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Investment Update – February 2017

2017 will be a year of stronger global economic growth. The incoming US administration promises to stimulate an economy already enjoying considerable momentum, while the Chinese authorities are expanding fiscal policy. Meanwhile, global PMIs (purchasing managers' indices) are once again rising in tandem. For shares, earnings momentum has already started to turn higher in each of the major global markets to help to support their valuations.

USA

In January, the World Bank said that the U.S. economy is picking up steam and stabilizing commodity prices are helping major emerging-market economies rebound as well. The bank estimates that Donald Trump's proposals to slash corporate and personal income taxes could add up to 0.3% to American growth this year and up to 0.8% next year.

However, he is forming an economic team with competing power centres and contrasting views that could lead the White House in unpredictable directions, as it tries to steer the U.S. toward even faster growth, and provide some market volatility. He has market-oriented advisers from the Washington and Wall Street establishment on one side and free-trade sceptics on the other.

China

The economics get-together of world leaders at Davos earlier this year will be remembered as delivering one of the strangest episodes in global economic history, as it marked a moment in time when a communist party leader lectured the US President about the benefits of free trade and economic openness.

Chinese President Xi Jinping issued a full-throated defence of international trade and economic integration, as doubts about the merits of globalization mount in the U.S. and elsewhere in the West. "No one will emerge as a winner in a trade war," Mr. Xi, the leader of the world's second-biggest economy, said to members of the world elite gathered for the annual World Economic Forum. "Pursuing protectionism is just like locking one's self in a dark room. Wind and rain may be kept outside, but so are light and air."

In December, China's PPI (producer price inflation) surged to a five-year high of 5.5% YoY (previously 3.3% YoY), way above market expectations. The increase was broad-based across subcomponents but most pronounced in the mining and raw materials sectors due to rising commodity prices as well as a weaker currency. Contrary to producer prices, consumer price inflation moderated in December to 2.1% YoY (from 2.3% YoY), as food price inflation normalized from elevated levels.

Japan

After a long year in 2016, the Bank of Japan (BOJ) now unexpectedly finds itself in a sweet spot. The yen has tumbled in recent months, thanks to surging global bond yields, while economic conditions at home and abroad are improving. Though less than bullish, the outlook for the world's third-largest economy looks more promising than it has for some years. One risk now is that the yen falls too far, too fast, hurting consumers' purchasing power just as they seemed to be finally shaking off the effects of a 2014 sales-tax increase.

Economists have speculated that the BOJ will need to lift its current rate target for the yield on the 10-year Japanese government bond from around zero percent to minimize the rate divergence that is helping to fuel yen weakness.

Europe

Mario Draghi, head of the European Central Bank (ECB), faces risks highly charged elections in the euro zone's biggest economies this year. Barely a month after announcing a half-trillion-euro extension of the ECB's quantitative-easing program and hinting the bank would do little for most of 2017, its president is back in the spotlight amid an anti-European Union backlash across the region. ECB officials extended their bond-purchase program by a longer-than-expected nine months in December 2015 to help counter potential volatility "relating in particular to shocks emanating from the political environment."

Australia

In January, Australian CPI data saw inflation surprising to the downside. In the fourth quarter, CPI rose by only 0.4%, taking year-ended core inflation lower to 1.6% from 1.7%. Headline CPI was also subdued, rising by only 0.5% in this last quarter.

We now expect the Reserve Bank of Australia to downgrade its growth forecasts for the economy and a February official rate cut is a "close call".

New Zealand

We expect GDP growth to moderate from 3.3% in 2016 to a still respectable 3.0% in 2017, albeit with some renewed inflation. The December 2016 quarter CPI outturn showed a quarterly increase of 0.4% and an annual rise of 1.3%.

Any potential official interest rate increase this year is complicated by RBNZ Governor Wheeler's term expiry in September and the pending New Zealand election. Consensus is therefore for a late 2017, or early 2018, rise in rates.

The current supportive economic factors include high net immigration, the strong tourism and building sectors and the current low OCR setting of 1.75%, while negative factors are the high NZ dollar, excessive house inflation, slower domestic growth on a per capita basis and the rise in political uncertainty in the run-up to the general election this year.

Summary

Even after the strong rise in share values over the last 8 years, we are cautious but not bearish on shares as there is no sign of recession for 2017 and financial authorities appear prepared to do whatever is required to ensure that the financial markets are well supported. Moreover, projected company earnings growth should support current share market valuations.

However, we also note that inflation and longer term interest rates are starting to rise, signalling the probable end of the 35-year bull market in bonds. This may well prove a headwind for equity markets later this year.