ERIKSENSGLOBAL
Actuaries & Investment Strategists

MARKET PERFORMANCE AND ECONOMIC COMMENTARY – MAY 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	-6.6	-2.9	-5.0
S&P 500 (US)	-6.6	-1.2	1.7
Nikkei 225 (Japan)	-7.4	-3.7	-7.2
FTSE 100 (UK)	-3.5	1.2	-6.7
DAX (Germany)	-5.0	1.8	-7.0
CAC 40 (France)	-6.8	-0.6	-3.5
Trans-Tasman Equities			
S&P/NZX 50	1.0	8.5	16.9
S&P/ASX 300	1.7	5.0	10.9
Bonds			
S&P/NZX NZ Government Stock	1.2	2.8	7.8
S&P/NZX A Grade Corporate Bonds	1.2	2.4	6.6
Barclays Global Aggregate Bonds	1.4	3.2	6.1
FTSE World Government Bonds	1.8	3.4	6.3
Oil			
West Texas Intermediate Crude Oil	-16.3	-6.5	-20.2
Brent Crude Oil	-12.4	-4.3	-18.4
NZD Foreign Exchange			
AUD	-0.7	-1.8	1.5
EUR	-1.7	-2.3	-2.7
GBP	1.1	0.9	-1.9
JPY	-4.7	-6.7	-7.2
CNY	0.5	-1.0	0.6
USD	-2.3	-4.4	-7.1

Source: Nikko Asset Management

We make the following key observations:

- Sharp sell down in global equities in May, trade tensions continue to unhinge markets
- Trans-Tasman equity markets have outperformed global equities over all periods analysed
- Bond markets provided stable returns
- Further falls in oil through May
- Mixed results with the NZD against the currencies analysed

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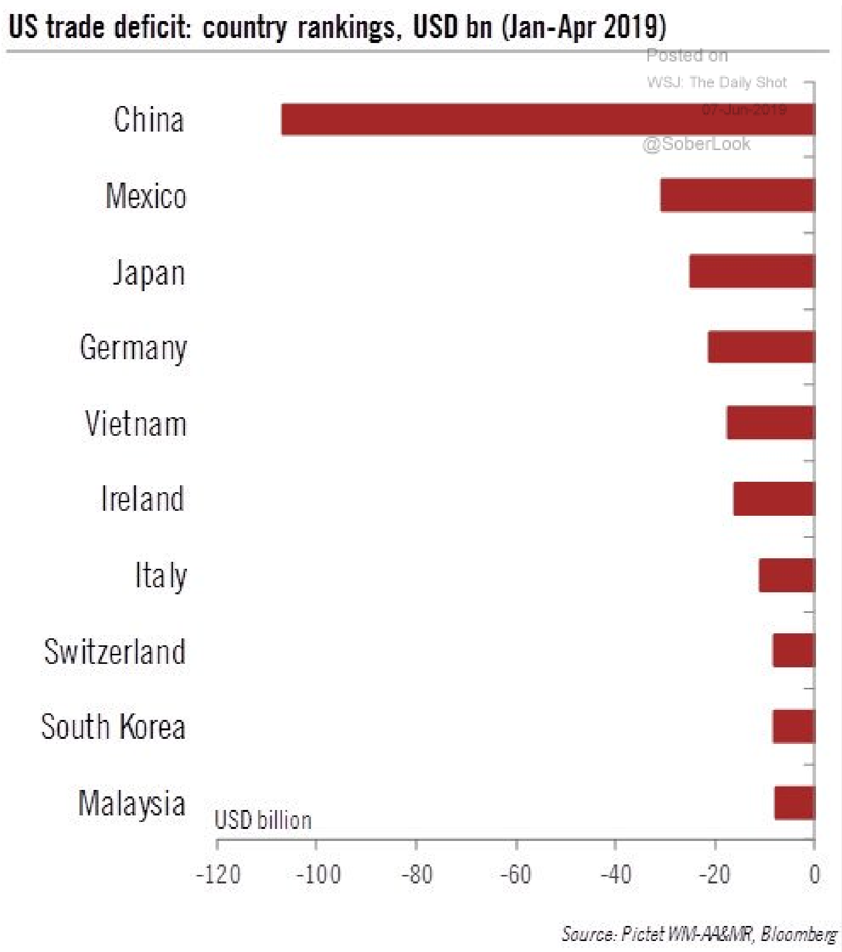
ECONOMIC COMMENTARY

