Axiome Winter Update

April—June 2020

IN THIS ISSUE

Investment Market Review

In our March update, markets were at the start of a recovery from the Covid-19 sell-off. Our judgement at the time was that markets were likely oversold, and hence rebalancing portfolios towards risky assets where necessary was the best course of action to take. We were confident that the long-term reward for bearing market risk remained intact, and that the Covid-19 "shock", like other large shocks markets have faced, will pass. However, we also cautioned that further volatility was a possibility given the dire economic conditions, and we certainly did not expect the recovery in equity markets to be as strong as it transpired.

Markets performed very strongly over the June quarter.

The global bellwether US S&P 500 Index closed the June quarter at December 2019 levels, only around 10% off the all-time highs it reached in early February this year. The gain for the quarter was around 20%, the biggest quarterly gain since 1998.

Equity markets had double-digit gains in local currency terms, with the NZ market continuing its stellar performance.

International shares rose around 10% in the quarter in NZD terms, whilst NZD hedged shares increased around 18% - mirroring the increase in global market terms (Figure 1). This is a reversal of last quarter's pattern where NZD hedged returns significantly lagged unhedged (NZD) returns. The NZD tends to fall in time of stress, and quickly rise when risk appetites improve. This time was no different.

Within global equities, higher risk small cap stocks increased around 15% in NZD terms, while value stocks continued their underperformance, rising only

