MARKET PERFORMANCE AND ECONOMIC COMMENTARY– AUGUST 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	-2.5	1.0	-2.8
S&P 500 (US)	-1.8	6.3	0.9
Nikkei 225 (Japan)	-3.8	0.5	-9.5
FTSE 100 (UK)	-5.0	0.6	-3.0
DAX (Germany)	-2.0	1.8	-3.4
CAC 40 (France)	-0.7	5.2	1.4
Trans-Tasman Equities			
S&P/NZX 50	-0.9	6.3	15.5
S&P/ASX 300	-2.3	4.3	9.1
Bonds			
S&P/NZX NZ Government Stock	2.2	3.9	9.5
S&P/NZX A Grade Corporate Bonds	1.5	2.9	7.9
Barclays Global Aggregate Bonds (Hedged to NZD)	2.3	4.4	10.2
FTSE World Government Bonds (Hedged to NZD)	2.9	5.1	11.4
Oil			
West Texas Intermediate Crude Oil	-5.9	3.0	-21.1
Brent Crude Oil	-7.7	-5.9	-23.3
NZD Foreign Exchange			
AUD	-2.2	-0.5	2.0
EUR	-3.4	-2.1	0.4
GBP	-3.9	0.1	1.4
JPY	-6.6	-5.4	-9.0
CNY	-0.8	-0.1	-0.4
USD	-4.4	-3.2	-4.9

Source: Nikko Asset Management

We make the following key observations:

- NZD depreciation following 50bps cut of the OCR on 7th August
- Negative equity market returns over the month largely due to US/China tariff escalation
- Negative or low returns in global equities over the year whilst trans-Tasman equities outperform
- Positive returns in bond markets over each time period as yields fell, pushing bond prices up

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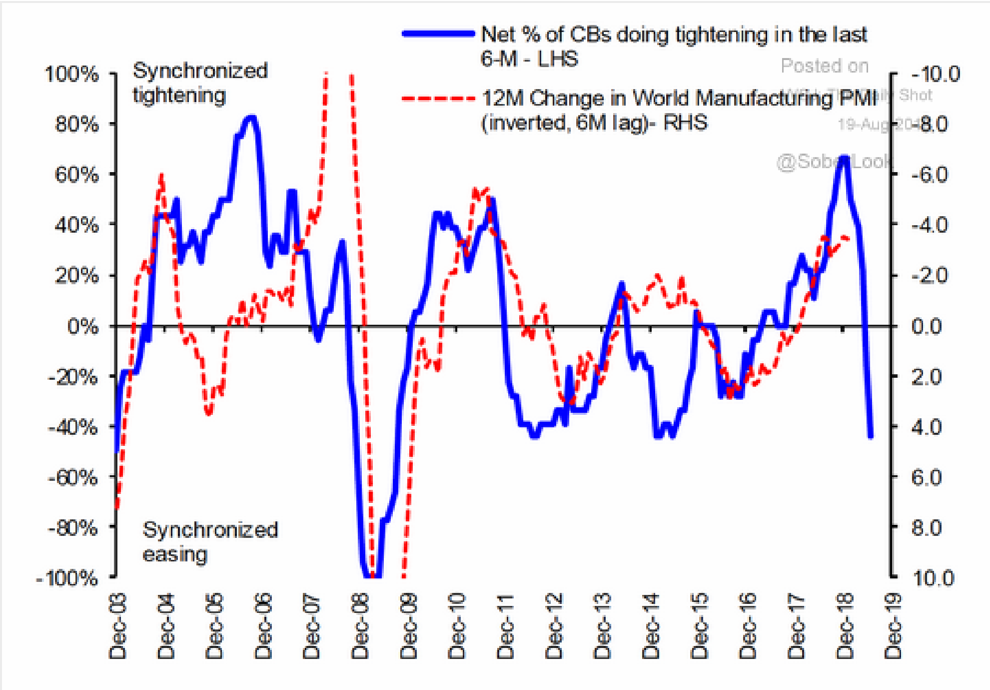
ECONOMIC COMMENTARY

Markets are stretched and have been a bit wobbly lately. Although the risk of a correction has increased marginally, central banks are either reducing or talking about reducing cash rates further which is operating to stabilise equity markets (Figure 1).

