Axiome Quarterly Update

January - March 2017

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Investment Market Review

Economic conditions improved further over the March quarter

In our market commentary for the beginning of 2017 we highlighted that a 'great rotation' from global bonds to global equities was underway given the market's conviction that the business cycle was back in the United States, with other countries following. Economic conditions are now strong enough in most developed economies to return inflation back to higher levels (see figure 1), necessitating central banks to gradually increase interest rates. This quarter has only reinforced our assessment that interest rate normalisation will continue.

Equity markets continued their rally whilst bonds and defensive assets in general fared poorly given the rising interest rate outlook. The wall of political noise emanating from the United States may be entertaining or deeply concerning depending on your views, but it has barely budged markets. The broad MSCI index of global developed market companies increased around 8% over the quarter and around 23% over the past year (in USD terms). The broad MSCI index of emerging market companies performed even better, increasing around 9.5% for the quarter and over 30% for the year.

In contrast, returns from bonds were paltry. The Barclays Global Aggregate bond index (the recognised global benchmark) returned around 0.2% for the quarter (in USD terms) and -0.3% for the year. This purely reflected the losses from falling prices that existing bonds had experienced in the second half of 2016 as interest rate expectations for the years ahead adjusted upwards rapidly. It does not reflect any defaults by corporates on their debt obligations or significant ratings downgrades – these remain negligible in investment grade bonds given the general strength in corporate balance sheets across developed market economies.

In the US, employment conditions further strengthened, business and consumer confidence levels rose to levels not seen in over a decade (figure 2), and corporate profitability continued to recover from the lower levels seen in 2016. The US Federal Reserve increased rates following its March policy meeting, for the second time in 3 months. The Federal Funds Rate in the US, the equivalent of our Overnight Cash Rate (OCR) is now 1% and the Fed has signalled at least 2 further rate rises over 2017. This would put US policy rates at a similar level to our OCR by the end of this year.

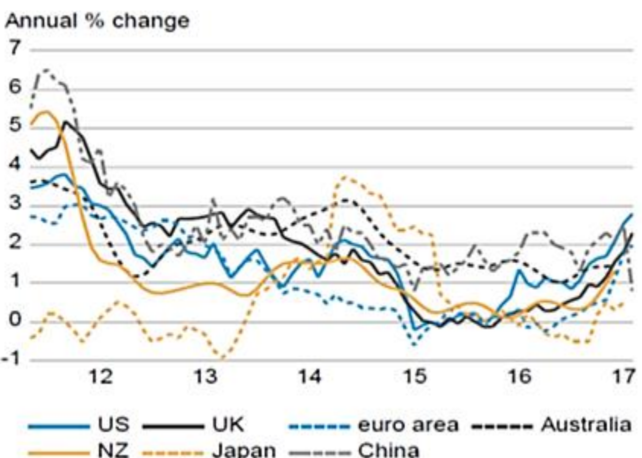


Figure 1: Headline CPI inflation is on the rise globally. Source: Haver

Interest rate normalisation is expected to begin in Europe in 18 months

In Europe, employment levels continued to climb and the European Central Bank took steps to reduce its quantitative easing. It also signalled that interest rate normalisation will likely begin in 2018. This may seem surprising given the steady stream of news we hear about the fragility in Europe's economies, the political risks around Brexit, and the rise of extreme right-wing parties. But the hard-economic facts are that Northern European economies continue to do well, with the unemployment rate in Germany now at the lowest level seen since 1980; the 'intensive-care peripheral economies' (Portugal, Ireland, Greece and Spain) have made huge progress to reduce fiscal and external imbalances; and France and Italy are growing modestly and slowly improving their employment conditions.

