

MARKET PERFORMANCE

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

Index	1 Month %	Quarter %	1 Year %
Global Equities			
MSCI Emerging Markets	1.4	9.8	-1.9
S&P 500 (US)	1.8	13.1	7.3
Nikkei 225 (Japan)	-0.8	6.0	-1.2
FTSE 100 (UK)	2.9	8.2	3.2
DAX (Germany)	0.1	9.2	-4.7
CAC 40 (France)	2.1	13.1	3.5
Trans-Tasman Equities			
S&P/NZX 50	5.6	11.7	18.3
S&P/ASX 300	0.7	10.9	11.7
Bonds			
S&P/NZX NZ Government Stock	1.9	3.1	7.4
S&P/NZX A Grade Corporate Bonds	1.2	2.3	6.0
Barclays Global Aggregate Bonds	1.7	2.8	4.6
FTSE World Government Bonds	1.8	2.5	4.5
Oil			
West Texas Intermediate Crude Oil	5.1	32.4	-7.4
Brent Crude Oil	2.6	27.0	-2.3
NZD Foreign Exchange			
AUD	0.2	0.8	2.1
EUR	1.5	3.5	3.5
GBP	2.2	-0.6	1.8
JPY	-0.5	2.6	-1.6
CNY	0.5	-0.5	1.1
USD	0.1	1.7	-5.5

Source: Nikko Asset Management

We make the following key observations:

- Steep rise in the New Zealand equity market over each time horizon
- Variance in one-year returns between different global markets
- Bond yields have fallen across each bond market giving good positive returns
- Rise in oil markets over the quarter due to lower OPEC production and concerns over output in Venezuela
- Rise in the NZD versus the AUD over each time horizon

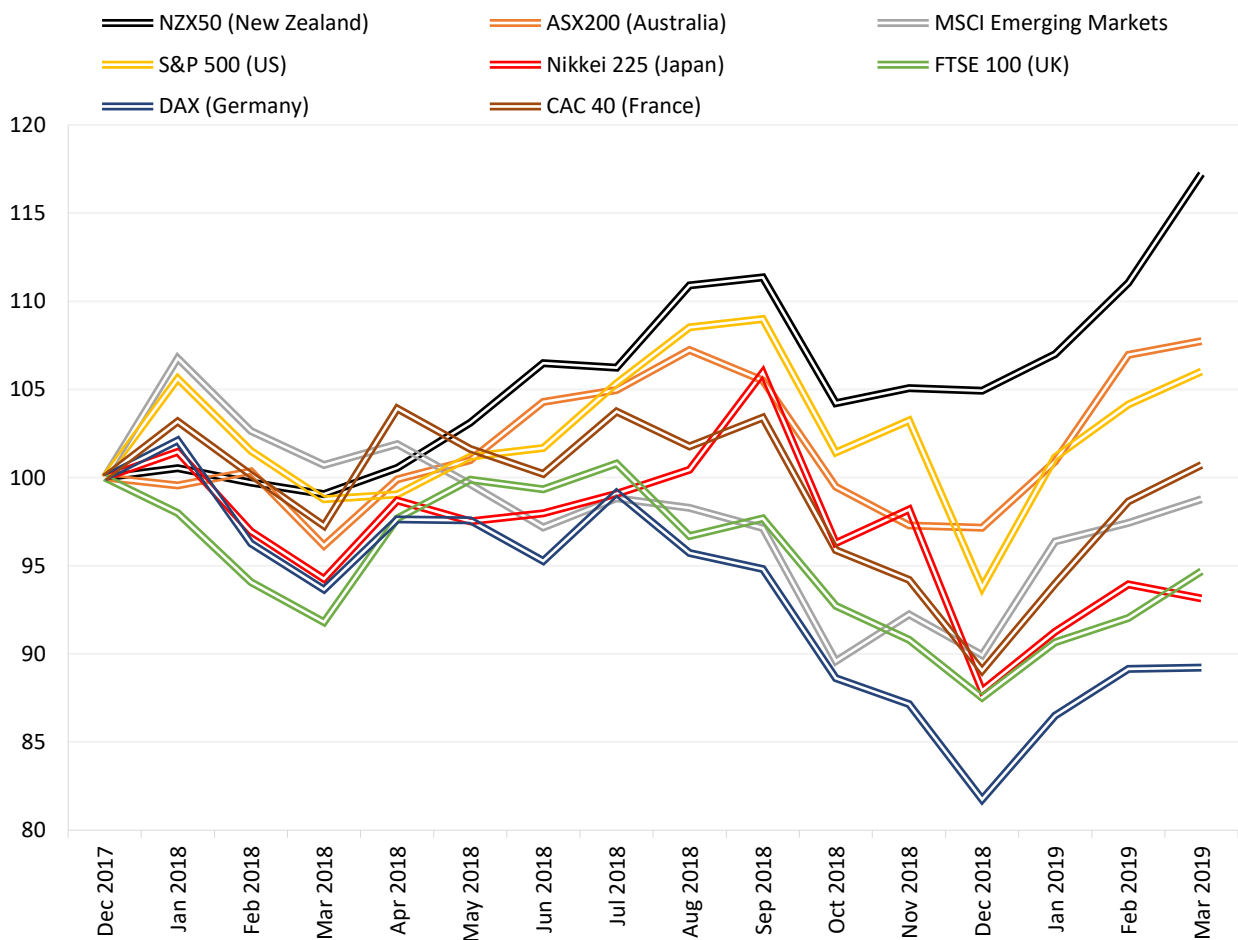
ECONOMIC COMMENTARY

Are ETFs the next CDOs?

