IWIinvestor Investment Report:

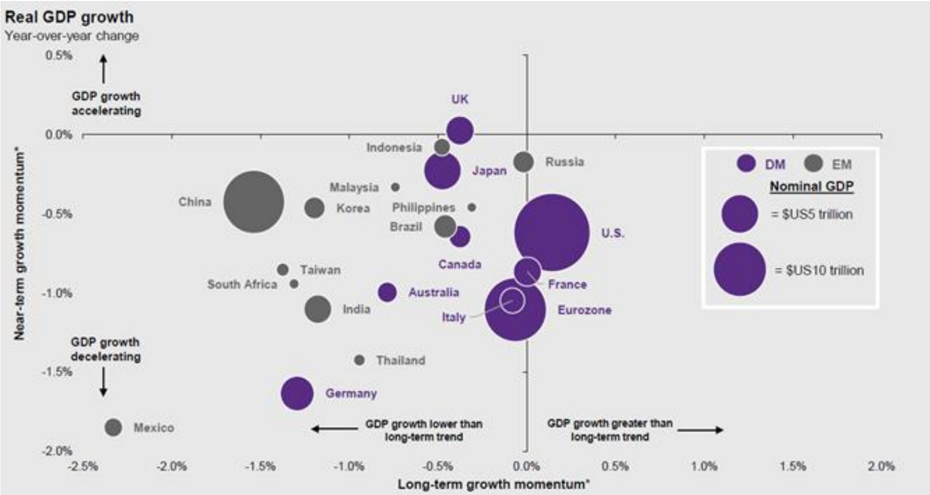
Economic & Market Commentary, Quarter End – December 2019

2019 ended strongly for most asset classes

What a difference a year makes! At the beginning of 2019 equity markets were treading water following a 15% decline over the end of 2018. Our view at the time was that markets were over-pricing economic recession risks, and the best course of action was to remain fully invested. We did not, however, expect that the year would close with equity, property and infrastructure returns of 25% or more in many markets!

Over the year economic growth and corporate earnings did in fact materially weaken as the trade war took hold (figure 1), but what is key for markets is how this compared to what was expected. Much of the bad news in 2019 was concentrated in business confidence surveys and global manufacturing and trade. The fear was that this would spill-over into the rest of the economy, in particular, denting the services sector, employment, and household spending in key economies such as the US, the Euro Area and China. But to a large extent this didn't happen. The services sector remained robust, and unemployment rates have remained exceptionally low in New Zealand, the US, the UK and most other OECD nations. As such, household spending and investor confidence remained high.

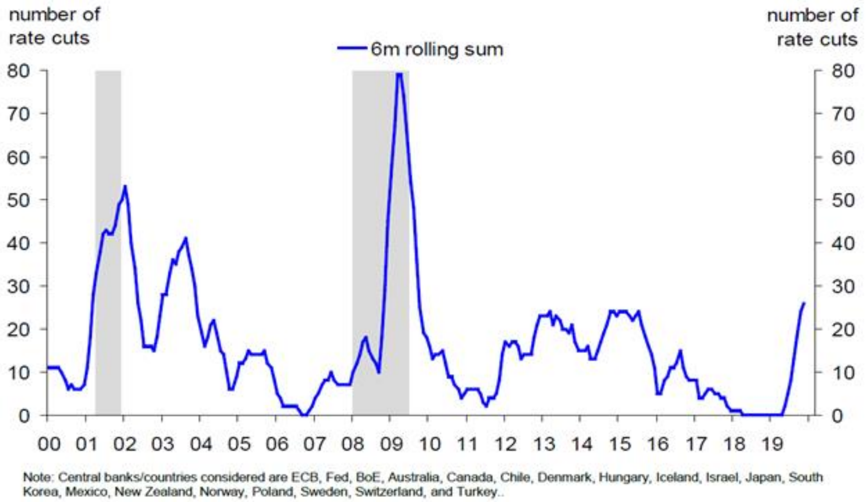
Figure 1: As economic growth faltered



Source: JP Morgan Economic Research, IMF

Instead, what clearly did happen in 2019 was a reversal by central banks - from tightening to easing interest rates and monetary conditions (figure 2). This was likely by far the single most important reason why asset class performances, across bonds (defensive assets) and equities (growth assets), were so strong in 2019.

Figure 2: Central banks cut rates



Source: Central Banks, DB Global Research

More than 15 global central banks cut interest rates in 2019, including the RBNZ cutting the OCR to a record low of 1%. In addition to this support, fiscal spending ramped up in some countries, most notably in China.

Turning to the quarterly market results, international shares rose around 1% in the December quarter in NZD terms, but returns were much stronger in NZD hedged terms at around 7.5% given the strong performance of our currency. It increased from around 63c to 68c versus the USD as markets backed off from the view that NZ rates were on course to join the zero-rate club (discussed further below). Over 2019, NZD currency impacts on returns have evened out, with both hedged and unhedged international equity returns at around 27%. Within global equities, small caps returned around 25% for 2019, while value stocks returned 'only' 21%.

Emerging markets had a strong quarter, returning 4% (in NZD terms) as the trade war between China and the US finally showed signs of resolution (or at least a pathway to this). This brought the 2019 annual return to around 18%, a good result but weaker than developed markets given emerging markets have felt the brunt of the trade war.

Trans-Tasman equity markets fared better. Australian shares returned around 23% for the 2019 year, and last but by no means least, the New Zealand market returned around 32%. This very strong performance for our market boosted the return for the decade to around 15% per annum - implying an exceptionally strong 400% total return over the decade.

