Economic Commentary

Prepared by Morningstar Research as at 20 June 2013

Outlook for Investment Markets

World and local equity markets had a difficult month, partly because the US Fed hinted it might start unwinding the bond buying that had kept bond yields very low, partly because shares had arguably risen too fast in earlier months, and partly on other grounds (Chinese growth, Japanese delivery of stimulus, Eurozone weakness). While lower share markets might appear to signal gathering global storm clouds, a more likely scenario is that global growth prospects are still reasonably good. The bond markets, however, face more challenging conditions as and when the Fed eases back on supporting bond prices. At home, economic data have been strong, and local equities should benefit from the upswing currently underway.

New Zealand Cash & Fixed Interest

Short term interest rates have been steady over the past month, with the 90 day bank bill rate at 2.65%. The stability reflects the unchanged stance of monetary policy, with the Reserve Bank keeping the official cash rate (OCR) at 2.5% at its latest Monetary Policy Statement on June 13. Longer term interest rates have risen, partly reflecting the strong local economy and partly following the rise in overseas bond yields. The 10 year Government stock yield, which had got as low as 3.15% in early May, has risen further over the past month, from 3.45% to its current 3.75%. The Kiwi dollar has continued to weaken, dropping over the month from 82.5 US cents to 80.9 cents, and has lost 3.0% in overall trade-weighted value. With the Aussie dollar falling even faster, the Kiwi gained slightly on the cross rate, rising from 82.8 Aussie cents to 84.0.

The Reserve Bank's latest policy statement said that "we expect to keep the OCR unchanged through the end of the year". Thereafter, the Bank is very likely to engage in a gradual tightening of monetary policy: the Bank expects the 90 day bank bill yield to be 3.2% at the end of next year and to be 4.0% by the end of 2015. Forecasters and the futures market expect much the same outlook.

Bond yields are also expected to rise. The latest (June) consensus forecasts compiled by the NZ Institute of Economic Research envisage a gradual and modest rise in the 10 year Government bond yield, from an average of 3.6% in the March year just finished, to 3.8% in the year to March' 14 and to 4.4% in the year to March' 15.

The Kiwi dollar had been universally regarded as overvalued, but it is only in the past two months that it has moved decisively lower. In the Reserve Bank's view, "Despite having fallen over the past few weeks, the New Zealand dollar remains overvalued" – the Reserve Bank Governor had pointed in a recent speech to the fact that the Kiwi dollar on one measure was some 18.0% over where it normally would be, and to IMF research indicating it was 10.0-20.0% overvalued – and the likelihood is that the Kiwi could go lower still in coming months.

New Zealand Property

Like the wider equity market, the property sector had made solid gains in the earlier part of the year, and (with the wider market) peaked on May 13, with the NZX Property index at 1024. It drifted down a bit to 1015 by May 22, at which point global equity weakness set in, and the index sold off to its current 953.02, recording a 6.5% loss for the month.

The corporate reporting season in May produced no great surprises, with current and future indicated dividends much as expected, except for a larger than expected insurance payment received by National Property Trust for earthquake damage in Christchurch, which with other revaluations led to a smart rise in its NTA and share price.

The strengthening domestic economy has been helpful for property performance. As the Property Council of New Zealand/IPD index of investment performance to March' 13 showed, direct holders of property earned a total return of 10.6% in the year to March' 13, made up of a healthy 7.9% income return and a 2.5% capital revaluation gain, and the performance was more or less evenly shared across all major sub-sectors.

Business conditions have firmed since then, and landlords' prospects have generally improved further. Although some buildings in secondary areas facing the costs of seismic strengthening have become uneconomic, these are typically not the kinds of properties held by the listed property companies. The listed companies should see further operational gains from modest increases in rentals and modest declines in vacancies, particularly in Auckland. Colliers' latest research, for example, is picking 3.0% rental gains for Auckland industrial and retail property and 4.0% for prime offices, and also lower vacancies across all sectors.

The competition from fixed interest assets will become more of a problem as local bond yields progressively rise, but New Zealand listed property faces less of an issue on that front than many other property markets. Any significant erosion of the substantial yield differential between local property (yielding some 8.0%) and bonds (10 year Government stock 3.75%) is still some substantial way down the track, and property looks able to deliver good returns in the current cyclical upswing.

Australian & International Property

The S&P/ASX200 A-REITs index had a fairly torrid time of it over the past month: its -10.7% decline was larger than the overall market's already substantial -8.2% loss.

