## Economic Update

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### Outlook for Investment Markets

Growth assets have performed well year to date, initially on the "Trump trade" theme of a fiscally-stimulated U.S. economy, but more recently on the back of wider evidence of faster global economic growth and a happy outcome from the French presidential election. The stronger state of world business activity will provide further support for global growth assets, but there is little room for slippage. If corporate profits deliver to investors' high expectations, all well and good, but the risk is that current expensive valuations (especially in the U.S.) are priced for perfection and could be vulnerable to setbacks. Defensive assets such as bonds and property have been lagging, and will be under further pressure if, as seems likely, bond yields rise over the next year—an exception is infrastructure, which remains in high demand. In New Zealand, the economy continues to perform strongly and looks well placed for 2018, but further out there will need to be some evidence that economic momentum can be maintained once the current construction boom winds down.

### New Zealand Cash & Fixed Interest — Review

It has been all quiet on the interest rate front, with little net change to short- or long-term interest rates. The 90-day bank bill yield has been very steady at close to 2.0%, as the Reserve Bank of New Zealand, or RBNZ, had left monetary policy unchanged, most recently at its May 11 Monetary Policy Statement. The 10-year government bond yield has generally stayed around 3.0%, though with some occasional day-to-day volatility. Year to date, the S&P /NZX interest rate indices are showing pretax returns of 0.76% for bank bills, 2.82% for government bonds, and 2.98% for investment grade bonds. The New Zealand dollar has been weak all round, and is down against all the major currencies in its trade-weighted basket. Against the U.S. dollar it has fallen year to date by 1.3%, and is down 3.4% in overall trade-weighted value.

### New Zealand Cash & Fixed Interest — Outlook

The RBNZ's latest policy statement came as something of a surprise. With March quarter inflation higher than expected, many market analysts had assumed that the RBNZ would start to raise interest rates earlier than it had previously indicated. In the event, however, the RBNZ—while stressing the uncertainties around its call—said that it would stick to its original plan of not raising the official cash rate, or OCR, before late 2019, and then only by one 0.25% hike. The financial markets do not believe this is a realistic scenario with bill futures prices currently predicting there will be one 0.25% increase by the middle of next year, and another before the end of the year. It may still be some time off, but bank depositors have the prospect, finally, of some modestly higher returns on their savings.

Longer-term rates also look set to rise if, as seems probable, U.S. bond yields move higher. Local forecasters have different views on how high U.S. bond yields will go, and how closely local bond yields will follow them, but the consensus is that the local 10-year yield will be somewhere in the high 3s to low 4s by the end of next year. At the low end of the forecast range, the BNZ is picking 3.65%, and at the high end, the ANZ Bank picking 4.1%. The outlook makes for likely poor performance, as rises of that order would imply capital losses that would outweigh the coupon income. A rise to 3.75%, for example, would lead to a capital loss of some 6% on the current 10-year benchmark bond.

The foreign exchange market was not best pleased with the RBNZ's latest policy announcement that it still planned to keep interest rates at current low levels for more than two more years. Although most of the immediate New Zealand dollar losses were clawed back in recent days, it is possible that interest rate differentials will continue to widen against the New Zealand dollar as, for example, the Fed raises rates further, and there could be significant downside. For example, Westpac, has the New Zealand dollar as low as USD 0.63 by the end of next year. On the

other hand, there is still quite a lot to like about other aspects of the New Zealand economy, notably a high rate of GDP growth by developing economy standards, and equity and property demand from overseas investors could keep the New Zealand dollar closer to current levels (the view of both ANZ Bank and BNZ, for example). From the perspective of local investors holding unhedged overseas assets, currently, the best assessment is some chance of little or no foreign exchange impact over the next year, though with some possibility of foreign exchange gains if the more bearish views on the New Zealand dollar eventuate.

### New Zealand Property — Review

Many listed property markets have underperformed year to date, compared with their wider overall equity markets, and New Zealand has been no exception, with the S&P/NZX All Real Estate Index recording a 2.2% capital gain and delivering a total return of 3.2% (3.5% including imputation credits). By comparison the overall S&P/NZX50 Index delivered a total return of 7.7%.

