Harbour Outlook

Strong growth with global inflation risks

Harbour Outlook 7/2/18 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

Over the latter half of 2017, the global economy experienced strong growth across all major regions. This theme has continued through the beginning of 2018 and supported markets. However, it has also been accompanied by the top risk on our list for 2018 – namely, inflation risk and ultimately worries about whether monetary stimulus will be removed in a way that is friendly for markets.[1] In the first few days of February, this has manifested itself in a sharp rise in both equity and bond market volatility.

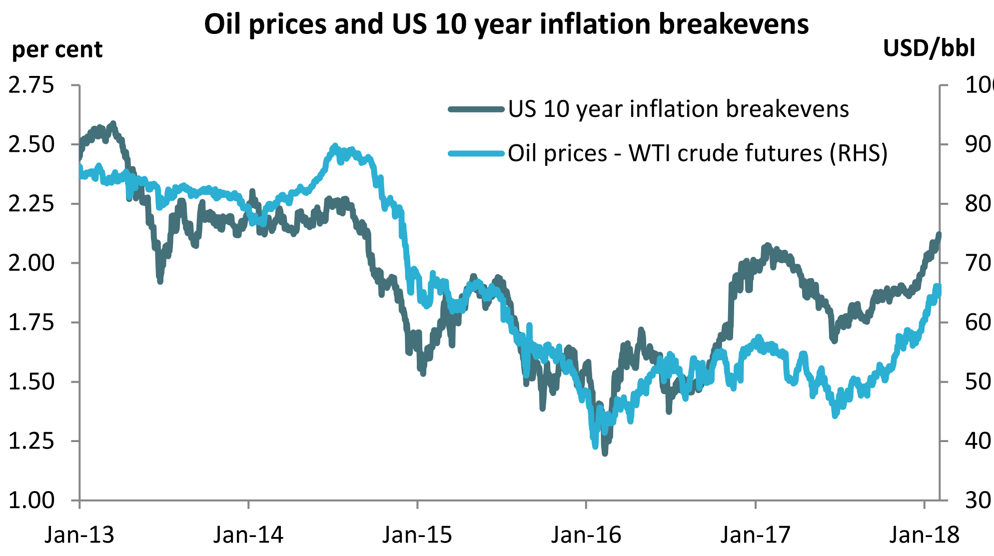
Global economic growth and equity market earnings forecasts continue to be revised up. The increase in activity is broad, with UBS economists revising up forecasts across 15 economies. Notably, 2018 was lifted over 0.5% in Europe to 2.5%, and almost 0.25% in China to 6.6% and the United States to 2.7%. The IMF not only revised up their global growth forecasts but noted that global growth is the most synchronised across regions since 2010, and that momentum is building.

But the corollary of this strong activity is that central bank monetary settings, particularly those of the US Federal Reserve (the US Fed), may be too stimulatory for a more normal (in a post GFC world) rate of economic growth. Through the course of January, markets focused on a confluence of inflationary factors - lagged demand, tight labour markets, the tax reforms impact on wages/bonuses and growth, higher oil prices, latent protectionism, and the weak USD. Reflecting this theme, market measures of inflation rose, and the global bond yields ended around 0.3% higher in January.

A key piece of data in early February reinforced this move higher in bond yields. The monthly US jobs report not only delivered a robust result for hiring in January, but much more importantly, average hourly earnings (the measure of wages) jumped higher. In recent years, strong wage growth has been conspicuously absent in the context of a strong US jobs markets. This latest piece of data appeared to vindicate the US Fed's hiking program and reinforced expectations that the removal of stimulus will continue over 2018.

There is a degree to which the move higher in rates is also self-reinforcing, at least in the short term. As the sell-off has taken US 10-year yields to the highest level since 2014, the move has generated ample headlines and increased focus amongst investors. The move through 2.65% also prompted some high-profile commentators to call the 30-year bull run in US Treasuries to an official end.

[1] Harbour Investment Horizon, "Risks to watch in 2018", 15 December 2017. https://www.harbourasset.co.nz/wp-content/uploads/2017/12/Harbour-Investment-Horizon-Risks-to-Watch-in-2018-Final.pdf



Source: Bloomberg.

Higher bond yields potentially create several issues for equity markets, and this has seen equity markets fall sharply in the first few days of February.

Many investors allocate capital by comparing the stock market earnings yield (the inverse of the Price to earnings ratio) to longer term government bond yields. At the beginning of February, the gap between the US S&P500 earnings yield and the US 10-year real bond yield was 3.9%. The average gap since 1980 is 3.4%. So, a 0.5% increase in real US 10-year bond yields could remove the argument that equities are undervalued versus bonds.

While equity investors have been unnerved by the velocity of the recent the rise in bond yields, research by J P Morgan indicates that equities do not tend to de-rate on higher bond yields, particularly if earnings growth is improving. Their research shows that global equities have delivered positive returns 90% of the time during major US 10-year Government bond sell-offs over the last 15 years, with cyclical strength in earnings offsetting the valuation impact of the higher cost of doing business.

So, while 'bond bears' may create more trouble for equity markets, as long as earnings continue to meet and/or beat expectations equity markets should continue to generate positive relative returns.

