Axiome Winter Update

April - June

2019

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Investment Market Review

An old investment mantra is "Don't fight the Fed". The Fed in this case is the US Federal Reserve, who sets monetary policy and interest rates in the United States. Historically investors in the US, and globally given the dominance of the US market, have done well when they have invested in a way that aligns with how the Fed sets its monetary policy. This pattern has repeated over the past 6 months.

Central banks ease interest rates boosting equity markets further in the June quarter.

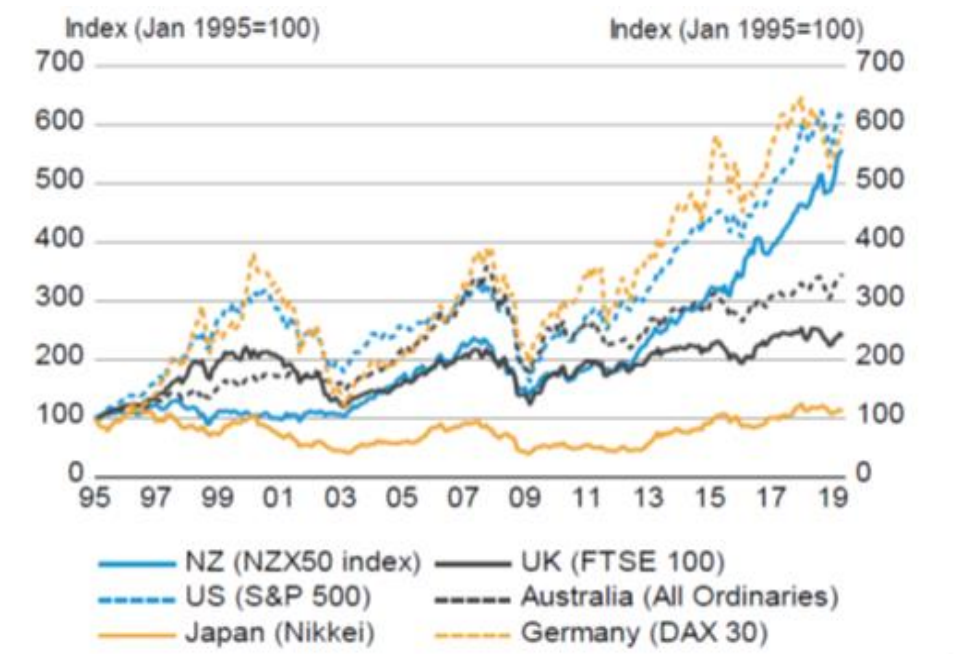
The Fed has now completely backed-off increasing rates in response to a slowing global economy and heightened Trade War risks. Markets forecast instead that they will cut interest rates, in line with cuts that have already taken place in New Zealand and Australia.

In response, markets have rallied strongly across all asset classes, including government and corporate bonds, property and infrastructure stocks, and equities. Investors and active fund managers who have reduced their risk allocations in response to the slowing economy – fighting the Fed – have missed out on this rally.

Many equity markets, including New Zealand's reached new highs in the quarter (figure 1). International developed market equities increased by around 5.5% over the quarter (in NZD terms), implying around a 7% return for the year ended June 2019. Within global equities, value stock and small cap stock returns are a little weaker returning around 4% for the quarter. Emerging market (EM) equity returns were weaker at 2% over the quarter, but this was enough to turn their annual return to a small (2%) positive figure.

Emerging markets have borne the brunt of the trade war, and on the flipside have the most to gain should growth recover. Trans-Tasman equity markets also enjoyed a strong quarter. Australian shares returned 8.3% and New Zealand shares returned 6.7%. These markets in particular have benefited from RBNZ and RBA rate cuts, with the Aussie market also boosted by the surprise re-election of Scott Morrison and the Liberal Party.

