Investment Report – May 2016

The International Monetary Fund (IMF) has warned that the recent period of slow growth has now left the global economy more exposed to negative shocks and raised the risk that the world could slide into stagnation. In April, the IMF cut its world expansion forecast, as weak exports and slowing investment dim prospects in the US, a consumption-tax hike saps growth in Japan and a slump in the price of everything from oil to wheat continues to hobble commodities producers.

The IMF estimates that the world economy will grow 3.2% this year, down from a projected 3.4% in January. The IMF cited among the biggest risks as a "return of financial turmoil itself, impairing confidence and demand in a self-confirming negative feedback loop."

There was one bright spot: the IMF upgraded its China growth forecasts by 0.2% for this year and next, following signs of "resilient domestic demand" and growth in services that offset weakness in manufacturing.

USA

In a widely expected move, the Federal Reserve left interest rates in the US unchanged in late April. The virtuous cycle of solid jobs growth and robust consumer spending will continue to sustain economic growth at a pace consistent with ongoing tightening in the labour market. The market still expects two 0.25% interest rate increases from the Federal Reserve in the second half of 2016.

The US Federal Reserve's Beige Book—an anecdotal summary of economic conditions compiled by the regional Reserve Banks— reported in April that activity continued to expand across most of the country in late February and March 2016. Consumer spending once again increased in the majority of Districts. The description of manufacturing activity was upgraded, in line with the improvement seen in most manufacturing surveys in March. Labour market conditions continued to strengthen and several Districts reported signs of a pickup in wage growth. Retail prices increased modestly across the majority of districts, while input cost pressures continued to decline. GDP grew at a rate of 0.5% for the first quarter of 2016 versus a median forecast of 0.7%. Unemployment remains at 4.9%.

Japan

While the latest IMF growth forecasts for the US and euro area were marked down by 0.2%, the deepest reductions in advanced economies made by the IMF came for Japan. The Bank of Japan (BOJ) currently has its benchmark interest rate at -0.1% and continues to defend negative interest rates as a useful tool against inflation as well as a tool to encourage economic growth.

In late April, the BOJ dashed market hopes by keeping monetary policy on hold. Its decision to keep monetary policy unchanged came despite inflation data showing a slide into year-on-year deflation for the first time since 2013. The decision gambles that Japanese business confidence will hold up, despite the stronger yen, and a recovering US economy will come to Japan's rescue.

China

China's economy grew 6.7% in the first quarter, its slowest quarterly expansion in 7 years but within the government's target range of 6.5% - 7%.

China's monetary and fiscal stimuli to date have yet to spur a rebound in the world's second largest economy. In March, nearly all the usual economic indicators remained at levels signalling deterioration, although the pace of declines is moderating.

There was one positive and strong exception: China's exports rebounded in March and declines in imports narrowed on recovering commodity prices, leaving a trade surplus of 194.6 billion yuan and adding some further evidence of stabilization in the world's second-biggest economy.

Europe

The ECB bank kept its benchmark interest rate at zero in April. It said that the ECB stands ready to use "all instruments available", including further cuts in all its interest rates, to ensure the inflation rate returns to its target. ECB President Mario Draghi warned that challenges to his central bank's independence by the likes of Germany would dent confidence in the euro zone's recovery and force policymakers to keep rates lower for longer. The ECB's main interest rate is now at 0% and its deposit rate is - 0.4%, meaning banks pay to park excess funds with the central bank.

GDP grew in the March quarter by 0.6%, slightly better than expectations.

Australia

The recent economic data in Australia have been firmer. Australia's GDP rose 0.6% in the last quarter of 2015, well above most expectations. In 2015, the economy grew by 2.5%, down only marginally from 2.6% in 2014. The unemployment rate dropped to 5.7% in March. As well, low petrol prices and supermarket wars are restraining inflation growth.

Indeed, against all expectations, first quarter inflation was a negative 0.2%, taking the annual rate to only 1.3% and, thus, reinforcing the case for more interest rate cuts soon.

Over-building and the flagging population growth is also squeezing growth in house rental costs.

However, there are a number of headwinds ahead, including excessive household debt and weaker demographics weighing on consumption growth and a corporate focus on distributions rather than capital spending, as mining investment has contracted sharply. Thus, more sluggish growth may well lie ahead, even as the outlook for China is now slowly improving.

New Zealand

In late April, the Reserve Bank left interest rates unchanged.

GDP growth this year should be around 2.3%pa, assisted by historic high net migration, rising construction sector activity, robust tourism growth and an expectation of a modest decline in the unemployment rate. However, the likely absence of a sharp recovery in dairy auction prices points to a longer period of below breakeven farm gate pay-outs and a continuation of challenging conditions going forward in the dairy sector.

The major risks to the outlook are assessed to arise from international developments, particularly a more pronounced than expected slowing in the Chinese economy and/or potentially a weaker-than-expected Australian economy.

The NZ economy retains a greater degree of both monetary and fiscal policy flexibility than a number of other developed market economies. A fall in the price of petrol saw inflation stay close to zero at the start of 2016. The official figures rose only 0.2% in the first three months of the year while, for the 12 months ended March 31, inflation rose by 0.4%.

Summary

Our current investment view is that the accommodative monetary policy settings in many jurisdictions around the world will continue to be supportive of global equity markets.

However, we do believe that risks have increased. Global growth outside of the US and China is very weak, the effectiveness of quantitative easing is coming into question as investors, companies and more generally economies are adjusting and become accustomed to the low inflation, low return world in which they are operating.

Accordingly, we are recommending to clients that their investment portfolios should be well aligned to their long-term strategic asset allocation positions and well diversified.