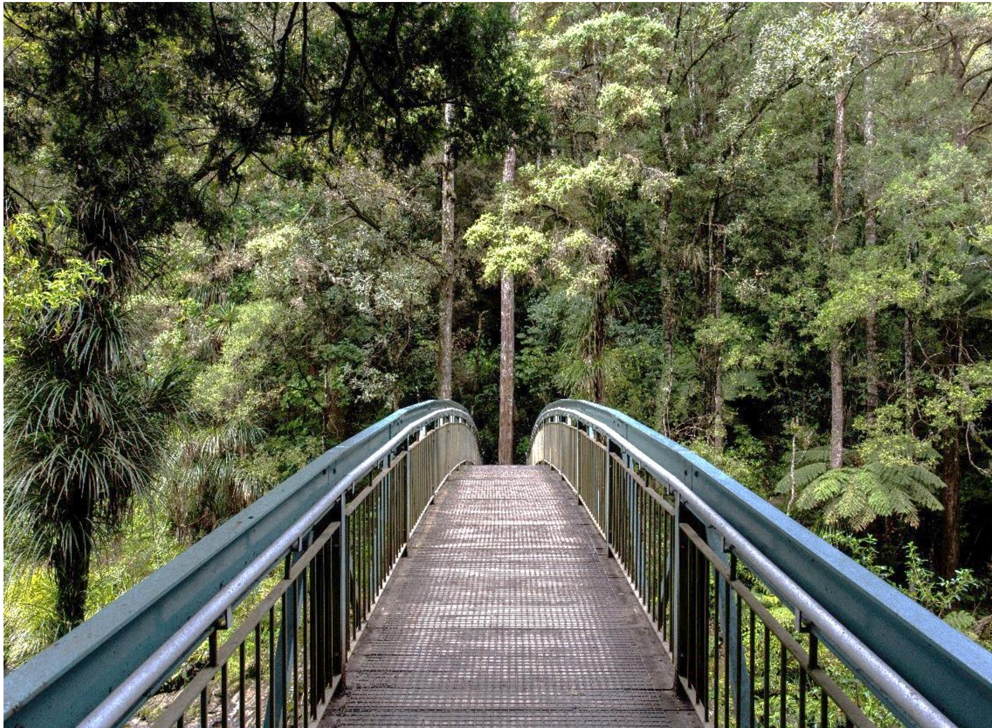
Axiome Autumn Update

January - March

2019



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Investment Market Review

In response to the mauling markets received in the December quarter, and concerns around flagging global growth, the US Federal Reserve changed its mind that US interest rates need to head higher.

Instead, it put monetary policy on hold and signalled that future rate increases are likely to be smaller than had been expected. In New Zealand, the RBNZ also changed its tune in its March economic update to signal that the next move in interest rates could be a cut.

Markets have rallied strongly in response to these developments so far this year across all risk assets, including government and corporate bonds, property and infrastructure stocks, and equities. This rally has largely erased paper losses that investors experienced in December, and some markets, including the NZ equity market, are now at an all-time high (Figure 1).

On the flip-side, long term interest rates are back near historic lows (see Figure 2 re mortgage rates), with New Zealand 10-year Treasury rates at an all-time low of around 1.75%.

Central bank signals have caused interest and borrowing rates to fall.

