Select WEALTH MANAGEMENT

Investment Update – January 2020

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Equities End 2019 Strongly

Most equity markets experienced strong returns over December. The New Zealand S&P/NZX 50 gross index increased 1.5% in December but lagged the S&P 500, the FTSE 100 and the MSCI World Accumulation index which were all up approximately 3% in the month (all in local terms). The December returns capped off a 30.4% return for the New Zealand equity market over 2019 and 31.5% in the US equity market. The Australian equity market could not match this performance and the Australian S&P/ASX 200 Accumulation index fell 2.2% in December while rising 23.4% for the year.

Locally Fixed Interest lost ground in December with the S&P/NZX Investment Grade Corporate Bond index down 0.61% in the month and the S&P/NZX Government Bond index down 1.89%. For the year these indices were up 5.32% and 4.89% respectively.

Fiscal Stimulus & Bank Capital

Central banks have lamented the weight placed on monetary policy to support economic conditions. To reduce the reliance on monetary policy the New Zealand government has moved to stimulate the economy through fiscal spending initiatives. NZ$400 million is to be spent immediately on school infrastructure as part of a NZ$12 billion stimulus package. NZ$8.1 billion of the package is to be spent over the period to 2024. Specific detail of the expenditure is yet to be announced. This additional expenditure if implemented in a timely fashion should continue to support construction related segments of the economy with flow on effects. Anticipated increased funding requirements to a degree would have contributed to rising interest rates in New Zealand since September. Potentially the introduction of government spending marks a return to the use of fiscal policy as a primary tool of economic management globally. Japan also announced a fiscal spending package equating to 2% of GDP over the next 15 months. Increased government expenditure was also a feature of the United Kingdom election campaign with both the major parties promising fiscal stimulus.

RBNZ Governor Orr referred to monetary policy being in a “holding phase” during the month, in part the pause being related to the nature and scale of the Finance Minister’s fiscal stimulus package. In early December the RBNZ announced its long anticipated bank capital proposals. The capital requirement has been softened from 18% to a minimum 16% Tier 1 capital ratio for the “Big 4 banks”. Currently the equivalent ratio is 8.5%. Further concessions include an extension of the implementation period from 5 to 7 years and the ability to use redeemable preference capital in calculating the contribution to the minimum capital requirement. The new regulatory capital proposals had also been seen as driving interest rates higher as banks were anticipated to lift rates to preserve return on capital. The RBNZ itself has calculated that the now proposed rules will lift the average lending rate by 20 bps instead of the 30 bps estimate for the original proposal.

Trade Wars Edge Closer to Resolution

The US and China progressed agreement in respect of the trade dispute. Prior to Christmas substantive agreement was reached on stage 1 of the negotiations. The US has agreed to scrap the next round of tariffs intended to be imposed on US$160 billion of Chinese goods and has also proposed slashing duties to 7.5% on US$120 billion of Chinese products. The agreement includes changes regarding intellectual property, technology and financial services. China has cancelled retaliatory tariffs and agreed to purchase US$200 billion of US agricultural and other products over the next two years.

Although the US and China have reached some form of accommodation other trade disputes continue to simmer. President Trump has proposed reinstating tariffs on steel and aluminium from Brazil and Argentina in response to weak currencies enhancing the competitive position of these economies farm products in the US market. Tariffs have also been proposed on French products (Cheese, wine and handbags) as high as 100% in response to French taxes on US digital companies.

Conservative Government Returned in the United Kingdom

The interminable Brexit negotiations appear to be closer to conclusion with the British public endorsing the Boris Johnson led Conservative government. Although the election outcome is interpreted as supportive of an expeditious exit by the UK from the European Union the election outcome should also be seen as a rejection of Labour party policies which would have radically restructured the UK economy. United Kingdom equities are more investable in the wake of the election. There are however several further cliff edge events over the next year in relation to Brexit and the fact that at least 28 individual European entities must agree to exit terms provides major hurdles to completion. The UK government will wish to maintain some form of trade agreement with the EU. Negotiation of an agreement is likely to result in further fluctuation in sentiment in the United Kingdom securities markets.

