Investment Report – September 2014

Interest rates will eventually rise in the US, perhaps in mid-2015, and world bond and sharemarkets are braced for such a possibility. An interesting question is how far will they rise? The general view now seems to be that rates will remain low by historical standards.

USA

The US economy is still growing steadily. US manufacturing output rose broadly in July and automobile production recorded its largest increase in five years, boosting the economy at the start of the third quarter.

US housing starts surged to an eight-month high in July, suggesting the nation's housing market recovery is back on track after stalling in the second half of 2013**.** While the rebound points to sustained economic strength, other data showed inflation was largely under control, which could give the Federal Reserve room to maintain its ultra-easy monetary policy stance for a bit longer.

China

China's expected growth rate is 7.5% in 2014 and it appears on target. The consumer price index rose 2.3% in July from a year earlier, well below the 3.5% target for the year. Commentators expect inflation to stay stable this year, leaving room for interest rate cuts. China's trade surplus rose to a record high of $47.3bn in July, up from $31.6bn in June and much stronger than consensus of $27.4bn.

Japan

Japan struggles to make any headway. An increase in Japan's sales tax last April is blamed for the biggest contraction in its economy since the earthquake and tsunami in 2011. Gross domestic product (GDP) fell at an annual rate of 6.8% in the second quarter, offsetting the bump in demand in the first quarter, as consumers brought forward purchases to beat the tax rise.

Europe

In stark contrast to the United States, China and Britain, economic output in the euro bloc is likely to have all but ground to a halt in the three months to June. The sanctions squabble between Russia and the West over Moscow's backing of rebels in the Ukraine, and US air strikes to block Islamist militants in Iraq, are also upsetting the traditional markets.

The Eurozone's painfully slow economic recovery has bolstered calls for the European Central Bank to take aggressive measures to boost growth and halt a slide towards deflation. GDP was flat in the second quarter of 2014, compared with growth of 0.2% in the previous three months. Inflation fell to a four-and-a-half-year low of 0.4% in July. Dismal performances from Germany, France and Italy, the core of the single-currency region, were responsible for the stagnation.

Australia

As expected in early August, the Reserve Bank of Australia (RBA) left official interest rates unchanged at 2.5%. At that time, the RBA said: *"Monetary policy is appropriately configured to foster sustainable growth in demand and inflation outcomes consistent with the target. On present indications, the most prudent course is likely to be a period of stability in interest rates"*. The RBA was not saying that rates are on hold because the economy is in a sweet spot, rather, that consumer demand is only growing moderately, that resources sector investment is beginning to decline significantly and that signs of improved private sector investment remain tentative as firms wait for more evidence of improved conditions before committing to significant expansion.

Australia's jobless rate climbed to its highest level in 12 years in July, i.e. to 6.4% from 6% in June.

New Zealand

In August, dairy prices slumped to their lowest level in two years**,** taking some of the shine off New Zealand's "rock star" economy. Prices were down 8.4% at the Global Dairy Trade Auction, only a week after Fonterra cut its milk price farmer pay out forecast by $1 a kilogram of milk solids to $6/kg.

However, New Zealand's unemployment rate fell to a five-year low of 5.6% in the June quarter, as employment growth in Canterbury helped to fuel the labour market. Leading indicators of domestic activity continue to point to a softening in the New Zealand growth rate in 2015. In particular, recent surveys of business and consumer sentiment points to a slowing in the rate of growth from the peak of around 4% in the first half of the year.

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 this level of risk.

The key positives for this stance are that the US recovery looks increasingly robust while 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.

A diversified approach to investment, as always, remains appropriate.