Investment Update – February 2020

New Zealand Starts New Decade in Pole Position

The new decade commenced with the New Zealand sharemarket leaping out of the starting gate but giving up some ground into the end of the month. The S&P/NZX 50 Gross index was up 2% for January. New Zealand business confidence as measured by the QBSO rebounded in the 4th quarter of 2019. Although markedly improved overall business confidence remains negative. Inflation has lifted to an annual rate of 1.9% and was marginally ahead of the markets 1.8% expectation. The better outcome has reduced the prospect of the Reserve Bank of New Zealand (RBNZ) cutting the Official Cash Rate (OCR) and resulted in the major banks revising their interest rate forecasts. Kainga Ora (previously Housing Corp.) has had its borrowing limit increased to NZ$7.1 billion from NZ$3.05 billion. This increased expenditure is additional to the government's additional fiscal spending announced last year and reinforces the fiscal impulse and inflationary pressure from construction. Potentially this could lift the RBNZ's OCR forecast track by as much as 0.5% at Q4 2021.

The New Zealand residential housing market has picked-up in the latter part of 2019 with house price appreciation in the provinces still strong while Auckland prices are beginning to lift. A shortage of supply within the residential housing market continued with Realestate.co.nz reporting 18,230 homes available nationally in December 2019 versus 60,000 in April 2008. The population has increased substantially since 2008 but the rate of net immigration is declining with a net increase of 41,500 in the year to November 2019 down from 43,000 in October. Higher house prices provided a knock-on benefit to retirement village sector as a whole. Metlifecare announced it had received a takeover offer at $7.00, well above its prior trading price of $6.38.

The first dairy auction of 2020 resulted in an improvement in prices from the December fall. Prices were up 2.8% in US$ terms and 1.9% in NZ$. The recovery in prices supports the pay-outs to dairy farmers and Synlait Milk in late January announced a milk price for the 2019/2020 season of $7.25 kgMS from $7.00. Tourism however is one of the largest earners of export receipts in the New Zealand economy. Although the sector generally remains in good health there has been deterioration in arrival numbers. Overall tourist arrivals fell 3% in November. Subsequently the occurrence of the Australian bush fires is likely to have affected bookings as travellers consider Australia and New Zealand a joint destination. The tourism sector (Auckland Airport, Tourism Holdings and Air New Zealand) will inevitably be at the forefront of shares impacted by virus related travel constraints.

Fitch Ratings affirmed New Zealand's long-term credit rating in January at AA. Fitch's endorsement of the management of the economy reflected the low government debt to GDP ratio.

Australia Investment Case Mixed

While the Australian sharemarket was strong in January, Australia has made a less confident economic start to the new year. Australian consumer confidence fell 1.7% in the first week of January to the lowest level in 4 years. In tandem with lower consumer confidence Australian consumption has been falling at minus 3% year on year in November. The confidence and consumption prints were consistent with job advertising which fell further in December.

Kaufland a German supermarket chain elected to withdraw from the Australian market after spending A$0.5 billion and not opening a single store.

Despite the consumer sector signalling a weak environment Australian unemployment fell to 5.1% which was better than expected. Australian inflation picked up to 1.8% for the 2019 calendar year. This has allayed concern that interest rates need to reduce further in Australia in the short term. Iron ore prices have improved again with renewed demand from Asia, and this has supported the large mining companies. Financials which comprise 28% of the ASX 200 managed to lift approximately 5% in January. The Australian listed property market did even better than the ASX 200 in the first month of the year up over 6%.

China's Significance to New Zealand Continues to Grow

New Zealand's trade ties with China continue to expand. In 2019 New Zealand recorded a NZ$3.8 billion trade surplus with China. China now takes 28% of all New Zealand exports. Chinese entities are large direct investors in the country. Chinese travellers have been the fastest growing segment of the tourist market until recently. As a large proportion of New Zealand soft commodities are exported to China, New Zealand currency movements have recently been correlated with movements in the Renminbi. The ongoing health of the Chinese economy is critical to the level of activity within New Zealand.

Parking the potential impact of the Coronavirus ongoing slowing of GDP growth in China is probable from the current level of 6% to a lower growth rate over the next 5 years. Although China's debt to GDP ratio continues to expand the rate of growth is decelerating and this is likely to plateau.

