

# Economic Update January 2017



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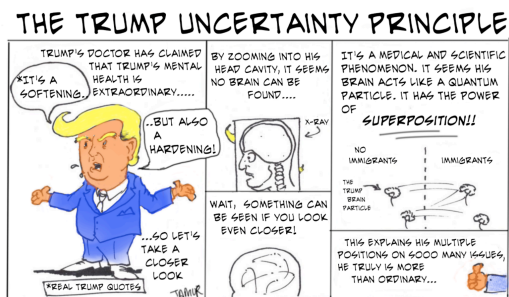
***"If you have one economist on your team it's likely that you have one more than you'll need."***

**Warren Buffett**

Because it's the summer break I have departed from the usual format and kept this update brief so that you can get on with other more important things like attending to the barbecue and catching up with friends and family (or going to work).

## The Global Economy

read this the US dollar may have recovered from this comment however it highlights his lack of experience.



*Usually, markets very much dislike uncertainty. As investors in good businesses, we don't mind so much because that means better buy prices for us.*

**Donald Trump has already had an impact on markets as evidenced by** currency and share price fluctuation. He is not afraid to upset people. He doesn't mind if those people are the Chinese government either! His favourite tool seems to be Twitter. Without doubt he has a different approach. But then, is this anything new? Dwight Eisenhower was the first president to take advantage of television as a way to communicate with people en masse. More recently Barack Obama made good use of social media including Twitter. It appears though that Donald Trump has little regard for off the cuff comments and the impacts they can have. For example his recent comment suggesting that the US dollar was too high sent the US dollar in a limited but sharp downward direction real quick. By the time you

- **Donald Trump and a few short-term policy adjustments will likely have little impact on the American economy long term.** That is because the American economy is a significant system that will ebb and flow in the short term but continue on its growth path longer term all things equal. Even though it has a significant amount of debt, the levels of debt whilst less than ideal are manageable providing ongoing growth can continue. America inc. still has options.
- **In the short term however,** infrastructure investment, possible tax cuts and bringing some businesses back to America would indeed be positive and somewhat stimulatory for the US economy. Also, the US Fed would likely get on with further interest rate increases which would have a flow on effect around the world including New Zealand. Other factors in the US such as solid employment, minimal although some wages' growth, some anecdotal evidence that manufacturing in America is growing ever so slightly, along with other factors suggest that despite the fragile state of the global economy, the US economy continues to muddle through in a relatively stable fashion and is growing.

- **Monetary policy continues to be an important factor** with interest rate rises in the US underway and further interest rate rises signaled for 2017. Central banks not only in the US but in other parts of the world have distorted interest rates which have in some countries reached historical lows. The UK is one example. Value Investors can use long term interest rates as a comparison to other investments in order to assess risk. With the recent distortions, risk assessments have been interesting to say the least. There is the possibility as interest rates rise that market prices may face headwinds however for those who are patient, the underlying strength of a good business will still see that business grow and ultimately the short term pricing fluctuations become less and less meaningful. The economic world does not know much about price and value being different things. Fortunately you and I do. In short, usually rising interest rates put downward pressure on assets.

*"You can't tell who's swimming naked until the tide goes out."*

Warren Buffett

- **The above comment by Warren Buffett many years ago** is referring to the underlying quality of assets. The point here is that when market conditions become challenging we had better be in quality assets otherwise we might be in for an unpleasant surprise.
- **Technology disruption** is becoming more mainstream conversation. For example one concern has been that the machines will take over and many people will therefore be without jobs. Although it is always difficult to predict what goes on in the future, we have seen technology disruption in the past. There are lots of examples. At the same time there will be investment opportunity and whilst I remain cautious about start up new technology companies that seem like the best idea ever, established businesses that actually make money and have good economics is an investment opportunity worth considering for our portfolios. To be clear though, it is not the new idea that I would be interested in investing in, but rather the sustainable competitive advantage, the brand strength and eco-system inherent within that business. Whilst companies like New Zealand's own Xero have been useful for those who were in early, the reality is that Xero makes the news because it is so rare. Technology disruption is well underway and yet it has a long way to go. It may well impact in a negative way on those whose skills can be replaced by robots and machines. For investors there will be opportunity.
- **What about Europe?** Referendums in Europe are something to watch as is the Italian banking system that will need some form of highly unusual financial support.

Indeed, the world's oldest bank, Monte Dei Paschi De Siena, lives in Italy and is having real problems now. My best guess is that there will be support for the bank (currently underway) otherwise there is a possible contagion effect that could unfold, impacting on most other Italian banks and to some extent on other European banks. By my estimation, the European economy continues to struggle but remains stable for now. Low oil prices, low interest rates and central bank intervention have all helped. On the negative side would have to be Brexit, the risks of the Italian banking system, and also the risk that Germany's export driven economy stumbles.

