

# Monthly View

June 2018

Global equities continued their rebound in May, after good gains in April, as interest rate and geopolitical risks eased somewhat, and the tail end of the US corporate earnings remained strong. The easing of interest rates has helped to support fundamental equity valuations and continues to encourage investors to favour equities over fixed interest securities.

The MSCI All-Country Index returned 0.8% in local-currency terms in May, after a gain of 1.8% the month prior. Forward earnings also rose 1.4%, implying the price-to-forward earnings (PE) ratio, an estimate of the relative value of company future earnings, eased slightly from 14.9 to 14.8, and down from a recent high of 16.4 at end-January. The recent trend of lower PE ratios globally, driven by better corporate profit expectations, has helped to calm concerns that global equities are overvalued. On a month-end basis, the MSCI Index is now down 3.2% from its January peak.

We have recently seen signs of slowing growth in Europe and Japan which is likely to reflect a more sustainable pace after comparatively strong growth in 2017. On a relative basis, we favour equities exposure in these areas, due to undemanding equity valuations and continued monetary and fiscal policy accommodation.

At home the NZX 50 Gross Index advanced +2.6% despite earnings downgrades across key names such as a2 Milk (ATM) and Fisher & Paykel Healthcare (FPH). Synlait, Restaurant Brands and Genesis build on their recent good performance and were the top 3 performers while Fonterra shareholders, A2 and Comvita were the worst performers at the other end.

After struggling in April, the US market enjoyed particular strength in May, with the S&P 500 returning 2.4%, compared to declines in Europe, Japan and Emerging markets. Australia's S&P/ASX 200 also did well, returning 1.3% and lead by a stellar performance from Seven West Media Ltd (+47.8%) but was diminished by poor performers such as Metcash Ltd (-19.4%).

Notwithstanding ongoing concerns regarding US President Trump's trade policies, the global backdrop for risk markets remains fairly encouraging. Importantly, key US wage and price indicators remain fairly benign, despite a tightening labour market. The majority of commentators now appear now to favour the view the Federal Reserve will lift rates twice, not three times, more this year. This implies one further move after a widely expected hike at the end of June.

Bond yields generally eased for May. The US 10-year government bond yield fell from 2.95% to 2.85%, as US inflation and wage data failed to provide red flags and the US Federal Reserve indicated it was still keen to lift rates only gradually. By the month's end concerns about the political turmoil in Italy and the stability of the euro, which had contributed to higher bond yields earlier in the month, had calmed.

We continue to advise that clients keep the fixed interest portion of their portfolios relatively short in duration while long term interest rates remain low.

Following concerns of American sanctions on Iran, Brent crude jumped close to \$80 a barrel early in May, the highest level in four years and up by almost 50% from a year ago. However, later in the month prices dropped and traded at around \$70 a barrel as supply concerns eased. The market remains watchful of higher oil prices which would eventually contribute inflationary effects that could drive interest rates up and potentially undermine equity valuations.

The New Zealand dollar continued to weaken in May and NZD/USD fell below \$US 0.7000 for the first time since December 2017. Over the month the NZD declined 2.4% against the USD, and 1.5% against the AUD. Clients will see the currency move as a small boost to their returns from unhedged global exposures. We see the weakening NZD as a return to more historically normal levels, particularly considering rising interest rates in the US.

## Our Current view

In summary we remain neutral with our view regarding global equities. US growth appears to have rebounded strongly in the June quarter, reflecting milder weather and stronger consumer spending. That is likely to continue to support solid strength in corporate earnings. In Europe, concerns regarding Italy are also expected to ease, particularly as it still seems very unlikely Italy will leave the EU anytime soon. We encourage clients to keep their global exposure to their benchmark exposure.

We also see New Zealand and Australia as showing signs of similarly robust economies in mature stages of economic cycles. Our respective reserve banks continue to indicate a preference for keeping interest rates low for the medium term. Australia's Reserve Bank and Treasury anticipate growth picking up to 3.25% over 2019 and 2020 which supports the view that there may be continued relative strength across the Tasman.

Globally investors are still seeing equities as offering value when compared to bonds, which despite US treasury yields showing signs of pushing higher, returned to low levels by the end of May. Considering low long-term interest rates, we continue to keep fixed interest securities at a short duration as long-term interest rates may potentially move higher over the medium term.

We are also mindful that if interest rates move sharply higher (here and abroad) as central banks attempt to curb inflation, it would have negative consequences for the sharemarket, particularly growth orientated shares. Also risks relating to the on-going saga of protectionist policies affecting global trade linger for the sharemarket.

Given the extended period of strength from investment markets, it is important that the share exposure levels in clients' portfolios are appropriate for their risk tolerance.

## Allocation to long-term benchmarks

Sector	Position	Comment
Cash	Overweight	We are slowly increasing cash levels to reduce some market risk.
Fixed Interest	Underweight	We think long-term interest rates will start to increase so are keeping duration relatively short.
NZ Shares	Slightly underweight	We continue to look for exposure to New Zealand companies with good dividend yields. Valuations still look high and defensive stocks are more attractive in our view.
Australian Shares	Neutral	There are some reasonably priced companies with solid growth prospects.
Global Shares	Slightly overweight	Our preferred exposure but still wary of trade and geopolitical risks.
Property	Neutral	Attractive yields offered. An increase in cash rates could have an impact on the sector.

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