Insights

News and Views on
Financial and Portfolio Matters
Issue 24, Winter 2018

In this issue:

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The world that was: A review of the quarter

Key themes for the period:

- Tit-for-tat tax trade tariffs not yet significant
- US interest rates risen above NZ - first time since 2000
- World economic growth remains buoyant and synchronised
- There are economic headwinds however - oil prices, rising interest rates and trade tensions

THE DECISION OF THE US TO IMPOSE TARIFFS HAS BEEN KEY IN CAUSING THE CHINESE EQUITY MARKET TO FALL MUCH MORE THAN THE EM OVERALL.

The NZ equity market flew high yet again

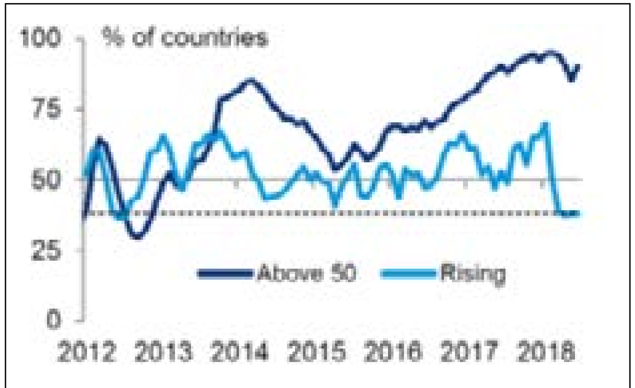
The pace of global growth slowed a touch over the June quarter, but overall conditions remain strong and consistent with global growth remaining above trend levels (Figures 1 and 2). Given the backdrop, global equities performed modestly well, however, performances were quite mixed with some markets performing very well, and some poorly. Currency markets also had a mixed performance, with the NZ dollar hit particularly hard. This boosted the return on offshore equities and property (on an unhedged basis). Overall, the period highlighted the importance we place on designing and maintaining a well-diversified portfolio – enabling your portfolio to benefit from strong markets, and to be cushioned from markets not doing so well.

Australian equities in the June quarter were the stand-out performer, returning around 8.5% in AUD terms, and 11.5% in NZD terms given the fall of the Kiwi against the Australian dollar. Overseas developed market shares returned around 1.7% in their home currency terms, and 8.5% in NZD terms. The much stronger NZ dollar return again reflected currency movements, with the Kiwi falling by around 6.5% against the US dollar over the period. Emerging Markets (EM), which were resilient to the sell-off early in the year, fell by around 2% in NZD terms. Their returns remain solid year to date at around 17%.

The Chinese equity market fell much more than EM overall, and this was largely attributed to an escalation in trade tensions and the decision of the US Administration to impose tariffs. At the time of writing China has responded by imposing a range of tariffs of roughly equal value, on products that are produced in US States seen as vulnerable to Republicans maintaining their hold on power. As discussed in our last update, the risk of an all-out trade war is assessed by markets to be small because it is such a "lose-lose" scenario. Nevertheless, it remains a key risk to watch.

NZ bonds returned around 1% for the quarter and 4.5% for the year. This return is well ahead of short-term cash rates and term-deposits, indicating the NZ bonds have offered a good premium. International bonds returns were softer for quarter at around 0.2%, bringing the annual return to around 2.2%. The soft annual return reflects interest rates increasing at a faster pace than what had been expected, particularly in the US whose economy is very strong and interest rates have been rising ahead of the pack.

