Harbour Outlook

New Year, similar themes

Harbour Outlook 12/1/18 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

This New Year brings with it a slew of market outlook articles and fresh investment strategies. In adorning the wall with a new Gregorian calendar in 2018, we see only an evolution of current themes. Chinese fund managers, after all, will be writing their new year outlook pieces in February.

In global financial markets, perhaps the least expected phenomenon through 2017 was low volatility. At the beginning of the year, as is usually the case, multiple risks were identified as posing threats for the coming year. The global economic expansion, reflected in strong equity prices, was described as mature. There was anticipation that rising inflation and QE removal would challenge markets, while the Trump Presidency promised all sorts of messy scenarios.

As it turned out, none of these quite presented anything the market couldn't stomach. The North Korean missile tests, along with the US response, could have, and could yet escalate. President Trump's endless and disturbing twittering created all sorts of angst, and certainly made it harder to get his policy initiatives underway. But there was no killer blow for markets. Much of the resilience was due to the developing and compelling evidence of robust and synchronised global growth. That this occurred without inflation picking up was hugely beneficial, as it allowed central banks to retain highly supportive of monetary policy. In the end, equity markets had a tremendously impressive year, with stable bond markets underpinning the equity indices rally into record territory. Persistently low inflation in New Zealand has enabled the Reserve Bank to judge that they would not need to change the Official Cash Rate for some time, anchoring the front end of the yield curve.

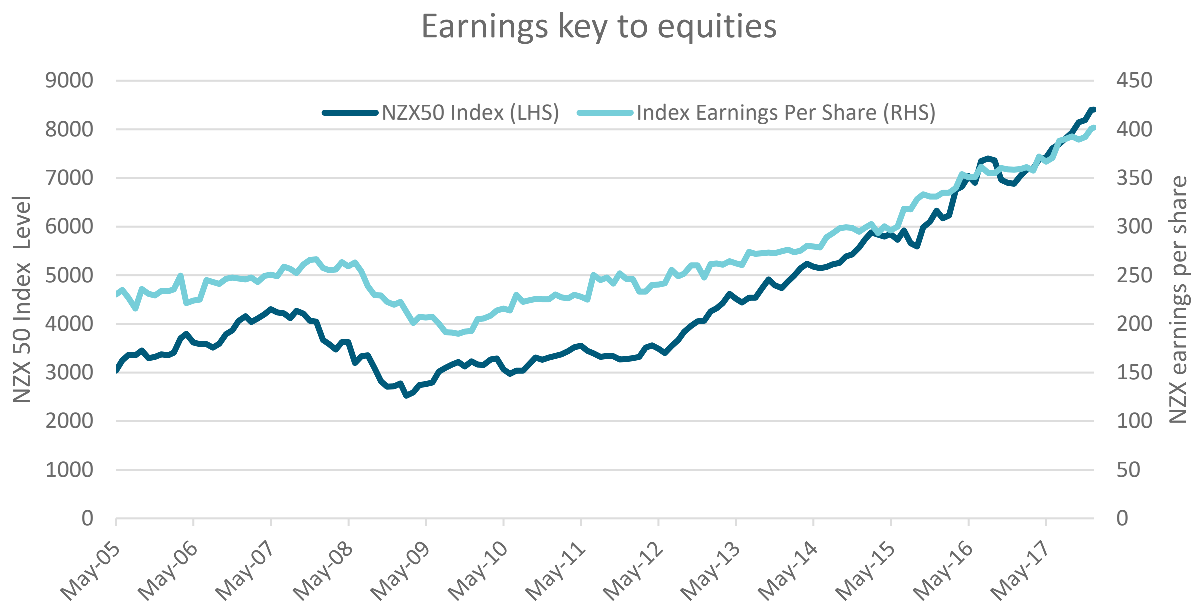
The rally continued to be supported into the end of the year, and into the beginning of 2018, by the passage of significant corporate and personal tax reductions in the US. We have already seen other nations preparing to also reduce tax rates to restore the relative competitiveness of their corporations.

What to watch

We retain a constructive outlook going into 2018, supported by the continuation of strong and synchronised global growth. But, we acknowledge that the longer the cycle continues and the higher multiples become, the greater risk of a mis-step grows. We doubt that valuations themselves pose the biggest risk, instead we remain vigilant for any weakness in earnings.

The pending profit reporting season will provide an important guide for markets, with several Australian companies in particular, needing a strong result for the second half 2017 to support stock price returns. With equity markets continuing to trade on elevated multiples, there is potential for disappointing news to impact disproportionally on some equity prices.

We have modest overall expectations for profit growth in New Zealand in 2018, with solid offshore sourced earnings growth, offsetting slowing domestic sourced earnings growth. We are paying careful attention to the impact that any changing government policies may have on different sectors and to aggregate demand.



Source: Bloomberg

We see rapid technology convergence and disruption as potentially the most influential medium-term trend for equity market returns. While some of these technologies are improving productivity, many businesses face disruptive threats, and we expect an increasing dispersion in stock returns between companies, depending upon how they are positioned for this change

We will continue to assess the appointment of Adrian Orr as the next RBNZ Governor and any changes the Government makes to the RBNZ's remit and decision-making structure. Orr's appointment was broadly welcomed in financial markets. He is known as a strong communicator and has deep experience in the domestic market. Naturally the new role will put him under deeper scrutiny. This may start early on with market participants eager to see if the assessment of the outlook for inflation or the housing market changes.

Market outlook

Looking ahead into 2018, there appears to be many similarities to 2017, although, anyone with a contrarian temperament will be raising their eyebrows to read that one measure of equity market sentiment is at the highest level in 11 years, with 95% of those surveyed (market traders) stating they are bullish on the market. At present, the momentum of the global economy is robust, with Europe providing the most positive surprise. The US has dropped slightly off very high levels of confidence, but upcoming tax cuts and the possibility of infrastructure spending could easily generate another surge. For bond markets, the challenges will be watching what course central banks choose to take. This will, in turn, be largely driven by inflation developments. In the near term, rising energy prices should boost CPI readings, but it is core CPI (excluding food and energy) that would really matter. The European Central Bank may be highly influential this year. If they decide, as the German officials advocate, to unwind QE quickly, this would push European bond yields higher and would ripple across the Atlantic to the US market and then pretty much everywhere else.

Equity markets remain supported in the near term by strong economic activity and low inflation driving solid earnings growth. Strong global manufacturing purchasing managers indices suggest companies will need to hire, invest or push up prices. Current global monetary policy settings may be too stimulatory if this momentum continues, with gradual increases in interest rates in some countries potentially cooling the rate of equity market earnings growth.

Capital market volatility may increase from low levels as monetary policy settings are altered. A gradual rise in long term bond yields may take the edge off investor demand for New Zealand and Australian yield-oriented stocks. With overall market valuations elevated, the potential is for lower local equity market returns than those that were generated over 2017. So long as liquidity conditions remain supportive, we remain encouraged to view near-term market weakness in the context of an ongoing positive environment for company earnings.

Harbour Asset Management

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