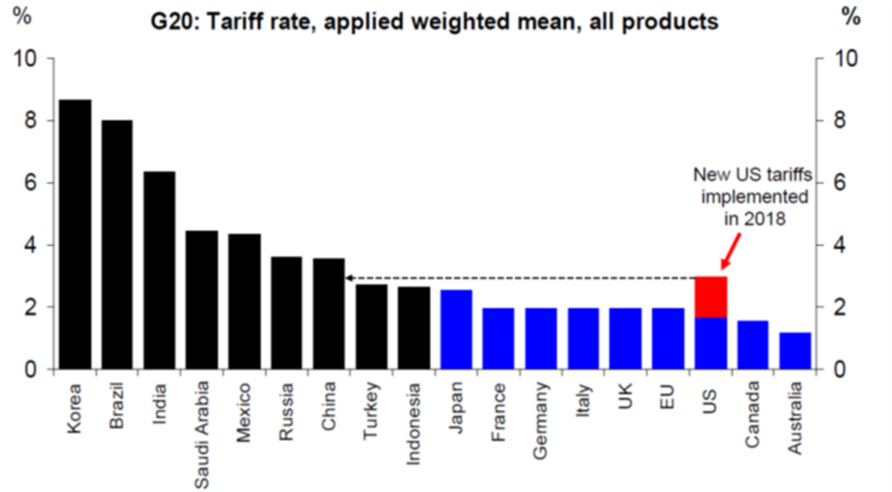
IWIinvestor Investment Report:

Markets Summary, Quarter End - September 2018

The pace of global growth remains strong and is expected to remain above trend levels according to the IMF's latest update, despite clear escalation in the Trump Administration's trade war. US tariffs are now higher than all other developed economies and approaching levels in Russia and China (figure 1). Despite this development, US GDP for the June quarter was 4.2% (annualised), the strongest reading in over four years. New Zealand GDP was also strong at 4% (annualised), or twice the pace expected by the Reserve Bank of New Zealand. NZ business confidence also modestly rebounded from the funk it has been in since the election.

Figure 1. US Tariff rates highest in the G7



Source: World Bank, Haver Analytics, DB Global Research

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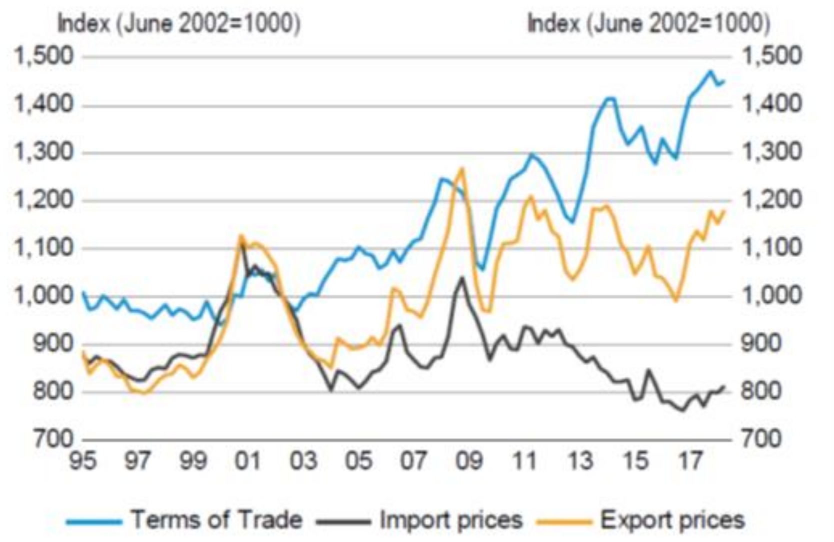
Given the strong NZ data, markets backed off from the view that our economy is rapidly slowing, and that the RBNZ may need to cut future interest rates. This change in view arrested the decline in the NZ dollar over the month of September, although over the quarter our currency is still around 4.5% lower against the USD, and over the year it is 8% lower.

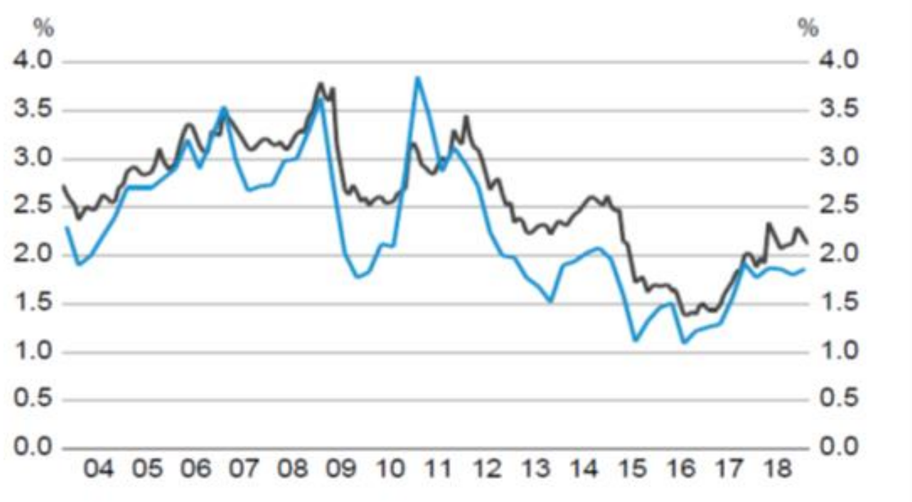
At present levels the RBNZ estimates that our exchange rate is in the 'goldilocks zone' that supports exporters and household spending and keeps our trade balanced. Through this lens the Kiwi should stay put. But should is not the same as will – no one knows for sure where the currency will go from here. On the plus side, our terms of trade are at record highs, which argues for a higher currency level (figure 2). Inflation and expectations is now around target levels (figure 3) and increasing, which may force the RBNZ off the fence.

