Harbour Outlook

Low inflation and solid earnings growth

Harbour Outlook 9/8/17 | contactus@harbourasset.co.nz | +64 4 460 8300

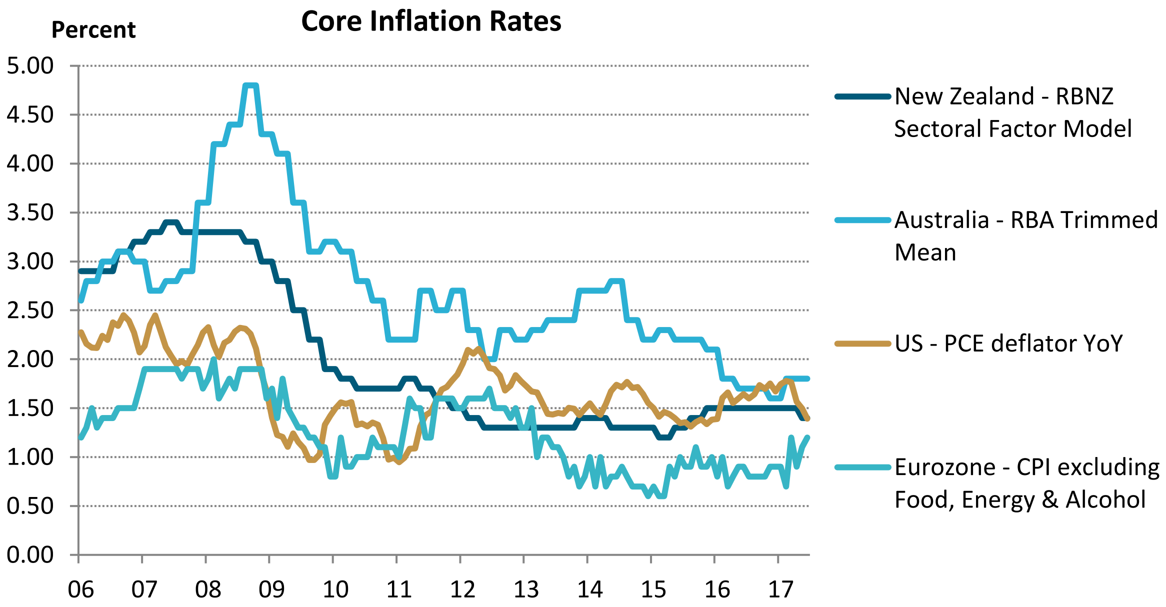
The Harbour Outlook summarises recent market developments, what we are monitoring closely, and our key views on the outlook for fixed interest, credit and equity markets.

Key developments

At the end of June, bond and equity markets were briefly rattled by concerns that central banks were readying the market for the removal of stimulus. Comments from the US Federal Reserve, European Central Bank, Bank of England and Bank of Canada had almost seemed co-ordinated, pointing to a shift in focus from the threat of deflation to the prospects of reflation.

Through the course of July, equity markets not only calmed but renewed their advance. Macroeconomic data on the global economy continued to point to a 'Goldilocks' combination of steady growth and benign inflation. Company profit results also continued to better expectations, particularly in the US and Asia. As a result equity markets rose, pushing both valuations higher and optimism about market trends to new cyclical highs.

The continued fall in the US unemployment rate to a pre-GFC low of 4.3% highlights why the US Federal Reserve is the first central bank to lift official interest rates. However, with US CPI inflation continuing to surprise on the downside, there is time for the normalisation of monetary policy to be a slow prolonged process. This theme of low inflation was reinforced locally, with annual NZ CPI inflation for Q2 coming in lower than expected at 1.7%, down from 2.2% in the previous quarter. The Reserve Bank of New Zealand (RBNZ)'s favoured measure of core inflation remains stuck around 1.5%.



Source: Bloomberg.

