash rate (OCR) was left unchanged by the Reserve Bank.

New Zealand

After a soft patch in the pace of economic growth around the middle of 2012, leading indicators have generally pointed to a pick-up over the fourth quarter of last year. Despite the Reserve Bank's concern that the New Zealand dollar is over-valued, a backdrop of continued global QE from the key central banks weakening their respective currencies is expected to underpin the NZD at its elevated levels. We believe that the Reserve Bank is unlikely to raise interest rates until early in 2014.

A significant surge in the value of total building consents in January versus the previous corresponding period was driven by a +34% increase in the value of residential consents. Total consents in January were up +27% against "only" a +6% gain in December.

Low interest rates and the housing shortage in Auckland appear to be the key drivers of this growth.

Therefore, the key downside risks to the New Zealand equity market prospects over the next few quarters are expected to include any further sharp appreciation of the New Zealand dollar, the emerging risk of a drought negatively impacting agricultural production and any sharp deterioration in global growth prospects.

Summary

The last few months have consistently provided strong investment returns and it is logical that markets should take a breather to consolidate these gains. However, the positive difference between dividend yields and bond rates and the weight of money returning to equities should still provide further modest but more gradual upside for equity markets in 2013.

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