➢ Economic Update October 2017

Peter Flannery CFP AFA

> ***"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

North Koreans sitting in a town square watching the launch of a missile. Should we be worried? It is something to watch however the irresponsible media highlighting the strange behaviour of two world leaders should also be taken into account.

The one thing that Kim Jong Un, the leader of North Korea wants is to engineer a deterrent that helps their him feel safe and a member of the nuclear missile fraternity. He appears to be at least part of the way there with his hydrogen bomb because the power and damage of such an explosion means that total accuracy is not required. Indeed, the electro-magnetic pulse could potentially take out much of the US war machine, making America and therefore the rest of the world surprisingly vulnerable.

The one thing that Donald Trump, president of the United States of America, wants is for Kim Jong Un not to achieve what he wants.

Therefore the two appear to be on a collision course. That said, there is nonetheless a fair amount of wriggle room in terms of diplomacy (even though Donald Trump recently pulled the rug from under diplomacy by letting his man know that he was wasting his time with the North Korean leader!!) as well as other initiatives such as assistance from China, possibly Russia with diplomatic efforts as well as additional sanctions.

I'm no expert on this subject however I find myself wondering if the likes of China and Russia are happy standing by to see what North Korea can come up with in terms of destabilising the American war machine – just a thought? On the other hand, it would hurt them economically as the American economy remains vital to global economic stability. After all, America trades significantly with Asian countries including China.

The other thing I wonder about (I'm just thinking aloud) is whether Donald Trump is smarter than we all give him credit for, or whether he is just making a delicate situation dangerous with his simple minded behaviour? One thing we know about Donald Trump is that he can be one determined individual and is not easily dissuaded – rightly or wrongly.

For the American economy, actually Donald Trump has been neutral to positive especially with his latest talk about tax reform. This would likely see further underpinning of the American economy although of course his failure after having announced tax reform might cause share prices to decline quite a bit should the markets take a negative view of any potential failure.

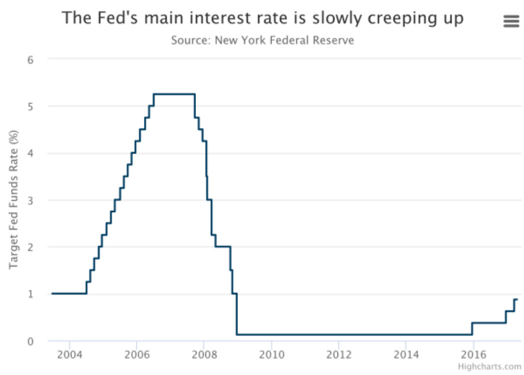
In general terms, not much has changed since my last update. The global economy whilst not without its risks and challenges, remains basically stable. Here is some evidence:

- US preliminary economic growth came out at 3% versus 2.7% expected;
- Australian private capital expenditure was 0.8% versus 0.2% expected;
- Canadian economic growth (GDP) was 0.3% versus 0.1% expected;
- UK manufacturing (PMI) was 56.9 versus 55 expected – a worthy difference;
- US ISM manufacturing (PMI) 58.8 versus 56.5 expected;
- US non farm employment change 156,000 versus 180,000 expected;
- US unemployment rate 4.4% versus 4.3% expected (slightly negative);
- UK construction (PMI) 51.1 versus 52.1 expected (slightly negative).

The above is a random selection of recent announcements that confirm the global economy at the moment is stable hence our favourite phrase that comes up from time to time … *"Steady as we go for now"!*

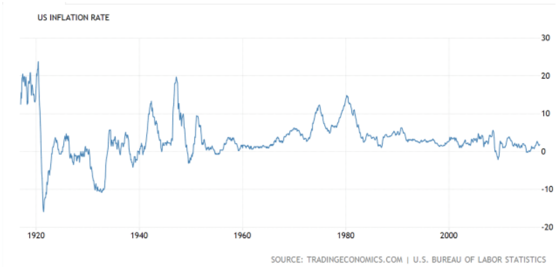
Oh by the way, notice I haven't mentioned the New Zealand elections in this section – basically it is relevant to us as Kiwis but is of limited importance to anyone else.

