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Economic and Market Commentary December Quarter 2023

Overview

Most asset classes performed well over the December quarter...

Markets reversed course – yet again – to rally strongly over the December quarter. Most asset classes enjoyed strong returns, including global and NZ equities, global and NZ fixed income, and listed property and infrastructure. Cash and short-term bonds also fared relatively well given interest rate levels remain relatively high, as did select alternative asset classes.

The main factor behind the rally was a flip-flop on the view that interest rates need to remain high to reduce inflation to central bank target levels. Instead, as CPI inflation in the US and globally trended lower, markets priced in cuts over this year and a so-called 'soft landing' scenario – the reduction in inflation is not expected to be accompanied by global recessionary conditions.

...as markets became more convinced that a global soft -landing scenario is the most likely outcome for the years ahead.

That said, the US economy has been a bright spot. New Zealand's most recent GDP release suggests our economy has been in mild recession over much of 2023. Chinese growth, while still positive, is at multi-decade lows and downside risks to their outlook remain given the massive debt levels that have been run-up to finance their residential and infrastructure spending. European growth has also been quite weak, with Germany also spending much of 2023 in mild recession. In part reflecting the differing macroeconomic conditions, the rally in equities was much stronger in US stocks than in most other markets.

Market roundup

Market performances are reported in Figure 1. All asset classes enjoyed positive returns in the quarter, with global property on an NZD hedged basis leading the pack (13% return) owing to listed commercial property bouncing back from quite depressed levels, and a rally of the NZD against the USD. NZ and global bonds also had very strong quarterly returns as long-term rate expectations fell, causing bond prices to rally. Short term credit and 'cash enhanced' funds benefited less from this 'marked-to-market' impact, but their annual returns have remained solid given their high current running yields.

Gains were strongest in US equities over the past year, in part reflecting the relative strength of the US economy.

Over the year to December international equities increased around 23%, more than offsetting their losses in 2022. Elsewhere, equity market performances were more subdued, with Australian equities returning around 13%, emerging markets (EMs) returning around 10%, and NZ equites returning only 3.5%. Our market's performance can be regarded as a 'reversion to the mean' – it is now performing in line with global equities over the past decade (around an 11% p.a. return) and is no longer regarded as over-valued c/f global markets. Over this longer time frame EM equites, however, remain in the doldrums with a decade return of only around 5.5%. They are cheap on conventional valuation metrics, but in our view are unlikely to recover the lost ground whilst various economic and political concerns remain with respect to China, which makes up around 40% of EM indexes.

The great re-set

Interest rates were slashed to historic lows in 2008/9 and remained at exceptionally low levels until late 2021.

Indelibly etched into this author's mind is the moment when Bloomberg terminals first flashed negative interest rates as central banks slashed rates to record lows in 2009 as the Global Financial Crisis (GFC) hit. In theory this should not **ever** happen – lenders should pay borrowers, rather than the other way around. Be that as it may, short and long-term interest rates remained at exceptionally low (even negative) levels all the way through to early 2021. In New Zealand, for example, the OCR averaged just over 2% from 2008 to 2019, and then was cut to near zero as the pandemic hit our shores in early 2020.

Central banks believed until recently that the balance of inflation vs. deflationary risks favoured keeping rates low. It took CPI inflation surging past 5% to shift this view.

The key reason why rates stayed so low for so long was that central banks' main concern over much of the period was the risk of deflation (i.e. ongoing declines in prices and wages). Modern economies with high household, government and corporate debt levels are simply not equipped to deal with deflation. Deflation implies that the cost of servicing debt increases in real terms. As such, had global deflation set in we would have seen widespread debt defaults, bank failures, massive declines in housing and asset prices, and depressionary economic conditions potentially far worse than the 2008/9 GFC.

On the flip side of the coin, central banks do know how to deal with high inflation – they simply raise rates to curtail economic activity and wait for this to reduce inflationary pressures. As such, the *balance of risks* favoured rates remaining low long after the financial crisis in 2008/9.

