Economic and Market Commentary September 2021

Markets performances were mixed

Performances were mixed over the quarter given different economic conditions and risks.

Market performances were mixed in the September quarter. Bonds performed poorly, particularly in New Zealand, yet New Zealand equities enjoyed a very strong performance. Emerging market equities had a poor quarter, but developed large cap equities performed well.

The performance differences reflected cross-currents in macroeconomic conditions and country or sector specific factors. Global growth is still strong, but rising inflation and the prospect of central banks increasing interest rates weighed down fixed income. Emerging market equities were hit by concerns around the solvency of one of China's largest property developers, Evergrande, its ability to meet its debt obligations, and the flow-on effect to markets and Chinese growth. This also impacted Australian stocks. In contrast, and despite our Covid outbreak, New Zealand's economic conditions are expected to remain firm and inflation risks are to the upside. As discussed below, the RBNZ lifted the OCR in early October, ending a seven-year period of easing.

Market roundup

Global equities marched higher...

Developed market equities climbed further over the September quarter, by around 1.5% in NZD terms. This resulted in a return of 23% for the year to September, while NZD hedged shares increased around over 28% (see Figure 1). Within global equities, higher risk small and value stocks mildly under-performed. Value stocks returned around 0.4%, and small caps fell slightly in NZD terms. Over the year, however, global small caps out-performed returning around 35%, and value stocks also outperformed returning 26%.

...while emerging markets fell and Australian stocks treaded water.

As noted in the introduction, emerging markets had a poor quarter, falling by around 7%. At the time of writing the Chinese property developer Evergrande is likely to declare bankruptcy and bond holders are expected to suffer large losses, but it is not expected that this "shock" will transmit to a full-blown financial crisis. On the other hand, the Chinese government's willingness to let one of its largest developers fold is seen as a strong signal that they are serious about curbing rampant property development and construction, which has long been an important driver of Chinese growth. This in turn led to falls in iron ore and a range of other commodity prices, negatively impacting Australian equities which declined around 1% in the September quarter.

NZ shares had a stand-out performance, largely due to replenishment of hydro lakes.

In contrast, New Zealand shares increased around 5% in the quarter and are up around 14% for the year to September 2021. This out-performance occurred despite the Chinese growth risks, New Zealand being moved to alert level 4 on the 17th of August (and Auckland remaining at L4 until the 21st of September), and a firm market consensus that the RBNZ will lift interest rates. A large contributor to the out-performance was from the energy sector, which

increased 25% in the quarter! This sector benefited from high electricity prices, and from high rainfall levels replenishing hydro lake catchments.

International infrastructure and property stocks were flat in the quarter, but on a year to date basis returns were around 10% and 30% respectively. In contrast, fixed income returns were poor. New Zealand investment grade (IG) bonds fell 1.2% in the quarter and 3.8% over the year. International IG bonds fared a little better, being flat in the quarter and falling around 0.5% over the year. Finally, NZ cash fared better still, increasing by around 0.5% over the year.

Fixed income returns were generally poor as markets priced-in higher interest rate levels, but short term bonds funds out-performed.

We have highlighted our concern around raising interest rates and the risks that this presents to bond markets in previous reports. For this reason, we have been reducing exposure to bond funds with "standard" maturity terms (or duration) in favour of bonds and related instruments including cash funds, with relatively short duration. These bond and "cash enhanced" funds have performed comparatively well over the quarter and year, being comfortably ahead of both standard bond fund returns, and the returns from cash.

New Zealand the first OECD country to lift rates

Despite the current covid outbreak New Zealand's economic recovery is seen as well-established and the RBNZ's focus has shifted to inflation. As mentioned in our previous update, the big question is whether the surge in costs seen this year will be temporary, or instead lead to a sustained increase in CPI inflation rates. Survey measures suggests risks point to the latter, with inflation expectation measures running at multi-year highs. Since our last update, while growth prospects have dimmed (particularly in China), unfortunately cost-pressures have not. Supply chain issues have become more acute, with the fuel shortages in the UK being just one notable example.

The RBNZ expects NZ's economic performance to remain robust despite the Covid restrictions.

