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Investment Update – December 2017

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, equity valuations around the world remain elevated while investors are cognisant of the many risks, including but not limited to, geo-political events.

USA

For the third quarter, the US reported GDP growth of 3%pa. The economy has now expanded by 3%pa or more in two consecutive quarters for the first time since 2014. At its November meeting, the Federal Reserve left official interest rates unchanged, as widely expected. The main surprise was the upgrade of the growth assessment to "solid" for the first time since January 2015.

Donald Trump nominated Federal Reserve Governor Jerome Powell to be the new Fed Chair, taking over from Janet Yellen at the end of her term in February 2018.

For October, nonfarm payrolls rose 261,000 as labour market activity normalized after the two recent hurricanes. The three-month average of 163,000 suggests a firm underlying trend in job growth that is little changed from that of the previous six months (164,000 average). The US core Consumer Price Index (CPI) for September was 0.1%, a fraction lower than expected.

We expect the US Fed to raise interest rates in December and several more times by the end of next year. Although this should prompt an increase in US Treasury yields, risky assets more generally should be resilient given the strong economic backdrop, low real interest rates and – most importantly – loose monetary policy elsewhere.

China

Chinese President Xi has raised speculation that he would defy the last 25 years of convention by staying in power for a third five-year term (beginning in 2022), as the other members of the Politburo Standing Committee would all have passed the unofficial retirement age of 68 by then. Having opted to not elevate an obvious, younger successor (as he was himself nominated), Xi is likely to be able to shape China's future in an even deeper way, and avoid leadership jostling during his second term.

The move underscores the extent to which he has been able to consolidate power and, consistent with his philosophy being added to the Party's constitution, cementing his status as one of China's pre-eminent leaders on a par with Mao and Deng. In terms of economic policy, we think that the pace of change will remain gradual.

Japan

During November, Japanese equities hit multi-year highs, with the Nikkei 225 at the highest level in 21 years. Japanese equities should continue to benefit from a combination of attractive valuations, high sensitivity to healthy global growth, very strong earnings revisions and accommodative monetary policy from the recently re-elected government.

Europe

For the third quarter, the euro zone reported GDP growth of 2.5%pa. In late October, the ECB announced that it would cut in half the amount of bonds that it buys each month, but said that its overall quantitative easing programme remained in place.

In early November, the Bank of England raised its benchmark interest rate by 0.25% to 0.5%, the first rise in 10 years. Inflation at 3%pa is now well above the Bank's target of 2%pa.

Australia

In early November, the Reserve Bank of Australia (RBA) left rates unchanged at 1.50%, as expected. Governor Lowe indicated that the RBA will not change its growth or inflation forecasts and that the Bank's central forecast remains for inflation to pick up gradually as the economy strengthens, with employment as well as wage growth expected to improve over the period ahead.

The Australian third quarter CPI rose by a weaker than expected 0.6% (the market expectation was for 0.8%). The annual inflation rate now is 1.8% compared to the RBA's target of 2%-3%. Thus, price pressures remain subdued with no need for the RBA to increase interest rates anytime soon: we see no policy move (i.e. a rate increase) until the end of 2018.

New Zealand

In early November, the Reserve Bank left the Official Cash Rate (OCR) unchanged at 1.75%. It said -. Global economic growth continues to improve, although inflation and wage outcomes remain subdued. Commodity prices are relatively stable. Bond yields and credit spreads remain low and equity prices are near record levels.

Monetary policy remains easy in the advanced economies but is gradually becoming less stimulatory. GDP in the June quarter grew broadly in line with expectations, following relative weakness in the previous two quarters. Employment growth has been strong and GDP growth is projected to strengthen, with a weaker outlook for housing and construction offset by accommodative monetary policy, the continued high terms of trade and increased fiscal stimulus.

The Reserve Bank has incorporated preliminary estimates of the impact of new government policies in four areas: new government spending; the KiwiBuild programme; tighter visa requirements; and increases in the minimum wage. The impact of these policies remains very uncertain.

Annual CPI inflation was 1.9% in September although underlying inflation remains subdued. Overall, CPI inflation is projected to remain near the midpoint of the target range and longer-term inflation expectations are well anchored at 2%.

Summary

Sharemarkets remain firm: the preconditions for strength remain, i.e. global economic growth is strong and synchronised, inflation is modest, recession risks remain low and company earnings are expanding at a double-digit rate.

Even though interest rates are gradually rising, bonds are not yet particularly attractive.

A balanced and diversified approach remains appropriate: as well, clients should remain close to their benchmark targets to control the level of portfolio risk.