

Economic Update March 2017 (Interim Update)

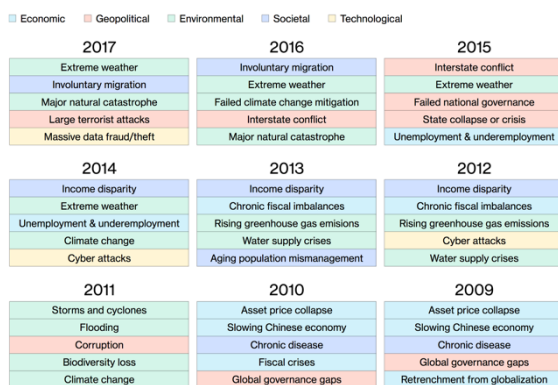


peter flannery

“If you have one economist on your team it’s likely that you have one more than you’ll need.”

Warren Buffett

The Global Economy



Notice how old risks become less meaningful and new risks emerge. This is natural as markets move from one cycle to the next and the global economy evolves.

2016 taught us that we now live in a world where global economic, social and political risks are becoming increasingly inter-linked. The World Economic Forum recently came up with five global risks that may need to be addressed:

1. **Growth and reform:** Up until around the 1980s inequality had actually been declining in the industrialised world however, since 2009 the incomes of the wealthiest people, particularly in the US, have grown significantly whereas the middle class is gradually disappearing and the poor people are becoming greater and greater in number. Inequality is now seen as a key trend that may need attention and certainly worth watching over the next few years.

2. **Rebuilding communities:** Decades of social and cultural change have seen generational gaps emerge and also issues of national identity in cultural value sets become the focus of dissension for many groups. In simple terms, it has almost become fashionable to be angry as an individual and en masse about matters of identity and cultural diversity.
3. **Technology disruption:** With automation and “the robots” taking jobs, by some estimates it is possible that nearly half of all jobs could be endangered as technology advances continue at a rapid pace. One of the consequences of rapid technology advances is increasing social disruption and income disparity (the rich get richer, the middle class disappear and the poor people increase in number, stay poor and get poorer).
4. **Global co-operation:** 2016 gave us a return to increasing weapons’ capability (a serious step backwards for global peace) as well as the unwinding of international trade agreements. Also the work done by international tribunals on such things as global warming has been rejected by some parties (the US). These rejections and setbacks may only be temporary however should they continue, could impact one way or another on the global economy and economic growth.
5. **Global warming:** Although there are still those who question the validity of global warming, there appears to be growing evidence that it may cause economic

disruption in some parts of the world. The last 16 of the previous 17 years have been the warmest on record and by some studies, emissions need to be reduced by somewhere between 40% and 70% as soon as possible to avoid long term irreversible damage to the earth's eco-system. In the short to medium term the economic consequences may start to emerge.

Other risks to the global economy include terrorist attacks, particularly those that are inflicted on a large scale as well as data fraud / theft which again can be highly damaging for individuals and also impact on a broader economic level where damage is done en masse.

The above all sounds a bit negative but is just an outline of some of the risks that we might take into account as we keep an eye on the world around us so that we can position ourselves effectively as we invest.

In general terms, US economic growth remains stable and in an upward direction although supported by increasing debt, Europe remains stable although again supported by quantitative easing, debt and low interest rates, China continues to vigorously manage an economic slowdown and so far remains stable. Japan also continues to struggle to achieve any real economic growth despite an ongoing increase in already massive debt. Australia remains stable and New Zealand, continuing to enjoy record immigration numbers, still has an economy growing at around 3% which is good – it is just a question of how sustainable this is in the more medium term?

The United States of America



Janet Yellen of the US Federal Reserve has just increased interest rates in the US by 0.25% - more to come.

As announced last year, Janet Yellen has increased interest rates by 0.25% signalling that the US economy is maintaining the right trajectory with unemployment numbers stable, inflation now close to the Central Bank's 2% target and business investment showing signs of firming up after several months of weakness.

Interestingly, there was no mention of accelerating the pace of monetary tightening with the general banter continuing to maintain the line of "steady as we go" and gradual increases over time. In theory, at the current pace, interest rates could possibly return somewhere near neutral towards the end of 2019, beginning of 2020 (all things equal).

Employment gains across America have averaged 209,000 per month over the last three months which is quite a distance ahead of the 75,000 to 100,000 needed to keep up with the increase in the working age population. At the moment the jobless rate in America is 4.7% which is considered to be around a level of full employment.

