Economic Commentary

Prepared by Morningstar Research as at 18 February 2014

Outlook for Investment Markets

World equity markets stumbled in late January and early February but have largely recovered from Nervousness about the outlook for American and global economic activity. Looking ahead, the economic outlook is reasonable for world equities, though higher valuations and weakness in emerging markets suggests a replay of the strong price gains of 2013 is unlikely. Fixed interest temporarily performed well in January but the outlook is more challenging as bond yields, at home and overseas, look likely to rise this year. Property (local and global) also weathered the January volatility quite well but investors remain largely on the sidelines. Domestically, the already strong economy looks to have become even more buoyant in recent months.

New Zealand Cash & Fixed Interest

Short-term interest rates have risen a tad, with the 90-day bank bill yield now 2.93% compared with 2.84% at the start of the year: it is likely that the money markets are in the process of anticipating a monetary policy tightening. Longer-term interest rates have followed the overseas trend: the 10-year government stock yield was 4.7% at the start of the year, dropped to 4.5% in early February, and has picked up a little since to 4.6%. The kiwi dollar has also been affected by international developments: it started the year strongly, rising from US82¢ to US83.75¢ by mid-January, but a global period of investor anxiety saw the kiwi sold back down to US80.8¢ by early February. More recently it has firmed again and is back up to US83.4¢. It has also been firm against the Australian dollar, rising from A92.1¢ to just under A93¢ currently. In the year to date, it has gained 1.3% in overall trade-weighted value.

There is a very strong consensus that short-term interest rates are headed up. On 30 January the Reserve Bank of New Zealand said, “The bank remains committed to increasing the OCR [official cash rate] as needed to keep future average inflation near the 2% target mid-point. The scale and speed of the rise in the OCR will depend on future economic indicators. ”Forecasters and the financial markets expect the rises to start in March and continue all year, with the futures market picking that 90-day bank bills will be about 3.9% by the end of the year, a full 1% higher than today.

There is also a consensus that there will be an increase in long-term interest rates but at a slower pace and on a smaller scale, with the forecasters at the big four banks all expecting the 10-year government stock yield to be 5.1-5.2% by the end of the year, up by about 0.5% from current levels.

The Reserve Bank repeated in its latest January statement that “the bank does not believe the current level of the exchange rate is sustainable in the long run”, but it is debatable when –or even whether –the kiwi dollar will drop to levels that would be more congenial for exporters, particularly as the Reserve Bank will be raising interest rates throughout this year when most central banks overseas will be sticking with very low interest rates. This may well mean that overseas investors will continue to support the kiwi dollar, even if it appears to be out of line with what would suit exporters. As a result, only one of the main bank forecasters (ANZ) is picking a sizeable fall (of about 5% in overall value) this year, while the others are picking either a slight fall (ASB, BNZ) or no fall (Westpac).

Global Infrastructure

The S&P Global Infrastructure index has performed relatively defensively in the year to date, dropping by less than world equities in late January/early February and doing well in more recent days. In US$ terms, the index is up 2.6% year to date, largely in the form of capital gains (+2.4%).

As noted in the international equity section, while the going is still reasonably good for mainstream global equities, they are facing stronger headwinds than in 2013 as they are starting the year on more expensive valuations that are more exposed to shifts in investor sentiment (as was seen in January).

Global infrastructure consequently currently occupies quite a useful niche. Infrastructure fund managers typically hold a mixture of assets, some with greater cyclical exposure to the firming global economy, but also some more defensive holdings in regulated sectors (such as utilities) that are likely to be less affected by any unexpected setbacks to the world economy. The combination looks well placed to cope with the likely economic outlook for 2014.

New Zealand Property

The local listed property sector has been largely ignored by investors – with a total return (including income) in 2013 of 3.9%, it substantially lagged the wider share market's performance of 16.5% – but somewhat paradoxically its isolation proved a blessing during the share market's volatility in January and early February. The NZX Property index barely moved in January while shares in general were bouncing around and picked up a little in February to record a modest year to date total return of 1.0%.

