Axiome Summer Update

October - December 2019

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Investment Market Review

What a difference a year makes! At the beginning of 2019 equity markets were treading water following a 15% decline over the end of 2018. Our view at the time was that markets were over-pricing economic recession risks, and the best course of action was to remain fully invested. We did not, however, expect that the year would close with equity, property and infrastructure returns of 25% or more in many markets!

2019 was an exceptional year for asset returns...

Over the year economic growth and corporate earnings did in fact materially weaken as the trade war took hold (figure 1), but what is key for markets is how this compared to *what was expected*. Much of the bad news in 2019 was concentrated in business confidence surveys and global manufacturing and trade. The fear was that this would spill-over into the rest of the economy, in particular denting the services sector, employment, and household spending in key economies such as the US, the Euro Area and China. But to a large extent this didn't happen. The services sector remained robust, and unemployment rates have remained exceptionally low in New Zealand, the US, the UK and most other OECD nations. As such, household spending and investor confidence remained high.

Instead, what did happen in 2019 was a reversal by central banks - from tightening to easing interest rates and monetary conditions. This was likely by far the single most important reason why asset class performances, across bonds (defensive assets) and equities (growth assets), were so strong in 2019.

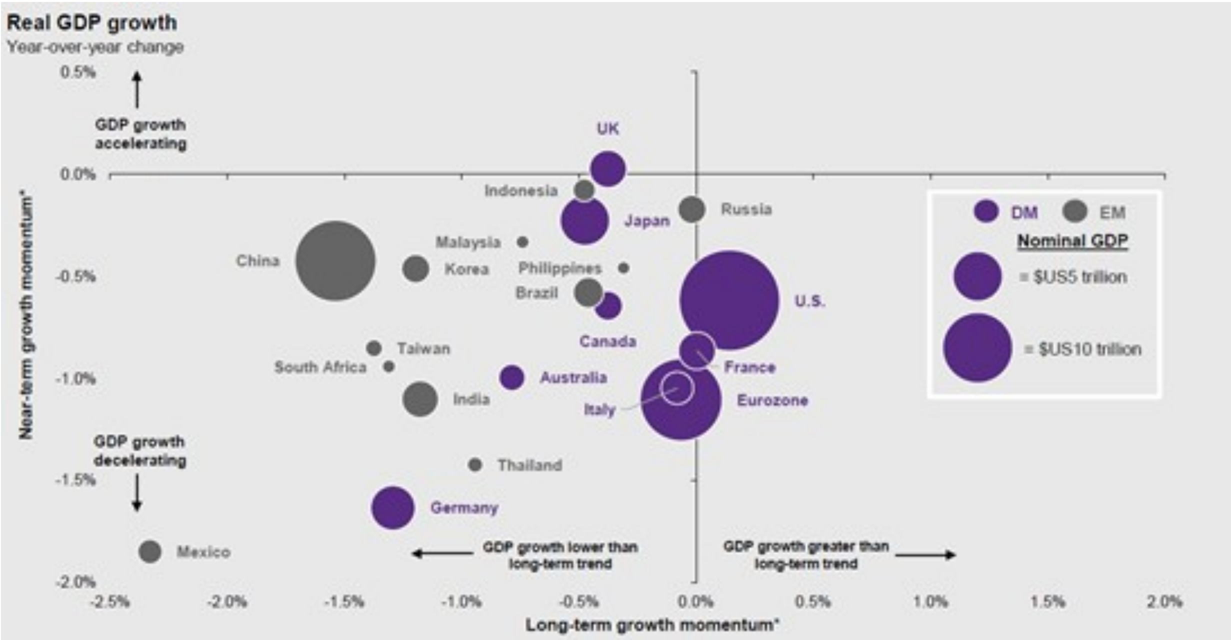

Fig. 1 Economic growth faltered internationally — year over year comparison *Source: JP Morgan Economic Research, IMF*

Turning to the quarterly market results, international shares rose around 1% in the December quarter in NZD terms, but returns were much stronger in NZD hedged terms at around 7.5% given the strong performance of our currency. It increased from around 63c to 68c versus the USD as markets backed off from the view that NZ rates were on course to join the zero rate club (discussed further below). Over 2019, NZD currency impacts on returns have evened out, with both hedged and unhedged international equity returns at around 27%. Within global equities, small caps returned around 25% for 2019, while value stocks returned 'only' 21%.

International shares had a good quarter

Emerging markets had a strong quarter, returning 4% (in NZD terms) as the trade war between China and the US finally showed signs of resolution (or at least a pathway to this). This brought the 2019 annual return to around 18%, a good result but weaker than developed markets given emerging markets have felt the brunt of the trade war.

New Zealand equities also continued its dream run

Although Australian shares were down 2.4% for the quarter, they returned around 23% for the 2019 year.

The New Zealand market returned around 32% for the year. This very strong performance for our market boosted the return for the decade to around 15% per annum - implying an exceptionally strong 400% total return over the decade.

