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

# IWIinvestor Investment Report:

## Economic & Market Commentary, Quarter End – June 2019

### Markets rally further in the June quarter

Central banks have changed course to easing.

An old investment mantra is "Don't fight the Fed". The Fed in this case is the US Federal Reserve, who sets monetary policy and interest rates in the United States. Historically investors in the US, and globally given the dominance of the US market, have done well when they have invested in a way that aligns with how the Fed sets its monetary policy. This pattern has repeated over the past 6 months.

The Fed has now completely backed-off increasing rates in response to a slowing global economy and heightened Trade War risks. Markets forecast instead that they will cut interest rates, in line with cuts that have already taken place in New Zealand and Australia. In response, markets have rallied strongly across all asset classes, including government and corporate bonds, property and infrastructure stocks, and equities.
Investors and active fund managers who reduce risk allocations in response to the slowing economy – fighting the Fed – have missed out on this rally.

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This boosted equity markets over the quarter.

Many equity markets, including the New Zealand's reached new highs in the quarter (figure 1). International developed market equities increased by around 5.5% over the quarter (in NZD terms), implying around a 7% return for the year ended June 2019. Within global equities, value stock and small cap stock returns were a little weaker returning around 4% for the quarter. Emerging market equity returns were weaker at 2% over the quarter, but this was sufficient to turn their annual return to a small (2%) positive figure. These markets have borne the brunt of the Trade War, and on the flipside have the most to gain should growth recover. Trans-Tasman equity markets also enjoyed a strong quarter. Australian shares returned 8.3% and New Zealand shares returned 6.7%. These markets in particular have benefited from RBNZ and RBA rate cuts, with the Aussie market also boosted by the surprise re-election of Scott Morrison and the Liberal Party.

Bonds and property stocks also had good returns.

Global bonds returned 2.7% in the quarter and 7.3% in the year to June 2019, while New Zealand investment grade bonds returned around 7% for the year. These returns are much higher than the running yield on bonds (around 3.5% or so) re-pricing higher as interest rate expectations have declined. This also boosted "bond like" property and infrastructure stock returns, which have experienced double-digit gains over the year across New Zealand, Australia and global markets in general.

But market volatility has not gone away.

This rally has however been accompanied by significant volatility as markets have grappled between contrasting forces. The slowing global economy reduces corporate sales and profitability. In contrast, lower interest rates reduce borrowing costs and how much investors discount corporate earnings (boosting asset prices).

Errant tweeting by the Commander and Chief have added to the volatility as threats on further tariffs (including on Mexico, China, the EU and India), trade restrictions (e.g. on Huawei) and military action (Iran) have gone on and off the radar. In the event, at the time of writing the Trump Administration has backed down from the worst of the threats and market fears of an escalating trade war have been soothed.

## Economies still likely to muddle through

Global economic growth is slowing, and central banks have limited ammunition to arrest downside risks.

Despite the Trump Administration backing off (for now) escalating the trade war the damage has clearly been done to global trade and growth (figure 2). World trade volumes before the Trade Wars were running around 5% per annum, and global growth around 3.5.%. Today global trade volumes are flat and global growth has fallen closer to 3%. In addition, a range of short-term economic indicators such as manufacturing activity and confidence levels have fallen (figure 3).

The key question is where do things go from here? The ANZ, in line with the market 'consensus' thinks that the environment warrants further interest rates cuts. It forecasts that the RBNZ and RBA will cut rates twice more within the year (reducing the OCR by around 0.5%), while the Federal Reserve will cut three times (figure 4). Our view remains that whether or not this happens markets and the global economy are likely to muddle-through the current cyclical slowdown. But this hinges on the Trade Wars not re-surfacing, or Brexit plunging the UK and Europe into recession. We are also mindful that while central bank easing rates has clearly boosted asset prices and market confidence, the impact on actual economic activity may be more limited given rates are already extremely low and there is debate whether further cuts will achieve much.

