Axiome Summer Update

October - December

2018

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Investment Market Review

The very strong returns markets have enjoyed since around 2011 came to crashing halt in the December quarter. Large declines occurred in equity markets in the month of October and then again in December as markets grappled with interest rates increases (in the US), the Brexit deadlock, ongoing trade tensions between the US and China, a partial US government shutdown, and some weaker than expected corporate earnings.

International developed market equities fell by around 14.5% over the quarter (in NZD terms), implying a -3.2% return for the calendar 2018 year. In contrast, emerging markets, which are also normally more sensitive to a major downturn, fell by 'only' 8.7% in the quarter. This partly reflects that emerging markets, particularly the Chinese equity market, had borne the brunt of the trade war fears earlier. But it may also reflect a view by many equity analysts than emerging markets now offer particularly good-value for investors.

The NZ equity market did not suffer as large a decline as global stocks.

Trans-Tasman equity markets did not escape the decline. Australian equities fell around 11.5%, and NZ equities were relatively robust to the global sell off, falling by around 6%. NZ equities returning around 5% for the year is a strong result compared to most other equity markets. Global property was also relatively resilient, declining by 5.6% in the quarter and 3.7% over the year.

Bonds offered some respite to the equity markets sell off, as should be expected given their defensive nature. NZ investment grade bonds returned around 1.5% for the quarter and 4.6% 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 bonds also returned 1.5% over the quarter. Over the year, however, returns have been weaker than the yield on bonds, reflecting the fact that interest rates have risen ahead of market expectations, causing bonds to re-price lower.

Global economy moves from hot to lukewarm

Economic conditions remain far from recessionary in much of the world. In the United States, the Federal Reserve increased short-term interest rates to 2.5% in December, despite the ongoing market weakness, given the strength it sees in the US economy. While this move was heavily criticised by President Trump and many market commentators, recent data has been very much in line with the Federal Reserve's assessment. The US economy added over 300,000 jobs in the December quarter, far exceeding the expectation of around 175,000. The US unemployment rate is now under 4% and US wages are expanding at their fastest pace in around a decade.

The US economy remains strong and NZ is growing around trend levels

Annual GDP in New Zealand is running around 3% according to the figures released by Statistics New Zealand just before Christmas, and our employment rate is now at a 30-year high. Despite weak business confidence levels, businesses are still hiring at a fast pace. Further upside growth potential remains in New Zealand given the huge backlog of housing and infrastructure spending that is in the pipeline.

Economic indicators elsewhere continue to suggest conditions are mildly expansionary and for the most part on trend. Of note, emerging markets are strong with India growing at 7.5% and China still recording growth of 6.5% (at least according to official numbers). This is the weakest reading since the GFC, but still very strong compared to developed market economies.

Australian growth has also been slowing as drought and falling house prices have hit exports and household spending. But the Australian labour market remains strong, and the most recent economic GDP growth reading was still one of the highest in the OECD at around 2.8%.

Growth is more likely exhibiting a cyclical slowdown that foreboding a recession…

To put it all in perspective, recent events suggest that the global economy has been cooling from red hot to lukewarm levels. Looking ahead, despite the risks, macro forecasters expect global growth to remain healthy at around 3.5% over the next two years (Figure 1). This is the level that has been achieved over the past two decades and hence can be considered a reversion of growth to trend levels from the very high pace that has occurred in recent years.

Figure 1: Global growth expected to revert to trend levels

Source: DB Global Research

GDP growth (%)	2017	2018	2019F	2020F
Global	3.8	3.8	3.6	3.5
US	2.2	2.9	2.7	2.1
Eurozone	2.5	1.9	1.4	1.3
Germany	2.2	1.6	1.3	1.4
France	2.3	1.6	1.4	1.3
Italy	1.6	0.9	0.7	0.9
Spain	3.0	2.5	2.4	2.1
Japan	1.9	0.7	0.7	0.2
UK	1.7	1.3	1.6	1.4
China	6.9	6.6	6.3	6.0
India	6.2	7.5	7.0	7.6

The recent sell off and long-term investment returns

The key question now is whether the sell-off is justified given the risks or, if instead, whether it has been an over-reaction to recessionary fears? History would suggest that the latter is more plausible – Nobel Prize winning economist Paul Samuelson once quipped: *"markets have predicted 9 out of the past 5 recessions"*. This may yet prove to be a reflection on 2018.

