Optima Wealth Spring Update

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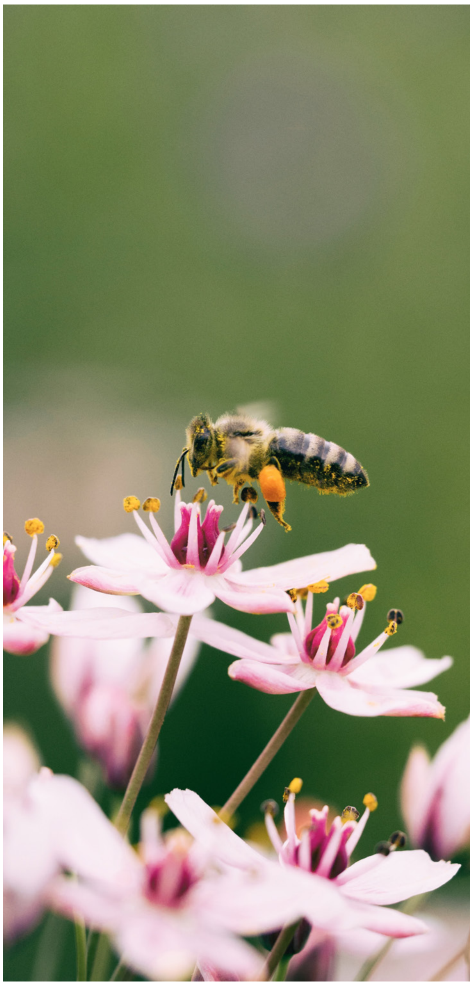

After an extraordinary first six months in 2020, share markets in the third quarter looked a little more settled.

We can get a sense of this from looking at the chart below, which highlights the quarterly market returns so far in 2020 of the New Zealand, Australian and US share markets.

After the outsized market movement downward (January to March) and back up again (April to June), the July to September quarter generally delivered more modest returns.

This is again a reminder of the contradiction that exists between real world data and market performance. We are all aware of the extraordinary impact that Covid-19 had on the world during the first quarter. With Covid-related fears reaching panic levels in late March, we saw a synchronised sell-off in global share markets unlike any other.

But look at what has happened since.

Share markets have changed course. In many ways that too seems equally extraordinary. After all, Covid-19 has not been defeated. A vaccine remains elusive. Covid 'second waves' are being experienced by many countries, and reports of job losses are still consuming significantly more column inches than stories of job gains. International travel remains impractical for many, and numerous firms (if not industries), have yet to demonstrate they will adequately be able to cope when the wage subsidies and other central support packages run their course.

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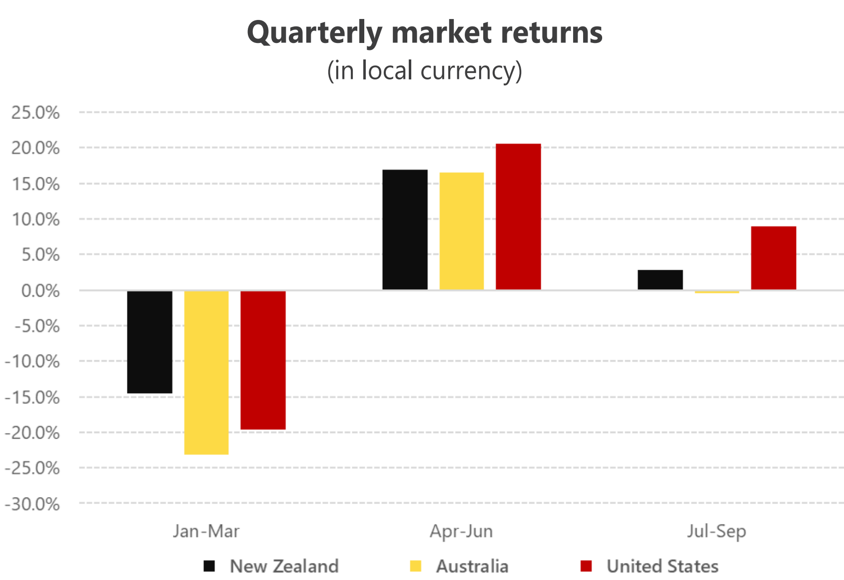

The above graph highlights major index returns in their local currency. The respective indices used were: New Zealand (S&P/NZX 50 Index (gross with imputation), Australia (S&P/ASX 200 Index total return), United States (S&P 500 Index)

Source: Dimensional Returns 2.0

To the everyday person on the street, this does not paint an overly optimistic picture. Which brings us back to the chart above. Share markets are clearly not looking at what is going on in the world today, they are relentlessly looking into the future.