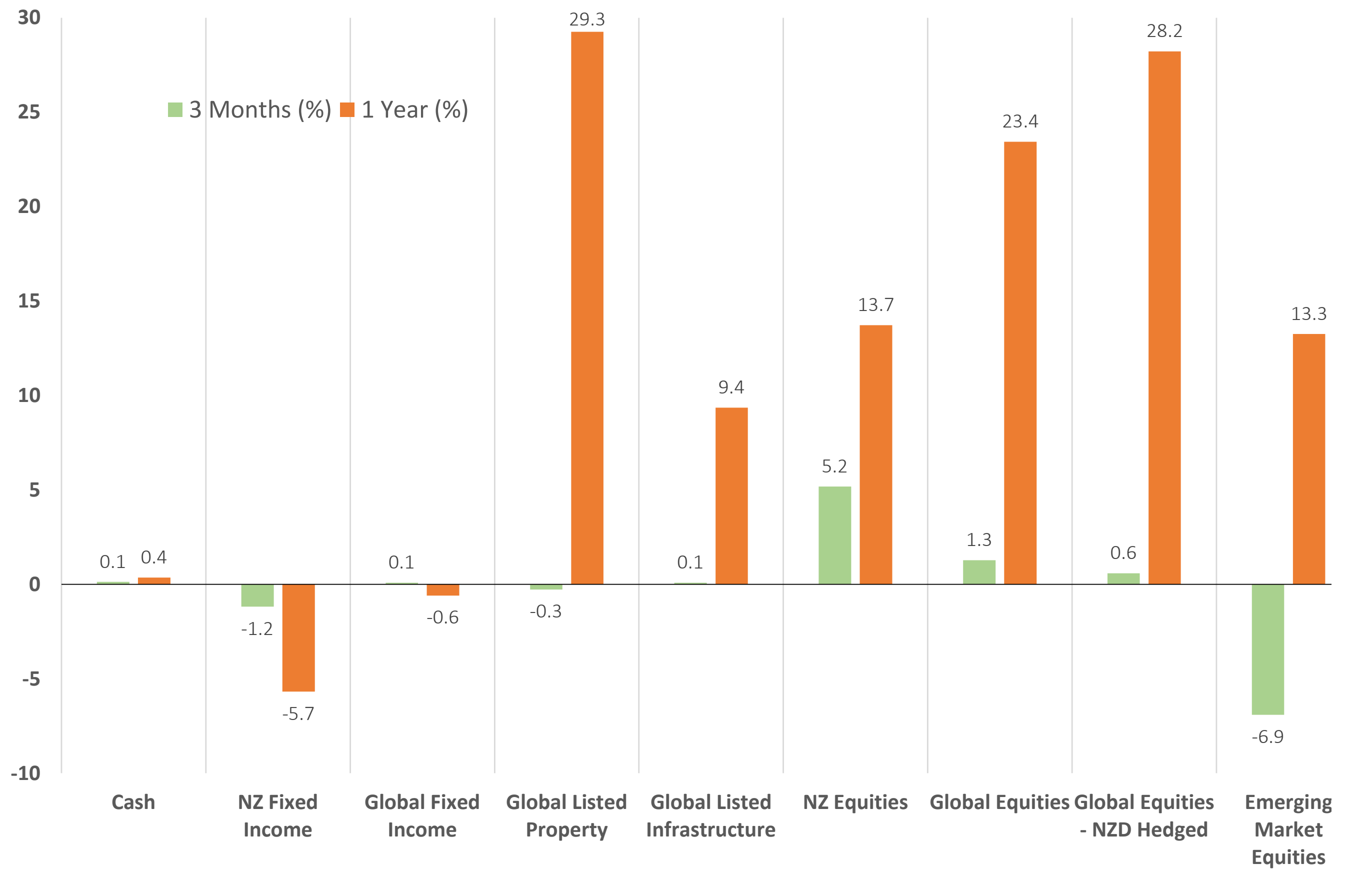
In this environment it is perhaps not surprising that the RBNZ lifted the OCR from 0.25% to 0.5%. This marked the first increase in the OCR since June 2014 – ending a seven year period of easing. The RBNZ's view was that the current COVID-19-related restrictions have not materially changed the medium-term outlook for inflation and employment, and as such further rate rises will be forthcoming.

The lift in the OCR marks a turning point in the support that asset prices have enjoyed from flat to declining interest rates.