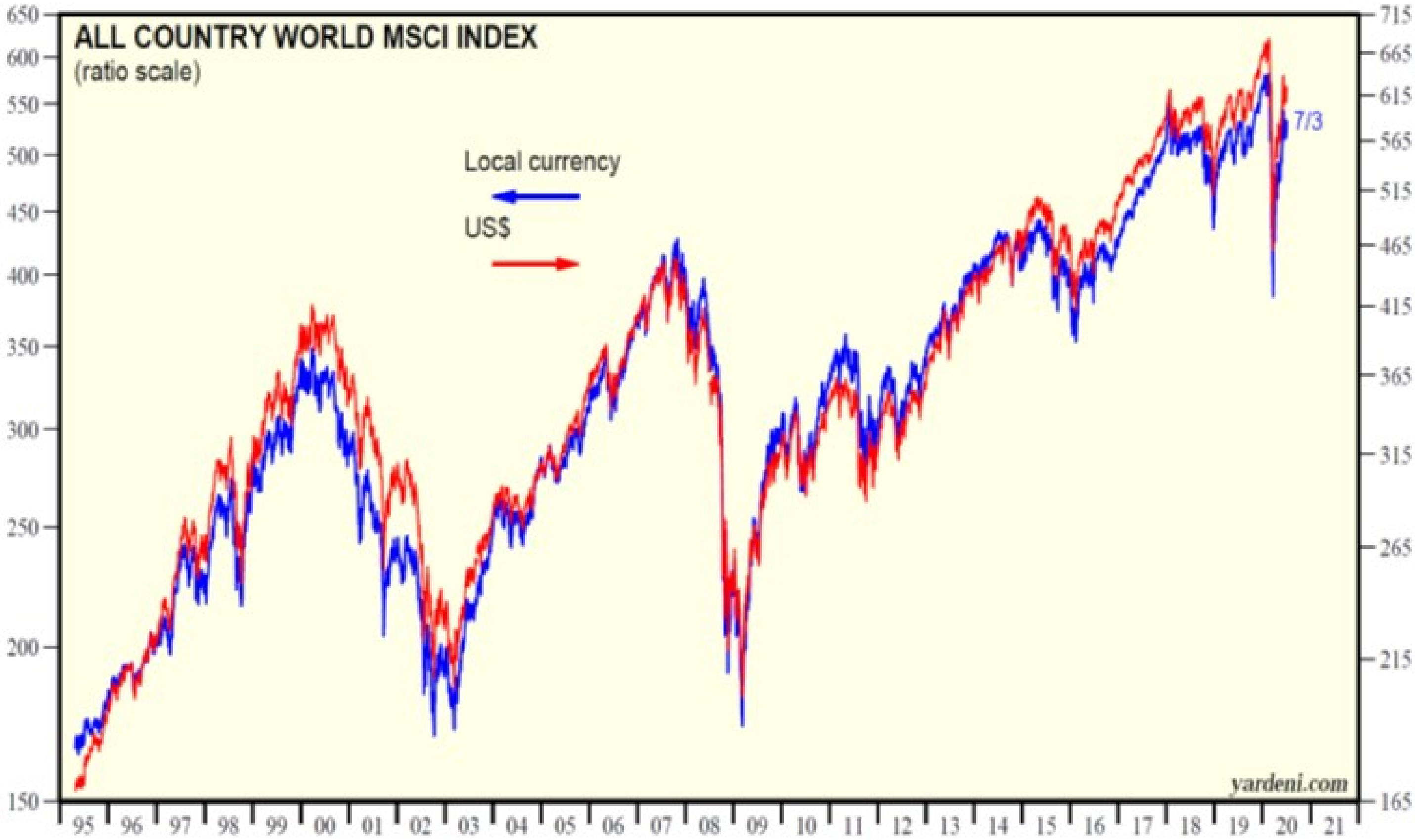


Figure 1: Morgan Stanley Capital Index (MSCI), *Source, Yardeni Research*

around 4%. Emerging market equities increased around 9% in NZD terms, broadly in line with developed market stocks. Trans-Tasman equity markets also fared well. Australian shares increased around 20% in NZD terms, reflecting in part the outperformance of the Australian dollar versus the Kiwi dollar. NZ markets increased around 17% over the quarter, bringing the 5-year performance to around 16% per annum – an exceptional result compared to most other equity markets, and the NZX's longer-term history.

Listed property, infrastructure and fixed income returns were also robust.

International property stocks rose by around 9% in the quarter, but are still down around 17% over the year to date, reflecting ongoing uncertainty around how landlords can cope with lower short-term rental income, and how much lower longer-term tenancy demand may be in the post-Covid world. International infrastructure has been more resilient, with returns broadly flat over the year.

Fixed income returns were also positive over the quarter, driven by credit spreads continuing to decline as central bank asset purchase programs restored confidence to the market. New Zealand and global investment grade bonds returned around 5.5% over the year to June, materially higher than the return to cash. The latter is now near zero (or even negative in some markets) given the slashing of central bank policy rates to the lowest levels ever reached.

Is it too much too soon?

The very strong rise in markets has led to much debate over whether the increase is justified. As is always the case in markets, there are opposing views, and no one can accurately predict what will happen next.

The market rally has occurred despite a very weak economic environment reflecting better economic conditions than feared.

On the positive side of the ledger we can point to the following factors supporting the market increase:

- The fact the short-term economic data has been stronger than expected. This is not to say that economic conditions are strong – they are very weak. Rather, economic production has not been as bad as feared. Short-term market movements tend to be much more driven by how conditions evolve relative to expectations, rather than levels of activity *per se*.
- The extremely supportive monetary and fiscal policy settings now in place globally. These have been instrumental in supporting lending, credit markets and asset prices.
- The fact that despite the rally,

Market Index	Current Yield (June 2020)
MSCI World	2.2%
MSCI Emerging Markets	2.6%
NZ 50	3.8%
ASX 200	4.5%
BBerg Barclaus Global Agg Bond	1.5%
S&P/NZX Composite Bond	0.7%
NZ 90-day bank bill index	0.30%

Figure 2: Yields are higher for risky assets
Source: various, MyFiduciary

equities (and risky assets in general) still offer reasonable value for investors compared to cash and bonds. Dividend yields are now materially higher than investment grade bond yields and cash yields (Figure 2). They are likely to remain so given central bank rate rises are off the table for foreseeable future while global inflation is extremely low. In addition, the US equity risk premium remains well above long-term average levels (Figure 3), as do risk premiums in other markets.

- While the public health management of the spread of Covid-19 has been patchy globally, and very poor in nations such as the US and Brazil, what has been impressive is the level of international scientific cooperation in developing treatment protocols and vaccines. Expectations are that mass production of vaccines and immunisation will occur sometime next year.

The bear case that cautions against the recent rally usually refers to:

- The fact that the current economic downturn is worse than at any time since the Great Depression (or outside of major wars). In this environment there is undoubtedly an elevated risk of "trigger events", such as potential high-profile corporate bankruptcies that may result in another market fall.

Downside risks remain high, and further market falls can't be ruled out.

