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Investment Update – July 2018

Overview

The near-term outlook for the world economy is still positive, however, mounting tensions over a potential US-China trade war suggests an elevated risk to the medium-term outlook. We expect events in early July will likely be the key to understand the effect of this potential trade war, as the US is poised to impose the first significant tariffs at that time. In the US, strong economic growth and low unemployment will likely prompt the Fed to raise rates two more times this year while, in the euro-zone, the ECB is on track to end its asset purchases by December. Any trouble in emerging markets could be largely confined to Argentina and Turkey.

Global

While world trade has softened in recent months, the stability in trade volumes recent months offers some reassurance. Although the protectionist measures and rhetoric have escalated in recent weeks, the consequences do not yet point to anything worse than a modest slowdown of a resilient global economy, supported partly by household spending expanding at a decent pace. Further ahead, however, with monetary tightening set to take a toll on the US economy next year and China losing some momentum, global growth is predicted to slow in 2019 and 2020. This assumes no catalyst. such as a severe trade war, eventuates prior to then.

USA

GDP growth should rebound in the second quarter, helped by the fiscal stimulus of recent tax cuts. This should keep pressure on the Fed to continue gradually hiking interest rates. Markets anticipate a total of four hikes this year and another two in the first half of 2019. As the stimulus fades and the cumulative monetary tightening bites, however, a slowdown in GDP growth could eventually force the Fed to reverse course by cutting rates around 2020. In June, the Federal Reserve lifted its benchmark interest rate by a quarter of a percentage point, to a range of between 1.75% and 2%, the second rise this year. The last time the rate reached 2% was mid-2008, before the worst of the financial crisis. The Fed hinted at two more rises this year and dropped its statement that monetary policy would remain stimulative for some time.

UK

The UK's Monetary Policy Committee (MPC) is unlikely to wait too much longer before adopting more hawkish measures and increasing interest rates. Although the beneficial effects on exports of the pound's fall may be fading, it is not clear that the sterling boost to growth is over. With sustained rises in real wages anticipated, real GDP is likely to rise by around 1.5% to 2% over 2018/19. This should allow the MPC to raise interest rates at a faster pace than markets expect. Indeed, the Committee could hike rates in August, and by a further three times by the end of 2019.

Europe

The European Central Bank (ECB) recently announced its plans to end asset purchases this year, but it also clearly outlined that it is in no rush to raise interest rates. Investors' expectations have now shifted to the view that the expansionary policy is set to continue and that the ECB will wait until late 2019 before raising interest rates. The Italian financial markets are likely to remain under pressure in the coming months due to concerns about the new government.

Emerging Markets

The growing threat of a US-China trade war and a strong US dollar are the key risks to emerging markets. Even if trade tensions don't worsen, GDP growth in Emerging Asia has peaked and is likely to ease over the coming year. Central banks in Indonesia, Korea and the Philippines are likely to raise rates further before the end of the year, but other central banks in the region will be in no rush to follow.

Regional growth is likely to slow over the course of 2018-19 in Emerging Europe. The sharpest slowdown will come in Turkey, where the recent tightening of financial conditions will feed into weaker economic activity. Meanwhile, Argentina's recently agreed IMF deal imposes an aggressive tightening of fiscal policy, which could push the economy into recession.

Australia

Although GDP remains strong, the end of the mining, housing and migration "booms" has softened the outlook for the economy and the financial markets. The result is that interest rates are unlikely to rise soon and the Australian dollar could weaken in response to rising US rates. There is a risk that tightening credit controls in response to the Royal Commission into Banking may conspire to weaken Australian housing.

The escalating trade spat between the US and China could potentially boost the Australian economy in the near-term, but any reduction in global trade would be bad news for Australia in the long-term.

Governor Lowe outlined in a speech in late June that, before interest rates are raised from their record low of 1.5%, the Reserve Bank of Australia will want to have "reasonable confidence that inflation is picking up to be consistent with the medium-term target and that slack in the labour market is lessening". We expect rates to remain on hold until at least the second half of 2019. In June, the Aussie dollar fell against the US dollar by -2.15%.

New Zealand

At home. the Reserve Bank of New Zealand left interest rates on hold at 1.75% in late June. Governor Orr repeated that the OCR will stay at the current expansionary level for a considerable period. Comparing this with the federal funds rate, which pushed higher in June to a target range of 1.75 to 2%, it is the first time since late 2000 that the OCR is lower than the Fed funding rate. In June, the New Zealand fell against the US dollar by -3.33%.

Summary

Global markets continue to face a more balanced set of tailwinds and headwinds than was the case a year ago. While the economic and earnings outlook remains relatively strong, the peaking of leading economic indicators and earnings revisions suggest a more challenging environment as momentum for both slows. Monetary policy generally remains accommodative and the expectations are for future policy direction to be neutral at best, but more restrictive in the US with multiple rate hikes planned over the balance of 2018.

We expect events in July are likely to be key to understand the extent of the impact of the US-China trade negotiations as the first significant tariffs are implemented. We will continue to monitor these events carefully to consider investment risk. Also, geopolitical risks such as the instability in Italy endangering eurozone stability and the overhang of Brexit negotiations will be important to watch too. Given the extended period of strength from investment markets, it is important that the risk levels in clients' portfolios are appropriate.

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