Snapshot

Market insights for investment professionals from Fisher Institutional — April 2018

David McLeish
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— Fixed Interest

Postcard from China

Fixed income investors understand the importance of having a thoroughly researched 'big picture' view of the world. That's because macroeconomic trends and events are responsible for a majority of the changes in value of fixed income investments that we observe over time.

In order to develop this '30,000-foot view' it's vital to get on the road and wear out the proverbial shoe leather. It's this on-the-ground research that allows us to zero in on the real issues and to build conviction around them.

The global aspirations of China and a potentially nuclear capable North Korea are two such topics. Both have the potential to shift the global landscape, quite literally. But they are also topics where there is also a lot of misinformation in the public domain, making critical analysis of these issues all the more important.

It was during a series of recent trips through Asia that I got to speak to some of the foremost thinkers on these subjects. I spoke to range of people from ex-high ranking U.S intelligence officials, members of the Chinese People's Party including senior figures within the trade and commerce ministries, and a range of company executives.

Of particular interest to me has been China's multi-trillion-dollar modern day Silk Road, they call it their Belt & Road Initiative. Billed as the dawn of a "new era in globalisation" our recent interest has been sparked by the growing leverage this project is affording China over its less developed neighbours.

At the heart of this ambitious plan are two key state-sponsored lenders, China Development Bank and Export-Import Bank of China. With access to almost limitless funds, at interest rates typically reserved for only the highest quality sovereign nations, these institutions have now lent hundreds of billions of dollars to governments and corporations throughout Asia, the Middle East, and Africa.

But rather than paving the way for co-operation and synchronised growth across the region we are now observing growing evidence that more and more of the 63 nations earmarked for collaboration are now turning down these Chinese advances. Concerned by both the possible ulterior motives of China as well as the many pitfalls of over indebtedness (see the evolving debt crisis in the Maldives), we feel the success of this project now sits firmly outside Chinese control.

This growing risk of failure is not lost on the upper echelon of the People's Party. So it was no surprise to hear an extremely conciliatory tone from the party members I spoke to in Beijing regarding the topic of potential trade wars. As with all disputes 'it takes two to tango' and I feel China is unlikely to want to enter into a tit-for-tat battle with the U.S — it simply has too much to lose. China instead looks to be shrewdly turning the tables, taking the moral high ground on trade, by pushing forward its globalisation plans — something it hopes will further endear itself to its trading partners.

My conversations with now retired senior leaders at the U.S Central Intelligence Agency (CIA) and National Intelligence have been invaluable in understanding the multi-variable issues facing the world from North Korea's nuclear aspirations. Despite recent developments, which suggest they may be willing to abandon their nuclear programme in return for assured safety of the regime, I came away from our meetings with the strong belief a nuclear capable North Korea was at some point an almost certainty. This is a problem for regional security that won't go away.

This creates a range of issues for the U.S and its allies, particularly Japan, which in turn creates major issues for China, as this would likely result in the deployment of the U.S-designed Terminal High Altitude Area Defense (THAAD) system on Japanese soil.

All this is of course very destabilising for the geo-political landscape. But unless North Korean leader, Kim Jong Un, goes the way of other previous nuclear-aspirational dictators Saddam Hussein and Muammar Gaddafi it seems unlikely much can be done to stop his progress.

At its core, fixed income investment is a negative art — you win by avoiding losses. Identifying, assessing, and managing key macroeconomic risks like the ones highlighted in this article are an integral part of our risk mitigation efforts.

Frank Jasper
Chief Investment Officer

Inflationary Rumblings and Goldilocks

If you look out of the Fisher Fund's office window you see Rangitoto Island. As the sea side dwellers in Auckland are acutely aware Rangitoto is a volcano. It last erupted between 550 and 600 years ago. These eruptions lasted for years and created the iconic cone we know today.

I'm no geologist but I am sure these eruptions were proceeded by a period of activity; earthquakes that started small and built in scale until what we would recognise as an eruption, blanketed the island with lava and the sky with ash.

Rangitoto is now dormant but the geologic history of the island shows us there have been bouts of activity dating back thousands of years.

Like Rangitoto, inflation has been dormant for many years. Inflation's spectacular Rangitoto like eruptions were in the 1970s and 80s when inflation topped 14%. Since then judicious management by the World's central banks and the deflationary pulse as global markets become more deeply integrated has driven inflation to generationally low levels.