- With corporate earnings being slashed due to Covid-19, the price-earnings (PE) ratios for markets are now very elevated. This conventional valuation metric is at least flashing orange.
- Optimism that earnings will recover is misplaced. Covid-19 cases continue to march upwards globally, raising the risk that at some point governments will have to re-impose strict lockdown measures.
- There will be a "day of reckoning" for the huge debt build-up that has taken place over the past decade. Bond term (risk) premiums are set to rise, and this will cause asset prices to be reset at lower levels.

But we remain more optimistic about New Zealand's economic prospects.

Our view leans more to the positive side of the ledger, but there may be further volatility. We note in particular that trailing PE ratios have not been reliable indicators of future returns, and instead, markets appear to have been driven more by the premium on offer relative to cash.

In New Zealand's case we remain more optimistic still, given how much better Covid-19 has been managed to date, the recovery in short-term activity levels, the large-scale infrastructure spending in train, and the fact that our agricultural sector has been resilient.

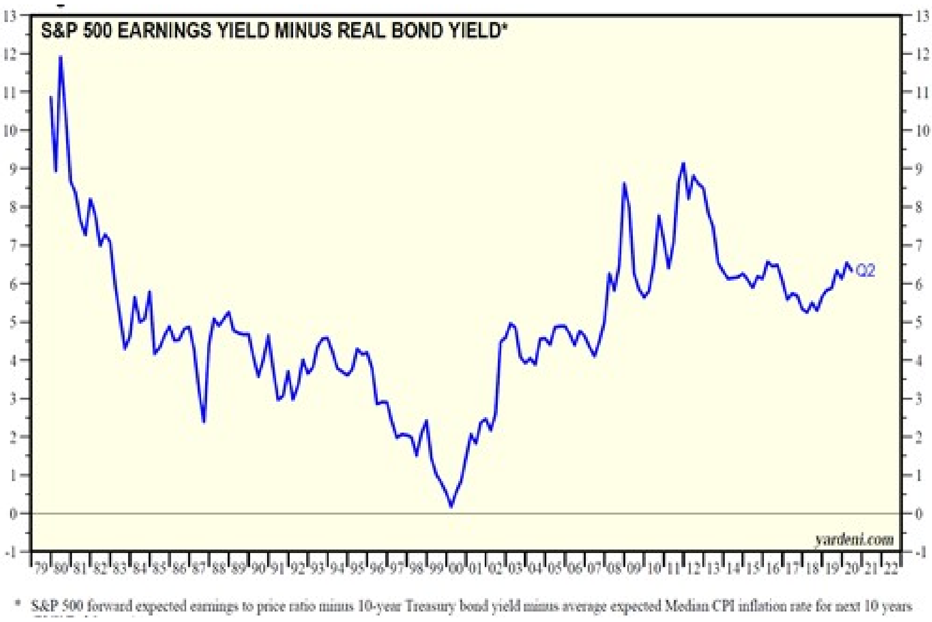


Figure 3: US equity risk premiums remain high
Source: US Federal Reserve, Yardeni Research

