

Key themes

Fourth quarter, October 2018





Managed Portfolio Service

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INCOME CATEGORY¹

The Income Category remains a game of two halves. For New Zealand the outlook is benign, while offshore the outlook is more challenging due to higher interest rates in the United States. Globally, investment grade bonds are on track for their fourth worst annual returns since 1994 (almost 25 years). Based on the current run rate, the only years that were worse have been 1994, 2008 and 2013.

For the last several years our allocation to global bonds has been exclusively comprised of corporate bonds. This reflected our view that we were in an environment that was positive for corporate credit risk. The steady rise of United States interest rates clouds this outlook as it means that cash is becoming a more compelling return alternative and it is a key reason for the poor returns from the corporate bond sector this year.

In the Income Category we have looked to mitigate the impact of rising interest rates in three ways. Holding a significant allocation of high yield bonds which are less sensitive to interest rate changes, increasing the levels of cash held and maintain futures positions to reduce the impact of rising interest rates. As United States government bond rates continue to move higher they become more attractive and in time we expect to reduce corporate bond holdings and add an allocation to government bonds to the Category.

As discussed in the previous quarterly update, the outlook for New Zealand remains neither too hot nor too cold and this translates into an environment where interest rates are not expected to change for some time. The implication of this is that yields on corporate bonds (and corporate spreads) are not expected to change. We are looking to drive returns by remaining fully invested to keep the running yield as high as possible, and optimising position weights by reducing positions that trade up in price and reinvest back into cheaper names.

The **Core Income Portfolio** owns a diversified portfolio of bonds issued by New Zealand and Australian based companies, with the Australian bonds hedged back into New Zealand dollars.

The **Global Income Portfolio** owns a diversified portfolio of bonds issued predominately by large United States companies, with the bonds predominantly hedged back into New Zealand dollars.

INFLATION CATEGORY²

The United States Federal Reserve has been tightening monetary policy by putting interest rates up for some time, but a combination of continued strong United States economic data and higher oil prices, which also create inflation, means the market has become more worried about the outlook for higher than expected inflation.

The worry around inflation is not unfounded with annual United States inflation running at 2.3%, slightly above the 2% rate many central banks consider optimal. We believe the Federal Reserve will continue to gradually raise interest rates, further bolstering the United States dollar. Official Chinese data showed annual inflation at 2.5% last month, a seven-month high, while eurozone inflation was 2.1% last month.

In New Zealand, inflation remains below the 2% target mid-point, but there are early signs of inflationary pressure rising. Higher oil prices and the depreciation in the New Zealand dollar have raised the outlook for import prices. In addition, announced increases in the national fuel excise tax are expected to continue to lift fuel prices.

The Inflation Category is well positioned for any sudden or protracted increase in inflation. At the same time it will continue to benefit from the positive environment in the global equity market that we believe will continue through to the end of 2018.

The **Core Inflation Portfolio** has an exposure to New Zealand dividend paying shares, including infrastructure assets and to Australian based commodity producing companies. The remainder of the Portfolio is predominately held in higher yielding floating rate bonds and cash.

The **Equity Inflation Portfolio** has an exposure to global share markets, financial companies, and commodity producing and energy shares via our global investment partner Impala Capital. The remainder of the Portfolio is predominately held in higher yielding floating rate bonds and cash.

The **Property Inflation Portfolio** has a balanced exposure to global and New Zealand listed property companies. The remainder of the Portfolio is predominately held in higher yielding floating rate bonds and cash.

1. The Category is based on a 50% allocation to the Core Income Portfolio and a 50% allocation to the Global Income Portfolio.

2. The Category is 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.

GROWTH CATEGORY³

The Growth Category predominately invests in shares listed on the New Zealand and global exchanges. The short to medium term outlook for global shares remains positive. The United States is experiencing strong growth as the impact of last year's tax cuts flow through to higher household spending. This is resulting in a significant increase in company profitability. However, the Federal Reserve is forecast to continue raising interest rates into 2019. Higher interest rates have always proven to be the tipping point for the United States share market.

The other major developed economies are taking longer to recover from the Global Financial Crisis. This has been due to one-offs such as the 2011 European banking crisis and the Brexit vote. Europe was also slower to implement quantitative easing. Barring further one-off crises, these countries are now at the point where growth becomes self-reinforcing, higher growth leads to higher employment and spending leading to higher growth. Consequently, we expect the monetary policy in these countries to start ending quantitative easing and then increase interest rates.