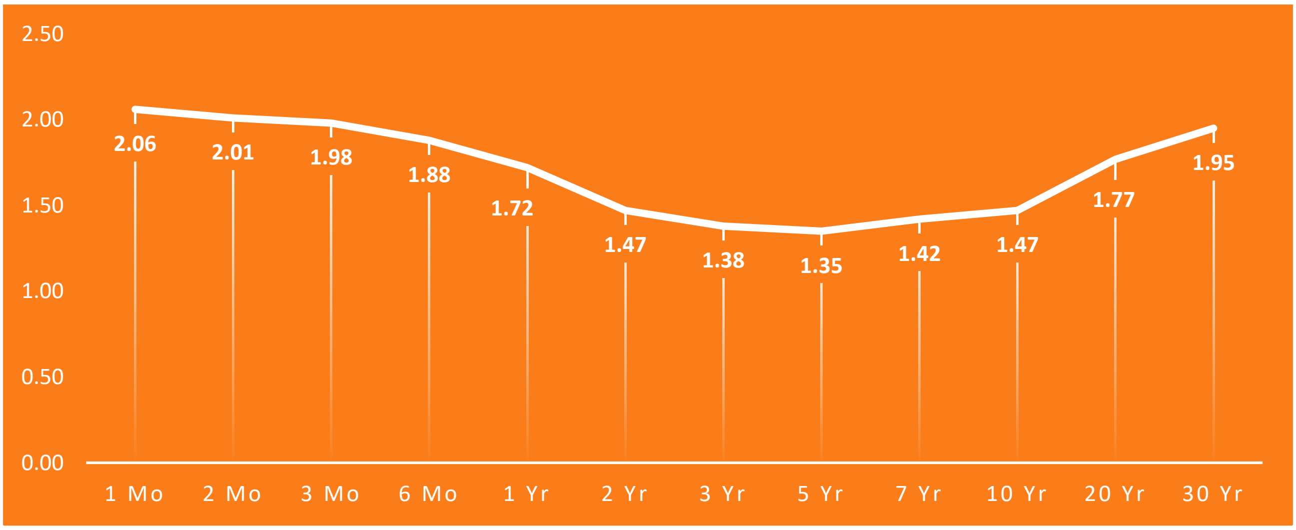
Figure 1: Percentage of central banks tightening to support slowdown



Source: Scotiabank Economics; WSJ, Daily Shot Brief

More importantly long-term interest rates are also falling as investors buy more bonds. Over $15 trillion of bonds have negative yields. Furthermore, yield curves are effectively flat. Figure 2 illustrates this in the US.

Figure 2: US Treasury Yield Curve (3 Sep 2019)

