Economic Commentary

Prepared by Morningstar Research as at July 2014

Outlook for Investment Markets

The New Zealand economy has continued to perform well. Although the latest business and consumer confidence surveys pulled back a little, they were still at historically robust levels and the economy is likely to grow strongly over the next 12 to 18 months. This has not translated automatically into easy gains for corporate profits, however, as the economy faced the headwinds of progressively higher interest rates and an overvalued currency. At some point, investors are also likely to start to concentrate more on how growth and profit prospects are shaping up on the other side of the current reconstruction boom but in the interim, business looks set to experience strong trading conditions.

New Zealand Cash & Fixed Interest

Short-term interest rates, not surprisingly, have been on the rise all year as first the prospect, then the actuality, of tighter monetary policy from the Reserve Bank of New Zealand hit home. With the latest 0.25% increase in the official cash rate (OCR) to 3.25% on June, the bank has raised interest rates by a cumulative 0.75% this year. Consequently, 90 day bank bill yields have increased to 3.65% from just below 2.85% at the start of the year.

Longer-term interest rates have been falling for most of the year, in line with developments in overseas bond markets. The 10-year government stock yield started the year at 4.7% and followed US bond yields downwards to late May. The US Treasury yield bottomed out at 2.44% on May 28 and the local 10-year bond mirrored the move, bottoming out at 4.24% on May 29. Since then, rates have moved a little higher in both markets and the local 10-year yield has risen to just under 4.5%.

It has not been a straightforward path for the currency, which sold off in January and again in May, but the overall trend this year has been upwards. In overall trade-weighted value, the kiwi dollar rose by a substantial 5.2% in the first half of the year and has risen a little further again in July. In terms of its headline rate against the US$, it was up 6.7% to the end of June (to US87.5¢ from US82¢) and it also rose modestly against the A$ (by 1.3% to AU93.35¢ from AU92.15¢)

The Reserve Bank says the currency is overvalued but there are quite a few reasons the kiwi dollar may be supported at its current high levels for some time. In particular, the recent rises in short-term interest rates and the prospect of a steady series of further increases as the Reserve Bank tightens monetary policy stand out in a world where investors have been aggressively chasing pockets of yield.

Other supportive factors include a domestic growth rate that is among the fastest of the developed economies, high export commodity prices, largely driven by strong Asian demand, competitive devaluations overseas, with a number of countries looking to gain advantage from lowering their exchange rates and the US policy of quantitative easing, which amounts to printing large amounts of extra US$, driving its value down.

Members felt that in the short term these factors, and especially the Reserve Bank's tightening of policy well ahead of other central banks, might keep the NZ$ high and might even sustain the currency at an overvalued level beyond the panel's 12 month horizon and some forecasters felt the same way. Westpac, for example, expects the kiwi dollar to be around current levels at the end of next year (its forecast is US84¢). But ultimately a lower kiwi dollar looks likely. The Reserve Bank, for example, expects the kiwi to gradually depreciate and is projecting a drop of 2.5–3.0% in overall value over the next year and a further decline of 2.0–2.5% in the year to March 2016. The consensus forecasts collated by the NZ Institute of Economic Research have a similar view of modest depreciation, with the currency expected to drop by 3.5%–4.0% in the year to March 2016.

Global Infrastructure

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Global infrastructure had a good half year. The Standard and Poor's Global Infrastructure index, which includes exposure to three kinds of infrastructure (energy, transport and utilities), was up 6.4% (in US$ terms), rose by 13.7% in capital value and provided a gross (pre-tax) income yield of 1.7%. For local investors, the total return on a tax-paid basis, hedged back into Australian dollars, was 15.7%.

The panel continued to have mixed views on the sector. For one member, global infrastructure was another example of investors "clutching at straws" to find sources of yield in a low interest rate world, driving infrastructure equities up to expensive levels. But for others, the relative defensiveness of the sector had appeal: the steady, often regulated, returns from infrastructure and its less cyclical profile compared with more discretionary sectors look to be supportive given that many other overvalued asset classes look likely to be challenged in coming months as central banks reduce the provision of liquidity. For one member, the very large pipeline of possible development projects was a plus. Post-GFC governments generally are not in strong financial positions to pay for needed infrastructure – postponed and deferred infrastructure spending, according to the managing director of the IMF, Christine Legarde, means there is a US$1 trillion gap between the current level of spending on basic infrastructure and that needed to support ongoing world economic recovery – and there is likely to be greater scope for private funds to access future projects. On balance, the members opted to maintain a benchmark allocation.

