Axiome Autumn Update

January - March

2018

IN THIS ISSUE

Investment Market Review

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**.**

Markets sold off over the quarter in part due to rising rates…

Amongst the pack, Australia fared the worst returning around -4% for the quarter (in AUD terms). This was not due to a mining sector downturn, but rather it reflected that the global sell-off coincided with more damning reports on Australian bank practices, with their excessive profits coming into the focus of regulators.

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.

…which are symptomatic of a strong global economy.

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).

Figure 1: OECD has revised up global growth prospects (again)

Source: OECD, March 2018 Economic Outlook

	2017	2018	2019		2017	2018	2019
World	3.7	3.9 ↑	3.9 ↑	G20	3.8	4.1 ↑	4.0 ↑
Australia	2.3	3.0 ↑	3.0 ↑	Argentina	2.9	3.2 =	3.2 =
Canada	3.0	2.2 ↑	2.0 ↑	Brazil	1.0	2.2 ↑	2.4 ↑
Euro area	2.5	2.3 ↑	2.1 ↑	China	6.9	6.7 ↑	6.4 =
Germany	2.5	2.4 ↑	2.2 ↑	India[1]	6.6	7.2 ↑	7.5 ↑
France	2.0	2.2 ↑	1.9 ↑	Indonesia	5.1	5.3 ↑	5.4 =
Italy	1.5	1.5 =	1.3 =	Mexico	2.3	2.5 ↑	2.8 ↑
Japan	1.7	1.5 ↑	1.1 ↑	Russia	1.5	1.8 ↓	1.5 =
Korea	3.1	3.0 =	3.0 =	Saudi Arabia	-0.8	1.6 =	1.7 =
United Kingdom	1.7	1.3 ↑	1.1 =	South Africa	1.2	1.9 ↑	2.1 ↑
United States	2.3	2.9 ↑	2.8 ↑	Turkey	6.9	5.3 ↑	5.1 ↑

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

We 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.

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.

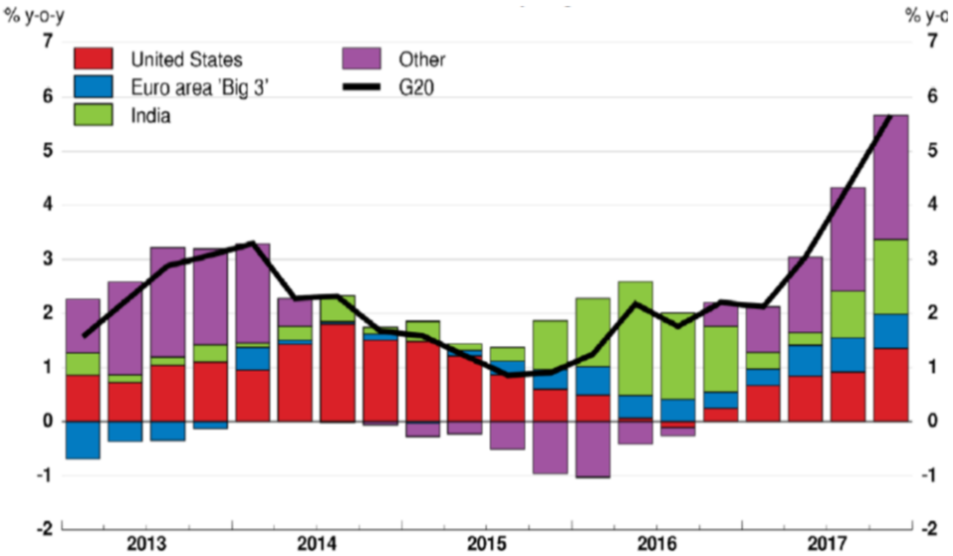


Figure 2: G20 Investment Growth – contributions by region, volume

Source: OECD March Economic Outlook

Global GDP growth is expected to mildly accelerate over 2018 and 2019 to around 3.9% (Fig.1), a level well ahead of the average growth rate of 3.3% that has been experienced over the past two decades.

