Harbour ASSET MANAGEMENT

Harbour Outlook

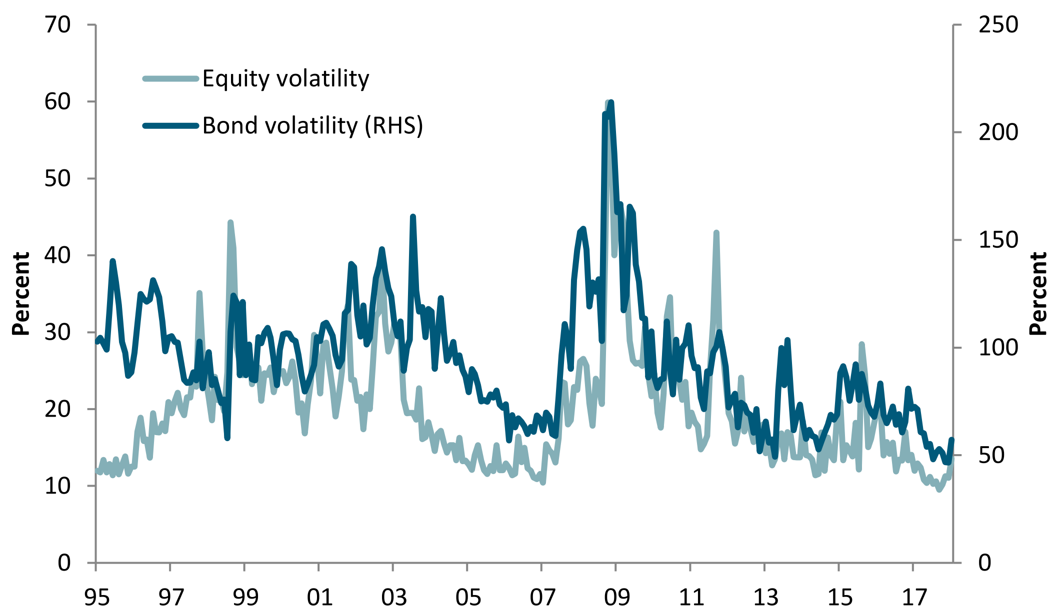
Rising volatility

Harbour Outlook 9/3/18 contactus@harbourasset.co.nz +64 4 460 8300

The Harbour Outlook summarises recent market developments, what we are monitoring closely, and our key views on the outlook for fixed interest, credit and equity markets.

Key developments

Following on from the same themes in January, markets continued to see strong global economic growth in February, but worried about the top risk on our list for 2018 – namely inflation risk and ultimately concerns about whether monetary stimulus will be removed in a way that is not friendly for markets.[1] We see the heightened volatility in financial markets in recent months as a normalisation of conditions, after a period where volatility and dispersion in markets have been remarkably low for an unusually long period.



Source: Bloomberg. Notes: VIX Index and MOVE Index.

Global bonds yields rose sharply higher in early February, following a similar move that occurred through December and January. In early February, the lift in yields was encouraged by the monthly US jobs report, which delivered a

[1] Harbour Investment Horizon, "Risks to watch in 2018", 15 December 2017. https://www.harbourasset.co.nz/wp-content/uploads/2017/12/Harbour-Investment-Horizon-Risks-to-Watch-in-2018-Final.pdf

robust result for hiring in January. Importantly, the data also reported average hourly earnings, a measure of wage inflation, lifting notably higher. After a long period of strong growth and little inflation, this was one of the first tangible signs that inflation pressures are finally building, which helps justify the US Federal Reserve lifting the Fed Funds rate over 2017 and reinforces expectations that this will continue over the course of 2018.

As a result, the bellwether US 10-year government bond yield pushed towards 3%. This rattled global equity markets, with the initial sell off causing the S&P500 to be down 10% at one stage, driven in part by ETF and futures strategies and the unwinding of derivatives betting on low volatility. Some of this initial correction was recovered through the course of the month, with the majority of global equity markets ending down between 4-6%.

