Economic and Market Commentary September Quarter 2022

Overview

Equity markets were mixed but bonds fell heavily.

The headwinds from war, inflation, and supply-side hangovers from the pandemic continued over the September quarter. Performances were, however, more nuanced than the broad sell-off across almost all asset classes in the June quarter. Bonds suffered amongst their largest losses since records began as central banks stepped up the tightening of monetary policy and communication that rates may need to be higher for longer to reduce inflation back to target levels. Equities rallied over much of July and August, only to fall back in the month of September.

Currency markets had significant moves.

A particular feature over the quarter was very large currency market swings, with the US dollar approaching record highs on its trade-weighted basis. The NZD in contrast fell around 8% over the quarter, which helped cushion returns on offshore assets held on an unhedged basis. Even more dramatically, the UK pound fell around 10% intraday to record lows against the US dollar following the release of a budget seen by the market as being fiscally unsound.

Timing markets is difficult, but cash yields are becoming meaningful again.

As in our previous update, we don't know how much further markets could fall - nobody does - but the large decline so far this year implies much better value today, and as such, higher likely returns over the medium to longer term. In addition, cash yields on various asset classes are now back to levels last enjoyed in pre-GFC days. For example, running yields on global and NZ investment grade bonds are now around 4-5%, compared to under 1% only a year or so ago. Dividend yields are also higher. This means investors do not need to rely as much on uncertain (over the short-term) capital gains to earn a return.

Market roundup

Unhedged exposures performed relatively well.

Developed market equities increased around 3% over the quarter in NZD terms, while NZD hedged equities fell around 5%. The difference in performance reflected the large decline in the NZD over the quarter, something we typically see in a "risk off" environment. The significant allocations in place to unhedged equities in part reflects the shock absorbing role the NZD can play in times of stress.

NZ and Australian equity markets were resilient.

New Zealand and Australian markets also fared relatively well, rising by around 2% and 3.5% respectively. Over the last 12 months however, there has been a large divergence, with NZ equities declining 16% and Australian equities up around 2% in NZD terms. Emerging Markets under-performed in the quarter, falling by around 3% in NZD terms.

Bonds continued their poor run. NZ bonds fell around 1% and global investment grade bonds fell around 3.7%. Over the year to September, international investment grade bonds returned -12% – the worst result

Fixed income returns were poor again.

since 1842 if the records are to be believed! The silver lining now is that their cash yields are back to around 'normal', and we can expect bonds to play their traditional diversification role should inflation and growth outturns be weaker than expected.

Rounding out the market update, international property stocks fell around 2.8% in the quarter in NZD terms while global infrastructure fell around 1.2%. On an annual basis infrastructure increased around 14%, while global property returned around -5.8% in NZD terms. These asset classes have been relatively resilient to higher inflation, as should be expected given their income streams typically rise with inflation.

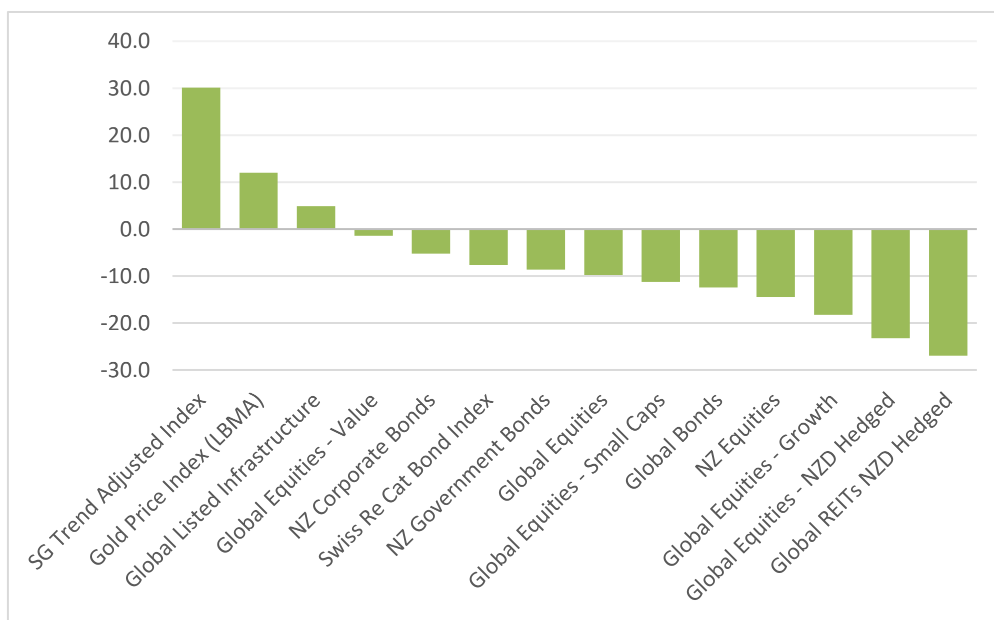
Alternative asset classes continue to provide resilience

Alternative asset classes have added substantial value to portfolio returns.

The portfolios we design may include allocations to listed property and infrastructure, gold, insurance linked securities (ILS), so-called 'trend following' strategies, as well as short-duration bonds. We have begun to unwind the latter as yields rise, but the diversification benefits and potential to mitigate inflation and interest rate risks of the other assets remains relevant.

Having contributed materially earlier in the year, these assets generally performed well again in the third quarter, although Hurricane Ian affected ILS returns. Prospective returns from ILS now look particularly attractive over the next couple of years.

Figure 1: 2022 year to date Index Returns



Source: Morningstar Direct, MyFiduciary