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Investment Update – October 2019

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Politics Intrudes on Markets

The risk of President Trump's impeachment increased in September with Democrats instigating the first stages of the process. The seriousness for US markets will take time to play-out but political focus is likely to drift from the economy and the US budget. In the United Kingdom the Brexit outcome remains chaotic making it difficult for investors to have confidence.

The continuing threat of geopolitical conflict disrupting the smooth functioning of economies was also evident in September. The attack on the Saudi Arabian oil refineries resulted in the oil price spiking short-term. Oil reserves and the ability to repair the damage quickly alleviated the immediate impact.

US Interest Rate Bounce

Interest rates in the US bond market fell dramatically in August. The US 10-year government bond rate fell half a percent, one of the largest monthly falls since the Global Financial Crisis (GFC). This resulted in a predictable response from borrowers in early September to the low rates with a rash of bonds being sold into the market. The US corporate bond market had record issuance on 8 September with 49 deals in 30 hours totalling US$54 billion. Even cash rich Apple took advantage issuing US$7 billion of bonds including a US$1.5 billion 30-year bond paying 2.99%. The US Government was also encouraged by the low rates to refloat the proposal to issue very long-term bonds of 50 years.

The overall trend in interest rates remains “lower for longer” but the trend has not been smooth. United States interest rates bounced back in mid-September. This unsettled the share market and investors switched from high priced revenue growth shares to more traditional profit generating companies.

Over recent years markets have been focused on growth over value. September may represent the first signs of a pivot between these two strategies.

Central Bank Policy

Central banks are concerned with the long-term management of financial conditions focusing on inflation and employment levels. In doing so they look through the short-term fluctuations experienced in the market. A number of central banks delivered policy statements in September. Generally, these statements were consistent with investor expectations. The Federal Reserve delivered a quarter percent cut in line with market pricing. The Bank of Japan kept monetary policy steady but signalled it could ease next month. The Bank of England kept rates steady at 0.75% and the RBNZ similarly held the Official Cash Rate (OCR) at 1%. Post its decision to reduce the US benchmark rate the Federal Reserve has had to intervene in the overnight cash market on numerous occasions and provide additional cash injections as cash rates rose above the target levels. This is the first time the Federal Reserve has had to intervene in this manner since the GFC. The liquidity problem appears to be more technical rather than a reflection of wider fundamental problem but may require the Federal Reserve to once again expand its balance sheet.

Central bank monetary policy implementation reflects actual and anticipated conditions in the real economy. Increasingly, the economic outlook is subdued, and hence central banks are continuing monetary stimulus. However, economists are challenging the effectiveness of such policies in isolation. The effectiveness of monetary policy alone is diminishing, and central banks are calling on governments to undertake more fiscal policy (increased government spending or tax cuts) to support economies.

Trade War Impact

The US economy has been only moderately impacted by the trade war to date, but the signs of increasing effects are becoming apparent. US GDP growth and inflation remain reasonable but below target and below prior levels. US GDP for the second quarter remained at a 2% annual rate. Inflation using the Federal Reserves' favoured measure was 1.9% annualised just below the 2% target. US job growth in August was lower than expected but unemployment has held at a steady and very low level of 3.7%. The US consumer remains healthy, but consumer confidence slipped in September. Signs in the industrial segment are less positive. The Cass freight index dropped 3% in August the 9th month of consecutive declines. Surveyed manufacturing activity declined in August for the first time since early 2016.

China is also experiencing a slowing of its economy. The Chinese manufacturing index for August showed contraction whereas non-manufacturing in August was expansionary. Exports fell in August by 1% year on year. The Chinese economy perhaps is not being as severely impacted as expected as the Chinese government took early action. Monetary stimulus is now being followed by fiscal stimulus and the authorities have further levers to pull. China appears to be positioning itself for a long-term impasse with the US developing technology internally and diversifying external trade relations so as not to be as reliant on the US.

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Australasian Effects

The health of the Chinese economy directly impacts on the export earnings of Australia and New Zealand and the general buoyancy of the Australasian economies. Australia achieved a current account (trade in goods and services) surplus of A$5.9 billion in the June quarter, the first current account surplus in 44 years. This result occurred despite the fall in coal and iron prices which may show up in future quarters. Australian GDP continued to grow at a rate of 1.4% year on year, but this is the slowest rate of growth in 10 years. The jobless rate has remained above 5% in Australia despite the cuts in interest rates by the RBA.

New Zealand similarly has a positive but slowing rate of GDP growth. In the June quarter GDP growth slowed to 2.1% annually, a five-year low. Services sector activity remained buoyant in August, but the manufacturing index contracted. Similar to the United States New Zealand borrowers were active. There was overall bond issuance of $3.2 billion in September and bond maturities of $314 million. The New Zealand Government issued $2 billion of bonds in September including $250 million of 2025 bonds. Demand for the 2025 bonds was strong with $810 million bid. However, despite the 3 times cover, the interest rate was not bid lower for the first time in 8 consecutive bond tenders.

Europe Continues to Slow

European markets appear to be more adversely affected by the trade war and their own local economic issues. Germany's manufacturing sector, the engine of Europe dropped to its lowest level since the GFC. The Bundesbank projected that the German economy has entered a mild technical recession. The European Community reflected global trends with the services sector remaining in mild expansion but the manufacturing sector contracting.

Summary

We continue to be cautious in our outlook. In isolation events such as US Presidential impeachment proceedings are unlikely to be overly disruptive, but the weight of factors combined requires ongoing vigilance. In the fixed interest market sentiment remains for low rates to prevail. Potentially short-term rates in New Zealand will likely continue to decline but some steepening of the yield curve could occur as short-term rates fall further, and longer-term rates do not decline to the same extent. The market currently prices an aggressive reduction in the OCR over the next year of a further 0.40%. That said the possibility of negative rates has diminished over the last month. RBNZ Governor Orr in his most recent speech stated "…in our current view we are unlikely to need unconventional monetary policy tools." Similarly, global interest rates appear likely to continue to moderately decline/remain with current trading ranges. In an absolute sense interest rates have limited scope to decline further. While the tail winds for the fixed interest rate markets are dissipating there appears minimal risk that rates will lift materially in the near term.

Although economies are slowing, they are not in recession. Within stock markets non-cyclical growth at reasonable price is becoming more difficult to identify. However, earnings yields remain positive and equity values are supported by interest rates. Given the differential in yields between fixed interest and shares is likely to persist, the relative attractiveness of shares is preserved.

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