Investment Update – March 2019

Global outlook: Grow, slow or stay the same?

It was a gloomy finish to 2018 for the global economy. Markets plunged and America's government was locked in a seemingly endless shutdown, but developments have not played out as dismally as feared. The government in Washington is open again. America and China appear close to a trade deal which, although modest in its achievements, would nonetheless reflect a welcome easing of tension between the world's two biggest economies. In addition, news that the US Federal Reserve Bank plans to put interest rate increases on hold, has lifted share markets: the MSCI index of global shares has risen by 10% so far this year.

Some economists share the market's recent optimism. According to two of Goldman Sachs' most senior economists, the global economy may be set to improve. They argue that while global growth "remains soft," there were "some signs that we are moving past the bottom." Most notably, the world's two largest economies, the US and China, look set to see growth pick up in the coming months after a long period of worry about a major slowdown in both countries.

However, notwithstanding some good news, many economic indicators have undergone a remarkable downward shift since early 2018. Back then, economists were celebrating the emergence of a broad-based expansion. When it assessed the world economy in January last year, the International Monetary Fund hailed the "broadest synchronised global growth upsurge since 2010". Now the progress on trade talks is occurring against a less rosy economic backdrop as the US corporates announce slowing earnings growth and some data from China see areas of slowing also.

US - China Trade negotiations

Developments over February suggest that, despite the gulf between the two nations, that 'progress' toward a trade deal is being made. President Donald Trump said the US would delay an increase in tariffs on $200bn of Chinese goods set for March 1, averting an imminent escalation in tensions between the world's two largest economies. Mr Trump said in a tweet that there had been "substantial progress in our trade talks with China on important structural issues including intellectual property protection, technology transfer, agriculture, services, currency, and many other issues". "I will be delaying the US increase in tariffs now scheduled for March 1," he added.

Mr Trump did not provide any further details on a potential future deadline for the tariffs increase. If the new increase was to be introduced, the punitive tariff rate on the $200bn of Chinese imports would move from 10 per cent to 25 per cent and would inflict much more severe damage on Chinese exporters, and US consumers, than has been the case so far. Despite Mr Trump's optimism and praise for the talks from the official Chinese news agency Xinhua, which described the negotiations as moving towards a "win-win" solution, there was deep scepticism that real progress was being made or that Beijing was offering substantial concessions. People briefed on the negotiations have been saying for weeks that the two sides remain far apart on issues such as technology transfer and how to ensure compliance with the agreement.

While some compromise may be reached between the US and China on certain trade matters, the process is unlikely to be smooth and the US-China relationship should remain contentious, swinging between compromise and conflict, and involving frictions not only on trade, but also on technology, investment and geopolitics.

USA: Solid fundamentals and American tailwinds

The recent GDP release showed US economic growth has slowed from exceptionally strong levels, but it remains healthy. Fourth quarter GDP rose 2.6% quarter on quarter annualized, compared with 3.4% in the third quarter of 2018. This was higher than the 2.2% expected. On top of this, high frequency data over recent weeks has offered more confirmation of a stabilisation in US growth. The ISM manufacturing PMI rebounded in January, and judging by the latest regional Fed manufacturing surveys, it is likely to further stabilise in February.

Price-related news was positive. The GDP price index rose 1.8% (annualised) compared with the previous quarter and the core Personal Consumption expenditure (PCE) price index rose 1.7% annualized. Unemployment remains very low with only a modest increase seen. In the week ended February 23, initial jobless claims increased 9k to 225k, against expectations for a higher increase. The four-week moving average of claims declined by 7,000 to 229,000.

Warren Buffett, in his recent letter to Berkshire Hathaway investors, was steadfast in his faith in innovative American businesses and the robustness of the American economy. He patriotically described the phenomena as the 'American tailwind'.

China: Turning on the stimulus tap

Chinese stocks have staged a resurgence this year, stoked by stimulus unleashed by China's central bank, a more positive tone around US-China trade tensions and a dovish US Federal Reserve, in a sharp reversal of its performance last year as the world's worst performing equity market.

