2016 and beyond: investment outlook

The markets are oscillating

"Prepare for lower-for-longer …" - BHP CEO Andrew Mackenzie

Volatility has been the watchword so far in 2016: after a tepid 2015, global equity markets literally tanked in January and February – with the oil price plunge leading the way. By late February some markets were down over 15% year to date. Bearish commentary on China and Emerging Markets prevailed and the view that US Fed rate hikes were coming down the track also put the skids under rate-sensitive sectors and triggered a credit market reversal.

However March and April have been much merrier: Global markets rallied on a 'risk-on' rebound. NZ shares were up an incredibly strong 8% over March month and a further 1% in April (as at time of writing). The scale of the January-February collapse provided value seekers with an opportunity. The most volatile global share markets were the strongest over the March: Shanghai has surged 12% in March for example. But the main markets also rebounded: US S&P 500 was up 7%, Germany's DAX and Japan's Nikkei up c5% and Australia's ASX200 up 4%. However year to date most markets are still in flat to negative territory and most emerging markets are down 20%-30% since their May and August 2015 peaks. In particular the rally in the Australian market has been largely driven by funds rotating into the heavily sold down Bank and Mining sectors rather than any conviction, we believe. Further, the Hong Kong and Singapore markets are reflecting very bearish views of the property markets there, and Brazil is experiencing a welter of concerns on growth, gearing and government stability.

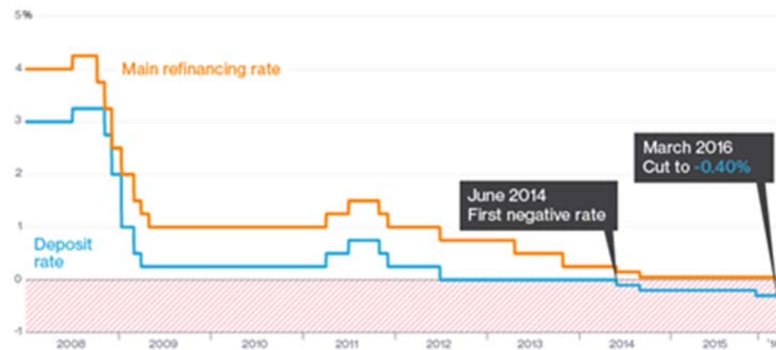
NZ fixed interest markets also continued to rally: NZ government bonds returned 0.3% for March and are up 2.8% year to date. The rally was also accompanied by a 4.8% rise on the NZ dollar vs. the US dollar, which further enhanced returns from an overseas investor perspective. We suspect that the NZX moves are now being largely driven by passive funds, ETFs and quant driven inflows rather than any fundamentals - albeit NZ is certainly looking like a better place to park money than many other parts of the world.

Commodities have certainly rallied hard also last month, but again this has been from heavily sold down levels – oil touched US$28/bbl. for a time when few would have forecast it go much below US$50/bbl. We believe that the global oversupply and weak demand issues are not going to suddenly go away. A few months of inventory restocking does not presage a boom summer.

Overall then we expect further volatility and a pull-back from the recent rebounds is likely. Equity markets may look cheaper than bond markets but that's because most have been boot-strapped higher and in an absolute sense they don't look that cheap. For the NZX50 benchmark index, for instance, we'd expect around 5% performance for the next 12 months, and little different for global equity markets.

The problem is bigger – negative interest rates make it a new World.

".. the monetary system has become so screwed up that a local government doesn't want its citizens to pay taxes early ..." - Financial Times on the Swiss canton of Zug requesting taxpayers hold back payments, as SNB deposit rates are minus 0.75%



There is a wider and deeper problem that needs to be recognised. We are in a new world now: 20 countries currently have Central Bank policy rates that are negative: 16 of the 20 ECB nations, plus Sweden, Denmark, Switzerland and Japan. Two - Japan and Switzerland - have negative rates out to the 20 years investment horizon. Two more - Canada and Israel - are teetering close to negative territory and one more, Portugal, is also not far off (it's probably safe to say however that Greece won't have negative rates anytime soon). The Bank of England has a positive rate but it has the lowest cash rate since it was formed, in 1684! The sheer scale of this intervention is mitigated only by the fact that the US is not in the negative camp and is widely regarded as moving to a hiking trend; if so it would be almost the lone beacon of growth and inflation.

The RBNZ "surprised" most commentators' expectations with a 25bps cut in the OCR, to 2.25%, at their March 2016 Monetary Policy Statement (MPS). While further cuts had been anticipated these were expected to be later in the year. The bringing forward of the timing of the easing appears to have been largely prompted by a combination of factors including a weaker global growth outlook, a material change in inflation expectations, together with an expectation that it would now take longer to reach the target range than previously expected. RNBZ Governor Wheeler made extensive note of the negative interest rate world in his MPS speech – confirming in our minds at least how much more serious this situation is than many investors appear to realise.