As noted above, many analysts now see equity markets offering good-value. To date in January 2019 markets are up. But that is not to say that the bottom of this cycle has been reached, or that economic conditions won't deteriorate further from here.

What we do know for sure, through many cycles in economies and markets, is that investors with long term horizons get amply rewarded for bearing equity market risk. As an illustration, Figure 2 shows that over the short-term returns are very volatile, and the weak December quarter is not statistically unusual in this respect.

What the figures also show is that as equity holding horizons are increased, equity returns are more stable and offer a more certain premium to cash.

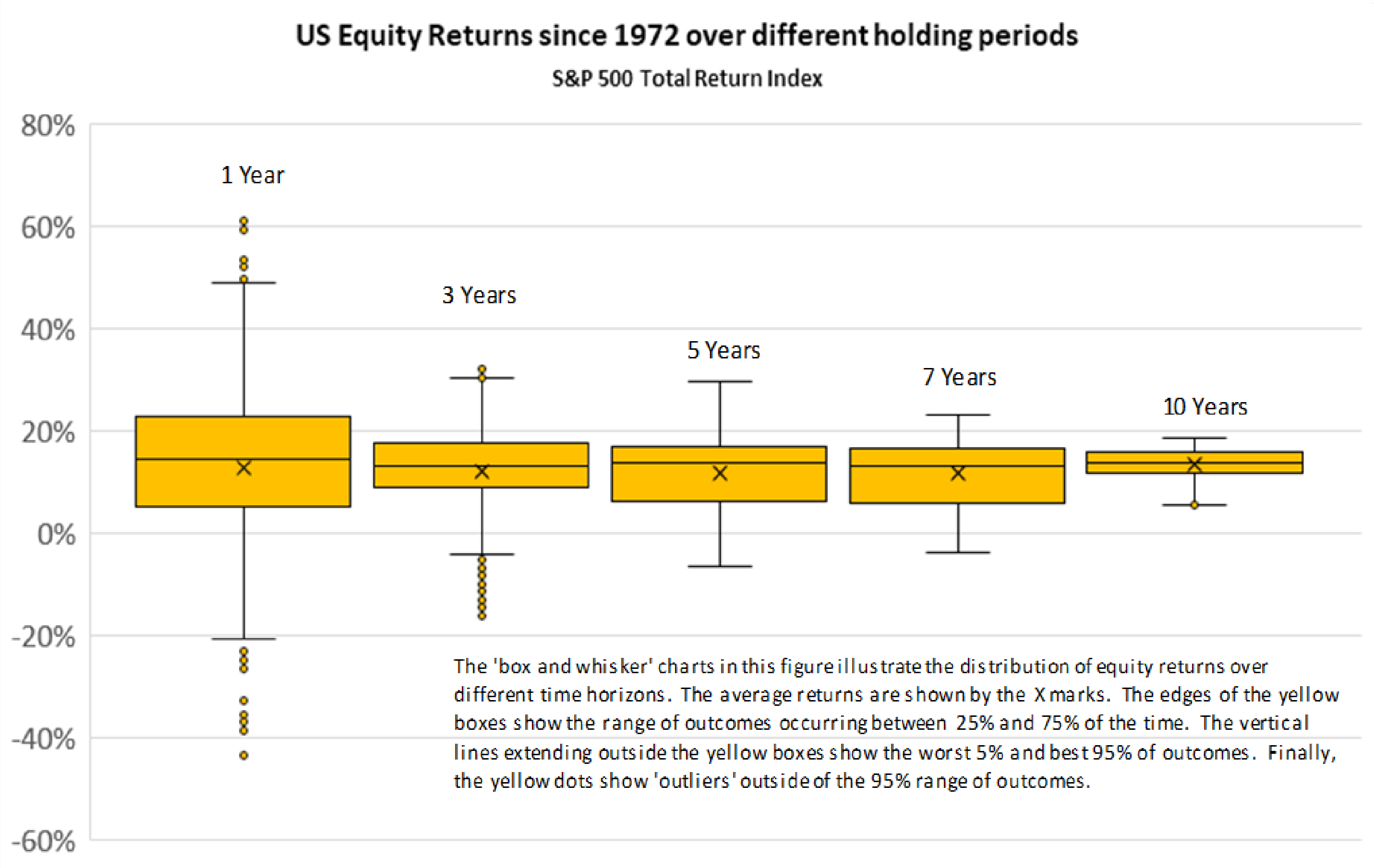
The recent sell-off is not unusual…

…and investors that stay the course are likely to earn a premium for bearing the market volatility

