Harbour Investment Horizon
Not too hot, not too cold

Harbour Investment Horizon 29/12/2017 contactus@harbourasset.co.nz +64 4 460 8300

After strong year for returns from Australasian equity markets, investors are asking: what does 2018 offer? Are the 'goldilocks' conditions of solid economic growth, low inflation and easy monetary policy settings likely to continue to support equity market returns?

While we believe the near-term outlook for local equity returns remains positive, two scenarios may challenge these goldilocks 'not too hot, not too cold' conditions.

Challenge 1: Earnings growth fails to meet expectations.

Market consensus is for local equity markets to generate mid-to-high single digit earnings growth per annum over the next few years. Key near-term risks to earnings forecasts are a) a rapid tightening in monetary conditions, and b) the consequences of possible government policy changes which might slow economic growth.

If monetary policy settings (including official interest rate targets and macro-prudential tools) are tightened too quickly, earnings may disappoint, as constrained access to debt capital slows economic growth and higher interest rates hit business profitability. Current above-average economic growth may give central banks globally the confidence to 'tap the breaks', and unwind supportive post global financial crisis (GFC) monetary policy stimulus. But lead global inflation indicators remain low, meaning central bankers don't have to act too quickly to increase interest rates. With central bankers globally maintaining a gradual approach to unwinding easy monetary policy settings, we believe the equity market risks related to near-term sharp hikes in monetary policy settings remain modest.

The re-emergence of modest inflation may contribute to rotation in market performance leadership. Long term interest rates may increase as signs of inflation emerge (even if only modest), or as central banks end their stimulatory bond buying programmes. Equity market sectors that are sensitive to bond yields, such as utilities and real estate, which have supported New Zealand equity market returns as interest rates fell to generational lows, may underperform should bond yields creep up.

If a tightening in monetary settings is sharp or unexpected, a market 'tail risk' (a low probability, high impact event) could manifest itself with forced deleverage of systematic equity strategies (such as options hedging/dynamic delta hedging, volatility targeting, risk parity and trend following) which have boosted market returns, and cause disruptions to market liquidity.

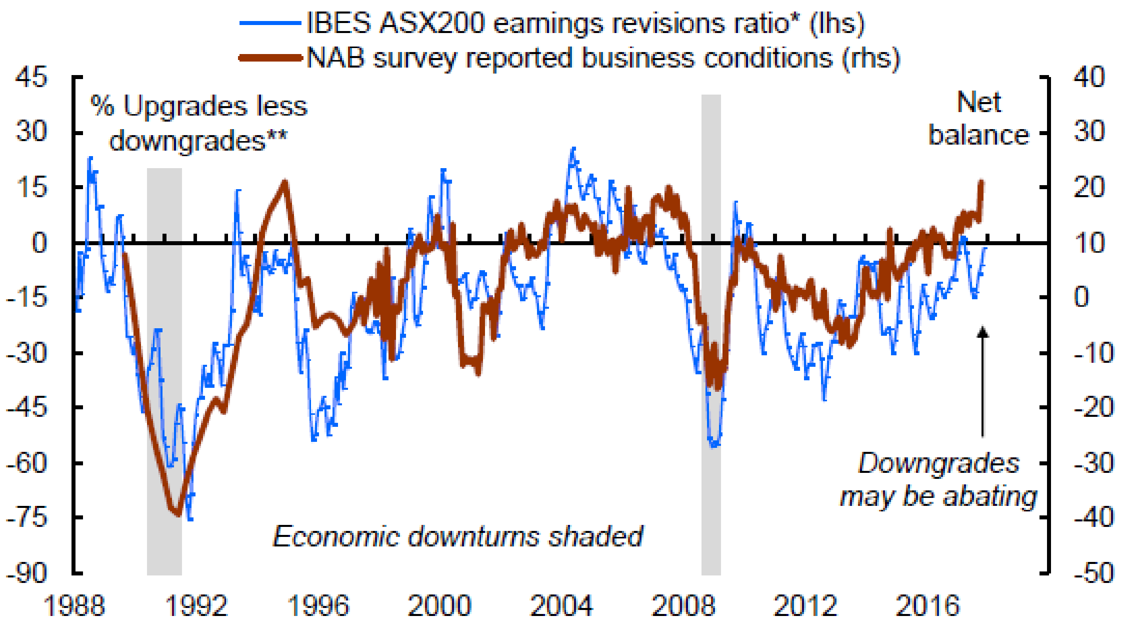
Changes to government policy settings, both locally and offshore, may moderate what has been a sustained period of above average growth. Policy changes could impact on robust migration (both inbound and outbound) influences growth, residential housing activity, business confidence and consumer confidence. Positive migration remains a strong underpinning for both the New Zealand and Australian economies, but regional variations may contribute to a new round of migration trends emerging. For example, Queensland is generating the best jobs growth in Australia as people shift in search of cheap housing, potentially attracting New Zealanders to move across the Tasman and Australians to move from southern states.