…the supportive global backdrop remains intact

This growth is expected to cause inflation to rise, but at a slow pace from relatively low levels. In the developed world, the US and the Australian economies, in particular, are expected to materially improve from present levels, whilst in emerging markets India remains the growth darling.

Given the global growth backdrop, the New Zealand economy is also anticipated to grow at a rate of around 3%, supported further by strong net migration levels and infrastructure spending. As discussed in previous reports, our overvalued housing market is probably the main risk to the domestic outlook.

An element that had been lacking from the global growth picture, particularly in developed markets, was business spending. This is clearly no longer the case. The current growth picture and outlook is founded on high business confidence levels, and business investment growth that is at its highest level since the GFC (Fig.2). This positive confidence and investment environment has been supported by strong corporate profitability growth and has underpinned good earnings for listed corporates.

Another catalyst for the sell-off in March was jitters about 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

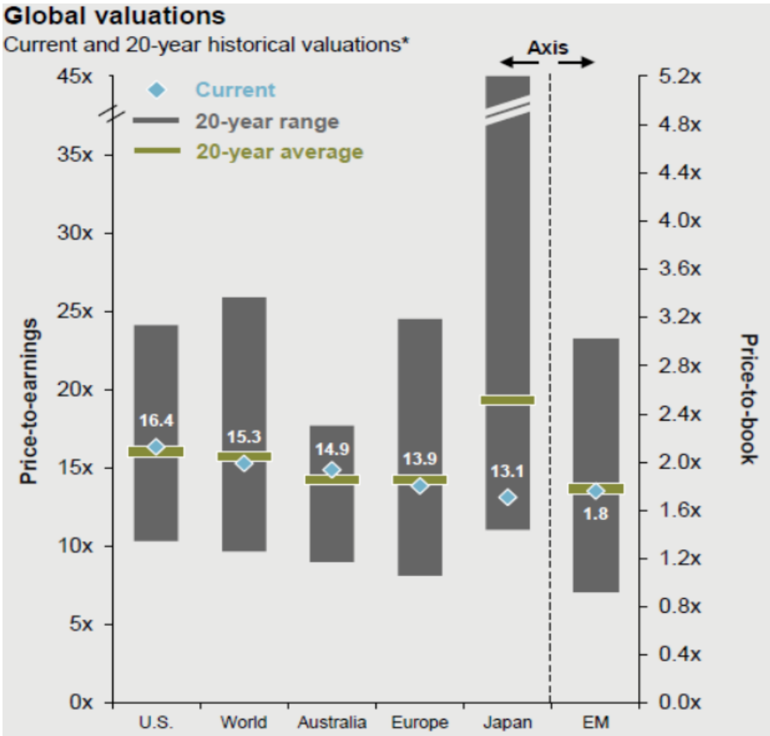


Figure 3: Global Equity Valuations

Source: JP Morgan Asset Management

As shown in Figure 3, with the recent sell-off in equities, price-to-earnings multiples are now back around long-term average levels. This common yardstick of equity market valuation suggests that markets in general are not overvalued (though valuations do look very stretched in the tech sector), and hence from a valuation standpoint there is no reason to expect that markets "must" correct further from present levels.

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 in India, are cases in point. As such, the rosy global expectation outlined above would be derailed if a tit-for-tat trade war were to escalate.

Global trade wars are a risk…

The key question markets and commentators are grappling with is how likely is a trade war? For now, the consensus view is not likely at all. As noted above this is partly because the political will is fragile - the Republican-controlled Congress and Senate are in opposition to the current measure, let alone further measures. It also reflects the view that China very much holds the economic upper 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, as well as accelerating measures to reduce overcapacity in the steel sector.