Chinese authorities have cut taxes and the central bank last year acted to improve liquidity and lending to private enterprises, lowering the amount of cash reserves banks must hold. Official data recently released by China's central bank showed new renminbi loans by domestic banks jumped to 3.23 trillion renminbi ($476.6billion) in January, the highest level on record. While policymakers in Beijing often seek to build up a liquidity buffer in January ahead of the lunar new year, when cash demand is high, last month's loan growth outstripped analyst expectations by more than 400 billion renminbi.

Recent inflation data suggested flagging price rises might be pressuring policymakers to turn on the taps in the face of weaker demand. China's factory gate prices rose just 0.1 per cent in January, while consumer prices grew at the slowest pace in more than a year.

UK: No-deal Brexit unlikely, delay likely

UK Prime Minister Theresa May promises a vote on final Brexit deal by March 12 and said that she would not sack three Europhile cabinet ministers who intend to break government orders on Wednesday in order to try to block a no-deal Brexit. Prime Minister May said: "We still have it within our grasp to leave the European Union (EU) with a deal on 29th March".

London based analysts at JPMorgan and Pantheon Macroeconomics both affirmed their belief that the chance of a no deal Brexit is around 10-15%, while Capital Economics said it believes the chances of no deal is 'receding'. It effectively boils down to the fact that Prime Minister May was forced into a compromise that will give members of parliament the ability to both create a short delay to Brexit, and to rule out no deal in the short term. Prime Minister May told MPs that should they reject her deal for a second time, they would be given a series of binding votes on whether to leave the EU without a deal or to delay Brexit.

According to Prime Minister May that means that “the UK will only leave without a deal on March 29 if there is explicit assent in the House for that outcome”. She added that if her deal were rejected for a second time, then MPs would be offered a vote on March 13 on leaving without a deal and then a vote on March 14 on whether to delay Brexit.

In contrast, the leader of the opposition Jeremy Corbyn, gave hope to Brexit opponents by announcing the opposition Labour party would back a new referendum on whether Britain should leave the EU. Corbyn proclaimed “If it’s a choice between [Remain] and a disastrous Tory Brexit, we will be campaigning to Remain — because that’s all we can do”.

New Zealand: Strong data overshadowed by policy uncertainty

Westpac has extended its expectation of the Official Cash Rate (OCR) remaining on hold until 2021 which is consistent with the Reserve Bank’s own prediction of mid-2021. Chief Westpac economist Dominick Stephens said the economy is in the “extraordinarily position" of having unemployment, inflation and exchange rate all close to average or neutral levels.

Data suggests that household consumption growth remains resilient, lessening the case for a rate cut. A further boost to households’ confidence in the housing market is likely due to the easing in the Reserve Bank’s loan-to-value (LVR) ratios, which includes reduced deposit requirements for property investors. NZ Retail Trade Survey for the end of 2018 showed a strong rebound from a lacklustre third quarter. Retail sales volumes in NZ rose by +1.7% (seasonally adjusted compared with previous quarter) and was stronger than expected.

The New Zealand Institute of Economic Research (NZIER) Quarterly Predictions claim a lift in business confidence and improved demand since the slowdown in the second half of last year. However, business confidence in the recent ANZ survey sank back, dashing hopes that the lift in sentiment late last year would continue into this year. Clouds on the domestic economy come from uncertainty over the effects of government policy changes, notably the recommendations from the Tax Working Group on capital gains tax.

Summary

After a period of nervousness, markets seemed to have settled for the time being. Fundamentals of economies remain reasonably robust and some optimism is emerging with respect to resolution of political risks which have plagued investor sentiment recently. However, even in the case of resolution of issues such as US-China trade and Brexit, our expectation on the upside is more modest as economic growth shows signs of slowing. We believe that basic principles of investing are applicable and maintaining your long-term neutral asset allocation continues to be appropriate in light of the uncertain times.