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Nikko Asset Management

2019 & BEYOND: A BOND MANAGER'S THOUGHTS

Overview

The word "volatility" crops up a lot when commentators try to explain price movements in financial markets. More often the word is used to explain a sudden drop in prices, whereas if prices rise investors compliment themselves on their astute insights rather than the vagaries of the markets. Psychologically, losses are felt more intensely than the pleasure of a gain.

Certainly, 2018 has been a year of volatility in equity, currency and commodity markets:

The NZX-50 peaked in September at 9375 points before tumbling around 8%. In the US, the S&P 500 equity index is down around 11% from its 2930 point peak.

West Texas Oil has traded in a US$25.80 range from $76.10 to $50.30, and the Kiwi dollar versus the USD traded from a high of 0.741 to a low of 0.644, a 13% drop from the high point.

At the same time, NZ cash and bond markets have been quite placid, with the Reserve Bank having the Official Cash Rate (OCR) on hold at 1.75%.

But volatility on its own should not be feared. As Warren Buffet is often quoted as saying, investors should "look at market fluctuations as your friend rather than you enemy; profit from folly rather than participate in it."

In my view, the biggest investment risk is not volatility of prices but whether you will likely suffer a permanent loss. This comment is equally valid whether applying it to bond, equity, credit or property markets. If the underlying asset is sound, falling prices or rising credit margins that occur on good quality assets are best looked upon as an opportunity to add to positions if funds allow.

In many ways the most important factor in investing is the timeframe you are investing for. The longer the timeframe the more likely superior returns will be achieved.

Expectations for 2019

Equity market returns below 5%

The number of Americans expecting the US economy to get worse over the next year is at its highest since 2013, according to a national NBC/Wall Street Journal Poll. Only 28% of those polled believe their economy will get better.

On a recent trip to China, a frequent visitor noted the local Chinese seemed more pessimistic than foreigners regarding their economy and investment prospects. Historically, the sentiment has been the reverse, and it seems the tightening of Chinese Credit Conditions may be starting to bite.

We are, however, seeing signs that China is readying itself for a further round of infrastructure spending. It's been reported China has built 234 new airports over the past 10 years but clearly even this is not enough to cater for the Chinese people's growing desire to travel, as an additional 450 airports are planned over the next 15 years. With that level of airline infrastructure planned it's difficult not to be bullish on the tourism industry worldwide.

Interest rates to be stable

I am expecting no change to New Zealand's 1.75% OCR in 2019, with the first of a modest number of rate rises occurring in mid-2020.

The next interest rate tightening cycle will likely be modest too, with the OCR expected to rise to the 2.75% to 3% level, and 10 year Government bond rates both in NZ and the US peaking around 3.25%. Corporate and bank bonds with yields about 3.75% or higher will represent good medium-term levels to buy at.

New Zealand interest rates have moved below similar maturities of US rates. This is an unusual state of affairs that will likely continue until the NZ interest rate tightening cycle begins and the US tightening cycle is completed.

Residential property market

Prices will be stable to lower in the short term; however, the long-term trend remains favourable as New Zealand and global income levels rise but the laws of supply and demand will ultimately apply to the property markets. The Christchurch property market is a good example of how a large supply of residential property stimulated by the earthquake rebuild resulted in a stable level of prices. The same is expected to occur in Auckland and other areas of the country as supply ramps up with new building activity. The negative sentiment that has gripped the housing market in Sydney and Melbourne is misplaced here.

Oil

The outlook for the oil prices is modest. Unless geopolitical tensions disrupt supply, it's hard to see a prolonged rebound in the oil price as advances in extraction methods and possibly long-term demand decline puts pressure on the industry.

Gold

The lustre of gold as an investment has reduced in my opinion. Prices have been reasonably stable, however, an asset that produces no income has limited appeal in my view.

End note

My parting thought relates to another favourite quote, this time from Albert Einstein: "Compound interest is the eighth wonder of the world he who understands it, earns it; he who doesn't, pays it."

Heading into 2019 and beyond it's worth remembering one can easily replace compound interest, with compound returns, and be very relevant to investors of all kinds.

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