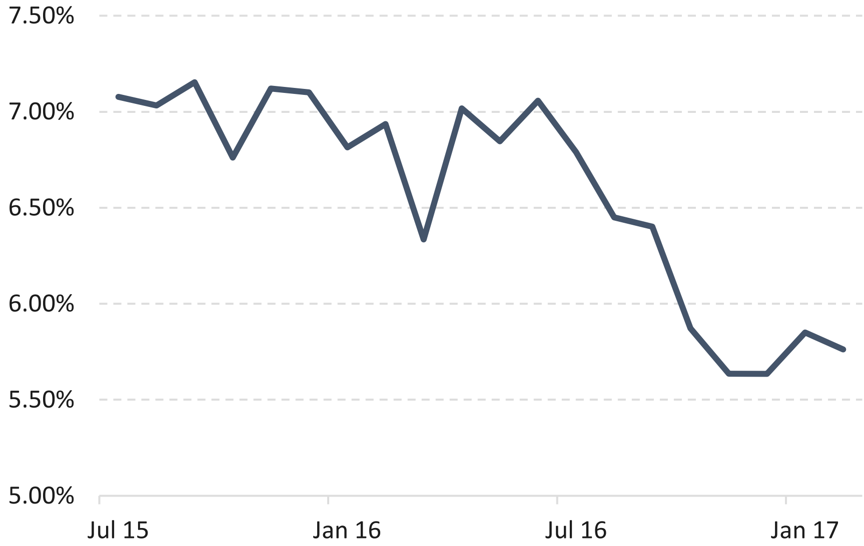
What to watch

While most macroeconomic data and leading indicators paint a solid picture for earnings and economic activity, a key risk we are watching is the slowdown in lending activity.

Private sector credit growth in New Zealand has slipped from over 7% to around 5.5% at the end of June 2017. Although that is consistent with nominal GDP growth, more recent anecdotal evidence from the large trading banks suggests a further deceleration to a 3-4% growth rate in new lending. Tighter capital standards in Australia, tighter loan to value ratio (LVR) restrictions from the RBNZ, and stricter internal credit policies appear to have finally bitten on bank lending behaviour, particularly on residential and commercial property lending.

There are already signs of house prices falling in Auckland in the year to date, and some development projects struggling to access sources of bank funding. If the supply of credit tightens further, we may see a broader weakness across a number of sectors.

NZ Private Sector Credit Growth is Slowing



Source: Bloomberg.

Political risk is also rising. The New Zealand election on the 23 September was looking like a fairly benign event, with polling for the leading opposition party, Labour, slipping to new low of 23%. The introduction of Jacinda Ardern as the new Labour Party leader has already provided a significant change in the political dynamic. Equity markets have traditionally looked through political risk, and it is no different in the US and Europe. However, this election in New Zealand could break the mould should polling change significantly.

Global investors, who still own more than 50% of the listed market in New Zealand, have historically seen the National government as more pro-growth and fiscally conservative. But for fixed interest investors, we see Labour's proposed changes monetary policy arrangements (introducing a committee decision making structure) as relatively mainstream by global standards.

Market outlook

We are increasingly of the view that short and long-term rates in New Zealand will remain fairly low and stable over the medium term. The primary reasons are that structural forces are keeping inflation low and that high debt levels around the world constrain the ability of economies to function with higher interest rates.

Indeed, when we assess the balance of macroeconomic data since the last *Monetary Policy Statement*, we believe that the RBNZ could shave around 25 basis points off its OCR projections and publish a flat track at 1.75% out to the end of 2019.   Our analysis suggests that stronger than expected net migration and commodity prices were more than offset by factors reducing future inflation pressures, including an elevated TWI (Trade Weighted Index), Q1 GDP growth below expectations and Q2 CPI inflation below expectations. While the RBNZ has already indicated that "monetary policy will remain accommodative for a considerable period", in our view there is a case that the RBNZ could indicate that the next move in the OCR could be **up or down**.

With the balance of risks changing, our strategy is to be positioned for the NZ dollar to weaken in those portfolios with scope for active management.

Similarly, in fixed interest portfolios, we favour an overweight exposure to the 1-3 year part of the yield curve, in anticipation of the market re-pricing to lower the chance of RBNZ rate hikes through 2018. As a way to mitigate the risk of rising global yields with the prospects of the US Federal Reserve removing stimulus, we are slightly underweight in longer maturities (7+ years) that tend to be driven more by global factors.

In credit markets, credit margins have narrowed, which is unusual when the economic outlook has the downside risks from tighter lending conditions and the weaker housing market. There are, however, positive offsets in NZ from stronger terms of trade, migration and fiscal bandwidth should the government seek to offer stimulus or support. With a more mixed outlook for credit, we have taken our exposure back from overweight to neutral.

Putting aside the risks of a slow-down in lending, and the forthcoming election, in our opinion the outlook for equity market generally is still supportive of quality growth companies. However, in addition we are increasingly wary of both extended valuations in yield stocks and the potential for a faster pace of disruption to impact upon large sectors. As a result, broad equity market indices may struggle to shift higher in the near term. In contrast active portfolio management may provide a greater opportunity for added value in equity portfolios.

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