Figure 1: Equity markets bounce back
(source Haver Analytics)



Global bonds returned 2.7% in the quarter and 7.3% in the year to June 2019, while New Zealand investment grade bonds returned around 7% for the year. These returns are much higher than the running yield on bonds (around 3.5% or so) because bonds have gained value this past quarter as interest rate expectations have declined. This also boosted "bond like" property and infrastructure stock returns, which have experienced double-digit gains over the year across New Zealand, Australia and global markets in general.

Bonds and property stocks also had good returns.

The rally in markets has, however, been accompanied by significant volatility as markets have grappled between contrasting forces. The slowing global economy reduces corporate sales and profitability. In contrast, lower interest rates reduce borrowing costs and how much investors discount corporate earnings (boosting asset prices).

Errant tweeting by the Commander and Chief have added to the volatility as threats of further tariffs (including on Mexico, China, the EU and India), trade restrictions (e.g. on Huawei) and military action (Iran) have gone on and off the radar. In the event, at the time of writing the Trump Administration has backed down from the worst of the threats and market fears of an escalating trade war have been soothed.

But market volatility has not gone away...

Despite the Trump Administration backing off (for now) from escalating the trade war, the damage has clearly been done to global trade and growth (figure 2). World trade volumes before the current trade war were running around 5% per annum, and global growth around 3.5%. Today global trade volumes are flat and global growth has fallen closer to 3%. In addition, a range of short-term economic indicators such as manufacturing activity and confidence levels have fallen.

Global economic growth is slowing, and central banks have limited ammunition to arrest the downside risks.

The Economic Indicators…

The key question is where do things go from here? The ANZ, in line with the market 'consensus' thinks that the environment warrants further interest rate cuts. It forecasts that the RBNZ and RBA will cut rates twice more within the year (reducing the OCR by around 0.5%), while the Federal Reserve will cut three times (figure 3).

Growth outlook from here?

Our view remains that whether or not this happens markets and the global economy are likely to muddle through the current cyclical slowdown. But this hinges on the trade war not re-surfacing, or a crash Brexit plunging the UK and Europe into recession.

We are also mindful that while central bank easing rates has clearly boosted asset prices and market confidence, the impact on actual economic activity may be more limited given rates are already extremely low and there is debate whether further cuts will achieve much.

Recession risks are small so long as the EM growth juggernaut continues.

Currently macro forecasters expect growth to be around 1.7% in developed markets over the next year, with US and Australian growth around 2.5%, and EU growth lagging at a little over 1%. In contrast, growth in the emerging world is expected to hold up over 4% over the next year - more than double the pace of growth in the developed world. This is key. High EM growth implies that these markets continue to make a large and increasing contribution to global growth rates. Global growth can remain reasonably firm at around 2% *even if* most economies are mildly slowing given the EM growth contribution. A global recession hence remains very unlikely unless there is a large slowdown in EM economies, with China and increasingly India being the lynchpins in this regard.

Figure 2: Global growth and trade is slowing:

(source: Havar Analytics)