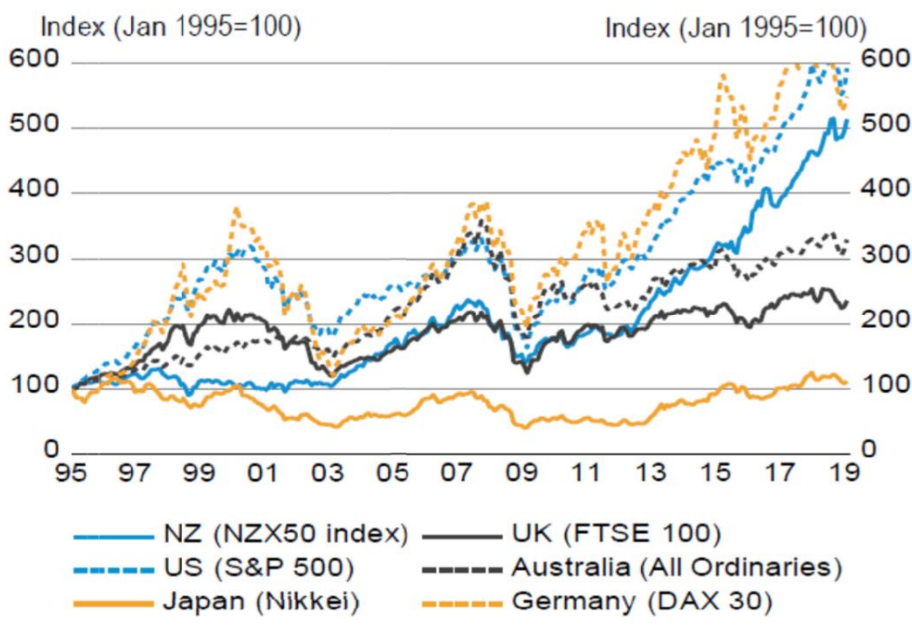
The rally in markets was not just due to central banks easing monetary conditions. As discussed in our last update, the size of the decline in December meant that markets had become better value for investors and while we did not necessarily expect such a strong bounce back, a recovery of some sort is not surprising. Additional good news came with trade tensions easing and the Trump administration holding off on threatened higher tariffs on Chinese exports.

International developed market equities increased by around 10.5% over the quarter (in NZD terms), implying a 10% return for the year ended March 2019. Within global equities, value stock returns were mildly lower over the year, whilst small cap stock returns were relatively weak at around 4.2% for the year despite returning 11.2% for the quarter. Emerging market equities also had a strong quarter, returning 8.1% overall and over 25% in the local Chinese A-share market. However, this bounce still leaves these markets with a slightly negative return over the year.

All equity markets enjoyed high returns in the March quarter, with some markets reaching fresh new highs…

Trans-Tasman equity markets also enjoyed a strong quarter. Australian shares returned 10% in the March quarter and 9.5% over the year. Within the Australian equity market, value stocks have mildly outperformed over the year (returning around 11%), while small cap stocks, which suffered large losses in 2018, have only returned around 3.5% despite a strong March quarter performance of 11.7%. New Zealand shares returned 11.2% in the quarter and 17.5% over the year to March 2019 - a very strong performance both in absolute terms and compared to offshore equity markets.

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

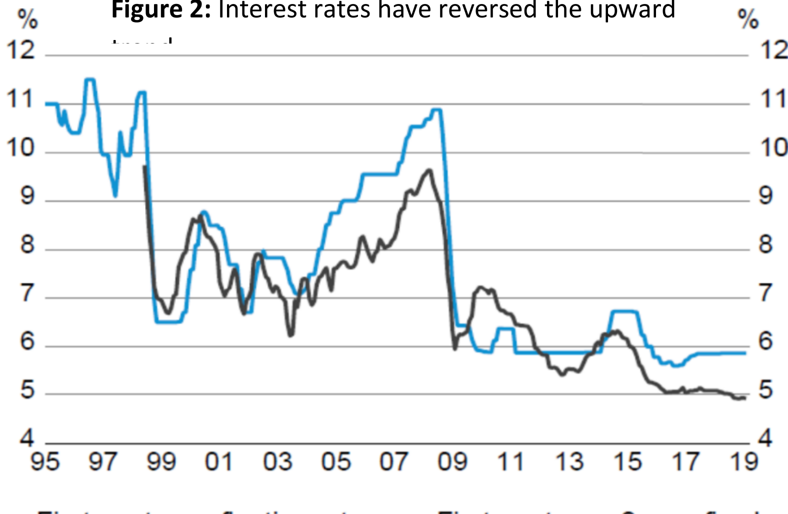


Bonds and property also had good returns.

In recent quarters we have often seen bonds suffering relatively poor returns when equities have been doing well and vice-versa. This quarter, given the nature of the 'shock' was a monetary policy easing, bonds also performed well. Global bonds returned 2.8% in the quarter and 4.6% in the year to March 2019. New Zealand investment grade bonds returned 2.3% for the quarter and around 6% for the year – a returns that has been significantly boosted by bonds re-pricing higher as New Zealand interest rate expectations fell.