The trade war between the US and China continues to disrupt financial markets. The largest 25 companies in the US stock market have about a third of their revenues coming from China, meaning that tariffs on Chinese imports will hit profits. Markets dropped several percent in late May, hitting tech and shoe companies the most. This story had played out before, 30 years ago in fact:

"When governments permit counterfeiting or copying of American products, it is stealing our future, and it is no longer free trade." – US President Ronald Reagan, September 1985.

Similar to Trump, when elected, Reagan implemented tax cuts, which were very popular but had the effect of reducing the savings rate from 7.8% to 3.7% in less than three years. And when the US aired its grievances over unfair and illegal trade practices, the Deputy trade representative was none other than a young Robert Lighthizer.

Figure 1: Countries that make up the US trade deficit



Source: The Daily Shot Letter, Wall Street Journal

That time Japan blinked first and lost, with three lost decades and counting. Will China blink first? They don't have to worry about re-election in 2020, but also, based on a white paper released in early June, they are in for the long run. They start by noting that "*A mutually beneficial and win-win relationship with strong* *complementarity and interlinked interests has been forged, benefiting not only the two countries but also the entire world*".

They do note that there have been issues that have needed to be resolved, saying that "*By adopting a rational and cooperative attitude, the two countries have managed to resolve previous conflicts, bridge differences, and render the bilateral commercial relationship more mature through dialogue and consultation.*"

At this point the tone turns negative. They point to the Trump administration threatening (and applying) tariffs right from election, not just on China but other countries (including allies) as well.

Whilst they note that they have responded strongly (to defend the interests of the nation as well as not to lose face), more importantly they noted that "*... cooperation has to be based on principles. There are bottom lines in consultations. China will not compromise on major issues of principle. China does not want a trade war, but it is not afraid of one and it will fight one if necessary. China's position on this has never changed.*"

If China wasn't enough, the US put the cat amongst the pigeons by putting tariffs in play for Mexico. Earlier in May, tariffs that were imposed last year on steel and aluminium imported from Mexico and Canada were lifted, seemingly bringing the USMCA trade agreement a step closer to ratification.

However, President Trump said he would impose a tariff on all goods arriving from Mexico in response to what he called a "mass incursion" of migrants entering the country "illegally". Trump indicated the tariff would start at 5% on June 10 but then rise every month to 25% on October 1 and would remain at that level unless Mexico stops migrants from crossing the US's southern border. This caused significant volatility in global equity markets at the end of May. Mexico is the US' third-biggest goods trading partner, importing roughly US$350b in 2018.

