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Economic Commentary

March/April 2013 *prepared by Morningstar Research*

Outlook for Investment Markets

Growth assets have continued to do well, albeit with interruptions from Eurozone issues (the Italian election, Cyprus). Internationally, the overall economic outlook continues to firm up, though with marked variations from one region to the next, and closer to home both the New Zealand and Australian economies have decent prospects. This modest growth environment should continue to support growth assets, and will continue to place pressure on bonds, which have been performing poorly year to date.

New Zealand Cash & Fixed Interest

Short term rates have been steady, with the 90 day bank bill trading around 2.65%, reflecting the stability of monetary policy: the Reserve Bank once again maintained the Official Cash Rate (OCR) at 2.5% at its latest Monetary Policy Statement on March 14. Longer term interest rates have again moved in synch with overseas bond markets: the 10 year Government stock yield started the year at 3.5%, and rose in line with overseas markets to a high of 3.94% by February 21. The yield dropped back on the worries around the Italian election, reaching a temporary low of 3.67% (March 5), before rising back in line with higher overseas yields, to its current 3.83%. The Kiwi dollar has continued to trade at historically high levels: it has gained 2.7% in overall value year to date, with the gain coming mainly from appreciation against the UK pound (from 50.7p to 54.5p) and the yen (70.4 to 79). Its cross rates against the US$ and the Australian dollar are essentially flat year to date, at around 82.2 US cents and 79.4 Aussie cents.

Local short term rates look like staying around current levels for some time yet: the RBNZ's latest Statement said that "At this point we expect to keep the OCR unchanged through the end of the year", and the local financial markets have few arguments with its view. The futures market, for example, is expecting a 90 day bank bill rate of 2.7% at the end of this year, effectively the same as at the time of writing. A few forecasters are saying that the RB will start raising rates at the end of this year, but most think the first half of 2014 is more likely, with bank bill yields expected to rise modestly but steadily through 2014. Although there is agreement on the general direction, there is quite a range of views on how much monetary policy tightening will occur: for end 2014, the ASB is picking a bank bill yield of 3.5%, while the BNZ has got 4.45%, for example.

Bond yields are also expected to rise gradually: while the general trend is widely expected, again there are differences between forecasters on how much, and how quickly. As a rough summary, the banks' forecasters expect the 10 year Government stock yield to be in the 4-4.5% area in a year's time, and around the 4.5-5% range by the end of 2014. The NZIER's latest (March) collation of forecasts shows a similar picture, with the expected yield rising from an average of 3.8% in the year to March 2014 to 4.4% in the year to March 2015.

For the Kiwi dollar, the RBNZ is of the view that it will stay up, in overall value, at around present levels for the rest of this year. The business community (as surveyed by the ASB in February) is expecting the Kiwi to peak around 87 US cents in June, before easing off to around 83 cents by March next year. The ASB itself doesn't think so: it reckons the Kiwi will still be at 86 cents next March, and most of the other main bank forecasting teams agree with it, with any substantial fall in the Kiwi seen as more likely to occur in later 2014 than anytime sooner.

New Zealand Property

After going quiet in December and January, when the NZX Property index went sideways, listed property improved in February and made further modest gains in March. As a result the NZX Property index is up 1.4% for the past month and 4.1% year to date.

The outlook for the sector remains solid. The improving economy is a clear plus: recent forecasts from Colliers International show that higher levels of business activity are expected to lead to modestly lower levels of vacancy (the Auckland office market, for example, is forecast to see its vacancy rate drop from 7.9% to 7.2% this year) and to higher rents (Colliers are expecting Auckland industrial rentals to rise by 5% this year). Investors remain keen on the sector – Colliers' latest (March) Commercial Property Investor Confidence Survey shows enthusiasm for the sector rising everywhere, though the absolute level of enthusiasm is still quite low in Wellington, the weakest of the major markets. And the attraction of the tax-paid income stream from the sector will remain a draw card for income hunting investors: there is still a wide margin between property and cash or bonds, and it will take some time for gradually rising bond yields to provide more of a competitive alternative to property yields.

Australian & International Property

The S&P/ASX200 A-REITs index is showing a capital gain of 2.5% for the past month, and is up 5.2% year to date. On an accumulation basis (adding in the pre-tax value of the dividend stream) the index is up 6.4% for the year.