The UK economy has also continued to surprise on the upside, in part because the depreciation of the Pound has created competitive conditions for exporters and domestic firms competing with imported goods and services. Nevertheless, the other shoe is yet to drop. Theresa May trigged Article 50 on the 29th March, which puts the UK and the EU on a two-year timeframe to negotiate the UK's exit. It is in the EU's political interest to make this costly for the UK, and the UK clearly has the much weaker bargaining position. This does not necessarily mean 'hard Brexit', but what is does mean is that if the UK wants to maintain a privileged trade arrangement with the EU it will need to maintain policy settings across immigration, trade, regulatory and tax policy that are close to the status-quo. This is of course what Brexit supporters voted against.

In the meantime, given the uncertainty and risk of hard Brexit, multi-nationals in the UK have begun the process of moving staff to Europe. HSBC has announced a shift of 1,000 staff from London to Paris, and estimates suggest over 20,000 high paying banking jobs will move. In contrast, smaller firms lack the same ability adjust to the Brexit shock. Market reaction reflects these currents. While the FTSE 100 has rallied with global counter parts over the past year (around 20%), the FTSE 250, which tracks the performance of mid and smaller cap companies, has lagged (up around 12%).

Figure 2: US consumers very optimistic about the employment outlook
Source: The Conference Board, Haver Analytics, DB Global Markets Research

Economic growth in Emerging Markets maintained its edge over developed economies. Over 2016 growth was around 4% across EM economies compared to around 1.6% in the OECD. Over 2017 and 2018 the IMF expects EM GDP growth to increase to over 4.5%, while in advanced economies growth is expected to increase to around 2%.

This outperformance masks, however, considerable regional variation. The largest nations of India and China are expected to remain bright spots, clocking up growth rates around 7% and 6% per annum respectively. The ASEAN region (including the populous nations of Indonesia, the Philippines and Vietnam) is also expected to maintain a growth rate of around 5% per annum.

In contrast, commodity exporters such as Brazil, Russia and Nigeria experienced recessionary conditions in 2016, and recovery is expected to be modest – reforms are required in these economies to reduce their reliance on commodities and improve the sustainability of government budget balances.

The theme of the rise of the Asian consumer remains intact. This has put a floor under commodity prices over the past year, although downside risks to energy prices remain given the vastness of American shale oil and gas resources and the Trump administration's efforts to stimulate the sector.

American shale coal and oil industries look set to increase production under the Trump administration

The recovery in commodity prices has contributed to better economic performance for Australia over 2016 (GDP increased around 2.5%). The Australian economy has also demonstrated resilience to the poor commodity price environment over the past few years, with large employing sectors such as tourism, education, and construction growing rapidly.

New Zealand also continues its relatively strong run. GDP growth has averaged close to 3% since 2012, well above the OECD economy average, on the back of factors such as demand for dairy, record tourism and immigration flows, and exceptional growth in our tech sector. Unemployment has reduced to around 5%, and the government is now running a small fiscal surplus. The outlook remains very solid, especially in the construction sector. However, broad inflationary pressures are clearly emerging (in line with the global trend) and are acute in some areas.

House prices nationally are now exceptionally high, both historically and compared other countries (see figure 3) – On an income basis Auckland is more expensive than London and New York! Recent indicators suggest prices have plateaued and sales volume are declining in Auckland and some other areas.

Trans-Tasman economies continue to do well, though high house prices are a material risk.

We don't expect a crash given strength in the domestic and global economy, but high house prices in New Zealand (and Australia) still present a large vulnerability that authorities so far have only managed at the margin. Our globally oriented portfolios provide diversification to this risk, and other factors that might lead to under-performance of New Zealand asset prices over the years ahead.

