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

# IWIinvestor Investment Report:

## Markets Summary, Quarter End – December 2018

### Markets get mauled in the December quarter

The very strong returns markets have enjoyed since around 2011 came to crashing halt in the December quarter. Large declines occurred in equity markets in the month of October and then again in December as markets grappled with interest rates increases (in the US), Brexit deadlock, ongoing trade tensions between the US and China, a partial US government shutdown, some weaker than expected corporate earnings for bell-weather stocks such as Apple, and last but not least, the potential for global recessionary conditions to emerge over the near future.

International developed market equities fell by around 14.5% over the quarter (in NZD terms), implying a -3.2% return for the 2018 year. Within global equities value stocks fell by a lesser amount, reflecting that the decline was concentrated in 'growth' stocks which are more sensitive to changes in perceptions of the global growth environment. In line with this sensitivity, global small cap stocks also suffered larger losses, falling by around 18.5% in the quarter. In contrast, emerging markets, which are also normally more sensitive to a major downturn, fell by 'only' 8.7% in the quarter. This partly reflects that emerging markets, particularly the Chinese equity market, had borne the brunt of the trade war fears earlier. But it may also reflect a view by many equity analysts than emerging markets now offer particularly good-value for investors.

Trans-Tasman equity markets did not escape the carnage. Australian equities declined around 11.5%, with small caps being hit harder in line with the international experience. NZ equities were relatively robust to the global sell off, falling by around 6%. This left the 2018 calendar year return for the NZ equity market at around 5% - a strong result compared to most other equity markets. Global property was also relatively resilient, declining by 5.6% in the quarter and 3.7% over the year.

Bonds offered some respite to the equity markets sell off, as should be expected given their defensive nature. NZ investment grade bonds returned around 1.5% for the quarter and 4.6% for the year. This return is well ahead of short-term cash rates and term-deposits, indicating that NZ bonds have offered a good premium. International bonds also returned 1.5% over the quarter. Over the year, however, returns have been weaker than the yield on bonds, reflecting the fact that interest rates have risen ahead of market expectations, s causing bonds to re-price lower.

## Global economy moves from hot to lukewarm

Through the lens of the rear-view mirror economic conditions appear lights years away from recession in much of the world. In the United States, the Federal Reserve increased short-term interest rates to 2.5% in December, despite the ongoing market weakness, given the strength it sees in the US economy. While this move was heavily criticised by President Trump and many market commentators, recent data has been very much in line with the Federal Reserves' assessment. The US economy added over 300,000 jobs in the December quarter, far exceeding the expectation of around 175,000. The US unemployment rate is now under 4% and US wages are expanding at their faster pace in around a decade (Figure 1). US businesses would hardly be taking on staff at such high rates if they were worried about a recession around the corner!

Annual GDP in New Zealand is running around 3% according to the figures released by Statistics New Zealand just before Christmas, and our employment rate is now at a 30-year high (Figure 2). Despite weak business confidence levels, businesses are still hiring at a high pace. And upside growth potential remains in New Zealand given the huge backlog of housing and infrastructure spending that is in the pipeline.

Economic indicators elsewhere continue to suggest conditions are mildly expansionary (Figure 3). European growth continues to bobble around trend levels with the domestic strength being tempered by slowing in global trade. Indian growth remains very strong at around 7.5% as its development juggernaut continues unabated.

In contrast, the Chinese economy, which has felt the full brunt of the trade wars, has had growth clipped to 'only' around 6.5% per annum (on official figures). This is the weakest reading since the GFC, but still very strong compared to developed market economies. Australian growth has also been slowing as drought and falling house prices have hit exports and household spending. But the Australian labour market remains strong, and the most recent economic growth reading was still one of the highest in the OECD, with annual GDP around 2.8%.

Overall, the rear-view mirror suggests that the global economy has been cooling from red hot to lukewarm levels. Looking ahead, despite the risks, macro forecasters expect global growth to remain healthy at around 3.5% over the next two years (Figure 4). This is the level that has been achieved over the past two decades and hence can be considered a reversion of growth to trend levels from the very high pace that has occurred in recent years.

Within this headline figure developed markets are expected to slow to around 2%, while emerging markets are expected to grow more than double this pace at around 4.8%, despite a continual slowing of the Chinese economy. This is key. High EM growth (excluding China) implies that these markets will make a large and increasing contribution to global growth rates. A global recession is hence very unlikely unless there is a large slowdown in EM economies.

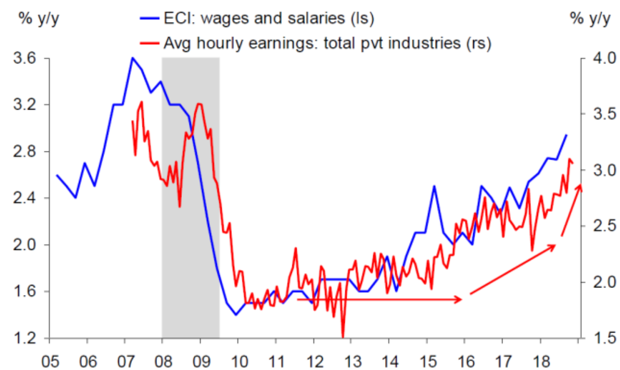
## The recent sell off and long-term equity returns

The key question now is whether the sell-off is justified given the risks or, if instead, whether it has been an over-reaction to recessionary fears? History would suggest that the latter is more plausible – as the saying goes markets have predicted 9 out of the past 5 recessions.