The booming economy is clearly a strong plus for the property market. As Colliers' latest research on the industrial market points out, there can be sub-sectors that will miss out in some part (manufacturing employment, for example, is being squeezed by outsourcing to emerging markets and by the high kiwi dollar) but in general the economy is a strong incoming tide that is lifting most property boats. In these conditions it is not too surprising (though a rare event all the same) to see New Zealand among the strongest of the 28 international commercial property markets surveyed by the Royal Institution of Chartered Surveyors RICS). In terms of tenant demand, for example, it was the second-strongest in the world (next to the UAE).
The fundamentals of the industry look in good shape and there is a wide margin between the (tax paid) yields available from the sector and bond yields which can go some way to cushion the impact of bond yields rising later this year. The big question remains, however: despite a good story to tell, the sector may struggle to attract investor interest so long as the wider equity market appears to offer easier capital gains.

Australian & International Property

Although there has been a good deal of high-profile corporate activity, notably the reorganisation of the Westfield group, Australian REITs by and large have also been on the sidelines for investors – with a capital gain in 2013 of 2.0%, they were well behind the wider share market's performance of 16.5%. The sector's total return (including income) was 7.1%. And, as in New Zealand, its isolation has helped more recently, with the S&P/ASX A-REITs index escaping relatively unscathed in January while shares in general were under pressure. The REITs gained in February and in the year to date are showing a decent total return of 4.2% (capital gain 2.3%, income 1.9%).

It was the same story for international listed property, where prices largely rode out the drop and rebound of global equity markets in January/February. The EPRA/NAREIT index of global property turned in a year-to-date gain of 2.4%, helped by good performances in the US (+7.1%) and the UK (+6.8%). However, the index was held back by the sharp plunge in Japanese property share prices (-14.3%) that followed the wider Japanese market down over anxiety about upcoming tax increases and their potential effect on consumer spending (all returns in their respective local currencies).

The Australian economy is growing rather more slowly than usual and this is having the sort of effect one would expect on the performance of property. The latest RICS survey, for example, shows that Australia is way down the pack in terms of rental expectations for the coming year. Along the same lines, Jones Lang LaSalle's latest Office Report shows that rents for grade A offices dropped by 5.0% last year in Sydney, by 6.0% in Adelaide, by 10.9% in

Melbourne and by even larger amounts in the cities most exposed to the rundown of the resource investment boom (14.4% in Brisbane, 15.2% in Perth). The Property Council of Australia's latest half-yearly report on the office markets also shows the impact of slowish growth, with office tenants taking up less space and the national vacancy rate rising to 10.4% from 10.1%.

It is not all doom and gloom in the sector: overseas investors are still interested in Australian property (local yields are higher than those typically available in Asia, for example) and several analysts are picking that there will be further corporate activity that may result in the prices of the target companies being bid up. But the sub-par economy, the reasonably narrow gap between the REIT sector yield (5.5%) and bonds, and the greater appeal of mainstream equities look as if they will continue to constrain the performance of the sector.

For overseas property markets, the gradual improvement in the global economy is helping performance: as the RICS commentary on its latest global survey notes, "sentiment is turning a little more positive across much of the real estate world, helped by a generally improving macro climate". Since then, the Japanese market has weakened markedly but the general thrust of the RISC assessment is still intact, with the important US, UK and German markets all in good shape from both a tenant and investor perspective.

The problem remains the yield on the sector. Currently the global yield is 3.67% – a bit lower in Asia (3.2%), 3.6% in the US, 3.7% in Europe and somewhat higher (4.4%) off the beaten track in the Middle East and Africa. These yields may provide little protection for the sector once bond yields rise to more normal levels.

Australasian Equities

The New Zealand share market has broadly followed the international trend since the start of the year – starting off with a modest increase, undergoing a sell-off in late January and early February (the NZX 50 index dropped by 3.0% between 22 January and 4 February) and recovering more recently. Year to date, the NZX 50 index is up 3.2%, which is a good performance by international standards.

In Australia, the overseas trend also played out in domestic prices, with prices dropping to 5 February, then rebounding. The weakness and the rebound have almost exactly cancelled out, with the S&P/ASX 200 index now 5,356, virtually unchanged from its year-opening 5,352. After a very erratic January, mining stocks have gained 2.1%, while the financials are down 0.7% and industrials are down 0.8%.

The January/February sell-off in the New Zealand market was milder than the international average and the rebound has been stronger. The common pattern is the relatively upbeat cyclical state of the New Zealand economy.

