

➤ Economic Update September 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

The Global Economy



Global tensions rise but then so does economic growth.

It is difficult to know what the leader of North Korea is really attempting to achieve in the end, despite the growing tensions (not helped by the usual media hype). Whilst it's possible that the unthinkable could happen, I believe we are quite some distance away from that event. The key point here is possible trade wars that could emerge. Indeed, a trade war just might be one way the battle is fought.

Although it's difficult to measure, share prices would decline around the world in that situation as the markets, no doubt ably assisted by the usual media banter about how dire things are becoming, run scared, looking for a safe haven. Although I'm no expert on geo-political tensions, to me it seems as though if this Kim Jong Un wanted to blow up somebody, he could already have done that by sending that recent missile straight to Tokyo and not into the sea. Interestingly, North Korea has gone from, as Nixon once said "that pip squeak economy", to one that now has America thinking twice about what action to take, but more importantly, the ramifications of any action. Missiles from North Korea can reach the West Coast of America. Recent tests in North Korea suggest the strength of a thermo-nuclear bomb is possibly 10 times the power of the one dropped in Nagasaki in World War II.

Ironically Kim Jong Un and Donald Trump make an unlikely pair when we think about the negotiations involved and the restraint required with regard to pressing that button. There has been a fair amount of sabre rattling and bluster from both North Korea and the US.

Notably China and other neighbouring countries are reasonably quiet at this point. I suspect there may be a lot more bluster, sabre rattling and posturing before any buttons are pushed – if ever. I'm not saying it will never happen – just that whilst it's possible, (and if you listen to the media high likely!) that does not mean it is inevitable.

The global economy by the way continues to grow with economic activity improving on several fronts.

Let's pull our heads out of the political rhetoric and focus on some good news ... okay, the global economy remains buoyed by central bank intervention, but nonetheless things are on the up and improving. By one estimate the global economy as measured by gross domestic product (GDP) grew by an annualised rate of 3.1% in the second quarter of 2017. A good result by itself but even better because it was similar to the result in the first quarter of 2017. Although we will need to wait and see, economic momentum is expected to continue through the third quarter of 2017 as well. In theory then, global expansion at around 3% is quite possible for 2017 which is good news.

The Eurozone economies expanded at the fastest pace in over six years on the back of declining unemployment and of course the European Central Bank's monetary stimulus program. There is now even some talk about when the European Central Bank might start normalising monetary policy – although I suspect that is a long way off.

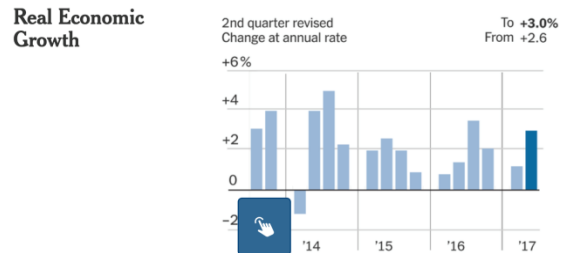
This highlights the point that interest rates are considered way too low and unsustainable in the long run. As you know, the US Federal Reserve is in the process of raising interest rates which is underway. The US Fed will continue to push for interest rate rises where possible but is somewhat constrained I believe by the lingering clutches of “deflationary funk”. In other words, whilst the global economy is stable and growing, the situation remains quite fragile.

The United States of America has also seen its economy grow reasonably strongly in the second quarter of 2017 following the first quarter's disappointing result. Also Japan's domestic economy in the second quarter of this year has grown to levels not seen for two years. Not only that, China's economy has also continued to remain resilient. Even the Russian economy is starting to show solid economic expansion at a pace that is the fastest in nearly five years.

The short of it is that synchronised global growth whilst not stellar, is nonetheless

underway and reasonably strong all things considered. Whilst not in perfect shape, nonetheless the global economy is stable and growing.

