Economic Commentary

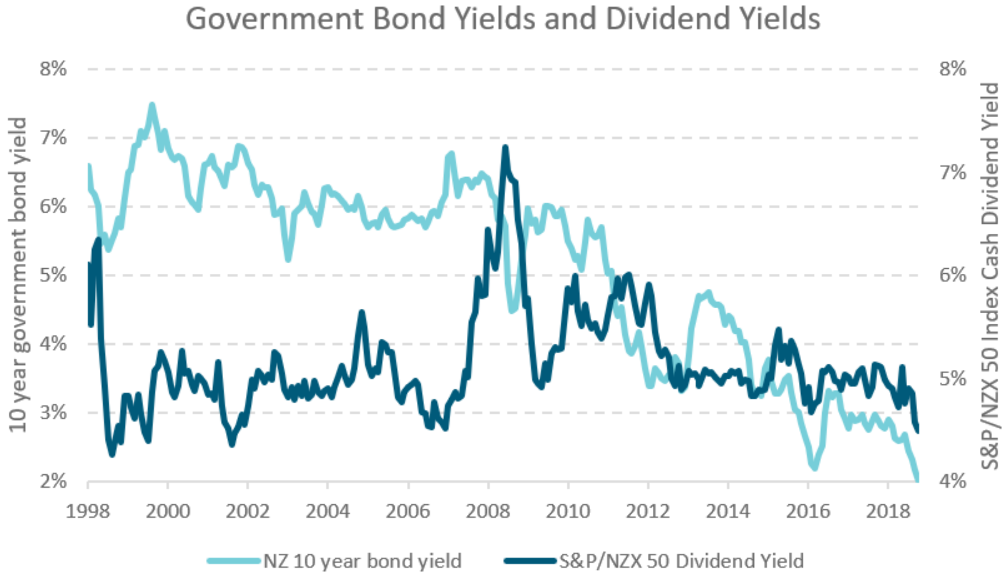
March/April 2019

We are now three months into 2019 and it has been a particularly strong quarter for financial markets. Global sharemarkets are up by nearly 12% over the period and this has been matched locally by our NZX 50 index. This is in stark contrast to the last quarter of 2018, when markets were heavily down in a short but sharp correction. The dramatic shift in fortunes has been driven primarily by the major turnaround in expectations for the path of interest rates, especially in the US. The potential for lower interest rates in NZ over the next year has also resulted in a decline in the NZD at the end of March, and this has provided a little end of quarter boost to investment returns.

Over the last year (or more), we have been “harping” about interest rates and the danger that a sudden spike in rates poses to your investments. The reason for our preoccupation with interest rate movements is the close connection between rates and asset prices. This has been clearly demonstrated over the last six months. At the beginning of October, the US Federal Reserve Chairman commented that US interest rates are “far from neutral” and that further rate hikes would be needed in 2018 and 2019. This triggered the dramatic fall in sharemarkets from October to December. As data came through over those months showing a slowdown in economic growth, the Fed dramatically changed their tune. By the end of December/beginning of January, the new projection was for interest rates to be on hold throughout 2019, with some analysts even anticipating a rate cut. In NZ, the latest monetary policy announcement from the Reserve Bank also indicates a rate cut is possible this year. What has caused the sudden shift in interest rate expectations? While there are no signs of an imminent recession, there is an increasing amount of data which (on balance) shows that economic growth is slowing around the world. Should this accelerate, the market anticipates that central banks will have to cut interest rates to support the economy.

As we’ve discussed before, the level of interest rates is a key determinant in prices for shares, property and bonds. For example, companies typically pay dividends to their shareholders, and these are expressed as a percentage of the share price known as the “dividend yield” (if the share price is $10 and the annual dividend is 50c, the dividend yield is 5%). If interest rates fall, this flows through into fixed interest investments such as term deposits and bonds. Investors look for improved returns and may find dividend yields in the sharemarket more attractive (5% starts to look good!). Demand for shares increases, the price is bid up and current shareholders benefit from capital gains as well as the ongoing dividends. Of course, the opposite applies when rates rise! It’s through these mechanisms that interest rates affect all investment choices. This is exactly what has occurred over the last six months as interest rate expectations first rose sharply and then fell just as dramatically.

The following graph shows the relationship between interest rates (10-year bond yield) and dividend yield. Since 2015, there has been a strong link between the two. As interest rates have fallen, dividend yield has also fallen as investors push up share prices. This means capital gains for shares and listed property investments in your portfolio.



Source: UBS, Bloomberg, Harbour Asset Management

The big question now is, where do markets go from here? There are two competing factors which represent “push-pull” effects on asset prices. Low (and possibly falling) interest rates will support prices on the one hand. On the other, a slowing economy may affect corporate earnings and profits and translate into lower prices. It is very hard to know which of these factors will prove dominant over the short- to medium-term, and it will depend on the extent of any economic slowdown. However, the last quarter has stretched asset prices to very high levels and it is hard to see how this can continue against the backdrop of slowing growth. The market has been driven by interest rates of late, but at some point the fundamentals of company earnings and future company growth potential must take prominence again.

Global events will continue to create volatility in the short-term. These include the US-China ‘trade war’, which seems to be coming to a head, and the ongoing Brexit farce in the UK. On the trade front, it is in the interests of both sides to reach some sort of deal soon. A long, drawn-out process will certainly be harder to sustain politically in a slowing economy. Brexit is becoming a nightmare for the UK and there seems no consensus amongst British politicians as to what is the best way forward. Even government MPs cannot agree and the result is absolutely impossible to predict.

Our investment approach remains as it has done for some time. There are enough risks in the current environment to warrant maintaining a conservative approach, tilting to the more defensive side in our asset allocation models and asset selection. An unexpected rise in interest rates or a sharper slowdown in growth and corporate earnings are the key factors which could disturb the current market rally.