Recent data suggests that an already strong economy has become stronger again. The ANZ/Roy Morgan Consumer Confidence survey for January rose to even dizzier heights, with households now more confident than at any time since early 2007. Normally, the ANZ economists would take these consumer confidence results and combine them with their business confidence results to get an estimate of how fast the overall economy is growing. The number that comes out is 5% GDP growth, which the ANZ team doesn't believe the economy is actually capable of delivering. Consequently it has scaled back its estimate of likely GDP growth to 3.5%. On the other hand, there are forecasters who reckon the ANZ surveys are right to be signalling very strong growth indeed: the Westpac folks, for example, are picking 4.2% GDP growth this year.

Big GDP numbers are also suggested by the latest BNZ/Business New Zealand Performance of Manufacturing and Performance of Services indices. Commenting on the services outcome, the BNZ economists said, "This is simply another indicator of how forceful New Zealand's economic momentum is becoming (indeed with other surveys suggesting GDP growth closer to 5%, even 6%, might be closer to the truth)".

Companies should be doing well in this environment: wage pressures are low, capital equipment (largely imported) is cheap thanks to the high kiwi dollar, commodity prices are very high and domestic demand is benefitting from the Canterbury rebuild and assorted wealth effects from higher house prices and a strong share market. Corporate profits should have a good year and normally that would flow through to higher share prices.

But there are some provisos. One is the price investors have to pay to access those profits – on a P/E ratio of 16.8 and a dividend yield of 3.7% (Thomson Reuters estimates) the New Zealand market is no bargain by historical standards. Another is the possible impact of this year's general election. It may hold prices back, both in terms of raising the general level of uncertainty and in raising issues about particular sectors (notably the utilities if, for example, Opposition policies are implemented that would change the way the electricity market works). And a third is the impact of tighter monetary policy: the economy is currently so robust that interest rates 1% higher by the end of the year may not take much gloss off corporate profits. But it will make it progressively more difficult for companies to deliver unusually good outcomes.
In Australia, the cyclical outlook remains somewhat unclear. The Reserve Bank of Australia, in its 7 February Statement on Monetary Policy, reckons GDP growth in 2014 will be between 2.25% and 3.25% and while that may prove true, the real issue is which end of the range will eventuate. A 2.25% growth rate is sub-par and would translate into higher unemployment and likely lead to profit disappointments for equity investors. A 3.25% growth rate is quite a different animal that at worst would stabilise unemployment or even bring it down a bit and would be a good outcome for corporate profits.

The Reserve Bank's own view was reasonably optimistic: it thought that "a number of indicators ... suggest a gradual increase in growth over time" and that "survey measures of business conditions moved to above-average levels late in 2013". But that seems to be a rather sanguine summary of the evidence. It is certainly an accurate summary of the latest NAB business survey – "Business conditions consolidated the strong pick-up in December, reaching an almost three-year high. Overall conditions are ... now close to their long-run average" – but it does not line up with the latest AIG business surveys, which found that manufacturing, services and construction were all contracting in January.

The RBA's view also does not fit comfortably with the latest consumer confidence reports: the Westpac/Melbourne Institute reading for February dropped significantly from January, with Westpac commenting that, "the theme from this survey appears to be that households are particularly worried about the future". And the Westpac/Melbourne Institute leading indicator has also softened a bit, with Westpac saying that, "this slight moderation in the growth rate of the leading index is moving more into line with our own view that growth in the Australian economy in 2014 will remain below trend for another year". The latest labour market news – a small loss of jobs in January and the unemployment rate up 0.1% to 6% – has also been on the weak side.

The most likely outcome is that the economy will pick up a bit from 2013 – consensus forecasts have growth of 2.7% (the Fairfax poll) or 2.8% (The Economist) this year, a bit faster than last year's 2.4% – but it does not look like being a stellar year for corporate performance. The economists in the Fairfax poll reckon that although 2014 is not looking like an exceptionally good year, the S&P/ASX 200 index may still finish the year around the 5,730 mark, which would be a 10% rise on the 5,200 or so when the poll was taken. That would be a useful result to bank – but whether it will come to hand is still arguable. Shares are already on the expensive side – the market is trading on a P/E ratio of about 18 times earnings – and in a reasonable rather than great year, it may be a stretch for companies to deliver the profit growth that this somewhat expensive valuation predicts.

