REDE ADVISERS
PROFESSIONAL FINANCIAL ADVICE

Market Update

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The Truth About Market Performance

Investment markets delivered another solid year in 2016. If we only looked at the year-end returns of the various asset classes, we might reasonably conclude it was a relatively benign investment environment. However, having navigated all the twists and turns throughout the year, we know nothing could be further from the truth!

The major news headlines lurched from gloom (China worries in January) to doom (Brexit vote in June, Trump election win in November) but, through it all, investment markets showed real resilience. In fact, if there was ever a year when it paid to 'stick to your plan' and not be swayed by unexpected events, then 2016 was surely it.

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By the end of the year, major share markets had generally delivered high single digit returns, while property and fixed interest delivered lower returns. In the case of fixed interest, these were naturally closely aligned with the low interest rate environment globally. Although overall these returns were not far away from our long term return expectations, it wasn't all plain sailing along the way. In fact, two of the biggest and most surprising stories of 2016 were the British vote to leave the European Union and Donald Trump's victory over Hillary Clinton in the US presidential elections. In both cases markets instantly experienced sizable shock waves as investors struggled to come to grips with these previously unforeseen events, while attempting to divine their implications for the future. Thankfully the initial shock waves subsided relatively quickly, although, in each case, some assets or asset classes were left rather more bruised than others.

The Brexit vote dented future prospects for the UK and the value of the Great British pound (GBP), in particular, took a beating. Global share markets were also hit hard initially, although recovered strongly over subsequent weeks. Unfortunately there was no such recovery in store for the GBP and, over the following six months, the pound weakened by almost 20% against the US dollar. The US elections saw a similar anti- establishment victory, with Donald Trump defying the pundits to be voted the 45th president of the United States. While his pledge to build a wall along the Mexican border and to take a tougher stance on China enhanced Trump's notoriety in the media, it was his promises to reduce taxes, and to provide fiscal stimulus to create jobs and boost growth, that suggested greater US indebtedness and higher US interest rates lay ahead.

It remains to be seen when (or if) many of these election promises can be implemented or how successful they will ultimately be, but regardless, the market rapidly reassessed a much greater likelihood of rising US interest rates. While Trump's growth focused policies helped support the share market, the realignment of interest rate expectations provided a sharp negative correction in the bond markets in the final quarter of the year as longer term US yields jumped.

However, with Brexit still facing a challenge in the UK courts and Trump only just inaugurated, it remains a matter of much conjecture about what lies ahead for these key developed markets and the global economy in general. Of course, it would be wrong to imply the resolution of these two issues alone will dictate the direction of markets in 2017. The next 12 months will no doubt also deliver events that we can't even imagine today, and these will also have an impact - positive or negative - on market and investment returns in the future.

As for 2016, the table below summarises the key asset class returns in a little more detail by highlighting the performance of a major market index in each asset class. All returns are gross and from a New Zealand investor's perspective (in New Zealand dollars):

Asset class	Index	Jan - Mar	Apr - Jun	Jul - Sep	Oct - Dec	12 month
New Zealand shares	S&P/NZX 50 Index (gross with imputation)	7.2%	2.3%	7.3%	-6.4%	10.1%
Australian shares	S&P/ASX 200 Index (total return)	1.2%	-2.1%	5.8%	4.0%	9.0%
International shares (hedged NZD)	MSCI World ex Australia Index (hedged NZD)	-1.8%	1.8%	5.2%	5.3%	10.8%
International shares (unhedged)	MSCI World ex Australia Index	-1.5%	-2.2%	2.7%	6.8%	5.7%
Emerging market shares	MSCI Emerging Markets Index (gross)	4.6%	-2.4%	7.0%	0.5%	9.9%
New Zealand property	S&P/NZX All Real Estate Index (gross with imputation)	5.4%	2.7%	2.3%	-6.2%	3.8%
International property	S&P Developed REIT Gross Total Return	5.9%	1.6%	-2.0%	-0.2%	5.2%
New Zealand fixed interest	S&P/NZX A-Grade Corporate Bond Index	2.7%	1.5%	1.6%	-1.7%	4.1%
International fixed interest	Citigroup World Government Bond Index 1-5 Years (hedged to NZD)	1.7%	1.2%	0.5%	-0.1%	3.4%
Cash	NZ 30 Day Bank Bills	0.6%	0.6%	0.5%	0.5%	2.3%

Note: The full 12 month return is not a simple sum of the four quarterly returns. The 12 month figures are compound returns which assume continuous investment throughout the year in each asset class.

