Investment Report – November 2014

In October, the International Monetary Fund (IMF) downgraded its global growth forecasts. This organization that represents 188 countries is now projecting world growth of 3.3% in 2014, down 0.1% from its last forecast in July. However, in 2015, it expects growth of 3.8% led mainly by the USA.

USA

In the US, current economic statistics are mainly positive. The unemployment rate dipped to 5.9% in September, a six-year low. The rate fell from 6.1% in August and is the lowest recorded since July 2008. Employers added 248,000 in September and the job growth figures for August and July were revised upwards. In line with these positive outcomes, US auto sales and housing starts continue to recover, while consumer confidence is at a 7-year high too.

China

After some improvement in economic growth in the second quarter of 2014, the economy has started to weaken again, despite exports actually picking up meaningfully. The weakness in industrial and property investment is the major factor behind this slowdown. Against an official target of 7.5%, Gross Domestic Product (GDP) rose 7.3% in the July-September period.

Indeed, the World Bank recently cut China's growth forecast for the next three years as the country tackles its structural reforms. It said that "the growth in the world's second-largest economy will fall to 7.4% from a previous estimate of 7.6%. Growth will gradually slow as efforts to address financial vulnerabilities and structural constraints increase. Growth in 2015 will go down to 7.2% and then 7.1% in 2016 from a previous forecast of 7.5% for both years".

Despite the weak structural growth momentum, there is little chance of a hard landing given the large array of tools in the government's hand. Indeed, China's banks stepped up lending at an unexpected volume in September, a sign that the government wants to boost credit to re-energize the economy.

Japan

Shares in Tokyo staged their biggest rally in 16 months in mid-October as the market rallied on news that Japan's Government Pension Investment Fund, the world's largest public pension fund with some US$1.21 trillion in assets, is working on raising its portfolio allocation devoted to domestic shares from 12% to around 25%. This country, and its sharemarket, should also benefit from the fast-falling oil price.

Emerging Markets

Growth in emerging markets is slowing to its lowest ebb since the aftermath of the financial crisis due to a combination of China's fading dynamism, a spluttering performance in Eastern Europe and Latin America's slowdown. Evidence that emerging economies are entering a new era of slower growth will fuel concerns for the global outlook as western countries continue to struggle, the oil price lurches towards a four-year low and Eurozone stalwart Germany suffers from declining growth.

Europe

In October, the European Central Bank President, Mario Draghi, offered a firm assurance that the ECB will successfully boost inflation in the Eurozone from its ultralow levels and that it is willing to enact more monetary stimulus, if needed. His comments suggest that, even after significant easing steps in June and September, the ECB is still in stimulus mode, in contrast with the US Federal Reserve and the Bank of England, which are considering tighter policies next year.

In Germany, exports in August suffered their biggest monthly fall since January 2009, adding to a recent spate of dismal economic indicators from the Eurozone's largest economy.

In contrast, the UK unemployment total has fallen below two million for the first time in almost six years. The number of jobless people fell by 154,000 to 1.97 million in the three months to the end of August. The drop, which is bigger than analysts expected, took the unemployment rate to 6%, its lowest level since late 2008.

Australia

In October, the Reserve Bank of Australia (RBA), as expected, left the Australian cash rate unchanged at 2.50% and signalled continued stable policy.

Falling real wages, rising unemployment and fears about job prospects are restraining investment and spending in Australia. Traditional guide posts for the economic outlook have provided numerous false-dawns on the much awaited non-mining economic recovery over the past year: the more powerful forces of declining terms of trade, a sharp fall in mining investment, few incentives to drive a pickup in broader business investment, ongoing fiscal consolidation challenges and an uncompetitive production base relative to Australia's trading partners, have instead dominated.

In the September quarter, Australia's rate of inflation increased by 0.5%, taking the annual pace of inflation down from 3.0% to 2.3%. Inflation is, therefore, well within the Reserve Bank's (RBA) 2%-3% target range.

New Zealand

The gloss has dulled on New Zealand's strong economic outperformance story. Whereas at the start of the year the message was of an economy that was growing well above trend and, although generally expected to moderate, was facing more upside risks than down. This message has now shifted to one where economic momentum has actually slowed and the risk profile for the outlook now contains some meaningful downside scenarios. The dairy sector, and financial strains that are emerging, top the list of worries. Along with a more fragile global backdrop, contained inflation pressures moderating growth momentum and a still elevated NZD, it is quite possible that the RBNZ could be on an interest rate hold for all of 2015. Annual inflation in the September quarter of 1% proved even more benign than forecast.

In mid-October, dairy prices stabilised but a sub-NZ$5 pay-out to farmers remains highly likely for the current season.

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 and the renewed volatility. The key positives for this stance are that, while the US recovery looks increasingly robust, interest rates and inflation around the world remains 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.

As doubts increase around the prospect of higher global economic growth, the need for higher interest rates is evaporating and even further accommodative monetary policy may be required. If US interest rates remain low and global growth fails to eventuate, New Zealand interest rates will also remain lower for longer.

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

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