Axiome Spring Update

July - Sept

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Investment Market Review

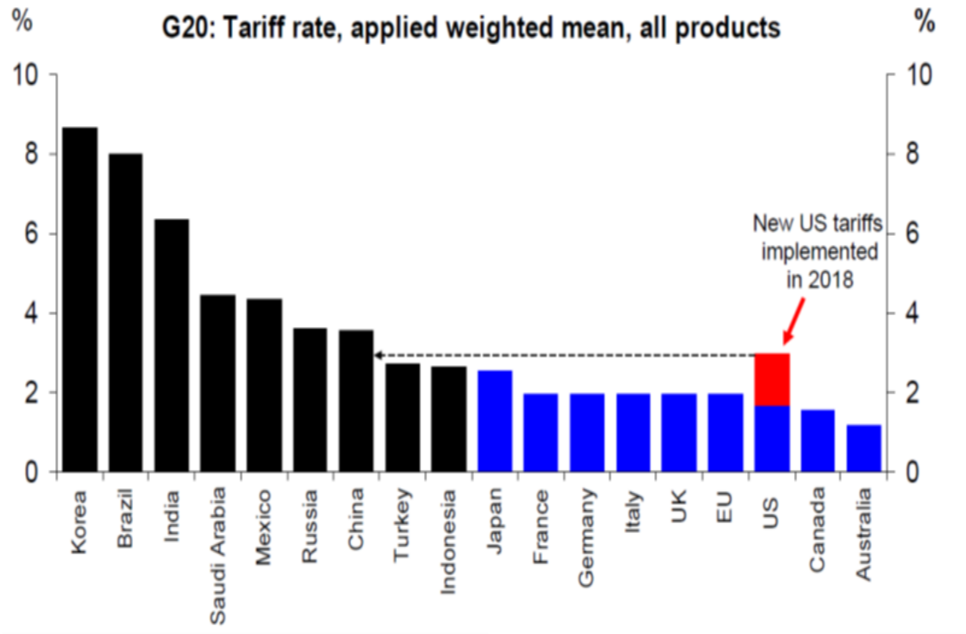
The pace of global growth remains strong and is expected to remain above trend levels, despite clear escalation in the Trump Administration's trade war. US tariffs are now higher than all other developed economies and approaching levels in Russia and China (figure 1). Despite this development, US GDP for the June quarter was 4.2% (annualised), the strongest reading in over four years. New Zealand GDP was also strong at 4% (annualised), or twice the pace expected by the Reserve Bank of New Zealand (RBNZ). NZ business confidence also rebounded from the funk it had been in since the election.

Given the strong NZ data, markets backed off from the view that our economy is slowing, and that the RBNZ may need to cut future interest rates. This change in view arrested the decline in the NZ dollar over the month of September, although over the quarter our currency is still around 4.5% lower against the USD, and over the year it is 8% lower.

Equity markets fly high again!

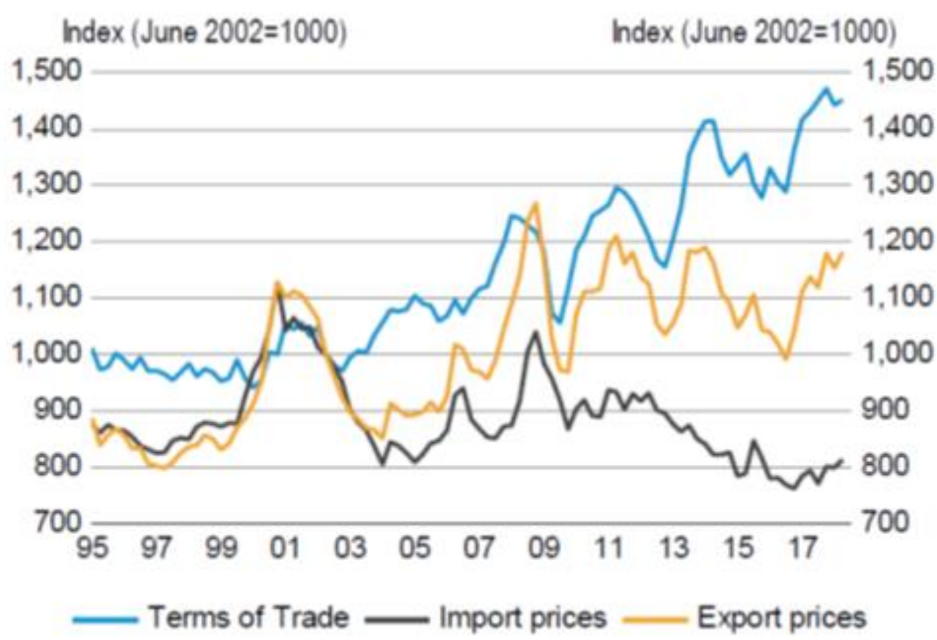
At present levels the RBNZ estimates that our exchange rate is in the 'goldilocks zone' that supports exporters and household spending and keeps our trade balanced. Through this lens the Kiwi should stay put. But should is not the same as will. Our terms of trade are at record highs, which argues for a higher currency level (figure 2). In addition, inflation expectations are now around target levels and may increase faster, forcing the RBNZ off the fence.

