



RUTHERFORD REDE

Insights

Spring 2019



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THE WORLD THAT WAS

Key themes of the period

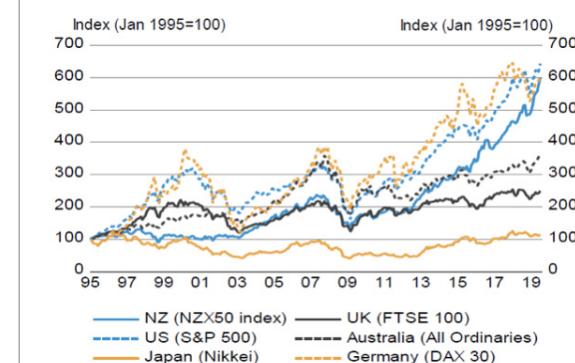
September - October 2019

- Central bank rate cuts gathered pace in the quarter
- Global equities markets enjoyed a strong quarter measured in NZD terms, although the annual return remains soft
- NZ and Australian equity markets have fared better.

Markets rally further in the September quarter

Market returns and the economic backdrop for September was very similar to the June quarter. As discussed in our last update, central banks have begun easing rates in response to a slowing global economy and the risk that ongoing Trade Wars will drag economies into recession. The US Federal Reserve cut interest rates by 25bps in both July and in September, bringing the US Federal Funds rate to 1.75%. Our Reserve Bank (RBNZ) has been quicker off the mark, with RBNZ cuts in May and August reducing the OCR to a record low of 1%. Fourteen emerging market central banks also cut rates in August – the largest number of concurrent cuts since the global financial crisis in 2008. In response to these developments, interest rate sensitive asset classes including government and corporate bonds, listed property, and infrastructure stocks have rallied very strongly. Equities have also fared well across most markets so far over 2019, with many reaching new highs (Figure 1). International developed market equities increased by around 7.7% over the September quarter and 25% in the year to date (in NZD terms). However, given the large decline in markets in December 2018, the return for the year ended September 2019 was materially lower at around 7.7%. In addition, our currency has flattered international equity returns over the year. The NZD has fallen around 10% against the USD since September 2019 in response to the RBNZ cutting interest rates materially lower than US rates. As a consequence, NZD hedged global equity returns have been only around 2.5% over the year to September.

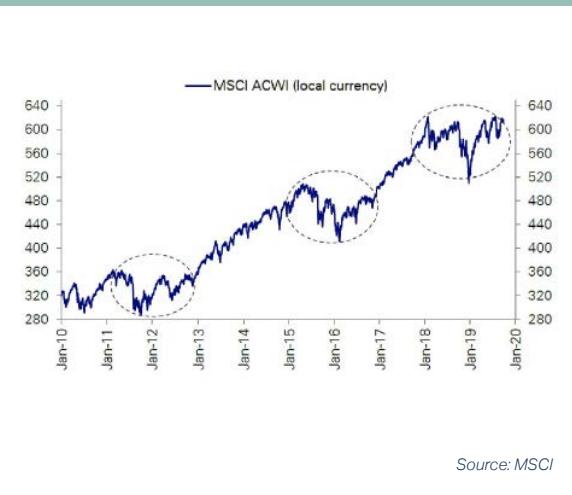
FIGURE 1: EQUITY MARKETS REACH NEW HIGHS



Source: Various

Within global equities, value stocks have performed largely in-line with the broad market over the past year. In contrast, small cap stocks – which are typically more sensitive to the growth environment – have been weaker, with the NZD return flat over the year. Emerging markets have also been weaker given they have borne the brunt of the Trade Wars, returning around 2.5% over the quarter and 3.5% over the year. Trans-Tasman equity markets have fared better. Australian shares returned 5.6% in the quarter and New Zealand shares returned 4%, bringing the annual return to around 11% and 17% in these markets respectively. The New Zealand equity market has benefited more than most from rate cuts given the predominance of listed property and utilities in the NZ50 index.

FIGURE 2: WITH HEIGHTED VOLATILITY



Global bonds returned 2.5% in the quarter and around 10% in the year to September 2019, while New Zealand investment grade bonds returned around 9% for the year. These returns are exceptional and much higher than the running yield on bonds, which are now under 2% for the main international and NZ investment grade indexes. Bonds have benefited from being re-priced higher as interest rates expectations have shifted over the past year from increases to declines. This also boosted "bond like" property and infrastructure company returns, which have experienced double-digit gains over the year across New Zealand, Australia and global markets.