Key Market Movements for the Quarter

Quarter	Past year	
+16.9%	+9.9%	**New Zealand Shares** *New Zealand shares returned around 17% in the quarter, bouncing strongly from the Covid-19 lows reached in late March. Over the past 5 years performance remains exceptional at around 16% per annum.* *Source of Figures: S&P/NZX 50 Total Return Index with Imputation Credits*
+3.5%	+5.8%	**New Zealand Fixed Interest** *New Zealand investment grade corporate bonds returned 3.5% for the quarter and around 5.8% for the year. This return is comfortably higher than both 90-day NZ bank bill and term deposit rates, showing that NZ corporate bonds have delivered a premium over the year, and through the Covid-19 sell-off.* *Source of Figures: S&P/NZX Investment Grade Corporate Bond Index*
+20.1%	-5.7%	**Australian Shares** *Australian shares returned around 20% in the quarter in NZD terms, reducing the annual return to around -5.7%. Within Australian equities, small cap stocks and value stocks outperformed returning around 28% and 23% for the quarter respectively. Overall, while a strong bounce, the Australian market remains at lower levels than other broad markets over the year owing to its higher sensitivity to global growth conditions.* *Source of Figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries*
+9.9% (18.2% hedged)	+7.3% (1.2% hedged)	**International Shares** *International shares rose 10% in the quarter in NZD terms, whilst NZD hedged shares increased around 18% - mirroring the increase in global market terms. The NZD tends to rally in a market recovery, and this time was no different, boosting hedged returns. Within global equities, small caps returned around 15% in the quarter while value stocks languished returning around 3.5%.* *Source of Figures: MSCI World Index; Morningstar Developed Markets NZD hedged, MSCI World Value, MSCI World Small Cap.*
+8.7%	+0.8%	**Emerging Markets** *Emerging Market equities rose 8.7% in the quarter, bringing the annual return to June back into the black at around 1%. Returns were stronger in local currency terms at around 17% for the quarter, with the difference reflecting the NZD appreciation over the past quarter.* *Source of Figures: MSCI Emerging Markets Index*
+2.4%	+5.7%	**International Fixed Interest** *Global bonds returned 2.4% in the quarter and 5.7% for the year. The annual return remains strong given their low income yields, and reflects bonds being repriced higher as longer-term interest rates fell on the back of global growth concerns.* *Source of Figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)*
+8.9%	-17.0%	**International Property and Infrastructure** *International property stocks rose by around 9% in the quarter but are still down around 17% over the year. This asset class has been hit hard by Covid-19, reflecting large uncertainty around tenant demand. International infrastructure has been a more resilient asset class, with returns broadly flat over the past year.* *Source of Figures: FTSE EPRA NAREIT NZD Hedged*

Has the Value Premium Disappeared?

Aristotle taught that patience is bitter but its fruit is sweet. Patient investing with tilts towards factors that have consistently produced market-beating returns: value stocks, smaller companies and higher profitability stocks, has yielded good results over time. In recent years, however, the value premium has been elusive and value investors may be feeling rather impatient for some sweetness. The charts below (Figures 1-3) illustrate how value stocks across size and geographical segments outperformed the broader index in the ten-year period from 2000-2009, only to consistently underperform in the following decade.

Over the 10-year period ending March 31, 2020, the Fama/French US Value Research Index returned an annualized 5.06%, well behind the 13.04% achieved by the Fama/French US Growth Research Index. This performance divergence has resulted in a substantial widening of the price-to-book spread between value and growth stocks in the US, as shown in Figure 4.

Figure 4 also shows that the disruption to the value premium has come primarily from the strong rise in growth stocks, with returns of value stocks in line with historic averages. The big five technology companies of Alphabet (Google), Netflix, Facebook, Amazon and Apple in particular, have had a material influence on growth stock returns, comprising 1.5 percentage points p.a. of the 3.95% p.a. excess return of growth over value between 2010-2019. These five big tech companies now comprise almost 20% by value of the S&P500 index.

However, we note that over the longer period of 2000-2019, value still outperformed the main index. (See Fig 3.) The current underperformance of value is an exception, but is not unprecedented, over a longer historical period. Data from a 10-year span of time is just not enough to conclude that the value premium has permanently disappeared. Over 90 years of US stock market data and 50 years of non-US developed stock market data the evidence suggests that what we are seeing is most likely an anomalous long interval in the cycle between growth and value.

Figure 1. Value's Performance 2000-2009 (annualised returns %)

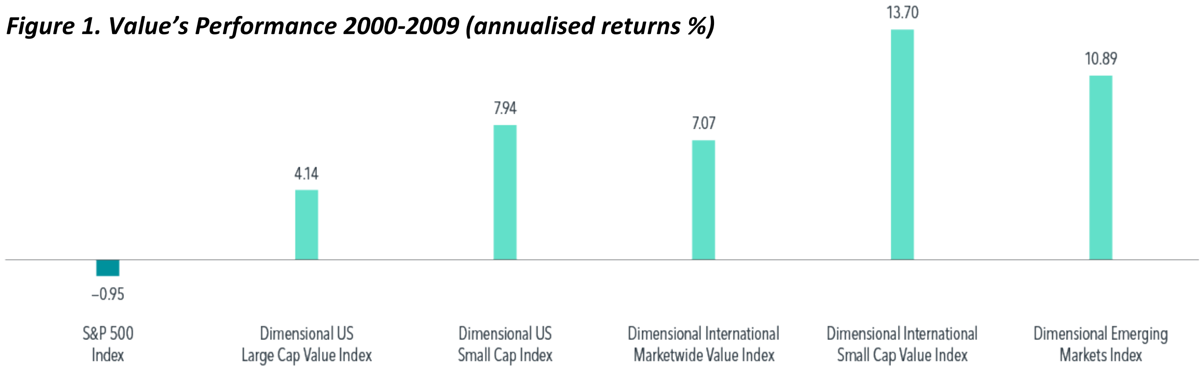


Figure 2. Value's Performance 2010-2019 (annualised returns %)

