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

IWIinvestor Investment Report:

Markets Summary, Quarter End – December 2017

Equity markets surged in late 2017 and closed on record highs, including in New Zealand and the United States. As discussed further below, on an annual basis, equities returned over 20% in NZ and developed markets, whilst emerging markets returned over 35%. Bond returns were more subdued in the low single digits, but still comfortably ahead of short-term cash rates in most economies.

The catalyst for the end of year surge in equities was likely the passage of very large corporate tax cuts in the United States, reducing their headline rate from around 35% to 20%. This increases profits for investors into US equities, and no doubt will put pressure on other governments to consider whether their rates remain competitive. New Zealand's corporate tax rate, at 28%, now stands out as one the highest rates in the OECD set of advanced economies.

Supporting markets is the very benign macroeconomic environment, which has generally flowed through to strong corporate earnings in New Zealand and abroad. Global and New Zealand monetary policy setting remain very accommodative despite rate hikes in the US over 2017, fiscal policy in most countries is no longer tight (i.e. austerity programs have largely ended) and global growth is solid, with all countries that comprise major MSCI equity indexes currently expanding.

The New Zealand economy is also performing well, with the latest GDP release in December containing a huge surprise – growth was substantially revised up over 2015 -2017 to average around 3.7% per annum (from under 3%). This completely changes the narrative that our economy was somehow suffering from low quality, low productivity growth. Instead, it has been going gangbusters, as we might have expected all along given record high net migration, tourism spending, commodity prices, and construction activity.

Index Returns

Below we report returns from general market benchmarks to show market trends and the performance differences between sub-asset classes in the market. In addition, we have included a 'base currency' conversion table to accompany the benchmarks summary and a calculation of NZD hedged returns. This enables us to look at performance on a local currency basis, in NZD terms, and in NZD hedged terms. Currency can have an important impact on returns, and hence evaluating market and Fund returns needs to consider currency impacts.

Global large cap developed market equities increased around 5.5% in local currency terms and 7.2% in NZD terms, bringing the annual NZD return to around 20%. On an NZD hedged basis, international equity returns have been slightly lower. In part, this is due to a resurgent Euro, which has strengthened considerably against the US dollar and its trade basket in the back of ongoing recovery in the Euro area. But the Kiwi has also declined around 4% against the USD in the quarter. This is at odds with the economic picture discussed above, and hence likely reflects a "shock" from a change in government. In the event, the currency has rallied strongly against the USD over the first couple of weeks of 2018.

Within global equities small and value slightly lagged. Year to date global small caps have performed in line with the market and outperformed over longer three, five and ten-year horizons. In contrast, the MSCI value index still lags the market over longer horizons. The broad MSCI index of emerging market companies was again the stand-out, returning 9.2% for the December quarter and around 23% on an annual basis. Returns in NZ dollars have been a little lower at around 35% for the year – the best performing broad market we monitor. Despite this rally they are still regarded as relatively good value - returns still considerably lag developed markets over 5 and 10 year horizons.

The Australian share market had a very strong quarter, returning 8.5%. This follows a relatively weak September quarter result. Within Australian equities, small cap shares returned over 15% for the quarter and 27% for the year – one of the best annual performances in global markets. The New Zealand market rallied around 5.9% over the quarter, broadly in-line with global market returns. Over the past 3 years New Zealand's equity market remains a stellar performer, returning around 14.7% per annum.

International Property stocks had a reasonable quarter (around 3.9% in US dollar terms), lifting the annual return to around 8.6%. This compares to around 7.5% for NZ property stocks and 12.5% for Australian property stocks. These returns are, however, all materially lower than their host equity market index returns. This reflects that the sector has "bond like" characteristics, and hence usually under-performs when markets favour risky assets.

International fixed interest returned 1% for the quarter and NZ bond fared better, returning around 1.6%. On annual basis global and NZ fixed income returns have exceeded short-term NZ bank bill and term deposit rates, indicating a premium has been achieved. Markets have now at least factored in materially higher rates, even in Europe, meaning that the risk of capital losses from unanticipated increases in interest rates has lessened.

How long will the good times last?

Despite the fact markets have been on a tear, and that this is supported by favourable macroeconomic conditions, the impression you may get from the media is that risks have never been higher and a recession, or market crash, or both, is imminent. Mostly we can safely ignore the hyperbole. At some stage, global growth will suffer a hiccup, but no one can predict with any accuracy when this occur, or its catalyst.

Our pick of the risks - if we are forced to make one - is that with continual strong economic and employment growth in the global economy eventually this will raise inflation and force central banks to increase rates faster than what is expected.

Along the way, we may see asset prices take a hit, especially fixed income and 'bond like' assets such as residential property. A well-diversified portfolio is the best way to guard against this and other risks.

We also expect that over the next 5 years or so returns are likely to be much weaker for risky assets such as equities than what has been experienced over the past several years, and possibly weaker than longer-term average returns. Markets do not deliver +20% returns forever! This does not mean, however, that we would advocate reducing risk in your client's portfolios. The last few years demonstrates that the opportunity cost of staying out of the market can be enormous, and we continue to expect equity markets to deliver a healthy premium to cash over the longer run.

Disclosure:

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