The rally in markets has however been accompanied by significant volatility as markets have grappled between contrasting forces (Figure 2). The slowing global economy reduces corporate sales and profitability. In contrast, lower interest rate reduces borrowing costs and how much investors discount corporate earnings (boosting asset prices). Errant tweeting by the Commander and Chief have added to the volatility.

Recession risks mounting but economies still likely to muddle through

World trade volumes before the Trade Wars were running around 5% per annum, and global growth around 3.5%. Today global trade volumes are in mild decline along with global manufacturing. The most recent September OECD estimates suggest that global growth has fallen under 3%. The key question is where do things go from here? Central banks have been quick to cut rates in response to slowing growth and downside risks. While this has clearly boosted asset prices and market confidence, the impact on actual

FIGURE 3: NZ BUSINESS CONFIDENCE TUMBLES

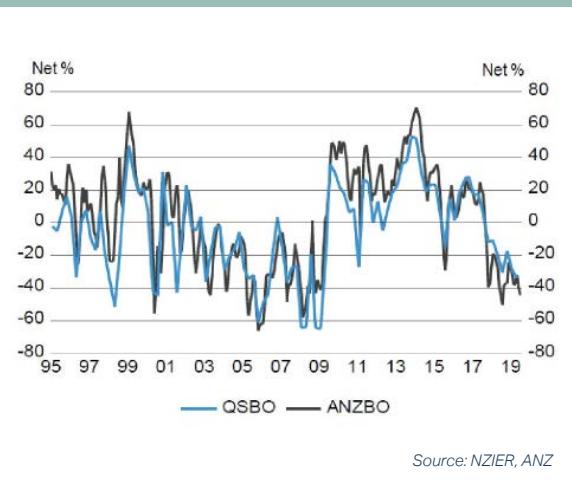
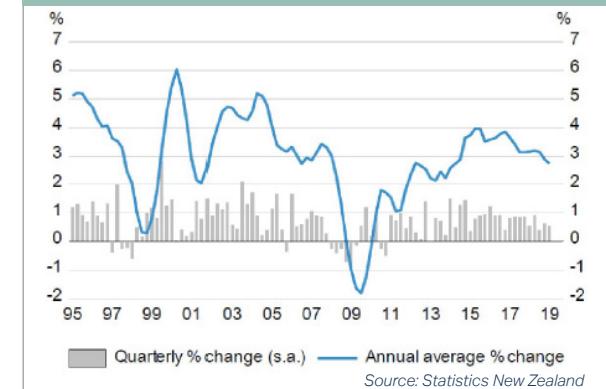
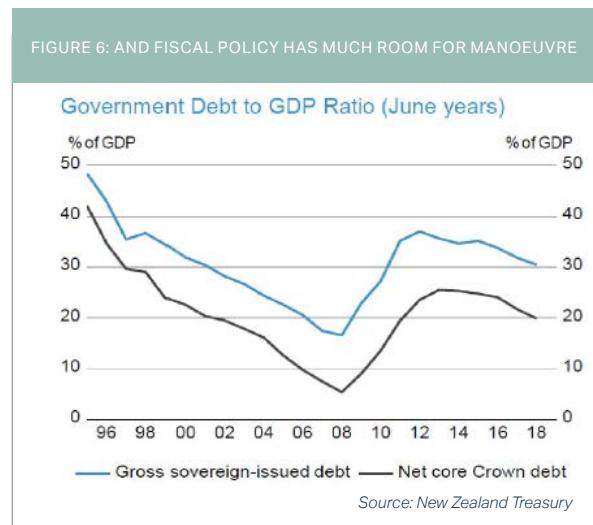
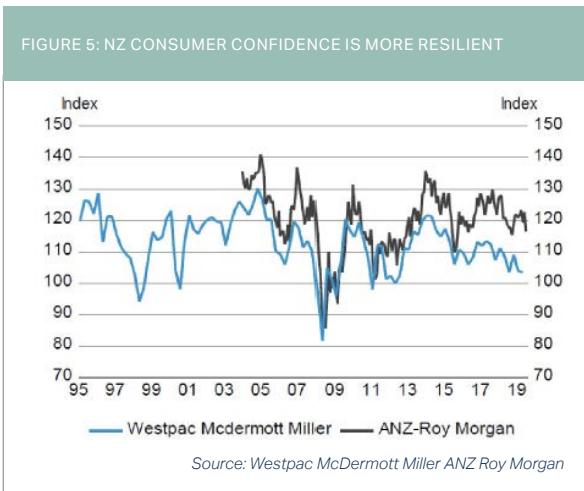


