DecisionMakers
Investment Advisers & Portfolio Managers

MyFiduciary
Governance & Investment Support

Economic and Market Commentary June quarter 2022

Overview

Equity markets fell into bear territory over the June quarter.

War, pandemic, and inflation. Markets have been grappling with all three of these headwinds this year, and fell further across most asset classes in the June quarter. US and NZ equity markets are down around 20% from their peak, putting them into "bear market" territory. Bonds have also suffered large declines.

Historically, investors have enjoyed outsized returns following a bear market.

We don't know how much further markets could still fall - nobody does - but with the large decline in bonds and equity prices we can say that they offer investors much better value today, and as such, higher likely returns over the medium to longer term. To provide some indication, figure 1 below shows that on average over the past century US equity markets have delivered a five-year cumulative return of over 70% (12% per annum) following a market decline of 20%. This reinforces the importance of not selling assets following a market drop.

The economic picture

The key economic determinant for markets forming a bottom and setting the stage for rallying will be whether inflation starts to moderate, and with it the quantum of interest rate increases central banks need to deliver. Global and NZ growth is no doubt slowing from the blistering pace that was achieved following the bounce from initial pandemic lockdowns, and with it in theory we should see inflation pressures and actual inflation decline.

The economic picture is very complicated, with upside and downside risks.

But on top of the economic cycle, the pandemic and war in Ukraine present considerable uncertainty and both upside and downside risks. We can expect prices for manufactured goods to fall *if* global supply chains don't face further significant covid and flu related interruptions. Despite the ongoing war, oil (and many commodity) prices at the time of writing are down over 10% from their peaks, as markets factor in slowing global growth. Any sign of war letting up in Ukraine would cause energy prices to plummet, and with it headline CPI inflation. Unfortunately, we would expect the opposite to occur if the war were to spread beyond Ukraine's borders.

While markets are pricing in a recession it is not inevitable.

Is economic recession inevitable? It's a very complex economic picture and economic forecasting is not something that is known for its accuracy. Equity markets have fallen to the extent that they are now "pricing in" an economic recession (i.e. at least 2 quarters of negative economic growth and a steep rise in unemployment rates.) Historically, however, markets have also not been very good at predicting recessions. They have forecast roughly twice as many recessions as have occurred! In contrast, the most recent June forecasts from the OECD still predict global GDP growth of 3%, and 2% growth for New Zealand. This is a large decline from the growth we have had recently, but still far from recession. Time will tell.

Market roundup

Global, NZ and Australian equity markets fell over the quarter, with value and emerging market stocks falling less.

Market performances were again mostly negative during the quarter. Developed market equities fell around 6.5% over the June quarter in NZD terms while NZD hedged equities fell around 15%. The difference in performance reflected the large decline in the NZD over the quarter, something we typically see in a "risk off" environment. We have significant allocations to unhedged equities that in part reflects the shock absorbing role the NZD can play in times of stress.

Within global equities, higher risk small caps fell around 7.5%, while value stocks again out-performed (falling around 1% and are up 4% over the year) as the rotation towards companies with lower valuations and hence less reliance on future growth conditions continued.

Emerging Markets outperformed most other equity markets in the quarter, falling by "only" around 1%. This reflects that they bore the brunt of the sell off as war broke out in Ukraine in the March quarter. On an annual basis returns were poor at around -16% in NZD terms. NZ and Australian equity markets both declined around 10% in the quarter as the RBNZ and RBA lifted interest rates. Over the year to June, however, the resource-sensitive Australian equity market has fared better, with it down around 4% compared to around 13.5% in New Zealand.

Fixed income has been a challenging area.

Fixed income returns were also poor as market interest rate curves steepened. NZ bonds fell around 3% to 6% and global investment grade bonds fell around 4.5%. Over the year to June, bond declines are close to 10%.

As featured in our last update international infrastructure is expected to be more resilient to inflation risks, and this has been the case over the past year. International infrastructure funds increased around 2% in the quarter and returned 11%% over the year to June in NZD terms.