Share prices today are based on aggregate investor perceptions of each company's asset base and growth opportunities in the months and years ahead, with that projected growth being discounted back to a present day valuation. In other words, share prices today represent the market's collective expectation of the future. And in that future, many of the issues we still see around us today may not even exist, including (we hope) Covid-19.

In contrast, many of the economic statistics used to try and help us quantify and understand the state of the world today (like GDP growth rates and unemployment figures) are backward looking. They are often calculated with a time lag of several weeks or months (meaning we generally don't find out this information until some considerable time after the fact). Even then, the data typically contains some degree of measurement error. It's therefore no surprise that a forward-looking share market can occasionally sprint ahead of our best understanding of the 'current' economic situation.

After a very strong second quarter, global share markets consolidated between July and September, largely delivering more positive results. Although the US share market was down during the month of September, it posted another very strong 8.9%[1] result for the quarter, by which time it was higher than it had been at the beginning of 2020. Barely six months earlier, that seemed like a highly improbable outcome.

Across international developed markets it was a broadly similar story, even if individual results were not quite as spectacular. Japan rallied 4.7%[2] and Europe (excluding the UK) gained 1.8%[2], although the UK bucked this trend by retreating -4.6%[2].

It has been a difficult time in the UK and the British public appears to be losing confidence in Boris Johnson's misfiring leadership. Britain has Europe's highest Covid-19 death toll, and Johnson's Conservative government is facing criticism from all sides. Opponents say tougher social restrictions are needed to suppress a second wave of Covid-19 that is sweeping the country, but many in Johnson's party argue that restrictions must be eased to save the battered economy. Meanwhile, the Brexit negotiations lurched from bad to worse. The European Union even launched legal action against the UK, after Johnson failed to respond to Brussels' demand that he drop legislation that would overwrite the Brexit withdrawal agreement and break international law. As relentlessly forward looking as share markets are, even they have struggled with the myriad uncertainties still confusing the growth outlook in the UK.

Many emerging market nations also delivered strong share market results in the third quarter. China and South Korea, both having displayed relatively robust Covid containment records in recent months, posted 12.0%[2] and 9.8%[2] respectively. Taiwan and India also

performed extremely well, posting 15.0%[2] and 12.5%[2]. The Russian share market, however, was up just 3.1%[2] as oil production, oil prices, and the US dollar all weakened to varying degrees during the quarter. In aggregate, the entire emerging markets asset class delivered an excellent 8.8%[3].

Closer to home, the returns of the New Zealand and Australian markets generally lagged their international peers. The New Zealand share market gained 2.9%[4] from April to June, while the Australian share market fell -0.4%[5].

In New Zealand, one of the talking points as the quarter progressed was the Reserve Bank of New Zealand (RBNZ) reinforcing its intentions to reduce bank funding costs. Having already signaled the possibility that short term interest rates could be allowed to turn negative in 2021 (mirroring the environment in a number of overseas countries), the RBNZ announced an alternative option to reduce bank funding costs even earlier.

The proposed scheme (the Funding for Lending Programme) is expected to be launched before the end of 2020 and would see the Reserve Bank offering funding to banks at ultra low interest rates. This, in turn, would enable banks to lend out more cheaply while maintaining a profit margin. This shapes as further bad news for term deposit investors, as the interest rates on these instruments would be likely to reduce as a result. However, for borrowers and, by implication, the property market, this is likely to be considered a positive.

The housing market here appears to have rebounded in response to lower interest rates. Household loan growth has clearly picked up and house prices have recovered from declines seen in April and May.

