Investment Update – July 2017

In the current sharemarket environment of low volatility but high valuations, the main headline issue to worry about for global investors seems to be a possible credit melt-down in China. Any set-back in China could trip up the bull market in the US and around the world.

While we can also worry about a belligerent North Korea and the potential failure of President Trump to implement meaningful tax reform, the recent moves by Chinese officials to tighten the screws on credit growth may have pushed China to the top of investors' current list of concerns.

USA

In mid-June, the Fed lifted official interest rates by 0.25%, as expected, and indicated there will likely be another similar increase this year, even though recent economic data has been a little disappointing with jobs growth undershooting expectations and core inflation staying near 1.5%, well below the 2% target.

The US economy showed signs it was leaving behind a soft start to 2017 as new data revealed consumer spending grew at its quickest pace of the year in April, suggesting the world's biggest economy was shrugging off political turmoil and was again poised to lead a global recovery. Consumer spending is the key driver of the US economy and a slowdown earlier in the year held gross domestic product growth to an annual pace of just 1.2% in the first quarter. However, in May, retail sales decreased 0.3% versus consensus expectations for a flat reading and the consumer price index (CPI) fell 0.13% over the month.

The year-on-year rate of CPI inflation, stripping out fuel and food, fell to 1.7% in May, its lowest level since 2015. The US unemployment rate now stands at 4.3%, down from 4.4%.

China

The current waxing and waning of Chinese policy announcements occur as the authorities try to ensure economic stability while they undertake the very large task of broad economic reform. China's official Purchasing Managers' Index (PMI) for May beat expectations at 51.2 which was level with the April reading. Any number above 50 indicates an expansion in activity. Annual retail sales growth was unchanged in May from April too.

Japan

Bank of Japan (BOJ) Governor Haruhiko Kuroda said the country had escaped from deflation but still had more progress to make before reaching its goal for 2% inflation. He said that "the rate of change in the consumer price index recently has been around zero, so there is still a long way to go until the price stability target of 2% is achieved."

Japan's economy grew at an annual rate of only 1% in the first quarter but gross domestic product (GDP) expanded for a fifth straight quarter, the longest streak in a decade. The BOJ held its Monetary Policy Meeting on June 15-16 and maintained its monetary policy in all categories, including both targets for short- and long-term interest rates (short-term: -0.1% and long-term: 0%) and asset purchase programs, as widely expected.

Europe

According to its President Mario Draghi, the euro zone still needs “an extraordinary amount of monetary support” from the European Central Bank (ECB) in spite of its growing economic recovery. Mr Draghi said that he was “firmly convinced” the ECB needed to stick with measures that have been controversial in Germany, including €60bn of monthly bond purchases to try to underpin the economic revival. A decision on when to rein in the stimulus programme, known as quantitative easing, is one of the key judgments for Mr Draghi and the ECB as the euro zone continues to rebound from a long economic crisis.

Consumer confidence in the euro zone reached a new ten-year high in May, the increase is supported by lower unemployment and more resilient growth.

Australia

In early June, the RBA left rates unchanged at 1.5%, as expected and for the ninth time in a row. Officials continued to talk up longer-term growth and rebalancing prospects, dismissing the weakness in first quarter GDP as temporary. GDP expanded +0.3% in the first quarter and +1.7% year-on-year, in line with consensus expectations. This was an encouraging outcome in the context of; i) earlier widespread speculation of a contraction in activity, ii) the robust expansion reported in the fourth quarter of 2016 (strongest in over 5 years), and iii) adverse weather conditions for housing construction.

Surveyed consumer sentiment fell for a third month in June by - 1.8%. Overall, consumer sentiment remains quite subdued for now - in contrast with elevated business sentiment and improving labour market conditions. However, we do expect a gradual recovery in consumer sentiment over the remainder of the year as the labour market continues to improve and nominal wages recover.

New Zealand

The outlook for the NZ economy remains positive and has been given an additional boost from an election year budget. Furthermore, it appears that the Reserve Bank of NZ wants to be in no doubt that inflation is back before raising interest rates here. Conversely, the US Federal Reserve appears keen to get on with the job of reducing monetary policy stimulus and the NZ dollar is thus left trapped in the middle of an unsupportive interest rate environment and a solid economy.

Summary

From an economic perspective, the global economy appears to be in good heart. However, there is presently an element of complacency in financial markets where volatility indices are at record lows.

While there are no real signs of an imminent economic recession, the usual precursor of a ‘bear’ equity market, investor complacency leaves little room for error when equity markets are at record highs.

A balanced and diversified approach to investment remains appropriate: as well, clients should remain close to their benchmark targets for risk control.