IWIinvestor
Pou Tiaki i Ngā Rawa
New Zealand's wealth advisers

IWIinvestor Investment Report:

Economic & Market Commentary, Quarter End – June 2020

The June quarter was very strong

Markets back in black

In our March update, markets were at the start of recovery from the Covid-19 sell-off. At the time we assessed markets were likely over-sold, 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 could happen given the dire economic conditions, and we certainly did not expect the recovery in equity markets to be as strong as it has transpired.

Notable performances included:

- The global bellwether US S&P 500 Index increased 20%, the biggest quarterly gain since 1998.
- International shares rose around 10% in the quarter in NZD terms, while NZD hedged shares increased around 18% - mirroring the increase in global market terms. This is a reversal of last quarter's pattern where
- NZD hedged returns under-performed. The NZD tends to fall in time of stress, and quickly rise when risk appetites improve. This time was no different.
- Australian shares increased around 20% in NZD terms, while NZ markets increased around 17%.

- International property rose by around 9%, but is down around 17% over the year, reflecting concern around tenancy demand in the post-Covid world. International infrastructure has been more resilient.

- New Zealand and global investment grade bonds returned around 5.5% over the year to June, materially higher than the return to cash.

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 bull case

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

- Short-term economic data has been stronger than expected. 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. This has been instrumental in supporting lending, credit markets and asset prices.

- While the public health management of Covid-19 has been patchy globally, and very poor in nations such as the US and Brazil, what has been impressive is the international scientific co-operation in developing treatment protocols and vaccines. Currently there are over 145 vaccines in development and 21 in human trials. Expectations are that mass production of vaccines and immunisation will occur sometime next year.

- Despite the rally, equities still offer reasonable value compared to cash and bonds. *See over page*.

US equity risk premium remains high

S&P 500 EARNINGS YIELD MINUS REAL BOND YIELD*

Q2

yardeni.com

* S&P 500 forward expected earnings to price ratio minus 10-year Treasury bond yield minus average expected Median CPI inflation rate for next 10 years.

Source: US Federal Reserve, Yardeni Research

Cash yields higher for equities than cash or bonds

Market Index	Trailing cash yields as at June 2020
SCI World	2.2%
MSCI Emerging Markets	2.6%
NZ 50	3.8%
ASX 200	4.5%
BBerg Barclays Global Agg Bond	1.5%
S&P/NZX Composite Bond	0.7%
NZ 90-day Bank Bill Index	0.3%

Source: various, MyFiduciary

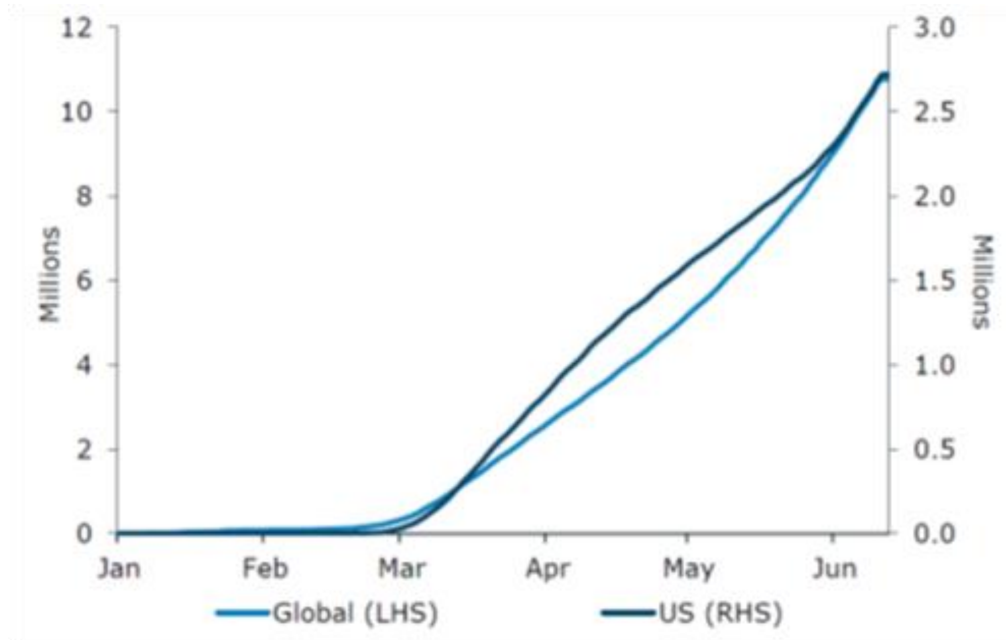
The Bear Case

The bear case includes:

- The economic downturn is the worst since WW2. In this environment there is elevated risk of "trigger events" causing another large market sell-off, such as high-profile corporate bankruptcies.

- 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 up globally, raising the risk that at some point governments will have to re-impose strict lock-down measures.



