Economic and Market Commentary June 2021

Markets continue their climb

Equity markets climbed to record highs over the June quarter.

Most equity markets continued to climb over the June quarter, extending their record highs. Robust economic growth, vaccine rollouts and ongoing or newly promised stimulus programs far outweighed concerns around re-surging Covid cases and lock-downs in some regions and countries. However, it wasn't plain sailing across all asset classes. Fixed-income returns were weak as cost pressures and inflation risk concerns continued to mount. As discussed at the end of this update, this is perhaps nowhere more evident than in New Zealand where there has been a complete U-turn in the RBNZ's outlook for interest rates – from cutting rates to increasing them as soon as next month (August).

Market roundup

Equity market performances were solid over the quarter and year.

Equity markets are now clearly higher than the levels reached before the Covid pandemic hit. International shares rose around 8% in the quarter in NZD terms and around 27% for the year to June. NZD hedged shares increased around 7.5% in the quarter, and over 35% for the year (see Figure 1).

Higher risk small-cap stocks had the highest annual return, while NZ equities lagged.

Within global equities, higher-risk small and value stocks mildly underperformed in the quarter, returning around 5% in NZD terms. Over the year, however, global small caps out-performed returning around 40% and value stocks performed in line with the market overall. Emerging Market and Australian equities also performed well, with both up around 30% for the year to June.

In contrast, New Zealand shares only returned around 1% in the quarter and are up around 11% for the year to June 2021. Their performance has slipped from being ahead of the pack to slightly below global market returns over the past three and five years. This illustrates the importance of diversification within equity market holdings, and that we shouldn't expect a single market to continue to out-perform.

International infrastructure rose around 3% in the quarter while international property stocks increased by around 9%. On an annual basis, returns were around 20% and 30% respectively. Concern that Covid would permanently reduce tenancy demand has clearly waned for the property sector overall, with sub-sectors such as industrial property surging on the back of very strong manufacturing activity and low vacancy levels.

Fixed-income returns continued to languish.

Fixed income posted small positive returns over the June quarter. New Zealand investment grade (IG) bonds rose around 0.3%, resulting in an annual performance of -1%. International investment-grade bonds have fared a little better, increasing by around 1% in the quarter with flat performance over the past year.

New Zealand is expected to tighten interest rates first

Economic growth has been strong as economies continue to re-bound from Covid.

Economic agencies are predicting growth over the next few years to be at multi-decade highs as life "gets back to normal" and as fiscal spending programs turbocharge growth. Actual data outturns over the June quarter have been broadly in line with this theme. Global manufacturing activity is firmly in expansionary mode, unemployment rates continue to fall, and consumer spending is surging. In NZ, data released in mid-June by Statistics New Zealand showed GDP for the March quarter rose 1.6%, well ahead of most forecasters' expectations and firmly putting to rest any concern that our economy might experience a technical recession.

Attention is now shifting to rising costs and inflationary risks.

With New Zealand's economic recovery well established and global growth on steroids, the focus has shifted to rising costs and inflation. The big question is whether the surge in commodity, freight, construction and a range of other costs seen this year will be temporary or instead lead to a sustained increase in CPI inflation rates. Survey measures of business and households suggest risks point to the latter, with inflation expectation measures running at multi-year highs.

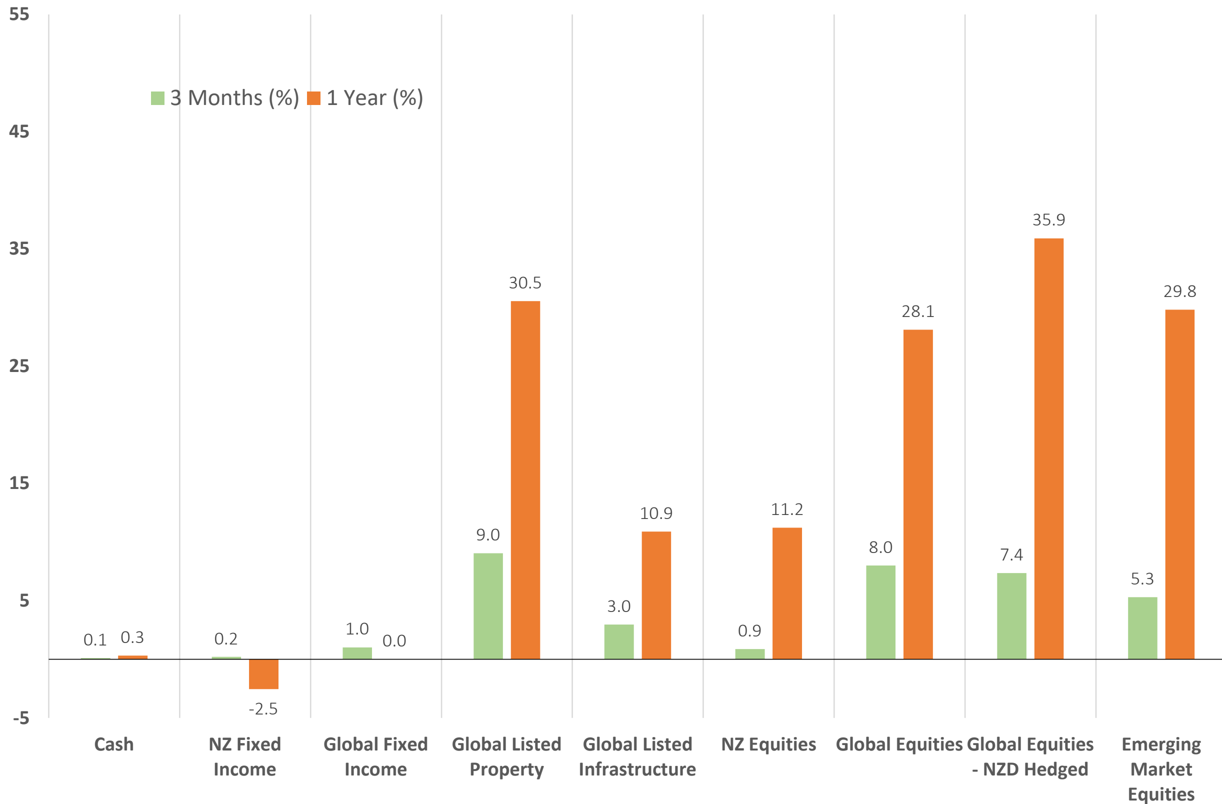
The RBNZ is leading the pack in signalling a need for higher interest rates.

