Economic Commentary

September / October 2018

A relatively sharp spike in interest rates in the US in the first week of October has caused the markets to react strongly, with global share markets moving lower in unison. The increase in interest rates is not unexpected, as the US economy has continued to outperform. Unemployment is at its lowest since 1969 and this is expected to lead to wage rises and hence inflation. As we have been discussing for some time, interest rate increases pose challenges to asset prices. An uptick in rates has broad implications across the economy and markets, not just in the fixed interest sector. For example, property and infrastructure stocks are (at least partially) priced based on yield, and so have provided attractive returns from dividends and capital gains as interest rates have fallen. As rates increase (especially quickly or unexpectedly), the market re-prices the assets to reflect a higher level of required returns and this can lead to reduction in the asset value. At this point the strong indications are that what we are observing is a market correction, rather than anything more sinister. We have been repositioning portfolios, reducing risk positions during the year, and will continue to watch longer-term trends and adjust accordingly.

Overall portfolio returns over the September quarter have generally been positive. Share markets in Australasia and the United States have produced solid returns. These have been supported by a weakening in the NZ Dollar, especially against the US Dollar. When the local currency weakens, any assets held in foreign currencies will increase in value in NZ dollars, resulting in an increase in the asset value (even if the asset price in the foreign currency is unchanged). The double effect of overseas market gains in the quarter and NZD weakness is good for your investments.

Economic conditions globally generally remain good, but the synchronised growth that we have seen over the last few years is fading. The US is the standout region, with strong GDP growth, low unemployment and continuing gains in equity markets. Over the past decade the US markets have now officially had their longest "bull run" in history. However, European markets are mixed and emerging markets are facing headwinds. This is partly due to trade tensions with the US, but also to their high levels of debt and the strengthening US dollar. The Chinese economy is showing signs of slowing down and trade issues are exacerbating the impact on the two major share markets in mainland China. Inflation is beginning to gradually lift, especially in the US where the Federal Reserve has recently increased rates and is expected to continue on its tightening path through 2019/2020.

At home, there are some signs that the NZ economy is slowing and that we are late in the business cycle. Manufacturing and services growth is slowing and the media frenzy around falling business confidence continues. Whether this decline actually results in reduced activity and becomes a self-fulfilling cycle outcome is hard to know. Even so, expectations are for a slowdown in GDP growth over the next 18 months rather than a recession or major downturn. The Reserve Bank is now projecting that the Official Cash Rate is likely to remain lower for longer. This will help to keep short-term interest rates low, but long-term interest rates are more affected by what is happening overseas. There are certainly domestic factors which support inflationary pressures – the increase in the minimum wage, industrial action from public sector employees, the decline in the NZ Dollar, increasing oil and petrol prices etc. While government debt levels are relatively low, the very high level of private debt (especially in home loans) in New Zealand and Australia does make us vulnerable.

Asset prices remain fully valued with the continued gains from markets in Australasia and the US. The stretched valuations mean greater sensitivity to developments and hence ongoing volatility. This could come from political events, unexpected inflation, a correction in the housing market, or contagion from emerging market woes. As a result, we continue to be cautious and tend toward a more defensive stance in portfolios. In equities, this includes reducing exposure to passive funds and instead using active managers with proven track records and an ability to take defensive actions to protect capital if the need should arise. In the fixed interest market, due to the interest rate environment we continue to watch the bond market with scepticism and in the meantime to persist with short-duration deposits.