New Zealand Property

The NZX Property index produced a 9.6% total return for the half year to June, with a capital gain of 6.5% (equal to that of the share market more generally) and dividend income of 2.9%. All of the gain came in quite a brief period from early April to the end of May when the global and local search for yield was at its height.

During the period, the index recorded a capital gain of 8.5%. At a corporate level, the main item of interest was a major expansion in scale by Augusta Capital, which acquired its main competitor in the property syndication business and expanded its funds under management to NZ$1.2 billion from NZ$350 million.

New Zealand property mirrors in microcosm the wider New Zealand economy – still doing very well but not quite as buoyantly as previously. The Property Council of New Zealand/IPD index of returns to holding physical property, for example, showed a healthy annual return of 11% in December 2013 but this has edged back a tad in the March quarter to a still respectable 10.4% (7.8% income, 2.4% capital gain, with office and industrial property to the fore but retail lagging in terms of capital gain). Similarly Colliers' latest (June) survey of confidence among property investors was still in strongly positive territory (a net 25% confident), though this was down a little from 31% in December 2013 and 28% in March of this year. The modest drop in confidence was spread across all regions and across industrial, commercial and retail property, which suggests the reason is the modest slowdown in the growth of the overall economy rather than anything specific to the property market.

While property shares elsewhere have some drawbacks – in Australia, the sub-par economy is handicapping operational returns, particularly in the retail sector, while further overseas many property markets have been driven to expensive valuations in the global pursuit of yield – New Zealand's property sector is unusual in offering both good operational performance on a strong economy and yields that offer a wide differential over fixed interest and look capable of remaining attractive even as local bond yields start to rise.

Australian & International Property

The A-REITs had a good half year, with a total return of 12.7%, made up of a capital gain of 7.7% and income distributions of 4.6%. The massive restructuring of Westfield, where Westfield Group and Westfield Retail morphed into Westfield Corp (the American and European assets) and Scentre (the Australian and New Zealand ones) was completed reaction was positive, with Westfield rising to $7.45 from $7.05 and Scentre up to $3.40 from $3.05.

International listed property started the half year slowly, returning 4% in the March quarter but the intensified global hunt for yield in the June quarter meant property yields were in higher demand. The EPRA/NAREIT Global property index advanced smartly in April and May and produced a total return for the half year of 12.4% (in overseas currency terms). Industry practice is to hedge international property back into A$, which over the six months did its job at protecting investors against the A$'s appreciation. The EPRA/NAREIT global index (ex-Australia) had a net return of 9.1% in unhedged A$ terms but a substantially better 15.9% on a hedged basis. The best markets were Europe (ex-UK), which returned 17.9% and the US market, which did almost as well, with a return of 17.2%. The worst performing market was Japan (-7.6%), where property shares suffered from the overall weakness of the Japanese share market (all regional data are in their local currencies).

The global economic outlook is broadly supportive for property performance. The latest forecasts for world output from the IMF, for example, has the global economy's growth rate progressively picking up to 3.6% this year and 3.9% next year from 3.0% in 2013. While these are a bit sub-par for world economic growth, as recovery from the GFC has been a protracted exercise, in many countries economic activity is gradually improving and property owners are benefitting from increased turnover, production and employment and also from unusually low financing costs.

In the two economies expected to start raising interest rates first – the US and the UK – property has been delivering strong returns. In the US, the IPD quarterly survey for March showed a total return from holding physical property over the past year of 11.6% and the UK did better again. Going by the latest (June) monthly IPD UK index, property in the UK has returned 17.6% over the past year, led by offices (23.2%) and industrial properties (22.3%).

The problem remains the valuations investors have to pay to access property performance. The yield on the global EPRA/NAREIT index is only 3.6%, which is a low target rate of income from property as an investment and at current levels is also highly vulnerable to higher bond yields. In some markets (Germany and the UK, for example), investors' yearning for yield has driven local listed property yields down to, or below, the yield on the overall share market, meaning investors can get an equal or better return from equities generally and with more diversified sectoral exposure.

