Select WEALTH MANAGEMENT

Investment Update – September 2019

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Yields Become More Negative and More Prevalent

The upside-down world of interest rates became even more contorted in August. Approximately a third of all government and corporate debt now carries a negative yield. German bunds across the yield curve in its entirety are negative to the extent that the German Government on 20 August offered a 30-year bond with a zero-interest rate. The 2 billion Euro auction was only partially successful with only half of the bonds sold.

The phenomenon of negative interest rates is not only evident at a wholesale level in government bond and corporate bonds, - Danish bank Jyske Bank is now offering negative rate mortgages and Finland's Nordea Bank zero rate mortgages.

Yield Curve Inversion

Since the beginning of the year the US yield curve has been increasingly flat and inverted several times in August when the difference between the 2 year and 10-year bond became negative. The extent of the inversion is currently modest but acts as a powerful indicator of the likely future performance of the US economy. In the last 50 years every time the yield curve has inverted it has been followed by a recession. In turn, when the US economy falls in recession, this has typically coincided with a fall in the equity markets. The issues for investors to wrestle with associated with an inverted yield curve are:

- Will the current inversion precede a recession?
- How long will it take after yield curve inversion for a recession to occur?
- If a recession happens will equites fall?
- If the equity market falls how deep will the decline be and how long will the resulting bear market last?

The current economic circumstances are unprecedented in that there has been a long period of US economic expansion and associated bull market (in fact the longest in United States economic history). This buoyancy has stemmed from the Federal Reserve and other central banks engaging in quantitative easing (QE). Capital markets have been awash with funds that has facilitated rising asset prices. This has now culminated in a low and negative interest rate environment together with low inflation and slow economic growth. The low absolute level of interest rates has resulted in the US30 -year bond rate falling under 2% as of 27 August, the lowest level since 2007. The S&P 500's dividend yield now exceeds the yield on 30-year bonds for the first time since 2009 and underlines the attractiveness of equities for long term investors.

The period between yield curve inversion and US recession varies depending on the data utilised, generally between 9 and 34 months later, with an average of 22 months. Therefore, although yield curve inversion is a reliable recession indicator it is less useful as a forecasting tool. To date the current inversion is modest and has not been deep. Combining the yield curve inversion with other economic indicators leads us to believe a slowdown in growth could occur. Indicatively the US August Manufacturing PMI was 50.9 versus 52.8 expected.

New Zealand Fixed Interest

The New Zealand fixed interest market has not been immune to the moves in overseas fixed interest markets. Typically, New Zealand's long-term bond market is more impacted by overseas interest rate movements than short term rates that are more influenced by domestic monetary policy. The New Zealand 10-year bond broke below 1% on 16 August for the first time on record. August saw the RBNZ reduce the Official Cash Rate (OCR) by 50 bps to 1.0%. The reduction in the OCR was all the more surprising given that the RBNZ's objectives are to hold inflation within a 1 -3 % band and target full employment. Inflation in New Zealand is currently below the mid-point of the target band but is within it. Employment data immediately prior to the RBNZ monetary policy statement was reported at a very low level of 3.9%. The RBNZ has justified its action on the basis that it is forward looking, and headwinds are rising. The OCR cut is therefore characterised as an insurance cut to preserve economic momentum. The pre-emptive nature of the RBNZ action has been reinforced by the RBNZ Governor's statements at the Jackson Hole central bankers conference. Governor Orr somewhat contradictorily stated that New Zealand economy is in a strong position and as a result the RBNZ could "afford to watch, wait and observe what is happening… we will have to see what the situation is in November and be willing to continue to cut if necessary." Perhaps the nub of the RBNZ's action in August is due to the Governor's observation that "if other countries are cutting more rapidly and our exchange rate is being forced up that becomes an issue for us". At present the market pricing is projecting further falls in the OCR potentially to 0.6%.

The momentum in the New Zealand fixed interest markets is therefore unequivocally downward. At issue is whether New Zealand can also plumb negative interest rates and if this is likely to be the preferred RBNZ policy. There are conflicting opinions as to the RBNZ's preferred policy while it is still in gestation. Will negative interest rates or quantitative easing be preferred by the bank? The Reserve Bank Governor is reported to presently favour negative interest rates in preference to QE. This contrasts with Australia where RBA officials have suggested that the terminal cash rate is 0% to 0.5% and other measures could be employed to prevent negative interest rates.

Trade War Intensifies

Trade conflict between the United States and China escalated in August and the rhetoric associated with the conflict became more extreme with China branded the enemy, and Trump threatening to force US corporations to cease manufacturing in China and regretting that imposed tariffs were not higher. For China's part it has announced intentions to raise the tariffs on US goods further. Although the US economy is largely inward looking and 70% of GDP is generated by the US consumer sector there is little doubt that the trade conflict is affecting the US economy. As of August, Goldman Sachs estimates the growth hit to GDP to have increased to 0.6%. Goldman Sachs estimate the drag on GDP growth would increase to 0.8% if the tariff rate on US$300 billion of imports from China increased to 25%. Currently US annual GDP growth is running at 2.0%.

The probability of a negotiated cease fire and resolution of the existing conflict appears to be diminishing. China is exhibiting increasing resolution and has been progressively reducing its dependency on the US export market over time. Chinese economic management is more integrated than that of the US and this enables a more co-ordinated response in relation to monetary and fiscal policy within China. Moreover, the Chinese currency is not freely floating, and this has enabled a managed response to maintain competitiveness. China appears to be increasingly sceptical that President Trump is a reliable negotiating partner. With little confidence that if a deal were agreed, the US leadership would not renege it is increasingly the view that Chinese leadership will wait out the outcome of the US Presidential elections.

China however does have its own 'internal' issues to grapple with in Hong Kong. The Chinese Government response to the escalating situation in Hong Kong and degree of assertiveness has implications beyond the immediate calm of the city. These include continuing confidence in the free flow of capital into and out of China via Hong Kong banks and the response of Taiwan to China's management of internal dissent. Taiwan is a global centre of microchip manufacture and availability of chip supply has global implications.

For offshore investors in the US equity market the impact is being directly felt as many of the large S&P 500 companies are multinational with significant offshore earnings.

Brexit

The Brexit saga in the United Kingdom continued in August without resolution. UK Prime Minister Boris Johnson has expressed a determination to lead the United Kingdom out of the European Community on the 31st of October regardless of whether an agreement has been concluded or not. He is prepared to continue to negotiate with the EU until this date but will deliver a hard Brexit if a satisfactory agreement cannot be concluded. Under this scenario the process will finally come to resolution with immediate effect on financial markets. The outcome is likely to be disruptive initially with the most visible impact the movement of the British pound. Brexit will result in increased border friction and the Bank of England estimates a one in three chance of a UK recession in the first quarter of 2020.

Australasian Company Reporting

August has seen those companies with June balance dates reporting results in New Zealand and Australia. New Zealand companies' scorecard has been balanced with reported earnings broadly in line with expectations. Overall there has been growth in company earnings but modest in quantum. Outlook statements have generally been cautious. The Australian reporting season has been marked by some very strong year on year performances particularly from resources companies.

Summary

The warning signals to investors are increasing in intensity but are not yet at a point where unequivocal downside risk is apparent. Investor returns have continued to be positive through August with investors positioned in fixed income and defensive yield investments experiencing very satisfactory returns. Although economies are increasingly sailing into unchartered waters given the absolute low levels of interest rates, main street indicators such as employment, employee earnings, and consumer spending continue to be favourable.