As well as making mortgage payments more affordable, low interest rates generally make buying property relatively more attractive, because as interest rates fall, it reduces the expected returns on alternative investments. Economic policies have also been helping support the property market. Significant wage subsidy support, and mortgage repayment holidays, have very likely helped prevent some Covid-affected workers from potentially having to sell their homes.

The housing market here appears to have rebounded in response to lower interest rates. Household loan growth has clearly picked up and house prices have recovered from declines seen in April and May. According to the Real Estate Institute of New Zealand (REINZ), New Zealand house prices (on a like for like and seasonally adjusted basis) have increased almost 3% since May and have reached new all-time highs.

During the last global recession just over a decade ago, real house prices in New Zealand fell by approximately 9.3%[6]. So, when it became clear that Covid-19 would push the world economy into its deepest downturn since the 1930s, homeowners braced for the worst. But that pessimism now looks misplaced.

With global interest rates remaining at or near historic lows, the returns coming from government bond markets over the quarter were generally subdued. Although most major 10 year bond yields were little changed, European government bonds performed relatively well as sentiment toward the region improved following the European Union's announcement of a €750 billion pandemic recovery fund. Continuing the recovery of the second quarter, corporate bonds also generally outperformed government bonds. Signs of an emerging economic recovery, backed by considerable government and central bank support, continued to ease earlier fears of widespread corporate defaults.

In this environment, the World Government Bond Index delivered 0.2%[7] for the quarter, while the Global Aggregate Bond Index - which has a greater exposure to investment grade corporate bonds - gained 0.7%[8]. In New Zealand, where the RBNZ reiterated their preference for negative short term interest rates next year, longer term bond yields fell quite sharply. These lower local yields saw the New Zealand Corporate A Grade Bond Index post a solid 1.7%[9] return for the quarter.

In what has already been a turbulent year, in many ways the most constructive thing we can do is shake our heads at what has happened around the globe, be grateful we live in New Zealand, and focus on the things that we can reasonably control. In the context of a long term savings and retirement plan, that might mean reviewing or updating our short, medium and long term goals and objectives. Alternatively, it might mean reviewing our budget or our savings plan; it might even mean reviewing our preferred investment risk settings.

We can, and should, focus on these things, because that's what will have the biggest positive impact on the outcomes most important to us individually. Of course, we should also exercise personal care and responsibility. But, when it comes to the big issues, we have to exercise patience, and have a little bit of faith that sustainable solutions will be found. After all, we have governments wrestling with how to keep people safe, we have central banks trying to keep economies functioning and we have pharmaceutical firms trying to find Covid vaccines.

2020 has already delivered a resounding reminder that the interrelated world of markets, economics, health and politics reflects an incredibly complex and ever-evolving system. While that's part of what makes forecasting so difficult, we are thankfully aware of our limitations.

We know we can't predict how Covid-19 will eventually be contained or controlled. We can't predict how investment markets may perform over any short term horizon. We certainly can't predict what new information or unforeseen events may emerge tomorrow to change how we think and act today. Without a crystal clear view of the future we simply don't know how the current, complex, issues of the day will all eventually be resolved. But not knowing, doesn't mean it won't happen.

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This is where the aggregate information contained in markets today might at least be a source of some reassurance. If the relative strength of the share market today is any guide, business is not expected to go out of business. In contrast to the challenging economic environment we still see around us today, the share market appears to be pricing in far more promising times ahead.

1 S&P 500 Index (total return in USD)
2 MSCI Country and regional indices (gross dividend in local currency)
3 MSCI Emerging Markets Index (gross dividend in local currency)
4 S&P/NZX 50 Index (gross with imputation)
5 S&P/ASX 200 Index (total return in AUD)
6 RBNZ housing inflation calculator
7 FTSE World Government Bond Index 1-5 Years, hedged to NZD
8 Bloomberg Barclays Global Aggregate Bond Index, hedged to NZD
9 S&P/NZX A-Grade Corporate Bond Index

Key market movements for the quarter

The third quarter of 2020 continued with heightened levels of uncertainty and volatility across markets, albeit significantly reduced than levels experienced in the first half of the year. There was a wide dispersion of returns across nations, industries and asset classes as capital markets continued to price in changing prospects at a global level, as well as the potential firm specific ramifications.