Australasian Equities

The NZX 50 index produced a total return including dividends of 8.5% in the first half of the year (+6.5% capital gain, +1.9% dividend income), although the gain was heavily concentrated in a short period from early February to early March when the index rose by 7.4%. It was also a good time to be more concentrated in the top 10 (+6.2%) and, especially, the midcaps (+10.7%), as the small caps lost ground (-3.75%). With share prices performing well and the economy in strong shape, new listings have picked up, with IT shares to the fore.
Of the three listings currently confirmed on the NZX website, two are software companies (ikeGPS, Vista), with the third (Scales) being a fruit and vegetable distributor and food manufacturer. What would have been one of the larger IPOs, Hirepool (an equipment rental company), was cancelled after a difference of views on pricing between the private equity company listing the shares and institutional investors that jibbed at the valuation.

Australian shares have gone sideways after dropping in January and recovering in February and the S&P/ASX 200 index finished the first half of the year only marginally up (+0.8%), though for New Zealand investors, the marginal gain turned into a marginal loss due to the 1.1% rise of the NZ$ against the A$. One reason for the sluggishness was the drag on overall equity performance from the resources sector, with the S&P/ASX 300 Metals and Mining index falling from February to the middle of June and turning in a loss for the half-year of 6.1%. On the positive side, IT stocks globally have been in hot demand, arguably over-exuberantly and the local IT sector mirrored the global pattern. It was the best performing of the non-property ASX sectors with a gain of 6.3%. The financials had a modest gain (+3.4%), as did the industrials (+1.5%), while stocks linked to consumer spending fared relatively poorly, with consumer staples down 2.4% and consumer discretionary down 2.7%.

The latest surveys and official statistics show a consistent picture of an economy that is still growing strongly but not quite as strongly as previously. On the business side, the latest results from the likes of the ANZ monthly business survey and BusinessNZ/BNZ's monthly indices of the performance of manufacturing and services show continued strong expansion, well above historical growth averages, though not quite matching the very vigorous growth of earlier in the year.

Forecasters are unanimous that 2014 and 2015 will be good years for GDP growth: the consensus forecasts collated by the NZ Institute of Economic Research (NZIER) suggest the economy will grow by 3.8% in the year to March 2015 and by 2.8% the following year.

It helps that consumer sentiment is buoyant, with good employment prospects the key driver. Employment grew by 3.2% in the year to March and despite large numbers of new people entering the job market on the back of improved job availability, the number of unemployed has been falling. Going by the results of recent ANZ/Roy Morgan consumer confidence readings, households do not feel they have benefitted a great deal from the upswing in the business cycle but they believe strongly that better times are ahead and most believe the economy will do well over the next five years and that they will be better off financially.

Conditions for profit growth consequently remain quite good. Output is growing rapidly and as firms reported in the latest Quarterly Survey of Business Opinion run by the NZIER, pricing power is improving. The percentage of companies expecting to raise their prices is rising when compared with the proportion expecting to pay cost increases. And wage costs are still growing quite slowly. In the March quarter, Statistics New Zealand's labour cost index, which measures the rate of increase in pay for the same job, was up only 1.6% on a year earlier, and average weekly earnings, which tend to grow faster because they include the impact of promotions and moves to better paying jobs, were up by a moderate 3.2%, which was a low outcome for what has been a rapidly tightening labour market.

The peak of the profit cycle may not be far away, however. Interest rates are rising, the exchange rate has moved into even more uncompetitive territory, commodity prices – while still high – are off their peaks and prospects for growth beyond 2015 are looking middling at best. The BNZ economists, for example, reckon that growth in 2016 will be only 1.8%. New Zealand is going into a very uncertain general election in September with the potential prospect of less business-friendly policies, including tighter regulation of electricity and other utilities, on the other side of it.

In Australia, virtually everyone sees reasonable economic growth continuing but at a pace that is somewhat slower than usual due to lower major resource project investment, cautious spending by consumers and fiscal restraint. While there has been some boost to overall GDP as production has started up in some of the completed resource projects, the rest of the economy is not growing strongly enough to make much of a dent in the unemployment rate or generate strong advances in corporate profits.

On the consumer side, there is evidence of shuttered shops and weak consumer spending beyond the prestige CBD shopping areas, which is all the more remarkable given that the current, very low interest rates normally would be expected to help consumer spending. But all the evidence suggests consumers remain hunkered down. The Westpac/Melbourne Institute measure of consumer confidence for July shows confidence picked up marginally during the month but had failed to make any real inroads into the sharp fall post-Budget. Currently, households are more pessimistic than usual (i.e. relative to their long-run average levels of confidence) about the outlook for family finances, economic conditions (both over the shorter and longer run) and, most markedly, about the outlook for unemployment.