### New Zealand Property — Outlook

Little has changed in terms of the outlook for the sector: the strong business cycle has continued to support the operating performance of property, but the threat of rising bond yields remains an issue for the sector.

The latest research reports from sector analysts have shown that business conditions are generally robust. Colliers' May monthly report, for example, found that the industrial sector was doing well, and that ongoing strong employment growth was helping the office sector. While recent retail sales statistics have been strong, and there are no immediate problems for the retail sector, Colliers noted that it, like its counterparts overseas, faces the longer-term issue of rapidly growing e-commerce sales: "e-commerce growth is changing the way consumers make purchasing decisions." Overall, though, the sector is performing strongly, as one would expect in a rapidly growing economy. In the latest (March quarter) survey of global commercial property from the U.K.'s Royal Institution of Chartered Surveyors, or RICS, Auckland unsurprisingly featured as one of the world's strongest, particularly from the perspective of demand from tenants.

But the potential for long-term interest rates to rise affects the future attractiveness of the asset class. The issue is not quite the challenge for local REITs as it is for some overseas property markets as yields have not been pushed down to unusually low levels and the sector offers much the same level of pickup in yield relative to bonds as it historically has. It also helps, as JLL's recent review of transactions in the sector pointed out, that "The New Zealand market still has a distinct yield advantage for offshore parties when compared to other mature markets in the Asia Pacific region." But while the prospect of higher bond yields lurks in the background, the most likely outlook is that local property will continue to underperform the wider sharemarket.

### Australian & International Property — Review

The A-REITs also underdelivered compared with the ASX, with the S&P/ASX 200 A-REITs Index providing a total return of only 0.5% versus the overall market's 4.5%.

It was same again for global listed property, with the net 4.2% return from the FTSE EPRA/NAREIT Global Index in U.S. dollars falling short of the 9.5% performance of the MSCI World Index on the same basis. Improving business conditions in the eurozone and a good outcome from the French presidential elections helped eurozone property shares to a 12.5% net U.S. dollar return, and U.K. property shares did the same, though the U.K. rise is from a previously highly depressed post-Brexit base. Asian markets also did well, with a 7.6% return. The poor performance of the overall sector was very much down to the weak outcome in the U.S., where shares delivered a 2.1% overall loss.

### Australian & International Property — Outlook

An economy that is growing at a somewhat slower rate than usual is producing an overall mixed outcome for property. Some regions and sectors are doing very well indeed: Savills' latest "Quarter Times" report on the office markets, for example, shows that yields have fallen to particularly low levels in Sydney, where the yield on prime central business district offices is now down to 4.75% to 5.25% due to high demand and tight supply. In the RICS survey, Sydney also featured as one of the world's strongest in terms of both investor interest and tenant demand. Melbourne offices, and industrial space in many areas (partly boosted by the logistics facilities needed to service e-commerce), are also doing well. But the two tier economy in the wake of the unwinding of the mining boom has also left some markets in a very weak place. On Knight Frank's latest estimate, "The Perth CBD vacancy rate increased to 22.5% as at January 2017 from 19.6% a year ago, the highest level recorded in 22 years."

On the plus side, the sector can look forward to ongoing reasonable, rather than boom-time, business conditions. But on the minus side, the A-REITs face a relative valuation threat from bond yields that look likely to increase over the coming year. The sector is reasonably well placed to face the challenge, as the sector is not currently on expensive valuations. REIT prices may be a bit on the expensive side, by historical standards, on a price/net tangible asset value basis, but on the other hand, the yield differential with bonds is modestly higher than usual, leaving the sector some room to cope with an erosion of the differential as bond yields rise. Even so, REITs, as the latest performance data show, typically tend to lag the wider equity market in a rising interest rate cycle, and it would not be a surprise to see more of the same during the rest of this year and into 2018.

