PHWM Spring Update

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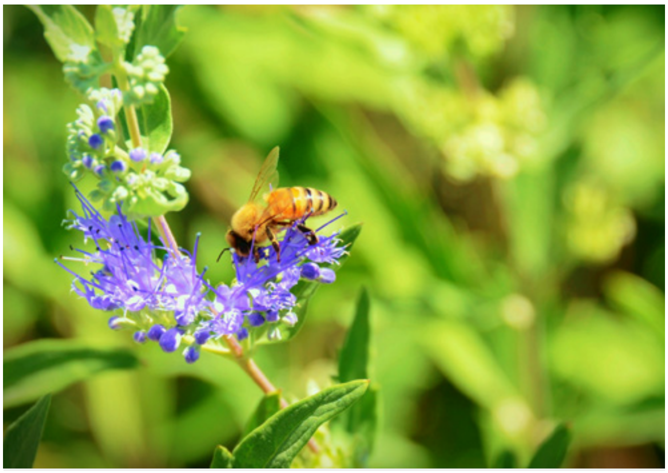

Diversified portfolios continued their resurgence during the third quarter of 2018 with another three months of solid gains.

As usual, these good returns were delivered in an international environment that looked anything but stable. Included in the melting pot of issues that surfaced during the quarter were heightened US trade tensions (with both China and Canada), emerging market strains in Turkey and Argentina, political instability in Australia generating their fifth prime minister in five years, and a US Supreme Court nomination process that further widened the political divide in America.

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It might be tempting to think that, if we knew all of this in advance, we might have avoided global equities for the quarter because that backdrop couldn't have been conducive to good equity market returns. Unfortunately, as logical as that may sound, it's also entirely wrong.

Global developed market equities delivered the best asset class returns for the quarter, which continues to make a lie of the idea that there is any reliable link between negative news events and investment outcomes. As we have noted many times in the past, if we'd let negative news flows dictate our investment strategy, it would have meant sitting on the sidelines for most of the last decade and missing out on some outstanding returns.

The New Zealand share market has been at the forefront of these good returns. In fact, over the last decade (October 2008 to September 2018, which includes the tail end of the Global Financial Crisis) the New Zealand share market[1] delivered an annualised return of 13.1% p.a. This has been one of the best single equity market returns in the world over this ten year period.

By way of comparison, the Australian share market[2] delivered 7.7% p.a., the main USA market[3] returned 12.0% p.a. and the emerging markets[4] (in aggregate) delivered 8.0% p.a. over the same timeframe.

After such an extended period of strong performance from the New Zealand market we need to be wary of becoming a little bit complacent. It's human nature that, the more we get accustomed to the market going up, the more we tend to expect it to go up next month as well. However, the recent run of great results tells us very little about where the local market may go in the future.

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In a slight break from tradition – as far as these quarterly articles go – we thought it might be useful to devote a little bit more time to assessing conditions in our own back yard.

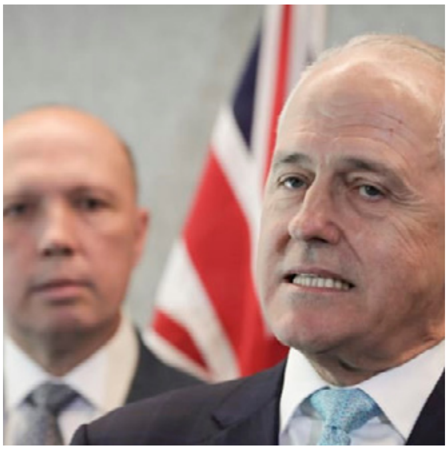
The Reserve Bank of New Zealand (RBNZ) surprised markets in their August monetary policy statement by moving back the projected start date of any interest rate hiking cycle by a full 12 months (into 2020). In addition, they published an alternative scenario that would actually see them cutting the Official Cash Rate by as much as 1% if future growth disappointed. With both a new Governor (Adrian Orr) and a new Policy Targets Agreement now in place, this communication illustrated the RBNZ's willingness to use the full width of its mandate, and its 1 - 3% inflation target range, to promote growth.

