



# Tactical Thoughts

## Year End Review and 2020 Outlook



As 2019 draws to a close, we reflect on what has been a remarkably strong year for investment returns. Although we can never count out the possibility of a pullback in 2020, the global economy looks to have turned a corner and we should see a return to growth in the new year. Rates are at all-time lows and this has been a helpful tailwind for asset prices around the world.

Hobson Wealth Brand Ambassador, Mahé Drysdale, was at our Auckland office opening in mid-November and talked about all the hard work he continues to put in for his Olympic campaign next year in Tokyo. Mahé spoke of all the training sessions being about the ability to withstand pain when it matters in the final leg of the race. Likewise for us at Hobson, **we believe the gradual build-up of resilience within a client's portfolio should stand it in good stead for when markets become more challenging.** We do not think that the time is upon us yet, and we are pleased we recommended staying invested. In the short term, underperformance, just like an intense training session, can be painful but the benefits of good portfolio construction accrue at the time they are needed.

### Key Highlights

- Supportive market backdrop in 2020 and improving growth outlook and fundamentals should further boost investor sentiment.
- Asset allocation remains a key tenet to long term wealth creation.
- The impact of lower interest rates and factor investing are topics we explore further.

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# Foreword

As another year closes, we thank you for your continued support. 2019 has been a big year for Hobson Wealth and pleasingly, investment markets have been co-operative. Many of you will have visited our new premises in Auckland. It took months of planning and hard work, and would not have been possible without you, our clients, and for whom we are especially grateful. Being in a new and aesthetically pleasing office space has had a positive impact on staff and work output and we look forward to continuing this for your benefit in 2020. We also launched our new Navigator Fund series in October which you will hear more about in the coming months.

This time last year it would have been hard to predict that the Official Cash Rate would be at 1% and our local equity market up almost +30% so far this year. The expectation that the All Blacks would retain the Rugby World Cup in Tokyo failed to materialise. Congratulations to South Africa who played a phenomenal tournament and achieved a well-deserved victory.

Despite the sizeable run-up in global equities this year, we don't see a recession looming and firmly believe clients will continue to be rewarded by staying invested. Despite interest rates being at all-time lows, we value the benefit of bonds as ballast in a portfolio in the event of uncertainty. We were pleased with our involvement in the recent Argosy Property and Synlait Milk bond offerings and we were pleased to be able to accommodate those clients who had interest in these bonds.

As Christmas fast approaches, we would like to thank you once again for your support.

Happy Holidays.



Warren Couillaut – Managing Director



# Executive Summary

**Global equity markets continued their climb in November**, with the MSCI World Index closing at an all-time high. Technology shares in the US in particular performed strongly during the month with the benchmark NASDAQ Index up +4.5%. The US / China trade negotiations appeared to be moving in the right direction over the course of the month and investor appetite improved as a result. Boris Johnson's Conservative Party victory in the UK general election on December 12<sup>th</sup> is a strong endorsement of Brexit and we now expect a resolution in the coming months.

**The S&P/NZX 50 Index rose +4.9% in November, its second highest monthly gain this year.** Retirement village operators rallied on the back of potential M&A activity in the sector, and heavyweight offshore earners, Fisher & Paykel Healthcare and a2 Milk also contributed to the index's sharp move higher. FPH was up +15.6% in November after the breathing mask manufacturer reported a +24.4% increase in first half profits. a2 Milk was +19.4% on the month after encouraging comments were made at their AGM.

**Overall, the S&P/ASX 200 Accumulation Index recorded a gain of +3.3%, which saw the index close November just short of the all-time high.** These gains occurred against a backdrop of weakening earnings, and we have seen the one-year forward P/E increase through the course of the year to currently 18.0x. Technology was the best sector on the ASX last month with Xero and Afterpay strong performers. Following Technology, Healthcare and Consumer Staples continued to outperform in a rising market.

**The US equity market was particularly strong in November and outperformed most other major markets.** It reached record highs during the month on optimism over trade relations and a fresh wave of M&A activity including LVMH buying luxury jeweller, Tiffany & Co. Investors were also cheered by a resilient US economy, strong job growth and corporate earnings, putting the US equity market on track for its largest annual rise since 2013.

**President Trump said he was "very close" to a trade pact with Chinese President Xi Jinping** as officials in Washington and Beijing said they are moving closer to finalising a 'phase one' trade pact. As we go to press, the US Federal Reserve has held its benchmark interest rate steady and signalled no appetite to raise it anytime soon. After lowering rates at their three previous meetings to guard the US economy from the effects of trade tensions and a global slowdown, Fed officials indicated they were comfortable with leaving policy on hold through next year. This is a positive signal for equities and we note it coincides with a pickup in the pace of the US economy's expansion, with data showing that GDP rose in the third quarter by more than initially forecast.