This summary contains several noteworthy elements. Firstly, in spite of the uncertainties encountered throughout the year, growth asset classes generally performed the best. International shares (hedged to NZD) was the best performing asset class, closely followed by Australasian shares and emerging market shares. At the other end of the spectrum New Zealand property, which was one of the darlings in 2015, only returned a little more than fixed interest in 2016.

The October to December quarter also highlighted a considerable divergence between the performance of New Zealand growth assets and the performance of growth assets in other regions. For example, the New Zealand share market declined -6.4% over the quarter, while the Australian share market gained 4.0% and international shares (hedged to NZD) gained 5.3%.

Although we experienced a new round of earthquakes centred near Kaikoura during the quarter, and also witnessed the surprise resignation of John Key as New Zealand Prime Minister, it is unlikely that either of these events had any material market impact. It appears the prospect of higher US interest rates (which had been signalled earlier in 2016 by the Federal Reserve and was reinforced by Trump's victory) may be a larger part of the reason for this disparity.

For several years the New Zealand share market and listed property companies had been popular destinations for offshore investors chasing yield in a global interest rate environment largely devoid of appealing options. However, with the recent spike up in US interest rates, a renewed expectation of additional rate rises to come, and a strengthening US dollar, there seems to have been at least a partial repatriation of these funds out of New Zealand assets and back into the hands of offshore investors.

If there is some good news in all of this it is that local share market valuations, which had been getting stretched after an extended period of strong returns, are now more aligned with fundamentals.

In the meantime the New Zealand investment story in general is still quite positive, with rising dairy prices, a migration-driven construction boom and record visitor numbers providing a significant benefit to the many New Zealand firms with ties to the tourism industry.

The bond markets were the other sector of concern to investors in the last quarter, with the unexpected US election result seemingly fast forwarding at least some of the rise in US yields that had been anticipated to occur in 2017 and beyond.

The unexpected jump in yields that occurred in the quarter has two impacts for bond investors:

Immediate – negative: *when interest rates rise, the price of existing bonds fall.*
Longer term – positive: *as bond yields rise, the expected future return on the bonds goes up.*

So, while the price fall is immediate and can be sharp (especially for holders of very long duration bonds), the higher future expected returns provides compensation for long term holders of these securities. There will be considerable speculation about where yields go from here but the reality, as always, is that nobody knows for sure. Certainly bond yields may go higher. Quantitative easing programmes in the US and Europe should eventually be wound back, and this could allow monetary policy settings to move towards neutral and away from the current very accommodative settings. However, the factors that took bond yields to such low levels last year can't be easily ignored either. Despite risks that inflation may rise, strong structural influences still remain, in particular, technological innovation (generally disinflationary) and global demographics (ensuring an ever increasing demand for yield assets). In addition, political uncertainty - both in Europe and in the new Trump administration - continues to provide considerable scope for unsettling surprises, and surprises more often tend to be positive for bond markets.

As the table of asset class returns in 2016 reminds us, different assets respond differently to the same market conditions and no single asset class can be expected to win all the time. This fact alone makes a compelling case for diversification; for ensuring you don't have all your eggs in a single basket. But not only do different asset classes perform better (or worse) at different times, they do so in an entirely unpredictable fashion. This is what elevates diversification from a good idea to a great idea.

Risk seeking investors may like the idea of having all their eggs in one basket to try and achieve extremely high returns, but the dangers of getting it wrong can be severe. Post Brexit, the wrong basket was GBP denominated assets, and in the fourth quarter of 2016 it was New Zealand shares and property assets. Investors who had a concentrated exposure to these assets at the wrong time only ended up with a basket full of broken eggshells.

Long term investors need to accept that risk is unavoidable and sometimes it will hurt returns. But by employing prudent strategies that include sound strategic asset allocation, and focusing on diversification across high quality and low cost assets, they put themselves in the best possible position to keep their nest eggs intact. And as 2016 also showed us, this approach can still generate useful returns even when the investment environment is at its most challenging.

