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Europe, how is the EU really going?

How are the key members of the European Union really going? This is a question now being debated widely, as one of the key members, the United Kingdom, prepares to start Brexit negotiations, a process that is expected to have a slowing effect on the region over the next year or two.

Overall, indications are that the EU is experiencing solid consumption and strong export growth, supported by rising domestic demand. This in turn, is on the back of much improved labour markets in the region, and a continuation of very loose monetary policy. Also supporting overall growth is a general pick up in global trade.

One of the effects of this has been a significant improvement with some of the region's laggards, notably, Ireland, Portugal and Spain.

This year, some of the biggest countries have been dealing with significant political issues. In France, Emanuel Macron beat off a challenge from Extreme Right Wing Marine Le Pen in the presidential run- off vote on the 7th of May. This was followed on June 11th, with a clean sweep of the parliamentary vote for the centrist parties, with Macron's Le Republique en Marche (REM) in alliance with the centrist Democratic Movement (Modem) securing a substantial majority of 350 seats. This will mean that Europe's second largest economy remains in pro-European Union hands. The election outcome also gives Macron the momentum to initiate economic reforms, along with an overhaul of France's labour laws and welfare system.

In Italy, election risks have moved out into 2018. Germany is facing a federal election this year on the 24th of September.

At this stage, Angela Merkel's CDU/CSU is the clear front runner in early polls for the upcoming vote.

There are however pressures elsewhere in the Eurozone. The Netherlands coalition talks have collapsed, and a government has not yet been formed almost three months after the election. This is seen as a reflection of the voters' anger and dissatisfaction over a number of issues affecting this country's membership of the EU. In Spain, the minority government is having its own struggles scraping together enough support to rule effectively. In Greece, the national debt load still haunts the country, as a stand- off looms over whether it will be able to meet a sizable debt repayment obligation in July this year.

The overall outlook in Europe however looks very much better, with individual countries showing very good growth prospects.

Of particular interest is Ireland, once one of the basket cases of the EU following the GFC, is expected to grow above 4%. Another former problem economy, Spain, is also on a much stronger recovery path, with growth expectations of around 2.2% for the year. The larger economies are expected to also perform much better this year, with a positive growth outlook on the two largest economies in the EU, Germany at 2.2%, and France on track for the best year of growth since 2011. In contrast, Greece and Italy will be the region's laggards, with growth at a very modest 1%.

One of the persistent problems within the EU is a stubbornly high youth unemployment rate, following the fallout from the global financial crisis. (Youth unemployment is defined as people 25 years and under). This is one of the major issues within the EU, with Greece in particular facing one of the highest seasonally adjusted rates in Europe at over 45%. Governments within the region are all keenly aware of the social and economic consequences of not addressing this key issue, and are now working on a number of government funded initiatives to support young people into further education and ultimately, jobs.

ESG explained in detail

Not long ago, investment geared to Environmental, Social and Governance (ESG) concerns was widely referred to as "socially responsible investment," or SRI. The phenomenon of responsible investing first emerged in the United States back in the 1920s, when churches with assets to invest began applying faith-based criteria to exclude certain investments from their portfolios—businesses in the alcohol or tobacco industry, for example.

In the post–World War II era, amid the rise of the civil rights and antiwar movements, activists turned to shareholder advocacy, a major form of SRI, to influence corporate behaviour in a manner consistent with their environmental and social goals. Whether faith-based or linked to a social movement, such "responsible investment" was regarded as a niche investment category by mainstream investors. It was unique in that it generally prioritised ethical or moral considerations over financial returns.

In the spring 2016 edition of Advantage we briefly discussed the growing awareness of the concept of Environmental, Social and Governance when integrated into investment factor analysis and portfolio risk management processes.

But what exactly does it mean to "integrate ESG factors"? To date, some investors have attempted to target specific criteria, such as carbon emissions, energy efficiency, resource efficiency, recycling, water resources, renewable energy, and control of chemical substances and preservation of forests and marine resources. In addition, the manufacture and sales of environmentally friendly products, social issues (including workplace diversity, working conditions across the supply chain, child and forced labour, and modern slavery), and corporate governance are attracting much more attention and scrutiny in recent times. While this may sound reasonable, in general this approach is somewhat hit and miss, and has proven to be unreliable, with some high profile names getting caught out, and embarrassing investors such as sovereign wealth funds and others focusing on this narrow band of criteria.

Sustainability addresses all of the issues discussed above, but in a broader framework, and accommodates firms and industries at different stages in their progress towards being better corporate citizens. It also acknowledges the fact that current standards are always in the process of being superseded.

Growing threats to society from such global problems as climate change, wealth inequality, the refugee crisis, and terrorism have spurred changes in attitudes among consumers, workers, and other stakeholders that are leading to regulatory and other systemic reforms. Within this new context, the realisation is spreading that in the twenty-first century, the neglect of sustainability and corporate governance issues in business strategic thinking and operations constitutes a significant risk.

As discussed in our spring 2016 issue, we indicated that we are now looking to address issues around ESG into our research processes at Accordia. This will continue to be a work in progress, and we will continue to update you on this project.

The strong New Zealand dollar. Why is it continuing to ride high?

At the present time, the exchange value of the New Zealand Dollar continues to defy expectations amid a number of opinions that it is fundamentally overvalued. This has long been the view of the Governor of the Reserve Bank, Graeme Wheeler. On a number of occasions, he has spoken publicly about this matter in an attempt to “talk the dollar down” with limited success.

There are a number of reasons for this situation, and a significant number of arguments and counter arguments as to where to from here.

Firstly, it is important to remember that our currency is one of the most highly traded in the world. Since the New Zealand Dollar was floated in 1985, the exchange value has moved significantly, both up and down. There are a couple of key drivers that influence the exchange rate.

