PHWM Winter Update

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The second quarter of 2018 was predictably unpredictable. Diversified investment portfolios bounced back from a weak first quarter by posting useful gains across the board.

You would be forgiven for thinking that these improved returns were the result of an improving economic/political/market environment. But when we look at the headline events through the quarter, it is difficult to conclude that was the case.

Globally, aside from the royal wedding (which shouldn't have an impact on markets), the two biggest events over the last three months both involved Donald Trump.

The first was the stop/start build up to the historic nuclear summit in Singapore on 12 June between North Korean President Kim Jong-un and The Donald. It was historic because there had never before been a meeting between the North Korean and US leaders.

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As to its actual significance, only time will tell. The world watched on while the two leaders met and hoped that some significant commitments and concessions might materialise. Unfortunately, analysts were almost unanimous in their disappointment that the one page signed 'agreement' made no undertakings that North Korea hasn't previously made and reneged on, and was virtually devoid of meaningful detail.
It was probably unrealistic to have expected the Singapore summit to deliver a giant step forwards, so perhaps - for now at least - we just need to take comfort that it didn't appear to result in a giant step backwards either.

The second event which bubbled away throughout the quarter was the escalating rhetoric surrounding trade sanctions between USA and China. With the next round of tariffs and retaliatory tariffs set to take effect in early July, it remains entirely unclear about how this will all eventually play out and what impact it may yet have on the global marketplace. Given Trump's public statement that "trade wars are good and easy to win" and his modus operandi of generally brushing aside any conflicting legal or public opinion, we should assume this story will stay in the headlines for some time to come. But then again, Trump is Trump, and doing a deal and ending this escalation is also still a possibility, even if it seems rather remote right now.

Should we be concerned by this looming trade war? Right now, not particularly. Initially at least, New Zealand will be well insulated from the emergence of targeted sanctions between foreign countries. However, like any war, the concern is whether we eventually get exposed to any of the crossfire. If it expands and extends over a long period of time and begins to impact global trade practices more generally, then New Zealand won't be immune from some impact, but it is way too early to start hoarding guns and butter just yet.

What will be interesting from an economic and political perspective is how long it will be before one side – potentially the US – blinks. The Chinese tariffs and even many of the US tariffs will negatively impact US businesses, and as we saw with the inhumane US border policy of separating children from their parents, even Trump can't stand in the way of a hurricane of negative opinion forever.

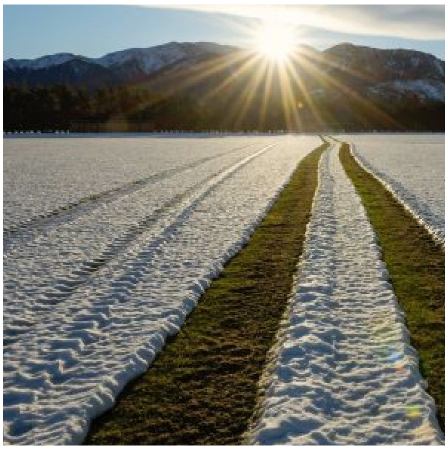
But in the meantime, you've probably heard it said that markets generally don't like uncertainty. What that means is that, when the future looks unclear, investors can lose confidence that the price they might pay for something today will still be considered a fair price in a week, or a month, or a year, and that can lead to a temporary reluctance to invest in risky assets. Therefore, in uncertain times, market prices can often come under pressure. Of course, as we know, the future is ALWAYS unclear, mainly because it hasn't happened yet! So, whether or not a trade war will escalate and whether or not it will impact us, is just added to an already very long list of events that will unfold in the future in ways that we cannot hope to accurately predict today.

And in that context, the market is signalling it's not getting overly anxious. Information about the pending trade war has already been circulating for a number of months and global equity markets over the last three months generally continued to go up, with the MSCI World Index gaining +3.78% from April to June. Notable country results (with returns all reported in local currency terms) came from USA +3.55%, UK +9.40% and France +5.67%, while the German market delivered +1.79%.