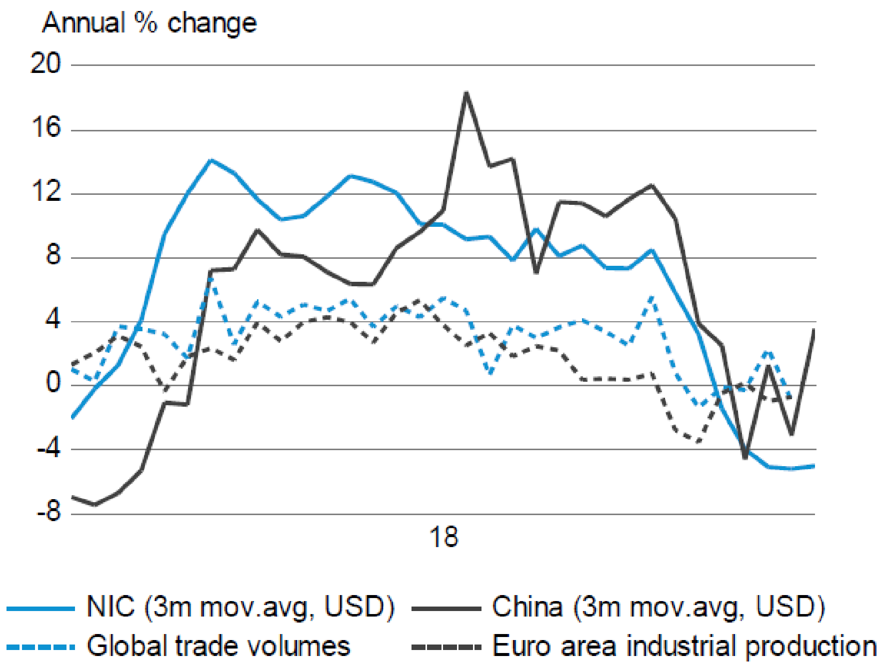


Figure 3: More rate cuts to come?

(source: NZ Treasury - referencing short term market rates)

	Current policy rate	Expected rate (year-end)	Change
US	2.38	1.61	-0.77
Eurozone	-0.37	-0.50	-0.13
UK	0.75	0.65	-0.10
Australia	1.25	0.71	-0.54
NZ	1.50	1.08	-0.42

The NZ economy is favourably placed to weather any slowdown.

In New Zealand the slowing global economy and downside risks should be seen as less of a concern. Current annual growth is running around 2.5% and the RBNZ in its latest Monetary Policy Statement expects this rate to pick up to around 3% over the next year as its rate cuts kick-in. Even if this is limited, with commodity prices at mostly attractive levels, high tourism inflows and net migration, and a large pipeline of construction projects, growth is likely to hold up well (figures 4 and 5).

In addition, the move of the NZ government debt target to a range in the so-called Wellbeing Budget provides a mechanism to boost fiscal spending further should it be judged necessary to cushion our economy from a global downturn. Compared with most OECD economies, our government sector debt levels are very low and fiscal policy is a critical lever to pull in an era where central banks have exhausted most of their ammunition.

Figure 4: NZ net migration remains strong:

(source: Statistics NZ)