FIGURE 4: BUT NZ GROWTH HOLDING UP SO FAR



economic activity may be much more limited given rates are already extremely low, and there is debate whether further cuts will achieve much. In relation, surveys suggest that business confidence in New Zealand and abroad has tumbled (Figure 3). The very real concern undermining business confidence is that the manufacturing sector contraction will spill-over to a much broader based slowdown in the services sector. This sector makes up around two-thirds of GDP, and three-quarters of employment, in most developed economies, including ours.

The silver lining to the mounting risks is that it is occurring in an environment where capacity and employment levels are very high. Unemployment rates in the OECD including in the US, the UK, Australia, New Zealand and Germany are around historic lows. This means there is a lot of in-built momentum in these economies. As above, we would need to see the services sector take a hit for recessionary



conditions to take hold in developed markets. In addition, the OECD and other forecasters expect growth in the emerging world to hold up at around 4.5% over the next year - more than double the pace of growth expected in the developed world. High EM growth implies that these markets will continue to make a large and increasing contribution to global growth rates. Global growth can hence remain positive even if most developed economies are mildly slowing given the EM growth contribution. Our view remains that the global economy is likely to muddle through despite the clear deterioration in conditions over the past quarter.

We also continue to expect that the New Zealand economy will fare relatively well. Current annual growth is running around 2.5% (Figure 4) and the RBNZ in its latest Monetary Policy Statement expects this rate to pick up over the next year as rate cuts kick-in. Key drivers of growth in our economy, including (mostly) high commodity prices, solid tourism and net immigration inflows, and a large pipeline of construction and infrastructure projects, remain in place. Given this backdrop, it is perhaps not surprising that consumer confidence has so far been quite resilient (figure 5). In addition, the New Zealand government has much more scope than most OECD governments to boost fiscal spending given our government debt levels are quite modest, with gross debt at around 30% of GDP (Figure 6). Fiscal policy is a critical lever to pull in an era where central banks have exhausted most of their ammunition. We can only hope that, unlike with the KiwiBuild program, the government moves faster when it is needed.



HOW THE MARKETS FAARED

*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.*

QTRLY RETURN	PAST YEAR	ASSET CLASS
 +4.0%	 +16.8%	New Zealand Shares: New Zealand shares returned 4% in the quarter and 16.8% over the year to September 2019, bringing the market to new highs. This continues the very strong run our market has had over the past five years. Source of Figures: S&P/NZX 50 Total Return Index
 +2.2%	 +7.8%	New Zealand Fixed Interest: New Zealand investment grade corporate bonds returned 2.2% for the quarter and around 7.8% for the year. This return is both comfortably higher than 90-day NZ bank bill and term deposit rates, indicating that NZ corporate bonds have delivered a good premium over the year. Source of Figures: S&P/NZX A Grade Corporate Bond Index
 +5.6%	 +10.9%	Australian Shares: Australian shares returned 5.6% in the quarter, bringing the September year result to 10.9% in NZD terms. Within the Australian equity market, value stocks performed in line over the quarter, while small cap stocks returned 6.2%. This was sufficient to more than reverse the large losses that small cap stocks suffered at the end of 2018. Source of Figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries
 +7.7% (+1.4% hedged)	 +7.7% (+2.1% hedged)	International Shares: International shares rose 7.7% in the quarter, whilst NZD hedged shares only rose 1.4%. The difference was due to a further decline in the NZD over the quarter on the back of interest rates in New Zealand heading lower. Within global equities, value stock returns were in line with the result for the market overall, whilst small caps were a little weaker returning 6.2% for the quarter. Source of Figures: MSCI World Index; Morningstar Developed Markets NZD hedged, MSCI World Value, MSCI World Small Cap
 +2.6%	 +3.6%	Emerging Markets: Emerging Market equities increased 2.6% in the quarter and 3.6% over the year to September 2019 (in NZD terms). This performance is weaker than developed markets and reflects that the Trump Administration's trade war has had a more negative impact on emerging markets. Source of Figures: MSCI Emerging Markets Index
 +2.5%	 +10.0%	International Fixed Interest: Global bonds returned 2.5% in the quarter, boosting the annual return to around 10% in the year to September 2019. This is an extremely strong outcome for bonds given their low income yields, and reflects bonds being re-priced higher as longer-term interest rates have fallen. The latter is due to central banks cutting short-term interest rates as concerns over Trade Wars and slower global growth have mounted. Source of Figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)
 +7.1%	 +18.2%	International Property: International property stocks increased by around 7% in the quarter and 18% over the year. Australian and New Zealand property stocks also enjoyed strong quarters. This asset class has benefited over the quarter both from the lower interest rate outlook, and the general bounce in equity markets over the year to date. Source of Figures: Morningstar DM REITS (NZD hedged), S&P REIT indexes