We also know that often the strongest equity market returns are experienced in the depths of a so-called 'bear market'. We have no reason to believe this time will be any different.

Figure 2: Long term equity market investors are well-rewarded

Source: Morningstar Direct, MyFiduciary



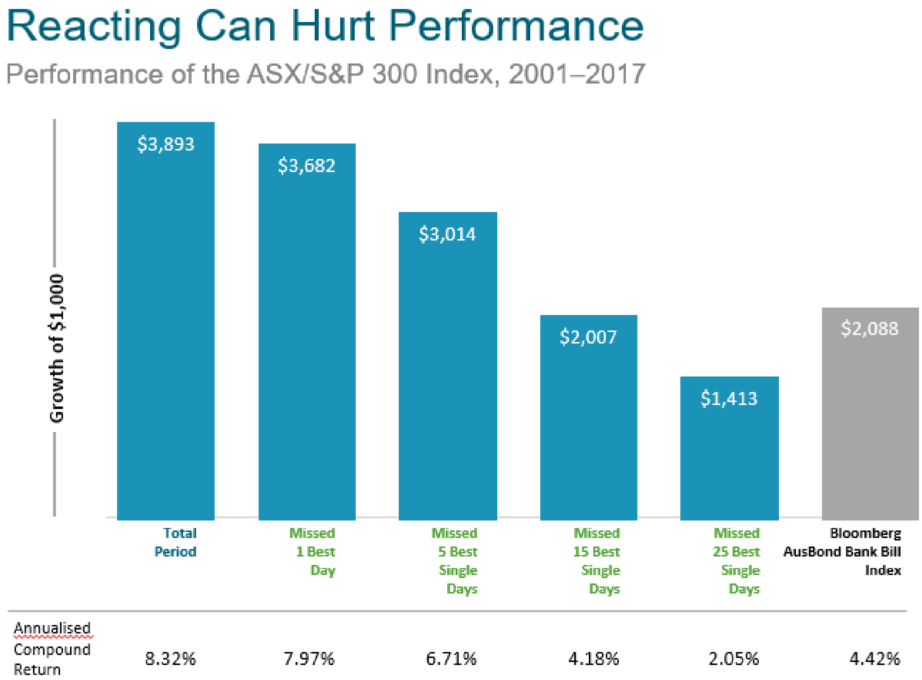
Key Market Movements for the Quarter

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

Quarter	Past year	
-5.8%	+ 4.9%	**New Zealand Shares** *The New Zealand market fell 6% in the quarter, reducing the calendar 2018 return to around 5%. This a relatively strong performance compared to offshore equity markets.* *Source of Figures: NZX 50 Index*
+1.2%	+4.5%	**New Zealand Fixed Interest** *New Zealand investment grade bonds returned 1.2% for the quarter and around 4.5% 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 2018.* *Source of Figures: NZX A Grade Corporate Bond Index*
-11.7%	-7.2%	**Australian Shares** *The Australian share market returned -11.7% in the quarter and -7.2% in the year in NZ dollar terms. This very poor return was partly due to a strengthening of the NZ dollar against the Aussie. Returns were around -3% in Australian dollar terms in 2018. Within the Australian equity market, value stocks mildly outperformed over the quarter and year, while small cap stocks suffered larger losses.* *Source of Figures: S&P ASX 200*
-14.4% (-13.5% hedged)	-3.2% (-7.3% hedged)	**International Shares** *International equities fell 14.4% (in NZ dollar terms) in the quarter, whilst NZD hedged equities fell 13.5%. These very poor returns reduced the annual return to -7.3% on a NZD hedged (and offshore currency basis), and -3.2% on an unhedged basis. The latter were stronger as our currency declined against major developed markets in 2018. In line with the Aussie market performance, value stocks mildly outperformed while small cap stocks suffered larger losses.* *Source of Figures: MSCI World Index; Vanguard international equity index funds data to proxy hedged returns*
-8.7%	-9.4%	**Emerging Markets** *Emerging Market equities fell 8.7% in the quarter, reducing the 2018 return to -9.4% (in NZD terms). This is weaker 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*
+1.4%	+1.6%	**International Fixed Interest** *Global bonds returned 1.4% in the quarter and 1.6% in the 2018 year. The annual return is still lower than the coupon on international bonds, and reflects bonds being re-priced lower over the year as interest rates increased more than markets expected.* *Source of Figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)*
-5.6%	-3.7%	**International Property** *International Property stocks declined 5.6% in the quarter and 3.7% over the year. Australian property stocks fell by a similar magnitude in the quarter.* *Source of Figures: Morningstar DM REITS (NZD hedged), S&P REIT indexes*