In 2020 we have been reminded to expect the unexpected and with Covid-19 still impacting all nations and economies, uncertainty and volatility will likely remain heightened for some time.

+6.6% *(hedged to NZD)*

+5.4% *(unhedged)*

International shares

International shares were generally positive in the third quarter, although it was anything but a clean sweep. The US market was very strong, as accommodative economic policy from the central bank continued to support businesses through the Covid-induced recession. A positive factor for the US was its share market composition, which includes a higher than average allocation to technology companies which have been relative beneficiaries of the Covid-19 crisis. The S&P 500 Index (total returns in USD) advanced +8.9% for the quarter and is now up +5.6% for the year.

In Europe, performance was more subdued and, in aggregate, the region was flat for the quarter. Covid-19 infection rates rose sharply in some nations and the rate of economic recovery was not as rapid as that observed across the Atlantic. For the quarter, the MSCI Europe ex UK Index gained +1.8% but remains down -7.4% year to date (in local currency).

Britain continued to struggle, with infection rates remaining high and the tightening of social restrictions impacting economic activity. Risks of a messy Brexit were again raised, as the end of year deadline for new rules regarding the UK-EU relationship approaches, with seemingly little progress made. In GBP terms, the FTSE 100 declined -4.0% for the quarter and is still down -20.2% year to date.

In New Zealand dollar terms, the MSCI World ex-Australia Index delivered a quarterly return of +6.6% on a hedged basis and +5.4% unhedged. Year to date, this asset class is now near flat with the hedged index down -0.3% and the unhedged index up +3.8%.

Source: MSCI World ex-Australia Index (net div.)

+7.0%

Emerging markets shares

The emerging markets asset class led the way in the third quarter, with the MSCI Emerging Markets Index advancing +8.8% and returning year to date performance into the black at +2.9% (gross dividend in local currency).

Chinese, Taiwanese and South Korean equities were among the best performers, as the technology heavy composition of these markets has meant they have been relative beneficiaries of this particular crisis.

Geopolitical issues were still prevalent. There remains ongoing US-China tension (including President Trump banning US firms from doing business with TikTok), and the May/June Himalayan border dispute between China and India remains unresolved.

Weakness in oil prices stymied returns from significant oil exporting economies such as Russia and Brazil.

In unhedged New Zealand dollar terms, the MSCI Emerging Markets Index produced a quarterly return of +7.0%, for a +0.8% year to date return.

Source: MSCI Emerging Markets Index (gross div.)

+2.9%

New Zealand shares

Despite the New Zealand stock exchange suffering persistent interruptions from cyberattacks, our domestic equity market delivered a handy +2.9% through the quarter and is now positive year to date at +2.8%.

In contrast to the first two quarters of the year, it was the small and mid-cap firms that outperformed while the two largest names faltered. a2 Milk fell by over -20% through the quarter as an earnings update saw a downward revision in earnings due to disruption in direct to visitor sales due to the border closure.

Fisher & Paykel has seen increased demand for their breathing aids helping the company's share price soar through the crisis. This quarter, however, saw some consolidation with the company returning -6%.

The delay in the New Zealand election continues to mean an ongoing lack of clarity for the future of the Tiwai Point aluminium smelter, and the potential for this large consumer of electricity to remain operational for longer helped support the utilities sector (Meridian: +5.2%, Mercury: +10.5%, and Contact: +9.9%).

Tourism related firms Tourism Holdings (+12.1%) and Auckland Airport (+10.9%) were up strongly, while Air New Zealand (+3.8%) was relatively more benign after a horrendous first half of the year.

The Reserve Bank of New Zealand's (RBNZ) signalling of a likely reduction in interest rates (and therefore borrowing costs) supported the property market, and the listed New Zealand real estate companies enjoyed a strong quarter after lagging through the first two. The listed real estate index advanced +13.4% in the quarter, but is still down-3.4% year to date.

Source: S&P/NZX 50 Index (gross with imputation credits)

+0.8%

Australian shares

After leading the recovery during the second quarter, the Australian share market was subdued with the S&P/ASX 200 returning -0.4% in Australian dollar terms, leaving its year to date performance at -10.8%. Small capitalisation companies outperformed their larger counterparts.