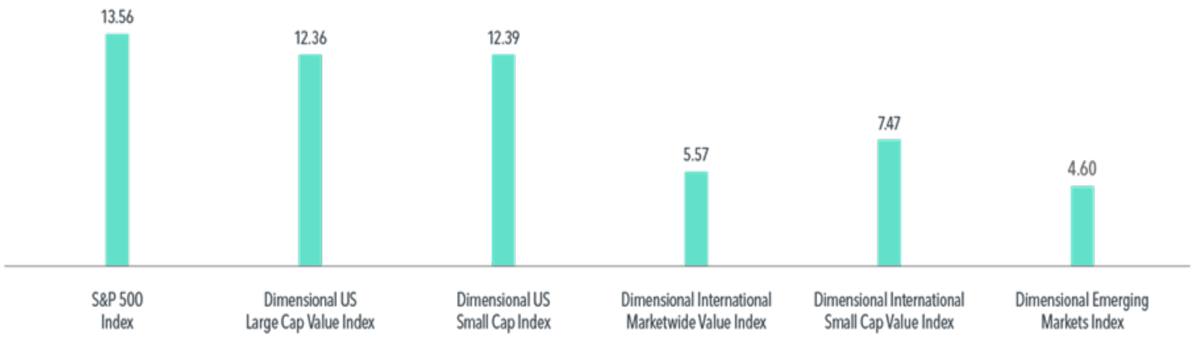


Figure 3. Value's Performance 2000-2019 (annualised returns %)

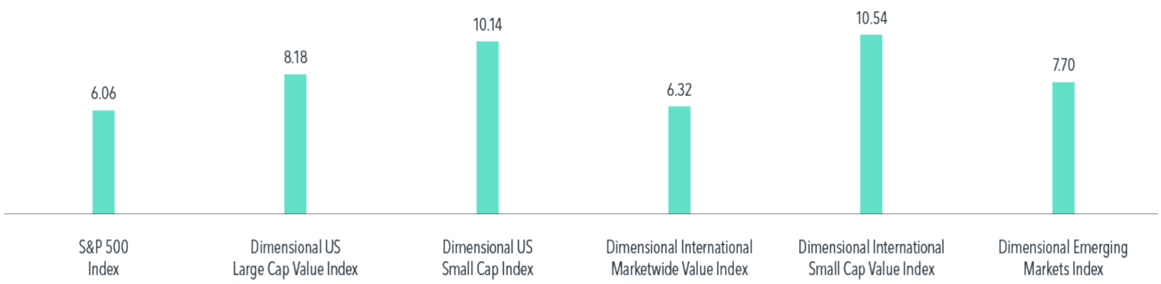
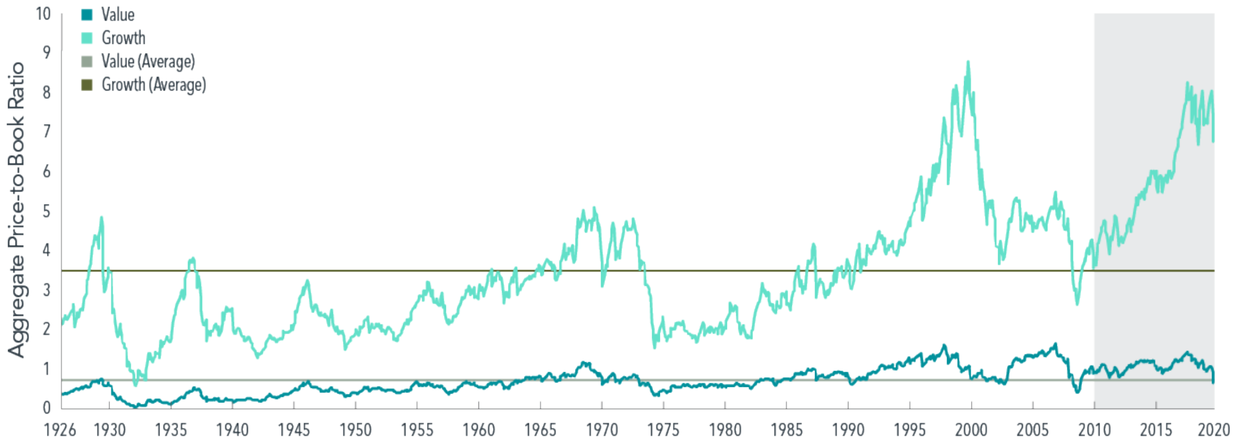