International property has also been doing well, with the EPRA/NAREIT Global index up 5.7% in US$ since the start of the year, with Morningstar's preferred benchmark for the sector, the Global ex Australia index hedged back into A$, up by a substantial 8.0%. The largest market in the index, the US, is up 7% (in US$), while the British market was up 3.8% (in sterling). The Eurozone was, unsurprisingly, rather weaker, with shares up only 1.3%. At the other extreme, extraordinary increases have been recorded in the Japanese market: after leaping in December after the election of a pump-priming construction-friendly government, property share prices at first looked as if they had calmed down in January, but they roared ahead again in February and (especially) in March, and the Japanese market is up a remarkable 35.75% (in yen) year to date. Asia as a whole is up 7.7% (in US$).

The current cyclical slowdown looks at this point as if it will be quite modest, and the Australian economy will likely continue to grow at a 2-3% pace over this next year. Even so, it means that business conditions are only fair to middling for Australian listed property. Markets that were more closely linked to the resource investment boom (such as offices in Perth) are weak, and although consumer confidence is now picking up, the retail sector as a whole has been affected by cautious consumer spending and by online retail channels. As the Westfield CEO noted at the group's latest profit announcement, new leases in its malls are being signed at 4-5% below previous rental levels.

The 5% yield from the sector is also looking less compelling. Deposit rates at the banks may drop a bit more if (as the financial markets currently lean towards) the RBA cuts short-term interest rates again, which would make property dividends look more attractive, but on the other hand bond yields are probably heading upwards, and there is already not much of a gap between property and Commonwealth bonds, and still less between property and corporate debt. On the RBA's data, the yield on decent quality (BBB) corporate debt was 5% at the end of February – already matching the property yield. In these conditions it is difficult to see property sustaining the strong gains it has delivered year to date.

The improving economic outlook for the global economy is generally good news for property fundamentals. In the key US market, for example, the steady if unspectacular recovery of the American economy is expected to lead to slightly lower vacancy rates and modestly higher rentals: on the (American) National Association of Realtors' latest forecasts, vacancy rates for industrial property are expected to drop from 9.5% this year to 9% next year, and similar modest falls are expected for the retail (10.6% to 10.1%) and office (15.9% to 15.7%) sectors. Rentals are expected to rise by 2-3% across the main sectors (and by more, 4.7%, for residential apartment blocks).

Not everything is rosy in the global garden – Eurozone property markets are mostly dire, and governments in a number of Asian markets are trying to rein in property markets they feel are overblown – but a generally firming world economy is an overall positive for the sector. Its main drawback, however, continues to be the valuation of the sector: it has run hard already on the back of investors looking for steady dividends in a low interest rate world, and looks expensive.

Australasian Equities

New Zealand has again gone something of its own way in recent weeks: it did not have the strong rises observed overseas before the Italian election, nor much of the same sell-off afterwards. Prices rose in March, with the result that over the past month the NZX 50 index is up 3%. Year to date it is up 6.9%.

Australian shares have continued to closely track overseas equity markets – rising in January and February until the Italian election worries caused a sell-off, and then rising again more recently (with the S&P/ASX200 index peaking at 5146.9 on March 11) before easing off a little, again in line with overseas sentiment, as the Eurozone's proposed Cyprus bailout rattled the markets. The Italian and Cypriot issues mean that the index has struggled over the past month (with a marginal -0.4% decline), but its strength earlier in the year means that Australian shares have banked a gain of 7.9% year to date. The figures are almost exactly the same in NZ$ terms, with the NZ$/A$ cross rate steady over the period.

The Industrials are up 8.6% year to date, Financials up 12.9%, Consumer Staples up 15.6% Consumer Discretionary up 16.6%, and the IT sector up 16.3%. The resources, however, have been quite another story, with the S&P/ASX300 Metals and Mining index parting company with the rest of the market. The miners dropped around the time of the

Italian election, like the wider market, but unlike shares generally have kept on falling since, with the index down by a substantial 11% for the past month and by 7.5% year to date, on worries of slower growth in China and other emerging markets.

Other than the impact of the current drought, which may take some toll on the agricultural economy, conditions are looking good for ongoing growth in the New Zealand economy and for growth in local corporate profits.

