ASB

Markets Monthly

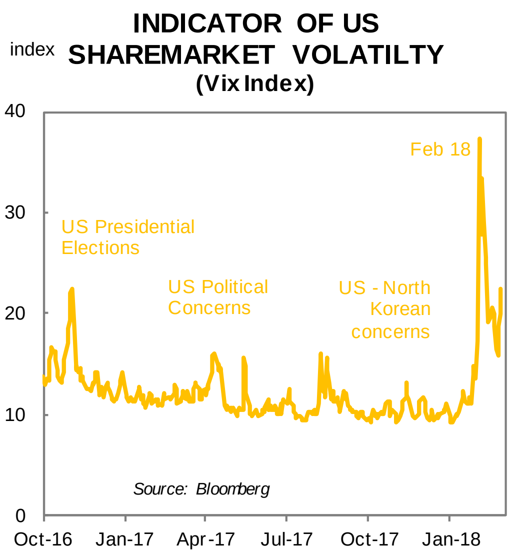
02 March 2018

Sharemarket volatility picks up in February

- Sharemarkets around the world dropped in early February, but recovered steadily later in the month.
- US yields are higher, and the FOMC is expected to deliver more interest rate hikes this year.
- The USD firmed and the NZD eased over the month.
- The RBNZ's first meeting of 2018 went as expected, and the OCR looks set to stay at 1.75% until late 2019.

Sharemarket volatility picked up in February, and US share markets recorded the biggest one-day decline in more than 6 years on 5 February. At one stage the S&P 500 index had dipped by nearly 12% from its all-time high in late January. However, a strong lift over subsequent trading sessions saw the index down only 3.9% for the month.

Until the current dip, the US sharemarket had been enjoying a stellar run, with the S&P 500 index of US shares up 5.6% in January alone. That gain was the 15th straight monthly gain, which was the longest winning streak recorded for the index. Also, the index lifted 23.9% over 2017, and 58% over 5 years. Rather than being surprised by the pick-up in volatility now, the lack of volatility in markets over the past year was more unusual.



Similarly, the NZ sharemarket has weakened over February, but is still trading at elevated levels. At the time of writing, our sharemarket is less than 3% off its all-time high.

All winning streaks come to an end unfortunately, but in the context of global sharemarket performance it's important to factor in the large gains over the past year when considering the February declines.

We can't rule out further sharemarket volatility, but at this stage market movements have not been out of line with what we have observed over past market downturns. The outlook for the global economy has actually been improving and interest rates are rising because of this. Sharemarkets are responding to a higher interest rate environment (which goes hand in hand with an improving economic environment) rather than a deteriorating economic backdrop.

For the latest performance information on ASB's funds click [here for ASB Kiwisaver Scheme](), click [here for ASB Investment Funds](). More information on [ASB Securities is here.]()

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Please refer to the important disclosures at the end of this document.

Historically low interest rates have been a supportive factor behind the strong performance of sharemarkets over recent years. As the US economic growth outlook has improved, the US 10-year government bond yield has lifted significantly. The yield is now around 2.9%, close to 1.6% above the record low of 1.32% touched back in mid-2016. Long-term bond yields have risen off recent lows in other key bond markets in Europe, but yields generally remain historically very low, particularly in relation to (higher) US yields. New Zealand Government bond yields have also risen since the start of the year, but are still historically low, both in absolute terms and in relation to US rates.

Interest rate developments over the year ahead are important for both bond and share markets. We expect more interest rate hikes from the US FOMC over 2018 and 2019, and the central banks in Europe and the UK should also reduce some of the stimulus they are providing with these very low interest rates. Nonetheless, global interest rates are expected to remain low relative to historical levels.

Meanwhile, we expect the RBNZ to keep its Official Cash Rate at a record low 1.75% until August 2019. That will serve as an anchor for short-term rates, but our longer term rates will be influenced by offshore movements.

For sharemarkets, what had been surprising has been how long the low volatility environment has persisted for. Recent market gyrations have confirmed that this benign environment was not going to carry on forever. However, this needs to be considered alongside the supportive environment for company earnings. Over the year ahead, the mix of reasonable economic growth and historically low interest rates should continue, and those should underpin companies' earnings and their share prices.

