Investment Update – February 2019

Overview

Politics continues to play a major role in the risks to the global economic outlook, with the threat of ongoing and potentially escalating trade tensions and a hard Brexit outcome still lingering. At this stage the potential long-term impact to global growth is uncertain. Global growth is still projected to be approximately 3.5%, unemployment in many major economies remains relatively low and corporate profits continue to rise (albeit with a low rate of growth over 2019). Economic data is mixed, and there are concerns over the breadth, magnitude and regionality of the slowdown in global economic growth.

US – Trade, Government shut-down and a more relaxed Federal Reserve

US President Donald Trump's tariffs on Chinese exports have not yet inflicted direct damage on the country's economy, according to the data. However, economists and corporate executives say the trade conflict has taken a heavy toll on sentiment, leading to a slowdown in consumer spending and capital investment. Optimistic investors will remember the trade pact Trump signed with Mexico and Canada in November which helped to boost confidence. If talks with Xi Jinping over the next month lead to a US-China deal, relieved markets will conclude that the trade war is about political theatre and squeezing a few concessions from China, not destabilising global commerce.

Investors are sensitive to news relating to the ebb and flow of the trade negotiations. Recently the Trump administration rejected an offer by two Chinese vice-ministers to travel to the US for preparatory trade talks because of a lack of progress on two important issues. US negotiators are demanding that Beijing end what they allege are "forced" technology transfers from foreign companies to Chinese joint venture partners and other firms. They also want President Xi Jinping's administration to scrap some state subsidies and industrial policies that they believe discriminate against foreign investors.

The two issues could ultimately derail the talks and cause more worry for financial markets. The developments have highlighted the difficulty that Washington and Beijing will face in trying to reach agreement by a deadline of March 1. If an agreement is not reached by March 1, President Donald Trump has said he will more than double the punitive tariff rate imposed on about half of all Chinese exports to the US, from 10% to 25%.

In another case of politics troubling economics, the Federal Government shutdown probably shaved $8bn off US economic activity in the first quarter, after a $3bn reduction in the final quarter of 2018, according to the Congressional Budget Office. The watchdog estimated that the shutdown would trim the level of real gross domestic product by 0.2% in the first quarter, after being lowered by 0.1% in the final quarter of last year. There should be a bounce in the second and third quarters as federal spending rebounds, but the office warned that about $3bn in forgone economic activity will never be recovered.

This assessment comes after President Donald Trump on Friday signed a bill to reopen the Federal Government for three weeks. The two sides are now preparing for intensive discussions on Capitol Hill over border security spending, but Mr Trump has warned that he could resort to a new shutdown if they fail to strike a deal that he supports.

Finally, providing some relief to markets, the Federal Reserve said it will be "patient" on any future interest-rate moves and signalled flexibility on the path for reducing its balance sheet, in a substantial reversal from its bias just a month ago toward higher borrowing costs. This is a significant "dovish" move.

China – GDP slows

China's economic growth dropped to its slowest annual rate in almost three decades last year as the US trade war and Beijing's crackdown on a debt-fuelled corporate spending spree took their toll on Chinese companies and consumers. The 6.6% increase in gross domestic product in 2018 was the lowest since 1990, when China was reeling from international sanctions following the Tiananmen Square massacre.

In China growth has now slowed for three consecutive quarters, prompting concern that this could drag down the global economy. Beijing has adopted a series of fiscal and monetary stimulus measures since July in an effort to boost investment and spending, but the new data shows that thus far the measures have failed to reverse the slowdown. Despite the gloomy outlook, financial markets across Asia took the announcement of weaker GDP in their stride, a sign of just how far they fell at the end of last year as guidance from technology companies like Apple and automakers, including Ford and Volkswagen, provided an early warning of the slowdown.

The UK – Brexit conundrum

Political uncertainty around Brexit has worsened in recent months. The contentious issue of the Irish border appears to be the main roadblock to the parties agreeing divorce terms. Brussels warns a no-deal Brexit would trigger an Irish 'hard border'. The European Commission has explicitly acknowledged that a no-deal Brexit would lead to the return of "a hard border" on the island of Ireland. However, the Irish government said it would not accept any border checks between Northern Ireland and the Irish Republic in the event of a no deal and warned that difficult talks with Brussels would be required in such an event. In unusually candid remarks, Margaritis Schinas, the commission's chief spokesperson, said it was "pretty obvious" that Britain's exit from the EU without a deal would prompt the return of border infrastructure, even at the risk of undermining peace in Northern Ireland. He made clear that the commission's willingness to discuss the issue reflected the increased possibility of a no-deal Brexit.

Europe - ECB dovish

The European Central Bank (ECB) is ready to use all its policy tools to support Europe's softening economy, including restarting a recently shelved bond-buying program, said ECB President Mario Draghi. The comments, delivered to European lawmakers in Brussels, underscore a new tone of caution from the ECB, which moved only last month to phase out its landmark stimulus policy, a €2.5 trillion bond-buying program known as quantitative easing or QE. The change of tone mirrors a shift among major central banks, including the Federal Reserve, amid mounting concerns over international trade tensions, volatility in financial markets and a slowdown in China. Mr. Draghi warned that recent economic data and surveys for the eurozone have been weaker than expected, and that continuing uncertainties, particularly relating to trade protectionism, are weighing on economic sentiment.

The ECB aims to keep inflation just below 2%, but the region's inflation rate tumbled to 1.6% in December. Policy makers will likely reassess the strength of the euro economy at their next policy meeting in March, when they will have fresh economic forecasts.

New Zealand - GDP, slowing house sales and falling immigration

For the Reserve Bank, the latter part of 2018 was characterised by the surprisingly strong third quarter employment forcing the new Governor to modify his prior dovish bias (bias toward cutting or maintaining the current low rate of 1.75%) at the November Monetary Policy Statement. Since then however, there have been some developments which are likely to persuade the Governor to return to his dovish stance. In particular, third quarter GDP was 2.6%, and much lower than the market (2.8%) and RBNZ (2.9%) expected.

Falling migration and softer residential housing market may weigh on GDP outcomes in 2019. Annual migration has now fallen by roughly a third from its peak and the fall seems to be accelerating and, while house prices have not yet taken a meaningful hit, the number of sales (which tends to lead prices) has fallen since the foreign buyer ban came into force in October. Recent data suggesting a correlation between New Zealand (particularly Auckland) and Australian residential house price fuels fears the slowdown may deteriorate into something more sinister, as seen in Sydney and Melbourne.

Summary

We are wary that weaker sentiment will eventually affect the fundamental of economies, which to date have proved fairly robust. There are opportunities for upside surprises but unfortunately these rely on politics to restore a more positive sentiment.

One thing that is clear is that the weaker investor sentiment and political uncertainty will continue to bring heightened volatility to markets in 2019. Basic principles of investing are applicable and maintaining your long-term neutral asset allocation continues to be appropriate in light of the uncertain times.