MARKET PERFORMANCE AND ECONOMIC COMMENTARY – DECEMBER 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	5.7	9.5	18.0
S&P 500 (US)	2.9	8.5	28.9
Nikkei 225 (Japan)	1.6	8.7	18.2
FTSE 100 (UK)	2.7	1.8	12.1
DAX (Germany)	0.1	6.6	25.5
CAC 40 (France)	1.2	5.3	26.4
Trans-Tasman Equities			
S&P/NZX 50	1.5	5.2	30.4
S&P/ASX 300	-2.0	0.7	23.8
Bonds			
S&P/NZX NZ Government Stock	-1.9	-2.9	4.9
S&P/NZX A Grade Corporate Bonds	-0.6	-1.2	5.2
Barclays Global Aggregate Bonds (Hedged to NZD)	-0.2	-0.6	7.5
FTSE World Government Bonds (Hedged to NZD)	-0.6	-1.6	6.9
Oil			
West Texas Intermediate Crude Oil	10.7	12.9	34.5
Brent Crude Oil	8.3	11.0	24.9
NZD Foreign Exchange			
AUD	1.1	3.2	0.8
EUR	3.2	4.5	2.5
GBP	2.6	0.1	-3.3
JPY	4.3	8.2	-0.3
CNY	4.1	4.9	2.0
USD	5.1	7.6	0.6

Source: Nikko Asset Management

We make the following key observations:

- Equity Markets rose following positive news on a US/China trade deal and the possibility of an orderly Brexit
- Bond market returns suffered from rising bond yields which stemmed from optimism in financial markets
- The NZD appreciated against all major trading pairs over the month and quarter
- Continued bushfires and low confidence saw negative returns from Australian equities

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ECONOMIC COMMENTARY

2019 started with a U-turn in monetary policy by the US Federal Reserve; the low interest rate environment and the hunt for yield saw New Zealand equities return 30.4% over the year (NZX 50 Gross). New Zealand equities returned 1.6% in December, but unhedged returns were offset by a rising NZ Dollar.

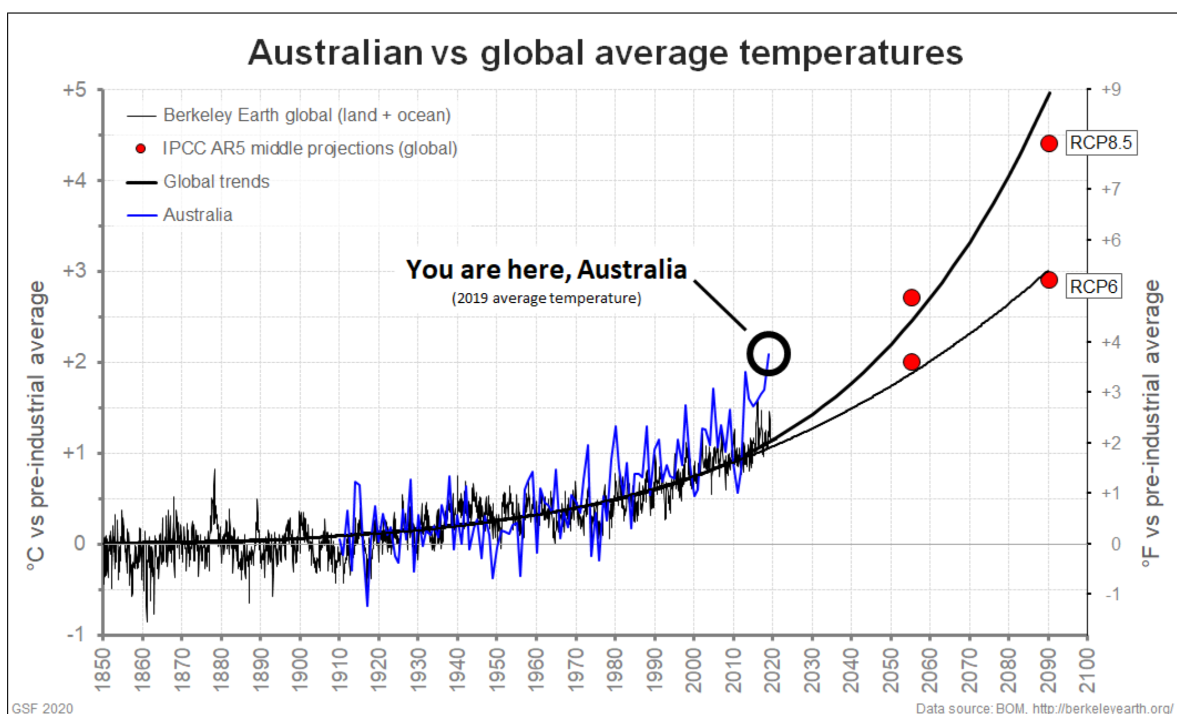
After dipping below 1% in early October, the NZ 10-year Government Bond yield rose to finish the year at 1.65%. Given the convex nature of bond yields this caused notable decreases in bond prices and poor returns for the quarter.