International property also had a poor month, with the EPRA/NAREIT Global index down 8.2% in US$ terms. The largest component in the index, the US market, was down by 8.4%, Europe ex the UK was down 8.2% in euros, while the UK fared a bit better, with a 4.5% decline in sterling. Asian markets were dragged down by the very weak outcome in Japan, where property shares dropped 14.5% (in yen), pretty much in line with the wider weakness of Japanese equities.

Recent surveys of the Australian property sector show that the current sub-par performance of the economy is having the sort of impact you would expect on property returns. NAB's latest quarterly Commercial Property Survey found that property investors and managers are still somewhat pessimistic about business conditions in the sector (though less so than in the preceding December' 12 survey), with market conditions somewhat positive for CBD hotels (the kind you sleep in, not the kind you drink in), more or less neutral in the office and industrial markets, but markedly downbeat in the retail sector. Gross rentals had fallen in all sectors in the year to March '13.

Jones Lang LaSalle's June survey of Retail Centre Managers confirmed the NAB picture of retailing. It found that confidence levels were down, vacancy levels were rising, there was pressure on rentals – "It continues to be a tenants' market, with landlords keen to maintain high occupancy and quality tenants within their centres at a time when new enquiry is subdued' – and incentives to tenants were on the rise. Unsurprisingly, outside of Western Australia where the resources boom is still helping things along, retail centre managers fingered the current sub-par state of the economy as their main issue, with 50.0% having negative or very negative views on the economic outlook, and another large group (32.0%) neutral. Only 16.0% thought' slightly positively' about the current economic outlook, and not a single respondent was 'very positive'.

The good news for the sector is that the NAB respondents were expecting markedly better levels of activity and returns down the track, and particularly from early 2014 onwards. In the interim, though, listed property looks like facing the same profit headwinds as the equity market more generally until it becomes clearer that the economy is starting to pick up speed again.

Overseas, the issue is not so much one of a sub-par stage of the economic cycle, as one of valuation. In the US, which is by far the largest component of the various global property indices, economic recovery is strengthening – consensus forecasts have the economy picking up from 2.4% growth this year to 2.8% growth next year and to 3.0% in 2015, and the impact is already gradually coming to hand in the property markets, with (for example) vacancy rates slowly falling in the office and retail markets, and rentals showing small increases.

The problem for the sector, however, is that the global search for yield, when yields on bonds (in particular) had fallen to very low levels, has driven US property share prices into expensive territory, with a dividend yield currently of 3.5% (yields are also low in Asia, at 3.1%, and the UK, at 3.4%). These are not the sort of incomerich returns one would normally expect from property, and were only sustainable when bond yields were abnormally low. With bond yields arguably now on the turn, the sector is vulnerable to increases in bond yields.

Australasian Equities

New Zealand shares weakened over the past month. The local market was slipping in any event before global equity markets softened – the NZX50 index peaked on May 13 at 4,761.6 and had eased back to 4,610.2 by May 22, when global weakness set in – and subsequently joined in the global sell-off. The NZX50 index ended down 4.8% for the past month. Mighty River Power, the big part-privatisation in May, was taken down with the wider market: on May 23 it was still trading at just above its $2.50 listing price, but has since dropped to $2.28.

It was the same story, only more so, for Australian shares. The S&P/ASX200 index peaked on March 14 at 5,221, and had eased back to 5,165.4 by May 22. It then dropped in line with the weakness in world markets, and is 8.2% down for the past month. For Kiwi investors, the outcome was worse again thanks to the A$'s 1.5% decline against the NZ$. The weakness was widespread, with most of the main index sectors selling off by comparable amounts – the resources down 8.3%, financials down 8.7%, and the industrials down 9.0%. IT stocks fared better, down 6.4% (all in A$ terms).

The news on the economic and corporate outlook has been almost uniformly good in New Zealand. The BNZ/BusinessNZ surveys of the performance of the manufacturing and services sectors in May showed activity in both sectors in good shape, with manufacturing in particular in strong form: activity was the highest it has been in almost nine years. The ANZ's surveys of business and consumer confidence for May pointed in the same direction: combining the two, the ANZ economists reckon that the economy will be growing at a rapid 3.7% rate by the end of this year.

Other forecasters have come to much the same conclusion. The Reserve Bank has the economy steadily picking up from 2.4% growth in the March year just been, to 2.8% in the year to March '14 and 3.3% in the year to March '15, and the NZIER's consensus forecasts have a very similar progression (2.5% to 2.7% to 3.1%).

