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Investment Update – March 2017

Looking back on 2016, two events stand out: Brexit and the US presidential election. In both cases, polls on results were wrong, but share markets still defied expectations - and rose. In 2017, we expect US politics and policies will again play a major role in driving markets and creating volatility. In addition, now, accelerating world growth and inflation, a stronger US dollar and a resurgent commodity cycle confound the investment outlook.

USA

In January, the Federal Reserve signalled it remains on course for further increases in short-term interest rates this year as inflation heads back towards target levels, but it avoided giving strong indications on the timing of the next move. The US central bank's Federal Open Market Committee left the federal funds target range at 0.5% to 0.75%, following a 0.25% increase at the prior meeting in December. The unchanged move was expected by markets and financial analysts. Non-farm payrolls increased by a strong 227,000 in January, higher than the upwardly revised 157,000 in December and above market expectation of 175,000. The unemployment level now stands at 4.8%.

China

In early February, the People's Bank of China (PBOC) increased interest rates on OMOs (open market operations) by 10bp and on its SLF (standing lending facility) by 10-35bp, shortly following the rise in interest rates on its MLF (medium-term lending facility) in January. We believe that the PBOC will retain its tightening bias in the near term as the underlying financial leverage and macroeconomic arguments for tightened monetary policy have largely remained. Chinese overseas deals worth almost $75bn were cancelled last year as a regulatory clampdown and restrictions on foreign exchange caused 30 acquisitions with European and US groups to fall through. The figures, which reveal a sevenfold rise in the value of cancelled deals from about $10bn in 2015, highlight a waning appetite for global deal-making by the world's second-largest economy.

Japan

The 2016 current account came in at a surplus of ¥20.6 tn, up ¥4.2 tn from the prior year. This represents the first recovery to a surplus over the ¥20 tn mark since 2007 and primarily reflects a turn to surplus in the trade balance of ¥5.6 tn. While 2016 exports were down, at -8.5% yoy, imports saw an even larger decline, of -16.6%.

Europe

The US bond markets remain calm, but Europe is not quite so stable with upcoming elections in France, Italy and the Netherlands causing some investor discomfort. It was only a few months ago that Europe seemed to be facing deflation or stagflation but now inflation is returning. Bond investors are migrating to safer assets such as German and UK bonds rather than bonds in the remaining European countries.

Australia

In mid-February, the Reserve Bank of Australia (RBA) kept the Australian cash rate unchanged at 1.50%. The RBA's policy stance presently remains neutral. Importantly, officials continue to highlight income gains from terms of trade improvement, with the potential for these gains to support the mining capex cycle. Officials see the third quarter contraction in real GDP as temporary and expect growth to return to a 3% per annum pace. They also remain of the view that core inflation will bottom at 1.5% per annum. However, 2017 will be a difficult year owing to weakness in business capital spending, fragility in residential investment, a cash flow squeeze on consumers and limited scope for import substitution. The delayed effects of macroprudential and exchange rate tightening are likely to manifest this year. Having said this, there is no incremental tightening effect visible just yet to prevent a moderate recovery. We expect the RBA may cut rates in 2017: in our view, we are unlikely to get a sufficiently large, timely or sustained fiscal stimulus package to prevent the RBA from cutting further. Australia's unemployment rate fell to 5.7% in January.

New Zealand

In mid-February, the Reserve Bank of New Zealand (RBNZ) kept the New Zealand cash rate unchanged at 1.75%. We expect no changes this year. The New Zealand economic backdrop suggests a continuation of above trend growth, with near-term GDP growth expected to be in the region of 3.0-3.5%. Underpinning this growth environment continues to be the drivers of historic high levels of net migration and tourist arrivals. While there are initial signs that recently introduced loan to value restrictions from the RBNZ are beginning to negatively impact on housing market activity, the broader construction sector is expected to continue to be a positive contributor to growth over the year ahead. The upward movement in annual headline CPI inflation over the December 2016 quarter back into the RBNZ's 1-3% inflation target band largely reflected the effect of higher housing-related prices, together with the impact of petrol price-induced weakness seen in the December 2015 quarter falling out of the annual calculation. The movement of annual headline inflation to back within the RBNZ's 1-3% inflation target band is likely to be of some comfort to the RBNZ, following the previous two years in which CPI outturns have been below the bottom of the band. New Zealand continues to create growth without much inflation accompanied by significant job expansion, rising fiscal surpluses and a well contained current account balance. An improving global economy and growing tailwinds from rapidly increasing dairy revenues are adding to business optimism.

Summary

The last eight years have been characterised by low growth, low interest rates and low inflation, as governments have moved to stimulate the global economy after the global financial crisis. These policies have been largely successful, so we are now entering a higher growth phase. However, there are uncertainties to this positive outlook, given the policy stance of the new US administration and its global ramifications. Nevertheless, in the short term, we think markets will be supportive and, with some volatility, probably "grind higher".

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