Inflated asset prices are a direct consequence of having rates so low for so long.

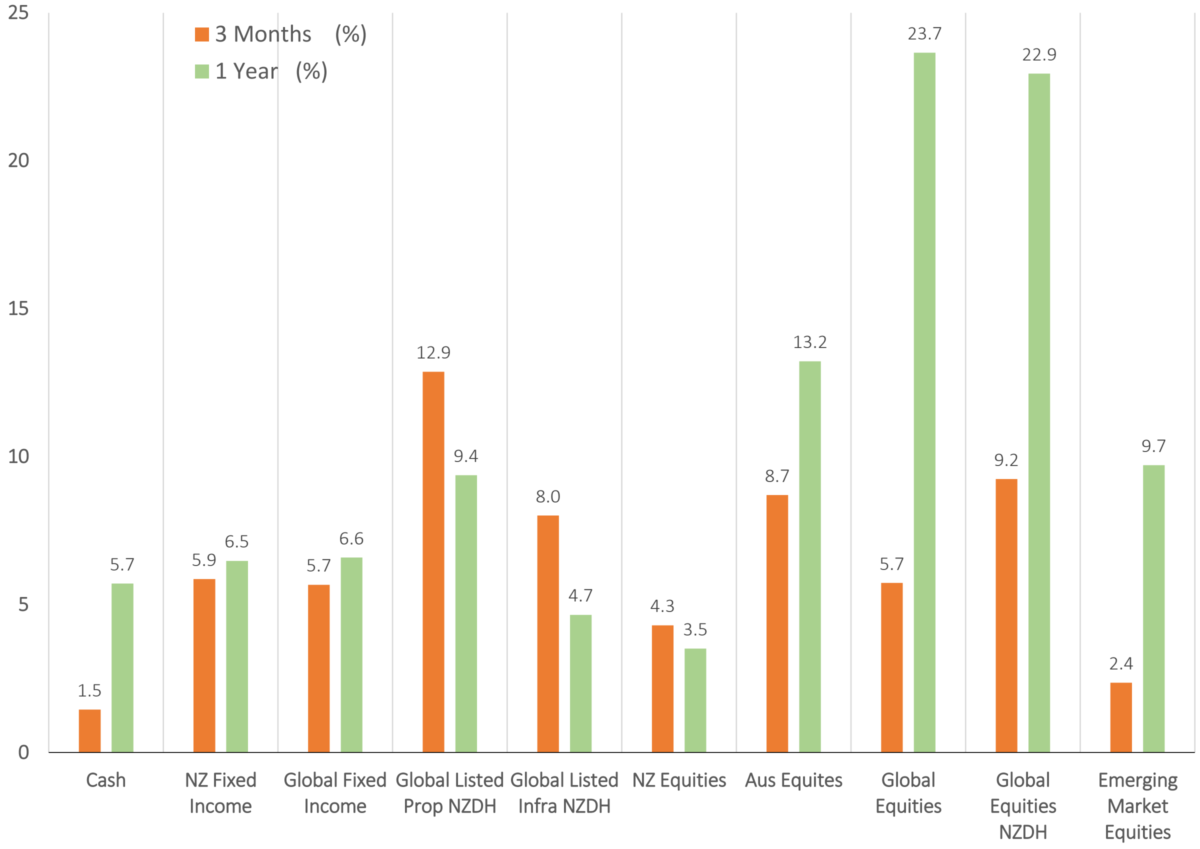
One very real consequence of having rates so low for so long is that it inflated asset prices as markets and households came to believe that rates would more-or-less stay permanently low. In the event, they were wrong. Rate and rate expectations rose quickly over 2022 and into 2023 as inflation surged past 5%. This caused the large marked-to-market bond losses in 2022, and the associated re-pricing of bonds to levels that deliver more 'normal' yields of 5% or more (see figure 2 for US 10-year bond yields).