Unsurprisingly, businesses are reporting that this environment of accelerating growth, low inflation, cheap borrowing rates and, latterly, a lower Kiwi dollar, is just the ticket for corporate earnings: as the ANZ team noted, profit expectations in May rose again, and are now at a 22-month high. There are question-marks in the distance about how businesses will fare after the $40.0 billion rebuild of Canterbury begins to tail away, and about the potential income effect if commodity prices (especially the dairy pay-out) were to ease back from today's high levels, but for now the outlook for local equities looks comfortably supportive.

In Australia, there is still no clear view of how much of a slowdown Australia will experience, or for how long, as the resources boom continues to wind down but non-mining sectors remain somewhat in the doldrums.

The latest official figures on company profitability, published in early June, were not especially encouraging. Using the 'trend' data, which are less volatile than the 'seasonally adjusted' ones, total profits were up by only 0.4% for the March quarter, mining profits fell by -0.5%, and manufacturing profits were down -1.0%. On the mining side, the peak of the boom is well and truly past, certainly in terms of profits. Profits peaked in September 2011, at a little shy of A$24.8 billion, and today's mining profits are now down some 28% from their peak levels. On the non-mining side, profits have been rising, but very slowly: they barely grew in the year to March '11 (+0.2%), were up 1.9% in the year to March '12, and up 3.1% in the year to March '13. A very determined optimist might read this as a pickup in profits growth, but the reality is that these are very sluggish numbers for growth in company earnings in recent years, and help to explain why the recent Australian share market sell-off was rather larger than occurred in a number of other developed economies.

The official profits data are admittedly historic, and don't throw much light on current prospects, but recent data and forecasters' analysis, while mixed, on balance suggest that the going is still reasonably heavy for corporate profitability. The Melbourne Institute/Westpac leading indicator measure, while formally pointing to a period of above-trend economic growth ahead, isn't seen as especially convincing even by its authors, with Westpac saying that "Our chief concern is that this respectable growth momentum will not be sustained...[with] the next few months...likely to see the downturn in commodity prices and mining investment start to show a more pronounced negative impact".

Business opinion surveys are still generally lacklustre: NAB's May monthly survey was summarised by the bank as "Business conditions remain at low levels (marginally higher) with unchanged mediocre confidence levels". Businesses' reported profitability has picked up a little in each of the past two months, but still remains at historically low levels. And the official economic data are mixed: you could read May's marginal rise in employment (+1,110 jobs) as good news, because forecasters had expected a 10,000 decline, or as bad news, as job gains of that magnitude are effectively zero.

Overall it is hard to disagree with the Reserve Bank's summary (from the minutes of its latest policy decision) that the economy has been in a sluggish patch, and looks like staying there a while yet: "For the domestic economy, the best estimate was that growth had been a bit below trend over the past four quarters. Most recent data were consistent with earlier forecasts of this continuing in the near term". Another good run for global equities might take the Australian share market up with it, but absent some positive catalyst from global share markets, or some greater clarity about non-mining sectors taking up more of the heavy lifting, the current business outlook isn't the best platform for ongoing strength in Australian shares.

Probably the single most important financial event of the past month was the US Fed's indicating that it might be turning its mind to the issue of winding back its existing programme of buying US$85 billion worth of debt securities a month. The existing programme is designed to make monetary policy even more supportive for the US economy: it supplements effectively zero short-term interest rates, by keeping long-term interest rates low as well, making longer-term borrowing debt cheaper for companies and for households (many US housing mortgages are keyed off long-term interest rates).

The news that 'tapering' of the existing programme might be in the offing contributed to higher bond yields globally. In the key US market, the 10 year Treasury bond yield had been on the rise in any event, from a low of 1.62% in early May, as investors had felt they had less need for 'safe haven' assets and were happier to buy more risk assets such as equities, and the Fed's news took it higher again. By May 22 the yield had risen to just over 2.0% (2.03%) and it hit a peak of 2.23% (June 12) before easing back a little in recent days to 2.12%, a 0.2% rise for the month. Other major government bond markets showed similar rises in 10 year yields: over the past month the German yield rose from 1.4% to 1.5%, the Swiss yield from 0.6% to 0.8%, and the British yield from 1.9% to 2.1%. In Japan, where planned monetary policy should have seen bond yields fall, the 10 year yield stayed at 0.8%.

