ADVISER WRAP

For June 2017

ANZ Investments brings you this summary of investment markets covering the quarter ended June 2017. Please contact your Business Development Manager if you have any questions or need further information.

MARKET REVIEW

Global markets

International share markets within developed economies were higher over the quarter, with several hitting record levels.

The US tech-heavy NASDAQ index was particularly strong for most of the period, with the so-called 'FANG' stocks – Facebook, Amazon, Netflix and Google (now known as Alphabet) – leading the way. The NASDAQ was up almost 7% in early June before a correction saw the quarterly gain cut back to around 4% in local currency terms.

Economic data was less impressive over the period. Since Donald Trump's election, inflation expectations had surged, based on how the new president's policies might affect prices ('Trumpflation'). However, inflationary concerns were parked for the moment as the new administration appeared hampered in getting its major policies through.

Elsewhere, Asian shares finished strongly after a poor quarter. Prices recovered towards the end of the period as MSCI (who manages one of the major international share indices) announced it will include Chinese stocks in the index from mid-2018. Chinese markets climbed on the news, but were still down for the quarter. By contrast, Hong Kong's Hang Seng index was up 6.8% in local currency terms.

A major factor for New Zealand investors was the strong New Zealand dollar (NZD), which outperformed the major currencies throughout the period. The exception was the euro, which itself rose strongly following the May election of Emmanuel Macron in France. As a result, returns from any unhedged holdings in US and Asian markets were relatively low or negative in NZD terms, while European markets proved the better investment for unhedged New Zealand-based investors.

The Australian market was the real laggard of the developed countries, finishing the quarter 2.4% lower, in local currency terms. This was largely from weakness in the key commodities, despite a strong rally in iron ore at the very end of the quarter. Other factors included a new government levy on the major banks and the feared arrival of Amazon in Australia, which saw the consumer staples sector weaker.

In the UK, the snap election – intended to consolidate the Conservative mandate – instead resulted in a 'hung Parliament' forcing a support agreement with the Democratic Unionist party. This was a poor start to Brexit negotiations, and criticism around the Grenfell Tower fire was also disastrous for Prime Minister May. The FTSE index closed down a fraction for the quarter, but was down more than 3% from its pre-election high.

Fixed interest markets performed well for much of the quarter, with the 10-year US Treasury bond rallying from over 2.40% in mid-May to 2.10% in late-June. However, a sharp sell-off was triggered by comments from several central bankers during the build-up to the July G20 meeting in Hamburg.

In June, the US Federal Reserve hiked the Fed Funds Rate by 0.25%, as expected. Subsequent comments left little question of further hikes and balance sheet reduction later this year.

Oil markets fell around 9% in US dollar terms over the period, fuelled by larger-than-expected inventories in the US, and the view that OPEC would not maintain its production ceiling.

New Zealand market

New Zealand shares had a solid quarter – one of the best of the developed markets – supported by continued strong economic data. Employment remains high even as immigration numbers break new records, and primary market prices (dairy, wool and red meat) rose, as did retail spending. However, first quarter GDP came in a little below expectations. Meanwhile, the budget helped as the declared surplus allowed for a general increase in government expenditure across the board. Consumer confidence remains high.

The market was held back somewhat by bank stocks, which fell following the levy imposed on the large banks in Australia. Other negatives were Fletcher Building's unexpected cost overruns on a couple of major projects and weaker Auckland property prices affecting the residential healthcare companies.

While the Reserve Bank of New Zealand has no rate increases in its outlook before 2019, the market still expects a hike in mid-2018. As Graeme Wheeler's current term as governor drifts towards a quiet end in September, bond markets were mostly focused on international news.

And much of this news was positive for bonds:

- Bond prices rose as inflation continued to 'go missing' in the US
- Political risk in Europe fell as Macron was elected President in France
- The Trump reflationary policies remained bogged down in political scandal.

However, ahead of quarter end, global central bankers issued coordinated warnings over the future direction of official cash rates and central bank balance sheets, forcing bond yields higher.

