IWIinvestor
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IWIinvestor Investment Report:

Economic & Market Commentary, Quarter End – March 2019

Markets bounce back in the March quarter

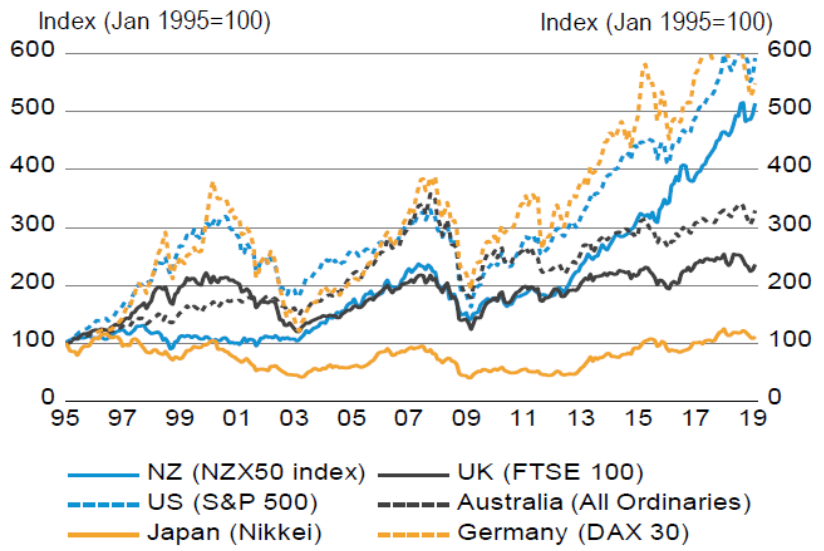
Central banks turned dovish over the past few months…

In response to the mauling markets received in the December quarter, and concerns around flagging global growth, the US Federal Reserve changed its mind that US interest rates need to head higher to nip building inflationary pressures in the bud. Instead, it put monetary policy on hold and signalled that future rate increases are likely to be smaller than what had been expected. In New Zealand, the RBNZ also changed its tune in its March economic update to signal that the next move in interest rates could be a cut.

..causing interest rates and borrowing costs to fall.

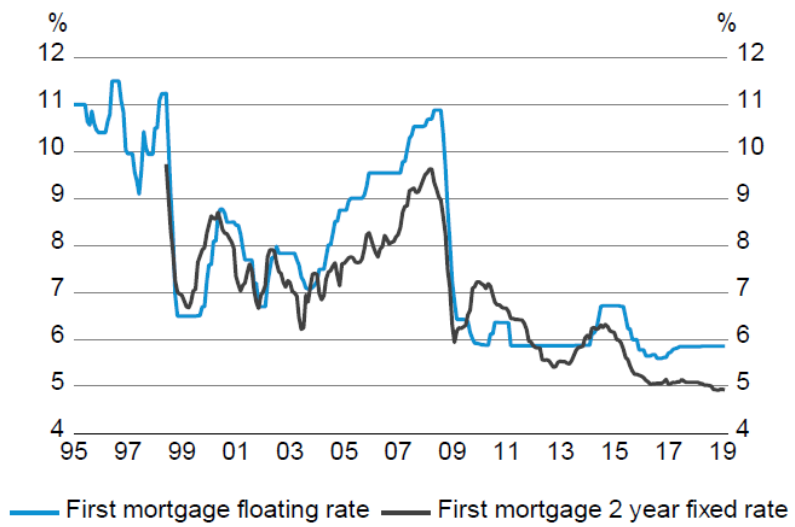
Markets have rallied strongly to these developments so far this year across all risk assets, including government and corporate bonds, property and infrastructure stocks, and equities. This rally has largely erased paper losses that investors experienced in December, and some markets, including the NZ equity market, is now on an all-time high (figure 1). On the flip-side, long term interest rates are back near historic lows, with New Zealand 10-year Treasury rates at an all-time low of around 1.75%. This has flowed through to significant falls in borrowing costs for New Zealand firms, government and households, with fixed rate mortgage rates are now at record lows (figure 2).

Figure 1: Equity markets bounce back



Source: Haver Analytics

Figure 2: NZ Fixed mortgage rates hit new lows



Source: ISM, Markit, Haver Analytics, DB Global Research

Downside trade risks have also receded for now.

But the rally in markets was not just due to central banks easing monetary conditions and financing costs. As discussed in our last update, the size of the decline in December meant that markets had become better value for investors and while we did not forecast such a strong bounce back, a recovery of some sort is not surprising. In addition, a key downside tail economic risk has also receded. The Trump Administration has backed down from imposing large tariffs on Chinese exports and has instead touted that a "great trade deal" between the US and China is imminent. While this remains to be seen, market fears of an escalating trade war have clearly been soothed.

All equity markets enjoyed high returns in the March quarter, with some markets reaching fresh now highs.

International developed market equities increased by around 10.5% over the quarter (in NZD terms), implying a 10% return for the year ended March 2019. Within global equities, value stock returns were mildly lower over the year, whilst small cap stock returns were relatively weak at around 4.2% for the year despite returning 11.2% for the quarter. Emerging market equities also had a strong quarter, returning 8.1% overall and over 25% in the local Chinese A-share market. However, this bounce still leaves these markets with a slightly negative return over the year.

