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Investment Update – September 2018

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Overview

Markets continue to be buoyed by confidence in strong economic fundamentals and improved corporate earnings. The US bull market is now officially the longest ever, i.e. the S&P 500 Index has gone more than 3,453 days without a drop of 20%.

After rebounding in the second quarter, global GDP growth is set to remain strong over the rest of this year. Inflation is likely to trend towards 2% in most advanced economies but will do so at different rates. Strong growth in the US should allow the Fed to raise interest rates two more times this year. The Bank of England is also likely to raise rates once more this year while the ECB should wind up its QE programme by December.

Next year, however, is likely to present some headwinds as the US economy potentially loses momentum and monetary tightening starts to bite. The cooling Chinese economy, and the potential increase in protectionist trade policies, could also contribute to global growth easing.

Global Trade Update

At the beginning of August, President Trump threatened to impose a tariff of 25% on a further $200bn of imports from China – up from 10% previously. The most recent trade negotiations between the US and China marked the first attempt to patch up differences since June, when economic relations between the two countries soured and lead to an escalation of the tariff battle. Even as the officials met at the Treasury department, 25% tariffs on an additional $16bn of Chinese imports was enacted by the Trump administration, bringing the total to $50bn. The move was immediately matched by Beijing with retaliatory measures of the same scale.

A recent breakthrough over the NAFTA trade agreement between the US and Mexico provided some optimism that tensions elsewhere can be resolved. The two countries agreed to stricter rules for Mexican car exports to the US with measures designed to discourage manufacturers from moving factories to lower-wage Mexico, while tariff-free trade for farm products was maintained. However, it remains unclear if Canada, NAFTA's third partner, will join the deal, which US president Donald Trump said would be renamed the US-Mexico trade agreement.

Also raising hopes that a bigger trade war could be averted were discussions in late July between President Donald Trump and the President of the EU Commission, Jean-Claude Juncker. The EU pledged to buy more US soybeans and natural gas, and the US agreed not to impose more tariffs on vehicle imports from Europe. The two sides also agreed to work towards free trade in non-auto manufactured goods.

So far, the scale of the tariffs implemented has been quite small. Goods on which new tariffs have been levied account for around 1% of world trade, and even if President Trump carried out the threats he has made so far and other countries retaliated, the share of world trade affected would be just over 6%. New barriers applied to all EU-US trade, China-US trade and remaining US imports would together affect around one-fifth of world trade.

The US

Fuelled by fiscal stimulus, GDP growth should remain strong over the rest of the year, allowing the Fed to continue raising interest rates. By the middle of next year, however, with the stimulus fading and cumulative monetary tightening beginning to bite, it is likely growth will slow, potentially forcing the Fed to reverse its direction of raising rates. Despite the apparent truce between the US and EU, trade tensions with China continue to mount.

China

The main headwind to the economy over the coming quarters will come from the ongoing slowdown in credit growth. Policymakers have shifted their focus from deleveraging to supporting growth and will potentially loosen policy more forcefully over the months ahead. Meanwhile, the renminbi's recent depreciation will offset much of the impact of the tariffs proposed so far. But a further escalation of the trade conflict with the US would clearly be a concern.

The EU

After a slightly disappointing start in the first half of the year, GDP growth is anticipated to pick up in the second half by investors who are optimistic about the domestic economy. Inflation continues to remain subdued, allowing the ECB to keep interest rates on hold for the short to medium term.

Turkey

The recent political and financial instability in Turkey has begun to affect global markets, boosting safe haven demand for the Swiss franc and high-grade government bonds as well as caused some weakness in the euro and the stocks of European banks. The government's efforts to launch a "new economic model" have not improved the outlook.

Much of the concern is focused on Turkey's banks, which have increasingly resorted to foreign wholesale markets to finance their domestic lending. About a third of Turkish bank lending is in foreign currencies and mostly for corporate clients. Although the ratio of non-performing loans is currently low, it will probably rise steeply as a result of higher interest rates, currency weakness and the potential recession.

The continued sell-off in the lira is likely to force the central bank into more monetary tightening, hitting the economy. The plunge in the lira which began in May now looks likely to push the Turkish economy into recession and it may well trigger a national banking crisis.

The European Central Bank is concerned about potential contagion through the eurozone banking system, with Spain, followed by Italy, the most heavily exposed countries. Also of wider concern is that Turkey's crisis will spill over into other emerging market economies as other vulnerable countries are coming under speculative attack. However, the wider economic spill-overs should be fairly modest, even for the euro-zone. With GDP of around $900bn, Turkey's economy accounts for 1% of the world economy, at market exchange rates.

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The UK

Optimistic ‘baseline’ assumptions for Brexit negotiations is for a status-quo two-year transition period paving the way for a free trade agreement. In this scenario the UK economy is likely to continue to expand at solid rates over the next few years while the Monetary Policy Committee would press ahead with the process of gradual policy normalisation (removing monetary accommodation). A breakdown in the negotiations or a change in UK government would clearly alter the outlook.

Australia

The recent political chaos in Canberra, which culminated in Scott Morrison taking over as Prime Minister from Malcom Turnbull, has increased the downside risks to the Australian dollar for both this year and next.

The Reserve Bank of Australia (RBA) will very likely leave interest rates at 1.5% at its next policy meeting, however, markets will be interested to see more subtle signals that the Bank is warming to the idea of raising rates.

In the previous announcement the RBA revised up its GDP growth forecast for 2018 from 3.0% to 3.25%, maintained the 3.25% growth forecast for 2019 and revised down its unemployment rate forecast for 2019 from 5.5% to 5.25%. The underlying inflation forecast for December 2018 was trimmed from 2% to 1.75%, but the RBA still expects underlying inflation to rise to 2.25% by June 2020. This is a relatively rosy forecast from the RBA and is consistent with the story of continued economic growth in Australia.

New Zealand

Economic growth has been supported by low interest rates, high terms of trade, strong population growth and improving labour incomes. Nonetheless, a few risks to the robust New Zealand outlook are emerging. A key risk stems from the recent trade spat between New Zealand’s major trading partners. Although the tariffs announced so far are likely to only have a small impact on global economic growth, there is a growing possibility that trade tensions escalate further, in which case increasing trade restrictions will reduce global growth and weaken one of New Zealand’s key economic supports. Another risk stems from New Zealand’s low level of business confidence, which has persisted for nine months and is at the lowest level since May 2009.

It must be noted that consumers are not as sceptical as businesses. A strong labour market, rising wages, population growth and low interest rates continue to support consumer spending and confidence. The ANZ Roy Morgan NZ consumer confidence index dipped 2 points to 118 in July but is around its historical average.

Building consents issued over recent months proved considerably stronger than expected, which has led to some sizable upward revisions to our near-term construction outlook. Nonetheless, we are still likely to be close to the peak in construction, with confidence
in the construction sector falling and evidence of limited spare capacity in the industry to enable further growth.

Summary

Although the global economy is strong, we continue to monitor risks associated with the likely impact of the US-China trade negotiations and Europe (such as Brexit and the political instability in Italy).

Investment returns have been strong for a considerable period and we continue to recommend that a balanced approach to investment be maintained.

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