IWIinvestor
Pou Tiaki i Ngā Rawa
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IWIinvestor Investment Report:

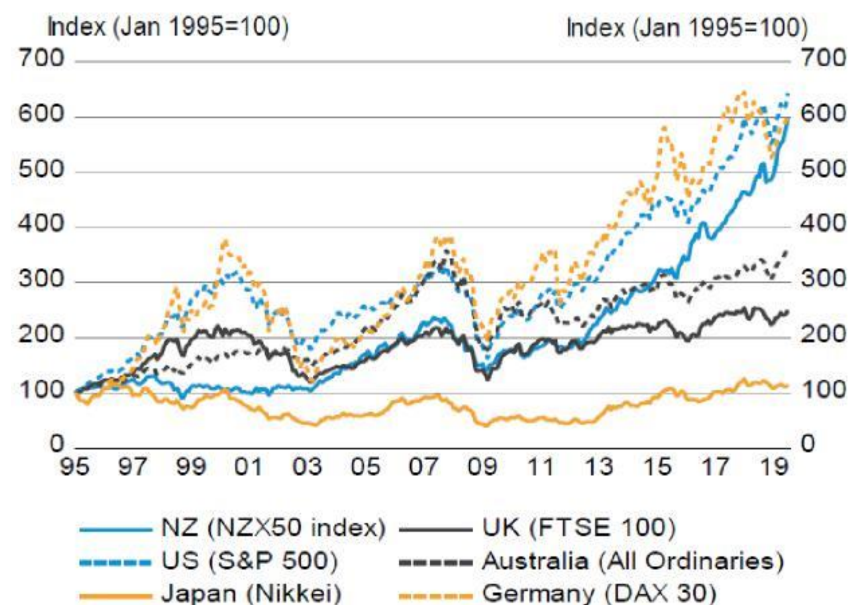
Economic & Market Commentary, Quarter End – September 2019

Markets rally further in the September quarter

Market returns and the economic backdrop for September was very similar to the June quarter. As discussed in our last update, central banks have begun easing rates in response to a slowing global economy and the risk that ongoing Trade Wars will drag economies into recession. The US Federal Reserve cut interest rates by 25bps in both July and in September, bringing the US Federal Funds rate to 1.75%. Our reserve bank has been quicker off the mark, with RBNZ cuts in May and August reducing the OCR to a record low of 1%. Fourteen emerging market central banks also cut rates in August –the largest number of concurrent cuts since the global financial crisis in 2008.

In response to these developments, interest rate sensitive asset classes including government and corporate bonds, listed property, and infrastructure stocks have rallied very strongly.

Figure 1: Equity markets reach new highs



Source: Various

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Equities have also fared well across most markets so far over 2019, with many reaching new highs (Figure 1). International developed market equities increased by around 7.7% over the September quarter and 25% in the year to date (in NZD terms).

However, given the large decline in markets in December 2018, the return for the year ended September 2019 was materially lower at around 7.7%. In addition, our currency has flattered international equity returns over the year.

The NZD has fallen around 10% against the USD since September 2018 in response to the RBNZ cutting interest rates materially lower than US rates. As a consequence, NZD hedged global equity returns have been only around 2.5% over the year to September.

Within global equities, value stocks have performed largely in-line with the broad market over the past year. In contrast, small cap stocks – which are typically more sensitive to the growth environment – have been weaker, with the NZD return flat over the year.

Emerging markets have also been weaker given they have borne the brunt of the Trade Wars, returning around 2.5% over the quarter and 3.5% over the year.

Figure 2: With heighted volatility

Source: MSCI

Trans-Tasman equity markets have fared better. Australian shares returned 5.6% in the quarter and New Zealand shares returned 4%, bringing the annual return to around 11% and 17% in the markets respectively. The New Zealand equity market has benefited more than most from rate cuts given the predominance of listed property and utilities in the NZ50 index.

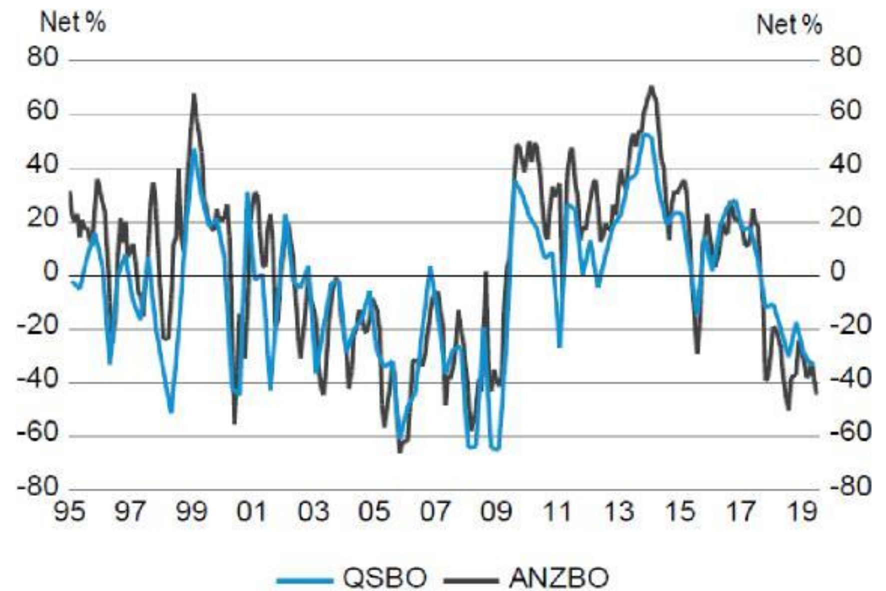
Global bonds returned 2.5% in the quarter and around 10% in the year to September 2019, while New Zealand investment grade bonds returned around 9% for the year.

