Investment Update – April 2018

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Potential trade wars and interest rates have dominated the news in March. The first quarter of 2018 continues to show signs of more volatility and nervousness in markets particularly as the US, being furthest of the advanced economies through its cyclical growth, presents a different economic narrative to the rest of the world. Fundamental indicators of economic growth still suggest advanced economies are continuing to grow and stay strong, albeit against a backdrop of political risks surrounding the US's move toward protectionist trade policies.

US

The Fed's decision to raise interest rates in March by 0.25% was widely expected but some have been caught off-guard by the degree to which Fed officials increased their projections for future interest rate hikes. The median forecast for the Fed funds rate at the end of 2019 is now 2.75-3.00%, which until recently was at the hawkish end of the spectrum.

The direct economic impact of the tariffs which have been announced by the Trump administration are unlikely to be significant, and even if they are implemented in full, we suspect that any retaliation will be moderate. Businesses in the US are generally united against the tariffs, and Chinese retaliation would fall hardest on the 'Farm Belt' States that helped Trump win in 2016 and heavily rely on the export of soy bean to China. In that event, a trade war may be bad politics as well as bad economics. But the protectionist announcements and actions continue to weigh on investor sentiment as it is unclear that a moderated rational approach will win out in trade negotiations.

With the benefits of the fiscal stimulus, strong global demand and the weaker dollar, the Fed officials raised their forecasts for economic growth, with the median rising to 2.7% this year (from 2.5%) and 2.4% in 2019 (from 2.1%) which we consider slightly optimistic. As the fiscal stimulus begins to wear off and the cumulative monetary tightening starts to bite, GDP growth could slow in the second half of 2019.

China

The tariffs on Chinese imports outlined by President Trump are unlikely to have a big impact on the Chinese economy directly, and we think that the measures will end up being watered down. But as the recent market reaction highlights, there is a clear risk that investor sentiment continues to deteriorate and the damage from a further escalation of the trade conflict with China could be much greater.

In monetary policy, Chinese authorities are cutting the amount of cash local banks are required to set aside to cover bad loans, a move that would boost lenders' bottom lines but potentially increase financial risk. With the sector struggling to boost profits, the country's banking regulator will lower the provision coverage ratio for commercial banks—a requirement to safeguard their ability to weather losses—to a range of 120%-150%, from the current minimum of 150% of their bad loans. It is likely that the recent 5bp rate hike by the People's Bank of China will not prevent market interest rates in China from continuing to fall, as they have done since the last rate hike in December.

Europe

The Euro-Zone should continue its expansion while allowing the European Central Bank (ECB) to wind-down its asset purchases this year, which would mark an end to a period of quantitative easing dating back to the financial crisis. We see it as unlikely that ECB will follow the US and raise interest rates anytime soon.

It is also likely that Europe will exercise restraint when considering retaliatory measures in the face of higher steel and aluminium tariffs, regardless of whether it is granted permanent exemptions, as its interests are to minimise the risk of trade conflict.

In the UK, news that an agreement has been reached on a transition period after the UK formally leaves the EU reduces the risk of a Brexit-related downturn. There is also mounting evidence of higher wage pressures, with average earnings growth at 2.8% in January and suggests that the Bank of England will be sooner, and more likely, to follow the US on interest rates.

Australia

In mid-March, the Reserve Bank of Australia (RBA) left interest rates on hold at 1.5% for the 17th consecutive meeting and it noted once again that progress in returning inflation to target is likely to be "gradual", suggesting that a near-term rate hike remains unlikely.

Further ahead, we expect that interest rates will remain on hold until the second half of 2019. Aside from an acknowledgement that "market volatility has increased from the very low levels of last year", the new policy statement wasn't much changed from February's statement. Indeed, the RBA retained its fairly optimistic view on the outlook for economic growth, saying that it expects the economy to "grow faster in 2018 than it did in 2017".

The unemployment rate may need to fall from 5.5% currently to around 4.0% before wage growth rises significantly. This is partly due to the existing excess capacity not captured by the unemployment rate, but also as the natural rate of unemployment may be notably lower than most estimates of 5.0%.

The economy will probably cope reasonably well even though both the mining and housing booms are over, but over the next couple of years it is unlikely to strengthen as much as policymakers hope.

New Zealand

The Reserve Bank of New Zealand Governor Grant Spencer finished his six-month term leaving interest rates at 1.75% for the 16th consecutive month and reiterating that rates are unlikely to rise until the second half of 2020 The new Governor Adrian Orr is unlikely to begin with a bang when he takes over on Tuesday, not least because he will have to deal with a slowing economy and not enough inflation, but we can't completely dismiss the possibility that he shakes things up a little.

The 2017 fourth quarter GDP report showed a healthy expansion with the RBNZ expected figures growing 0.7% and the trend appears to be in line with expectations and unaffected by an election transition. Weather extremes are likely to affect farming outputs however other well performing areas such as retail and services have contributed to the growth in the economy.

NZ's underlying economic momentum should continue with the current trajectory of domestic demand growth that will continue to put pressure on capacity constraints and inflation wages over the course of 2018. There is a potential small divergence in business confidence as compared to Australia this year, some explanations suggest that it could be linked to uncertainty surrounding the policies of the new government in NZ. Best estimates are that GDP growth in Australia will accelerate from 2.3% last year to 2.5% this year while growth in New Zealand will probably hold steady close to 3.0% or perhaps drop slightly.

Summary

Global macroeconomic indicators still point to a global growth story despite markets becoming increasing cautious and volatile. The first rise in interest rates in the US suggests that inflation is around the corner. US protectionist policies are likely to affect market sentiment more than the fundamentals of economies.

Given the length of the economic recovery and period of strength from investment markets, it is important that clients' portfolios are no more growth orientated than their long term strategic asset allocations.