The conflict between acceptable operating performance and the valuation risks from rising bond yields is starker overseas. The economic backdrop is certainly improving. As the latest RICS report said, business sentiment in the property sector is "improving (or becoming less negative) in the majority of markets reported on in this survey. This is broadly consistent with macroeconomic news flow which generally continues to surprise on the upside". The German market has been benefiting from a stronger eurozone economy, with Berlin, Frankfurt and Munich all reporting strong demand. They are in a group with the highest expectations for rental growth and capital appreciation over the next year, which also includes Bangalore and Mumbai, and some smaller European markets of Budapest, Dublin, and Lisbon.

But the value on offer is not attractive. The latest yield on the FTSE/EPRA NAREIT Index is only 3.75%, and even a modest and gradual rise in global bond yields will put pressure on sector valuations. Ongoing underperformance looks like the most likely prospect.

### Global Infrastructure — Review

Global listed infrastructure has continued to do well. The S&P Global Infrastructure Index in U.S. dollars year to date has had a capital gain of 10.1% and a total net return of 11.3%, and has outperformed the 9.5% net return from the MSCI World Index.

### Global Infrastructure — Outlook

It is not difficult to see why investors have been keen on infrastructure. On top of the general boost to growth assets from a strengthening world economy, infrastructure looks to be one of the stronger performing sectors due to the very large volumes of overdue and now necessary projects.

The biggest focus has been on the shortfall in the U.S., where the Trump administration has said it plans to spend USD 1 trillion over the next 10 years, but it is a global phenomenon. The recent Australian Budget, for example, included a pledge to spend AUD 75 billion over the next seven years on everything from a second Sydney airport to new rail connections. And the forthcoming New Zealand Budget will include NZD 11 billion of new infrastructure spending, and even though some NZD 1 billion represents

repairing Kaikoura earthquake damage, there will also clearly be a step up in the scale of new investment. Private sector investors expect they will be able to participate in these new projects: the proposed Melbourne to Brisbane rail route, for example, will include a long-term concession to build and operate parts of the line.

The sector, in summary, is perceived, and probably correctly, as one where growth prospects are unusually strong. In the current gung-ho mood, rather expensive valuations have taken a back seat. S&P calculates, for example, that the dividend yield on global infrastructure is only 3.71%, and the forward-looking P/E ratio is a reasonably demanding 20.8 times expected earnings. The current love affair with infrastructure looks to have further to go.

### Australasian Equities — Review

This year has generally been equity-friendly, and the New Zealand sharemarket has also been a beneficiary. While it has broadly moved in line with global shifts in equity sentiment—going quiet in March and the first half of April, and strengthening since—it has also been underpinned by an ongoing local business cycle that is impressive by developed economy standards. As a result, the S&P/NZX50 Index year to date has provided a capital gain of 6.1% and a total return including dividends of 7.7% (8.2% including the value of imputation credits).

Australian shares have followed a somewhat similar pattern, but the scale of the gains has been more modest, due mainly to still subpar growth in the economy and the impact of lower commodity prices on the previously strong resources sector. Year to date, the S&P/ASX 200 Index is up 3.0% in capital value and has returned 4.5% including dividend income. The industrials (9.9% capital gain) have done very well, as have IT shares (8.0%) and consumer staples stocks (7.8%), but the resources sector has lost ground (down 3.3%) and the financial sector has made only limited gains (1.9%), not helped by the new tax on the big banks announced in the May 9 Budget.

### Australasian Equities — Outlook

The current economic cycle continues to roll on. The latest official data on retail sales, for example, showed a larger rise in retail sales in the March quarter than forecasters had expected, with a big splurge on new cars (almost 6% more than in the previous quarters).

Consumer and business confidence surveys have also been holding up at higher than usual levels, though not showing quite as strong a picture as previously. The ANZ Bank economists combine their consumer and business results into an overall predictor of future GDP growth, and it is currently signalling a 3.5% to 4.0% rate of growth for the months ahead, which compares very well with likely growth rates in other developed economies. While the latest (April) sectoral performance indices from the BNZ/BusinessNZ were well down on previous months, it looks as if timing (school holidays) and horrid weather were the culprits, rather than any serious fundamental weakening in the strength of the business cycle.