The first driver to understand is commodity prices and their influence on the currency. Although the media frequently reports on gold, oil and copper prices (examples of hard commodities), a commodity price index will also comprise of soft commodities, or ‘commodities that are grown’. With agriculture being the largest sector of New Zealand’s tradable economy, a strong positive correlation exists between commodity indices and the strength of the New Zealand Dollar; so much so that it is often referred to as a ‘commodity currency’.

Another notable characteristic of the Kiwi Dollar is the rate of interest paid in New Zealand. At a time when many central banks around the world are holding their cash rates near 0-0.5%, our bank rates are very much higher, even though they are historically low. For example, New Zealand Government 10 year bonds currently yield around 3.01%, while German 10 year bonds are currently yielding 0.57%. Global rates remain very low as a result of the long slow recovery from the GFC. This very low global interest rate environment is also fuelling investor demand for yield in other assets, namely the local share-market, where New Zealand listed companies are known for their high dividend distributions to investors. A real conundrum for the Reserve Bank of New Zealand will be the timing of a raise in the Official Cash Rate, (OCR) as any talk of increasing rates can send the Kiwi upwards. This will be a prime concern for the bank, as a strong dollar reduces the competitiveness of exporters selling goods and services to our trading partners.

These first two points have a direct link to the most influential of the NZ Dollar’s traits over the last few years; its status as a ‘risky asset’. Due to its correlation with commodity prices, which boom in times of global growth, and its high yielding status which equates to a higher level of risk, the Kiwi’s value is strongly influenced by global market sentiment towards risky assets, known as ‘risk appetite’. The Kiwi rallies strongly on positive news. This is called a ‘risk-on’ environment where investors rush to buy higher yielding assets or those highly correlated to commodities. Conversely, when doubt resurfaces as to whether or not Europe will be able to manage its debt and generate some growth, or questions over the outlook for China’s growth prospects re-emerge and the threat of a global economic slowdown rears its head, the New Zealand Dollar has a tendency to sell off in a ‘risk-off’ environment.

Such characteristics can often lead to high levels of volatility, leaving companies involved in foreign trade, exposed to high levels of market risk. As uncertainty in the Euro-Zone looks set to continue for some time, both importers and exporters are increasingly looking to money market professionals who can assist by developing tailored hedging strategies aimed at minimising the impact foreign exchange risk can have on their bottom line.

A review of the annual overseas research trip

In May, the Caliber Limited Chief Investment Officer Mark Wooster, and Senior Portfolio Manager Michael Gray went to the United States for the annual technical research trip. Caliber is the manager for the Accordia portfolios.

This year, Mark and Michael went to San Francisco, Philadelphia, and Austin, Texas. This was a very busy itinerary, which involved researching new institutions for new investment solutions that may have application now or in the future. In addition, Mark and Michael had an extensive programme for the monitoring of existing managers, industry issues and current market developments.

A key part of the visit this year was an extended working programme with Jason Fergusson, Caliber's US based Investment Strategist based in Boise, Idaho. Jason flew in to San Francisco for the meeting over three days. This provided an opportunity to work together to review their respective roles within the research and portfolio management team at Caliber. Over the three days, Mark, Michael and Jason reviewed portfolio construction processes, incorporating Strategic and Dynamic Risk Allocation issues. In addition, they also discussed portfolio optimisation structures (A process of choosing the various proportions of assets to improve portfolio performance and efficiency) and a review of currency, and its role in portfolios. This 3 day programme was a very full one, and an integral part of the management framework that is used to manage portfolio risk for our clients.

While in San Francisco, The Caliber team met with key managers such as Blackrock, and Franklin Templeton, two of the biggest managers in the world. Those meetings covered off a review of Group and Fund Structures, management team dynamics, internal processes, risk management programmes, underlying holdings, and fund performance.

Mark and Michael then went on to Philadelphia to attend the Chartered Financial Analysts 70th Annual Conference. The CFA Institute is regarded as the premier professional body for investment professionals globally. This was an excellent opportunity to hear some of the top experts in their respective fields presenting on important key topics.

The speakers included Richard Thaler, an acknowledged academic in behavioural finance, who spoke on the efficiency of markets. A notable presentation was from Larry Siegal, Professor of Chicago Booth Business School, University of Chicago, along with his good friend and academic colleague Robert Shiller, a Nobel Prize winner, Professor of Finance at Yale University. This was an excellent discussion and debate about the valuation and dynamics of the US and global share markets.

Other key speakers included presenters from the CIO of Northern Rock, an institution with one trillion dollars under management globally. The key themes were the need to avoid falling victim to home country bias, the importance of diversification, and not attempting to time markets. Another speaker, Scott Klosoky spoke about the impact of technology and the impact on business and our lives.

A presenter from Goldman Sachs presented an analysis on the strength of the US economy, especially the significance of export growth and its importance to the long term recovery. Overall, the outlook for the U.S was positive.

The final leg of the trip involved going to Austin, Texas to visit Dimensional Fund Advisors. We have a key relationship with this manager, as all our portfolios have a core holding with Dimensional. This was a monitoring visit to review their investment team, internal processes and structures, funds and holdings. This proved to be a very worthwhile visit and no outstanding issues needed to be addressed.

Both Mark and Michael were very happy to be back in Auckland after a very rewarding, but demanding trip.

Accordia Freephone 0800 444 999
Accordia Email service@accordia.co.nz
Accordia Christchurch Unit 4B, 303 Blenheim Rd
Accordia Auckland Level 7, 203 Queen St
Accordia Hamilton 22 Westminster Place

accordia

www.accordia.co.nz