INVESTMENT BRIEF

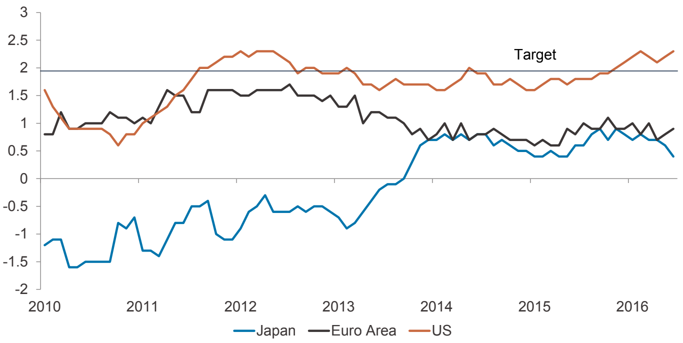
AUGUST 2016

Global equities delivered positive returns over the month of August. It marked the sixth month this year that emerging markets have outperformed their developed market counterparts, outstripping them by 7% year-to-date. The New Zealand share market marginally outperformed the global market, with the S&P/NZX 50 Index returning 0.7% over August. Global bonds were mixed over the month, with movements in yields dominated by the regions' central banks. Similarly, New Zealand bond yields were mixed over August as the RBNZ cut the Official Cash Rate to a record low of 2%. The New Zealand dollar continued to rally despite the RBNZ not meeting market expectations of a more aggressive interest rate track.

1. Monetary policy

Mind the gap: core inflation

Annual % change



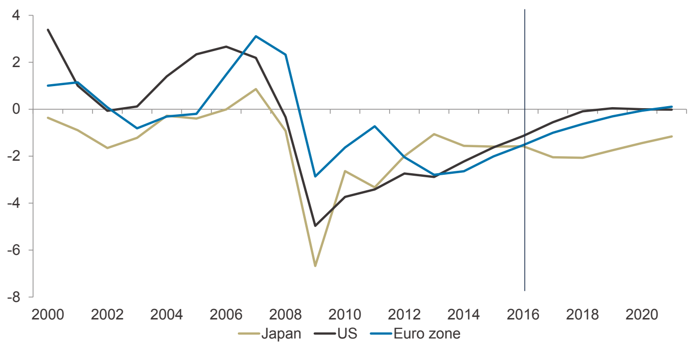
Source:Eurostat, METI, BLS, AMP Capital

- At the annual monetary policy symposium at Jackson Hole, Wyoming, some big questions were being asked, including the current efficacy of monetary policy, the ability of monetary policy to be effective in the future, and whether the current widely accepted approach to inflation targeting may have run its course.
- In our view not enough attention was paid to the bigger issue of the extent to which monetary policy needs to work in conjunction with other policies (fiscal, structural) to achieve higher growth and mandated levels of inflation.
- It is no accident that the country that is closest to closing its output gap and achieving its inflation objective, the United States, is the only major developed economy that did not implement some form of fiscal consolidation post the Great Recession.

2. Output gaps still matter

Spare capacity

Output gap as a % of potential GDP



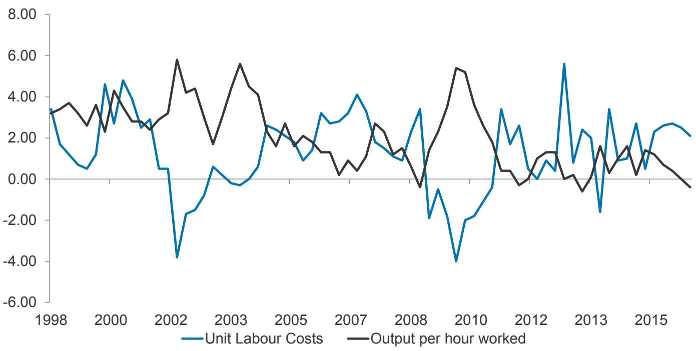
Source: IMF

- Over the past few years, much has been made of the global nature of the disinflationary/deflationary forces at play. This has largely been attributed to global spare capacity, exacerbated by commodity price weakness.
- Short of some more formal framework for policy co-ordination at the country level, central banks have been left to deal with large and persistent output gaps on their own.
- These output gaps have, in many cases, been exacerbated by fiscal austerity measures. As an example, the Eurozone output gap was closing rapidly following the recession, only to widen again as front-loaded austerity was implemented during the sovereign debt crisis. That gap has been harder to close through just monetary policy endeavours.