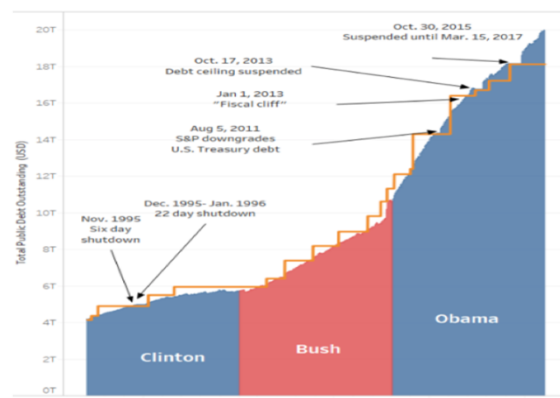
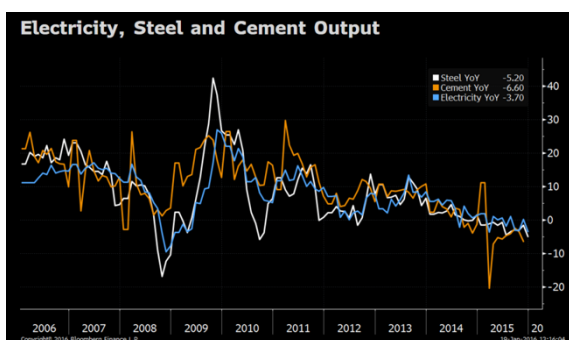


Figure 6. Public Debt & Debt Ceilings across different Administrations
Source: US Treasury

The US economy, not unlike the global economy, is supported by what can only be described as a significant amount of debt. The idea is that stimulus packages and the use of a number of macro-prudential tools by a number of central banks around the world should see economies stabilise and eventually return to growth mode. Looking at the US, there is definite evidence that economic stability is underway and economic growth is also happening although it is a delicate balancing act to keep this on track. So far so good ...

As for the US debt ceiling, remember it is not much of an issue apart from the fact that a growing mountain of debt has to be serviced and one would think paid back at some point. It is an arbitrary ceiling that was set many years ago by Congress in 1917 during WWI. The debt ceiling was suspended on October 30 2015 and is due for review in a couple of days' time – March 15 2017. In my view the debt ceiling, whilst it can be used for political expediency, is not a line if crossed that means that the United States of America is bankrupt and cannot function. It is a control measure or a speed bump if you like that as we have seen can easily be overlooked for the sake of convenience. I know what you are thinking ... if you and I breached our banking covenants, the bank would be all over us in a second! Anyway, in the short term at least it is not a fundamental issue to be concerned about for us as investors.

China



The above chart shows decline and deleveraging of steel, cement and electricity in China. Deleveraging appears to be ongoing.

The Chinese economy as I have mentioned many times is being vigorously managed by the Chinese government which so far has managed to keep the economy stable. This has not been easy as the economy has gone from boom to slowing growth. A couple of years ago the world worried whether or not the Chinese economy might slip into serious recession, tipping the whole world into a recession, creating tough times for everyone. So far this has not occurred. However, scaling back and deleveraging continues.

The Chinese government is very focused on resolving any structural imbalances and are focused on five major areas:

- Cutting industrial capacity;
- Destocking;
- Deleveraging;
- Lowering corporate costs;
- Improving weak links.

The Chinese government is looking to use fiscal policy in a way that is more proactive and effective to help accommodate supply side structural reforms, cutting business tax and helping support income for business owners and employees.

On the risk side, curbing asset bubbles will be on their radar over 2017 as the property market remains a risk to financial stability. Last year China adopted a two pronged approach whereby they cut interest rates and also lowered deposit requirements. This as you can imagine stimulated growth in real estate investment which is a driver of economic activity although they need to watch out for unintended outcomes with this approach. House prices in most major cities have soared and required some tightening measures. In any event the Chinese government is focused on maintaining stability and curbing real estate bubbles is one of the many factors they watch and manage closely.