If the immediate outlook remains positive—and it was noteworthy that businesses responded to the latest ANZ Bank survey with higher expectations for profits—there are growing question marks over what New Zealand will do for an encore. The temporary boost from the Canterbury rebuild is running down, and construction elsewhere is not growing fast enough to make up for the reduced level of Canterbury activity. On the latest Westpac forecasts, for example, this is the last year when the construction sector will be adding to GDP: they expect a 4% growth in building activity. But next year, construction will shrink by 0.5%, and will contract further, by 2.3%, in 2019.

The local equity market will be challenged by any slowdown: investors are already paying 19.8 times expected profits (on S&P's calculations), an even more expensive proposition than the 17.5 times expected earnings in the U.S. market. It may be that the improving global outlook, and steady or improving dairy prices, will keep the ball in the air for a while longer. But investors will

need some clearer evidence of what will drive higher corporate profits from 2019 onwards if prices are going to advance much from present levels.

In Australia, there have been a couple of big set-piece forecasting exercises. In the May 9 Budget, Treasury said that in the fiscal year ending this June, the economy grew by a distinctly subpar 1.75%, but it predicted that it will pick up to 2.75% growth in the June 2018 year, and to 3.0% the year after that, which would be fast enough to get the unemployment rate down a bit, to 5.5% in 2019. Earlier in the month, the latest quarterly *Statement on Monetary Policy* from the RBA had come to the same broad conclusions, with growth expected to pick up (on the midpoint of the RBA's forecasts) from 2% in the fiscal year just finishing to 3.25% in each of the coming two years.

The latest business surveys also give some cause for optimism. National Australia Bank's latest (April) monthly survey "posted another strong result in April, with both business conditions and confidence improving—pointing to ongoing strength in business activity in the near term. In addition to elevated levels of business conditions, improvements appear to have become increasingly broad-based (across states and industries)."

But it is not as straightforward as it looks to translate what looks like a potential pickup in economic activity into unambiguously good news for the equity market. There have been various false dawns in recent years that did not in the event lead to permanently faster growth, and some forecasters think the latest official forecasts will again disappoint. Westpac, for example, believes that, compared to the Budget view, "a significantly sharper downturn in dwelling investment; ongoing soft consumer spending; and no real uplift in non-mining investment in 2018/19," and it also takes a significantly dimmer view of the prospects for commodity prices.

Even if the rosier RBA and Treasury views prove correct, however, they may not translate into a gush of corporate profits. In the details of the Budget documents, Treasury's estimates for corporate profits (predepreciation) show distinctly modest, rather than strong, growth. Treasury calculates that corporate profits grew by 14.25% in the June fiscal year just finishing, an amount that (while real) is distorted by the large impact of higher commodity prices on the profits of the resources sector. For the coming fiscal year, Treasury is picking 5.25% profits growth, which is a bit faster than the 4% growth expected for the overall economy in nominal (i.e. money) terms, but then it sees profits growth slowing down markedly, to only 2.75% in the 2018-19 fiscal year, which will be slower than the 4% growth of the money economy.

The Australian sharemarket, at around 16 times prospective earnings, is not as expensively priced as some overseas markets, but it is on the expensive side of its own historical average, which is around 14 times expected earnings. It will require confirmation that the more optimistic views on the economy and on growth in corporate profits over the coming year are, finally, coming to hand, to justify current pricing and to see share gains start to match those achieved overseas.

### International Fixed Interest — Review

Politics has been behind much of the recent movements in global bond yields. In the U.S., Treasury bond yields have tended to fall when investors have taken a dimmer view of the Trump administration's likely ability to get its economic stimulus ideas implemented. Slower growth puts less upward pressure on inflation and bond yields. The 10-year yield reached a recent low of 2.18% on April 18 when investors were especially disillusioned with the administration's inability to repeal "Obamacare." More recently, investors have begun to think that the administration might be getting some traction with its tax cut agenda, and yields rose again, to a recent high of 2.42% on May 10. In the last few days, however, the controversy over the firing of the head of the F.B.I. has again raised issues about the administration's effectiveness, and the 10-year yield has dipped back to 2.33%.