International Fixed Interest

As noted in more detail in the international equity section, global financial markets had an outbreak of nervousness in January about the outlook for world economic activity. A side-effect was that US bond yields dropped throughout the month, with the 10-year Treasury yield falling from 3.03% at the start of the month to a low point of 2.57% by 3 February. More optimistic markets in February resulted in bond yields rising again (the US 10-year yield is currently 2.74%) but the net effect has been that in the year to date, global government bond yields are lower in the US and elsewhere. The 10-year yield in Germany, for example, is down to 1.68% from 1.94% and in the UK to 2.79% from 3.04%.

Lower government bond yields translate into capital gains for bond prices, with the Barclays Global Aggregate up 1.74% year to date. Within the aggregate, government bonds are up 2.15%, outpacing the 1.6% gain in corporate bonds.

Unusually, compared with the experience of the past few years, the bigger gains were made at the more creditworthy end of the asset spectrum: global high-yield (low-quality) assets are up by only 0.9% in the year to date.

Emerging economies have been having a hard time of it in the equity markets and the same has been true of emerging market fixed interest. There is a diverse range of emerging market bond indices and the year to date numbers vary from a small gain (+0.7% on the Barclays' Emerging Markets index) through a small loss (-0.3% on the JP Morgan Emerging Markets Bond Plus index) to a reasonably substantial loss (-3.8% on the Barclays International High Income Sovereign index). However measured, emerging markets underperformed relative to their developed economy equivalents.

The recent gains in bond prices look more like an anomaly than a reversal of the inevitable longer-term trend towards more normal levels of bond yields. The yield on the Barclays Aggregate index is only 2.1% (and on global government bonds only 1.5%), a level that makes more sense in depressed or deflationary conditions but which looks anomalous in the current state of the world. While recent economic data out of the US in particular have been weaker than expected, and some of the larger emerging markets have been running into trouble, overall it is still likely that 2014 will be a year of reasonable growth for both the US and the world economy as a whole.

That means the US Federal Reserve is likely to continue to "taper". Its monthly bond purchases have already been pared back from US$85 billion a month to US$65 billion. With ongoing economic growth and lower levels of monetary policy support through the Fed's reduced bond buying, it looks likely that US bond yields will resume their gradual rise. The latest (January) Wall Street Journal poll of US economists has the US 10-year yield increasing slowly but steadily to 3.5% by the end of this year and to 4% by the end of next year. Although this will not be matched one-for-one in overseas markets – the eurozone economy is likely to be weaker than America's and Japan is likely to remain committed to a policy of very low bond yields – some trend towards higher yields in non-US markets is also likely.

This may create challenging conditions for international fixed interest. The extra credit spread income from better quality corporate bonds will help cushion the capital losses from gradually rising levels of base bond yields. The asset class as a whole, however, faces a difficult outlook, although it will continue to provide some insurance value against the kind of equity market setback that occurred in January.

World equities ran into a rough patch in the second half of January and early February and although they have recovered some ground, most markets are a bit below their starting points at the beginning of the year.

The MSCI World index was particularly weak between 21 January and 4 February, when it dropped by 5.5% and even though it has recovered, world shares in overseas currency terms are still a bit below (-0.8%) where they started the year. In local NZ$ terms, the loss was bigger due to the 1.3% rise in the kiwi dollar's value over the period.

European shares have fared a bit better than other major regions, with the FTSEurofirst 300 index up 1.2% year to date (Germany +1.2%, France +1.0%) on signs of a gradual turn for the better in the previously depressed eurozone. The US (-0.5%) and the UK (-1.3%) are still slightly below their opening year levels. The weakest of the major markets by some distance was Japan, where the Nikkei is now down 12.1% year to date on concerns that a stronger yen and an impending rise in consumption taxes may crimp the economy's growth.

Emerging markets were especially weak as a number of emerging economies ran into one kind of trouble or another at the same time, with Argentina, Turkey and the Ukraine (among others) all hitting the headlines with a mixture of economic and political problems. Consequently, the MSCI Emerging Markets index is down 3.3% year to date. Asia was down 3.3%, eastern Europe down 0.8% (a mix of Russia down 8.5% and the rest of eastern Europe up 3.5%), while in Latin America, where the concerns were greatest over economic maladministration in Argentina and slowing growth in Brazil, shares are down 5.4%. Shares in the largest and most important developing economies (the "BRIC" group of Brazil, Russia, India and China) are down 5.2% year to date.

