Monthly Review

For the month of June 2019

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Markets

NEW ZEALAND

Global interest rates are falling and New Zealand is no exception. Already the Reserve Bank of New Zealand (RBNZ) has cut the Official Cash Rate (OCR) once this year and is widely expected to do so again at the next Monetary Policy Statement announcement on 7 August. This expectation was reinforced when the RBNZ released its latest OCR decision. In the 26 June release, while there was no cut to the OCR, the RBNZ indicated that further interest rate cuts may be needed. This view was predominantly predicated on the RBNZ's forecasts of slowing economic growth and low inflation.

The expected interest rate cuts are proactive rather than reactive moves, with the economy still experiencing robust growth. This was affirmed with the release of the March quarter GDP estimate over the month. In the March 2019 quarter, the New Zealand economy is estimated to have grown by 0.60% giving an annual growth rate of 2.50%[1].

The New Zealand share market increased by 4.43%[2] in June. Like in May, this appreciation was driven by investors looking for yield. Companies that pay high sustainable dividends were the strongest performers. This includes Mercury NZ (+20.78%), Auckland International Airport (+12.38%) and Meridian Energy (+12.03%).

The New Zealand dollar appreciated over the month, increasing from US$0.6531 to US$0.6718. This reflected the view that interest rate cuts in New Zealand are likely to be less than in other markets, particularly the United States and Australia.

AUSTRALIA

The Australian economy continues to slow and during the month the Reserve Bank of Australia recognised this by finally cutting their official interest rate from 1.50% to 1.25%. Given the weakness in the economy, most economists are picking at least another two interest rate cuts in Australia. The weaker economy was highlighted by the release of their March quarter GDP estimate. This showed that economic growth was only 0.40% for the quarter and 1.80% year-on-year. The consumer sector remains the weakest sector of the economy, with house prices and consumer sentiment continuing to fall over the month. Unemployment remains relatively high at 5.20%.

The Australian share market appreciated by 3.70% over the month. The Materials sector was the top performing sector, driven by a strong rise in the price of iron ore. This is surprising given that other industrial commodities have declined. The rise in the price of iron ore was driven by increased demand from China.

The Australian dollar fell against the New Zealand dollar over the month. At month-end the exchange rate was A$0.9570.

INTERNATIONAL

Global markets continue to price in lower interest rates and slowing economic growth. The United States Federal Reserve (Fed) confirmed this view when it committed to act to sustain economic expansion. This statement was widely seen as a signal that the Fed would cut interest rates at its next meeting in July. The Fed's target rate is currently between 2.25% and 2.50% with most commentators expecting this to fall to around 1.75% by year-end.

These lower short-term interest rate expectations feed through to the yield curve with United States 10-year bonds declining from 2.13% at the start of the month to 2.01% at the end. Bond yields in the rest of the world also declined, with 10-year government yields in Europe moving back into negative territory. In Germany 10-year bond yields ended the month at -0.33%, despite an inflation rate of 1.60%.

Global share markets reacted positively to the decline in interest rates. This reflected the view that the expected rate cuts would underwrite the economic growth cycle. Markets generally expected there to be some form of trade truce between the United States and China announced at the G20 meeting. This expectation proved correct with both countries agreeing to return to negotiations.

1. Statistics New Zealand.
2. S&P NZX 50 Portfolio Index with imputation credits.
3. S&P ASX 200 Index.

Managed Portfolio Service

INCOME CATEGORY[1,2]

The Income Category returned 1.12% for the month of June, taking the year-to-date return to 5.15%.

Substantially lower interest rates across the globe have created an asset-grab environment in fixed-income markets. Investors everywhere are searching for assets that have yield and they are willing to pay up to own them. We continue to see potential for interest rates to move even lower over the coming months and as a result we aim to keep the Category fully invested and exposed to interest rate moves.

A local example of the search for assets that have yield is a subordinated bond issued by WEL Networks. The Portfolio purchased a significant holding in this bond when it was issued in July 2018 at a yield of 4.90% and a price of $100. We recently sold a small amount of our holding at a yield just 3.00% which equates to a price of $107. Thanks to the coupon income of 4.90% this equates to a gain on this investment of more than 10% for the year.

INFLATION CATEGORY[1,3]

The Inflation Category returned 2.81% for the month of June, taking the year-to-date return to 14.98%.

The Inflation Category generated strong returns in June given its exposure to global and New Zealand share markets. We discussed previously that we have reduced the Category's allocations to inflation sensitive sectors as low inflation globally means inflation sensitive sectors were more likely to perform in line with, or below, the broader market. At the same time, we have added inflation swaps as a hedge should there be an inflation 'shock'.

The current market environment is ideal for active management. In general, volatility is beneficial for active managers because it gives us and the managers we work with more opportunity to add value. We have therefore added our suite of global investment managers to the Inflation Category. These include long-only global equity managers LSV Asset Management and newly appointed MFS Asset Management, as well as our alternative long/short managers Suvretta Capital and Emerson Point Capital. The Category also includes downside mitigation options managed by United States-based hedge fund, Universa.