The election of Emmanuel Macron as French president has also had an impact. The difference between French and German 10-year government bond yields had widened as France went into a presidential campaign that featured some potentially dramatic changes to French economic policy. A "hard left" candidate, for example, came a close fourth in the first round, and the National Front's Marine Le Pen won through to the final round. In the end, markets relaxed after Macron's win, and the differential between French and German yields dropped back to more normal levels. Overall, however, bond yields have moved a little higher since the start of the year on growing evidence of an improving eurozone economy.

There is a political element in the U.K, too, where Brexit uncertainties are high. The Bank of England, for example, is currently using the operating assumption (as stated at its May 10 policy meeting) that "the adjustment to the United Kingdom's new relationship with the European Union is smooth," but clearly there is significant potential for an unpleasant divorce.

Compared with their levels at the start of the year, there has not been much net movement in bond yields, with some capital gains from modestly lower U.S. yields offset by capital losses from modestly higher eurozone yields. Year to date the Bloomberg Barclays Global Aggregate Index in U.S. dollars has returned 2.6%.

### International Fixed Interest — Outlook

Although the short-term direction of U.S. bond yields is at the mercy of volatile shifts in investor sentiment, the longer-term outlook is clearer. The likelihood is that the Fed will continue to tighten monetary policy by raising interest rates, which will affect the shorter end of the yield curve, and will also move to reduce its bond buying programme, which will affect the longer end of the yield curve.

In both cases, the rationale is clear: the U.S. economy has continued to progress, with the rate of unemployment now down to only 4.4%, which means the economy no longer needs aggressive monetary policy support, and inflation has risen close to where the Fed would like it to be, so it too needs little or no further boost. The key measure for the Fed is the "core personal consumer expenditure deflator," which on its latest reading (1.8% in March) was effectively at the Fed's 2% target level.

The upshot is that the Fed will very likely continue to raise the federal-funds rate from its current 0.75%–1.00% target range, most likely starting with another 0.25% increase at its June meeting, and probably raising it by another 0.25% by the end of the year.

In addition, the Fed is likely to stop reinvesting in bonds as its quantitative easing, or QE, holdings mature, and instead will let its outstanding holdings gradually run down over a long period of time. The timing is still uncertain, but market surveys suggest that bond investors think the Fed will stop reinvesting in bonds sometime next year, and will have the effect of taking a major bond buyer out of play. Reduced demand is likely to lead to lower bond prices and (equivalently) higher bond yields.

The outlook for U.S. dollar bonds is consequently challenging. Assuming nothing happens to derail the U.S. or global economies and to reignite "safe haven" bond buying, the latest consensus estimate (from the *Wall Street Journal*'s May poll of forecasters) is that by the end of 2018, the 10 year U.S. Treasury yield will be a full 1% higher, at 3.3%, than it is today, which would imply a capital loss of some 8% on the benchmark Treasury.

There is likely to be less pressure on still ultra-low bond yields in other major markets, but they too will face some headwinds: a combination of the knock-on effect of higher U.S. yields and the eventual prospect of normalisation of their own monetary policies. For the time being, the European Central Bank is still in full stimulus mode, including adding to its QE hoard of bonds, but the progressively strengthening eurozone economy will likely

lead to a change of course sometime next year. And the Bank of England has also said that it might have to raise rates a bit earlier than the markets currently expect, though its timing looks to be more like 2019 rather than 2018. Only in Japan does it look likely that bond yields will be kept very low for the indefinite future.

While bonds always carry some useful insurance value—and as noted elsewhere, investors in the equity markets appear to be ignoring potential risks, so some insurance against nasty surprises may well be worthwhile—overall, the economic fundamentals are running against the asset class.

### International Equities — Review

After a quiet period in March and the first half of April when world shares traded sideways, shares have risen in late April and month to date, helped by a rally in eurozone equities after the first round of the French presidential election on April 23, and by ongoing high investor confidence in the U.S. As a result, at the time of writing, the DAX index in Germany, and both the S&P500 and Nasdaq indices in the U.S., had reached all-time highs.

