Economic Commentary

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Outlook for Investment Markets

Investment markets have enjoyed a strong risk rally over the last six to nine months. The recovery is rolling through the US, and central banks have been willing to do whatever it takes to take out tail risks [the likes of a recession or another GFC]. Policy was practically forcing people to take on risk, in a situation where economies were recovering, and it has paid off. However, the state of risk asset valuations when seen against the more recent mixed economic backdrop has caused concern amongst some market participants.

The New Zealand dollar ended 2012 at 82 US cents and 79.1 Australian cents: since then it has advanced to 85.2 US cents and 81.2 Aussie cents. Given that this year both the Euro and, especially, the yen have also been weak – the Kiwi is up from 62.1 Eurocents to 65.2, and from 70.4 yen to 84.6 – the effect on the overall trade-weighted value of the Kiwi has been substantial. The Kiwi is up about 6.5% since the start of the year.

New Zealand Cash & Fixed Interest

Once again, there has been no change to short term interest rates, with the 90 day bank bill yield steady at just over 2.65% since the start of the year. The stability reflects the unchanged stance of the Reserve Bank's monetary policy.

Longer term interest rates moved in parallel with overseas bond yields. The 10 year Government stock yield started the year around the 3.6% mark, and got close to 4.0% in February. It was still around the 3.8 – 3.85% when the Cyprus news started to affect the markets, and then dropped in line with stronger global demand for the relative safety of government bonds. By the end of the March quarter it was down to 3.5%, and has edged a little lower since, to 3.4%.

The RBNZ said in its latest (March 14) Monetary Policy Statement that "There are both upside and downside risks" to the growth and inflation outlook, and that "At this point we expect to keep the OCR unchanged through the end of the year". The financial markets tend to agree, with the futures market picking that the 90 day bank bill yield will be steady for the next six months, with a chance of an interest rate increase by the end of the year, and in any event definitely by the middle of 2014, when the bank bill yield is expected to be 3%.

The outlook for the Kiwi Dollar is very much dependent on what other parties do, particularly in the Eurozone, and in Japan, if they deliver on their stimulus policies. These factors would, everything else being equal, tend to push the Kiwi dollar higher. Regarding domestic factors, again they may favour the Kiwi – New Zealand rates are better than other countries on a number of metrics including growth, and its inflation profile is better.

New Zealand Property

In what was otherwise a quite buoyant environment for equities, the New Zealand listed property underperformed the wider market, and delivered a relatively modest 4.9% gain in capital value during the March quarter. Post quarter end, however, the sector has continued to make further progress, and is now up 7.3% year to date.

The outlook for the Kiwi listed property sector is solid rather than spectacular for a couple of key reasons.

One is that the yield (around 6% post-tax, around 9% pre-tax) continues to shine out as a rare source of relatively low risk income: by comparison, the yield on global 'high yield' fixed interest, of lower credit quality, is now down to 5.7% (pre tax, on Barclays Capital estimates).

The other is the cyclical upswing in the New Zealand economy that has turned out to be stronger than expected (although the drought threatens it to some degree), and which is already having spillover benefits for the sector. As recent research reports from Colliers have pointed out, for example, net absorption (take-up of space) in the key Auckland industrial market over the past year was at the fastest rate in eight years, the vacancy rate is falling (now 4%, a five year low), while in the prime office markets Colliers is expecting the Auckland vacancy rate to drop from 7.9% to 7.2%, and the Wellington rate to drop from 4% to 3.9%. A combination of solid income and improving business conditions underpins the outlook.

Australian & International Property

In what was otherwise a quite buoyant environment for equities, the A-REITs underperformed the wider market, and delivered a relatively modest 4.1% gain in capital value during the March quarter, and a 5.2% overall gain including (pre-tax) dividend income.

Global listed property delivered some useful gains in the March quarter, with the EPRA/NAREIT Global index up 6.3%, while the Global Ex Australia index, hedged back into A$, produced a gain of 8.9%. The index is dominated by the US market, which rose by 7.9% (in US$). The real drama in the sector occurred in Japan, where property shares rose by a scarcely credible 35.5% (in yen), reflecting the high expectations investors have of the benefits the government's spend up on infrastructure will bring to Japanese development and construction companies. In other major markets, the UK, with its currently weak economy, recorded only a small rise of 3.2% (in sterling), while in Europe ex the UK, prices barely moved at all (+0.8%), reflecting the depressed state of the Eurozone markets.

While the A-REITs do stack up pretty well valuations are no longer compelling – the 2% pickup in yield over 10 year Commonwealth bonds (5%-5.5%dividend yield versus 3.25% on bonds) is in line with the long-run historical average for the sector. On a p/e basis, A-REITs are trading on the same multiple (15-15.5 times earnings) as the wider equity market, which is pushing things for a relatively defensive, lower growth sector, especially in an environment where the economy is going through a sub-par patch.

