Select Wealth Management

Sophisticated investing made easy

Investment Update – January 2018

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Usually at this time of the year, financial market comments cover the performance of the year just finished and look forward to the likely prospects and outcomes for the coming year.

The Year to 31 December 2017

In an economic sense, this year will be remembered as the year that the US Federal Reserve raised its key policy interest rate three times in the year and promised three more increases in 2018, as well as starting to scale back its massive balance sheet nearly eight years after it started its quantitative easing programme.

In a political sense, it will be remembered as the year of Donald Trump and his policies, the tortuous Brexit negotiations in Europe, the New Zealand elections and the nuclear aspirations of North Korea.

It will also be remembered as a surprisingly strong year for most investment markets.

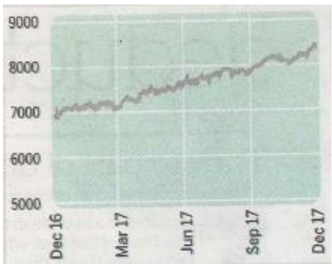
The performance from bond markets was modest in 2017 as US interest rates moved lower then higher during the year. The US 10-year treasury note yield bottomed at 1.36% in mid-2016. Its yield was 2.41% at year end after starting the year at 2.44%.

At the beginning of the year, the official New Zealand cash rate (OCR) was sitting at 1.75% and the Reserve Bank of New Zealand (RBNZ) left it unchanged during the year, following three rate cuts by the RBNZ in March, August and November 2016.

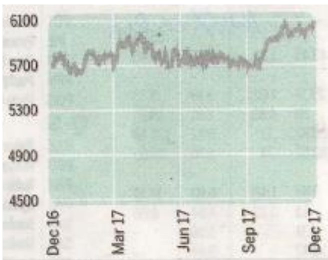
The New Zealand markets had very satisfactory returns for these twelve months compared with Australia and the rest of the world.

Bonds (as measured by the S&P/NZX A Grade Corporate Bond Index) provided a total return (income plus capital gain) of 5.8%, while shares (the S&P/NZX50 Gross Index) provided a 22.0% annual return to equity investors. Listed property shares (the S&P/NZX All Real Estate Index) generated 13.9%.

New Zealand Shares 2017



Australian Shares 2017



Beyond New Zealand, sharemarkets were all positive. Australia had a strong year in AUD, 11.8%, and the results from other major bourses in their local currencies were similar, i.e. USA 19.4%, France 9.3% and Germany 12.5%. London, in the throes of its Brexit negotiations, provided a less impressive return of 7.6%.

Therefore, as a composite, the most rewarding sectors in 2017 were New Zealand shares and global shares. For the latter, the MSCI World Index (in NZD) rose by 17.8% in the twelve months.

The Year Ahead

In 2016, nearly all sharemarkets provided positive returns as dividend yields offered higher yields than bonds with the ultra-easy monetary policies and low interest rates around the world.

In 2017, this scenario was effectively repeated even though interest rates began to rise in the second half of the year.

In 2018, there is no sign yet that the synchronised upturn of the world economy is running out of steam even at a time when inflationary forces remain surprisingly low too.

The US Fed's decision to begin scaling back its balance sheet nearly eight years after it started quantitative easing is a major milestone, but global financial conditions should still remain highly accommodative for a time yet. The latter are probably more influenced by central bank asset purchases throughout the world, which are likely to slow but remain positive at least for the next two years. Although the Fed and Bank of England raised policy rates in late 2017, short-term rates elsewhere will remain very low for the foreseeable future.

However, we are conscious that the bull market of over eight years has seen significant asset price appreciation in shares and that future investment returns are likely to be more modest. It is also clear that the bull market in bonds of the last 35 years is now over.

As statistics emerge around the prospect of higher economic growth, the need for higher interest rates appears to be gaining impetus but it will be a very gradual process.

Summary

Although the economic outlook is positive for 2018, we are fully aware that sharemarkets have risen sharply in recent years and valuations are high. Consequently, we will continue to monitor economic and political developments for any negative signals.

We still believe that the risk of an imminent bear market is not high at present. There are two main reasons for this.

First, inflation has played an important part in rising bear market risks in past cycles. Structural factors may be keeping inflation lower than in the past and central bank forward guidance is reducing interest rate volatility. Without monetary policy tightening, concerns about a looming recession – and therefore risks of a 'cyclical' bear market – are lower.

Second**,** financial imbalances and leverage in the banking system have been reduced post the financial crisis. This makes a 'structural' bear market less likely than in the past.

However, there are two portfolio catch-cries to heed to control risk within funds:

1) Stay well diversified.
2) Stay close to your benchmark sector targets, i.e. monitor your risk level.

Prudence suggests moderate caution towards markets in 2018.