PERSPECTIVES, PROPOSALS, AND POSSIBILITIES

Insights from the RBNZ Assistant Governor

Christian Hawkesby is the Assistant Governor and General Manager of Economics, Financial Markets and Banking at the RBNZ. He is responsible for formulating monetary policy, providing liquidity in financial markets, managing the foreign reserves, operating interbank payment and settlement systems, and the circulation of currency.

Prior to taking the role in 2019, Christian was part of the team that established Harbour Asset Management, which was awarded Morningstar New Zealand Fund Manager of the Year in 2014, 2016, and 2017. Before this, Christian spent nine years at the Bank of England, where he held senior positions including Private Secretary to the Deputy Governor, Chief Manager of the Sterling Markets, and Head of Market Intelligence.



Christian Hawkesby shares his thoughts about the OCR, interest rates, and an unconventional monetary policy.

Q. *What exactly is the Official Cash Rate and how does it influence interest rates in New Zealand?*

A. The Reserve Bank is the banker to the banking system. All the major banks hold a deposit account with the Reserve Bank (so-called reserve balances). The Official Cash Rate (OCR) is the overnight rate of interest paid on the agreed size of those balances. In effect, the OCR determines the wholesale price of borrowing money (i.e. the interest rates that banks face), which has a big impact on retail interest rates (i.e. the rate that the NZ public face). The Reserve Bank sets the OCR as a tool to influence the economy, with the ultimate goal of achieving our consumer price inflation and employment objectives.

Q. *Specifically, how does a lower OCR influence deposit and lending rates that banks offer?*

A. The floating interest rate that banks charge their customers to borrow is typically set at a margin above the OCR. So, moving the OCR up or down will normally result in the floating rate of interest charged to households and business to move up or down. Longer term interest rates (say, a 2-year fixed rate mortgage) are influenced by what the banks expect the overnight OCR to be on average over period (e.g. 2 years). So, if banks expect the OCR to move sometime in the future, that can result in banks changing the fixed rate mortgage interest rates they apply to their customers in anticipation.

Q. *There has been some talk that negative interest rates may happen here as they have already in some parts of the world. How would you expect that negative interest rates would alter investor behaviour?*

A. Setting a negative OCR is one form of so-called 'unconventional' monetary policy. We do not anticipate that New Zealand will require a negative OCR. But we are exploring unconventional monetary policy tools as a contingency. If the OCR was lowered to a negative level, it is likely that would also lower the interest rates that banks charge to household and businesses to borrow. Given these are set as a margin above the OCR, it is unlikely these would also be negative, but they may be close to zero. There are many channels by which lower interest rates influence economic behaviour – for example, by lowering hurdle rates for investment, and changing the incentives to consume now versus later. These are set out in see Figure 7 of the speech in the following link
www.rbnz.govt.nz/research-and-publications/speeches/2019/speech2019-08-20

Q. *How far ahead do people making investment decisions think about interest rate levels. For example, the banks are making loans assuming interest rate levels that are going to prevail in the medium term. How much do you think it is possible for short term interest rates to influence purchasing and investment behaviour?*

A. We believe that where we set the OCR has a strong influence on the interest rates that households and business face on fixed rates out to 2 to 3 years maturity. Over much longer horizons there are a number of factors that influence interest rates, including the compensation that investors demand for inflation risk and term risk for locking in their investments over long horizons. The level of long-term interest rates also influences investors' choices for other long-term asset classes, such as equities and property.

