QUARTERLY STRATEGIC OUTLOOK

APRIL 2017 Text finalised 27 April 2017

HIGHLIGHTS...

- Economic news generally upbeat, but remain cautious on reflation
- Policy uncertainty high in the US
- China near-term stability comes at expense of medium-term sustainability
- Global institutions in defence of free trade
- Monetary policy on hold in the antipodes
- No significant changes to current investment strategies

Executive summary

Economic news has remained generally upbeat over the first few months of 2017, supporting our expectation of higher global growth this year. Approaching the half-way point of the year, the issue is becoming the sustainability of the improvement in the data, especially inflation.

We remain cautious on the reflation story as much of the increase in inflation recently has been driven by higher commodity prices and is largely contained to headline inflation. The reflation story is still playing out best in the US where the economy is at full employment and the output gap is effectively closed. The US Federal Reserve will therefore continue to tighten, with a total of three hikes in 2017 the most likely outcome.

In China the authorities have done an excellent job at stabilising the economy, but it appears the near-term stability has been at the expense of longer-term sustainability. Emerging markets are staging somewhat of a growth renaissance, though this recovery is in large part contained to commodity export countries benefiting from the recovery in commodity prices. Industrial production is improving in both Brazil and Russia, but less so in emerging economies more reliant on manufacturing, such as India and Turkey.

The UK economy has come through the immediate post 'Brexit' period better than feared, thanks largely to the upbeat UK consumer. But the Brexit negotiation process will be tough and a likely dampener on business investment.

We have been keeping a close eye on three critical elections in Europe this year: the Netherlands, France and Germany, in particular how well the populist Euro-sceptic parties would perform and what that would mean for the stability of the Eurozone. Geopolitical issues have also come to the fore as events in Syria and North Korean have seen tensions intensify, while in contrast tensions have eased between the US and China.

In New Zealand, the economy put in another solid performance over 2016, though growth disappointed at the end of 2016 as poor weather hit dairy production and the Kaikoura earthquake also impacted. There should be some degree of bounce-back in the March quarter of this year, though we are expecting growth to slow over 2017 and 2018, particularly as lack of spare capacity increasingly constrains the ability of the economy to grow.

We don't see a compelling case for significant changes to our current investment strategies, which have been proving successful. AMP Capital sees share markets continuing higher over the next 12 months, helped by improving corporate earnings and still-fair valuations, economic optimism, and supportive global monetary conditions due to European and Japanese monetary stimulus.

We still expect rising US government bond rates to continue pushing up other countries' long-term yields and underpin an uptrend in the US dollar. We also expect higher bond market volatility, firm (but not sharply higher) oil prices, and potentially, some fragility in the exchange rates of the world's more indebted commodity-producing economies.

Portfolio positioning is now slightly more defensive due to lowering the allocations to property and commodities, which we consider the most vulnerable asset classes at present. Our higher cash weightings have also been retained, as have the underweight allocations in both domestic and international fixed interest. Retaining a decent cash allocation provides flexibility to lift our holdings of other assets once greater value emerges.

ASSET CLASS	NEAR TERM VIEW	MEDIUM TERM VIEW	BIAS
Global equities	Expect markets to be higher on a 12 month horizon on still-accommodative monetary policy, possible fiscal easing and US economic optimism lifting corporate earnings.	Valuations are still positive for this asset class relative to bonds and cash.	Overweight
Emerging market equities	EM countries with external funding needs will be impacted by higher USD and bond interest rates. If US trade policy becomes discriminatory, there would be grounds to move defensively.	Medium-term fundamentals remain attractive on an absolute and relative basis. Short-term country and currency risks justify u/w EM position at present.	Neutral
Australasian equities	NZ should underperform global shares as global sentiment improves. NZ cycle may be affected by election cycle. Australian shares offer better value but require more certainty on China outlook and improving domestic corporate earnings news.	Australasian shares are reasonably priced given current financial and economic conditions.	Neutral
Listed property	Should track global equities in the near term with risk of underperformance if longer-term US interest rates continue to rise and the yield curve to steepen.	These sectors look fair value following recent performance. From an absolute return perspective, the low real yield environment should provide support over the medium term.	Neutral
Alternative Growth	Infrastructure better placed due to US policy agenda boosting stimulatory projects. Commodity prices are in a period of consolidation. Global supply remains ample for metals and energy commodities.	Cyclical price lows and improving demand are positive factors but the energy oversupply issue is expected to weigh on prices for some time.	Overweight
Global bonds	After Q4 2016 upward adjustment, yields have stabilized but with an upside bias. Growth surprises strong in both US and Europe. Continuing softness expected, but a gradual process as core inflation pressures remain contained around the world.	Global bonds are still poor value, with yields remaining artificially supressed by central bank activity. US Federal Reserve has signalled it will begin normalizing its balance sheet in 2018.	Underweight
New Zealand bonds	Expect long-end and returns to take lead from US but relatively robust fiscal outlook could maintain moderate demand for NZ bonds.	As with global bonds, pressure on yields foreshadows low returns over the medium term.	Underweight
Cash	The Official Cash Rate is 1.75%. We believe this is the low for this cycle. Interest rates now likely on hold until 2018.	We forecast similar returns from cash and bonds over the medium term but cash has lower risk of capital loss than bonds.	Overweight
Foreign currency	Diverging monetary policy between the US Fed and RBNZ suggests NZD risks are skewed to downside on a 12 month horizon. Political uncertainty could rise with NZ and EU elections.	The NZD is a little overvalued on a MSCI weighted basis. Domestic growth lacks catalysts beyond migration at present.	Overweight

ECONOMIC OUTLOOK

Economic news has remained generally upbeat over the first few months on 2017, supporting our expectation of higher global growth this year.

As we approach the half-way point of the year, the issue is becoming the sustainability of the improvement in the data, especially inflation. The reality is that much of the recent good news has been related to the rebound in commodity prices. The reflation story is largely one of commodity price inflation that is impacting headline inflation while core inflation remains subdued in many key economies.

The recovery in aggregate emerging markets is largely contained to commodity producers, particularly Russia and Brazil, which are both expected to be out of recession this year. Stability in China is also helping, but we worry that near-term economic stability there has come at the expense of long-term sustainability.

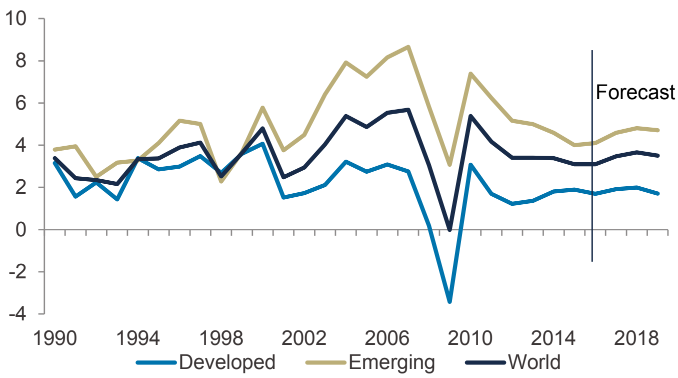
THE CRITICAL QUESTION IS WHAT HAPPENS ONCE THE COMMODITY IMPULSE TO GROWTH AND INFLATION FADES.

