Tactical Thoughts – November 2019

Global equity markets continued their climb in October, as the MSCI World Index closed a little shy of its record high. Confidence grew with the hope of a resolution to the US/China trade tensions and increasingly accommodative monetary policy. The US Fed cut rates by another 25 basis points to a range of 1.50 - 1.75% and has all but reversed their tightening bias from this time a year ago.

Our local equity market was one of the weakest performers in October after a number of negative news stories hurt sentiment. Rio Tinto shocked the gentailers by initiating a review of the Tiwai aluminium smelter which, if closed, would result in much less electricity consumption nationwide. The announcement took $1.5bn of market value off the sector even though the review will not be concluded until Q1 2020. A large fire at the SkyCity Convention Centre caused more pain with SkyCity shares weaker as well as Fletcher Building, the main contractor.

Australian equities fell in October as Healthcare stocks were some of the only bright spots. A strong Australian dollar explained some of the underperformance, although the main detractor was weakness in the banks and resources. The macro-economic backdrop darkened, with Australian consumer confidence falling to the lowest level since December 2014 and business confidence dipping into negative territory.

UK stocks fell as Brexit remains unclear, and the rising Pound creates a headwind to growth. Prime Minister, Boris Johnson, was unable to engineer a withdrawal by his self-imposed deadline of 31 October. Investors will now have to wait until an election on 12 December to determine the next step and hopefully a resolution to the current deadlock.

While the UK equity market was negative in October as domestic politics continuing to weigh on sentiment, **European markets made modest gains**. Investor confidence was underpinned by improving US-China trade tensions, talk of increased government spending across continental Europe and less likelihood of a no-deal Brexit. On the economic front, the Eurozone grew by +0.2% in the third quarter, which beat consensus estimates who were expecting to see growth stall. The positive figure was largely driven by robust growth in France and Spain.

In Japan, the equity market ended the month higher as the partial trade agreement between the US and China eased concerns about a global economic slowdown. **It was a positive month for Emerging Market equities too** with all the regions recording gains. Asia was the best performing region, followed by Latin America.