In this environment, it is perhaps not surprising that central banks have begun to change their tune. No central banker wants to win the economic battle with Covid only to fight an inflationary war. In the US, a number of senior officials at the Federal Reserve have begun to call for an explicit timeframe for rising rates. In its May update, the RBNZ signalled that it will lift interest rates from the middle of next year, possibly sooner, if the economy and inflation continue to run ahead of expectations. Some economists now expect an increase as soon as next month (August). In this respect the RBNZ is leading the pack – rates are expected to lift here ahead of other major economies (see Figure 2).

Interest rates need to be considerably higher to make bonds an attractive asset class again.

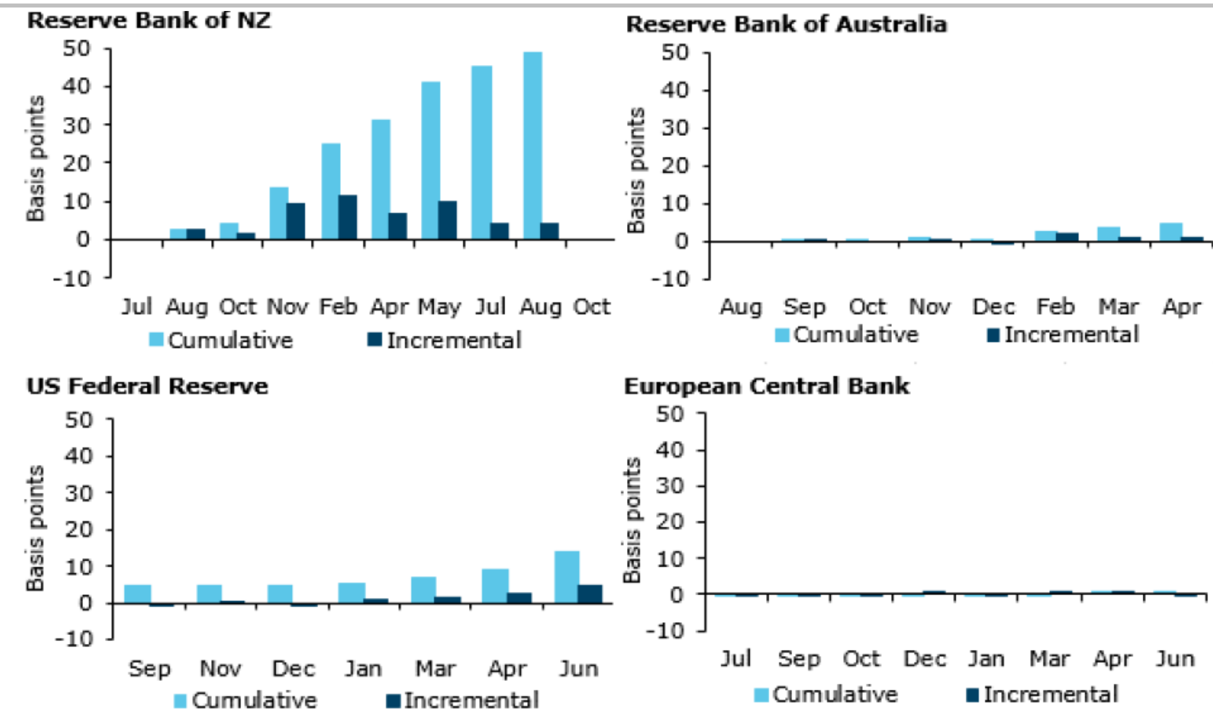
Will we see a sustained increase in interest rates over the next year or so? This is in our view remains unlikely. The lockdowns in parts of Australia are a reminder that we are not out of the woods yet. Regardless, in our view, the balance between risk and reward for bonds remains poor, and one or two small changes in short-term rates are unlikely to change this. We need to see a sustained increase to make bonds an attractive asset class again.

Figure 1: Double digit returns across growth assets



Source: Morningstar Direct, MyFiduciary

Figure 2: Markets predict the RBNZ to lift rates first



Source: ANZ Research