Investment Report – October 2014

Global financial conditions remain accommodative with low interest rates and low volatility across a range of markets. Accommodative financial conditions are supporting a moderate rate of global economic growth, albeit quite uneven across the main regions. The world is now contemplating how the transition from the massive readjustment of the prevailing liquidity injections and low interest rates will play out in markets in the next few quarters.

USA

The US economy rebounded more strongly than initially thought in the second quarter of 2014, with a bigger chunk of the growth driven by domestic demand in a bright sign for the future. Gross Domestic Product (GDP) expanded at a 4.2% annual rate instead of the previously reported 4.0% pace. Both business spending and exports were revised higher, while a build-up in business inventories was smaller than previously estimated - a mix of growth that provides a stronger underpinning for the remainder of the year.

However, in early September, the US non-farm payrolls report showed US employers added only 142,000 jobs in August, missing expectations for 225,000 jobs in a Reuter's poll of economists and the slowest pace this year. Data for the previous two months were also revised a little lower. That prompted new concern about the pace of the US economic recovery and suggested that the Federal Reserve Open Market Committee will not signal higher rates at its next meeting after all. The unemployment rate in the US is now 6.1%.

Lower gasoline prices and better job growth encouraged consumers to open their wallets over the northern summer, pushing up sales at US retailers in August. Retail and food sales rose a seasonally adjusted 0.6% in August from July. Sales in July advanced 0.3% from June, up from an initial estimate that said spending had been flat. The revision largely dispelled concerns about a summer retail lull. US consumer prices fell for the first time in nearly 1½ years in August and underlying inflation pressures were muted.

In mid-September, the Federal Reserve renewed its pledge to keep interest rates near zero for a "considerable time," but also indicated it could raise borrowing costs faster than expected when it starts moving.

US manufacturing activity hovered at a near 4½ year high in September and factory employment surged, supporting views of sturdy economic growth this quarter. The economic picture was further brightened by other data showing acceleration in factory and services industry growth in some areas of the country.

Sales of new US single-family homes surged in August to their highest level in more than six years, a sign the housing recovery remains on course too.

China

China's manufacturing activity missed expectations in August, indicating that the country's economy may be losing some momentum and require more stimulus. The official Purchasing Managers Index (PMI) fell to 51.1 for the first time in seven months from 51.7 in July.

China's industrial production growth also slowed sharply in August, casting more doubts on the fragile economic recovery. Value-added industrial output rose 6.9% in August from a year earlier, slowing from a 9.0% on-year increase in July. The year-on-year expectations were for growth of 8.8%, whereas the numbers were actually only 6.9%.

Therefore, China looked likely to miss its 7.5% overall growth target unless there was further policy easing and, in mid-September, the People's Bank of China put $100 billion yuan ($18 billion) into each of its five biggest commercial banks for a 3-month period to ease liquidity and support lending in the property sector.

Japan

Japan's economy shrank 1.8% in the April-to-June period**,** worse than forecast and raising more questions about the government's economic policy. The official data confirmed that the world's third largest economy suffered its sharpest quarterly contraction since the 2011 earthquake disaster. On an annualised basis, it would mean gross domestic product (GDP) fell 7.1%.

Japan's consumer prices kept rising in July**,** with the inflation rate steady, but consumers and businesses were slow to shake off the hangover from the sales-tax increase in April. Policy makers and market participants are keenly watching how swiftly the economy gets back on its feet after contracting sharply in the April-June quarter following the rise in the local sales tax from 5% to 8%.

In mid-September, the Bank of Japan (BOJ) set a short-term interest rate below zero, a dramatic step in its already unprecedented effort to stoke inflation and a likely sign it will continue its aggressive asset purchases. The BOJ bought three-month bills for more than their redemption value, essentially paying to lend money to the market. The central bank's first purchase at a yield less than zero underscores its determination to pay literally any price to help reflate the long-moribund economy.

Europe

What started out more than four years ago as a banking and sovereign debt crisis is now turning into a growth crisis for the three major economies of Europe. Germany is now on the edge of a recession, France is mired in stagnation and Italy's GDP is barely above its level of 15 years ago. Since these three countries account for two-thirds of the euro zone's GDP, any growth now in places like Spain and the Netherlands is being swamped.

The euro zone inflation rate fell to 0.3% in August**,** near a five-year low, compared with a rate of 0.4% in July, adding to fears of deflation. The drop, driven by lower food and energy prices, added to pressure on the European Central Bank (ECB) to take action to further stimulate the economy. Also, the Purchasing Managers' indices showed that factory activity in Europe cooled in August after a strong July, as new orders dwindled in the face of escalating tensions in Ukraine and a patchy recovery in China.

In early September, the European Central Bank cut its benchmark interest rate to 0.05% and introduced new stimulus measures**.** The ECB had earlier cut its rate from 0.25% to 0.15% in June, and also became the first major central bank to introduce negative interest rates. It also launched an asset purchase programme, which will buy debt products from banks, to add liquidity to the financial system and revive lending.

Australia

As expected, the Reserve Bank of Australia (RBA) left the cash rate unchanged at 2.5% in mid-September. Australia's economy is likely to remain weak for the balance of this year and into 2015, as sliding commodity prices offset better news among consumers and in the housing market. Indeed, the Westpac-Melbourne Institute Leading Index, which indicates the likely pace of economic growth over the next 3 – 9 months, fell - 0.9% in August from the prior month's reading of -0.75%. This was the seventh month in a row for declines in this index. The prudent course for the RBA is likely to be a period of stability in interest rates.

In September, the RBA revealed at its interest rate-setting meeting that it was increasing its scrutiny of Australia's very buoyant housing market. It does not think housing is in a speculative bubble that will end in collapse, but it does see conditions that could make it happen and it will work with its sister regulator, the Australian Prudential Regulation Authority, to head off the prospect.

New Zealand

While the New Zealand economy continues to be supported by the stimulatory effects of Canterbury rebuild construction, strong net migration inflows and still above average aggregate commodity prices (despite recent sharp declines in log and dairy prices), leading indicators of business and consumer sentiment point to a further softening in the growth rate of the domestic economy over the second half of this year.

In mid-September, the Reserve Bank left the Official Cash Rate unchanged at 3.5%. New Zealand's economy is expected to grow at an annual pace of 3.7% over 2014. The economy seems to be adjusting to the policy measures taken by the Reserve Bank over the past year. House price inflation is easing, despite strong net immigration. CPI inflation remains moderate, reflecting subdued wage increases, well-anchored inflation expectations and weak global inflation. The New Zealand dollar is now at a 13-month low after the Reserve Bank intervened to force a downward trajectory in late September.

In late September, the National Party secured the first ever outright win under the Mixed Member Proportional (MMP) electoral system. A third term for Prime Minister John Key's Government was seen as a positive for current economic policies. The local sharemarket reacted well to the victory, especially the politically sensitive stocks such as the newly-privatised electricity generators now that the threat of a centrally controlled electricity market proposed by Labour and the Greens had been removed. There was also relief that the result did not contain the need for last-minute policy compromises with minor parties to form a coalition.

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 higher 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 maintains a dovish stance on interest rates, while Europe, Japan and now China are all in easing modes.

However, a diversified approach to investment, as always, remains appropriate. Moreover, as sharemarkets have risen strongly over the last few years and a regular analysis of clients' overall portfolio risk is now becoming a more necessary exercise.

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