Key Market Movements For The Quarter

New Zealand shares

-6.40%

The local market endured a weak final quarter in 2016. With overseas interest rate markets reacting swiftly to Donald Trump's victory companies still performed well, including Pacific Edge +28.3%, New Zealand Oil & Gas +22.4% and Air New Zealand +18.0%. But, overall, losers outnumbered winners with Orion Health -42.7%, Trustpower -35.7% and Auckland International Airport -15.0% helping drag the index lower. *Source: S&P/NZX 50 Index, gross with imputation credits*

New Zealand fixed interest

-1.69%

The Reserve Bank of New Zealand reduced the Official Cash Rate by a further 0.25% in November. However, global and domestic bond yields continued to rise through the quarter, fuelled in part by the US Federal Reserve hiking rates in the US and additional anticipated stimulus from the Trump presidency. Although the bond sell-off over the quarter returned longer dated bonds closer to fair value, the immediate pricing impact saw the New Zealand Corporate A Bond Index deliver its worst quarterly result on record. *Source: S&P/NZX A Grade Corporate Bond Index*

New Zealand property

-6.23%

The rapid shift in overseas interest rate expectations provided a strong headwind for New Zealand property assets. With relatively high yielding New Zealand property having been a popular destination for foreign yield-seeking investors in recent years, the turnaround in US interest rate expectations saw a sizable rotation away from New Zealand property this quarter. This resulted in the domestic real estate index suffering its worst quarter since the March 2009 quarter at the end of the GFC. *Source: S&P/NZX All Real Estate Index, gross with imputation credits*

Australian shares

+3.95%

The Australian share market performed significantly better than the New Zealand market over the quarter, driven by the energy sector (higher oil prices) and banking shares (higher interest rates and Basel IV relief). This led to large capitalisation companies faring the best on a relative basis with the S&P/ASX 100 delivering a useful +4.57%, while the S&P/ASX Small Ordinaries shed -3.59% (both returns in New Zealand dollars). *Source: S&P/ASX 200 Index (total return)*

International shares

+5.27%
(hedged to NZD)
+6.79%
(unhedged)

Developed market shares performed well over the quarter, generally benefitting from an increased investor appetite for risk assets. Economic data, particularly for the US and China, continued to beat expectations, and the additional economic stimulus anticipated under the Trump administration proved to be positive for US shares in particular. Commodity prices also strengthened, with the oil price lifting further after OPEC announced production cuts. A slightly weaker New Zealand dollar saw reported returns from unhedged equities outperforming the comparable returns from hedged investments. *Source: MSCI World ex-Australia Index (net div.)*

Emerging markets shares

+0.53%

Returns from emerging markets shares were only mildly positive for the quarter (in New Zealand dollars). While the fundamentals in emerging markets are strong with gross domestic product growth accelerating, their prospects became a little more clouded given the stated economic and trade policies of the incoming Trump administration in the US. Egypt was again the best performing single country in the emerging markets this quarter, however, it was the double digit returns from many of the European constituents, including Russia, which helped offset weaker returns from China and India. *Source: MSCI Emerging Markets Index (gross div.)*

International fixed interest

-0.13%

The US Federal Reserve met expectations by hiking interest rates by another 0.25%, and the US Federal Open Market Committee members also raised the projected path of forward rate movements (at least partly due to the anticipated stimulus from the Trump presidency). This resulted in a sharp spike in longer dated bond yields, which saw the US ten year bond yield unexpectedly rise 0.85% over the quarter and impacted yield curves around the globe. This pulled most bond indices into the negatives, with longer duration and/or credit indices generally faring worse than the relatively shorter duration Citigroup World Government Bond Index 1 - 5 Years (in NZD). *Source: Citigroup World Government Bond Index Years (hedged to NZD)*

International property

-0.24%

International property fared somewhat better than domestic property during the quarter, when the main investor reaction appeared to favour some movement from bonds (and previously high yield New Zealand assets) into selected international risk assets. The S&P Developed REIT Index was negative in US dollar terms, however, a general weakening in the value of the New Zealand dollar during the quarter helped offset the bulk of the underlying asset class weakness. The Australian listed property sector was also down for the quarter, with the S&P/ASX 300 A-REIT Total Return Index shedding 0.73% in Australian dollar terms. *Source: S&P Developed REIT Index (total return)*

**All returns are expressed in NZD. It is assumed that Australian shares, emerging markets 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*

New Zealand – The Strongest Society in the World

As we begin 2017, we thought it might be appropriate to take a moment to consider how fortunate we are to live in such a great country as New Zealand. A recent reminder of this came from a nurse who had just returned from volunteering in an impoverished Pacific country. She described her efforts to treat wounds that, due to volcanic ash and unsanitary conditions, could easily change from mere scratches to life threatening illnesses.

