Harbour Investment Chronometer

AUSTRALASIAN EQUITIES MONTHLY COMMENTARY

Information as at 31 March 2017

Overview for the Month

- The New Zealand S&P/NZX 50 index rose 0.8%, and the Australian S&P/ASX 200 index increased 3.3% (+5.9% in NZ Dollars) over March.

- The MSCI World developed markets index increased 1.1% (in US Dollar terms) over the month, led by Europe and Asia (ex-Japan) equity market returns. The March quarter began with a move towards beneficiaries of inflationary growth, but ended with a move toward stocks that benefit from deflationary growth. The new US Government's failure to push through healthcare reforms was taken by some to indicate that other proposed stimulatory policy change may be difficult to deliver on, and US equities underperformed. The US Federal Reserve maintained a measured path to increasing official interest rates, providing relief to investors wary of an aggressive interest rate hiking path. A more benign political environment in the Eurozone, with moderates winning the Dutch elections and French polling moving towards the centrist presidential candidate, combined with strong economic data to see Eurozone equities outperform. Mining stocks were the worst performing sector globally as commodity prices fell from recent highs as consumer inventory levels rose to relatively high levels.

- The pull back in global long term bond yields over the month contributed to positive funds flow into the New Zealand market. The New Zealand market's performance was driven by a 26.7% increase in the a2 Milk stock price as new Chinese regulations reduced market access risk, and strong returns from Fisher & Paykel Healthcare, Meridian, Spark and Air New Zealand. But a -10.9% return from Fletcher Building after the company cut its full year operating forecast by $110m due to construction division losses, and weakness in the Auckland Airport, Ryman, Z Energy and Fonterra stock prices pulled overall market returns back. The Reserve Bank of New Zealand said it was comfortable with economic projections to keep the official cash rate on hold at 1.75% on hold until mid-2019, subject to local housing market pressure and external events.

- Utilities, healthcare and consumer staples were the best performing Australian sectors over March. The telecommunications, materials and real estate sectors delivered relatively weak returns. The worst performing sub sector was discretionary retail where stocks fell as investors anticipated the entry of Amazon into the Australian retail industry. Australia's bank regulator APRA announced a limit in the flow of new interest only lending to 30% of total new residential banks loans and other measures aimed addressing risks that continue to build in the Australian mortgage lending market.

- The portfolio outperformed its benchmark over the month. Overweight positions in positive returning a2 Milk, CSL, Challenger, Fisher & Paykel Healthcare and Sirtex boosted portfolio returns. Underweight positions in positive performers Meridian, Chorus, Freightways, Sky City and Comvita detracted from portfolio returns.

Outlook – Running hot

While equity markets are have rallied significantly, we believe the back drop for equity returns remains supportive, with economic growth continuing to beat expectations and credit conditions remaining conducive to positive returns. But the overall market move is getting mature, and the central bank liquidity super cycle is coming to an end. In our view, equity markets are running hot but they may need a pause, to cool down and keep running.

While there is potential for a short sharp pull back in equity markets if investors unwind their expectations of inflationary growth (the reflation trade), central banks have to hike rates aggressively to offset inflation or Middle East tensions broaden, we see support from investor who remain generally nervous and under exposed to equities versus their long term targets. Currently investor asset allocation continues to have a strong bias to secular deflation continuing. There are good structural reasons for deflation to continue, including aging developed economy demographics and technology. But deflation expectations may have gone too far, and Government policy changes including fiscal stimulus and increased trade protectionism may nudge up cyclical inflation expectations. We expect the reluctant move of capital from assets that benefit from deflation to assets that benefit from inflation such as equities (an inflection point higher for inflation and bond yields is better for stocks than bonds), will most likely continue to support the outperformance of inflation assets over deflationary assets in 2017. Closer to home, kiwi saver pools continue to grow faster than the New Zealand equity market, providing a cushion to a significant pullback. To be clear, we don't expect a secular rise in inflation that would debase equity returns.

