Economic Commentary

February/March 2019

After quite a significant market correction from the beginning of October until Christmas, international sharemarkets have bounced back in January and continue to perform well at time of writing. The NZ dollar remains strong, however, and this is preventing the full effect of the market improvement from flowing through into portfolio valuations. After a decade of steady growth in most major economies, there is increasing evidence that we are approaching the end of the business cycle and things are beginning to slow. At this point there is no dramatic shift, more an accumulation in the economic data showing a gradual slowdown in growth.

Ironically, it is this evidence which has partially underpinned the improvement in market sentiment since Christmas due to the implications for the future path of interest rates. In October, a statement by the US Federal Reserve Chairman indicated that official cash rates in the US were likely to be raised 3-4 times in 2019. This was in response to strong US data at the time, implying a greater chance of increases in inflation. Since then, we have seen less positive data emerging and comments from central banks have become less “hawkish” about increasing rates. Many analysts now predict no interest rate increases at all in the US in 2019, and the situation is much the same in NZ and Australia. Although the global economy is slowing, the ongoing low interest rate environment continues to underpin sharemarket performance as investors seek higher returns and dividend yield. The threat to this current equilibrium is a pickup in inflation and an unexpected spike in interest rates as a result.

Global politics continue to affect markets. Trade tensions between the US and China are ongoing and the Chinese economy is starting to show the effects of this and a more general slowdown. The government has taken steps to improve the situation, cutting taxes and reducing the reserve requirements of the banks to encourage greater lending (although there is a high level of debt already). To put China’s slowing growth in context, their economy has grown by an estimated 6.4% over the past year, compared to an annual rate of 8-14% in the decade from 2000-2010. Even at current rates, this is three times faster than the NZ economy and a high level of growth by global standards. In contrast, the UK is in turmoil as the proposed Brexit deal with the EU has been rejected by the British parliament. It is almost impossible to predict the Brexit outcome and implications for the Pound and markets at this point.

Perhaps the biggest news in the financial sector in Australasia is the recent release of reports from regulators around misconduct in the banking and insurance industries. In NZ, the Reserve Bank and FMA have criticised the conduct of life insurance companies, especially around soft commissions (e.g. overseas trips) and “churning” of customers –

selling replacement policies to gain commissions when this may not be in the best interests of the customer. In Australia the big four banks are facing increased regulation after some shocking conduct was exposed by the recent Royal Commission into Banking and Financial Services. The housing markets in the main centres in Australia are already feeling the effects as banks have tightened lending standards, leading to falls in house prices of up to 10% in Sydney and Melbourne. We are likely to see some fallout from this here also, despite the FMA finding only minor issues amongst the NZ bank subsidiaries. The FMA's review of NZ banks was much more limited in scope and based on self-reporting by the banks themselves. It is hard not to be sceptical! There are a number of factors aligning which may impact our local housing market – proposed changes to NZ's bank capital requirements, ring-fencing of tax losses on rental properties, new tenancy requirements for landlords, and the Tax Working Group recommendations for a capital gains tax. Prices have plateaued in Auckland, and it will be interesting to watch the housing market over the next year or so to see how it reacts to these changes.

The debate around the capital gains tax (CGT) has already been fierce and will likely become more so over the next 18 months until the next election. The recommendation from the Working Group for a broad CGT on property (other than the family home), investment assets and businesses was largely predictable, but did surprise in the extent of some of the proposals. For example, imposing the tax at the individual's marginal rate would result in a much higher tax burden than that of most countries with a CGT. It seems likely that the Labour government will adopt some of the recommendations but "water down" the overall approach to be more politically acceptable. Could this have been the intention from the outset? It's quite possible that the final result from this whole process will be a CGT on residential rental property only (which seems to be the real target). NZ needs more investment in businesses and capital assets, not less. Let's hope the government fully considers all of the potential implications of any changes in the tax system. There are always second and third order effects beyond the obvious ones, and politicians rarely understand these before they act!

Our investment outlook overall remains as it has done for some time. There are enough risks in the global and domestic environment to warrant taking a conservative approach, tilting to the more defensive side in our asset allocation models and asset selection. As always, the best course of action is to follow proven investing principles, look through the short-term and focus on long-term plans for success.