We will likely be left with our prior position that global growth will be constrained in advanced economies by demographics and weak productivity growth. In addition, while demographics and productivity are tailwinds for the emerging economies, their own idiosyncratic structural impediments will see them growing at a more subdued pace in aggregate than they were pre the Global Financial Crisis (GFC).

The commodity recovery is expected to give global growth a leg up to around trend, but we don't see it pushing on much from there. We see global growth of 3.5% in 2017, up from 3.1% in 2016. This is expected to be followed by 3.7% in 2018 and 3.5% in 2019.

Global GDP growth

Annual average % change



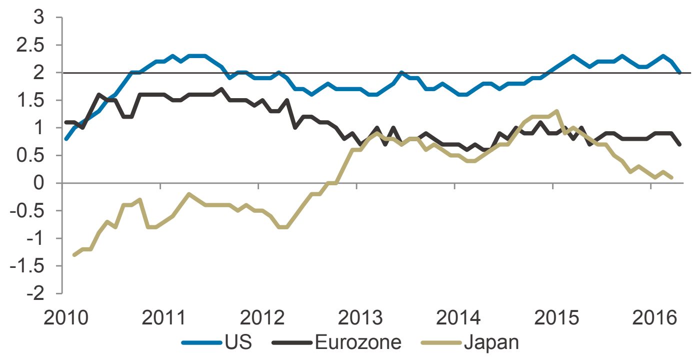
Source: IMF and AMP Capital

REMAINING CAUTIOUS ON REFLATION

We have been urging caution on the reflation story. Much of the increase in inflation recently has been driven by higher commodity prices and is largely contained to headline inflation. The conditions for genuine reflation, of the sort that central banks will choose to act on, are only met when core inflation is judged to be not only moving higher, but moving higher on a sustained basis. Many developed economies are still well-short of this mark.

Core inflation

Annual % change

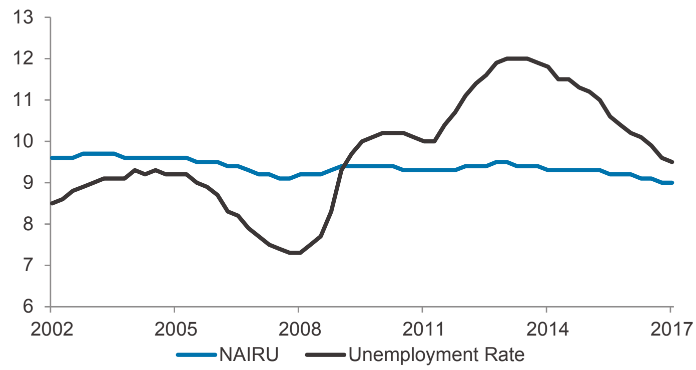


Source: BLS, Eurostat, MIAC

Indeed, the annual rate of core inflation is currently stuck at less than 1% in the Eurozone. This is a useful reminder of the reality that the Eurozone output gap is still large and negative, and persistent increases in core inflation are still some way off. Most importantly, the current unemployment rate of 9.5% is still some way short of applying any persistent pressure on wages, the 'lynchpin' of a self-sustaining increase in inflation according to European Central Bank (ECB) President Mario Draghi.

Eurozone unemployment

Percent



Source: Eurostat, Bloomberg

The good news is that, with activity looking to be somewhat stronger this year, spare capacity will be absorbed more quickly. That said, we think ECB forecasts for core inflation of 1.1% this calendar year rising to 1.8% in 2019 look a tad optimistic.

Progress towards that forecast will be the key determinant of the ECB's monetary policy stance and particularly their intentions towards their asset purchase programme (APP). We know the Governing Council is concerned about the financial risks around prolonged aggressive monetary easing, but an early exit in the absence of anything else (fiscal policy) risks derailing what are still only nascent reflationary trends. The current APP is scheduled to conclude at the end of this year.

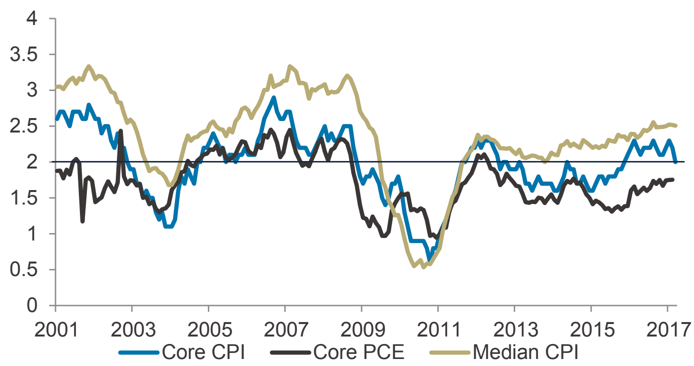
Towards the end of the year we expect an announcement to extend the programme into 2018, probably with an element of tapering. The risk for the ECB is a premature tightening in conditions that derails the growth still required to close the output gap and get the unemployment rate continuing to move lower.

In Japan there is little sign of any inflation aside from the impact of the recent depreciation in the yen. To say wage growth is going nowhere would be over-optimistic: spring wage negotiations delivered increases in 2017 that were lower than those achieved in 2016. Also, inflation expectations remain low and demand is insufficiently strong to provide firms with any pricing power.

THE US IS CLOSEST TO GENUINE REFLATION

The reflation story is still playing out best in the United States. That's because the economy is at full employment and the output gap is effectively closed. But core inflation is not running away, indeed it has dipped lower in the last couple of months to be bang-on 2.0% at the end of the first quarter. Furthermore, the core personal consumption expenditure deflator (core PCE deflator), the Federal Open Market Committee's (FOMC's) preferred measure of inflation, is trending higher, but at 1.8% is still short of the Committee's mandated 2% target.

US inflation
Annual % change



Source: BEA, BLS, Federal Reserve Bank of Cleveland, AMP Capital

The FOMC will therefore continue to tighten. We are at the point in the cycle now where the FOMC will have growing confidence that their dual mandate of full employment and 2% inflation will be met. In fact, they are now more inclined to look through temporary data weakness and continue the process of interest rate normalisation.

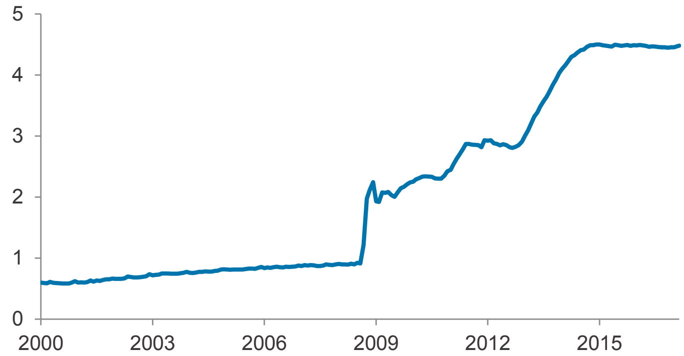
The current range for the Fed funds rate of 0.75-1.00% is still some way short of the Committee's estimate of neutral (2.85%).