Trans-Tasman equity markets also enjoyed a strong quarter. Australian shares returned 10% in the March quarter and 9.5% over the year. Within the Australian equity market, value stocks have mildly outperformed over the year (returning around 11%), while small cap stocks, which suffered large losses in 2018, have only returned around 3.5% despite a strong March quarter performance of 11.7%. New Zealand shares returned 11.2% in the quarter and 17.5% over the year to March 2019 - a very strong performance both in absolute terms and compared to offshore equity markets.

Bonds and property stocks also had good returns.

In recent quarters we have often seen bonds suffering relatively poor returns when equities have been doing well and vice-versa. This quarter given the nature of the 'shock' was a monetary policy easing bonds also performed well. Global bonds returned 2.8% in the quarter and 4.6% in the year to March 2019. New Zealand investment grade bonds returned 2.3% for the quarter and around 6% for the year – a returns that has been significantly boosted by bonds re-pricing higher as New Zealand interest rate expectations fell.

Economies muddling through

Global economic indicators are mixed, but no longer clearly all in decline.

Our view in the December update was that markets were over-pricing economic recession risks – as the saying goes markets have predicted 9 out of the past 5 recessions. Instead, we thought it much more likely that economies would muddle-through the cyclical slowdown. To date, this view is more in-line with actual data readings on most economies. Economic indicators suggest conditions are mildly expansionary or mildly slowing:

- Chinese and US manufacturing indicators are pointing to mild expansion, European indicators to mild decline (figure 3).
- Global container traffic, a leading indicator of reported global trade, is starting to bounce back (figure 4).
- Global metal prices, again a leading indicator of global demand, have stabilised (figure 5).

Macro forecasters see global growth at around long-term trend levels

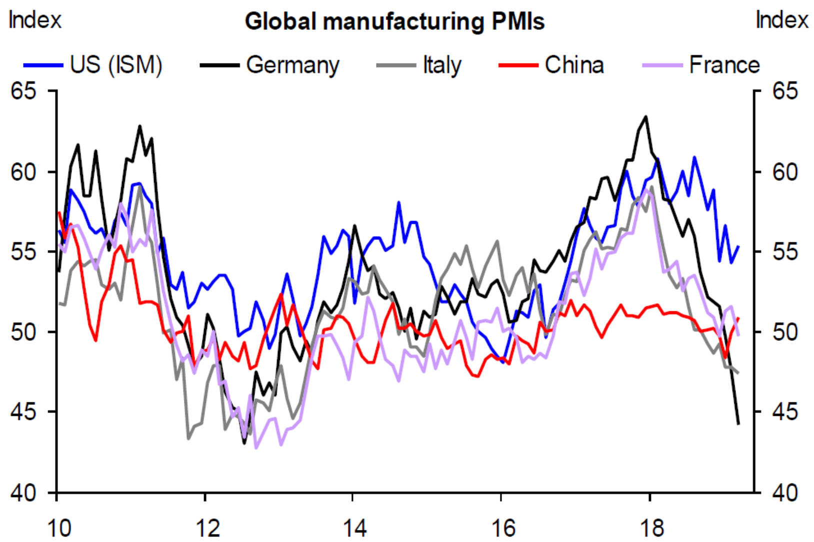
New Zealand's GDP growth for the December quarter came in at 0.6% or 2.8% for the year. This was a stronger outcome than many economists had feared, but slower than the +3% pace of growth that the economy had enjoyed over the past few years. Despite a cooling housing market and weak business confidence levels, upside growth potential also remains in New Zealand given the huge backlog of housing and infrastructure spending that is in the pipeline. Capacity constraints in our economy remain high (figure 6), and this can only be relieved through a long period of sustained investment.

Recession risks are small so long as the EM growth juggernaut continues.

Overall, the rear-view mirror suggests that the global economy has been cooling to lukewarm levels. Looking ahead, despite the risks, macro forecasters expect global growth to bobble around 3.3% or so over the next two years. This is only a little below the average level that has been achieved over the past two decades, and hence can be considered a "normal" cyclical slowdown from the higher growth that had been seen in recent years. The main caveat to this being that central banks do not have anywhere near the room to manoeuvre to cushion demand given rates are at such low levels.

