Economic Commentary

December 2020

The quarter to the end of November was choppy but ended on a strong note following a market-friendly result in the US election and positive developments on a Covid vaccine. Democrat Joe Biden is now the President Elect, despite the refusal of President Trump to concede and the probability of further disputes. The first vaccinations have been carried out in the UK following the emergency approval of the Pfizer vaccine. In New Zealand, the virus remains well-contained, but overseas there has been a huge resurgence in cases. Vaccines will take some time to be manufactured and distributed and it is going to be a long, hard and tragic winter for many northern hemisphere countries. The latest analysis is that the global economy will still recover in 2021, and there have been some promising developments, but risks remain tilted to the downside. Strong fiscal and monetary policy support will remain necessary. The world's central banks will be keeping interest rates extremely low for some time. New Zealand also looks as if it may be headed for a better 2021, but investors will not know the scale or actual timing of the pickup for a while yet. In current risky conditions, extensive diversification and defensive portfolio positioning remains a high priority.

The US election proved to be a long and drawn-out affair with initial results showing greater levels of support for President Trump than polls had suggested. Despite being in the balance for some days, the final tally has gone to Biden and he will undoubtedly be the next President (despite Trump's ongoing machinations). Markets have reacted well to the result, with day-to-day drama in the White House likely to subside under Biden. However, the main reason for the strong market reaction seems to be that the US political system will more than likely remain split, with Democrats holding the House of Representatives and Republicans controlling the Senate. This means that the new administration will be somewhat hamstrung, potentially unable to reverse some of Trump's more market-friendly policies (such as the large 2017 corporate tax cuts). However, the level of support for Trump in the election results shows that his 'style' of politics is far from dead. More than 70 million Americans voted for Trump, proving how deeply divided the country remains (and there is also the possibility that Trump will run again in 2024).

Short-term interest rates globally are now extremely low, with the Reserve Bank of New Zealand (RBNZ) continuing to hold the official cash rate, or OCR, at 0.25%. Longer-term yields, however, have picked up in recent weeks due to the US election result and vaccine advancements. Even so, further monetary policy easing is on the way. The RBNZ will commenced a Funding for Lending programme on 7th December, which involves lending up to $28b to registered banks at the level of the OCR to encourage them to 'on-lend' to businesses and consumers. While there are people beginning to worry about the longer-term inflationary consequences of ultra-low interest rates for long periods of time, for the next few years providing support to the world economy will continue to dominate. At this point, the concern is that too much cheap money is finding its' way into assets, including shares, commercial and residential property. The housing market is rapidly becoming out of control. Latest figures from REINZ show that median house prices across the country increased by 20% in the 12 months to the end of October, and the median price of a house in the Auckland region is now $1 million! Clearly, there is a lot of money being moved from term deposits and bank savings into residential property especially, but also into the sharemarket.

New Zealand shares have had the same volatile year as other equity markets but have ended up ahead for the year to date. Australian shares have been doing well since the end of September, but the recent strength has not been enough to make up the losses experienced earlier in the year. It is clear from a swathe of recent business surveys that the economy has bounced back robustly from the impact of the COVID-19 lockdowns. While the immediate situation has improved, what lies ahead is more important and the outlook remains uncertain. New Zealand shares have had a good run and may continue to benefit from the attraction of steady dividends in a low interest-rate world. In global sharemarkets, investors are now ahead year to date. As has been the case all year, the outcome has been heavily reliant on the U.S. market. European shares have been especially weak. Emerging markets are slightly up year to date.

There have been some constructive developments in the global economy. World economic activity has picked up strongly from the Covid-19 setback. It has been helpful that China has emerged from the other side of its outbreak and is providing significant support to world economic activity. In a global equity market so dependent on U.S. shares, it helps that forecasters are still upbeat about the prospects for U.S. corporate profits. The IMF's latest assessment is that 2020 has turned out a bit better than initially thought. The growing resurgence of Covid in the US, however, is extremely concerning and there are indications that this is threatening to derail their recovery. At time of writing, Republicans and Democrats are continuing to fight over a new fiscal stimulus package worth nearly U$1 trillion. This is desperately needed to protect jobs and ensure that the US economy remains supported through their winter.

The recent commencement of vaccinations in the UK using the vaccine produced by US pharmaceutical company Pfizer is definitely a positive development. There are also two other vaccines (Moderna and Oxford Uni/AstraZeneca) with strong trial results which should be approved for use soon. However, even if these prove to be what the world is desperately wanting, there are massive logistical issues to overcome in achieving widespread distribution. We need mass vaccination in order to achieve the level of immunity required for the world to return to 'business as usual'. For investors, guarded and skeptical optimism looks like a reasonable stance, but the high levels of economic and political uncertainty suggest that portfolios will still need to be covered, through diversification and defensive strategies, against likely risks eventuating for a while yet.