Global Covid-19 case curve is not flattening

Our view leans more to the positive side of the ledger - over the past decade trailing PE ratios have not been reliable indicators or future returns, and instead, markets appear to have been driven more by the premium on offer relative to cash. But of course, we can't rule out further volatility.

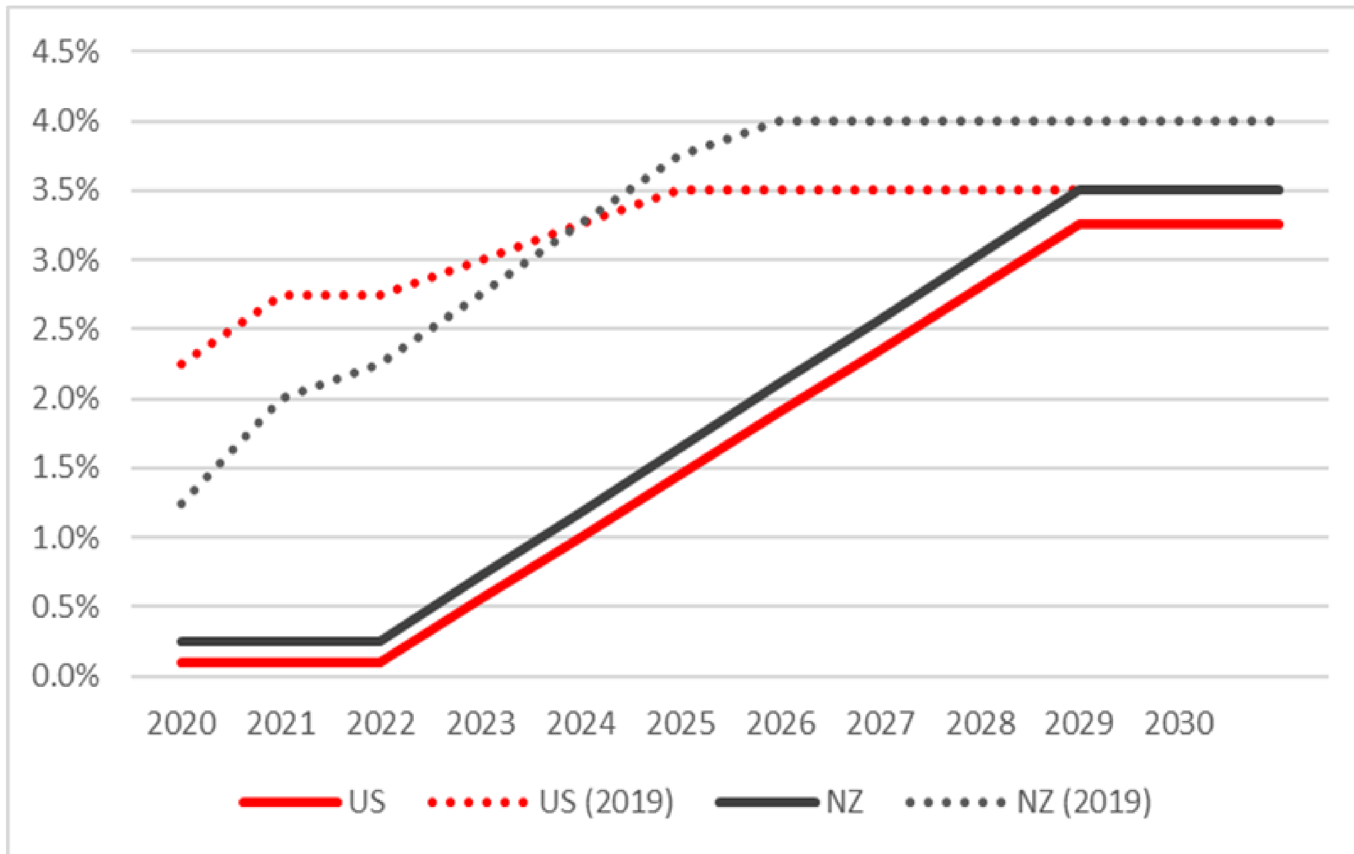
Impact of COVID-19 on our expected returns for cash

Central bank cash rates are now around zero in all OECD countries following the Covid-19 shock. It will be some time before we see normalisation again, and the prospect of negative central bank rates cannot be ruled-out.

This is a material change from mid-2019 where central banks (including the RBNZ and Federal Reserve) were still forecasting rates to rise over the medium-term, even if bond prices suggested a more tepid path.

Our methodology for forecasting rates takes market implied rates for the first two years. After that point (i.e. from 2022) we converge rates over a 7-year period to levels that are in-line with different economies' trend nominal GDP growth. This is illustrated in the chart below which also compares our 2019 interest rate assumptions (the dotted lines) for NZ and US cash. The horizon of interest for our adviser model portfolios is 30-years, and this forecast is formed by averaging rates over a 30-year period.

Changes in the path if expected return for NZ and US cash rates



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