Figure 4. Aggregate price-to-book ratios for value stocks vs growth stocks, US market, 1926-2020



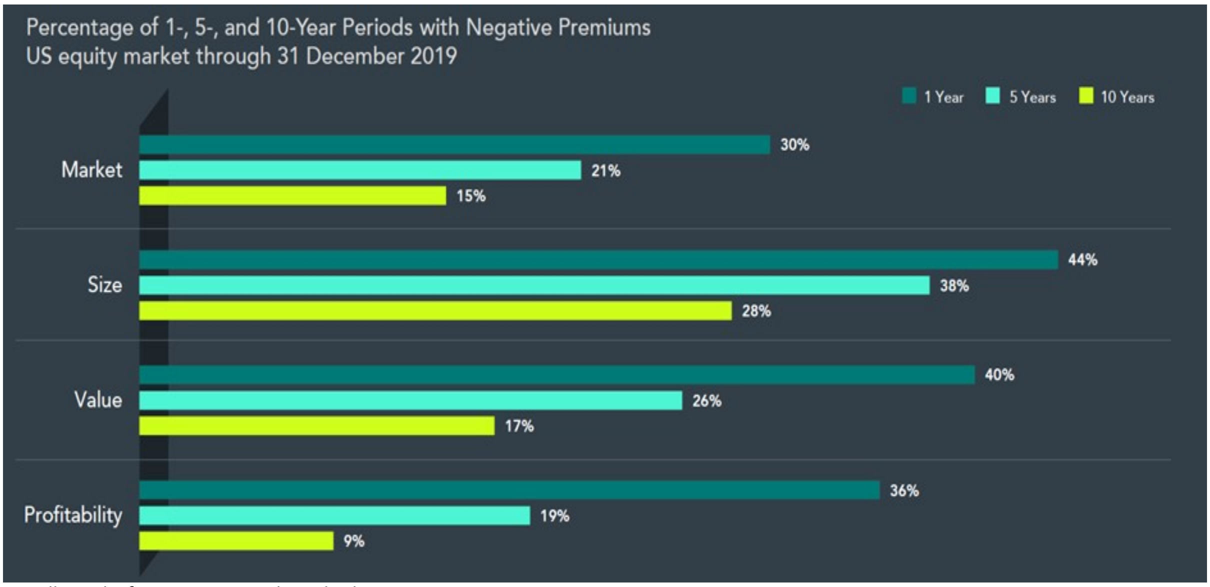
Where to from Here?

History provides robust evidence of premiums, or excess returns, for the risk factors of size, profitability, and value. These are in addition to the equity premium of the stock market as a whole compared to fixed return financial assets. All premiums can be negative in short or 'relatively short' timeframes.

Figure 5 below plots negative instances of each risk factor for different time periods. Markets adjust rapidly and the reward for factor exposures can present very quickly. Active timing strategies that switch between value stocks and growth stocks fail to consistently outperform a simple buy-and-hold value strategy.

The current prolonged absence of the value stock premium has been a dampener to portfolios with a value tilt. The evidence is clear that excess return from the value premium is available over time. An asset allocation that captures value along with the small company and profitability factors will provide diversification and return enhancement over time that is well worth capturing.

Figure 5. Frequency of Negative Premiums



Source: All graphs from Dimensional Fund Advisors

Like what you've read? Please feel free to pass this update on to friends and colleagues who may enjoy it...
If you would like to talk about anything discussed in these articles further, please feel free to call or email.

Phone: 09 445 2134 **Email:** info@axiome.co.nz