**European equity markets rallied for third consecutive month in November.** Investor turned to "risk-on" mode, after encouraging economic data was released and the hope that the US / China trade dispute will eventually be resolved. Mario Draghi signed off after his final monetary policy meeting at the European Central Bank last month with a call for unity on the ECB's main aim of boosting inflation. There was agreement that risks in the Eurozone were "still tilted to the downside" which makes it an interesting time for Christine Lagarde, who replaced Draghi, effective from November 1. At her first meeting as Chair in mid-December, we expect no change to the current policy settings. Brexit continued to dominate headlines in the UK and the Conservative Party victory in the election means Britain is likely to negotiate a deal early in the new year.

**Asian equities finished the month only slightly in the black** as investors in the region were more reserved in their expectations for a US-China trade deal. Although earlier in the month there was hope a deal could be done, by month end, all hopes were dashed. The passing into US law










of the Hong Kong Human Rights and Democracy Act, effectively giving protection to Hong Kong protestors, may test China's patience at a critical point in the prolonged negotiations.

**Looking ahead into the first half of 2020, we believe the positive tailwinds to markets will continue and therefore we remain bullish for now.** Equity investors have stayed largely on the side-lines this year as evidenced by outflows from global stock markets. We see an uptick in the macro-economic outlook and do not see signs yet of a recession looming. Any truce on trade between the US and China would be another catalyst for equities in general. Global manufacturing data is expected to rebound and the easing bias of central banks is likely to continue to filter through to the respective economies.

**As we come into year end, with what could be the best yearly performance for the S&P/NZX 50 since its inception in 2003, we are glad we stuck to our call of staying invested.** We remain constructive on equities, both locally and internationally, and happily, are seeing more signs of improving economic activity. Low interest rates and the potential that they may go lower, is supportive for asset prices around the world. Any fiscal stimulus would further boost sentiment. With an election year in both NZ and the US, and a yet to be resolved trade war between China and the US, it must be remembered that risks to the downside are always present. **Despite this we believe it is prudent to stick with this investment cycle for some time yet.**