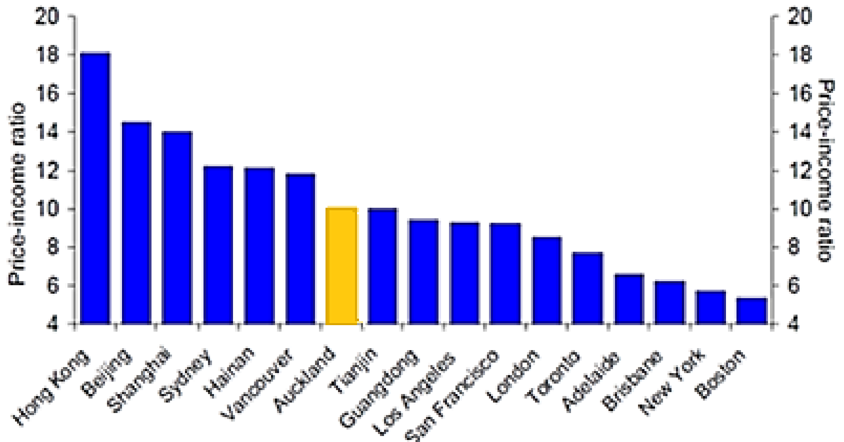


Figure 3: Auckland's housing market is now one of the most expensive in the world
Source: Demographia 2017, E-House, DB Global Markets Research

Key Market Movements for the Quarter

Quarterly Return	Annual Return	Asset Class
+ 4.59%	+ 6.58%	**New Zealand Shares** The New Zealand market rallied around 4.5% for the quarter following a generally solid reporting of results for the quarter, and a bounce back of the large sell-off experienced over the second half of 2016. Over the past 3 years New Zealand's equity market remains a stellar performer. *Source of Figures: NZX 50 Index*
+1.48%	+3.13%	**New Zealand Fixed Interest** New Zealand Fixed Interest mildly rallied over the first quarter as markets pared-back their expectation of domestic interest rate rises. Neverthess, over the past year bonds have stuggled as markets have became convinced that monetary policy normalisation is underway. *Source of Figures: NZX A Grade Corporate Bond Index*
+9.97%	+18.41%	**Australian Shares** The Australian share market had a strong quarter following good company earnings announcements (particularly in the dominant banking sector) and strengthening in conviction that the tide has turned back in favour of commodity producers. *Source of Figures: S&P ASX 200*
+5.89% (NZD hedged) +5.29% (unhedged)	+19.41% (NZD hedged) +12.99% (unhedged)	**International Shares** International equities had another strong quarter given economic data that generally exceeded expectations (across Europe, North America and developed Asia), a strengthening in reported corporate earnings (particularly in the energy sector), and on ongoing rotation from fixed income to riskier assets. The lower unhedged returns in NZD terms reflect the depreciation of the NZ dollar against most currencies. *Source of Figures: MSCI World ex-Australia Index*
+10.48%	+16.01%	**Emerging Markets** The very strong emerging market equity performance over the quarter reflects the fact that these markets tend to do very well when global markets rally (and relatively poorly when they sell-off). But in addition to this, economic data in many emerging market economies also continued to improve or exceed expectations. Notably the Indian and Chinese economies continue to do well, whilst the Brazillian, Russian and South African economies are recovering from the very weak conditions experienced over the past couple of years. *Source of Figures: MSCI Emerging Markets Index*
+0.58%	+2.19%	**International Fixed Interest** Global bonds had another soft quarter given markets continued to re-price monetary policy normalisation; i.e. bonds perform poorly when forward interest rate expectations increase. The US Federal Reserve increased rates in the quarter and 2 further increases are expected this year. The European Central Bank announcements also indicate lifting rates in late 2018. *Source of Figures: Citigroup World Government Bond Index 1 - 5 Years (hedged to NZD)*
+0.39%	-1.04%	**International Property** International Property underperformed because in a rising rate environment exposures with "bond like" characteristics tend to underperform. *Source of Figures: S&P Developed REIT Index*

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 NZD

Asset Class Diversification

Diversification is one of the key principles of investing. Importantly, diversification is more than simply holding a large number of assets. It's also about investing in different *types* of assets.

We can already invest in hundreds of different companies through equity and bond markets. But prudent portfolio construction dictates that we must also look across a range of different *asset classes*.

Asset classes are a way of grouping companies based on the different characteristics they exhibit, such as profitability (growth or value), size (large or small) and geography.