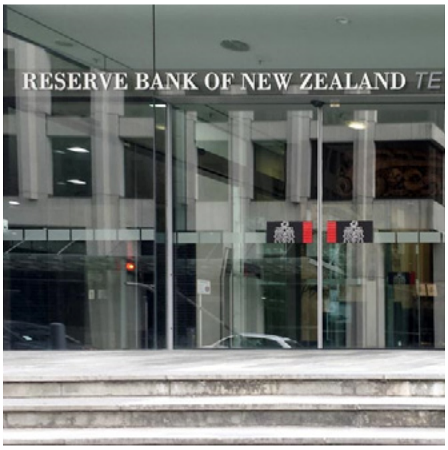
One of the motivations for the RBNZ taking this stance, including signalling the chance of interest rate cuts, was the recent fall in business confidence. While the initial reduction in confidence indicators immediately following the 2017 general election could have been dismissed as a political hangover, the more recent fall in mid-2018 cannot be brushed aside quite so easily, and it implies the prospects of a slowdown in economic activity may be increasing.

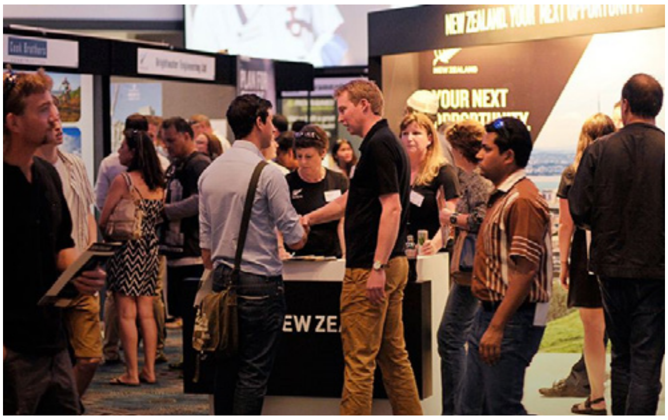
This would not be a great surprise given the mix of economic activity in New Zealand is clearly changing. It has been more evident in recent months that we are seeing a moderation in business' own activity surveys, a slowdown in the housing market, a reduction in net migration, tighter credit conditions in the banking sector, and capacity pressures which are constraining important growth sectors like construction and tourism.

In spite of all this, in late September Statistics New Zealand released the second quarter GDP growth figures, and these came in above expectations. In August the RBNZ projected a 0.5% result, while estimates from bank economists ranged from 0.7% to 1.0%. On this occasion it was the bank economists who won out, as the number came in at 1.0% for the quarter. This outcome (a 4.0% annualised rate) indicates a much brighter picture than the confidence indicators would otherwise have us believe. The caveat is that low confidence today reflects expectations about the future, whereas the growth announcement in September only confirms activity levels in the past. If the future does result in reduced activity and output, it will only be future GDP announcements that will capture this.

Time will tell whether today's low business confidence turns out to be prescient or whether, as Finance Minister Grant Robertson would like us to believe, business leaders are simply continuing to cry wolf. Perhaps the government should just take solace from the bond market, which appears to be far less concerned with future risks. This year, for the first time in 25 years, the yield on ten year New Zealand government bonds moved below the comparable yield on ten year US government bonds. Even if that proves to be unsustainable over the longer term, it represents quite a vote of confidence.







Looking back over the quarter the New Zealand share market[1] delivered a healthy 4.9%, comfortably beating neighbouring Australia[2], which returned 1.5%. Internationally there were generally strong returns coming from developed equity markets, propelled by the USA[3] with a 7.7% return for the quarter. Emerging market[4] countries generally provided a less reliable source of returns, advancing only 0.1% for the quarter in aggregate, with enduring concerns about China's trade war with the USA continuing to weigh heavily.

