Harbour Investment Horizon
Risks to Watch for 2018

Harbour Investment Horizon 15/12/2017 contactus@harbourasset.co.nz +64 4 460 8300

When investing in an uncertain world, it is useful to distinguish between a core view of the most likely outcome for economies and markets, and the key risks that could challenge this core or central view.

In our most recent monthly Harbour Outlook, we set out how our core view is evolving.[1] Markets have experienced goldilocks conditions over the past 5 years, with solid economic growth, low inflation and low interest rates. We are seeing increasing signs of a transition from this backdrop, particularly in New Zealand, where growth is moderating while inflation pressures are building from a very low base. After being spoilt by a period of unusually low volatility, we are expecting a pick-up in market volatility to more normal levels.

To be clear, we still see interest rates remaining relatively low for some time, with central banks able to normalise policy in a market-friendly, slow and steady way. This would leave us in an environment that is still favourable for fixed interest and equity markets. Indeed, we believe it will be beneficial for active portfolio management, given we are moving away from a time when the value of all markets and securities rose on the same tide of extraordinary monetary stimulus. In our view, market themes like technological disruption will create a situation where there are more winners and losers, generating more dispersion in returns for active investors to identify.

It is this core view which primarily drives our positioning in active portfolios. So, what high-impact risks might challenge our constructive view of markets in the year ahead?

Seven risks to watch in 2018

1. **An upside inflation surprise**: This has been near the top of our watch-list for the past 5 years, but has not yet materialised, with global inflation remaining relatively low. The main reason this is at the top of the list is due to its potential impact; that is, a sharp rise in core inflation pressures would remove the ability for central banks to withdraw stimulus in a slow and steady way which is market-friendly. By contrast, it would create an environment where official interest rates were forced to rise sharply to head off an inflation problem. In that case, the adverse impact on financial markets would become mere collateral damage. As the spare capacity available since the Global Financial Crisis (GFC), continues to be used up, and unemployment rates fall, there is a growing probability that inflation pressures will build. However, we do not believe this is an imminent risk - just one to watch closely.

2. **Central banks tightening policy faster than expected:** This risk relates to the first on the list, but rising inflation may not be the only reason that interest rates rise faster than currently priced by markets. For example, central banks may become more worried about the financial stability implications of leaving interest rates too low for too long (i.e. sowing the seeds for the next crisis), and decide to tighten policy pre-emptively. There will be a series of changes in leadership for central banks in 2018 (most notably Jerome Powell becoming Chair of the US Federal

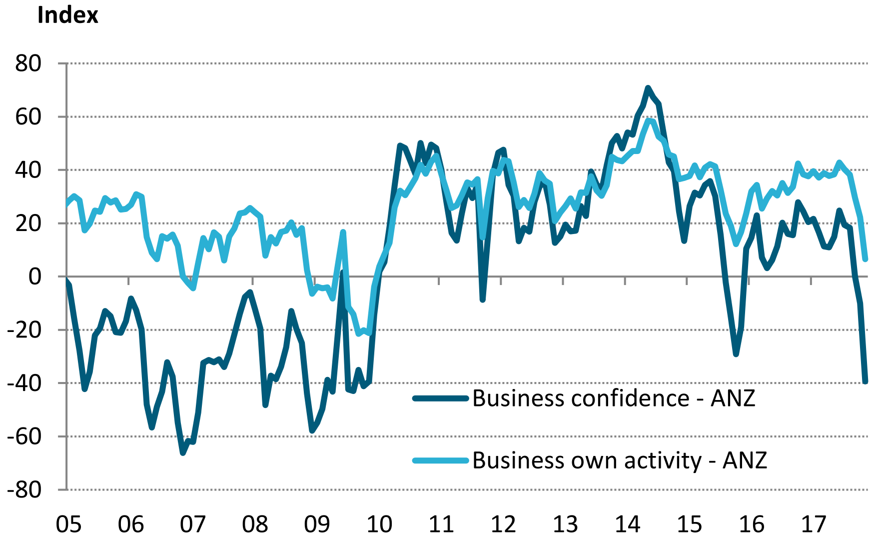
[1] Harbour Outlook: "Nearing an end to the NZ Goldilocks?", 7 December 2017.

Reserve, but also changes at the Bank of Japan (BoJ), European Central Bank (ECB) and Reserve Bank of New Zealand (RBNZ)), which creates uncertainty about their approaches going forward. There are also practical reasons that may cause interest rates to rise, like the ECB running out of bonds to buy as part of their quantitative easing programme. It's important to emphasise that these are possible risks, rather than our central view. We are monitoring central bank speeches and announcements for a change in tone or direction.