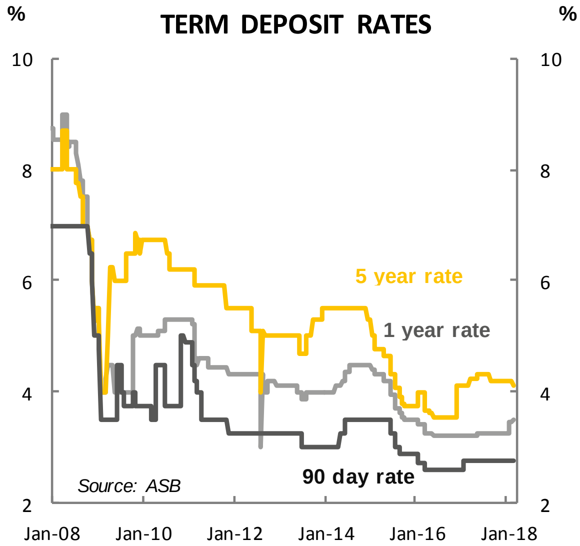
However, sharemarkets could be vulnerable if US interest rates keep lifting at the pace we've observed in recent months. Inflation concerns are the likely catalyst for such a move. And companies need to deliver on the earnings forecasts that are underpinning current share valuations. Accordingly, bond yields, inflation data, and company results will be closely watched by investors over the coming months.

Date	Instrument	28-Feb-18	Month %	Quarter %	Year %	5-Year %
Cash	NZ Official Cash Rate	1.75	0.00	0.00	0.00	-0.75
	NZ 90-day bank bill	1.92	0.03	0.01	-0.08	-0.74
Fixed	NZ 5-year gov't stock	2.43	0.03	0.12	-0.15	-0.69
Interest	NZ 10-year gov't	2.95	0.04	0.24	-0.29	-0.80
	AUS 10-year gov't	2.78	-0.02	0.27	0.04	-0.58
	US 10-year gov't	2.90	0.19	0.51	0.53	1.00
Australasian	NZ - NZX50 Capital (NZ$)	3843	-0.8%	2.1%	12.5%	56.7%
	- NZX50 Gross (NZ$)	8374	-0.2%	2.6%	17.2%	93.8%
Equities	AUS - All Ords (A$)	6117	-0.5%	1.0%	6.2%	19.5%
International	JAP - Nikkei (¥)	22068	-4.5%	-2.9%	15.4%	90.9%
Equities	UK - FT100 (£)	7232	-4.0%	-1.3%	-0.4%	13.7%
	US - S&P500 (US$)	2714	-3.9%	2.5%	14.8%	79.2%
	WORLD - MSCI (US$)	2118	-4.3%	2.0%	15.2%	50.7%
	MSCI in NZD (NZ$)	2931	-2.3%	-3.4%	14.5%	73.4%
Exchange	NZD/USD	0.72	-2.0%	5.6%	0.6%	-13.1%
Rates	NZD/AUD	0.93	1.5%	2.8%	-0.8%	14.6%
	NZD/JPY	77.44	-3.6%	1.0%	-4.3%	0.8%
	NZD/GBP	0.52	-0.1%	2.3%	-10.0%	-5.2%
	NZD/EUR	0.59	-0.5%	2.5%	-12.9%	-6.5%
	NZ TWI	74.43	-0.9%	3.0%	-4.7%	-1.8%
Equity indices are the respective end-of-month closes. Interest rates and exchanges rates are at 5pm NZ.						

Income Assets

Cash

At its first interest rate announcement for 2018 the RBNZ left the Official Cash Rate (OCR) on hold at 1.75%, where it has been since November 2016. With inflation yet to pick up materially, the RBNZ remains comfortable with forecasts that suggest it will leave the OCR on hold until at least the second half of 2019. If OCR hikes are still a long way off, most short-term fixed interest returns on term deposits will likely stay near current levels over the year ahead.

