Investment Commentary

The third quarter of 2021 generally delivered small positive returns to diversified investors.

While it's human nature to enjoy seeing the value of your investment portfolio increase quickly, it's also not reasonable for us to expect large gains each quarter. In fact, if markets got too far ahead of themselves, it could increase the chances of a future correction. In that context, a small positive return can sometimes be more reassuring than a large one.

Following the extended strong bounce-back from the Covid-19 market crash in March 2020, the recent quarter represented both a consolidation of those prior gains and an opportunity for the market to digest new information.

And what a considerable amount of new information there was to digest.

One relatively recent development has been the emergence of an evolving energy crisis across both Europe and China, resulting in record price increases in commodities used to generate electricity and heat; namely oil, natural gas and coal.

About 40% of the UK's energy comes from renewable sources, but the reliability of a renewable supply can be problematic. With low winds across Europe and the UK in their northern summer, wind power generation waned, forcing these regions to turn to gas and coal. UK petrol prices have also hit an eight-year high with widespread reports of petrol stations running dry.

In a similar vein, demand for natural gas has been surging in China, as low water levels restricted hydropower generation and severe coal shortages affected electricity supply. A combination of coal shortages, toughening emissions standards and strong demand from manufacturers and industry, pushed coal prices to record highs and triggered widespread curbs on usage.

Chequered pathway back to normal

With much of the developed world having abandoned strategies designed to eliminate Covid-19 and instead opting to "live with it", there has been a continued reorientation underway globally whereby individuals, businesses and governments are exploring pathways back towards normal, or "post-Covid normal".

Increasingly, this is being reflected in many countries through a relaxation in previous social and business restrictions, and in some cases travel restrictions.

Unfortunately, on the trade front, the pathway back to normal faces some significant hurdles, at least in the near term. Anyone who has recently tried to buy consumer goods from overseas, will already have a sense of this – shortages and delays are now commonplace – but why is this?

It's what can happen when an extremely complex system gets disrupted.

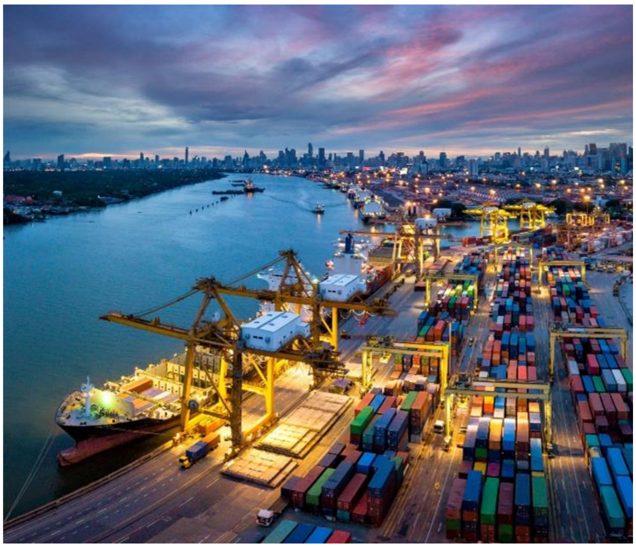
Supply chain breakdown

During the first half of 2020, when much of the global economy went into lockdown, demand for most consumer goods came to a near standstill. In short order, manufacturing capacity was cut, sailings by container ships were cancelled, and workers everywhere were furloughed or displaced.

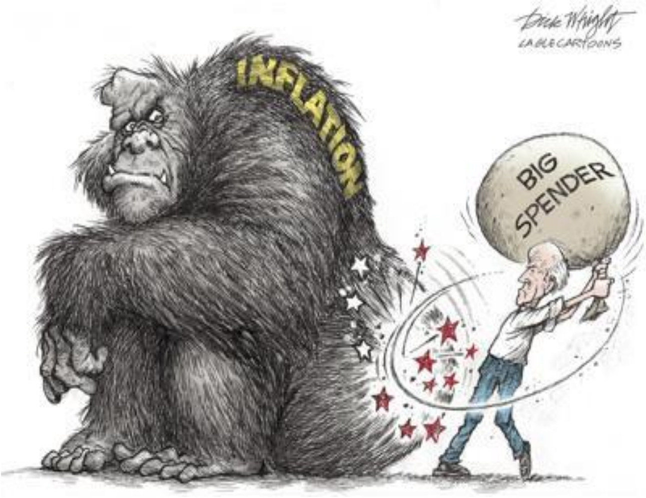
By the second half of 2020, following massive fiscal and monetary stimulus by most central banks, consumers started flooding online retailers with new orders. Manufacturing restarted and international trade resumed. The global economic switch was suddenly turned back on.