International property also looks stretched on valuation grounds. The big issue is the heavy US weighting in the international property sector, because the US is one of the most overvalued property markets. Some of this reflects investors desperately searching for yield in American where cash in the bank pays nothing and government bonds pay very little. This income-chasing has pushed American property shares up to very expensive levels. Some select international property markets offer more attractive value, but with the expensive US sector dominating the value on offer, valuations have now reached a point where further advances will be harder to achieve.

Australasian Equities

The New Zealand share market has been in good shape, with the NZX50 index performing broadly in line with overseas markets, registering an 8.8% rise for the March quarter. With some strong domestic data emerging in recent weeks, as discussed in more detail below, Kiwi shares have been relatively resilient, and at its current level (4420) the index is still close to its April 5 peak of 4433.

Australian shares also had a reasonable outturn, though not matching the rise in world shares, with the S&P/ASX200 index gaining 6.8% in A$ terms in the March quarter: for New Zealand investors, the gain was partially impacted by the rise in the NZ$ against the A$ (up 1.65% year to date).

One factor holding back the overall performance was the poor showing of resources shares, which have been affected by investors blowing hot and cold on the prospects for the Chinese economy. The S&P/ASX300 Metals and Mining index dropped by 12.1% during the March quarter, and dropped further in early April before recovering somewhat on the back of better than expected Chinese inflation data. The other sectors of the market fared considerably better, with the Financials up 13.4%, Consumer Staples up 11.9%, and Consumer Discretionary up 16.4%.

The outlook for New Zealand shares is solid at least within the context of the wider Australasian equity asset class.

Recent data have been encouraging. Two items in particular stand out – the latest official GDP figures, and the March Quarterly Survey of Business Opinion (QSBO) from the NZIER. On the GDP front, although the December quarter data are now somewhat on the historic side, they were highly significant in that the economy was shown to have started 2013 in much feistier shape than forecasters had expected. GDP grew by 1.5% during the quarter in real terms, way above the 0.8% expected by the analyst community, and it reflected growth across the board, rather than just the sectors most directly concerned with Canterbury reconstruction. It was also a very strong result set against somewhat subpar global economic conditions.

More recently the March QSBO has shown that the strong growth picture has continued into this year (with much the same being shown in the ANZ's earlier monthly Business Opinion Survey for March). Businesses reported that they were increasingly optimistic about the general business situation and were also optimistic about their own particular businesses' trading activity. Firms are currently significantly more optimistic about future profits than they usually report in this long-running survey.

There are risks – as the RBNZ summarised them, “The overvalued New Zealand dollar is undermining profitability in export and import competing industries, and worsening drought conditions are creating difficulty in much of the country. Ongoing fiscal consolidation will also act to slow overall demand” – but even on the RBNZ’s nuanced reckoning, the economy looks set to grow by 2-3% a year in coming years, while the ANZ’s economists reckons their surveys point to 2.8% growth by the middle of this year. The drought, though, could yet upset affairs – the most recent estimate, from Treasury, is that it will subtract 0.7% from growth – but even so the cyclical outlook for New Zealand shares appears favourable.

The outlook for Australian Equities is cloudy when seen against the backdrop of higher valuations and potentially sub-par economic growth in the Australian economy. There are concerns about valuations overshooting companies’ ability to deliver the profits to back them.

The recent official statistics have had some startling numbers on occasions – seasonally adjusted employment supposedly grew by 71,500 in February (later revised up to 74,000), then slumped by 36,100 in March – which can make it difficult to pick out exactly what is going on. On the employment front, the ‘trend’ numbers, which do not have the wild month-to-month swings of the ‘seasonally adjusted’ numbers, show that employment has been growing modestly (12,600 extra jobs in March), but not fast enough to stop a gradual rise in the ‘trend’ unemployment rate, which over the past half year has risen from 5.3% to 5.5%.

This picture of ongoing but sub-par growth is confirmed by quite poor readings from the latest business opinion surveys. NAB’s March survey for example found “business conditions deteriorating to the lowest level since May 2009. The slump in activity reflects a weakening in trading and employment conditions, while profitability was unchanged at a subdued level. While forward orders improved, they remained weak”.

Forecasts for the Australian economy are being gradually wound back: in the Economist’s latest (April) poll of international forecasters, expected GDP growth for Australia in 2013 has been cut from 2.8% to 2.6%, though expected growth in 2014 is holding steadier, at 3.1%.

International Fixed Interest

The March quarter was an interesting period for international fixed interest. At first, it looked as if the long-awaited move towards higher bond yields had got underway: the key 10 year US Treasury yield, which had started the year at just over 1.75%, started to rise, and by the first half of March had got up to just over 2.05% (March 11), taking other major bond market yields up with it. While not a major move in absolute terms, it looked at that point as if the long march back towards more normal bond yields may have taken its first step.