The latest Performance of Manufacturing and Performance of Services Indices from the BNZ/Business NZ, for example, showed that activity has picked up in both sectors of the economy: new orders, which arguably are the most forward looking sub-component of the indices also rose in both sectors. Consumer confidence is holding up pretty well: going by the latest Westpac McDermott Miller survey of consumers, confidence is consistent with the economy growing by some 2.5-3%. In the same vein, the economists at the ANZ combine their ANZ Roy Morgan consumer confidence results (which are also holding up well) with the results of their business survey, and reckon that the current readings are consistent with the economy growing at a 2.7% pace by mid-year.

The latest consensus forecasts collated by the NZIER are for the economy to grow by 2.7% in the year to March 2014, and by the same amount the following year, with the multi-year job of Canterbury reconstruction an important element. Downside risks look limited – the worst any forecaster has picked, of the 10 polled by the NZIER, is growth of 1.9% a year over the next two years – and it looks like a slowish but steady environment for corporate profits to do reasonably well: businesses have been reporting steadily increasing optimism about profits in the ANZ's monthly survey since around August of last year. The current cyclical upswing continues to looks like a decent backdrop for equities to continue to perform.

In Australia, the ongoing question has been how the economy will fare as the boom in resources investment peaks and then drops away. Opinions vary on the scale and the timing, but the consensus view – and the RBA's – is that there will be a relatively modest slowdown in economic growth, from the 3.1% mark recorded in 2012 to more like 2.5% this year, and then modestly faster growth again in 2014. Indeed, if the latest poll of views amongst the Economist 's panel of international forecasters is right, the slowdown will be barely noticeable, with 2.8% growth this year and 3.1% in 2014.

Recent data have also been consistent with a relatively upbeat view of Australia's prospects, in particular the completely unexpected and outsize jump in new jobs of 71,500 in February, when analysts had been expecting only 10,000 new jobs. The people who pore over the minutiae of these statistics argue that the 'real' number was probably a lot lower, and the labour market is not in fact as strong as these numbers suggested. We ought (they say) to pay more attention to the 'trend' number, which takes out a lot of the month to month random noise. But even on that basis, there were 15,900 new jobs in February, and it is not surprising that, between lower interest rates and more jobs, consumer confidence has been firming up. The Westpac/Melbourne Institute of consumer sentiment rose again in March in what the compilers described as "a strong result": they found that the previous drip feed of bad news from overseas has begun to abate, and that consumers have perked up as a result.

None of this automatically translates into easy profits for Australian corporates. It's worth remembering that the latest official statistics on business profitability are not signalling champagne conditions: in the December 2012 quarter total company profits were down 6.2% on a year earlier. Obviously, sharply lower mining profits (-26%) had a lot to do with it, but profits in the non-mining economy grew by only 3.2% over the year, a lacklustre result by any standards and only half the 6.7% increase that happens in a typical year (on the Westpac economists' calculation of long term profit performance). And the latest (February) monthly business opinion survey from the NAB showed that companies are still rather downbeat about their profitability prospects.

Even so, the Australian economy looks like weathering the transition from the boom mining years a bit better than previously expected, and although it is not an environment that will necessarily gush corporate profits, it is one where shares can still do well.

International Fixed Interest

International government bond yields rose in January and the first half of February as investors became more optimistic about the world economy and less concerned to hold ultra-low yielding 'safe haven' assets. They dropped again in later February as Eurozone worries raised their head again: the inconclusive Italian general election and the strong showing of Eurosceptic and anti-austerity parties raised the possibility of Italy's ability or willingness to remain in the Eurozone. Subsequently, however, investors seem to have become somewhat less worried, and government bond yields have risen again. In the key US Treasury market, for example, the ten year yield was just over 2% before the Italian worries resurfaced, dropped to 1.84% by March 1 (the Italian general election had been held on 24-25 February), and has since moved back up to 2%.

In the Eurozone itself, government bond yields dropped a little in the two heavyweight economies (German yield down from 1.65% to 1.45%, French yield from 2.3% to under 2.1%) and in the peripheral economies, but, as might be imagined, rose a bit in Italy, from 4.4% to 4.6%. Elsewhere, Japanese bond yields were marginally lower, while Swiss and British yields were unchanged.

Eurozone worries also extended into the corporate bond markets where credit spreads widened around the time of the Italian election, but as in the government bond markets investor confidence has improved since then, and spreads have dropped back again. As an example, Markit's iTRAXX Europe index, which tracks the annual cost of insuring a wide portfolio of European bonds against default, rose from around 110 basis points before the election to 120 in late February, but has since fallen back to 105 basis points.