What to watch

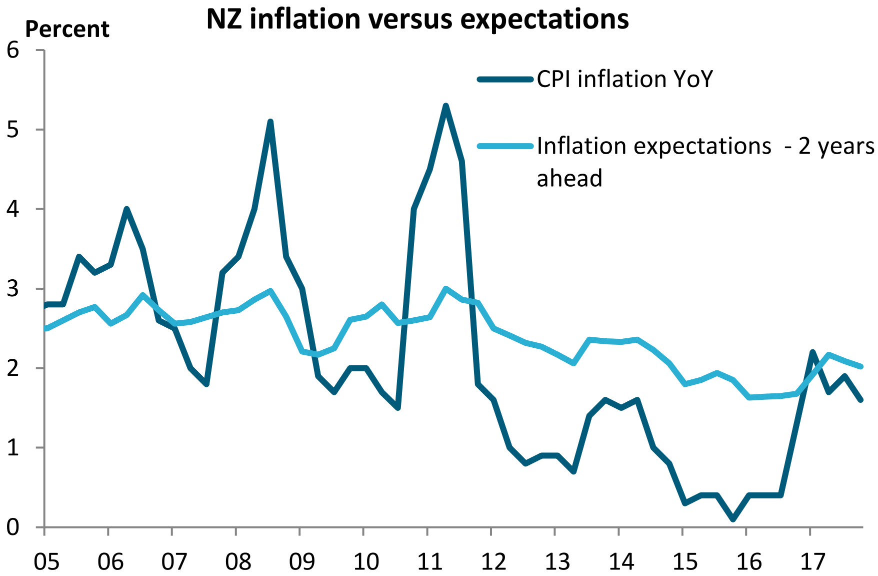
Looking ahead into February, there are two main domestic events that we are watching.

First, the pending New Zealand company reporting season (42 companies reporting for the December period) is expected to show a slowing in the rate of earnings growth. Consensus expectations are for 5% aggregate earnings growth over the next three years, with forecasts dragged down near term by weaker returns from larger capitalisation companies in the utility, building and telecommunications sectors. In Australia, consensus expectations are for benchmark ASX200 earnings to grow by 6-7% per annum over the next three years, kick started by a +10% in 2018. While strong commodity prices are providing much of the positive earnings momentum for the ASX 200 benchmark, the overall Australian macroeconomic backdrop has improved significantly over the last year. Business confidence is relatively high, employment growth is strong and consumer confidence has risen.

Overall, within the Australasian reporting season we will be watching for good governance – companies managing their capital structures appropriately, investing in research and development, expansion, where supported by a solid business case, positioning for disruptive technology, and implementing sustainable social and environmental policies which allow businesses to continue to operate profitably over the long term. With market valuations at high levels we see potential for outsized moves to earnings announcements, both positive and negative.

The second domestic event on the radar is the RBNZ's Monetary Policy Statement and OCR decision.

This will be made in the context of a very large downside surprise in Q4 annual NZ CPI inflation, coming in at 1.6% vs 1.9% expected. As a result, the starting point for headline inflation has fallen, making it more likely that headline NZ CPI inflation stays at or below 2% through the rest of the year. Rising headline inflation was meant to be one of the factors that would help lift NZ inflation expectations and bring core inflation measures comfortably back to 2%. That dynamic now looks much less likely to play out through 2018. Indeed, for the February Monetary Policy Statement, it makes it much easier for the RBNZ to stick to the current narrative that the OCR is on hold for a considerable time, and to wait for the arrival of Adrian Orr in March to reassess.



Source: Bloomberg.

Finally, we are watching for whether the diverging directions of the RBNZ and US Fed may have broader implications for markets. The prospect of the RBNZ retaining the OCR at 1.75% while the US Fed Funds rate lifts above that level would tend to push NZ bond yields closer to US yields. The "high-yield" status that has enticed offshore investors into the NZ market may disappear, bringing into question their willingness to stay. To date, the NZD dollar has remained elevated despite this theme. Looking at other factors, NZ is in a much better position with regards to the terms of trade, the current account and the fiscal position than historically. With the US fiscal position looking tenuous, New Zealand is also potentially becoming more appealing from a fundamental perspective. While interest rate differentials matter, they are not the only consideration for the NZ dollar.

Market outlook

For bond markets, the driving fundamentals will be growth and inflation. We continue to have portfolios positioned with short duration, to protect investors from rising inflation and rising long-term bond yields. We have also been increasingly defensive and selective in credit markets.

While the recent surge in US 10-year bond yields has taken its toll on the defensive/bond proxy sectors, our portfolios remain underweight to bond-sensitive stocks in the utilities, real estate and telecommunications sectors, mainly because they are expensive relative to modest levels of potential cashflow and earnings growth.

Our portfolios remain overweight in companies in the information technology, consumer staples and healthcare sectors that can grow ahead of expectations due to structural drivers such as technology change and industry disruption. We also remain skewed to better quality cyclical companies in the financial and materials sectors that are expected to generate strong cashflows.

Finally, we expect market volatility to continue to normalise from low levels, reinforcing the case for active management.

Harbour Asset Management

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