Investment Report - April 2013

The negative economic shocks of recent years are easing, although some risks (like Cyprus) still remain. However, markets have been giving them less attention in 2013. There now appear to be better prospects of a more synchronised global recovery during 2013, as a general upswing is emerging fuelled by highly stimulatory monetary policies. While the global recovery remains unbalanced, positives in the US and China, and more recently Japan, together with growth in emerging markets, are gradually overwhelming the negative influence of continued weakness in Europe.

US

While increased taxes and some spending cuts will constrain US demand, powerful expansionary factors are the improving fundamentals in housing, the stronger labour market and better results in the retail sector.

Hiring in the US has gathered momentum. In February, non-farm payrolls rose by 236,000 people. This was far higher than the 157,000 new jobs created in January. Moreover, the unemployment rate fell from 7.9% in January to 7.7% in February, a four-year low. The unemployment rate needs to fall to 6.5% for the Fed to consider ending its quantitative easing programme, but this is unlikely to occur until 2014 at the earliest.

US consumers shrugged off their higher taxes to boost retail spending in February by 1.1% over January. This was the highest rise for the last five months.

Europe

The data from the major European economies still indicate very weak activity levels, but leading indicators are beginning to turn and point to better momentum in 2013. A crucial change is that the global backdrop is now more favourable for Europe. This may see the end to economic contraction in the middle of 2013, with momentum turning positive thereafter. However, political risks are still very high in several countries.

In mid-March, Cyprus needed to seek assistance from the European Central Bank to support its banking system. The conditions of the “rescue” package dented the enthusiasm of most worldwide share markets and again tested the commitment to and longer term viability of the euro market.

China

If global growth rates in 2013 and 2014 continue to improve, then China’s high historic growth rates of around 8% will continue in the short term. In February, China’s exports grew by 21.8% from the previous year, boosted by strong demand from the US and Asia. Exports, which are a key driver of China’s growth, have been hurt recently by a slowdown in its key markets.

In March, manufacturing activity expanded at its fastest rate in almost a year, indicating that conditions in the world’s second biggest economy are improving. The official purchase managers’ index (PMI) hit 50.9 points in March, the highest since April 2012. The March reading improved from 50.1 in February and signalled the sixth consecutive month of expanding manufacturing activity.

Japan

A material shift in monetary policy has weakened the currency and lifted Japanese industrial competitiveness. Machinery order statistics suggest manufacturing is expected to recover significantly. The new fiscal and monetary stance is shifting away from two decades of deflationary policies.

Australia

Economic growth is expected to slow, particularly from the wind down of the earlier mining capital expenditure boom which was responsible for much of the more recent growth. Weaker employment growth, elevated house prices and further household deleveraging could negatively surprise, although the Reserve Bank of Australia has plenty of scope to ease policy again. The strong Aussie dollar remains a drag on growth prospects. However, Australia is in a relatively strong position. Inflation is under control, unemployment is low, the economy is growing at a "normal" pace and debt levels are low compared with other advanced nations.
Moreover, Australia hasn't experienced a recession in the last 21 years.

The economy's GDP grew at 0.6% for the December quarter and 3.1% for the year. Although this growth matched market expectations, the underlying results were a little on the soft side. If it were not for a particularly large increase in public sector capital investment, the rate of growth in the December quarter would have been well lower. Most measures of consumption were fairly weak in the quarter and the figures suggest that the economy slowed in the second half of the year.

New Zealand

In March, the Reserve Bank left official interest rates unchanged at 2.5% as expected, and it expects to see this level unchanged "through the rest of this year". The Bank warned again about rising house prices and the strong NZ dollar, but noted the impact of the growing drought. It also noted that the domestic recovery remains uneven. Demand and business output is rising, but the labour market is weak with unemployment high at 7%. The Canterbury rebuild continues to gain momentum while business and consumer confidence is lifting.

In March, Fonterra's Global Dairy Trade auction produced a Trade-Weighted Index increase of +15%, following a +10% gain at the previous auction. Prices are now at their highest levels since this trading platform was introduced in 2008. Also in March, the December 2012 quarter GDP increase of 1.5% quarter-on-quarter was far stronger than expected and well above the Reserve Bank's expectation of a 0.8% increase. Overall growth for the economy is expected in the 2-3% range in 2013.

Summary

The main factors behind the recent strength of share markets seem to be twofold. The first is a degree of confidence that some "tail risks" have been reduced in Europe and the US, at least for now. The second factor is that shares look better than the alternatives. Cash and bank deposit rates are historically low and central banks have made it clear that interest rates will not rise in the near term to maintain the stimulus. For the share rally to continue in a sustained fashion, the current phase of assisted economic growth needs to give way to genuine economic growth in the major economies.

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