Economic Commentary

Prepared by Morningstar Research as at 19 May 2014

Outlook for Investment Markets

World equity markets have been see-sawing between optimism and anxiety, most recently towards anxiety, with little progress for world shares and gains for more defensive assets – local and international property, bonds and infrastructure. More of the same looks in prospect: although the global business outlook is slowly improving (with marked regional variations), the relatively expensive valuations of growth assets leave them vulnerable to adverse political shocks or economic surprises. In New Zealand, the economic cycle remains robust, though again shares may be overpricing the good times ahead.

New Zealand Cash & Fixed Interest

The Reserve Bank of New Zealand has continued on its tightening course, with another 0.25% increase in the official cash rate (OCR) on April 24, taking it to 3.0%. Not surprisingly, short-term interest rates have risen as well, with the 90-day bank bill yield now at 3.4%. Its 0.5% rise since the start of the year exactly matches the two 0.25% increases in the OCR to date. Local bond yields have tracked overseas developments quite closely: the 10-year government stock yield dropped in January, traded sideways (generally in a 4.5-4.6% range) until late April, and more recently has fallen again to its current 4.25%, a pattern that lines up with the behaviour of US Treasuries over the same periods. The kiwi dollar has shown little change over the past month: it has maintained its elevated levels against the US$ (at around US86.6¢), the A$ (at around US92.1¢) and in overall trade-weighted value (with the trade-weighted index around 80.5). Year to date, the kiwi dollar is up 4% in overall value.

Short-term interest rates are headed upwards, though there is some divergence of views on how far, how fast, with some forecasters reckoning that the Reserve Bank may stop and take stock, whereas others reckon it will steam ahead with an uninterrupted series of rate rises. Among the bank forecasters, the ANZ and ASB are relatively dovish, with the OCR expected to be 3.5% at the end of this year, Westpac is middle of the road, with a forecast of 3.75%, while the BNZ expects a more vigorous policy tightening, leading to a 4% OCR. The financial markets as a whole expect rate rises to carry on through next year, with the futures market predicting that 90-day bank bill yields will be roughly 1% higher in a year's time.

Longer-term interest rates are also likely to increase. Perhaps the most committed forecaster of government bond yields is the Treasury, as it will be the entity paying the higher yields. In the Budget on May 15, the Treasury forecast was for a 10-year bond yield of 4.8% in March 2015, rising to 5.0% by March 2016. But there may be an element of wishful thinking in the Treasury's view. Private forecasters believe the bond yield will rise a bit faster than that. All the big banks expect the 10-year yield to be 5.0-5.1% by March next year.

Forecasters tend to agree with the Reserve Bank's view that the current high level of the kiwi dollar is "unsustainable" but have rather different views about when it might depreciate and by how much. The ASB and Westpac expect little change over the next year, with forecasts of US84-85¢ for June of next year, with a lower kiwi dollar only coming to hand over a two- to three-year time horizon. ASB, for example, has the kiwi declining to US77¢ by March 2016 and to US74¢ by March 2017. The prospect of rising New Zealand interest rates when overseas rates are still likely to be low tends to support their view. But others are less sure that the kiwi will continue to find support and expect the kiwi's decline to happen a lot earlier, with the ANZ picking US78¢ by June next year and the BNZ even lower again, at US75¢. Forecasters are more aligned when it comes to the cross-rate with the Aussie dollar: they all expect the kiwi to hold up reasonably well against the Aussie, with June 2015 forecasts ranging from a low of A89¢ (ASB) to A93¢ (ANZ).

Global Infrastructure

Global listed infrastructure has done well in the year to date, with the S&P Global Infrastructure index in US$ up 9.2% in total (pre-tax) return, split between a 7.9% capital gain and a 1.2% yield.

As was evident from the quiet performance of equities year to date, compared with the recent increased appetite for bonds and property, investors are at least temporarily more wary of risks to the global financial outlook. In the circumstances, it has not been surprising that global infrastructure has also been a beneficiary as it tends to offer a relatively appealing combination of defensive, predictable assets and a middle of the road income stream.
The sector is likely to remain well placed as an asset class in a year where the mainstream equity markets are likely to experience further episodes of investor wariness. The slowly improving global economic outlook is helpful for infrastructure: assets such as toll roads have a high leverage to pick-ups in economic activity as all the costs have already been incurred and extra revenue tends to go straight to the bottom line. Various fund managers' commentaries have also pointed to good investment opportunities from infrastructure projects that had been deferred during the GFC but are now likely to proceed, as well as to strong ongoing infrastructural investment in the emerging economies.