Merit of discipline in investment decisions

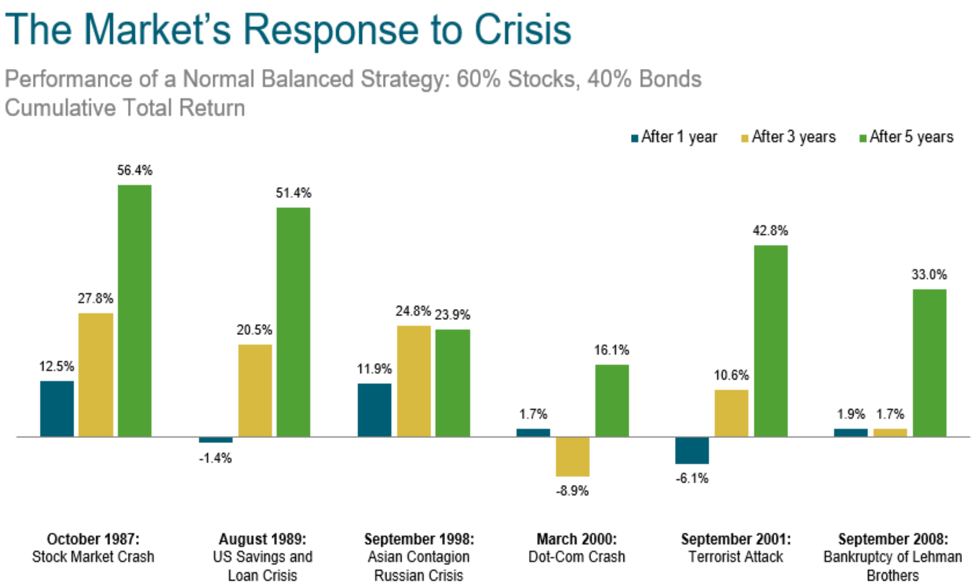
After a long period of relatively high positive returns, markets have been nervous over the last quarter due mainly to trade tensions and interest rates rising somewhat faster than expected. However, volatility is a normal part of investing and sticking to a well-thought-out investment plan has proved to reward the investor in the long run. Emotional responses to market movements are best avoided, especially those encouraged by dramatic media headlines chasing reactions. The chart on the right shows the risks of missing out on spikes in market upturns that are concentrated in relatively few days.



There would of course be a benefit to missing out on the most negative return days, but studies show that 75% of days show positive returns and only 25% show negative returns, so the chances of picking the best days to be in and out of the market are slim.

Market corrections are to be expected – security prices rise and fall continuously based on a multiplicity of influences, including supply and demand, news about an individual company and its industry, developments in the economy or even general expectations about the share market. Trying to untangle all these influences and profit from perceived mispricing is not possible in a systematic and scalable way. While information frequently changes, this is quickly built into prices. Ultimately, the market is like a giant information processing machine. The premiums we expect from investing are not there every day, every month, every quarter or even every year. But the longer we stay invested, the more likely we are to capture them. Even when prices are falling there are still people buying. The market is doing its job and the rewards will be there for disciplined investors.