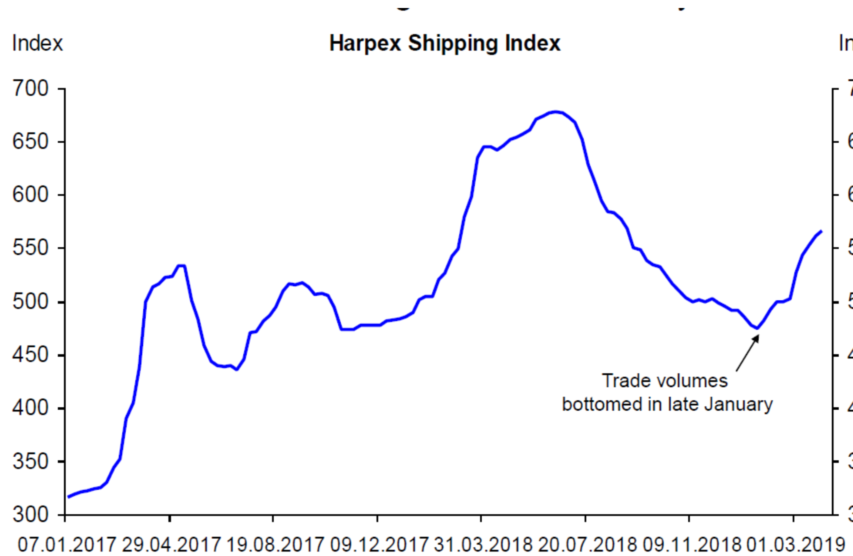
Within the headline global growth figure developed markets are expected to slow to around 1.5% or so, with European growth facing the largest downside risks given Brexit and the threat of auto-and other tariffs hanging over the head of the German manufacturing machine. Emerging markets are expected to grow more than double this pace at around 4.5%, despite a continual slowing of the Chinese economy. This is key. High EM growth implies that these markets will make a large and increasing contribution to global growth rates. A global recession remains very unlikely unless there is a large slowdown in EM economies, with China and increasingly India being the linchpins in this regard.

Figure 3: Global container shipping volumes is starting to rebound



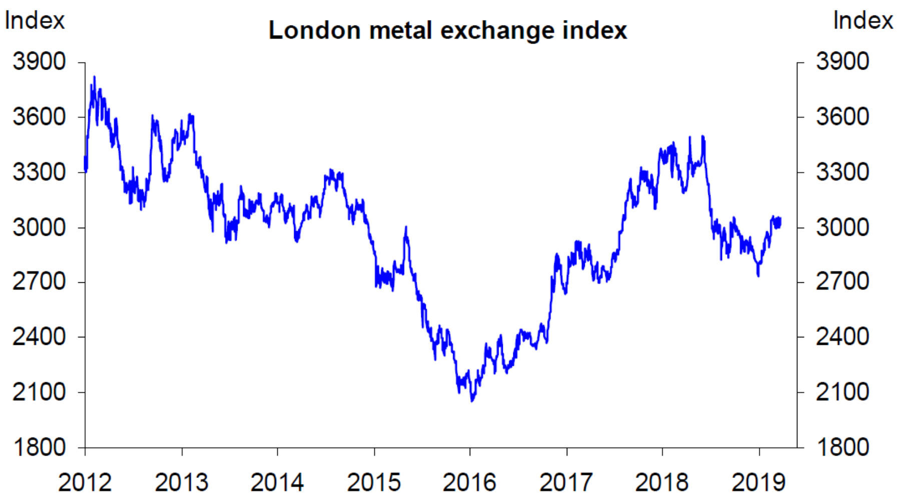
Source: Harper, Petersen and Co.

Figure 4: Global container shipping volumes is starting to rebound



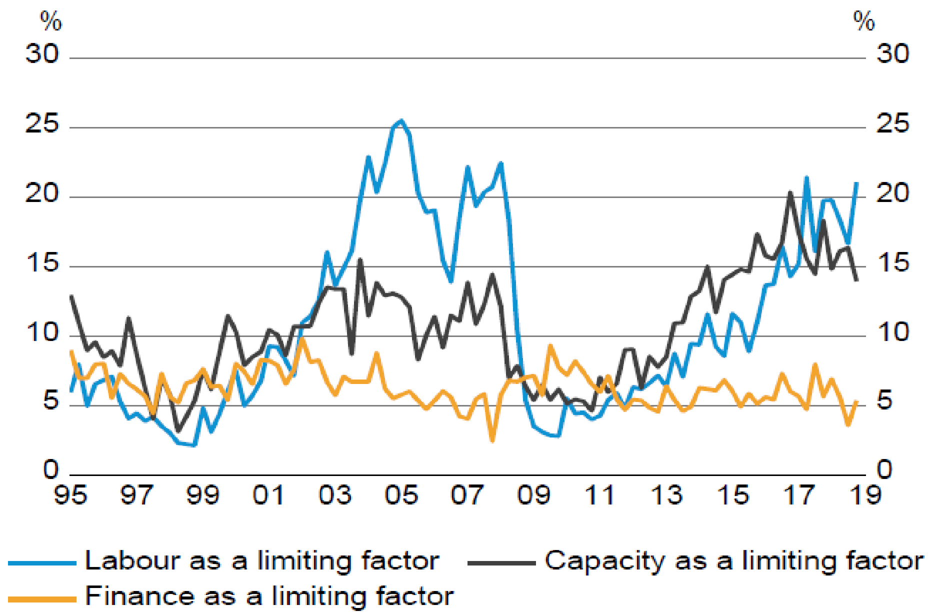
Source: Bloomberg Finance LP, DB Global Research

Figure 5: Industrial metal prices have stabilised



Source: Bloomberg Finance LP

Figure 6: Labour and physical capacity constraints remain high in New Zealand



Source: NZIER

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