Unfortunately, restarting the global manufacturing machine after the lockdown turned out to be anything but seamless. The vast and interconnected system that continuously moves raw materials and finished products all around the globe, requires predictability and precision. But with the advent of Covid, both had been lost. And, when the switch did turn back on, it occurred when thousands of shipping containers were stuck in the wrong place.

Many containers that carried millions of protective face masks to Africa and South America early in the pandemic today remain empty and uncollected because shipping companies, aiming to make up for lost time and lost profitability, decided to direct their vessels towards their most profitable routes between Asia and North America or Europe.



With significantly fewer containers suddenly in circulation, this resulted in an immediate imbalance between the supply and demand for usable shipping space. Unfortunately, it is this global supply chain breakdown that is directly contributing to the spike in transportation costs we are now witnessing, as well shortages in key manufacturing components, order backlogs and frustrating delivery delays. Perhaps most obvious of all, we are seeing these effects coalesce all around us in the form of rising consumer prices.



Inflation – temporary or permanent?

And that leads to the question that policymakers and market participants are now grappling with – are these price rises likely to be temporary or something more permanent?

Inflation measures have certainly gone up but that only reflects what we already know – that many prices have already increased. It doesn't tell us how persistent those price rises may prove to be. In fact, if recent price rises can largely be attributed to supply chain issues, which are likely to be remedied in time, then the idea that the current inflation spike will only be temporary may have more credence.

Earlier in the year, long term interest rates rose sharply as forward-looking markets were anticipating a global economic acceleration would propel both growth and inflation rates higher. However, as the year has progressed, several of the world's largest economies have recently had their future economic growth projections revised downwards in light of these existing manufacturing and supply side constraints. At least temporarily, this paints a picture of rising inflation and reducing growth – a relatively rare condition (known as stagflation) that most central bankers are extremely wary of.

Interest rate arm wrestle

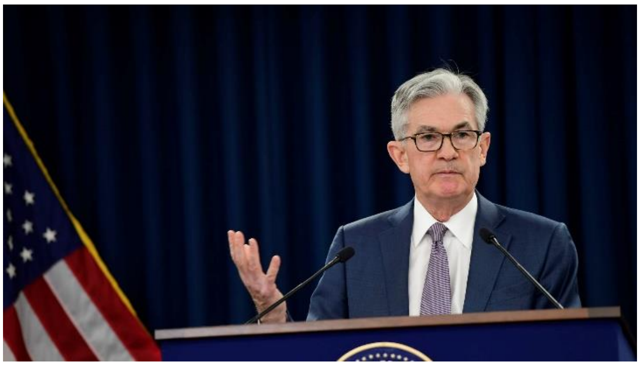
After losing momentum from April through to early September, long term bond yields – led by the 10-year US Treasury bond – rose again during the second half of September following policy meetings from the Bank of England and the US Federal Reserve, both indicating a need to consider raising interest rates in the wake of rising inflation.

Although many of the current inflationary forces are still seen as transitory, persistent disruptions in supply chains and surging energy costs have increased fears that inflation might last longer than anticipated. This added impetus to the increase in global yields from mid-September.

Weighing into this debate, Federal Reserve Chairman Jerome Powell said they anticipate the current surge in prices, due primarily to supply-chain bottlenecks, continuing into next year before fading. He said the Federal Reserve doesn't expect the current inflation spike to "lead to a new inflation regime, in which inflation remains high year after year."

Powell also conceded that the Federal Reserve faced a situation it hasn't encountered for a very long time: an emerging tension between the bank's two primary objectives of low, stable inflation and high employment. The dilemma for Federal Reserve rate setters is that any movement towards increasing interest rates to dampen inflation is likely to be negative for economic growth, which could in turn lead to increased unemployment.

The world continues to watch developments in this space with keen interest.