Where this has come from

"Desperate times call for desperate and somewhat speculative measures. The European Central Bank (ECB) cut its deposit rate last Thursday, pushing it deeper into negative territory…"
 - Forbes

This all reflects a major problem globally: little or no growth, too much exogenous risk potential, and expensive assets. Our usual signposts, market interest rates, simply no longer contain useful information and there is a large disconnect with the reality of growth being disappointingly low. This will continue to create a major problem for savers and investors in most countries - NZ included, even though we have positive rates. RBNZ Governor Wheeler's latest cut was driven largely by the spectre of deflation - it's this that has caused Sweden and Denmark to push rates below zero. We understand that the RBNZ analysts are already preparing scenario reports on how NZ will manage negative interest rate settings. Since then Reserve Bank of Australia (RBA) Governor Stevens surprised the Australian market with a rate cut to 1.75%, following signs of deflation in a record low CPI data.

Since the GFC enormous amounts of liquidity have been pumped into world debt and credit markets to prop up the financial system. This has worked to some extent but it's possible that this was just 'round one', and this action has had the effect of throwing gasoline on the fire. A huge equities and bond markets rebound has taken place since then, at the same time as using up the Central Bank's stack of firefighting ammunition – the policy rates. As each intervention has mounted, the degree of financial repression had to be lifted: moving from an ineffective use of low interest rates to supplying more money in total ('Quantitative Easing' or QE), to a mix of both, and a move to what can only be described as financial repression – punishing savers and dropping barriers to investment to zero.

What this implies

"We live in an "extend and pretend" world in which economies pathetically fight between themselves for any scraps of demand. One burst of money printing is met by another in an ultimately futile, zero-sum game of competitive currency devaluation… " – Jeremy Warner, The Telegraph

It must be stated that this problem must be big, much bigger than the GFC, to warrant such enormous financial intervention. The TARP of 2008 and after was enormous, but the scale of these moves when one considers the broad impact of its effects, is larger. So whilst share markets have rallied it's against a backdrop of a worsening outlook, given the scale of the problem that these measures imply. And it's getting bigger: the latest announcement by the ECBs head Draghi, to extend the Euro QE, follow Japan's Central Bank also stepping their QE up. The US Feds outlook has moderated, implying lower rates for longer, despite it being one of the few growth bright spots.

Fed watching is thus more than an interesting sideline, it's become vital signpost to the future. Fed Governor Janet Yellen's most recent statements have a dovish tinge however, and despite market expectations of a series of US rate hikes to come the reality is these are likely to be lower and later. The trend is still arguably deflationary and although recent employment and inflation data in the US do support a constructive view, this has to be set against a very weak world.

Negative implications for investors

"Banks seem unable or unwilling to pass negative deposit rates to their retail customers"
- JP Morgan

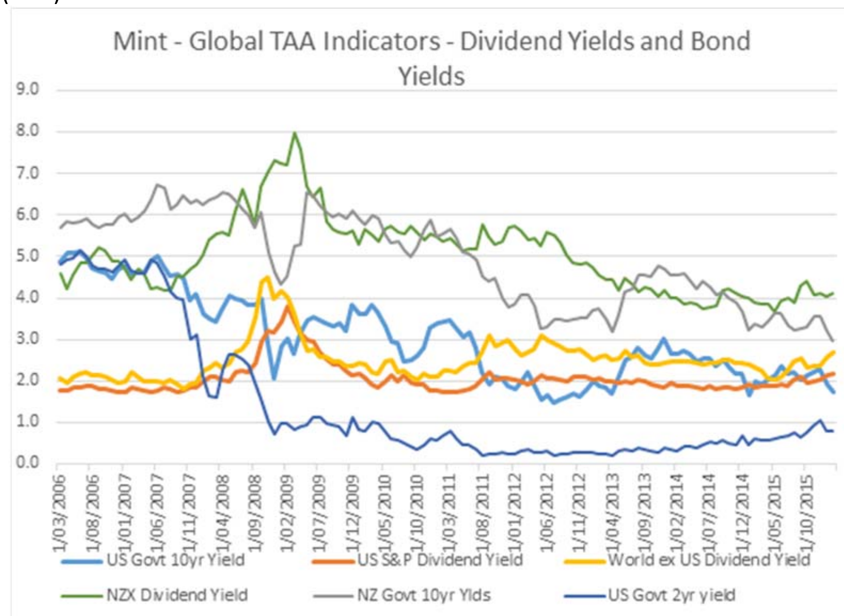
Interest rates should contain information to help guide investors (and lenders and borrowers). They act as signposts or provide a buoyed channel for the global investor to steer by. We now have a major navigational problem: we are way out beyond the usual comfortable shipping route, far from the buoyed channel – to continue the analogy - with few if any markers to guide our way. There is nothing in any textbook – apart from specialist works on the 1910s – nor anything within the experience of any investment professional alive – including us – that deals with this world, or gives one a chart back to the safer channels.

