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Investment Update – December 2018

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Global Markets Overview

Globally, the Fed and US-China trade relations continue to take centre stage in the economic theatre of 2018 (so far a drama not a tragedy) while Brexit and Italy present challenges to the European outlook.

US / China Trade

In a much-anticipated working dinner in Buenos Aires following the G20 summit, Mr Trump and Mr Xi agreed to a temporary ceasefire, in which the US president suspended his decision to impose higher tariffs, from 10% to 25% on $200bn on Chinese imports until March 1st, 2019 at the earliest. In exchange, China will increase its purchase of American farm produce, energy and some industrial goods. However the truce is fragile and formal talks between the two countries could well fail due to the high hurdles that stand in the way of agreement. First, the Chinese commitment to raise purchases of American goods is by an amount "not yet agreed upon, but very substantial" is unlikely to reduce America's bilateral trade deficit with China by a significant amount. Second, the challenge that negotiators now have 90 days to agree "structural changes with respect to forced technology transfer, intellectual property protection, non-tariff barriers, cyber intrusions and cyber theft, services and agriculture" is ambitious, particularly when levels of trust between the two sides are so low. It is evident that this theme will continue into 2019.

US

The Fed's tightening path had fuelled fears about a sharp downturn in the US housing sector. Home sales have slowed, inventories are rising, and homebuilder equities have sold off over 30% YTD.

However, the recent market reaction to a statement from the Federal Reserve Chairman Jerome Powell that we are approaching neutral shows how critical investors see this current period of tightening. Sharemarkets rallied as Jerome Powell said he sees current interest rates "just below" neutral. That proved to be significant because the language Mr. Powell used 6 weeks earlier indicated a view that the fed funds rate was "a long way from neutral." Powell added that there is no pre-set policy path, and the Fed will be data-dependent in its decision making, which pleased investors. By highlighting risks, though, that included previous rate increases, trade disputes, and Brexit/EU political uncertainty, the market chose to read between the lines that the Fed chair isn't wedded to three rate hikes in 2019.

The results for the recent US midterm elections were widely predicted (which is a surprise by itself). Democrats took the House of Representatives which will provide some oversight of the White House when members of the new Congress take their seats in January. Republicans held the Senate—with a bigger majority, which will make presidential appointments easier to confirm. Both sides declared victory. A starkly divided country now has a divided government. Underpinning the results, though, is the deepening of a structural shift in American politics that will make the country harder to govern for the foreseeable future.

China

China's recent slowdown in gross domestic product growth is unsettling global markets and testing the Communist party leadership. Beijing is determined to keep its economy stable but doing so means tackling the politically sensitive issue of its private sector. Private enterprises are China's economic mainstay, contributing about two-thirds of output and investment and the lion's share of jobs. They drive the prosperity upon which the Communist party's legitimacy rests. Yet Mr Xi has favoured state-owned firms since he took power in 2012 and clipped the wings of several high-flying private entrepreneurs. Now, as Beijing seeks to stiffen its resolve in the US-China trade war, the private sector's dynamism is flagging, creating economic headwinds. Third-quarter GDP growth slipped to 6.5 per cent, year on year, its slowest since 2009. While this is by no means lacklustre, there are signs momentum could slacken further.

We expect flexible policy to come from Beijing as it attempts to manage headwinds associated with trade disputes, slowing demand and negative sentiment toward its equity markets causing investment outflows. China has accounted for 36% of global GDP growth since 2010 and has played a vital role in the economic recovery. This too will be a key focus for the global economic outlook in 2019.

Brexit

Political uncertainty in the UK is extreme currently and reflected in investor positioning in sterling and UK equities.

Theresa May is battling to save her Brexit deal and her own position as Prime Minister after a series of ministerial resignations and the threat of a Eurosceptic coup left the Conservative party on the brink of civil war. Mrs May insisted she would stick to her plan, which would keep Britain closely tied economically to the EU, and said she was not about to quit in spite of growing criticism from Brexiters in her own party. Mrs May warned that Britain would embark on "a path of deep and grave uncertainty" if it abandoned the withdrawal deal it had agreed with the EU.

