Tactical Thoughts – March 2020

Financial markets recoiled in the last week of February as fears of coronavirus escalated beyond just China. Global equities witnessed one of their sharpest corrections in history. Investors initially looked through the risks when the outbreak first surfaced in China in late December, early January but as it spread around the world - most notably Italy, South Korea, Iran and the US - panic set in. Not only did stock markets fall sharply but one of the main global risk indicators, the US 10 Year Treasury note fell to a record low yield exemplifying the level of fear.

Prior to February, equity markets round the world had had a remarkedly strong run over the last 12 months and many commentators had been saying they were due a pullback. The coronavirus has proved to be the reason. Much of the rally had been driven by the extraordinary liquidity conditions provided by the Reserve Bank of New Zealand, the US Federal Reserve and other central banks round the world. The strength in stocks and bonds can be largely attributed to central banks keeping interest rates artificially low and in the current environment we do not see this changing anytime soon. At the end of this month's edition of Tactical Thoughts there is an article about the investment merits (or otherwise) of owning Government debt. Please contact your adviser if you would like to learn more.

New Zealand equities were in no way immune from the sell-off but the magnitude of the fall was less than most other global benchmarks. The NZX 50 Gross Index fell -3.9% on the month as the virus which had been brewing in China went global. Our domestic corporate earnings season and company results were largely forgotten as market complacency gave way to a significant correction. The stocks that managed to avoid heavy selling were those with positive earnings surprises and core earnings that are unrelated to travel, tourism and/or China. Fisher & Paykel Healthcare, a2 Milk and Chorus all performed well.

Domestic economic data for the month was mixed. The Reserve Bank of New Zealand left the Official Cash Rate (OCR) at 1.0%, but noted that monetary policy "had time to adjust if needed" should the coronavirus worsen; the market is now pricing in two and a half rate cuts in the next year. The BNZ (PMI) manufacturing index was stable but remained in contractionary territory at 49.6 for January. Housing prices and sales continue to improve as REINZ data showed house sales were up +3.2% year on year, while QV showed house prices up +4.4% year on year.

Australian shares fell sharply in February, down -7.7% for the month. Healthcare stocks noticeably fell less than other sectors, while Energy and Technology fell the most. The -4.0% fall in defensive healthcare and utilities was roughly half the fall in the broader market. The ASX released an All Technology Index on February 24th which tracks the performance of an initial 46 technology companies listed on the Australian exchange. This proved a tough period for the index to begin its track record, down -14.0% in its inaugural week.

The UK was the worst performing developed global market, with the FTSE 100 down -9.7%, due to both coronavirus concerns and Brexit. Sentiment was no better in Europe, given an explosion in cases in Northern Italy which has caused lockdowns and closures across much of the continent.

Chinese equites actually outperformed over the course of the month with figures showing that perhaps cases peaked in mid-February and thus China may have already passed the worst. We believe China is in a better position to stimulate, which could mean HK/China stocks may continue to outperform in the near term. We are also keeping a close eye on commodities and resource related stocks as these will benefit from any China stimulus measures. Understandably gold mining stocks have traded higher as fears continue to linger. The safe-haven precious metal surged to near all-time highs.

It is difficult to predict the medium-term impact of the coronavirus on markets. The closest comparable is SARS in 2003 which ultimately proved to have a transitory effect. The coronavirus death rate so far seems to be lower than SARS but it is spreading faster. China is also far more integrated into the world’s supply chain than it was back in 2003 when the world grappled with SARS. SARS took place at the end of a bear market not long after the tech wreck and 9/11 terror attacks. Coronavirus has hit at a time when we have had a phenomenal bull market and underlying investor sentiment today is very different.

We think most people (and reassuringly Governments) have realised the gravity of the situation and are responding accordingly. We see further earnings downgrades to come from companies affected and the likelihood that the continued spread of the virus will result in reduced consumption across a number of industries. Workplaces and productivity could all be affected. If the situation materially worsens, fiscal and monetary policy will help alleviate any short-term pain and central banks have reassured us they are willing to act and will do so promptly. The Federal Reserve surprised markets on March 3rd with an emergency 50 basis point cut and said it was “closely monitoring developments and their implications for the economic outlook and will use its tools and act as appropriate”.

As we go to press the situation is by no means improving. While markets have priced this into a large degree, daily gyrations make for a challenging investment environment. Until the number of cases (especially in the US) peak, we expect equity volatility to continue. We see merit in owning solid cashflow backed businesses and expect listed property, gentailers, gold and defensive equities like Spark and Chorus to continue to outperform. For investors looking to the recovery, we would add names negatively impacted by coronavirus (e.g. travel, tourism and technology). In the near term, we stay cautious but what gives us assurance is that historically these bouts of volatility have resulted in investment opportunities for those who are long term focused.

