Patience is a Virtue

In recent weeks global equity markets have been in good spirits making new highs on hopes that a "Phase One" trade deal between the US & China will be concluded shortly. Only a couple of months ago the consensus was that the global economy was headed towards recession and central banks were clamouring to cut rates in a kind of joint pre-emptive strike against the slowing economic conditions and a beggar thy neighbour effort to weaken their currencies. The lower global interest rates have contributed to a "melt-up" in asset prices as the TINA effect we wrote about in February kicks in again. The danger now is in being too hasty to deploy cash and chase rising asset values. That is not to say the situation is easy to navigate. Investment does not have to be binary, all in or all out. That only ever works in hindsight. The challenge now is to be patient and deploy cash as appropriate opportunities present themselves, not plunge in with a fear of missing out. Low interest rates are also challenging traditional valuation methods.

There is no end to the parade of analysts and managers on CNBC telling investors that asset prices are too expensive based on historical comparisons and metrics. Often the statistic cited goes back decades and looks ominous, but these claims are frequently very misleading. Simply put, if interest rates are 5% then a sound company with some growth selling for 15 times earnings seems a sensible investment. With interest rates at 1% the same company could still be a sensible investment at 25 times earnings but historically on an earnings basis 25 times is expensive. But expensive on an earnings basis does not equal overvalued if interest rates remain low for several years or longer. In a low growth, low inflation world the stability of a companies' earnings is key, and the ability to grow earnings, even at a slow pace, attracts a premium price if that growth is relatively predictable. Double digit earnings growth (think **Microsoft**) attracts a large premium while flat earnings (banking stocks) brings a sizable discount to the market. The small, but serious, risk facing investors now is what would happen if interest rates moved sustainably higher likely leading to a decline in equity valuations. What has been bought over the past few years for perceived safety (high quality stable companies with dividends) may be becoming unsafe for the simple fact that the price of safety is becoming too high. Remember that a great company can make a poor investment if purchased for too high a price. Patience is your friend. Although we expect interest rates to stay low for possibly years to come opportunities will continue to present themselves. We don't even have to take advantage of all the opportunities either, but a disciplined approach will ensure we pay justifiable prices for assets, not just any price. Rather than a spray and walk away approach to investing we see investing as like collecting acorns until your bag is full of sound investments.

In recent weeks listed NZ Property stocks have retreated about 8-10% from their highs as longer term NZ interest rates look to have found a base in the 1.2-1.5% range. However, the property sector still looks attractive with premiums to net asset values retreating to more sensible levels. In the next 6-12 months likely valuation gains will close these premiums further and with gross yields of 5.0%-6.5% listed property still looks to be a sound place to invest and provides better income than corporate bonds with yields languishing in the 2-3% range. As 2019 draws to a close it is worth reflecting on events this year.

The year began with the US Federal Reserve back-tracking from their 2018 tightening cycle and switching to a "mid-cycle" adjustment of interest rates. This saw 3 quarter point rate cuts in 2019 to 1.50% and similarly Australia and New Zealand cut rates aggressively to 0.75% and 1.0% respectively. The world economy has slowed this year while asset prices have risen strongly driven by low interest rates. This is unlikely to continue in 2020. Either growth picks up to support corporate earnings, or asset prices will likely stagnate trapped between the headwind of sluggish corporate earnings and low interest rates supporting valuations. Against this backdrop we believe patience will be a virtue.

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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