MONTHLY ECONOMIC ROUNDUP

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Our View

Companies in New Zealand and abroad continue to enjoy strong profit growth, which is good news for equities (shares) and commercial property. Despite very good returns over recent years, in general, equity markets remain reasonably valued. We are starting to see the robust economic environment feed through to higher commodity prices, wages, and inflation. This means interest rates are likely to increase over coming years. This is not a bad thing as our economy does not need ultra-low interest rates to support growth. But unfortunately, New Zealand households have taken on very high levels of personal debt, mostly to buy into very expensive housing. This creates a risk to our economy, and the Italian drama shows us that rate rises can have serious consequences when debt levels are high. A global trade war is also a concern, but hopefully, the awareness that no one wins will keep politicians in check.

JUNE FEATURE

Trade Wars

President Trump followed through on his promise to introduce a 25% tariff on steel and a 10% tariff on aluminium on the EU, Canada and Mexico. This move was widely condemned both globally, and in the US, even by members of the Republican Party. Of course, the EU, Canada and Mexico have responded with their own tariffs. Canada and the EU are also challenging the Trump Administration's tariffs at the World Trade Organisation (WTO), which sets the rules of global trade that all WTO member countries must abide. The US is also threatening China with further penalties on its trade unless it opens its market further to US exports.

As the saying goes, an eye for an eye will leave everyone blind. There is little doubt that the gradual move towards freer trade over the past few decades has been key to raising national and global prosperity, at least in general. Since 1970 around 3 billion people have escaped living in extreme poverty, as countries such as China have become part of the global trading system. A trade war risks this progress. A significant increase in tariffs and other anti-trade measures would disrupt global supply chains, raise prices for consumers and firms, reduce productivity and innovation, and ultimately depress growth and living standards.

Could a trade war impact the value of shares, property and bonds? A key aspect to focus on is how the challenge to the US tariffs plays out at the WTO. Trump has threatened to leave the WTO, and if this happened a trade war would certainly escalate. At this stage market valuations suggests such a scenario is very unlikely. The tariffs that the EU and Canada have applied are focussed on hurting Republican-held States in the US. And the US knows that China is not powerless by any means as they are a very large lender to the US. The US deficit was quite large before Trump's spending decisions, and now this much larger deficit needs to be funded. A large portion of this is done by China buying US Bonds (known as Treasuries). If China were simply to slow the pace at which they buy these, then the price of Treasuries would rise, meaning US interest rates would increase. Under this pressure, it is not hard to see public sentiment changing, and unlike China, the US President faces a public test every four years at the ballot box.

Even if the ripples don't escalate too far it is clear the world has changed. Brexit, the 2016 US election and the recent Italian election are indicators that many people are not happy with where things are. Some commentators are suggesting that globalisation has hit its peak and that the pendulum is due to swing back the other way. On the other hand, New Zealand will face significantly reduced trade barriers over the next decade due to the ratification of TPP (ex-US) and the negotiation of a free trade agreement with the EU – a real prize for our economy given the EU economy is larger than the US economy. Our view is that odds continue to favour risk assets like shares given this, and the robust economic environment we are currently in.

KEY FACTS

Events

- The first budget of the new Labour coalition government was given on May 17. There were few surprises and most economists viewed the Budget as fiscally prudent. A new 12.5% tax credit for eligible R&D spending, that will apply from April 1 next year, received broad business support.
- Markets were roiled and interest rates on Italian government bonds spiked when a new coalition government in Italy was proposed, with a finance minister in favour of ditching the Euro. In response, the Italian President threatened to veto the coalition. Markets calmed down when the coalition parties settled on a finance minister less hostile to the EU.
- The Trump Administration announced that a 25% tariff on steel and a 10% tariff on aluminium will apply to the EU, Canada and Mexico from June 1st. See our May Feature for discussion.