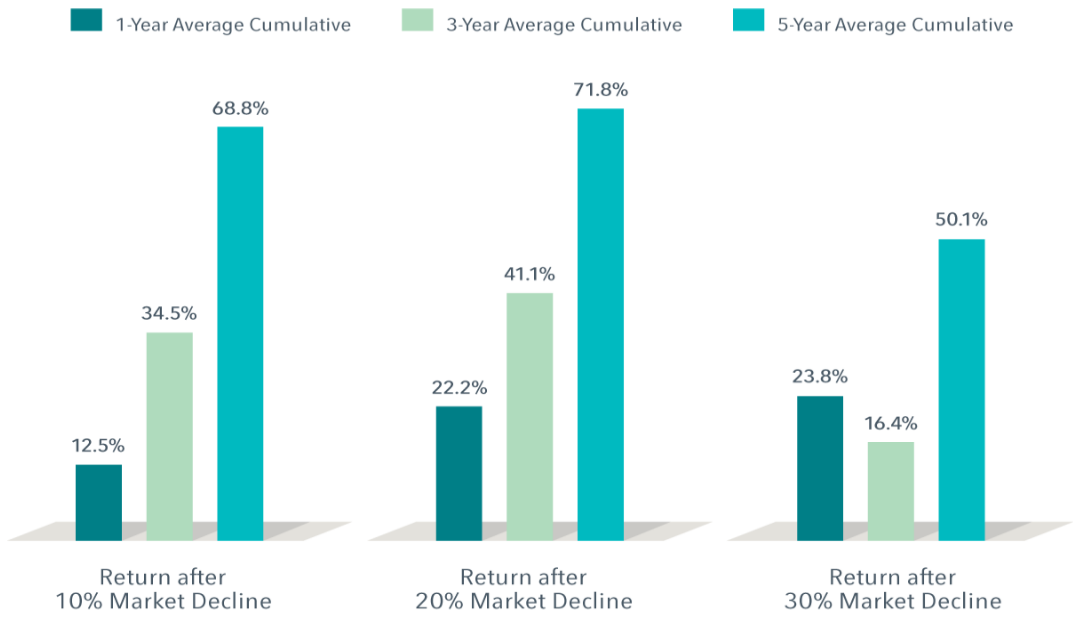
Alternative asset classes are playing the role intended

The portfolios we design may include allocations to listed property and infrastructure, so-called "trend following" strategies, as well as short-duration bonds. These exposures offer some level of diversification benefit in normal times, but they were also in large part selected for their potential to mitigate the inflation and interest rate risks we have become quite concerned about over the last few years.

Alternative asset classes have added substantial value to portfolio returns.

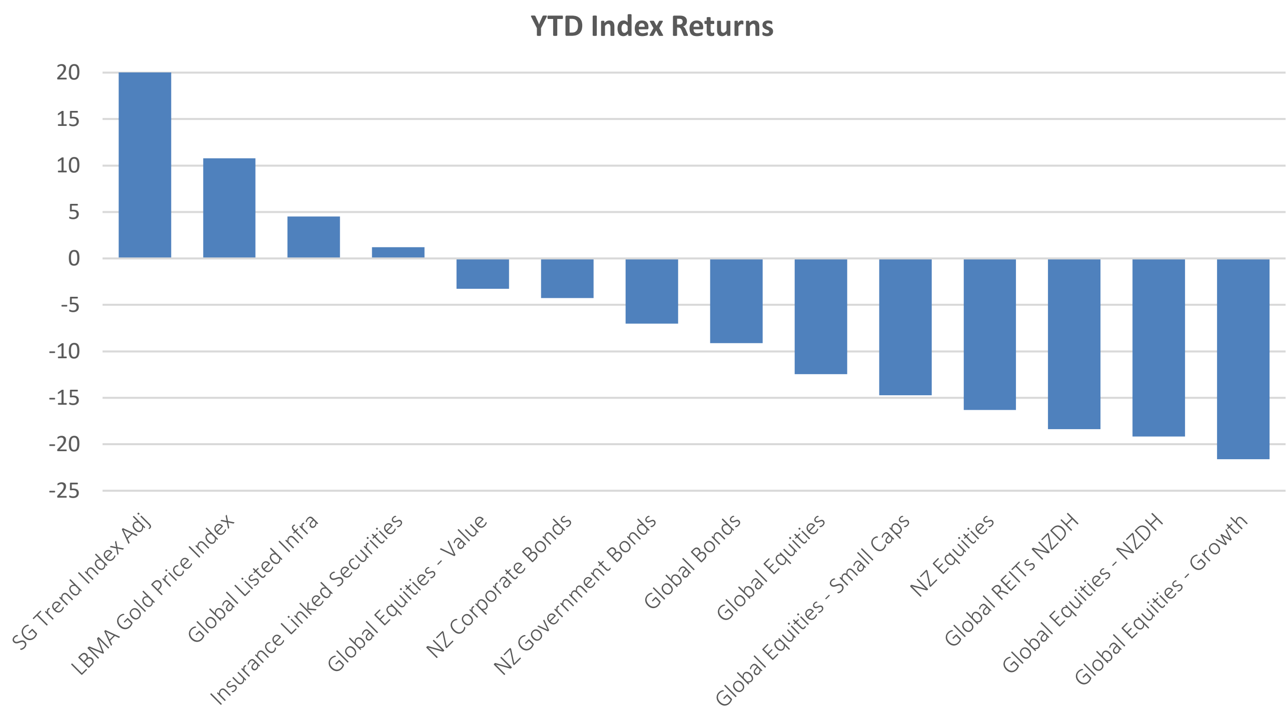
Have these exposures helped cushion portfolios as bonds and equities have sold off this year? The short answer is very much so, as shown in figure 2. All have outperformed conventional equities and bonds, with some delivering double digit returns year to date. These performances have not only materially reduced the losses portfolios have experienced, they also provide the opportunity to re-balance back into asset classes that have sold off. For example, from short duration to standard duration bond holdings.

Figure 1: Over the past 100 years large gains have followed large falls



Source: Dimensional Fund Advisors

Figure 2: Alternatives and infrastructure have delivered the highest returns this year



Source: Morningstar Direct, MyFiduciary