Figure 1: US tariffs new highest in the G7
Source: World Bank, Haver Analytics, DB Global Research



With rising petrol prices, capacity constraints, and the huge construction and infrastructure backlog in New Zealand this is certainly possible. But against this is the fact that the US cash rate is now 2.25%, well over our 1.75% overnight cash rate (figure 3). This is quite unusual from a historical perspective, where typically NZ short term rates are at least 1% higher than the US. Higher US rates favour currency speculators selling (shorting) the NZ dollar to buy US dollars, which could cause our currency to fall further.

Figure 2: Terms of trade argues for a higher NZ dollar
Source: Statistics New Zealand



Regardless of where the currency goes from here one thing that is clear is that the decline in the NZ dollar has very much flattered the return from offshore equities and property (held on an unhedged basis).

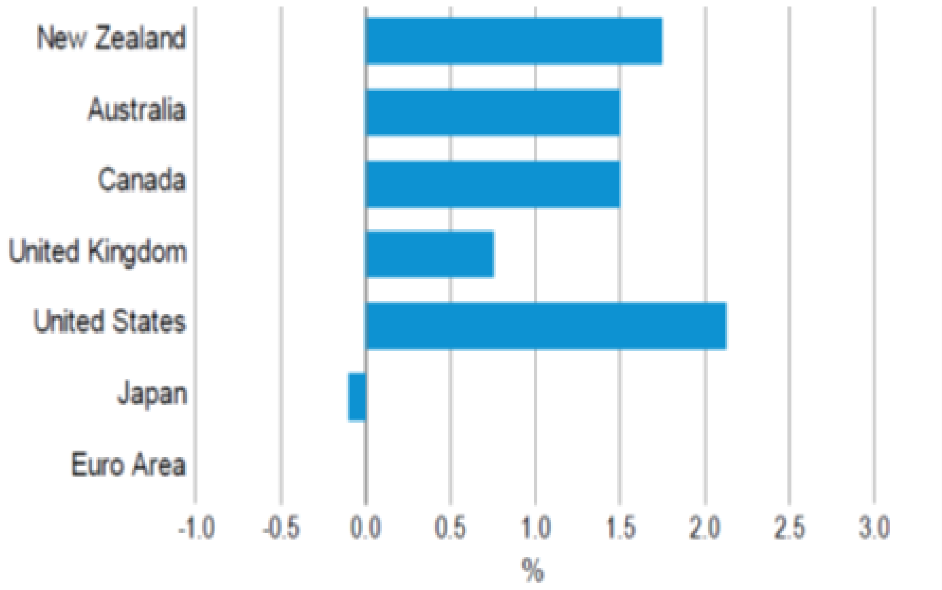
Over the quarter developed international equity returns were solid, returning around 5% in USD terms and 7.5% in NZD terms. Over the year returns have been an impressive 21.5%, but 'only' 11.5% in foreign currency terms. NZ equities also had a strong quarter, increasing 4.6%. This brings the annual return to around 18% and the return over the past 3 years to around 19% - one of the strongest global performances in markets over this time frame. The Aussie market also had a solid quarter, bringing the return to around 14.6% on an annual basis.

In contrast to developed markets, Emerging Markets (EM) fell slightly in the quarter (although they mildly increased in NZD terms and are up around 8% year to date). While EM economic growth, in general, remains robust, EM equities face several headwinds - capital outflows as the US has tightened interest rates, concern over rising trade tensions (hitting the Chinese market in particular), and instability in some economies such as Turkey and Brazil. The silver lining to this is that with the soft performance, EM equities are now seen as very good value, particularly compared to the high-flying US equity market.

Fixed income returns have continued to struggle as US interest rates have risen.

NZ investment grade bonds returned around 1.5% for the quarter and 4.8% for the year. This return is well ahead of short-term cash rates and term-deposits, indicating that NZ bonds have offered a good premium. International bond returns were, in contrast, flat for the quarter and have returned only around 1.2% over the past year. The soft annual return reflects long-term interest rates increasing at a faster pace than had been expected, particularly in the US. While this is disappointing for investors it reflects a temporary "marked to market" impact only from interest rates heading higher. It hasn't reflected bond issuers getting into difficultly making bond payments (as occurred in NZ in the finance company collapses) - default rates on investment grade bonds remain negligible and corporate balance sheets are in general quite healthy.