Property returns also varied by region. Domestically, with the prospect of lower interest rates for longer, the New Zealand listed property sector[5] rose 5.9%. After a very strong second quarter, international listed property securities[6] delivered only a flat return following a continuation of US interest rate rises in September.

With the RBNZ effectively benching the idea of New Zealand interest rate rises any time soon, bond yields in New Zealand generally drifted lower during the quarter, which was good for local bond returns. This was reflected in the performance of the New Zealand Corporate A Grade Bond Index[7], which gained 1.3%. The reverse was true internationally where ten year bond yields in the USA, Germany, UK and Japan all crept higher over the quarter, acting as a temporary headwind in those bond markets. As a result, the returns of the World Government Bond Index[8] and the Global Aggregate Bond Index[9] were both relatively flat for the quarter.

With local and international yields moving in opposite directions, it can be more challenging for bond investors to identify a sensible long term strategy. What investors need to keep in mind is that, when interest rates go up, the value of existing bonds goes down. While that may have an immediate impact on the short term returns of those bonds, it also means your expected future return from those same bonds goes up (because the yield on the bonds is now higher). The reverse is true when interest rates fall - the value of existing bonds goes up, but the expected future return from those bonds goes down (because yields just got lower).

Unless you have a strong view about the timing and direction of future interest rate movements (something that even central banks around the world struggle with), it generally means that selecting your bond exposures based on what has outperformed in the recent past could easily be a flawed strategy.

When we step back from a review of the individual asset class returns over the quarter, what we see more than anything else is a reconfirmation of the benefits of prudent diversification.

The New Zealand market has experienced a great ride over the last decade and portfolios that have had an appropriate exposure to New Zealand assets have benefitted as a result. But economic good fortune is not a constant. The global marketplace, interest rates, inflation, government policy and political ideology all can and do change over time. When that change impacts parts of your portfolio in ways you did not necessarily predict or anticipate, it is diversification – assets that don't all behave in exactly the same way under the same set of economic conditions – that will carry your strategy forward.

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1 S&P/NZX 50 Index (gross with imputation)

2 S&P/ASX 200 Index (total return in AUD)

3 S&P 500 Index (total return in USD)

4 MSCI Emerging Markets Index (gross dividend in local currency)

5 S&P/NZX All Real Estate Index (gross with imputation)

6 S&P Developed REIT Index (gross total return in USD)

7 S&P/NZX A-Grade Corporate Bond Index

8 FTSE World Government Bond Index 1-5 Years, hedged to NZD

9 Bloomberg Barclays Global Aggregate Bond Index, hedged to NZD

Key market movements for the quarter

+4.94%

New Zealand shares

The NZX 50 delivered another strong performance in the September quarter, returning 4.94%. The majority of companies within the index saw their share prices advance. This was led by medical distribution company Ebos and health services provider Orion Health, with both firms gaining +27% in the quarter. Several of New Zealand's larger listed companies, including Fletcher Building and former market darling a2 Milk, disappointed by posting small negative returns. The laggard for the quarter was Sky Network Television, which fell -12.5% as competition from new age streaming services providers like Netflix and Lightbox continues to disrupt their subscriber base. *Source: S&P/NZX 50 Index, gross with imputation credits*

+1.29%

New Zealand fixed interest

Reserve Bank Governor Adrian Orr extended the 'no change' streak to 13, by keeping the Official Cash Rate on hold at 1.75% in both the August and September updates. In September, the prospect of interest rate rises was pushed out until 2020, and, in line with the new Policy Targets Agreement, Orr even outlined a scenario where interest rates could fall if future GDP growth rates disappointed. This softening in outlook, coupled with ongoing muted inflation pressures, helped contribute to New Zealand's long term government bond yields drifting lower over the quarter. This proved beneficial for bond returns.
Source: S&P/NZX A Grade Corporate Bond Index