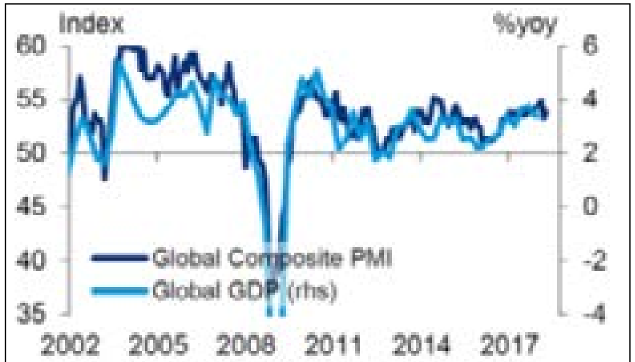
Figure 1: The pace of expansion in the global economy has slowed



Source: Deutsche Bank Global Research

GLOBAL GROWTH HAS SLOWED A TOUCH OVER THE JUNE QUARTER, BUT REMAINS ABOVE TREND

Figure 2 : But overall growth still remains above its average over the past decade



Source: Deutsche Bank Global Research

GIVEN THE BACKDROP, GLOBAL EQUITIES PERFORMED MODESTLY WELL, WITH MIXED PERFORMANCES

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The NZ equity market deserves special mention as our market again had a strong quarter, returning around 7.5%. Over the past 5-years it is a stand-out performer, returning around 15% per annum. This pleasing result is, however, heavily influenced by a handful of stocks that have performed exceptionally well, most recently A2 Milk. Figure 3 shows that this is a feature of our market over longer time periods too. We see the distribution of company returns are very 'skewed'. A handful of companies have returned over 10-times their initial value, while around 15% of companies have failed. This implies that the middle or median NZ listed company return is much lower than the average return across the market. This pattern also helps explain why most active equity managers fail to consistently beat the market – they miss out on the small handful of stocks that do extremely well. In contrast, a passive fund that tracks the market will hold the exceptional performers as they progress from being a modest to a larger and larger component of the market.

House pricing at the margin

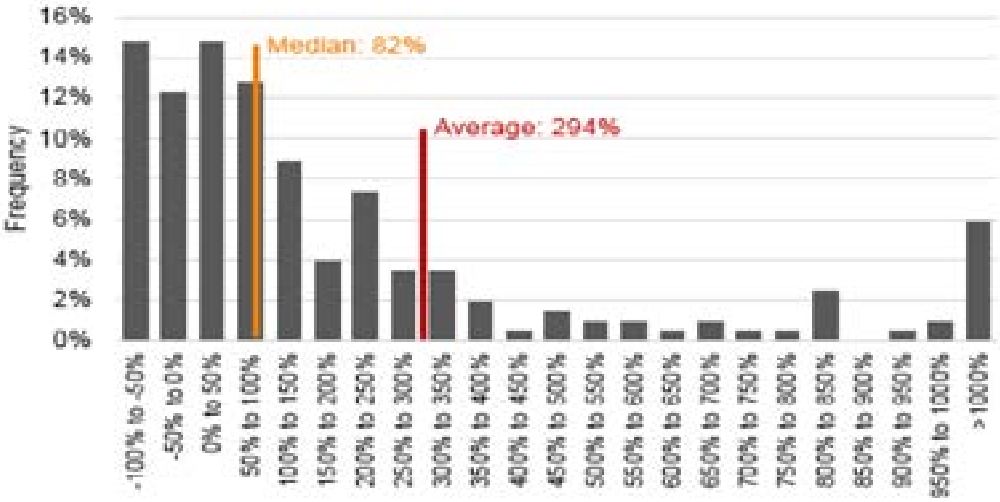
Alfred Marshall was a very influential English economist in the late-19th Century who was first to develop the standard demand and supply graphs now taught at high schools throughout the world. The basic idea is simple – the "equilibrium" or market-clearing price of a good or service is found when demand matches its supply. But there is an implication of Marshall's work on prices that is often forgotten, and which matters enormously for a debate that has raged in NZ since at least the mid-1990s: the impact of foreigners on the price of housing.

