Harbour Outlook

Adjusting to Change

Harbour Outlook 9/11/17 contactus@harbourasset.co.nz +64 4 460 8300

The Harbour Outlook summarises recent market developments, what we are monitoring closely, and our key views on the outlook for fixed interest, credit and equity markets.

Key developments

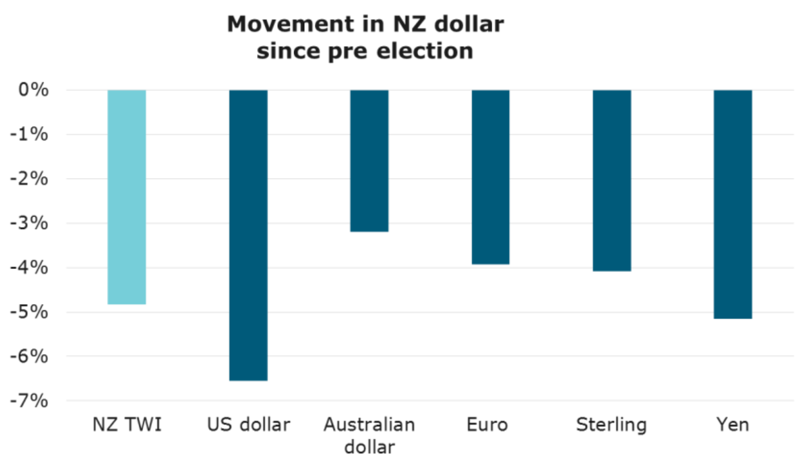
'Adjusting to change' continued to be a key theme driving markets in October, whether it was political change, normalising global interest rates or changing consumer behaviour reflecting disruptive technological changes.

In New Zealand we had the drama of watching the election coalition negotiations unfold, which eventually enabled the Labour Party and New Zealand First to form a government with supply and confidence provided by the Green Party. At this very early stage, the key policy themes of the new government seem to be:

- less net migration
- restrictions on foreign buying of houses and land
- increases in the minimum wage
- the RBNZ with a dual inflation and employment mandate
- an increase in fiscal spending relative to a National-led government.

The main reaction to the announcement of the new NZ government came in the fixed interest and foreign exchange market, where foreign investors demanding a higher risk premium saw NZ government bond yields initially rise and the NZ dollar fall around 5% against the trade-weighted index (Chart 1).

Chart 1. Foreign Exchange Market



Source: Bloomberg.

The New Zealand equity market generally took the news of the new government in its stride. The New Zealand equity market returned +2.8% in the month, which was generally a small underperformance relative to offshore markets in NZ dollar (NZD) terms. This cautious underperformance is not unusual - the New Zealand market has underperformed against offshore peers the last five times the New Zealand Prime Minister has changed.

Globally, markets continue to be focused on the puzzle of strong synchronised growth with the apparent absence of inflation.

While the US economy has been performing very creditably for a few years, it is only more recently that other regions have joined the party. Specifically, Japan and the Eurozone have picked up notably this year, at the same time that economic and financial stability concerns in China have diminished. Core global inflation is yet to rise materially, but central banks have still started the process of change by gradually shifting away from extraordinarily easy monetary policy, with rate hikes in the US, Canada and most recently the UK. The ECB has also announced a tapering their QE program. We expect this process of change to continue.

What to watch

In New Zealand, the change in government introduces a raft of new policy initiatives.

At this stage we can readily identify intentions but, in most cases, detail is yet to be worked through. Most initiatives appear likely to increase inflationary pressure somewhat, with increased fiscal spending and the increases in the minimum wage the most obvious drivers. We think it is likely that inflation pressures do mount and that this will flow through to higher inflation expectations over the medium term.

The offset is likely to come from the housing market, which may soften further as a result of changes to immigration policy. At present we see business confidence adjusting lower and there may be more to come. However, we have often seen past episodes where measures of confidence decline but actual activity does not change materially. This will be a dynamic that is watched closely.

Our view is that any change to the Reserve Bank's mandate or decision-making structure following the government's review of the Reserve Bank Act will not have a material impact on actual policy settings through time. In this regard we sense that the market is misplaced in thinking that adding a dual mandate of inflation targeting and full employment will see easier monetary policy than otherwise.[1]

Investors in New Zealand equities also have a lot to think about. In October many companies had their annual general meetings and provided forward-looking statements for the year ahead. The dispersion in outlook statements created significant divergence in returns across the market. Investors also had to factor in election uncertainty, then consider new potential policies including changes to the Reserve Bank Act, housing, wages and potentially migration and the electricity sector. A key theme to watch is the fall in the dollar and a weakening in domestic confidence favouring New Zealand's globally-oriented companies.

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[1] Harbour Investment Horizon, "Dispelling the myth that a dual mandate implies easier monetary policy", 7 November 2017.

Market outlook

We continue to expect a gradual rise in long-term bonds yields over coming months, driven by both global trend of normalisation and the local news around increased NZ government borrowing.

In fixed interest portfolios, we remain positioned for rising bond yields. We have also now closed out our overweight position in 1-3 year bonds, given we believe the market is reading too much into the introduction of a dual mandate for the Reserve Bank.

In credit portfolios we remain near neutral to slightly overweight, mainly as we see valuations as somewhat expensive. In addition, there is some risk that if we do see inflation and bond yields rise, the outlook for some sectors of the corporate world could weaken and flow through to the credit market.

The New Zealand equity market is also exposed to a rising global interest rate environment and technology disruption trends. Rising yields can take the edge off investor demand for yield-oriented stocks. However, potentially the most influential medium term trend continues to be changing consumer behaviour reflecting disruptive technological changes.

As we look forward, we are cognisant of a lot of change. We also have modest overall expectations for profit growth in New Zealand in 2018. But we do not see a recession any time soon.

Companies that are exposed to global growth trends may benefit from the fall in the New Zealand dollar and continuing robust global growth. However, we are monitoring the weakening in NZ business confidence and the housing market. The caveat on developing a negative stance is the strong employment environment and that government spending is expected to rise significantly. The market continues to trade on elevated multiples suggesting the potential for disappointing news to impact disproportionally on some equity prices. In this environment, we expect that an active approach to equity investing is likely to continue to be attractive.

This environment reinforces the need to invest selectively, in companies with their own growth drivers that are not solely dependent strong economic growth.

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