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Investment Update – June 2018

Prepared by JMIS, investment consultant to Select Wealth Management

Generally, the month of May was consistent with the 2018 story of a global economy entering a mature stage characterised by market volatility, the gradual emergence of inflation, higher interest rates (primarily in the US) and a softening of global economic growth indicators. This cooling off period, which is usually accompanied with weaker equity markets, is likely to represent a healthy return to normal levels of growth as opposed to alarming signs of an economic deterioration. However, it is also likely to be true that the consistent and highly profitable financial markets are now behind us. Geopolitical issues in countries such as Italy, Turkey and Argentina also added new concerns for global markets over May.

Global Trends

The OECD's most recent general assessment of the global macro-economic environment predicts that expansion is set to persist over the next two years, with global GDP projected to rise by close to 4% in 2018 and 2019. Growth in developed countries is predicted to remain around 2.5% per cent per annum, helped by fiscal easing in many economies. It is also considered that GDP will strengthen to close to 5% growth among some developing countries.

Although job growth is likely to ease in advanced economies, the OECD-wide unemployment rate is projected to fall to its lowest level since 1980, with labour shortages intensifying in some countries. Wage and price inflation are accordingly projected to rise, but only moderately, given the apparent muted impact of resource pressures on inflation in recent years and the scope left in some economies to strengthen labour force participation.

US 10-year bond yields started strong in May and pushed through the psychologically important 3% barrier. However, the political upheaval in Italy toward the end of May caused U.S. Treasury yields to post their largest daily decline in nearly two years, and at the end of the month, traded well below 3%.

The rally continued in *oil markets early in May*. The latest spur for price rises stems from American sanctions on Iran which drove Brent crude close to $80 a barrel, the highest level in four years and up by almost 50% from a year ago. However, later in the month prices dropped and traded at around $70 a barrel as supply concerns eased.

The US

While America and China continued negotiations, trade conflicts opened on new fronts. Japan, Russia and Turkey notified the World Trade Organisation that they would follow the lead taken by the EU and India in applying tariffs on American *steel* and *aluminium* in retaliation for the duties America recently imposed on such imports, unless those duties are reversed. Mr Trump, meanwhile, signalled a new battle with Europe and Japan by ordering the Commerce Department to look at imposing tariffs on *imports of cars* on the ground of national security, the same argument that lies behind the levies on steel and aluminium. However, so far tough talk by the White House to renegotiate trade relationships has ended up as incremental concessions.

The US Federal Reserve's (Fed) preferred inflation gauge, the change in the core Personal Consumption Expenditure Index, reached 1.9% at the end of March. This supports the expectation that the Fed will increase the Fed Funds Rate by a further 0.50%-0.75% in 2018, with further increases expected in 2019.

The Fed continues to include the word "gradual" in its commentary regarding the expected future path of interest rates, so not to alarm markets.

If the current level of job growth is maintained and the proportion of people participating in the labour market remains unchanged, then a 3.5% unemployment rate could be hit in a year's time. In this scenario wage inflation is likely to be the biggest concern for the Fed.

The UK

Although the Bank of England left rates unchanged in March, two members of the MPC (Monetary Policy Committee) voted to increase rates suggesting a tightening bias existed for the UK.

Europe

Italy's political turmoil unnerved markets. Italy had been without a government since its March election, which yielded a hung parliament with no party or coalition holding a majority. The recent jolt to markets came after populists named Paolo Savona, an economist who thinks that Italy should quit the euro, as finance minister. President Sergio Mattarella vetoed Mr Savona and the populists threatened for a moment to impeach him and even hinted at a march on Rome. Amid talk of a political, constitutional and economic crisis, bond yields spiked and global stock markets shuddered. The yield on Italian sovereign bonds rose at a pace not seen since the euro-zone debt crisis. The ten-year bond yield rose to 3%, the highest level since 2014. Ignazio Visco, the governor of the Bank of Italy, warned the quarrelling politicians about the danger of "losing the irreplaceable asset of trust".

Emerging Markets

Argentina faces pressure to hasten economic overhaul. President Marci's efforts to curb inflation and jump-start the economy without shocking Argentina hasn't gone as planned. Investors continue to question the Argentina central bank's credibility as it cut interest rates in January to support growth despite inflation at 25%, well above target. They worried about the government's ability to reduce expenses to plug the fiscal gap and enact regulatory changes intended to improve business competitiveness and cut red tape.

Facing a currency crisis, Turkey's central bank simplified its system of multiple interest rates. The one-week repo rate (the rate at which the central bank lends money to commercial banks in the event of any shortfall of funds) became its new benchmark, which it also doubled to 16.5%. The central bank's governor met investors to offer reassurances that monetary policy would tighten further if inflation remains stubbornly high. The Turkish lira, which has taken a battering over concerns that the central bank's independence is under threat from politicians wanting lower interest rates, rallied in response.

Australia

While Australia's Reserve Bank and Treasury anticipate growth picking up to 3.25% over 2019 and 2020 many market commentators are predicting more conservative growth of around 2.5 – 2.7%. The sceptical commentators attempt to balance the growth story of strong non-residential construction, government investment and exports with reservations around slower residential construction and potentially weaker consumer spending.

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New Zealand

The most recent OCR announcement reiterates the global economic growth story which is forecast to continue supporting demand for New Zealand's products and services. It is also considered that ongoing spending and investment, by both households and government, is expected to support economic growth and employment demand. Business investment should also increase due to emerging capacity constraints.

The growth and emerging capacity constraints are projected to see New Zealand's consumer price inflation gradually rise to the Reserve Bank's 2% annual target. However, before then, the bank has indicated it will keep the OCR at the current expansionary level (1.75%) for a considerable period of time. Maintaining low and stable inflation is also thought to be the best way to maximise sustainable employment which now forms part of the Reserve Bank's mandatory considerations.

The Reserve Bank also publishes a six-monthly Financial Stability Report which assess the soundness and efficiency of the New Zealand financial system. The report, among other things, highlighted household and dairy farming debt levels as potential risks to the economy, however, was more positive about the financial strength of New Zealand's banking system.

Summary

Looking ahead, global markets face a more balanced set of tailwinds and headwinds than was the case a year ago. While the economic and earnings outlook remains strong, the peaking of leading economic indicators and earnings revisions suggest a more challenging environment as momentum for both slows.

Monetary policy generally remains accommodative, but again from here, the expectations are for policy direction to be neutral at best, but more restrictive in the US with multiple rate hikes over the balance of 2018.

Geopolitical risks such as the instability in Italy endangering eurozone stability, continuing trade war concerns and the overhang of Brexit negotiations will be important to watch unfold.

Given the extended period of strength from investment markets, it is important that the risk levels in clients' portfolios are appropriate.

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