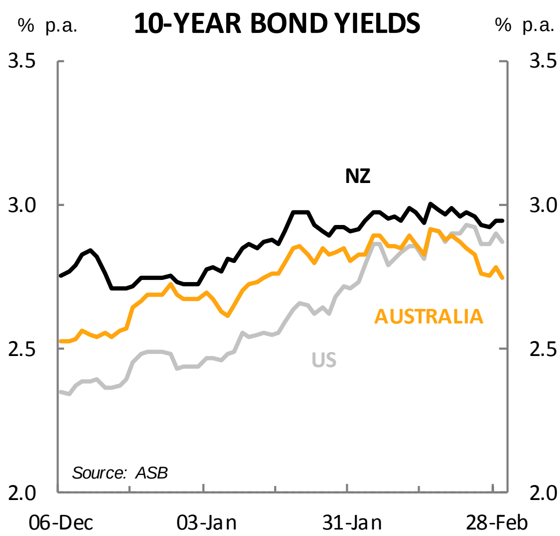


Term deposit rates for the popular terms out to 18 months were little-changed over 2017, largely reflecting the low, stable OCR. At the time of writing, term deposit rates are between 2.75% to 4.1% for terms between 90 days and 5 years for term deposits over $10K. Over the past 10 years rates have averaged between 0.9% and 1.5% higher than the current rates available for the various terms. The upward pressure on long-term global rates we have observed over recent months, if sustained, could translate to slightly higher interest rates on some of the longer term deposit rates. However, the opposite actually happened in February, with the term rates for two years and longer dipping 0.1%, while the 9- and 12-month rates lifted 0.05%. We are factoring in upward pressure on the longest term deposit rates over the year from lifting global rates. However, we expect term deposit rates for all terms to remain low this year relative to the long-term averages mentioned above.

The latest ASB term deposit rates can be found here.

NZ Fixed Interest

New Zealand bonds typically trade with yields that are higher than their US counterparts, but that yield advantage has disappeared for short term bonds. The yields on Government bonds out to 5 years are now lower in New Zealand than in the US. The NZ-US 10-year Government bond spread remains positive, but the NZ bond's yield advantage has compressed to less than 0.1%, with yields close to 2.9% in both countries in late February.



The dominant force over recent months has been rising US (and global) yields, which are discussed in the international section below. In contrast, the combination of strong investor demand for NZ bonds and limited supply has been an opposing force that has been keeping NZ yields low, offsetting the upward pressure from rising global rates on local yields.

We expect long-term local bond yields to rise modestly over the year ahead, which will eventually boost the income for investors receiving income from fixed interest investments. Despite this, we expect the return on NZ fixed income investments over the year ahead will remain lower than long-term averages.

International Fixed Interest

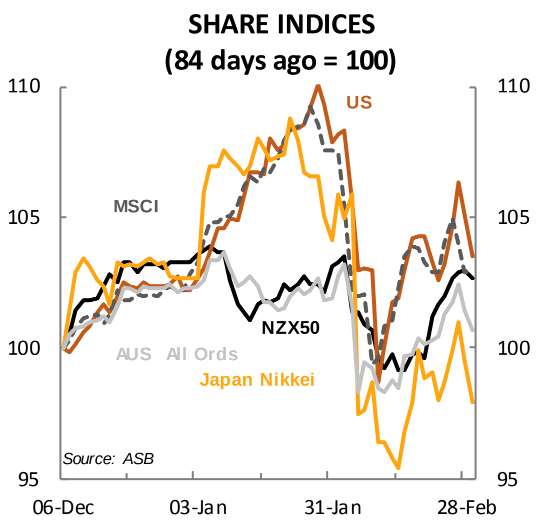
The new Chair of the US Federal Reserve is Jerome Powell, who took over from Janet Yellen on 3 February. The change of Chair isn't expected to change the course of US monetary policy - the direction is up for the FOMC's target rate over the year ahead, the question is by how much. Within his first testimony to US Congress on 27 February, Powell noted "some of the headwinds the US economy faced in previous years have turned into tailwinds: In particular, fiscal policy has become more stimulative and foreign demand for U.S. exports is on a firmer trajectory". Powell said the Fed will continue to "strike a balance between avoiding an overheated economy and bringing inflation to 2% on a sustained basis". Powell warned "if we fall behind, we'll have to raise rates faster". We expect the Federal Funds rate will rise at the Fed's March meeting, and the Fed will deliver a total of five rate increases over 2018 and 2019. The combination of the rate hikes delivered, and the prospect of more to come, is putting upward pressure on bonds in the US. US 10-year government bond yields rose to an intra-month high of 2.95% late in the month.

