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Actuaries & Investment Strategists

MARKET PERFORMANCE AND ECONOMIC COMMENTARY – SEPTEMBER 2019

MARKET PERFORMANCE

Financial market behaviour over the past year is summarised in the table below:

Index	1 Month %	3 Months %	1 Year %
Global Equities			
MSCI Emerging Markets	1.5	-2.1	-0.2
S&P 500 (US)	1.7	1.2	2.2
Nikkei 225 (Japan)	5.1	2.3	-9.8
FTSE 100 (UK)	2.8	-0.2	-1.4
DAX (Germany)	4.1	0.2	1.5
CAC 40 (France)	3.6	2.5	3.4
Trans-Tasman Equities			
S&P/NZX 50	1.6	4.0	16.8
S&P/ASX 300	1.9	2.6	12.6
Bonds			
S&P/NZX NZ Government Stock	-0.1	2.9	9.6
S&P/NZX A Grade Corporate Bonds	-0.1	2.2	7.8
Barclays Global Aggregate Bonds (Hedged to NZD)	-0.6	2.5	10.0
FTSE World Government Bonds (Hedged to NZD)	-0.7	3.0	11.1
Oil			
West Texas Intermediate Crude Oil	-1.9	-7.5	-26.2
Brent Crude Oil	1.1	-7.1	-27.8
NZD Foreign Exchange			
AUD	-0.7	-2.9	1.5
EUR	0.4	-2.5	0.8
GBP	-1.7	-3.6	0.1
JPY	1.2	-6.4	-10.0
CNY	-0.8	-3.0	-1.8
USD	-0.6	-6.6	-5.4

Source: Nikko Asset Management

We make the following key observations:

- Weak NZD over the past 12 months, primarily due to the RBNZ cut in August
- Mixed returns of global equities over the year whilst trans-Tasman equities returned double figures
- Negative returns from bond indices over the month as bond yields rose marginally at longer durations
- Equity markets were still supported by the low interest rates and expectations of central banks easing further (bad news is good news)
- Positive returns in bond markets for the year which outperformed global equity markets

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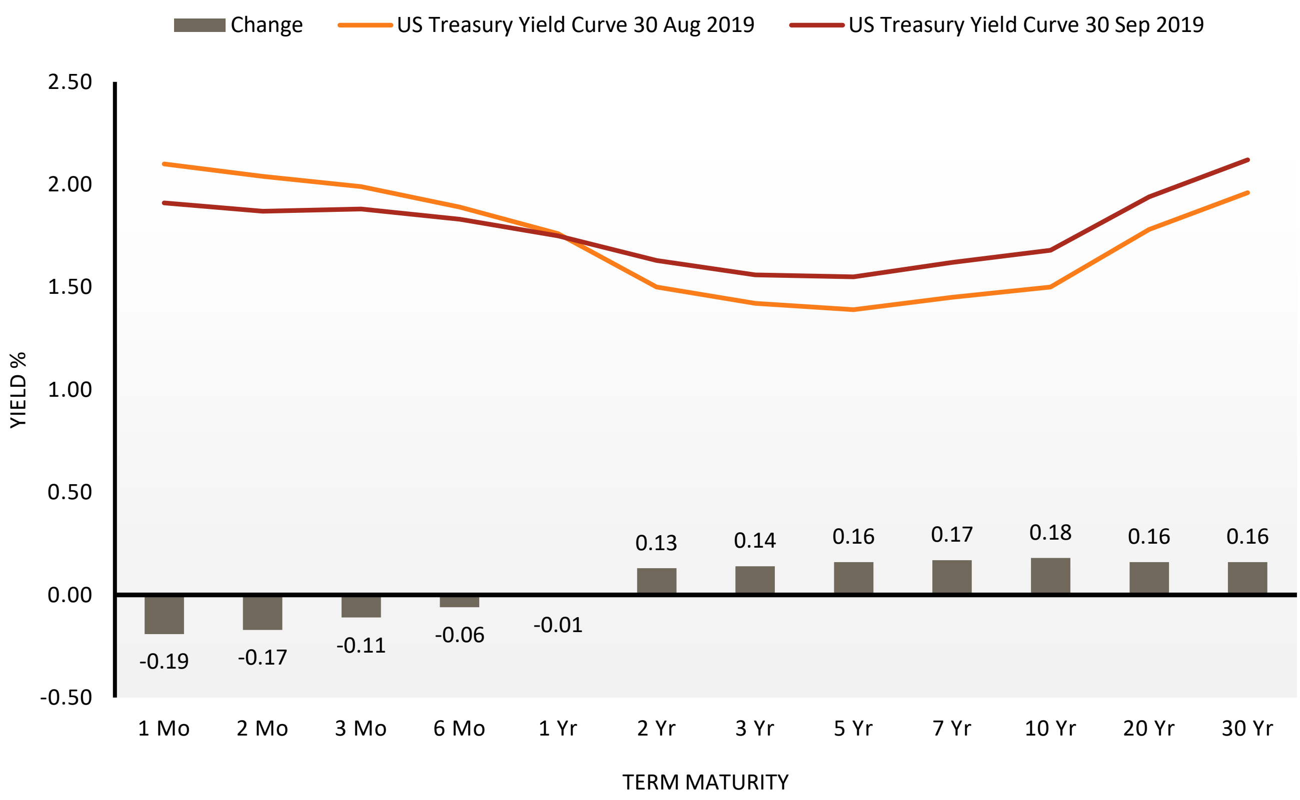
ECONOMIC COMMENTARY

