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

IWIinvestor Investment Report:

Economic & Market Commentary, Quarter End – March 2020

Overview

In our last update we highlighted the exceptionally strong returns in 2019, with markets registering gains of 25% or more. The good run continued into January 2020, but cracks started appearing in February as concerns mounted that Covid-19 was spreading to other parts of the world. Central banks started to cut interest rates, which initially supported markets rallying further. But from around the 20th February a large and rapid sell-off began as the true scale of the global pandemic became apparent, and governments started to implement social distance measures and close borders.

The sell-off from late February was also accompanied by extreme volatility and various stresses in financial market conditions such as reduced liquidity, longer trade settlement time frames, and increased credit spreads on bonds. In response, central banks were quick to deploy the 'toolkit' they developed in the GFC in 2008/9. Interest rates were cut to zero in countries where they were still above this level (notably, the US, Australia and New Zealand). Quantitative easing programs were also re-started or kicked into life, including in New Zealand for the first time.

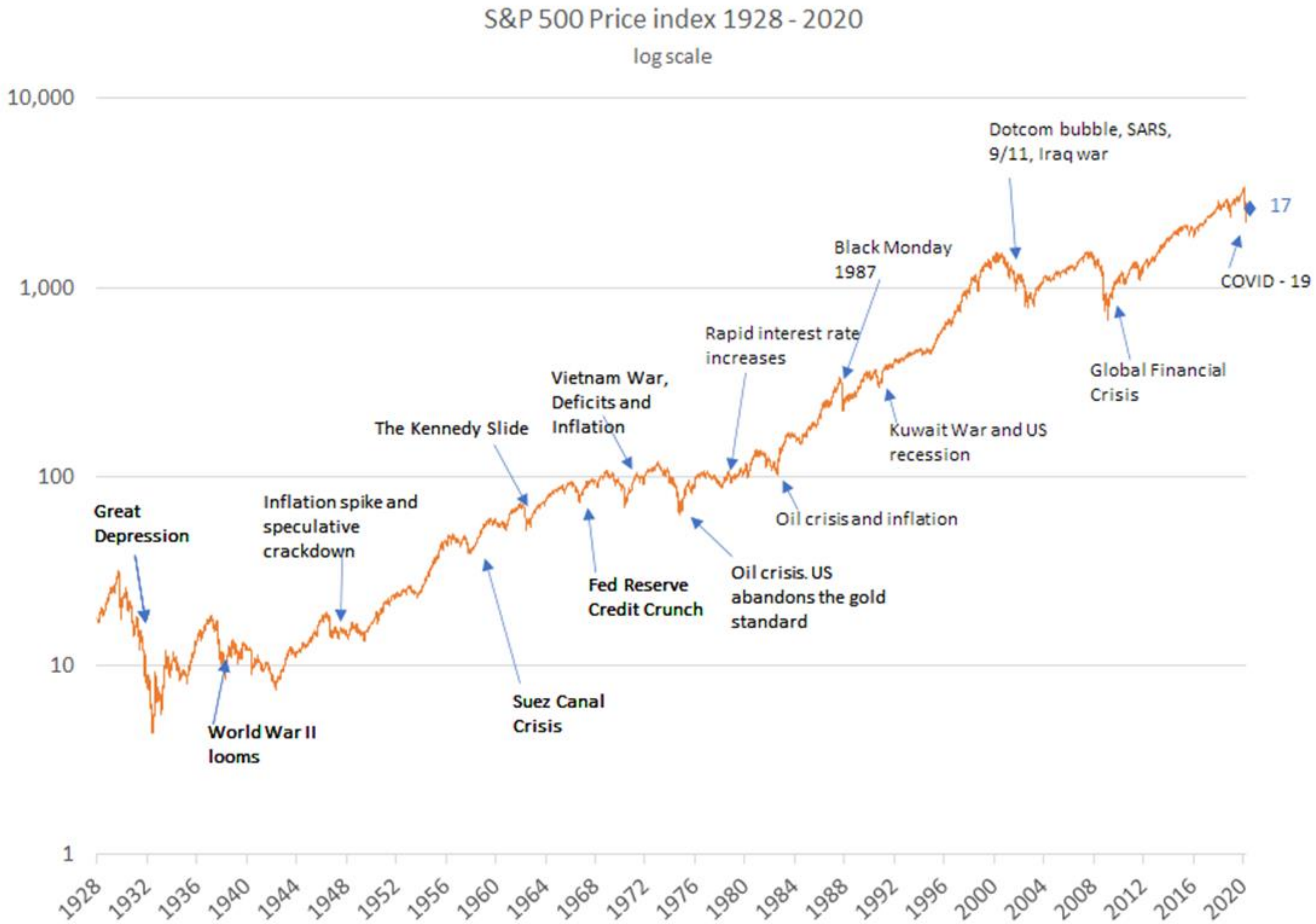
Central bank action, along with the unprecedented scale of fiscal support measures that governments have put in place, were successful in arresting the free fall in markets that began in late February. To provide some context, in the space of a month the US S&P500 index fell by 33% – the fastest descent ever. But since that point it has clawed back about half of the decline, as at the market close before the Easter break.

Nobody knows whether the lows reached in the 3rd week of March will be the bottom, or if instead markets will suffer further large declines given the dire immediate economic situation. But we are confident that the long-term reward for bearing market risk remains intact, and that this shock, like other large shocks markets have faced, will pass (see figure over page). We are also optimistic that a GFC-styled financial crisis, or a Great Depression scenario, is quite unlikely given:

- The scale and speed of government support (fiscal, monetary and direct business) is unprecedented in modern times.
- The increasing health successes in curtailing Covid-19 transmission, particularly in New Zealand, but also in US and European epicentres of the disease.
- The accelerated timelines for the development of anti-viral treatments and vaccines, which ultimately means the life can get back to some degree of normality.
- The countries hit earlier and harder are already recovering. Economic activity in China, for instance, has already bounced back significantly from its low point in February.