The US must 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, the supply of which is set to increase materially following the passage of the recent Federal budget. Such a shock could substantially raise US mortgage rates and business borrowing costs, which would clearly be extremely unpopular with the voting public.

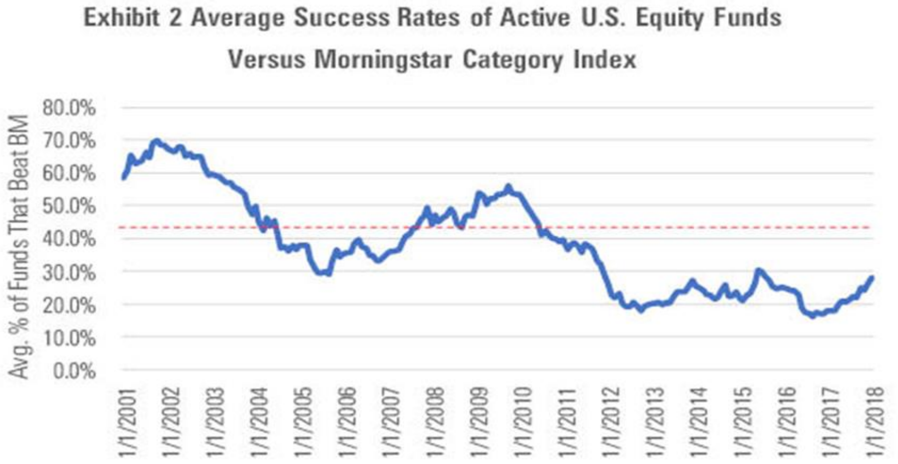
Accordingly, despite the rhetoric and the media noise, the underlying environment is likely to remain supportive for investors.

Key Market Movements for the Quarter

Quarter	Past year	
- 0.9%	+ 15.6%	**New Zealand Shares** *The New Zealand market fell slightly over the quarter, ahead of global market returns with A2 Milk, in particular, being a very strong performer. Over the past 3 years New Zealand's equity market remains very strong, returning around 12.6% per annum.* *Source of Figures: NZX 50 Index*
+0.6%	+4.7%	**New Zealand Fixed Interest** *New Zealand Fixed Interest returned around 0.6% and around 4.7% for the year. The annual return is both comfortably higher than 90-day NZ bank bill rates 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*
-7.1%	-1.0%	**Australian Shares** *The Australian share market had a very poor quarter in NZD terms, returning -7.1%. Around half of this decline reflected, however, a strong climb of the Kiwi against the Australian dollar (from around 91c to 95c). In Australian dollar terms the market fell around -3.9%, and the annual AUD return was still positive at around 1.6%.* *Source of Figures: S&P ASX 100*
-2.7% (NZD hedged) -2.6% (unhedged)	+10.6% (NZD hedged) +10.4% (unhedged)	**International Shares** *International equities mildly fell in the quarter as expectations for faster rate rises in the US increased, and fears around a global trade war rose. Annual, three and five year returns still remain very solid and aside from the US most analysts do not think markets are over-valued.* *Source of Figures: MSCI World ex-Australia Index*
+0.0%	+21.1%	**Emerging Markets** *Emerging Market equities were fairly resilient to the March quarter market sell-off, something that is not usually expected given Emerging Markets are generally considered more risky and hence under-perform in periods of market stress. The resilience this time round likely reflects the relatively robust macro and corporate earnings environment in emerging markets, especially in EM Asia.* *Source of Figures: MSCI Emerging Markets Index*
+0.0%	+3.2%	**International Fixed Interest** *Global bonds were flat in the quarter, reflecting that the return from coupon payments was broadly offset by bond capital losses. The latter was due to a steepening of global interest rates, particularly in the US where the Federal Reserve affirmed its tightening commitment.* *Source of Figures: Barclays Global Aggregate (hedged to NZD)*
-4.6%	+0.3%	**International Property** *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 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 attractive in the low interest rate environment investors still face.* *Source of Figures: FTSE/EPRA/NAREIT Global 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.

