Economic Commentary

December 2019

The November quarter has proven to be a solid one for investors. Markets have continued the trend from the first half of the year, generating good overall returns despite headwinds which have continued to produce volatility. Perhaps more than ever, the key tool in smoothing this volatility is ensuring that portfolios are well diversified – across geographical areas, asset classes, industries, and currencies. Over the quarter, international share markets have outperformed the Australian and NZ markets. The NZD strengthened significantly in November against the AUD after the Reserve Bank decided to hold interest rates, and this has impacted portfolios in the short-term.

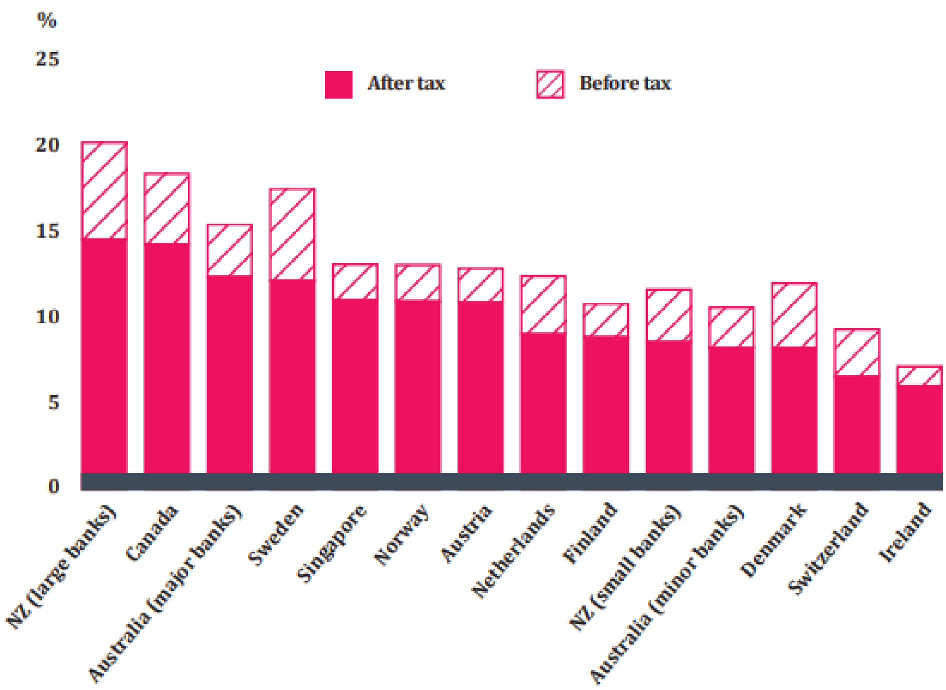
International markets have continued to move around based on geopolitical news and economic data. The US and China have made some progress toward "phase one" of a trade agreement, and this may be signed in the next few weeks. If so, the US would drop the upcoming tariffs on $160 billion in goods from China, which were due to take effect in mid-December. In return, China would increase their purchases of agricultural products from the US. The rural sector is a major base of support for President Trump and has been one of the most affected parts of the US economy from the trade war, so there is additional motivation for the deal to go through prior to the US election year in 2020. President Trump has been particularly concerned about US share market movements and seems to view it as a survey on his own performance (which is why he continues to harass the US Federal Reserve to reduce interest rates, as falling rates will support asset prices). Even if the "phase one" deal is signed and the trade tensions settle for the meantime, the ongoing arm wrestle between the US and China is a long-term reality.

There have been some significant developments in the UK around Brexit over the last couple of months. A general election has been called for December 12 to try to resolve the issue once and for all. Should the Conservatives be returned with a stronger majority and a more pro-Brexit caucus, there is a greater likelihood that the deal will pass and there will finally be some certainty for businesses to invest and plan ahead. If, on the other hand, Labour is elected or there is a small majority for the Conservatives (e.g. coalition government), it is impossible to see how the whole fiasco will play out. There are also major implications for the Pound, which against this backdrop continues to be weak compared to historical rates (at time of writing, the NZD/GBP cross rate is around 0.495c). If a deal is passed in the UK Parliament, the GBP will likely strengthen, which will be advantageous for any portfolio holdings denominated in Pounds. If the deadlock continues, there will be continuing weakness in the currency. Given that the direction is impossible to predict, we are avoiding any additional exposure to the Pound at this point.

The last couple of weeks have been busy for the Reserve Bank of New Zealand (RB), with announcements around Loan-to-Value Ratios (LVRs) and changes to bank capital requirements. These are areas in which the RB has imposed regulations on the major banks to support the stability of the financial system. The LVRs restrict the amount of lending that banks can offer against residential property at high debt levels. The current rules are that only 20% of a bank's total new mortgage lending to owner-occupiers can be at a level greater than 80% of the property's value. For investors, only 5% of new lending can be above 70% of the value. Despite some calls for these restrictions to be eased, the RB has decided to maintain them at the current ratios. The concern is that allowing the banks to extend greater amounts of credit to borrowers with low equity will leave the financial system exposed should we see a sharp decline in house prices, a lift in interest rates, or a major spike in unemployment. The level of personal debt in NZ is already high and compared to incomes we have some of the most elevated house prices in the world. Some commentators have argued that the LVRs are shutting first home buyers out of the market by requiring them to have a large deposit. This ignores the risk that a first home buyer assumes when taking out a large mortgage of (say) 90% of a property's value. If a recession hits, house prices fall by 20% and unemployment rises, that first home buyer could be left owing more to the bank that their property is worth, and with reduced income to service the debt. As Warren Buffett has famously said, "It's only when the tide goes out that you find out who has been swimming naked"!

More recently, the RB has announced a significant increase in the level of shareholders capital that banks are required to hold in their capital structure. Again, this is designed to improve the strength of the financial system by making the banks more resilient to any economic shocks (such as occurred a decade ago during the GFC). Holding more of their own capital will mean that banks have a greater buffer to absorb losses in their loan books. Since the review of the capital requirements were announced earlier in the year, there has been lobbying from the banking sector against the proposal on the basis that the NZ banks are already well capitalised. Of course, an increase in the requirement for shareholder's capital would likely hurt bank profitability, and there has been some argument that this will push up interest rates on home loans and reduce those offered on term deposits. As the below graph shows (see next page), the NZ banking sector is one of the most profitable in the world. There is some room for the sector to absorb costs from the new requirements and if these improve the strength of the system, we see it as a positive.

RETURN ON SHAREHOLDERS' EQUITY (2018 FINANCIAL YEAR)



Source: Reserve Bank of NZ

It is interesting to note that of the banking sectors in twelve countries covered in the graph, nearly all are generating a gross return on shareholder's equity of over 10%.

Our approach to portfolio management continues as it has done for some time. It is important that, despite the low interest rates and returns from fixed interest, the level of risk in investment portfolios is carefully managed to ensure that it remains appropriate for the investor's risk profile/capacity. This means ensuring the right balance between defensive and growth assets and avoiding the temptation to allow an increase in risk exposure in order to chase an improved yield. We will continue to focus on maintaining this balance, locking-in profits from market gains where possible and repositioning portfolios to ensure that they remain fit for the long-term.