Economic Commentary

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Outlook for Investment Markets

Investment markets have seen a global rotation out of income assets and into growth assets, as investors have become more confident about global growth prospects and less tolerant of very low cash and bond yields. Sharemarkets have consequently had a strong run, and bond prices have fallen. More of the same looks likely for the rest of the year, with the provisos that recent price rises may have taken some sharemarket valuations into expensive territory, and that it is still an open question whether bond yields will continue to rise.

New Zealand Cash & Fixed Interest

New Zealand short-term interest rates are once again unchanged, the 90-day bank bill still just under 2.70 percent. The Reserve Bank of New Zealand held the Official Cash Rate at 2.50 percent at its latest review on 31 January. Longer-term interest rates followed the lead of offshore bond markets, the 10-year government stock yield up from 3.50 percent at the close of 2012 to 3.90 percent. The $NZ has continued to strengthen: it has risen from 82.8 to 84.5 US cents this year so far, and from 80.0 to 82.1 Australian cents. The $NZ has gained a substantial 4.60 percent in the space of a month and a half for the year to date.

The Reserve Bank's latest monetary policy decision did not detail what the Bank might do next. Both forecasters and the markets however noted the Bank's comments about the housing market – "House price inflation has increased and we are watching this and household credit growth closely. The Bank does not want to see financial stability or inflation risks accentuated by housing demand getting too far ahead of supply" – and read this to mean that the Bank is probably going to lean against house prices in due course. Currently expectations are that the Bank will start raising short-term rates later this year or at the latest in early 2014, with further modest rises beyond that, which would take the 90-day bank bill yield to around 3.50 percent by the end of 2014. Market expectations are also for higher yields at the longer end of the yield curve, following the expected overseas trend towards gradually higher bond yields.

Analysts are currently of the view that the $NZ could well hang in at its current high levels, or even go higher: ASB, BNZ, and Westpac, for example, all have the $NZ up at 87 US cents at the end of 2013.
This outlook is generating considerable angst in exporter and official circles, given that in the Bank's words the $NZ is already "overvalued" and "undermining profitability in export and import competing industries". Any respite still looks some way off, as forecasters expect that the $NZ will not revert to levels that would make more sense from an export competitiveness point of view until 2014.

New Zealand Property

The NZX Property Index, like the broader Kiwi sharemarket, did very little in November and December and continued to go sideways in January, even as the wider sharemarket got its skates on. February has proved better, and the NZX Property Index is therefore showing a 2.70 percent rise for the year to date.

The outlook for the Kiwi listed property sector is solid rather than spectacular. The latest profit reports from industrial manager Property For Industry (PfI) and office manager Precinct revealed no surprises. Although operating income was down a bit, mostly for timing reasons, there were also some positives, notably PfI's 3.30 percent revaluation gain on its portfolio, and Precinct's signalling of a stronger second half of the year ahead in the central business district office markets. And Argosy Property's capital raising from retail investors (after an earlier institutional whiparound) closed oversubscribed, suggestive of ongoing investor interest in the sector.

There are quite marked regional and sectoral variations: Auckland is the strongest market, Wellington the weakest, and Christchurch obviously still in reconstruction mode. But overall the sector should benefit from the modest acceleration in business activity expected over the next couple of years, and from the ongoing attraction of its high dividend yield. While local bond yields are likely to rise, the scope of the rise is likely to be modest and gradual, and property will continue to deliver a large pick-up in yield for some considerable time yet.

Australian & International Property

Australian listed property is showing a three percent capital gain for the year to date, and a total pre-tax return of 4.10 percent. This somewhat overstates the shape of the sector, however: while the sharemarket as a whole is still making good ground, the AREITs peaked on 6 February, and have fallen 2.20 percent from their peak.

Global property securities have tracked wider global sharemarkets, rising from mid-November through to the end of January and levelling out more recently. The EPRA/NAREIT Global Index is up 3.20 percent in $US since the start of the year, and the Global ex- Australia Index hedged back into $A up 4.50 percent. The US gained 5.20 percent (in $US terms), while the UK was up 3.20 percent (in sterling). Europe was predictably weaker, with a small (0.30 percent) decline in Euro terms. Japan had an especially steamy December, set alight by the prospect of new construction contracts from the incoming government, and the Japanese index rose 17.10 percent for the month. The euphoria has since subsided, and Japanese property share prices have risen by a more modest three percent over the year to date.

The expected cyclical economic slowdown is not the best of environments for Australian listed property. Although consumer confidence has improved, this has yet to translate into stronger retail sales. Businesses are reluctant to hire, the labour market has been seeing modestly higher unemployment rates, and there is an unwinding of the resources investment boom.

As the Property Council of Australia's latest (January) survey of the office market shows, for example, cumulatively these trends have led to rising vacancy rates in the office sector (from 7.30 percent in July 2012 to 8.10 percent in January 2013), with an outright fall in take-up of space in Perth as the resources sector cools down. The relative attraction of the yield (a little over five percent) is also not quite what it was. Even if Australian bonds do not keep rising, the earnings pickup from property has been eroded by 0.30 percent since the start of the year. This has been partly offset by lower yields from another income alternative to property, the banks' deposit 'specials', where rates on offer have been dropping and may fall further if the Reserve Bank cuts the cash rate again. All up, between the effects of a cyclical slowdown, a less compelling income proposition relative to bonds, and a change in investors' demand from a search for income to a more risk-tolerant search for capital gain, it's hard to see a strong year ahead for Australian listed property.

