Economic Commentary

Prepared by Morningstar Research as at 22 January 2014

Outlook for Investment Markets

At the start of 2014, there is low volatility, high levels of confidence among investors and expanded valuations, which is causing some exuberance in the markets. However, there is strength the local equity market as the domestic economy expands on agriculture-based growth and on the expectation the effects of the Christchurch rebuild and of Auckland housing construction are still to come through. A likely consequence, however, is that the Reserve Bank of New Zealand will embark on a series of tightening moves, possibly with some pauses along the way while the bank assesses their impact.

New Zealand Cash & Fixed Interest

Short-term interest rates were steady for virtually the whole of last year: the 90-day bank bill rate started the year at 2.7% and stayed there or thereabouts through to mid-December, reflecting the Reserve Bank's unchanged monetary policy (the official cash rate stayed at 2.5% all year). At the very end of the year, the bank bill yield ticked up a bit to 2.85% as investors began to anticipate a tightening of monetary policy this year.

Longer-term interest rates moved gradually higher over the year, with the 10-year government stock yield starting at 3.5% and finishing 1.2 percentage points higher at 4.7%. Much of the rise occurred in a short burst in June-July when global bond markets started to absorb the implications of the Fed's "tapering" (reducing the degree of support it intended to provide to the US bond markets).Between 10 June and 4 July, the 10-year yield rose to 4.3% from 3.6%. The strength of the local economic cycle also contributed as it became increasingly obvious to investors during the year.

The Kiwi dollar, meanwhile, started 2013 at US82.03¢ and ended at US82.02¢, according to the RBNZ's statistical database. But the almost identical starting and finishing points do not give a good feel for the volatility of the year. At one point (April 12) it touched US86.3¢ and at another (July 8) it sank as low as US77.2¢. Much of the volatility had to do with the confidence levels of global investors, with the Kiwi tending to rise when investors were relatively confident and prepared to entertain the risks of investing in distant currencies and conversely tending to sell off when investors were more of a mind to batten down in their home markets. In trade-weighted terms, the Kiwi dollar gained 5.2% in value during the year: in particular it rose to A92.1¢ from A79.1¢ and to ¥86.2 from ¥70.4, reflecting the yen's global weakness.

Everyone--the forecasting community, the futures market and not least the Reserve Bank itself--expects short-term interest rates to rise over 2014. The RBNZ is not expected to wait much longer to see the effect of its introduction of loan-to-value-ratio limits on banks' mortgage lending and given so many borrowers' exposure to floating interest rates, it is expected to start tightening. On current futures market pricing, the 90-day bank bill yield is expected to rise by a full percentage point in 2014 to 3.9% and a bit more again in the first half of 2015.

Local bond yields may experience a modest rise, reflecting a variety of factors--pressure from gradually rising bond yields overseas, the strength of the local economy, which is likely to show up in rising inflation and the impact of gradually tighter monetary policy. The latest consensus forecasts compiled by the NZ Institute of Economic Research tips the 10-year bond yield will average 5% in the year to March 2015 and 5.3% in the year to March 2016.

The Kiwi dollar is in a good place. After the GFC and the eurozone crises, it has weathered the storm better than people would have thought for a commodity currency. The tight fiscal policy, good terms of trade and capital inflows from reinsurance companies after the Christchurch earthquakes are all positives for the Kiwi. The economy is good and interest rates are moving higher sooner than anywhere else. The only potential problem may be if a weaker Aussie dollar takes the Kiwi with it--as it did last year--as the view of the outlook for the Aussie dollar is uniformly pessimistic.

Global Infrastructure

In 2013, Morningstar's benchmark for the sector, the net return from the Standard and Poor's Global Infrastructure Index, which includes exposure to three kinds of infrastructure (energy, transport and utilities) and hedged back into Australian dollars, produced a total return of 17.7%.

Infrastructure may be seen as a hybrid kind of investment asset, with some equity-like characteristics but also with a reasonable income yield as there is a dearth of alternatives offering that combination in the New Zealand marketplace--there are few global property vehicles available, for example, while the local listed property sector is also heavily concentrated on a small range of property shares. It can be used to get a customised exposure focused to regulated industries, which have a more defensive quality and tend to produce an inflation-linked revenue stream.

New Zealand Property

Listed property substantially underperformed in 2013 compared with the wider equity market. Property shares started the year well and by mid-May were up 11% on their starting level but then went into a long slide and ended with a small capital loss of 2.1%. Including the yield, the total return from the sector was 3.9%.