The outlook for emerging markets is less positive. Emerging markets are reliant on foreign capital to drive growth. The higher interest rates in the United States are starving these economies of this much needed capital. A repeat of the 1994 Tequila crisis or the 1998 Asian crisis is therefore possible. This lack of capital is not a problem for most Asian countries, as these countries have built large internal savings pools since 1998. However, the trade impasse between the United States and China is also impacting these countries as Asia's exports to China are then re-exported to the United States and thus are also attracting tariffs. The trade tariffs are also having a negative impact on sentiment in the Chinese share market. Since the beginning of the year the Chinese share market has fallen by over 20%. The People's Bank of China has reacted to this weakness by easing monetary policy and increasing the availability of credit. We expect authorities will continue to stimulate the economy as they do not want to enter trade negotiations with a weak economy.

For economists, the New Zealand economy is a bit of an enigma. Business and consumer confidence has fallen sharply over the year. The recent increase in the price of petrol has not helped this sentiment. Nevertheless, economic growth remains robust with second quarter Gross Domestic Product (GDP) recording stronger than expected growth. The strong growth in tourism seems to partly explain this contradiction. In the past year inbound tourist numbers have increased by 4.6% and is now the largest contributor to GDP growth.

The current environment highlights the need for an active management approach. Global share markets are experiencing greater volatility and there is a lower correlation between each market. This means asset allocation becomes key. This is especially the case given returns from shares in aggregate are likely to be lower over the next ten years. Year-to-date we have seen the New Zealand dollar depreciating against the United States dollar. At the same time, long-term interest rates are now trending higher. We have accordingly positioned the Growth Category to take advantage of these trends.

The **Dividend and Growth Portfolio** invests in New Zealand and Australian companies, with a preference for those that offer a strong and sustainable dividend. The Portfolio has relatively little exposure to the high growth and very high multiple parts of the New Zealand share market, which we believe positions it well should the current equity market correction turn into something more serious. The Portfolio's Australian investments complement the industry exposure of the New Zealand component and are currently concentrated in resource companies. These companies should benefit from a widely anticipated increase in global inflation.

The **Global Equity Growth Portfolio** provides a diversified exposure to global shares. The Portfolio is primarily invested with Chicago-based global investment manager LSV. LSV uses a value-orientated approach to selecting global shares and has outperformed the global share market index since its inception in 1994. The Portfolio also has an allocation to global share futures. The downside mitigation strategies in the Portfolio include an exposure to Universa and to North American credit default swaps.

The **Core Growth Portfolio** is invested in a select number of global share managers who can utilise hedge fund techniques to mitigate the downside. Suvretta invests in companies which are experiencing strong growth due to industry trends and are therefore less likely to be impacted by higher interest rates. Warren Buffet was once quoted as saying "You don't know who is swimming naked until the tide goes out." In the current environment, interest rates are the tide. In a low interest rate environment, companies can run losses and fund these through increasing debt. However, as interest rates rise this strategy becomes risky. Kynikos looks to identify companies which have an unsustainable business model. While Kynikos has struggled over the last eighteen months, we expect the rising interest rate environment to better suit their investment style. A portion of the Portfolio is also managed by ISAM, a trend follower. This Portfolio also has a position in credit default swaps. These latter two positions are the key mitigation strategies within the Portfolio.

The **Global Multi-Asset Growth Portfolio** has an 80% exposure to commodity producing companies. This includes energy, metals and mining and agricultural companies. This exposure includes an allocation to Impala, a New York-based commodity share specialist. A portion of the Portfolio is managed by ISAM. ISAM invests in exchange listed futures and foreign currencies. These markets tend to exhibit trending behaviour, both up and down, and ISAM run mathematical models to capture these trends. This allocation provides diversification benefits to the Portfolio especially during periods of declining shares.

3. The Category is based on a 40% allocation to the Dividend and Growth Portfolio, a 25% allocation to the Global Equity Growth Portfolio, a 25% allocation to the Core Growth Portfolio, and a 10% allocation to the Global Multi-Asset Growth Portfolio.

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