Investment Update – May 2019

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Last month we wrote about the significance of the dovish positioning from the central banks around the world led by the Fed backing off interest rate increases earlier in the year. This response from central banks worked to support markets and was essential to offset investors' concerns around slowing global growth. The relationship between slower growth and low interest rates remains a central theme to the global economy and is a key consideration for investors.

There were some positives in April to restore some confidence that a slowdown in global growth was previously overstated by some commentators. Trade flows are picking up in Asia, America's retail sales have been strong and even Europe's beleaguered manufacturing industry has shown flickers of life. Also positive, albeit retrospective, was the news that the US delivered beyond market expectations for first quarter 2019 GDP growth, while defying claims of a possible earnings recession.

However, it would not take much bad news to reinstate caution. The global economy has slowed and further downwards momentum, or a new negative shock, could further weaken economic prospects. Policy risks in the form of deteriorating US-China trade relations and a No-Deal Brexit remain key threats too.

US – Economy boasts +3.2%… but still no inflation

The US economy defied fears of a first-quarter slowdown, overcoming a prolonged government shutdown, trade tensions and global economic uncertainty to deliver growth that trounced analysts' expectations. Gross domestic product rose at an annualised pace of 3.2 per cent during the first three months of the year, handily topping Wall Street predictions for 2.3 per cent growth. It is also an improvement from the 2.2 per cent pace of expansion recorded during the fourth quarter of 2018. The robust reading is a boost for economies around the world after a growth scare earlier this year triggered a fall in bond yield.

The data quelled previous fears that the US is running into an imminent recession and leaves the economy on track to hit its longest-ever expansion later this year. But beneath the impressive headline growth figure, some of the underlying detail in the report was less buoyant. Consumer spending slowed from the fourth quarter and growth relied heavily on a build-up in inventories, which could reverse later this year. The report will further complicate the policy deliberations at the Federal Reserve, which is weighing firm headline growth and a resilient labour market against perplexingly soft inflation as it considers whether the next move in rates should be down rather than up.

The US central bank, led by chairman Jay Powell, is likely to keep policy unchanged at 2.25 to 2.5 per cent for the more immediate future. With US activity improving after a shaky start to the year and overseas risks diminishing, many commentators suggest the Fed will likely keep rates at their current level for the remainder of the year.

US-China trade negotiations – high hurdles remain

As U.S. and Chinese officials try to close a trade deal, the punitive tariffs the governments slapped on each country's goods in the conflict stand as a major obstacle. High-level talks between the U.S. and China recently resumed in Beijing. As they work through final issues, including planned Chinese purchases of U.S. goods, how and whether to remove the tariffs the two governments imposed in the earliest phases of the dispute are now at the forefront of the talks. At issue is how much of the tariffs the U.S. levied on $250 billion of Chinese goods will be removed. The U.S. wants to leave some in place as a tool to enforce the agreement while Chinese negotiators see those tariffs as an affront, and negotiators have batted the issue back and forth for at least a month.

One can be confident Beijing won't want to accept a deal where the U.S. continues to insist on imposing tariffs, and prohibits China from retaliating, as a way to make sure Beijing fulfils commitments in a trade deal. The tariffs would be embarrassing for the leadership and politically difficult to sell to Chinese businesses and other domestic constituencies. The current tariffs also created uncertainty for investors, compounding last year's slowdown in the Chinese economy.

Europe – Some green shoots

In March this year, the narrative surrounding the euro region was driven by fears of 'Japanification' (describing the environment of deflation and expansionary monetary policy such as experienced in Japan). The manufacturing Purchasing Managers' Index (PMI) for the region had declined, despite a rise in PMIs around the world. At the same time, the European Central Bank extended their forward guidance for the period in which rates will remain negative to the end of the year, raising the prospect of a negative rate trap (where target interest rates are set below zero) for the region and its banks. Just one month later the macro view of Europe is turning more positive. Business confidence is still low but has recently posted its first increase in six months and retail spending has improved, supporting the case that strong labour markets will continue to support household spending. However more generally, across Europe confidence continues to wane across all sectors, which suggests activity indicators will continue to print on the soft side and interest rates will remain low for the foreseeable future.

UK – Kick Brexit down the road

In our April economic report, we wrote about the chaos created by Brexit and apparent lack of a clear and viable way through. Since then not much has changed except to provide for more time (31 October is the third 'final' deadline). Mrs May asked the EU for more time because MPs voted down her exit deal three times. Getting the House of Commons' bipartisan approval for the draft treaty is still a big challenge, unless the talks between the Conservatives and Labour produce a breakthrough. But the Prime Minister is wishful that the deal can be approved and ratified before May 23, so Britain can avoid holding elections to the European Parliament that day.

In a blow to the chances of a second referendum, Jeremy Corbyn has seen off a challenge from Labour's Europhile wing, defeating a bid to commit the party to holding a second EU referendum in all circumstances. The Labour leader announced afterwards that the party would maintain its existing policy of backing a soft Brexit with a customs union. He added that Labour would support the "option" of a public vote only if it was unable to secure the changes to the government's existing withdrawal deal and could not force a general election.

Australia – Location, Location, Location

Across the Tasman, Australian economic growth remains constrained as the housing market in Sydney and Melbourne continues to negatively impact consumer spending and housing construction. The labour market is holding up well, but the softening in the housing market is expected to hit jobs related to construction, housing services and retail, and cause a rise in the unemployment rate. Business investment growth is improving as mining investment is no longer acting as a large drag on the economy, but non-mining business investment remain underwhelming.

Sydney's median house price will fall below $1 million within the next two months even if the property downturn eases slightly from its current pace. Sydney house prices have now fallen 14.3 per cent from their mid-2017 peak, including a drop of 3.1 per cent over the March quarter. Melbourne house prices fell 10.4 per cent over the year and 2.4 per cent over the quarter.

An election later this month is likely to see a new Labour-led coalition. This has the potential to bring some policies which are business unfriendly.

New Zealand – following the herd

New Zealand GDP growth, emblematic of the global economy, shifted down a gear as the data for second half of 2018 was disappointing, and rising capacity constraints will continue to have a moderating influence on growth in activity. There are tailwinds, largely on the back of fiscal stimulus and growth in labour income.

According to the ANZ Business Outlook Survey, business confidence and firms' own activity outlook were little changed in April with both remaining at levels well below their long run average (47pts below and 20pts below respectively). Capacity utilization fell to a new post-GFC low.

The RBNZ signalled a material dovish pivot at its April meeting part of which highlighted concerns around a slowdown and ongoing weak business surveys. There is little in the ANZ survey to allay the RBNZ's concerns on the latter. The RBNZ decided to cut the OCR by 25bp at its May meeting.

Summary

We are cautiously positive on equities because economies around the world are still expanding at decent rates and there are no apparent inflation trends. While there are risks that could push the markets periodically downwards, we believe that last year's bearish moves restored some value to the markets and interest rates now look to be heading lower, not higher.

We believe that maintaining your long-term neutral asset allocation continues to be appropriate in light of the environment.