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

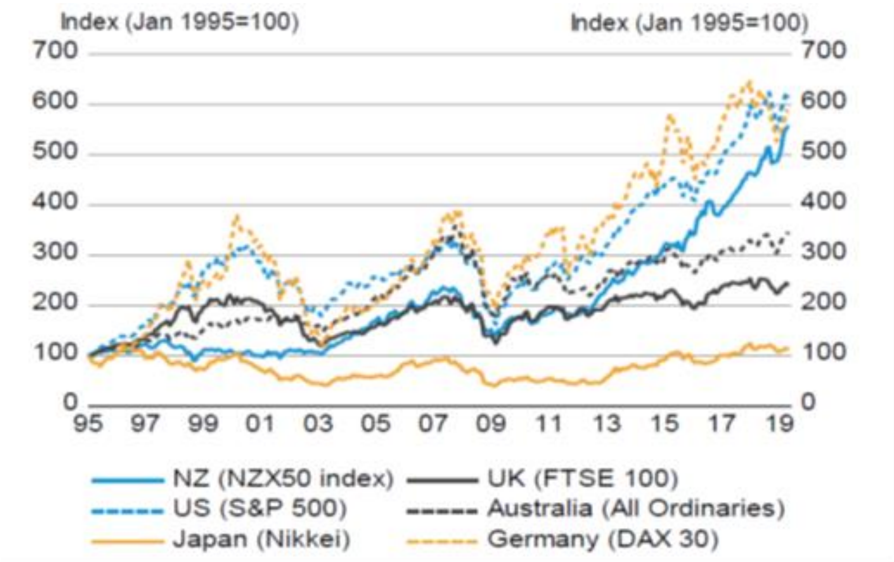
Currently macro forecasters expect growth to be around 1.7% in developed markets over the next year, with US and Australian growth around 2.5%, and EU growth lagging at a little over 1%. In contrast, growth in the emerging world is expected to hold up over 4% over the next year - more than double the pace of growth in the developed world. This is key. High EM growth implies that these markets continue to make a large and increasing contribution to global growth rates. Global growth can remain reasonably firm at around 2% *even if* most economies are mildly slowing given the EM growth contribution. A global recession hence remains very unlikely unless there is a large slowdown in EM economies, with China and increasingly India being the linchpins in this regard. Both economies are still forecast to experienced growth rates of around 6% over the next year or two.

The NZ economy is favourably placed to whether any slowdown.

In New Zealand the slowing global economy and downside risks should be seen as less of a concern. Current annual growth is running around 2.5% and the RBNZ in its latest Monetary Policy Statement expects this rate to pick up to around 3% over the next year as its rate cuts kick-in. Even if this is limited, with commodity prices at mostly attractive levels, high tourism inflows and net migration, and a large pipeline of construction projects, growth is likely to hold up well (figures 5 and 6).

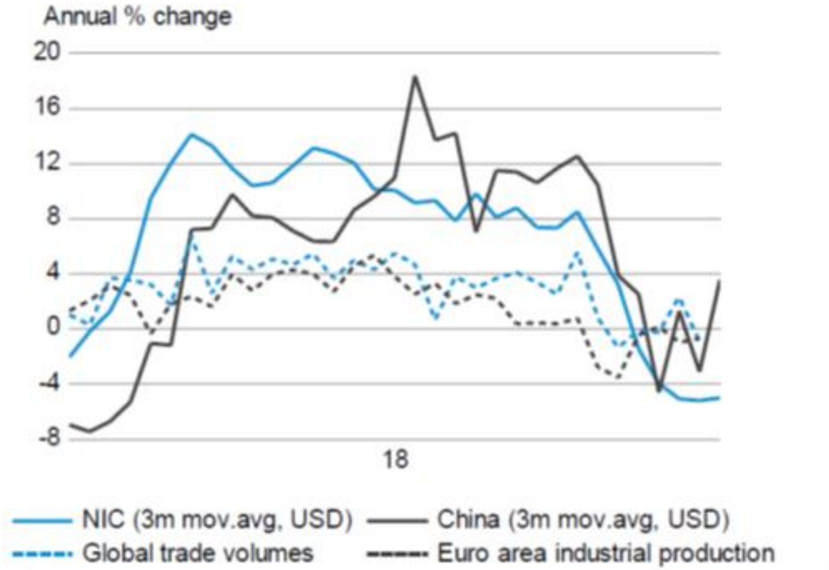
In addition, the move of the NZ government debt target to a range in the so-called Wellbeing Budget provides a mechanism to boost fiscal spending further should it be judged necessary to cushion our economy from a global downturn. Compared with most OECD economies, our fiscal debt levels are very low and fiscal policy is a critical level to pull in an era where central banks have exhausted most of their ammunition.