The economic backdrop for global listed property is more supportive. World economic activity is picking up in aggregate, and as the Royal Institution of Chartered Surveyors' latest survey of global commercial property noted, this has led to "broadly positive occupier and investment momentum across Asia, the United Arab Emirates, North America, and Russia; this is also reflected in a declining flow of distressed properties coming onto the market in these areas". Some previously devastated property markets (Ireland, the UAE) have even started to come right, and the only remaining outright area of weakness is the Eurozone, where the Dutch, French, Greek, Italian, and Spanish markets are all in poor shape. The improving economic outlook is a given, but whether investors are getting a good deal from global listed property is more debatable. The sector was bid up strongly in 2012 as investors chased pockets of yield, and has been bid up further in recent weeks as part of the global sharemarket rally. For a relatively defensive sector, valuations have now reached a point where further advances will be harder to achieve.

Australasian Equities

The New Zealand sharemarket has gone its own idiosyncratic way in recent months. Local shares did nothing much in November and December when global markets were strong, did rather better in January, and have gone sideways in February. The NZX50 Index is therefore showing a relatively modest 2.70 percent gain for the year to date. Australian shares, on the other hand, have been tuned in to the global sharemarket rally, the S&P/ASX200 Accumulation Index up 8.90 percent year to date. (This was partly eroded for Kiwi investors by the 2.90 percent rise in the $NZ against the $A.)

The Reserve Bank's take on the economy at the end of January was that "recent data on business confidence and construction activity suggest GDP growth is recovering from the softness seen through the middle of last year. The Canterbury rebuild is gathering momentum and its impact will be felt more broadly in incomes and domestic demand".

The data since then has pointed in the same direction. The ANZ/Roy Morgan Consumer Confidence survey for January showed solid levels of confidence, and it is clear that households have been feeling progressively happier over the past six months both about the current state of the economy and where they expect things to go. When combined with what their business survey is also saying about business prospects, the ANZ team estimates the economy will be growing at a 2.20 percent rate by the middle of this year – hardly shooting out the lights, but still a welcome pick-up in the pace of local business expansion. Retail sales for the December quarter rose strongly – up 2.10 percent, substantially more than the 1.20 percent forecasters had been expecting – and the latest BNZ/BusinessNZ Performance measures of manufacturing and services have also chimed in showing ongoing growth.

While there are some headwinds – the high dollar, tightening fiscal policy – the outlook for local corporate profits is good, with export markets improving, export commodity prices at historically high levels, households and businesses more optimistic, and domestic reconstruction taking a stronger grip, all making for a cyclical upswing. It looks like a reasonable background for equities to continue to make at least modest gains.

The key question in the outlook for Australian shares remains how the economy, and corporate performance, will fare during an ongoing transition from the 'two-speed economy' (boomtime in resources, weaker domestic non-mining sectors). The Reserve Bank is predicting a slowdown in GDP growth in 2013 to a slower than usual 2.50 percent (private sector forecasters on average have a similar view), with slowing resources investment, the high dollar, and fiscal tightening weighing more heavily in the mix than a strengthening housing market and, potentially, investment picking up in the non-mining economy. Recent data has tended to bear out this slower growth scenario, retail sales and the labour market on the weak side, although the latest Westpac/Melbourne Institute consumer confidence survey recorded a significant improvement in household sentiment, and particularly about the economic outlook.

This outlook of a modest cyclical slowdown, with some pick-up expected in 2014, is a decent but not strongly supportive backdrop for Australian shares. The latest profit reporting season has been going quite well, but it may be that the recent strong run in share prices and rather optimistic profit expectations investors appear to have are running ahead of what companies are actually going to be able to continue to deliver.

International Fixed Interest

Global government bond yields in the major markets have risen since the start of the year, the key 10- year US Treasury yield up from 1.75 to just over two percent, with similarly-sized rises in Germany (from 1.30 to 1.65 percent), France (two to 2.30 percent), and Switzerland (from 0.45 to 0.77 percent). Japan, whose new government is set on an even easier monetary policy, was an exception, the 10-year yield dropping slightly from 0.80 to 0.75 percent. The more indebted Eurozone economies also benefitted from perceptions that their debt problems are being tackled, Ireland benefitting from a renegotiation of the interest rate on its bailout funding. Greek, Italian, and Spanish 10-year yields dropped, although less dramatically.

Higher yields have meant losses for most categories of fixed interest investment, as the capital losses have outweighed the interest income. Global government debt is down 2.90 percent and corporate debt down one percent year to date. Global high yield investments have done rather better, up 1.20 percent year to date.

The opening months of the year have been difficult for international fixed interest. Investors have become more confident about the economic and financial outlook, and less inclined to take out 'safe haven' insurance against uncertainty. The bigger question is whether the recent rise in the yields is the start of a longer-term march towards more normal levels of yield and ongoing capital losses.

