Investment Commentary

Positive global share market momentum carried into the second quarter of 2024 for the USA, although share market returns in other regions were variable.

The outlook for interest rates remained unchanged, however there is growing expectation for a general reduction in interest rates around the globe. In June, the European Central Bank and the Bank of Canada became the first of the major banks to begin cutting rates. With local inflation heading in the right direction, it looks as though the Reserve Bank of New Zealand may soon follow suit.

In the key US market, the Federal Reserve held the federal funds rate steady at 5.25% throughout the quarter, with officials there citing the need to cool persistently high inflation.

Against this backdrop, the US share market extended its bull run that began in late 2022, with the S&P 500 Index reaching all-time highs during the quarter. This performance was led, once again, by the strong performance from a handful of large capitalisation companies in the information technology sector. Unfortunately, the New Zealand share market continues to lag many of its global peers with weak economic growth, and stubborn inflationary pressures, continuing to challenge local policymakers.

On the global political stage, uncertainty and change seems to be in store in 2024. After a relatively brief campaign, the Conservatives have just relinquished Downing Street after 14 years in power in the UK. Emmanuel Macron's snap election resulted in no clear winner, leaving France without a new prime minister or

government and in political chaos just weeks before they welcome the world for the Olympic Games. Meanwhile, the lead-up to the US presidential election has been even more volatile than pundits expected, including the shocking attack on former president Donald Trump in early July and the late withdrawal of Joe Biden from the 2024 Presidential election campaign. President Biden is endorsing VP Kamala Harris as the Democratic Party nominee. Biden said the decision was "right for America."

There has been increasing pressure on Joe Biden to step aside from within the Democratic campaign, following a widely ridiculed performance in the Presidential debate, and concerns over his age and declining mental capacity. His approval rating has recently sunk to around 30%, and history has shown that anything less than a 45% approval rating is a barrier to a candidate being elected President. Kamala Harris has also won backing from the Clintons but will also need to work to lift her rating (which also sits below 40%) if nominated.

Voters (and markets) may now have to deal with the uncertainty for a period, given the question of who will step in for Joe Biden. A virtual vote could lock in a candidate by early next month, while the

other prospect is the Democratic convention starting in early August being an “open one.”

Markets had been increasingly pre-supposing a Trump win and will now be forced to consider a different outcome.

Bigger isn’t necessarily better

Over recent months, share market news has been dominated by the strong returns of some of the largest companies in the world, including several of the technology giants based in the USA.

If we look at the leading US share market index – the S&P 500 – we can break it into ten different company groupings (or deciles) of 10% each, according to company size. In other words, we can group together the largest 10% of firms in the index all the way down to the smallest 10% of firms. If we calculate the past five year returns from each of these groups, we can see that the largest 10% of firms have beaten all other size segments. This seems consistent with the reported strong performance of many large technology companies.

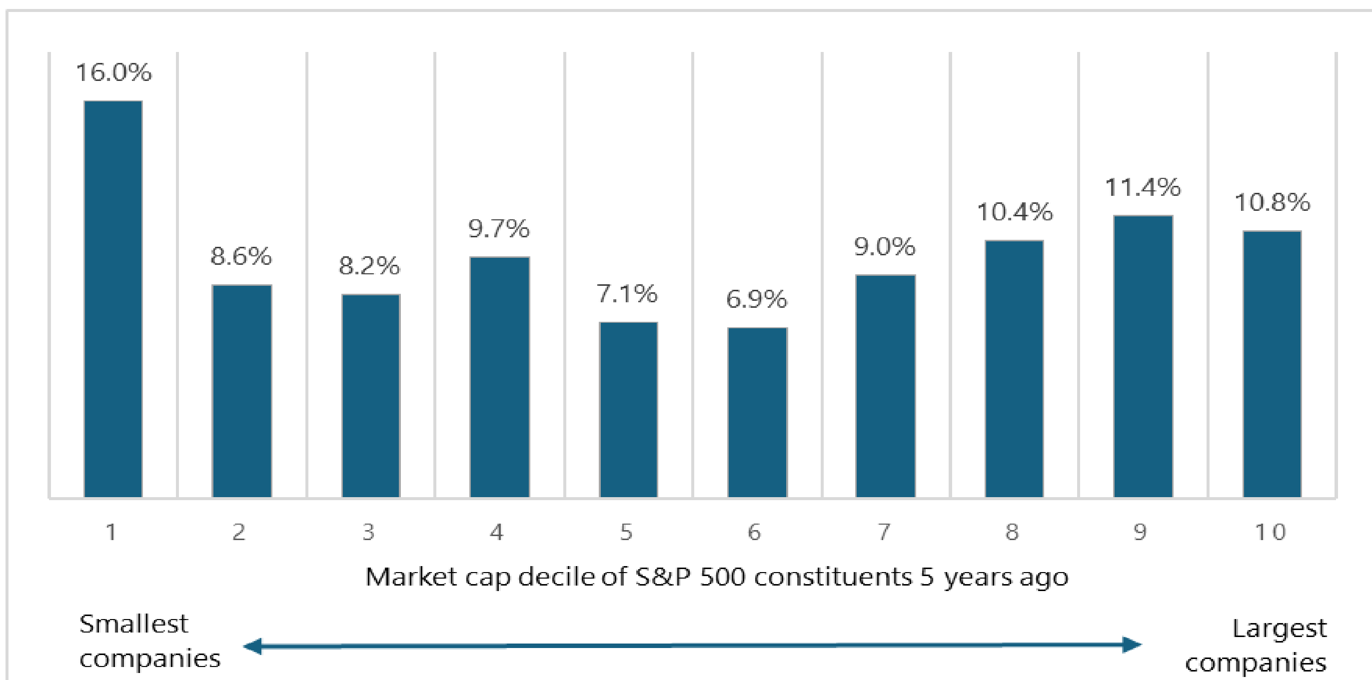
Median 5 year ***forward*** *annualised S&P 500 return by market cap decile 5 years ago*[1]*:*