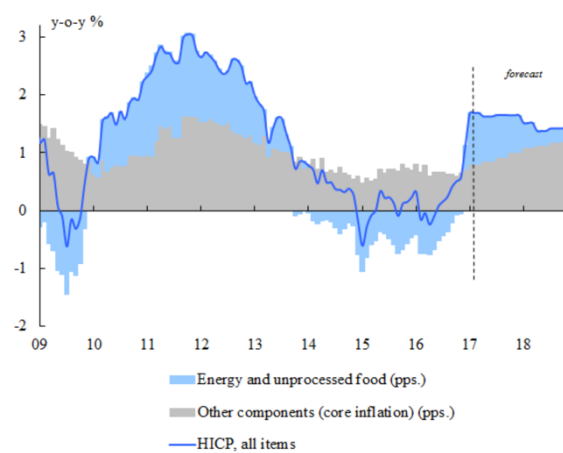
In other initiatives, the Chinese government is looking at policy that includes advancing structural reform in agriculture which should help

to revive the real economy in China as well as overhauling state firms. The latter is seen as a critical step for China as it seeks to stabilise its economy and move towards sustainable economic growth.

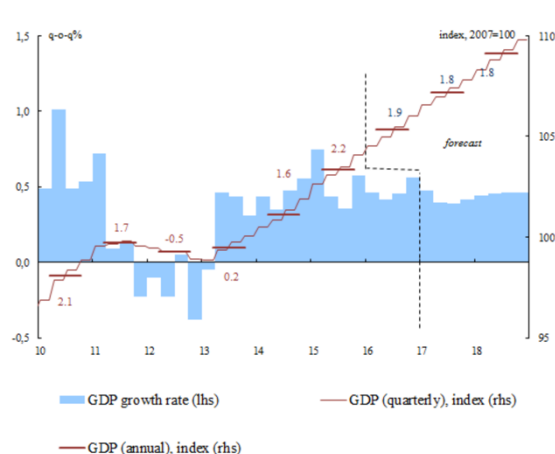
China is focused on economic stability as well as reducing corruption throughout China which has been entrenched in the economy over many decades. Whilst there is always scepticism around the voracity of official data, the hard landing for China predicted by many a couple of years ago has failed to materialise and their economy whilst not without its challenges for the Chinese government, remains relatively stable so far.

The Eurozone

Graph I.2: Inflation breakdown, euro area



Graph I.1: Real GDP, EU



The above two charts tell a simple but important story about Europe – stabilisation although fragile is underway. Economic growth is up. Inflation is up.

Overall the Euro area has navigated its way through choppy waters reasonably well. The emergence of inflation will be a welcome signal for the central bankers in Europe which is welcome relief from a lengthy period of deflation. The challenge with deflation is that once in it, it can be very difficult to get out (e.g. Japan). At

the moment at least it looks like they have achieved it.

Although fragile and slow, nonetheless economic growth is underway driven by private consumption, also helped by improvements in employment and a small rise in nominal wage growth. Wages growth is quite important because it can be a fundamental driver of economic growth for an economy. That said, rising inflation could put a dampener on the growth of household spending power which in turn could hinder private consumption. Whilst the hindrance may not be significant, any head winds are unwelcome for an economy where economic stability and growth are fragile at best.

Although it remains to be seen, by some estimates investment in the Euro area is forecast to grow by around 2.9% this year and possibly 3.4% in 2018. Interestingly, the share of investment in economic growth (as measured by GDP) remains below its value at the turn of this century (that was 20% in 2016 compared with 22% in the period 2000 through 2005). Persistent weakness in investment raises question marks over the sustainability of any economic recovery.

Another mild positive for the Euro is the government debt to GDP ratio is expected to fall further in 2017 and 2018. This appears to be as a result of lower interest rates reducing interest costs as well as improvement in the labour market. In other words more people are paying taxes and fewer people receiving welfare benefits. The significant debt that has accumulated over the last 10 years is far from resolved but nonetheless heading in the right direction. Some estimates project government debt to GDP reducing gradually from 91.5% in 2016 to 90.4% in 2017 and 89.2% in 2018.

India is included for the first time in our Economic Update because of its size and scale, recent changes to government and the resulting economic reforms that could lead India to being an economic power house in the future.

India is one of the fastest growing major economies despite Brexit, Trump and demonetisation. For example, India's real economic growth (GDP) by some estimates could continue at a pace of between 6.75% and 7.5% over the 2017-2018 financial year, according to the Indian government in its recent economic survey.

The Indian government has been undertaking a number of bold reforms, a recent one being the introduction of goods and services tax (GST). This is considered to be a game changer for the Indian economy in the future.

One of the biggest risks to the Indian economy appears to be the growing trend of protectionism initiated to some extent by Donald Trump, trade related tensions between major economies and for India, rising oil prices which if that were to occur would also be a head wind for the economy.