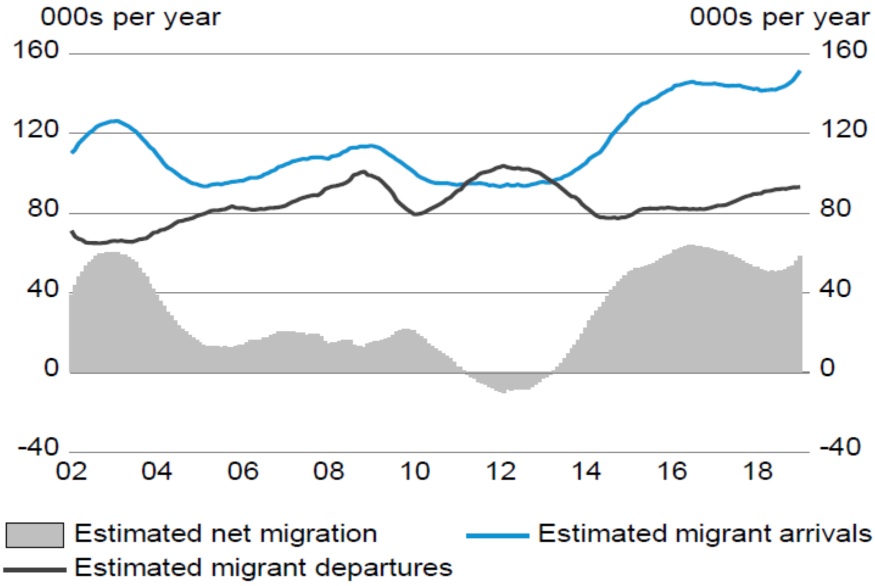
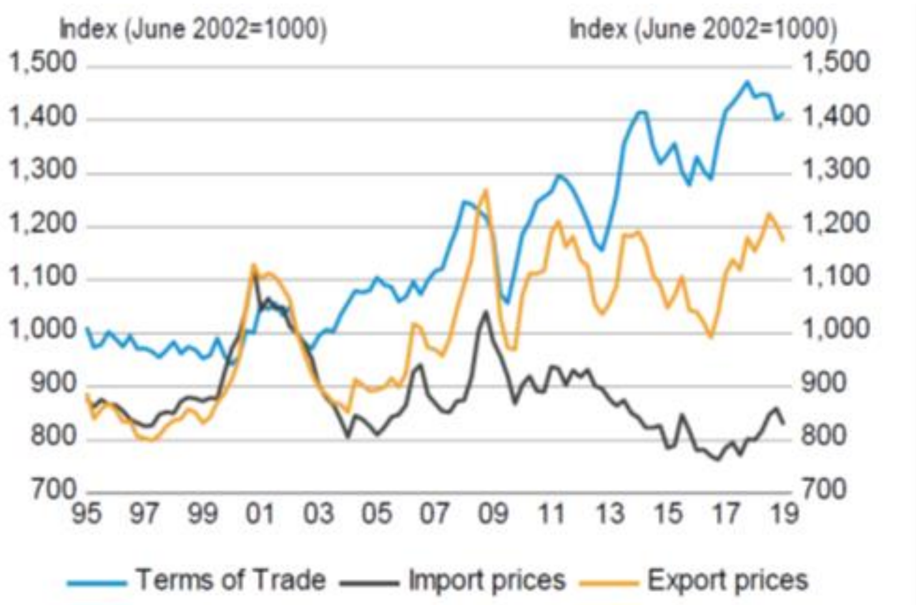


Figure 5: NZ terms of trade are high:

(source: Statistics NZ)



Key Market Movements for the Quarter

Quarter	Past year	
+6.7%	**+ 17.4%**	**New Zealand Shares** *New Zealand shares returned 6.7% in the quarter and 17.4% over the year to June 2019. This continues the very strong run our market has had over the past five years or so.* *Source of Figures: S&P/NZX All Total Return Index*
+1.9%	**+6.9%**	**New Zealand Fixed Interest** *New Zealand investment grade corporate bonds returned 1.9% for the quarter and around 6.9% 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*
+8.3%	**+6.8%**	**Australian Shares** *Australian shares returned 8.3% in the quarter, bringing the June year result to 6.8% in NZD terms (11.5% in AUD terms). Within the Australian equity market, value stocks mildly out-performed over the year. In contrast, small cap stocks, which suffered large losses in 2018, returned around -2.5%.* *Source of Figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries*
+5.6% (+3.4% hedged)	**+7.2% (+6.5% hedged)**	**International Shares** *International shares rose 5.6% in the quarter, whilst NZD hedged shares rose 3.4%. This good quarterly performance boosted the annual return of global shares to 7.2% on an unhedged basis, and 6.5% on a hedged basis. Unhedged returns over the year were boosted by a fall of the NZ dollar against the US dollar. Within global equities, value stock returns were mildly lower over the year, whilst small cap stock returns were relatively weak at around -2% despite returning 3.5% for the quarter.* *Source of Figures: MSCI World Index; Morningstar Developed Markets NZD hedged*
2.2%	**+2.0%**	**Emerging Markets** *Emerging Market equities increased around 2% in the quarter and over the year to June 2019 (in NZD terms). This performance is weaker than developed markets and reflects that the Trump Administration's trade war has had a more material negative impact on emerging markets.* *Source of Figures: MSCI Emerging Markets Index*
+2.7%	**+7.3%**	**International Fixed Interest** *Global bonds returned 2.7% in the quarter and 7.3% in the year to June 2019. The return over the quarter and year was boosted by bonds being re-priced higher as longer-term interest rates fell. The latter was driven by central banks reversing course on tightening rates as concerns over Trade wars and slower global growth have mounted.* *Source of Figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)*
+1.6%	**11.0%**	**International Property** *International property stocks increasing by around 1.5% in the quarter and 11% over the year. Australian and New Zealand property stocks also enjoyed strong quarters. This asset class benefited over the quarter both from the lower interest rate outlook, and the general bounce in equity markers.* *Source of Figures: Morningstar DM REITS (NZD hedged), S&P REIT indexes*