China struggles

Outside of the major markets, China also hit the headlines for a range of reasons recently, not least of which being the relatively poor performance of the Chinese sharemarket last quarter.

Chinese shares have always been subject to something of a "China discount" in respect of the perceived additional political risk, but investors appeared to be surprised by the speed and swiftness with which large parts of the economy have been targeted for new regulations.

A regulatory crackdown on social media and education firms contributed to weaker share prices in those areas. Companies with exposure to property also suffered as a result of the government's clampdown on leverage coupled with a liquidity crisis at Evergrande, a very large Chinese property developer. There was even a Chinese ban on cryptocurrency transactions announced on 24 September which knocked the price of bitcoin.

As if that wasn't enough, a rush by provincial authorities to meet strict national carbon-emissions targets, together with tight supplies of coal, have led to power shortages, which could in turn weigh on both the wider economy and asset prices.

But . . . not all doom and gloom

So, on the surface – where the media tend to search for their headlines – the new information presented during the quarter seemed rather negative. It might be one explanation as to why returns during the quarter were fairly flat. However, when you scratched a little deeper, there was often better news to be found.

Globally, most countries have successfully reduced the spread of the highly infectious delta strain via a combination of vaccines and increased mobility restrictions. And, with global vaccination rates still climbing, there is a sense of the tide slowly turning in this global fight. It is far from an immediate salve but is a brighter light at the end of the tunnel.

On this pathway towards greater personal and economic freedoms, we can begin to consider the impact this might have on trade, business profitability and economic prosperity. Taken together, the International Monetary Fund and World Bank see an average global growth rate next year of 4.6%. This may be a touch below the current growth rate, but this is still a very healthy rate of annual growth for the world economy relative to its pre-Covid pace of around 3%.

A global reopening with increasing vaccination rates may also help reduce inflation pressures as the business community consistently gets back to work. Earnings volatility should reduce as supply chain pressures ease and businesses incur less of the stop/start disruptions they have experienced with respect to operations and earnings. And while global interest rates may have commenced an upward path, they are likely to remain highly attractive (by historical standards) for quite some time, providing significant ongoing support to share markets.

Covid-19 will go down in history as a global health disaster and an extraordinary economic disrupter. It is rare that the world is so utterly unprepared for something so seismic. But, while its health impact may linger long into the future, its long-term economic impact – in aggregate – may be considerably less devastating.

Key Market Movements for the Quarter

The quarter started on a positive note for most markets but gains generally eased in September amid concerns of rising inflation, worries about China, and energy shortages in Europe.

The New Zealand share market performed better than most developed markets with the economic growth rate (2.8% in the second quarter) reported to be much stronger than expected. Before heading into a new lockdown in the third quarter, New Zealand's economy was enjoying high employment, relatively strong household and business balance sheets, and the expectation of ongoing fiscal support from the New Zealand government.

Key interest rates changed little internationally although, as inflation fears strengthened, the focus returned to the likely size and timing of future interest rate hikes around the globe. Rising yields on US Treasuries in September underlined the market view that rate hikes could be brought forward in addition to an earlier tapering in their asset purchase programme.

In August, New Zealand was poised to be one of the first developed nations to commence raising interest rates; its first hike in seven years. This was only stymied at the eleventh hour as New Zealand went into another Covid-related lockdown, with the highly anticipated first move upwards in rates being deferred until early October.

International Shares

+0.5% (hedged to NZD)

+1.3% (unhedged)

International developed share markets generally delivered low positive returns during the third quarter of 2021.

In the USA, the flagship S&P 500 Index (total returns in USD) was in line with the broad market, gaining +0.6% for the quarter. Strong company earnings supported the index through July and August, but growth and inflation concerns late in the quarter saw US shares retrace their steps in September.

European markets followed a similar pattern, with weakness later in the period due to rising energy prices and concerns that supply-chain bottlenecks would drive inflation higher.

Although the headline returns for USA and Europe were similar, the drivers of returns varied quite markedly. In the USA, leading performers were in the large capitalisation space, with financials and utilities sectors leading the way. In Europe, it was small capitalisation companies that generally outperformed, with the energy sector, in particular, recording strong gains.

After generally lagging over the last couple of years, the UK market performed a little better than its European peers over the quarter with the MSCI UK Index gaining +2.2%. Increased merger and acquisition activity helped drive market sentiment overall, while weakening economic indicators were otherwise reflected in a wide dispersion in company returns across sectors.