The problem is illustrated by The Sydney Morning Herald journalist Peter Hartcher's recent column, telling of an Australian expat in Japan wanting to withdraw funds and then discovering that he'd be charged 1% negative rates - plus the usual 0.25% handling fee, sir - by his Japanese Bank. Japan is, so far the only country that has pushed negative rates into retail land, but this can't be far off for many others.

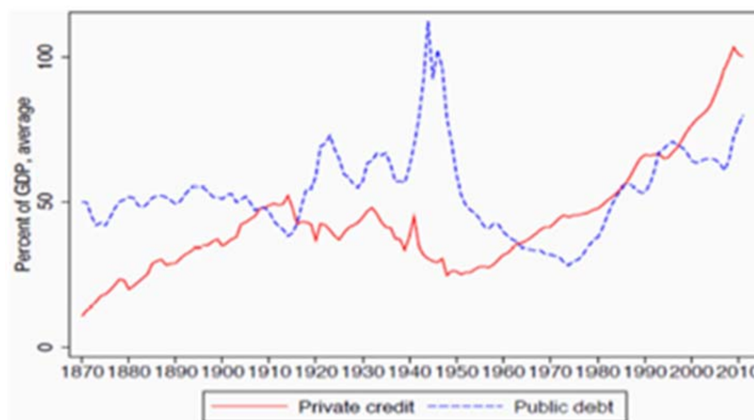
The impact on the older demographic and the retirement savers – generally the same group – is potentially enormous and is widely unrecognised. If banks feed through these low rates then savers would be increasingly forced out of term deposits. Notably the sales of deposit safes for the home have been surging in Japan - it's gone beyond mattresses! Only in NZ and Australia do you see attractive interest rates and dividend yields: thus unsurprisingly we are seeing large inflows of 'passive' money to the NZ share and property markets. Real Estate is in a purple patch: strong fundamental demand for bricks and mortar, low borrowing costs, attractive income streams and capital appreciation potential will continue to be supported by international money looking for a home.

The Central Banks and policy makers aren't looking out for the savers, that's clear: the aim is to stimulate consumption and defeat deflation. The strategy however smacks of over-simplification: are the retirees the target market anyway? They aren't likely to respond to negative rates by going out and building factories. In fact to raise demand and employment will require an asset transfer down the demographic scale and certainly out of the hands of today's savers. The longer this goes on then the 'baby boomer spending spree', that has been widely expected to support many industries and investment strategies, may need to be questioned.

So what happens if they're right and growth and returns are lower for longer? Japan's decades of stagnation are a clear warning of what happens if enough people get scared: they keep their money in savings deposits, under futons or in the newly acquired safes. It's the same old problem: interest rates can act as a string to pull back excessive growth, but you can't push on a string to drive growth when it's low. The chart of the various yield options available are shown below under Mints 'Tactical Asset Allocation' (TAA) chart.



For savers the world of negative interest rates is like Alice's Looking Glass (or down the white rabbit hole). The size of your assets that you've spent years accumulating may not matter: zero real returns mean insufficient income, and probably no capital appreciation. In fact you'll face a large cash outflow from interest rates and in fact many may be forced to sell assets to fund their retirement lifestyle. What happens if a large number of retirees have to start de-accumulating assets at same time?

