Investment Update – July 2020

Investment Rebound Loses Velocity

Investment markets continue to be dominated by the impact of the COVID 19 virus and the health management and economic stimulus responses. Economies globally are at different stages in combatting the virus and resuscitating economic activity. This has been reflected in asset class performance. Fixed income markets have been flooded with monetary stimulus driving down interest rates. However, the absolute extent of growth in the capital value of existing bonds has been more modest in June with returns from bond indices subdued. Equity markets since March had been in recovery mode with strong bounces in share values as investors looked through the current economic disruption and sought to redeploy from cash.

To a degree equity markets have been gripped by a fear of missing out (FOMO) and benefitted from participation from new investors as equity investment has become more accessible and lower cost. These drivers of investor returns began to dissipate in June as doubts emerged over the extent and length of time it will take for activity to return to more normalised levels. A key factor in market hesitation has been the increasing number of COVID 19 infections in emerging markets and the potential for a second wave of infections in developed countries as restrictions are removed perhaps prematurely. The performance of equity markets has reflected the health situation with Australasian markets fairing relatively well compared with the United States where the S&P 500 index had a less pronounced lift for the month. Another feature of the equity markets in June has been increased volatility with daily investment returns fluctuating by up to several percent. This reflects the fragility of markets and the degree to which confidence has a relatively weak underpinning.

Political events continue to be a destabilising influence

The instability in policy is particularly evident in the United States. This has several dimensions. The primary concern is the ongoing status of relations between China and the US, the two largest trading nations in the world. Potential continues to exist for trade between the two countries to once more be derailed. Attribution of blame for the virus's spread being a prime catalyst. Clearly a decoupling of the China and US economies is in neither countries immediate best interests but there are hardening attitudes that the respective countries prosperity and security is best served by a less close relationship. Partly in response to COVID 19 a domestication of supply chains is being implemented and China is pivoting to other emerging markets as a source of demand and is developing its expertise so as to remove dependency on US technology.

Related to the China US tension is the relationship between Australia and China. The issues between the two countries have extended to attendance at Australian educational institutions by Chinese students. Changes to Australian takeover legislation is considered to be targeted at limiting Chinese investment in Australia. China in turn has indicated it may seek alternative sources of coal for its industry. Despite these manifestations of a rift between the two countries the price of iron ore continues to be elevated with Chinese traders the primary buyers.

Re-emergence of trade tensions and increasing isolationist trade policy is also possible between the US and Europe. The US is investigating whether digital services taxes levied on US technology companies requires a response in the form of punitive tariffs. Proposed retaliatory tariffs could be as high as 100% on cheese and olives. The action follows a ruling by the World Trade Organisation that found the European Union can legally impose tariffs on US$11 billion of US goods in retaliation for US subsidies to Boeing. The US elections are now looming. For the first time candidate Joe Biden is ahead of the incumbent in US popularity polls. Together with this, support for the Democratic party has also risen. This raises the prospect of a Democratic Senate and Congress. Current Democratic party policy envisages a roll back of tax concessions. If implemented this will be negative for US earnings and share values.

China Emerging in Stronger Position

China as the first to experience COVID-19, and implementation of counter-measures is ahead of most countries in its economic recovery. As New Zealand's major trading partner this is a significant benefit to New Zealand companies. China's manufacturing activity expanded in May. China is implementing a 'new infrastructure' programme intended to modernise the country and advance the technological base. New infrastructure focuses on 5G networks, renewable energy charging stations, internet of things networks, cloud computing, big data and artificial intelligence. At a more prosaic level total excavator sales increased 60% in April on a year on year basis. Chinese car sales rose 15% in May after a 4% rise in April. Chinese industrial production was up 4.4% in May from a year ago Retail sales were down on a year on year basis but substantially improved from the prior month. A key signal of the improving Chinese economy is electricity production which increased 4.3% year on year.

Stimulus Measures in Context

The New Zealand Debt Management Office issued a record NZ$7 billion in a single May 2024 NZ Government Bond. The bond was sold at a yield of 0.43%. It is twice as large as the largest prior single issue. Non-Australasian investors bought 36% of the issue indicating strong support for NZ Government credit despite the low interest rate. This was followed by a May 2041 NZ Government bond later in the month which extended the term of government debt. The longer-term debt has allowed some minor steepening of the yield curve. The Reserve Bank of New Zealand (RBNZ) Monetary Policy Review during the month indicates the RBNZ is prepared to provide additional stimulus as necessary but given interest rates near the lower bound has a 'readiness to deploy alternative monetary policy tools'. The RBNZ will provide more information on its intentions at its August statement. New Zealand's total annual GDP is approximately NZ$310 billion (pre any COVID19 induced falls). The RBNZ reported that gross government debt was NZ$101 billion at the end of May. Government debt to GDP is therefore around 33% of GDP. The New Zealand Treasury projects that if public debt continues to rise at planned rates to NZ$190 billion over the next 5 years it will represent over 50% of forecast GDP.

Monetary stimulus only indirectly stimulates economic activity. Since January US$2 trillion has been deposited in US banks according to the Federal Deposit Insurance Corporation. April deposits grew by US$865 million more than the previous record for an entire year.

Substantial cash funds are believed to reside in retail investors investment accounts with Charles Schwab clients thought to hold over US$4 trillion alone.

The flood of cash is demonstrated by Marcus, Goldman Sachs online savings account in the United Kingdom which has been closed to new investors after 500,000 British users deposited GBP 21 billion.

Despite the flood of funds there is some friction in the flow on to borrowers. The recent US bank stress tests have resulted in further restrictions being placed on US banks in relation to buyback programmes and dividend levels. Locally banks have been cautious to lend and have slowed loans to new borrowers with above 80% loan to value ratios. This in effect limits the benefit of falling mortgage rates. With the banking system awash with cash it is no surprise that term deposit rates have fallen through the month.

Conclusions

Although a vaccine remains a distant prospect an economic recovery will ultimately eventuate. However, judgements must be made as to the extent to which investment value is already reflected in prices and which geographies and sectors will continue to experience the lingering impact of the virus. The effects will be uneven and sporadic and accordingly navigation of investment markets will require the charting of a prudent course. Further complicating the short and medium-term strategy is the local political overlay. From here-on politicking will ramp up. Wide policy divergence is likely in respect of the impact on investment assets. This in turn is further complicated by the various coalition permutations that emerge. Pull backs in index values may occur in coming months. If and when these occur the depth of decline is unlikely to be severe or prolonged as monetary stimulus applied will likely support asset values. In the current interest rate environment, the low returns will continue to push investors towards riskier and potentially higher returning opportunities. However, any unexpected economic data is the greatest threat and investors should manage their risk levels.