Infrastructure's main appeal, however, is likely to be its relative immunity from the economic cycle. The relative stability of infrastructure derives from a combination of the essential nature of the services they provide, the often high barriers to entry and the semi-guaranteed rates of return offered where infrastructure earnings are subject to regulation. With financial markets prone to recurrent episodes of worry about the economic and political outlook, this is likely to be a strong drawcard for the sector.

New Zealand Property

Listed property markets in New Zealand, Australia and globally have showed the same pattern – modest improvement at best up to mid-April and strong advances since. The NZX Property index is up 5.5% in capital value year to date and up 7.1% in total return (including dividends), with virtually all of the gain occurring over the past month or so.

In a buoyant economy, property would be expected to perform well, and it has. The latest listed entity to report (Goodman Property), for example, showed increased profits slightly ahead of analysts' forecasts, plans for a higher dividend, and the largest pipeline of new projects in five years. It also said there was strong investment demand for New Zealand property, which has enabled it to sell assets into a strong market.

Overall, the sector is in good shape. The Property Council of New Zealand/IPD Quarterly Property index looks at the returns property owners have been earning and for the year to March 2014, the total return was 10.4%, made up of a rental yield of 7.8% and a capital gain of 2.4%. By sub-sector, office properties performed best, with an 11.6% total return, with industrial also doing well (10.5%) and retail property lagging the other sub-sectors (8.8%).

Until the past month, the sector had been rather beneath investors' radar, with the wider equity market looking more attractive and it is still not entirely clear why the domestic (and international) property markets have become more appealing. It may be some combination of non-property equities being seen as overpriced, a reduction in risk appetite leading to greater demand for relatively defensive property shares, the recent drop in global bond yields (making property income relatively more attractive), or merely some belated recognition of the sector's good economic outlook and sustainable income yield. Whatever the reasons, the outlook for listed property has improved.

Australian & International Property

Australian REITs have performed well, with the S&P/ASX 200 REITs index showing a capital gain of 7.9% and a total return of 9.1%. The rise in prices is relatively recent, with nothing much happening up to late March and prices rising strongly since then.

Global listed property shows the same pattern: listed property securities made small gains up to mid-April but have advanced strongly since then. The EPRA/NAREIT Global index of listed property is up 10.1% year to date (in overseas currency terms). The US (+16.5%) and the eurozone (+10.6%) led the way and the UK also performed well (+9.4%), but there was another sharp fall for Japanese property securities (-11.9%) in line with the weakness of Japanese shares generally.

With the economy still going through a period of relatively slow economic growth, property has been performing steadily rather than spectacularly. The latest (March) Property Council of Australia/IPD Australia All Property index shows a total return over the past year of 9.3% (an income yield of 7.1% and a capital gain of 2.1%). As has been the case for a while, industrial property was the strongest sub-sector, with a total return of 11.3%, while offices and retail property both returned 9.1%.

As is the case with the wider equity market, the prospects for markedly improved business conditions in the property sector still look somewhere over the horizon, rather than imminent. NAB's March survey of commercial property shows that current industry sentiment, while improving, is still mildly negative. Rents are still falling in all sectors, particularly in the office market. There is general over-supply as well as the severe impact on the West Australian office market of the resources boom winding down. Property owners are having to offer generous leasing incentives, especially in the office and the retail markets, to try to attract tenants but even so, the generally subdued level of tenant demand in a slower than normal economy has caused vacancy rates to rise.

The recent gains in REIT prices do not appear to reflect a substantially improved economic outlook for the sector. A turn for the better still looks some time off, with the NAB survey showing industrial rents may increase next year but rises in office or retail rents are still at least two years away. The recent investor interest more likely reflects some wider changes in risk tolerance and changed assessments of the rather expensive value on offer in bonds and equities. To that extent, the REITs may well continue to attract investor buying in the near term, although as the year progresses there is the prospect of a significant narrowing between the REIT income yield (about 5.5%) and Commonwealth bond yields, which may gradually reduce investor interest in listed property.

Overseas property markets share many of the characteristics of the global equity market – some spinoff benefit from a modestly growing level of world business activity, very marked regional divergences and generally expensive valuations.

The impact of global growth is clear-cut. Jones Lang LaSalle's latest (Q2 2104) Global Market Perspective notes that in the global office market, for example, "2014 is expected to be a year when many of the dominant office markets move into a more robust recovery phase" and it predicts that leasing volumes will increase by 5-10% from last year's levels, while office rentals will rise by some 4%, compared with the 1.6% rise in 2013.