Overall, year to date, the MSCI World Index is up 7.4% in capital value in the currencies of its component markets, and up 8.6% in U.S. dollar terms (9.5% including the taxed value of dividends). Among the developed markets, the best performers have been the big eurozone economies, with the DAX up 11.5% and France's CAC index up 11.4%. The S&P500 is up 7.3%, while there were lesser contributions from the U.K. (FTSE100 up 4.4%) and Japan (Nikkei up 4.0%).

Emerging markets have been outperforming the developed economies all year, with the MSCI Emerging Markets index year to date up 12.7% in the emerging markets' own currencies, and by 17.2% in U.S. dollar terms. Once again, the biggest gains arose in India, where the Sensex was up 13.9% and the rupee appreciated by 6.1% against the U.S. dollar and in Brazil, where the Bovespa index rose 13.7% and the Brazilian real rose by 4.9%.

### International Equities — Outlook

In the U.S., the latest data has been a mixed bag. Although the single most-watched indicator, new jobs, has been doing well (211,000 new jobs in April, at the upper end of expectations), and consumer confidence has been rising, both April's retail sales and April's inflation rate came out a little lower than expected, hinting that the economy may not be running as strongly as anticipated. Even so, the latest data look more like a wobble than a shock, and forecasters remain confident about the outlook. The *Wall Street Journal* panel of forecasters is picking that the U.S. economy will grow by 2.0% to 2.5% this year and in 2018 and 2019, and it is also becoming less worried about downside risks with the panel putting only a 15% possibility of a recession within the next year, down from 20% a year ago.

The news from the rest of the world is also good, particularly in the formerly sluggish eurozone where a wide range of indicators are pointing to an acceleration in economic activity. The latest IHS Markit eurozone "composite" surveys (taking in both manufacturing and services) "portray an economy that is growing at an encouragingly robust pace and that risks are moving from the downside to a more balanced situation."

Markit aggregates its national and regional purchasing manager surveys into a global aggregate, the J. P. Morgan Global All-Industry Output Index, and it too is travelling well, with the latest (April) reading showing that "Growth of global economic output was maintained at a solid clip at the start of the second quarter." When sliced by industrial sector, the global survey shows that, remarkably, every single sector is currently in expansion mode, with the strongest rates of growth being seen in technology, the industrials, and healthcare.

The economic backdrop for corporate performance consequently looks reasonably good. In the U.S., for example, share analysts (on the data compiled by data company FactSet) expect that profits for the S&P500 companies will increase by 11.8%. While the figure is distorted by a massive turnaround in the energy sector (where profits are expected to soar by 45%, due to higher energy prices), most sectors (excepting real estate, the utilities, and telco services) look set for solid profit growth.

But, as has been the case for some time, the positive outlook needs to be tempered by noting expensive equity valuations and potential investor overoptimism. Valuation concerns are especially severe for the U.S. market—while, as noted, investors expect strong profit growth, they are also paying substantially more for it than they normally would. Estimates of the forward-looking price/earnings ratio vary in detail—the ratio is around 17.5 times expected profits, give or take—but agree that whatever the exact number is, it is well above normal. Some of this reflects the world of unusually low interest rates, where investors have been prepared to pay more for nonbond assets, given the very poor value on offer on fixed interest. But that support is on the turn as bond yields threaten to rise. All may yet turn out well, but a combination of pricing for corporate performance perfection and a deterioration in relative equity-bond value makes the future going rather harder.

The other potential issue is investors' apparent disregard of potential risk. The most widely publicised example is the unusually low level of the VIX, the measure of investors' expected volatility from holding the S&P 500 Index, and which has headed even lower in recent days. But going by similar indices for other asset classes, investors are also expecting unusually little turbulence in, for example, European equities, global bond markets, and foreign exchange markets.

Again, events might pan out just fine, and there have even been some pleasant upside surprises, notably the French presidential election result, but investing is a road with bumps in it, and investors expect to be compensated for the risks they run. Currently, they may be underestimating the likely potential for unexpected upsets, and consequently paying too much for assets that carry more risk than they are allowing for.

*Performance periods unless otherwise stated generally refer to periods ended May 15, 2017.*

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