A TOTAL OF THREE HIKES IN 2017 STILL SEEMS THE MOST LIKELY OUTCOME, BUT IT WILL BE WAGES THAT WILL PROVIDE THE MOST USEFUL GAUGE OF ANY CHANGE IN THAT VIEW.

The good news on that front is the labour market appears in fine fettle. Latest payrolls employment growth was lower than expected, but we expect payrolls growth to slow and business investment to increase with the economy at full employment.

Given the increased confidence in the inflation outlook, the FOMC is now preparing the ground for the final phase of the monetary policy normalisation process – their balance sheet.

US Federal Reserve total assets
USD trillion



Source: US Federal Reserve

In September 2014 the US Federal Reserve said (the Fed) they would only look to shrink their balance sheet once the normalisation of interest rates was "well underway". That time is soon, with the minutes from the March FOMC meeting signalling a likely beginning of balance sheet normalisation later this year. This is no great surprise given our belief the current leadership team wants to start the balance sheet normalisation process before the new team is in place in 2018.

In the early stages, balance sheet run-off appears likely to be initiated with the decision to phase down its current practice of reinvesting or 'rolling over' the proceeds from maturing bonds. More aggressive normalisation through asset sales will remain an option but will be dependent on the growth and inflation outlook further down the track.

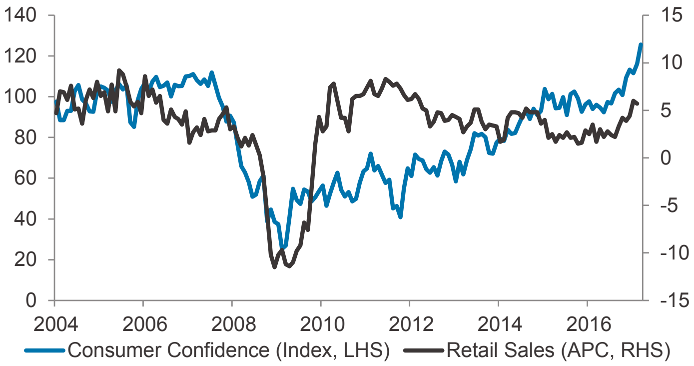
We expect that, like interest rate normalisation, balance sheet normalisation will be a slow and gradual process. Given the experience of the 'taper tantrum' in 2013, the FOMC is likely to take a cautious approach with any decisions communicated well in advance.

POLICY UNCERTAINTY HIGH IN THE US

Helping the US reflation story is our expectation of above trend growth of 2.3% this year. This has been pared back from the 2.5% we were projecting in our last report as inventory destocking is expected to be drag on growth in the first quarter, and our expectation of fiscal stimulus beginning to have an impact by late 2017 seems now to be over-ambitious.

The consumer remains the backbone of the growth story with consumer spending likely to expand at a 3.0% pace this year, helped by continued solid employment growth and rising labour income. Even better growth seems to be broadening out to business investment, an element of the recovery we have been nervously waiting for. We see this as a necessary part of the story if US growth is to continue and not be derailed by weak productivity and eventual capacity constraints.

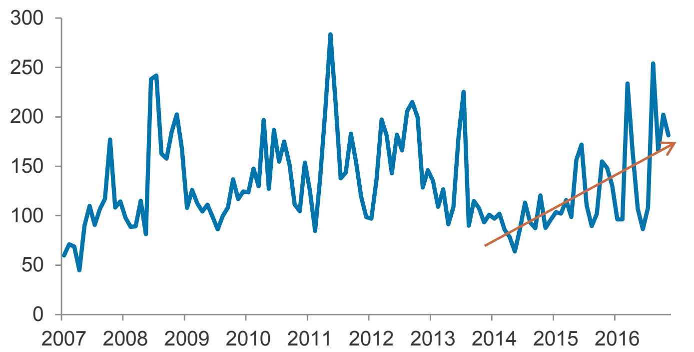
US consumer confidence and retail sales



Source: The Conference Board and Dept of Commerce

Our theme of US policy uncertainty this year is already playing out with the failure of the new US administration to pass its alternative to the Affordable Care Act (Obamacare) through Congress.

US Economic Policy Uncertainty Index



Source: Baker, Bloom and Davis

This is a timely reminder that just because the Republicans hold the trifecta of the White House, the House of Representatives and the Senate, the President may not be able to do everything he wants. In this case, it was the Freedom Caucus, a conservative faction of the Republican Party with sympathies with the Tea Party, that led to the legislation being pulled as in their view it did not go far enough.

While this is embarrassing for the President, we don't believe it has any significant implications for the President's pro-business and tax agenda, much of which will have the support of the Republican caucus, including the conservative faction. However, any fiscal stimulus looks likely to be delayed until 2018.

At the same time, however, rising policy uncertainty could, if it were to persist, be negative for business confidence and investment. We also worry about the impact of fiscal easing on longer-term US fiscal sustainability and the implications for the FOMC of fiscal easing at a time when the economy is already at full employment.

CHINA: NEAR-TERM STABILITY COMES AT EXPENSE OF MEDIUM-TERM SUSTAINABILITY

Our thesis through much of the China turmoil of recent years is that markets have been worrying too much. The reality is that since late 2015 the authorities have done an excellent job at stabilising the economy. But it appears to us the near-term stability has been at the expense of longer-term sustainability. In that respect the risk is that markets have become too sanguine about the outlook for China.

The Government needs to use the new-found stability to push ahead with the reform process. However, we don't expect much to happen over the remainder of this year. 2017 is a political transition year with the 19th Communist Party Congress scheduled for later this year. With that on the horizon, the Government is unlikely to risk further potentially disruptive reform.

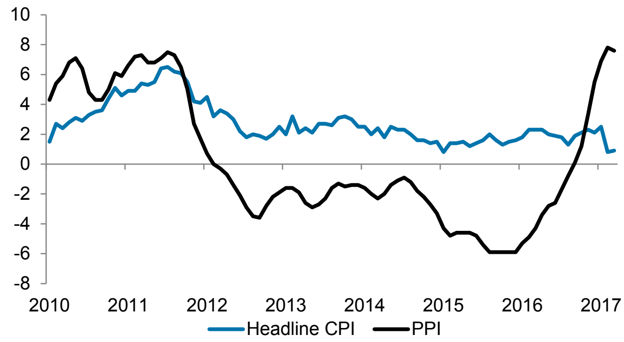
To be fair, the reform process has not ground to a halt completely, but it is certainly not running at the pace necessary to reduce the risk of a more painful adjustment down the track.

WE EXPECT THE REFORM PROCESS TO STEP UP AGAIN IN 2018 AND 'CHINA WORRIES' TO RE-EMERGE.

