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Investment Update – December 2019

Confidence Returning

Some improvement in the degree of confidence in the underlying economic outlook was evident in November. The US equity market was resurgent. In Australia smaller capitalisation companies experienced investor support despite the ASX 200 index not exhibiting the same momentum. In New Zealand the equity market consolidated and lifted into the end of the month to achieve record highs.

United States Economy Remains Resilient

Long term interest rates in the United States climbed in the first week of November. The 10-year government bond rose 0.15% on 7 November. This was the largest single day upward movement since President Trump's election but subsequently came off the peak of 1.94%. Rising rates generally reflect increased investment confidence with sellers of bonds exceeding buyers as capital is shifted to higher returning investments. The 10-year rate remained above the low in early September of 1.44%. The higher rates reflect an improvement in economic confidence. There is also an expectation that interest rates are likely to remain at relatively low levels for the next few years in the absence of higher inflation or any other unforeseen eventualities.

US employment numbers were markedly higher in October and earlier August and September numbers were also revised upward. The US work force expanded in October by 325,000. The US non-manufacturing index recovered in October from a 3-year low. The healthy employment numbers are translating into average hourly earnings growth of 3% but not yet demand-pull inflation. US inflation moderated slightly with the latest print at 1.6%. The improved employment data allayed fears that the weaker manufacturing sector was spilling over into the services sector.

The Federal Reserve reflected this in its commentary and rate decision at the end of October cutting to 1.75%. Subsequent comment by the Chairman of the Federal Reserve suggests that the Fed will pause for the time being and that the hurdle for rate increases is high.

The US government budget deficit grew past US$1 trillion and the US national debt load surpassed US$23 trillion. US corporate debt is close to US$6.5 trillion nearly double that leading into the global financial crisis. Despite this Fed Chairman Powell expressed the view that the national debt and deficit do not pose any immediate threat to economic activity.

Increased confidence in the state of the economy despite the ongoing trade dispute gave a boost to US equities. Information Technology remains the strongest performing sector in the S&P 500.

China Providing Mixed Signals

In contrast China is experiencing significantly higher inflation with the China Consumer Price Index at 3.8% driven by a 15% increase in food prices. Pork has doubled in price; beef is up 20% and lamb by 16% year on year. Core inflation remains more modest and producer prices were down 1.6%.

The food price inflation in China continues to support New Zealand's pastoral agriculture. A2 Milk reported continued strong revenue growth and now anticipates an increased EBITDA margin, up from previous guidance. The company is facing increasing competition with an offer for Australian milk powder producer Bellamy's from China Mengniu in prospect and Nestle expanding its in China milk powder production. Mixed data is coming from China in relation to the economic activity. Manufacturing contracted for the 6th month in a row but non-manufacturing continues to expand.

The Hong Kong economy has felt the impact of the current civil unrest falling into recession with GDP falling by 3.2%. Despite this the largest global public offering this year of Alibaba shares was made on the Hong Kong stock exchange with the shares up 10% immediately after listing.

Australian Banks Drag on Market Performance

In Australia the Reserve Bank (RBA) has paused its rate cutting. The RBA kept the official interest rate unchanged at 0.75%. Moreover, the Australian Treasurer agreed to no change in the RBA's official monetary agreement with the RBA's inflation range maintained at 2% to 3%. This is despite the RBA's projection that inflation will remain below the target for the next 2 years. This gives the RBA further time to achieve the target and reduces the pressure on the RBA to take more aggressive action.

The Australian services sector remained stable in October with no expansion despite the tax cuts in July and two prior interest rate cuts. Australian construction has experienced a downturn with commercial construction down 5.5%, residential down 10.1% and engineering minus 11.4%. The sector may have reached its nadir with Fletcher Building forecasting growth in Australian market of 9.2% pa from 2020 to 2023.

The woes of the Australian banking sector continued in November. Westpac having commenced an A$2.5 billion capital raising to meet capital adequacy requirements announced that AUSTRAC has lodged civil proceedings in relation to breaches of the bank's anti- money laundering and counterterrorism financing obligations. Potential litigation could result in the bank incurring fines equivalent to the recent capital raising and the Chairman and CEO will depart as a consequence. Net interest margins remain under pressure and sentiment towards the Australian banks deteriorated further.

New Zealand Catching a Fresh Breeze

New Zealand 10-year government bonds likewise rose and spiked mid-month at 1.54% before falling back into the end of the period. The New Zealand economy remains relatively resilient. New Zealand unemployment rose marginally in the most recent data point to 4.2%. The labour cost index increased 2.4% in the year to September. Weekly earnings in New Zealand are growing at an annual rate of 3.7%, primarily in the government sector, private sector earnings trailing at an annual rate of 3.3%. A more restive labour force may be emerging with industrial action by bakers and bus drivers' indicators of this. The increasing cost of labour is clearly a concern for company management's and is impacting profit growth in labour intensive businesses. This is unquestionably providing a strong domestic inflationary pulse combined with non-tradeables CPI inflation above 3%. It is only tradable inflation that is keeping a lid on overall inflation. At this time, it is far too early to suggest that inflation is about to re-emerge, but inflation is not dead.

Other factors suggest that the case for further cuts to the Official Cash Rate has weakened. Business confidence and consumer confidence lifted, the latter from 4-year lows and back to the average of 2018-2019.

Building permits issuance rebounded from the previous month. The level of New Zealand building consents for October was elevated across the country with residential at 39,440 consents (annualised). The prospect of further spending stimulus from the government is also increasing with further announcements in this regard to be made in December. The ongoing strength in the construction sector should ensure a reasonable foundation for building related companies but does not necessarily translate to share price growth. Steel & Tube, Metro Performance Glass and Fletcher Building have all disappointed market expectation to some degree in the last month despite the high activity levels. In contrast to construction the retirement village sector experienced a strong rebound in share prices in November with residential sales volumes picking up and prices outside Auckland remaining firm. Metlifecare was prominent with a 21% gain as the company was subject to a possible takeover.

Outlook

The deceleration in economic activity that was concerning central bankers has eased. Pre-emptive action and/or inherently robust structures have maintained fertile investment market conditions. This appears to be common to economies around the globe as economies adjust to overarching macro-economic drivers and specific regional issues. Acknowledging that the weaker elements of economic activity are now less acute the outlook however is not unambiguously assured.

The trade negotiations between China and the United States continue with conclusion of the first step of phase one remaining elusive. The continuation of negotiations represents an opportunity cost for both protagonists and a brake upon the trade potential of other counterparties. At this time the expectation remains that interest rates will continue to remain low for the next few years, with the inability to absorb a sharp increase being one factor in ensuring that easy money is a primary policy.

The continuation of low rates will maintain the hunt for yield from investments and support equity values that are able to provide income on a sustainable basis. Balance sheet capacity also contributes to the sustainability of share values. Share buy-backs supporting share prices are a factor in US share price support where the individual company's growth opportunity is less apparent. At a market average around 18 times forward earnings and a positive earnings outlook it is difficult to argue that US equities are overextended even though the length of the bull market is one of the longest in history.

The New Zealand share market trades at higher multiples versus other markets and its own historical norms. Investors not prepared to invest at prevailing market multiples and allocating to fixed income must accept the less palatable alternative of an income return that in many cases is half that of the more risky equity market.