But the pattern of growth is also very disparate. The Royal Institution of Chartered Surveyors' latest global survey shows that, looking at the combination of tenant demand for space and investor interest in the sector, some markets are in strong shape: Japan on the back of massively reflationary policy, the UK in its surprisingly strong recovery, Ireland and some other eurozone economies as they turn the corner from previous property wipeouts. But some are very weak, notably France and the Netherlands among the developed economies and Brazil, Hong Kong and Russia in the emerging world.

Valuations are also stretched. While an attraction of the property sector is that it should offer a relatively competitive yield compared with equities, this is not on offer everywhere. In the US market, which dominates international property indices, there is still a reasonable pick-up in yield between property (3.7%) and the wider equity market (2.4% yield on the S&P 500) but in a number of other major markets, including Germany, Japan and the UK, the property yield is less than you would get from holding the wider market.

Lower global bond yields in the past few weeks have provided some valuation support to the global property market, but this is likely to be temporary. As and when bond yields in the US and elsewhere return to higher levels, global property shares are likely to find it more difficult to make further gains.

Australasian Equities

The New Zealand share market has produced a good performance year to date, although most of the gains were made in the first three months and the pace of advance has been noticeably slower more recently. Year to date, the NZX 50 index is up 7.9% in capital value and by 9.5% in terms of total return (including dividend income). The solid returns were helped by a successful listing of “gentailer” (electricity generator and retailer) Genesis. The government's part-privatisation float was in strong demand and after listing at NZ$1.55 on April 17, has risen to NZ$1.85.

Australian shares have produced a modest return, with the S&P/ASX 200 index up 2.4% year to date (and by the same amount in NZ$ terms, with the kiwi unchanged against the Aussie dollar). Concerns about the economic outlook for China have continued to hold back the resources sector, which is down 1.6%, but the rest of the market has been doing reasonably well, with industrials up 4.9% and financials up 3.5%. IT shares have also done well and are up 8.1%. An exception, however, is the 1.4% decline in shares linked to consumer discretionary spending, which is understandable in the current climate of wary consumer confidence. Shares linked to spending on less cyclical consumer staples have done somewhat better, with a 1.0% gain.

The outlook for the New Zealand economy got well picked over by analysts as they assessed the 15 May Budget and there is a wide consensus that economic activity over the next year or two will be strong. The Treasury's own forecasts are for GDP to grow by 3.9% in the year to March 2015 and by 3.0% in the year to March 2016. If anything, growth in the near term could be even faster. The ANZ's consumer and business confidence indicators, when taken together, suggest growth this year could hit an annual rate of 6%.

The issue for the share market, however, is how much of this lively economy will flow through to bottom-line corporate profits. Despite the boost to business from the Canterbury reconstruction and from high export commodity prices, companies face a number of headwinds that are affecting profits – a high dollar, rising interest rates and tighter fiscal policy as the government aims to restore its books to surplus in the year to March 2015.

Treasury itself is not expecting a very strong track for corporate profits. While it expects its corporate tax take to rise by a reasonable 6.6% in the year to March 2015, it expects an increase of only 3.1% in the year to March 2016. The peak for corporate profitability may well be close to hand and it may be significant that, in the latest ANZ survey, businesses, while still reporting quite high current profitability, have started to become a bit less optimistic about the outlook. With shares already expensive – the New Zealand market is trading on a P/E ratio of 17 times earnings, according to Thomson Reuters – but profit growth close to slowing, the share market may well struggle to repeat its recent gains.

In Australia, the immediate outlook for the economy has improved a little. The Reserve Bank of Australia, for example, has revised up its estimate of GDP growth for the year to this June from 2.75% to 3%. The labour market has been a bit better than expected: there were 14,200 new jobs in April, more than forecasters had been predicting. And forecasters now believe the economy will no longer need extra stimulus by way of lower official interest rates.

However, this has not materially changed the medium to longer-term outlook, which is one where the economy is likely to be travelling rather more slowly than usual. Consumer confidence remains below normal levels and the latest Australian Industry Group's indices of manufacturing, services and construction are all showing that businesses are finding the going tough. As the Australian Treasury noted in its 13 May Budget economic outlook, "The Australian economy is going through an extraordinary period of transition, with investment in resources projects shifting from being the key driver of growth towards becoming a significant detractor from growth... These influences on the Australian economy are expected to persist for some time."