The lift in US interest rates is being felt in bond markets around the globe. Long-term bond yields in other major bond markets such as the UK, France and Germany have also been lifting over 2018. Japan is an exception, with rates remaining near zero.

Growth Assets

Australasian Equities

The local NZX50 Gross Index was caught in the downdraft of the US sharemarket decline, but was down a modest 0.2% over the month. Local developments included a trading halt followed by disappointing news of more losses from key projects for Fletcher Building, as well as the resignation of Chairman Ralph Norris. At the other end of the scale, the good news keeps coming for The a2 Milk Company, with strong half year results and the formation of a strategic relationship with Fonterra announced. The Australian All Ords share index eased 0.5% over the month. Australian companies reported earnings results over February, and the main conclusion was that the season was solid, rather than spectacular. It is encouraging to see companies laying the groundwork for the future through increased spending and investment. Based on firms spending plans revealed in Australia's latest CAPEX survey, non-mining capex is expected to post solid increases in both the current 2017/18 and the 2018/19 financial years.



International Equities

2018 started with the S&P 500 index of shares, making its strongest start in over 20 years, gaining 5.6% over January. February was a stark contrast, with the S&P 500 index posting the biggest one-day decline in more than 6 years on 5 February. The initial catalyst for the correction was the US jobs report (released February 2). Average hourly earnings rose by 2.9% over the year – the highest level since 2009 – as the labour market tightened. In turn, investors focused on the risk of rising inflation and interest rates in the US, and chose to sell. Other global markets followed and selling continued during the start of the following week. U S earnings results have been largely positive so far this year, and the economic backdrop is supportive. But with sharemarket valuations historically high, investors are sensitive to news that might upset the positive picture. Over February the US S&P 500 index fell by 3.9%. Across Europe the German Dax fell by 5.7%, while the London FTSE fell by 4.0%. In Japan, the Nikkei was 4.5% lower.

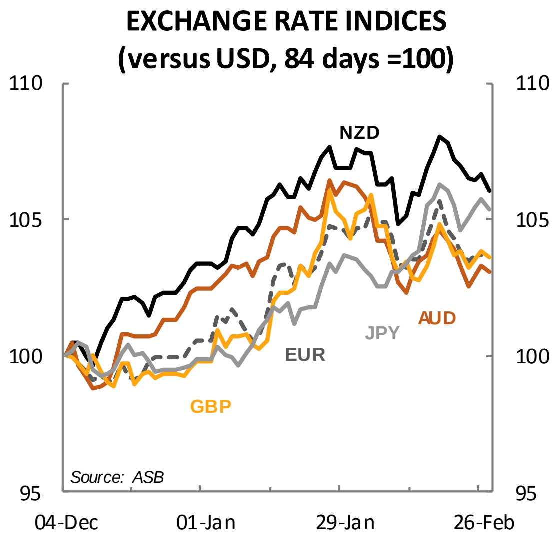
ASB Securities has more information on sharemarkets and trading here.

Exchange Rates:

The USD range traded during February, but NZD weakened into month-end to close down nearly 2% vis-a-vis the USD and 1% on a trade weighted basis. Over late 2017 and early 2018 a key NZD theme was a recovery from weakness stemming from the 2017 General Election uncertainty, combined with broad USD weakness.

Over February NZD/USD movements were largely a function of the USD side of the equation. All the major currencies had been strengthening against the USD over recent months, but range traded over February and dipped as the USD strengthened into month end.

Elsewhere the NZD eased against a firmer JPY, was flat vis-a-vis the GBP, and gained on the AUD in February.



For more insights into currency issues, our latest **ASB Kiwi Dollar Barometer can be downloaded** here.

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