The China reflation picture is largely contained to producer prices, itself largely a function of the recent rebound in commodity prices. While this is good for industrial sector profitability, the economy still suffers significant spare capacity. The recent dip lower in CPI inflation was partly food related, and can be expected to reverse somewhat in the next month or two.

China Inflation

Annual % change



Source: NBS

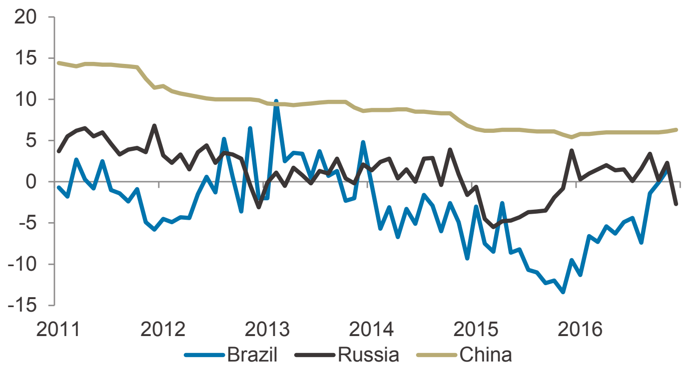
The improved activity backdrop certainly helps the reflation story in China, though given still significant excess capacity, we think the economy is still well short of the sustained upward pressure on core inflation a central bank would be concerned about. The People's Bank of China (PBoC) has been tightening money conditions since late last year, albeit gradually. This is more directed at financial sector risks, particularly in the housing market and a desire to stabilise the renminbi in the wake of US tightening. More aggressive tightening risks derailing the reflation story.

OTHER EMERGING MARKETS 'MIXED'

Emerging markets are staging somewhat of a growth renaissance. However, it's important to recognise this recovery is in large part contained to commodity export countries benefiting from the recovery in commodity prices.

Industrial production is on an improving trajectory in both Brazil and Russia, both countries having suffered deep recessions over the last two years. The most recent out-turn in Russia looks weak, but we put this down to statistical base effects rather than a renewed deterioration. Recent stability in China is also helping the emerging market picture.

Industrial production
Annual % change



Source: Bloomberg

Industrial production hasn't seen the same degree of uplift in those emerging economies more reliant on manufacturing, such as India and Turkey. In these cases, recovering commodity prices are contributing to higher production costs.

With respect to India, the economy has weathered the demonetisation storm well. GDP growth held up better than expected at the end of 2016 with stronger than expected household consumption. Furthermore, the reform process got a shot in the arm with a victory for the ruling Bharatiya Janata Party (BJP) in the Uttar Pradesh state elections. BJP now governs in 17 of 30 states, making for stronger central/state policy co-ordination.

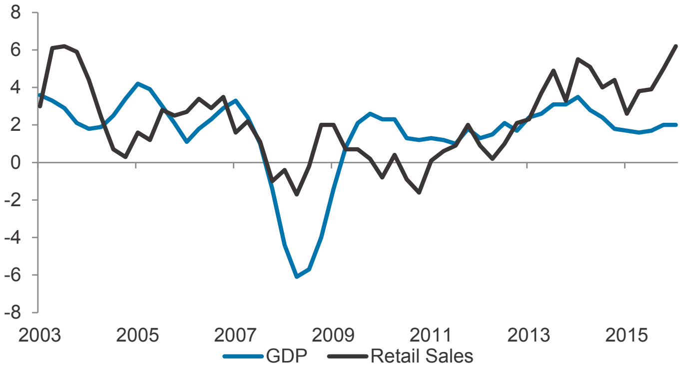
The end of recessions in both Russia and Brazil, along with stabilisation in China, is the main factor behind our expectation of aggregate emerging market growth of 4.5% in 2017, up from 4.0% in 2016.

BREXIT REALLY DOES MEAN BREXIT

The UK Prime Minister Theresa May has triggered Article 50 of the Lisbon Treaty. The UK now has two years to negotiate its exit from, and the new form of, its relationship with the European Union (EU). We wouldn't be surprised if this ends up taking longer than two years – the complexities are immense.

The UK economy has come through the immediate post 'Brexit' period better than feared, thanks largely to the upbeat UK consumer. Annual retail sales volumes reached in excess of 6% at the end of 2016, its highest level since mid-2004.

UK GDP and retail sales growth
Inflation adjusted, annual percent change



Source: ONS

The Bank of England recently revised up its 2017 GDP forecast to 2.0%. This seems a bit strong in our view.

THE EVOLVING BREXIT NEGOTIATION PROCESS, WHERE WE DON'T EXPECT THE EU TO GIVE AN INCH, WILL BE TOUGH AND A LIKELY DAMPENER ON BUSINESS INVESTMENT.

Also, rising inflation is likely to put a dampener on the recent strong retail sales volume growth. Indeed, more recent monthly retail sales reports have been on the soft side of expectations.

The UK will go to the polls on June 8th. We had been postulating the possibility of an early UK election late last year, but had gone increasingly cold on the idea more recently. To that extent, the PM's decision to go to the polls is a surprise.

The Conservatives are ahead in the polls and Mrs May is far and away the preferred Prime Minister, so in that sense the early election isn't a surprise. As it looks right now, the Conservatives appear likely to increase their small majority in the Parliament. But this election is three years ahead of schedule and there is risk of a voter backlash from election/referendum fatigue.

EUROPEAN POLITICS AND GEOPOLITICAL RISKS

Following the Brexit and Trump 'surprises', we have been keeping a close eye on three critical elections in Europe this year: in the Netherlands, France and Germany. The interest was in how well the populist Euro-sceptic party would perform and what that would mean for the stability of the Eurozone.

So far so good (assuming you are pro-Euro!!). The Dutch election came and went without much drama. The Euro-sceptic Freedom Party (PVV) had been polling as high as 20% in the lead-up to the election but achieved only 13% of the vote on election day. Prime Minister Mark Rutte's VVD remained the biggest party in a fragmented Parliament. A coalition is likely to be formed between a group of centrist pro-Europe parties, with Rutte remaining Prime Minister.

As polls had accurately predicted (we haven't been able to say that very often in the last 12-months!), National Front leader Marine Le Pen and En Marche! leader Emanuel Macron will run-off in the second round of voting for the French Presidency on May 7th. Polls have Macron comfortably ahead of Le Pen in head-to-head polling, but as always a week is a long time in politics and nothing is guaranteed.

A Macron victory would be positive for markets. He should be seen as moderately reformist and in favour of a stronger European Union and continued openness. That compares with Le Pen who wants to re-establish the French franc for domestic transactions and allow the Bank of France to print money to finance deficit spending.

Meanwhile, in Germany Angela Merkel's CDU party performed far better than expected in regional elections in Saarland recently. Current coalition partners CDU and Martin Schulz's SDP are vying for Bundestag supremacy with the leader of the largest party likely to become the next Chancellor. The Saarland result is a fillip to Merkel's chances of a fourth term.