Global investment grade bonds returned around -0.5% in the quarter and 7.5% for the year. The annual return is a very strong outcome given the low running yields on bonds, and reflected bonds being re-priced higher over 2019 as longer-term interest rates fell on the back of central banks easing discussed above. However, markets backed slightly off the view that rates need to be lower for longer in the December quarter, as the global growth picture moderately improved. This change of view to a stronger (less negative) outlook was even more the case in New Zealand, where markets backed off the view that rates were headed to zero. As such, investment grade bonds returned -2.3% for the quarter and 5% for the 2019 year (Corporate bond returns were stronger at 5.5%).

Fixed income returns were weak for the quarter but still strong over the year

Rounding out the return picture for 2019, infrastructure and property stocks have also had a strong year - benefitting both from the lower interest rate settings, and the general bounce in equity markets from the low point at the beginning of 2019. International property stocks returned around 22% in 2019, while Aussie REITs were a touch weaker at around 19%.

Finally, global listed infrastructure stocks returned around 25% in 2019.

Real asset returns were also strong.

2020 and looking ahead...

We anticipate no change in current economic conditions given exceptionally supportive monetary conditions, easing trade frictions, and the fact that there remains a lot of in-built momentum in the global growth picture.

Steady growth in the economy is expected

This is in part fuelled by a structurally higher rate of growth in emerging markets, while the services sector (comprising around 70% of GDP in the OECD) remains resilient in developed markets.

The OECD's latest forecasts are that global growth will average around 3% over 2021 and 2022. This is weaker than the 3.5% average growth rate that had been experienced since the bounce from the GFC, but it is by no means alarmingly weaker. In addition, they (along with other forecasters) expect emerging market growth to remain much stronger at 4% or more. Global growth can hence remain positive *even if* most developed economies slow mildly given the EM growth contribution.

We remain more positive about New Zealand's growth prospects. Along with very low interest rates, our economy will face a significant fiscal boost over coming years as the Government ramps up infrastructure spending. In addition to this, we continue to enjoy high commodity prices and commercial construction activity, and strong net migration levels.

The NZ economy is favourably placed to weather any slowdown

The last quarterly GDP release for the September quarter was 0.7%, stronger than the RBNZ and most bank forecasters expected. As a consequence, expectations of further rate cuts have been pulled back.

Downside risks to markets remain and it is important to recognise that volatility can still resurface. The chart below (figure 2) reflects the contributing drivers to stock market returns in 2018 vs. 2019.

Drivers of investor returns vary across years and surprised forecasters...

In 2018 the expectation of rising interest rates reduced share valuations based on the metric of earnings multiples. This resulted in a sharply negative December quarter and flat returns for the year overall notwithstanding growth in dividends and earnings per share. Conversely, in 2019 sentiment reversed in synch with Central Bank interest rate cuts and restored those previous multiples of earning valuations. Converesly, earnings per share declined in most markets.

That said, we can't forecast short term market movements and longer term asset class risk, return relationships remain intact.