The United States of America



As the chart shows, interest rates are creeping up slowly as the US economy remains stable.

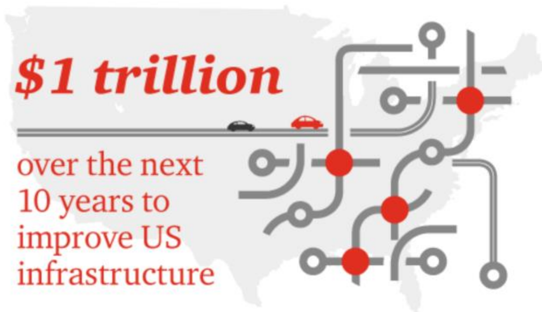
Interest rates in the US are on an upward trajectory however the slope of the trajectory or the pace of the increase is questionable. I suspect a slow and uneven rise in interest rates is likely because the global economy is still caught in the grip of the deflation. I noticed also the US Federal Reserve in a recent meeting was split over the pace of interest rate rises which may signal a slowing down in the pace of interest rate rises because of concerns over lagging inflation. The Federal Reserve Bank has been targeting 2% inflation since 2012 however since then inflation has only averaged 1.3%.



Throughout the 1970s, the 1980s and beyond there was too much inflation. Now there is not enough.

Elsewhere in the economy many indicators reflect ongoing stability and slow growth across the US economy.

Donald Trump's proposed tax reforms is an idea that has not been overlooked by the markets. It is possible that some of the benefits of lower taxation for businesses in America may have already been factored into trading prices on the market. There is a lot of work yet to be done before those reforms can be implemented.

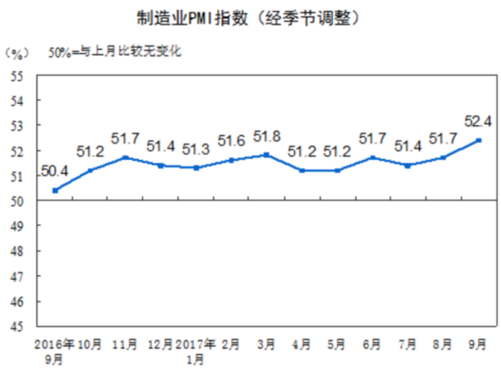


Still looking bigger picture, infrastructure spending is another potential boost for the American economy however the legislation continues to stall. There appears to be general consensus that "something must be done" about the nation's increasingly dilapidated infrastructure. It will be a question of whether or not there is sufficient political will to push this one across the legislation line. Interestingly, a couple of fund managers have set aside funds inside of their pension schemes for infrastructure investing which highlights the fact that there is general willingness for the project and that some funding is already underway. Success here would be a positive for the US economy and also a win for Donald Trump.

China

The Shanghai skyline at night. Martin Puddy–Getty Images

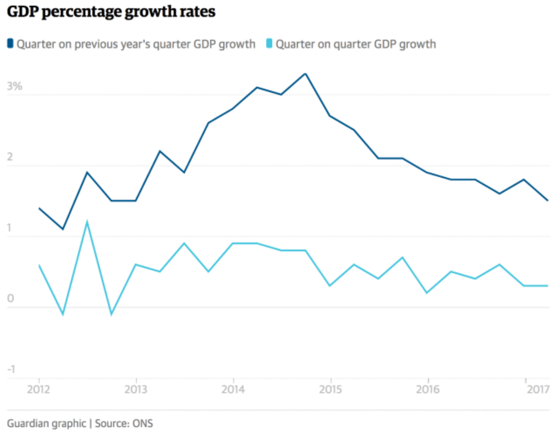
Standard and Poor's downgraded China from AA- to A+ due to increasing debt growth. This follows the recent Moody's downgrade from A1 from Aa3. China wasn't happy about the most recent downgrade and protested, stating that Standard and Poor's have adopted a clichéd approach based on their experience with Western economies. In addition, S & P analysts also lowered their rating on three foreign banks that primarily operate in China, namely HSBC China, Hang Seng China and DBS Bank China Limited. Their rationale is that these banks would unlikely avoid default if China were to default on its sovereign debt – a highly unlikely situation in my view. Following the downgrade, S & P revised its outlook from stable to negative.