Recommended Tactical Asset Allocation

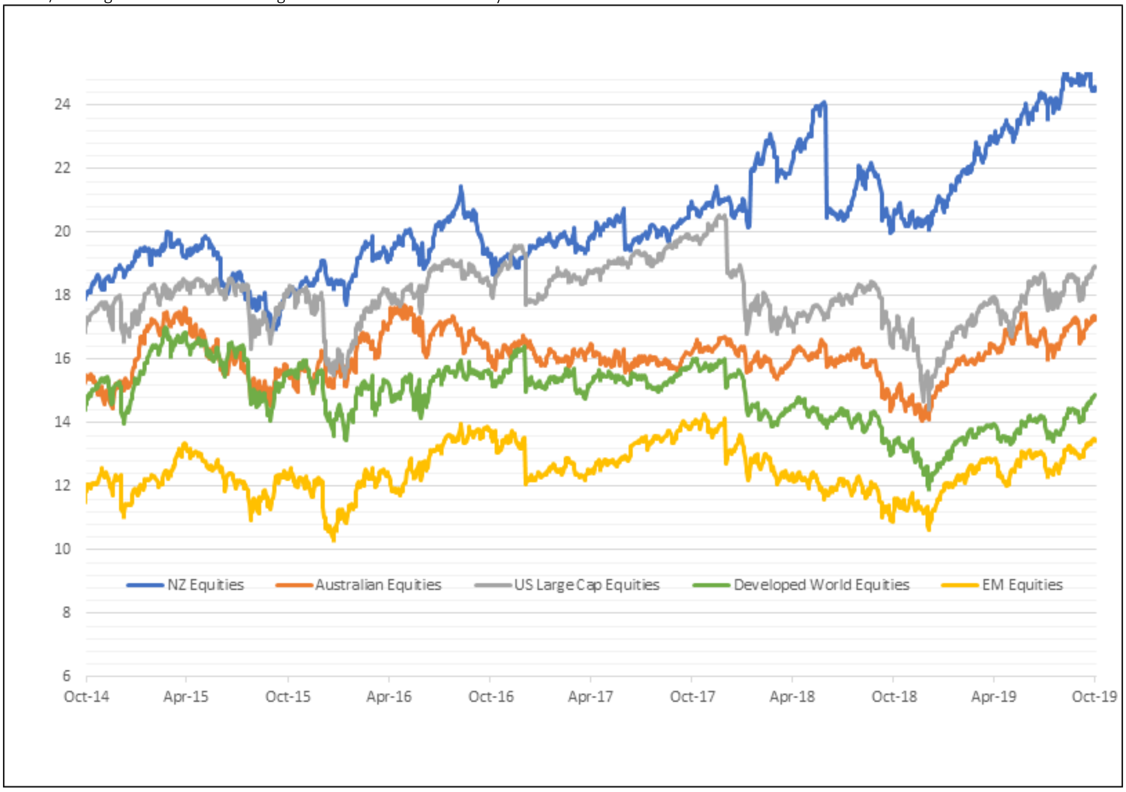
Underweight ☐☐■☐☐ **Overweight**

Asset Class	Tactical	Rationale
NZ Equities	☐☐■☐☐	This month's pull back offers the chance to selectively add but the more cautious may pause given this year's strong run. We see the hunt for yield persisting but retain our Neutral recommendation.
Australian Equities	☐■☐☐☐	With no resolution yet on trade and a weaker domestic economy, we retain our Moderately Underweight call.
US Large Cap Equities	☐☐☐■☐	Earnings growth has remained resilient and we believe the US still offers the most attractive investment opportunities.
US Small Cap Equities	☐☐■☐☐	A cautious Fed and compelling valuations, underpin our positive view on US small caps.
Developed World Equities	☐■☐☐☐	With the UK now facing a general election we see Brexit further delayed. This is a headwind for the UK and Europe and we also see Japan struggling after the recent consumption tax hike.
EM Equities	☐☐■☐☐	We remain bullish on EM as positive net fund flows indicate optimism for a resolution on trade.
NZ Listed Property	☐☐■☐☐	Listed property has pulled back along with the rest of the local market. We like its yield and recommend clients stay invested.
Fixed Interest	☐■☐☐☐	Fixed Interest continues to provide a key component within our asset allocation framework and should act as a buffer in the event of an equity drawdown.
Cash	■☐☐☐☐	With the RBNZ explicitly stating their desire to keep short term interest rates at low levels, we see little benefit in holding large quantities of cash.

Market Price Earnings ratios

Price Earnings ratios 2014 – 2019*

*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
As at 31 October	24.6	17.2	18.9	29.9	14.9	13.5
10-year average	18.1	15.1	16.3	25.4	14.0	12.0
5-year average	20.4	16.1	18.0	26.8	14.9	12.5

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

FX Returns to 31 October 2019

NZ$ FX performance percentage returns to 31 October 2019

Currency Pair	1m	3m	6m	12m
NZ$/ US$	2.4%	-2.2%	-3.9%	-1.6%
NZ$/ AU$	0.3%	-2.9%	-1.8%	1.0%

Source: Eikon, Bloomberg, October 2019.

Index Returns to 31 October 2019

Index percentage returns in their currency

Asset Class	Index		1m	3m	6m	12m
NZ Equities	S&P/NZX 50 Gross	NZ$	-1.3	-0.6	7.7	23.3
Australian Equities	S&P/ASX Accumulation 200	AU$	-0.4	-0.9	7.6	19.3
US Large Cap Equities	Russell 1000 Total Return	US$	2.1	2.0	3.8	14.2
US Small Cap Equities	Russell 2000 Total Return	US$	2.6	-0.4	-1.1	4.9
Developed World Equities	MSCI EAFE*	US$	3.5	3.1	1.8	7.7
EM Equities	MSCI EM*	US$	4.1	0.5	-3.5	9.0
NZ Listed Property	S&P/NZX Property Gross	NZ$	-2.8	2.2	16.2	35.5
Fixed Interest	S&P/NZX Corporate A	NZ$	-0.4	1.1	3.8	6.9
Cash	ANZ New Zealand Call Rate	NZ$	0.1	0.3	0.6	1.5

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

Index percentage returns translated into NZ$

Asset Class	Index	1m	3m	6m	12m
NZ Equities	S&P/NZX 50 Gross	-1.3	-0.6	7.7	23.3
Australian Equities	S&P/ASX Accumulation 200	-0.6	2.1	9.6	18.2
US Large Cap Equities	Russell 1000 Total Return	-0.2	4.9	8.2	16.1
US Small Cap Equities	Russell 2000 Total Return	0.3	2.5	3.1	6.7
Developed World Equities	MSCI EAFE*	1.1	6.1	6.1	9.6
EM Equities	MSCI EM*	1.7	3.4	0.6	10.9
NZ Listed Property	S&P/NZX All Real Estate	-2.8	2.2	16.2	35.5
Fixed Interest	S&P/NZX Corporate A	-0.4	1.1	3.8	6.9
Cash	ANZ New Zealand Call Rate	0.1	0.3	0.6	1.5

