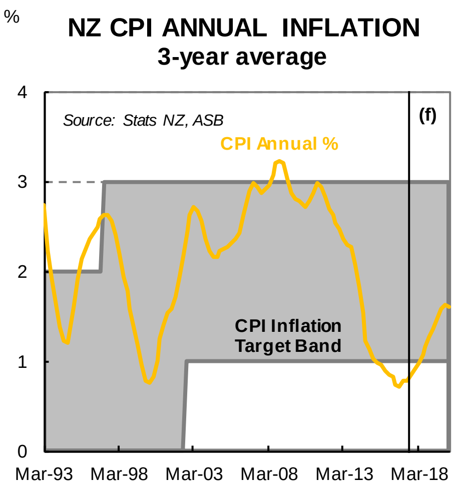
Markets Monthly

02 August 2017

O Inflation, Inflation! Wherefore art thou Inflation?

- Inflation has fallen both here and abroad. Low energy prices are only part of the story: inflation seems like it's not behaving like we used to expect. This is impacting central banks - and investment markets.
- Most central banks remained on the interest rate side lines in July, with an exception being the Bank of Canada, which hiked for the first time in seven years. The Bank of England could be next to lift rates.
- Meanwhile sharemarkets pressed higher, with the NZ market and others offshore reaching fresh highs in July.

Inflation developments over recent years have kept central bankers and economists puzzled. Given the reasonable economic growth and employment growth that has taken place over recent years, inflation should be stronger by now. Look no further than many of the forecasts made five years ago to see just how different inflation has been compared to those expectations. Many forecasters, including ourselves, expected local inflation to lift from around 1% in 2012 right back up towards the top of the RBNZ's 1-3% target range. **But with parallels to Romeo and Juliet, the growth and inflation relationship is proving more complex than initially thought***. Instead of tracking to the top of the RBNZ's target range, **since 2012, inflation has spent more time below 1-3% range than within it, and economists are still debating why.**



Data released in July showed New Zealand Consumer Price Index (CPI) inflation dipped back down to 1.7%p.a. over Q2. **Within the latest data, low fuel prices weighed on headline CPI inflation, as expected. But in addition to the fuel impact, inflation pressures were lower than expected in other parts of the economy.** For sure, higher housing construction costs and rent increases are evident, but elsewhere inflation pressures are harder to find. Another inflation surprise over recent years is within labour markets, where wage inflation is low, despite strong employment growth. In New Zealand, despite very solid employment growth and a low unemployment rate, wage inflation is as low as it was in 2010 when the economy was still recovering from the Global Financial Crisis.

*The quote *O Romeo, Romeo! Wherefore art thou Romeo* does not mean *"Where are you, Romeo?"* but "*Why are you Romeo?"* i.e. "Why did you have to be a Montague, the rival family to Juliet's Capulet family?" With inflation, economists are wondering both where it is, and why it is behaving so differently to what we imagined a few years ago.

For the latest performance information on ASB's funds click here for ASB Kiwisaver Scheme,

click here for ASB Investment Funds. More information on ASB Securities is here.

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Please refer to the important disclosures at the end of this document.

For investors, an important consequence is this weak inflation pulse is keeping the RBNZ comfortable with the record low 1.75% Official Cash Rate. And in turn, the low OCR is impacting investment returns.

It's a similar story abroad. Inflation is low, and so are central bank interest rate policy settings. In the US, core inflation was running comfortably above 2%p.a. last year, but has since dipped to 1.7%p.a. over recent months. **Weakening inflation pressure in the US is a reason why market participants have pared back the extent to which they expect the Federal Reserve to lift the Federal Funds rate.** We expect only one more 0.25% hike this year, and another next year. The expected hikes would lift the upper end of the Fed Funds rate target range to a still-low 1.75%. The Federal Reserve remained on hold in July, but still expects to deliver multiple interest rate increases over the coming years. **Financial market pricing suggests market participants don't think the Federal Funds rate will get anywhere near the levels Fed officials are suggesting in their forecasts for the next few years.** Reflecting these developments, US bond yields remain low.

Australian CPI was also softer than expected in the second quarter, printing at an annual rate of 1.9%. We expect the Reserve Bank of Australia (RBA) to be disappointed that headline inflation is again below its 2-3% target range. We think the RBA will most likely keep interest rates on hold until late 2018. Low inflation means the risks over this year lie with a rate cut rather than a hike in Australia.

One central bank that lifted interest rates in July is the Bank of Canada (BoC), which lifted the policy rate 0.25% to 0.75%. That's the first hike in seven years. The BoC noted that *"future adjustments to the target for the overnight rate will be guided by incoming data".* That suggests more rate hikes are in the pipeline for the next 18 months, assuming the BoC's expectation of a lift in inflation transpires. **We think the Bank of England may also begin raising interest rates** later this year. UK CPI inflation is an outlier, running close to 3%p.a. A weaker GBP in the wake of last year's Brexit vote has boosted UK inflation.