And as noted above, many analysts now see equity markets offering good-value. And in January 2019 so far markets are up. But that is not to say that the bottom has been reached, or that economic conditions won't deteriorate further

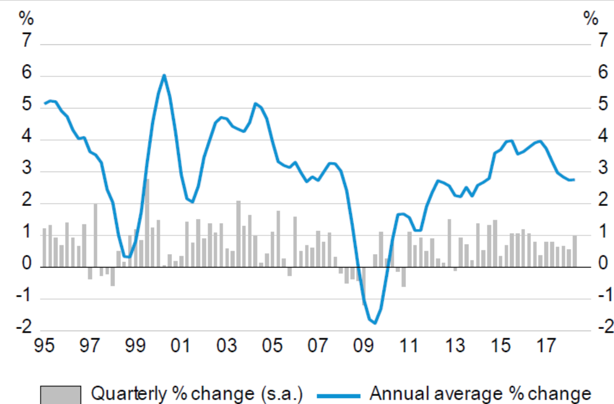
Reading the tea leaves is hard and often futile. What we do know for sure, through many cycles in economies and markets, is that investors with long term horizons get amply rewarded for bearing equity market risk (See Credit Suisse Global Investment Returns Yearbook, 2018). As an illustration, Figures 5 shows that over the short-term returns are very volatile, and the weak December quarter is not statistically unusual in this respect. What the figures also show is that as equity holding horizons are increased equity returns are more stable and offer a more certain premium to cash. We also know that often the strongest equity market returns are experienced in the depths of a so-called 'bear market'. We have no reason to believe this time will be any different.

**Figure 1: US wages on the up**



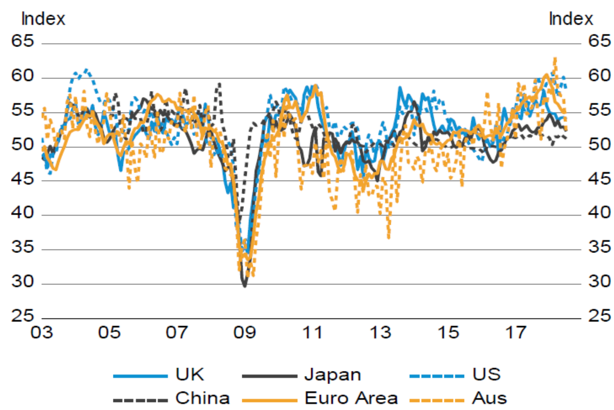

Source: Haver Analytics, DB Global Research

**Figure 2 NZ GDP around trend**




Source: Statistics New Zealand

**Figure 3: Global purchasing manager indexes are still expansionary**




Source: NZ Treasury, Haver Analytics

**Figure 4 Global growth expected to revert to trend levels**

| GDP growth (%) | 2017 | 2018 | 2019F | 2020F |
|---|---|---|---|---|
| Global | 3.8 | 3.8 | 3.6 | 3.5 |
| US | 2.2 | 2.9 | 2.7 | 2.1 |
| Eurozone | 2.5 | 1.9 | 1.4 | 1.3 |
| Germany | 2.2 | 1.6 | 1.3 | 1.4 |
| France | 2.3 | 1.6 | 1.4 | 1.3 |
| Italy | 1.6 | 0.9 | 0.7 | 0.9 |
| Spain | 3.0 | 2.5 | 2.4 | 2.1 |
| Japan | 1.9 | 0.7 | 0.7 | 0.2 |
| UK | 1.7 | 1.3 | 1.6 | 1.4 |
| China | 6.9 | 6.6 | 6.3 | 6.0 |
| India | 6.2 | 7.5 | 7.0 | 7.6 |

Source: DB Global Research

## Figure 5: Long term equity market investors are well-rewarded

**US Equity Returns since 1972 over different holding periods**

S&P 500 Total Return Index

80%
60%
40%
20%
0%
-20%
-40%
-60%

1 Year
3 Years
5 Years
7 Years
10 Years

The 'box and whisker' charts in this figure illustrate the distribution of equity returns over different time horizons. The average returns are shown by the X marks. The edges of the yellow boxes show the range of outcomes occurring between 25% and 75% of the time. The vertical lines extending outside the yellow boxes show the worst 5% and best 95% of outcomes. Finally, the yellow dots show 'outliers' outside of the 95% range of outcomes.

Source: Morningstar Direct, MyFiduciary

**Disclosure:**

The information contained in this report is given in good faith and has been derived from sources believed to be accurate. However, neither IWIinvestor (Taupō Moana Investments Limited) and its associated companies nor any of their employees or directors gives any warranty of reliability or accuracy nor accepts any responsibility arising in any other way for errors or omissions.