MARKET PERFORMANCE AND ECONOMIC COMMENTARY – JULY 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	-1.0	-3.3	-0.8
S&P 500 (US)	1.3	1.2	5.8
Nikkei 225 (Japan)	1.2	-3.3	-4.6
FTSE 100 (UK)	2.2	2.3	-2.1
DAX (Germany)	-1.7	-1.3	-4.8
CAC 40 (France)	-0.4	-1.2	0.1
Trans-Tasman Equities			
S&P/NZX 50	3.4	8.4	21.7
S&P/ASX 300	3.0	8.6	13.2
Bonds			
S&P/NZX NZ Government Stock	0.7	2.9	8.5
S&P/NZX A Grade Corporate Bonds	0.8	2.7	7.3
Barclays Global Aggregate Bonds (Hedged to NZD)	0.7	3.5	8.0
FTSE World Government Bonds (Hedged to NZD)	0.7	3.9	8.3
Oil			
West Texas Intermediate Crude Oil	0.2	-8.3	-14.8
Brent Crude Oil	-0.5	-10.7	-12.2
NZD Foreign Exchange			
AUD	0.0	1.1	4.6
EUR	0.5	-0.4	1.9
GBP	2.1	5.4	3.9
JPY	-1.0	-3.5	-6.0
CNY	-1.5	1.2	-2.0
USD	-1.7	-1.0	-3.1

Source: Nikko Asset Management

We make the following key observations:

- Negative returns in global equity markets over 12 months except the US and France
- Trans-Tasman equities positive over each period with extraordinary double-digit returns over 12 months
- Bond markets have rallied recently, leading to significant returns over 12 months (higher than global equity markets!)
- The NZD strength against the AUD
- Oil prices much lower compared to this time last year

Auckland
2/2 Burns Avenue Takapuna
PO Box 33-1318 Takapuna 0740
p: +64 9 486 3144
auckland@eriksensglobal.com

Wellington
Level 9, 111 The Terrace
PO Box 10-105 Wellington 6143
p: +64 4 470 6144
wellington@eriksensglobal.com

ECONOMIC COMMENTARY

The first couple of weeks of August saw a paradigm shift in yields around the globe. At the start of August Federal Reserve Governor, Jerome Powell, announced a cut to the Fed rate for the first time in over a decade. The upper range of the Fed rate was reduced by 25bps, down to 2.25%. This move was expected by the market, however, the reasoning/justification for this move expressed by Powell in the press conference was what caused dissatisfaction for the market. Powell said the current cut was a “mid-cycle adjustment” which wasn’t necessarily the start of a lengthy cutting cycle. This was viewed as a negative for equities because the support that lower interest rates provide equities in terms of valuation could be muted or removed.

Figure 1 shows how flat the yield curve is across the globe, with only one 10-year government bond having a higher yield than the relevant cash rate – New Zealand.

Figure 1: 10 Year Government Bond Yields vs Cash Rates (as at 16 August)

