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Spring Update
July - September 2022

Investment Commentary

The global economy has been buffeted by multiple challenges in 2022 and it is fast shaping up as a year not many will remember fondly. During the drawn-out lockdowns and upheaval that accompanied the peaks of Covid-19, the world collectively pined for a seamless post-Covid recovery. The reality however, has been rather bumpy.

Amidst a backdrop of sharply increasing inflation, tight labour markets, rapidly rising interest rates, and ongoing uncertainties surrounding both the war in Ukraine and the lingering pandemic, the global economy has stutter-stepped its way through 2022.

Soaring food and energy prices are eroding real incomes, triggering a global cost-of-living crisis. Economic growth in the world's three largest economies - the United States, China, and the European Union - is weakening, with significant spill over to other countries.

Business confidence has been on a gradual decline since mid-2021, with the deterioration particularly concerning for many developing countries that are yet to fully recover from the pandemic. Global trade has remained relatively subdued, as global supply chain disruptions and bottlenecks in international freight movements have been slow to improve.

Although international food and energy prices may have eased from recent peaks, they continue to sit at uncomfortably high levels. Inflationary price pressures, which have reached multi-decade highs in many countries, are hitting vulnerable population groups hard and prompting central banks to accelerate their efforts to tame inflation.

Good news is seemingly in short supply at present and these highly publicised economic, political and health challenges have all contributed to persistent headwinds for investment markets. However, the unforgettable lesson from all previous market corrections is that periods of weakness can often provide the best opportunities for long term investors.

Ripple effects

Even before Russian President Vladimir Putin ordered the invasion of Ukraine, the global economy was under pressure.

Inflation was already higher than markets were anticipating, as the initial recovery from the pandemic recession was stronger than expected. The demand surge quickly overwhelmed factories, ports and freight yards, causing delays, shortages and pushed prices higher.

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In response, central banks began raising interest rates to cool economic growth and contain spiking prices. Unfortunately, with the stop-start nature of the Covid-era causing much more volatility in key economic indicators like growth and inflation, it became more difficult for central banks to 'steer the ship'. If they leant too far towards supporting economic recovery and growth, they faced a bigger fight to control mounting inflation. But if they focused too rigidly on dampening down price increases, they pushed economies much closer to possible recession. It's an economic highwire act with a hefty consequence attached to any misstep.

At the same time, China, pursuing a zero-Covid policy, imposed lockdowns that temporarily weakened the world's second largest economy. Elsewhere, many developing countries still grappled with the pandemic and the heavy debts they had taken on to protect their populations from economic disaster.

As disruptive as they were, all of those challenges might have been manageable. But when Russia invaded Ukraine on 24 February, the West responded with heavy economic sanctions which further disrupted trade in the critical areas of food and energy. Russia is the world's third-biggest petroleum producer and a leading exporter of natural gas, fertiliser and wheat, while farms in Ukraine feed millions globally.

The inflationary impacts resulting from this disruption have rippled out to the world.

Inflationary indicators easing

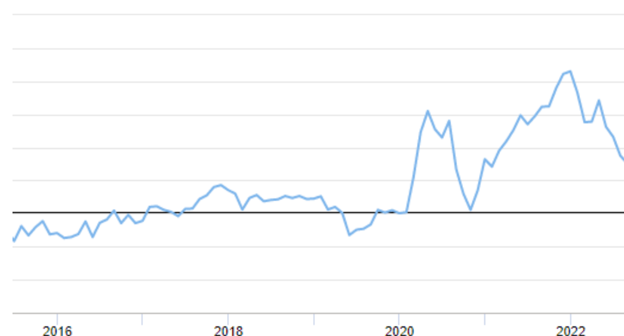
The fight against inflation is being waged globally. And, while it is too early to declare victory, economic data continues to point to a peaking in inflation which, all things being equal, should begin to be reflected in lower average inflation readings in the future.

Importantly, the decline in inflation indicators is relatively broad-based. Delivery times and shipping costs are improving amidst the economic slowdown. Backlogs of electronic components have reduced back to their long-run averages. Ratios of orders-to-inventory, which swung to historical highs following the covid shutdowns, have moved back towards historical lows as many inventories have been significantly replenished.

The general slowdown in global demand has also taken pressure off commodity prices and allowed supply chains to partly normalise. Oil prices continued to recede in the recent quarter, providing some welcome relief to consumers at the petrol pump. Ending September at around US$80 per barrel, the international oil price has fallen by US$40 from its early June peak of US$120 per barrel, a 33% decline.