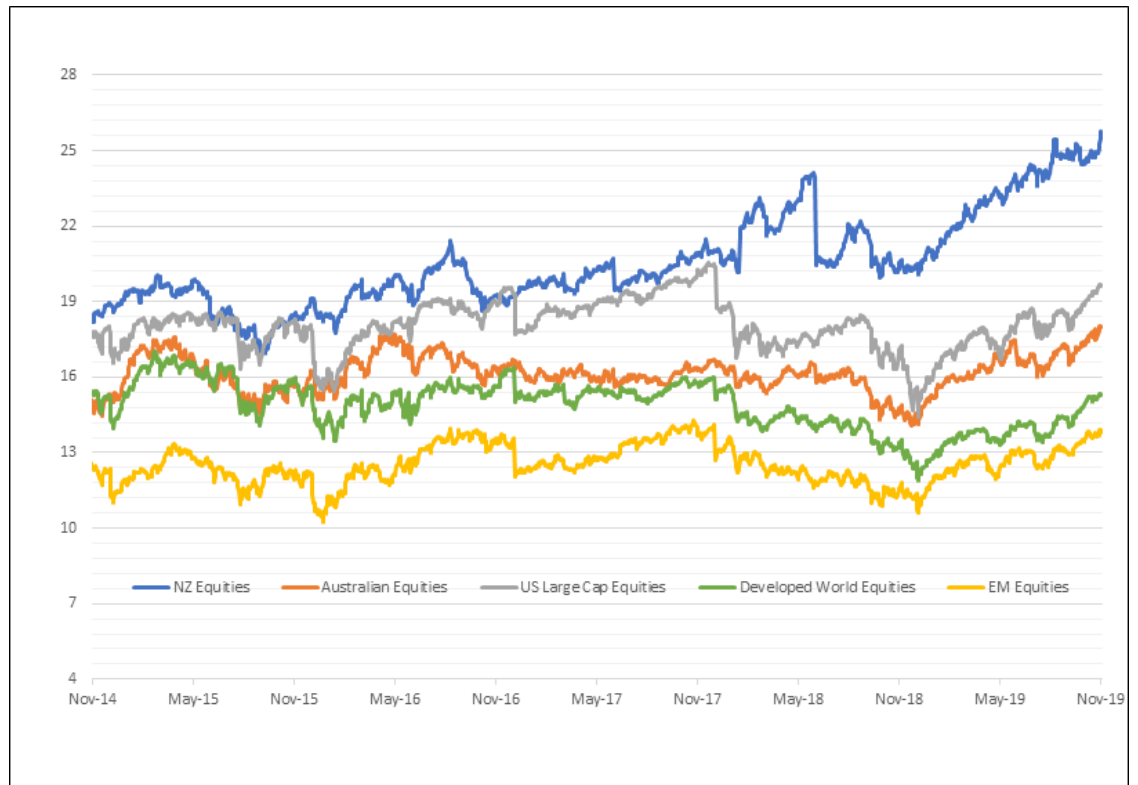
# Recommended Tactical Asset Allocation

Underweight  Overweight

Asset Class	Tactical	Rationale
NZ Equities		While we think Labour will do what they can to be re-elected next year, following such a strong run we opt to retain our Hold/Neutral call on NZ equities.
Australian Equities		Despite signs of life in the property market and the prospect of another RBA rate cut, we see headwinds for the banks and resources.
US Large Cap Equities		The US stock market continues to offer the most compelling growth biased investment opportunities.
US Small Cap Equities		While a balanced Fed and positive economic data are supportive, we down-weight small caps as we believe large caps offer more compelling exposure.
Developed World Equities		We are constructive on Europe but remain cautious on the UK despite the Conservative Party victory. Japanese stocks are showing signs of upward momentum and we upgrade to Overweight DM.
EM Equities		We remain bullish on Emerging Markets on the back of a stronger global economy, potential resolution on trade, and ideally a weaker US\$.
NZ Listed Property		While we like the yield, we are cognizant of the exceptional run this year and do not think that will be repeated next year.
Fixed Interest		Fixed Interest will always be a key component of client portfolios but with rates at such low levels we believe it prudent to move to Moderately Underweight.
Cash		With the RBNZ explicitly stating their desire to keep short term interest rates at low levels, we see little to no benefit in holding excess cash.

## Market Price Earnings ratios

Price Earnings ratios 2014 – 2020\*



Price/Earnings ratios are Bloomberg Best estimates for forecast year one.

## Price Earnings ratios versus average\*

Price Earnings*	NZ Equities	Australian Equities	US Large Cap Equities	US Small Cap Equities	Developed World	EM Equities
<b>As at 30 November</b>	25.8	18.0	19.6	31.8	15.3	13.8
<b>10-year average</b>	18.1	15.1	16.4	25.2	14.0	11.9
<b>5-year average</b>	20.5	16.2	18.1	26.8	14.9	12.5

\*Price Earnings ratios are Bloomberg Best estimates for forecast year one.

## NZ\$ FX performance percentage returns to 30 November 2019

Currency Pair	1m	3m	6m	12m
<b>NZ\$/ US\$</b>	0.1%	1.5%	-1.7%	-6.5%
<b>NZ\$/ AU\$</b>	2.0%	1.0%	0.7%	0.8%

Source: Eikon, Bloomberg, November 2019.

## Index Returns to 30 November 2019

Index percentage returns in their currency

Asset Class	Index		1m	3m	6m	12m
<b>NZ Equities</b>	S&P/NZX 50 Gross	NZ\$	4.9	5.2	11.8	28.3
<b>Australian Equities</b>	S&P/ASX Accumulation 200	AU\$	3.3	4.8	9.2	26.0
<b>US Large Cap Equities</b>	Russell 1000 Total Return	US\$	3.8	7.8	15.0	16.1
<b>US Small Cap Equities</b>	Russell 2000 Total Return	US\$	4.1	9.1	1.7	7.5
<b>Developed World Equities</b>	MSCI EAFE*	US\$	1.0	7.2	8.6	9.1
<b>EM Equities</b>	MSCI EM*	US\$	-0.2	5.7	4.2	4.6
<b>NZ Listed Property</b>	S&P/NZX Property Gross	NZ\$	-0.4	-1.3	11.4	30.0
<b>Fixed Interest</b>	S&P/NZX Corporate A	NZ\$	-0.1	-0.6	2.4	6.9
<b>Cash</b>	ANZ New Zealand Call Rate	NZ\$	0.1	0.2	0.6	1.5

Source: Eikon, Bloomberg, November 2019 (\*not total return index).

Index percentage returns translated into NZ\$

Asset Class	Index		1m	3m	6m	12m
<b>NZ Equities</b>	S&P/NZX 50 Gross		4.9	5.2	11.8	28.3
<b>Australian Equities</b>	S&P/ASX Accumulation 200		1.2	3.3	8.4	24.9
<b>US Large Cap Equities</b>	Russell 1000 Total Return		3.5	5.7	17.0	24.2
<b>US Small Cap Equities</b>	Russell 2000 Total Return		3.9	6.9	13.6	15.0
<b>Developed World Equities</b>	MSCI EAFE*		0.7	5.0	10.5	16.7
<b>EM Equities</b>	MSCI EM*		-0.4	3.6	6.0	11.8
<b>NZ Listed Property</b>	S&P/NZX All Real Estate		-0.4	-1.3	11.4	30.0
<b>Fixed Interest</b>	S&P/NZX Corporate A		-0.1	-0.6	2.4	6.9
<b>Cash</b>	ANZ New Zealand Call Rate		0.1	0.2	0.6	1.5

Source: Eikon, Bloomberg, November 2019 (\*not total return index).