Data from Statistics NZ suggests that foreign buyers may have counted for around 20% of house sales in Auckland, 10% in Queenstown, and around 3% nationally, over the past year. For real estate agents and other parties incentivised to keep the ball rolling (such as developers and some local body politicians) these figures are seen as too low to matter, and hence measures to restrict foreign buyers in our market are decried as unnecessary and damaging for NZ's international reputation. This view largely swayed National when in power, who was even loathe to support collection of data on foreign buyers (though they did tighten up on the sale of 'sensitive' land to offshore purchasers). The current Labour-led coalition government, in contrast, has ploughed ahead with their pre-election promise to limit the ability of foreigners to purchase residential housing. Associate Finance Minister David

THE CURRENT LABOUR-LED GOVERNMENT IS PLOUGHING AHEAD WITH THEIR PRE-ELECTION PROMISE TO LIMIT RESIDENTIAL FOREIGN OWNERSHIP

Figure 3:

Spread of company returns on the NZ equity market over the past 15 years (a small number of great performers massively impact overall market returns)



Source: S&P Dow Jones Indices LLC, Fact Set.
NZX all companies index from May 31, 2003 to May 31, 2018.

Figure 4: Net migration matters for house prices.

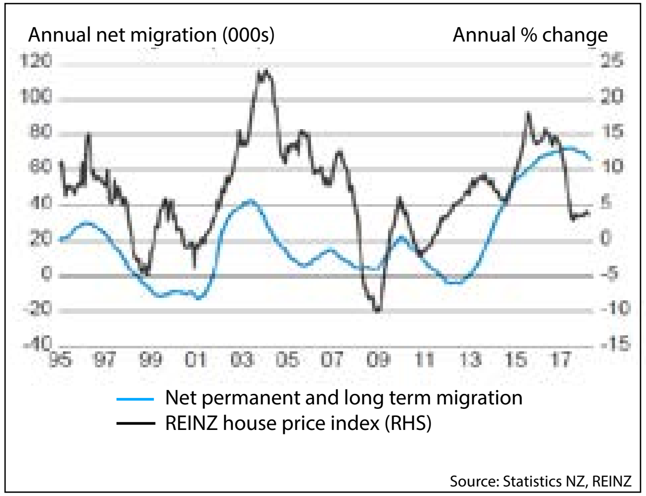


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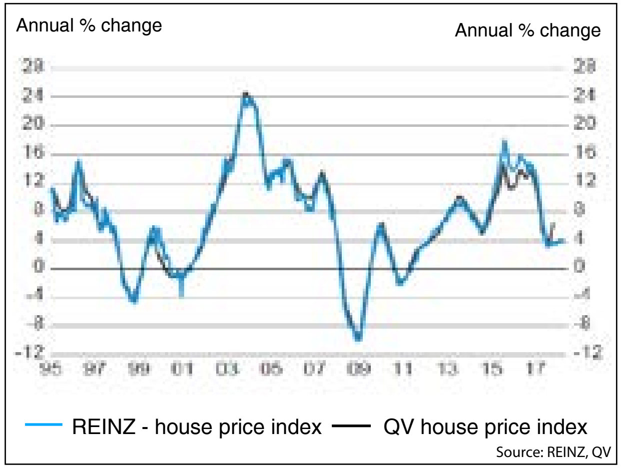
Figure 5 House price growth is slowing fast, has the worm turned?



Source: REINZ, QV

WITH HOUSE PRICE GROWTH SLOWING AND RESTRICTIONS COMING ON FOREIGN BUYERS AS WELL AS THE RING-FENCING OF TAX LOSSES, HAS THE WORM FINALLY TURNED?

FOREIGN BUYERS AND RETURNING KIWIS HAVE BEEN MAJOR MARGINAL PRICE SETTERS OF RESIDENTIAL HOMES

Parker suggested that the fact foreign activity was higher in the more expensive parts of NZ vindicated the move to ban foreign buyers.

So, who is right? Marshall's analysis from over a century ago would suggest that the portion of foreign vs. domestic buyers is a red herring. Instead, what matters is the marginal price setter or buyer who is willing to pay just that bit more than anyone else. This buyer will obviously be the successful house purchaser. But more than that, such a buyer can establish a new "reference point" for real estate agents' to market other listings at, which in turn can impact prices for a street, and then a neighbourhood, and then a suburb, and so on.