The financial sector was weak while the materials sector was mixed with most firms flat. Fortescue Metals Group was a highlight advancing +24.9% thanks in part to strong demand for their iron ore from Chinese steel makers.

Melbourne was forced to endure a fresh round of prolonged lock down measures following a second Covid-19 outbreak. In part, this would have contributed to strength in the consumer discretionary sector, with Domino's Pizza, JB Hi Fi and Harvey Norman enjoying a good quarter.

Returns to New Zealand investors were enhanced by a relatively strong Australian dollar over the quarter.

Source: S&P/ASX 200 Index (total return)

+0.2%

International fixed interest

The international fixed interest market was relatively quiet with central bank support holding yields low and stable.

Corporate bonds continued their trend of recovery from the second quarter, with increased economic activity and central bank support reducing the likelihood of widespread corporate defaults.

In aggregate, corporate bonds outperformed higher quality sovereign bonds, and longer duration bonds outperformed shorter duration. The FTSE World Government Bond Index 1-5 Years (hedged to NZD) posted a +0.2% gain to take its year to date return to +3.0%, while the broader Bloomberg Barclays Global Aggregate Bond Index (hedged to NZD) returned +0.7% for the quarter, for a +4.5% year to date return.

Source: FTSE World Government Bond Index 1-5 Years (hedged to NZD)

+1.7%

New Zealand fixed interest

The New Zealand fixed interest market delivered more price action than was generally seen in global markets, with the 10 year New Zealand government bond yield pushing lower to close the quarter at 0.53%, down from 0.96% at the beginning of the quarter.

Although the Official Cash Rate (OCR) was held at 0.25% at the August and September meetings, these announcements were accompanied by strong signals from the RBNZ of interest rate reductions in the short to medium term.

The decline in local bond yields was positive for bond prices, resulting in a +1.7% return for the S&P/NZX A-Grade Corporate Bond Index over the quarter, taking the year to date return to +6.5%.

Source: S&P/NZX A-Grade Corporate Bond Index

Table 1: Asset class returns to 30 September 2020

Asset Class	Index Name	3 months	1 year	3 years	5 years	10 years
New Zealand shares	S&P/NZX 50 Index (gross with imputation credits)	+2.9%	+8.3%	+15.0%	+17.2%	+15.3%
Australian shares	S&P/ASX 200 Index (total return)	+0.8%	-9.8%	+4.7%	+7.0%	+4.8%
International shares	MSCI World ex Australia Index (net div., hedged to NZD)	+6.6%	+7.2%	+7.4%	+10.8%	+11.5%
	MSCI World ex Australia Index (net div.)	+5.4%	+4.9%	+11.1%	+9.8%	+10.7%
Emerging markets shares	MSCI Emerging Markets Index (gross div.)	+7.0%	+5.0%	+5.8%	+8.6%	+3.9%
New Zealand fixed interest	S&P/NZX A-Grade Corporate Bond Index	+1.7%	+5.3%	+5.9%	+5.2%	+5.7%
International fixed interest	FTSE World Government Bond Index 1-5 Years (hedged to NZD)	+0.2%	+3.1%	+2.8%	+2.9%	+3.6%
New Zealand cash	New Zealand One-Month Bank Bill Yields Index	+0.1%	+0.7%	+1.4%	+1.7%	+2.3%

Unless otherwise specified, all returns are expressed in NZD. We assume Australian shares and emerging market shares are invested on an unhedged basis, and therefore returns from these asset classes are susceptible to movement in the value of the NZD. Index returns are before all costs and tax. Returns are annualised for time periods greater than one year.

The markets are not the economy

The world is different now. We know people in Australia that routinely travel 150 days in a year, who have been homebound for months. We know others in Europe that are working from home now as a way of life and cannot foresee when that will change. We hear stories from people in the United States who report that the most common vehicles on the roads these days are delivery trucks.

The world feels very different to what it was just months ago. And although we are very privileged in New Zealand to be sitting closer to the 'normal' end of the spectrum, almost everyone we know has had their lives influenced by this virus. In fact, it was not until March that some of us had even heard the word "staycation" to describe an exotic holiday taken...at home.