3. Productivity and trend growth

US productivity and Unit Labour Costs

Annual % change

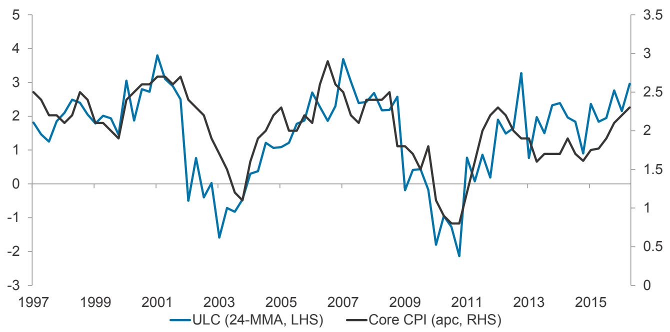


Source: BLS

- Standard cyclical theory tells us to expect that as an economy reaches full employment, labour becomes more difficult to find, wages rise and firms then turn to investment to resource the growth in their businesses.
- The unemployment rate is now down, or close to estimates of full employment and recent labour market survey data suggests it is getting harder to find skilled labour. So it's about now we expect business investment to rise and labour productivity to improve.
- That expectation is on the assumption that much of the recent weakness in labour productivity is cyclical. It is a bigger problem if it turns out to be structural.
- If it doesn't recover the theory is that firms will continue to grow earnings with cost cutting, which will mean job layoffs and potential recession. While a risk, at the very least the problem of the last seven years (low growth, low inflation) could be replaced with a new one (low growth, high(er) inflation).

4. So what does this mean for US interest rates?

US Unit Labour Costs and inflation



Source: BLS, AMP Capital

- Weak productivity growth and a tightening labour market are putting pressure on costs. Unit labour costs are up 2.1% over the past year, and is pointing to a continued trend higher in inflation that the Fed won't be able to ignore for much longer.
- That means the Fed may need to get on with interest rate normalisation sooner rather than later. It seems the primary reason they won't hike in September is that the market isn't expecting it. We expect the next move in December.
- While we will see the next hike in the Fed funds rate soon, the expectation that the neutral rate is lower than in the past means monetary policy is less stimulatory than previously thought. The upshot is we are looking at a much shallower interest rate cycle.

5. The USD, the CNY and EM currencies

USD/CNY

Spot

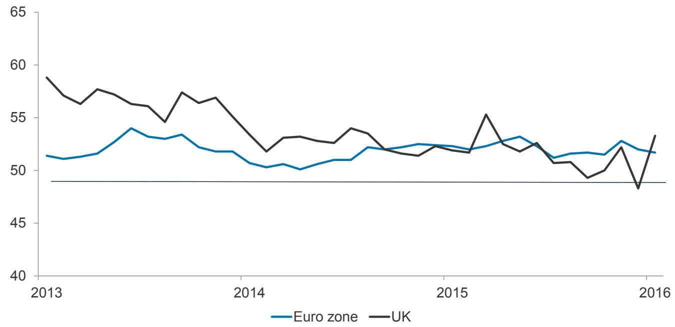
Source: Bloomberg

- Resurgent strength in the US dollar remains a risk for emerging market sentiment, but things are a bit different from August last year and the start of this year:
  - Emerging markets are looking fundamentally stronger now.
  - There is an understanding that the Fed isn't going to do anything that will upset/unsettle global economic and financial conditions.
  - There is less concern about the gradual depreciation in the Renminbi. That's because there is now a bit more clarity around People's Bank of China's intentions towards the Renminbi and their view that they don't see the need for a significant depreciation. The Chinese economy itself has also stabilised more recently.

6. Eurozone and UK post brexit

Manufacturing PMIs

Index, seasonally adjusted

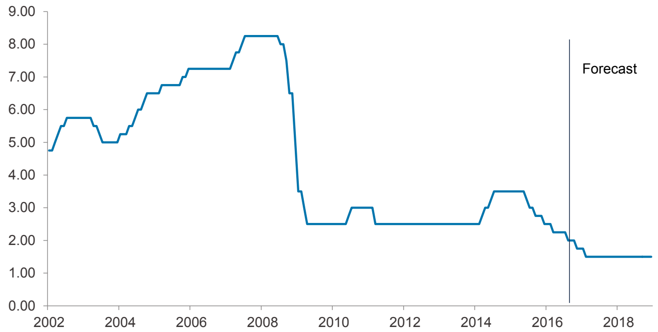


Source: Bloomberg

- Data has held up well in both the Eurozone and the United Kingdom post-Brexit. The biggest impact was always going to be in the UK itself, but there activity data is surprisingly upbeat, albeit after an initial wobble.
- Latest manufacturing PMI indicated a strong bounce back following a dip after the referendum, with the July reading the highest since October last year.
- The strength in retail sales was unsurprising given a third of the population didn't vote, another third of the population (those voting to "Remain") were disappointed in the outcome, while the final third (the other half that voted) were quite happy!
- The UK may come through the immediate post-Brexit period in better shape that expected and not slip into recession, but the medium-term implications for the UK economy are still negative.

7. RBNZ cuts in August, more to come

NZ Official Cash Rate



Source: RBNZ, AMP Capital

- Despite the solid growth outlook, strong housing market and risks to financial stability, persistently low inflation saw the RBNZ cut the Official Cash Rate to a new historical low of 2.0% in August.
- Low inflation remains a function of both external (weak global inflation, low commodity prices, high exchange rate) and domestic (subdued wage growth) factors.
- The RBNZ is concerned that low inflation becomes entrenched through the impact of persistently low inflation outcomes on inflation expectations. It has flagged further cuts are likely and the market is currently pricing two 0.25% cuts – one in November this year and a further cut early next year.
- To counter the financial stability risks associated with low interest rates, the Bank has announced further macroprudential limits on housing investment effective from 1 October.

