Insights

News and Views on
Financial and Portfolio Matters

Issue 23, Autumn 2018

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The world that was: A review of the quarter

Key themes for the period:

- Equity markets gave back recent gains
- Global GDP growth expected to above average
- Emerging and NZ markets showed some resilience
- Global trade importance evident as super-powers flex their muscles

EMERGING MARKET EQUITIES WERE RESILIENT. THEIR RESILIENCE THIS TIME AROUND LIKELY REFLECTS A VERY ROBUST GLOBAL ECONOMIC ENVIRONMENT.

A market sell-off had to happen at some stage…

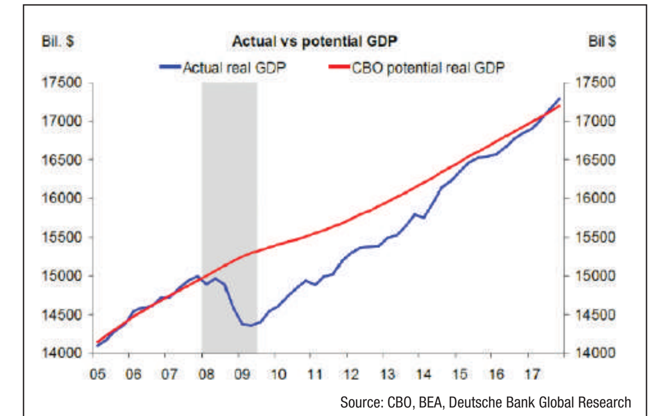
At the year ended December 2017, we reported that equity markets had closed on record highs, including in New Zealand and the United States. In the March quarter of 2018, we saw a reversal of fortune, with sell-offs in most equity markets, including in New Zealand, Australia, Developed and Emerging Markets.

Amongst the pack, Australia fared the worst returning around -4% for the quarter (in AUD terms). This was not due to the mining sector taking a large hit, rather it reflected that the global sell-off coincided with more damning reports on Australian bank practices, including in insurance and wealth management. We may in time see repercussions in New Zealand – regulators globally are becoming increasingly tough on organisations that place business ahead of their client's interests and this is "challenging" for banks who earn a margin from re-marketing product from managers or insurers that could be accessed directly.

In contrast to the Australian equity market performance, Emerging Market equities were resilient, ending the quarter broadly flat. This result is at odds with the common view that Emerging Markets are riskier than Developed Markets, and hence sell-off more strongly in times of market stress. Their resilience this time around likely reflects a very robust global economic environment, as discussed below. The New Zealand equity market also fared reasonably well, though this was mainly due to the stellar performance of A2 Milk rather than the market broadly doing well (and in contrast, it is notable that Fletcher Building had another woeful performance following a further earnings downgrade).

Global fixed income returns were a soft performance in the quarter. This reflected that one of the catalysts for the March sell-off was the Federal Reserve in the United States re-affirming the need it sees to tighten monetary policy (a risk we have raised as likely in our previous commentary), given US growth has (finally) eroded spare capacity in the US economy (Figure 1), and inflation is starting to increase (Figure 2). We should not, and indeed do not, expect interest rate rises to have ongoing negative consequences for equities – rising interest rates are a sign that the global economy continues to heal from the GFC, and historically equity markets have fared well, despite rising rates, when accompanied by a solid economic and corporate earnings environment.

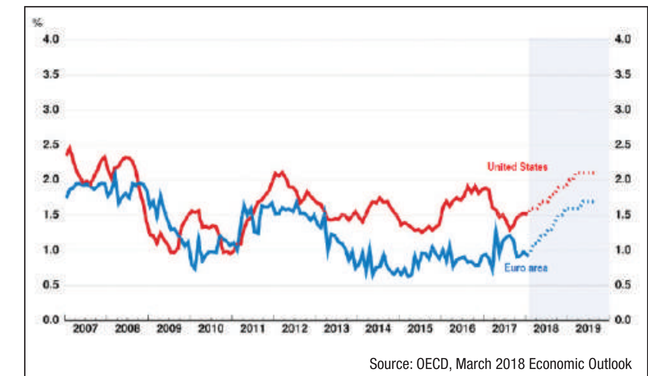
Figure 1: US economy at full capacity



Source: CBO, BEA, Deutsche Bank Global Research

US GROWTH HAS (FINALLY) ERODED SPARE CAPACITY IN THE US ECONOMY.