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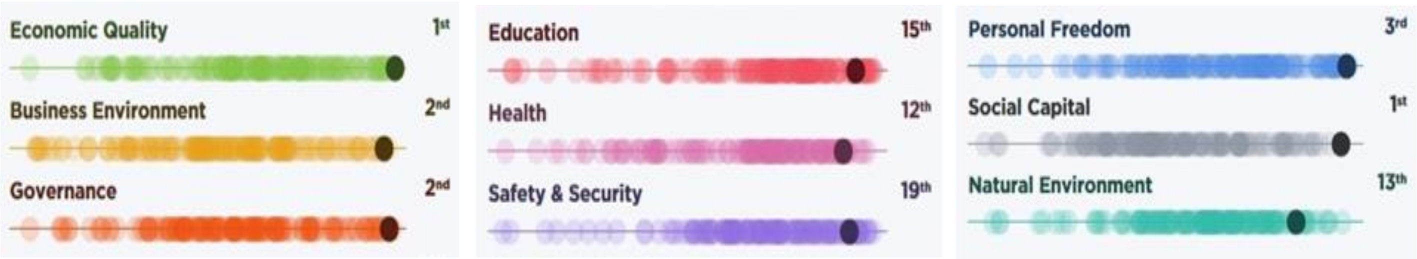
It's the most human of qualities to adapt our expectations to our local surroundings. As a result, we can easily find that gratitude is a difficult feeling to capture and retain. There is, however, a London based research institute that takes a truly global, as opposed to local, perspective. The Legatum Institute ranks 149 nations on their prosperity. It considers prosperity a function of nine different societal factors, including:

- Economic quality - openness of their economic and macro-economic factors, foundations of growth, economic opportunity and financial sector efficiency.
- Business environment - entrepreneurial environment, business infrastructure, barriers to innovation and labour market flexibility.
- Governance - effective governance, democracy and political participation, and rule of law.
- Education - access to education, quality of education and human capital.
- Health - basic physical and mental health, health infrastructure and preventive care.
- Safety and security - national security and personal safety.
- Personal freedom - basic legal rights, individual freedoms and social tolerance.
- Social capital - strength of personal relationships, social network support, social norms and civic participation in a country.
- Natural environment - quality of natural environment, environmental pressures and preservation efforts.

New Zealand is rated by the institute as the most prosperous nation in the world. Broken down by the nine factors mentioned above, New Zealand scores as illustrated in the chart:



Source: http://www.prosperity.com/globe/new-zealand

You may be thinking that, in terms of GDP per capita for westernised nations, New Zealand isn't an unusually wealthy country. However, this report reminds us that prosperity and monetary wealth are different things. In particular, the report commends New Zealand in areas such as social capital.

According to the report: "New Zealand has the strongest society in the world, with 99% of New Zealanders saying they can rely on family and friends in times of need. This social strength has been proved globally to not only have a significant impact on wellbeing, but on economic growth also. New Zealand's mighty social capital performance is certainly at the heart of its success."

In other words, how much more 'wealthy' are we for friends, family and neighbours we can count on during difficult times? In global terms, New Zealand is very prosperous in this regard. The report also praises New Zealand for economic freedom. We are a free people who trade freely with many world markets.

The report states: "So too has trade been critical. A small nation of just 4.7 million, exporting has long been necessary to secure rising wealth and economic growth in the country. New Zealand is one of the least distorted markets in the world, with unrivalled free market access. A recent signatory to the Trans-Pacific Trade Partnership, which includes access to over 40% of global GDP, New Zealand already has free trade agreements in place with ASEAN, was the first developed nation to secure an FTA with China, and was a signatory to the P4 (Brunei, Chile, Singapore, and New Zealand), the first FTA linking the Pacific, Asia, and the Americas. New Zealand is proof that a small nation whose exports are still dominated by the primary sector, can trade its way to prosperity."

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Put succinctly, New Zealand is prosperous because of free markets, free people and a strong society. Referring back to GDP, which is still the most common way of measuring a society's financial prosperity, the institute has created a chart with a prosperity index score on the vertical axis and GDP per capita on the horizontal axis. New Zealand is the dot with the green circle around it (see the chart at the bottom of this page).

What this chart suggests is that, per capita, we derive more prosperity from our wealth than any other nation on earth. The news wasn't just good for New Zealand - the institute said that the global average prosperity is now 3% higher than it was in 2007. The report cited increased personal freedom in Western Europe and Latin America, improvements in wealth and education in Asia and better business environments in Africa and Eastern Europe. In a world that can seem scarier than it was a decade ago, this is a very welcome perspective.

As financial advisers, we realise that wealth isn't just about how large your portfolio balance is. It's about connectedness to your family, society and loved ones. It's about experiences, education, health and joy. The challenge for advisers isn't just to accumulate wealth, it's to guide our clients to use that wealth to increase their prosperity, security and wellbeing.

Source: http://www.prosperity.com/globe/new-zealand

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