ERIKSENSGLOBAL
Actuaries & Investment Strategists

MARKET PERFORMANCE AND ECONOMIC COMMENTARY – JANUARY 2019

MARKET PERFORMANCE

Financial market behaviour over the past year is summarised in the table below:

Index	1 Month %	3 Month %	1 Year %
Global Equities			
MSCI Emerging Markets	7.2	7.6	-9.7
S&P 500 (US)	7.9	-0.3	-4.2
Nikkei 225 (Japan)	3.8	-5.2	-10.1
FTSE 100 (UK)	3.6	-2.2	-7.5
DAX (Germany)	5.8	-2.4	-15.3
CAC 40 (France)	5.5	-2.0	-8.9
Trans-Tasman Equities			
S&P/NZX 50	2.0	2.7	6.4
S&P/ASX 300	3.9	1.4	1.1
Bonds			
S&P/NZX NZ Government Stock	0.6	1.7	5.8
S&P/NZX A Grade Corporate Bonds	0.6	1.4	4.9
Barclays Global Aggregate Bonds	0.6	1.5	5.2
FTSE World Government Bonds	0.9	2.7	3.4
Oil			
West Texas Intermediate Crude Oil	18.5	-17.6	-16.9
Brent Crude Oil	14.6	-17.5	-11.5
NZD Foreign Exchange			
AUD	-0.1	3.2	4.1
EUR	3.0	4.9	1.7
GBP	0.1	3.2	1.3
JPY	2.6	2.4	-6.6
CNY	1.0	2.2	-0.1
USD	3.4	6.2	-6.3

Source: Nikko Asset Management

We make the following key observations:

- Significant bounce in equity markets in January following December quarter falls, it's been a volatile four months
- Positive returns in Trans-Tasman Equities over the year compared to negative global markets
- Low returns from bond markets, though better than most equity markets over the year
- Rebound in oil prices with concerns over shale production, lower OPEC output and reduced concerns over the US/China trade war
- Broadly stronger NZD against most currencies in recent months

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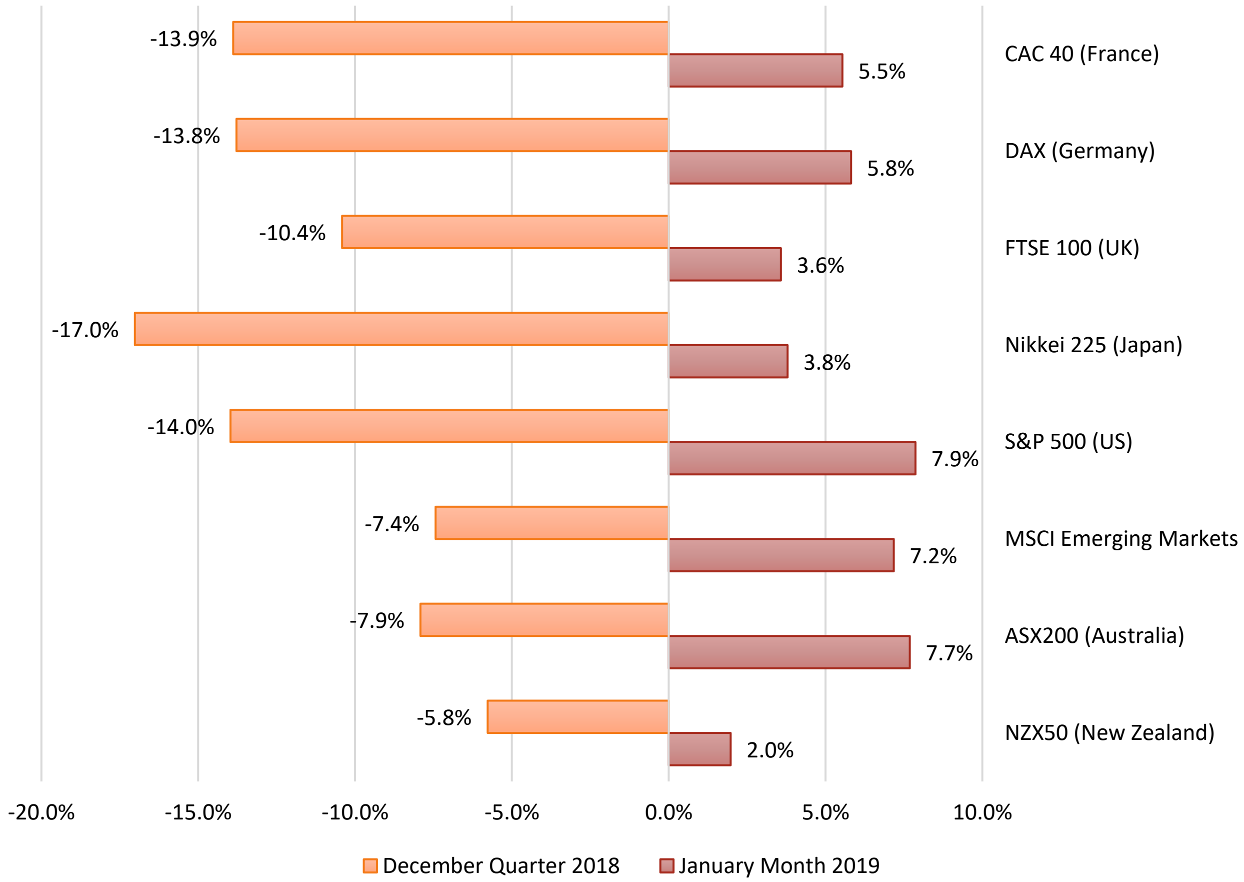
ECONOMIC COMMENTARY