In the first quarter of 2018 the inflation volcano rumbled again. It was a small tremor but it was very clearly felt. Investors have become used to low and incredibly stable inflation; in fact deflation was the bigger fear for most market participants. Markets do not like change.

The first jolt we felt was from payrolls data in the United States which showed early evidence that there is upward pressure on wages. This was followed by Consumer Prices data which again were surprisingly strong.

Financial markets reacted badly. Shares fell sharply from recent highs on January 26, with the United States S&P 500, as an example, down over 10% to its lows for the quarter on February 8. Meanwhile interest rates have been steadily rising for the past six months. In September 2017 US government ten year bond rates were close to 2%. They are now within sight of 3%. Changes in the price of money, which is what interest rates are, have an important impact on the price of other financial assets.

We take this uptick in inflation seriously. Our comfort with asset markets has been predicated on a "Goldilocks" perspective. The argument was that while the economy is growing it is not sufficiently strong to create inflation and lead to more aggressive central bank tightening.

Higher than expected inflation raises the prospect that this thesis, like milk in the fridge, has passed its use by date. We expect inflation to continue to lift from here. This is a function of the tightness in labour markets and a number of one off factors dissipating that had held inflation low.

Herein lies the dilemma for investors. If inflation spikes more than expectations that will be bad for markets. We saw exactly that in early February. On the flip side the global economy is strong, more and more people are working and wages are rising, which fuels more activity. Company earnings will continue to be robust. This is very supportive of the market although some of this is priced into share price valuations.

Investing is always a balancing act. It involves a trade-off between generating a return on your capital while at the same time protecting it. Until very recently we have felt that opportunity and risk were in balance. That meant we were happy having an average exposure to global shares in those portfolios where have discretion on asset allocation.

The recent inflation data has altered this perspective. We now see a risk of asymmetric returns. In our view the most likely outcome is for share prices to continue rise but at a slower rate than we have enjoyed in the past few years but there is a low probability of a nasty sell off if inflation surprises on the upside.

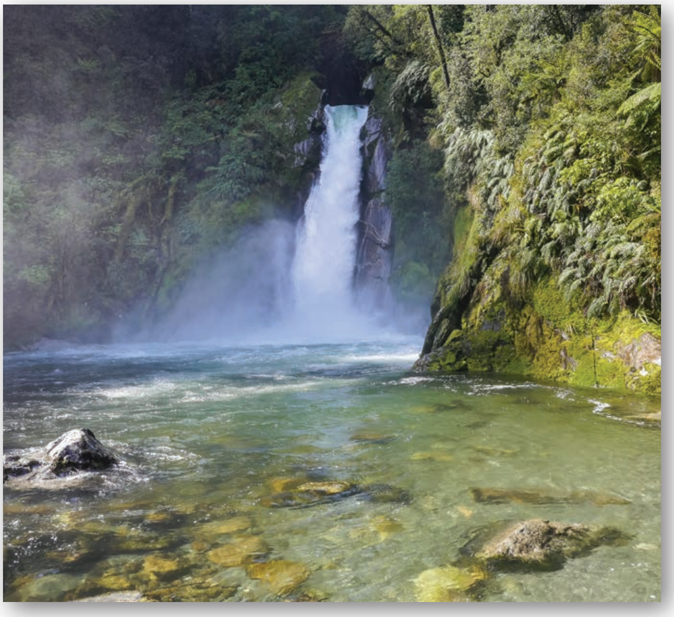
This is a time to actively manage risk in your portfolio. We have, where we have discretion, reduced exposure to global shares and global fixed income. This is a small move at this stage and reflects a subtle change in our view, but, if things play out as we expect, it is the first step in more meaningfully reducing overall portfolio risk as asset prices rise.

A couple of shakes don't mean an eruption, and we don't think inflation is returning to the levels of the 1980s, but the level of risk has gone up. It's time for a bit of prudent caution.

The future in the palm of your hand

Bruce McLachlan
Chief Executive

Over Easter I walked the famous Milford track with 40 or so others from around the world. Four days of the very best scenery and outdoors that New Zealand has to offer. Four days without any internet or phone connection. Anything could have been happening around the world and we would have had no idea. We all survived — not being able to use our phones that is. Our calf muscles only just survived the Mackinnon Pass!



