Investment Report – May 2014

A broad investment theme so far this year has been the generally positive news out of the US and the developed nations offset by a series of disappointing numbers from China. The major issues facing China are growth (lower than last year and slowing), credit (too easy, maybe encouraging a property bubble) and structural issues (how to grow consumption expenditure at the expense of capital expenditure).

USA

The economic recovery seems to be broadening and deepening rather than accelerating. In the first quarter of 2014, GDP grew at an annual rate of only 0.1%. An unusually disruptive winter and tumbling exports were the main culprits. The consensus view is that the economy will expand by 3%pa in the second quarter.

In March, the economy added 192,000 jobs, in line with expectations, and the unemployment rate was steady at 6.7%. The severe winter weather did not prevent the monthly average for new jobs from continuing a climb towards pre-economic crisis levels.

Growth in manufacturing accelerated in March from the previous month as productivity recovered from the severe winter weather. The ISM index rose to 53.7 from 53.2 in February. A reading above 50 indicates expansion.

Retail sales in March were up +1.1%, ahead of market expectations and the biggest gain in 18 months. In addition, February sales were adjusted upwards to +0.7% from the initial estimate of +0.3%.

As expected, in early May, the Federal Reserve decided to reduce its monthly bond purchases again by a further $10 billion to $45 billion.

China

Official government data showed that manufacturing expanded slightly in March. The Purchasing Managers' Index was 50.3 in March, up from an 8-month low of 50.2 in February. However, two other surveys indicated another contraction to the lowest level since last July. The figures underscore a growing concern that the Chinese economy may still be slowing. Indeed, the official GDP numbers for the country expanded by 7.4% in the first quarter of this year, which was slower than the 7.7% for the last quarter of 2013.

The government acted for the first time this year in April to stimulate the economy after the recent disappointing economic data by cutting taxes for small firms and speeding up the construction of railway lines.

Japan

A long-awaited tax increase took effect on 1 April, the first since 1997. The move, which will see sales tax rise from 5% to 8%, is intended to combat the country's rising debt as its population ages. Economists believe that this could lead to a slowdown in the world's third-largest economy.

Europe

Even though inflation fell to a 5-year low of 0.5%, the European Central Bank (ECB) kept its benchmark interest rate at a record low of 0.25% in March. March was the third month in a row when inflation fell, indicating the possible need for further intervention and stimulus, because the rate remains consistently below the 2% target.

The ECB has said it will provide further stimulus to the euro zone economy if inflation continues to stay low. The rise of the single currency's exchange rate is one of the key reasons why inflation has remained dangerously low. One remedial option would be quantitative easing.

Australia

The economy's growth rate is likely to be near 2.5% this year. Despite the unemployment rate still rising and resource sector capital investment still slowing from the strong rates of recent years, 2015 should register some improvement. There are now encouraging early signs of a hand over of mining-led growth to domestic consumption and the economy may well improve later in 2014.

Following soft domestic macro data in Australia, the RBA left the official cash rate unchanged at 2.5% in early April and shifted its view to a more neutral stance, suggesting a period of stable interest rates in the near term.

New Zealand

In mid April, the NZ Reserve Bank again raised the official cash rate (OCR) by 0.25% to 3.00%. At this time, it said:

"*New Zealand's economic expansion has considerable momentum, with GDP estimated to have grown by 3.5 percent in the year to March. Growth is gradually increasing in New Zealand's trading partners, but inflation in those economies remains low. Global financial conditions continue to be very accommodating.*

Prices for New Zealand's export commodities remain very high, though auction prices for dairy products have fallen by 20 percent in recent months. Domestically, the extended period of low interest rates and strong growth in construction sector activity are supporting the recovery. Net immigration continues to increase, boosting housing and consumer demand. Confidence remains very high among households and businesses, and measures of investment and employment intentions are positive.

Spare capacity is being absorbed, and inflationary pressures are becoming apparent, especially in construction and other non-tradable sectors. The high exchange rate remains a headwind to the tradables sector, and along with low import price inflation has been holding down tradables inflation. The Bank does not believe the current level of the exchange rate is sustainable.

There has been some moderation in the housing market. Restrictions on high loan-to-value ratio mortgage lending are easing pressure, and rising interest rates will have a further moderating influence. However, the increase in net immigration is adding to housing demand.

Headline inflation is moderate, but inflationary pressures are increasing and are expected to continue doing so over the next two years. In this environment it is important that inflation expectations remain contained. To achieve this it is necessary to raise interest rates towards a level at which they are no longer adding to demand. The speed and extent to which the OCR will be raised will depend on economic data and our continuing assessment of emerging inflationary pressures, including the extent to which the high exchange rate leads to lower inflationary pressure.

By increasing the OCR as needed to keep future average inflation near the 2 percent target mid-point, the Bank is seeking to ensure that the economic expansion can be sustained."

Summary

Shares have made strong gains over the last 15 months led by the New Zealand and Global markets. Even Australia with its declining dollar has managed to outperform NZ bonds in NZ dollar terms. We expect this trend to continue in 2014, albeit for shares at a slower pace and with more volatility.

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