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Investment Update – October 2020

Interest Rates Continue to Fall

Interest rates in New Zealand have continued to fall consistent with Reserve Bank policy. The month of September saw the emergence of negative rates in New Zealand with government bonds out to five years maturity selling at negative yields. Consistent with wholesale market trends term deposit rates sank over the month also. Bank term deposit rates are now all below 2% out to five years. New Zealand interest rates are below those in Australia with 10-year government rates of approximately 0.44% and 0.84% respectively. The equivalent United States 10-year government bond is 0.66%.

The continuing fall in interest rates and the emergence of negative rates is challenging fixed income investment managers to determine forward strategy in response. Fixed income remains primarily a capital preservation asset for most investors but maximising the income aspect of the asset class is a conundrum in a near zero rate environment. It may tempt managers to increase the risk profile they adopt moving into lower credit, extending duration of portfolios longer and engaging in more trading.

Impact on Real Estate

The historically low interest rates are finding expression in various markets. The volume of house sales has increased despite the uncertainty COVID-19 has engendered and together with volume of sales, average price has increased markedly in the last 2 months with Auckland for once not leading the market. The buoyancy in the established housing market is also eliciting a supply response. Statistics New Zealand recorded 10,430 new dwelling consents in the 3 months to July, the most in any three-month period since the 1970s.

Impact on Savings

The low interest rate environment has also induced other changes in investor behaviour. In response to low rates and uncertainty consumers have increased saving despite the low interest reward. For example, the Australian household savings rate has increased from less than 5% of income to almost 20% in the last year. The inverse of the higher savings level has been a reduction in debt particularly credit card debt which has declined over the last 2 years. Australian credit card balances have reduced from over A$30 billion to less than A$25 billion. Falling credit card debt may also relate to the popularity of buy now pay later services. New Zealand data demonstrates the same pattern.

Impact on Retail Spending

Savings and borrowing trends could be expected to result in a subdued retailing environment and the closure of high street retail outlets would tend to support this. However, some retailers are reporting buoyant market conditions in part driven by the expansion of ecommerce. Some redirection of consumer spending away from travel and hospitality is also likely. Briscoes Managing Director observed that there was 'extraordinary demand' in the suburbs after the lockdown. Gerry Harvey, Harvey Norman Chairman, has claimed he has never seen trading conditions like those currently experienced. Hallenstein Glasson's sales for the twelve months to 1 August illustrated this resilience, flat over the year despite the disruption of lockdowns.

Supply chain disruption may be a residual effect of the present upheaval from COVID-19. Specific examples are pharmaceuticals and medical devices as well as consumer durables being impacted.

Impact on Debt Issuance

The low interest rates favour borrowers if they have higher returning projects available. The low rates are now calling forth new issuance from the corporate bond market as it appears that rates are nearing a floor and banks will be reluctant to lend at highly compressed margins. A feature of September's bond supply was not only lower rates but also longer duration. Auckland City issued a 30-year bond marking a record for a non-central government issue.

Impact on Government Borrowing Costs

Despite the increase in government debt since the onset of COVID-19 the total cost of new borrowing has decreased in the short-term. The New Zealand Government's interest expense on new borrowing this year was $21 million less than the cost of new 2018 borrowing despite the amount of money being borrowed being almost four times the amount. In the short-term this makes the additional debt more manageable.

Impact on Share Markets

Falling interest rates are a double-edged sword for sharemarkets. The weakness in rates generally reflects a low level of activity in the economy and a surplus of capital or a poor macroeconomic environment for operating businesses. The low rates provide further support for shares as dividend yields become more attractive and investors reallocate from fixed income to dividend income. This in turn propels share values higher as dividend yields are driven down consistent with the lower interest rate environment.

Offshore Experience of Negative Interest Rates

Some European countries have had negative interest rate environments for over five years. The Swedish experience is perhaps the most pertinent with both New Zealand and Sweden smaller export orientated trading countries. When Sweden implemented negative rates house prices increased by double digit rates similar to the current New Zealand situation.

The Swedish authorities felt compelled to introduce debt ceilings etc to dampen the effect on housing values. The monetary policy was effective in that unemployment fell and GDP growth was reinvigorated. The inflation effect over the five-year period was modest. A further effect of the negative interest rate policy was a weaker currency that improved competitiveness of exports and increased the price of overseas goods and services. The negative interest rate policy appears to have retarded the availability of business loans and may encourage consumers to hoard cash. Sales of safes have increased by a third in Germany since the introduction of negative rates.

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Elections Draw Closer

Normally investment markets are averse to uncertainty with election outcomes a negative headwind for investment values. In New Zealand the sharemarket appears to be relatively sanguine over the outcome of the general election with other factors having greater sway. Political parties have progressively released policy agendas as the election approaches. The Labour Party appears to be promoting a continuation of the status quo. Although a Labour government will introduce a new tax tier above $180,000 at 39% the party has undertaken not to introduce a capital gains tax under the current prime minister's leadership. A Labour government will continue to spend on transport projects despite the budgetary constraints of COVID-19 support. The Labour Party is currently in coalition with the Green Party. The Green Party has introduction of a wealth tax as a policy plank. Reconciliation of this policy with Labour if the two parties need to enter a coalition to form a government could be negative for investors. The Green Party has also committed to higher income tax for individuals and further tightening of overseas investor controls. The National Party's policies envisage increased government spending in areas such as infrastructure, the suspension of contributions to the New Zealand Super fund and a temporary reduction in tax rates for individuals. None of the major parties appears to suggest change to corporate tax rates.

The United States election will follow that in New Zealand. Re-election of President Trump will see a continuation of the present approach to policy making. Should contender Joe Biden be elected then tax policy is likely to weigh on the US sharemarket. A Biden presidency will revert to prior levels of corporate taxation and will impose a fresh capital gains tax. These policy settings will undisputedly be a negative short-term headwind for the US sharemarket to overcome. A Biden regime however is also committed to a spending programme that will be the largest in decades with US$5.4 trillion of spending envisaged over ten years.

United States Monetary Policy

During September the US Federal Reserve committed to retaining the Federal Funds Rate at 0-0.25% until employment is a at a maximum level and inflation reaches 2%. Additionally, the Federal Reserve has indicated that it will adopt an inflation averaging approach which will allow inflation to exceed 2% and remain above that level for some time. The implication of these policy statements is that US interest rates will remain low for the foreseeable future.

Summary

Some of the momentum in the technology led growth segment of the US market has dissipated over September. The growth segment of the market is not yet a spent force but some refocusing and a shift of emphasis to new disruptors versus established leaders may be occurring. Apple in September fell 13.7%.

In New Zealand similar weakness was exhibited with a pronounced fall in A2 Milk. Whether this represents a trend of sharemarkets broadening their focus or a temporary reset is not yet clear. Ongoing support for shares appears likely to continue given no respite from falling rates. There will be continuing mixed performance from shares as COVID-19 effects continue to accumulate and greater dispersion of returns is likely.

If you have any question, please contact me on 04 939 2902.

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