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Investment Update – June 2017

Many economists continue to forecast a synchronised global economic recovery: they expect global real GDP growth at 3.0% in 2017 and 2.9% in 2018 compared with 2.5% in 2016. Even though expectations for the size, scope and timing of US tax cuts have diminished, it is still possible a significant fiscal package will be passed in the US, providing the global economy with a further tailwind in 2018.

Tighter labour markets and rising business confidence should strengthen investment spending in the USA and Europe, while private capital expenditure in China has rebounded. China's accelerating investment growth should support robust demand for commodities for the remainder of 2017.

USA

In early May, the Federal Reserve left official interest rates unchanged so the probability of a June rate hike has moved higher. Janet Yellen acknowledged that household spending growth had grown “only modestly” lately, but emphasised that the “fundamentals” behind consumption growth remained solid. US non-farm payroll jobs data in April was stronger than expected (+211,000 actual versus +185,000 expected), unemployment fell to 4.4% (a 10-year low) and wages growth was +2.5% year-on-year versus +2.7% expected.

The consumer price index (CPI) increased by just 0.17% in April and the year-on-year rate fell by two tenths to 2.2%.

China

The economy had a strong start to the year with GDP growth of 6.9% compared with the same quarter last year. Industrial output rose by an impressive 7.6% in the same three months. The economy continues its rebalancing with consumption now accounting for a much larger proportion of this growth.

Japan

The Governor of the Bank of Japan said that he will continue with very accommodative monetary policy and maintain the current pace of asset purchases for some time yet.

While Japan’s economy is doing better than a few months ago, he said that the inflation rate is still quite sluggish, the exchange rate could affect inflation in the short term and that, if the yen appreciates, there is a chance of a delay in hitting Japan’s 2% price goal.

Europe

The euro area GDP growth of 0.5% quarter-on-quarter in the first quarter of the year was in line with (the quite robust) expectations i.e. an annualised rate of about 2%pa.

Australia

As widely anticipated, the RBA left the cash rate unchanged in early May. Its meeting statement was also little changed from the April version. The Bank did say that the data is evolving broadly in line with its expectations, that growth would return above 3% and that core inflation is rising back to the target band. Officials also noted that the terms of trade continue to boost national income, although some of this effect is in the process of reversing.

In mid-May, the government issued its Budget: it was contractionary in nature, with the deficit expected to shrink from 2.1% of GDP in 2017 to 1.6% in 2018. It could be argued that the combination of sub-trend GDP growth, above-trend unemployment and near stagnant wage inflation require bigger deficits in the near term, not smaller.

The main feature was a new levy on the big four banks and Macquarie Group. The new tax will cost these five companies around $1.5bn p.a., or about 5% of current profits.

New Zealand

The next move in NZ rates will probably be higher, but the move is still likely to be a mid-2018 story. In mid-May, the Reserve Bank left the Official Cash Rate (OCR) unchanged at 1.75% and said:

"Global economic growth has increased and become more broad-based over recent months. However, major challenges remain with on-going surplus capacity and extensive political uncertainty. Stronger global demand has helped to raise commodity prices over the past year, which has led to some increase in headline inflation across New Zealand's trading partners. However, the level of core inflation has generally remained low. Monetary policy is expected to remain stimulatory in the advanced economies, but less so going forward.

The trade-weighted exchange rate has fallen by around 5% since February, partly in response to global developments and reduced interest rate differentials. This is encouraging and, if sustained, will help to rebalance the growth outlook towards the tradables sector.

The increase in headline inflation in the March quarter was mainly due to higher tradables inflation, particularly petrol and food prices. These effects are temporary and may lead to some variability in headline inflation over the year ahead. Non-tradables and wage inflation remain moderate but are expected to increase gradually".

Summary

The environment for equities remains broadly neutral, as central banks unwind their stimulatory policies in response to improving growth prospects rather than the need to stamp out any problematic rising inflation.

However, even though interest rates are starting to rise, bonds are not yet particularly attractive. In May, the relative calm in sharemarkets drove a widely-watched measure of anxiety, the CBOE Volatility Index, or VIX, to its lowest level since 1993.

Investors appear to be as sanguine about the stock markets as they have been in almost a quarter of a century, despite months of global political turmoil. May's election result in France of the centrist candidate Emmanuel Macron as president helped remove a major market overhang and gave investors more confidence that shares are unlikely to face a big selloff.

A balanced and diversified approach to investment remains appropriate.

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