Investment Report – July 2016

Overview

Unexpectedly, in late June, the British voted to leave the European Union (EU), a decision which now leaves the world's fifth largest economy facing deep uncertainty about its future growth prospects. This decision in the UK will also hurt the economies and markets of the EU and beyond.

The Brexit vote initially triggered a sharp downturn in share values, particularly in Europe, and a strong rally in safe haven assets like bonds and gold. The pound also suffered a swift devaluation.

This is an unexpected political crisis rather than an economic or banking crisis like the 2008 Global Financial Crisis. In economic terms, it is likely to lead to a modest UK recession as well as an ensuing slowdown in the EU, along with a period of considerable political turbulence in the UK and Europe. Even aside from Brexit, global economic conditions are still far from robust. The existence of near zero or negative interest rates in many countries indicates something very unusual is happening.

In early June, the World Bank has recently slashed its global growth forecast for 2016 to an "insipid" 2.4% amid what it calls stubbornly low commodity prices, faltering growth in advanced economies, weak global trade and shrinking capital flows. In January, the Bank had forecast global growth of 2.9% for 2016. The latest downgrade to 2.4% reflects slides in the prices of commodities, including oil and iron ore, and an inability of countries that benefit from the lower prices to use them to bolster growth. After Brexit, a further down grade now looks likely.

USA

The World Bank cut its forecast for the United States growth from 2.4% to 1.9% in 2016. In mid- June, the Federal Reserve pushed back its plans to raise its benchmark short-term interest rates, a widely-expected move following a series of mixed US economic reports, particularly in employment data. Although the unemployment rate has declined to 4.7% now, job gains have diminished.

The cautious stance comes after an unexpectedly weak payrolls report in which the US economy added only 38,000 jobs in May, the lowest level in six years. Brexit is likely to delay interest rate rises in the US even further. Meanwhile, on the plus side, inflation, which has run below the Fed's 2% target for four years, has shown signs of strength in recent months, as oil prices and the US dollar stabilised.

Japan

The World Bank cut its forecast for growth in Japan from 1.3% to 0.5% in 2016. In June, the Prime Minister changed his mind and kept the consumption tax unchanged to assist internal demand and growth prospects.

China

The World Bank held its forecast for China's growth rate at 6.7%. Soaring corporate debt is a serious and worsening problem in China that needs to be tackled quickly if Beijing wants to avoid potential systemic risk to itself and the global economy. While China's total debt of around 225% of gross domestic product is not particularly high by global standards, its corporate debt at approximately 145% of GDP is high by any measure.

Europe

The World Bank held its forecast for the Euro area at 1.9% in 2016. With policy interest rates approaching their lower bounds and the Euro yield curve already very low and flat, the focus on macroeconomic policy discussion has now switched towards possible fiscal policy in Europe.

The UK's decision to leave the EU now puts further pressure on EU growth, and asks the question: what are the likely responses now from the European central bank?

Australia
In early June, the Australian Reserve Bank kept interest rates on hold at 1.75% and delivered a statement that gave no indication that it is inclined to ease monetary policy any time soon. The general election result in early July is looking to be a close contest with polls suggesting a narrow Liberal victory.

New Zealand
In early June, the Reserve Bank left the Official Cash Rate unchanged at 2.25%.

At this time, it said: "*Global financial market volatility has abated and the outlook for global growth appears to have stabilised after being revised down successively over recent quarters. There has been a modest recovery in commodity prices in recent months. However, the global economy remains weak, despite very stimulatory monetary policy and significant downside risks remain. Domestic activity continues to be supported by strong net immigration, construction, tourism and accommodative monetary policy. The dairy sector remains a moderating influence with export prices below break-even levels for most farmers. There continue to be many uncertainties around the outlook. Internationally, these relate to the prospects for global growth and commodity prices, the outlook for global financial markets, and political risks. Domestically, the main uncertainties relate to inflation expectations, the possibility of continued high net immigration, and pressures in the housing market. Monetary policy will continue to be accommodative. Further policy easing may be required to ensure that future average inflation settles near the middle of the target range".*

Summary
Brexit brings with it heightened uncertainty and financial markets certainly do not like the unknown. We therefore expect a period of weaker and more volatile share markets. We also expect a low interest rate environment for even longer now.

We expect investors to be more cautious, maybe to adopt a "wait and see" strategy. We feel that accommodative monetary policy settings in most jurisdictions around the world will probably continue to be broadly supportive of markets, however we have now had over 7 years of rising share prices and corrections in some markets are more likely to occur as investors adjust their risk positions and "take some profits".

For some months, to control portfolio risk, we have recommended to clients that their investment portfolios should be well aligned to their long term strategic asset allocation positions and well diversified. For those that can accept some risk, well managed companies with the capacity to grow and pay regular dividends still look relatively attractive when term deposits at the bank pay so little. They may soon pay even less.