NZ interest rates are following global trends down

Figure 2: Interest rates have reversed the upward



The Economic Indicators…

Our view in the December update was that markets were over-pricing economic recession risks. Instead, we thought it much more likely that economies would muddle through the cyclical slowdown.

To date, this view is more in line with actual data readings on most economies. The influential economic indicators for China and the US are pointing to a mild expansion, whilst European indicators suggest a mild decline.

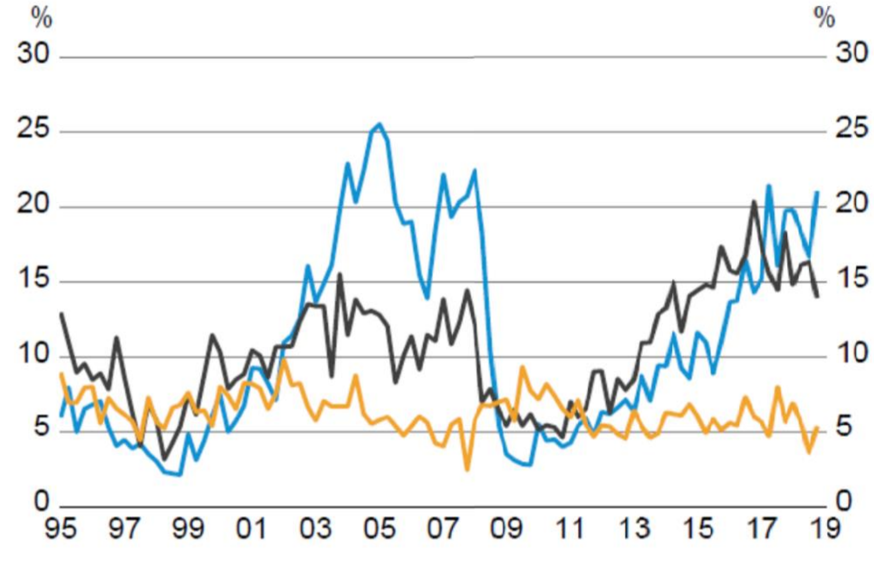
New Zealand's GDP growth for the December quarter came in at 0.6% or 2.8% for the year. This was a stronger outcome than many economists had feared, but slower than the +3% pace of growth that the economy has enjoyed over the past few years.

Macro forecasters see global growth at around long-term trend levels…

Despite a cooling housing market and weak business confidence levels, upside growth potential also remains in New Zealand given the huge backlog of housing and infrastructure spending that is in the pipeline. Capacity constraints in our economy remain high (Figure 3), and this can only be relieved through a long period of sustained investment.

Overall, the rear view mirror suggests that the global economy has been cooling to lukewarm levels. Looking ahead, despite the risks, macro forecasters expect global growth to hover around 3% over the next two years. This is only a little below the average level that has been achieved over the past two decades, and hence can be considered a "normal" cyclical slowdown from the higher growth that has been seen in recent years. The main caveat to this is that central banks do not have anywhere near the room to manoeuvre to cushion demand given rates are at such low levels.

Figure 3: Labour and physical capacity constraints remain high in NZ *(source NZIER)*



Recession risks are low - so long as the Emerging Markets juggernaut continues

Within the headline global growth figure, developed markets are expected to slow to around 1.5% or so, with European growth facing the largest downside risks given Brexit and the threat of auto and other tariffs hanging over the head of the German manufacturing machine. Emerging Markets are expected to grow more than double this pace at around 4.5%, despite a continual slowing of the Chinese economy.

High Emerging Markets growth implies that these markets will make a large and increasing contribution to global growth rates. A global recession remains very unlikely unless there is a large slowdown in Emerging Market economies, with China and increasingly India being the linchpins in this regard.