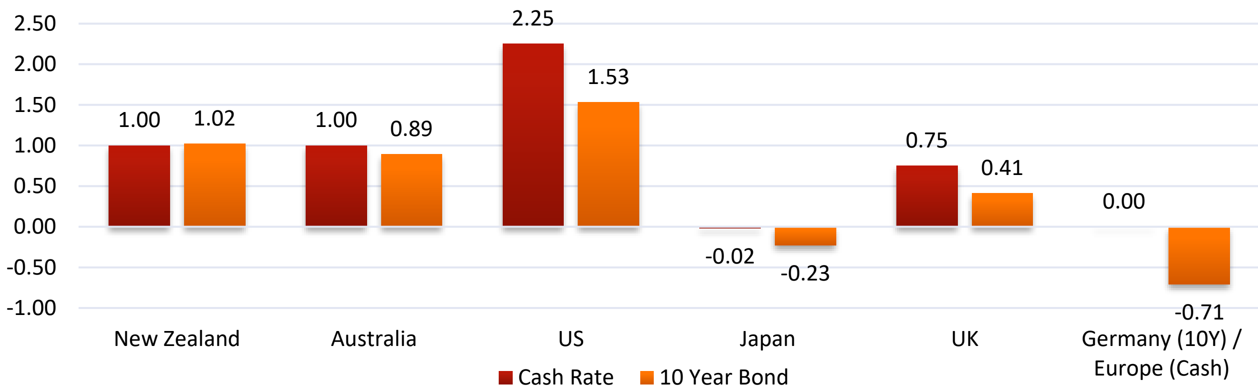
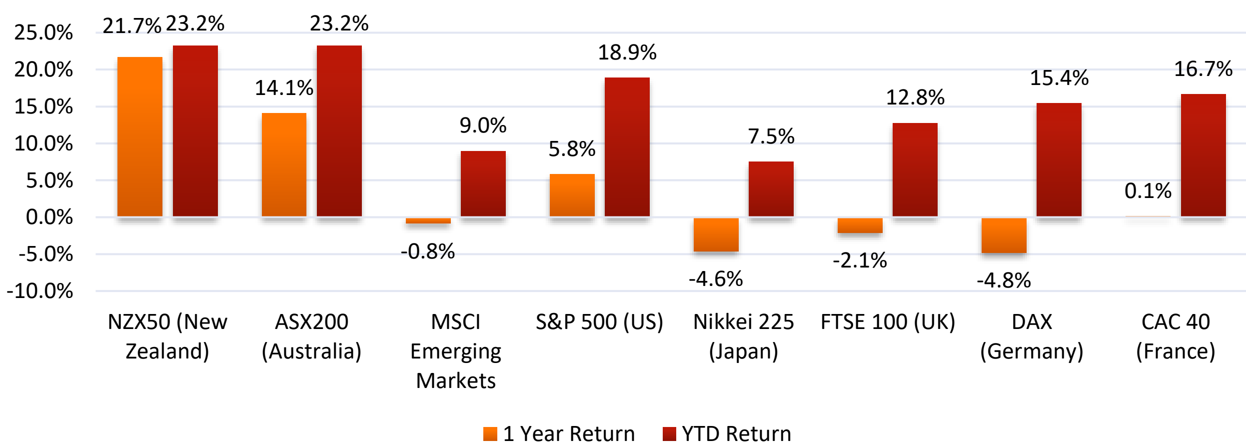


Figure 2 shows the performance of equity markets to 31 July. The key driver for the year-to-date returns has been the dovish central bank outlook. If you then add on the return for the five months previous to this (end of 2018), you get an idea of how quickly things can change in equity markets. The difference with respect to the New Zealand market returns (and perhaps Australia) less affected by the turbulence last year.

Figure 2: Equity Market Performance 1 Year vs Year-to-Date (7 months)



Despite strong labour market conditions currently seen in New Zealand, fears of weakening global growth and continuing trade tensions are putting downwards pressure on inflationary expectations. The Reserve Bank of New Zealand responded by cutting the OCR by 50bps to a record low of 1% at its August meeting. This was more aggressive than market expectations which had priced in a 25bps decrease. Furthermore, Adrian Orr suggested he is open to the idea of further rate cuts - even into negative territory (given the historic low allows little room for cuts). The market's reaction saw the NZX50 index gain 1.9% on the day with the chase for yield causing defensive dividend paying stocks to rise by even more (see Figure 3 below).

Figure 3: NZ Utility Stocks on the day of 50bps OCR cut

Source: Yahoo Finance

As the price of these defensive stocks rise, the yields fall, and thus the margin of safety investors are searching for reduces due to lower capital growth potential. At what point will the relationship between lower rates and higher prices collapse?

"Usually, a natural course of action for an investor in a stable system is to look for abnormal variations to normal relationships, and position a portfolio to capitalise upon this variation reverting to type. This year, however, it is clear that we have neither a stable financial system nor (for the same reasons) a basis upon which to believe historic norms should be a natural order. Mean reversion is a flawed strategy when fundamental shifts occur, whether that is with respect to the cost of capital, or community and political expectations of acceptable returns for corporations and the level of acceptable penalties that can apply should those expectations be breached."

– Andrew Fleming, Portfolio Manager, Schroders Australia