Economic Commentary

September 2019

The quarter has produced solid returns for portfolios despite a volatile month in August due to international developments around economic growth, trade and Brexit. Interest rates are being reduced to support growth and in response to the threat of longer and more serious trade disputes, especially between the US and China. Since the beginning of August, there has been a major increase in these trade tensions. In an effort to pre-empt a slowdown here, the Reserve Bank of New Zealand surprised almost everyone by reducing our official cash rate by 0.50% to 1.00%. This is punishing for those reliant on fixed interest for income, but on the other hand provides support for prices of growth assets as savers with cash to invest look for other sources of return. The NZD has also significantly weakened against most other currencies in the last month, and this has provided protection for portfolios as assets held in foreign currencies increase in value when converted back to NZD.

Initial hopes that the “trade war” would be short, sharp, and quickly resolved now seem to have been too optimistic. While media reports often refer to the issue as a US-China trade dispute, this is far too simplistic as the implications are felt across the global economy. Trade makes up around 70% of the world’s GDP and supply lines are complex, with most manufacturing firms sourcing components and primary materials from multiple countries. For example, the US technology company Apple has over two hundred suppliers from a large number of countries across Europe, Asia and North America. Their iPhone mobile phone is designed in the US and assembled in China, but it includes components (and basic materials) which were themselves manufactured/produced in other countries, such as Japan, Korea, Switzerland, Germany etc. China is essentially just the final finishing point of the product. When the US imposes a tariff on goods originating in China, the impact is felt throughout globally. It has been estimated that the iPhone 7 cost US$240 to make, but that only US$9 of this value was added in China[1]. The tax is not just on Chinese exports, it is on the entire supply chain.

When the US President sent out a tweet in early August stating that trade negotiations were not progressing well and that additional tariffs were being applied to US$300bn of goods from China, global sharemarkets reacted to the news and fell quite sharply. The tariffs are a threat to corporate profits, which in turn translates into lower business confidence, investment and growth. The strong sharemarket performance since the beginning of the year has meant that the share prices for many of these companies are elevated already, and so are sensitive to any news which would indicate lower future profitability. It is hard to know how the trade dispute will play out from here. Both sides seem to be becoming increasingly frustrated with the other, and it is highly likely that investors will continue to see periods of significant volatility as news comes to market. Ultimately, it is in the interests of all that a mutually beneficially agreement is reached to restore some certainty.

The other major issue which continues to affect markets is the recent developments around interest rates. Despite indicating in their commentary that the underlying US economy is still in a fundamentally good position, the US Federal Reserve recently reduced US rates by 0.25%. As mentioned earlier, the Reserve Bank here went further at their meeting on 7th August and reduced our local Official Cash Rate (OCR) rate by 0.50%, which was a surprise. Based on the explanation from the bank, it appears that the cut was intended as a pre-emptive move to boost demand and ward off a more significant slowdown in growth. Normally, rates are adjusted in 0.25% increments, and we would only expect to see such a large reduction at a time when the economy is either in recession or particularly vulnerable. The last time we saw a 0.50% cut was just after the Christchurch earthquake in 2011, and prior to this during the financial crisis in 2008/2009. The OCR is now at 1.00%, its lowest ever level, and the Reserve Bank has indicated further reductions and even the possibility of negative rates. Rather than receiving interest, you may have to pay the bank to hold your money! In our view, while there has been some slowing of growth in NZ and globally (and the trade issues continue), it is hard to see an imminent recession or crisis which would justify such dramatic action. In fact, the Reserve Bank's move may have contributed to already poor business confidence by fuelling perceptions that the economic situation is more dire than it really is.

Media reports on the OCR cut usually focus on mortgage rates for borrowers, but the flip side of this is the impact on savers and investors relying on fixed interest income. At time of writing, all four of the major banks are offering one-year term deposit rates of around 2.80%. For an investor with a tax rate of 17.5%, the after-tax rate reduces to 2.31%. Taking into account inflation of 2% (the Reserve Bank's midpoint target), the actual real return, which shows the change in your purchasing power, is reduced further to just 0.30%. It's no surprise that investors are looking for alternative sources of return, and as a result are moving at least some of their money out of deposits and into shares and listed property for the higher dividend yields. This is pushing up share prices and introducing greater risk exposure. It is important that, despite the low interest rates and returns from fixed interest, the level of risk in investment portfolios is carefully managed to ensure that it is appropriate for the investor's risk profile/capacity. This means ensuring the right balance between defensive and growth assets and avoiding the temptation to take on an increase in risk exposure in order to chase an improved yield. We will continue to focus on maintaining this balance, locking-in profits from market gains where possible and repositioning portfolios to ensure that they remain fit for the long-term.

1. Platinum Asset Management: "China is not in crisis, it is reforming".