RUTHERFORD REDE

Insights

News and Views on
Financial and Portfolio Matters

Issue 25, Spring 2018

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The world that was: A review of the quarter

Key themes for the period:

- Strong equity growth for the quarter
- Equity wobbles since
- No-one can accurately forcast so unsure whether the blip is short term
- NZ dollar weakness is much to do with US dollar strength

GLOBAL AND NZ GROWTH REMAINS STRONG.

- July to September -

Equity markets fly high again, but have wobbled since

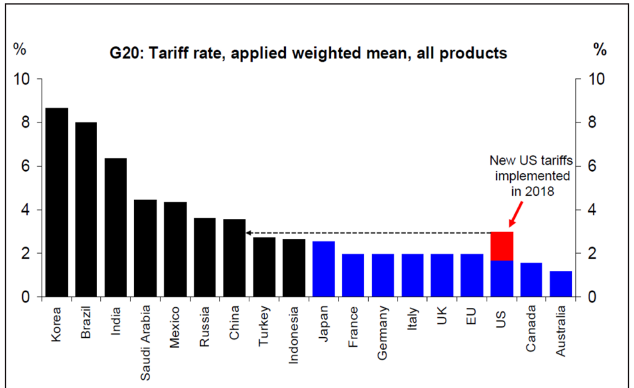
The pace of global growth remains strong and is expected to remain above trend levels, despite clear escalation in the Trump Administration's trade war. US tariffs are now higher than all other developed economies and approaching levels in Russia and China (figure 1). Despite this development, US GDP for the June quarter was 4.2% (annualised), the strongest reading in over four years. New Zealand GDP was also strong at 4% (annualised), or twice the pace expected by the Reserve Bank of New Zealand. NZ business confidence also rebounded from the funk it had been in since the election.

Given the strong NZ data, markets backed off from the view that our economy is slowing, and that the RBNZ may need to cut future interest rates. This change in view arrested the decline in the NZ dollar over the month of September, although over the quarter our currency is still around 4.5% lower against the USD, and over the year it is 8% lower.

At present levels the RBNZ estimates that our exchange rate is in the 'goldilocks zone' that supports exporters and household spending and keeps our trade balanced. Through this lens the Kiwi should stay put. But should is not the same as will. Our terms of trade are at record highs, which argues for a higher currency level (figure 2). In addition, inflation and expectations are now around target levels (figure 3) and may increase faster, forcing the RBNZ off the fence. With rising petrol prices, capacity constraints, and the huge construction and infrastructure back log in New Zealand this is certainly possible. But against this is the fact that the US cash rate is now 2.25%, well over our 1.75% overnight cash rate (figure 4). This is quite unusual from a historical perspective, where typically NZ short term rates are at least 1% higher than the US. Higher US rates favour currency speculators selling (shorting) the NZ dollar to buy US dollars, which could cause our currency to fall further.

Regardless of where the currency goes from here one thing that is clear is that the decline in the NZ dollar has very much flattered the return from offshore equities and property (held on an unhedged basis). Over the quarter developed international equity returns were solid, returning around 5% in USD terms and 7.5% in

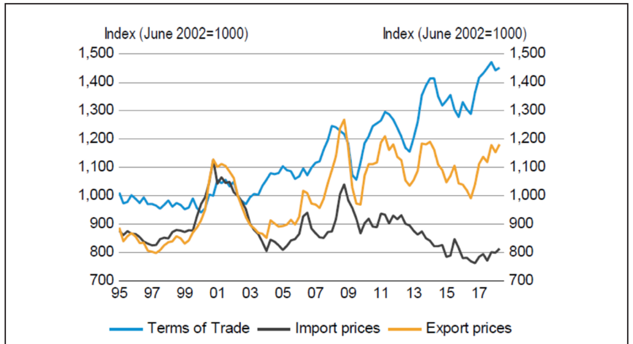
Figure 1: US tariffs now highest in the G7



Source: World Bank, Haver Analytics, , DB Globl Research

INTERNATIONAL EQUITY MARKET RETURNS HAVE BEEN SOLID AND BOOSTED BY THE FALL IN OUR CURRENCY.

Figure 2 : Terms of trade argues for a higher NZ dollar



Source: Statistics New Zealand

OUR CURRENCY HAS DECLINED OVER THE PAST YEAR, BUT THAT DOES NOT MEAN IT WILL CONTINUE TO FALL.

NZD terms. Over the year returns have been an impressive 22%, but 'only' 11.5% in local currency terms. NZ equities also had a strong quarter, increasing 4.6%. This brings the annual return to around 18% and the return over the past 3 years to around 19% - one of the strongest global performances in markets over this time frame. The Aussie market also had a solid quarter, bringing the return to around 14.5% on an annual basis.