However, global markets remain on edge, particularly after new US Fed Governor, Jerome Powell, gave his first testimony in his new role. Traditionally, since Alan Greenspan, the Fed has been seen as sensitive to market conditions, creating a perception that heightened volatility may encourage rate cuts or at least, postponing plans to hike. By contrast, Powell emphasised the strength of underlying economic data since the FOMC's last projections in December, reinforcing his case for at least another 3 Fed Fund hikes over the course of 2018. This is now largely priced-in by markets, with a pause in hikes anticipated in 2019 to reassess conditions.

Locally, the major event in financial markets was company reporting season. The New Zealand equity market ended down only around 1%, but this masked heightened volatility and dispersion amongst individual stocks. In particular:

- a2 Milk was a huge standout with the stock price up 44%, making it New Zealand's largest listed company. Earnings not only beat expectations, but a2 announced a transformational deal with Fonterra that may provide significant growth opportunities in new markets.
- Retirement village operator Summerset rose 11% after reporting a very strong result across the majority of its reporting lines and ahead of the market's and company's guidance. More importantly the company signalled a significant lift in build rates and an intention to expand into Victoria, Australia.
- Fletcher Building finished down 17% after announcing a further unexpected significant provisioning in their B&I business, which was several times larger than anticipated by the market.
- In early February, CBL detailed that an actuarial review required additional capital reserves, and an unexpected write-off against their newly-acquired businesses. The subsequent news flow reflected the response of regulators, the cessation of business lines and then an interim liquidation and voluntary administration.

For more detail on NZ and Australian equities, see the Harbour Equities Update.[2]

What to watch

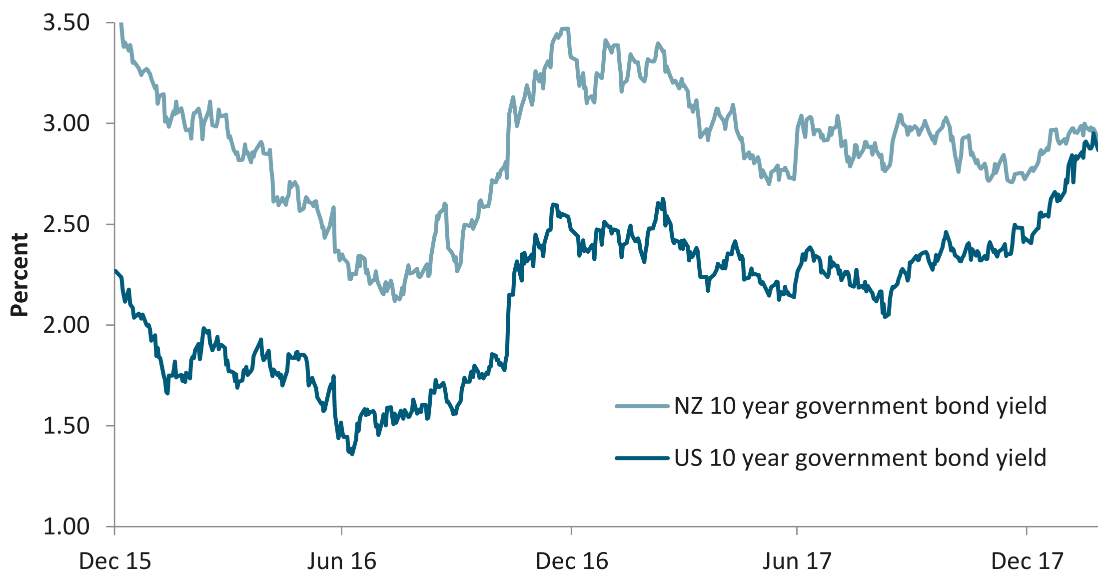
While it was rising global bond yields that sparked volatility in global equity markets, local bond yields have not pushed as high we would normally expect, given the global moves. There were two main factors at play here.