Australia Experiencing Mixed Fortunes

The RBA held the Australian cash rate at 0.75% in December. The RBA believes that easing of monetary policy to date has supported employment and income growth and that inflation will return in the medium term. Despite this the Australian fixed income market has maintained an easing bias into 2020. The economic data flowing from Australia in early December was contradictory. Company profits were reported lower, firms were undertaking destocking and the indices measuring levels of manufacturing and service activity contracted in the prior month. Job advertising also declined. Indicative of international trade conditions the 4 major Australian container ports' volumes were on average down 5.6% in November, year to date. Car sales in Australia were -9.8% in November versus November 2018, the 20th straight month of decline. All of these signals indicate that caution is warranted in the Australian economy.

In contrast the metropolitan residential property markets rebounded with Corelogic reporting Sydney and Melbourne house prices +2.7% and +2.3% respectively month on month. Despite the negatives Australian GDP growth remains positive and improved to 1.7% per annum in the latest data.

The current fire season's longer-term repercussions are clouded. Undoubtedly there has been an immediate impact on sentiment and consumer confidence is declining.

New Zealand Markets Overcome Hurdles

New Zealand interest rates bottomed in September and rose through the quarter. The rising rates reflected a similar trend in the US bond market and constituted an impediment to equity market performance. Property and infrastructure stock returns were lacklustre as the rising rates were absorbed in pricing. Property stock prices were affected to the extent that the retail component of Kiwi Property Group's capital raising was substantially undersubscribed.

The New Zealand dollar has appreciated through December against the US Dollar, Japanese Yen and European currencies (including surprisingly the Pound). This has diminished the returns from offshore equities for the period and is a negative for export receipts. However, the terms of trade have remained reasonable. Dairy commodity prices had been rising up until the December auction when the whole milk powder price fell. Other Agricultural products particularly meat experienced high prices into calendar year end.

The best performing New Zealand equities in December included 3 retirement village companies Oceania (+22%), Arvida (+20%) and Metlifecare (+17%). The retirement village operators had previously lagged the market but regained momentum with a strengthening residential market and takeover interest in Metlifecare.

The poorest performing companies were Z Energy (-14%) and Sky Network Television (-16%). Z Energy again disappointed the market with reduced earnings guidance and lower dividend outlook. Sky Network Television in November reported several broadcasting initiatives with the NZ Rugby Union and Tokyo Olympics. This was followed in December with the company acquiring Lightbox for an undisclosed sum. The strategies are intended to defend the company against further encroachment from streaming services.

Outlook

Diligent advisors must continuously maintain surveillance for signs of vulnerability or opportunity. High debt levels, tight employment conditions, emerging market devaluation and general corporate and market complacency are all areas under observation. In addition, the shadow of geopolitical disruption remains an ever-present overhang. On the whole however the present investment outlook appears to remain reasonably benign.

Admittedly tax stimulus has waned, trade is suffering from tariff impediments and markets are unlikely to receive a boost from interest rate declines. Equity and bond prices to a degree reflect these factors and arguably prices are not excessive with these considerations baked in. The gap between equity and bond yields continues to favour equity investment in New Zealand and the United States. The US S&P500 forward PE multiple at 19.6 is elevated from an average of around 16x but is consistent with a lower cost of capital. Some debate exists as to the extent of earnings growth in recent years, but it seems reasonable for Citigroup's expectation of operating earnings growth of 4.8% to be achieved in 2020 consistent with recent upward earnings revisions. Share buy backs have been supportive of large US corporates and there is no apparent reason for this activity to desist.

Volatility and more modest returns appear to be the most probable scenario for the 2020 year. In a lower return environment key to success will be avoidance of investment reversals. Investors are unlikely to be able to rely on rising values in all asset classes and uniform performance of securities within investment sectors. Shares are preferred in the current environment with bonds and bond proxies less well placed on the assumption that longer term interest rates rise, and short-term interest rates are anchored at current levels.