Moving into 2020, equity markets are still overpriced despite lower earnings forecasts. The continued rally in stock prices along with rising 10-year bond yields cannot continue long term. The bond yields act as a proxy for the risk-free rate of return and in theory should result in lower equity prices. If equity markets are to correct, passive funds may be hurt badly by a sharp sell-off due to forced selling and less liquidity. Some active managers can employ risk management tools such as derivative strategies.

The OCR is likely to stay on hold at 1.00% at the RBNZ's meeting next month. Reserve Bank Governor Adrian Orr has noted there is still an easing bias – and the markets have priced in a 25-bps cut for May.

Australian fires continued throughout December and worsened into January (typically their driest month). The loss of life and displacement of people and animals alike is tragic. Australian equity markets experienced losses as a result while all other countries analysed showed positive returns in December. Officials have noted due to rising temperatures the fire season is starting progressively earlier. This double-edged sword both limits time for controlled burnings and worsens conditions.

Figure 1: Australian vs Global Average Temperatures

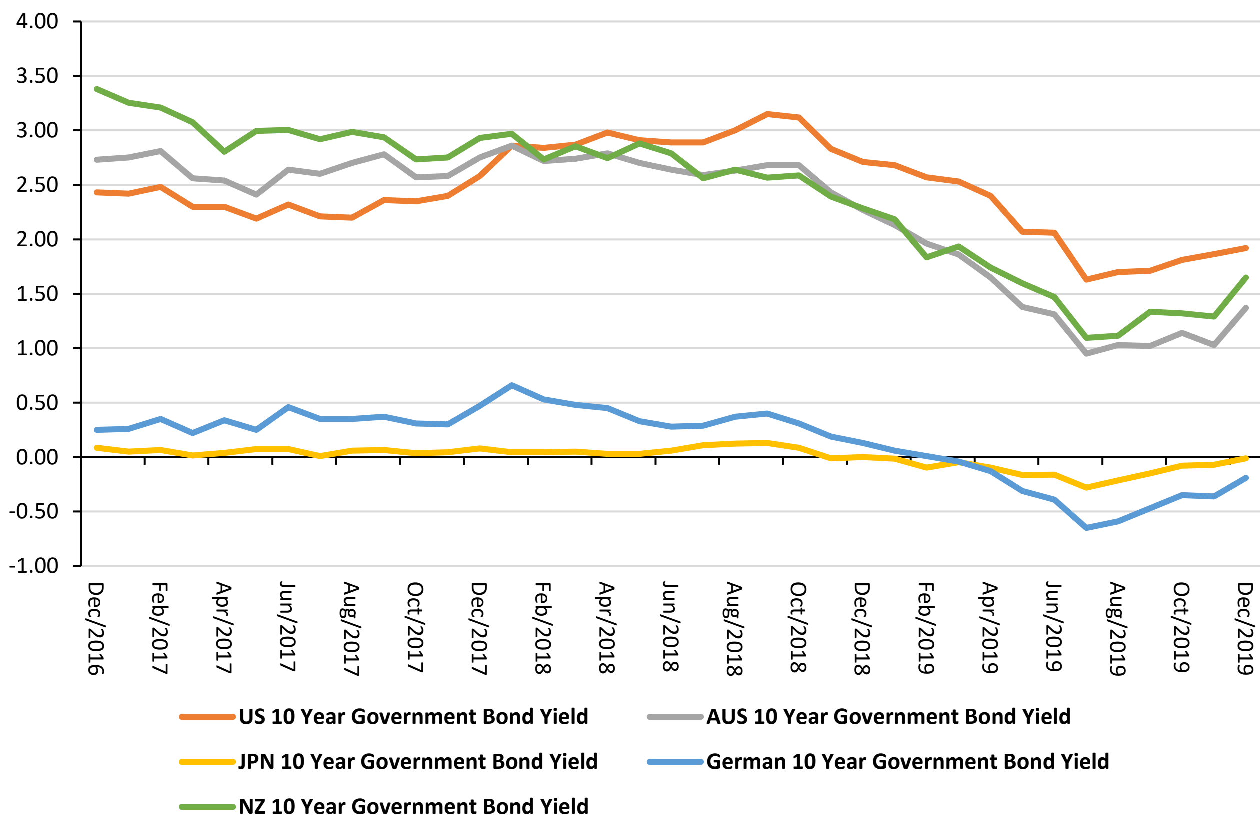


Source: berkeleyearth.org

The Weekly ANZ-Roy Morgan consumer confidence index fell by 1.7% to 106.2 points – the lowest reading since January 2009. Job ads also hit a fresh 3.5 year low. Fear of the fires lessening the already cautious consumers desire to spend has left some economists calling an interest rate cut at the RBA's meeting next month. However, lowering rates can act as a signal of a weaker economy by the RBA – further impeding sentiment.