While all of this is *indicative* of an improving global supply chain, this is a complex system in which change can be difficult to quantify. To that end, the Federal Reserve Bank of New York has developed a 'Global Supply Chain Pressure Index' that combines variables from multiple indices in transportation and manufacturing, such as those related to delivery times, prices, and inventory. Since hitting a historical peak in December 2021, this measure of global supply chain pressure, while still reporting elevated readings, is now more than three quarters of the way back to typical pre-Covid levels.

Global Supply Chain Pressure Index (GSCPI)



Interest rates

Fixed interest markets continue to be highly focused on inflation, monetary policy signals from central banks and the state of the economy.

Considerations about the economy are largely centred on two competing themes:

a) supply-based constraints leading to higher labour and goods prices
b) forward-looking concerns about potential recession risks

In New Zealand, escalating recession fears in July, linked to the idea of potentially fewer interest rate hikes, drove New Zealand 10 year government bond yields down to their lowest levels since April. By late August, however, the focus had shifted almost entirely to the policy comments made by central banks. In synchronicity with other major central banks, the Reserve Bank of New Zealand (RBNZ) reaffirmed its absolute focus on getting inflation back down towards its target range, resulting in the New Zealand 10 year government bond yield moving back to its June highs.

It was a very similar pattern in the USA. The yield on the US 10 year treasury bond reached an intra-year high of 3.5% in the middle of June, before steadily declining over the next six weeks as market concerns about recession risks took centre stage. However, as it became clear the Federal Reserve was steadfast in its commitment to subduing inflation, yields quickly rose again from early August, back beyond the prior peak, and briefly touched 4% near the end of September, a yield not seen on the US 10 year treasury bond since 2010.

With interest rates rising everywhere, the degree of tightening will ultimately depend on local conditions. In New Zealand, the RBNZs latest projections are for the Overnight Cash rate to rise to just over 4% in 2023. With the RBNZ having recently adjusted this benchmark rate to 3.50% on 5 October, it implies we are getting closer to the end of the current round of rate rises. That’s certainly what many homeowners with mortgages will be hoping.

Farewell to Queen Elizabeth II

The UK hit the headlines for a very different reason during the quarter - on 8 September the world was met with the sad news that Queen Elizabeth II, the UK's longest-serving monarch, had died at Balmoral aged 96, after reigning for 70 years.

The Queen ascended to the throne in 1952 and witnessed enormous social change during her reign. She also worked with 15 different prime ministers, from Winston Churchill in 1952, to Liz Truss who took office on 6 September, just two days before Queen Elizabeth’s death.

Goodbye modern monetary theory

With the UK barely out of its official mourning period, Liz Truss alongside Chancellor Kwasi Kwarteng announced the country’s biggest tax package in 50 years. The package was aimed at boosting UK growth by cutting taxes and regulation and was to be funded by vast amounts of new government borrowing.

Unfortunately, the announcement met with almost universal opposition.

The International Monetary Fund openly criticised the plan, warning that the proposed measures were "likely to fuel the cost-of-living crisis." The financial market reaction was equally severe, sending a very strong signal that modern monetary theory, which was fashionable during the Covid-19 pandemic, is now completely discredited.

This modern monetary theory was that monetarily sovereign countries (like the UK, USA and New Zealand) do not need to rely on taxes or borrowing to support their spending objectives. Since they are the monopoly issuers of their own currency, they can simply print and spend as much as they need. However, the seismic market fallout that erupted following the UKs late September tax proposals strongly suggests otherwise.

The proposed plan triggered an immediate crisis of investor confidence in the UK government – jolting global financial markets to such an extent that the Bank of England had to intervene with a pledge to purchase 65 billion pounds of UK government bonds in order to stem a potential market rout.

This led to the UK government quickly back-tracking and scrapping some of the tax plans they had unveiled to much fanfare, only a few days earlier.

What next?

Quite apart from the ever-present challenge of living in a world that is still managing the ongoing impacts of the pandemic, grappling with a significant geopolitical conflict, and enduring a cost-of-living crisis, long term investors have also had their patience tested by these events.

Portfolio valuations have been volatile in 2022, reflecting the uncertainties surrounding these complex real-world issues. Share markets have been buffeted as investor confidence has waned, and bond markets have suffered due to rapidly changing interest rate expectations.