Emerging markets countries weren't as resilient overall, with winners being outnumbered by losers this quarter. At least part of the reason can be attributed to a strengthening US dollar. A stronger US dollar is generally regarded as a negative for these regions, because global investment capital tends to flow towards the US when the dollar strengthens, and the local emerging market cost of US dollar denominated debt also increases. The MSCI Emerging Markets Index returned -3.41% for the quarter. India was the pick of the major players returning +4.42%, however, China's greater market size meant its -3.43% had a bigger impact on the performance of the index.

Australasian markets fared considerably better, with the NZX 50 gaining +7.68% and the ASX 200 (in AUD) advancing +8.47%.

At first glance New Zealand's strong result seems at odds with business confidence, which has become entrenched at very low levels since the 2017 election. It also implies that other well publicised factors, like the spread of mycoplasma bovis amongst domestic cattle herds, the softening in the domestic construction industry and the easing in net



migration numbers, are not immediate causes for concern either. At least with mycoplasma bovis that appears to be true, as there are no food safety risks attached to the disease. However, the government's planned eradication programme is expected to have an economic cost of at least $1 billion over the next decade.

More pertinent to our local equity market performance is that our major export prices remain strong (Fonterra is projecting its highest milk payout since 2013/14), unemployment at 4.4% is at its lowest since December 2008, and the budget announcements increasing government spending on social and infrastructure initiatives (such as KiwiBuild) are anticipated to be stimulatory.

Local property assets moved in line with the broad New Zealand equity market by returning +6.31%. Demand was underpinned by the Reserve Bank maintaining the Official Cash Rate at 1.75%, and reinforcing this is unlikely to change for some time.

Internationally, property assets were the surprise winners over the quarter, with the S&P Developed REIT Index gaining +6.99% in US dollar terms and the S&P/ASX 300 A-REIT Total Return Index gaining +9.82% in Australian dollar terms. For unhedged New Zealand investors, a weaker New Zealand dollar lifted these reported returns even further.

These gains occurred in spite of the US remaining firmly in a rate tightening cycle. In part we view this as a continuation of the 'catch-up' for the asset class after a poor December to February period, when international property fell by over 10%. We also attribute some of the improving sentiment in June to the growing realisation that threats of trade war escalation were not disappearing any time soon, and that property may have appealed as a slightly safer harbour.

Global bonds delivered a largely flat result. Interest rates in the US moved higher on the back of another 0.25% interest rate hike in June, and the Federal Reserve continued to forecast five further hikes before the end of 2019. Elsewhere the interest rate environment was generally more benign, with shorter duration and higher credit quality securities tending to perform best. By quarter end, the FTSE World Government Bond Index 1-5 Years (hedged to NZD) gained +0.25% while the Bloomberg Barclays Global Aggregate Bond Index (hedged to NZD) returned +0.19%.

It was business as usual for the local bond market. The S&P/NZX A-Grade Corporate Bond Index and the S&P/NZX NZ Government Bond Index gained +1.10% and +1.06% respectively.

All in all, it was another good quarter for investors following a long term diversified strategy. The still improving global growth environment continues to provide support to equity markets and it is tangible factors such as this, along with low inflation and low interest rates, which encourage businesses to invest and expand.

The less tangible factors, like threats of a trade war, don't have such a direct or immediate impact, but they often cause us to stop and ask the "what if" questions... What if it continues to escalate and expand? What if New Zealand gets caught in the crossfire?

But in investing, as in life, you shouldn't succumb to the uncertainty of the what if questions. Otherwise, we would never cross the road, never get on an aeroplane, never swim in the ocean and never eat adventurous food.

What you should do is be aware of the risks, mitigate them as much as you can and then get on with living. Or, in our case, get on with investing.