The China manufacturing purchasing managers index (PMI) provides an early indication each month of economic activity in the Chinese manufacturing sector. Looking OK.

Whilst increasing debt levels are not ideal, the Chinese economy continues to grow and remains stable.

UK



The above chart compares last year with this year and shows slowing economic growth in the UK.

Britain recorded its weakest annual economic growth rate since 2013 in the three months to the end of June this year according to the Office for National Statistics**.** The country's service sector appears to be showing signs of contracting along with Britain's trading position with the rest of the world. Consumers are also borrowing more with credit cards and car finance loans continuing to increase. For example, consumer credit increased by 9.8% in the year to August 2017 and now stands at £203 billion – a level not seen since the Global Financial Crisis in 2007/8.

UK banks have been ordered to hold more capital as consumer debt continues to grow. The Bank of England must be feeling a little anxious as it forces banks to strengthen their financial position in the face of rising personal debt. Of course those whose glass is half empty would see this as growing deterioration in the UK economy whereas those with the glass half full will see these measures as prudent and pre-emptive.

Farmers in Britain beware. Michael Gove recently stated that it is time to stop subsidising rich land owners with what has been termed a post-Brexit farmer funding shakeup. Simply, many have argued for years that farmers in Britain have been unfairly subsidised, making it difficult for others to compete. The subsidies are now considered "just plain wrong" because they are based on those who are already wealthy and the amount of land that they have. What is being suggested is a new system once Britain has left "the block" that will focus on "enhancing the environment and supporting innovation". More challenging times ahead for the UK farmer it would seem.

The Euro Area

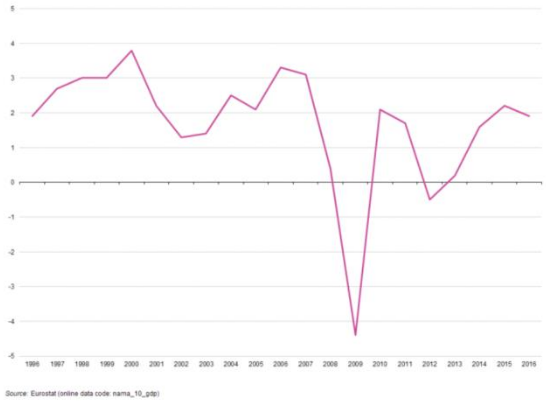


Figure 1: Annual growth rate of gross domestic product (GDP) in real terms, EU-28, 1996–2016
(%)
Source: Eurostat (nama_10_gdp)

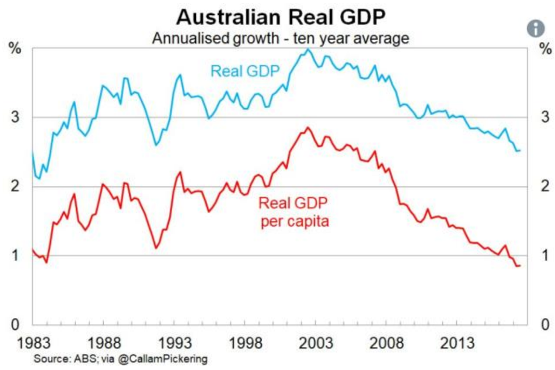
Growth in the European economy appears to have recovered from the 2008 Global Financial Crisis.

Growth in the European economy remains on track with some reports suggesting economic expansion at around 1.8% over 2018. Whilst this is a bit light, it is a whole lot better than the significantly slower growth that would otherwise be underway without central bank intervention. Luxemburg and Slovakia are expected to be the fastest growing economies in the region over 2018 with economic expansion rates of around 3.5%. On the other hand, Italy looks to be a laggard with economic growth slowing to around 1.1%. Germany which of course is important to all of Europe looks as though it may expand its economy at a rate of 1.8% with France behind it at around 1.6%.

Inflation remains below the European Central Bank's target.