These returns are exceptional and much higher than the running yield on bonds, which are now under 2% for the main international and NZ investment grade indexes. Bonds have benefited from being repriced higher as interest rates expectations have shifted over the past year from increases to declines. This also boosted "bond like" property and infrastructure company returns, which have experienced double-digit gains over the year across New Zealand, Australia and global markets.

The rally in markets has however been accompanied by significant volatility as markets have grappled between contrasting forces (Figure 2). The slowing global economy reduces corporate sales and profitability.

In contrast, a lower interest rate reduces borrowing costs and how much investors discount corporate earnings (boosting asset prices). Errant tweeting by the Commander and Chief have added to the volatility.

Figure 3: NZ business confidence tumbles



Source: NZIER, ANZ

Recession risks mounting but economies still likely to muddle through

World trade volumes before the Trade Wars were running around 5% per annum, and global growth around 3.5.%. Today global trade volumes are in mild decline along with global manufacturing. The most recent September OECD estimates suggest that global growth has fallen under 3%. The key question is where do things go from here? Central banks have been quick to cut rates in response to slowing growth and downside risks. While this has clearly boosted asset prices and market confidence, the impact on actual economic activity may be much more limited given rates are already extremely low, and there is debate whether further cuts will achieve much. In relation, surveys suggest that business confidence in New Zealand and abroad has plunged (Figure 3).

The very real concern undermining business confidence is that the manufacturing sector contraction will spill-over to a much broader based slowdown in the services sector. This sector makes up around two-thirds of GDP, and three-quarters of employment, in most developed economies, including ours. The silver lining to the mounting risks is that it is occurring in an environment where capacity and employment levels are very high. Unemployment rates in the OECD including in the US, the UK, Australia, New Zealand and Germany are around historic lows.

Figure 4: But NZ growth holding up so far

Source: Statistics New Zealand

This means there is a lot of inbuilt momentum in these economies. As above, we would need to see the services sector take a hit for recessionary conditions to take hold in developed markets. In addition, the OECD and other forecasters expect growth in the emerging world to hold up at around 4.5% over the next year more than double the pace of growth expected in the developed world.

High EM growth implies that these markets will continue to make a large and increasing contribution to global growth rates. Global growth can hence remain positive *even if* most developed economies are mildly slowing given the EM growth contribution. Our view remains that the global economy is likely to muddle through despite the clear deterioration in conditions over the past quarter.

We also continue to expect that the New Zealand economy will fare relatively well. Current annual growth is running around 2.5% (Figure 4) and the RBNZ in its latest Monetary Policy Statement expects this rate to pick up over the next year as rate cuts kick-in.

Key drivers of growth in our economy, including (mostly) high commodity prices, solid tourism and net immigration inflows, and a large pipeline of construction and infrastructure projects, remain in place.

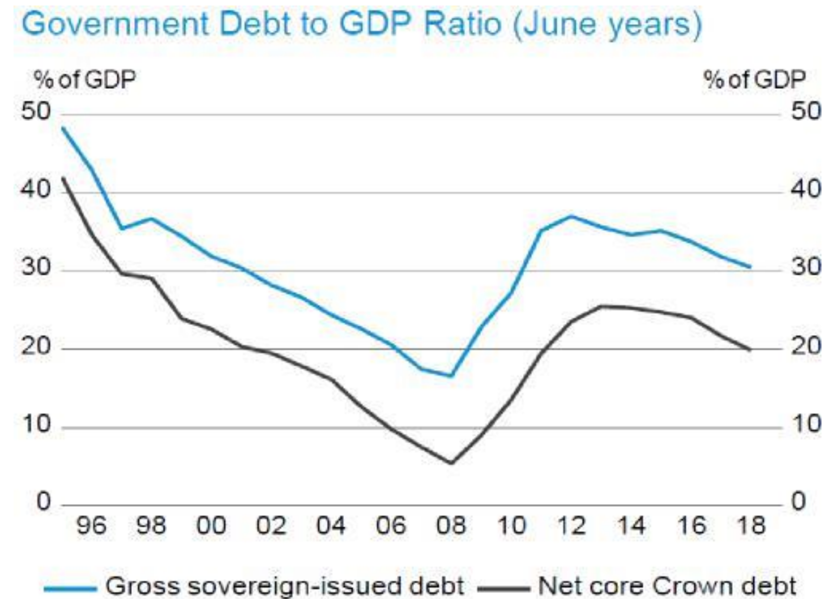
Figure 5: NZ consumer confidence is more resilient

Source: Westpac Mcdermott Miller, ANZ-Roy Morgan

Given this backdrop, it is perhaps not surprising that consumer confidence has so far been quite resilient (figure 5). In addition, the New Zealand government has much more scope than most OECD governments to boost fiscal spending given our government debt levels are quite modest, with gross debt at around 30% of GDP (Figure 6).

Fiscal policy is a critical lever to pull in an era where central banks have exhausted most of their ammunition. We can only hope that, unlike with the KiwiBuild program, the government moves faster when it is needed.

Figure 6: And fiscal policy has much room for manoeuvre



Source: New Zealand Treasury

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