The ever-strengthening economy is clearly a plus for New Zealand property, which is showing up on measures such as Colliers' latest quarterly survey of confidence levels among commercial property investors, which surged to new highs in the quarter, with both Christchurch and Auckland buoyant (Wellington less so, though also improving). The yield from the sector remains attractive: the larger names are offering tax-paid yields in the 5.25% to 6% range (which gross up to 7.3% to 8.3%, pre-tax). And, somewhat paradoxically, the recent quiet performance of the sector may be an advantage in disguise as it may be going back to how it ought to behave, which is more as a hybrid asset. It had been behaving like a high-beta asset--like the share market in general--but more recently it is getting more defensive and that is reassuring.

The offsets, however, are the prospect of gradually shrinking differentials between property yields and both bond yields and term deposit rates and the continuing absence of significant investor interest in the sector since prices started to slump in the second half of last year.

Australian & International Property

It was much the same story in Australia, where the A-REITs started 2013 in strong fashion and by 21 May (their peak for the year) the S&P/ASX 200 A-REITs index was showing a capital gain of 16.6%.

Thereafter, however, it all fizzled out and by the end of the year the index was up by only 2.0%. The accumulation version of the index, which includes the value of the sector's dividend income, was up 7.1% for the year. The sector was well underwater from a Kiwi investor's point of view after allowing for the Kiwi dollar's 16.4% rise against its Aussie equivalent.

Some see the recent underperformance of A-REITs as a potential advantage. The scale of their underperformance relative to other asset classes has certain investors thinking about rebalancing towards more REITs. Even so, thinking is as far as it has gone. Overall, the main concern is the potential impact of a slow and steady creep upwards in local bond yields. If there is a small rise in bond yields, equities in general can still go ahead but REITs will continue to struggle. But if there is a large rise in bond yields, equities would sell off and REITs could emerge as a defensive asset. However, on the view that there may be modest rises in local bond yields, property looks less attractive than before. The sub-par evolution of the Australian economy is also a factor as various market reports have indicated downward pressure on rentals across the sector.

International property markets are also seen as seriously overvalued, especially in the US. During the period when bond yields had been exceptionally low, yield-focused investors had driven property prices up to unsustainably high levels and the subsequent poor performance of property equities consequently came as no surprise. As a Wall Street Journal article pointed out on 7 January, the total return (dividends included) from the S&P 500 index in 2013 was 32.4%, whereas the total return from the Dow Jones All-REIT index was only 2.7%, and the underperformance of the US REITs relative to equities more generally was the biggest since 1998. With bond yields on a gradual rise, that's likely to erode the relative attraction of property yields even further.

Australasian Equities

The NZX 50 index recorded a gain of 16.5% in 2013. While a good result for what is often regarded as a "low-beta" market (with relatively more slow-and-steady listings and relatively fewer high-growth companies), it was a somewhat modest outcome considering the global bull market in equities and New Zealand's economic outlook, which improved steadily all year. Part of the reason was a succession of individual share setbacks (Chorus, Fonterra) and part was the drag on the market of the government's semi-privatisations (Air New Zealand, Meridian, Might River Power), all of which subsequently dropped below their sale prices.

In Australia, the S&P/ASX 200 index was up 15.1% in 2013, though none of the gain crossed the palms of New Zealand investors as the Kiwi dollar rose by slightly more (16.4%) against the Aussie dollar, resulting in a slight loss in Kiwi dollar terms. By sub-sector, and in A$ terms, consumer discretionary shares led the way (+36.3%), with good performance also by IT stocks (+24.3%) and by the financials (+23.6%), while the industrials came in with a more modest +11.75%. Resources was the weakest sector, although it recovered a bit in the second half of the year, it never made back the ground lost during a big sell-off in the first half of the year and ended up with a loss of 8.3%. As the Reserve Bank of Australia noted in its December 2013 policy meeting minutes, "its [the local equity market's] underperformance relative to most other developed markets was a reflection of both the weaker performance and larger size of the resources sector in Australia".

All the official data and private sector surveys at the turn of the year were showing a domestic economy in strong shape. The most recent GDP numbers show the economy grew by 1.4% in the September 2013 quarter alone (for a 3.5% increase year on year) and although there were some unusual features in the numbers that may have exaggerated the scale of what was actually happening, there were also some very positive signs in the data (notably a big rise in business investment in plant and equipment) that suggest businesses are looking forward to even better times. The growth in the September quarter was all agriculture-based and the effects of the Christchurch rebuild and of Auckland housing construction are still to come through in 2014. The last business and consumer confidence surveys for 2013 from the ANZ Bank also showed very strong readings. The New Zealand Institute of Economic Research's authoritative Quarterly Survey of Business Opinion in December 2013 confirmed the positive outlook in spades.

