Investment Report – June 2016

On 23 June the UK holds its EU referendum. This will decide whether Britain exits or remains in the European Union. The uncertainty around this event has the ability to generate short-term volatility in financial and currency markets. It also could affect US policy, e.g. whether markets remain calm enough for the Federal Reserve to continue reducing its own monetary stimulus.

USA

In the US, recent labour force data has shown wages rising slightly, but durable goods orders and industrial production has been a little softer calling into question whether the Federal Reserve (Fed) may keep rates on hold at their June meeting. Moreover, nonfarm employment numbers released for May were a very disappointing 38,000 new jobs. Expectations are for two 25bp Fed interest rate hikes this year, with the first being in June or July. However the Fed may hedge its risks on timing given the uncertainty of the Brexit result and the weak non-farm payrolls number.

The US presidential race is warming up with no apparent favourite. If Donald Trump becomes president, it seems likely that US policy could take a more protectionist direction, as he has threatened heavy tariffs upon Mexico and China to encourage on shoring for US technology companies. He has also stated he would seek to repatriate all illegal immigrants (which account for about 5% of the workforce). His fiscal policy commitment might also be concerning to some investors and could add $11.7trillion to $15.1trillion to national debt over the next 10 years according to the bipartisan think tank, the Committee for a Responsible Federal Budget

Japan

In late April, the headline consumer price index was announced down by 0.1% on a year ago, as slumping global commodity prices and a stronger yen weighed on efforts to drive inflation up towards 2%. In general, the data continue to paint a picture of a sluggish Japanese economy over the past six months, with no sign of a downward spiral towards recession but none of the momentum needed to finally escape the many years of deflation and generate steadily rising prices. In late May, the Prime Minister Shinzo Abe was therefore forced to postpone his promised nation-wide sales tax hike.

China

While the macro picture in China is improving; (i) there has been a surprisingly sharp and recently broad rise in both Tier 1 property prices and housing turnover; (ii) a surge in infrastructure investment; (iii) a shortage of inventory, with PMI (Purchasing Manager's Index) new orders less inventory implying a further pick-up in IP (Industrial Production) growth; (iv) a stabilisation in FX reserves, and (v) signs of reform.

However, the ongoing challenge is that there has been no rebalancing; (i) credit to GDP over a seven-year period has increased significantly; (ii) the investment share of GDP is 44% (higher for longer than any other country); (iii) real estate appears in a bubble; and (iv) exports, financial services and demographics are all much less supportive. The Renminbi continues to fall, albeit gradually, and may continue to do so until the loan to deposit ratio of the banking system rises above 100%, or bond yields rise.

Europe

The gap between the "Remain" and "Out" voters for Brexit is diminishing with a recent Guardian newspaper poll actually suggesting the split was 52 to 48 points in favour of leaving the EU, noting 13% were undecided. It looks like the vote on 23 June will be close.

There were no policy changes at the recent ECB meeting and there were no clear signals that further easing is imminent. ECB president Mario Draghi claimed that their policies "are effective, they will work and they just need time". This seems to indicate that the ECB will remain on hold for the foreseeable future.

Australia

In early May, the RBA dropped the official cash rate from 2% to 1.75% and said "Inflation has been quite low for some time and recent data were unexpectedly low. While the quarterly data contain some temporary factors, these results, together with ongoing very subdued growth in labour costs and very low cost pressures elsewhere in the world, point to a lower outlook for inflation than previously forecast".

Recent Australian growth figures were encouraging – the economy grew 1.1% in the first quarter and 3.1% over the past year, its fastest quarterly growth since March 2012. Major drivers were export volumes, household consumption and mining, while the largest detractor from growth was falling business investment in engineering construction and new buildings. Australians will go to the polls on 2 July with the result "too close to call".

New Zealand

The 2016 Budget, delivered on 26 May, contained no major fiscal or social policy announcements. Rather, the message from the Minister of Finance is that New Zealand is heading in the right direction and trends are favourable, but future economic shocks cannot be ruled out. Therefore, the economy demands further prudent management. The key elements of this year's Budget were directed at science and innovation, infrastructure investment, health and other social investment.

The maintenance of operating surpluses is a key objective, together with debt reduction. It is clear that any prospect of tax reductions is dependent on the achievement of these latter goals. In terms of fiscal strategy the focus is on the medium-term. Temporary variations in forecasts, such as a projected reduction in the tax take, are to be disregarded in the interests of business and taxpayer certainty. Essentially the Government has delivered a mid-term Budget which pulls existing policy levers. The results of this fine-tuning are awaited.

Summary

Our current investment thesis is that the accommodative monetary policy settings around the world will continue to be broadly supportive of global equity markets. However, we continue to recommend to clients that their investment portfolios should be well aligned to their long-term strategic asset allocation positions and well diversified.