In other terms, if a foreign buyer thinks our market is cheap compared to what they perceive the value of housing to be, the buyer may well-be the marginal price setter. And not just for a market in which foreign buyers are active. If some NZ residents are unwilling to pay a new reference price in, say, Auckland, and move to other parts of NZ to grab what they perceive to be a bargain, this can set up a dynamic of prices ratcheting up in regional NZ too. The media has called this the "halo effect". In economics jargon it is an example of marginal price setting.

The argument above suggests that even with small numbers foreign buyers may have had an outsized influence on the dizzy levels that house prices are today. Alternatively, have foreign buyers been passive actors in this story, buying at prices set by Kiwis who found they could afford higher and higher prices as interest rates fell to very low levels? Reserve Bank of NZ evidence on the matter suggests that net migration is a very important driver of house prices, which tend to suggest that foreign buyers (and returning kiwis) have been key marginal price setters. Net migration has peaked (Figure 4) and house price growth is slowing (Figure 5). With this and restrictions coming on foreign buyers, as well as the ring-fencing of tax losses, has the worm finally turned?

See "Migration and the housing market" by Chris McDonald (December 2013) and "Housing Markets and net Migration in NZ" by Andrew Coleman (2007).

How the markets fared

QTRLY RETURN	PAST YEAR	ASSET CLASS
+7.5%	+17.5%	NZ Shares: The NZ market had solid and broad based gains over the quarter, reflecting that stocks had been beaten up over March (with the notable exception of A2 Milk which held the index up). Over the past 5 years our market is a stand-out performer returning around 15% per annum. Source of Figures: NZX 50 Index
+1%	+4.5%	NZ Fixed Interest: NZ Fixed Interest returned around 1% and around 4.5% for the year. The annual return is both comfortably higher than 90-day NZ bank bill rates and term deposit rates, indicating that NZ corporate bonds have delivered a good premium over the year. Source of Figures: NZX A Grade Corporate Bond Index
+11.5%	+16.7%	Australian Shares: The Australian share market had a very strong quarter in NZD terms, returning 11.5%. Around 3% of this return reflected, however, a fall of the Kiwi against the Australian dollar. Much of the return was also a bounce-back from the very poor March quarter performance. Source of Figures: S&P ASX 100
+3.8% NZD hedged +8.3% unhedged	+11.4% NZD hedged +20.2% unhedged	International Shares: International equities mildly increased in the quarter following the sell-off in March. NZD returns for unhedged equities were very strong at 8.3%, largely reflecting the 6% decline in the NZ dollar against the US dollar over the period. Source of Figures: MSCI World ex-Australia Index; Dimensional Global Core hedged and unhedged funds.
-2.0%	+17.0%	Emerging Markets: Emerging Market equities fell around 2% in the quarter, bucking the global bounce-back trend. They had, however, been fairly resilient to the March quarter market sell-of. The year to date performance also remains strong with returns around 17%. Source of Figures: MSCI Emerging Markets Index Source of Figures: MSCI Emerging Markets Index
+0.2%	+2.2%	International Fixed Interest: Global bonds mildly increased in the quarter and returned 2.2% for the year. This return is lower than the (NZD hedged) coupon on international bonds, and reflects bonds being re-priced lower over the period as interest rates have risen ahead of what markets had expected. Source of Figures: Barclays Global Aggregate (hedged to NZD)
+13.8%	+13.4%	International Property: International Property stocks bounced strongly over the June quarter following the March sell-off. Returns were around 13% in NZD terms, although around half of this reflects our currency decline. NZ and Australian listed property stocks also fared well in the quarter, although over the year NZ listed property stocks have returned only around 1%; much lower than the return from international and Australian property. Source of Figures: S&P global REITs (NZDs

All returns are expressed in NZD. We assume Australian shares and international property are invested on an unhedged basis, and therefore returns from these sectors are susceptible to movement in the value of the NZD.