## Interest Rate and FX Forecasts as at 30 November 2019

Rate	4Q2019E	1Q2020E	2Q2020E	3Q2020E	4Q2020E
<b>Australia Cash Rate</b>	0.75	0.50	0.50	0.50	0.50
<b>Australia 10yr govt</b>	1.30	1.50	1.80	1.90	1.90
<b>US Fed Funds Rate</b>	1.50	1.50	1.50	1.50	1.50
<b>US 10yr Treasury</b>	1.80	2.10	2.50	2.50	2.50
<b>NZD OCR</b>	1.00	0.75	0.75	0.75	0.75
<b>NZ 10yr Govt</b>	1.40	1.65	1.95	2.05	2.05
<b>NZ\$/ US\$</b>	0.640	0.650	0.650	0.645	0.640
<b>AU\$/ US\$</b>	0.690	0.700	0.710	0.705	0.700
<b>NZ\$/ AU\$</b>	0.928	0.929	0.916	0.915	0.914
<b>EUR/ US\$</b>	1.090	1.110	1.130	1.130	1.150
<b>US\$/ JPY</b>	109.0	109.0	107.0	105.0	102.0
<b>GBP/ US\$</b>	1.300	1.300	1.300	1.320	1.350

Source; Macquarie Securities, November 2019.



# Market Outlook and Portfolio Positioning

## New Zealand equities

The New Zealand sharemarket was up strongly in November, returning +4.9% for the month. The market was driven higher predominately by the outperformance of Fisher & Paykel Healthcare (+15.6%) and a2 Milk (+19.4%), two of the biggest weights in the index. The S&P/NZX 50 Index's performance now stands at +28.3% for year to date and looks set to break records with one month to go in 2019. Since the advent of the S&P/NZX 50 in 2003, the record performance for a calendar year was +25.1% in 2004.

Economic data this month surprised on the upside: BNZ business manufacturing picked up to a mildly expansive 52.6 from a contractionary reading previously; REINZ housing data saw year-on-year median price growth pick up to +8.2% nationally and +0.8% in Auckland; and retail sales came in at +1.6% for the third quarter, ahead of expectations for +0.5%. Only third quarter unemployment at 4.2% and building permits for October at -1.1% weakened.

### Tactical Positioning

2019 does not feel like a bull market despite the almost +30% domestic equity rally. Earnings have broadly been better than expected but what has driven a lot of this rally has been the shift lower in interest rates. The Official Cash Rate was at 1.75% as recently as March this year and is now at 1.00%. The rate was already low, but this is a further material reduction. This has caused a rally in defensive, income yielding stocks which has driven the benchmark index much higher than we anticipated this time a year ago.

We are now looking at what could be the best yearly performance for the S&P/NZX 50 since its inception in 2003. We are glad we have stuck to our call of staying invested and we maintain our recommendation of continuing to hold a full allocation to NZ equities. What is a little concerning however is the fact that the strong index return is not necessarily the result of a broad based rally across the entire New Zealand equity market. Many investors in our market are income focused and passive flows and yield-seeking investors have pushed the market higher particularly in the utility sector and high-dividend paying companies.

We remain constructive on the outlook for domestic equities but are somewhat cautious on what we believe are elevated valuations. At 25.8x next year's earnings – this is materially above the 5 and 10-year averages. The domestic outlook is mixed and the Labour coalition is now talking about fiscal stimulus to boost the economy further. Coming into an election next year Labour will do what it can to be re-elected which could further boost investor sentiment. However, looking at past election years in New Zealand, since the inception of the S&P/NZX 50, there have been five years with general elections and only in three of them has the index finished in positive territory. 2019 has been a stellar year, and we do not think this will be repeated in 2020. We are therefore Neutral on NZ Equities rather than Overweight.

## Australian equities

The Australian equity market was up +3.3% in November, outperforming buoyant global markets which saw the MSCI All Country World Index up +2.7%. Banks continued to struggle this month as weaker operating trends, the possibility of more capital raisings, and AUSTRAC's civil proceedings against Westpac dragged on the sector; four out of the five worst performing stocks

in the ASX 100 were banks. The weakness in banks meant that the Financials sector (-2.0%) was the worst performing sector in the market, edging out Utilities (-0.5%).