New Zealand bonds also provided among the best returns of other developed markets over the quarter.

With the September general election not too far away, the 'politicking' has already begun and this will clearly become more of a factor in the third quarter.

As mentioned under *Global markets*, the strong NZD generally diminished the value of unhedged offshore investments, other than those in euro-denominated countries.

SECTOR REVIEWS

International shares

International shares were higher over the quarter. Asia saw a particular spike in prices when it was announced that Chinese shares will, from mid-2018, be included in a major global share index. Many institutional investors will now be looking to include these shares in their portfolios.

US shares also performed well, led by the tech-heavy NASDAQ Index, despite a sharp pullback over the final days of the period. New record levels were set by the NASDAQ, the German Dax, the UK FTSE 100, the S&P500 and the Dow Jones. Over the last six months, the US indices have had their best start to a year since 2013, while the NASDAQ's result is the best since 2009.

Accommodative monetary policy remains positive for international shares. In the US, despite the Fed Funds Rate rising in June, lower market rates and a lower US dollar mean monetary policy is 'easier' than it was.

Oil prices fell over the quarter, although they recovered in the final week to halve losses to around 9%.

The reversal in both oil share prices and bond yields in the last days of the quarter was driven by statements – which some considered coordinated – from several central bank leaders. Mario Draghi, President of the European Central Bank, started the ball rolling with his comment that deflation was no longer a risk for the euro zone. The Bank of Canada and the Bank of England also came out as more hawkish than the market was expecting.

The strength of the NZD was a major factor throughout the period, as it strengthened against all the major currencies, with the exception of the euro. Meanwhile, the US dollar had its worst quarter for seven years.

Politics became a major issue in the UK where the snap election resulted in a 'hung Parliament' and a controversial support agreement with the Democratic Unionist Party. The FTSE index was down a fraction for the quarter, but down more than 3% from its pre-election high. European stocks were up, with Denmark and Austria particularly strong – the stronger euro helping returns for NZD investors.

Emerging markets also had a good quarter, up by more than 5%, helped by a weaker US dollar.

International fixed interest

International fixed interest assets (bonds) provided a positive return for the quarter. Bond yields fell to their lowest for the year, before a sell-off late in June trimmed returns as the major central banks warned of possible interest rate tightening ahead.

The key US 10-year Treasury bond traded down to a yield of 2.10% – a level not seen since after the surprise US election result in November. Despite this, returns were respectable. Another feature of the market was the perceived lower risk in many markets punished in recent months – such as Greece, Portugal, Venezuela and other peripheral European markets – thus providing some of the best returns for the quarter.

Core European markets saw a slight increase in bond yields as European Central Bank President Mario Draghi alluded to a 'tapering' of its asset purchase programme later this year and a possibility of a return to positive cash rates.

Another theme for the quarter was the continued outperformance of corporate bonds (particularly the lower rated issues) over Sovereign debt – a trend noticeable even as yields sold off in the final week of the quarter. Long bonds fared the best, as yields closed the period lower, and long duration was the better position for portfolios.

Japanese bonds changed little, stalled by the Bank of Japan's policy to hold its 10-year bond yield around zero percent. The UK was the only major market to see its 10-year yield rise, which was a result of the poor showing by the Conservatives in the snap election and the less-than-ideal start to the Brexit negotiations.

The single largest positive influence on developed market bond yields over the quarter was the safe election of Emmanuel Macron as French President. Markets rallied in relief and French bonds led European returns.

The fixed interest market tended to swing in reaction to the uncertainties of the early weeks of the Trump administration in the US. However, by quarter end, the reflationary and expansionary policies on which Trump was elected appeared to be delayed. Much now hangs on a desperate attempt by Republican legislators to push through an Obamacare replacement bill and the administration's use of the fiscal savings that would result.