Geopolitical issues have also come to the fore since our last report. At that time we thought the area of greatest tension would be between the US and China, and the US relationship with Russia would be somewhat more convivial. Of course things have turned out to be quite the opposite. President's Trump and Xi had a 'successful' meeting in Florida recently, while events in Syria have seen relations between the US and Russia sink to new post-cold-war lows.

North Korean sabre-rattling has intensified in recent weeks. It's hard to know where this goes, but we remain wary of an escalation of tensions and the impact this may have in markets.

GLOBAL INSTITUTIONS IN DEFENCE OF FREE TRADE

In our January edition of Quarterly Strategic Outlook we wrote of the risks to global growth from the anti-free trade, anti-globalisation populist political movements that contributed to the rise of Donald Trump and the UK's decision to leave the European Union. We said we were looking for the key multilateral institutions to lead the defence of the benefits of free trade.

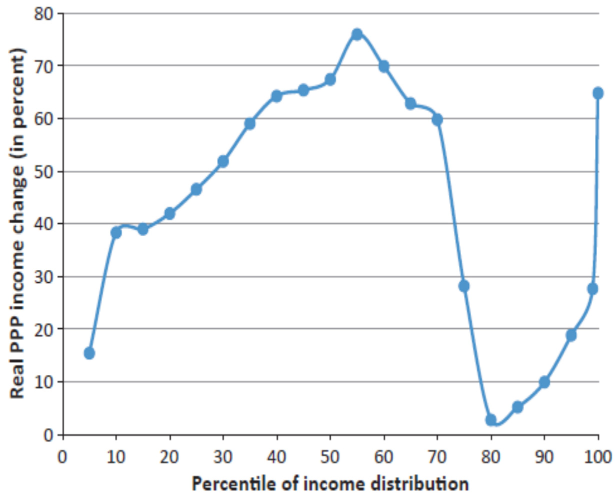
They are stepping up. In an unprecedented move, the International Monetary Fund (IMF), the World Bank and the World Trade Organisation (WTO) recently issued a joint report extolling the historical benefits of free trade, including higher productivity, greater competition, lower prices and improved living standards. Furthermore, a continued commitment to free trade is essential if we are to make further gains in those areas.

No disagreement from us here at AMP Capital.

THE REPORT ALSO HELPS DISPEL A MYTH: THAT GLOBALISATION IS TO BLAME FOR RISING INEQUALITY WITHIN MATURE DEVELOPED ECONOMIES INCLUDING THE UNITED STATES AND THE UNITED KINGDOM.

One of the most widely used charts of recent times is Branko Milanovic's so-called 'elephant chart'. We've used it repeatedly ourselves over the past 18 months to demonstrate the importance of globalisation and the rise of global trade volumes in the closing up of inequality BETWEEN rich and low & middle income countries.

Relative gain in per capita income by global income level 1988-2008



Source: Branko Milanovic - "Global Inequality"

Causality is always debatable, though the case seems pretty compelling to us. But some wags have taken things too far. Mr Milanovic's chart has also been used to decry rising inequality WITHIN countries and that globalisation is to blame. The causal link is at best dubious.

The report acknowledges that trade is not costless, but also notes the rise and rise of technology is more to blame for the loss of low skill jobs in mature developed economies than globalisation. We'd add to that the diminution of union power over the last two or three decades.

Importantly, the report argues it's the failure of domestic policy settings that has seen the costs of trade and technological change become entrenched. These factors include the general health of the broader economy, the rigidity of the labour market, other impediments to resource allocation and the adequacy of social protection policies.

The demise of free trade remains a key risk to the global outlook. Efforts towards greater protectionism will be counter-productive and end up hurting the very people policymakers are most wanting to help. Indeed, continued commitment to free trade along with appropriate domestic policy settings is the best recipe for increased prosperity.

The report can be found here. It should be required reading for all world leaders, policymakers and anyone who wants to understand more about globalisation and its consequences.

MONETARY POLICY ON HOLD IN THE ANTIPODES

The rebound in the Australian economy in the December quarter was broad-based across consumer spending, public demand, housing investment, business investment and trade. Economic data for 2017 has remained reasonable and stronger commodity prices are boosting income growth. However, growth is still fragile and inflation is still below the Reserve Bank of Australia's (RBA's) 2-3% target.

The RBA is likely to leave interest rates on hold given reasonable growth and concerns around the surge in Sydney and Melbourne dwelling prices. Further weakness in the Australian dollar is likely required to help lift non-mining business investment.

In New Zealand, the economy put in another solid performance over 2016, though growth disappointed at the end of 2016 as poor weather hit dairy production. The Kaikoura earthquake probably also had an impact as quarterly growth slowed to just 0.4% in the December quarter, the slowest quarterly growth rate in nearly two years. Annual growth slipped to 2.7% in December, down from 3.3% in the year to September.

But we're not getting negative on the outlook. To the extent that some of the weakness at the end of 2016 was weather related, there should be some degree of bounce-back in the March quarter of this year.

MORE GENERALLY, WE HAVE BEEN EXPECTING GROWTH TO SLOW OVER 2017 AND 2018, PARTICULARLY AS LACK OF SPARE CAPACITY INCREASINGLY CONSTRAINS THE ABILITY OF THE ECONOMY TO GROW.

We also believe the credit cycle is close to peaking as banks find it increasingly challenging to attract funding. The rising cost of funds for banks is already being demonstrated by recent increases in retail lending rates, despite the Official Cash Rate being on hold at the record low level of 1.75%.

But there are positives too. Despite some renewed weakness over the last couple of global auctions, dairy prices are well off their lows. The already higher terms of trade index is contributing to a rebound in nominal GDP growth. Construction activity is expected to remain solid for a while yet, household consumption is strong and net migration is yet to demonstrate the anticipated softening, so population growth will remain a significant contributor to growth in the near-term.

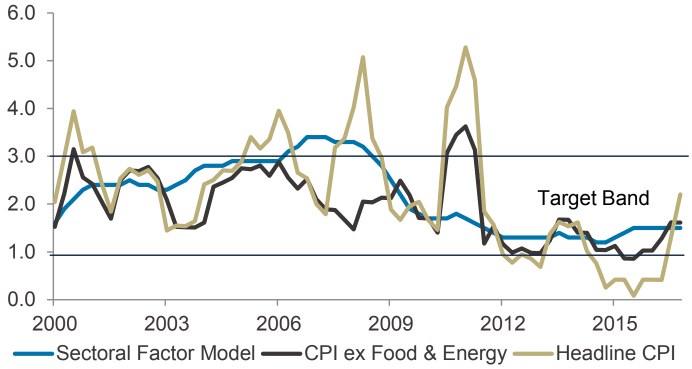
On the inflation front, we have seen a meteoric rise in inflation over the past six months as the annual rate of increase in the headline Consumers Price Index (CPI) has moved from 0.4% in the year to September 2016 to 2.2% in the year to March 2017.

TRENDS IN CORE INFLATION REMAIN CRITICAL FOR THE OUTLOOK FOR MONETARY POLICY SETTINGS.