Although it is hard to point to much obvious good news at present, one source of comfort should be that investor sentiment is currently very negative. That may sound counterintuitive, but when investor sentiment is strongly negative it means the markets have very likely factored in (and priced in) all of the existing bad news.

That's why at the end of September, investors could buy a 10 year New Zealand Government bond yielding 4.3%, when at the start of the year it was yielding just 2.4%. It's also why the price-to-earnings ratio of the globally significant S&P 500 Index in the USA was at 19.8, down from 26.3 at the start of the year and 37.3 at the end of 2020. In the investment world, unlike in our real-world supermarkets, almost everything is now cheaper.

S&P500 P/E ratio (30 year history)

In many ways, the investment discounts available today versus what investors were paying only a matter of months ago should be enough to see buyers queuing around the street. For the moment, the queues are relatively short. But as greater clarity gradually emerges about global inflation, interest rates and economic growth rates, the prices available in financial markets today might very well look highly appealing. And one thing we do know is that forward-looking markets always have the capacity to respond (and respond quickly) to the prospect of better times ahead.

While investor patience has been tested this year, it is always important to remind ourselves that:

i) ***investment returns often come in spurts*** - making it important that we stick to our long term strategy.

ii) ***markets are volatile*** - meaning they can go down as well as up, so down periods should always be expected.

iii) ***critical to achieving sound long term investment outcomes is good 'investor behaviour'*** - which means holding on to quality assets that have become temporarily cheaper, rather than being tempted to sell at a discount.

As always, we don't profess to know how or when the most significant events in the world today will be resolved. However, we do expect that central bank actions to contain inflation will eventually achieve that aim. We also expect that interest rates will eventually stop their ascent and reflect a new post-Covid equilibrium. We even expect the current conflict in Ukraine to reach a conclusion.

In the meantime, in spite of prevailing uncertainties, we expect global capitalism to continue to find ways to survive and thrive and for long term investors to continue to benefit from a consistent exposure to those endeavours over time.

Key Market Movements for the Quarter to September, 2022

Volatility remained high through the third quarter of 2022 as markets priced in changing expectations on the economic impact of rapidly rising interest rates, increased European energy uncertainty, and the lingering effects of COVID-19. The quarter was a story of two halves, with July and August delivering some initial relief and strong returns for battered investors in both share and bond markets, until September reversed course, wiping out the majority of earlier gains.

Inflation continues to run hot in most nations and central banks remain committed to raising interest rates hard and fast in order to achieve greater price stability, in spite of the risk to future economic growth. The quarter included rate hikes from almost every major central bank, and in many cases multiple hikes, leading to aggregate rate increases rarely seen in history.

Economic indicators have already begun to reflect increased business costs and a general reduction in consumer demand. While this will dampen inflationary pressures it has also started to erode firm earnings and overall global economic growth. In fact, the US formally entered a technical recession on 30 September with the official measure of real GDP growth (i.e. after adjusting for inflation) coming in negative for two consecutive quarters. To date, the job market has remained robust with unemployment near all-time lows. However, as growth weakens, the prospect of a 'hard' or 'soft-landing' hinges on the ability of firms across all industries to weather the storm and keep their labour force employed as the global economy slows.

International Shares

-5.1% (hedged to NZD)
+4.7% (unhedged)

The quarter began with a sharemarket rally, as hopes of a pivot to interest rate reductions in 2023 helped raise growth prospects. These hopes were dashed following a summit of central bankers which reaffirmed their commitment to fighting inflation through higher interest rates which took place through the quarter.

The S&P 500 Index lost -4.9% for the quarter in USD terms after being up +9.2% at the end of July. Consumer discretionary was the strongest sector, led by Amazon who reported solid mid-year revenue growth and a rosy projection for the third quarter. The energy sector was also a strong performer with Exxon Mobil and Chevron Corporation advancing, despite the oil price having declined from its June peak.

Across the Atlantic, European shares were down with inflationary concerns, in particular increasing energy costs, weighing on the economy. Nord Stream 1, the main gas pipeline between Russia and Europe was 'closed for maintenance' for long periods, and leaks to the Nord Stream 2 under the Baltic Sea have raised concerns of energy shortages this European winter. Natural Gas prices remain heightened, trading as much as three times the 2022 opening price. The European and British central banks raised interest rates through the quarter and the Euro tumbled to a 20 year low against the US dollar. All of this contributed to losses and the S&P Europe 350 index declined -4.0% in local currency terms.