Q. *The Australian banks who own the New Zealand banks that make up the majority of the New Zealand banking system are regulated by the NZ Reserve Bank and also by the Australian regulator. How does this work in practice and what is the effect on the strength of these banks?*

A. Banks that are registered in New Zealand are regulated and supervised by the Reserve Bank, given our responsibility for the stability of the New Zealand financial system. So, we regulate and supervise the prudential strength of the New Zealand operations based on what we think is best for New Zealand society. Those banks that are Australian owned will also have the group-wide activities regulated and supervised by the Australian Prudential Regulation Authority (APRA). We have a strong relationship with APRA. We also work very closely with the Council of Financial Regulators (CoFR) which includes other authorities that supervise different aspects of the activities of banks such as their conduct with customers and competitive behaviour.

Q. *Can you explain the initiative the Reserve Bank is proposing to increase the amount of capital that banks in New Zealand hold? If this does come into place, how do you expect the banks will respond to this?*

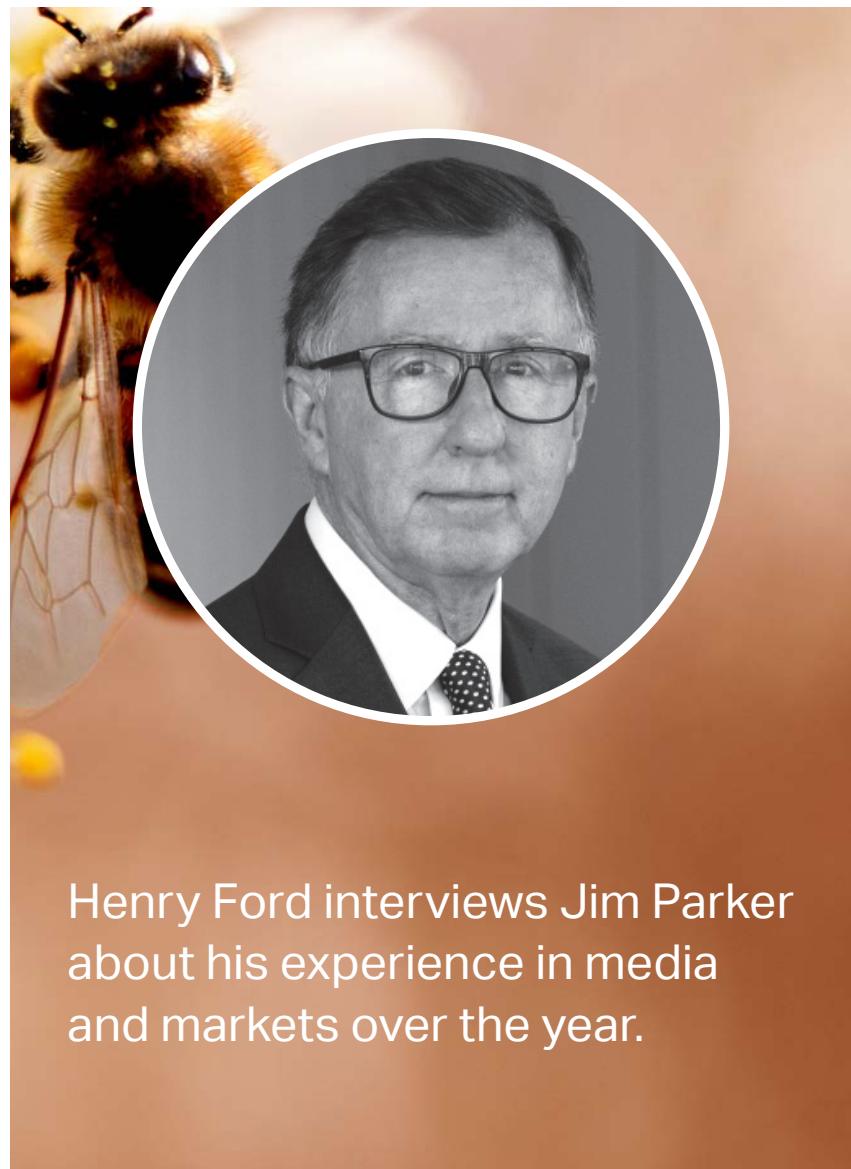
A. Our Capital Review proposes, among other measures, changes to regulatory capital requirements for locally incorporated banks. These include requiring bank shareholders to increase their stake so that they absorb a greater share of losses should their bank fail, and ensuring banks more accurately calculate how much capital they have. On 1 October, we released three independent international experts' assessments of our Capital Review. Each independent reviewer signalled their support with the direction proposed. The proposals aim to protect the public from the personal, social, and economic impacts of a potential bank failure. The goal is to ensure a safer banking system for New Zealanders, with less scope for booms and busts in the availability of credit. Final decisions are expected in the first week of December 2019.



