Has TINA spread to Australasia?

What a difference a US Federal Reserve meeting and a couple of speeches makes to asset prices and the outlook for 2019. Last time we discussed that the major risk this year was the Fed hiking on a predetermined course and upsetting the proverbial apple cart. The Fed's reaction to the prospect of slower global and possibly US growth and the asset markets late 2018 meltdown has been swift and now the markets are pricing no rate hikes at all in 2019. This has effectively opened the door for the RBNZ and RBA to signal, and consider, lowering official cash rates in our part of the world as New Zealand and Australian growth slows with the added risks of further house price declines and Chinese tantrums affecting us. So, what might asset prices do in a slower growth, lower interest rate environment?

It is worth considering what has happened in the US over the past decade or so. The US Federal Reserve lowered the Federal Funds rate to 0.0-0.25%, effectively zero in December 2008 and left it there for seven years until the first hike of the current cycle in December 2015. During that period US stocks soared with the powerful mantra of "TINA", or There Is No Alternative, gaining traction. Cash was trash – why hold it when stocks are going up and they pay dividends? That is a simple and powerful argument that gains more traction every year you own 0% yielding cash as the Europeans have also come to appreciate. The related problem with very low interest rates is what is the appropriate rate to discount future earnings to value a stock in order not to over pay for those future earnings as a dollar of profit in 5 years' time with 0% rates is worth pretty much a dollar now whereas at 10% rates that future dollar is worth only about 60 cents now. That valuation challenge is an issue for another newsletter. There is no doubt that low global interest rates, led by the US Federal Reserve, has boosted asset prices and allowed other central banks like ours and Australia's to keep our interest rates lower than they otherwise would have been. And now the Fed has opened the door again for the RBNZ and RBA, both at record low official rates already of 1.75% and 1.50% respectively, to cut rates even further as growth slows in this part of the world. Which brings us back to TINA.

Mortgage rates in New Zealand are edging lower as banks fight over a diminishing number of creditworthy borrowers after tightening their lending standards, a flow on from events across the ditch. Term deposit rates have remained stubbornly high to date, but this seems unlikely to persist for much longer. Slowing credit growth and lower mortgage rates will likely reduce banks appetite for deposit funding. A possible RBNZ rate cut later this year would further reduce deposit rates for local savers. Against a sluggish global economic backdrop, it is no coincidence that New Zealand and Australian 10-year bond rates are around record lows around a measly 2.15%. The risks appear evenly spread between a melt-up in asset prices as investors chase reliable dividends from local companies (the NZX50 is almost back to record highs despite the late 2018 meltdown) and the odds of a growth slowdown lowering profits which should lead to weaker asset prices. The real risk is that local stocks become overvalued because there is no alternative for investors that want a reasonable level of income.

One of the strongest performing sectors has been NZ listed property with several companies still offering yields around 6.5-7.5%, far above corporate bond yields of around 3.0-4.5%. However, many of these listed property stocks are no longer bargains, now trading at 5-20% over their net assets whereas only a couple of years ago they were at 5-10% discounts to net assets, but again what is the alternative? Likewise, the reliable dividend paying NZ power companies are all grinding higher in unison as investors chase income and become less concerned about valuation. No-one likes to miss out when assets are inflating in value, but this is a time to tread more carefully. Being selective in the effort not to overpay for future earnings is what investors should be focussed on this year. There are always opportunities even if you have to hold onto some low-yielding cash while you wait.

The companies mentioned above are named to further the discussion. This should not be construed to be personalised advice nor a recommendation to invest in these companies. Please contact Kinnell & Co. regarding how best to take advantage of the trends discussed above.

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