The upshot has been that fixed interest, as an aggregate asset class, is in the red, year to date. On the Barclays Capital indices, the Global Aggregate has lost -1.75% for the year, mostly due to weaker global government bonds (-2.55%), though corporate bonds are also underwater (-0.66%). Corporate bonds have been relatively protected by their higher running yield and by steady or improving credit spreads as the global economic outlook has improved. 'High yield' (low quality) bonds are still ahead for the year - +1.95% globally, +2.4% in Europe, +2.8% for US corporates – but not all higher-risk assets have continued to pay off. Investors in 'PIIGS' debt had been making substantial profits, but in the past month the Eurozone's ongoing malaise saw their yields move back up again (Ireland's from 3.5% to 3.95%,for example, and Portugal's from 5.4% to 6.3%). And yield-desperate investors who had been piling into emerging markets government debt also got a setback over the month, with the Barclays Emerging Markets US$ Aggregate now showing a year to date loss of -3.8%.

International Fixed Interest

At time of writing the US Fed was in the middle of its latest two-day policy meeting, and it was not yet clear whether it was about to elaborate on its previous May announcement. Then, it had said it "is prepared to increase or reduce the pace of its [bond] purchases to maintain appropriate policy accommodation as the outlook for the labor market or inflation changes". Chairman Bernanke subsequently said on May 22 that "If we see continued improvement and we have confidence that that is going to be sustained, then we could in the next few meetings take a step down in our pace of purchases".

Observers generally expect no change to the Fed's objectives for short-term interest rates: the Fed looks likely to keep to its present plan of a 0-0.25% Fed funds rate at least until America's unemployment rate is below 6.5% (there are other Fed conditions, too, but that is the main one). Going by current consensus forecasts, that does not look likely to happen before the second half of 2015. Cash rates will also remain exceptionally low in the Eurozone, the UK, and Japan, as their central banks similarly maintain ultra-easy monetary policy: there is no relief on the horizon for investors looking for an acceptable yield from bank deposits or money market funds.

For bonds, the outlook remains more uncertain. Clearly, even the Fed cannot go on buying US$85.0 billion of bonds a month into the indefinite future: as the lone dissenter from the present bond buying programme argued in May, "the continued high level of monetary accommodation increased the risks of future economic and financial imbalances and, over time, could cause an increase in long-term inflation expectations". Bond yields cannot be kept below the rate of inflation indefinitely, as they currently are in the US and elsewhere, and at some point need to return to offering investors a real (above inflation) rate of return, after tax. And it is even arguable that the Fed's possible willingness to wind back its bond buying should be read as a good signal that the US economy no longer needs quite the same degree of economic life-support as it has up to now.

The good news on the economic outlook is unlikely, however, to cheer fixed interest investors faced with the prospect of rising yields and hence lower capital values. The economists polled in the latest (May) Wall Street Journal survey are strongly of the view that 'tapering' isn't far away – 89.0% believe it will start in the next nine months – and that there will be an outright winding up of bond buying by the end of next year (87.0% think so). If this occurs, bond yields in the US are headed upwards: the WSJ economist panel was picking 2.2% by the end of this year, although this already looks left behind by events, and the ultimate rise (absent any financial or economic shocks from left field) could easily be higher. Bond yields elsewhere won't necessarily march north in lock-step with the US – the Eurozone, UK and Japanese economies are not in as good shape as America's, and their central banks will lean harder against any interest rate rises – but overall the bond market looks like facing more challenging times in coming months.

International Equities

International equities went off the boil over the past month. After strong rises in the second half of April and the first three weeks of May, world share markets weakened more recently. The MSCI World index (in overseas currency terms) is down 4.1% for the past month, and by 5.4% from its peak on May 21. Despite this recent reverse, world shares have still done well year to date, with the MSCI World index up 10.9% from its end 2012 level. In Kiwi dollar terms the past month's losses were largely cushioned by a 3.0% decline in the overall value of the Kiwi dollar.

American shares were relatively unscathed, with the S&P500 index down by only 1.4%, as were German shares, down by only 2.5%. Other European markets fared rather worse, however, with France down 4.1%, British shares down 5.7%, and European shares in general down by around 5% (4.9% by the FTSEurofirst 300 index, 5.1% by the MSCI Europe).

Among major markets, the worst by far was Japan, where the Nikkei index slumped by 14.0% over the past month and by 18.8% from its recent peak (15,627 on May 22). Emerging markets were also quite weak, with the MSCI Emerging Markets index down 6.4%, though one of the more important emerging markets, China, got away with only a 2.5% decline in the Shanghai Composite index.

