Investment Update – November 2019

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Heightened sensitivity

Investors continue to face two contrasting scenarios:

A) Global economies remain subdued and markets decline from elevated levels; or

B) Central bank stimulus continues to prime the pump and markets continue to climb in value.

As a result, investors are fine tuned to market signals as to whether to retreat to safety or continue to pursue returns from more risky positioning.

Investor returns in October were driven by sentiment relating to the immediate impact of interest rate policy decisions and trade negotiations. Consensus outlook improved over the month as the new calendar year approaches. The International Monetary Fund (IMF) published its projections for 2020 and expects 2020 to be a better year than 2019 in terms of economic growth. However, the IMF, as usual makes its projections with significant caveats.

United States key to global trends

The United States sharemarket is being buffeted by the trade dispute with China but has remained remarkably resilient. The S&P500 rose over the month recovering early losses. Third quarter earnings reporting occurred over the month with 74% of companies delivering earnings in excess of admittedly muted market expectations. This is despite most of the S&P 500 earning substantial revenues offshore and the US industrial sector showing definite signs of deceleration. Supporting the equity market is resilient US consumer demand which comprises 70% of US GDP and the effect of the Federal Reserve's prior interest rate reductions. Where the central bank makes a change to the benchmark interest rate it typically takes several months for the effect to translate to the real economy. US GDP's latest print was 1.9% per annum. This exceeded market expectations of 1.6%. The better result was driven by higher consumer and government expenditure. In contrast investment and trade segments of the US economy were weaker.

The US Federal Reserve has continued to cut short-term interest rates as 'insurance' against a slowing economy. The Federal Reserve reduced the Federal Funds rate to a range of 1.5% to 1.75% at the end of the month, down 0.25%. It appears that the Federal Reserve will not increase the Federal Funds rate while inflation remains dull.

Australasia not isolated

The local economy and sharemarket are affected by offshore developments in terms of externally facing companies' revenues and capital flows into and out of the New Zealand fixed interest and equity markets. The New Zealand sharemarket slipped in the month with some intra month volatility. This volatility reflected the circumstances of particular companies and positioning in relation to changes to the MSCI index as it relates to New Zealand's largest companies. The composition of the MSCI was reviewed with market speculation that Fletcher Building would be removed, and Mercury enter the index. These changes drive passive offshore investment flows into and out of shares.

In addition, both Fletcher Building and the electricity companies which represent a substantial proportion of the market index were impacted by company specific events. Fletcher Building's convention centre project for Sky City suffered a fire which will delay completion of the project. As the insurance position of the respective companies is unknown the financial impact of the fire remains uncertain. Nevertheless, the issue will likely impact sentiment for a lengthy period of time as the parties' dispute liability for the actual and consequential costs of the fire.

The electricity companies have been impacted by a reopening of negotiations by Rio Tinto over the price of electricity supplied to their aluminium smelter at Tiwai Point in Bluff. The smelter is a sufficiently large electricity consumer that if the smelter closes it will result in a fall in power prices for several years. All power companies are impacted by a market wide fall in electricity prices. Although closure is thought to be a low probability outcome, ongoing uncertainty will hang over company share prices until resolution.

Long-term interest rates in New Zealand and the United States rose slightly over the month. Longer term interest rates globally are impacted by US rates although the strength of the correlation fluctuates over time. Investors in fixed interest became less pessimistic as to the outlook for growth (trade negotiations between the US and China appeared to make progress) and the supply of bonds continued to expand. New Zealand interest rates reached a six-week high with the government 10-year bond at 1.27% on 29 October. This is a large move in interest rates in a short time period but is still outweighed by falls earlier in the year. Bond fund returns were adversely impacted as a result. Market pricing in relation to a further cut in the Official Cash Rate moderated over the month but an overall expectation of a further cut remains.

Like New Zealand, the Australian sharemarket was flat over the month. The Australian economy is providing mixed signals. There are a number of positive signs. Residential housing prices in the major Australian cities appear to have bottomed, but building consents declined 23% last month relative to the previous comparable period.

The Australian business outlook per Reuters forecast poll is for GDP to print at 1.9% for 2019 and for the Australian economy to pick up in 2020 to 2.5%. Positively, investors in

Australian equities are paying a much lower average price earnings multiple than New Zealand although this is distorted by the preponderance of banking and resources stocks**.**

Performance of the Australian sharemarket was held back by the major Australian banks taking further substantial customer remediation charges, and a further inquiry into bank's mortgage pricing. Uncertainty over the Australian bank's capital positions in response to changing regulatory requirements is also impacting bank share prices. The major mining companies, BHP and Rio, continue to be affected by a weakening iron ore price. Rio also owns aluminium smelters (including Tiwai Point) and clearly weak aluminium profitability is also a drag.

A feature of the month in Australia was the withdrawal of six company listings, including Latitude, a consumer finance business. The current biggest uncertainty in Australia is the Australian consumer who remains subdued, impacting consumer finance demand and discretionary retailers. To combat the absence of strong consumer demand, below target inflation and higher level of unemployment compared to New Zealand, the Reserve Bank of Australia reduced the cash rate to 0.75% at the beginning of the month. The withdrawal of the floats is being interpreted as exhibiting healthy tension between investors and promoters rather than symptomatic of inherently weak demand for new issues.

New Zealand Property

The returns from New Zealand commercial property in the last year have been exceptional, at over 30% including dividends. The domestic property market is not homogeneous, and returns can vary depending on geography and property type. Although high returns have been achieved rental growth has not kept pace and yields have fallen. While there appears to be strong demand for industrial property, extra supply of office property in the major centres may result in higher vacancy and minimal near-term rental growth in this market segment. While property may remain attractive to yield investors relative to fixed interest, continued gains of the past magnitude are unlikely.

International Interest Rates

International interest rates outside of the US look likely to remain at low levels in the year ahead with minimal signs that central banks will pull back from quantitative easing. The outlook appears to be asymmetric in terms of investor risk from a yield and capital appreciation perspective. The ECB kept rates unchanged at Governor Draghi's last meeting on 25 October. One example of the extremes now occurring are interest rates in Greece. Greek 3-month Treasury Bills were issued at an average negative yield during the month. This contrasts starkly with the situation several years ago when Greek rates surged, and it was feared a Greek default would lead to a widespread collapse.

Outlook

Despite the caution arising from the subdued industrial outlook and lower prevailing business confidence, share values could be justifiable. The immediate outlook for short-term interest rates is for them to remain anchored at current levels due to central bank actions attempting to lift prevailing inflation rates. There is some scope for longer term interest rates to rise as markets re-assess the growth outlook and conclude that it is not as bleak as pre-supposed. A steepening of the yield curve is not to be discounted but any increase in interest rates is unlikely to be large. Equally, interest rates may continue to remain around present levels. Less likely is a scenario where rates diminish materially from current levels. That being the case it is unlikely that investors will experience the same level of capital return from yield sensitive stocks. In particular given the high rate of capital appreciation from property that is unlikely to be repeated, client portfolios that have been overweight property might bank some of these gains. Given the better potential returns from equities and what appears to be a benign forward outlook a higher allocation to equities appears to provide greater scope for portfolio accretion.

In an environment where GDP growth and general earnings growth is likely to be more subdued, that is all boats will not be lifted to the same extent by the economic tide, selective share positioning will be increasingly important to optimise portfolio returns. We increasingly believe an active rather than a passive approach is desirable.