Monthly View as at 31 August 2023

Overview

Global economic uncertainty dominated market sentiment in August. This reflects the fact that central banks are nearing the end of their interest rate hiking cycles and concerns are raised as to the speed at which inflation can fall from here, given the dramatic declines witnessed so far this year.

Driving markets in August was the concerns that the US economy remains too strong, with inflation elevated, and the Federal Reserve (Fed) is forced to raise interest rates again.

The release of the Fed's meeting minutes early in the month added weight to this scenario. The minutes noted that risks remain that US inflation might not fall as much as anticipated, and this may require the Fed to increase interest rates further. The risks to inflation remaining elevated include stronger than anticipated US economic growth, a still tight labour market, the reversal of recent supply chain improvements and declines in commodity prices, which have been largely responsible for the decline in inflation in recent months. The Fed's Chairman Jerome Powell's much anticipated speech at the Jackson Hole central bank symposium late in the month outlined the Fed's current thinking. Powell argued for keeping interest rates steady for now but kept the door open to further interest rate increases later in the year, saying the Fed would "proceed carefully" as they consider the next steps in its fight against inflation. This is a view echoed by most major central banks around the world as they near the end of their respective interest rate hiking cycle and maintain a bias towards raising interest rates further.

US headline annual inflation rose to 3.2% in July from 3.0% in June, which was slightly better than anticipated. Core annual inflation (excluding food and energy prices), fell to 4.7% from 4.8%.

Inflation outcomes in other parts of the world disappointed over the month, adding to the concerns over the speed to which inflation can fall. Canadian inflation rose more than expected and UK prices fell by less than forecasted. European core inflation (excluding food and energy prices) was also higher than anticipated.

US economic data remains mixed. Labour market data, although softening, remains robust. US retail sales rose for a fourth straight month in July. Conversely, measures of activity within the manufacturing sector remain weak and indicators of activity in the services sector have declined to six-month lows. Outside of the US, business conditions have deteriorated across Europe, raising concerns over the growth outlook for the remainder of this year. A backdrop of rising interest rates, weak consumer confidence, and high inflation are impacting on the demand for goods.

Chinese economic data continues to weaken, with exports falling 14.5% over the year. Imports have declined 12.4% on a year ago, indicating weak domestic demand. China's consumer inflation has declined 0.3% over the last year. Although China's central bank has eased interest rates, the rate of reductions to date have been modest and less than anticipated. Overall, the government's response to weakness in the economy has been underwhelming. Given the risks to the economy a more forceful response is likely at some point.

New Zealand

The New Zealand share market fell -4.2% in August, declining on the softer than anticipated domestic and Chinese economic data, along with a weaker than forecasted corporate profit announcements. Tourism related companies Tourism Holdings (+9.3%) and Air New Zealand (+1.9%) were amongst the better performing stocks delivering profit results that reflected activities are returning toward pre-covid levels.

Highlighting the headwinds within the domestic economy, Fletcher Building underperformed (-13.4%) after it cut its dividend. Although the core business is holding up well in a slowing market, higher debt and interest costs are impacting on earnings. Port of Tauranga (-3.2%) warned of a challenging year ahead, as import volumes soften amid higher interest rates and high inflation.

At its most recent meeting the Reserve Bank of New Zealand (RBNZ) left the Official Cash Rate (OCR) at 5.5%, as expected. The RBNZ continues to be confident that with policy remaining at current restrictive levels for some time, inflation will return to its 1-3% target band. In its forecasts the RBNZ assumed the OCR remained higher for longer. Domestic economic data is weak, retail sales fell again, and business activity indicators are depressed. Encouragingly, business confidence has drifted higher.

Australia

The Australian share market fell -0.7% in August. Australia outperformed the rest of the world, despite the weakness in Chinese economic data, on better-than-expected profit results and inflation data supporting the Reserve Bank of Australia maintaining its official cash rate at the current level of 4.1%.

Although the Australian corporate earnings season was better than expected, the results were mixed, and this was reflected in individual company performance in August. Coles (-10.6%) profit result disappointed the market. In a common theme across company announcements higher wages, rents, interest, and energy costs are weighing on profitability. James Hardie (+7.0%) delivered a profit announcement better than anticipated as they benefit from a recovery in the US housing market.

Global Markets

Global share markets fell -1.8% (in local currency) in August. The main catalyst for the falls were rising longer-term interest rates and concerns over economic growth prospects for China and Europe. US markets also declined on the risk that the Fed may need to raise short-term interest rates higher than previously anticipated.

European markets underperformed on the weaker than expected economic data. The European Stoxx 50 index fell -3.8% compared to the -1.6% decline in the US S&P 500 Index.

Helping to offset declines in global share markets was a softer New Zealand dollar. In New Zealand dollar terms global shares rose 2.1% in August. The New Zealand dollar fell against most major currencies over the month, including a -3.9% decline versus the US dollar and was -2.5% and -2.7% weaker against the Euro and British Pound respectively. Although global forces drove the New Zealand dollar lower, including global higher interest rates, resilience of the US economy, and weaker Chinese economic data, domestic factors also played a part, particularly the sharp decline in dairy prices and weak retail sales.

Summary

Global economic uncertainty has risen after the dramatic declines in inflation witnessed this year and as central banks near the end of their interest rate hiking cycles. While US economic data remains mixed, softening labour market data is encouraging for the continued decline in US inflation. The ongoing resilience of the US economy pushes out recession fear.

The current environment is supportive of both fixed income and share markets. Fixed income offers an attractive yield with the potential for capital gains as inflation falls further and central banks end interest rate increases.

Therefore, the outlook for inflation remains the key. Further declines in inflation will eventually allow central banks to pause interest rate hikes and in time, commence interest rate reductions. This outcome would be positive for global bond markets and provide further support for share markets in an environment of likely softer economic activity.

Indices for Key Markets

As at 31 August 2023	1 Month	3 Months	1 Year	3 Years p.a.	5 Years p.a.
S&P/NZX 50 Index	-4.2%	-2.1%	0.4%	-0.4%	5.2%
S&P/ASX 200 Index (AUD)	-0.7%	3.9%	9.6%	10.7%	7.0%
MSCI ACWI Index (Local Currency)	-1.8%	6.9%	13.9%	8.9%	8.0%
MSCI ACWI Index (NZD)	2.1%	7.4%	19.3%	13.1%	10.8%
S&P/NZX 90 Day bank bill Total Return	0.5%	1.4%	4.7%	2.0%	1.8%