Economic data for the month was largely in line with expectations and similar to previous readings with a few exceptions: Westpac Consumer Confidence increased +4.5%, reversing some of the previous months -5.5% decline; building approvals also rebounded +7.6% after a -1.1% fall the previous month; and the RBA's index of commodity prices was up by the biggest monthly margin since April 2010.

The RBA left rates unchanged at 0.75% in November. The RBA's statement stayed close to the script but leaving the option for quantitative easing if stimulus was needed. Macquarie is pricing in one cut in early 2020 but speaking with a number of active managers who were recently in Auckland, in their view, it now does not matter so much if the RBA does not cut further. Cuts to date are working and even the credit squeeze, which has made it hard to access funding, is starting to thaw a little. The recovery in property has sent building stocks higher but mining is yet to turn as profitability in the sector has been under pressure. The 25% fall in the price of Nickel in the last three months is evidence of this.

While we may be seeing early signs of a turning point, we remain hesitant on the outlook for Australian corporate earnings growth next year. Interest rate cuts and tax cuts are no match for high household debt and low wage growth. Manufacturing data has been resilient but valuations are pushing to extreme levels. Ex-resources, and based on Macquarie data, ASX stocks were on a forward P/E of 19.2x at the end of November, close to the highest since 1960. If you exclude Banks, Insurance and REITs, the P/E is closer to ~24x. The rise is largely driven by lower global bond yields, and demand for high dividend yield from, particularly, the ASX Industrials sector.

### Tactical Positioning

Despite signs of life in the property market and the prospect of another RBA rate cut, we see headwinds for the banks and resources. We expect volatility to persist and with downgrades likely coming, we see a growing risk of downward moves in stock prices. We therefore maintain our call to stay underweight the Australian equity market.

## International equities (excluding Australia)

### US equities

The US equity market ended November in positive territory after reaching record highs earlier in the month. Both the S&P 500 and the Dow Jones Industrial Index have benefited from a US Federal Reserve that has put interest rate rises on hold for the foreseeable future. Investors have been buoyed by a resilient US economy, putting the US equity market on track for its largest annual rise since 2013.

The big overhang is the uncertainty relating to President Trump's spat with China on trade. The trade war has escalated into a larger conflict between China and the US, and the West, and now involves not just trade in goods, but also technology, intellectual property protection, investment flows, industrial policies, and potentially much more. The back and forward nature of the negotiation has been very hard for investors to gauge progress but recently US investors have been buoyed by optimism about a potential "phase 1" deal. However, despite weeks of ongoing negotiations, no concrete details have emerged.

## Tactical Positioning

With the US Fed on hold, we expect a relatively restrained outlook for the 10-year US Treasury yield next year in the 1.75 - 2.00% range. This should translate into a stable environment for US equities and an environment that is maybe more about stock picking rather than a call on the interest rate setting and how that affects investor sentiment. We still prefer large caps over small caps.

We are optimistic about the continued investment case for US equities for next year. In fact, we are seeing signs of a “melt-up” scenario materialising, which should get more investors off the sidelines. Retail sentiment is not exuberant and we have seen consistent outflows from US equity funds this year. Hedge fund positioning is also light, so we expect the outflows to reverse as the year progresses. Markets have been buoyed by the prospect of a “phase 1” deal reached with China and if that materialises, then we would expect US equities, particularly large caps, to be well-bid. It is for this reason, we up-weight our call on US large caps and down-weight our call for US small caps. Unfortunately, most money flows have been to the larger US companies and we think this trend is unlikely to change in 2020.

## Developed World equities

The MSCI World Index of Developed Markets excluding the United States is up +19% year to date. Without feeling like a bull market, equities round the world have rallied and many investors feel like they have not truly participated in the rally. Investor sentiment is not euphoric, positioning is light, bond yields are down and defensive stocks have led the market higher. Having secured victory in the general election on December 12<sup>th</sup>, all eyes are on Boris Johnson to see if he can, once and for all, end the multi-year political deadlock. This would revive investor interest for UK equities and deliver more certainty for the Eurozone too. We look forward to seeing how this eventuates over the coming days and weeks.

At this stage we prefer Europe to the UK as we believe the Continent offers more leverage to a recovery in global growth which we see playing out in 2020. The decision (or not) to leave the European Union has generated a substantial increase in macro-economic uncertainty in the UK. This has depressed business investment which has had the cumulative effect of severely hurting business formation, and confidence within the small and medium enterprise sector.

Japanese equities have rebounded strongly in the last few months, reversing the negative trend experienced earlier in the year. A positive global industrial backdrop is supportive of Japanese equities and a further tailwind would be a weaker yen. Tokyo hosts the Olympics next year and this may be why we are seeing momentum build in Japanese equities. Prime Minister Shinzo Abe has announced a stimulus package of almost US\$240bn to support growth in an economy contending with an export slump, natural disasters and the fallout from a recent sales tax increase. The measures are aimed at boosting GDP and protect against downside economic risks and prepare the country for longer-term growth after the Olympics.