Figure 3: US Short term rates lead the pack
Source: NZ Treasury



Key Market Movements for the Quarter

Quarter	Past year	
+ 4.6%	+ 17.9%	**New Zealand Shares** The New Zealand market had a strong quarter, increasing 4.6%. This brings the annual return to around 18% and the return over the past 3 years to around 19% per annum - one of the strongest global performances in markets over the past several years. *Source of Figures: NZX 50 Index*
+1.5%	+4.8%	**New Zealand Fixed Interest** New Zealand investment grade bonds returned 1.5% for the quarter and 4.8% for the year. The annual return is both comfortably higher than 90-day NZ bank bill rate and term deposit rates, indicating that NZ corporate bonds have delivered a good premium over the year. *Source of Figures: NZX A Grade Corporate Bond Index*
+1.5%	+14.6%	**Australian Shares** The Australian share market returned around 1.5% for the quarter and 14.6% for the year in both NZD and Australian dollar terms (as the currency has been flat over the year). Within the Aussie market small cap stocks (which are closer in size to much of the NZ share market) have returned around 21% over the year. *Source of Figures: S&P ASX 200*
+5.7% *(NZD hedged)* +7.4% *(Unhedged)*	+13.3% *(NZD hedged)* +21.5% (Unhedged)	**International Shares** International equities also had a strong quarter, returning 5% (in foreign currency terms) and around 11.5% over the year to September. In NZD terms, returns were much stronger given the decline in our currency (especially against the USD) over the period. Returns in NZDs were around 7.4% in the quarter and 21.5% over the year. Hedged returns were around 5.7% over the quarter and 13.3% over the year. *Source of Figures: MSCI World ex-Australia Index; Vanguard international equity index funds data to proxy hedged returns*
+1.0%	+8.2%	**Emerging Markets** Emerging Market equities increased 1% during the quarter (in NZD) and have returned a little over 8% for the year to September. This is softer than developed markets and reflects capital outflows as the US has tightened interest rates, and that the Trump Administration's trade war has had quite a negative impact on the large Chinese equity market. *Source of Figures: MSCI Emerging Markets Index*
+0.0%	+1.2%	**International Fixed Interest** Global bonds were flat over the quarter and returned only 1.2% for the year. This return is lower than the (NZD hedged) coupon on international bonds, and reflects bonds being re-priced lower over the period as interest rates have risen ahead of what markets had expected. *Source of Figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)*
+2.4%	+13.5%	**International Property** International Property stocks increased over the September quarter, up around 2.4% in NZD terms (and 0.2% in USD terms) and 13.5% over the year. NZ and Australian listed property stocks also increased in their quarter, up around 2% and 3.5% respectively. *Source of Figures: S&P global, NZ and Australian REITs (NZD)*

Australian Royal Commission

Royal Commission
into Misconduct in the Banking, Superannuation and Financial Services Industry

The Australian Royal Commission finds things are not well over the ditch.

In Australia the financial services industry is being rocked by the Royal Commission into its behaviour and practices. It has found many concerning practices across wealth advice, insurance and banking - ranging from carelessness to outright fraud. Public confidence in the financial services industry has been shattered.

In New Zealand the problem has been described as one of 'culture' – senior management in Australia has encouraged a culture rewarding sales and profits at the expense of what the customer needs or should pay for the services rendered. Fiduciary obligations have been trumped by short-term business interests.

Across the ditch the view being taken is that no amount of well-meaning 'cultural' initiatives will fix the fundamental problem. It has been well-known for many years that the vertically integrated businesses within the financial services industry embed structural conflicts of interest that place advisers and staff in a continual dilemma. Do I serve what is my own and employer's best interest, or my clients? For this reason, most of the big banks in Australia are removing the temptation by divesting themselves of their wealth and asset management divisions or shareholdings.

In New Zealand, while the Banks have been at pains to say they have a different culture, clearly the same structural conflict of interest is present in our banking system. For example, their private wealth offerings tend to be stuffed full of their own products, many of which are simple overlays on funds that can be obtained more cheaply by going direct to the underlying fund manager.

Given the presence of the same underlying conflicts it seems untenable for the industry to remain the same in New Zealand. At the very least, there should be more contestability and independence in the investment and advice processes that vertically integrated firms run. We would also hope to see a lifting of standards from mere compliance with FMA regulations, to higher fiduciary standards of practices and conduct. The experience in Australia clearly shows that regulatory compliance does not guarantee putting client's interests first. We may also see the divestment option being taken to safeguard reputational risks, as has occurred in Australia.

In the meantime, investors should be aware that the waves from the Australian Commission will increasingly hit our shores. The lessons from the Royal Commission enquiry underscore the merit of independent advice. There is opportunity to select providers who are transparent across their fee structures and costs, who operate at a higher fiduciary standard, and who can demonstrate they put your interests first.

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