Investment Report - July 2013

In recent weeks, risk assets have been vulnerable to rising concerns over Federal Reserve tapering, some disappointment on Japan's stimulatory policies and China's slower growth. We believe that the markets are overly bearish on the timing of the end of quantitative easing (QE) in the US and on the Japanese reflation efforts, but acknowledge that ambiguous economic numbers out of China recently somewhat cloud the belief that the country is able to continue to grow so rapidly with low inflation.

USA

In mid June, the US Federal Reserve confirmed that, subject to economic conditions continuing to improve in the US, it would begin to slow its asset purchasing programme in late 2013 and wind them down completely by the middle of 2014. The bench mark 10-year bond yield rose sharply to a 15-month high on this news.

May saw a rise in new jobs and the unemployment rate. In May, there were 176,000 new non-farm payrolls jobs created which was above expectations but, as the participation rate rose and previously disenchanted workers returned to look for new jobs, the official unemployment rate actually rose marginally to 7.6%. In June, the actual new non-farm payrolls jobs added was a very strong 195,000 against expectations of 165,000.

US retail sales increased by 0.6% in May, helped by a 1.8% increase in car sales, the largest increase in six months. Retail sales account for about 30% of all US consumer spending and the latter accounts for about 70% of all economic activity.

Builders began work on more US houses in May and permits for new single-family homes rose to a 5-year high, as residential real estate underpins the economy which is showing very little inflation.

Europe

The euro zone economy is still under pressure and its recovery continues to be uneven.

In mid May, the European Central Bank (ECB) lowered its official interest rate to 0.5% from 0.75%, the first cut in 10 months. The bank said that it was prepared to act if further stimulus was needed to boost the region's economic health.

Official data showed record unemployment above 12% and inflation well under control at a 3-year low.

In mid June, the ECB President, Mario Draghi, said that interest rates would remain at current or lower levels for an extended period. This represented the first time that the ECB had given guidance on future interest rates in the euro zone. The Bank of England also said that it will keep interest rates at a record low for longer than investors had expected. This signalled that the two banks will keep monetary policy accommodative as higher bond yields and volatility threaten economic recovery.

China

China's economy grew at its slowest pace in 13 years in 2012 and, so far this year, economic data has surprised on the downside, such that the country could miss its growth target of 7.5% for 2013.

Exports posted their lowest annual growth in May of just 1%. May exports to the US and Europe, China's two largest markets both fell from a year earlier for the third month running. Imports fell 0.3% in May against expectations for a 6% rise as the volume of many commodity shipments fell from a year earlier.

China's trade, inflation and lending data for May all trailed estimates, signalling weaker demand that will test the nation's leaders' resolve to forego short term stimulus in favour of slower, more sustainable growth. We suspect that the new leadership in Year 1 of a 10-year term will opt for reform at the expense of growth. Inflation of 4% by year-end and 5% by mid-2015, with minimum wages in the majority of provinces accelerating, now looks likely.

In an Economist article of 15 June, there was a strong argument made that, after some 10 years of under-valuation, the Chinese Yuan was now slightly over-valued, given the slowing growth rate the spectre of higher inflation and relatively high local interest rates.

Activity in the manufacturing sector deteriorated further in June to a 9-month low as orders faltered, reinforcing signs of tepid growth in the second quarter. The manufacturing sectors are weighed down by deteriorating external demand, moderating domestic demand and rising destocking pressures.

We believe China only becomes a problem for global markets when China's GDP slows to about 6%. Up to that point, slower Chinese growth might even help global equities as it causes a correction in commodity prices, eases inflationary pressures and might even postpone the rate at which US Fed tapering occurs.

Australia

In early July, the Reserve Bank left the official cash rate (OCR) unchanged at 2.75%, judging that the easier financial conditions now in place will contribute to a gradual strengthening of growth for the country.

Commodity prices have declined but overall remain at high levels by historical standards.

The recent national accounts confirm that the economy has been growing a bit below trend. This is expected to continue in the near term as the economy adjusts to lower levels of mining investment. The unemployment rate has edged higher over the past year but the growth in labour costs had moderated somewhat.

The AUD has depreciated by around 10% since April, although it still remains at a high level. It is likely that the AUD will depreciate further yet, which would help to foster a gradual rebalancing of growth in the economy.

New Zealand

In mid June, the Official Cash Rate (OCR) was left unchanged at 2.5%. At that time, the Governor of the Reserve Bank Graeme Wheeler said, “Growth in the economy is picking up but remains uneven across sectors. Consumption is increasing and reconstruction in Canterbury continues to gather pace and will be reinforced by a broader national recovery in construction activity, particularly in Auckland. This will support aggregate activity and eventually help to ease the housing shortage”. He also said, “Fiscal consolidation will continue to constrain aggregate demand over the projection horizon. Reflecting the balance of several forces, we expect annual GDP to accelerate to about 3.5% by the second half of 2013, and inflation to rise towards the midpoint of the 1% - 3% target band. Given this outlook, we expect to keep the OCR unchanged through the end of the year”.

New Zealand consumer confidence surged to its highest level in three years in June buoyed by improving economic prospects, rising house values, low interest rates and low inflation according to the June Westpac survey. A high level of consumer optimism has now been sustained for the last three quarters.

Summary

Despite the recent volatility in global markets, it is important to remain focused on the fundamentals of the markets and, if need be, look through the short term volatility.
In particular, the fundamentals of the US economy, still the worlds largest and a key driver of risk assets globally continue to improve.

At times of heightened volatility, cash always looks appealing but for most providing positive real returns over the long term is most important and to that end hoping to beat the market by holding excess cash with the aim of picking a better entry point is fraught with difficulty.

As such a structured, disciplined and well diversified investment approach across multiple asset classes remains paramount.

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