The outlook for the Australian economy, however, is less heartening, with the economy still trundling along at a slower than usual pace of growth as the activity linked to the mining investment boom continues to wane and with no clear evidence that the non-mining parts of the economy are picking up fast enough to fill the gap. Recent data have been mixed, with some (such as retail sales, house prices and housing construction) suggesting that the economy may be more on the rise and corporate profits easier to come by, but others suggesting the economy is still sub-par. Most of the business surveys have not reappeared since the Christmas/New Year holidays but going by one that has--the December results from the AIG suite of activity indices in manufacturing, services and construction--the sub-par period seems to be extending into this year, with manufacturing and service activity both contracting and construction still growing, but not as rapidly as previously.

While the relatively slow growth is not disastrous, it is obviously not the best backdrop for equities to shine. With the Australian economy slowing, there have been pressures on equities for some time, especially as there is not the same room for fiscal stimulus. And monetary policy does not have the same firepower with interest rates already very low. On valuations, the Australian market is either as expensive as the US, or a bit more expensive again depending on the measures used.

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International Fixed Interest

The international bond markets experienced one of the more momentous financial market developments of 2013. After staying lower for longer than many analysts had expected could happen, global bond yields finally started to rise. The 10-year US Treasury yield started the year at an already low level of just under 1.8% but thanks to massively stimulative monetary policy from the Fed, plus an increase in "haven" buying in response to eurozone debt difficulties, the yield had dropped to an even lower level by early May (1.66% on both 1 and 2 May).

Thereafter, however, investors started to focus more on the Fed's likely reduction ("tapering") in the scale of its bond buying, which had been keeping bond yields exceptionally low and the US yield started to rise, very nearly reaching 3% by early September and closing the year just over 3% at 3.04%, for an overall increase during the year of 1.25 percentage points. The rise in US rates fed through to other developed markets, though with some exceptions. The peripheral and more indebted eurozone countries, the "PIIGS" (Portugal, Ireland, Italy, Greece, Spain), experienced a decline in yields as a result of domestic restructurings and reforms and greater investor confidence that the eurozone authorities would assist with financial support. And Japan went its own way, with bond yields staying exceptionally low as the new administration of Prime Minister Shinzo Abe pursued a very vigorous policy of monetary easing.

Overall, however, the higher yields were not good news for investors in international fixed-interest assets. Barclays Capital indices show that investors had made a loss of 1.6% for the year from holding the Barclays Global Aggregate, with a loss of 3.0% on global government bonds only partially offset by a small positive return (1.1%) from holding higher-yielding global corporate bonds.

The only areas showing decent returns were at the riskier end of the fixed-interest spectrum: global high-yield (low-quality) debt produced a return of 6.4%. Not all high-risk punts paid off, however. Earlier in 2013, when developed markets yields were still very low, there had been a rush into higher yielding (and riskier) emerging markets bonds. As developed economy yields picked up, the money surged out again and emerging market bonds fell sharply in value: the Barclays Emerging Markets US$ Aggregate index was showing an annual loss of 3.9%.

At the short end, interest rates are likely to remain extremely low. In the US, the Fed has made it clear that increases in the Fed funds rate are out of the question until it is beyond all doubt that the US economy is back in robust shape. In Japan, the authorities also remain committed to very stimulative monetary policy. And in Europe, the weakest part of the global economy, the latest (9 January) statement from the president of the European Central Bank said that monetary support for the eurozone might even be increased if inflation continued to remain lower than the ECB's target level and the eurozone economy continued to struggle.

Longer-term bond yields are likely to rise gradually, led by the US market. While the Fed is in the process of winding back its program of bond buying, it is doing it in incremental moves with its first careful move being to a cut from US$85 billion worth of purchases a month to US$75 billion. The Fed is clearly sensitive about allowing any sharp rises in bond yields (and may be even more sensitive for a while as it digests the latest, surprisingly low number of new jobs created in the US) and forecasters expect only a modest and slow rise in US bond yields. The Wall Street Journal's panel of US forecasters is picking that the US 10-year yield will have risen to only 3.5% by the end of this year. While rising bond yields are not ideal for fixed-interest holdings, the price of some modest capital loss may be worth paying as insurance against the risk of equity market turbulence.