A weak New Zealand dollar and a very strong US dollar moved the USD/NZD rate by over 10% (from 0.624 to 0.559). While this now makes holidays to Hawaii more expensive for Kiwis, it also means significant foreign exchange gains for local investors holding unhedged securities. This sort of price action often occurs during times of market stress.

In New Zealand dollar terms, the MSCI World ex-Australia Index delivered a return of -5.1% for the quarter on a hedged basis, and +4.7% unhedged. This meant the rolling 12 month

return for the New Zealand dollar hedged index reduced to -17.1%, while the unhedged index is down -1.0%.

Emerging Markets Shares

-1.1%

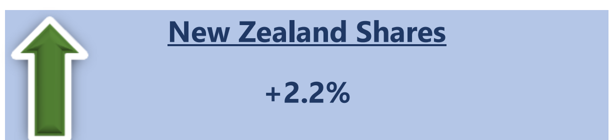
Against the backdrop of slowing global growth, heightened inflationary pressure and rising interest rates, emerging market equities posted negative returns in the third quarter.

China underperformed by a significant margin which dragged the overall index down. A slump in the Chinese property market weighed on investor sentiment, and the imposition of Covid-related lockdowns in various major cities negatively impacted domestic demand. Growth-sensitive north Asian markets, such as South Korea and Taiwan, also declined as the outlook for global trade deteriorated.

Poland and the Czech Republic were also among the biggest decliners, as the Russian war in Ukraine escalated and led to an energy crisis in Europe, which in turn has contributed to accelerating inflation across Europe.

India and Indonesia posted positive returns which were well ahead of the broader index, and Brazil also performed well as Brazilian growth and inflation data both improved.

The MSCI Emerging Markets Index produced a quarterly return of -1.1% in unhedged New Zealand dollar terms and has returned -10.9% over the trailing 12 months.



New Zealand Shares

+2.2%

The New Zealand market was able to hold on to early gains through the quarter with the S&P/NZX 50 Index posting a welcome gain of +2.2%. The quarter again delivered a high level of dispersion with individual company returns ranging from -30% to +25%.

Electricity 'gentailers' (generators/retailers) enjoyed a strong quarter with almost all of the big players advancing. Our largest company Meridian, delivered a solid gain of +5%, while infrastructure investment company Infratil returned a healthy +12.6% with news of its stake in a US renewable energy company having tripled in value.

Second largest index constituent, Fisher & Paykel Healthcare, declined -7.4% after the company advised its profits would fall sharply from the same year-ago period, when demand was extraordinarily high due to the Covid-19 pandemic.

Other larger firms, Air New Zealand (+25%) and a2 Milk (+24%), saw their share prices surge for contrasting reasons. The airline reversed losses from earlier in the year as sales continued to pick up thanks to border re-openings and the continued relaxation of the Covid-19 restrictions. Stronger than expected revenue results and a share buyback announcement boosted a2's returns, rewarding company investors who have endured a challenging few years.

Fast food retailer Restaurant Brands NZ Ltd (owner operator of KFC, Pizza Hut, Carl's Jr. and Taco Bell in New Zealand) was the biggest loser over the quarter. The share price fell -29% as rising food costs resulted in declining profits and the group announced the retirements of their CEO and CFO.

Australian Shares

+3.8%

The Australian share market (ASX 200 Total Return Index) was robust through the quarter delivering +0.4% in local currency terms. Returns to unhedged New Zealand investors were better at +3.8% due to the relative strength of the Australian dollar.

The fate of the Australian market is largely tied to the performance of their banking and mining companies, and both were, in

aggregate, positive over the quarter. The 'Big Four' lenders (CBA, NAB, Westpac and ANZ) were especially robust with their revenue expectations benefiting from higher interest rates. Materials giants Rio, BHP, Fortescue and South32, declined on the back of weakening global growth expectations, while smaller players, especially those involved in lithium, cobalt and other clean energy metals (eg. Pilbara Minerals Ltd: +99%, Mineral Resources Limited: +38%) thrived.

Large biotech firm CSL led the Healthcare sector up, while energy producers such as Woodside benefitted from increased demand for their oil and gas as opposed to supplies from Russia. Real estate struggled with increased borrowing costs and uncertainty about future tenant viability weighing on the sector.

International Fixed Interest

-1.9%

Fixed income markets began the quarter pricing in the possibility of interest rate *reductions* ahead, given concerns the initial rate hikes might cool the economy too quickly. This generally pushed yields down and delivered gains for fixed income investors. However, hopes of a pivot to a loosening of policy (i.e. lower interest rates) were dashed following the Jackson Hole Economic Symposium in late August and subsequent announcements from the US Federal Reserve, in particular, reaffirming their dedication to fighting inflation.