Australasian shares

Australian and New Zealand shares travelled in opposite directions over the quarter. Australia was one of the weakest developed markets over the period, closing down 2.4%. By contrast, New Zealand matched some of the better performers as it continued to attract international interest.

Australia was hit hard by two particular issues. Firstly, the finance sector (36% of the index) was slammed as a levy was imposed on the five major banks by the Government in its May budget. Secondly, the retail sector fell sharply as Amazon's arrival on Australian shores draws nearer. Australian investors would not have had a good quarter, particularly in NZD terms, as the Australian dollar fell against the NZD to extend losses for unhedged NZD investors.

Elsewhere, the commodity sector was relatively flat as key iron ore and coal prices fell steeply before recovering somewhat late in the quarter.

Australian economic data had been relatively underwhelming early in the quarter but surprised on the upside in June, with employment, retail sales and GDP all printing better than expected.

Meanwhile, New Zealand shares were among the best of the developed markets, supported by continued strong economic data, including higher employment figures and primary market prices. The Government's budget surplus also implied a boost in spending across the board. However, the market was held back by bank stocks, which also fell as a result of the Australian levy, and retirement village stocks hit by lower house prices in Auckland.

New Zealand fixed interest

New Zealand fixed interest saw strong gains over the quarter, particularly in May as the French presidential vote settled markets and bond prices rose (as yields continued to fall).

However, in the final week of the quarter, yields turned upwards, along with international bonds, as the Bank of England, the Bank of Canada and the European Central Bank (ECB) all appeared to be considering a change of direction in the liquidity cycle.

Mario Draghi, President of the ECB, started the ball rolling by suggesting that deflationary forces were being replaced by inflationary ones. The market saw this, and supporting comments from other central bank leaders, as creating the environment for higher yields by raising rates and reducing the amount of assets on their balance sheets – even if at a glacial pace.

The bond sell-off in the final days of the quarter knocked about 1% off quarterly returns in New Zealand.

The Reserve Bank of New Zealand has remained relatively side-lined, although its May Monetary Policy Statement surprised markets with no rate hikes in its outlook for the next couple of years. Nevertheless, the market still foresees a rate hike around the middle of next year.

The yield curve flattened slightly over the period meaning that longer-dated bonds performed best. New Zealand yields also narrowed towards the US and other international markets, making New Zealand one of the stronger performers over the period.

International property

International property was down in local currency terms over the quarter, with Europe and Japan outperforming the other regions.

The well-flagged rate hike from the US Federal Reserve in June, together with guidance from the Federal Reserve, European Central Bank and Bank of England confirms that that interest rates are expected to gradually normalise to higher levels over the next few years. In this environment, property could likely underperform the broader share market. However, good quality assets can be expected to hold their value over the business cycle.

Australasian property

The New Zealand listed property market had a reasonable quarter, with Real Estate Investment Trusts (REITs) up by almost 4.5%. Although this was a good result, the sector lagged the broader New Zealand share index. The retirement village sector did not fare so well, being particularly hit by falling residential property prices in Auckland.

In the relatively weak Australian market, property was also behind the main share market. In fact, the real estate sector is one of just three that are down on a year-to-date basis, along with energy and telecoms. The A-REIT market fell precipitously on concern around weak retail sales and the potential impact of Amazon's entry on the Australian retail market.

At the same time, the Reserve Bank of Australia continued to signal the indebtedness of the Australian household in the context of high house prices. Reports of declining house prices across the country also helped explain the poor returns.

OUTLOOK

Little has changed in our views from a month ago; our investment thesis is that the lift in global growth will remain above trend into 2018, buoyed by a brighter outlook in Europe and Japan and with the US and China consolidating.

We expect US and European central banks to gradually reduce policy support, something that was signalled clearly in late June, and this will result in a modest increase in yields and a tightening of financial conditions. That said, global financial conditions will remain very accommodative and, against this supportive fundamental backdrop, share markets can continue to deliver reasonable returns to investors.

Nevertheless, we continue to recommend holding a neutral global equity position given the pace of the advance this year and with traditional measures of valuations slightly elevated.

