Investment Report - September 2013

Global shares were down 2% for the month, in local currency terms but for unhedged investors the fall in the NZ dollar more than offset the loss in shares. Sharemarkets have started to price in that the US policy stimulus will be reduced, causing sharemarkets to fall. The geopolitical tension in Syria is also causing markets to take a breather, as sharemarkets have had a good run so far this year.

Expectations of quantitative easing (QE)-tapering by the US Federal Reserve have raised fears that emerging markets, which have benefitted the most in recent years from capital inflows during the QE, will now have difficulty funding their current account deficits as the QE is gradually reduced. This fear has been reflected in weaker equity, bond and currency markets in the emerging markets recently, with countries like Indonesia, the Philippines, Turkey and India most exposed. Prospects for the global economy actually brightened somewhat in August according to a fresh round of economic surveys. The Purchasing Managers' Indices (PMIs) for US, China and Europe all showed much improved manufacturing activity.

USA

The Minutes of the July meeting of the Federal Reserve revealed few clues about the central bank's likely timing for unwinding its extraordinary efforts to support the economy. The pace of US price inflation increased in July pushing the annual rate to 2%, the rate targeted by the Federal Reserve. The Fed plans to keep short-term interest rates at a level near zero until the unemployment rate (7.4% in July) drops to at least 6.5%, provided inflation remains under control.

The rate of new US home building rose in July, spurred on by the rise in new apartment building. However, the Commerce Department reported that new home sales in July were -13.4% month-on-month, raising concern that higher mortgage interest rates will perhaps indeed slow the recovery. Also, consumer confidence unexpectedly dropped in August from a 6-year high as consumers faced these higher interest rates. In contrast, activity in the US manufacturing sector grew at its fastest pace for 5 months in August with a pick-up in new orders. The Markit Purchasing Managers' Index (PMI) rose to 53.9, up from 53.7 in July. A reading above 50 indicates growth.

The major issue for the Federal Reserve will be how it implements its policy to unwind QE without triggering major dislocations in markets around the world.

Europe

In recent weeks, the lead indicators from Europe are markedly more positive after six consecutive quarters of recession. Eurozone business activity grew at its fastest pace in 26 months in August. The Markit Purchasing Managers' Index (PMI) rose to 51.7 in July, up from 50.5.

China

The Chinese economy seems to be stabilising after a short period of deceleration.

China's manufacturing activity rebounded in August. The official Purchasing Managers' Index (PMI) rose to 51.0 from 50.3 in July, easing fears of a slowdown in its economy.

Australia

In August, the Reserve Bank left its benchmark interest rate unchanged at 2.5% as expected and noted that economic growth was “a bit below trend” and that the dollar, despite a recent fall since April of some 15%, was still at an elevated level. Another drop in official rates by 0.25% is possible in November after the September elections.

June retail sales rose only 0.1%, which was well below the market expectation of a rise of 0.4%. On a year-on-year basis, sales rose 2.3% which is in line with the average over the last year. This leaves little doubt that the retail sector is still very subdued in Australia. The second quarter GDP rose by 0.6% taking the annual growth rate to 2.6%. While this is below trend growth, it does continue Australia’s long running economic expansion.

The Australian sharemarket had another 3% rally during August, and with the Australian appreciating 2% against the NZD dollar for the month, this led to a 5% return for NZ investors. The resources sector was up 5% and the energy sector also had a great month. Holding back these gains was the financial sector, as the banking stocks provided updates that showed a mix of slow lending growth and lower margins in the near term.

New Zealand

The latest leading indicators of business and consumer sentiment suggest that the pace of growth is likely to continue to pick up over the next one or two quarters. Moreover, the recent upward revision to Fonterra’s forecast dairy pay-out, combined with activity increasingly underpinned by the Canterbury earthquake rebuild, now suggests annual growth over the calendar 2014 year may exceed a rate of 3.5% pa.

On the monetary policy front, we continue to expect that the Reserve Bank will not raise official interest rates until March next year.

The New Zealand sharemarket was flat for the month of August, as the last of the end of June results were released. Despite most companies remaining cautious on their outlooks, the majority of companies beat expectations and a number of companies raised their dividends.

Summary

Despite a rise in interest rates over the last few months, the outlook for shares is still positive because liquidity and monetary conditions are still supportive while valuations remain relatively attractive. There are now clear signs of bond-to-equity switching on a large scale in the US mutual fund industry.

Moreover, year-on-year global GDP growth is beginning to accelerate for the first time in three years. With inflation subdued worldwide and surplus capacity in many countries, a sharp liquidity reversal to deter equity markets is most unlikely.

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