Realised volatility in equity markets has been significant in the past four months or so. It is amazing how quickly things can change based largely on the comments of just US Fed Chair Jerome Powell and their interest rate outlook. The change in tone just before Christmas to a more accommodative tone meant risk-on for equity investors. Markets bounced significantly due to the resumption of the "Fed put". The red bars to the right of Figure 1 show the one month return in January (all positive) versus the quarter return to the end of December (all negative).

Figure 1: Equity market returns - December quarter 2018 vs January month 2019



Source: data from Nikko Asset Management

Now that we are over eight weeks in to 2019 the likely scenarios are becoming clearer. We are more optimistic about markets than we have been for three years because last quarters downturn showed complacent investors the risks of investing in growth assets are not a one-way bet. Central banks, regulators, investment managers and investors are now more focussed on managing their respective responsibilities within the markets.

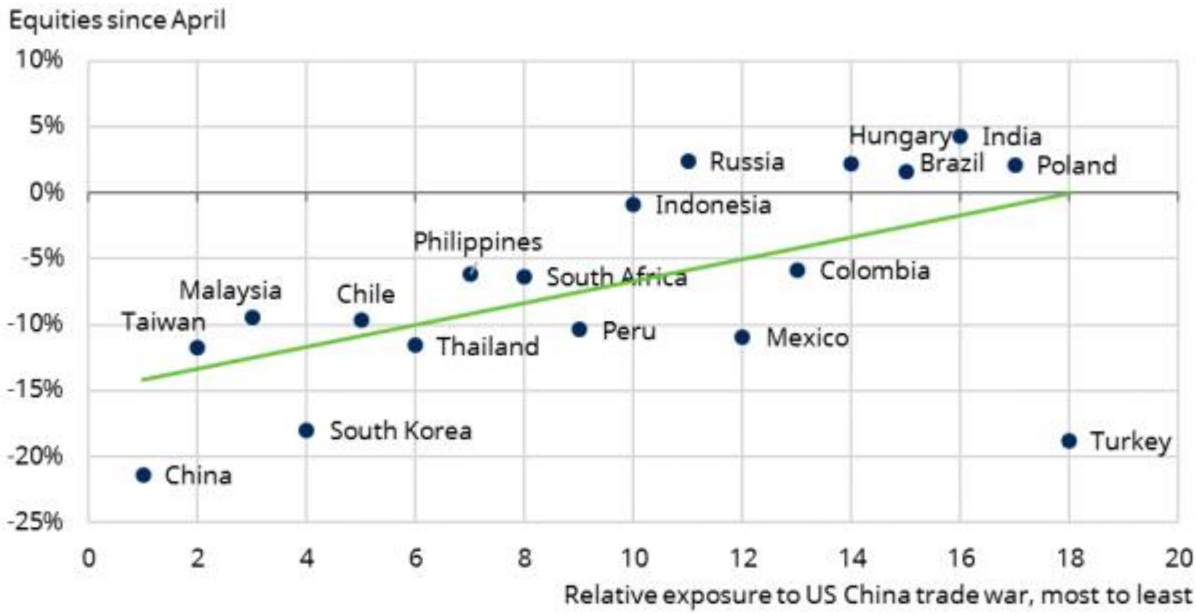
The Central Bank put option ("Fed put" mentioned above), in other words, positive intervention to either reduce interest rates or provide additional liquidity when economic growth or stock markets fall significantly, should keep the current abnormally low interest rates (cost of capital) lower for longer.

We consider there is just one significant risk which is hard to assess. That is the ongoing risk of a trade war between China and the US. Provided the negotiations continue to progress and hopefully a lower or non-tariff solution is found, the global economy may remain less volatile.

But should tariffs be imposed or other geopolitical events occur the risks are for another large-ish correction, which would erase all the returns achieved to date this year and some.

Figure 2 below shows the effect of the trade war on Emerging Market equities since April 2018. The countries that were most exposed by the trade war are to the left. The equity returns of these countries were generally more negative, as shown by figures on the vertical axis. If trade negotiations do not progress positively then we could see negative returns like below in both emerging markets and developed markets.

Figure 2: Exposure to US-China trade was fears versus equity performance



Source: OECD, Thomson Reuters Datastream, Schroders Economics Group
https://www.schroders.com/en/sysglobalassets/digital/insights/2019/pdfs/viewpoint/economic-and-strategy-viewpoint-january-2019.pdf

In New Zealand the recent report from the Reserve Bank of New Zealand on banking capital ratios is something to watch closely moving forward. The main proposition by the RBNZ is to increase equity capital held by banks from 8.5% of risk-weighted assets to 16% for larger banks and 15% for smaller banks. This would be phased in over a five-year period. The banks' willingness to lend will certainly be affected and could mean an increase in lending rates. UBS estimates this could increase mortgage rates by between 0.80% and 1.25%.