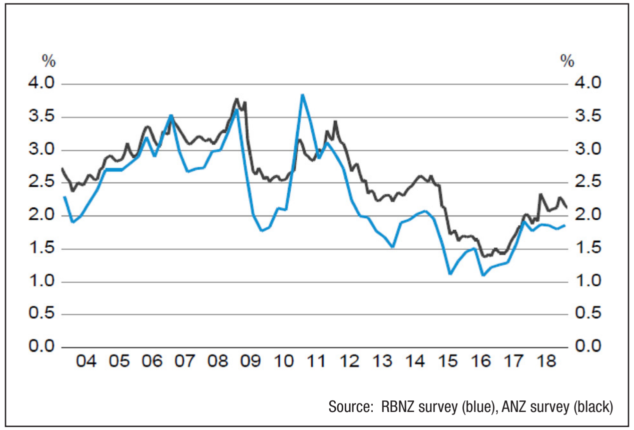
In contrast to developed markets, emerging markets fell slightly in the quarter (although they mildly increased in NZD terms and are up around 8% year to date). While EM economic growth, in general, remains robust, EM equities face several headwinds - capital outflows as the US has tightened interest rates, concern over rising trade tensions (hitting the Chinese market in particular), and instability in some economies such as Turkey and Brazil. The silver lining to this is that with the soft performance EM equities are now seen as very good value, particularly compared to the high-flying US equity market.

NZ investment grade bonds returned around 1.5% for the quarter and 4.8% for the year. This return is well ahead of short-term cash rates and term-deposits, indicating that NZ bonds have offered a good premium. International bonds returns were, in contrast, flat for the quarter and have returned only around 1.2% over the past year. The soft annual return reflects long-term interest rates increasing at a faster pace than what had been expected, particularly in the US (figure 5). While this is disappointing for investors it reflects a temporary "marked to market" impact only from interest rates heading higher. It hasn't reflected bond issuers getting into difficultly making bond payments (as occurred in NZ in the finance company collapses) - default rates on investment grade bonds remain negligible and corporate balance sheets are in general quite healthy. In addition, the increase in rates implies higher bond yields going forward. For the 'flagship' Bloomberg Barclays aggregate global bond index this is currently around 2.6%.

The Australian Royal Commission finds things are not well over the ditch

In Australia the financial services industry is being rocked by the Royal Commission into its behaviour and practices. It has found many concerning practices across wealth advice, insurance and

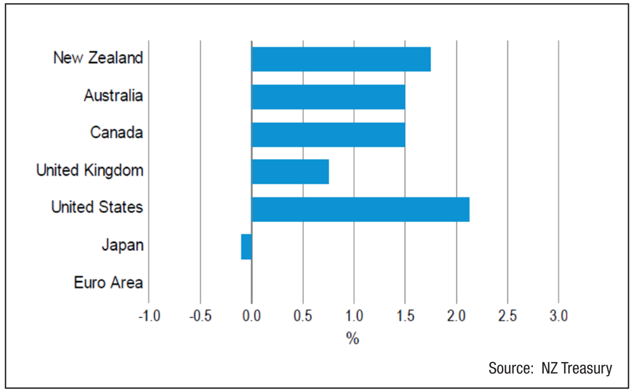
Figure 3: NZ inflation expectations back on target



RBNZ'S ROLE IS TO KEEP INFLATION BETWEEN 1.3% PA.

REGULATION IS NO PANACEA, INSTEAD THE SOLUTION IS TO BETTER MANAGE OR AVOID CONFLICTS OF INTEREST, INSTEAD, IT IS UP TO THE END INVESTOR TO DEMAND SERVICES TO PUT YOUR INTEREST FIRST.

Figure 4: US short term rates lead the pack



US INTEREST RATES ARE 0.5% AHEAD OF NZ AND RISING.

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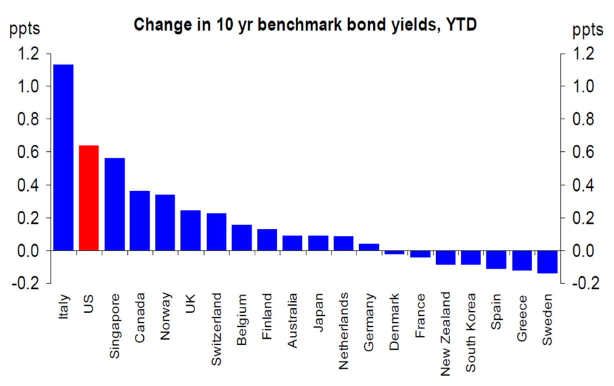
Figure 5: US long term rates have also increased sharply



Source: DB Global Research

FIXED INCOME RETURNS HAVE CONTINUED TO STRUGGLE AS US INTEREST RATES HAVE RISEN.