However, concluding that the largest companies have performed the best would be incorrect. What the analysis as described above only tells us is how the current largest companies have performed looking backwards in time, not how the largest companies five years ago performed over the subsequent five years. If we use company size as they were five years ago as the starting point and then calculate the forward-looking returns of each size grouping, the analysis changes quite significantly.

The largest companies from five years ago have still performed well (+10.8% pa), but the top performer over the period, by a healthy margin, has actually been the smallest decile of companies (+16.0% pa).

This is the case because some of the big companies today were actually much smaller five years ago and some of the smaller companies today were also much bigger.

It’s generally unusual for the largest companies in an index to continue to outperform all others, and history tells us the best time to buy these companies is before they become large, not after.

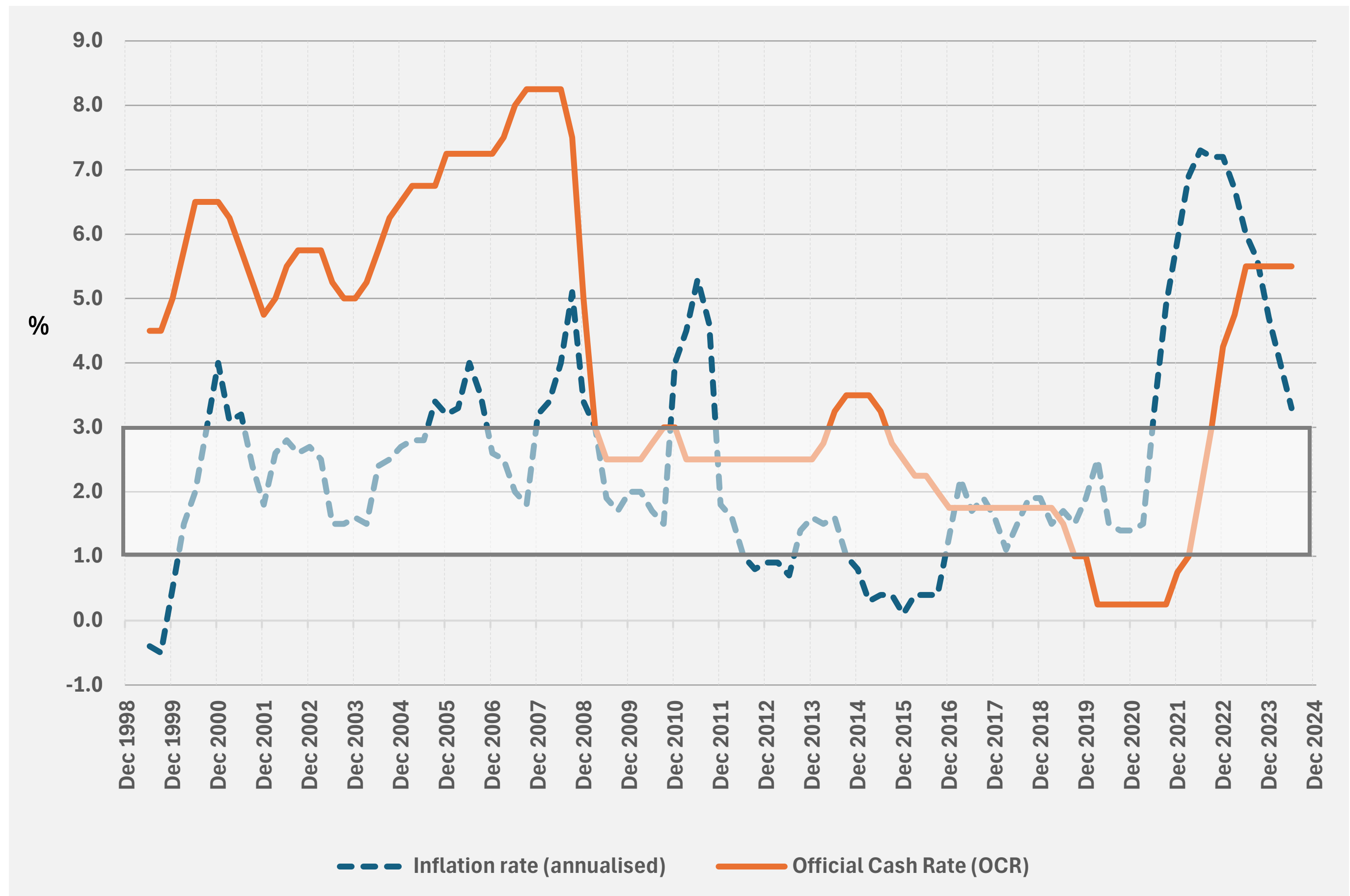


[1] Data sourced from Ritholtz Wealth Management as at 18 June 2024

New Zealand interest rates - the wait goes on

The chart below shows the annualised inflation rate (dotted blue line) plotted against New Zealand's Official Cash Rate (OCR) which is the short-term interest rate set on a periodic basis by the RBNZ (orange line).

New Zealand interest rates versus inflation:



The RBNZ aims to keep inflation within the range of 1% to 3% over the medium term (the area shaded in white). For the most part they have achieved this fairly consistently over the last 25 years. Up until 2021, there had been only occasional deviations of inflation outside this band, and most had returned back to the target range within 12 months.

However, the cost-of-living crisis has been a different story. The significant 'spike' in inflation that commenced in 2021 has so far not returned to the target band. This is why the orange line is not budging yet. The length of time that inflation has stayed above target (now three years and counting) has backed the RBNZ into a corner. They are highly reluctant to reduce interest rates until they see inflation back inside their target band. This caution has resulted in the OCR being stuck at 5.5% since May 2023.