A number of developments were behind the recent setback. Probably the most important was the prospect of the US Federal Reserve beginning to edge away from its massive bond-buying programme (which keeps long term interest rates low). There were also supporting actor contributions from concerns about potentially slower growth in China, a stream of poor economic news out of the Eurozone, and worries about how effective the Japanese government will be in reflating the Japanese economy.

It is also likely that world equities may have risen too quickly as investors had become more upbeat in April and May about global prospects. Last month's update had noted that "The major issue is whether equity markets have run too far, too fast, on this increase in optimism", and a number of other commentators had also pointed to valuations getting rather on the pricey side, in possibly overoptimistic anticipation of profits that might not yet materialise. This was especially true in Japan. The big economic stimulus would certainly have justified a higher share market to some substantial degree, but between the start of this year and its peak on May 22, the Nikkei index had risen by what looked like an irrationally exuberant 50.0%.

All that said, it is easy to make too much of the recent declines in prices. Investors do not appear to have become seriously worried about a deterioration in the global economic and corporate outlook. The VIX, the index of expected volatility in US shares, has admittedly risen, but only slightly (12.8 to 16.4, well shy of any kind of GFC-fearing levels). The gold price, another barometer of potential investor alarm, has also shown only a very small rise (from US$1,370/oz to US$1,390/oz), and there hasn't been the flight into safe haven bonds that has occurred in previous periods of investor anxiety. Neither world commodity prices in general, nor the oil price, have weakened markedly over the past month, which might have been expected if there was a genuine global slowdown in activity underway or in prospect.

Certainly the latest authoritative review of the outlook for the world economy, in the World Bank's June Global Economic Prospects, was reasonably assuring (though the more alarmist media tried to make a meal of the forecasts being slightly lower than in the Bank's previous bite at the cherry, back in January). World trade growth is expected to gradually accelerate, from 4.0% this year to 5.0% next year and to 5.4% in 2015; the US economy is expected to continue to improve (2.0% this year, 2.8% next year, 3.0% in '15); and Japan's expansionary policies will also see it delivering three years of modest growth (1.4%, 1.4%, 1.3%), which will be a turnaround from its previous years of stagnation. And all this against a background of low inflation and ongoing low interest rates: the World Bank reckons that short-term interest rates in 2015 will still be only 1.4% in the US, and 1.5% in the Eurozone. Other leading forecasters tend to have a similar view.

The more optimistic view of the outlook for global business activity that investors started to take in April and May, in sum, continues to look a realistic one. Investors may have temporarily got over-excited about the implications for corporate profits, and may have been assisted in that view by the fact that yields on alternative asset classes such as cash and bonds continued in general to be pitifully low. But the underlying assumption that the next twelve to eighteen months should generally be supportive for international equities still looks reasonable.

There are, as always, uncertainties and risks. The markets have tended to take fright at signs that China might not grow quite as fast as expected, and a sharp slowdown in China would indeed be a genuine reason for concern. But on the other hand the markets have been reading too much significance into small monthly variations in China's economic data: in truth there is precious little difference between China growing at 7.5% and China growing at 8.0%. The World Bank is picking a barely perceptible slowdown this year (7.7% growth versus 7.8%) and a slight pickup in coming years (8.0% in 2014, 7.9% in 2015): provided the actual outcomes are somewhere in the region of these very fast rates of growth, China will go on providing an important stimulus to global business.

Equally, Japan's fiscal and monetary policymakers could fail to deliver the degree of reflation the markets expect: the incumbent Liberal Democratic Party does not have a strong track record in recent years for effective economic management.

Some further mutation of the GFC could materialise: as has been widely observed, the bond and credit markets have seen the reappearance of the sorts of unreliable securities that were common pre-GFC ('covenant lite' debt issues, for example, which place few behavioural constraints on borrowers), and banking systems remain fragile in a number of countries.

Perhaps most plausibly, the Eurozone could drag on global growth in a worse than expected way. Forecasts for the Eurozone are already pretty poor: outright recession this year (both the World Bank and the Economist's June poll of international forecasters are picking a -0.6% decline in zone GDP) and only a modest recovery next year (+0.8% from the Economist poll, +0.9% from the World Bank). It would not take much of a policy mistake in the Eurozone, or an external shock, to see this anticipated slow recovery knocked off track.

All these qualifications noted, however, the central scenario remains one of continued and gradually accelerating improvement in the global background for business activity, and equity markets tend to benefit in this sort of low inflation, cyclical pickup environment.

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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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