The Italian episode meant that global interest rates dropped (and credit spreads widened), but only for a relatively short period, and its subsequent reversal meant that markets went back to square one – with higher yields than at the start of the year. As a result, virtually all the main Barclays Capital bond indices, year to date, are underwater, due to capital losses (from rising yields) which have outweighed the very low income yields. The Global Aggregate index is down 2.35%, with global Treasuries down 3.4% and global Corporates down 1.2%. The higher risk end of the bond markets has done somewhat better, however, as higher income yields have protected the overall return, while investors have remained keen to buy into the last outstanding pockets of relatively attractive income: the Global High Yield index is up 1.8% year to date.

Logic has been saying for some time that global interest rates would at some point need to move to more sensible levels, and in that light the recent modest rises in yields and the associated capital losses make sense. There had been no value on offer in the mainstream government bond markets, only modest returns left on the table from corporate credit spreads, and in some areas of the fixed interest market there were very clear signs of overheating. Ever more exotic investments (such as Honduran government bonds, and bonds backed by unusual assets, reminiscent of pre-GFC instruments) were coming onto the markets at ever sillier yields.

It appears at least plausible that the long march back towards more acceptable yields is underway, and that further capital losses are on the horizon. The process is likely to take some considerable time. Central banks will be highly wary of removing monetary policy stimulus before they are absolutely sure that their economies and banking systems can stand it, and will be persisting with 'quantitative easing' (buying of bonds to keep long-term interest rates lower than otherwise) for some time yet, particularly in Japan. Central banks will still be buying the bonds that institutional and retail investors will be abandoning.

Given the reasonably positive outlook for the US economy, however, it is inevitable that the Fed will carefully and progressively begin to scale back its bond buying and allow long term rates to start to rise. In the Wall Street Journal ''s latest poll, US forecasters were asked when they thought the Fed would begin to ease up on bond buying, and 65% of respondents picked the second half of this year. Consistent with this view, forecasters are picking a small rise in the US 10 year Treasury yield to 2.4% by the end of this year, and then further rises, to 3.0% by the end of 2014 and to 3.6% by the end of 2015.

Rises in yields in other markets may not be as large, particularly in the Eurozone and Japan, and it is always possible that some upsetting GFC-style event might come along that might send bond yields scuttling back down again. A more likely view is that it looks as if the tide has turned against bonds, and may keep going out for some considerable time.

International Equities

As noted earlier, bond prices have mostly been falling this year as investors have been getting more optimistic about the global economy and less tolerant of near-zero yields on cash and government bonds, though there was a brief episode of Eurojitters in late February when bond yields temporarily fell and bond prices recovered.

Exactly the reverse has been happening in the equity markets: equity prices have been mostly rising, interrupted by a late February fall that was later reversed, and normal service has since resumed with rising equity prices, although in recent days Cyprus's problems have been weighing on global shares. In the bond market, the net effect, year to date, has been losses: in the equity markets, the net effect has been gains, with the MSCI World index up in overseas currency terms by 7.9% so far this year. Most of this has passed through in Kiwi dollar terms as well, though a chunk has been eroded by the 2.7% rise of the Kiwi dollar year to date.

The passing impact of the Italian election can be particularly seen in the VIX index, which is the amount of volatility investors expect to encounter in the US share market. The VIX had been trading at a benign, no clouds on the horizon level of around 12.5 before the Italian electorate sprang its surprise, but then jumped to 19 by February 25. As in the bond markets, the anxiety did not last for long, and the VIX not only returned back to where it started but carried on down a bit further again, to its current 11.3. A VIX at these levels has not been seen on a sustained basis since the pre-GFC years of 2005-6.

The recent media coverage of rising global equity markets has focussed on the US, where prices have reached record highs: first the Dow, and more recently the broader S&P500, have surpassed their previous highs (recorded in late 2007, before the GFC broke out). While the US market has been performing reasonably well – the S&P500 is up 4.4% year to date – in fact the spotlight should more properly be on some of the other major markets, and particularly Japan, where the Nikkei is up by a very strong 20.8% on the back of proposed reflationary economic policy. European shares, despite the very poor recent economic data out of the Eurozone, have also chipped in, with the EuroSTOXX index up by +5.4%. Emerging markets, however, have been disappointing, with the MSCI Emerging Markets index down marginally (-0.5% in overseas currency terms) since the start of the year, with the key 'BRIC' emerging markets (Brazil, Russia, China and India) down 2%. Chinese shares had been performing very strongly: between bottoming out on December 3 below 2000 (at 1959.8) and its peak of 2434.5 on February 6, the Shanghai Composite index had risen by 24.2%. More recently, however, fears of tighter economic policy have combined to send the Chinese market back down to 2278, and it is now back to where it started 2013.