INSIGHTS FROM A MEDIA VETERAN

In a recent visit to the Rutherford Rede office, former New Zealand journalist and fund management executive, Jim Parker, highlighted the perils of making long-term investment decisions based on short-term media noise.

Born and educated in New Zealand, Jim spent a quarter of a century as a reporter, editor and producer for media outlets in the UK, the US, Asia and Australia. For the past 13 years, he has been a regional director of communications for our investment partner, Dimensional Fund Advisors, based in Sydney.



Henry Ford interviews Jim Parker about his experience in media and markets over the year.

Rutherford Rede director and adviser Henry Ford speaks to Jim Parker about the plight of the media and its implications for people in making investment decisions.

Q. *Drawing on your journalistic experience, what strikes you most about the media today?*

A. The short story is that the mainstream media, like many other industries, has been disrupted by the internet. The advertising-driven business model that subsidised journalism is broken. The new digital platforms like Facebook and Google are capturing the vast bulk of the revenues that once went to traditional outlets like newspapers and television. Newsrooms have been downsized at the same time as deadlines have grown shorter. Fewer journalists are having to do more with less. That has consequences for the quality and reliability of information."

Q. *Does this mean people should just ignore the news?*

A. "Not at all. There is good journalism out there, but you need to be discerning and sceptical. As with investment, diversification is a smart idea. Never rely on just one source and make sure the sources you do go to are reputable ones. It's good that people want to keep themselves informed as citizens. The danger is when they react to news as investors and make decisions about long-term goals based on information that is already built into prices."

Q. *The world seems to be full of bad news. How can investors deal with all the uncertainty?*

A. "Firstly, accept that there is always uncertainty in markets. I'm old enough to remember the oil shock of the '70s. We had fuel rationing in NZ back then. Twenty years ago, I was reporting on the Asian currency crisis. Then came the dot-com boom and bust; then the GFC, the Euro crisis and on it goes. Today, it's Brexit and the US-China trade war. There is always something unsettling markets. But we also know that over time there is a capital market rate of return. It is not there every day,

every month or every year. But if you stay disciplined within the plan your adviser has designed and if you let markets do the worrying for you, chances are you'll be OK."

Q. You talk about an information balance sheet. How does that work?

A. "I draw a line down the middle of the page. On the left-hand side are all the interesting topics that we have no control over. This includes geopolitics and market movements and media noise. On the right-hand side are all the things that advisers CAN help clients with. It includes how their assets are allocated, how diversified they are, the costs and taxes they pay and how frequently they rebalance their portfolios. Now, this second group of topics may not be great conversation starters at the pub, but the fact is that over the long-term these are what make the biggest difference to investment outcomes."

After the interview, we asked Jim about his favoured news sources and other reading suggestions. On sources, he said his first stop were either primary information sources or established media outlets like Reuters, Bloomberg, The Financial Times, The New York Times,

The Wall Street Journal, the BBC and The Guardian.

For reading about the plight of the media, he suggested 'Breaking News: The Remaking of Journalism and Why it Matters' by the former editor of The Guardian, Alan Rusbridger.

For an antidote to all the 'world-is-coming-to-an-end' stories in the media, he pointed to a recent book by Canadian psychologist Stephen Pinker called 'Enlightenment Now: The Case for Reason, Science, Humanism and Progress'.

We also have copies of Jim's book '*Outside the Flags: Timeless Messages for Uncertain Times*'. This is the fifth edition of a series that began in 2007 and which tells in layperson's terms the ideas underpinning Dimensional's investment approach. Please contact your Adviser if you wish to receive a copy.





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