Economic and Market Commentary December Quarter 2022

Interest rate increases and the pandemic and war hit returns hard over 2022.

So long and good riddance to 2022. War, inflation, rising interest rates, and economic bottlenecks led to poor returns in most asset classes. In fact, 2022 was unusual in the sense that equities and bonds both fell simultaneously by large amounts. Usually, bonds act as a safe haven when equity markets fall. As a result, a balanced 50/50 portfolio of global stocks and bonds had its worst year for nearly a century (Figure 1).

In contrast, asset classes that offer inflation resilience such as infrastructure, as well as value stocks, select alternative investments and short-term credit, fared much better. Our portfolios have been positioned for just such an event, and as such performed relatively well in the context of the large market declines.

Purely speculative investments fared the worst, while inflation resilient assets and alternatives did well.

Markets had to adjust to interest rates returning to more normal levels, and large cap growth-stocks (such as Meta and Tesla), which had led the market on the upside, suffered much larger declines than the overall market. Purely speculative investments, such as digital currencies and NFT tokens, were harder hit still, with some suffering complete capital loss. These type of adjustments – unfortunately – occur every cycle as speculative excesses are worked through (or, less euphemistically, as the naïve are parted from their money). Closer to home, we also saw residential property prices begin to fall - ending the myth that they can only rise.

The adjustment was not accompanied by a financial crisis as in 2008.

Despite the seismic shift in interest rates and accompanying asset price declines, one welcome thing that we didn't see over 2022 was the type of stresses associated with the global financial crisis of 2008. Overall, the adjustment to higher rates globally has been fairly orderly, and, as discussed below, the silver lining is that we should now expect higher longer-term returns from most asset classes given higher cash rates and income yields on offer. In our view, risks are now more evenly balanced. Although economic growth is expected to be weak in 2023, with many economies likely to be in recession, this reduces the risk of core inflation rising higher still. Energy prices are now clearly off their peak, in part due to the good luck of a warm European winter, which will reduce headline inflation rates.

Market roundup

Currency movements again had a large impact on December quarter returns. NZD hedged international equities offered the best return, while unhedged equities fared poorly.

Market performances are reported in Figure 1. International shares on an NZD hedged basis rallied around 7% in Q4, but fell by around 2% in NZD terms. The difference reflected that yet again currency volatility was a key feature of the quarter, with the NZD rallying as the shine came off the previously very strong USD.

For calendar 2022 international equities declined around 11% in NZD terms, which was in line with the return from NZ equities. In contrast, Australian equities with their resource focus performed relatively well.

Value stocks had a relatively strong year, as did global infrastructure.

Within global equities, value stocks also outperformed, returning around 2.6% over the quarter and 1.2% over the year in NZD terms. However, higher risk small caps and emerging markets fared worse, returning around –12% and –13.5% in 2022 respectively.

Bonds are back and can now play a more normal role in the portfolio.

NZ and international investment grade bonds eked out small positive returns in the quarter bolstered by their now meaningful running yields. The silver lining is that their cash yields, at +5%, are back to around "normal" pre-GFC levels. This means that we can expect bonds to play their traditional diversification role should inflation and growth outturns be weaker than is currently being priced by the market.

International property stocks increased 4% in the quarter in NZD hedged terms, but performance over 2022 was very weak on both a hedged and unhedged basis as the office segment in particular priced in much lower tenancy demand. In contrast, global infrastructure performed well once again, returning a handy 3% for calendar 2022 on an unhedged basis.