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Key market movements for the quarter

+7.68%

New Zealand shares

The NZX 50 returned to its winning ways in the June quarter, returning 7.68%, its highest return since the fourth quarter of 2015. This was in spite of the largest constituent, a2 Milk, declining -7.6% following an announcement of projected revenue increase of 'only' 67% for the year ending June, when the market was expecting more. An extension and increase to its supply deal with Synlait (who advanced +36% in the quarter) helped limit a2's correction. Other winners in the quarter included Fletcher Building, Ryman Health and Fisher & Paykel Healthcare. Conversely, Air New Zealand was slightly down on the back of an increase in fuel prices. *Source: S&P/NZX 50 Index, gross with imputation credits*

+1.10%

New Zealand fixed interest

With Adrian Orr picking up from where his predecessor left off, the RBNZ maintained the Official Cash Rate at 1.75% in both May and June. This extended the streak to 11 consecutive announcements of no change. Inflation remained subdued, and the Reserve Bank continued to reinforce their stance of a low likelihood of a change in interest rates in the near term. Long term government bond yields in New Zealand remained in a tight band through the quarter, oscillating between 2.7% and 3.0%. Overall, this resulted in asset class returns broadly in line with expectations. *Source: S&P/NZX A Grade Corporate Bond Index*

+6.31%

New Zealand property

The New Zealand property asset class delivered a robust +6.31% return, only slightly underperforming the broad equity market. Goodman and Stride both returned above 9%, with Argosy not far behind. Of the six largest trusts only Vital was down in the quarter, and is now down -7% year to date. All others in the top six are positive year to date, as is the overall index, which is up +2.35%. *Source: S&P/NZX 50 Index, gross with imputation credits.*

+11.53%

Australian shares

The Australian share market posted a large gain for the quarter with the ASX 200 advancing an impressive +8.47% in Australian dollar terms, easily reclaiming the losses from the first quarter. Large capitalisation companies fared best, with the S&P/ASX 100 advancing +8.45% versus +7.67% for the S&P/ASX Small Ordinaries (both returns in Australian dollars). Returns to unhedged New Zealand investors were further enhanced by the Australian dollar strengthening by almost 3% relative to the New Zealand dollar over the quarter. The best performing sectors included energy, healthcare and consumer staples. Telecommunications was significantly down amid uncertainty surrounding the nationalisation of the Australian broadband network, which weighed heavily on Telstra in particular. *Source: S&P/ASX 200 Index (total return)*

+3.70% (hedged to NZD)

+8.46% (unhedged)

International shares

Economic data and earnings announcements across developed nations were favourable, with solid corporate earnings growth and US unemployment at an 18 year low. In spite of a backdrop of geopolitical unease, this asset class performed well. As was widely anticipated, the US Federal Reserve raised interest rates by 0.25% in June, while the European Central Bank announced their rates will remain unchanged for the next year. The UK was the pick of developed nations, with foreign inflows helping drive prices higher. This was supported by a weakening of the GBP after the Bank of England decided against what was a largely expected rate rise in May. Overall Europe was positive, although Italian equities were down amid a fresh round of political concern. Japan was mildly positive, due in part to a relatively weak yen. *Source: MSCI World ex-Australia Index (net div.)*

-1.68%

Emerging markets shares

Emerging markets shares was the only asset class to deliver a negative return for the quarter, declining -1.68%. Increased trade tensions led to export concerns for many emerging markets nations. China was the focus of many of the proposed US tariffs and led the index down, although it was not the worst performer. That mantle was held by Brazil, which was crippled by a truck driver strike and fuel shortages, both of which severely impacted output. Korean equities were down sharply even with positive geopolitical developments on the peninsula, including visits by Kim Jong-un to both South Korean president Moon Jae-in and US president, Trump. Of the other main emerging markets countries, Taiwan was down while India, Russia and South Africa managed gains. *Source: MSCI Emerging Markets Index (gross div.)*