Figure 2. Terms of trade argues for a higher NZ dollar



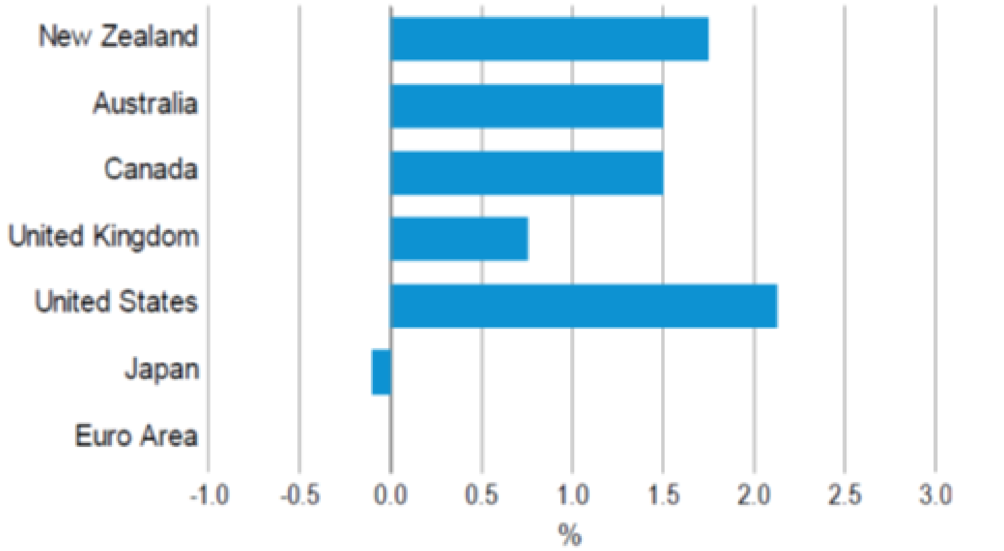
Source: Statistics New Zealand

Figure 3. NZ inflation expectations back on target



Source: Statistics New Zealand

Figure 4. US short term rates lead the pack



Source: New Zealand Treasury Monthly Economic Indicators

But against this is the fact that US cash rate are now 2.25%, well over our 1.75% overnight cash rate (figure 4). This is quite unusual from a historical perspective, where typically NZ short term rates are at least 1% higher than the US. Higher US rates favour currency speculators selling (shorting) the NZ dollar to buy US dollars, which could cause our currency to fall further.

Market Performances

Regardless of where the currency goes from here one thing that is clear is that the decline in the NZ dollar has very much flattered the return from offshore equities and property (held on an unhedged basis).

Over the quarter developed international equity returns were solid, with the MSCI global equity index returning around 5% in USD terms and 7.5% in NZD terms. Over the year returns have been an impressive 21.5% (the highest return amongst major indexes covered), but 'only' 11.5% in local currency terms. The MSCI NZD hedged index return was around 13.3%.

NZ equities had a strong quarter, increasing 4.6%. This brings the annual return to around 18% and the return over the past 3 years to around 18.7% - one of the strongest global performances in markets over this time frame. The Aussie market also had solid quarter, bringing the return to around 14.5% on an annual basis.

In contrast to developed markets, emerging markets fell slightly in the quarter (although they mildly increased in NZD terms and are up around 8% year to date). While EM economic growth, in general, remains robust, EM equities face several headwinds - capital outflows as the US has tightened interest rates, concern over rising trade tensions (hitting the Chinese market in particular), and instability in some economies such as Turkey and Brazil. The silver lining to this is that with the soft performance EM equities are now seen as very good value, particularly compared to the high-flying US equity market.

Within global and Australian equities small caps underperformed in the quarter, although the small cap indexes have considerably outperformed over a one, three and five-year horizon. In contrast the MSCI global value index underperformed in the quarter, continuing the relatively poor run that value has had over the past decade.

Turning to property markets, REIT indexes covered were all up in the quarter. Global REITs returned around 2.5% (in NZD terms), Australian REITs returned 2% and NZ REITs were strongest at 4.6%. Over the year, however, global and Australian REITs have outperformed NZ REITs in NZD terms.

NZ investment grade bonds returned around 1.5% for the quarter and 4.8% 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. The Bloomberg Barclays aggregate global bond index is currently around 2.6%.

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