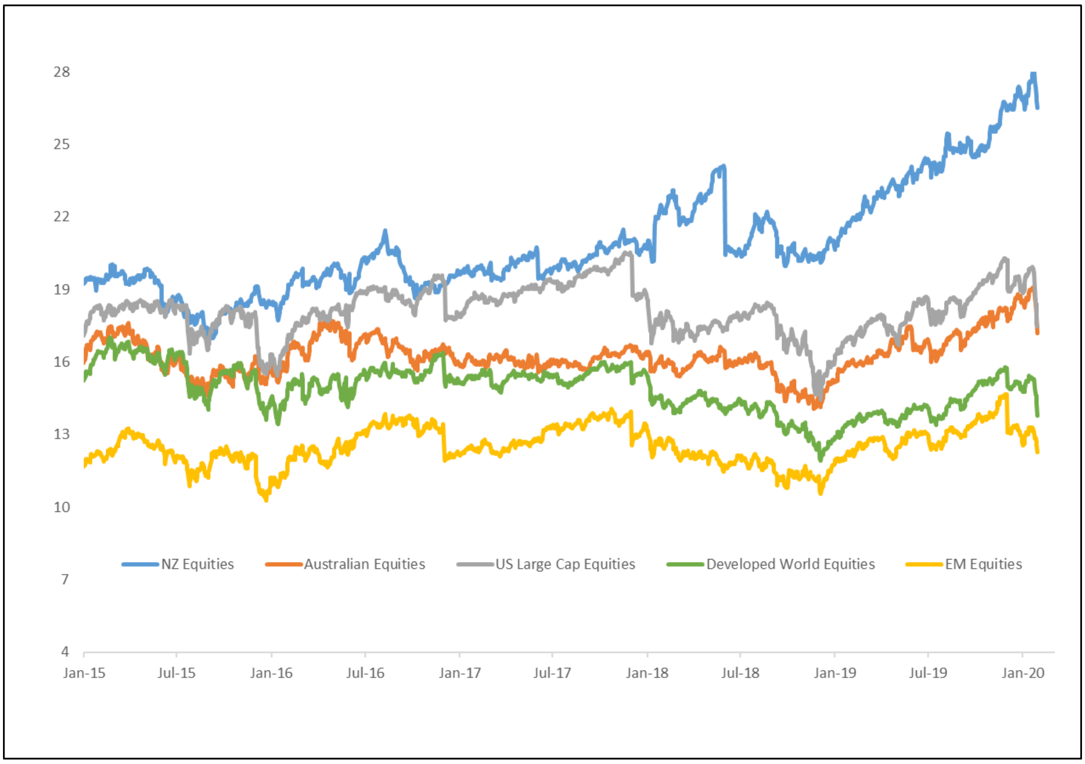
Recommended Tactical Asset Allocation

Underweight □□■□□ **Overweight**

Asset Class	Tactical	Rationale
NZ Equities	□□■□□	We retain our Neutral call for NZ equities. The coronavirus may present buying opportunities, but we prefer to wait on the sidelines.
Australian Equities	□■□□□	Earnings season has delivered mixed results for corporate Australia. Given the coronavirus backdrop we maintain our Moderate Underweight.
US Large Cap Equities	□□■□□	Until infections peak in mainland US, we think US equities will remain volatile. Clients should be ready to buy oversold names when news improves.
US Small Cap Equities	□■□□□	We continue to down-weight US small caps as we believe large caps offer more compelling exposure.
Developed World Equities	□□■□□	The outbreak in Italy has had a significant impact on Europe. We are now Neutral on Developed Markets as Japan has also had trouble containing the virus.
EM Equities	□□■□□	EM equities are traditionally more volatile than Developed Markets but even though infections may have peaked in China, we opt to stay Neutral.
NZ Listed Property	□□■■□	Listed property had an exceptional run last year. We had not expected this to continue but due to unprecedented central bank action we are now tactically more constructive.
Fixed Interest	□□■□□	Fixed Interest has provided the necessary protection that we expected it to, but with such low rates for the foreseeable future, it offers capital preservation / insurance benefits rather than a meaningful yield.
Cash	□■■□□	We upweight Cash tactically to acknowledge the current backdrop and keep our powder dry.

Market Price Earnings ratios

Price Earnings ratios 2015 – 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
As at 29 February	26.5	17.2	17.5	23.5	13.8	12.3
10-year average	18.4	15.1	16.4	25.0	14.0	11.8
5-year average	20.9	16.3	18.1	26.9	14.9	12.5

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

FX Returns to 29 February 2020

NZ$ FX performance percentage returns to 29 February 2020

Currency Pair	1m	3m	6m	12m
NZ$/ US$	-3.4%	-2.7%	-1.3%	-8.2%
NZ$/ AU$	-0.8%	1.0%	2.0%	-0.1%

Source: Eikon, Bloomberg, February 2020.