The 'Fed' raised US rates twice to 3.25%, a long way from the 0.25% setting in March this year. The US 10 year bond yield rose from 3.02% to 3.83% over the quarter spending some time briefly above 4%, a level not seen since 2010. Shorter duration bonds saw even higher increases as the prospect of higher rates for longer were priced in; the US 2 year bond yield closing the month at 4.27% after commencing at 2.96%. With 2 year yields ending the quarter higher than 10 year yields, this 'inverted' yield curve is a clear signal that investors remain wary about the future strength of the US economy.

The European Central Bank (ECB) faces an even more complex task with their policy decisions affecting many nations with varying economic stability. This is compounded by the energy crisis unfolding as a result of the Russian invasion of Ukraine and Euro Area inflation reaching a record high 10% p.a. The ECB increased interest rates twice from zero to 1.25%.

In the UK, the Bank of England ('BoE') continued their tightening cycle with two further 50bps interest rate hikes, bringing the total to seven in the current cycle. The late quarter 'mini-budget' announcement by the new UK Chancellor was very poorly received and sparked a sharp selloff in UK Government Bonds ('Gilts') as the market priced in expectations of increased borrowing to finance these policies. The gilt market volatility spiked and the BoE was forced to provide emergency liquidity to protect bondholders, in particular large pension funds. With the market remaining highly critical of the UKs ability to finance these polices, the British pound weakened significantly.

In this increasing yield environment, fixed income securities were negative across the board, with longer duration bonds generally delivering worse returns. Corporate bonds also suffered, and generally underperformed government bonds as credit spreads continued to widen, especially in September.

The FTSE World Government Bond Index 1-5 Years (hedged to NZD) returned -1.9% for the quarter and is -5.4% over the trailing 12 months. The broader Bloomberg Global Aggregate Bond Index (hedged to NZD) declined returned -3.7% in the quarter and is -12.3% for the last 12 months.

The Reserve Bank of New Zealand (RBNZ) continued with its monetary tightening cycle, increasing the Official Cash Rate (OCR) twice in the quarter taking this benchmark rate to 3.00%.

In their accompanying statement, the RBNZ noted that "Global consumer price inflation has continued to rise, albeit with some recent reprieve from lower global oil prices. ... The outlook for global growth continues to weaken, reflecting the ongoing tightening in global monetary conditions."

The statement also noted that monetary conditions needed to continue to tighten until the Monetary Policy Committee are confident there is sufficient restraint on spending to bring inflation back within its 1-3 percent per annum target range.

With New Zealand inflation at 7.3% year-on-year in July (next announcement due 18 October), and the August unemployment rate at a very low 3.3% this continued tightening policy is consistent with the banks dual mandate to maintain price stability and contribute to maximum sustainable employment.

Similar to the effects seen overseas, rising bond yields generally resulted in negative short-term returns for bonds of all durations, with longer term and lower quality bonds declining more.

The S&P/NZX A-Grade Corporate Bond Index fell -1.1% for the quarter, while the longer duration but higher quality S&P/NZX NZ Government Bond Index fell -1.9%.

Asset Class Returns to 30 September 2022

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)	2.2%	-8.2%	-16.0%	1.1%	7.8%	12.4%
Australian shares	S&P/ASX 200 Index (total return)	3.8%	-6.4%	0.8%	4.7%	7.9%	7.4%
International shares	MSCI World ex Australia Index (net div., hedged to NZD)	-5.1%	-19.4%	-17.1%	4.5%	5.7%	10.3%
	MSCI World ex Australia Index (net div.)	4.7%	-2.6%	-1.0%	8.6%	10.9%	12.6%
Emerging markets	MSCI Emerging Markets Index (gross div.)	-1.1%	-2.7%	-10.9%	2.0%	3.7%	5.5%
New Zealand fixed interest	S&P/NZX A-Grade Corporate Bond Index	-1.1%	-2.4%	-6.6%	-1.9%	1.2%	3.1%
International fixed interest	FTSE World Government Bond Index 1-5 years (hedged to NZD)	-1.9%	-2.9%	-5.4%	-0.9%	0.5%	2.1%
New Zealand cash	New Zealand One-Month Bank Bill Yields Index	0.8%	1.3%	1.7%	0.9%	1.2%	2.0%

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.