Predictions of an eventual rise in bond yields have been a commonplace in the post-financial crisis years, but have repeatedly proven premature. Yields have stubbornly remained at unusually low levels for longer than virtually anyone expected. In addition, the major central banks remain committed to substantial bond purchases (keeping yields down), and there remains the possibility that there could be further market squalls that could prompt investors to scurry back into bonds. And for all their poor income value, bonds still offer a yield pick-up over cash, a situation that is not going to change for some time, with all the major central banks likely to keep short-term interest rates low well into the future. A case, in sum, can still be made that long bond yields will stay very low, or even return to last year's levels.

At the very least, though, the odds are rising that bond yields have started on the long road back to more normalised levels. Any rise in longer-term yields will be gradual and modest: the US forecasters surveyed by the Wall Street Journal, for example, currently expect the US 10-year yield to rise slowly to 2.40 percent by the end of this year and to three percent by the end of 2014. This looks like a reasonable prognosis, in which case the recent setback to returns may well become par for the course during the remainder of this year.

International Equities

International equities rose strongly in the second half of November, in December, and again in January. The pace of increase has dropped off more recently, and in some markets prices have actually declined. The aggregate MSCI World Index rose 6.20 percent in January, but was up only 0.30 percent (month to date) for February. (The strong 4.60 percent rise in the overall value of the $NZ unfortunately ate up most of these gains.)

The global rally has carried most national sharemarkets along with it, but there have been some relative winners and losers. Japanese shares have been especially strong on expectations of business-friendly stimulus from the new government: the Nikkei Index is up 29.0 percent since the global rally in world shares got underway in the middle of November. Chinese shares have also been powering along. At the weaker end, European shares have been slipping in recent weeks. In France, for example, the CAC40 Index had gained 13.30 percent between mid-November and 29 January, but it has since dropped 3.30 percent.

There have been good reasons for the improved performance of global equities. Monetary policy in the major economies has been set on 'ultra-easy' for some considerable time, the effects are accumulating, and investors are becoming more optimistic, as the fall of the gold price and the ongoing decline in the VIX volatility index have showed.

The US continues to grow at a moderate pace, confounding fears of a relapse into slower growth or even back into recession. Jobs growth was stronger in 2012 than first thought (181,000 jobs a month, rather than the 153,000 originally estimated), and has continued into 2013, with 157,000 new jobs in January. While not earth-shattering, this is consistent with a gradual pick-up in GDP growth in the US from 2012's 1.70 percent to 2.40 percent this year and 2.90 percent in 2014 (according to the latest Wall Street Journal forecaster poll).

Financial crises, particularly in the Eurozone, have been at least partially defanged – credit ratings agencies have recently upgraded Ireland, for example – and growth prospects in Asia in particular have been boosted. Investors had been worried about unexpectedly weak data, but this has come and gone. The Markit/HSBC Purchasing Managers Index, a good guide to the Chinese economic cycle, picked up again late last year, and latest official Chinese statistics have also been strong. As a result, China appears likely to avoid any significant slowdown from its previous eight percent-plus growth, and latest consensus forecasts have been revised up to 8.50 percent growth for this year. And in Japan, the new administration is determined to get the moribund economy growing at a faster rate. The Economist's latest poll of international forecasters shows that they have lifted their estimate for Japanese GDP growth this year from 0.70 percent in the previous poll to one percent in the current one – again, like the outlook for US growth, not massively game-changing, but another bit of evidence that the world economy is turning for the better compared with previous investor expectations.

None of this necessarily makes a positive outlook for international shares in 2013 a certainty. The US economy could be derailed by the shambles that is its fiscal policymaking. The 'fiscal cliff' was bodged with a Band-Aid, the next crisis (automatic spending cuts if nothing better is agreed) will potentially kick in from 1 March, and there is the issue of the Federal Government's debt ceiling after that. The Eurozone may be less likely to spring a sovereign default or banking system crisis, but its structural growth challenges are formidable – particularly in France, Italy, Spain, and Holland – and recent data has been very poor. Eurozone GDP fell 0.60 percent in the final quarter of 2012, a worse than expected outcome. Chinese political and financial developments are relatively opaque to outside investors, and in Japan the new government is summoning up policies that reached their use-by date in the 1980s.

More fundamentally, there is the risk of herd behaviour driving share prices to levels beyond what might have been justified by a genuinely improving economic and financial outlook. This 'great rotation' out of bonds into equities, as it has been dubbed, could mean that the recent strength of world shares more reflects a global wall of money looking for a new home than any sustainable lift in expected corporate profitability. The share price gains are still real enough, but they could be losing touch with the fundamentals of corporate performance.

From that perspective, the slowdown in share price appreciation in February after January's sharp gains isn't necessarily all bad news: a more measured response to an improved outlook is more likely to bank longer-term gains. Looking ahead, there is enough positive news to support further gains, but investors are increasingly going to have to satisfy themselves that valuations are not getting out of synch with reality.

Performance periods refer to the month and three months to 18 February 2013.

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