- **The global financial crisis of 2008 resulted in decreased demand for Chinese goods from Europe and the United States.** As China transforms itself from an export driven economy to a consumption based economy, trade with Germany may remain in decline, hurting Germany's exports. This is important because over 40% of Germany's economic activity and growth (as measured by GDP) comes from exports which equates to potential problems for the German economy and the possibility of flow on effect along with political implications for other European countries too.
- **What about China?** Economic growth at 7% each year in the future looks unsustainable. George Friedman, the founder of GPF, suggested a while back that with slowing growth China might face a choice between implementing a dictatorship or face the collapse of the economy into so-called regionalism that indeed has been a strong component of Chinese history. It appears that the dictatorship of President Xi Jin Ping has been underway for some time and by some accounts 2017 might be the year that he eliminates the last of his political rivals and establishes his control over the Chinese political system. This might be useful because China's economic stability is not without its problems which include unemployment. It is possible that China is under-reporting the real unemployment rate. This is relevant because the fact that China recently publicly announced that it may lay off 5 million to 6 million state workers over the next two to three years is not normal discussion from China. They do not usually announce job cuts publicly. This makes me think that the situation is more difficult than the world realises for China and many Chinese companies that have been performing less well since the global financial crisis in 2008.
- **At the same time China has** come out strongly in favour of globalisation and is ready to step in where it can to support (undermine?) where the US is saying under Donald Trump that it will advance a more isolationist policy (away from globalisation).

There has been some talk from Donald Trump that he is less interested in globalisation and much more focused on the US economy and looking after Americans, “making America great again”. On the surface, this does seem to provide China with real global expansionist opportunity – what do you think? Let’s watch this space ...

- **Closer to home here in New Zealand** we can expect interest rate rises, reasonable economic growth at around 3% as measured by GDP, residential property prices to either grow more slowly or flatten right out. And some excitement of course with the upcoming election here in New Zealand later this year.
- **Rising interest rates** usually depresses asset prices (direct shares, property). If like most, you play the markets as an investor then you might be a bit worried about rising interest rates. If you adhere to a Value Investor’s approach, rising interest rates might mean lower prices, which definitely means better buying opportunity – yippee!
- **Apart from Christchurch** residential property appears to still be increasing at a rapid pace in some areas although this will likely change as rising interest rates begin to bite alongside the new debt to equity ratio speed bump implemented late last year. Although you never know, at this stage it looks less likely that the New Zealand Reserve Bank governor will implement the debt to income ratio that was seriously looked at just prior to Christmas. The reality is that supply and demand in the short term will override a number of policy initiatives, however in those markets (e.g. Christchurch) where demand pressures have fallen away, rents have declined and property price increases have also be moderate or flat. Obviously one suburb is different from another.
- **From an investment perspective generally, markets remain fully priced, however as you know** because we invest inside the market rather than across it, opportunity still exists. It is one thing to invest in a managed fund or a selection of investments that span the market. Volatility is reduced that way but then so too is long term returns – honestly, who really wants that?! Whilst a more narrow approach to investing in individual businesses means we need to get it right, depending on your tolerance for risk and volatility, the investment selection approach at WISEplanning using as far as we can Warren Buffett and Charlie Munger’s business methodology and **The Rule of Five** help keep our money safe.

- **Donald Trump without doubt is** one of the key uncertainties in the immediate future that global markets will have to find a way to work with. His stated aim is to dismantle trade arrangements that have been in place for many years and taken decades to craft and put together. This means a more isolationist approach and appears to be anti globalization (but not totally anti trade). Trump is happy to engage in uni-lateral trade deals, county by county, knowing that most countries need to trade with America more than America needs to trade with them. It is all about America and making America great again. On the other hand China appears ready to step right up and fill any void left by America which will have interesting implications not only with regard to trade but also politically and in terms of global security.
- **Expect interest rates to rise** (already underway) along with recently implemented debt to equity limitations to begin go impact. Against this though we still have, particularly in some parts of Auckland and other centres too, the ongoing demand for property. Immigration remains strong which combined with a low interest rate environment at least in the short term will possibly offset those rising interest rates and the new loan restrictions. More medium term, let’s keep an eye on the upcoming elections as there remains negative sentiment around the level of immigration which if changed might also be a game changer in the short term for residential property as an investment. Bad for those who rely on prices rising all the time in order to make money. Good for those of us who like good value and better buying.
- **Steady as we go for the New Zealand economy.** It will be interesting to see how the system around Donald Trump manages a president like we have never seen before ... Hopefully there will be some shocks, providing some much needed uncertainty in the markets for us as Value Investors so that we can see our way clear to take advantage of better buying opportunity in that situation.

*“I was quite depressed two weeks ago when I spent an afternoon at Brentano’s book shop in New York and was looking at the kind of books most people read. Once you see that you lose all hope.”*

Friedrich Hayek

## To Summarise