## Figure 1: Equity markets reach new highs



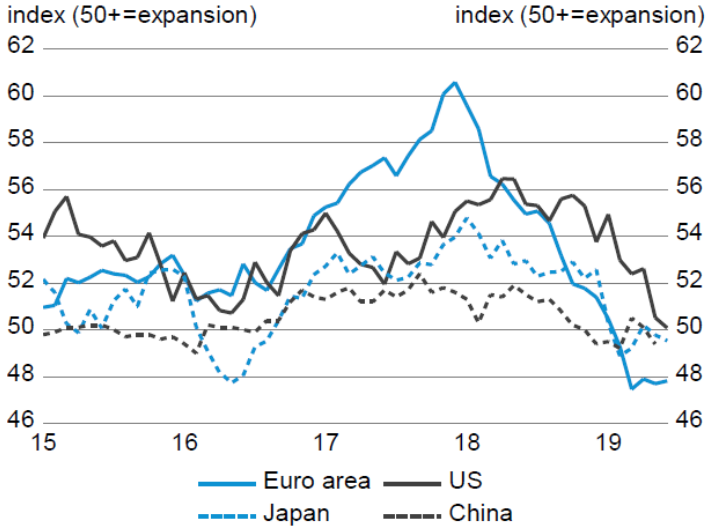

Source: Haver Analytics

## Figure 2 Global growth & trade is slowing




Source: Haver Analytics

## Figure 3: Global manufacturing is declining



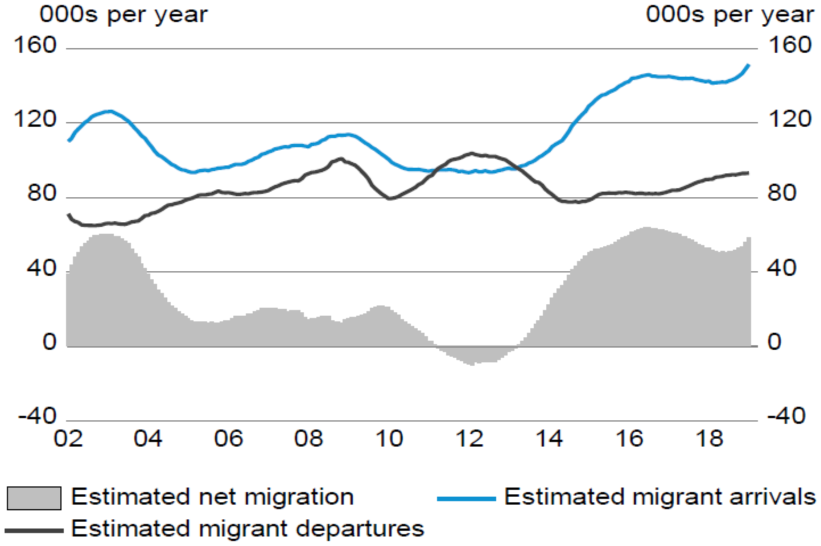

Source: ANZ.

## Figure 4: More rate cuts to come?

| | Current policy rate | Expected rate (year-end) | Change |
|---|---|---|---|
| **US** | 2.38 | 1.61 | -0.77 |
| **Eurozone** | -0.37 | -0.50 | -0.13 |
| **UK** | 0.75 | 0.65 | -0.10 |
| **Australia** | 1.25 | 0.71 | -0.54 |
| **NZ** | 1.50 | 1.08 | -0.42 |

Source: ANZ.

## Figure 5: NZ Net Migration Remains Strong




Source: Statistics New Zealand

## Figure 6 NZ Terms of Trade on a high


Source: Statistics New Zealand

| **Disclosure:** |
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