Meanwhile, sharemarkets continue to rally, as investors hunt for returns. Our NZX-50 (Gross) index of shares set a record high in July. So did the US Dow Jones Industrial Average, the US S&P 500 and MSCI World Share indices.

We will be watching with interest how inflation developments continue. We are also watching how central banks manage the risks of inflation being too low for their liking at a time when low interest rates are supporting very high prices for other assets such as housing and shares.

Date	Instrument	31-Jul-17	Month %	Quarter %	Year %	5-Year %
Cash	NZ Official Cash Rate	1.75	0.00	0.00	-0.50	-0.75
	NZ 90-day bank bill	1.95	-0.03	-0.03	-0.33	-0.72
Fixed	NZ 5-year gov't stock	2.57	-0.09	0.14	0.70	-0.40
Interest	NZ 10-year gov't	2.98	0.01	-0.07	0.80	-0.54
	AUS 10-year gov't	2.70	0.10	0.12	0.80	-0.34
	US 10-year gov't	2.28	0.01	0.00	0.75	0.77
Australasian	NZ - NZX50 Capital (NZ$)	3575.22	0.3%	2.9%	-0.1%	72.8%
Equities	- NZX50 Gross (NZ$)	7639.51	0.2%	3.5%	3.9%	115.5%
	AUS - All Ords (A$)	5755.20	-0.2%	-3.2%	2.0%	34.2%
International	JAP - Nikkei (¥)	19960	-0.4%	4.0%	20.5%	129.6%
Equities	UK - FT100 (£)	7368	0.8%	2.3%	9.6%	30.8%
	US - S&P500 (US$)	2472	2.0%	3.7%	13.7%	79.2%
	WORLD - MSCI (US$)	1960	2.3%	4.4%	13.9%	56.8%
	MSCI in NZD (NZ$)	2611	-0.2%	-4.4%	7.7%	69.1%
Exchange	NZD/USD	0.7509	2.5%	9.2%	5.8%	-7.3%
Rates	NZD/AUD	0.9403	-1.2%	2.2%	-0.2%	22.2%
	NZD/JPY	82.97	1.2%	8.6%	13.1%	31.0%
	NZD/GBP	0.5719	1.7%	7.4%	6.2%	11.0%
	NZD/EUR	0.6397	-0.1%	1.1%	-0.1%	-3.0%
	NZ TWI	78.98	0.9%	5.6%	4.2%	7.3%

Equity indices are the respective end-of-month closes. Interest rates and exchanges rates are at 5pm NZ.

Income Assets

Cash

The RBNZ held its latest review on 22 June, and kept the Official Cash Rate (OCR) at 1.75%, as expected. Since then, the lower than expected Q2 inflation data will reinforce the RBNZ's current policy stance. RBNZ forecasts released in May suggested the RBNZ expects to keep the OCR around the current level (1.75%) until late 2019. We think that the healthy economic growth outlook will eventually prompt the RBNZ to increase the OCR a little earlier, but not within the next year. The RBNZ's next OCR announcement, and a full set of forecasts, are due on 10 August.

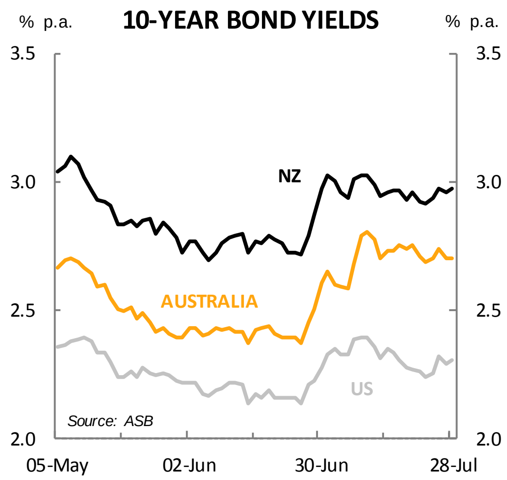
What does it mean for investors: The upward pressure we saw on longer-term rates earlier in 2017 has eased somewhat, and term rates remained steady in July. If OCR hikes are still a long way off, most short-term fixed interest returns on term deposits will likely stay near current levels over the next year. However, banks are continuing to offer higher "specials" on selected term deposit rates. **The latest ASB term deposit rates can be found here.**

NZ Fixed Interest

The 10-year NZ Government bond yield ended the month up 1 bp or 0.01%, at 2.98%, as the late June lift in long-term yields ran out of puff. In contrast, the 2- and 5-year yields actually dipped 0.14% and 0.09% (14 bps and 9bps) respectively during July. Those shorter dated bonds were more responsive to the lower-than-expected local inflation data, and appear more popular with investors than the longer-dated bonds at present.