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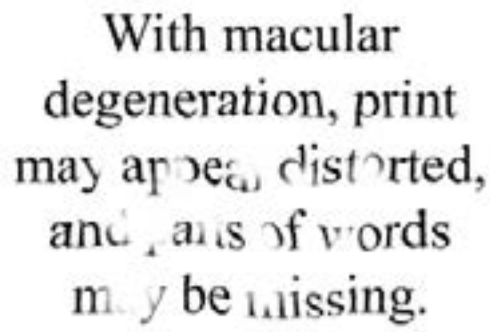

Special Feature:
MACULAR DEGENERATION – KEEPING AN EYE ON THE FUTURE

DR ANDREW THOMPSON, FRANZCO

As the global population ages, macular degeneration (MD) is becoming an important public health issue. Gone are the days when patients were told "there is nothing more we can offer you" with almost certainty that severe vision loss would result. Patients now have a 94% chance of stabilising or increasing vision with appropriate intervention, but early detection and prompt treatment are vital.

What is Macular Degeneration?

MD is degenerative retinal eye disease that causes loss of central vision, leaving the peripheral or side vision intact. MD is progressive and painless and, although MD can lead to legal blindness, it does not result in total or black blindness.

You are reading this using your macula. The macula is the central area of the retina at the back of the eye. The macula is responsible for detailed central vision and most colour vision, the ability to read, recognise faces, drive a car and see colour clearly.

How common is MD?

In NZ, one in seven people (633,000) aged 50 years and older have some evidence of MD. Approximately 17% of these (108,000) experience vision impairment. MD is the leading cause of legal blindness in NZ and is responsible for nearly 50% of all cases of blindness. MD is three times more common that dementia and half as common as diabetes.

The incidence of MD increases dramatically with age. One in four people over 80 years of age have significant vision loss from MD. It is estimated the number of people with MD will increase by 70% by 2030.

How does it affect people?

MD causes blind spots in the central vision. There are two forms of the condition, dry and wet. Most patients, about 90%, have the less severe dry form that is slowly progressive over many years. The wet form of MD causes more sudden and severe central vision loss.

How can I tell if I am getting symptoms?

Symptoms of MD include one or more of the following:

- Blurred vision
- Difficulty reading
- Distorted vision where straight lines appear wavy or bent
- Reduced contrast
- Difficulty distinguishing faces
- Dark patches or empty spaces in the centre of the vision.

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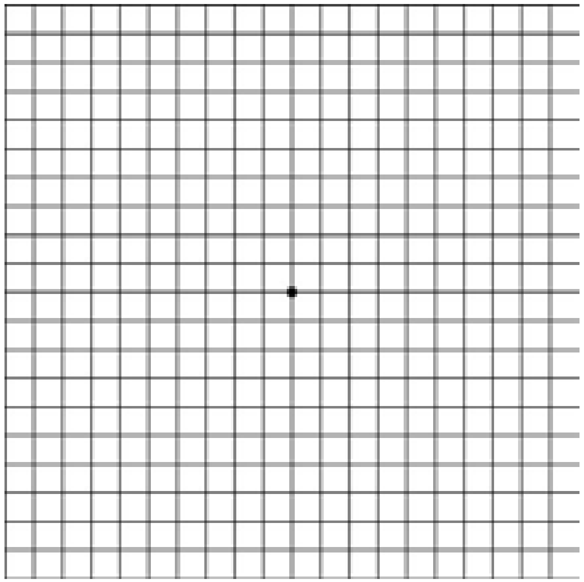
The Amsler grid is a self-monitoring tool used to detect changes in vision. It is a grid of horizontal and vertical lines with a dot in the centre. It is useful to detect visual changes caused by changes in the macula such as MD.