Why do we do this? Just as individual companies face risks unique to them, different asset classes and geographic markets also face unique risks and varying economic cycles. Accordingly, we can exploit this range of differences to reduce the volatility of your portfolio.

Reducing volatility is a key to enhancing compound returns over time. Of two portfolios with the same average return year by year, it is the one with the lower volatility that that will provide a more consistent reliable return over those years.

By creating a diversified asset class portfolio we mitigate risk. The example below highlights the merit of global diversification.

Diversification is about breadth as much as it is depth. Investors can reduce risk, or increase returns, by holding more asset classes

Taking the NZX 50 as a broad representation of the New Zealand market, over the past 20 years it has yielded an annual average return of 7.3%. Similarly, our 'Conservative 30/70' portfolio (30% shares and 70% bonds), diversified across asset classes and international markets, yielded a similar annual return of 7.5%.

Investors who put $10,000 into either strategy may have ended up with roughly the same amount after the 20 years (Fig. 1).

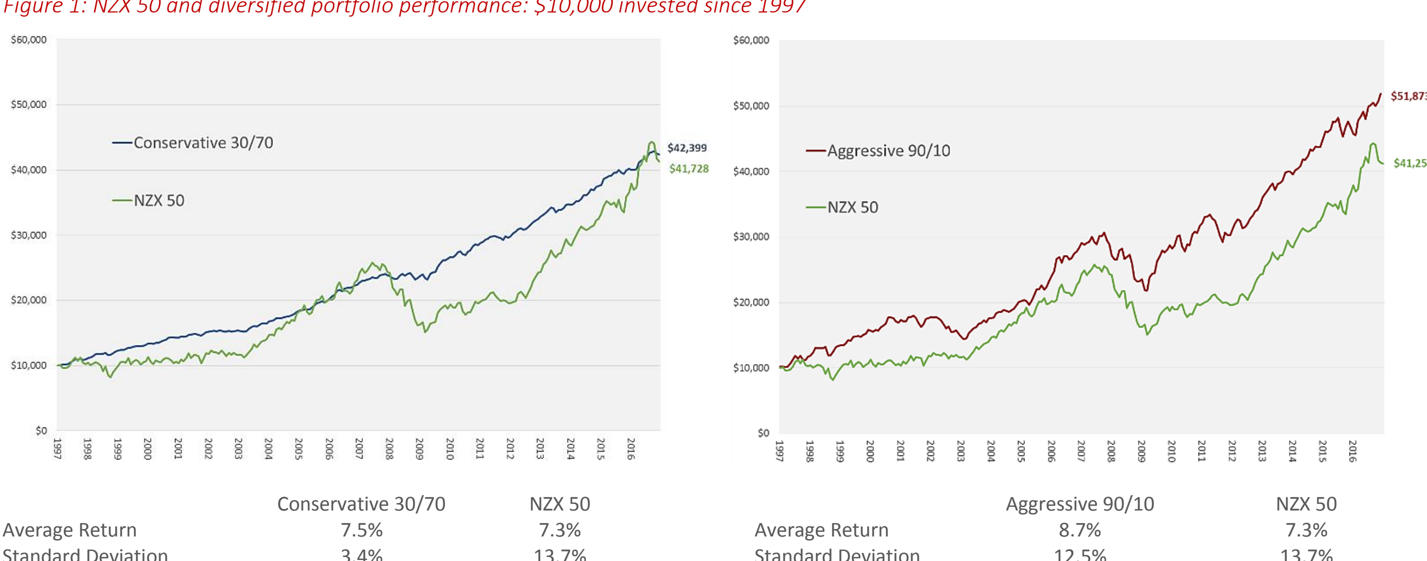
Having an investment portfolio with only one asset class is still putting all your eggs in one basket

So what's the difference between the two? The volatility around the average return for the NZX 50 for that period was 13.7%, whereas the volatility of the portfolio with a range of asset classes was only 3.4%, a significant difference.