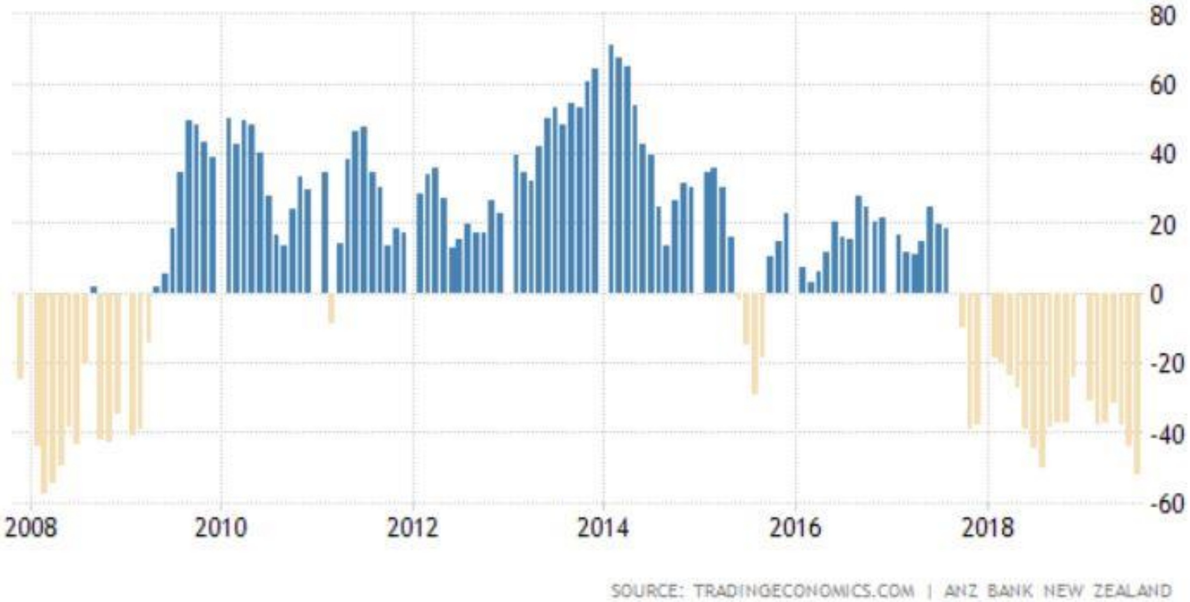


European and Japanese investors are actually paying banks to hold their money in either cash or bond form. Consequently, they seek higher yields in other markets such as the US which pushes the yield on those bonds down.

Many investors use the 10-year government bond yield as the discount rate on shares. When this discount rate falls, the net present value of future dividends and earnings on shares becomes higher. In New Zealand the 10-year bond is now approximately the same as the OCR at 1%.

The RBNZ surprised the market by cutting the OCR by 0.5% (as opposed to just 0.25%) to a fresh low of 1%. It is an attempt by the RBNZ to get ahead of the curve due to slowing growth and low business confidence (at its lowest level since 2008, see Figure 3).