At the beginning of the Global Financial Crisis in late 2007 liquidity tightened sharply. A contributing factor was that collateralised debt obligations (CDOs) which were parcels of a variety of credit instruments including subprime debt, consumer credit as well as corporate credit of varying grades. These were rated as AAA or top investment grade whereas some of their component parts proved to be illiquid and effectively worthless. A CDO worth \$100 was marked to market at \$10 or \$20 and finding a buyer was still difficult if not impossible.

With the current emphasis on protecting consumers by reducing fees, exchange traded funds (ETFs) which are listed securities normally based on an index such as the NZX50 or S&P500, are becoming increasingly popular as a way of generating market returns at a low cost. Market segments in both bonds and equities are being sliced and diced to create alternative vehicles to access different investment opportunities. In theory, because ETFs are listed on stock markets, they are liquid. But like CDOs, how liquid are the underlying securities?

Figure 1: Equity market performance since end of 2017



Source: Data from Nikko Asset Management

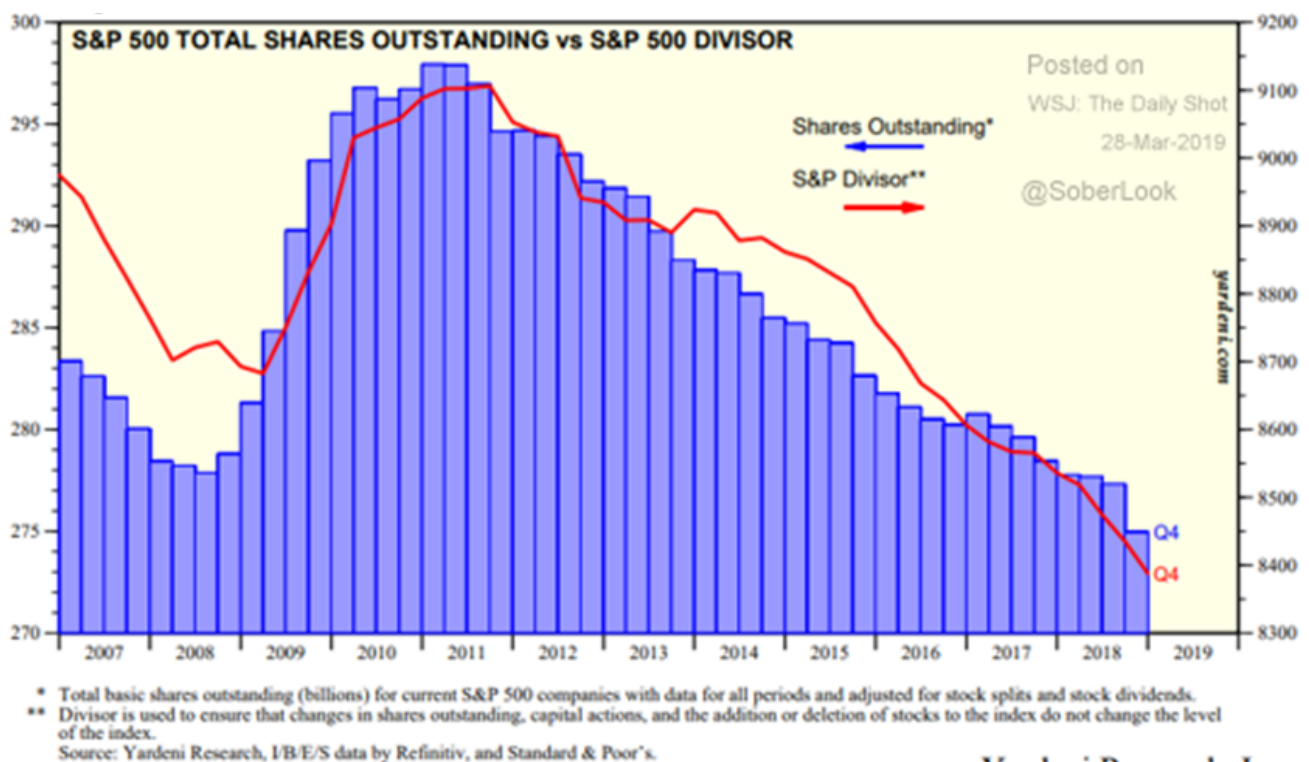
For example, there is a bond ETF in the UK with hourly liquidity on the market. However, the underlying bank securities have T + 10 liquidity. In other words, you have to wait 10 days after putting in the redemption to receive the sale proceeds if you own the actual bonds themselves.

ETF investors allocate the most funds to higher market cap weighted stocks. This makes highly priced stocks even more expensive. Algorithmic trades generated by computer, which are the most common style of investor in North America and Europe, generally seek growth stocks or the high dividend stocks which are more common in Australia and New Zealand. When the markets start to fall, the algorithms tend to generate sell orders until the stop loss levels are reached.

In North America, dividend yields have risen to around 2% from nothing. Share buy backs (see Figure 2) also help to increase stock prices. Both of these techniques help the particular stock to attract a bigger piece of the ETF pie.

So liquidity today, as in 2007/08, still depends on counter parties. If you want to sell, is there someone prepared to buy on the other side at that price? If not, the price will fall to a level at which any purchaser is willing to do the trade. Sounds obvious?

Figure 2: Steady decline in S&P 500 total shares outstanding



Source: The Daily Shot Brief