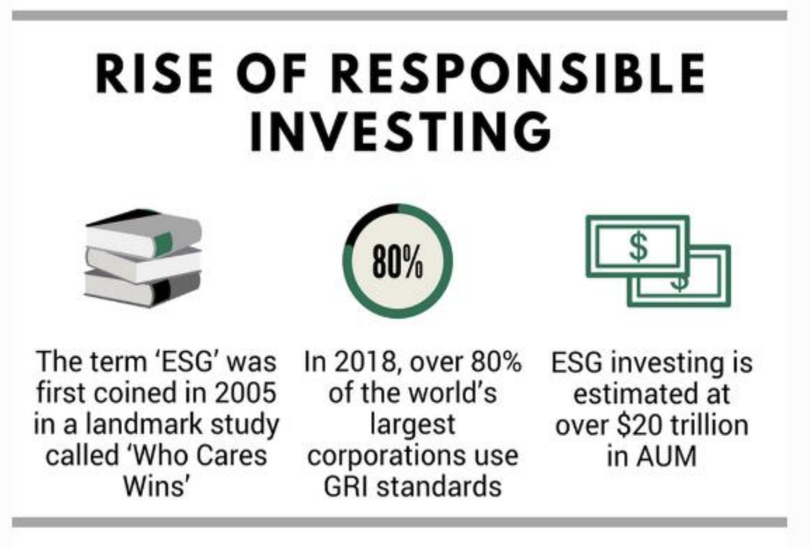
All returns are expressed in NZD. We assume Australian shares and international property are invested on an unhedged basis, and therefore returns from these sectors are susceptible to movement in the value of the NZ.

How Do We Incorporate Sustainability?

Around the world, concern regarding the environment has never been more heightened. This is influencing all avenues of life, from our power consumption to housing. We eat ethically, shop ethically – but can we invest ethically? Surveys indicate that young people, the investors of the future, are "conviction investors", bringing their values to bear on their investment decisions.

For many years there have been funds that excluded armaments, tobacco and gambling investments, also known as Socially Responsible Investments. These were based on simple exclusions, easy to define and avoid. The SRI philosophy has, over time, developed into a more comprehensive Environmental, Social and Governance (ESG) framework. According to a recent survey, nearly half of investors say they choose funds or companies with ESG considerations in mind.

But adding an ESG filter to investments is complicated. Sustainability can be hard to pin down. Where do you draw the line? Companies such as BP or Shell, for example, get most of their revenues and profits from fossil fuel related businesses, but also use their gargantuan profits to invest in renewables. Should they be excluded from investment on the basis of the first factor, or included because of the second? There is additional complexity where indexed investing is concerned. BP for example is the world's eighth largest company by revenue and



Source: The Remarkable Rise of ESG (Forbes)

ranks highly in the market cap weighted FTSE-100 index. (2nd as of 30 April 2019). Excluding it could result in an unwelcome skew for portfolios that aim to hold most of the stocks in an index.

Social factors are similarly nuanced. The Tearfund Ethical Fashion Report is concerned with investigating and grading fashion brands on their production and labour standards. Results of their survey of 480 brands are very mixed. Gap Inc, for example, scored highly for environmental management, but very poorly on worker empowerment. Should it be included or excluded? Closer to home, The Warehouse Group does well on traceability of goods and supplier relationships, but badly on both worker empowerment and environmental management. Overall, only 5% of companies pay a living wage to workers, but 60% are investing in using sustainable fibres. How do we treat investing in such a mixed picture?