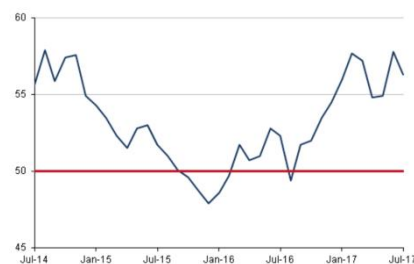
The United States of America



Economic expansion in the US was revised up from 2.6% to 3% - good news.

Donald Trump is still talking economic expansion at 4% per annum or more which most commentators (myself included) regard as highly optimistic. Still, if America can maintain an average economic expansion rate at 3% per annum over the long term that is significant progress. For example, 3% over 10 years represents a 30% improvement in economic activity. Whilst this economic improvement in prosperity is unlikely to be evenly spread across the population of America, it is a reasonable outcome all things considered if it can be achieved.

United States PMI Chart



Note: Composite index in the Manufacturing Report on Business (PMI). Readings above 50% indicate an expansion in the manufacturing sector while readings below 50% point to a contraction.
Source: Institute for Supply Management.

Although the ISM manufacturing index fell slightly in July from 57.8 in June to 56.3 in July, nonetheless this index still sits well above the 50 threshold (the red line) that separates expansion from contraction in the US manufacturing economy. I mention this indicator because I regard it as a fundamental driver of economic activity that has helped to stabilise the US economy and inevitably should flow through into economic expansion at some point. In other words, it's a good thing.



Coming up soon in America is yet another round of debate about raising the debt ceiling. The bottomline here is that whilst they may argue about it, they have no choice but to extend it – therefore they will. Although it's not ideal, the debt ceiling is just the number that was made up many years ago for the best of reasons however economic growth and expansion has been limited in the US for decades which is partly why we now have solid central bank intervention in the US as well as many other economies around the world.

China

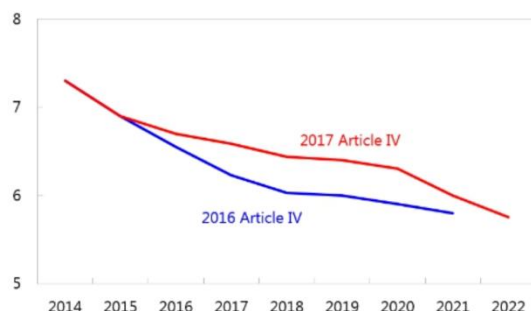


Economic growth in China appears to remain stable – more good news for the global economy.

The Chinese government continues to vigorously manage the Chinese economy. Debt is on the rise in China and whilst a number of commentators are concerned about it, it is at a level that is manageable. Everyone agrees that rising debt needs to slow down at some point however China's debt has quite a long way to go before it becomes a major issue in my view. I'm not suggesting it's a good thing. Just saying that the media banter around China's debt level representing "dire consequences any day now" smacks of a media agenda beyond just informing people of the facts.

Higher growth projected

China's growth over the medium term was revised up this year.
(percent of GDP)



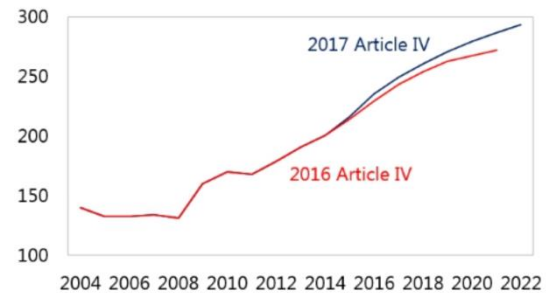
Sources: CEIC Data Company Ltd.; and IMF staff estimates.

Whilst most have been expecting economic growth in China to decline, the International Monetary Fund (IMF) estimates an upward revision of economic growth in China over 2017.

Debt: trending up

China's non-financial debt is now projected to rise even more strongly.

(percent of GDP)



Sources: Haver analytics and IMF staff estimates.

