



## Review of 2018 and Forecast for 2019

### SHARP SELL-OFF IN 2018 HAS BEEN FOLLOWED BY STRONG REBOUND IN 2019

As anticipated, financial market volatility increased in 2018. After a strong start to the year global shares dipped twice; once in February and again in the fourth quarter. The year ended with many of the major global share markets well off their highs. New Zealand's small local share market bucked the trend, closing modestly higher.

Client portfolios broadly mirrored the global composite of international and local share markets which we track to monitor progress. While portfolios performed strongly in the first half of the year, they ended the year down slightly more than we would have liked.

Importantly, had the market declined further in December, our downside mitigation portfolio (managed by global investment manager Universa) was positioned to add significant value. Our downside mitigation is designed to help mitigate the effect of large share market drawdowns of greater than 20%.

Markets began rallying into the close of the year, and have bounced strongly off the bottom, in some cases some 10% higher than their lows. During the pullback, NZ Funds and a number of our global investment managers increased clients' global share market holdings by approximately 10%. Consequently, client portfolios are recovering strongly and have so far captured more of this rebound than global indices. As discussed below, we anticipate markets will continue to rally, creating an ideal opportunity to 'buy the dips' along the way.

### GLOBAL SHARE MARKET RETURNS FOR 2018

Table 1: Global market indices performance

Country	Index	2018 performance*
China	Shanghai Composite	-22.74%
Japan	Topix Index	-16.03%
Europe	Eurostoxx 50 Index	-11.34%
Hong Kong	Hang Seng index	-10.55%
United Kingdom	FTSE 100 Index	-8.78%
United States	S&P 500 Index	-4.39%
United States	Dow Jones	-3.48%
United States	Nasdaq (technology)	-2.81%
Australia	ASX 200 Index	-1.47%
New Zealand	NZX 50 Index	+4.92%

\* local currency

### OUTLOOK FOR 2019

The sharp sell-off late in 2018 was fueled by three things. First, the fear that the Federal Reserve would increase interest rates in the United States faster than businesses and consumers could stand. Second, that this would lead to a recession with rising unemployment and negative GDP growth. Third, that the ongoing trade dispute between the United States and China would start to impact companies' earnings and global growth rates in general.

As with most market sell-offs, these concerns are valid. The question for investors who are thinking of selling up is, are these concerns not already priced into the market? We think the answer is yes. We do not expect equities to decline meaningfully in 2019.

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In fact, as the market concerns are overcome we anticipate global shares will play catchup, much as they did following the sell-off in February 2018. The United States Federal Reserve has already comforted markets by saying it has not baked in rate rises and will continue to assess the strength of the economy before acting. In the meantime, the global economy, and the earnings of the companies which drive it, continue to grow. This should lead to a period of share market strength.

On the trade front, while there has been little new news, the fact that the United States and China are in talks is a positive step. Our United States-based global investment managers put a low probability on the potential for an all-out trade war.

For the first time in several years global shares look attractively priced, implying medium to long-term returns of around 10%. The same can be said for many companies listed on the New Zealand share market. This gives clients two geographically diversified areas of upside for their portfolios.

The United States government shutdown, Brexit and concerns about the strength of the Chinese economy will continue to occupy short-term investor mindsets. Therefore, NZ Funds will continue to maintain its downside mitigation exposure with Universa. If our portfolio of options pays out, we anticipate reinvesting the proceeds into local and international share markets to take full advantage of any further sell-offs, such as the one we are currently experiencing.

We are currently finalising our forecasts for 2019. We will share them with you in next month's market update and in the 1H 2019 Investment Report.

## **PORTFOLIO POSITIONING IS FOR A CONTINUING RECOVERY IN 2019**

Client portfolios remain fully invested following the recent share market sell-off. Our downside mitigation portfolio (managed by global investment manager Universa) was not triggered and remains in place should markets unexpectedly decline further.

NZ Funds, and several of our global investment managers, made additional purchases of assets at steeply discounted prices. As a result, clients are positioned as follows:

First, our asset allocation recommendation for all advised clients is to hold a diversified mix of growth and defensive assets in line with the clients' age and stage. Clients under the age of 60 will hold approximately 60-70% exposure to growth assets and a 20-30% exposure to defensive assets. For clients closer to or in retirement, the mix is reversed.

Secondly, our asset allocation continues to favor around 60-70% of clients' assets invested globally with the remainder invested locally. In our view, a higher allocation to domestic shares and bonds puts clients at risk of a significant impairment of wealth given the extremely low volume of shares and bonds traded on the New Zealand stock exchange compared to global markets.

Thirdly, we include a 10% exposure to alternative assets, and in particular hedge funds. This allocation is broadly in line with global endowment and pension schemes which hold 10-20% allocations. NZ Funds' hedge fund allocation is designed to mitigate the downside in the event of a sharp and disorderly collapse in global financial markets.

Finally, all portfolios remain fully invested. We have successfully increased clients' exposure in their growth portfolios to approximately 110% in local and global shares. We have taken profit on our international currency exposure but retain a 30% allocation to the Australian and United States dollar as we expect the New Zealand dollar to decline further over the course of 2019. We anticipate local and international interest rates will not rise much further in 2019. Our bond portfolios should therefore enjoy a slightly higher rate of return this year than in 2018.

If you would like to discuss the markets, performance or portfolio positioning in more detail please do not hesitate to contact me, or one of the team at NZ Funds directly.

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**Chief Investment Officer**

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