Interest rate levels in NZ and globally of course remain extremely low by historical standards, but in our view the OCR change marks an important turning point. Markets have enjoyed a long period of flat or declining rates, which tends to support asset values through, for example, lower discounting of their future cash-flows, and enabling higher levels of leverage. Figure 2 below provides longer term market performances. These drivers of course have also contributed to the huge run up in house prices since the GFC slump in 2009.

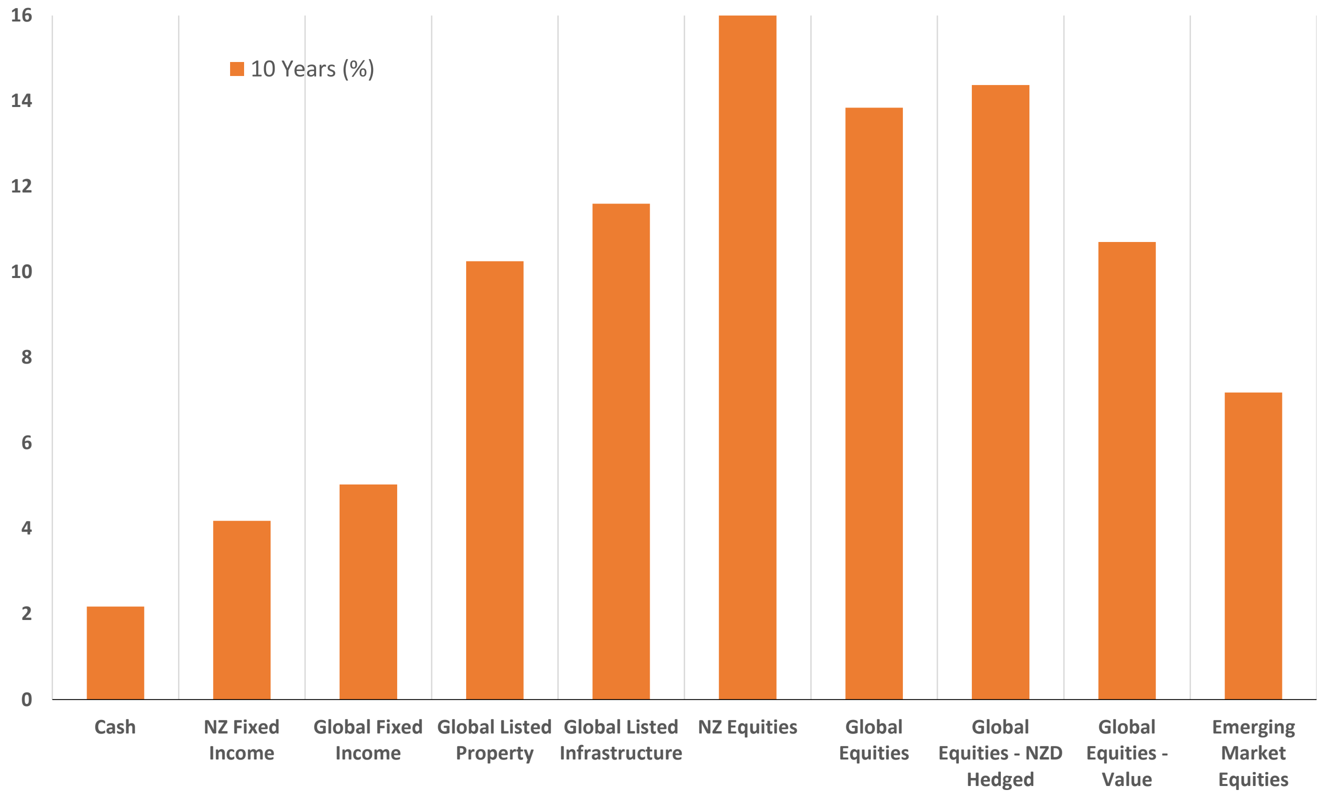
Will the seven years of plenty be followed by seven years of famine? No one knows, but in our view, it is unlikely that the feast will continue another seven years. One thing we are confident about is that well-diversified portfolios will continue to offer a better return than cash over the medium to longer term.

Figure 1: Patchy returns over the quarter



Source: Morningstar Direct, MyFiduciary

Figure 2: But very strong returns over the past decade



Source: Morningstar Direct, MyFiduciary