MARKET COMMENTARY

GLOBAL SHARES

Global equities delivered positive returns over the month, with developed markets gaining 0.4% while emerging markets rallied 2.8%. The month of August marked the sixth month this year that emerging markets have outperformed developed markets, and are now outstripping their developed market counterparts by 7% year to date. The Bank of England helped push markets higher at the start of the month by cutting rates aimed at stabilising the economy following the Brexit fallout. The UK's FTSE 100 returned 1.7% over the month. US shares were flat over the month as the expectation for a Fed rate hike ramped up. Japanese shares (as measured by the Nikkei 225) finished 2.0% higher, while the MSCI China Index rallied 8%. The latter was helped by further steps towards market liberalisation as the Chinese government approved a linkage between the Shenzhen and Hong Kong stock exchanges. This will allow foreign investors greater access to the domestic Chinese market. Authorities are also planning on removing the limits on how much foreigners can invest in the country's stocks.

NEW ZEALAND SHARES

The New Zealand share market marginally outperformed the global market, with the S&P/NZX 50 Index returning 0.7% over August. Gains were again broad-based with only 17 stocks in the top 50 producing a negative return. Summerset led the market forward, gaining 16.6% after the company announced its first-half earnings which beat market expectations. Fletcher Building was the strongest performing large cap stock, rallying 9.4% after reporting a solid full-year result. Small cap stocks outperformed large caps, rallying 2.8%.

NEW ZEALAND LISTED PROPERTY

The New Zealand listed property index returned 1.3% over August to outperform the broader domestic equity market. CDL Investments' share price rallied strongly over the month, gaining 16.4%. The gain was primarily driven by its interim result released early August. The result showed a strong increase in both revenue and net profit following a period of elevated section sales.

GLOBAL BONDS

Global bonds were mixed over the month, with movements in yields dominated by the region's central bank. As anticipated, the Bank of England cut rates in August, however it was the total package that surprised the market. The central bank's stimulus package included adding to its quantitative easing programme and introducing a corporate bond buying programme. Its forward guidance also flagged the possibility of additional easing if required. This saw the yields on the UK 10-year gilt fall to record lows. Yields in the US moved higher following Janet Yellen's Jackson Hole speech which reinforced the message that the Fed is gaining more confidence about resuming rate hikes. Yields on the US 10-year Treasury closed the month at 1.58%, up 13 basis points over the month.

NEW ZEALAND BONDS AND CASH

New Zealand bond yields were mixed over August despite the Reserve Bank of New Zealand (RBNZ) cutting interest rates by 25 basis points (bps) to an all-time low of 2.0%. The RBNZ clearly under-delivered with some market participants expecting a 50 bps cut or a more aggressive interest rate track. The 90 Day Bank Bill yield ended August 5 bps lower, while the 10-year NZ Government bond yield ended up 3 bps, both finishing at 2.24%.

COMMODITIES

Unlike most asset classes, the Bloomberg Commodity Index produced a negative return over the month, ending down 1.8%. The index was led lower by the decline in the agriculture sector, particularly cotton and wheat. Brent crude moved from a bear market to a bull market in the space of two weeks as its price surged following the possibility of an OPEC output cap. This was short-lived as the price of oil fell over the second half of the month following Iraq's announcement it would boost production by 150,000 barrels per day.

GLOBAL LISTED PROPERTY & INFRASTRUCTURE

Both global listed property and global listed infrastructure ended the month lower, with the former declining 2.4% while the latter declined 2.2%. The lower beta, yield sensitive asset classes underperformed the broader market with rising bond yields (particularly in the US) making the asset class less attractive.

NEW ZEALAND DOLLAR

The New Zealand dollar (NZD) continued to rally despite the RBNZ cutting the Official Cash Rate to a record low of 2.0%. The RBNZ failed to meet market expectations with the NZD finishing up 1.9% on a trade weighted basis. Over the month the NZD strengthened 0.7% against the US dollar, finishing at 0.7250.

	AS AT 31 AUGUST 2016	CHANGE OVER THE MONTH (%)	CHANGE OVER THE YEAR (%)
MSCI - US	8560.96	+0.2	+12.0
MSCI - UK	13251.09	+1.5	+12.8
MSCI - Germany	3318.56	+2.4	+3.3
MSCI - Japan	1685.02	+1.3	-11.9
S&P/NZX 50	7398.83	+0.7	+30.8
MSCI - World (local curr.)	5098.16	+0.5	+7.0
MSCI - World (NZD)	9251.61	-0.6	-6.1
NZ Official Cash Rate	2.00	-25 bps	-100 bps
NZ 90-day bank bill yield	2.28	0 bps	-64 bps
NZ 10-year bond yield	2.25	4 bps	-102 bps
US 10-year bond yield	1.58	13 bps	-64 bps
NZD-USD	0.725	+0.7	+14.4
NZD (TWI)	77.5	+1.9	+11.5
NZD (MSCI weighted)	79.9	+1.0	+14.0