As such, sticking with your long-term investment strategies, and rebalancing through the volatility as necessary, remains the best course. We have increased the monitoring of your portfolios to consider rebalancing opportunities and remain in close contact with fund managers to ensure that they remain liquid. We are also keeping an eye on private market opportunities that may arise from the need for businesses to raise capital to see them through the economic slump.

Equity markets eventually recover from shocks



The economic picture

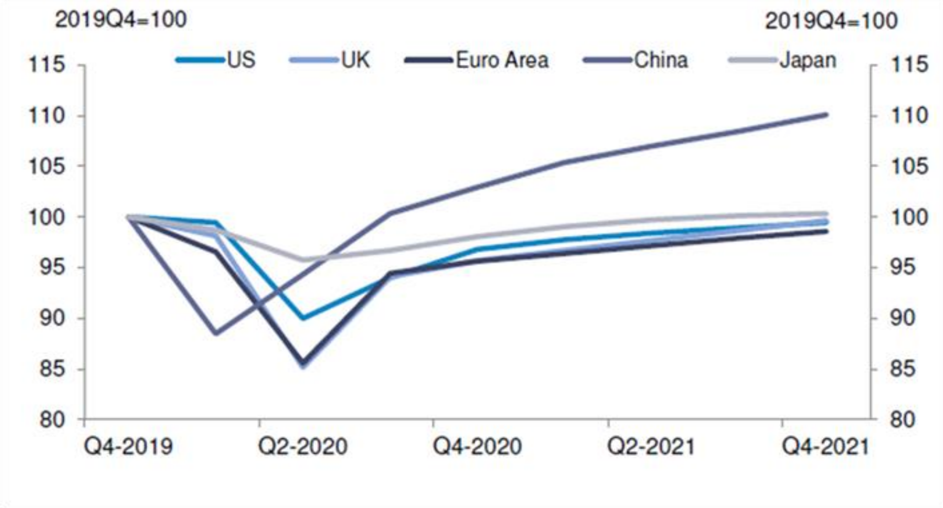
Current economic readings are dire. Various measures of activity and employment are showing the largest declines on record. The New Zealand Treasury, for example, forecasts GDP will decline at least 13% in the year to March 2021. Pre-covid global growth was bobbling slightly below trend. Now there is no doubt that most economies are in recession, and the debate is over the recovery picture and whether some impacts (e.g. to tourism and commercial property) will be permanent. Current market pricing is consistent with a Nike "swoosh" pattern, meaning that global activity will stay very depressed for the next few months, but should start bouncing back from the September quarter forward.

The uncertainty around the economic outlook is very large - economic forecasts should be taken with an even larger "pinch of salt" than normal given a lot depends upon public health risks and the policy responses. Given the uncertainty, markets may see further bouts of volatility. But ultimately, as vaccines and better treatment protocols are developed, the pandemic will pass.

We remain relatively positive about New Zealand's prospects. Covid-19 will have a larger short-term economic impact given the stringency of our lock-down measures, and our greater reliance on tourism than most OECD counties. But we are a relatively flexible economy, with much greater scope to use fiscal policy to help re-deploy resources to "plug the gap" in activity (e.g. to domestic construction, as the government has already signaled).

In addition, our largest trading partners (China, East Asia and Australia) will likely be the amongst the first countries to re-bound given their progress in managing Covid-19. This is crucial in the context of New Zealand being a small open economy whose prosperity is tightly linked to its trading partners.

Economies eventually recover too



Source: Deutsch Bank Research, April 2020 Forecasts

Market Returns

Turning to the quarterly market results (see figures over page), fixed income returns were a bright spot, with international investment grade bonds returning around 1.5% over the quarter and around 6% over the year. NZ investment grade bond returns were also positive. But under the surface results were more disparate. Government bond returns were much stronger as long-term rates fell over the quarter and investors "fled to safety". Investment grade corporate bonds returns were weaker, materially so until the central bank interventions started reducing investment grade credit spreads.

International shares fell around 10% in the quarter in NZD terms, whilst NZD hedged shares fell around 21%, mirroring the decline in global markets. The NZD tends to fall in time of stress, and this time was no different, which significantly helped cushion the blow from the global market decline.

Emerging Market equities fell around 13% in the quarter, reducing the annual return to around -5%. While this is a poor absolute outcome, it is better than what we would normally expect in a market sell-off given emerging market stocks (like small cap and value stocks) are typically seen as more risky than large developed market stocks. The better performance likely reflects that key Asian emerging markets - China, South Korea and Taiwan - are further ahead in their management of the Covid-19 pandemic.

Trans-Tasman equity markets had mixed fortunes. Australian shares fell around 23%. In contrast, the NZ market fell by 'only' 15% over the quarter, and is still up around 12% over the past three years. The differences largely reflect the make-up of our markets. Amongst New Zealand's largest listed companies are Fisher & Paykel Healthcare, A2 Milk, Spark and Contact Energy, which are in sectors that are less impacted by Covid-19.

In contrast, Australia's largest listed companies include banks and mining stocks, which are much more affected by the current economic conditions.

Rounding out the return picture, infrastructure and property stocks also had mixed fortunes. International property stocks fell by around 28% in the quarter (-39% on a hedged basis), reflecting large uncertainty around when commercial buildings can be re-occupied, and what tenant demand might be post-Covid.

Global infrastructure has been more resilient than real estate, but has turned out to be less defensive than expected this time around, mainly because of the impact on airports and seaports.