Investment Report - December 2014

The US is growing at a steady rate but the rest of the world is not as vibrant. Japan's economy is now officially in a recession and Europe is teetering on the brink of one. China is still growing but at a slower pace, after being one of the main drivers of the global economy in 2013. Russia is struggling with lower oil prices and economic sanctions, while Brazil is in a recession and trying to avoid a credit downgrade. The rapid moves underway in currency markets, driven by stark variations in world growth rates and monetary policies, might make their way into markets in 2015.

USA

The U.S. economy expanded at a healthy pace during the September quarter, a sign of sustained growth fuelled by government spending and a narrower trade deficit, despite mounting concerns about the health of overseas economies. Gross domestic product (GDP), the broadest measure of goods and services produced across the economy, advanced at a seasonally adjusted annual rate of 3.5% in the third quarter.

US manufacturing activity unexpectedly accelerated in October and automobile sales were strong, easing concerns of a significant moderation in economic growth in the fourth quarter. The pick-up in manufacturing, which was driven by robust growth in new orders and production, suggested the economy was weathering a slowing of demand in major markets such as China and the euro zone. Furthermore, the economy added 214,000 jobs in October, while the unemployment rate fell to 5.8%. These figures are a significant gauge of the health of the economy: US employers have added at least 200,000 jobs for nine months in a row, the longest growth period since 1995.

China

In October, a gauge of China's manufacturing activity fell to a five-month low, despite a series of government support measures aimed at aiding growth, suggesting that more help may be needed to boost the world's second largest economy. China's official Manufacturing Purchasing Managers' Index dropped to 50.8 in October from 51.1 in September.

In mid-November, the People's Bank of China surprised the markets by announcing a 40 basis point (bp) cut in the one-year lending rate to 5.6% and a 25 bp cut in the one-year deposit rate to 2.75%. This was China's first rate cut since July 2012.

Japan

Japan's economy unexpectedly shrank for the second consecutive quarter, leaving the world's third largest economy in a technical recession. GDP fell at an annualised 1.6% from July to September, compared with forecasts of a 2.1% rise. That followed a revised 7.3% contraction in the second quarter, which was the biggest fall since the March 2011 earthquake and tsunami.

The yen plunged and the Nikkei share index jumped after the Bank of Japan announced on 31 October that it would increase its asset buying programme to 80 trillion yen a year, from a previous rate of 60-70 trillion yen, in an attempt to encourage more lending and boost spending. Japanese core machinery orders rose for the fourth straight month in September, suggesting capital spending remains solid even as consumer spending falters in the wake of the April sales tax increase, while exports grew in October at the fastest pace in eight months, an encouraging sign that global demand could help the country recover from recession and support the central bank's optimistic economic outlook.

Europe

The economy of the 18-country strong euro zone will grow by only 0.8% this year**,** the European Commission has said. This forecast is below the 1.2% estimate made earlier this year. The Commission has also has cut its growth forecast for 2015 to 1.1% from 1.7%.

Inflation in the euro zone rose slightly in October**,** giving some hope that the spectre of deflation can be staved off, but GDP figures confirmed sluggish activity in the third quarter, growing by just 0.2% quarter-on-quarter. The figure was slightly better than expected. Germany registered growth of 0.1% in the third quarter, allowing the largest economy in the euro zone to dodge recession, while French GDP expanded 0.3%, coming after a slight contraction in the second quarter. However, Italy's GDP contracted 0.1% in the third quarter. On more upbeat notes, Spain's GDP grew 0.5% and Greece posted growth of 0.7%, marking an end to its recession.

The European Central Bank has now started buying asset-backed securities in a move to encourage banks to lend and revive the economy.

Australia

In recent months, the Reserve Bank of Australia (RBA) has kept the cash rate at 2.5%, repeating its statement that current monetary policy is "appropriately configured to foster sustainable growth in demand and inflation outcomes consistent with the target". However, the lie of the land seems to be shifting in favour of a possible stimulatory interest rate cut next year according to market pundits.

At present, the RBA still believes that the recent sharp declines in the prices of key commodities like iron ore warranted further declines in the value of the Australian dollar, which would spur economic growth on its own. However, Goldman Sachs has cut its estimate of economic growth for 2015 in Australia to 2% from 2.3% and listed a rate cut in the first half of next year as a "high probability". Credit Suisse says that leading indicators including confidence and inflation expectations are consistent with weaker growth and suggest that "a case can be made for further interest rate cuts".

New Zealand

The New Zealand Institute of Economic Research expects the economy to grow 3.4% this year but then slow, to a moderate average rate of around 2.5% over the next five years.

In late October, the Reserve Bank left the Official Cash Rate unchanged at 3.5%, as expected. At that time, it said that:

"Growth in the New Zealand economy has been faster than trend over 2014, reducing unemployment and adding to demands on productive capacity. Strong construction sector activity, high net immigration, and interest rates, which remain low by historic standards, continue to support the expansion. Output growth is expected to moderate over coming years, towards a more sustainable rate.

Lower commodity prices and increased global financial market volatility have taken some pressure off the New Zealand dollar. However, its current level remains unjustified and unsustainable and continues to constrain growth in the tradables sector. We expect a further significant depreciation.

The economy appears to be adjusting to the policy measures undertaken by the Bank over the past year. CPI inflation is currently at a low level despite above-trend growth. However, inflation is expected to increase as the expansion continues. A period of assessment remains appropriate before considering further policy adjustment".

We agree with the view that the New Zealand dollar could weaken, especially as we reflect on the impact of a much weaker milk price for dairy farmers.

Summary

Over the long term, sharemarket returns are generated from company earnings prospects. The continued expansion of the business cycle and relatively muted wage growth pressures should provide support to revenue growth and maintain profit margins for the next few years. Interest rates that are lower for longer also support equity values, especially in the higher yield markets of New Zealand and Australia.

Therefore, 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 volatility. In a world facing low inflation and growth against a back drop of very cheap money, real asset like shares should continue to attract investors. A potentially depreciating NZD over the next year or so is a key pillar behind our preference now for unhedged global equities.

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.