+5.86%

New Zealand property

The New Zealand property asset class outperformed the broader equity market by delivering a robust +5.86% return for the quarter. The prospect of lower interest rates for longer in New Zealand played its part in helping maintain positive sentiment towards the sector. The seven largest listed property trusts delivered returns ranging from +3.35% to +8.16%, with Goodman, Precinct and Stride all delivering between +7.70% and +8.16%. *Source: S&P/NZX All Real Estate Index, gross with imputation credits*

+1.33%

Australian shares

After posting a stellar return in the second quarter of 2018, the Australian share market delivered a far more modest return in the third quarter, with the ASX 200 gaining +1.53% in Australian dollar terms. Gains were fairly evenly distributed across the market, with the largest 100 companies delivering an average return of +1.55% and the small ordinaries (companies ranked 101 to 300 by size) delivering +1.10%. The best performing sector by far was communication services with a +25.29% return. This was propelled in no small part by a +23.11% recovery in the price of Telstra. Reported returns to unhedged New Zealand investors were slightly reduced by the Australian dollar weakening by approximately 0.2% relative to the New Zealand dollar over the quarter. *Source: S&P/ASX 200 Index (total return)*

+5.62% *(hedged to NZD)*
+7.42% *(unhedged)*

International shares

The tone in global markets has remained relatively cautious, with trade tensions in particular creating a backdrop of uncertainty. However, global macroeconomic data, particularly in the USA, continued to paint a picture of solid actual economic activity running at or near expectations. The US Federal Reserve raised rates by another 0.25% in September, but this was so widely anticipated that, aside from a generally strengthening USD over the quarter, there was otherwise no discernible market effect. In fact, the S&P500 Index in the USA was one of the standout developed market equity performers in the third quarter, posting a gain of +7.71%, while the Japanese and French share markets also enjoyed good results. On the other hand, the German and UK markets were both slightly down. In the UK's case the lingering uncertainty around Brexit negotiations continues to act as a handbrake on UK equities. European banking stocks were generally weaker amid concerns over their exposures to emerging markets as well as worries over the Italian budget. *Source: MSCI World ex-Australia Index (net div.)*

+1.21%

Emerging markets shares

In USD terms the underlying emerging markets region posted a small negative return for the quarter (down -0.95%), but a weaker New Zealand dollar led to small reported gains to unhedged investors. US dollar strength and trade tensions continued to weigh heavily on the region and the Chinese share market in particular underperformed, as the US implemented tariffs on a total of $250 billion of Chinese goods. Thailand, on the other hand recorded a strong gain and was the best performing country within the emerging markets region, with energy stocks leading their local index to a double digit gain. The Mexican market was also a beneficiary, following their general elections and an agreement with the US and Canada on NAFTA negotiations.
Source: MSCI Emerging Markets Index (gross div.)

+0.18%

International fixed interest

Major government bond yields rose over the quarter due to positive economic data, particularly from the US. This outweighed a bout of safe haven demand in August caused by concerns relating to emerging market instability, trade tensions and political issues in Europe. The Federal Reserve implemented its third rate hike for the year, removing references to "accommodative" policy and striking an optimistic tone. The Bank of England raised rates by 0.25% to 0.75%, citing the weather as the cause of a weak first quarter. US 10 year yields rose from 2.86% to 3.06%, with Bund and UK gilt 10 year yields rising from 0.30% to 0.47% and 1.28% to 1.57% respectively. The rising yields provided a slight headwind to returns this quarter, with high quality sovereign bond indices generally returning low/flat returns. *Source: FTSE World Government Bond Index 1-5 Years (hedged to NZD)*