Similar to the Growth Category, the Inflation Category's passive, index-tracking allocation enables clients to capture the long-term beta of share markets, while its partnership with some of the top active managers is designed to add above market returns (alpha). NZ Funds' active managers will also help protect members' investments in a severe market downturn in a way that an index-oriented fund could not.

GROWTH CATEGORY[1,4]

The Growth Category returned 4.88% for the month of June, taking the year-to-date return to 14.07%.

Over the past six months there has been a significant change in the way the Dividend and Growth Portfolio (the Portfolio) has been managed. We are glad to report that this new methodology has paid off. To use a sporting analogy, we had previously used an offensive investing strategy, only investing in the companies we liked and that we thought were fairly valued. Today we still follow this strategy, but we also employ a defensive strategy, investing in good companies despite them looking expensive.

This month was a good example of how the strategy works. One of the top performers in the Portfolio was Auckland International Airport (+12.38% in June). We have always thought this company had a great franchise but that it was expensive. In a way it could be considered a 'bond-like' share, good stable earnings but – due to its price – only paying an average dividend yield. As interest rates fell over the month, bond-like shares including Auckland Airport rallied strongly. This re-rating fed through directly into the Portfolio which appreciated by 3.32% over the month.

The global growth Portfolios – Core Growth, Global Multi-Asset Growth and Global Equity Growth – appreciated strongly over the month, reflecting their global share exposure. Over the past 12 months global share markets have been volatile. Markets fell sharply late last year, only to rally strongly at the start of this year. Similarly, markets fell sharply in May but recovered all of those losses in June. Over this period we have continued to hold a full exposure to these markets. This view was predicated on our expectation that the global economic upswing would continue and that we were at least a year away from a possible recession. This is still our view today. In a low interest rate environment, shares remain one of the few 'fairly' valued asset classes. We therefore continue to remain constructive on global shares despite the strong appreciation experienced year-to-date.

1. All returns are after Portfolio fees but before investor tax.
2. The return calculations are based on a 50% allocation to the Core Income Portfolio and a 50% allocation to the Global Income Portfolio.
3. The return calculations are based on a 34% allocation to the Core Inflation Portfolio, a 33% allocation to the Property Inflation Portfolio, and a 33% allocation to the Equity Inflation Portfolio.
4. The return calculations are based on a 25% allocation to the Core Growth Portfolio, a 10% allocation to the Global Multi-Asset Growth Portfolio, a 25% allocation to the Global Equity Growth Portfolio, and a 40% allocation to the Dividend and Growth Portfolio.

INCOME STRATEGY[1]

The Income Strategy returned 0.98% for the month of June, taking the year-to-date return to 4.88%.

Substantially lower interest rates across the globe have created an asset-grab environment in fixed-income markets. Investors everywhere are searching for assets that have yield and they are willing to pay up to own them. We continue to see potential for interest rates to move even lower over the coming months and as a result we aim to keep the Strategy fully invested and exposed to interest rate moves.

A local example of the search for assets that have yield is a subordinated bond issued by WEL Networks. The Strategy purchased a significant holding in this bond when it was issued in July 2018 at a yield of 4.90% and a price of $100. We recently sold a small amount of our holding at a yield just 3.00% which equates to a price of $107. Thanks to the coupon income of 4.90% this equates to a gain on this investment of more than 10% for the year.

INFLATION STRATEGY[1]

The Inflation Strategy returned 3.11% for the month of June, taking the year-to-date return to 15.20%.

The Inflation Strategy generated strong returns in June given its exposure to global and New Zealand share markets. We discussed previously that we have reduced the Strategy's allocations to inflation sensitive sectors as low inflation globally means inflation sensitive sectors were more likely to perform in line with, or below, the broader market. At the same time, we have added inflation swaps as a hedge should there be an inflation 'shock'.

The current market environment is ideal for active management. In general, volatility is beneficial for active managers because it gives us and the managers we work with more opportunity to add value. We have therefore added our suite of global investment managers to the Inflation Strategy. These include long-only global equity managers LSV Asset Management and newly appointed MFS Asset Management, as well as our alternative long/short managers Suvretta Capital and Emerson Point Capital. The Strategy also includes downside mitigation options managed by United States-based hedge fund, Universa.

Similar to the Growth Strategy, the Inflation Strategy's passive, index-tracking allocation enables clients to capture the long-term beta of share markets, while its partnership with some of the top active managers is designed to add above market returns (alpha). NZ Funds' active managers will also help protect members' investments in a severe market downturn in a way that an index-oriented fund could not.

GROWTH STRATEGY[1]

The Growth Strategy returned 5.30% for the month of June, taking the year-to-date return to 14.55%.

Over the past six months there has been a significant change in the way the Australasian component of the Strategy has been managed. We are glad to report that this new methodology has paid off. To use a sporting analogy, we had previously used an offensive investing strategy, only investing in the companies we liked and that we thought were fairly valued. Today we still follow this strategy, but we also employ a defensive strategy, investing in good companies despite them looking expensive.