+0.25%

International fixed interest

In June the US Federal Reserve increased interest rates by 0.25% (the target range is now 1.75 – 2.00%). This was again highly anticipated, and the Federal Reserve is projecting two further rate hikes this year and three for 2019. This outlook helped push the US ten year treasury yield momentarily above 3% to a seven year high, although late in the quarter this yield settled back at 2.86%. Overseas, yields were generally more stable. Corporate bonds were generally negative contributors during the quarter, as were longer dated securities, but the shorter term global government bond index delivered a small gain.*Source: FTSE World Government Bond Index 1-5 Years (hedged to NZD)*

+14.16%

International property

Even with rising interest rates, global property assets delivered an impressive +14% return for the quarter. This was its strongest quarter since 2009, and is a good reminder of the benefits of diversification. This performance was partly driven by an apparent investor rotation into more defensive sectors late in the quarter. The S&P Developed REIT Index gained +6.99% in US dollar terms and the S&P/ASX 300 A-REIT Total Return Index gained +9.82% 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.

Longevity's impact on retirement planning

Across the industrialised and non-industrialised world, humans are experiencing greater longevity. This includes New Zealanders.

For instance, a female child born in New Zealand this year will have an average life expectancy of around 83 years, and a male child, around 80 years. Compare this to a child born in the mid-1950s, who would have had a life expectancy at birth of 73 years (female) or 68 years (male) You can also see from those figures that the gap between men and women is closing.

Over time life expectancy has increased as we push out the maximum age. However, it's possible there's only so far that can be pushed. Some think 115 is the maximum. Medical advances, environmental factors and so on, are allowing more of us to live to an older age, but are not necessarily changing that maximum figure itself. This means that more of us will live well into our 80s, 90s, or even past 100, but it doesn't necessarily mean we'll all be living to 120 and beyond.

In the first half of the 20th century, when most of the old age social benefits started to emerge, they began to take effect at an age close to or beyond average life expectancy. In many cases work was hard on the body, and retirement wasn't really a time people looked forward to for the opportunity it offered, as much as a time when the body was no longer capable of doing work.

For many of us now the nature of work itself has changed. We work in ways that stimulate the mind, but less so the body. When we get into our 60s and 70s we might, in fact, be at the top of our job knowledge and capability. Our bodies haven't worn out - and our jobs don't tax our bodies in the way they used to, at any rate – and our minds are sharp.

It is a perfectly reasonable situation for someone, in that case, to continue to work and enjoy the purpose that it brings to their life.

All of this has a lot of implications for the work we do as financial advisers.

1. **We need to plan for long life expectancy.** Basing your life expectancy on the age your parents or grandparents lived to might not be as good a guide as it has been in the past.
2. **People want to work longer.** Many clients want to know that work is optional, but that doesn't mean they want to stop working as soon as they reach 65. Increasingly, we see that they want flexibility to enjoy their work. Financial planning is increasingly an exercise of exploring the possibilities, and weighing up the priorities to hit the balance between spending, working and enjoying life free from financial worry.
3. **There's a need for a post retirement plan.** Given the change in the types of work done, it's very likely many reach retirement age with the better part of 30 years ahead of them, with both mind and body in good health. Retirees need to think about how they will enjoy that time in ways that are interesting and fulfilling. This is as important a consideration as the financial side of things.

Overall, what we see is that retirement isn't the milestone in life it once was. We expect that new careers, community involvement and impactful philanthropic work will increasingly be the things our clients are talking about in their 60s and 70s.

Our purpose as an adviser is to help you use your wealth to enjoy these years to the fullest. That means offering comprehensive but flexible planning, insuring that you fully understand your choices and guiding you towards the ones that best meet with your values, priorities and purpose. It also means planning, to the greatest extent possible, for you to be around a while, not only because we hope you are, but because it's also increasingly likely.

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1. https://www.stats.govt.nz/topics/life-expectancy
2. http://www.nature.com/nature/journal/v538/n7624/full/nature19793.html