The investor who put their dollar in the NZX50 took on additional risk that they could have avoided. This volatility shows up on the bumpier green line of the left hand chart below with returns at times lagging the compound return of the more conservative global portfolio.

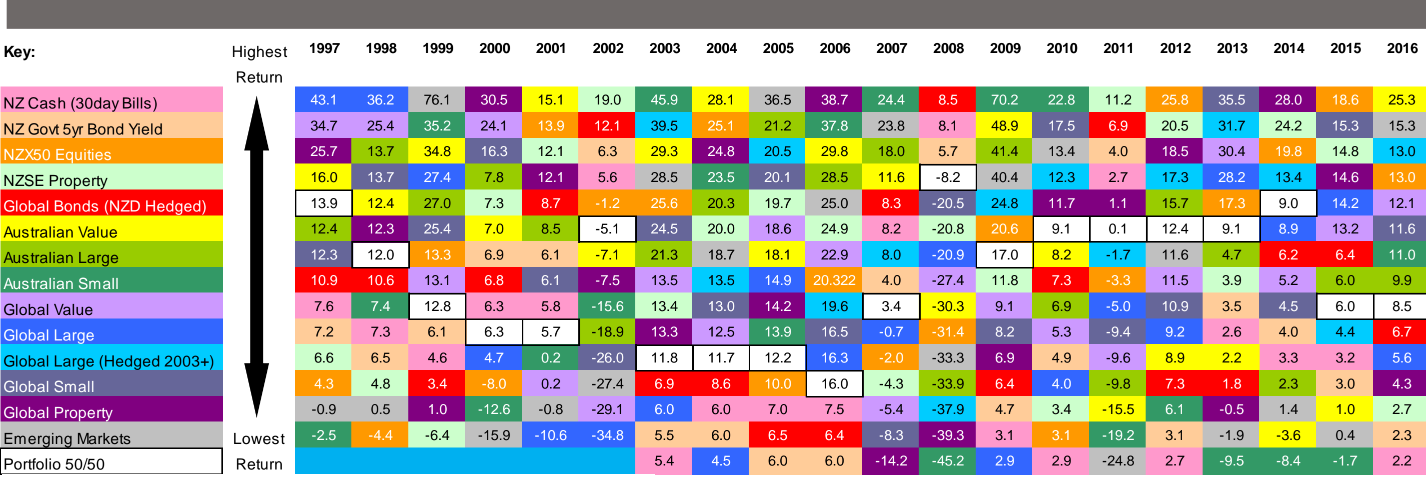
Alternatively, with about the same amount of risk as the NZX 50, an investor could have invested in a more diversified asset class growth portfolio, the 'Aggressive 90/10', and received a greater return. In fact some 1.4% p.a. more, with a compound effect amounting to over $10,000 additional return over 20 years.

Figure 1: NZX 50 and diversified portfolio performance: $10,000 invested since 1997