Figure 2: Inflation is expected to rise



Source: OECD, March 2018 Economic Outlook

WE SHOULD NOT, AND INDEED DO NOT, EXPECT INTEREST RATE RISES TO HAVE ONGOING NEGATIVE CONSEQUENCES FOR EQUITIES.

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…but the supportive global backdrop remains intact

This is precisely the economic environment most forecasters expect over the next few years. Global GDP growth is expected to mildly accelerate over 2018 and 2019 to around 3.9% (Figure 3), a level well ahead of the 3.3% growth that has been experienced, on average, over the past two decades. This growth is expected to cause inflation to rise, but at a slow pace from relatively low levels. In the developed world, the US and the Australian economy, in particular, is expected to materially pick-up from present levels, whilst in emerging markets India remains the growth darling. Given the global growth backdrop, the New Zealand economy is expected to also grow at a fairly good clip (around 3% or so), supported further by strong net migration levels and infrastructure spending. As discussed in previous reports, our over-valued housing market is probably the main risk to the domestic outlook.

An element that had been lacking from the global growth picture, particularly in developed markets, was business spending. This is clearly no longer the case. Underpinning the current growth picture and the outlook is high business confidence levels (at a 43-year high in the case of Germany!) and business investment growth that is at the highest level it has been since the GFC (Figure 4). The surge in business confidence and investment has been underpinned by strong corporate profitability growth, which has, in turn, underpinned earnings for listed corporates. As shown in Figure 5, with the recent sell-off in equities, price-to-earnings multiples are now back around long-term average levels. This common yardstick of equity market valuations suggests that markets, in general, are not over-valued (even if valuations look very stretched in the tech sector), and hence from a valuation standpoint, there is no reason to expect that markets "must" correct further from present levels.

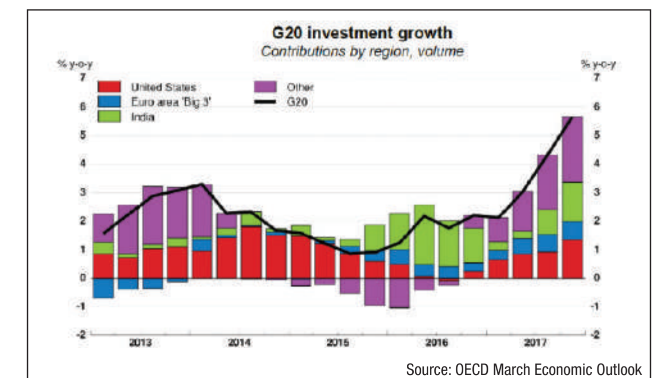
Figure 3: OECD has revised up global growth prospects (again)

	2017	2018	2019		2017	2018	2019
World	3.7	3.9 ↑	3.9 ↑	G20	3.8	4.1 ↑	4.0 ↑
Australia	2.3	3.0 ↑	3.0 ↑	Argentina	2.9	3.2 =	3.2 =
Canada	3.0	2.2 ↑	2.0 ↑	Brazil	1.0	2.2 ↑	2.4 ↑
Euro area	2.5	2.3 ↑	2.1 ↑	China	6.9	6.7 ↑	6.4 =
Germany	2.5	2.4 ↑	2.2 ↑	India[1]	6.6	7.2 ↑	7.5 ↑
France	2.0	2.2 ↑	1.9 ↑	Indonesia	5.1	5.3 ↑	5.4 =
Italy	1.5	1.5 =	1.3 =	Mexico	2.3	2.5 ↑	2.8 ↑
Japan	1.7	1.5 ↑	1.1 ↑	Russia	1.5	1.8 ↓	1.5 =
Korea	3.1	3.0 =	3.0 =	Saudi Arabia	-0.8	1.6 =	1.7 =
United Kingdom	1.7	1.3 ↑	1.1 =	South Africa	1.2	1.9 ↑	2.1 ↑
United States	2.3	2.9 ↑	2.8 ↑	Turkey	6.9	5.3 ↑	5.1 ↑

Source: OECD, March 2018 Economic Outlook

GLOBAL GDP IS EXPECTED TO MILDLY ACCELERATE OVER 2018 AND 2019 TO AROUND 3.9%.