Fund Management: Active vs. Index vs. Enhanced

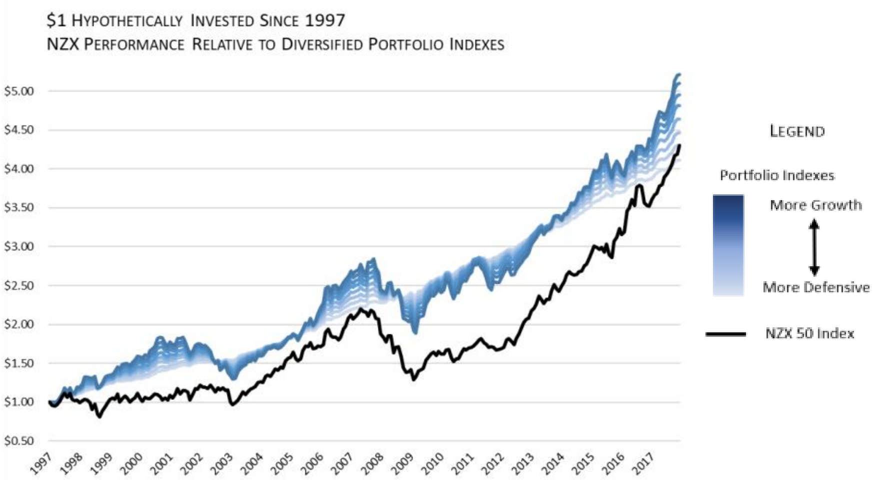


Source: Morningstar Analysts. Rolling 36-month periods from Feb. 1, 1998 to Jan. 31, 2018.

Morningstar, a Chicago-based investment research firm, recently surveyed the performance of active US equity funds during the two-decade period up to January 31st, 2018. The conclusion? That "most active US equity funds did not show consistent outperformance". Fewer than half of active equity funds in the US beat their comparative indices on average, and this has reduced to between 20% and 30% in more recent years. (refer adjacent top chart).

Index funds which construct portfolios to match or track the components of a market index, such as the NZ Top 50 shares (NZX50) provide an alternative to the speculative task of identifying the minority of active managers who may perform well.

Even better than a single sector index strategy is the construction of a portfolio of enhanced or 'smart beta' diversified funds. For example, the second chart on this page provides compound 20-year returns of such portfolios with varying risk exposures (light blue to darker blue lines represent defensive to aggressive portfolios). Even the most conservative diversified strategy performs well against the single sector NZX 50 index. The benefit of geographic and asset class diversification is seen in the lower volatility experienced by all portfolios. Lower volatility also enhanced returns with an aggressive (90% growth) strategy showing compound growth of $1 to nearly $5.50 versus the single asset class NZX index delivering growth to $4.30.



Portfolio Ind composition is based on Axiome portfolio weightings for each asset class. The graph above shows the hypothetical performance of investing $1 in each portoflio index and is for descriptive purposes only. You cannot invest in an index directly. Past performance is not indicative of future performance.

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.

Disclaimer

This document has been provided for general information purposes only. The information is given in good faith and has been prepared from published information and other sources believed to be reliable, accurate and complete at the time of preparation but its accuracy and completeness is not guaranteed. Any information, analysis or views contained herein reflect our opinion at the date of publication and are subject to change without notice. To the extent that any such information, analysis, views or opinions may be construed as advice, they do not take into account of any person's particular financial situation or goals and, accordingly, do not constitute personalised advice under the Financial Advisers Act 2008, nor do they constitute advice of a legal, tax, accounting or other nature to any persons. Past performance is not indicative of future results and no representation or warranty, express or implied, is made regarding future performance. To the maximum extent permitted by law, no liability or responsibility is accepted for any loss or damage, direct or consequential, arising from or in connection with this document or its contents.