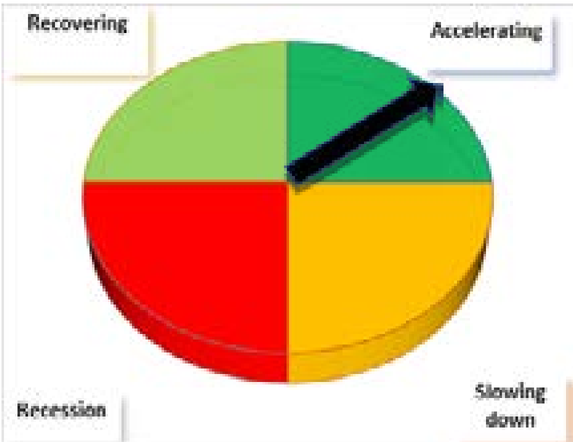
Economics

- All 24 economies that are members of the MSCI developed equity markets index are currently growing, as are the 26 economies that make up the MSCI emerging market index.
- Global real GDP growth is currently running at around 3.8%, well above the 2.5% level experienced on average over the past decade. The OECD expects global growth to accelerate further in 2019. New Zealand GDP growth is currently running at around its long-term trend of 3% per annum.
- Inflation remains below central bank target levels in most OECD economies and interest rates are still on hold at very low levels. The US is the notable exception, where their central bank increased short-term rates to 1.75% in March, and more rate increases are expected this year.

Markets

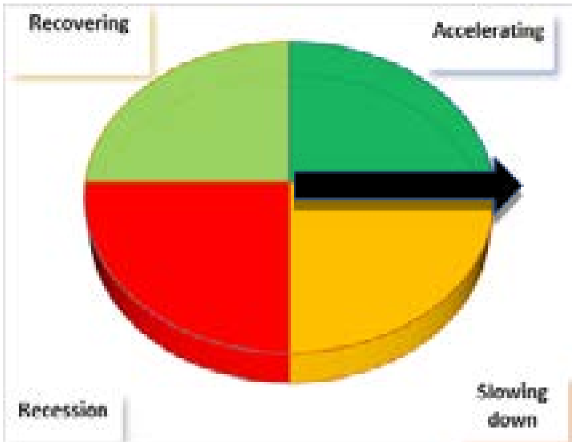
- The NZ, US and UK equity market was up around 2% for the month of May, Australian and Emerging Markets were flat, while European and Japanese markets were down around 1%.
- Oil prices finished flat for the month of May at around $67 US per barrel.
- The NZ dollar was also flat against its main trading partners, declining around 1% against the AUD and USD, but increasing around 2.5% against the Euro and British Pound.

Figure 1: Global growth is accelerating



Source: MyFiduciary, OECD

Figure 2: NZ growth is around trend

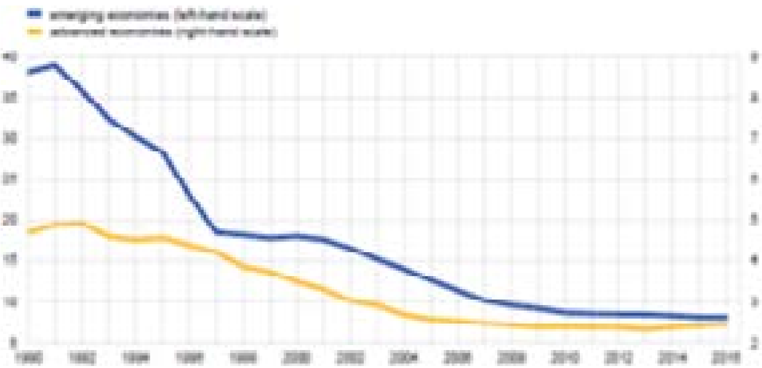


Source: MyFiduciary, Statistics New Zealand

Figure 3: Risk to growth and markets are moderate but event risk is material

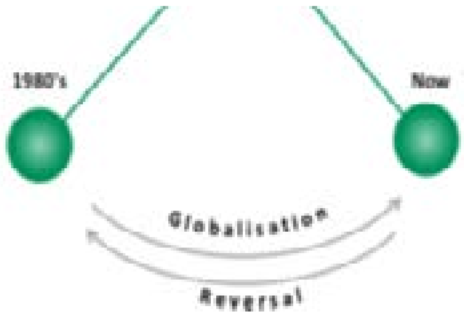
Source: MyFiduciary, BlackRock Market Risk Monitor

Figure 4: Average tariff rates are now low major economies…



Source: World Bank, ECB calculations of simple average tariff rates across the 14 largest developed and emerging market economies in the world

Figure 5: But is the globalisation pendulum swinging back?



Source: BNP Asset Management