Investment Report – August 2014

For the first 7 months of 2014 to 31st July, most share markets have maintained a positive momentum, particularly Australasian.

The returns for this period have been: US +4.5%, UK -0.3%, Germany -1.5%, Australia +7.6%, New Zealand +9.1% and Emerging Markets +7.7%.

The question now is, can economies, and thus company profits, still grow at a rate to sustain, or lift, share prices higher from the current levels?

USA

With a background of encouraging economic statistics, the Federal Reserve has begun detailing how it plans to ease the US economy out of an era of loose monetary policy, indicating it will end its asset purchases in October this year and appearing near agreement on a plan to manage interest rates in the future. Thus, the US sharemarket will likely soon face the headwinds of higher US interest rates, but maybe not until next year.

US employment growth increased by 209,000 in July, down from 298,000 in June, but more evidence that the economy is growing briskly heading into the second half of the year. The unemployment rate is now 6.2%, just above the 6.1% average for the last seven decades. Also, data for May and June were revised upwards to show a total of 15,000 more jobs created than previously reported. In addition, the ranks of the long-term unemployed shrank and the share of Americans with a job hit its highest level since August 2009.

US consumer prices rose in June at a slightly slower pace than in May with two-thirds of the June advance driven by the largest jump in gasoline prices in a year. US auto sales in July were the strongest for the month since 2006**,** and a rise of 9% above last year. As a result, GDP expanded at a strong 4% annual rate in the June quarter, confirming the view that the first quarter contraction was transitory.

China

China’s economic growth edged up in the June quarter and more than 7 million new jobs were created. The growth rate rose to 7.5% over a year earlier in line with the government’s growth targets.

China's trade surplus narrowed to $32bn (£18bn) in June after export growth slowed and imports increased, showing the economy is still stabilising after a weak start to the year. Exports rose by 7.2% from a year earlier, which was below market expectations for a 10.6% increase. Imports also missed forecasts, rising by 5.5 percent due to sluggish demand.

However, a Chinese manufacturing gauge rose to an 18-month high in July, bolstering the government’s chances of meeting its 2014 economic-growth targets.

Japan

Japanese Economics Minister Akira Amari warned that it would be premature for the Bank of Japan to consider an exit strategy from its massive stimulus program, voicing hope instead for further monetary easing if achievement of its inflation goal falls behind schedule. Amari also said that while Japan appears to be emerging from years of persistent price declines, it was too early to formally declare a sustained end to deflation with the economic recovery still vulnerable to external shocks.

Europe

In July, European Central Bank (ECB) president Mario Draghi said that euro zone interest rates would stay at 0.15% for an "extended period" of time. Mr Draghi was speaking after the ECB left rates on hold, a month after it cut them to help economic growth. In June, the ECB cut its deposit rate from zero to -0.10% and its benchmark rate from 0.25% to 0.15%.

In late July, IMF head Christine Lagarde warned that financial markets were maybe a little too upbeat given the persistently high levels of unemployment and debt in European economies. She also warned that continuing low inflation could undermine growth prospects in the region, but noted that the European economy was recovering and interest rates should stay low until demand picks up.

Australia

The CPI rose by 0.5% in the June quarter to give an annual rate of 3%. Despite rising consumer prices, the Reserve Bank of Australia looks likely to remain sanguine about this inflation rate because of sluggish consumer spending, wage restraint and job market weakness. Some economists even argue that the Reserve Bank may be forced to lower the official cash rate before the end of the year to slow the appreciation of the Australian dollar, which is currently a haven for foreign capital attracted by the high local interest rates. The confluence of weak domestic growth, an expected fall in inflation as the carbon tax is discarded and the high currency point to a possible rate cut.

If this came at a time when US interest rates were rising, the Australian dollar would fall sharply lower, nearer to levels sought by the Australian Reserve Bank.

New Zealand

New Zealand's economic growth continued to build momentum over the March quarter with Gross Domestic Product (GDP) increasing by 3.8% over the year. Leading indicators suggest that GDP growth is likely to accelerate further over the June 2014 quarter to annual growth of around 4.0-4.5%. However, it appears we may now be close to peak growth in the current economic cycle. In particular, recent softening in business and consumer confidence, the latest PMI and PSI surveys and further weakening of dairy and log prices suggests the best may have been seen.

The Reserve Bank lifted the official interest rate by 25 basis points to 3.5% in late July, as expected, but indicated a pause was coming to assess the impact over the next quarter or so, coinciding with the timing of the General Election.

Summary

We continue to see relative appeal in equities rather than bonds and we remain overweight this asset class for our clients, so long as they are comfortable with these increased risk levels.
The key positives for this stance are that the US recovery looks increasingly robust and interest rates and inflation around the world remain low. In the US, the Federal Reserve has retained a dovish stance on interest rates, while Europe and Japan are still in an easing mode.

After the Dow Jones Index passed 17,000 in July**,** the US market's next focus will be whether the current earnings season can justify US stocks continuing their climb further into record territory. Some commentators feel that many factors point to a second-quarter earnings season poised to surprise to the upside, with an outside chance that profits for S&P 500 companies could return to double-digit growth for the first time in nearly three years.

In New Zealand, the reporting season for our companies will begin in mid-August to test the recent share market highs here. We note that interest rates in New Zealand are gradually rising and share valuations here now appear somewhat elevated in historical terms. With a strong New Zealand dollar that is avowed to be well over-valued by the New Zealand Reserve Bank, better share buying opportunities may now well be offshore.

For some time now, we have been positive on the likely outperformance of shares and have positioned client portfolios accordingly. We now suspect that we are getting closer to the time when a more balanced approach between shares and bonds may be appropriate.

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