Equities (at least outside of the large cap tech stocks) and other listed asset classes such as infrastructure and property have also largely re-set to the higher interest rate levels. The good news inherent in this is that we no longer have the risk of large rate rises hanging as a cloud over asset prices. In addition, we no longer need to rely as much on capital gains – which are always uncertain over the short-term – to deliver an acceptable total return in a portfolio now that bond and dividend yields are at higher levels.

The increase in rates since 2022 has re-set asset prices, with the notable exception of residential property which may take a long time to adjust to more 'rational' levels.

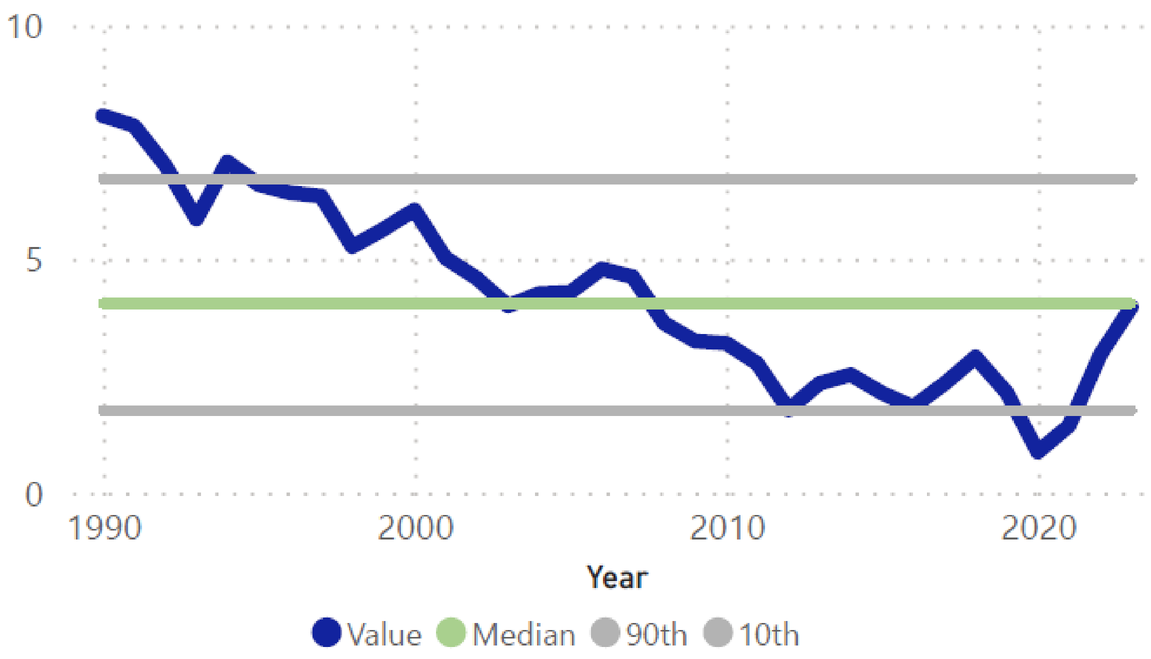
Does this mean the great re-set is over? Not completely. Perhaps the main exception is residential property, where the 'maths' still doesn't add up for the property investor in New Zealand (and many other countries). One would need to believe in large ongoing capital gains (and associated further increases in house price-to-income levels) to justify today's price levels given net cash flow yields are very low, even if we factor in the re-introduction of mortgage interest rate deductibility. Could a long-term stagnation in house prices, as happened in Japan when its bubble burst in the early 1990s, be the enduring legacy of the low interest rate period?

Figure 1: Most asset classes rallied in the December quarter



Source: Morningstar Direct, MyFiduciary

Figure 2: US 10-year bond yields – the great re-set



Source: Datastream, MyFiduciary