On the business side, the only real bright spot has been a large rise in house building as developers have responded to high house prices. This has been enough to take the Australia Industry Group's index of construction activity into positive, expansionary territory in June. But the AIG indices of manufacturing and services are still pointing to contraction in both sectors (for the past four months in the services sector and for the past eight months in manufacturing). And there is little sign of any imminent pick-up in the pace of economic activity, either in the AIG data or elsewhere.

The leading indicator compiled by Westpac and the Melbourne Institute, which aims to identify the pace of business activity three to nine months ahead, on its latest (May) reading "continues to point to a significant loss of momentum. The growth rate has now been below trend for four months in a row and is consistent with a slowdown over the second half of 2014 carrying into early 2015". And NAB's latest (June) business survey, while finding the month itself went a bit better than previously, also found that "conditions remain below the long-run average for the monthly series, which along with soft conditions in wholesale (a bellwether industry), suggests little momentum for domestic demand in the near term".

These trends present a somewhat challenging environment for corporate equity performance. While there are pockets of good profitability this year – most notably in mining and energy, construction materials and transportation, and to a lesser degree in health care and the financials – brokers' estimates suggest that the high-flying sectors of 2014 will not produce a repeat performance in 2015 and profit growth in other sectors will not accelerate enough to make up the difference, with overall profits for S&P/ASX 200 stocks expected to be up only slightly next year.

With the profit outlook middling at best and shares already reasonably fully priced on a P/E ratio of 17 times earnings, it is not surprising that the latest six-monthly Fairfax BusinessDay poll of economists reveals very modest expectations for the S&P/ASX 200 – an increase of about 3% for the rest of this year and a further small rise of 2.0-2.5% in the first half of next year.

International Equities

World equities have produced modest returns, year to date. After some setbacks – particularly in late January and early February and again on a lesser scale in April – world shares rose more or less steadily to the end of June and the net result was that the MSCI World index was up 4.3% in capital value and by 5.5% on a net return basis (including tax-paid dividend income), in overseas currency terms. For Australian investors, however, the gain was eaten up by the appreciation of the Aussie dollar over the period, with the net return of 5.5% in overseas currency terms translating into a marginal 0.6% increase in A$.

The star of the show among the developed economies was the US, where evidence of improving business activity resulted in a 6.1% gain for the S&P 500. Europe was up modestly, with the MSCI Europe index up 2.9%, while the FTSEurofirst 300 index was up 4.1%. France (+3.0%) and Germany (+2.9%) advanced but the UK market missed out, with the FTSE 100 index down marginally (-0.1%) for the half year. Japan, as usual, went its own way: up to mid-May it was sliding on disillusion with the pace of the Abe government's reforms and on fears of the impact of a higher rate of sales tax and while it has been improving since, the earlier weakness meant the Nikkei dropped 6.9% for the first half of the year.

Among emerging markets, India stood out, with the Sensex index up 20.0% for the half year as investors reacted positively to the election of a reforming Modi government but it was the only one among the key BRIC emerging economies to perform strongly. Brazilian shares were up 3.2% (Bovespa index) but Chinese shares were down 3.2% (Shanghai Composite), while Russian shares never recovered from the impact of the Ukrainian crisis and poor Russian economic conditions and were down 5.3% for the period (FTSE Russia). Across emerging markets as a whole, the MSCI Emerging Markets index was up 3.25%, with Asia (+3.9%) the best performing region, outpacing Latin America (+1.3%) and eastern Europe (-1.9%).

A key question for investors is the outlook for the US economy and its implications for global financial markets, with the recent focus on how strongly it may be growing and the consequences of strong American growth for Fed monetary policy and for knock-on effects on global interest rates and global equities.

June's payroll numbers were strong – 288,000 new jobs in the month, well above the forecasters' pre-release consensus of 211,000 and unemployment dropped to 6.1%, again lower than the consensus expectation of an unchanged 6.3% – giving rise to speculation about whether tighter Fed monetary policy is on its way sooner than previously thought. This gives rise to concern about whether international equities markets are prepared enough to absorb an unexpectedly early rise in interest rates. For one thing, investors seemed to be far too relaxed about potential issues. The VIX, which is an estimate of the volatility investors expect in the US share market, fell to a seven-year low in early July and similar measures in other markets are showing investors are unusually relaxed about events. While, good performance of the US economy may have a lot to do with it, it also possibly reflects complacency on the part of market participants about potential risks.