## Tactical Positioning

In the Eurozone, we see growth picking up gradually over the course of next year as external headwinds ease and the impact of policy stimulus begins to be felt. We expect only a modest recovery but this should be enough to drive returns higher for equity investors.

While we believe the Conservative Party's sizeable majority in the December election is a major endorsement of Britain's desire to leave the EU, we stay underweight the UK specifically until we see more clarity. We expect the UK to exit in the first quarter next year, but we remain cautious of the possibility of a “No Deal Brexit”. The risks to free-flowing trade between the UK and the Continent are not insignificant and we believe this uncertainty may persist for longer

than expected. That being said, an end to the multi-year deadlock could revive investors' appetite for the UK and we expect at some point next year to turn bullish on the UK, and not just the Eurozone at this time.

Japan remains cheap on a valuation basis and global investor positioning is light. Foreign investors have sold the most Japanese equities in 2019 since 1984 and only now are we seeing some of these flows return coming into year-end. We see the positive momentum for Japanese stocks continuing in 2020.

## Emerging Market equities

Emerging Market equities have had a challenging 2019. Trade tensions and a stronger than expected US dollar have been the main headwinds. In the last couple of months, as the outlook for global growth has begun to improve, we have seen some small gains. Unfortunately, these gains were short-lived in November as sentiment turned negative due to a mixture of economic, political and corporate factors. Plagued with strikes and anti-government protests across the region, Latin American equity markets, along with their respective currencies, came under the most pressure. Chile has been the worst performer as the riots there forced the cancellation of the APEC meeting that was to be hosted in Santiago. Brazil also lost ground on concerns that the protests in Chile could spill over to Brazil and force the government to water-down their reform agenda. By comparison, equity performance in Asia and EMEA (Europe, Middle East and Africa) has been more mixed.

Chinese leadership may have struggled to predict which way Trump will turn on trade during 2019 but Chinese equities, with the exception of Hong Kong, have performed well relative to other Asian and global markets. To an extent they are pricing in a deal being done. Domestic A-share markets, particularly Shenzhen, have benefited from ongoing inclusion in global indices and the Government's stimulus measures helping to counter any potential trade-related slowdown.

### Tactical Positioning

While our positive call on Emerging Markets for 2019 did not materialise, we remain constructive over a longer-term timeframe. The direction of the US dollar remains one of the key drivers of Emerging Market equity performance. A strong US dollar has pressured EM equities but we feel that could be about to turn next year. Under our Hobson Wealth Asset Allocation model, we aim to maintain a small allocation to Emerging Markets in all but the most conservative portfolios. We believe that while Emerging Markets do present downside risk, they also offer the most upside if they stage a turnaround. Valuations are cheap, global investors are underweight, and a weaker US dollar will be positive for stocks in these regions. We maintain our call on being invested in Emerging Markets.

## New Zealand listed property

The NZ listed property sector has had a weaker 4<sup>th</sup> quarter to this point but it is important to note that this is in the context of a sector that has delivered a +30% return over the last 12 months. Overall YTD performance has been buoyed by falling bond yields, while exposures to industrial properties remains the preference of the sector. The lower-for-longer interest rate rhetoric should continue to see solid demand for equity yield but acknowledges that elevated returns in 2019 would appear difficult to repeat in 2020. We maintain our preference for holding listed property companies with high quality assets.

## Tactical Positioning

We move to an Underweight recommendation for New Zealand listed property. While we like the yield, we are cognizant of the phenomenal run in 2019 and do not think this is likely to be repeated in 2020.

## Fixed Interest and cash

It has been another solid year in 2019 for our domestic bond market. We continue to see new borrowers raise money through our debt capital markets and many of these corporates will be well known to our investors. Companies such as the aged care provider Metlifecare, and Synlait Milk are two recent examples.

Despite all the talk around the potential for higher interest rates in 2019, this ultimately has not materialised. In fact, central banks globally have embarked on further interest rate cuts to try and stimulate growth and shore up confidence in financial markets. Locally, the RBNZ reduced our official cash rate (OCR) down to 1.00%, after starting the year at 1.75%. Persistently lower inflation and slowing global growth have been some of the reasons cited by Governor Orr.