On this front, the key measures for us are the Reserve Bank of New Zealand's (RBNZ's) calculations of inflation from their sectoral factor model and the CPI-less-food-and-energy. Both measures are steady at an annual rate of just under 2%.

New Zealand inflation

Annual % change



Source: Statistics New Zealand and RBNZ

Core inflation is grinding higher but is still well short of the level and trend that would have the RBNZ worrying about sufficiently robust generalised inflation pressure to start hiking interest rates. The latest data confirms a couple of things for us: we are at the bottom of the interest rate cycle, and that the RBNZ won't be able to wait until 2020 to raise interest rates.

That said, the timing of the first hike remains highly uncertain. We have the first hike in the Official Cash Rate pencilled in for mid-2018. This latest CPI result suggests the risk to that view is biased to earlier rather than later.

BEVAN GRAHAM
NZ Chief Economist

ASSET STRATEGY

The second quarter so far has been a period of relatively confident markets, following on from the strong developed market rally at the end of 2016. Equity markets across the board posted gains for the first quarter, with the emerging markets participating once again despite continuing global trade policy concerns. Both New Zealand and Australian equities also joined the rally, returning 4.6% and 4.8%, respectively, in the first three months of 2017.

The swathe of political concerns on both sides of the Atlantic have periodically given investors reason to pause and increase their exposure to the sovereign bond markets, which are still seen as havens despite the trend to higher yields that now appears entrenched. Broadly positive economic news in Europe and the US, alongside the improving corporate earnings outlook, are permitting investors to hold on to the 'growth reflation with low inflation' scenario, and to seek out assets that provide the highest exposure to the strengthening world economy.

ROBUST EMPLOYMENT GAINS ARE BEING TAKEN ABOVE ALL AS A BAROMETER OF HEALTHY ECONOMIES AND A SYNCHRONIZED INTERNATIONAL EXPANSION.

With European unemployment approaching an eight-year low, and industrial sentiment near to six-year highs, investors have finally acquired the confidence to buy more European stocks. This allowed the Eurozone markets to finally outperform, with a 7.2% return for Europe ranking ahead of both the 6.1% quarterly gain logged by the S&P 500 and the 4.0% rise in United Kingdom's FTSE All Share Index. The Dutch election, which saw the centrist government returned to power, has soothed nerves that a US-style swing to the isolationist right is probably not going to disrupt the Euro area this year, although much depends on the final Presidential vote in France on May 7th.

Japan has once again lagged, returning 0.6% for the quarter, as the positives of much-improved corporate earnings and exports have been more than offset by recent gains in the yen amid regional tensions.

Elsewhere in Asia, equity returns have been mixed, with India, South Korea, Malaysia and Indonesia outperforming the global index, while mainland Chinese shares continue to struggle as authorities are restricting leveraged trading as part of the attempt to lower financial system risk. We expect this attempt to restrain asset bubbles and forestall further bad debt issues in China could play a disruptive role either later this year or in early 2018. Having navigated a two-year period when market risks emanating from China were being over-stated, we think that the current market degree of complacency is also overdone. A China-centric credit shock could provide a wild card event to test the global equity rally, and ultimately result in a more attractive entry point for upgrading our exposure to Australasian equities, from their current neutral portfolio positioning.

MARKET PERFORMANCE Q1 2017

ASSET CLASS	31 MAR 2017	QUARTER	YEAR
CASH AND FIXED INTEREST			
NZ cash	2.00%	0.5%	2.3%
NZ bonds	3.19%	1.4%	1.0%
Global treasuries	3129	0.3%	1.4%
Global aggregate	375	0.8%	2.6%
DOMESTIC AND GLOBAL SHARES			
NZ shares	7197	4.6%	6.6%
Australian shares (AUD)	56653	4.8%	20.5%
Global shares (local)	3978	5.4%	17.2%
Emerging markets (local)	457	7.8%	15.1%
REAL ASSETS			
NZ listed property	1130	1.4%	-1.0%
Global property	1828	0.8%	4.1%
Global infrastructure	210	7.2%	13.5%
Commodities	66	-2.1%	10.1%
CURRENCY			
NZD / USD	0.699	0.2%	0.7%
NZD / GBP	0.559	-0.9%	15.8%
NZD / AUD	0.916	-4.9%	1.5%

FAVOURING EQUITIES AND INFRASTRUCTURE WHILE STILL CAUTIOUS ON BONDS AND NZD

We don't see a compelling case for significant changes to our current investment strategies, which have been proving successful. The main change we made during the March quarter, reflected in our new strategic asset allocation for the AMP Diversified Funds (ADFs), was to lower our exposure to the New Zealand dollar (NZD), by means of lowering the hedging level on our international equities holdings. We anticipate softness in the NZD, up until the point next year that the Reserve Bank actually begins increasing domestic interest rates.

Notwithstanding recent comments from President Trump, the appreciation trend for the US dollar should re-assert itself, given that no other developed market central bank is about to turn hawkish. The European Central Bank, the non-Eurozone European monetary authorities in Switzerland and the Nordics, the Bank

of Japan, and the Reserve Banks of Australia and New Zealand all remain accommodative and willing to 'look through' any short-term increases in inflation.

We also have a more neutral outlook for property (both global and domestic), albeit at a lower overall allocation level in the ADFs. Our higher cash weightings have been retained, as have our underweight allocations in both domestic and international fixed interest. Retaining a decent cash allocation provides flexibility to lift our holdings of other assets once greater value emerges. It is important to note that our cash stockpile is funded by low bond holdings, and thus does not restrict our participation in the continuing equity market rally. Portfolio positioning is now slightly more defensive, but this is due to lowering the allocations to property and commodities, which we consider the most vulnerable asset classes at present.

EQUITIES PERFORMANCE REFLECTS GOOD NEWS, BUT ALSO A LACK OF ATTRACTIVE ALTERNATIVES

AMP Capital sees share markets continuing higher over the next 12 months, helped by improving corporate earnings and still-fair valuations, economic optimism, and supportive global monetary conditions due to European and Japanese monetary stimulus. Overarching other concerns is the first synchronous global recovery since 2010, with both developed and emerging markets experiencing mutually-supportive improved growth. Price pressures remain in abeyance, for now.

A variety of indicators suggest that the risk of a shock to markets from an inflation surge remains very low. For example, US wage growth has been more muted than expected in spite of the sub-5% unemployment rate. This benign fact allows the US Federal Reserve to continue along a gently-gradated path for interest rates, rather than needing to tighten conditions rapidly. Fed Chair Janet Yellen recently noted that in the last two cycles, inflation did not surge even as the unemployment rate declined below what had been assumed to be the 'trigger level'. If that level is currently around 4.0%, the inference is that the US central bank will not be unduly concerned in allowing the expansion to continue, until unemployment falls into the mid-3% zone or wage growth (as a leading indicator of inflation) persistently rises above 3%. In this environment, fundamental support for equities can be expected to build further.