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

Macquarie Interest Rate and FX Forecasts

Rate	3Q2019A	4Q2019E	1Q2020E	2Q2020E	3Q2020E
Australia Cash Rate	1.00	0.75	0.50	0.50	0.50
Australia 10yr govt	1.15	1.20	1.20	1.25	1.25
US Fed Funds Rate	1.75	1.50	1.50	1.50	1.50
US 10yr Treasury	1.70	2.00	2.20	2.20	2.10
NZD OCR	1.00	0.75	0.50	0.50	0.50
NZ 10yr govt	1.10	1.15	1.15	1.15	1.15
NZ$/ US$	0.6263	0.6300	0.6400	0.6500	0.6500
AU$/ US$	0.6750	0.6900	0.7000	0.7100	0.7200
NZ$/ AU$	0.9279	0.9130	0.9143	0.9155	0.9028
EUR/ US$	1.0899	1.0900	1.1200	1.1300	1.1500
US$/ JPY	108.08	103.00	102.00	100.00	100.00
GBP/ US$	1.2290	1.1700	1.2500	1.3000	1.3200

Source: Macquarie Securities, October 2019.

Sector in Focus: Gentailers

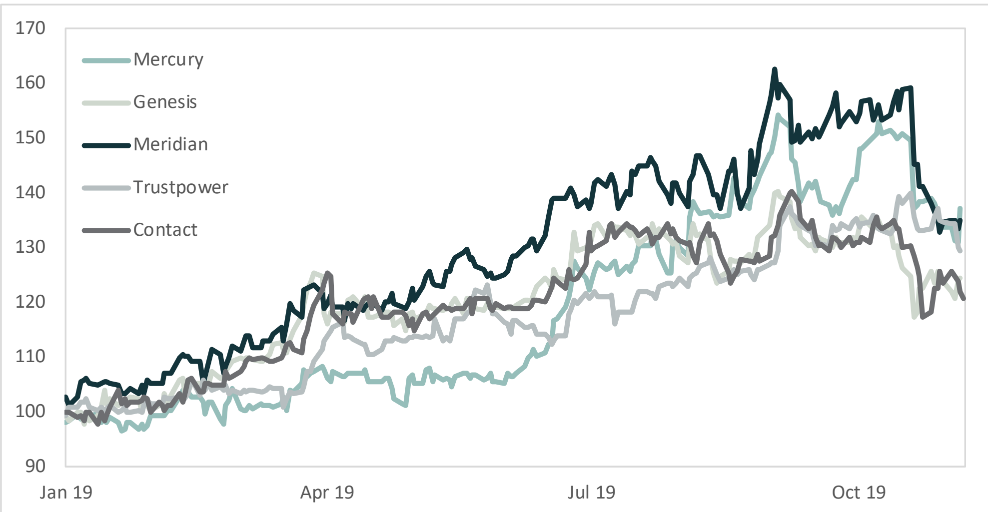
Rio Tinto (RIO) announced a strategic review of its interest in New Zealand's Aluminium Smelter (NZAS) at Tiwai Point to determine the operation's ongoing viability and competitive position. This resulted in $1.5bn of market value being wiped off the gentailer sector on the day of the announcement.

NZAS is 79% owned by RIO and 21 % by Japan's Sumitomo Chemical. The smelter contributes $400mn to the Southland economy, $1bn in annual exports and employs over 1,000 people. Weakness in aluminium prices combined with what RIO considers "high energy prices" has resulted in the review. NZAS consumes approximately 13% of the country's total power usage. This is supplied by Meridian Energy from its hydro dams in the South Island, and partially offset by agreements with Contact, Genesis and Mercury Energy.

The threat of closure last surfaced in 2013 but nothing materialised. RIO has said all options are on the table this time including closure and expect the review to be completed by Q1 2020. If the smelter closed, this would be a material hit to Meridian, and to the broader sector given the offset agreements and the sizeable drop in national electricity demand. Tiwai currently produces approximately 10% of RIO's total aluminium production but RIO has said they expect the smelter to remain unprofitable in the short to medium term. That being said, Tiwai's renewable energy credentials means their aluminium is sold at a premium to spot and it is rumoured NZAS would incur up to $250mn in exit costs if it were to close completely. This means there may be an element of posturing on RIO's side.

We believe RIO management is using the review to improve its energy input costs which if renegotiated would equate to a hit of around $40mn-$50mn of annual revenue to the gentailers. The listed sector makes around ~$2.3bn of EBITDA per annum so this equates to less than 2% of industry EBITDA. It is also possible that RIO could renegotiate transmission costs as the NZAS pays a sizeable amount for grid infrastructure that it does not use. In our view, the 10%+ sell-off was an overreaction. Meridian and Contact Energy have been hit the hardest as they would be the most affected by the closure. Despite this, we think the chance of closure is low, and therefore these two stocks now offer the best value in the sector. Short-term, there may be volatility as both sides posture, but ultimately the situation will be resolved. We believe the sector will continue to be favoured in this low interest environment given its strong dividend yields and cashflows, and therefore the current situation represents a good buying opportunity.

NZ Gentailers – Share Price Year to Date (normalised to 100)



Source: Eikon

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