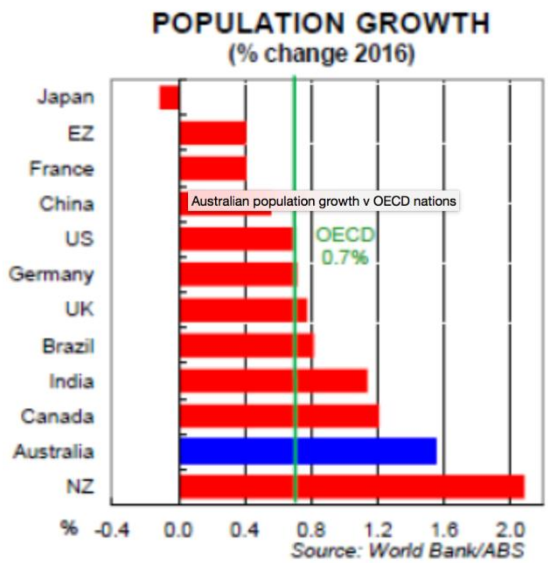
With economic expansion in the Euro area heading in the right direction although at a slower pace than everyone would like, interest rates remain low and also inflation remains stubbornly low. The European Central Bank is targeting a rate of 2.0% inflation however as the previous chart shows, inflation remains stubbornly low in the Euro area, as it does elsewhere in most other parts of the world. As I have said before, this is because deflation maintains a strong hold over the global economy, at least for now.

Australia



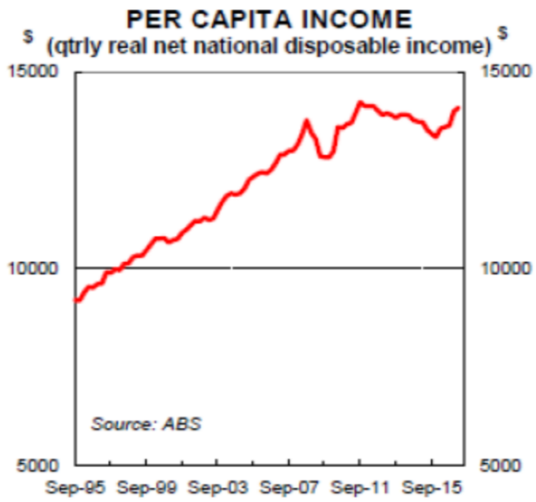
Economic growth has been slowing, highlighting the impact of the mining boom and bust. Despite the mining bust though, the economy remained resilient.

Australian economic expansion has remained resilient despite the Global Financial Crisis and the bust in the mining boom. However, economic growth in the economy is settling down to more normal levels and will be supported in the future by consumer spending among other things. Housing construction may be less of a support to the Australian economy moving forward, depending on immigration levels into that country. Interestingly, immigration has supported economic growth in Australia for several years.



The chart above shows Australia's strong immigration numbers. Note India's strong immigration numbers too. Of course, right next to Australia there is New Zealand.

Population growth in Australia has without doubt supported economic activity and expansion. By some measures, immigration has contributed up to 50% of economic growth and expansion in Australia over the last few years. Where would the Australian economy be without immigration!? Some argue though that the strong immigration numbers have been masking an otherwise weak economy.



The above chart shows a flattening out of disposable income per capita over the last several years.

Another way to look at these numbers is to consider that the per capital measures of the economy are suggesting that growth in living standards has stagnated and for some sectors of the population (e.g. younger people) it may have gone backwards. These numbers may also reflect stubbornly high unemployment along with weak wages growth and some consider the surge in home prices along with the increasing levels of debt.

In other news most economists expect the reserve bank will leave the cash rate steady at a record low of 1.5% in its October board meeting (which will have been announced by the time you read this). The Australian Central Bank is looking for economic growth at around 3% per annum however so far growth has trended below that level.