To put some numbers on it, looking at the S&P500 index, a study of every downturn since 1945 shows that there were 77 drops of between 5% and 10% and that the average time it took for the market to recover was just one month. In the postwar period, there have been 27 corrections of between 10% and 20%, which have taken an average of four months to reverse. Even the eight bigger crashes, of 20% to 40%, took only 14 months to recover from. This is illustrated in the chart below – in most instances, a year is not long enough to recoup losses, but within three years, a short timeframe for most investors



planning for their retirement, returns are positive.

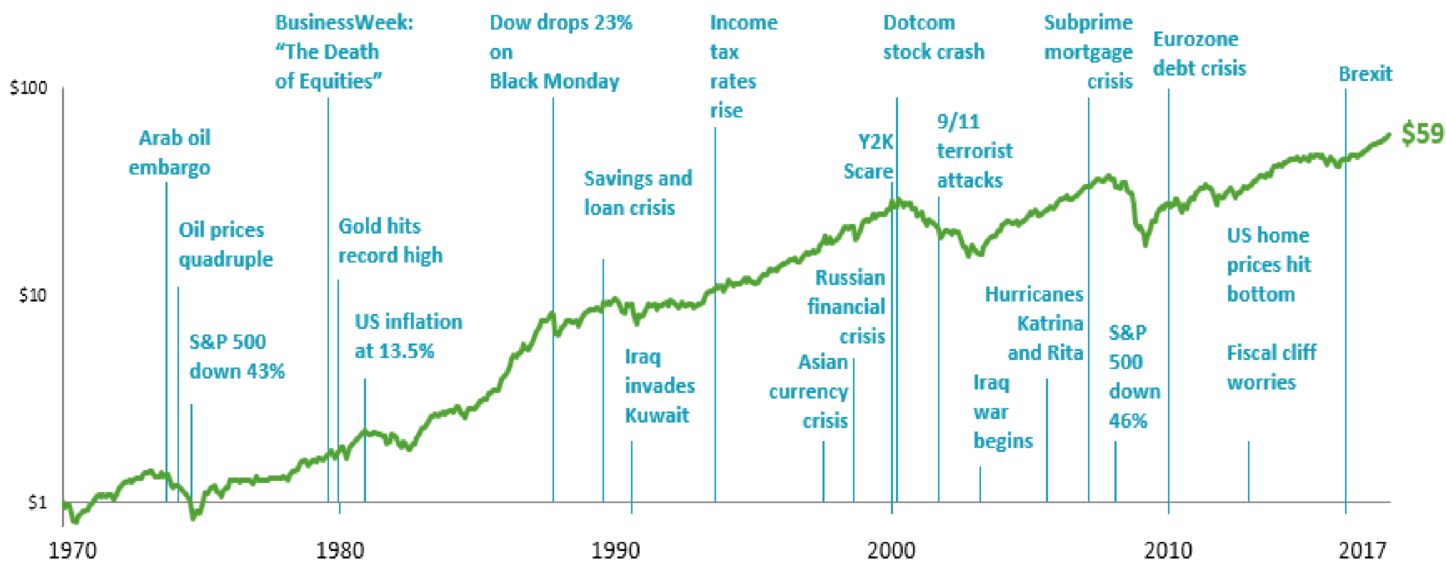
Just as the price of petrol goes up and down, individual stocks and bonds and other securities, and therefore markets, go up and down. Volatility is merely a measure of these price moves – both their frequency and their magnitude. I.e. the uncertainty of the future movement is risk. Without volatility, investors would not be rewarded for the risks they take.

> *A disciplined investor looks beyond the concerns of today to the long-term growth potential of markets.*

Risk and return go together. An investor's personal risk tolerance will dictate the amount of volatility they are comfortable with and a portfolio structured with reference to the projected standard deviation of a particular asset allocation, should ensure portfolios that do not produce movements that will cause an individual investor to forsake a well-structured approach to investing. The chart below shows the importance of being resolute in the face of market turbulence and worrisome news events. Providing investments are well diversified, the market will reward those who stick to a well-considered strategy suited to their requirements.

Markets Have Rewarded Discipline

Growth of a dollar—MSCI World Index, 1970–2017



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