International Fixed Interest

The biggest influence on the global fixed interest markets in the six months to June was the sustained fall in US bond yields. The 10 year US Treasury had risen towards the end of 2013 as investors had started to look ahead to a progressive unwinding of ultra-easy monetary policy. In the event, the US Fed made it clear that very supportive monetary policy would be maintained for an extended period and the 10 year Treasury yield, which had reached a high of 3.04% in early January, fell (with some backing and filling volatility) all the way to a low point of 2.44% on May 28. Since then yields have picked up a tad and at the end of June, the 10 year Treasury was yielding 2.53%

but the net effect has been to generate capital gains in the US bond market and, through its knock-on effect on other countries, in the global bond market as a whole.

The Barclays Global Aggregate consequently returned 4.9% in the six months to June, in US$ terms. Fortunately most local international fixed interest funds hedge the forex exposure. The unhedged return from the Barclays Aggregate in A$ terms, for example, was -0.5%, reflecting local currency appreciation, whereas the hedged return was 5.4%. Both government and corporate fixed interest contributed to the 4.9% aggregate return, with governments returning 5.15% and corporate 5.35%. "High yield" (lower credit quality) provided a return of 6.1% and emerging markets returned 7.4% (going by the Barclays Emerging Markets US$ Aggregate).

Long-dated government bonds, which benefit most in terms of capital gain from lower yields, produced outsize returns: US Treasuries of 7-10 years' maturity returned 5.2% but Treasuries with maturities of 20 years and more returned 13.2%. Other big beneficiaries were the more indebted eurozone PIIGS economies, where bond yields in some instances fell to levels not seen in two centuries. The Spanish 10 year yield, for example, dropped to 2.67% from 4.14% and the Irish yield to 2.4% from 3.5%. Yields fell even for the still troubled Greek economy, to 6.6% from 8.5%.

Bond yields had been expected to rise from what have looked like unusually low and unsustainable levels but those expectations have been confounded as yields have stayed stubbornly low.

The move to higher interest rates would not be uniform across countries. While even as bond yields rise in some of the better performing economies, notably the US and the UK, some bond markets are unlikely to follow soon, with both the eurozone and Japan likely to persist with ultra-easy monetary policy for some time. In the eurozone, the European Central Bank (ECB) is struggling with both a weak economy and lower inflation than the ECB would like to see. The latest inflation estimate, at 0.5% for June, is well below the 2% that the ECB is meant to be targeting. Japan is also still midway through a large planned boost to its money supply to reverse its previous deflation (consumer prices fell each year from 2009 to 2012).

Nonetheless, interest rates must rise as central banks begin to reduce the degree of monetary policy support they have been giving to moribund economies. For the US, the latest economic data points to an economy beginning to use up its spare capacity faster than expected and that consequently rising inflation is closer than anticipated.

In a recent speech, one of the Fed governors came to much the same conclusion, noting that a year ago the Fed's view was that unemployment would be 7% now whereas it is actually 6.1% and he also noted that the Fed had expected to be finished with its bond purchasing program by now, though in fact it is still going, albeit at a reduced rate that will finally taper off to zero in October. Unemployment markedly lower than expected and more monetary stimulus than originally planned, add up to supporting an earlier move towards less supportive monetary policy.

Even on the current consensus view in the markets, interest rates are set to rise in 2015. Of the 15 participants surveyed in the Fed's latest policy meeting, 12 believe the first Fed funds rate increase will occur in 2015 (one picked this year, two picked 2016), while most economists surveyed by The Wall Street Journal also expect an increase next year (the June quarter is their most likely pick). The economists also expect bond yields to rise, with the 10 year US Treasury yield expected to be 3.2% at the end of this year and 3.75% by the end of 2015. In the UK, it is possible that bond yields are on the move already. The two year gilt (government bond) yield jumped to 1.1% from 0.7% after the Governor of the Bank of England, Mark Carney, said UK rates might rise faster than the markets expected and even though it had dropped more recently to 0.9%, markets are evidently now sensitised to the looming prospect of less expansionary monetary policy.

Performance periods refer to the month and three months to 30 June 2014

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