	Conservative 30/70	NZX 50
Average Return	7.5%	7.3%
Standard Deviation	3.4%	13.7%

	Aggressive 90/10	NZX 50
Average Return	8.7%	7.3%
Standard Deviation	12.5%	13.7%



Key:	Highest Return	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
NZ Cash (30day Bills)		43.1	36.2	76.1	30.5	15.1	19.0	45.9	28.1	36.5	38.7	24.4	8.5	70.2	22.8	11.2	25.8	35.5	28.0	18.6	25.3
NZ Govt 5yr Bond Yield		34.7	25.4	35.2	24.1	13.9	12.1	39.5	25.1	21.2	37.8	23.8	8.1	48.9	17.5	6.9	20.5	31.7	24.2	15.3	15.3
NZX50 Equities		25.7	13.7	34.8	16.3	12.1	6.3	29.3	24.8	20.5	29.8	18.0	5.7	41.4	13.4	4.0	18.5	30.4	19.8	14.8	13.0
NZSE Property		16.0	13.7	27.4	7.8	12.1	5.6	28.5	23.5	20.1	28.5	11.6	-8.2	40.4	12.3	2.7	17.3	28.2	13.4	14.6	13.0
Global Bonds (NZD Hedged)		13.9	12.4	27.0	7.3	8.7	-1.2	25.6	20.3	19.7	25.0	8.3	-20.5	24.8	11.7	1.1	15.7	17.3	9.0	14.2	12.1
Australian Value		12.4	12.3	25.4	7.0	8.5	-5.1	24.5	20.0	18.6	24.9	8.2	-20.8	20.6	9.1	0.1	12.4	9.1	8.9	13.2	11.6
Australian Large		12.3	12.0	13.3	6.9	6.1	-7.1	21.3	18.7	18.1	22.9	8.0	-20.9	17.0	8.2	-1.7	11.6	4.7	6.2	6.4	11.0
Australian Small		10.9	10.6	13.1	6.8	6.1	-7.5	13.5	13.5	14.9	20.322	4.0	-27.4	11.8	7.3	-3.3	11.5	3.9	5.2	6.0	9.9
Global Value		7.6	7.4	12.8	6.3	5.8	-15.6	13.4	13.0	14.2	19.6	3.4	-30.3	9.1	6.9	-5.0	10.9	3.5	4.5	6.0	8.5
Global Large		7.2	7.3	6.1	6.3	5.7	-18.9	13.3	12.5	13.9	16.5	-0.7	-31.4	8.2	5.3	-9.4	9.2	2.6	4.0	4.4	6.7
Global Large (Hedged 2003+)		6.6	6.5	4.6	4.7	0.2	-26.0	11.8	11.7	12.2	16.3	-2.0	-33.3	6.9	4.9	-9.6	8.9	2.2	3.3	3.2	5.6
Global Small		4.3	4.8	3.4	-8.0	0.2	-27.4	6.9	8.6	10.0	16.0	-4.3	-33.9	6.4	4.0	-9.8	7.3	1.8	2.3	3.0	4.3
Global Property		-0.9	0.5	1.0	-12.6	-0.8	-29.1	6.0	6.0	7.0	7.5	-5.4	-37.9	4.7	3.4	-15.5	6.1	-0.5	1.4	1.0	2.7
Emerging Markets	Lowest	-2.5	-4.4	-6.4	-15.9	-10.6	-34.8	5.5	6.0	6.5	6.4	-8.3	-39.3	3.1	3.1	-19.2	3.1	-1.9	-3.6	0.4	2.3
Portfolio 50/50	Return							5.4	4.5	6.0	6.0	-14.2	-45.2	2.9	2.9	-24.8	2.7	-9.5	-8.4	-1.7	2.2

Figure 2: Annual returns for different asset classes

Picking asset classes

The Greek philosopher Heraclitus is quoted as saying ***"The only thing that is constant is change."***

The mosaic chart above shows the annual returns for different asset classes (each block of colour) and ranks them from highest to lowest return year by year. It depicts a random pattern of returns, and the inherent uncertainty of forecasting the next "winning asset class".

Why 'forecasting' doesn't work

Investors should be sceptical of any claims to add value by forecasting based strategies that purport to get a jump ahead of future trends or events.

Empirical evidence confirms that markets rapidly assimilate information or knowledge about individual securities, and the aggregated asset class groupings they belong to, rapidly by price movement. Thus security prices constantly reflect all current information.

This does not mean the markets are perfectly priced - just that they are always in equilibrium - every security is owned at the end of every trading day. Future events have the capacity to surprise markets positively or negatively which results in a price adjustment when the news breaks.

This was seen in 2016 following the Brexit vote. Those who were "forecasting" stronger future growth in the UK than the markets were predicting, were simply betting on the outcome of the referendum. The result was that they were over-exposed to the specific risks that faced this market and added unnecessary volatility to their investment portfolio.

Although in hindsight this seems obvious, often what causes asset classes to under or over perform are unexpected at the time. The best we can do is to diversify across asset classes to reduce portfolio volatility and provide a much less 'bumpy' ride for investors.

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