It's unclear whether the refusal of May's deal by British parliament would turn into a 'hard' Brexit (i.e. with no deal). The crucial vote in Parliament is on December 11th. May said there was no plan B, however, some commentators suggest that the transition period may get extended again due to the complexities of reaching a deal. The more it is extended, the closer it gets to the June 2022 election, increasing the likelihood of a potential second referendum.

Britain's Treasury estimated that GDP will be 3.9% smaller in 15 years' time than it would otherwise have been if the country leaves the European Union under the deal recently agreed with EU leaders. Under a no-deal Brexit, it would be 9.3% smaller.

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Europe

The fate of the euro strongly depends on Italy. With annual GDP of more than €1.6trn ($1.9trn), about 15% of euro-area output and debt of nearly €2.3trn, it poses a challenge to the single currency that Europe seems unable to manage but cannot avoid. Matters are now coming to a head, as Italy's new coalition government instigates a showdown over the European Union's fiscal rules. The disagreement might well become disastrous. But it is also an opportunity for the euro zone to begin building a better, more durable approach to fiscal policy.

Trouble began earlier this year when the populist Five Star movement, led by Luigi Di Maio, formed a government with the right-wing Northern League, led by Matteo Salvini. Both promised budget goodies: Mr Salvini a hefty tax cut and Mr Di Maio a basic minimum income. Such a bounty may test the deficit limit of 3% of GDP set by the EU's stability and growth pact and it seems certain to break other fiscal rules set by the bloc: the government's initial budget plan is forecast to raise borrowing to 2.4% of GDP in 2019, above the 0.8% target to which Italy previously committed itself and enough to reverse recent, modest declines in its debt burden.

The EU did not take the news well. On November 5th other countries' finance ministers warned that failure to revise the budget would lead to an "excessive deficit procedure" and possible sanctions.

Australia

We expect real GDP growth of around 3% by end-2018. Such a pace of growth should see the unemployment rate largely track sideways over 2018. Household incomes and consumption growth remain weak, possibly due to a weaker housing market, particularly in Sydney and Melbourne.

New Zealand

While actual economic output continues to grow a persistent downturn in business sentiment has emerged. The ANZ business outlook survey reported that headline business confidence remained stubbornly low, with a net 37% of respondents reporting they expect general business conditions to deteriorate in the year ahead. The likely explanation for which confidence is being rocked is a combination of policy uncertainty, capacity restrictions and margin pressure.

Labour market conditions have now tightened to a point where we expect wages to (finally) begin to move higher. However the RBNZ took an unexpectedly dovish turn in the August MPS, despite expecting modestly higher inflation in the near-term, and it has reiterated this approach recently.

Summary

For New Zealand, our economy has been supported by the tailwinds of record-high Terms of Trade, low interest rates and strong population growth. Nonetheless, business confidence remains weak and points to an upcoming slowdown in growth led by a fall in business investment.

Globally the combination of strong growth and loose financial conditions was highly supportive for equities in 2017. This year we have seen a tightening of financial conditions alongside a divergence of global growth, with the US outperforming. In 2019, we see renewed economic convergence driven mainly by the US economy slowing at a time when inflation pressures and interest rates are increasing. We do not see a recession as likely in 2019. Without a recession, it is unlikely that profits fall. Without profits falling, it is unlikely that we see a sustained equity bear market.

There has been a cyclical increase in global economic activity over the past couple of years, but we believe the longer-term outlook for economic growth remains subdued with risks to the downside because of structural headwinds. The US - China trade talk news will underpin investor sentiment in the short term. In 2019, investors should ensure that their portfolios have a risk exposure consistent with their risk tolerance.

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