THE ROYAL COMMISSION IN AUSTRALIA HAS SHOWN HUGE CONFLICTS OF INTEREST IN THE FINANCIAL SERVICES INDUSTRY.

banking - ranging from carelessness to outright fraud. Public confidence in the financial services industry has been shattered.

In New Zealand the problem has been described as one of 'culture' – senior management in Australia has encouraged a culture rewarding sales and profits at the expense of what the customer needs or should pay for the services rendered. Fiduciary obligations have been trumped by short-term business interests. Across the ditch the view being taken is that no amount of well-meaning 'cultural' initiatives will fix the fundamental problem. It has been well-known for many years that the vertically integrated businesses within the financial services industry embed structural conflicts of interest that place advisers and staff in a continual dilemma. Do I serve what is my own and employers best interest, or my clients? For this reason, most of the big banks in Australia are removing the temptation by divesting themselves of their wealth and asset management divisions or shareholdings.

In New Zealand while the Banks have been at pains to say they have a different culture, clearly the same structural conflict of interest is present in our banking system. For example, their private wealth offerings tend to be stuffed full of their own products, many of which are simple overlays on funds that can be obtained more cheaply by going direct to the underlying fund manager.

Given the presence of the same underlying conflicts it seems untenable for the industry to remain the same in New Zealand. At the very least, there should be more contestability and independence in the investment and advice processes that vertically integrated firms run. We would also hope to see a lifting of standards from mere compliance with FMA regulations, to higher fiduciary standards of practises and conduct. The experience in Australia clearly shows that regulatory compliance does not guarantee putting client's interests first. We may also see the divestment option being taken to safeguard reputational risks, as has occurred in Australia.

In the meantime, investors should be aware that the waves from the Australian Commission will increasingly hit our shores. The opportunity is to select providers who are transparent across their fee structures and costs, who operate at a higher fiduciary standard, and who can demonstrate they put your interests first.

How the markets fared

QTRLY RETURN	PAST YEAR	ASSET CLASS
+4.6%	+17.9%	**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
+1.5%	+4.8%	**NZ Fixed Interest:** NZ Fixed Interest returned around 1.1% and around 4.4% 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
+1.5%	+14.6%	**Australian Shares:** The Australian share market had a very strong quarter in NZD terms, returning 11.3%. 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
+7.4%	+21.5%	**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.
+1.0%	+8.2%	**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
+0.0%	+1.2%	**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)
+2.4%	+13.5%	**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: BRAIN HEALTH

RUTHERFORD REDE IS MARKING MENTAL HEALTH MONTH BY DEDICATING THIS ISSUE OF INSIGHTS TO BRAIN HEALTH

Lifestyle has a profound impact on our brain health. What we eat, drink, how much we exercise, how well we sleep, the way we socialise, and how we manage stress are all critically important to our brain health.

So, what is brain health

There's an abundance of information available on the internet. What we have realised by clicking through the plethora of website articles is that - put simply - throughout our life, our brain's job is to help us make sense of the world. As if summarising the specification of a job description, our brain has the important role of helping to oversee our daily operations and life. What a terrifyingly responsible job!

Having synthesised the views of countless experts, brain health – it would seem – refers to the ability to remember, learn, play, concentrate and maintain a clear, active mind. It's the ability to draw on the strengths of our brain – information management, logic, judgement, perspective and wisdom.

It is about making the most of our brain and helping reduce some risks to it as we age.

Did you know your brain is always changing

Now, this process is called 'brain plasticity' and we touched on it briefly in a previous publication of Insights, which is available on our website. As we experience the world, practise habits and learn new information, our brains change; they grow new connections and repair broken ones.

As we age, our experiences and knowledge keep our brains working, developing and learning. You may experience noticeable changes, but not all changes are a sign of concern. We all lose our keys and forget people's names. We do it throughout our entire lives. It's not until we are older that these common mishaps cause us to worry. It's also important to know there are several other reasons lapses in memory occur, like taking certain medication, lack of sleep and excessive alcohol.