Even when growth eventually picks up, it does not look like a pick-up that will generate strong rises in corporate profits. Treasury, again in its Budget documents, indicated that the outlook for corporate profits was rather indifferent. It expected corporate ”gross operating surplus” (an indicator of corporate profits) to grow by 5.25% in the current 2014-15 year, to show very little growth (0.5%) in the 2015-16 year and to show a fairly modest 5% rise in 2016-17. Longer-term projections for 2018-19 and 2020-21 also showed no profits bonanza on the horizon, with profits expected to grow by 4.0-4.25% a year.

As in New Zealand, Australian shares are rather expensive – the Australian market is also trading on a P/E ratio of 17 times – and with distinctly modest profit growth in the pipeline, the share market may continue to produce rather ordinary returns.

International Fixed Interest

The international bond markets sprang a sizeable surprise in May. After trading around the 2.6-2.7% range for much of this year, the US Treasury bond yield dropped to a new low for this year and at time of writing was just under 2.5%. Lower US yields took many other bond yields down with them and the upshot has been that fixed interest returns have perked up. Year to date, the Barclays Capital Global Treasury Aggregate has returned 4.3% and the Global Corporate Aggregate has returned 4.6%.

Bond yields fell particularly sharply for the more peripheral members of the eurozone. The 10-year Irish government bond yield, for example, is now only 2.67% and the Italian equivalent only 3.07%. As a result, the JPMorgan index of overall eurozone government bonds is up 5.7% (in euros), compared with the 4.15% gain on the most creditworthy eurozone bonds (Germany's). Among the major government bond markets, Japan remains the exception: yields are low (10-year 0.59%) and have not fallen in recent weeks, which means that the total return from holding Japanese bonds year to date has been only 1.2% (in yen).

Emerging markets also had a change of fortune, which mirrored the improvement in their equity markets. Investors were more prepared to hold emerging market debt and the Barclays Capital Emerging Markets US$ Aggregate is now up 5.5% year to date, while the JPMorgan Emerging Markets Bond index is up 6.9%.

Media coverage of the latest drop in government bond yields suggests there has been a variety of influences – principally heightened concerns about global economic growth, particularly in the light of weaker than expected growth data out of the eurozone, but also some general rise in risk aversion, leading investors worried about expensive equity valuations to have a greater preference for safe haven assets such as government bonds.

One positive aspect of the recent move in yields is that it demonstrates the potential value of fixed interest as an insurance policy against upsets in other asset classes. And there is also the possibility that lower than usual bond yields are becoming the new norm rather than an exception from historically higher yields. One theory in vogue at the moment is the idea of "secular stagnation" – that long-term economic growth rates will be lower than previously and that correspondingly both inflation and bond yields will be lower than investors have been used to.

But another, and probably more realistic, way of looking at the recent moves is that bond yields have dropped to unsustainably low levels, where government bond prices look very expensive and where corporate bond yields offer at best a fair to middling reward for credit risk. It is difficult to square, for example, the current US 10-year yield with the likely rate of inflation in the US, which on consensus forecasts is likely to be about 1.8% this year and 2% next year. Forecasters reckon the mismatch will be resolved by US bond yields rising: The Wall Street Journal's latest (May) poll of US economic forecasters has the US 10-year yield rising to 3.3% by the end of the year and to 3.85% by the end of 2015. And on the corporate side, yields on the lower quality issuers now look inadequate. In the US, for example, "high yield" debt issues now pay a little over 5%, which is unlikely to be a paying proposition over the longer term.

In some markets there are good reasons why bond yields are likely to remain low. The European Central Bank has indicated that it may go down the same bond-buying (and hence yield suppressing) route the Fed has been following for some time and Japan is also fully committed to a policy of extremely low bond yields. Elsewhere, unless investors are in the market for expensive insurance policies against global uncertainties, bonds look to have moved into overvalued territory and the risk is that yields will rise from their current unusual levels.

International Equities

World shares have been tracing a zigzag path – down in January, up in February, weak in April, mostly improving in the rest of April and into May, but weakening again recently – and the net effect has been that the ups and downs have roughly cancelled each other out. The MSCI World index is showing a marginal gain in the year to date of 0.9% in overseas currency terms and a loss after allowing for the 4.2% appreciation of the Aussie dollar over the period.

Among the major markets, while much was made in the media of the S&P 500 hitting a record high (1897.45 on 13 May), in reality American shares have been only inching their way up, with the index showing a year to date gain of 1.6%. European markets were a little better, with the FTSEurofirst 300 index up 3.4%, partly due to a firmer French share market, where the CAC index is up 3.7% – President Francois Hollande's appointment of a more effective prime minister has helped local shares along. British shares also rose modestly, with the FTSE 100 up 1.6%, while Japan continued to be the weakest of the major markets and by a wide margin – the Nikkei index is down 13.5% year to date.

