MARKET PERFORMANCE AND ECONOMIC COMMENTARY – APRIL 2019

MARKET PERFORMANCE

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

Index	1 Month %	3 Months %	1 Year %
Global Equities			
MSCI Emerging Markets	2.6	5.1	-0.6
S&P 500 (US)	3.9	8.9	11.2
Nikkei 225 (Japan)	5.0	7.1	-0.9
FTSE 100 (UK)	1.9	6.4	-1.2
DAX (Germany)	7.1	10.5	-2.1
CAC 40 (France)	4.4	11.9	1.2
Trans-Tasman Equities			
S&P/NZX 50	1.7	11.4	18.6
S&P/ASX 300	2.5	9.4	10.3
Bonds			
S&P/NZX NZ Government Stock	-0.3	2.1	7.2
S&P/NZX A Grade Corporate Bonds	-0.1	1.7	5.9
Barclays Global Aggregate Bonds	0.0	1.8	5.0
FTSE World Government Bonds	-0.2	1.4	4.7
Oil			
West Texas Intermediate Crude Oil	6.3	18.8	-6.8
Brent Crude Oil	6.4	18.0	-4.0
NZD Foreign Exchange			
AUD	-1.3	-0.4	1.5
EUR	-2.0	-1.6	2.0
GBP	-2.3	-3.0	0.0
JPY	-1.6	-1.6	-3.7
CNY	-1.9	-3.4	1.0
USD	-2.2	-3.8	-5.4

Source: Nikko Asset Management

We make the following key observations:

- Strong returns in trans-Tasman equities over the year, particularly in the New Zealand equity market
- Bounce in global equity markets over the last three months, but low returns over the year (except in the US)
- Negative returns in April for all bond markets
- Rise in oil markets over the month and quarter due to risks around a civil war in Libya, continued political concerns in Venezuela and the United States' tougher stance on Iran sanctions by not extending any waivers that expired on 2 May for countries such as China, Turkey, India and Japan
- Fall in the NZD against all currencies over the month and three-month period

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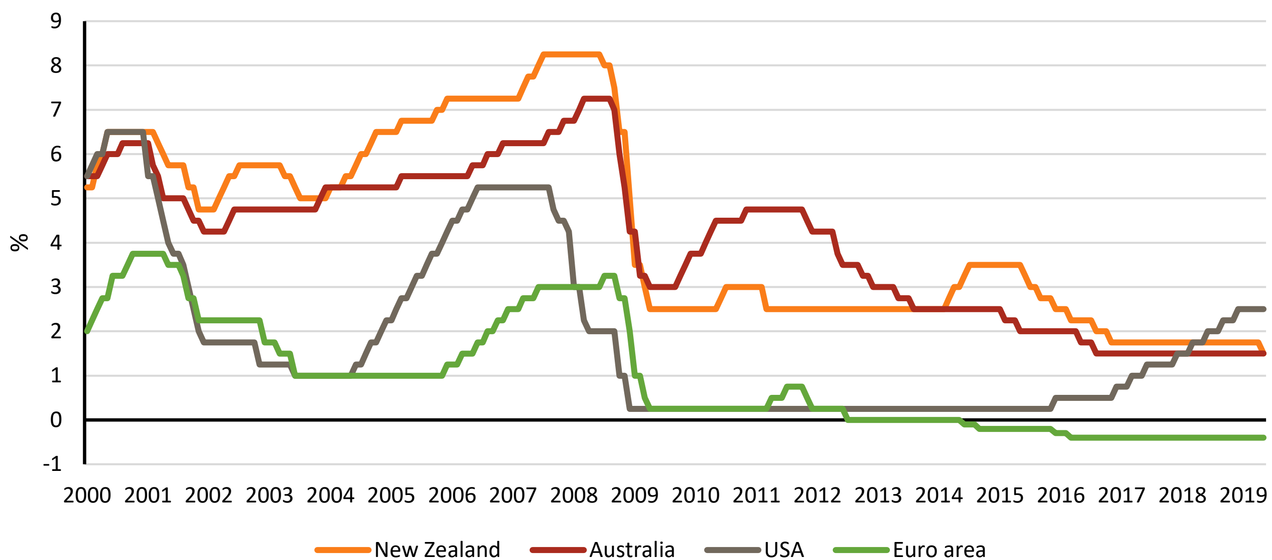
ECONOMIC COMMENTARY

In the last two weeks Central Banks have collectively decided to move to an easing bias. The Canadian, Japanese and Swedish Central Banks have explicitly stated this. The Reserve Bank of Australia kept their rate on hold last week, possibly because of the pending Federal Election. The Reserve Bank of New Zealand cut the OCR to a fresh record low of 1.5% on 8 May.

Investors have generally welcomed the confirmation that the Central Bank put option is still in play. This is effectively the desire by Central Banks to reduce rates to even more accommodative low levels when financial markets appear to be running out of steam. Mr Powell the Chair of the Federal Reserve started the trend at the end of December 2018 and it seems to be catching on.