All of these results paled next to the Japanese market where the MSCI Japan Index increased by +5.3% with corporate profit results, purchase orders and capital expenditure plans all looking relatively strong. The quarter also saw the surprise resignation of Prime Minister Yoshihide Suga who was replaced by Fumio Kishida, an establishment politician considered to be a safe, if unexciting, choice to guide Japan through the next stage of its post-Covid recovery.

In New Zealand dollar terms, the MSCI World ex-Australia Index delivered a quarterly return of +0.5% on a hedged basis and +1.3% unhedged. The rolling 12-month return for the New Zealand dollar hedged index was +28.4% while the unhedged index gained +23.4%.

Emerging Markets Shares

-6.8%

Emerging market equities struggled in the third quarter which saw a sell-off in Chinese shares, concerns over continued supply chain disruptions, and worries over the implications of higher food and energy prices in some markets.

Regulatory actions in China were the initial trigger for market weakness. These were compounded by the re-imposition of some Covid-19 restrictions, power shortages, and worries about possible systemic financial system risks stemming from the potential collapse of Chinese property developer Evergrande.

Brazil was also weak as above-target inflation continued to rise and the central bank there responded with further interest rate hikes, while the South Korean market was impacted by falling prices for dynamic random access memory chips (DRAM) as well as general supply chain concerns.

In stark contrast, net energy exporters generally outperformed, most notably Colombia, Russia, Kuwait, Saudi Arabia, Qatar and the UAE. India also delivered a strong gain, with investor sentiment boosted by a recent stream of initial public offerings.

In unhedged New Zealand dollar terms, the MSCI Emerging Markets Index produced a quarterly return of -6.8%, for a +13.6% return over the last 12 months.

New Zealand Shares

+5.2%

New Zealand was one of the better performing global developed share markets through the quarter with the S&P/NXZ 50 Index returning +5.2%.

With underlying economic conditions still broadly favourable and the market 'looking through' the ongoing Covid uncertainties, it was generally the larger companies within the index which performed better than the smaller capitalisation firms. The most significant contributions came from firms in the Healthcare and Industrials sectors.

In the Healthcare sector, it was Pacific Edge leading the charge with a gain of 24.4% following strong interest in a retail placement to help support their US growth strategy. Ryman Healthcare also performed strongly, up 15.0% after announcing record first quarter sales and continued expansion in Melbourne.

In the Industrials sector, the continuation of a stellar year for Mainfreight saw their share price advance another 26.6%. On 1 September, they announced significantly improved revenue and profitability figures compared with the same 22-week period last year.

All sectors made a positive contribution over the quarter with the exception of the Consumer Discretionary sector, where the increased lockdown restrictions likely had a more immediate impact. SkyCity Entertainment, down -6.8% for the quarter, was the worst affected in this sector.

Australian Shares

-0.7%

In spite of a September sell-off, the Australian share market also returned a positive quarter in local currency terms, with the S&P/ASX 200 Index (total return) in Australian dollars gaining 1.7%. In direct contrast to the New Zealand market, the largest capitalisation firms generally struggled over the quarter, while good returns were delivered by the mid and small capitalisation end of the market.

Within the large capitalisation space, it was the Materials sector that caused the largest drag on performance, with market heavyweights BHP (-17.0%) and Fortescue Metals (-26.9%) delivering disappointing returns on the back of weakening iron ore prices and, in BHPs case, an underperforming energy business.

Offsetting this was a positive contribution from all other sectors, and, in particular, a good performance from the important (i.e. sizable) Financials sector, where a number of firms recorded strong double digit returns, including Clearview Wealth (+38.0%), Challenger (+18.0%), Suncorp Group (+17.4%) and Macquarie Group (+16.4%).

Returns to unhedged New Zealand investors were slightly negative due to a depreciation in the Australian dollar over the quarter.

International Fixed Interest

0.0%

While the US 10-year Treasury Bond yield finished the quarter at 1.49%, only one basis point higher than it closed in June, it was the pathway to get there that interested markets. Yields fell initially, as the rapid economic recovery appeared to be moderating. However, as the market's focus turned to rising inflation and the prospect of the withdrawal of monetary policy support, yields rose back to the levels seen at the start of the quarter. The Federal Reserve also recalibrated expectations regarding their ongoing asset purchase programme, suggesting they could commence a tapering of asset purchases as early as November 2021 and completed by mid-2022, earlier than originally expected.