What are ways to keep our brain young and healthy

According to an article published in Harvard Health, every brain changes with age, and mental function changes along with it. Mental decline is common, and it's one of the most feared consequences of aging. But cognitive impairment is not inevitable. Below is a summary of what Harvard Health says are 12 ways we can help maintain brain function. Now, some of these may be familiar to you, however, it's always helpful to have a gentle reminder to help keep things in perspective:

1. **Get mental stimulation:** Read, take courses, try "mental gymnastics," such as word puzzles or math problems. Experiment with things that require manual dexterity as well as mental efforts, such as drawing, painting, and other crafts. While writing this article, a colleague suggested visiting the website of the Memory Foundation. Dr Allison Lamont and New Zealand educator Gillian Eadie have published a number of practical 'brain exercises' in the form of e-books (7-day brain boost plan; Health memory workout; and How to improve your short-term memory) to help build brain resilience. We've just placed an order for all three.
2. **Get physical exercise:** Research shows that using your muscles also helps your mind. Exercise lowers blood pressure, improves cholesterol levels, helps blood sugar balance and reduces mental stress, all of which can help our brain as well as our heart. Neuroscientist Wendy Suzuki discusses in her TED Talk the science of how working out boosts our mood and memory – and protects our brain against neurodegenerative diseases like Alzheimer's.
3. **Improve our diet:** Good nutrition can help our mind as well as our body. For example, people that eat a Mediterranean style diet that emphasises fruits, vegetables, fish, nuts, unsaturated oils (olive oil) and plant sources of proteins are less likely to develop cognitive impairment and dementia. As we age, we need to take more care of our bodies, our brains

and our nervous system, says culinary expert and author of the cookbook "Maggie's Recipe for Life". Maggie believes that good food can dramatically improve our quality of life – particularly as we age. The popular 73-year old cook teamed up with leading health expert Professor Ralph Martins to focus on identifying specific nutritional and lifestyle factors associated with avoiding cognitive decline. The recipe book contains over 200 recipes aimed at providing the nutrients we need for optimum brain health.

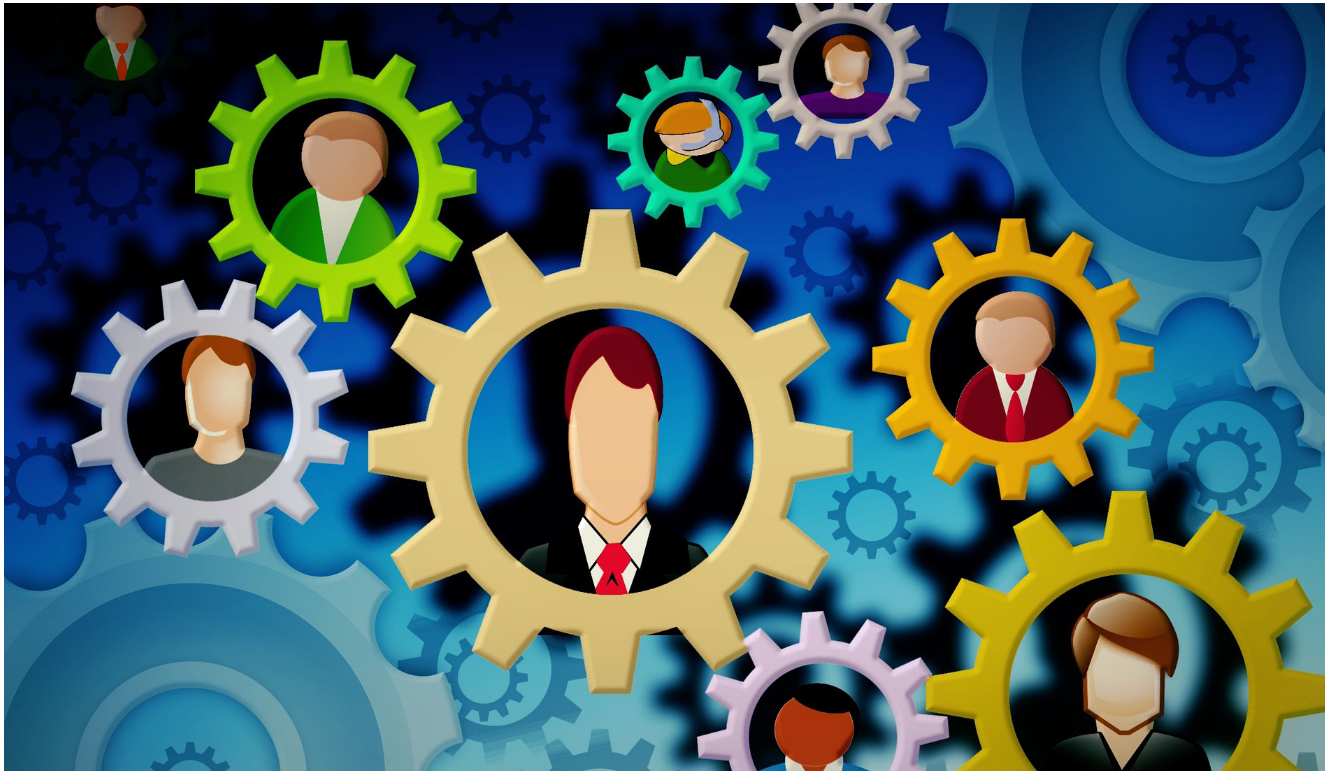
4. **Improve blood pressure:** High blood pressure in midlife increases the risk of cognitive decline in later years. Stay lean, exercise regularly, limit alcohol intake, reduce stress, and eat a nutritious diet.
5. **Improve blood sugar**: Diabetes is an important risk factor for dementia. As with our blood pressure, remember to eat right and exercise regularly.
6. **Improve cholesterol:** High levels of bad cholesterol are associated with an increased risk of dementia. Diet, exercise, weight control, and avoiding tobacco will go a long way toward improving cholesterol levels.
7. **Consider low-dose aspirin:** Some observational studies suggest that low-dose aspirin may reduce the risk of dementia, especially vascular dementia. Ask your GP if you are a candidate.
8. **Avoid tobacco:** Avoid tobacco in all its forms.
9. **Don't abuse alcohol:** Excessive drinking is a major risk factor for dementia.
10. **Care for your emotions:** According to the article, people who are anxious, depressed, sleep-deprived, or exhausted tend to score poorly on cognitive function tests. Poor scores don't necessarily predict an increased risk of cognitive decline in later years, but good mental health and restful sleep are certainly important goals.
11. **Protect your head:** Moderate to severe head injuries, even without diagnosed concussions, increase the risk of cognitive impairment.
12. **Build social networks:** Strong social ties have been associated with a lower risk of dementia, as well as lower blood pressure and longer life expectancy.