Some caution by Chinese investors is illustrated by Chinese holdings of US Treasury bonds which has fallen by US$32 billion in the last six months with Japan replacing China as the largest foreign holder of US treasuries. The Chinese equity markets were generally weaker into the end of the truncated month with the Shanghai index down 3.5% and the Hang Seng minus 7.8%. The first trading day after Chinese New Year was also very weak

US Continues to Expand

The US Economy continues to expand but the rate of growth decelerated. 145,000 jobs were added in December below the 160,000 expected. Wage growth continued at a positive 2.9% clip but slightly behind the 3% rate earlier in the year.US housing starts jumped 16.9% in December to 1.608 million units, a 13-year high. US house prices have grown 7.8% year on year. The US GDP grew 2.1% in 2019 based on the 4th quarter data. The US Federal Reserve at its late January meeting remained on hold keeping the Federal Funds rate in the 1.5% to 1.75% range. Although the Federal Reserve has withdrawn official quantitative easing the bank's balance sheet is expanding as liquidity is required to support the repurchase agreement market. Some argue this represents a stealth monetary easing.

Despite various economic and political upheavals, the US equity market has remained robust. The year commenced with the assassination of Iranian general Soleimani and an exchange of missiles sparking fears of escalating conflict with Iran. Late January saw the commencement of impeachment proceedings against President Trump without market sentiment being dented.

US quarterly company reporting has generally surprised on the upside. US bank's revenues and profitability exceeded expectations.

Technology companies continued to report earnings growth and to dominate index performance. In the final quarter of 2019, the S&P 500 increased 8.5%.

The surprise company performance has come from the much-maligned Tesla. The company has continued to expand production and put together two quarters of profitability. The company was the most shorted large company in terms of percentage of company value and a short squeeze has contributed to the upward trajectory +51%.

Europe Exhibits Signs of Life

The European Central Bank (ECB) at its first meeting of the year held rates steady and is maintaining quantitative easing at a rate of Euro 20 billion per month. Interestingly despite maintaining policy settings the ECB has launched the first strategic review since 2003 investigating whether inflation targeting (and the target level) is still appropriate.

This follows Sweden's Riksbank exiting a negative interest rate regime at the end of 2019. Despite the European economy remaining in the doldrums European equity markets performed well with the German DAX up over 7% in the final quarter of 2019.

The month of January also saw the final implementation of Brexit. In the short term the actual exit will change little for the UK economy while trade agreements etc are negotiated although there is clear scope for disruption in the coming year in sectors such as manufacturing and fishing. UK inflation fell to its lowest level in 3 years at 1.3% but Bank of England Governor Carney maintained the bank rate at 0.75% at his final meeting.

Outlook

The key consideration in the immediate outlook is the path that the Coronavirus will take. Optimistically the impact of the virus will be confined in the same manner as previous SARS, MERS and Zika outbreaks. Should this not be the case, which we think has low probability, then re-evaluation of investment strategy will be required. The fall in long-term New Zealand interest rates in January appears to be driven by safe haven demand in response to the Coronavirus outbreak. To the extent that the outbreak does not become a global epidemic and the economic effects are temporary then there is scope for domestic bond yields to return to pre-Coronavirus levels.

This scenario is predicated on the OCR remaining anchored and inflation at least persisting at current levels over the next year. Ten-year bond rates below the level of inflation are inherently unattractive to investors. Low yields will likely support the local equity market which continues to provide superior dividend yield compared to fixed income. In the event long rates are maintained this is unlikely to drive equities up to the extent experienced to 2019. Price appreciation in 2019 was largely a result of multiple expansion as opposed to earnings growth. Local equity returns in 2020 are likely to be far more modest with dividend yield representing a large proportion of the total return.

Average NZ market earnings growth is likely to be around mid-single digit in 2020 and as a result company values will need to grow into prices over time.

Further the actual earnings performance will be variable between sectors and individual companies.

Inflation will need to exceed central bank's target levels for a sustained period before monetary authorities are inclined to tighten monetary policy which would drive up rates.

Therefore, from an income perspective, domestic shares continue to be favoured. Given current prevailing valuation multiples in New Zealand increased exposure to international equities may provide a better investment proposition particularly if offshore economies and market performance becomes less synchronised. Offshore investment needs to be growth as opposed to income focused and undertaken on a selective basis.