Economic Commentary

January / February 2019

Financial markets experienced quite a significant correction from the beginning of October until Christmas Eve. Major stockmarket indices were down 10-15% over the three months, with the NZX50 gross index one of the "better" performers at -6%. Although portfolios have been exposed to this correction, the effects have been softened somewhat by our adopting defensive asset allocations over the last few years with greater weightings toward cash and fixed interest. January has seen more settled markets with a solid bounce back from previous lows. Unfortunately, the gains have been offset by the recent strength of the NZ dollar. This is likely to be a temporary effect as exchange rates fluctuate and there seems to be little reason for the NZD to strengthen, but it does negatively influence returns in the short term.

After a decade of steady growth in most major economies, there is increasing evidence that we are approaching the end of the business cycle and things are beginning to slow. At this point there is no dramatic shift in the economic data, more an accumulation showing a gradual slowdown. Ironically, it is this evidence which has partially underpinned the improvement in market sentiment since Christmas due to the implications for the future path of interest rates. In October, a statement by the US Federal Reserve Chairman indicated that official cash rates in the US were likely to be raised 3-4 times in 2019. This was in response to strong US data at the time, implying a greater chance of increases in inflation. Since then, we have seen less positive data emerging and comments from central banks have become less "hawkish" about increasing rates. Many analysts now predict no interest rate increases at all in the US in 2019, and the situation is much the same in NZ and Australia. As discussed in previous letters, low interest rates underpin higher asset values due to the pricing of required returns. As interest rates increase, asset prices can fall as purchasers require higher returns to compensate for the higher rates.

Global politics continue to affect markets. The US has recently had its longest government shutdown in history as President Trump and the Democrats both refuse to budge over funding for a border wall with Mexico (who strangely don't seem willing to pay for it, either!). Trade tensions with China continue and the Chinese economy is starting to show the effects from this and a more general slowdown. The government has taken steps to improve the situation, cutting taxes and reducing the reserve requirements of the banks to encourage greater lending (although there is a high level of debt already). To put China's slowing growth in context, their economy has grown by an estimated 6.4% over the past year, compared to an annual rate of 8-14% in the decade from 2000-2010. Even at current rates, this is three times faster than the NZ economy and a high level of growth by global standards. In contrast, the UK is in turmoil as the proposed Brexit deal with the EU has been rejected by the British parliament. It is almost impossible to predict the Brexit outcome and implications for the Pound and markets at this point.

As developments around the future path of interest rates and the “trade war” reach investors, the markets are reacting quite violently. We are seeing drops of 3%+ in major sharemarkets one day, followed by rises of similar amounts the next. In many cases the extent of the volatility defies logic and is based on seemingly insignificant events. Even intraday trading is volatile with significant falls in the morning matched by gains in the afternoon! Part of the reason for this is the increased use of computerised trading by major fund managers overseas. Algorithm trading refers to automated buy or sell orders that are triggered by computer systems when certain rules are met. These systems can be incredibly complex but basically are designed to protect against market losses or enhance gains for investors. For example, if interest rates spike and hit a certain level the computer systems initiate sell orders on stocks en masse, which exacerbate the losses and cause greater falls in the market than would otherwise be expected. These systems may control up to 80% of all market trades. As long-term investors (rather than short-term traders/speculators), we need to keep this kind of extreme volatility in a broader context.

Perhaps the biggest news in the financial sector in Australasia is the recent release of reports from regulators around misconduct in the banking and insurance industries. In NZ, the Reserve Bank and FMA have criticised the conduct of life insurance companies, especially around soft commissions (e.g. overseas trips) and “churning” of customers – selling replacement policies to gain commissions when this may not be in the best interests of the customer. In Australia the big four banks are facing increased regulation after some shocking conduct was exposed by the recent Royal Commission into Banking and Financial Services. The housing markets in the main centres in Australia are already feeling the effects as banks have tightened lending standards, leading to falls in house prices of up to 10% in Sydney and Melbourne. We are likely to see some fallout from this here also, despite the FMA finding only minor issues amongst the NZ bank subsidiaries. The FMA’s review of NZ banks was much more limited in scope and based on self-reporting by the banks themselves. It is hard not to be sceptical! There are a number of factors aligning which may impact our local housing market – proposed changes to NZ’s bank capital requirements, ring-fencing of tax losses on rental properties, new tenancy requirements for landlords, and the upcoming release of the Tax Working Group report (and their proposal for a capital gains tax). Prices have plateaued in Auckland, and it will be interested to watch the housing market over the next year or so to see how it reacts to these changes.

It is always interesting at this time of year to read the forecasts of various “experts” as to what they predict for the year ahead. There is usually a degree of similarity but also significant differences of opinion from different commentators, most of whom are credible sources with good rationale for their views! As always, the best course of action is to follow proven investing principles, look through the short-term craziness and focus on long-term plans for success. There remain good reasons to take a cautious approach, and we continue to do so as we watch developments with interest.