Select WEALTH MANAGEMENT

Investment Update – May 2018

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Since February, equity market volatility has jumped from historically low levels, although this largely seems to have been technically-driven. Continued synchronized global growth and historically low interest rates are still supportive of equity markets, while economic indicators are not yet signaling the end of the business and market cycle that started in 2009. However, with valuations remaining high by historical measures, concerns around higher inflation, increasing interest rates, peaking economic and earnings momentum, global trade friction and geopolitical risks may continue to weigh on global share markets.

Global

The IMF's latest forecast for global growth painted a relatively rosy outlook for the world economy, which it said will benefit from America's expansionary fiscal policy. It raised its projections for almost all the world's advanced economies (bar Japan). But the IMF also issued a stark warning about the rising level of global debt, which reached $164trn in 2016, higher than at the time of the financial crisis.

Bond yield curves have been remarkably flat in recent times which some suggest is an indication of a potential economic slowdown as investors start to lose short-term confidence in the economy and lock in longer-term interest rates. However, the ten-year US Treasury yield recently rose above 3% for the first time in four years. It is unclear whether long term interest rates will continue to rise compared to short term rates given the unprecedented set of circumstances surrounding the global economy.

US

GDP figures suggest slowing economic growth in the first quarter this year, to between 2.0% and 2.5% annualised when compared to the 2.9% annualised gain in the fourth quarter of 2017, however, recent survey evidence supporting these figures has been mixed. Regardless, assuming GDP growth has fallen slightly, the movement is likely to be reversed in the coming quarter as the boost from the recent fiscal stimulus outweighs any hit from escalating trade tensions. Further, tax cuts have already raised real disposable incomes and consumer confidence is close to a decade-high, which is likely to show up in stronger household spending over 2018.

Tariffs and counter-tariffs on up to $150bn of trade with China will most likely be scaled back, but even if they aren't, they would have only a small impact on GDP growth. With the near-term economic outlook still solid, Fed officials will be more focused on the rebound in inflation, which markets expect will prompt them to raise rates a further three times this year.

The biggest banks in America reported good earnings for the first three months of 2018. Bank of America and Morgan Stanley made quarterly net profits of $6.9bn and $2.7bn respectively, boosted by revenues from share trading during a comparatively turbulent period for markets. Goldman Sachs generated a profit of $2.8bn while JPMorgan Chase made a record $8.7bn.

UK

A surprise fall in British consumer-price inflation to 2.5%, marking a 12-month low, did not dampen economists' expectations of an interest-rate rise by the Bank of England in May. Average earnings grew at their fastest rate in the three months to February since the summer of 2015, but some households may still be struggling. Outstanding secured borrowing has grown by more than 3% in the past year.

China

China's economy grew by 6.8% in the first quarter compared with the same three months last year.

China's bilateral trade surplus with the US and concerns about unfair trade practices are likely to keep US-China trade tensions boiling for a while. But China's overall current account surplus is much less of a concern for the world economy than it was a few years ago. As it happens, China's overall current account surplus has narrowed significantly in recent years and is no longer particularly large by past standards or compared to several other economies. Indeed, as a share of its own GDP, China's surplus has fallen dramatically from a peak of 10% in 2008 to just 1.5% last year (compared to Germany which had an 8%-of-GDP surplus last year).

Overall, the escalation of trade tensions with China is taking place at a time when there is relatively little reason to worry about its external surplus.

Australia

The Reserve Bank of Australia's apparent downward revision to its previously published 3.0% GDP growth forecast for 2018 shows once again that the RBA has been hopeful. We suspect it will also ultimately conclude that growth in 2019 won't be as strong as its current forecast of 3.25%. The RBA has hoped that recent rates of subdued economic growth would be followed by a period of much stronger growth. But if the legacy of the rapid gains in household debt and house prices is not a sharp slump in growth, then it will surely be a few more years of average growth.

New Zealand

The New Zealand economy is still seeing solid growth and low inflation. One of the risks facing the economy is that capacity constraints could act to slow the pace of domestic expansion. The labour market is currently very tight with the unemployment rate at a nine-year low and labour force participation, the employment rate and surveyed measures of labour shortages at elevated levels.

With respect to interest rates New Zealand largely followed overseas trends led by the US. The NZ yield curve has steepened over the past month as longer-term rates lifted, while NZ one and two-year swap rates have remained relatively steady.

The NZD was down late April by 1.5% lower on a Total World Index basis, with larger falls against the AUD and USD. Domestic data had a short-lived impact on the NZD, which briefly firmed on marginally higher than expected CPI inflation and an increase in dairy prices also supporting the NZD. The strengthening USD, however, was the dominant currency theme in the April month.

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. The recent weakness in equities coupled with the strong reported earnings and revisions has lowered equity valuations; however, risks have also risen which suggests multiple expansion from here is less likely. Monetary policy generally remains accommodative, but again from here, the expectations are for policy direction to be neutral at best, and more restrictive in the US with multiple rate hikes over the balance of 2018. Geopolitical issues will continue to weigh on markets as well in 2018 with the ongoing trade war concerns, the upcoming US midterm elections and the continued overhang of Brexit negotiations, to name a few.

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