It should be noted, however, that we are not overly concerned about the level of valuations. A peak in the investment cycle is typically accompanied by overly bullish sentiment (a condition that remains absent) and it is not uncommon for markets to trade at higher prices when inflation is moderately low.

The New Zealand economy remains on a solid footing compared to Australia and global markets. New Zealand assets are in strong demand, which has pushed up share prices and the NZD. We expect this momentum to ease over the coming year as debt-servicing costs rise, albeit at a gradual pace.

ASSET ALLOCATION STRATEGY: NO CHANGE

Contact your BDM for specific approval to share this section with clients.

Global Equities Maintain NEUTRAL	We expect global equities to perform relatively well this year, with economic and earnings uncertainty low and investor sentiment positive but not overly bullish. Financial conditions are expected to remain supportive with a very gradual tightening in monetary conditions. High valuations relative to history tempers our view but we continue to see value in global equities relative to bonds.
NZ equities Maintain NEUTRAL	New Zealand and Australian equities can continue to perform well relative to bonds and offer an attractive yield. However, valuations are more expensive than offshore equities and the market could underperform substantially if growth and inflation improves globally. Weak domestic demand in Australia could undermine earnings in related sectors.
Australian equities Maintain NEUTRAL	The outlook for Australian equities has diverged from the positive outlook for global equities. Growth has slowed and the household sector is running well below trend with soft wages, under-utilised labour and high debt. However, business sentiment remains buoyant and our key employment indicators are neutral. Overall, we expect earnings per share (EPS) growth of around 4% in 2018 with downside risk. We would have to see a breakdown in business confidence before we would mark down EPS growth to zero or below.
International Property Maintain NEUTRAL	Global REITs will likely underperform broader market global equities as global economic growth improves and central banks tighten monetary policy. Cap rates globally have narrowed substantially, so gains will be limited going forward. However, provided the growth backdrop remains firm as central banks reduce policy accommodation, the sector can still deliver a reasonable return.
Australasian Property Maintain NEUTRAL	The listed property sector could underperform in a rising global interest rate environment, especially if domestic economic growth is slowing at the same time. For now, the sector provides stable cash flows and an attractive yield
International fixed interest Maintain UNDERWEIGHT	The return on bonds will be constrained by rising interest rates but still deliver positive returns if accommodative monetary policy is gradually removed as we expect. Credit spreads should widen from current low levels as the cycle matures.
NZ fixed interest Maintain NEUTRAL	Local bond markets are largely going to be driven by rising interest rates offshore. However, we expect only a gradual removal of accommodative monetary policy and only factor in modest capital losses. The yields on bonds are low but we continue to advocate holding bonds to offset losses on equities should the cycle not progress as we expect.
NZD Maintain NEUTRAL	The NZ dollar is fairly valued around 0.70c against the US dollar and we therefore expect movements to be fairly limited around this range depending on shifts in risk appetite and an eventual appreciation in the USD as the Fed tightens monetary policy so less hedging than normal is required. We are comfortable holding higher than normal levels of USD exposure when the NZD is elevated. This can provide an offset to losses in equity markets as investors shift to the safety of US treasuries and the USD.
Cash Maintain OVERWEIGHT	

As at 30 June 2017. Note: equities, fixed interest and cash are relative to benchmark. Currencies are relative to an absolute return outlook (short term). Cash is the balancing asset class.