Interest rate markets globally have 'back-tracked' swiftly when we consider this time last year there was a growing belief that 2019 would finally be the year that would usher in higher interest rate settings. In fact, the opposite has happened. The Federal Reserve in the US has been forced to ease (reduce) interest rates despite a domestic economy that appears to be on a far firmer footing. However, in order to stay competitive globally, and with the US-China trade war continuing, the Fed has taken the path of least resistance. The US 10-year benchmark bond yield has traded within a 1.45% - 2.55% range (currently ~1.84%) for much of 2019, now settling closer to the bottom of that range as equity market volatility and softer central bank rhetoric has started to have an impact. The recent moderation has market pricing continuing to question global central banks' willingness to raise interest rates and remove monetary policy stimulus. We think a breakthrough higher above this recent range will need support from underlying economic data.

## Tactical Positioning

We move to a Moderately Underweight tactical position in Fixed Interest as we are mindful of what is a backdrop of historically low interest rates. Fixed Interest will always be a key component of client portfolios, but we are mindful that it will be difficult to move interest rates materially lower from here short of a global shock; and are therefore happy to allocate to bonds on a case by case basis.

# Deal in Focus: Synlait Milk Bonds

It has been another noteworthy year for NZ debt capital markets, and we take this opportunity to highlight the \$NZ180m Synlait Milk subordinated bond deal in which Hobson Wealth was mandated for the Co-Manager role.

Synlait has grown from a dairy manufacturing start-up back in 2009 to now producing 146,000 metric tonnes (MT) of milk solids in 11 years, growing top line revenue by a 25% compound annual growth rate (CAGR) since FY09. This exceptional growth has seen revenue exceed \$1 billion for the first time in FY19.

Synlait (SML) has a clear growth strategy of 'doing milk differently' and developing a world class value chain. This includes significant investment in infant nutrition, their ingredients business and everyday dairy products.

In order to help achieve this objective, Synlait, through their capital management programme embarked on an inaugural domestic bond deal with the help of retail and institutional investors.



Key highlights of the deal:

- NZ\$180 million raised in what was Synlait's first foray into the domestic bond market
- Synlait is an NZX and ASX listed company with an NZX market capitalisation of NZ\$1.7 billion that produces a range of nutritional milk products for global customers, including their largest customer, the a2 Milk Company
- A straight 5-year maturity that is line with their recently extended exclusive supply agreement with the a2 Milk Company
- Internal policy to maintain shadow investment grade credit metrics through the cycle – targeting a total leverage ratio of less than 2.5x over the long term

The company is executing a number of large-scale capital projects supported by new and existing customer commitments and acquisitions including Talbot Forest Cheese and Dairyworks.

Synlait is investing for the future and it is great to be involved to help them do this.

# Hobson's Corner

## Cost of Equity and Impact on Valuations

### Ed Glennie - Investment Strategist

As the S&P / NZX 50 Gross Index heads into year-end at all-time highs, the doomsayers grow louder declaring that the market is too expensive and surely it must drop sometime soon. While we agree it is naive to think the market will stay elevated forever, it is also useful to understand some of the reasons why prices are so high.

One reason valuations are higher is because of the macro-economic backdrop. Interest rates are low and inflation is largely non-existent. Historically, when interest rates and inflation are low, valuations tend to be higher. Intuitively, investors require a return above interest rates for investing in the equity market and so when interest rates are higher, the return required to invest in equity is higher. When rates and inflation are low, investors should be content with a low return. In practice, this means investors bidding up share prices, paying high prices and in doing so potentially reducing their future returns.

Valuations can be helpful for setting reasonable expectations for investors because higher valuations typically lead to lower long-term returns while lower valuations typically lead to higher returns. The stock market's reaction to interest rates is generally immediate, but the economy usually lags by up to 12 months. Credit becomes less expensive with lower rates which in many cases positively affects earnings and stock prices.

As the economy has slowed both here and abroad, the RBNZ has cut the cash rate to stimulate economic activity. A decrease in interest rates is a catalyst for growth because borrowing rates come down which, in turn, should lead to greater profits and a more robust economy. Consumers tend to spend more, as lower interest rates make them feel wealthier because they can afford to borrow more. Businesses can finance themselves at a cheaper rate, thereby increasing their future earnings potential, which, in turn, should lead to higher stock prices.

Big winners of the lower cash rate in NZ have been the high dividend-paying stocks such as the gentailers, listed property sector and bonds. As the cost of funding has come down, we have observed investment houses lowering their discount rates which they use to value the long-term cash flows of companies. This results in a higher target price for a particular stock because the rate used to discount the cashflows is smaller, hence the value is higher. What may also happen is that if rates drop even further and the discount rate comes down too, then investors could still be prepared to pay even more for assets. Traditional metrics such as Price / Earnings ratios are less relevant in a world where funding costs are low and investors are willing to pay higher and higher prices. This combined with the rise of passive flows where the buyer may be less sensitive to underlying fundamentals (and valuations) means the market gets pushed ever upwards.