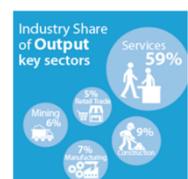
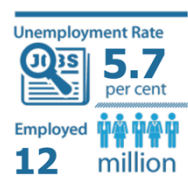
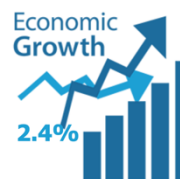
The recent demonitisation is where the Indian government removed two high value currency notes, the impact of which is to reduce economic growth by between 0.25% and 0.5%. However, the Indian government expects the impact of this demonitisation will be short lived.

In the future, India is likely to have an increasing impact on the global economy. I will include it in Economic Updates from time to time as I watch the growing impact of this economy on the rest of the world and also potential for investment opportunity in the future.

India



Australia



Although mixed from one part of Australia to another and from one sector to the next, overall the Australian

economy remains stable and growing at a modest pace. Interestingly, economists have become divided about Australia's future direction of late.

Is Australia heading towards stagnation and no growth? Tim Toohey from Goldman Sachs recently predicted economic growth in Australia would sit at around 2.8% this year, rising to 2.9% next year. He expects the Reserve Bank of Australia to lift rates three times in 2018.

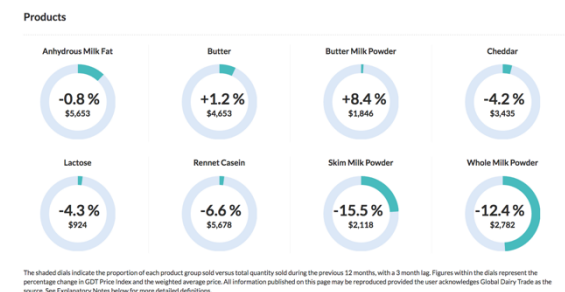
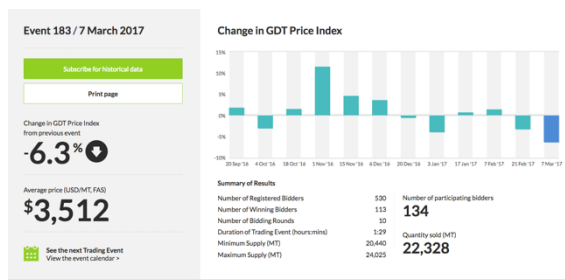
On the other hand, Damien Boey, an economist with Credit Suisse, recently put out a note predicting zero real economic growth for Australia (nominal growth less inflation) this year, suggesting that therefore two Reserve Bank of Australia rate cuts would be appropriate in 2017. His gloomy forecast he suggests is based around the slump in business investment along with an expected slowdown in housing construction. Further, he suggests that due to minimal increases in real wages and a weakening labour market, Australia as a whole might see sluggish consumption growth over the next year or so.

The Reserve Bank, at least for now, is staying with "the glass half full" view of the economy.

We care about Australia because they are one of our major trading partners. This means that when they have good times that rubs off on us to some extent. When they have bad times that can also impact on us too.

New Zealand

Dairy auction price



After what appeared to be price increases stabilising, the recent result was a decline of 6.3% in the milk solid price which was on the back of a noticeable decline at the previous auction.

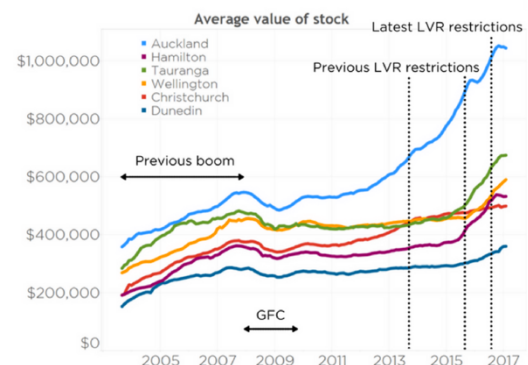
THE ANZ HEATMAP

Variable	View	Comment	Risk profile (change to view)
GDP	3.2% y/y for 2017 Q3	The economy is recording decent momentum, and we expect that to generally continue at least over the first part of 2017. Downside risk mainly stems from offshore.	Neutral Negative Positive
Unemployment rate	4.7% for 2017 Q3	We are looking through the Q4 lift in the unemployment rate. Job ads firmly signal it lower. Finding staff is a huge challenge for firms.	Neutral Negative Positive
OCR	1.75% by Sep 2017	With strong growth, capacity pressures emerging and inflation past its lows, further OCR cuts would now be hard to justify. Next move is up.	Neutral Down Up
CPI	1.9% y/y for 2017 Q3	Headline inflation is past its lows, with base effects seeing it return to the target mid-point early next year. Risks are that this occurs earlier.	Neutral Negative Positive

Steady as we go for New Zealand. Note increasing inflation (CPI).

