MARKET PERFORMANCE AND ECONOMIC COMMENTARY – MAY 2020

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	0.6	-4.7	-0.6
S&P 500 (US)	4.5	3.0	10.6
Nikkei 225 (Japan)	8.3	3.5	6.2
FTSE 100 (UK)	3.0	-7.7	-15.2
DAX (Germany)	6.7	-2.6	-1.2
CAC 40 (France)	2.7	-11.6	-9.8
Trans-Tasman Equities			
S&P/NZX 50	3.3	-3.4	7.6
S&P/ASX 300	4.6	-9.7	-6.5
Bonds			
S&P/NZX NZ Government Stock	0.2	2.8	7.4
S&P/NZX A Grade Corporate Bonds	0.8	2.6	6.4
Barclays Global Aggregate Bonds (Hedged to NZD)	0.3	0.2	6.5
FTSE World Government Bonds (Hedged to NZD)	-0.1	0.8	7.7
Oil			
West Texas Intermediate Crude Oil	88.4	-20.7	-33.7
Brent Crude Oil	54.6	-26.8	-41.8
NZD Foreign Exchange			
AUD	-1.0	-3.0	-0.8
EUR	-1.2	-1.4	-4.8
GBP	2.4	3.1	-3.1
JPY	1.1	-0.3	-5.7
CNY	1.9	2.3	-1.8
USD	0.4	-0.2	-5.0

Source: Nikko Asset Management

We make the following key observations:

- Surge in equity markets through the month as economies start to reopen, or move closer to reopening; and fiscal and monetary stimulus continues to fuel the rally.
- Returns in positive territory over the last 12 months for the US and Japan.
- Positive returns from bond indices across almost all time horizons due to quantitative easing.
- Steep increase in oil prices on the back of reduced production from OPEC.

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ECONOMIC COMMENTARY

Global developments

- Tension between the US and China has resurfaced in recent weeks. The anti-China rhetoric in the US will be an important risk to monitor this year in the build-up to the US election in November. President Trump continues to blame China for the virus pandemic and subsequent economic downfall. This will be a common theme between now and November.
- The weakening US dollar currency. Do not forget that the US dollar is the global reserve currency. We are grateful to Johnny Cochrane of Jarden for the following:
  - The US economy fell from 40% of world GDP in 1960 to just 25% today.
  - However, 79.5% of all world trade is conducted in US dollars.
  - 84% of all non-domestic debt globally is US dollar debt.
  - Around $100Trn of global debts are denominated in US dollar.
- The risk China poses to the Australian economy has increased in the last month or so. Tensions have arisen from several events: the Australian government pushing for an investigation into China's handling of the pandemic, and speaking out against the national security law in Hong Kong; an 80% tariff placed on Australian barley imports over the next five years; a ban on beef imports from four Australian abattoirs; and an alert announcement from China's Ministry of Culture and Tourism not to travel to Australia due to an increase in racist attacks.
- Germany announced another fiscal package, equivalent to 3.8% of GDP (€130b), to help drive their recovery.
- The European Central Bank added €600b to its Pandemic Emergency Purchase Program which now totals €1.35 trillion. The duration of this program was also extended by six months until June 2021, or until the ECB deems the crisis to be over. Inflation is forecast to fall to 0.3% for 2020 which is well below the target of 2%.

Inflation or deflation?