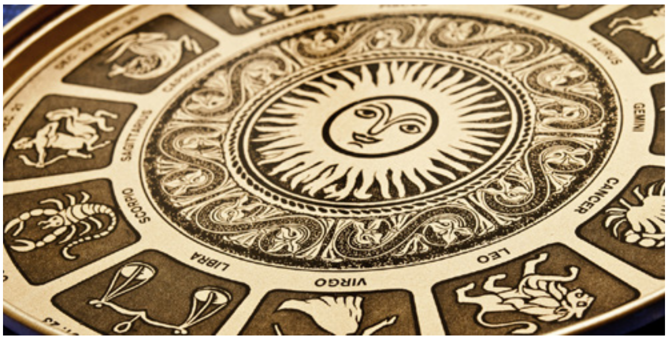
+2.49%

International property

A backdrop of slowly rising global interest rates saw international property stocks generally struggle to match the returns of broader equity markets. With risk assets and, in particular, US equities back in favour, the greater defensive attributes of property took a back seat for the quarter. The S&P Developed REIT Index gained +0.31% in US dollar terms and the S&P/ASX 300 A-REIT Total Return Index gained +1.98% in Australian dollar terms. A relatively weak New Zealand dollar further enhanced reported returns to New Zealand investors holding unhedged investments in this asset class.
Source: S&P Developed REIT Index (total return)

All returns are expressed in NZD. We assume Australian shares and international property are invested on an unhedged basis, and therefore returns from these sectors are susceptible to movement in the value of the NZD.

Share market forecasting about as useful as astrology



Not long after Ronald Reagan's tenure as US president, chuckles were heard around the world when word got out that his wife Nancy sought an astrologer's guidance for all manner of things during his presidency, including matters of diplomacy, Cold War politics, and even the timing of the president's cancer surgery. People were flummoxed to think that momentous issues were influenced by an astrologer's musings.

However, belief in the magical ability of some people to foretell events isn't confined to the political world. A form of it, albeit a much more sophisticated variant, exists in the investment world – forecasting.

Before anyone says that it's unfair to place market forecasters in the same bucket as astrologers, have a look at this - 1 January 2012, Otago Daily Times forecast "a middling year" for New Zealand's share market.

So, what actually happened? The NZX50 index rose 24% that year. So much for a middling year!

A look through market forecasts in any newspaper, in any year, will throw up many such examples; headlines and forecasts that generated hullabaloo, but later proved to be way off the mark.

More recently, in January 2017, *Noted* wrote that "the easy gains for [New Zealand] share investors appear to be over." Last year, the NZX50 index rose 22%. National Business Review predicted "the end of the golden run" in early 2016. That year, the NZX50 index rose 9%.

The New Zealand market isn't the only one that has surprised. In 2017 forecasts for markets in the USA, UK and Australia all defied predictions. Emerging markets also challenged gloomy predictions by posting substantial gains.

Looking back is always illuminating. If there is one lesson to be learned, it is that forecasters rarely get it right.

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Are forecasters to be ignored?

It is true that, in early 2017, share market valuations were high and there was a great deal of uncertainty surrounding the new Trump administration. It's always wise to be aware of factors that can influence markets, both positively as well as negatively.

But remember that share markets are efficient – all publicly available information, whether optimistic or pessimistic, is already reflected in prices.

Most economic models use a range of assumptions and point to a range of future possibilities, which generally means, the more precise the forecast, the more likely it is to be wrong. That kind of nuance isn't easy to report.

And that is largely because of the unforeseen. Risk, in other words. This is the price of investment and, in fact, of life. Humans, as a rule, aren't comfortable with facing this uncertainty. It is much easier to hone in on what look like specifics and certainties.

Yes, there are unexpected calamities, but don't forget that the unexpected can be a positive. Not only that, but seemingly bad news can boost markets. A bad earnings result can see a share market gain, if the result was not as bad as had been expected. A feared piece of economic news can result in an upturn if the statistics, which had already been priced in, were not as dire as predicted.

Should an astute investor dismiss all forecasts and commentary as simply noise?

It's wise to be aware of market concerns. It's important to assess the amount of individual risk you're comfortable with. It's folly to be swayed by forecasts.

Certainly, it would be foolishness to exit your investments on the basis of forecasts which may never come to pass. Instead, take the challenge of carefully designing a portfolio which is robust enough to ride out an unexpected downturn and optimistic enough to take advantage of unexpected gains.

The only certainty about the future is that is it uncertain. What we can be certain of, though, is that a shrewd and well planned investment strategy sure beats relying on forecasting or astrology.