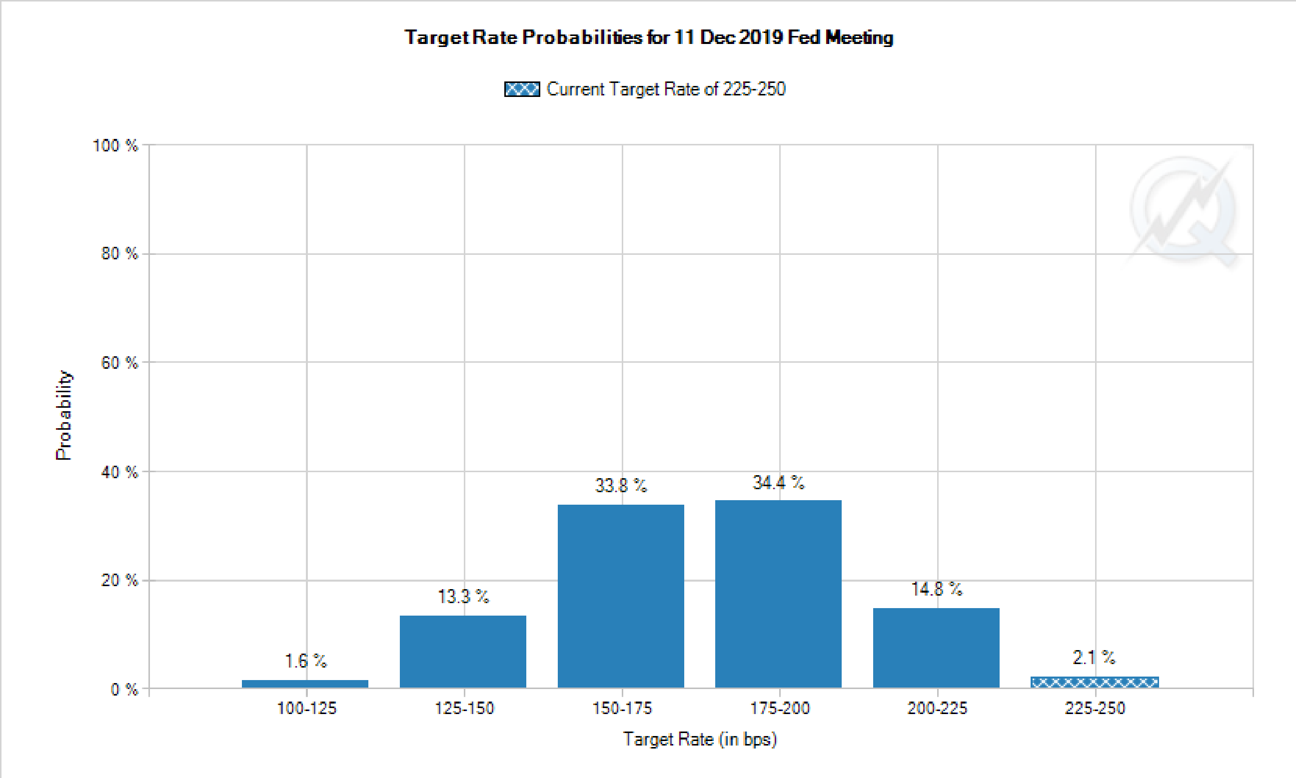
The June 10 start to the tariffs was stopped by Trump because Mexico agreed to address the issue of illegal migrants. However, the threat of tariffs still remains if Mexico don't follow through.

A speech by Federal Reserve Chair Jerome Powell following Trump's tariff threat supported equity markets. Powell said the central bank is *"closely monitoring the implications of these developments for the U.S. economic outlook and, as always, we will act as appropriate to sustain the expansion*". This implied a cut to interest rates if markets continue south. Equity markets are distracting them from their dual mandate of maximising employment and stabilising prices.

The US employment report released 7 June also increased the likelihood of reducing interest rates. The change in nonfarm payrolls was lower than previous months, suggesting a slowdown in the economy. Equity markets jumped on the news at the prospect of lower rates, disregarding the implications that lower wage growth usually means a slowing economy! Counterintuitive? The economic cycle that drives relative equity market movements over time is being outweighed by the central bank cycle.

The futures market was pricing in around an 83% chance of two cuts in the US by the end of 2019 (i.e. 0.50% of cuts). See Figure 2.

Figure 2: Probabilities of the US Fed Rate by the end of 2019



Source: https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html

The Reserve Bank of New Zealand cut the official cash rate to 1.5% in early May. This is the first change in rates since November 2016. The impact of cutting the OCR supported an increase in already inflated equity prices on the New Zealand stock market. Lower interest rates feed into discounted cash flow models used to value companies. Defensive dividend paying stocks became relatively more attractive in the search for yield, driving the aggregate valuation of the overpriced NZ listed stocks even higher.

The Reserve Bank of Australia also cut its cash rate, down to 1.25% in early June. This is the first move since August 2016 and continues the rate cycle which started in November 2011 at 4.75%.