Economic and Market Commentary March Quarter 2023

Overview

Markets climbed higher over the March quarter despite monthly volatility and wobbles in the banking sector.

Both equity and bond markets bounced higher in the March quarter, following increasing signs that central banks are getting on top of inflationary pressures. However, the pattern of returns was quite volatile. Equity markets surged in January on the back of reducing interest rate expectations, only to sell-off most of this gain in February and into early March as the banking sector particularly, came under pressure with the failure of Silicon Valley Bank. Later in March markets rose again as banking contagion risks receded, and macroeconomic data, in general, reported better than expected (see Figure 1 for the US economy).

Market roundup

Global equities had the strongest returns, followed by emerging markets and then NZ and Australian stocks.

Market performances are reported in Figure 2. International shares rallied strongly over the quarter, by around 9% in NZD terms and 7.2% in NZD hedged terms. Within global equities, value stocks took a breather and returned only 2% over the quarter, but they still outperformed over 12-months, returning 5.6% in NZD terms. Small caps have fared worse, returning around 5.5% in the quarter, but only 0.7% in the year to March 2023.

Emerging markets returned around 5% over the quarter, slightly stronger than the 3.9% and 3.3% returns posted by the NZ and Australian markets respectively. Over the year to March, however, all performed quite similarly returning around -1%.

Bonds also rose over the quarter, in part because they now offer +5% running yields.

NZ and international investment grade bonds returned around 2.5% in the quarter with some of this gain reflecting a paring back of future rate rise expectations. Over the year to March NZ investment grade bonds fell around 1%, while international investment grade bonds fell around 5%. This difference in performance largely reflects that the RBNZ was generally quicker than offshore central banks to raise rates, and hence the marked-to-market capital losses were incurred earlier in our bond market than most offshore markets.

International property stocks again struggled in the quarter, increasing only 0.6% in NZD hedged terms. In contrast, global infrastructure performed well once again, returning a handy 2.6% for the quarter and 3% for the year to March 2023. Finally, gold performed well in response to the banking sector stress and increasing efforts being made by Petroleum States and China to reduce their reliance on US dollars for trade settlements.

Bonds and their role in your portfolio.

Bonds are held in your portfolio because of their income stream and risk diversification potential.

Bonds play an important role in all but the highest risk portfolios. They provide a predictable income stream, and typically rally in times of stress, providing a portfolio diversification benefit. We assess these benefits to be more certain and material today than they were a year or so ago now that both short term interest rates and bond yields have risen to more normal levels. We can expect returns of 5% p.a. or more from most NZ and offshore bond funds, whether they are of short or longer-term duration, given their current yields.

While increasing rates in 2022 caused significant marked-to-market losses the upside is now bonds offer higher yields and enhanced potential to cushion returns when equity markets fluctuations.

Most of the bond funds in your portfolio comprise highly rated investment grade bonds. While issuers of investment grade bonds very rarely default on their debt obligations, this does not mean that they are risk-free. Bonds can still suffer negative returns even when there is no default, for several reasons:

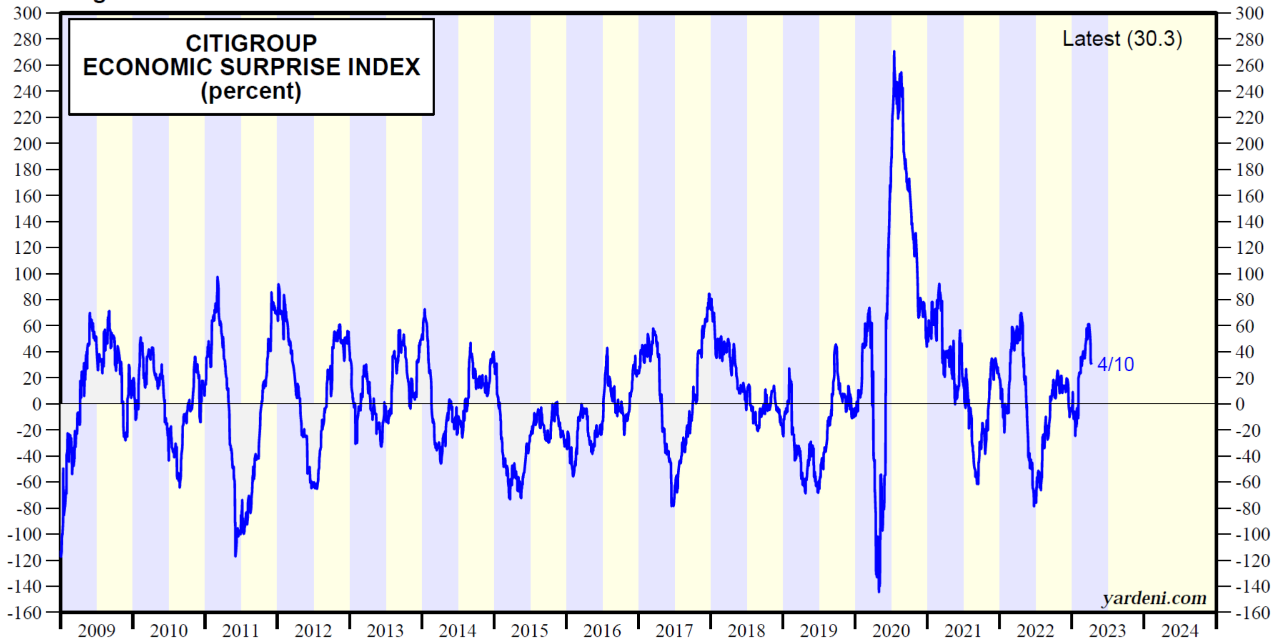
- The assessed creditworthiness of the issuer deteriorates, causing the value of the bond to decrease. An example would be if the NZ government has a credit rating downgrade.
- Interest rates rise by more than is factored into bond prices when they are bought. This is the main reason why bonds suffered a large decline in 2022, and why we allocated to “short duration” bonds earlier to reduce this risk.
- Some bonds may be difficult to sell during times of market stress. In these circumstances the investor may have to sell them at a lower price.
- Finally, most bonds pay a coupon that is fixed and does not adjust for inflation. As such real returns will fall when inflation rises, as it has over the past year.

Your bond investments are mainly in investment grade bonds funds diversified across government, country, term, and country issuances to mitigate individual bond and country risks.

Your exposure to bonds is in the form of well-diversified bond funds that have been selected in part to mitigate the risks above, and in part because of the strong conviction we have in the selected fund managers due to their track record, SRI credentials, business stability, and operational risk controls.

Finally, while bonds are not risk-free, they still may be preferred to term deposits (TDs) for several reasons. Firstly, because they typically offer a higher yield than TD rates. Secondly, because an investor can, in most circumstances, sell their holdings at any time without financial penalty, unlike with TDs where “break fees” apply. And thirdly, because a diversified portfolio of bonds may in fact be *lower risk* than putting money “in the bank”. The GFC in 2008, and the more recent wobbles in US banks, serve to illustrate that bank deposits are not risk free. Furthermore, NZ does not have a deposit guarantee scheme, and the scheme expected to be enacted later this year will only guarantee up to $100k per investor.

Figure 1: US data has been positive relative to expectations so far this year



Source: Citigroup, Yardeni Research Inc.

Figure 2: Markets bounced higher in 2023 March quarter

Source: Morningstar Direct, MyFiduciary