Investment Report – February 2014

As the residual influences and uncertainties of the global financial crisis (GFC) fade, we expect 2014 will be a year of solid, albeit uneven, growth for the global economy.

Significantly 2014 should be the first year in three where none of the major economies are in recession. Thus growth will be more balanced in contrast to prior years that were overly reliant on either China or the US to prop up weaknesses in Europe and Japan. Goldman Sachs forecast global growth to pick up to 3.6% in 2014 from 2.9% in 2013.

USA

The US is still the main engine of the world economy and it is likely to build further momentum during the year as the housing and employment numbers there continue to improve and capital spending in plant and equipment begins to recover.

Sales of new single-family homes fell more than expected by 7% in December, but lean inventories and steady price gains still suggested sufficient strength in the housing market to support the economy.

In late January, the Federal Reserve decided to reduce its bond buying programme by a further $10 billion as it stuck to its plan to wind down this stimulus programme. Importantly, the Fed will stick to its promise to keep interest rates near zero until well after the unemployment rate, now at 6.7%, falls below 6.5%, especially if inflation stays below 2%.

China

China grew at 7.7% in the fourth quarter of 2013, a little slower than the 7.8% of the third quarter. The slowdown was mainly driven by weaker infrastructure spending. However China is trying to pivot away from an investment-fuelled economy to one driven by domestic consumption and the slowdown in infrastructure building was a deliberate policy move.

Household incomes grew relatively quickly in real terms over 2013 so this should support greater consumption in 2014 and offset some of the weakness in public consumption and infrastructure spending.

Europe

We expect improvement in growth in the euro zone to continue, supported by Germany's strength and "less bad" outcomes for the periphery countries like Spain, Greece, Portugal and Ireland. The latest Markit Purchasing Managers' Index for the euro zone rose to 53.2 from 52.1 in December. A figure above 50 indicates expansion.

The UK economy grew by 1.9% in 2013, its strongest annual rate since 2007. However, excluding Germany and the UK, the rest of the euro zone countries are still presently suffering from stagflation. The zone's GDP in total is currently still below pre-GFC levels. With the euro in its present trading range, deflationary pressures are strong, particularly in southern Europe, and the zone is facing a classic economic choice between devaluation or deflation.

Japan

Japan reported a record trade deficit for the 2013 year due to the declining spending power of the yen after a series of aggressive government policy measures to stimulate the economy. Japan has seen the costs of its energy imports rise sharply in recent years after it shut all its nuclear reactors in the aftermath of the tsunami and earthquake in 2011 and it is now having to pay more for its imports.

Australia

Recent business conditions surveys have risen to a 2½ year high amid continuing low interest rates, higher share and house prices and a far weaker exchange rate. These results came as economists pushed back their forecasts for the Reserve Bank's next interest rate cut from May to November this year after a surprise jump in fourth quarter inflation and an improvement in overall business conditions. At the same time, while many sectors recorded improved conditions, in particular transport, utilities, retail and services, the manufacturing sector was still weak and falling while the mining and construction industries were steady.

New Zealand

The First NZ Capital Leading Indicator of Production continues to suggest that momentum is building in the New Zealand economy. This index estimates that the annual GDP growth rate is likely to accelerate from the actual 3.5% year-on-year recorded to September 2013 quarter to around 4.2% by year end.

In late January, after the OCR was left unchanged at 2.5%, the Reserve Bank said:

New Zealand's economic expansion has considerable momentum. Prices for New Zealand's export commodities remain very high, especially for dairy products. Consumer and business confidence are strong and the rapid rise in net inward migration over the past year has added to consumption and housing demand. Construction activity is being lifted by the Canterbury rebuild and by work in Auckland to address the housing shortage. Continued fiscal consolidation will partly offset the strength in demand. GDP grew by 3.5 percent in the year to September, and growth is expected to continue around this rate over the coming year.

While agricultural export prices are expected to come off their peak levels, overall export demand should benefit from improving growth in the global economy. However, improvements in the major economies have required exceptional monetary accommodation and there remains uncertainty about the timing of withdrawal of this stimulus and its effects, especially on emerging market economies.

Annual CPI inflation was 1.6 percent in 2013, and forward-looking measures of firms' pricing intentions have been rising. Construction costs are increasing and risk feeding through to broader costs in the economy. At the same time, there appears to have been some moderation in the housing market in recent months. The high exchange rate continues to dampen inflation in the traded goods sector, but the Bank does not believe the current level of the exchange rate is sustainable in the long run.

While headline inflation has been moderate, inflationary pressures are expected to increase over the next two years. In this environment, there is a need to return interest rates to more-normal levels. The Bank expects to start this adjustment soon.

The Bank remains committed to increasing the OCR as needed to keep future average inflation near the 2 percent target mid-point. The scale and speed of the rise in the OCR will depend on future economic indicators.

While the current strong economic momentum is expected to be a boon for New Zealand company earnings in 2014, interest rate rises pose a risk for some sectors of the equity market.

Summary

Global economic recovery leaves us positively disposed towards equities and we prefer to be overweight this asset class versus bonds and cash.

We see expected earnings growth of around 10% in 2014 as a good guide to return prospects for the year.

Moreover for the first time in many years the prospects for Global shares look even better than for New Zealand shares (rising interest rates and an election year) and Australia (low economic growth and a slower resource sector).

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