Figure 1: Central Bank Policy Rates



Average Cash Rate	New Zealand %	Australia %	USA %	Euro Area %
2001 - 2008	6.4	5.5	3.3	2.2
2009 - 2019	2.5	2.8	0.6	0.0
Difference	**-4.0**	**-2.8**	**-2.7**	**-2.2**

As a result, stock markets have reached record highs again, especially in the US and New Zealand – even surpassing the levels last achieved in September last year when liquidity and trade war concerns triggered a sharp change in sentiment from risk on (buy shares) to risk off (sell shares and buy bonds).

Geopolitical risks remain and in the case of trade wars and US/Iran risks seem to be increasing somewhat. Brexit and the negotiations between China and the US continue, interrupted by the occasional tweet from President Trump.

The consensus view seems to be that low interest rates will be with us for several years to come. Unless there is another liquidity or geopolitical event to trigger a risk off mood, investor sentiment should remain

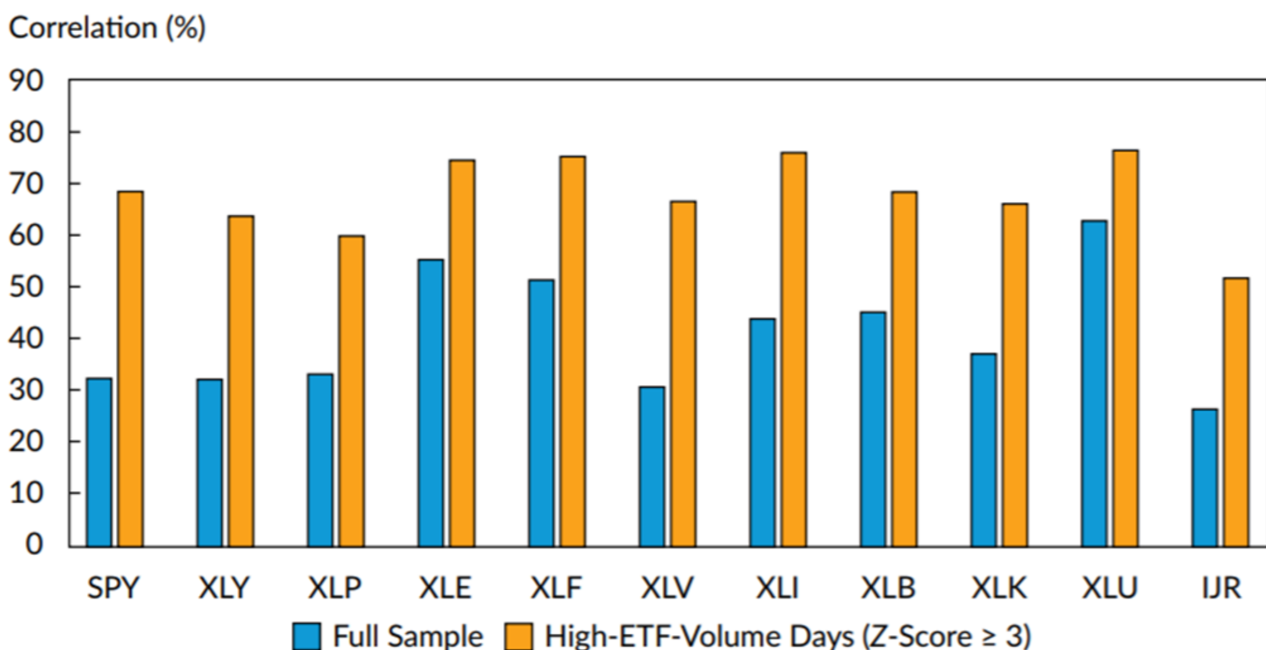
reasonably stable. However, we do not think now would be a safe time to choose to adopt a fully passive investment strategy. Interest rates may begin to normalise before you can exit falling stock markets safely.

In times of market stress, such as falling equity markets, asset correlations tend to move towards one. If all asset values within a portfolio move together at the same time, you lose the ability to protect capital effectively. A properly diversified portfolio should mitigate this somewhat but so should having active managers with an increased focus on downside protection.

The following graph (Figure 2) shows a broad range of exchange-traded funds (ETFs) in the US market. What the graph demonstrates is that in periods of market stress (high trading volume), the correlation between each of the underlying securities within that ETF increases. Whilst there may be systemic reasons that mean all underlying securities are sold off, it also may be due to idiosyncratic reasons driven by investor sentiment towards that particular ETF sector.

The team of analysts at T. Rowe Price used this data to show market inefficiencies. The example they used was the US health sector ETF which fell significantly in September 2015 following negative news in regards to pharmaceutical companies and the steep increase in their human drug prices. The pharmaceutical stocks within the ETF understandably fell in value but so too did the medical equipment companies and animal medicine companies, neither of which should be affected by the news on human drug prices.

Figure 2: Average Cross Constituent Correlations: Full Sample vs. High-ETF Volume Days, 4 January 2010–29 December 2017



Notes: Data are as of 29 December 2017 and include daily data for the SPDR S&P 500 ETF (SPY), nine US sector ETFs, and the iShares Core S&P Small-Cap ETF (IJR).

Sources: Standard & Poor's (S&P); IDC. Data analysis by T. Rowe Price.

Source: Financial Analysts Journal: Hailey Lynch, Sébastien Page, CFA, Robert A. Panariello, CFA, James A. Tzitzouris, Jr., and David Giroux, CFA. 2019.