The UK 10-year yield increased from 0.72% to 1.02%, with the move occurring in September. As with the Federal Reserve, there was clear signalling from Bank of England policymakers that rate rises might be warranted before the end of the year. Recent economic indicators came out worse than expected, while year-on-year consumer price inflation rose to 3.2% in August, the highest since 2012.

The German 10-year yield was one basis point lower at -0.19%, while Italy's 10-year yield finished 0.04% higher at 0.86%. In spite of worries about inflation and higher energy prices, economic activity continued at a robust pace across Europe. Having come out of lockdowns relatively late, the region appeared to benefit from a similar release of pent-up demand that had been witnessed elsewhere. In August, Eurozone inflation recorded a decade high 3.4% per annum.

With little overall movement in international yield curves over the quarter, returns for high quality, low duration bonds were largely flat, while investment grade and higher yielding credit securities generally outperformed government bonds.

The FTSE World Government Bond Index 1-5 Years (hedged to NZD) made +0.0% for the quarter, while the broader Bloomberg Global Aggregate Bond Index (hedged to NZD) returned +0.1%.

New Zealand Fixed Interest

-1.3%

At its 18 August 2021 meeting, the Reserve Bank of New Zealand (RBNZ) once again elected to leave the official cash rate at 0.25% however, it was only the recent return to Level 4 lockdown that deferred the anticipated increase in interest rates. The Monetary Policy Committee advised this was only a delay due to the sudden increase in health uncertainties, not a change in their planned approach. This was subsequently verified on 6 October when they announced an increase in New Zealand's official cash rate from 0.25% to 0.50%.

Faced with clear signalling about inflation concerns and higher interest rates, the NZ 10-year yield, after bottoming out at 1.49% in late July, rose steadily throughout August and September to close the quarter at 2.01%. This led to negative quarterly returns for both the corporate and government bond indexes.

Over the quarter, the movement up in yields was slightly larger for shorter duration bonds, resulting in a 'flattening' of the New Zealand yield curve. This culminated in shorter duration bonds performing a little worse than longer duration bonds.

The S&P/NZX A-Grade Corporate Bond Index fell -1.3% for the quarter, while the longer duration but higher quality S&P/NZX NZ Government Bond Index fell -1.2% for the quarter.

Asset Class Returns to 30 September 2021

Asset Class	Index Name	3 months	6 months	1 year	3 years	5 years	10 years
New Zealand Shares	S&P/NZX 50 Index, (gross with imputation credits)	+5.2%	+6.1%	+13.7%	+13.2%	+13.5%	+16.1%
Australian Shares	S&P/ASX 200 Index (total return)	-0.7%	+6.0%	+26.3%	+8.2%	+10.3%	+8.7%
International Shares	MSCI World ex Australia Index (net div., hedged to NZD)	+0.5%	+8.2%	+28.4%	+12.0%	+13.8%	+14.7%
	MSCI World ex Australia Index (net div.)	+1.3%	+9.5%	+23.4%	+11.7%	+15.1%	+14.0%
Emerging Markets Shares	MSCI Emerging Markets Index (gross div.)	-6.8%	-3.1%	+13.6%	+7.5%	+10.8%	+7.5%
New Zealand Fixed Interest	S&P/NZX A-Grade Corporate Bond Index	-1.3%	-1.0%	-4.1%	+2.9%	+3.1%	+4.5%
International Fixed Interest	FTSE World Government Bond Index 1-5 Years (hedged to NZD)	+0.0%	+0.1%	-0.1%	+2.5%	+2.0%	+3.2%
New Zealand Cash	New Zealand One-Month Bank Bill Yields Index	+0.1%	+0.2%	+0.3%	+0.9%	+1.3%	+2.1%

Unless otherwise specified, all returns are expressed in NZD. We assume Australian shares and emerging market shares are invested on an unhedged basis, and therefore, returns from these asset classes are susceptible to movement in the value of the NZD. Index returns are before all costs and tax. Returns are annualised for time periods greater than one year.