International Fixed Interest

Offshore, the US Federal Reserve held its target Fed Funds rate as expected in July, and, through a very subtle wording shift, signalled some caution about weakening inflation in the US. However, the Federal Reserve has signalled that the process of selling down its huge holdings of bonds purchased in the wake of the Global Financial Crisis will start "relatively soon". That announcement reinforces our view that the process of unwinding the so-called Quantitative Easing program will get underway at the next FOMC meeting on 20 September. Despite this well signaled policy shift, long-term rates remain low in the US, with the 10-year Government bond yield lifting only 1 basis point or 0.01% to 2.28% over July.

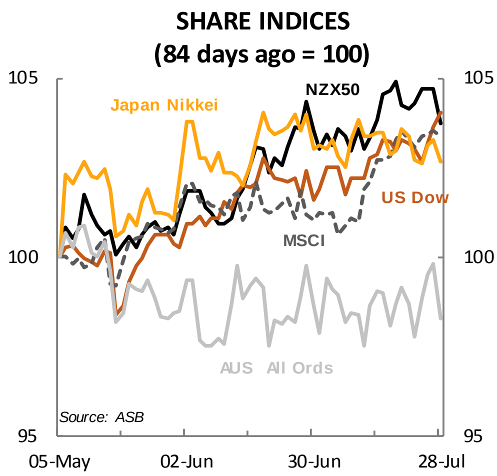


Growth Assets

Australasian Equities:

The NZX50 index of local shares lifted modestly over July, and the Gross index set another record high.

The challenges continued for Fletcher Building, with the company announcing on 20 July another large downgrade to its forecast earnings, the likelihood of impairments of as much as $220 million, and the departure of its CEO. Unsurprisingly the share price plummeted over 8% in the wake of the announcement, but by month end was trading significantly off its lows. In contrast, A2 Milk Co's strong run continues, with the stock lifting another 10% over the



month. Across the Tasman, a lift in iron ore and coal prices over July was a shot in the arm for the big resource exporters, including BHP Billiton. However, the Australian sharemarket still lagged in the performance tables over July, with the All Ords index down 0.2% in AUD terms. The two largest sectors in the Australian Sharemarket performed well: the financial sector was up 1.3%; and the materials sector was up 3.6%. The weakness was in Healthcare (-7.47%), Utilities (-5.33%) and Telcos (-4.29%).

International Equities:

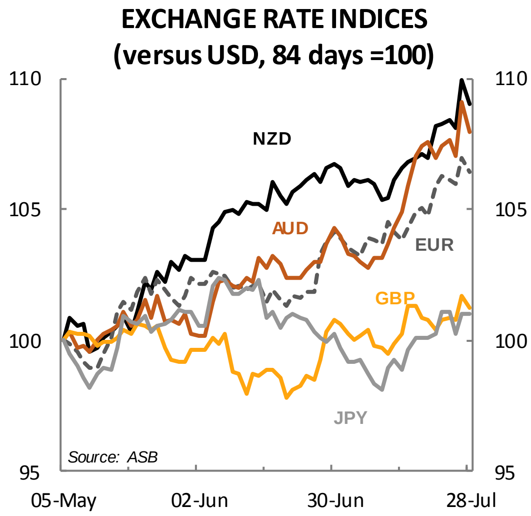
International sharemarkets were mixed, but largely positive in July. Returns ranged from a 0.4% dip for the Nikkei index of Japanese shares, to a 2.0% lift for the US S&P 500 index of shares. Although the Nikkei index dipped over the month, the annual gain of 20.5% keeps the Japanese sharemarket the top performer of the markets we monitor. The US Dow Jones Industrial Average, the US S&P 500 and MSCI World Share indices all set record highs in July. In USD terms the MSCI index was up 2.3% over the month, and 13.9% over the year to 30 July.

ASB Securities has more information on sharemarkets and trading here.

Exchange Rates:

The USD continues to weaken, and during July that pushed NZD/USD back above 0.7500 for the first time since early 2015. Soft US inflation pressure and fiscal policy inaction undermined the USD during the month. The NZD itself has also been guided higher recently by New Zealand's relatively healthy economic outlook, and favourable developments for NZ's key foreign currency earners. High profile examples are dairy and tourism, but other key exporters are also performing well. On a trade-weighted basis the NZD lifted 0.9% over the month.

The AUD is also on the rise, boosted by improved hard commodity prices in July. The AUD strength has seen NZD/AUD ease back towards 0.9400 over July.



For more insights into currency issues, our latest **ASB Kiwi Dollar Barometer can be downloaded here.**

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