The ECB and US Federal Reserve both cut rates in September. The ECB also announced a return to its quantitative easing programme from 1 November onwards.

A 0.10% cut was made to the ECB deposit rate, from -0.4% down to -0.5%. The QE program will resume at a rate of €20 billion per month. The Governing Council of the ECB expects this programme "…to run for as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it starts raising the key ECB interest rates". In other words, a long time.

The US Fed cut the Fed Funds target range by 0.25% which was expected. The target range is now set at 1.75-2.0%. The market is pricing in another cut this year (50% current probability), potentially two (31% current probability). Figure 1 below illustrates just how flat the curve was at the end of September (the red line), with the reduction in the Fed Funds rate pulling short-term yields lower.

Figure 1: US Treasury Yield Curve, 30 August vs 30 September

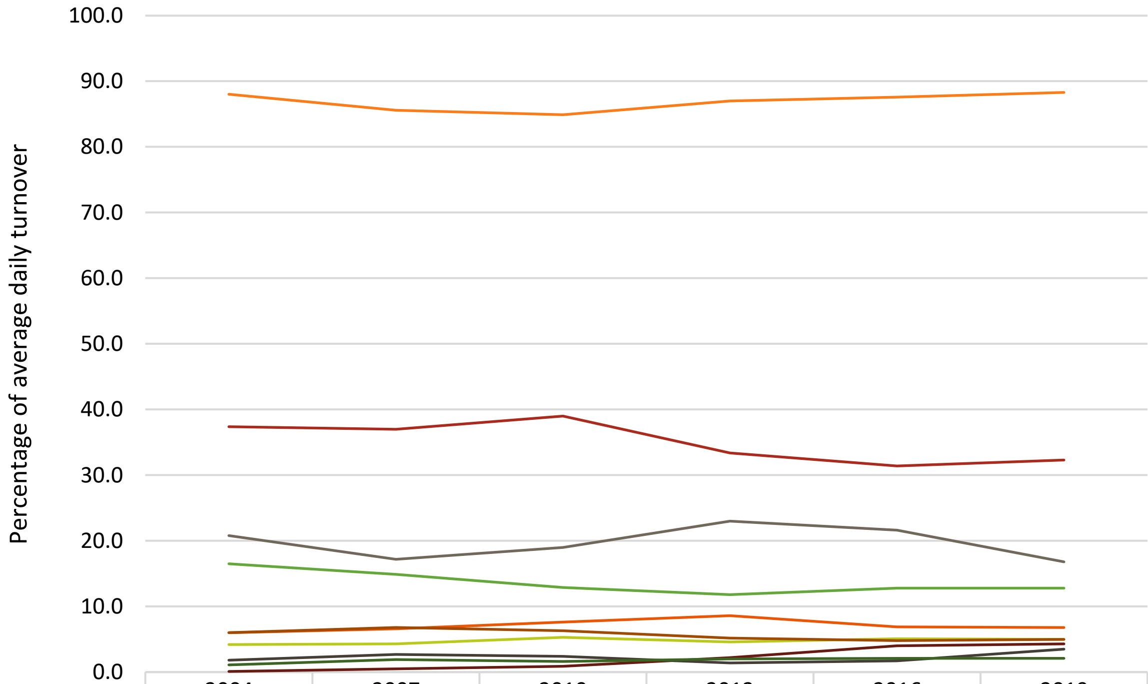


An uncommon move made in September regarding short-term funding was the injection of up to $75 billion into the overnight repo market on consecutive days by the New York Fed. This was the first time in a decade that this has occurred. On September 16th banks required cash to buy T-bills and lend for corporate tax payments, so their need for cash increased significantly, thus requiring overnight funding via the repo market.