China and the US establishing a 'Phase 1' trade deal eased tension throughout global equity markets (ex-Australia). Improved sentiment also fed into 10-year bond yields as they steadily increased throughout the month across many counties. This deal could act as a steppingstone for further negotiations. A Chinese delegation travelled to Washington to sign the deal on 15 January.

Figure 2: 10-Year Bond Yields



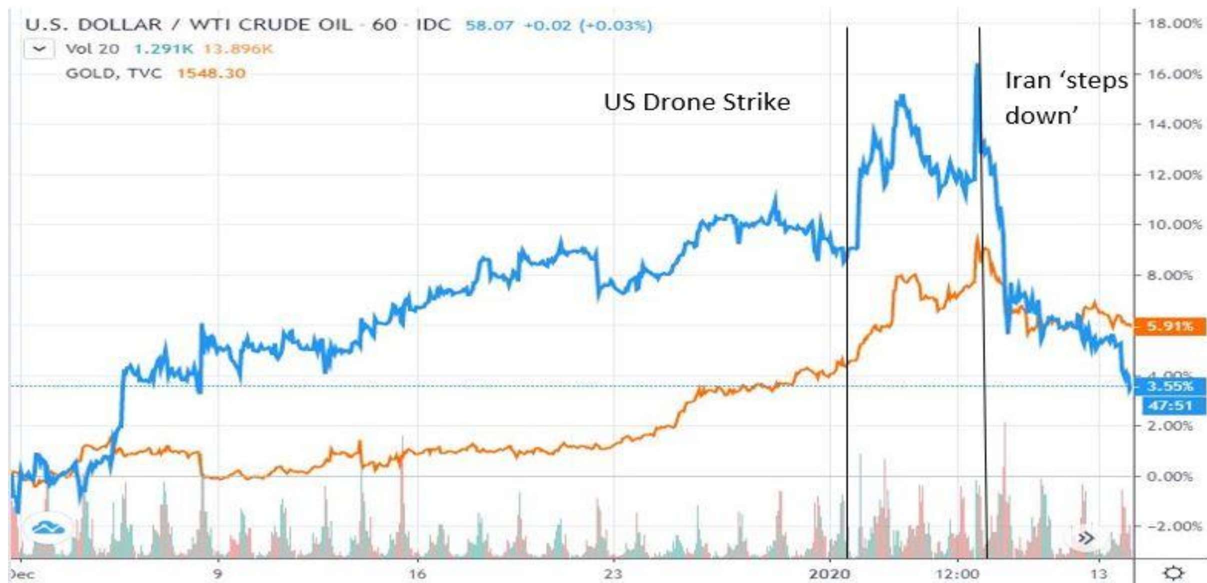
Source: data from St. Louis Fed

Prime Minister Boris Johnson's Conservatives won a decisive majority in the UK General Election. Johnson should be able to fast track his Brexit deal through Parliament. If Royal Assent is given, the UK will be able to leave the EU on 31 January, with a transition period still up for debate. This put market participants at ease in December as an orderly Brexit became more likely.

As China/Brexit worries have dissipated somewhat, raised tensions in the Islamic republic have taken over. Iranian General Qassem Suleimani was assassinated by a US drone strike in Iraq. Iraq, who are allied to both the US and Iran, called for a resolution for US troops to leave the country. Trump promised "punishing" sanctions against Iraq if they followed through and went as far to threaten Iranian sites within Iraqi boarders. Oil prices rose as any conflict could threaten the supply of oil.

Since then President Trump has noted that "Iran appeared to have stood down". The possibility of a war has declined, and oil prices subsequently fell due to less supply. Investors are still wary of future conflicts; some have looked to the safe haven gold provides to protect their capital from inflation.

Figure 3: Gold vs. Oil Returns



Source: macrotrends.net

In this period of very high stock markets and record low interest rates, volatility is heightened and tends to reflect a change in investor sentiment from risk on or risk off to the opposite. Any apparent calm or stability is probably just that. Complacency from the belief that central banks or governments have things under control should be cautioned against.

Such swings in sentiment tend to occur at the end of calendar quarters. The period of Q4 2018 is an example although the previous risk off period started in February 2018 and lasted till March.

At Eriksens we watch the momentum of the markets and check a range of indicators which may signal the risk on/risk off switch. The current setting is modestly risk-on.

Geopolitical risks may also change sentiment quickly. The assassination of the Iranian general in Iraq and potential escalation in the Iran/US level of military engagement or the US/China trade wars are such examples. Financial indicators appear reasonably stable at present. Hopefully they will remain so, but for how long?