In the day and age of Instagram, Snapchat and Facebook, the Managers who oversee the Milford track are considering providing internet access to the hikers. That way New Zealand would be promoted globally on a real-time basis by those experiencing the waterfalls, glacier-formed mountains and native birdlife. This is a challenging issue. Should the wilderness remain just that, or should it be opened up to the wonders of modern technology?

The issues are not dissimilar with investment. Given much investment is about the medium to long term and riding out short term volatility, then how do investment managers deal with the accessibility to real-time markets across every asset class being in the hands of nearly every investor? Should accessibility to minute by minute data and updates be made easier, or should it be withheld to encourage more disciplined investor behaviour?

The answer has to be driven by investors themselves. This has been exacerbated in 2018 with markets being materially more volatile than they have been since the start of 2016. Consider the major issues and disruption highlighted in the following pages of this newsletter. This has driven a desire by investors to know the impact of market volatility on a real time basis on their investments, even though many have no intention of acting upon it. In this day and age investors have the expectation and believe it is their right to know. Unfortunately, this does also mean that on occasions investors will act impulsively to market events with negative long run consequences. Continual education therefore becomes the cornerstone of any investment manager responsibilities, and this is something we here at Fisher Funds take very seriously.

In response to investor demand, this month Fisher Funds will be launching a new online portal for our retail investors. It will be mobile friendly and will provide access to a range of information and transaction capability that has previously not been available. This will be the launch version of the portal, and there will be significant functionality added over the coming year. The intention is to make access to your investor information easier than it is today. The challenge going forward will be to keep up with you, our investors' own expectations for more and more investing capability from the palm of your hand.

Frank Jasper
Chief Investment Officer

Social media: companies can't afford not to listen

A US election twisted by the use of your private Facebook data; 180,000 students march in Washington seeking changes to gun control, a move to that has influenced how weapons are sold; Chipotle, a US fast food chain, has a health scare and it is transmitted around the world in a tweet storm leading to a dramatic fall in sales.

The way that brands, customers and social media interact has undergone a revolution in recent years. This has profound effects for investors, representing both risks and opportunities. This is where responsible investing, one element of which involves understanding how a business interacts with society, and traditional, financial focussed investing intersects.

All of us, every day, make decisions about what we believe in. We reflect these decisions in our conversations with friends and where we shop. Social media has given these conversations a reach and influence that they never had. Views that reach public consciousness are literally influencing the world that we live in.

Businesses are becoming attuned to this, attuned to the moods of their customers and decisions that they make. Leading businesses are even more aware of this than most, moving quickly to change how they operate in response to the attitudes of customers.

This is a powerful force.

The examples noted in the introduction have all prompted responses that have had an influence over how companies operate and on their profitability and hence impacting share prices.

In the case of Facebook, global web searches on how to delete Facebook profiles have doubled since the Cambridge Analytica scandal. Facebook will have to respond with heightened privacy controls to retain its leading market position.

Following the February shooting of 17 teenagers in Parkland, Florida a number of companies changed policies in relation to weapon sales. Dicks Sporting Goods announced an immediate and total ban on the sales of assault style rifles in its stores. It said it would no longer sell high capacity magazines or sell guns to people under 21 years of age, regardless of local laws. Walmart followed with a similar announcement. These companies made those decisions regardless of federal law, instead reflecting the voice of their customers.

The case of Chipotle, a Texmex style food outlet, is an interesting one. In 2015 more than 50 Chipotle customers suffered food poisoning. This story was spread far and wide on social media and Chipotle's sales plummeted. Sales have not yet recovered to 2015 levels.

Chipotle is not alone in poisoning customers. In 1992 Jack in the Box, a US hamburger chain, suffered a food poisoning scandal which ultimately killed 4 customers. This was in the pre social media days and the company was able to respond with an advertising message that it controlled. While sales fell the company was able to restore customer faith and now Jack in the Box is a leading fast food outlet.

Time will tell if Chipotle can manage a similar renaissance but it is already taking a lot longer to recover than Jack in the Box did. This is a potent

example demonstrating how powerful the voice of the customer has become in determining a company's fortunes.