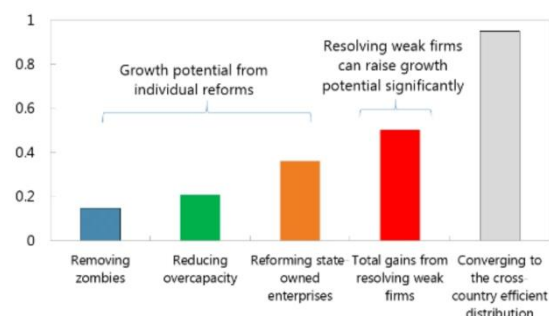
Chinese debt continues to climb but in my view remains manageable.

I have talked from time to time about the shadow banking problem in China which is a separate issue to the trending debt building in the Chinese economy. The shadow banking issue is significant and enough to destabilise not only the Chinese economy but also the global economy should it disintegrate in a significant way. Separate to the China shadow banking issue there is the increase in household, corporate and government debt. This is expected to continue to rise strongly, reaching around 300% of GDP by 2022, up from 242% in 2016. Again, it's not ideal but is not in my opinion a cause for immediate concern. Longer term though, it will create a drag on economic growth and make it more difficult for the Chinese government to maintain ongoing economic growth.

Room to improve productivity

Better resource allocation from resolving China's weak firms can raise growth potential.

(percent per year)



Sources: Hsieh and Klenow (2009); IMF Fiscal Monitor (2017); NBS; and IMF staff estimates.

The much talked about reforms whilst underway still need to be pushed along by the Chinese government in order to increase economic productivity.

Not unlike many other countries, China would benefit from an increase in productivity. By the way, New Zealand is in the same boat. The issue for China is that there appears to be resources going into loss

making “zombie” companies, over subsidised industries and state owned enterprises. The International Monetary Fund estimates that good efforts in this area could increase the contribution of productivity to growth by about 1% point over the long term – worth doing.

The Chinese economy despite some strong banter two or three years ago around Chinese debt and other factors, remains stable and continues to grow. The Chinese government continues to vigorously manage the Chinese economy and therefore it is definitely ... steady as we go for the Chinese economy – and therefore the global economy to some extent.

But wait! Where does China fit into the US and North Korean debacle? At this stage I need to investigate more however what I do know is that China is a significant trading partner with North Korea. Interestingly China has been relatively quiet as the US and North Korea have rattled each other's cage. The US is hoping that China will do something to rein in the unruly dictator in North Korea. Let's watch this space ...

New Zealand

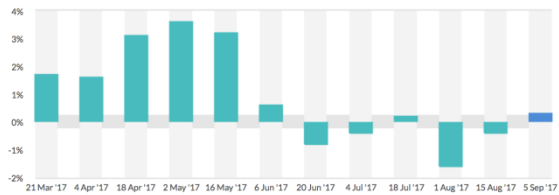
Overview	Last	Reference	Previous	Range	Frequency
GDP Growth Rate	0.5 %	Mar17	0.4	-2.4 : 2.8	Quarterly
Unemployment Rate	4.8 %	Jun17	4.9	3.3 : 11.2	Quarterly
Inflation Rate	1.7 %	Jun17	2.2	-15.3 : 4.4	Quarterly
Interest Rate	1.75 %	Aug17	1.75	1.75 : 67.32	Daily
Balance of Trade	85 NZD Million	Jul17	246	-1388 : 1158	Monthly
Government Debt to GDP	24.6 %	Dec16	25.1	4.4 : 54.8	Yearly

Markets	Last	Reference	Previous	Range	Frequency
Currency	0.72	Sep17	0.73	0.39 : 1.49	Daily
Stock Market	7769 points	Sep17	7727	3202 : 7874	Daily
Government Bond 10Y	2.77 %	Sep17	2.8	2.12 : 19.2	Daily