The outlook ahead

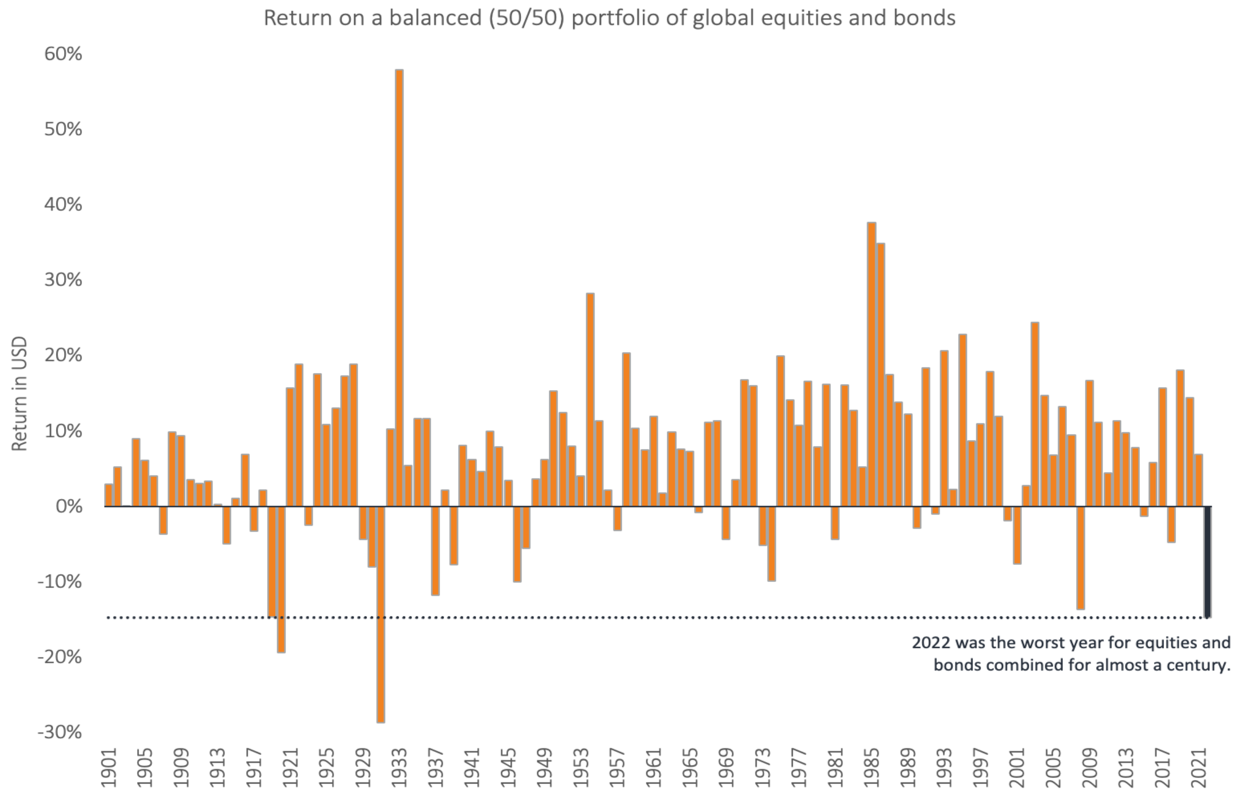
We expect higher longer-term returns given higher cash rates and the market declines over 2022

No one can consistently forecast short-term market movements, though, as per our last update, we believe that inflation is the key economic determinant for markets to be able to form a bottom and to rally from current levels. In our view, current and forecast interest rate levels should be sufficient to reduce inflationary pressures, though the surge in Covid in China may reignite short-term supply-side challenges. Of course we also need to take into account the war in Ukraine, which presents considerable uncertainty and both upside and downside risks.

One thing we are more confident about given both long term financial history and basic investment logic is that over the medium to longer term markets offer a premium to cash to compensate for their higher level of investment risk. It follows that with central banks now having finally done their jobs and raised rates to more normal levels, we should expect higher longer-term returns. To take a simple example, NZ investment grade bonds now offer running yields over 5% per annum (a 1% or so premium to the OCR), compared to under 2% a couple of years ago.

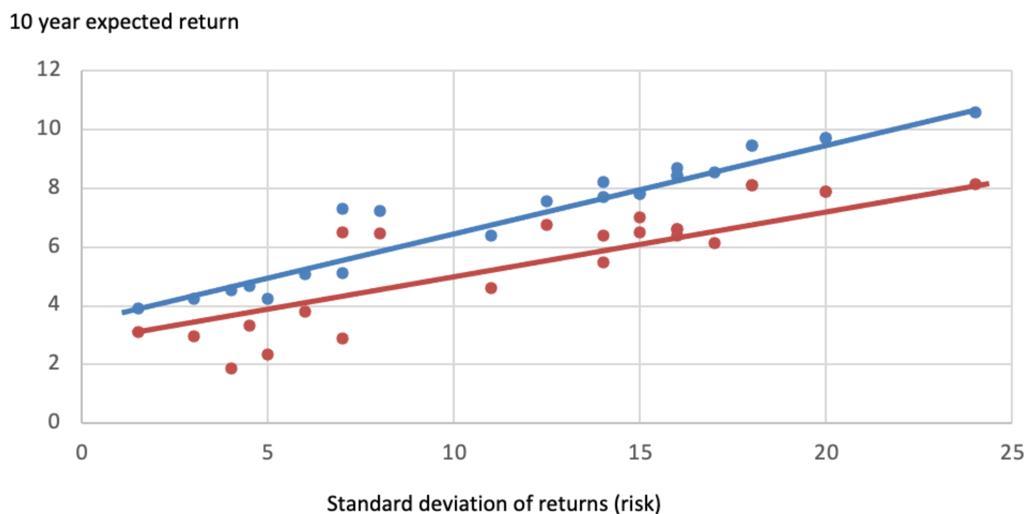
Figure 2 overpage presents our updated long-term forecasts for a range of asset classes taking into account higher cash rates and the sell-off in markets over 2022. These are compared to the same forecasts made in 2021. We see that there is an increase in the level of returns expected for the risk inherent across all the asset classes we consider (compare the blue line to the red line). Furthermore, we see that most assets classes lie close to the blue line, indicating that they are now around "fair value". This is a marked change from 2021 where we saw more variability with low-risk assets classes being particularly expensive, as indicated by the red dots lying well below the red line in the bottom left.

Figure 1: 2022 Annus Horribilis



Source: Dimson Marsh, MyFiduciary

Figure 2: The longer-term risk return trade-off has improved



Source: MyFiduciary