International Equities

The outlook for global shares is better than the January wobbles might suggest, though there are some challenges ahead for the world's equity markets.

In the US, it is true that the recent job numbers in particular have worried investors about the speed of economic growth. Forecasters had expected 200,000 new jobs in December but got only 74,000 and were expecting 180,000 in January but got only 113,000. If maintained, this may suggest slower growth than anticipated, but a more likely outlook is that the US economy is in reasonably good shape.
While the appalling winter weather in the northern hemisphere is making the data hard to read (and worse than things would appear in more normal conditions), the likelihood is that the US economy will grow at a rate that will meet share investors' expectations this year. The economy grew a little faster than expected in the December quarter (3.2% versus 3.0% anticipated), and forecasters in The Wall Street Journal survey still expect a gradual pick-up in the rate of growth from 2.5% in 2013 to 2.8% this year and 2.9% in 2015. Interestingly, the economists on the panel were asked about whether the risks to US growth were to the upside or to the downside and by a very sizeable margin (74% to 26%) forecasters thought the risks were to the upside and that the US economy could produce some positive surprises. It has also been helpful that the highly partisan politics of American fiscal policy has recently taken a more sensible approach (over the federal government's debt ceiling, for example) and that the risks of "fiscal cliffs" and "sequesters" have receded to some degree.

The eurozone, which has been a very substantial drag on growth in the developed world, has also shown signs of recovery. The "flash" estimate of December quarter GDP ("flash" being an early estimate based on some, but not all, of the data being available) from the European statistical office, Eurostat, shows the eurozone grew by 0.1% in the quarter and the whole 28-member European Union grew by 0.3%, helped by 0.7% expansion of the UK economy. The numbers are not large but on the positive side they show more widespread growth in Europe (with previously troubled countries such as Portugal doing a lot better) and they also represent a turnaround from the poor conditions of 2013. On The Economist's latest consensus poll of international forecasters, the eurozone will move from a 0.4% contraction in GDP of 2013 to a 1.0% expansion this year.

If Europe is turning, however slowly, for the better, Japan may be an example where the opposite is happening. GDP growth was much slower than expected in the final quarter of 2013 –1% at an annualised rate, compared with the 2.8% that had been anticipated – and there is still a lot of uncertainty about the impact of the proposed 8% sales tax (up from5%) on household confidence and behaviour. Unfortunately Japan has form in mishandling sales taxes: an increase to 5% from 3% in 1997 was widely seen as contributing to a recession. The government is predicting that Japan's economy will grow by 1.4% in the year to March 2015 but it may easily fall short of expectations.

In the emerging markets, the road is likely to remain bumpy. One of the key triggers for the late-January global equity sell-off was a widely watched report indicating that the Chinese economy was weaker than expected. The HSBC/Markit purchasing managers index of manufacturing activity slowed in January for the third month in a row and suggested that the Chinese manufacturing sector may actually have contracted during the month. The market reaction was probably excessive – China is still likely to record economic growth of 7% or more this year – but there are enough other issues in play in emerging markets for investors to have more substantiated concerns. In Brazil, for example, the central bank has estimated that the economy shrank by 0.2% in both the September and December quarters of last year, and in Argentina an assortment of poor policies has led to inflation in the 25% to 30% range, massive capital flight and enforced devaluation of the peso (and it needs to drop much further still if trading in the unofficial market is any guide).

Overall, the developed world is largely picking up steam, while the emerging markets are likely to be growing more slowly. Taken together, it should make for another year of modest, non-inflationary global economic growth and it is an environment in which shares should continue to advance. The large price gains of 2013 are rather unlikely to be repeated, however, given the recent weakness of emerging markets, the now higher valuations of world equity markets, which leave them more vulnerable to any adverse profit or other surprises, and the currently underrated potential for various political hotspots (Iran, North Korea, Syria, Turkey, Ukraine) to cause investor anxiety.

Performance periods refer to the period ending 14 February 2014.

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