The good news, as you can see from the chart, is that inflation is heading in the right direction, and many commentators consider that we could see interest rate reductions later this year (ahead of the RBNZ's own forecasts). Whenever it begins, it will mark the end of the most restrictive interest rate settings New Zealand has experienced in 15 years.

Does the US election matter?

We are readying ourselves for a final dash to the finish line for the US Presidential elections in November. A yet to be nominated Democratic contender versus an often divisive and controversial challenger whose run is likely to include significant time in the court rooms as well as on the campaign trail. It is surely an indictment of the US political system that we can be in such a position only months out from electing the new leader of the most influential nation in the free world.

Does it matter who wins?

In some ways, probably not. Both the Democrats and Republicans will aim to be expansionary and will keep issuing bonds and printing money. While the Democrats might spend more, the Republicans will aim to reduce taxes more.

In some ways, almost certainly. In matters of foreign policy, we can expect a Republican presidency to renew stronger rhetoric around Europe's contributions to NATO, possibly not supporting efforts to arm Ukraine, and likely promoting greater trade protectionism, particularly in respect to China. Conversely, President Biden has indicated he will propose extending tax breaks for those on low incomes while raising corporate tax rates, and potentially further promoting renewable energy development. Clearly the outcome in November will have a significant impact on some sensitive corners of the economy.

How investment markets might perform is much less predictable, although history says that patient investors will be rewarded regardless of which political party controls the White House at any given time.

One of the reasons why is because the president has no direct control over the share market. While the president influences fiscal policy to varying degrees, it is Congress that ultimately creates the federal budget, and government spending is only one of many variables that affect the share market. Also, when considering events like the dot-com bubble, the Great Recession, and the COVID-19 pandemic - no president caused those events, but all three caused share market crashes.