The emerging markets are also up modestly year to date, with the MSCI Emerging Markets index up 1.4%. There have been contrasting fortunes among the major BRIC emerging economies. Brazilian shares are up 4.8%, though this rather understates the sharp pick-up in recent weeks. Brazilian shares have risen 20% from their low point on March 14 to their current level. Russian shares are also up from their Ukraine-crisis lows of mid-March, but are still well down year to date (-12.2% on the FTSE Russian index, -12.5% on the RTS index). Indian shares are up strongly, with the Sensex index gaining 13.9%, much of which occurred after it became clear that Narendra Moti's BJP party had had a large win in the general election and investors clearly expect a more technocratically efficient administration. And in China, shares have continued to drift slowly downwards, with the Shanghai Composite index down 4.2% year to date.

The global economy still looks on track for a year of modest improvement in global business activity. The latest (April) JPMorgan Global Purchasing Managers Index (PMI), compiled by Markit, is pointing to global economic growth of about 2.5%. But there are question marks over how much of this growth will translate into even higher equity prices. In the US, the data remain a bit difficult to read as the after-effects of terrible northern hemisphere winter weather are still affecting the statistics. It is probable, for example, that the reported fall in industrial production in April (-0.6%) is not as bad as it appeared as it was being compared with the strong numbers of February and March when manufacturers had been catching up with winter-affected delays. But equally it is possible that the larger than expected rise in new jobs in April (288,000) is not as good as it looks either, as hirers may have been catching up with job offers they did not put into the market earlier. Overall, however, forecasters remain reasonably confident that the US recovery is still on track, with the WSJ poll of forecasters picking 2.4% growth this year, picking up to 2.9% next year.

In Europe, the UK is also likely to do well, as it emerges, somewhat surprisingly, from a program of severe fiscal austerity with a stronger performance than had been thought likely: the UK is expected to grow by nearly 3% this year. Elsewhere in Europe, the news is less encouraging and the latest GDP statistics for the eurozone were one of the proximate reasons for the recent weakness in equities and the concomitant rise in bond prices. Eurozone GDP rose by only 0.2% in the March quarter, even less than the already downbeat 0.4% forecasters had been expecting. While Germany is doing well (+0.8% in the quarter), other major eurozone economies are not, notably France (no growth) and Italy (a small 0.1% decline). The current consensus expectation is that the eurozone will strengthen gradually in 2015 but it remains one of the more fragile developed regions.

In Japan, the outlook is mixed. On the positive side, the government looks as if it has been able to turn deflation around: in the latest Economist poll of international forecasters, inflation is expected to be 2.6% this year. But on the negative side, GDP is responding only tepidly to what generally has been a very large program of fiscal and monetary stimulus and the economy is also dealing with the after-effects of the April rise in sales tax. The Economist poll is picking growth of only 1.2% this year and 1.3% next, a very modest outcome given the scale of government support. Investors who had bid up the Japanese share market in the expectation of a larger payoff consequently have been forced to readjust their over-optimistic expectations of corporate performance.

It is also a mixed outlook for the emerging markets. The HSBC Emerging Markets PMI is showing very little growth across the emerging markets as a whole but that is down to a mixture of poorer performance in the BRIC economies and better performance elsewhere.

The biggest questions concern China and Russia. Although forecasters are still picking quite high rates of growth for China this year and next, in the region of 7% a year, there is quite a high degree of anxiety about potential shocks to the Chinese economy from its rickety financial sector and in particular from the unwinding of a speculative boom in housing. And Russia appears to be in recession, partly due to the political instability associated with Ukraine. Elsewhere, however, the emerging markets look in better shape. Markit noted in its commentary on the Emerging Markets PMI that there is strong growth in parts of the Middle East and in central and eastern Europe (other than Russia), and there is now the prospect, after this month's general election result, that India's performance will improve under a less corrupt and more growth-friendly government.

An outlook of modest overall global economic growth (albeit with sharp regional variations), on its face, is none too bad for global equities. But share valuations are already expensive and look to be based on a stronger outcome than currently appears realistic, while there is a series of political hot spots that could also derail investors' expectations. As recent weeks have shown, investor sentiment can turn quickly for the worse and global equity markets may continue their recent zigzag pattern as investor confidence continues to wax and wane.

Performance periods refer to the month and three months to 16 May 2014

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To discuss how this economic update may impact on your current and future investment strategy please contact Selwyn Parker of **Investment Management Solutions Ltd (IMS) below.**

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