This month was a good example of how the strategy works. One of the top performers in the Australasian component of the Strategy was Auckland International Airport (+12.38% in June). We have always thought this company had a great franchise but that it was expensive. In a way it could be considered a 'bond-like' share, good stable earnings but – due to its price – only paying an average dividend yield. As interest rates fell over the month, bond-like shares (including not just Auckland International Airport but also Contact and Meridian Energy that are also held in the Strategy) rallied strongly. This re-rating fed through directly into the Strategy with the Australasian component appreciating 3.59% over the month.

The global growth portion of the Strategy appreciated strongly over the month, reflecting its global share exposure. Over the past 12 months global share markets have been volatile. Markets fell sharply late last year, only to rally strongly at the start of this year. Similarly, markets fell sharply in May but recovered all of those losses in June. Over this period we have continued to hold a full exposure to these markets. This view was predicated on our expectation that the global economic upswing would continue and that we were at least a year away from a possible recession. This is still our view today. In a low interest-rate environment, shares remain one of the few 'fairly' valued asset classes. We therefore continue to remain constructive on global shares despite the strong appreciation experienced year-to-date.

1. All returns are after Strategy fees but before investor tax.

Managed Superannuation Service

INCOME STRATEGY[1]

The Income Strategy returned 1.00% for the month of June, taking the year-to-date return to 4.95%.

Substantially lower interest rates across the globe have created an asset-grab environment in fixed-income markets. Investors everywhere are searching for assets that have yield and they are willing to pay up to own them. We continue to see potential for interest rates to move even lower over the coming months and as a result we aim to keep the Strategy fully invested and exposed to interest rate moves.

A local example of the search for assets that have yield is a subordinated bond issued by WEL Networks. The Strategy purchased a significant holding in this bond when it was issued in July 2018 at a yield of 4.90% and a price of $100. We recently sold a small amount of our holding at a yield just 3.00% which equates to a price of $107. Thanks to the coupon income of 4.90% this equates to a gain on this investment of more than 10% for the year.

INFLATION STRATEGY[1]

The Inflation Strategy returned 3.26% for the month of June, taking the year-to-date return to 15.15%.

The Inflation Strategy generated strong returns in June given its exposure to global and New Zealand share markets. We discussed previously that we have reduced the Strategy's allocations to inflation sensitive sectors as low inflation globally means inflation sensitive sectors were more likely to perform in line with, or below, the broader market. At the same time, we have added inflation swaps as a hedge should there be an inflation 'shock'.

The current market environment is ideal for active management. In general, volatility is beneficial for active managers because it gives us and the managers we work with more opportunity to add value. We have therefore added our suite of global investment managers to the Inflation Strategy. These include long-only global equity managers LSV Asset Management and newly appointed MFS Asset Management, as well as our alternative long/short managers Suvretta Capital and Emerson Point Capital. The Strategy also includes downside mitigation options managed by United States-based hedge fund, Universa.

Similar to the Growth Strategy, the Inflation Strategy's passive, index-tracking allocation enables clients to capture the long-term beta of share markets, while its partnership with some of the top active managers is designed to add above market returns (alpha). NZ Funds' active managers will also help protect members' investments in a severe market downturn in a way that an index-oriented fund could not.

GROWTH STRATEGY[1]

The Growth Strategy returned 5.24% for the month of June, taking the year-to-date return to 14.94%.

Over the past six months there has been a significant change in the way the Australasian component of the Strategy has been managed. We are glad to report that this new methodology has paid off. To use a sporting analogy, we had previously used an offensive investing strategy, only investing in the companies we liked and that we thought were fairly valued. Today we still follow this strategy, but we also employ a defensive strategy, investing in good companies despite them looking expensive.

This month was a good example of how the strategy works. One of the top performers in the Australasian component of the Strategy was Auckland International Airport (+12.38% in June). We have always thought this company had a great franchise but that it was expensive. In a way it could be considered a 'bond-like' share, good stable earnings but – due to its price – only paying an average dividend yield. As interest rates fell over the month, bond-like shares (including not just Auckland International Airport but also Contact and Meridian Energy that are also held in the Strategy) rallied strongly. This re-rating fed through directly into the Strategy with the Australasian component appreciating 3.59% over the month.

The global growth portion of the Strategy appreciated strongly over the month, reflecting its global share exposure. Over the past 12 months global share markets have been volatile. Markets fell sharply late last year, only to rally strongly at the start of this year. Similarly, markets fell sharply in May but recovered all of those losses in June. Over this period we have continued to hold a full exposure to these markets. This view was predicated on our expectation that the global economic upswing would continue and that we were at least a year away from a possible recession. This is still our view today. In a low interest-rate environment, shares remain one of the few 'fairly' valued asset classes. We therefore continue to remain constructive on global shares despite the strong appreciation experienced year-to-date.

1. All returns are after Strategy fees but before investor tax.

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The Product Disclosure Statement and the Disclose Register contain important information to help you to understand how your money is managed and the risks associated with investing.

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