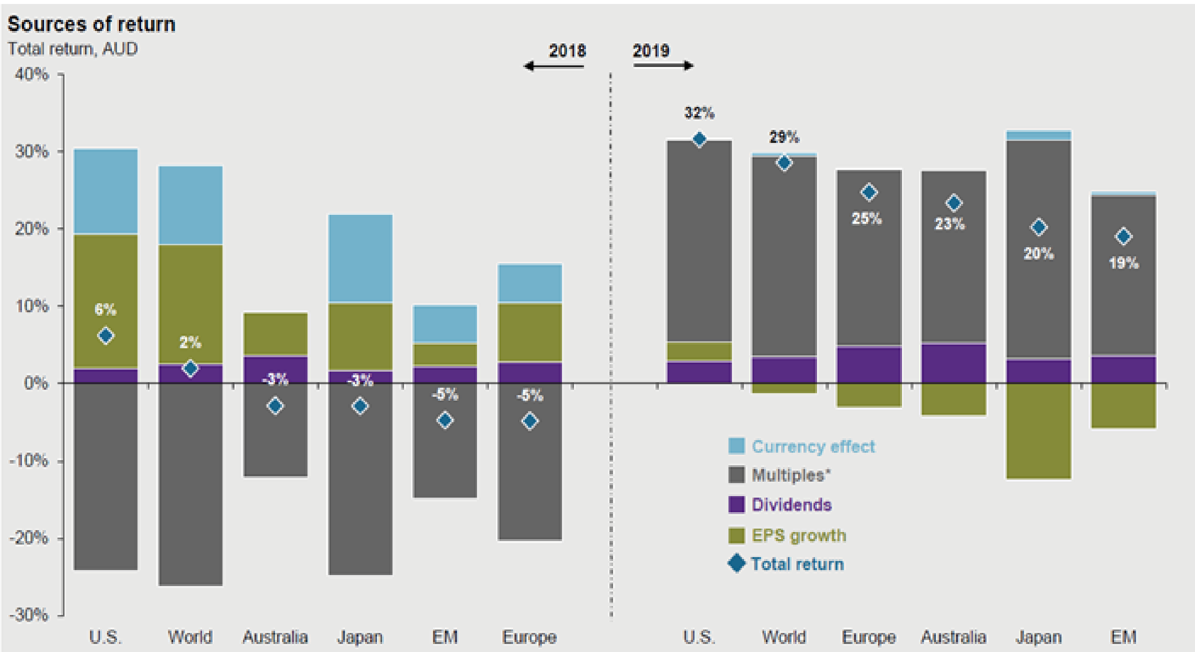

Figure 2: Contributions boosting equity returns over the past 2-years

Source: JP Morgan Asset Management

Key Market Movements for the Quarter

Quarter	Past year	
+5.3	+ 31.6%	**New Zealand Shares** *New Zealand shares returned 5.3% in the quarter and 31.6% over calendar 2019. This is an exceptional performance for our market, which also helped boost the return for the past 10 years to almost 15% per annum – a 400% return for the decade.* *Source of Figures: S&P/NZX 50 Total Return Index With Imputation Credits*
-1.2%	+5.2%	**New Zealand Fixed Interest** *New Zealand investment grade corporate bonds returned -1.2% for the quarter and around 5.2% for the year. This return is both comfortably higher than 90-day NZ bank bill and term deposit rates, indicating that NZ corporate bonds delivered a good premium over the year.* *Source of Figures: S&P/NZX A Grade Corporate Bond Index*
-2.4%	+22.8%	**Australian Shares** *Australian shares returned -2.4% in the quarter in NZD terms, which reflected our currency strengthening (in Aussie dollar terms the return was around 0.7%). The annual return was still very strong at around 23% in NZD terms. Within Australian equities, small cap stocks performed in line over the quarter and year, while value stocks have had a weaker performance, returning around 19% in 2019.* *Source of Figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries*
+0.9% (+7.5% hedged)	+26.9% (+26.8% hedged)	**International Shares** *International shares rose around 1% in the quarter in NZD terms, whilst NZD hedged shares rose around 7.5% given the strong performance of our currency. Over 2019 the currency impacts have evened out, with both hedged and unhedged returns at around 27%. Within global equities, small caps returned around 25.5% for 2019 while value stocks returned 'only' 21%.* *Source of Figures: MSCI World Index; Morningstar Deveeloped Markets NZD hedged, MSCI World Value, MSCI World Small Cap.*
+4.0%	+17.7%	**Emerging Markets** *Emerging Market equities increased 4% in the quarter as the trade war between China and the US finally showed signs of resolution. This brought the annual return to around 18%, a still weaker peformance than developed markets given that the trade war has had a more negative impact on emerging markets.* *Source of Figures: MSCI Emerging Markets Index*
-0.6%	+7.5%	**International Fixed Interest** *Global bonds returned -0.6% in the quarter and 7.5% for the year. The annual return remains a very strong outcome for bonds given their low income yields, and reflected bonds being re-priced higher over 2019 as longer-term interest rates fell on the back of mounting global growth concerns. This reversed course slightly in the December quarter as the growth picture moderately improved.* *Source of Figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)*
+0.7%	+21.5%	**International Property** *International property stocks increased by around 0.7% in the quarter and 21.5% over the year. This asset class has benefited over the year both from the lower interest rate settings, and the general bounce in equity markets from the low point at the beginning of 2019. International Infratructure also had a good year, returning around 25% in 2019.* *Source of Figures: FTSE EPRA NAREIT (NZD hedged), S&P REIT indexes*

2019 Year in Review...

In place of our usual internally produced 'Article of Interest', we have appended the '2019 Year in Review' market overview prepared by Dimensional Fund Advisers (DFA).

Dimensional Fund Advisors

DFA provide a depth of analysis and academic rigor to portfolio design, which sees a range of their funds selected by our Investment Committee as the building blocks to implement a significant proportion of our portfolio asset allocation mandates. Whilst constantly reviewed and measured against alternative options, DFA have retained their place as a key provider of investment solutions for our clients because they are 'best of breed' as an institutional wholesale fund manager.

We hope that you will take the time to enjoy the appended DFA market overview. For ease of reference, we summarise some of the concluding 'takeouts' of the report below:

TAKEOUTS from DFA Market Overview:

- ***The performance of equity and fixed income markets in 2019 highlights once again the folly of using news headlines as an indicator of future investment performance.***
- ***Calendar 2018 ended with intense volatility and a wave of pessimism by commentators responding to ongoing news events like the US-China trade war, Brexit and the IMF's downgrade of the global economic outlook.***
- ***While market volatility can create anxiety for some investors, the record shows that reacting emotionally and challenging long-term investment strategies in response to immediate news and short-term declines can prove more harmful than helpful.***
- ***Now the new year begins, the media's focus inevitably turns to speculating about possible developments in 2020… While it is natural to have an opinion on any of these issues, it is worth remembering that all these views and expectations from market participants are already built into prices.***

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Phone: 09 445 2134 **Email:** info@axiome.co.nz