Change – the only constant

Financial markets are constantly responding to economic events and change. So should you as well? That really depends on the sort of changes taking place.

A successful investment strategy needs to be responsive to change – but not too responsive. Some changes will necessitate a review of how your portfolio is structured, while others are best ignored.

For example, asset prices can fluctuate simply on the basis of investor 'perceptions' rather than any actual change in the economic environment. This kind of activity is often referred to as 'noise' and generally does not warrant any real concern.

Noise aside, change is one of the few constants in the economic environment, and financial markets must constantly assess each development and its likely effect on asset values. In other words, cause and effect.

Most economic changes contribute to further change, so when looking at the likely effect, you also need to look back at how that change came about. For example, if the Reserve Bank raises its Official Cash Rate (OCR), mortgage rates and term deposit rates usually follow suit. However, taking a step back, the reason the Bank raises the OCR is usually because it sees inflationary pressures building in the economy – and those pressures can affect much more than just interest rates.

Significant economic changes are mostly due to trends in the general direction of the economy, as well as cyclical patterns. For example, some major drivers of economic growth are the rate of population growth and improvements in productivity. However, against the backdrop of these trends also lie the various cycles, many of which are seasonal.

Take interest rates. They are currently rising and will eventually peak – probably around the middle of next year – before falling. Once they hit a trough, they will start to rise again… and so it goes on. Each cycle may be longer or shorter than the previous one and the peaks and troughs closer or further apart, but the patterns remain.

However, today's interest cycles are different from those 15 or 30 years ago. This is because New Zealand underwent a major change in the early 90s when it changed from being a medium-to-high inflation/interest rate economy to a low inflation/interest rate economy (at least by OECD standards).

While that means high mortgage rates can now be anything over, say, 9.5% rather than 15%, it also means house values tend to be more stable without the old inflationary pressures driving them.

For investors, all of this means two things. First, it pays to know where the economy is in its current business cycle and also the dominant trends driving the economy. Second, devise an investment strategy that combines your economic readings with your individual investment situation and objectives.

As you can see, there's more to successful investment than just picking a few shares or bonds out of the paper. For best results, seek the help of a professional adviser.

ENDS