AT A GLANCE – AT 30 JUNE 2017

SHARE MARKETS

	Index Level	Performance – local			Performance – NZD		
		1mth	3mth	1yr	1mth	3mth	1yr
MSCI All Country World Index	539.2	0.0%	2.4%	16.8%	-2.8%	-0.8%	13.3%
MSCI Emerging Markets	54,162.9	1.2%	5.8%	19.2%	-2.9%	0.8%	17.9%
NZX 50 Index (New Zealand)	7,611.4	2.6%	5.8%	10.4%	2.6%	5.8%	10.4%
ASX 200 (Australia)	5,721.5	-0.1%	-2.4%	9.3%	-0.2%	-6.2%	9.6%
S&P 500 (US)	2,423.4	0.5%	2.6%	15.5%	-2.9%	-2.0%	12.3%
NASDAQ 100 (US Technology)	5,646.9	-2.5%	3.9%	27.8%	-5.8%	-0.8%	24.4%
Euro Stoxx 50 (Eurozone)	3,441.9	-3.2%	-1.7%	20.1%	-5.0%	0.7%	20.2%
Nikkei 225 (Japan)	20,033.4	1.9%	5.9%	28.6%	-2.9%	0.4%	15.0%
FTSE 100 (UK)	7,312.7	-2.8%	-0.1%	12.4%	-5.1%	-1.0%	7.0%
Shanghai Composite (China)	3,192.4	2.4%	-0.9%	9.0%	-0.5%	-4.0%	3.9%

CURRENCIES

	Rate v NZD	1mth ago	3mths ago	1yr ago	NZD Performance*		
					1mth	3mth	1yr
Australian dollar	0.955	0.954	0.919	0.958	0.1%	4.0%	-0.3%
US dollar	0.733	0.709	0.701	0.713	3.5%	4.7%	2.8%
Euro	0.642	0.630	0.658	0.642	1.9%	-2.4%	-0.1%
UK pound	0.563	0.550	0.559	0.536	2.5%	0.8%	5.1%
Japanese yen	82.377	78.480	78.058	73.628	5.0%	5.5%	11.9%
Chinese renminbi	4.972	4.831	4.819	4.740	2.9%	3.2%	4.9%

* Positive number means NZD has risen

COMMODITIES

	USD price	1mth ago	3mths ago	1yr ago	NZD Performance		
					1mth	3mth	1yr
Oil	46.04	48.32	50.60	48.33	-7.7%	-12.9%	-7.4%
Gold	1,242.3	1,272.0	1,247.3	1,320.6	-5.4%	-4.6%	-8.5%
CRB Index	174.78	179.77	185.88	192.57	-5.8%	-10.0%	-11.8%

INTEREST RATES

	Official Cash Rate %			3mth Deposit Rate %			10yr Govt Bond Yield %		
	Latest rate	1mth ago	1yr ago	Latest rate	1mth ago	1yr ago	Latest rate	1mth ago	1yr ago
New Zealand	1.75	1.75	2.25	2.14	2.19	2.77	2.98	2.78	2.35
Australia	1.50	1.50	1.75	1.89	1.92	2.26	2.60	2.39	1.98
US	1.25	1.00	0.50	1.30	1.21	0.65	2.30	2.20	1.47
Euro	-0.41	-0.42	-0.37	-0.33	-0.33	-0.29	0.47	0.30	-0.13
UK	0.25	0.25	0.50	0.31	0.29	0.56	1.26	1.05	0.87
Japan**	-0.07	-0.07	-0.06	0.00	-0.02	-0.02	0.09	0.05	-0.22
China	1.62	1.62	1.62	1.10	1.10	1.10	3.57	3.64	2.86

** Changed from target to actual

NEW ZEALAND BONDS

	Total returns		
	1mth	3mth	12mth
Government	-0.7%	1.4%	0.2%
Corporate A	-0.2%	1.3%	3.0%
Corp Inv Grade	-0.2%	1.4%	3.0%
Call Deposits	0.1%	0.4%	1.9%
90D Bank Bills	0.2%	0.5%	2.2%

GLOBAL GOVT BONDS (7-10YR)

	Total returns		
	1mth	3mth	12mth
US	-0.6%	1.3%	-4.0%
Eurozone	-0.6%	1.0%	-2.2%
Japan	-0.3%	-0.1%	-2.4%
UK	-1.5%	-0.7%	-0.6%
Australia	-1.5%	1.3%	-1.7%

Source: Bloomberg

Important information

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