Let's keep an eye on the upcoming New Zealand elections in September. Although it is only a short few months away, nonetheless a lot could happen between now and then. A change in government is a potential game changer for the New Zealand economy although I am not concerned as an investor. Any volatility is an opportunity for us to buy at lower prices. We also have an advantage of being able to invest in a number of economies around the world and so as investors we are not reliant on the fortunes of the New Zealand economy.

Residential property



Note the difference in growth in the various regions.

Residential property in New Zealand has been a favourite investment (although a long way behind the bank account) and one that could be impacted significantly should a change of government occur. For example, Winston Peters is not the only political voice trumpeting a change in immigration for New Zealand. A sharp slowdown in immigration would likely result in a sharp slowdown in the growth of the New Zealand economy too. Whilst there are always growing pains, a slowdown in the economy hurts more people than it helps. For example, the disappearing middle class continue to disappear and those who are challenged financially become more challenged as the economy makes life more and more difficult for them. Interesting to note too that the economic growth number for the December quarter last year was only 0.4% versus the market expectation of 0.7% and a Reserve Bank forecast of 1.0%.

The New Zealand economy is tracking reasonably well however it is fragile against the backdrop of new risks emerging globally around trade and to a lesser extent rising interest rates.

To Summarise ...

The new economic risks emerging appear to relate to identity and cultural values whereby groups en masse are voting for change. This includes those who do not feel they have participated fully and fairly in global prosperity as they watch the wealth concentrate mostly away from them. The rich get richer and the poor get poorer as the middle class continues to disappear.

Forget the economists, bring on the psychologists. This phrase relates to the mood change around the world which manifests itself in changes such as Brexit, now both Scotland and Ireland looking to move, dissention in some European economies and of course the election of US president Donald Trump. This changing sentiment is well underway and is likely to further impact on economies around the world.

The dismantling of trade agreements, which have taken many years to assemble, sounds quite negative. Further, Donald Trump in his usual rhetoric has stated quite bluntly that he intends to “go hard” on China for unfair trade practices with the US. I would be surprised if China stands by and allows Donald Trump to create problems for their economy which they are vigorously managing. The result appears to be a possible trade war that in theory would escalate globally and see New Zealand caught up in the middle of it, making life difficult for us. Let’s wait and see though. It is easy to imagine the worst and whilst there may be an element of reality about it in the future, talk of pending gloom and economic disaster is no more intelligent or valid than the economic growth and prosperity that continues around the world, improving the lifestyle of millions of people. That continues to be a fact.

The global economy whilst not without its risks and dangers, is nonetheless growing at a rate of around 3% which, when we take into account the global financial crisis and the results of that event, the global economy is actually doing okay when all is said and done. As Warren Buffett has mentioned many times, let’s not expect 7% or 10% growth each year – it’s just unrealistic. That also means our investment portfolios are unlikely to grow at such a pace in the future. Let’s remember too that even 3% economic growth is significant. Over 10 years that means that living standards (granted not spread evenly to every man, woman and child) increase by 30% over that time. It’s not perfect but it’s not bad!

But wait, it gets even better ... we are Value Investors who invest in the underlying business.

We do not play the markets. We are not relying on economic stability or economic growth (but nice if we can get it). We are not interested in trying to smooth out the volatility in the cash up value of our portfolios from one month to the next, or one year to the next. We are focused on investing in businesses that have sound economics – not economies that will ebb and flow creating uncertainty or prices that rise and fall sometimes quite sharply. Economic fluctuations may cause prices to move, particularly in the short term. We however are focused on our investment goals, our opportunity and those good businesses that have sound underlying economics.

“Another thing that does one in, of course, is the self-serving bias to which we are all subject. You think the “True Little Me” is entitled to do what it wants to do. And, for instance, why shouldn’t the “True Little Me” overspend my income. There was once a man who became the most famous composer in the world but was utterly miserable most of the time and one of the reasons was because he always overspent his income. That was Mozart. If Mozart can’t get by with this kind of asinine conduct, I don’t think you should try.”

Charlie Munger’s USC Law commencement speech, May 2007