First, during February the Reserve Bank of New Zealand (RBNZ) reiterated its message that monetary policy will remain accommodative for a considerable period, fuelling expectations that the OCR will continue to remain unchanged through 2018. Low NZ CPI inflation outturns have enabled the RBNZ to continue its narrative, held since they cut the OCR to a record low in November 2016. Looking ahead, the change of leadership at the RBNZ, with

[2] Harbour Navigator, "Harbour Equities Update", 1 March 2018.
https://www.harbourasset.co.nz/wp-content/uploads/2018/02/Harbour-Navigator-Equity-Update-1-March.pdf

Adrian Orr starting as Governor at the end of March, could provide an opportunity to refresh the narrative, particularly if inflation pressures build globally.

Second, while the US fiscal position is deteriorating, in New Zealand the fiscal position remains relatively strong. In addition, there has been a shortage of available NZ government bonds in the local market. Heavy bond maturities over the last 3-6 months have left investors short of assets in the secondary market. Compounding this shortage, wholesale investors have been waiting for a new placement of a new NZ government bond maturing in 2029 (a new 10-year benchmark). This was originally planned for H2 2017 but is still not issued. Providing this new NZ government bond supply may relieve some of the pressure in the local government bond market and, on the margin, see our bond yields move more in tandem with global developments.



Source: Bloomberg.

Similarly, the local corporate bond market has been relatively immune to the widening in global credit spreads in recent months, given strong retail demand. Whilst this might persist for a period, if global credit spreads continue to widen and risk appetite diminishes, the local credit market may not stay immune.

Market outlook

We continue to expect that long-term yields, globally and in New Zealand, are biased towards rising over the next 1-3 months as interest rates normalise.

We also anticipate that this will come hand-in-hand with a continued normalisation in volatility, in both bond and equity markets. In practice, this means that we may see periods where bond yields fall temporarily during bouts of risk aversion, as equity and bond markets adjust to this environment of transition.

History suggests that, even with higher volatility, a solid economic backdrop can create a moderately positive time for equity returns. There are more grounds for additional caution because equity valuations remain relatively high, policy uncertainty is rising, and some growth is coming from fiscal expansion, which may not be entirely positive for

corporate profits. Our strongest conviction is that there is likely to be a large divergence in returns at a sector and stock level as a result of disruptive technologies.

Our preference remains for globally-facing companies, especially those facing faster growing opportunities in Asia. We also note that Australian business confidence continues to build, and we continue to examine opportunities for investment in Australia against an improving backdrop of economic growth.

Harbour Asset Management

This column does not constitute advice to any person.

www.harbourasset.co.nz/disclaimer/

IMPORTANT NOTICE AND DISCLAIMER

Harbour Asset Management Limited is the issuer and manager of the Harbour Investment Funds. Investors must receive and should read carefully the Product Disclosure Statement, available at www.harbourasset.co.nz. We are required to publish quarterly Fund updates showing returns and total fees during the previous year, also available at www.harbourasset.co.nz. Harbour Asset Management Limited also manages wholesale unit trusts. To invest as a Wholesale Investor, investors must fit the criteria as set out in the Financial Markets Conduct Act 2013. This publication is provided in good faith for general information purposes only. Information has been prepared from sources believed to be reliable and accurate at the time of publication, but this is not guaranteed. Information, analysis or views contained herein reflect a judgement at the date of publication and are subject to change without notice. This is not intended to constitute advice to any person. To the extent that any such information, analysis, opinions or views constitutes advice, it does not take into account any person's particular financial situation or goals and, accordingly, does not constitute personalised advice under the Financial Advisers Act 2008. This does not constitute advice of a legal, accounting, tax or other nature to any persons. You should consult your tax adviser in order to understand the impact of investment decisions on your tax position. The price, value and income derived from investments may fluctuate and investors may get back less than originally invested. Where an investment is denominated in a foreign currency, changes in rates of exchange may have an adverse effect on the value, price or income of the investment. Actual performance will be affected by fund charges as well as the timing of an investor's cash flows into or out of the Fund. Past performance is not indicative of future results, and no representation or warranty, express or implied, is made regarding future performance. Neither Harbour Asset Management Limited nor any other person guarantees repayment of any capital or any returns on capital invested in the investments. To the maximum extent permitted by law, no liability or responsibility is accepted for any loss or damage, direct or consequential, arising from or in connection with this or its contents.