Take this simple test now.

- Wear your reading glasses, if any
- Hold the grid 35 cm in front of the eye being tested
- Cover one eye with your hand and focus on the centre dot with the uncovered eye. Test the other eye
- If any line of the grid is distorted, broken, blurred, missing or there is a dark area then there may be a problem with your macula.



What should I do if I get symptoms?

You should report symptoms urgently to an eye healthcare professional such as an optometrist or ophthalmologist.

What can I do to lower the chances of contracting the condition?

Age is the strongest risk factor and the incidence increases with age 50 years and older. There is a 50% chance of inheriting the genetic predisposition to develop MD if one or other parent has MD. Therefore, people with MD should inform their siblings and children and encourage them to have their eyes, including the macula, checked. The strongest environmental risk factor associated with MD and its progression is smoking. Smokers are 3 to 4 times more likely to develop MD and smokers may develop the disease 5 to 10 years earlier than non-smokers.

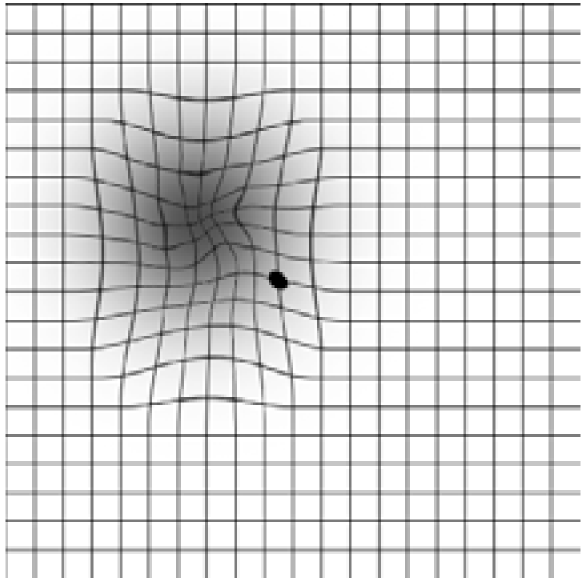
Whether or not a person has been diagnosed with MD the risk of MD can be reduced by:

- Eating a healthy, well balanced diet
- Eating green leafy vegetables and fresh fruit daily
- Eating fish two to three times a week. Fish and shellfish contain omega-3 with higher concentrations found in oily fish varieties such as salmon, anchovies, sardines and tuna
- Choosing a low glycaemic index (GI) carbohydrates instead of a high GI
- Eating a handful of nuts a week
- Limiting intake of fats and oils
- Maintaining a healthy lifestyle, controlling weight and exercising regularly.

Why do the treatment options vary so much around the country?

Currently there are no medical treatments for dry MD. Treatment of wet MD usually involves injecting a drug such as Avastin or Eylea into the eye.

Availability of, and access to, treatment is generally excellent in NZ but varies throughout the country due to different levels of funding by each District Health Board. Many ophthalmologists regularly advocate for improved and equitable access to sight saving treatment through their local health boards and the Ministry of Health.



Where can I find more information?

Further information and resources can be obtained from the MDNZ website www.mdnz.org.nz.

Dr Andrew Thompson is a Consultant Ophthalmologist and Retinal Subspecialist, at Tauranga Eye Specialists. He is also a trustee of Macular Degeneration NZ. Andrew has authored several publications and co-authored a book chapter on Molteno implants. He has teaching responsibilities for both under and postgraduate students, is an Honorary Clinical Senior Lecturer at the University of Otago, and is involved in preparing registrars from Australia and NZ for their final fellowship examination. He is also a College examiner for the Ocular Pharmacology and Emergency Medicine module of the Basic Sciences examination registrars must take on entering the training programme.

We hope you enjoyed reading Insights. If you are interested in reading about other subjects, please let Phil Ashton know by emailing pashton@rutherfordrede.co.nz

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