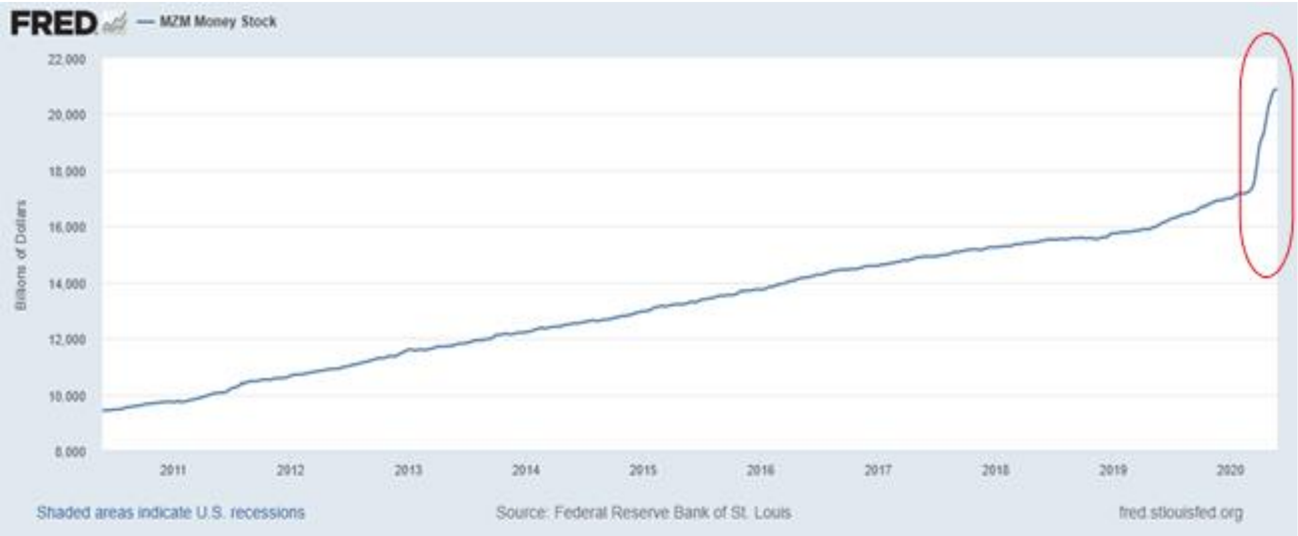
There are reasonable arguments for each of these scenarios. Deflation could occur due to the following arguments:

- The Phillips curve is the relationship between unemployment and inflation. It suggests an inverse relationship. High unemployment, like the environment we are currently in, means lower wages and less demand for goods and services, thus lower prices.
- Advancements in technology also support the argument for deflation. For example, due to the proliferation of online meetings through platforms such as Microsoft Teams and Zoom, there will be less demand for physical meeting places such as conference centres and any travel that would have occurred otherwise. The deflationary effect of technology is nothing new but the changes in human behaviour from the pandemic may accelerate current trends.

The following points support the argument for inflation to occur:

- For inflation to occur it will depend on the mechanics of money in the economy i.e. MV = PQ. The steep increase in money supply ("M") this year (**Figure 1**) suggests that if the velocity of money ("V") doesn't fall proportionately more than the quantity of transactions ("Q"), then prices ("P") will increase. It is the steepness of the increase in money supply which makes it harder to avoid inflation in the future. However, Japan proves this theory may not work.
- The supply shock caused by COVID-19 and the shutdown of economies worldwide means less is being produced, so the equilibrium price increases. This could be termed "deglobalisation" with supply chains disrupted from the pandemic.

Figure 1: Money Supply in the US



Ultimately it is difficult to weigh up each of the opposing arguments with so much economic uncertainty around the globe at present. The most recent data shows disinflation in many places and depending on the time horizon you look at, both inflation and deflation could occur in the future.

A key factor in our minds is how the current environment actually affects human behaviour. With interest rates so low should people take out loans, spend money on consumables, invest in riskier assets? Or since interest rates are so low and with less job security, is there cause for concern and thus a preference to hold cash for safety?

Equity markets continue to rise (**Figure 2**) despite such an uncertain economic picture when you consider fundamentals such as unemployment, contraction in GDP, lower business earnings and inflation/deflation.

New Zealand equities rose 3.3% in May and continued to rally into June. The Australian equity index was up 4.6% in May. Large numbers of retail investors have been entering the market. The Australian Securities and Investments Commission found that the increase in the number of new retail investors to the market was up by some 3.4x between 24 February and 3 April 2020. New Zealand seems to be following a similar trend with NZ based online share trading platform Sharesies growing by 50,000 members over lockdown.

Figure 2: Equity Markets Year-to-Date