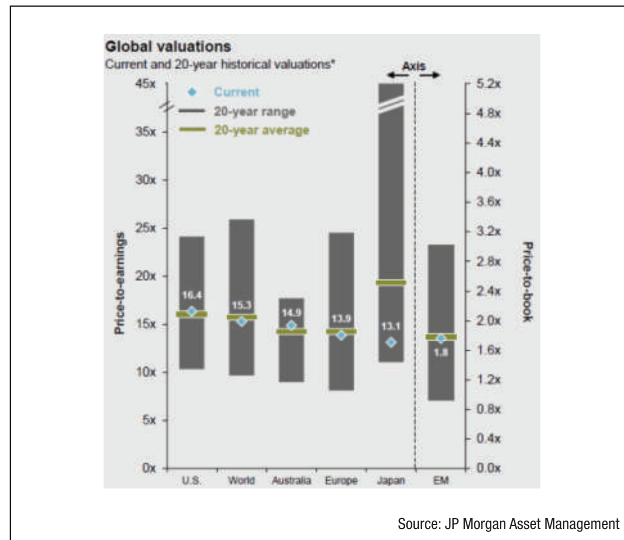
Figure 4: Global investment is surging



Source: OECD March Economic Outlook

BUSINESS INVESTMENT GROWTH IS AT THE HIGHEST LEVEL IT HAS BEEN SINCE THE GFC, UNDERPINNED BY STRONG CORPORATE PROFITABILITY GROWTH, WHICH HAS, IN TURN, UNDERPINNED EARNINGS FOR LISTED CORPORATES.

Figure 5 Equity market valuations are around average levels



Source: JP Morgan Asset Management

FROM A VALUATION STANDPOINT, THERE IS NO REASON TO EXPECT THAT MARKETS “MUST” CORRECT FURTHER FROM PRESENT LEVELS.

HOW LIKELY IS A TRADE-WAR SCENARIO? FOR NOW, THE CONSENSUS VIEW IS NOT LIKELY AT ALL.

THE RICHEST COUNTRIES IN THE WORLD TEND TO BE THE MOST OPEN TO TRADE, WHILST POORER COUNTRIES TEND TO HAVE HIGHER TRADE BARRIERS.

Global trade wars are a risk

Another catalyst for the sell-off in March was jitters around the prospects of a global trade war. Despite broad opposition from within the Republican Party and his economic advisors, President Trump pressed ahead with tariffs on Chinese steel. In turn, China has responded with promises to raise tariffs on a range of US goods, strategically focussing on sectors or products that are important in Republican-held areas. At the time of writing, China has taken the dispute to the World Trade Organisation and it is unclear how long the tariff measures will last, or whether the dispute will escalate. What is clear is that trade is the lifeblood of global economies and economic growth – the richest countries in the world tend to be the most open to trade, whilst poorer countries tend to have higher trade barriers. The rapid growth in China as it opened itself to global trade, and more recently India, are cases in point. As such, the rosy global expectation outlined above would be derailed if a tit-for-tat trade war were to escalate.

The key question markets and commentators are grappling with is how likely is a trade-war scenario? For now, the consensus view is not likely at all. As noted above this is partly because the political will is fragile - the Republican-controlled Congress and Senate are in opposition to the current measure, let alone further measures. In part, it also reflects the view that China very much holds the upper economic hand. It has already made moves to placate the US and give Trump a “win” by promising to open its markets further to US goods and services and accelerate measures to reduce overcapacity in the steel sector. The US must also be extremely wary of the threat China represents from it being the single largest holder of US Treasury bonds. China could easily raise the cost of US borrowing by simply reducing the pace at which it acquires US Treasuries, whose supply is set to increase materially following the passage of the recent Federal budget. Such a “shock” would materially raise US mortgage rates and business borrowing costs – needless to say, something that would be extremely unpopular for the voting public!