International Equities

World equities had a strong year. Despite intermittent setbacks, mainly related to assorted eurozone crises and the prospect of less accommodative monetary policy in the US, the MSCI World Index recorded a 26.25% rise in overseas currency terms, a gain further amplified in local currency terms by the sharp depreciation of the Aussie dollar.

By far the largest gain among the developed markets, at least in terms of its own local currency, was the Japanese market where the Nikkei index soared by 56.7% in yen terms in response to strongly stimulatory economic policies.

The gain was substantially less in terms of other currencies because of the sharply lower yen--in US$ terms, for example, the Nikkei was up by 28%--but it was still a sizeable contribution to the overall annual outcome. The US was also strong, with the S&P 500 up 29.6% in US$ terms as investors became more confident about US economic recovery and less worried that the Fed might tighten monetary policy too soon. European markets did reasonably well, with the FTSEurofirst 300 index up 16.1%. The pick of the major European markets was Germany, where the DAX finished with a gain for the year of 25.5% (in euros), with France in the middle (CAC up 18%, also in euros) and the UK a bit behind, with the FTSE100 up 14.4% (in sterling).

Emerging markets missed out on the party. The MSCI Emerging Markets Index was marginally up (0.9%) for the year in overseas currency terms, with gains in Asia and eastern Europe offset by losses in Latin America and the former superstar “BRIC” economies (Brazil, Russia, India, China) went completely off the boil: the MSCI BRIC index finished the year almost exactly where it started. China was especially weak in the first half of the year on concerns that its rapid growth might falter. A more optimistic rally later in the year also fizzled out and the Shanghai Composite index finished the year with a loss of 6.75%.

One long-held view has been that the world economy is “muddling through” and that the more pessimistic views of the US, or the developed world more widely, relapsing into recession are too bearish. But the recent stream of data out of the US indicates that the American economy may be doing rather better than “muddling through” and the pace of US economic growth may be picking up to a respectable speed. For example, revised official data shows that the US economy was growing at a 4.1% annualised rate in the September quarter, rather than the 3.6% originally estimated. And while the US December jobs report shows a substantially lower 74,000 new jobs in the month than forecasters had been expecting (an earlier private sector payroll survey had suggested that the number was going to be above 200,000), this looks more like an anomaly rather than any deterioration in the underlying trend of improvement.

The rest of the developed world is also starting to grow faster, with the UK in particular expected to pick up from 1.4% growth in 2013 to 2.6% in 2014 and Germany from 0.5% to 1.7%, helping to turn the eurozone around from its 0.4% GDP fall in 2013 to an expected 1.0% growth in 2014. Japan, too, will continue to benefit from very expansionary economic policies, with growth of 1.8% last year and 1.5% this year (all forecasts sourced from The Economist’s latest poll of international forecasters). And the emerging markets--while slowing from their previous very fast rates of growth--are still likely to turn in a respectable showing. HSBC’s Emerging Market Index, which is built up from Markit’s individual country Purchasing Managers Index surveys, has been slowing but on its latest (December) reading is signalling emerging market GDP growth of about 4-5%.

Nevertheless, while the global macroeconomic outlook continues to be reasonably good, investors are paying too much for it and are proving blind to potential shocks, risks and setbacks. Some market watchers have referred to “staggering” levels of optimism, “fantastic” levels of investor confidence and “complacency”, and pointed out that share prices had been rising far faster than corporate profits, leading to higher P/E ratios across the board.

This has been particularly true of the US, where the P/E ratio on the S&P 500 index started 2013 at 13.4 times earnings and finished the year at 19 times earnings. There were rises in most other major markets as well, though not to the extent that occurred in the US, with (for example) German shares moving from a P/E of 12.1 to 15.9, and French shares from 14.5 to 18.7, while valuations rose more modestly in the UK (12.6 to 14.4) and in Japan (15.6 to 16.8), on the basis of Thomson Reuters estimates.

But P/E ratios are only one way of looking at whether shares are good value and it is possible that there could yet be a surge in corporate profits that may justify the prices being paid today. But overall, it would pay to be wary of equity valuations after their strong run in 2013, especially when set against the prospect of gradually rising bond yields. In short, investors should be prepared for whatever volatility might lie around the corner.

Performance periods refer to the month and three months to 22 January 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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