New Zealand

Overview	Last	Reference	Previous	Range	Frequency
GDP Growth Rate	0.8 %	Jun/17	0.5	-2.4 : 2.8	Quarterly
Unemployment Rate	4.8 %	Jun/17	4.9	3.3 : 11.2	Quarterly
Inflation Rate	1.7 %	Jun/17	2.2	-15.3 : 44	Quarterly
Interest Rate	1.75 %	Sep/17	1.75	1.75 : 67.32	Daily
Balance of Trade	-1235 NZD Million	Aug/17	98	-1388 : 1158	Monthly
Government Debt to GDP	24.6 %	Dec/16	25.1	4.4 : 54.8	Yearly

Markets	Last	Reference	Previous	Range	Frequency
Currency	0.72	Oct/17	0.72	0.39 : 1.49	Daily
Stock Market	7926 points	Oct/17	7934	3202 : 7938	Daily
Government Bond 10Y	2.98 %	Oct/17	2.98	2.12 : 19.2	Daily

GDP	Last	Reference	Previous	Range	Frequency
GDP Growth Rate	0.8 %	Jun/17	0.5	-2.4 : 2.8	Quarterly
GDP Annual Growth Rate	2.5 %	Jun/17	2.5	-2.5 : 7.3	Quarterly

The New Zealand economy continues to progress favourably, subject though to international events as always.

The New Zealand elections have been hard to miss in the popular media and again we have Winston Peters as the potential king maker or queen maker. One of his interesting options is to sit on the side lines and allow other parties to govern which would allow him to have an easier life but to still hold significant control over issues that were important to him or his party. I'm no expert in politics however at this stage whilst it's difficult to know (you will know by the time you read this) the more difficult road one would think would be to go with Labour and the Greens, giving him two political parties to deal with rather than just going with National, making things possibly a bit easier for him. Whatever the outcome, whilst there may be some changes for property investors should Labour be favoured, overall the international community are not concerned which way Winston Peters swings. They see both National and Labour as being positioned somewhere around the centre.

	12 month change	Average Value
1. Whangarei	15.7%	$497,489
2. Auckland Region	2.8%	$1,041,957
3. Tauranga	9.6%	$694,361
4. Hamilton	5.0%	$544,469
5. Rotorua	17.1%	$407,318
6. New Plymouth	8.3%	$426,255
7. Napier	18.8%	$459,393
8. Hastings	18.4%	$425,780
9. Palmerston North	11.5%	$362,557
10. Wellington Region	12.9%	$605,435
11. Nelson	13.6%	$538,136
12. Christchurch	0.1%	$493,069
13. Queenstown Lakes	18.0%	$1,098,037
14. Dunedin	12.6%	$375,814
15. Invercargill	5.3%	$240,725
NEW ZEALAND	4.8%	$641,648

Price increases slowing down in some areas and remaining flat in Christchurch.

Residential property prices appear to have moved through the synchronised growth phase into a slowdown phase for the likes of Auckland and Hamilton whereas other parts of the country such as Whangarei are still getting there. Overall it's a mixed bag. Inevitably of course prices will slow down around the country although with interest rates still low and immigration still strong, I wouldn't be surprised to see some resurgence of growth over October and November this year. Too much growth though and the Reserve Bank will act with the dreaded debt to income ratio. That I believe, would be a game changer for New Zealand residential property, at least for as long as that particular measure remained in force.

To Summarise …

The trading of personal insults between North Korea and America is odd …an unusual situation. Usually everyone lets Kim Jong Un bleat until he tires of it and moves onto something else. Engaging with him this way seems strange and at the moment has only served to raise the so-called rhetoric to dangerous levels, for what possible gain? One hopes that Donald Trump knows what he's doing.

And in other news … the global economy continues to grow and remains stable. Although I am watching the Chinese shadow banking risk, it remains in hand at the moment. Interestingly, Standard and Poor's followed Moody's by downgrading Chinese debt although the Chinese refuted the rationale used by Standard and Poor's which they say was based more on clichéd methodologies based on Western economies that are different to the Chinese economy.

Angela Merkel and her government in Germany did not fare well in the recent elections which potentially has some significance for the European economy, given Germany's scale. Overall the European economy continues to exhibit fragile and slow economic growth but remains stable.

Although by the time you read this you will know the outcome of Winston Peters' decision, whilst there may be some changes to the way some things are done, generally it will be business as usual for the New Zealand economy in my view. Obviously, with portfolios invested outside of New Zealand, those offshore investments are unlikely to be impacted much by a New Zealand election.

From the current stand point, I am finding it difficult to see the next major event for the global economy which could well be right round the corner, but could just as easily be some time away yet. In the meantime though economic stability remains at play …

"You and I come by road or rail, but economists travel on infrastructure."

Margaret Thatcher