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Investment Update – November 2017

There is no sign that the synchronised upturn in the world economy is running out of steam. The two hurricanes which recently hit the US should only have a short-lived impact on this economy's growth while the latest business surveys suggest that activity in the euro-zone, Japan and China remains strong.

Thus, global economic data continues to portray relatively robust global growth and little inflation. Forward-looking inflation indicators remain relatively low, suggesting a modest pace in any normalisation of monetary settings. As a result, share valuations around the world remain elevated and investors are cognisant of many risks, including geo-political events.

USA

The US Fed's decision to begin scaling back its balance sheet nearly eight years after it started quantitative easing is a major milestone, but global financial conditions should remain highly accommodative for a long time yet. The latter are probably more influenced by total central bank asset purchases throughout the world, which are likely to slow but remain positive at least for the next two years.

Although the Fed (and the Bank of England) will probably raise interest rates before year-end, short-term rates elsewhere will remain very low for the foreseeable future.

The non-farm payroll report missed already low expectations for September and showed a contraction in the number of jobs available. The 33,000 decrease in jobs was the first monthly decline since 2010 and was well below expectations for 80,000 jobs to be added. However, during the month, the US had to contend with two major hurricanes and these had a large impact on this result. The unemployment rate fell to 4.2% from 4.4% while hourly wages saw a healthy 2.9% increase for the year.

China

At the Communist Party Congress, President Xi Jinping signalled his ambition to shape China far into the future as he set a new goal potentially achievable within his own lifetime to build a modern nation by 2035 boldly aligned more closely with his own reign and he reinforced the expectation that he intends to remain a political force for years to come.

The Chinese Caixin/Markit services purchasing managers' index (PMI) fell to 50.6 in September, the lowest reading since December 2015 and one of the weakest since the survey began in 2005. The survey reinforces views that China's smaller companies are continuing to struggle, while large state-owned giants are apparently reaping most of the benefits from a year-long, government-led construction boom, thus perhaps "blurring the picture of a resilient economy".

Japan

The recent snap election results in Japan were a success for the incumbent party led by Mr. Abe who maintained his supermajority: this enabled him not only to maintain ultra-low interest rates but also to strategically amend the Japanese constitution away from a purely self-defence military objective.

Japanese equities hit multi-year highs in October, with the Nikkei 225 at the highest level in 21 years. Most commentators now have a positive outlook on Japanese equities, as they should benefit from a combination of attractive valuations, high sensitivity to healthy global growth, very strong upward earnings revisions and accommodative monetary policy.

Europe

The European Central Bank (ECB) has recalibrated its bond buying programme, cutting the monthly asset purchases to 30 billion euros from the current 60 billion euro, however the programme has been extended for an additional nine months. The ECB also hinted that rates would remain low until at least 2019 and said that further easing would be implemented, if required. This move was in line with the broad expectations of the markets.

In the UK, strong inflation data could see the Bank of England raise rates this year. The UK CPI increased 3% for the year to September, the strongest reading since 2012 and well above the targeted 2%

Australia

The encouraging signs about the health of the Australian economy have continued over the past month, with employment growth gathering pace and the outlook for business investment improving. In early October, the Reserve Bank of Australia (RBA) maintained its firmly neutral stance, holding the official cash rate at the historic low of 1.5%. It is the 13th consecutive hold since the RBA made its last move, a 0.25% cut in August 2016.

The statement accompanying the decision from RBA governor Philip Lowe was generally more upbeat about the economy and commented: " A large pipeline of infrastructure investment is also supporting the improved outlook. Against this, slow growth in real wages and high levels of household debt are likely to constrain growth in household spending."

The RBA believes that the next move in rates will be up, rather than down, while investors are also becoming convinced that strong full-time employment growth is evidence of strong activity growth and a precursor to faster wage inflation.

New Zealand

The General Election result is now finalised and Winston Peters' New Zealand First has chosen to bring the Labour and Greens into coalition to form a new centre-left government.

By global standards, the National Party and Labour Party are relatively centrist and mainstream. Both have a record and reputation for monetary stability, fiscal responsibility and respect for the rule of law and role of markets. This should provide on-going confidence to investors. However, we are now likely to see more fiscal spending, more government debt, higher inflation and higher long-term interest rates along with a lower NZ dollar.

From what has been reported by each new coalition partner, we expect that immigration will be reduced, overseas buyers of land/houses will be curtailed, more affordable homes will be built, labour costs will increase and there may be higher investment in regional infrastructure. A range of more detailed policy announcements from the new government will come out gradually over the coming months.

Summary

Even though the current bull market in shares is now over eight years old, we believe that the risk of an imminent global bear market is not high. There are two main reasons for this.

First, inflation has played an important part in rising bear market risks in past cycles. Structural factors may be keeping inflation lower than in the past and central bank forward guidance is reducing interest rate volatility. Without monetary policy tightening, concerns about a looming recession – and therefore risks of a 'cyclical' bear market are lower.

Second, financial imbalances and leverage in the banking system have been better controlled post the financial crisis. This makes a 'structural' bear market less likely than in the past.

Notwithstanding, we acknowledge that share valuations are historically high at present and require a continuation of good earnings and dividend growth to justify and support the current levels.