In the event the problems of Cyprus, and in particular the widely criticised and subsequently withdrawn ‘bail in’ proposal, whereby small depositors would lose some of their deposits as part of a banking sector refinancing, reawakened the fears of investors about Eurozone fragilities, as well as calling into question the competence of the European authorities. The result was that ‘safe haven’ demand for government bonds was resuscitated, and bond yields dropped back again, to 1.85% in the US by the end of the quarter, and a little further since then (currently 1.74%).

The Cyprus events also affected corporate bond spreads: the Markit iTraxx Europe index, which measures the credit risk of larger European companies, had fallen to a 3-month low of 100 basis points on March 18, but had climbed to a 3-month high of 128.4 basis points by March 27. It has subsequently dropped back too just over 110 basis points.

The net effect year to date has been for small losses in the bond markets (in overseas currency terms, offset modestly by the pickup in yield from forex hedging). The Barclays Capital Global Aggregate, in
US$ terms, is showing a -1.84% loss, with Corporates all square and Treasuries down -3.1%. As has been the case for some time, the riskier end of the fixed interest markets has been producing the better returns, though not at the outsize pace of last year: global ‘high yield’ (lower quality) securities are up 2.4% year to date, with Europe +1.8% and the US +3.2%.

The yields on government bonds may be pitiful – the running yield across all US Treasuries (not just the benchmark 10 year one) is only 0.84%, and on all global government bonds only 1.27% – but on the other hand they do not look like rising substantially anytime soon, and they continue to provide (as the Cyprus episode again showed) some welcome insurance in the portfolio.

To get a big structural move up in in government bond yields growth would have to accelerate enough to raise the concern that central bank stimulus removal is being countenanced, and so there appears to be limited upside risk on the shortterm horizon. Also, equity markets have run quite a bit, so bonds could thrive on any setback to equities.

That said the minutes of the Fed's March 19-20 meeting showed that there was some debate about whether, and when, to start tapering off the Fed's bond buying, but the markets, thus far, have not reacted by taking bond yields higher. Corporate credit spreads are still wider than they were before the GFC, but less than during the GFC, they're somewhere in the middle offering a degree of value.

International Equities

World equities have performed well, with the MSCI World index gaining 9.2% in overseas currency terms for the March quarter. The headline good news need to be tempered, however, by two factors. Local currency appreciation has eroded the overseas gains (the Kiwi dollar's appreciation ate up about two-thirds of the foreign currency increase), and the world markets achieved much of the gain in January and February, whereas they have struggled more recently. The MSCI World index peaked on March 14.

By major market, the star of the show has been the Japanese market, where the Nikkei soared by 19.3% in the March quarter on the back of aggressively expansionary economic policy. The US has been one of the more solid performers, reflecting ongoing economic growth, with the S&P500 up by 10% for the March quarter

European markets, on the other hand, have carried the burden of depressed economic conditions and increased scepticism about Eurozone direction and national economic policies. Emerging markets missed out on the rally, with the MSCI Emerging Markets index down 2.9% year to date (again in overseas currency terms), on fears that the emerging markets would not be able to contribute as much to global growth as they have in recent years. All the main emerging regions lost ground.

A moderate recovery is now priced into the global equity markets. Valuations in equities are of some concern, because p/e ratios have widened, rather than earnings themselves improving. So for current prices to be validated, profits need to improve.

While the US economy is doing reasonably well, American shares may have at least temporarily over-reached themselves. The US appears to be shrugging off the political headwinds [from US Congressional fiscal standoffs] and the data are generally improving – there had been occasional weaker than expected data, notably a lower than expected 88,000 new jobs in March, well below the 190,000 that had been predicted. That said, US equities have been one of the better performers so there may be limited upside in the short-term.

There are levels of complacency in the European markets, and Cyprus was a good example, and systemic problems are not being addressed, What if the US$1 trillion to do what it take turns out to be inadequate if one of the major Eurozone economies lost the confidence of the markets, with both Spain and France being possible candidates.

Elsewhere the outlook was somewhat better. Despite equity markets tending to have bouts of optimism and pessimism about the outlook for China as a driver for the world economy, investors now more hopeful that low inflation would allow the Chinese authorities to ease up on a crackdown on house prices and inflation more generally - the latest inflation data out of China (a lower than expected annual rate of 2.1%), triggered another round of investor reassessment.

Growth in China might be a little bit lower than it had been previously but should provide ongoing support to world growth and corporate activity from a China still likely to grow at a substantial pace for years to come.

In Japan, the members noted that there had been good reason for stronger Japanese share prices, with the Bank of Japan now embarked on a radical plan to double the country's money supply in short order. But, as with international equities more generally, the value on offer is questionable. A lot of good news has now been priced into both the foreign exchange markets and into Japanese equities.

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