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Special Feature: MIDDLE-AGED CAN REVERSE HEART RISK WITH EXERCISE

ALEX THERRIEN, HEALTH & SCIENCE REPORTER, *BBC NEWS*

There are plenty of good reasons to be physically active. Physical activity has long been known to reduce the risk of developing heart disease, stroke, and type-2 diabetes. Another important reason is that exercise changes the brain in ways that protect memory and thinking skills. Through exercise the brain receives a greater supply of blood, oxygen and nutrients that boost its health as well as growth hormones that help the development of new neurons and connections.

Exercising can reverse or reduce the risk of heart failure

A recent article by BBC News Health and Science Reporter, Alex Therrien, highlights the results of a study conducted by Dr Benjamin Levine, lead author of the study and the founder and director of the Institute of Exercise and Environmental Medicine in Texas. The study concluded that people into late middle age can reverse or reduce the risk of heart failure caused by decades of sedentary living, by exercising. This is encouraging news for those of us who haven't been moving enough. But, as Therrien reveals, there is a catch. It takes two years of aerobic exercise, four to five days a week, and you need to start before the age of 65 which is when the heart appears to retain 'plasticity' and the ability to remodel itself.

In his article, Therrien discusses the results of the study performed by Dr Levine. In particular, and according to Dr Levine, he focuses on "the key to a healthier heart in middle age is the right dose of exercise, at the right time." Dr Levine terms this optimal dose as the 'sweet spot'.

Finding the 'sweet spot'

As reported by Therrien, in his study, Dr Levine analysed the hearts of 53 adults aged 45-64 who were healthy but had no history of regular exercise regimes. He divided the study participants into two groups – those who performed aerobic exercises, and others who did anaerobic exercises such as yoga, tai chi, and balance training.

It turns out that, over a period of two years, the aerobic exercise group showed an 18% improvement in their oxygen intake and a more than 25% improvement in 'plasticity' in the left ventricular muscle of the heart – both indicators of a healthy heart. However, according to Dr Levine, the benefits were not seen in the second group.

"We found what we believe to be the optimal dose of the right kind of exercise, which is four to five times a week, and the 'sweet spot' in time, when the heart risk from a lifetime of sedentary behaviour can be improved – which is late-middle age. The result was a reversal of decades of a sedentary lifestyle of the heart for most of the study participants."

Putting it to the test

Dr Levine encourages people to look for ways to incorporate exercise into their daily activities. A significant message from his research is that *"exercise needs to be a part of people's personal hygiene, like brushing teeth."* And he's not alone in his thinking.

IT TAKES TWO YEARS OF AEROBIC EXERCISE, FOUR TO FIVE DAYS A WEEK, AND YOU NEED TO START BEFORE THE AGE OF 65.

PEOPLE INTO LATE MIDDLE AGE CAN REVERSE OR REDUCE THE RISK OF HEART FAILURE CAUSED BY DECADES OF SEDENTARY LIVING.

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In full support of the study is Dr Richard Siow, Vice-Dean for the Faculty of Life Sciences and Medicine at King's College London and Director of Ageing Research at King's. He told the BBC that the study provided further evidence that *"we can, in a way, rejuvenate or make the cells in the heart, and also in the blood vessels for that matter, resemble younger cells through an exercise programme."*

So, how much exercise is required to reduce heart risk? What's the right dose?

Standard recommendations advise 30 minutes of moderate physical activity most days of the week, or 150 minutes a week. If that seems too daunting, start with a few minutes a day, and increase the amount you exercise by 5 or 10 minutes every week until you reach your goal. If you don't want to walk, consider other moderate-intensity exercises, such as swimming, stair climbing, tennis, squash, or dancing. You might consider joining a class or working out with a friend who will hold you accountable. And, if you're able, hire a personal trainer.

