

## IWIinvestor Investment Report:

### Markets Summary, Quarter End – March 2018

At the year ended December 2017 we reported that equity markets had closed on record highs, including in New Zealand and the United States. In the March quarter of 2018, we saw a reversal of fortune, with sell-offs in most equity markets, including in New Zealand, Australia, Developed and Emerging Markets.

Amongst the pack, Australia fared the worst returning around -4% for the quarter (in AUD terms). This was not due to the mining sector taking a large hit, rather it reflected that the global sell-off coincided with more damning reports on Australian bank practices, including in insurance and wealth management. We may in time see repercussions in New Zealand – regulators globally are becoming increasingly tough on organisations that put business ahead of their client's interests and this is 'challenging' for banks who earn a margin from re-marketing product from managers or insurers that could be accessed directly.

In contrast to the Australian equity market performance, Emerging Market equities were resilient, ending the quarter broadly flat. This result is at odds with the common view that Emerging Markets are riskier than Developed Markets, and hence sell-off more strongly in times of market stress. Their resilience this time round likely reflects a very robust global economic environment, as discussed below. The NZ equity market also fared reasonably well, though this was mainly due to the stellar performance of A2 Milk rather than the market broadly doing well (and in contrast it is notable that Fletcher Building had another woeful performance following a further earnings downgrade).



Global fixed income returns were a soft performance in the quarter. The latter reflected that one of the catalysts for the March sell-off was the Federal Reserve in the United States re-affirming the need it sees to tighten monetary policy (a risk we have raised as likely in our previous commentary), given US growth has (finally) eroded spare capacity in the US economy and inflation is starting to increase.

We should not, and indeed do not, expect interest rate rises to have ongoing negative consequences for equities – rising interest rates are a sign that the global economy continues to heal from the GFC, and historically equity markets have fared well, despite rising rates, when accompanied by a solid economic and corporate earnings environment.

This is precisely the economic environment most forecasters expect over the next few years. The OECD expects global GDP growth is expected to mildly accelerate over 2018 and 2019 to around 3.9%, a level well ahead of the 3.3% growth that has been experienced, on average, over the past two decades. This growth is expected to cause inflation to rise, but at a slow pace from relatively low levels.

Given the global growth backdrop the New Zealand economy is also expected to also grow at a fairly good clip (around 3% or so), supported further by strong net migration levels and infrastructure spending.

### **Global trade wars are a risk**

Another catalyst for the sell-off in March was jitters around the prospects of a global trade war. Despite broad opposition from within the Republican Party and his economic advisors, President Trump pressed ahead with tariffs on Chinese steel. In turn, China has responded with promises to raise tariffs on a range of US goods, strategically focussing on sectors or products that are important in Republican-held areas. At the time of writing, China has taken the dispute to the World Trade Organisation and it is unclear how long the tariff measures will last, or whether the dispute will escalate.



What is clear is that trade is the lifeblood of global economies and economic growth – the richest countries in the world tend to be the most open to trade, whilst poorer countries tend to have higher trade barriers. The rapid growth in China as it opened itself to global trade, and more recently India, are cases in point. As such, the rosy global expectation outlined above would be de-railed if a tit-for-tat trade war were to escalate.

The key question markets and commentators are grappling with is how likely is a trade-war scenario? For now, the consensus view is not likely at all. As noted above this is partly because the political will is fragile - the Republic controlled Congress and Senate are in opposition to both the current measure, let alone further measures. In part it also reflects the view that China very much holds the upper economic hand. It has already made moves to placate the US and give Trump a 'win' by promising to open its markets further to US goods and services, and accelerate measures to reduce over-capacity in the steel sector. The US must also be extremely wary of the threat China represents from it being the single largest holder of US Treasury bonds. China could easily raise the cost of US borrowing by simply reducing the pace at which it acquires US Treasuries, whose supply is set to increase materially following the passage of the recent Federal budget. Such a 'shock' would materially raise US mortgage rates and business borrowing costs – needless to say, something that would be extremely unpopular for the voting public!

## **Index Returns**

Below we report returns from general market benchmarks to show market trends and the performance differences between sub-asset classes in the market. In addition, we have included a 'base currency' conversion table to accompany the benchmarks summary and a calculation of NZD hedged returns. This enables us to look at performance on a local currency basis, in NZD terms, and in NZD hedged terms. Currency can have an important impact on returns, and hence evaluating market and Fund returns needs to consider currency impacts.



Global large cap developed market equities fell around 2.5% in local currency and in NZD terms, bringing the annual NZD return to around 10.5%.

Within global equities small out-performed while value stocks lagged. Small caps have out-performed over longer three, five and ten-year horizons. In contrast, the MSCI value index lags the market over a 1 - 3-year horizon.

The broad MSCI index of emerging market companies was again the stand-out with a flat performance, whilst as discussed above the Australian share market had a very weak quarter. Within Australian equities, small cap shares out-performed while value lagged, in line with international counter-parts.

The New Zealand market fell around 1% over the quarter, slightly ahead of global market returns. Over the past 3 years New Zealand's equity market remains a stellar performer, returning around 12.5% per annum.

International Property stocks faced a 'double whammy' shock, i.e. rising interest rate expectations and a general market sell-off. The -4.6% return for the quarter to global REITS reduced the annual return to roughly flat. In Australia, property returns were even weaker at -9.3% for the quarter, whilst NZ property stocks returned around -4%. The global sell off in listed property over the past year has boosted their dividend yields to well over 4%, a level that is now mildly attractive in the context of the low interest rate environment investors still face.

International fixed interest had a flat return for the quarter and NZ bonds fared better, returning around 0.6%. Markets have now at least factored in materially higher rates, even in Europe, meaning that the risk of capital losses from unanticipated increases in interest rates has lessened.

**Disclosure:**

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