The outlook remains one of an improving world economy, with economic growth picking up and inflation staying low. This is normally the sort of environment when equities can be expected to do well, though there are some downside risks and some valuation issues to confront in what looks otherwise like a supportive state for growth assets.

One key moving part is the ongoing recovery in the US economy, where the news has continued to be good. The jobs market has been better than expected, with 236,000 new jobs in February (more than the 171,000 forecasters had expected) and a larger fall in the unemployment rate, to 7.7%, than the markets were looking for (they were picking 7.8%). The latest retail sales numbers also came in stronger than predicted. The US forecasters polled in the Wall Street Journal survey continue to see steady improvement in the US, with GDP growth this year of 2.3% this year, rising to 2.9% next year and 3.0% the year after. Surprisingly, despite the ongoing drag on the US economy that is the chaos of fiscal policymaking, a large majority of forecasters (73%) now believe the risks are more to the upside than the downside for American economic growth.

The picture is the same internationally. The Economist's latest (March) poll of international forecasters, for example, is picking that all the major developed economies will grow faster in 2014 than they will have grown this year. Japan in particular, which has been relatively moribund for some time, is expected to pick up from 1% growth this year to 1.4% in 2014, on the back of easier economic policy settings and ongoing reconstruction activity. The actual rates of growth expected are none too flash in some regions, particularly in the Eurozone, but at least the situation will have turned around from outright recession in 2013 (with Eurozone GDP expected to contract by -0.2%) to some small positive rate of growth (+0.8%), with Germany (+1.5%) leading the way.

Businesses are consequently becoming more optimistic about their business activity levels over the next twelve months, as Markit's latest (February) Global Business Outlook survey shows. Businesses are generally significantly more optimistic than they were in the previous survey (last October), with the exception of some of the larger emerging markets (Brazil, India, Russia) where business confidence has not improved, though is still positive (especially in Brazil).

The outlook still has its risks. The US fiscal negotiations could easily go awry, and accidentally tighten fiscal policy. And the Eurozone continues to be a source of financial fragility. Few, for example, would have expected that the problems of Cyprus would have had the ability to cause a setback to the world's equity markets, as they have in recent days. The size of the bailout required for Cyprus (Euro 16- 17 billion) was not enormous in the Eurozone's wider scheme of things, but the package was widely seen as ineptly handled. A March17 editorial in the UK's respected Financial Times called it "destabilising as well as morally unconscionable", and many other commentators also felt it called the Eurozone authorities' competence into question. In particular a levy on Cypriot bank deposits was seen as raising the risk of runs on weak banks in other parts of the Eurozone.

China, too, could arguably disappoint expectations. In China, the main issue has been that the authorities appear to have become more concerned about speculative housing investment: new house prices rose by 1% in February, and various measures are being introduced to slow the sector down, including capital gains taxes on sales of second homes. The worry for investors has been that attempts to rein in the housing sector will result in slowing down the economy more widely. At this point, the worry does not look especially threatening: Markit's latest (February) Composite Indicator of Chinese business sentiment across both manufacturing and services showed improvements across the board compared to its previous (October '12) readings. Businesses were already upbeat about revenues, new orders, and profits, and have become even more so in recent months. Consensus forecasts for Chinese economic growth remain high, at around the 8.5% mark for this year, and only a little slower (7.5-8%) next year.

There is also the issue of valuations. At its current level, for example, the S&P500 is trading on a p/e ratio of 14 times anticipated earnings this year – not outright expensive, but not a bargain, either. Another flow of 'great rotation' money out of bonds could push shares into expensive territory and leave them more vulnerable to earnings disappointments or other adverse surprises.

All that said, the economic outlook is firming up, monetary policies remain very supportive, and investors are more willing to hold equities. There may be further bumps on the road, but overall conditions remain favourable for growth assets.

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

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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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