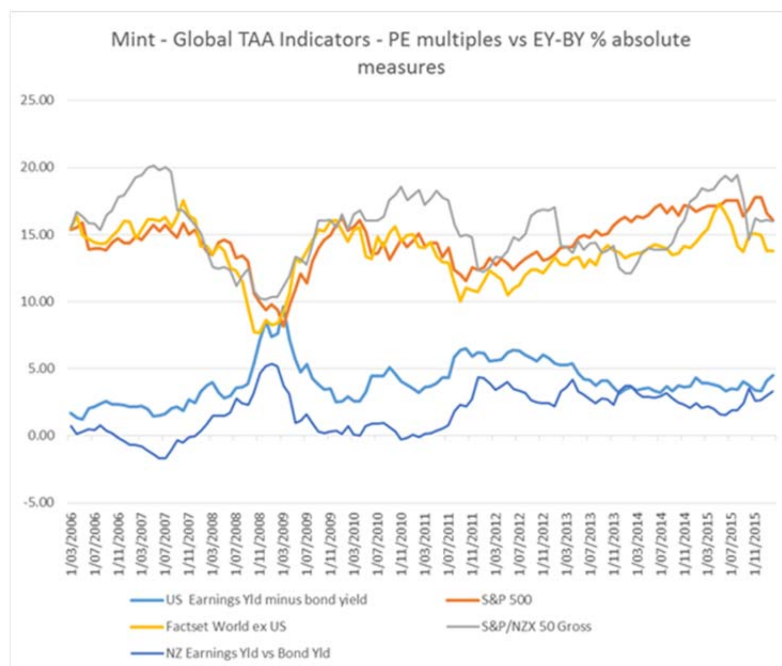


Low cost of debt also doesn't mean taking on more gearing is sensible: it's the quantum of debt that matters now, not just whether you can service the interest charges. The Australian energy companies Santos and Origin are a salutary lesson that nemesis generally follows hubris: their massive debt funded energy projects have lost value due to falling oil and gas prices, but the size of the project debt has not. Both have been left with equity market capitalisations below the book value of their debt with the inevitable result being the banks have stepped in, assets are now tagged for sale at bottom drawer prices, and senior executives and Board Directors face the axe from wrathful investors.

Notably, the ‘bad boys’ of the 2007-2008 debacle, the REITs, are being more conservative in these times despite having a golden period with asset appreciations. It's unlikely any of the Boards or Management of the REITs will forget “last time”, despite the temptation of low borrowing costs.

The flip side – what if it works?

If this all sounds too apocalyptic, let’s turn to the other side. Accepting that this is one of, if not the, largest financial intervention in history, it must surely have some effect? If this massive intervention does get traction, then it follows that it may drive a big rebound in investment markets. It would be tempting to think this way, and indeed we at Mint are certainly positive on the US long term future: it's certainly where some growth is being seen globally. However despite the general approval of economists for the stimulatory push, it's not as if they're getting very bullish on the outcomes. Global, US and NZ GDP growth forecasts 2 years out have been lowered, in fact. In effect the pundits are arguing that whilst the intervention will get growth up and going it will still be lower than normal (albeit they’re still in the 2.5%-3% range which is hardly a depression). If growth rates are lower, then despite lower interest rates it will be necessary to keep pulling back share and bond return forecasts. A check on global valuations using conventional means - no easy task with such low interest rates – shows that both equity and bond markets are expensive currently and are already pricing in a recovery and stronger growth (see chart below).



Well before any strong growth has re-emerged the interest rates will have to be re-set back closer to 'neutral' settings (and, where neutral is, is a debate itself now in a low growth world). Policymakers will be looking for signs of rising inflation as spare capacity is soaked up. This is not a trivial matter for investors: generally if risk free rates rise 2% or +200bp from the current levels – and that would still be a lower than a full shift back to neutral levels – this would impact stock and bond discount rates significantly. If this rise is fed into a discounted cash flow model it could have over 20% impact on share and bond valuations. Thus US Fed watching is intense: the forecasters have 4-6 hikes to come in next 18 months.

What to do?

So what would we advise – given our point that no-one in the market has experience of these sorts of times? Some thoughts would be:

- Connect to the real world: Yellen is more important than Trump. It's interesting to us that the REIT managers are not being swept up in the low rates and are still measured and cautious, for example.
- Seek advice from many sources, more than the usual ones and preferably from unconventional ones. Look for what explorers call the "ground truth".
- Diversification is more than important, it's vital, and breaking away the old textbook approaches may be necessary,
- Where returns come from is important – the old sources of returns (e.g. everyone's old friend Government Bonds) may fail to do this. However 'Too good to be true' investment options will also re-emerge in these times, as always e.g. watch out for the return of those CDOs/CLOs and other yield-constructing vehicles,
- Be careful about gearing – the low funding rates aren't a good sign, they're a warning,
- If necessary, do as most businesses do and be prepared manage your costs and ride out a 'lower for longer' environment.

The Mint Diversified Income Fund thus continues to have a large cash and short term interest rate holdings, to provide lower volatility and risk averse positioning; income is being sought from a combination of NZ and Australian high rated corporate credits and lower risk listed property and defensive shares, with virtually no global share holdings nor local or global sovereign bonds. Yield continues to be tougher to find, but the good news is that at least what is being found is at a wider spread to cash rates and term deposits.

Paul Richardson is Chief Investment Officer at Mint Asset Management Ltd

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