Key Market Movements for the Quarter

Quarter	Past year	
+11.2%	+ 17.5%	**New Zealand Shares** *New Zealand shares returned 11.2% in the quarter and 17.5% over the year to March 2019. This is a very strong performance both in absolute terms and compared to offshore equity markets.* *Source of Figures: S&P/NZX All Total Return Index*
+2.3%	+6.0%	**New Zealand Fixed Interest** *New Zealand investment grade corporate bonds returned 2.3% for the quarter and around 6% 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*
+10.0%	+9.5%	**Australian Shares** *Australian shares returned 10% in the March quarter and 9.5% over the year. Within the Australian equity market, value stocks have mildly outperformed over the year (returning around 11%), while small cap stocks, which suffered large losses in 2018, have only returned around 3.5% despite a strong March quarter performance of 11.7%.* *Source of Figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries*
+10.6% (+12.7% hedged)	+10.0% (+6.8% hedged)	**International Shares** *International shares rose 10.6% in the quarter, whilst NZD hedged shares rose 12.7%. This strong quarterly performance boosted the annual return of global shares to 10% on an unhedged basis, and 6.8% 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 4.2% despite returning 11.2% for the quarter.* *Source of Figures: MSCI World Index; Morningstar Developed Markets NZD hedged*
8.1%	-2.1%	**Emerging Markets** *Emerging Market equities increased 8.1% in the quarter and decreased 2.1% over the year to March 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*
+2.8%	+4.6%	**International Fixed Interest** *Global bonds returned 2.8% in the quarter and 4.6% in the year to March 2019. The return over the quarter and year was boosted by bonds being repriced higher as longer term interest rates fell. The latter was driven by the US central bank changing its view on the need for rates to increase as much as they had previously thought.* *Source of Figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)*
15.1%	17.4%	**International Property** *International property stocks rallied strongly over the quarter, increasing by around 15%. 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.

Securities Lending – What is It?

When you own securities, and especially if you are planning to hold them for a long time, there is a way of securing some extra income from them. Think of it as adding icing to your investment cake. Shares or bonds can be lent out other parties who might need the shares for a short-term trading strategy or to settle a trade that would otherwise fail. The chart on the right illustrates the procedure.

Securities Lending Process:

The borrower of the security is required to put up collateral in the form of cash, security or a letter of credit and the deal is detailed and formalised through a loan agreement. Typically, this is facilitated by clearing brokers, who receive a cut of the fee paid by the borrower to the lender of the securities. In 2018, the global market for securities lending covered $2.3tn of assets and produced $9.2bn of additional revenue.

Securities lending greases the wheels of the market by improving liquidity and gives participants some visibility into potential supply and demand for a stock. This can provide important information regarding optimal sale or purchase points for the stock. For example, if Security A is expensive to borrow compared to Security B in the same sector, it may be a signal that there is short-term downward pressure on Security A. A fund planning to buy may use this information to delay the purchase. This patient trading and careful execution can all contribute to higher returns over time.

The funds providing the securities enhance their returns by defraying some of their operational costs – in some cases, as can be seen in the chart below, covering a very substantial part of their net expenses.

Essentially, it is a monetisation of the liquidity they hold in their portfolios. Fund managers such as Dimensional Fund Advisers (DFA) that include hundreds of securities in their funds will have greater opportunities to lend stock purely from the breadth of their portfolios. Their low levels of turnover are also advantageous in the context of securities lending.

What happens to the income from securities lending?