Boosting the body and the brain

There is sufficient evidence to support exercise in improving cognitive abilities, such as thinking, reading, learning and reasoning, while muscle training – for example, using weights, – has a significant effect on memory and the brain's ability to plan and organise.

Now, there is evidence to support the right dose of exercise at the right time in life – the 'sweet spot' – can reverse decades of a sedentary lifestyle of the heart for people into late middle age.

Whatever exercise and motivators you choose, commit to establishing exercise as a habit. After all, they say that exercise is the best medicine, and if there was ever a time to get off the couch and lead a more active lifestyle – it's now.

From the article – this is what the study's participants did:

Participants exercised generally in 30-minute sessions, plus a warm-up and cool-down. Their routine included:

- One high-intensity aerobic session, such as four-by-four interval training where participants did four sets of four minutes of exercise at 95% of their maximum heart rate followed by three minutes of active recovery at 6—75% peak heart rate
- Two or three days a week of moderate intensity exercise (where exercisers sweat but can still carry on a conversation)
- At least one weekly strength training session
- At least one long session of aerobic exercise a week, such as an hour of tennis, cycling, running, dancing or brisk walking

They built up to those levels, beginning with three 30-minute moderate exercise sessions for the first three months after which high intensity exercise was included.

We strongly recommend that you consult with your local general practitioner (GP) before beginning any exercise programme.

How the markets fared

QTRLY RETURN	PAST YEAR	ASSET CLASS
-0.9%	+ 15.6%	**New Zealand Shares:** The New Zealand market fell slightly over the quarter, ahead of global market returns with A2 Milk, in particular, being a very strong performer. Over the past 3 years New Zealand's equity market remains very strong, returning around 12.6% per annum. Source of Figures: NZX 50 Index
+0.6%	+4.7%	**New Zealand Fixed Interest:** New Zealand Fixed Interest returned around 0.6% and around 4.7% 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
-7.1%	-1.0%	**Australian Shares:** The Australian share market had a very poor quarter in NZD terms, returning -7.1%. Around half of this decline reflected, however, a strong climb of the Kiwi against the Australian dollar (from around 91c to 95c). In Australian dollar terms the market fell around -3.9%, and the annual AUD return was still positive at around 1.6%. Source of Figures: S&P ASX 100
-2.7% NZD hedged -2.6% unhedged	+10.6% NZD hedged +10.4% unhedged	**International Shares:** International equities mildly fell in the quarter as expectations for faster rate rises in the US increased, and fears around a global trade war rose. Annual, three and five year returns still remain very solid and aside from the US most analysts do not think markets are over-valued. Source of Figures: MSCI World ex-Australia Index
+0.0%	+21.1%	**Emerging Markets:** Emerging Market equities were fairly resilient to the March quarter market sell-off, something that is not usually expected given Emerging Markets are generally considered more risky and hence under-perform in periods of market stress. The resilience this time round likely reflects the relatively robust macro and corporate earnings environment in emerging markets, especially in EM Asia. Source of Figures: MSCI Emerging Markets Index
+0.0%	+3.2%	**International Fixed Interest:** Global bonds were flat in the quarter, reflecting that the return from coupon payments was broadly offset by bond capital losses. The latter was due to a steepening of global interest rates, particularly in the US where the Federal Reserve affirmed its tightening commitment. Source of Figures: Barclays Global Aggregate (hedged to NZD)
-4.6%	+0.3%	**International Property:** International Property stocks faced a "double whammy" shock, i.e. rising interest rate expectations and a general market sell-off. The -4.6% return for the quarter reduced the annual return to roughly flat. In Australia, property returns were even weaker at -9.3% for the quarter, whilst NZ property stocks returned around -4%. The global sell off in listed property over the past year has boosted their dividend yields to well over 4%, a level that is attractive in the low interest rate environment investors still face. Source of Figures: FTSE/EPRA/NAREIT Global Index

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.

What do you think of our publication? On what subjects would you like to read further?
Let Phil Ashton at the office know. Email pashton@rutherfordrede.co.nz , or call 09 361 3670

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