Governance is arguably nothing new as a factor in assessing companies. Effective governance should translate to good management and this of course will have an impact on environmental and social policies within companies.

Dimensional Fund Advisers (whose funds Axiome portfolios include) takes a pragmatic approach to navigating these choppy waters. Instead of attempting to filter and select certain companies whilst excluding others, they underweight the weaker candidates and overweight the stronger ones, thereby neatly sidestepping the problem of having to choose one company over another in a complex and nuanced world.

Does responsible investing dilute returns? Data suggests the contrary - companies that take ESG concerns into account in their decision-making tend to be the ones that are the most profitable. (Source: Legg

Mason Global Investment Survey 2018 and From the Stockholder to the Stakeholder report, 2015).

It is difficult to evaluate directly because of a lack of historical data on companies' sustainability profiles, but research using proxies in the form of excluding energy and utilities companies (which tend to be the least environmentally friendly investments) show very little drag on performance, if any. (See chart below.)

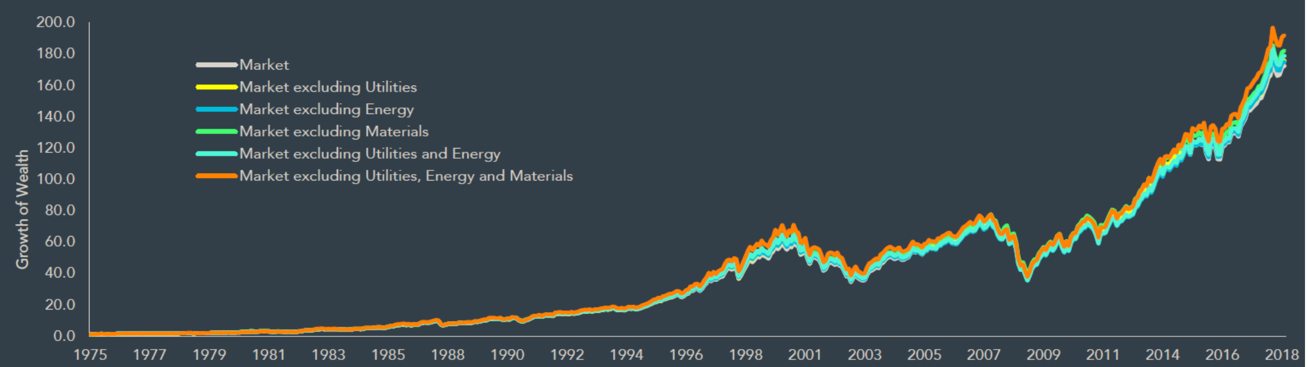
The ESG market is estimated at over $20 trillion in assets under management – equal to a quarter of all professionally managed assets around the world. However, as with governance, which has always been a factor assessed by investors, there will undoubtedly be a blurring of the division between ESG investing and non-ESG investing. Responsible investing is going mainstream.

Market Returns vs. the Market ex Energy and Utilities

US Market, January 1975-June 2018

Dimensional

	Market	ex Utilities	ex Energy	ex Materials	ex Utilities and Energy	ex Utility, Energy and Materials
Annualised Compound Return	12.57	12.62	12.61	12.71	12.66	12.85
Annualised Std Dev	15.06	15.51	15.38	14.99	15.92	15.94
Monthly Average	1.09	1.10	1.09	1.10	1.11	1.12
Annualised Tracking Error vs. Market		0.78	1.98	0.70	2.37	2.69
t-Stat vs. Market		0.97	0.27	1.10	0.61	0.94



Filters were applied to data retroactively and with the benefit of hindsight. Performance is hypothetical, doesn't reflect trading in actual accounts, and is for information purposes only. Please see "Methodology and Disclosures " for more information. Past performance is not necessarily indicative of future performance. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio.

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