Index Returns to 29 February 2020

Index percentage returns in their currency

Asset Class	Index		1m	3m	6m	12m
NZ Equities	S&P/NZX 50 Gross	NZ$	-3.9	-0.5	4.7	20.8
Australian Equities	S&P/ASX Accumulation 200	AU$	-7.7	-5.2	-0.6	8.6
US Large Cap Equities	Russell 1000 Total Return	US$	-8.2	-5.4	2.0	7.8
US Small Cap Equities	Russell 2000 Total Return	US$	-8.4	-8.8	-0.5	-4.9
Developed World Equities	MSCI EAFE*	US$	-9.2	-8.3	-1.8	-3.4
EM Equities	MSCI EM*	US$	-5.3	-3.3	2.2	-4.3
NZ Listed Property	S&P/NZX Property Gross	NZ$	-1.9	3.1	1.7	27.5
Fixed Interest	S&P/NZX Corporate A	NZ$	0.9	1.4	0.8	6.3
Cash	ANZ New Zealand Call Rate	NZ$	0.1	0.2	0.5	1.3

Source: Eikon, Bloomberg, February 2020 (*not total return index).

Index percentage returns translated into NZ$

Asset Class	Index	1m	3m	6m	12m
NZ Equities	S&P/NZX 50 Gross	-3.9	-0.5	4.7	20.8
Australian Equities	S&P/ASX Accumulation 200	-7.1	-6.2	-3.2	8.5
US Large Cap Equities	Russell 1000 Total Return	-4.7	-2.5	3.0	17.8
US Small Cap Equities	Russell 2000 Total Return	-4.9	-6.0	0.5	3.9
Developed World Equities	MSCI EAFE*	-5.8	-5.5	-0.8	5.5
EM Equities	MSCI EM*	-1.7	-0.4	3.2	4.6
NZ Listed Property	S&P/NZX All Real Estate	-1.9	3.1	1.7	27.5
Fixed Interest	S&P/NZX Corporate A	0.9	1.4	0.8	6.3
Cash	ANZ New Zealand Call Rate	0.1	0.2	0.5	1.3

Source: Eikon, Bloomberg, February 2020 (*not total return index).

Macquarie Interest Rate and FX Forecasts

Rate	4Q2019A	1Q2020E	2Q2020E	3Q2020E	4Q2020E
Australia Cash Rate	0.7500	0.7500	0.7500	0.7500	0.7500
Australia 10yr govt	1.3700	0.8500	1.0000	1.3000	1.5000
US Fed Funds Rate	1.5000	1.5000	1.2500	1.2500	1.2500
US 10yr Treasury	1.9200	1.3000	1.4000	1.6000	1.8000
NZD OCR	1.0000	1.0000	1.0000	1.0000	1.0000
NZ 10yr govt	1.6500	1.1500	1.2500	1.5000	1.6500
NZ$/ US$	0.6740	0.6400	0.6500	0.6600	0.6600
AU$/ US$	0.7021	0.6500	0.6800	0.7000	0.7000
NZ$/ AU$	0.9600	0.9846	0.9559	0.9429	0.9429
EUR/ US$	1.1213	1.1000	1.1200	1.1300	1.1500
US$/ JPY	108.61	107.00	108.00	105.00	104.00
GBP/ US$	1.3257	1.2800	1.2700	1.3000	1.3500

Source: Macquarie Securities, February 2020.

10 Year Government bonds, Investment or Insurance?

Mark Fowler, Head of Investments

The last couple of weeks has been something of a rollercoaster ride for investors, with volatility spiking as the world and financial markets try to come to grips with COVID-19, and both the human and economic implications.

Unsurprisingly, we have seen a co-ordinated global central bank response. In simple terms, the US, Canada and Australia have all come out and lowered interest rates, with it widely expected that the United Kingdom and New Zealand will follow suit.

What has been somewhat lost in the ensuing chaos, is the yield or return of a New Zealand ten-year government bond is now ~1.00%. Let's just think about that for a minute. Investors are prepared to lend money to the government (assuming they hold to maturity) for a period of the next ten years for a one percent return. The European example is even more head scratching with the return on ten- year German bonds now falling to a negative -0.60%. In other words, you pay the government a fee to hold your money.

What makes this equation even more baffling is that in New Zealand inflation is tracking somewhere close to two percent along with GDP growth. In a normalised economic environment, those two numbers alone would be key detractors when considering investing in long dated government bonds. Normalised economic environment times these are not.

At this juncture the notion of investors buying government bonds for a modest return is lost. More likely, government bonds are now effectively an insurance contract. A contract whereby investors believe they will get their money back, and the belief that there is liquidity to access their money if circumstances change.

A government bond is deemed the closest thing to a 'risk-free' investment and investors have flocked there on safe-haven demand. For many, knowing that their capital will be preserved far outweighs the thought of their capital being at risk seeking a higher return.

NZ 10 Year Yield

Source: Bloomberg

Note: This in an abridged version of the article written by Mark Fowler, Hobson Wealth Head of Investments, that originally ran in the New Zealand Herald on Friday March 6th, 2020.

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