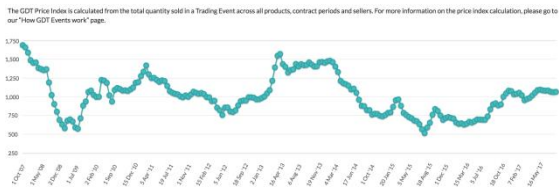
GDP	Last	Reference	Previous	Range	Frequency
GDP Growth Rate	0.5 %	Mar17	0.4	-2.4 : 2.8	Quarterly
GDP Annual Growth Rate	2.5 %	Mar17	2.7	-2.5 : 7.3	Quarterly
GDP	185 USD Billion	Dec16	176	0 : 201	Yearly
GDP Constant Prices	58022 NZD Million	Mar17	58178	26766 : 58178	Quarterly
Gross National Product	61169 NZD Million	Mar17	61130	25099 : 61169	Quarterly
Gross Fixed Capital Formation	14531 NZD Million	Mar17	14370	4071 : 14531	Quarterly
GDP per capita	36842 USD	Dec16	36192	21506 : 36842	Yearly
GDP per capita PPP	35269 USD	Dec16	34646	22768 : 35269	Yearly
GDP From Agriculture	3219 NZD Million	Mar17	3145	1804 : 3266	Quarterly
GDP From Construction	3489 NZD Million	Mar17	3575	1107 : 3575	Quarterly
GDP From Manufacturing	5809 NZD Million	Mar17	5754	3968 : 6266	Quarterly
GDP From Mining	774 NZD Million	Mar17	781	437 : 1187	Quarterly
GDP From Public Administration	2493 NZD Million	Mar17	2449	1311 : 2493	Quarterly
GDP From Services	38669 NZD Million	Mar17	38459	16867 : 38669	Quarterly

New Zealand's economy is doing quite well, particularly compared to many other economies.

Change in GDT Price Index



GDT Price Index over 10 years



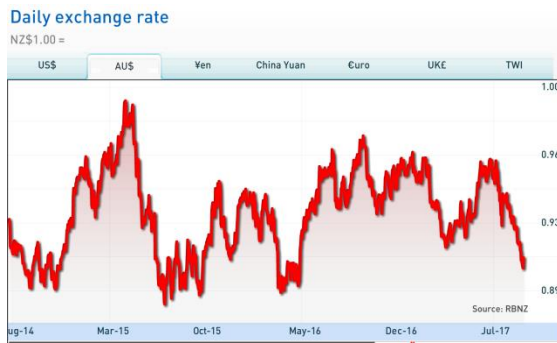
Although the milk powder price is reasonably stable, the latest result was a bit disappointing.

The elections in New Zealand interestingly are of little concern to the global economy because they see both National and Labour having similar policies. For us in New Zealand though of course we are far more interested because of the implications flowing from whichever party wins (and the mix of parties that come together as a result). I vote for the party that looks after New Zealand's best interests long term – who do you vote for?

Just on that election, the Labour Parties tax policy remains unclear but they have talked about introducing a capital gains tax and stopping foreign buyers from purchasing existing houses in NZ, which I suspect might have an impact on property prices in the short term. Longer term though, a capital gains tax I believe would have limited impact on property prices. Interest rates I believe will be a key indicator for property prices, particularly once they have increased by 2% or 3%. That said, it might be a while before we get there.

Daily exchange rate





For those not in business, investing using the Value Methodology will help to override short term economic fluctuations and elections.

“Economics is extremely useful as a form of employment for economists.”

John Kenneth Galbraith

To Summarise ...

The strong banter between Kim Jong Un and Donald Trump is concerning. However, there is something to be said for focusing on things that we can change or that are useful. You and I are unlikely to have any impact on whether or not that button is pushed by either North Korea or America. Whilst it is possible, the chances are it won't happen and therefore it is useful to focus on other things.

The global economy is stable and growing. Whilst that stability and growth is somewhat fragile, the significant central bank intervention over the last 10 years has not necessarily solved any problems but has definitely stabilised the global economy and provided some space for it to restructure, recuperate and begin to grow. That is happening now.

The New Zealand elections are interesting and will impact on different people in different ways. For us as investors, unless all of our money is tied up in residential real estate in New Zealand (in which case should Labour win expect some changes) we are investing globally which means that the New Zealand elections have little impact on those global investments.

Also, for those of us that are in business, whilst in the short term elections can have some impact, in the more medium to long term elections come and go as do economic cycles. What matters is our innovation around the culture of our business, procedures, the use of technology and the development of intellectual property.