And in staying with this theme, we recently posted a TED Talk to our website which emphasises that strong social bonds throughout life can positively influence our well-being. In her talk, developmental psychologist Dr Susan Pinker reveals how in-person social interactions are not only necessary for human happiness but also could be a key to health and longevity. An important message for us all.

In the words of Dr Allison Lamont:

"Your memory is a living part of you that can grow and expand to meet the demands you make of it. Now is the time to build your memory resistance, the 'cognitive reserve' you need to have as a buffer against forgetting and other signs of memory loss that occur without intervention. Just as you know you need to keep physically fit to be healthy, so your brain needs exercise, too."

And as we head into the festive season and contemplate spending time with our loved ones, we leave you with this parting thought: Love your family. Spend time, be kind, and serve one another. Make no room for regrets. Tomorrow is not promised and today is short.



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Bonus Feature: TO BE OR NOT TO BE: TAX WORKING GROUP'S INTERIM REPORT

On 20 September, the Tax Working Group (TWG) published their interim report on how to address NZ's tax system going forward. The Group, headed by Sir Michael Cullen, acknowledges the challenges in addressing such issues as changes in the nature of work, technology, wealth (in) equality, and possibly foremost, treatment of assets such as retirement savings and housing. It has identified a main area of focus to be the treatment of capital income (gains from the sale of capital assets).

Firstly, what the interim conclusions have not recommended:

- A wealth or land tax
- New consumption taxes (such as sugar) or changes in rates of existing tax (tobacco, alcohol)
- Reduction in GST rates or introduction of new GST exceptions (such as food). Neither does it recommend GST on financial services.
- Reduction in company tax, or introduction of a progressive company tax on small businesses

Secondly, The Group have identified capital income as a linch-pin in such areas as the growing gap between income of low and high income households and the gains accrued to asset accumulation. Their recommendations include:

- Extension of tax on assets not already taxed or apply risk-free rate of return method on particular assets, such as New Zealand shares (they may also reject both, but unlikely)
- Develop a framework to address negative environmental externalities
- Consider review of tax rates and thresholds
- Limit the use of closely-held companies converting taxable income to untaxed capital gains
- Expand possible use of withholding tax on self-employed
- Continue to cooperate with OECD work on an international tax framework addressing multinational and digital companies
- Greater enforcement and penalties for non-compliance of tax obligations
- Greater public access to tax data and improved dispute resolution processes

Changes made on the proposed tax treatment will be future-dated, not retroactive. The Group is scheduled to publish its Final Report in February 2019, with implementation to take place in the 2021 tax year