As investors we have to be aware of the social environment that companies operate in. Companies both reflect and may even lead, our social views and opinions. These views affect the outlook and ultimately the share prices for these companies. This is now a major focus for our research team.

Responsible investing is not an aside to how we invest your money. It is front and centre. It will become even more important over time. If we, as consumers, continue to advocate strongly for our beliefs the way each and every company responds will become a key driver of what marks out the leaders from the also-rans. It will driver share prices and is a change we welcome.

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Market Movements

As at 31 March 2018

Stock Markets*	Closing Values	Changes over: 1 Mth %	3 Mths %	6 Mths %	12 Mths %
S&P Developed LargeMidCap - (Local Curr)	726	-2.2	-2.1	3.2	10.7
S&P Developed LargeMidCap ($NZ)	N/A	-2.2	-3.6	3.3	7.2
S&P Global LargeMidCap ($NZ)	N/A	-2.0	-2.2	5.3	12.0
USA - S & P 500	5173	-2.5	-0.8	5.8	14.0
USA - Nasdaq	8141	-2.8	2.6	9.3	20.8
Japan - Topix	2522	-2.0	-4.7	3.6	15.9
UK - FTSE100	6050	-2.0	-7.2	-2.5	0.2
Germany - DAX	12097	-2.7	-6.4	-5.7	-1.8
France - CAC40	13193	-2.7	-2.5	-2.5	4.1
HK - Hang Seng	81487	-2.3	0.9	9.8	29.5
Australia - S & P 300	57468	-3.7	-3.8	3.7	2.9
NZ-S&P/NZX 50 Gross Index (inc imp credits)	9956	-0.3	-0.6	5.5	16.9
NZ-S&P/NZX 50 Gross Index (excl imp credits)	8319	-0.7	-0.9	4.9	15.6
Market Volatility - VIX	20.0	0.6	80.9	110.0	61.4

New Zealand Property		%	%	%	%
S&P/NZX All Real Estate (inc imp credits)	1242.5	1.1	-3.7	2.8	7.9
S&P/NZX All Real Estate (exc imp credits)	1209.1	0.9	-3.8	2.4	7.0

Ten Year Bonds	%	Yield Changes			
USA	2.74	-0.13	0.34	0.54	0.26
Japan	0.04	0.00	0.00	-0.02	-0.02
United Kingdom	1.35	-0.15	0.16	-0.01	0.21
Australia	2.58	-0.21	-0.06	-0.26	-0.11
New Zealand	2.72	-0.23	0.00	-0.25	-0.47

90 Day Interest Rates	%	Yield Changes			
USA	1.73	0.08	0.39	0.68	0.98
Japan	0.69	0.00	0.62	0.63	0.63
United Kingdom	0.71	0.13	0.19	0.38	0.37
Australia	2.04	0.25	0.25	0.33	0.25
New Zealand	1.96	0.04	0.08	0.00	-0.04

Bond Indices	Closing Values	Changes over: 1 Mth %	3 Mths %	6 Mths %	12 Mths %
S&P/NZX Bank Bills 90-Day	706.82	0.15	0.46	0.96	1.98
S&P/NZX NZ Government Bond Index	1679	0.91	0.49	2.20	4.56
Barclays Capital Global Aggregate Index (Hedged NZD)	N/A	0.86	0.02	1.00	3.24

Hedge Funds & Commodities		%	%	%	%
HFRX Global Hedge Fund Index (USD)	1263	-1.0	-1.0	0.5	3.2
DJ-UBS Commodity Index Total Return	179	-0.6	-0.4	4.3	3.7
Gold (US$/ounce)	1322.80	0.6	1.3	3.2	6.1
Oil (US$/barrel)	69.02	4.4	3.4	21.5	32.2

Currencies		%	%	%	%
NZD / USD	0.7214	-0.1	1.4	-0.2	3.2
NZD / EUR	0.5866	-0.9	-1.0	-4.1	-10.3
NZD / GBP	0.5143	-1.9	-2.2	-4.6	-8.0
NZD / AUD	0.9405	1.5	3.4	2.1	2.6
NZD / YEN	76.72	-0.4	-4.2	-5.7	-1.5
Trade Weighted Index	74.72	-0.5	1.7	-1.5	-2.4

**Total Return Indices. Indices are net of offshore tax.*
Source: Thomson Reuters Datastream