GROSVENOR RESEARCH

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ResearchWatch Special – Market Update

As you will no doubt be aware, global share markets have fallen sharply over the last few days, mainly in response to significant volatility in the Chinese Shanghai stock market, which declined 8.5% yesterday. This in turn caused the US market to fall by 4% overnight and European markets by around 5%. The US share market is now down 10% since the end of July, whilst the German DAX index is down almost 15% month-to-date. Closer to home, the Australian All Ordinaries is now off 12% in August, whilst the NZX50 is down 5%.

Why have markets dropped sharply?

The recent volatility and declines have mainly been caused by continuing uncertainties regarding the outlook for growth in China. Weakness in the latest Purchasing Manager's Index (a key business confidence indicator), combined with lower consumption and retail sales data, were all released within a few days of each other, creating something of a perfect storm of negative news. All of which has undermined market confidence that the decline in economic growth is bottoming out around current levels of 6% pa.

How have portfolios been affected?

During periods of short term market volatility, well diversified portfolios will benefit from those asset classes and strategic investments which display positive diversifying offsets to those assets which are falling….this latest period is no exception. Whilst world share markets (MSCI Index) have now fallen 11% on average in local currency terms during the August month-to-date (mtd), the following two key assets in your clients' portfolios have helped to provide a buffer against this decline:

- Both New Zealand and Global Fixed Interest (Bond) markets are up 1% mtd;
- The New Zealand dollar has fallen 3% mtd (all last night), helping to limit the decline in the MSCI to less than 8% mtd when measured in NZ dollar terms.

Most significantly though, the options insurance protection strategies in place across part of the US and European stock markets have helped to further counter the effect of the falls and smooth returns. Specifically, in the Investment Series and MIA portfolios, the insurance options have reduced the impact of the fall in the global shares sector by 1.5%. For KiwiSaver funds this is around 0.6% of the sector. Taking all of these factors into account, the gross returns for the multi-sector funds and MIA / IIA profiles for the August mtd (AND allowing for further weakness in Australasian share markets today) are as follows:

MIA / KiwiSaver Profile / Fund	Conservative	Balanced	Growth	High Growth
August MTD	-2.0%	-4.0%	-5.5%	-6.5%
Sept QTD	-0.6%	-2.4%	-3.7%	-4.5%

IIA Profile / Fund	IF18	IF28	IF50
August MTD	-0.5%	-1.4%	-2.3%
Sept QTD	0.4%	-0.4%	-1.2%

Looking forward

Markets will remain volatile for a time and we can expect to see further days with large swings, both down AND up. However, we are comforted that the Chinese government has demonstrated a strong commitment to cushioning their economy from the negative effects of transitioning to a more consumer-led growth economy; they also have over $3 trillion in reserves which they can utilise where needed.

Similarly, the US and European economies remain on a healthy growth recovery path and the US Federal Reserve has yet to pull the monetary policy tightening trigger. The Euro zone is still in a strong stimulus phase, as is Japan.

Australia and New Zealand have some continuing economic challenges, but both country's central banks have ammunition left in the form of lowering interest rates further if required; both the NZD and AUD are also significantly lower this year and this should provide an offset to the lower commodity prices.

From an investment strategy perspective, the options protection strategy in place has been specifically designed to provide 'disaster' insurance against a very significant fall in global share markets – we will continue to maintain a level of protection throughout the coming days and weeks, although we will take some profits where we believe it is appropriate relative to the assessed risks. We have already done some of this during last night's sharp declines.

We will keep you up-to-date with any further market developments.