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Investment Update – October 2016

After several benign months, some volatility returned to investment markets in September to coincide with renewed talk of a pending Fed rate rise in the US, a lack of any new quantitative easing in Europe and fluctuating long bond rates.

USA

In late September, the US left its official interest rates unchanged. Janet Yellen said the case for an increase in short-term interest rates had strengthened recently amid firm jobs growth, signalling a move is becoming more likely in the coming months and, potentially, soon after the US election. The Federal Reserve chair highlighted solid consumer spending and a string of payroll gains as she predicted moderate growth in the US economy as well as a return of inflation in the next few years.

US consumer spending, contributing about two-thirds of the US economy, rose +0.3% for a fourth straight month in July, bolstered by stronger income gains (+0.4%) and with strong demand for autos and raising the possibility of a Fed rate rise in 2016. However, the August US employment report was softer than expected, with a 151,000 gain in non-farm payrolls falling short of the 180,000 median consensus forecast. The jobless rate was unchanged at 4.9%.

Japan

In late September, the BOJ held official interest rates steady but said that it would expand its monetary base further by keeping 10-year bond yields around zero. It has vowed to keep easing monetary policy until inflation reaches 2%. Mr Kuroda, governor of the Bank of Japan since 2013, claimed the central bank's policies "have contributed significantly to the positive turn-round in Japan's economy" and said there was no chance of reducing the level of monetary accommodation. His remarks pave the way for further easing even including the possibility of cutting interest rates from the current minus 0.1%. However, both growth and inflation still remain elusive.

China

The recent G-20 summit of major economies meant to be a moment of glory for China coincided with a world-wide backlash against globalization—and much of it is blamed on China. As China's growth slows and economies in the U.S. and Europe remain in the doldrums, complaints have gathered pace in recent months as China's industrial overcapacity has dampened prices abroad. The problem is that access for foreign investors has not matched the terms Chinese encounter overseas, while Western officials and businesses see the bidders in ever-larger Chinese acquisitions of major global brands as state-controlled beneficiaries of protected markets.

China's official NBS manufacturing PMI improved to 50.4 from 49.9. This was above the market consensus of 49.8 and is the highest reading since November 2014. As such, it is probably an upside surprise for policy makers as well.

Europe

In early September, after official figures showed an easing in underlying inflation figures, the European Central Bank disappointed markets and left interest rates in the Eurozone unchanged, but kept the door open for more cuts in the months ahead. Meanwhile, it renewed calls to politicians to do more to support the bloc's languid economic recovery.

Australia

In Australia, second quarter GDP growth rose +0.5%, and therefore +3.3% on an annualised basis: the latter represents the fastest growth rate in 4 years. Growth is being driven by strong domestic demand and increased government spending. This also represents the 100th consecutive quarter without a recession for the country.

New Zealand

In New Zealand, second quarter GDP growth rose +0.9%, and therefore +3.6% on an annualised basis, to out-perform Australia.

Activity data released over August has continued to suggest that momentum in the NZ economy remains robust, supported by strong inward migration, construction and tourism activity, together with accommodative monetary policy settings. In particular, retail sales growth over the June quarter showed a robust increase of 2.3% quarter-on-quarter.

Nevertheless, despite this backdrop of above trend growth, inflation pressures continue to remain muted, with inflation expectations data continuing to track around historic lows.

Such an outturn will likely further compound the difficulties the RBNZ currently faces in setting appropriate monetary policy conditions.

In particular, the RBNZ needs to balance the risks of further exacerbating imbalances in the economy – such as excessive house price inflation – through a more aggressive easing profile, against the risk of not easing policy sufficiently and prompting a further and more enduring undershoot of their mandated 2% inflation target. A high exchange rate continues to be a problem.

The RBNZ has said that "*further policy easing **will** be required to ensure that future inflation settles near the middle of the target range*". However, in late September the RBNZ left the rate unchanged at 2%.

Summary

Overall, we find that markets are still pricing in a world of low growth, low interest rates and low inflation without any visible road blocks to "more of the same" in markets. The end of quantitative easing is not apparent yet.

Even after the strong rise in equity values over the last 8 years, we are cautious but not bearish on equities as there is no sign of recession and financial authorities appear prepared to do whatever is required to ensure that the financial markets are well supported.

Politics are becoming increasingly important to investment outlook. Sentiment seems to be moving away from policies that assist assets owned by the wealthy - real estate and shares - towards a greater focus on support for the average person in the electorate. Fiscal stimulus may be coming.

A diversified and balanced approach to investment remains appropriate.