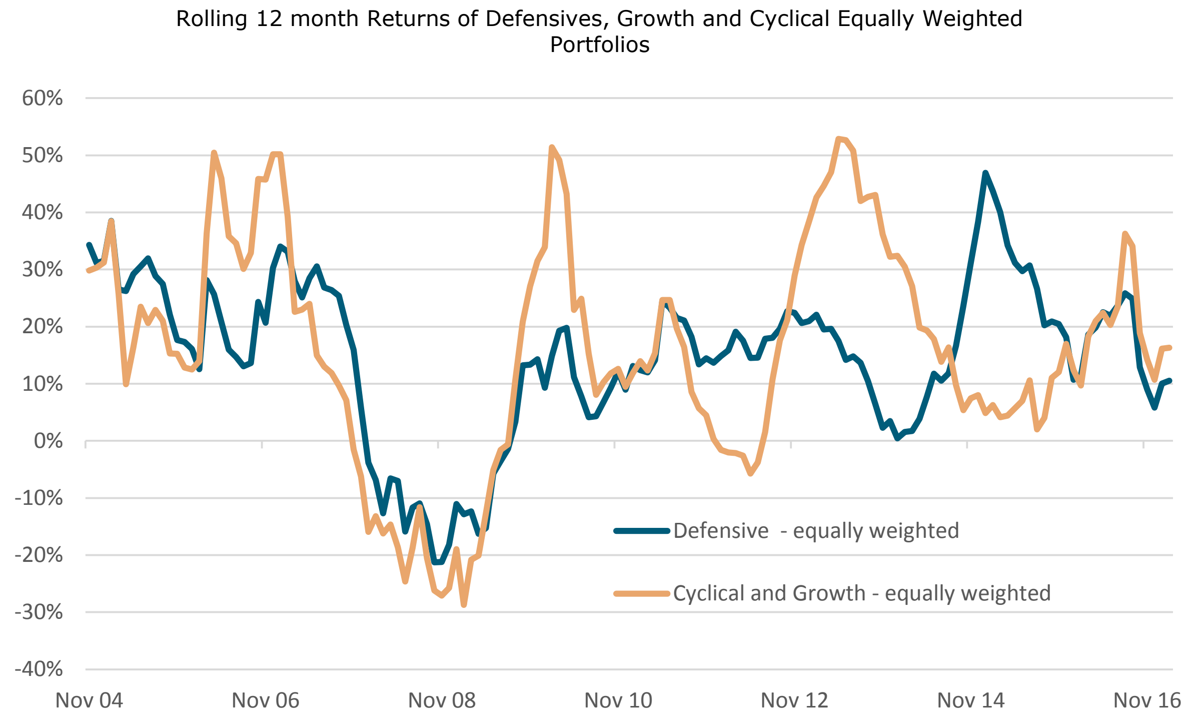
Global economic growth appears robust. In part this sets the scene for gradual further interest rate rises in the US later in 2017. We are not overly concerned with a gradual pace of interest rate increases. However, a key risk is the possibility of a pick-up in general price inflation in 2017 which would see a more significant need to raise interest rates and risk synchronized monetary policy tightening (reversing five years of synchronized monetary policy easing). A flatter yield curve, with modestly higher short term rates, may lead to increased volatility in equity markets.

The key risk to equity returns is that lead indicators deteriorate, signalling a peak in earnings growth. Globally, expectations of a US economic boom may take longer than expected to emerge. The Chinese economy may also take a different path post the Chinese Communist party's 5 yearly plenary later this year. Recent New Zealand economic data releases indicate that the cycle is maturing, but remain consistent with high 2% economic growth, which is supportive for company earnings. We are watching company operating leverage closely, ensuring companies can pass on cost increases or improve productivity as costs start to grow faster than revenues in some cases.

Locally, the elevated level of house prices, not only in Auckland, but also in many cities in Australia, remains a risk. New constraints on bank lending to investors, and for interest only loans, may serve to slow house price inflation. Already house price growth rates in New Zealand are reducing. Lower bank credit availability for developers and increased capital requirements to meet new construction industry retention bonds is slowing the pace of new development in New Zealand. All of these components could be associated with slower New Zealand economic growth.

Our focus on stock quality is expected to support relative portfolio performance. Quality companies can generally grow their cash flows through the cycle, while bond yield sensitive low sensitivity stocks often have low pricing power and can't pass on higher costs to the same degree. While long term interest rates have fallen from recent highs as expectations of strong reflation have been unwound, supporting valuations of bond proxy stocks such as utilities, investors are becoming increasingly focused on stocks with a yield plus some ability to grow earnings. Certainly the performance of defensive, bond proxy, New Zealand stocks has reverted recently, as shown in figure 1 below.

Figure 1. The performance of defensive, bond proxy, New Zealand stocks has reverted



Source: Bloomberg, Harbour.

We expect an increasing spread of returns between individual stocks within the market. In our view, being selective and investing in stocks that benefit from structural growth and cyclical stocks with pricing power, is likely to support future portfolio returns. The portfolio is positively skewed towards selected stocks in the healthcare, financials, consumer staples, material and information technology sectors, where growth opportunities are not fully reflected in stock prices. The portfolio has a low exposure to consumer discretionary stocks, where industry risk remains high, and the utilities, real estate and telecommunications sectors, where valuations are high due to investors seeking a yield pick up over low yielding bonds rather than valuing stocks in these sectors based on medium term cash flow growth potential.

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