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Investment Update – May 2017

In assessing prospects for markets, investors remain understandably focused on political risks: there are political outcomes in the USA, Europe, and Asia that could well invite a more pessimistic outlook this year but economic fundamentals should not be ignored. In the absence of political shocks, the global economy should grow at a healthy pace even though the extraordinary amounts of monetary stimulus seen in recent years will probably abate.

Although expectations for the size and scope of the US tax cuts and reforms have diminished, it is still possible a significant package is passed, one that would provide the global economy with a new growth tailwind in 2018.

USA

Federal Reserve officials are zeroing in on a strategy to begin winding down their $4.5 trillion portfolio of mortgage and Treasury securities, possibly later this year, as part of their broader effort to lessen stimulus in the financial system. Under the emerging strategy, the central bank would raise short-term interest rates two more times in 2017 and then potentially pause rate increases, perhaps late in the year. That would allow Fed officials to start winding down their portfolio of securities in a gradual and measured way to assess how markets handle the moves before resuming additional rate increases in 2018.

However, recent key US economic statistics have been mostly disappointing. Nonfarm payrolls increased only 98,000 in February, but household employment rose sharply for a third consecutive month on an adjusted basis and the unemployment rate fell to 4.5%, its lowest level since May 2007.

In March, the consumer price index declined by 0.29% and the year-over-year rate decelerated by 0.3% to 2.4%, while retail sales decreased 0.2%.

China

Labour costs continue to grow strongly and now represent a significant component of production costs in many Chinese industries. Aggressive cost cutting measures have been implemented in recent years by Chinese companies in the wake of excess capacity and tepid global demand.

Absent weakness in the currency, further increases in labour and other input costs will force companies to raise prices to remain profitable, which would see China become an exporter of inflation rather than of deflation.

First quarter GDP and March activity growth surprised on the upside. Retail sales posted a particularly large jump, bouncing back from a weak reading in January-February. Overall economic growth is tracking well above the policy target so far in 2017

Japan

Japan’s Consumer Confidence Index (for general households) has remained high since the beginning of 2017 and in March it rose 0.7 points to 43.9 to a level not seen since after the launch of Abenomics in 2013. The Cabinet Office raised its assessment of consumer sentiment to 'picking up', from 'showing signs of improvement' in February.

Europe

In late March, Theresa May triggered a two-year countdown to Britain's break from Europe by serving notice to Brussels that she intends to end their 44-year relationship, while in mid-April she called a snap UK general election.

Australia

In early April, the Reserve Bank of Australia left official rates unchanged at 1.5% for its seventh consecutive meeting and stated:

"Conditions in the global economy have improved over recent months and this has contributed to higher commodity prices, which are providing a significant boost to Australia's national income. Headline inflation rates have moved higher in most countries, partly reflecting the higher commodity prices. Core inflation remains low.

Long-term bond yields are higher than last year, although in a historical context they remain low. Interest rates have increased in the United States and there is no longer an expectation of additional monetary easing in other major economies.

The Australian economy is continuing its transition following the end of the mining investment boom. Recent data are consistent with ongoing moderate growth.

Most measures of business confidence are at, or above, average and non-mining business investment has risen over the past year. At the same time, some indicators of conditions in the labour market have softened recently.

The unemployment rate has moved a little higher and employment growth is modest. The various forward-looking indicators still point to continued growth in employment over the period ahead. Wage growth remains slow. Inflation remains quite low. Headline inflation is expected to pick up over the course of 2017 to be above 2%. Taking account of the available information, the Board judged that holding the stance of monetary policy unchanged at this meeting would be consistent with sustainable growth in the economy and achieving the inflation target over time."

New Zealand

In late March, the Reserve Bank left the official rate unchanged at 1.75% and stated:

"Macroeconomic indicators in advanced economies have been positive over the past two months. However, major challenges remain with on-going surplus capacity in the global economy and extensive geo-political uncertainty. Global headline inflation has increased, partly due to a rise in commodity prices, although oil prices have fallen more recently. Core inflation has been low and stable. Monetary policy is expected to remain stimulatory, but less so going forward, particularly in the US.

Quarterly GDP was weaker than expected in the December quarter, but some of this is considered to be due to temporary factors. The growth outlook remains positive, supported by on-going accommodative monetary policy, strong population growth, and high levels of household spending and construction activity.

Dairy prices have been volatile in recent auctions and uncertainty remains around future outcomes. Monetary policy will remain accommodative for a considerable period."

The March 2017 quarter CPI outturn showed a quarterly increase of 1.0% and an annual rise of 2.2%, this was the highest annual increase since the September 2011 quarter and above median market expectations.

Summary

The environment for equities remains broadly neutral, as central banks unwind their stimulatory policies in response to improving growth prospects rather than the need to stamp out any problematic rising inflation. However, even though interest rates are rising, bonds are not yet particularly attractive.