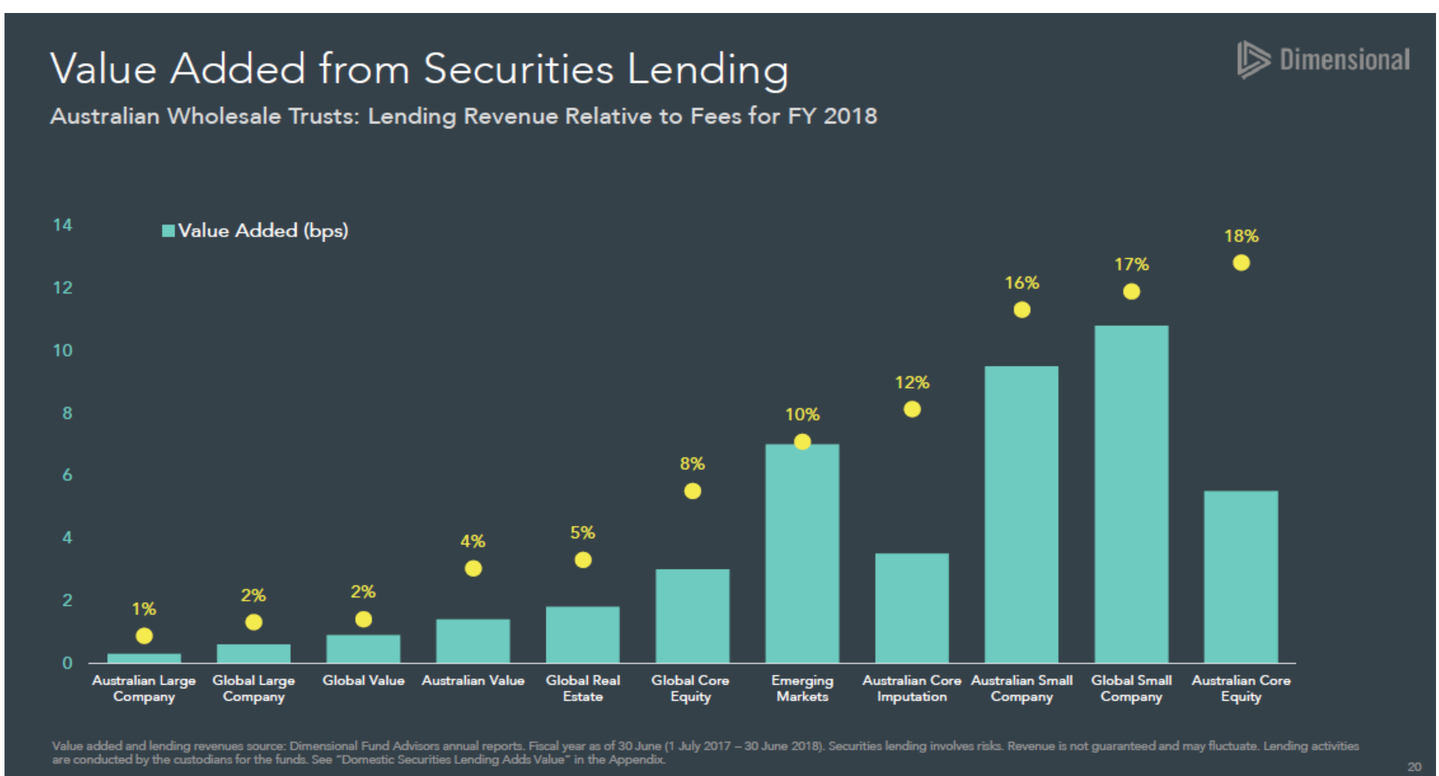
There has been a move away from using securities lending purely to offset operational costs towards lending being another strategy to boost returns. A survey of investors by DataLend and Funds Europe showed 59 per cent of respondents said their main reason for engaging with stock lending was to boost returns, compared with 36 per cent who said they did so to cover operational costs.

There is a risk that using securities lending to improve returns leads to the interests of the fund manager no longer being properly aligned with the end investor, with stocks being chosen because of their potentially higher security lending returns rather than in line with a clearly defined investment philosophy. It is essential to understand the rationale behind a fund manager's use of securities lending.

What the lenders of stock and bonds return to their investors varies. BlackRock, the world's biggest money manager, made $597m of revenue from lending last year, but investors only retained 62.5% of this, with the remainder kept by the lending agent, part of the BlackRock group. Vanguard, on the other hand, returns all lending revenues, net of direct programme costs, which include operating expenses and agent lender fees, to the Vanguard funds. Returns have been enhanced by 1 to 27 bps, depending on the fund in question.

Dimensional Fund Advisers (DFA) (a fund manager that plays an important part in Axiome's client portfolios) earned US$372 million from global equity securities lending in 2017, increasing returns by 11 basis points or 0.11% on average. In the case of DFA all extra income from securities lending is returned to the investor, amplifying returns.

As investors become more aware of securities lending, there is likely to be pressure on managers who don't pass on all revenues from lending to do so in full. This trend towards greater transparency will only serve to benefit the end investor.



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