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Investment Update – November 2020

Australasian Equity Investors Optimistic in October

The New Zealand share market experienced a positive performance in October with the S&P/NZX 50 gross index up 2.9% for the month. The S&P/ASX 200 rose by a more modest 1.9% in the same period. Currently there are two divergent economic scenarios which prospectively could result in markedly different outcomes for investors. Equity markets look forward and over October the optimistic outcome held sway in Australasia.

Pessimistic pundits are focused on the inability to suppress the COVID 19 virus in Europe and the United States. In their opinion the near-term disruption to economic activity is projected to continue and result in business collapses or at best subdued trading activity and increasing unemployment which consequently will have trade impacts for the rest of the world. This in turn will limit growth or result in declining revenues for externally facing New Zealand companies. Within this scenario global economic uncertainty is further amplified by political instability. The pessimistic scenario anticipates New Zealand's domestic economy as being on the edge of an economic cliff which will see a dramatic increase in unemployment numbers as international tourism remains absent and employment subsidisation schemes cease or are scaled back.

The contrary optimistic scenario looks beyond the current global second wave of virus-related hospitalisations. The optimists believe that sufficient vaccine trials are in stage III testing and that an effective vaccine is on the cusp of approval. Effective vaccination and treatments will be transformational in enabling day to day economic function to return to normality. In this scenario quantitative easing will be sufficient to not only maintain economic activity but will provide a boost to economic growth resulting in a sharp recovery in demand. Low interest rates will direct investment capital away from fixed income to more risky equity investments. Gradually overseas markets and travel will re-open representing an upside option from current levels. The stimulus provided should enable a return of business confidence, employment and consumer demand sufficient to enable a quick recovery from recession. In turn this should buoy share markets and the values of hard assets.

In all probability the actual outcome will most likely lie between these optimistic and pessimistic scenarios but with a tendency for share values to overshoot on either the upside or downside depending on the prevailing sentiment as markets react to events.

NZ Election

Events during October tended to have an ambient influence rather than being market moving in themselves and a continuation/confirmation of investor expectation. Auckland joined the rest of New Zealand at alert level 1 which enabled a return to normality in the hospitality and leisure sector and welcome relief to business operators and landlords.

The delayed general election was held with an emphatic victory for the incumbent Labour government such that it is no longer reliant on minor parties for support. Investors have interpreted this as a continuation of existing economic management with less opportunity for more extreme market intervention and specific agenda project spending.

Term Deposit Rates Continued to Fall

Continuation of existing trends was also evident in the fixed income markets although conviction in the long-term results of current policy initiatives continued to evolve. Term deposit rates offered by banks continued to fall. Term deposit rates for some banks have now fallen below 1% for all maturities.

The upcoming terms of the Funding for Lending Programme (FLP) is a focus of attention for the New Zealand fixed income markets. The size and term of the FLP will be a strong indicator of the longer-term prevailing interest rate outlook and how long investors may have to suffer the current low rates. Interplay between the FLP, Reserve Bank of New Zealand (RBNZ) NZ bond buying activity and trends in international interest rates will all contribute to the shape of the New Zealand yield curve and in turn the appeal of shares and alternative investments.

While Australasian and other central banks remain committed to monetary easing there has been moderate increase in the United States 10-year Treasury bonds over October from 0.68% to 0.88%. This is not sufficient in itself to establish a new direction for rates, but it is in marked contrast to other rates which are negative or trending towards negative. Debate continues as to whether the RBNZ will implement negative interest rates, but the balance of probability currently favours negative rates which may go as far as -0.5% at an Official Cash Rate (OCR) level. Investors should plan on the basis that very low rates are likely to persist beyond the very short-term, irrespective of whether the OCR becomes negative or not.

Housing Market Surges

An immediate impact of the low rate regime has been continuing mortgage rate falls and with the lower cost of funds a surge in residential property prices. REINZ data for September provided the highest sales volumes in 14 years and record median prices in nine regions. Nationally house prices are more than 7.25x individual household gross income and in Auckland it is 12.2x. The growth in house values will contribute a positive wealth effect and encourage further consumer spending and vigour in residential construction. The RBNZ's attitude to house price inflation is unclear given broader objectives but the reintroduction of loan to value lending ratios remains a possibility.

International Share Markets

International share markets except for Hong Kong did not generate the positive returns experienced in Australasia over October. The S&P 500 declined by 2.7% in the month, but even more severe declines occurred in Europe with the German DAX index down 9.4% in October as lockdowns in Europe bite on returns. The US market was captive to the election outcome and the likelihood of further fiscal stimulus in terms of magnitude and timing. As the prospect of further stimulus prior to the completion of US elections waned the US share markets also weakened even though it appears that further government stimulus will be delivered in the near future.

As the electoral process proceeds the composition of the US Senate may be of more interest than the actual presidential election outcome. Composition of the Senate will impact on the ability to enact new legislation.

A Democratic majority in the Senate will not necessarily increase the likelihood of market unfriendly legislation being introduced as the filibuster rules constrain legislation being passed without a 60% majority and the various factional interests in the Democratic caucus itself will impede the implementation of radical change. A further factor weighing on the US share market was the threat of further regulation, fines or company break-up of the large technology companies as the Department of Justice instigated an antitrust law suite against Google. Ironically the value of the company increased after the threatened case eventuated.

NZ Exchange Rate Range Bound

The New Zealand dollar exchange rate has been relatively range bound in its trading over recent months with the Trade Weighted index fluctuating in a band. This pattern is also reflected in the Commodity Price index. The strength of the currency is somewhat surprising given the degree of turmoil in the world. The Kiwi dollar has held its value against the US dollar despite higher US interest rates. Against the pound and yuan trading has also been range bound. The most significant movement in the last month has been against the Australian dollar with the Kiwi currency strengthening since mid-August. COVID impacts have lingered longer in Australia, with the Victorian quarantine only recently ended and it has become evident that the RBA is equally determined to hold rates at a very low level if not into negative. The rising NZ dollar cross still has a long way to travel before it reaches March's high of A$0.99 but is a headwind to New Zealand investments in Australia.

Summary

New Zealand continues to be in a relatively sound position in terms of debt to GDP despite the increase in government spending and monetary stimulus. GDP and employment have been resilient. To date the amount of economic distress suffered by the economy has been less than that projected in the immediate aftermath of the COVID 19 outbreak. Further improvement in economic conditions will be supportive for share investors. Persistent low interest rates should underpin investment. It will continue to be important for investors to monitor the balance between fixed interest exposure and riskier, but potentially higher earning share exposure.

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