Global investment grade bonds returned around -0.5% in the quarter and 7.5% for the year. The annual return is a very strong outcome given the low running yields on bonds, and reflected bonds being re-priced higher over 2019 as longer-term interest rates fell on the back of central banks easing discussed above. However, markets backed slightly off view that rates need to be lower for longer in the December quarter, as the global growth picture moderately improved.

This change of view to a stronger (less negative) outlook was even more the case in New Zealand, where markets backed off the view that rates were headed to zero. As such, investment grade bonds returned -2.3% for the quarter and 5% for the 2019 year (Corporate bond returns were stronger at 5.5%).

Rounding out the return picture for 2019, infrastructure and property stocks have also had a banner year - benefitting both from the lower interest rate settings, and the general bounce in equity markets from the low point at the beginning of 2019. International property stocks returned around 22% in 2019, while Aussie REITs were a touch weaker at around 19%. In contrast, NZ property stocks were very strong returning around 31% for the year. Finally, global listed infrastructure stocks returned around 25% in 2019.

2020 vision - economies will likely muddle through, markets are more vulnerable.

We continue to expect that economies will muddle through given exceptionally supportive monetary conditions, easing trade frictions, and the fact that there remains a lot of in-built momentum in the global growth picture. This is because there is a structurally higher rate of growth in emerging markets, while the services sector (comprising around 70% of GDP in the OECD) remains resilient in developed markets.

The OECD's latest forecasts are that global growth will bobble around 3% over 2021 and 2022. This is weaker than the 3.5% average growth rate that had been experienced since the bounce from the GFC, but it is by no means alarmingly weaker. In addition, they (along with other forecasters) expect emerging market growth to remain much stronger at 4% or more.

Global growth can hence remain positive even if most developed economies slow mildly given the EM growth contribution.

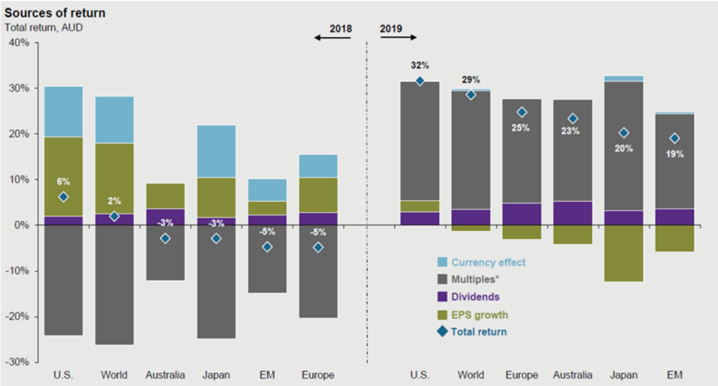
We remain more positive about New Zealand's growth prospects. Along with very low (in our view too low) interest rates, our economy will face a significant fiscal boost over coming years as the Government (finally) ramps up infrastructure spending.

In addition to this, we continue to enjoy high commodity prices and commercial construction activity, and strong net migration levels. The last quarterly GDP release for the September quarter was 0.7%, stronger than the RBNZ and most bank forecasters expected. As a consequence, expectations of further rate cuts have been pulled back.

Even if economies muddle through as we expect, and downside risks do not materialise, (e.g. from a re-start of the Trade War, or the new risk of war between the US and Iran) it is important to recognise that market volatility can still resurface.

With the exceptionally strong 2019 year, many equity markets have become more over-valued and this itself may cause a correction at some point (figure 3). In addition, should global growth prospects pick-up, we could paradoxically see a sell-off in risk assets as interest rate expectations rise again.

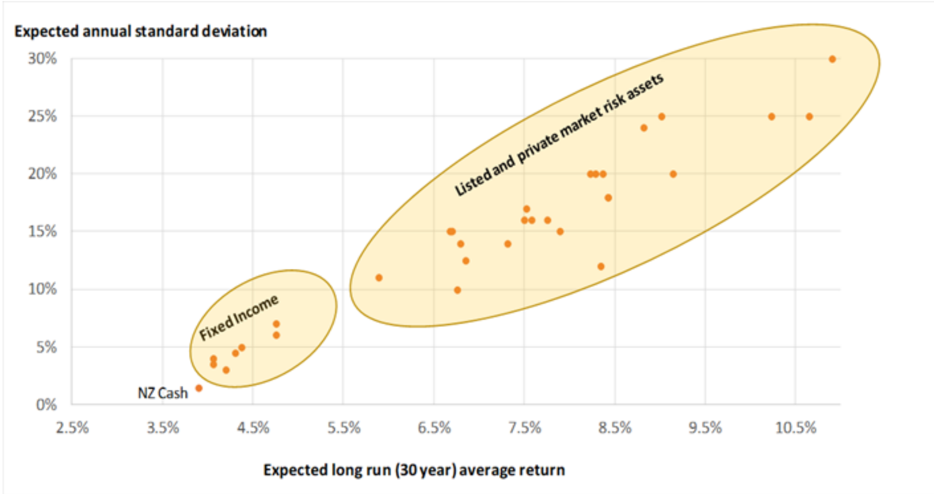
Figure 3: Boosting equity returns via multiple expansions…



Source: JP Morgan Economic Research, IMF

That said, we can't forecast such sell-off events and our longer term expected asset class returns still suggest the reward for bearing risk remains intact (figure 4), in line with most institutional asset managers and investors. We are also mindful that any correction is likely to be short-lived in an environment where rates are low, and there is ample liquidity sitting on the side-lines waiting for any such event to occur.

Figure 4: …but in our view the longer run reward for bearing risk remains intact



Source: MyFiduciary capital market assumptions as at December 2019