3. **Global geopolitical risks:** There is typically a laundry list of geopolitical risks that markets worry about at any one time. It is easy to forget that markets have in the past, obsessed over risks like the Russian-Ukraine conflict and then quickly moved on to something new. Last year it was the Trump and Brexit risks. This year it was the Trump and North Korean risks. Next year, we believe it is likely to be the Trump risk and something else. The key questions for markets are: how likely is each risk, and will the impact make a material difference to economic activity or risk appetite? In the case of Trump being impeached or resigning, it would be likely to cause a brief period of caution and flight to safety. However, it could be swiftly superseded by a positive effect, especially if markets saw a new administration as more competent. In the case of North Korea, a nuclear conflict could result in an enormous loss of life and economic activity across the Pacific Rim. However, the probability is extremely low, hard to analyse, and difficult to factor into a medium-term investment strategy, outside of using option strategies.

4. **Domestic political and economic risks:** Closer to home, Australia has lived with political uncertainty and instability for a number of years. In New Zealand, we also now have a more fragile political environment, with a relatively new and inexperienced Government, a coalition and support agreement between three different parties and, a very large vocal opposition party. On the margin, the risk of policy errors cannot be ruled out, and trade partners, like China, may retaliate against new polices that they see as unfair. NZ business confidence has already fallen sharply in recent months. We know that confidence surveys sometimes diverge from reality, and there may be an element in the latest surveys of a protest vote from the business community. There is also some evidence that business confidence is steadily lower during Labour-led governments. However, we are undoubtedly in a more fragile economic environment in the business sector, which needs to be monitored.

Chart 1. NZ business confidence



Source: Bloomberg.

5. **Australasian housing market correction:** The New Zealand and Australian banking systems are intertwined by ownership. Both are heavily exposed to the respective residential mortgage markets, and both countries are under the spotlight on global lists of cities with overvalued housing. In New Zealand, the new Government's policies of increased public housing supply, reduced immigration and restrictions on foreign buyers, all increase the prospect of a faster correction in house prices and risks to private construction and development. Against that, a long period of under supply since the GFC, continued low interest rates, and the relaxation of macro-prudential restrictions helps underpin the market. If this risk were to materialise, the New Zealand and Australian banking systems could face a funding problem. However, they should be much more resilient than before the GFC, given their increased capital and liquidity buffers. More likely, the impact would be felt most through a fall in consumer confidence and its effect on the economy more generally.

6. **Hard landing in the Chinese economy:** Much like inflation risks, this is something that everyone has been talking about for years now, but has not materialised. New Zealand is exposed directly through our exports of dairy and tourism, and indirectly through Australia's exposure to hard commodity exports. Our view continues to be that the Chinese economy will navigate a managed moderation in growth, and re-orientate over the medium-term towards being a more consumer-orientated, environmentally-focused, middle-class society. With regular analyst research trips to China, we will continue to monitor the short-term risks around this view.

7. **Bitcoin:** Right now, everyone is talking about it.[2] But we do not see Bitcoin (or other cryptocurrencies) as a systemic risk. The price of Bitcoin has risen exponentially over the latter half of 2017, raising the prospect of a tulipmania-style euphoria and correction. However, Bitcoin is still a very small, niche market, which is absolutely dwarfed by the size of traditional fixed interest and equity markets. As such, it is possible that there could be a sharp correction in the Bitcoin price without causing a ripple in core financial markets. It could be that the main channel to watch is the possible effects on broader market sentiment and risk appetite. At this stage, it seems like a stretch to believe that a collapse in Bitcoin would make investors question the valuation of core markets.

It is important to remember that risk is not always asymmetric and tilted to the downside. There are some upside risks to our core view in 2018. In the global economy, after a year of political gridlock, Trump may finally deliver an economic and tax package that stimulates the US economy. In New Zealand, businesses may shrug off their post-election blues. More generally, technological advances may see some companies grow their margins and the earnings of some sectors could exceed expectations. Finally, global inflation pressures may remain dormant for yet another year, keeping central banks on the side-lines, with monetary policy accommodation supporting markets yet again. These also need to make up the possible scenarios that investors contemplate, when looking ahead to 2018.

[2] "A boy asked his bitcoin-investing dad for 1 bitcoin for Christmas. Dad: What? $15,554??? $14,354 is a lot of money! What do you need $16,782 for anyway?"

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