Investment Report - October 2013

USA

In late September, the major event to affect markets worldwide was the unexpected decision by the US Federal Reserve to delay for the present any lowering of its monthly $85 billion of asset purchases. The reason was that employment and growth in the US economy was still too hesitant and sluggish to stop the current level of its monetary stimulation. The response in markets to this initiative was fast; equities rallied and the US dollar fell against all other currencies. As well, the yield on US 10-year bonds fell sharply. The Fed’s target for unemployment is 6.5% (and it is currently 7.3%) before reducing or removing its stimulus package.

There is evidence that the earlier tapering talk has had a small tightening effect on the economy. For example, numerous US housing indicators have started to roll over with negative implications for consumer spending, and world industrial production more generally. US retail sales grew at a slower-than-expected rate in August, despite increased demand for high-priced, one-off items like cars.

However, there is still ample evidence of positive growth numbers in the major countries other than the US.

China

A series of recent economic releases have all been positive, i.e.

1. China’s trade performance was better than expected in August, as stronger exports to recovering overseas economies caused the trade surplus to widen to US$28.6 billion. Improved exports are a key driver of growth for China.

2. China’s annual consumer price inflation rose by a manageable 2.6% for the year to August.

3. China’s industrial production rose by more than expected in August, another sign that the world’s second biggest economy may be on the mend. Factory output grew by 10.4% in August year-on-year compared with 9.7% in July.

4. China’s manufacturing activity expanded in September to a six-month high. The HSBC preliminary Purchasing Managers’ Index (PMI) hit a level of 51.2, the highest since March. The August level was 50.1 and July was 47.7.

Japan

The Bank of Japan kept its interest rates at 0.1% in August, as the country showed signs of modest sustained recovery. The economy expanded 0.9% in the June quarter which translates to an annual growth rate of at least 3.6% pa. This may encourage Prime Minister Abe to proceed with a planned increased sales tax next year.

Europe

The European Central Bank (ECB) improved its outlook for the euro zone economy this year. It now expects the single-currency area to shrink 0.4% compared to its previous forecast in June of 0.6%. The stronger economies are still Germany and France. The ECB expects the recovery to continue in 2014.

The Bank of England has kept interest rates at 0.5% since March 2009. It will not lift these rates until unemployment falls below 7%.

Australia

Tony Abbot's election victory should provide Australia with some much needed political stability. However, with an outright majority in the Senate unlikely and business confidence low, re-balancing the economy remains a definite challenge.

In August, consumer confidence soared to three year levels, propelled by record low interest rates and the election of the new government. This will be a relief to the Reserve Bank which is counting on a revival in consumer and business confidence to help plug the gap left by a cooling mining boom.

The Reserve Bank left the official interest rate unchanged at 2.5% for the second consecutive month in September.

New Zealand

In September, the Reserve Bank held its official interest rate steady at 2.5%. This was widely expected as inflation remains low even with a strong housing market. In his review, the Governor of the Reserve Bank stated:

"In New Zealand, GDP is estimated to have increased by 3% in the year to the September quarter. Consumption is rising and reconstruction in Canterbury will be reinforced by a broader national recovery in construction activity, particularly in Auckland. This will support aggregate activity and start to ease the housing shortage. In the meantime rapid house price inflation persists in Auckland and Canterbury. As has been noted for some time, the Reserve Bank does not want to see financial or price stability compromised by continued high house price inflation. Restrictions on high loan-to-value residential mortgage lending, which will come into effect next month, are expected to help slow the national housing market.

OCR increases will likely be required next year. The extent and timing of the rise in policy rates will depend largely on the degree to which the momentum in the housing market and construction sector spills over into broader demand and inflation pressures. We expect to keep the OCR unchanged in 2013."

Summary

Despite strong recent performances, we believe that the foundations for further positive equity market returns remain in place.

Although investor uncertainty surrounding the eventual removal of policy support by the US Federal Reserve and slower Chinese growth will probably result in market volatility, we believe these issues will ultimately be outweighed by the economic recovery underway in the US, the gradual recovery in Europe and Japan and the broad valuation support that exists across the equity markets.

Furthermore, there are now clear signs of bond-to-equity switching on a large scale in the US mutual fund industry.

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Peter's disclosure statement is available free of charge upon request.