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Investment Update – August 2017

The first half of 2017 has seen global shares and fixed interest securities deliver returns well above average, while the US dollar and commodities like oil have declined much more than expected. The prospects for world growth are still sound but, in late June, there was some concern in the markets around likely central banks' policy tightening in the second half of this year, i.e. Janet Yellen (US), Mario Draghi (Europe) and Mark Carney (UK) all hinted that better-than-trend growth must eventually lead to normalisation and higher official interest rates.

USA

A sustained run of weak US inflation readings has yet to derail the Federal Reserve's plans to start unwinding quantitative easing as soon as September this year. The sensitivity of efforts to unwind crisis-era stimulus were underscored in June as top officials in the euro area, Canada and the UK struggled to fine-tune similar messages, triggering a mini bond market sell-off, but the US is sticking to the basic case that falling unemployment will eventually drive up price growth and that tightening remains in order.

Janet Yellen reiterated plans for gradual rate rises and said the Fed's balance sheet plans were "well understood" by markets, but other officials warned that allowing unemployment to fall too low could lead to the US economy overheating, or the emergence of financial excesses.

US nonfarm payrolls increased by 222,000 in June, slightly better than the expected 178,000 new jobs.

China

China's June headline CPI inflation was unchanged from May at 1.5% year-on-year, marginally below consensus of 1.6%. The second quarter real GDP growth and June activity growth indicators were all above expectations i.e. real GDP growth: +6.9% year-on-year, industrial production: +7.6% year-on-year and retail sales: +11.0% year-on-year.

We see the strength of this activity growth coming mainly from firm external demand, but the depreciation of the RMB effective exchange rate is also likely to have contributed. We expect the Chinese economy will be resilient ahead of the 19th Communist Party Congress in November.

Japan

In late July, the Bank of Japan (BOJ) raised its forecasts for growth but lowered its projections for inflation, postponing by a year the timetable for hitting its 2% target level. It is the sixth delay since the BOJ started on huge purchases of government bonds and other assets in 2013.

Europe

In late June, the European Central Bank (ECB) renewed debate over its €60bn of monthly asset purchases, sending government bond prices lower as markets anticipated a possible end to the euro zone's ultra-loose monetary policy. The minutes of the ECB's June meeting showed that officials discussed whether to end the central bank's promise to step up the pace of asset purchases, if needed to stimulate the euro zone economy.

After discussion, the ECB decided not to change course, maintaining its guidance to markets that it stood ready to increase bond buying, if needed. However, it did end a similar pledge to cut interest rates further, if warranted. Consumer confidence in the euro zone reached a new ten-year high in May, this increase is supported by lower unemployment and more resilient growth.

Australia

In early July, the RBA left interest rates unchanged and said: As expected, GDP growth slowed in the March quarter, partly reflecting temporary factors. The Australian economy is expected to strengthen gradually, with the transition to lower levels of mining investment following the mining investment boom almost complete.

Business conditions have improved and capacity utilisation has increased. Business investment has picked up in those parts of the country not directly affected by the decline in mining investment.

At the same time, consumption growth remains subdued, reflecting slow growth in real wages and high levels of household debt. Indicators of the labour market remain mixed. Employment growth has been stronger over recent months.

The various forward-looking indicators point to continued growth in employment over the period ahead. Wage growth remains low, however, and this is likely to continue for a while yet. Inflation is expected to increase gradually as the economy strengthens.

The outlook continues to be supported by the low level of interest rates. The depreciation of the exchange rate since 2013 has also assisted the economy in its transition following the mining investment boom. An appreciating exchange rate would complicate this adjustment.

New Zealand

Economic indicators continue to paint a solid outlook for the economy. There are pressures in some sectors with tourism facing infrastructure constraints, house construction running at close to full capacity and some mortgage interest rate increases. However, consumer confidence is solid, supported by firm house prices, low unemployment and increased government spending. The wild cards for future growth are immigration, which remains high under the current government, and the forthcoming election result.

Over the June quarter, consumer price inflation did not change, reinforcing the Reserve Bank's view that there is no need to raise interest rates at present. This zero movement in the CPI meant that the annual increase was a lower-than-expected at 1.7%, after reaching 2.2% in the March quarter. This means that the economy is not in danger of over-heating and there may not need to be any official cash rate hikes for some quarters.

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.

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