We have also seen off-shore investors who have access to even lower funding lines pay higher prices than what local investors were prepared to pay. The acquisitions of Tip Top ice-cream and Trade Me by overseas interests are examples of this.

Although the relationship between interest rates and the stock market is indirect, the two tend to move in opposite directions. As a general rule of thumb, when the RBNZ cuts interest rates, it causes the stock market to go up and when the RBNZ raises interest rates, it causes the stock market as a whole to go down. But there is no guarantee how the market will react to any given interest rate change the RBNZ chooses to make. That being said we are still of the view that rates will be lower for longer - so long may the rally in stocks continue!

## Petrol Price Farce

Mark Fowler – Head of Investments

If we are led to believe the latest rumblings coming out of the current Government, apparently fuel prices through competition could be expected to drop 18 cents to 32 cents a litre because of new petrol company rules breaking the supply dominance of the big fuel companies.

This is premised on the Commerce Commission finding that major petrol suppliers will need to change how the wholesale fuel supply market works, essentially to improve competition.

So how has this figure been calculated?

According to Consumer Affairs Minister Kris Faafoi: "Those are examples of what happens when competition does happen." One of 'those' examples he is referring to is an 18c price drop in Wellsford petrol when Gull entered the local market. That sadly, seems the depth of the analysis.

Z Energy recently flagged that the first five months of FY20 trading had been adversely affected by several factors but notably compression in both volumes and margins in the retail fuel market.

One could argue that fuel retailing has already been through a differentiated step change and that the landscape has never been more competitive.

During July and August, increased industry discounting and promotional activity has resulted in margin contraction of both the Z and the Caltex brands. Z Energy noted that its percentage of retail fuel sales on discount has increased from about 75 per cent to about 90 per cent.

If we take the latest retail petrol margin data, MBIE estimate a regular petrol margin of about 25c/litre, which is consistent with Z Energy's estimates at the end of September 2019 (see graph below).



Source: Z Energy

Is the Government to have us believe that petrol retailers shouldn't be making any money? That doesn't seem a sensible premise to attract new competitors into a market.

Z Energy reported a return on capital of around 7% in its latest result, down from a 12 per cent high in FY17.



By my way of thinking, a 7 per cent return does not sound outlandish. What does this mean for all New Zealand industries? Is this a Government that is opposed to an industry making a reasonable return on their assets? If so, then should all industries be looking over their shoulder under the current regime?

Clearly, the Government has no idea about the commercial realities of this industry. Instead of attempting to score political points, how about focusing on making the industry more efficient, or better yet, supporting local players to achieve better outcomes for everyone?

**Note:** The original article appeared in the NZ Herald on December 7<sup>th</sup>, 2019.

## Factor Investing

### Ed Glennie - Investment Strategist

The use of Factor Exchange Trade Funds (ETFs) has been a growing investment trend as a way to enhance returns or reduce risk within portfolios.

All investment portfolios are exposed to factors. Factors are historically persistent drivers of returns within and across asset classes. Strategies that target certain factors can be used to potentially improve a portfolio's investment returns. Based on BlackRock research, the four main factors that have outperformed the broader equity market over the long term are:

1. **Value investing** - Finding securities that are underpriced relative to fundamentals
2. **Momentum investing** - Investing in securities with upward trending prices
3. **Quality investing** - Preferring companies with solid balance sheets and less volatile earnings
4. **Small size investing** - Tilting to smaller, more nimble companies

There are also strategies that target stocks with low exposure to the Volatility factor which can be used to help reduce portfolio risk. Minimum Volatility investing is selecting stocks that have historically displayed lower risk. This builds up a portfolio's resilience without necessarily giving up potential upside. Minimum Volatility ETFs do this by aiming to deliver the same return as the underlying index but with a lower level of risk because they are invested in less risky stocks. They have become a popular alternative to reducing portfolio risk from traditional means such as fixed income or defensive equities. As global interest rates stay lower for longer, we think it is prudent to consider some of these as options.

Quality stocks are financially healthy companies which have tended to perform better over time. They exhibit the characteristics of being 'quality' companies, defined as demonstrating earnings persistence, high profitability and low leverage. These quality companies have typically outperformed during periods of economic slowdowns and over a long-term time horizon. Quality as a factor has historically performed best in periods of modest growth, and as we start seeing signs of global growth coming back, we believe that this is an environment when the Quality factor should outperform.

Another option is a diversified multi-factor ETF because it is hard to know exactly what factor is going to work at what time. These ETFs aim to outperform the index with the same level of risk by targeting Value, Momentum, Quality and Size which are the four main factors as spelt out above.

If you would like to learn more about factor investing and how factors could complement your existing portfolio and potentially improve outcomes, please do not hesitate to contact your Hobson Wealth adviser.

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