However, recall that another key support to global equity markets is the continued absence of value in other asset classes, particularly in bond markets.

EVEN IF BOND INTEREST RATES AROUND THE WORLD REMAIN HISTORICALLY LOW, ENTHUSIASM FOR THE SECTOR NOW TENDS TO DEVELOP MAINLY AT MOMENTS OF PERCEIVED CRISIS OR GEOPOLITICAL THREAT.

From the investors' viewpoint, there is little in the way of further capital gain to be expected from sovereign bonds, given the level of yields and the likelihood that the US Fed will trim its balance sheet and cease to re-invest in maturing securities from late 2017 or early 2018. Corporate bonds are still trading at record-low yield levels, implying a cloudless outlook, even as the credit cycle matures and heavy re-financing needs in 2018 move closer. This looks excessively optimistic.

Barring a major shock to global confidence, it is therefore difficult to see a resumption of a bull market in global sovereign bonds, or in credit generally. Five factors arguing against a 'return of the bond bull market' scenario are:

> Globally, inflation is on the rise. While this is extremely gradual in many markets due to the fact that they are operating below full capacity levels, the disinflation dynamics of the past decade are now wholly absent. Political populism (or, policy compromises to ward it off) add to inflation pressures. Higher minimum wages or 'special upward adjustments' in remuneration are becoming more commonplace. Fiscal initiatives (for example, new infrastructure contracts) are also likely to engender a greater sense that businesses have more pricing power, as governments tend not to be particularly price-sensitive when they have a greater goal in mind.

> Central Banks and politicians are more sceptical about the effectiveness of quantitative easing (QE) and negative interest rate policies (NIRPs.) Such policies have served their purpose in terms of stabilisation, but arguably at the price of producing asset bubbles, hurting bank profitability, intensifying wealth inequalities and mis-directing capital away from productive investment.

> Inflation expectations are too low. If as a rough guide, 60% of US inflation is a product of labour market dynamics and 30% the result of commodity price shifts, then the balance of risks is now clearly to higher future inflation risk. In more trade-dependent economies like New Zealand and Australia, not to mention China, weakening currencies add some further upside pressure.

> The US Federal Reserve is increasingly uncomfortable with carrying current levels of government and government agency debt on its balance sheet. The recent signalling that maturing bonds owned by the Fed will not be replaced, from some point later this year, removes a 'guaranteed buyer' from the bond market and should allow fewer distortions in the pricing of credit and inflation risk. That puts upward pressure on yields.

> Finally, there is considerable evidence that after almost a decade of market risk aversion and deflation concern, with an associated hunger for yield, an imbalance has developed in global portfolios toward fixed interest assets. As investors gradually re-position towards hedging inflation (rather than deflation) risk, it is likely that longer-term allocations to bonds will be trimmed.

An exception to that would be, if substantially more infrastructure bonds with government participation came to market specifically to finance new large-scale projects (eg ports and other transportation upgrades or power generation conversions.)

We would be keen to see that market develop to kick-start the overdue projects across the world, but so far there have been only tentative signs of this. In the absence of any trend to higher-yielding but less risky debt issuance, which could be taken up by the wave of retirees from the baby boom generation, equities are set to be the favoured investment option for both institutions and individuals, as we potentially approach a more inflation-tolerant era.

CLIMBING THE REFLATION STAIRCASE

We still anticipate the expectation of rising US government bond rates to continue pushing up other countries' long term yields and underpinning an uptrend in the US dollar. However, as outlined last quarter, these market moves will resemble a 'staircase' rather than a 'ski-lift'. In other words, it will proceed in steps, with quite extended periods of sideways markets punctuating bouts of upward repricing. At times, there will be phases of concern which will temporarily interrupt the broader trends. However, we are convinced that reflation is well underway. For reasons of economic synchronisation, political expedience and monetary normalization, the associated asset classes (equities and listed infrastructure) will continue to outperform.

We also expect higher bond market volatility, firm (but not sharply higher) oil prices, and potentially, some fragility in the exchange rates of the world's more indebted commodity-producing economies.

Geopolitical and trade policy tensions will doubtlessly disrupt markets from time to time this year, so we expect bouts of volatility within a broadly supportive macro environment. So far, emerging markets have managed to avoid being caught up in sharp US trade policy shifts because the new President's review of the causes of the US trade deficit has only just begun. If the second half of 2017 brings a more aggressive stance from the Trump administration, we would expect their equities to show vulnerability, particularly because the main adjustment mechanism for an exporting emerging country in difficult times is through a lower currency. In principle, this should boost earnings but that is only meaningful if trade access to the developed end-market is not disrupted. This can no longer be taken for granted.

While emerging markets are now undervalued, economic and earnings momentum are not yet really supportive. We believe the potential upside to be earned from this volatile segment of the equity universe is insufficient to build up significant exposure as yet. However, while we hold a neutral weighting at present, we could look to lift our exposure if the US dollar resumes its strengthening track and triggers a bout of profit-taking in key emerging markets. Until Chinese equities adjust lower as domestic credit support is ratcheted down, the value to be had in the emerging markets complex is probably not worth the risks that would be incurred to obtain it.

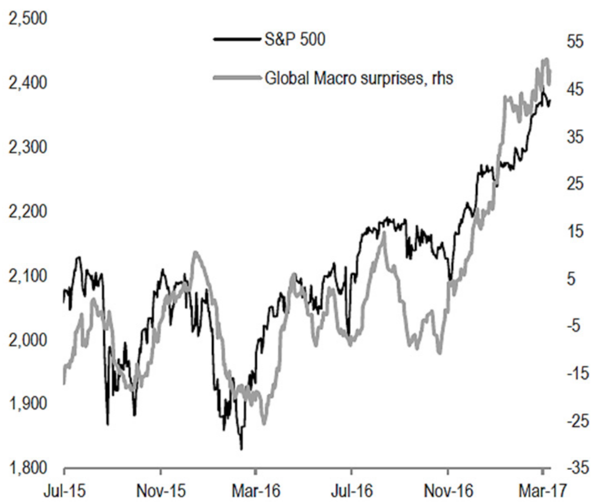
As expected, assets that acquired rich valuations in recent years as global interest rates ground ever-lower, such as commercial property and lower-rated bonds, may face a difficult year. While investments offering a decent yield advantage above government bond yields will still attract interest from investors, the advantage of holding potentially more volatile or vulnerable assets is being eroded, as the yield component of returns on liquid, cash-equivalent assets is now improving.

The global hunt for yield is both gently weakening, and becoming more selective in respect of underlying asset quality. While it won't happen overnight, waning demand for yield from riskier assets like corporate bonds and dividend-paying stocks, combined with mounting wage pressures, would be expected to see companies incrementally replacing share buy backs and high dividends with a phase of substantial capital expenditure. A capex boom would reinforce economic growth in the countries concerned, and build more resilience into their corporations' profit outlook, with productivity gains lowering the impact of higher wage and salary costs.