Harbour's response: Profitability and earnings may remain elevated for longer.

In Harbour's view, the outlook for near term profitability remains solid, with economic lead indicators remaining supportive for equity returns. While the rate of global economic upgrades may peak near term, overall activity is at an elevated level. Synchronised global economic growth supports the profitability of New Zealand and Australian companies with offshore earnings.
Locally, the New Zealand and Australian economies remain relatively resilient, with prudent government and private sector debt levels. Residential housing activity, which had become stretched, is slowly cooling. In New Zealand, while the rate of economic growth may slow as net positive migration rolls over, slowing but still firm business confidence supports solid economic activity and elevated employment levels.

Despite varying a lot across sectors, as shown in figure 1, Australian business condition indicators have strengthened significantly over the last year. This improvement in business confidence supports earnings for parts of the Australian equity market, and some NZ companies with Australian operations, which have been missing over the last few years.

Figure 1. Australian business confidence supportive of earnings



*Source: Citi Research Published 5 December 2017; *3 month moving average, last observation is preliminary. ** Upgrades less downgrades as a percent of all stocks in the ASX200 index. Source: NAB, IBES, S&P, Datastream, Citi Research.*

Challenge 2: The speed of technological disruption.

The speed of technological disruption is challenging many business models. Credit Suisse highlights in their 2018 Global Equity Strategy that this disruption is being driven by the convergence of at least four technologies coming of age, including: smartphone, 4G and unlimited data giving circa 60% of the world's population huge processing power at their fingertips; 3D printing; battery storage; and machines being able to replicate human tasks (with the OECD highlighting that a third of jobs have the potential to be replaced by a machine today).

This rapid convergence is testing businesses in different ways. Increased pricing transparency via the ability to access online searches anywhere, anytime, is exposing previous competitive advantages (such as geographic isolation or the differences between wholesale and retail selling prices) to rapid disintermediation. We all do price checks on our smart phones before buying items, with the more efficient price discovery process increasing our bargaining power. Some companies face the real threat of being replaced by new technology-based business models that offer a more effective solution, with a better delivery mechanism than existing models.

In Harbour's opinion, rapid technology disruption is likely to impact on returns from parts of the equity market. The pace of technology change is exposing structurally weak businesses, and the returns that such challenged businesses deliver for investors may remain suppressed until strategies are put in place that address the disruption risk. In most circumstances, the disruptive impact of rapid technology change requires companies to increase their capital investment to keep up with competitors, potentially at the cost of near-term profitability.

Harbour's response: New technology supports profit growth for some companies.

While technology disruption offers challenges for some businesses, it may offer upside to profitability margins to other businesses, and may allow totally new economic models to emerge.

New technology is allowing businesses to do more with the same (or less) inputs, boosting profit margins. Technology disruption is improving inventory management, reducing development time lines and improving connectivity with customers. Rapid technology change may be a key reason behind current low levels of inflation.

Ultimately businesses that can pivot to use disruptive technology have the potential to grow faster and for longer than others, growing returns to shareholders ahead of expectations. To benefit from technology disruption businesses will need to be prepared to invest and to challenge existing business models. For most companies, investment in disruptive technology may take time to be reflected in profitability.

'Goldilocks' environment to continue in the near term

In the near-term, equity markets remain supported by robust profitability. Profit growth is being driven by positive underlying economic activity (with some degree of resilience) and investment in disruptive technology which boosts profit margins. But with overall market valuations elevated, the potential is for lower local equity market returns than those that have been generated over 2017. Relatively easy monetary conditions remain supportive near-term, meaning equity markets may continue to offer an attractive return relative to cash and bonds, until such time that sustained central bank interest rate hikes constrain growth.

Earnings growth (rather than valuation multiple expansion) is likely to be the key determinant of equity market returns. Market consensus single digit earnings growth expectations provide a reasonable underpinning for returns. Company balance sheets are relatively strong, providing some protection against a sustained slowing in activity.

New Zealand and Australia's relatively solid population growth, relatively low policy uncertainty, and history of good returns should continue to appeal to offshore investors. Current low interest rates and easy access to debt mean that merger and acquisition activity may accelerate, as industries consolidate to deal with rapid technology disruption.

Not all equity market strategies and industry sectors will do well in this changing environment. Dispersion in stock returns is likely to increase from recent low levels, as monetary policy settings change and as rapid technology convergence continues to impact on business models. In Harbour's opinion, high quality growth and high quality income equity strategies are likely to outperform over the medium term as this dispersion increases.

So, while conditions may get a little colder (if economic growth peaks) and a little warmer (as monetary policy conditions gradually tighten), the goldilocks 'not too hot, not too cold' market conditions which have been in place over the last few years are likely to remain supportive for equity returns, from both the land of milk and honey (New Zealand) and the land of macadamias and vegemite (Australia).

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