A shortage of cash means borrowers (banks in this case) are more likely to pay a higher rate for the cash (in exchange for collateral, usually Treasuries). And lenders would be able to demand a higher rate. The repo rate spiked in mid-September, over twice what the Federal Funds rate was. The significance of this is that the link between the repo rate and Federal Funds rate is what enables monetary policy to influence the economy. In other words, by changing the Fed Funds rate the US Fed can influence how much banks borrow and lend to businesses and consumers. The break down between this link is a serious concern, though the New York Fed effectively applied a band-aid and avoided any damage from occurring. They are now expanding their balance sheet by buying up to $60 billion of Treasury bills each month.

The Fed Funds rate also has a significant influence in a global context due to the prominence of the USD in global foreign exchange markets. Figure 2 illustrates the gap between the USD and the next most widely-used currencies. Changes in US interest rates spread throughout the global economy. Of note is how small the daily turnover of the Chinese Yuan is still, 4.3% as of this year.

Figure 2: Currency distribution of foreign exchange turnover



	2004	2007	2010	2013	2016	2019
USD	88.0	85.6	84.9	87.0	87.6	88.3
EUR	37.4	37.0	39.0	33.4	31.4	32.3
JPY	20.8	17.2	19.0	23.0	21.6	16.8
GBP	16.5	14.9	12.9	11.8	12.8	12.8
AUD	6.0	6.6	7.6	8.6	6.9	6.8
CAD	4.2	4.3	5.3	4.6	5.1	5.0
CHF	6.0	6.8	6.3	5.2	4.8	5.0
CNY	0.1	0.5	0.9	2.2	4.0	4.3
HKD	1.8	2.7	2.4	1.4	1.7	3.5
NZD	1.1	1.9	1.6	2.0	2.1	2.1

Source: Bank for International Settlements. Note the total sum is 200% since each transaction requires two currencies.

Geopolitical events have been even more pervasive in recent times with the continued see-saw of US vs China and EU trade war news; the Japanese/South Korean trade war; Brexit and Boris Johnson; dispute between the US/Saudi Arabia and Iran; changes in the Italian coalition government; unrest in Hong Kong and the Argentinian economic crises.

A full-scale trade war between the US and China would tip the US and global economies into a severe recession.

The drone attack on two oil processing facilities in Saudi Arabia in mid-September is evidence of how geo-political risks can affect financial markets. The attacks threatened oil supply of around 5.7 million barrels per day. To put this into context this is about 50% of Saudi Arabia's daily output, or 5% of global oil production. Brent oil crude oil prices jumped up 10 - 20% following the attacks. Tensions in the Middle East were higher following reports out of the US and Saudi Arabia that Iran were responsible for the attacks. Fitch credit rating agency consequently downgraded Saudi Arabia's long-term foreign currency issuer default rating from A+ to A due to risks of further attacks that could result in economic damage.[1]

A military conflict between the US/Saudi Arabia and Iran could drive oil prices higher and slow economic growth further. It would also increase inflation.

A hard Brexit could lead to a recession in the United Kingdom as well as a potential recession in Europe. Interestingly, the growth rates of Germany and France are already low.

Are passive investors causing a bubble? In deep liquid markets perhaps not. There are signs that some equity investments are shifting from growth stocks to more defensive value businesses. However, in the relatively small Australian market and tiny New Zealand stock market the risks are higher.

Following the latest US payroll figures (released October 4), the US reported reasonable job growth and a low unemployment rate of 3.5%. This lifted stock markets. In our view the risk of a recession in the US has reduced. Provided the trade wars don't escalate and China continues to manage its liquidity and slowing economy, then Australia and New Zealand are well-placed to avoid a recession too over the next one or two years. This bodes reasonably well for equity markets during this historically volatile quarter and beyond.

[1] https://www.fitchratings.com/site/pr/10091114