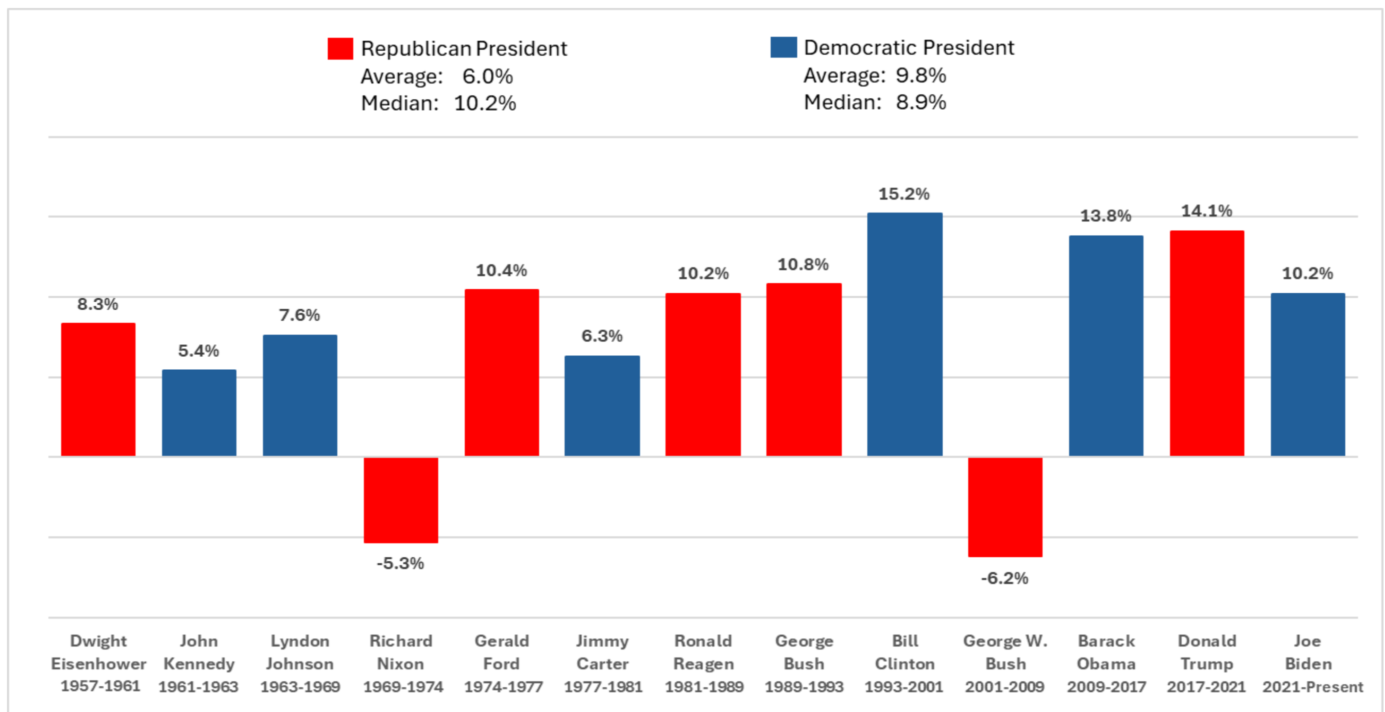
Since the inception of the S&P 500 share market index in 1957, the respective market performance under different presidencies is highlighted below.

Given the ability for statistics to be easily manipulated, Republicans (higher median return) and Democrats (higher average return) could both try to claim the share market has performed better when they controlled the presidency.

However, investors should ignore such comments. Share prices, determined by business fundamentals like revenue and earnings growth, are merely influenced (not controlled) by a president's fiscal policies.

While the winner in November may not have much of an impact on eventual market returns, this will nevertheless be a point of considerable global attention over the next 4-5 months.

S&P 500 compound annual growth rate:



Tune out the noise

There is a near constant swirl of speculative opinion both in the general news media and in the financial press about a range of factors or events for which the outcome is, and always will be, uncertain.

Not a day goes by without a big, scary headline professing at least some level of consternation about one or more of the following:

- the timing and size of future interest rate changes
- the long-term impact of AI
- the consequences of a changing global political landscape
- whether inflation is really back under control
- whether technology companies are forming the next market 'bubble'
- when the conflict in Ukraine or the Middle East might end
- the ongoing impacts of climate change

Unfortunately, reading (or watching) the guesses of different pundits about an unknown future provides no useful benefit to long term investors.

Markets, in aggregate, are aware of the prevailing uncertainties and, to the greatest extent possible, that uncertainty is already factored into asset prices today. Yes, as information changes, prices will move to reflect that new information. But, as the exact nature of future information is usually unguessable in advance – even by so-called experts – this speculation is nothing more than an unwelcome distraction and investors should exclude it from their strategic decision-making.

The best response a long-term investor can have to uncertain events is to tune out the persistent noise about everything that is unknown or could go wrong and focus instead on the consistent behaviours that have been proven to add value over time.

Unlike the list of potential issues, which is always concerning and always changing, the list of great investor behaviours never changes.

These are – in no particular order:

- ✓ allocate strategically (not tactically),
- ✓ keep costs low, stay diversified, rebalance periodically to manage risk,
- ✓ don't engage in panic buying (or selling),
- ✓ and always consult your adviser if your circumstances or requirements change.

Mastery of these relatively simple steps means you will dramatically improve your chances of achieving your long-term investment goals and objectives.