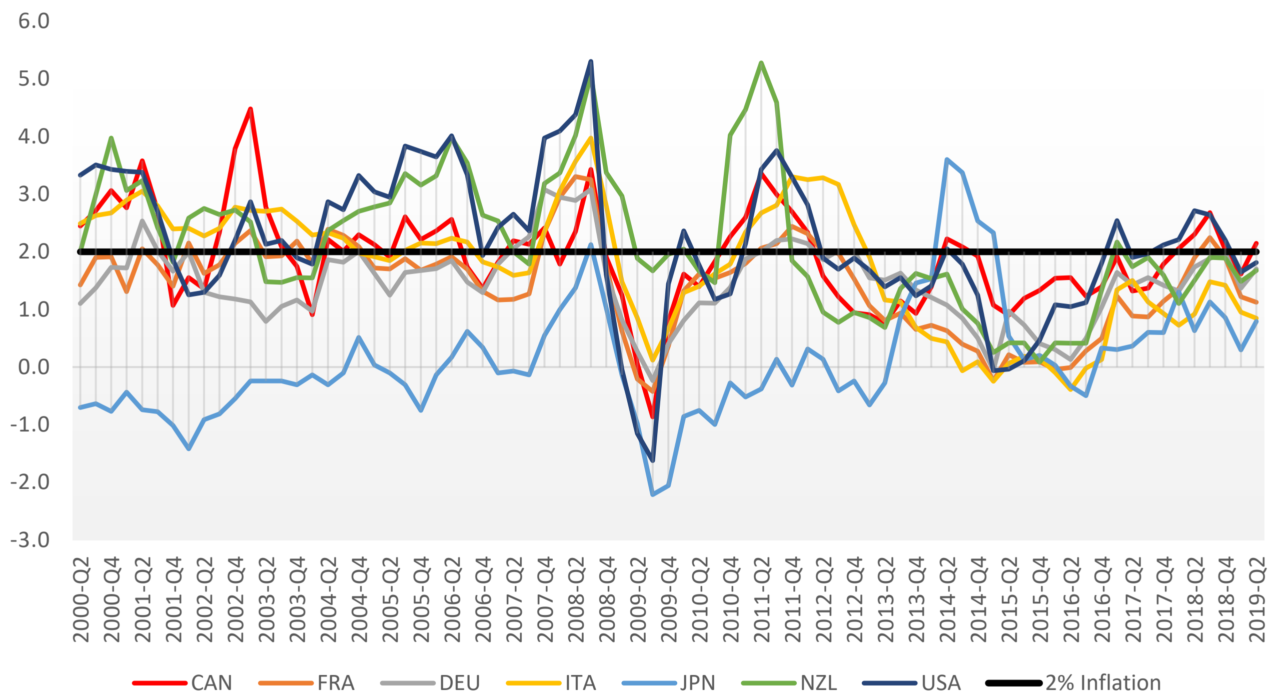
Figure 3: ANZ Business Confidence Index



Although global growth is slowing, inflation is also low, barely reaching the 2% general target in many developed countries. Figure 4 shows the annual inflation rates for a selection of OECD countries. There are a few structural reasons for this persistently low inflation:

- Globalisation. Easier movement of labour and financial capital between countries mean that companies will search globally for the most cost-effective places to produce goods/services thereby reducing the final cost of their product for the consumer.
- Technology. Two examples of technological developments are the increase in automation, and the use of the internet. Automation means that more goods can be produced quicker and at a lower cost, reducing the dependence on labour and thus also meaning lower wage inflation pressure. The network effects that the internet provides enables better price transparency, which increases competition and puts downward pressure on prices. The internet has also enabled a "sharing economy" where otherwise idle goods/services may not have been accessible e.g. Airbnb and Uber.
- Demographics. An increase in longevity has a negative effect on inflation.

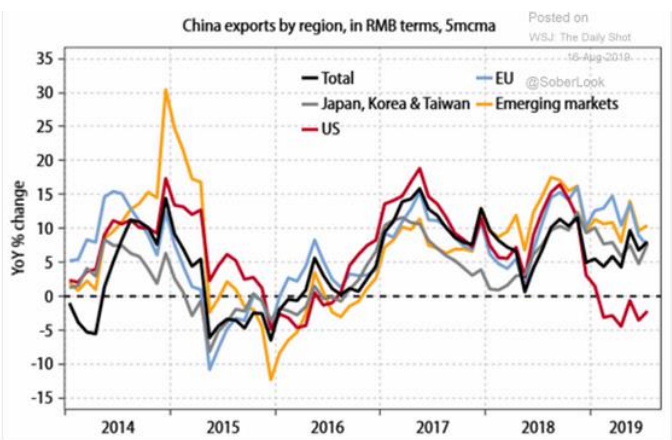
Figure 4: Annual inflation rates in the OECD

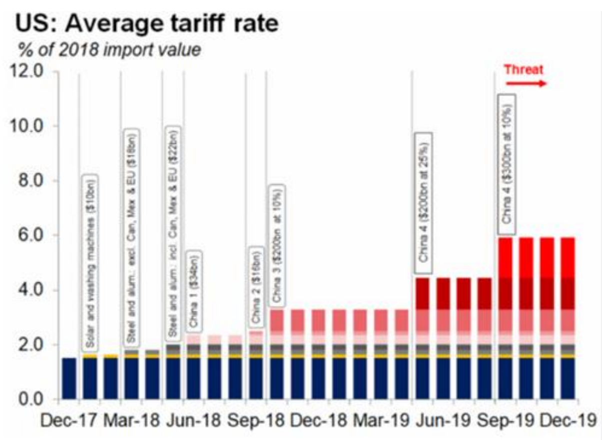


Source: data.oecd.org

Geo-political risks have risen a tad with protests in Hong Kong and ongoing tensions in the Middle East. The announcement of additional tariffs by the US and China around the beginning of August caused markets to drop. Equity markets were volatile through the month on any sort of trade news. Figures 5 and 6 illustrate aspects of the trade war as it has developed over the past year or so. Chinese exports to the US have declined significantly compared to other regions. The average tariff in the US has increased from about 1.7% in 2017 to almost 6% today.

Figure 5 and 6: Chinese exports by region; Average tariff % in the US





Source: Gavekal, WSJ, Daily Shot Brief; Oxford Economics, WSJ, Daily Shot Brief