With this shifting landscape in mind, it should not be surprising that some companies have prospered during this upheaval while others - especially travel-related firms like Air New Zealand - have struggled. From its record high on 21 February 2020, the NZX 50 fell 29.6% in less than five weeks, as the news headlines grew more and more concerning. But the recovery was swift as well. From its low on 23 March, the NZX 50 Index jumped 13.3% in just three trading sessions, one of the fastest momentum swings ever. As at 1 October, the NZX50 Index had recovered to about 99% of its record high.

Many individuals are puzzled by this turn of events. For those under the age of 75, the news headlines are likely the grimmest in memory. Thousands have found themselves suddenly unemployed or only employed by virtue of an emergency government package. The International Monetary Fund projects that unemployment will approach 10%. In the United States, famous retailers such as Neiman Marcus and JC Penney have entered bankruptcy proceedings, yet share prices in the US have recovered just as strongly as New Zealand and they are still in the midst of uncontrolled community transmission of this deadly virus.

How can share prices be close to new highs when the news is so discouraging? The New York Times observed that the stock market "looks increasingly divorced from economic reality."

> No one could have predicted the tumult we have seen this year in financial markets. But investors would do well to focus on what hasn't changed.

That same article had the best answer in its clever title, "Repeat After Me: The Markets Are Not the Economy". We've borrowed it for this article.

The stock market is a mechanism for combining opinions from millions of global investors and reflecting them in prices they are willing to accept, when buying or selling fractional ownership of a company. Share prices represent a claim on all future earnings and dividends. As a result, current prices incorporate not only an assessment of recent events, but also those anticipated to occur in the distant future. In some sense, the share market has always been divorced from reality, since its job is not to report today's temperature, but what investors think it will be next year, and the year after that, and the year after that, and so on.

Table 1: The five best and worst performing NZX50 companies over the 12 months to 30 September 2020.

Company	Sector	Market cap 2020 ($m)	Growth year to date (to 30 Sept)
			Top five performers in the NZX 50
Pushpay Holdings Ltd	IT	$2,440	166.10%
FP Healthcare Corp Ltd	Healthcare	$19,165	90.20%
Chorus Ltd (NS)	Telecommunication	$3,849	71.10%
Investore Property Ltd (NS)	Real estate	$814	62.90%
Summerset Group Holdings Ltd	Healthcare	$2,057	36.00%
			Bottom 5 performers in the NZX 50
Z Energy Ltd	Energy	$1,425	-35.80%
ANZ Banking Group Ltd	Financials	$52,980	-39.30%
Synlait Milk Ltd (NS)	Consumer staples	$983	-40.40%
Westpac Banking Corporation	Financials	$65,660	-41.00%
Air New Zealand Ltd (NS)	Industrials	$1,538	-51.80%

That's a difficult job. The fact that it's so difficult is the reason share prices go up and down so much when new and unanticipated information hits the markets.

It's also true that the universe of shares does not march in lockstep. At any point in time, some firms are soaring while others are crashing. This year's wrenching economic turmoil has inflicted great hardship on some firms while opening new opportunities for others (such as health care and electronic retail firms). Above we show the 12 month returns, to 30 September 2020, of the best and worst NZX 50 performers. Based on this admittedly abbreviated list, it appears the share market is doing just what we would expect - reflecting new information in share prices.

No one could have predicted the tumult we have seen this year in financial markets. But investors would do well to focus on what hasn't changed.

1. **Markets are forward-looking**, so focusing on today's economic data is akin to looking in the rear view mirror rather than at the road ahead.
2. **Broad diversification** makes it more likely that investors capture market returns that are there for the taking - including companies that do far better than expected.
3. **Since news is unpredictable**, a strategy designed to weather both expected and unexpected events will likely prove less stressful and easier to stick with.

Bottom line: read the newspaper to be an informed citizen, not for advice on how to navigate the financial markets.

Note: thanks to Weston Wellington for inspiration for this article.

1 https://www.ceicdata.com/en/indicator/new-zealand/forecast-unemployment-rate

2 https://www.nytimes.com/2020/05/10/business/stock-market-economy-coronavirus.html