AMP CAPITAL BELIEVES THESE MAIN MARKET TRENDS WILL CONTINUE BECAUSE THEY REFLECT A SHIFT IN THE GLOBAL ALLOCATION OF CAPITAL, AND A SUNNIER MACROECONOMIC PERIOD AHEAD, ACCOMPANIED BY A GREATER APPRECIATION OF INTEREST RATE RISK.

We therefore resist chasing sentiment-driven shifts over short timeframes, because these remain heavily influenced by media speculation and the political fear-and-relief cycles which are only likely to intensify in this election-heavy year.

US equity market reflects a more positive global picture



Source: AMP Capital. Thomson Reuters, Credit Suisse

ON THE ALERT FOR EQUITY MARKET DANGER SIGNS

We are paying attention to the following forces that could provide a setback in world equities. We are still not at the stage of predicting that one or all of these threats will materialize, but believe late 2017 is quite likely to see market setbacks (but not a bear market) which will provide better entry opportunities for deploying our cash.

Some risks are:

> As election risk subsides in the fourth quarter, or even in anticipation of this, equity markets could enter a phase of euphoria. A buying climax would benefit investors short-term, but would be highly vulnerable to bad news (eg earnings disappointments, emerging market debt shocks, geopolitical crises).

> Bond yields could rise too far: yields are at present expressing a vote of confidence in growth, but if, for example, the US 10-year yield were to move up beyond 3.0%, it would begin pressuring corporate earnings growth and undermine equities' valuations and corporate share buy backs.

> China is restraining leverage and could tighten up policy following the 19th Party Congress in October/November.

> The Brexit process could de-rail, or become more acrimonious than currently foreseen.

> Corporate-positive initiatives proposed by the US administration (such as making it more advantageous to repatriate profits from offshore subsidiaries, and tax cuts) may not eventuate as quickly or in the form that markets are hoping for.

> The 'excess liquidity' that normally accompanies global bull markets is growing less rapidly, and historically such a cooling often precedes a substantial market correction by between 12 and 18 months.

> Credit spreads, which have provided a fairly reliable 6-9 month advance warning of developed equity market reversals, have only just begun ticking up from record lows. This shows that markets still expect minimal corporate defaults, despite high levels of corporate leverage. Any re-assessment of that view would be (at least, temporarily) disruptive to the rally. A sharper jump in spreads – for instance, into the 3%-4% range – may suggest the top of the eight-year bull market is pending. This development would boost the probability of a US recession emerging in the course of 2019.

However, US policy initiatives during the interim have the capacity to delay the end of the expansion and thus, extend the bull market. Given the Administration's willingness to favour industrial sectors chosen for political reasons, we would expect to observe ever-narrower market leadership with ever-fewer sectors participating. A classic reduction in market breadth, accompanied by an inflationary growth environment, would be a compelling warning signal, which we might provisionally anticipate for the early months of 2019 as the post-GFC recovery market approaches its tenth anniversary.

US BBB-rated corporate yield spread (%)

Source: Bank of America Merrill Lynch, St. Louis Federal Reserve

EVENT	POTENTIAL IMPACT	SIGNIFICANCE	PROBABILITY
Intensification of dysfunction in various branches of US government as 2018 Congressional Election nears	Issues with debt ceiling; Fed independence; court challenges to policies etc.	High	Medium
European elections in 2017: France Apr-May, UK June, Germany September	Who might leave the European Union next?	High	Low
Ongoing IS terror threat, or Russia/ US frictions spiking	Disruption	Medium	Medium
South China Sea escalation or Iranian/North Korean missile or warhead mishap	War	High	Low-Medium
Trade war with US and China	Economic disruption	High	Low-Medium

Source: AMP Capital

IMPLICATIONS FOR INVESTORS

As we expect re-assertion of the dominant market trends we identified at the beginning of this year, there are few changes to the implications for investors which are:

> Improving economic growth around the world will generally support equities and challenge bonds, because this growth is more 'traditional' in nature – arising from better employment and demand and thus allowing prices and potentially, profits to rise. An additional traditional growth source – capital spending and business investment – should also kick in over the next two years. Growth opportunities are now a key focus for our investment selection.

- However, the diminishing 'artificial' component of growth – the part generated in recent years by extreme monetary stimulus, both via interest rates and quantitative easing – means that global interest rates need to rise. Central banks are less willing to buy up additional large tracts of the bond market to keep credit ultra-cheap. Yield enhancement is still a valid approach, but becoming more selective about avoiding undue credit risk is vital.
- The path to higher rates has begun in the US, and eventually (over the next 18 months), Australasia and the UK will follow suit. This path can be interrupted from time to time by market shocks, but a jagged upward course for yields is now the most likely trend. Caution is therefore warranted in investments that rely on low interest rates, particularly property but also debt-funded corporate mergers.
- The US dollar will tend to strengthen further, and if this occurs alongside equity market strength it would attract capital inflows to North America. New Zealand investors should embrace more international currency exposure, and we are actively seeking foreign exchange diversification.
- New Zealand and Australian assets and industries that have benefited from Chinese capital outflows and 'offshoring' of wealth will need to adapt to a higher degree of regulatory restriction and scrutiny.
- Growth-oriented shares that earn profits from consumer demand and demographic, technology or medical trends (ageing, migration, IT security, internet retail, healthcare reform) can perform better than defensive shares with high dividend yields. Those 'bond proxy' shares will become less attractive as the yields on government bonds progressively increase. Governments adopting substantial fiscal stimulus at a time of high existing sovereign debt will add to the upward pressure on interest rates and reinforce this trend.
- Once governments decide where to concentrate the stimulus (eg building infrastructure, subsidising housing, increasing benefits, or lifting military outlays), associated sectors of the share market will respond quickly as their profit outlook improves.
- The global oversupply of commodities will only slowly diminish, so expect raw materials prices to move in a band, rather than to rally strongly. Sentiment on China is currently resilient but any trade friction or sharp move in CNY/USD would undermine recent gains in industrial metals. Credit restrictions could trigger asset weakness.
- There is still too much debt in the world, contributing to sluggishness. Governments (especially those with unorthodox leaders or facing new situations like the US and UK) may be tempted to deploy inflation-boosting policies as a means of lowering the future debt-servicing burden. We could be in store for a challenge to the set of assets that are conventionally viewed as risk-free (developed country government bonds.)
- Finally, it is prudent not to chase well-developed market rallies, even when immediate risks are not apparent. Holding an uncommitted cash buffer is of considerable value because of the scope it allows for re-entering markets at those (inevitable, if not imminent) moments of distress. While cash yields remain low, the yield premia available for taking on bond duration risk is barely adequate, and the income benefit available from hedging international portfolio returns back to NZ dollars while still positive, is shrinking. We would contemplate lowering our cash allocation in the event of compelling value emerging, but not simply in order to take on more investment risk in the hope of squeezing minor additional returns from the still-expensive global debt markets.

GREG FLEMING
Head of Investment Strategy

CONTACT US

If you would like to know more about how AMP Capital can help you, please visit www.ampcapital.co.nz or call us on 0800 400 499