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Investment Update – April 2017

Solid global economic growth is expected in 2017. However, political uncertainties could create turbulence and any expectations of further economic stimulus may be optimistic. Improving economic growth will generally support equities and challenge bonds, because this growth is now more "traditional" in nature, i.e. it arises from better employment and demand, thus allowing prices and potentially profits to rise, rather than the ultra-loose monetary policies of recent years.

US

We expect GDP to accelerate in 2017, primarily driven by strong consumption, higher employment and stabilising business investment. Consumer confidence measures have been surging since the Trump election and the outlook for investment is improving, i.e. less regulation, lower taxes and higher defence spending should support selected US companies.

Three recent developments have confirmed the likely upward path of US interest rates. First, US core inflation has risen more than expected. Second, incoming data have been consistent with strong global growth momentum. Third, Fed rhetoric has become increasingly hawkish.

In early March, solid US employment data report (+235,000 jobs, unemployment lower at 4.7% and average earnings +2.7%) set the stage for the widely-anticipated interest rate hike by 0.25%.

China

We expect GDP to be around 6.5% in 2017, slightly lower than last year's range of 6.5%-7%. China has been criticized by the World Bank and others for lofty growth targets that push up debt levels, but China has many "innovative tools and policy options" to reach this target and the "confidence, the ability, and the means to forestall systemic risks."

Politics dictates that economic growth take priority over any reform effort in 2017, as the Communist Party will set a leadership slate at the end of the year for the next half-decade – and there is little tolerance for instability that could disrupt President Xi Jinping's second-term mandate.

Japan

After a strong fourth quarter of 2016, the Bank of Japan revised up its forecast for growth in the current year from 1.0% to 1.4%.

Europe

Mario Draghi (ECB president) has declared victory against deflation and moved a step towards ending the European Central Bank's ultra-loose monetary policy, sending the euro and German bond yields higher as investors bet on the end of crisis-era stimulus measures. The ECB president said the bank decided to change its guidance to investors – omitting a reference to using all the weapons in its policy arsenal – because of its success against a destabilising bout of falling prices. Though the ECB agreed to keep interest rates at record lows, Mr Draghi said the bank no longer had a "sense of urgency" to take further action on monetary stimulus and that policymakers "do not anticipate that it will be necessary to lower rates further".

We expect the euro area GDP growth to accelerate to 2.0% this year on the back of stronger investment, improved export growth prospects and higher government spending, but continue to expect the ECB's asset purchases at the rate of €60bn a month at least until December 2017.

Australia

As expected, in mid-March, the RBA left the official interest rate unchanged at 1.5%. The accompanying RBA statement was little changed from the last one, but the changes that were made reflected the recent data flow – notably, the upside surprise to GDP, the draw down on household savings and the trend weakness in full-time employment. The RBA continues to place the global reflation story at the core of its views.

New Zealand

The RBNZ left the official interest rate unchanged in late March as expected at 1.75% and said that "*monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain, particularly in respect of the international outlook, and policy may need to adjust accordingly".*

The December 2016 quarter's GDP increase of 0.4% was well below both RBNZ and market expectations for quarterly increases of around 1.0%**.** At a sectoral level, the key contributor to this weaker-than-expected rise was the decline in agriculture (down 0.6% on falling milk production).

Over the year ahead, we would assess that the key risks to the projected profile of a continuation of above trend NZ GDP growth is likely to emanate from developments in the international economy. In particular, US political risks or policy moves from the Trump administration could easily result in a heightened state of market agitation.

On the domestic front, we assess the largest downside risks are associated with a potential sharp correction in house prices – estimated to be nationally overvalued by more than 30% – together with a potential rise in political risks associated with the upcoming 23 September general election. In particular, reflecting the contribution to growth currently coming from historic high levels of net migration, any major policy changes in migrant numbers following the election has the potential to have a reasonably significant effect on headline GDP growth rates going forward.

The RBNZ also noted that "*the trade-weighted exchange rate has fallen 4% since February, partly in response to weaker dairy prices and reduced interest rate differentials. This is an encouraging move, but further depreciation is needed to achieve more balanced growth*".

Summary

Even after the strong rise in share values over the last 8 years, we are cautious but not bearish on shares as there is no sign of recession for 2017 and financial authorities appear prepared to do whatever is required to ensure that the financial markets are well supported. Moreover, projected company earnings growth should gradually support current sharemarket valuations.

However, we also note that inflation and longer term interest rates are starting to rise, signalling the probable end of the 35-year bull market in bonds. This may well prove a headwind for equity markets later this year.

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