Investment Commentary

After finishing the year with another generally positive quarter for diversified investment portfolios, 2024 is set to be remembered fondly by investors.

The strong 12 month returns from most share markets sit in contrast to a global economic environment still searching for its post-Covid equilibrium. In New Zealand, for example, the local S&P/NZX 50 Index (gross with imputation) gained 12.2% for the year. However, the environment facing workers and households was characterised by slowing growth, lingering inflation, weakening house prices, high interest rates and rising unemployment.

This apparent disconnect between markets and the real world is because long term investors consistently look to the future. That means current market prices (and returns), are not just based on observed economic conditions, they also reflect the future expectations of all market participants.

In many ways, the solid share market returns in 2024 imply a general market expectation of better economic times ahead. Hopefully, for workers, households and investors alike, this will be delivered over the coming 12 months and beyond.

Political changes and Ukraine's ongoing conflict

After a highly unorthodox contest, with sitting president and presumptive Democratic nominee Joe Biden pulling out of the race in July, Donald Trump eventually prevailed over Kamala Harris in November to win a second term as US president.

While the president campaigned on a raft of issues, including the mass deportation of illegal immigrants and imposing widespread trade tariffs, the world now watches with interest to see exactly which initiatives the incoming administration will look to prioritise.

Political instability was also a feature in Europe during the quarter, with Germany and France in the spotlight. In Germany, the three-party governing coalition collapsed in November after Chancellor Olaf Scholz sacked his finance minister. This paves the way for new elections to be held in February.

In France, Prime Minister Michel Barnier was ousted in a no-confidence vote as other parties declined to back his budget. On 12 December French President Emmanual Macron named centrist ally Francois Bayrou as Barnier's replacement, after several days of tense political gridlock.

Further east, the Russian invasion of Ukraine will tick over the three-year mark in the coming quarter and is sadly showing no signs of concluding.

Republicans returned to power in the US

We often note that the government of the day has little influence over whether investment markets go up or down. Moving from Labour to National (in NZ) or from Democrats to Republicans (in the US) typically results in minor policy tinkering, but usually not wholesale changes that could spook or energise markets.

This is what makes the result of the recent US elections more intriguing. The Republican Party, headed by President Donald Trump, secured a grip on power in Washington that is uncommon in US postwar history.

In 2025, the Republicans will control the White House, the Senate and the House of Representatives. Republican appointees already represent a majority on the US Supreme Court and heavily populate the federal judiciary. It is also highly likely that Republican political appointees will more widely and deeply populate agencies that make up the US federal regulatory system.

Such political dominance is rare.

History suggests that when one party wields significant power, big changes can ensue. In 1933, President Roosevelt used expansive powers to usher in the 'New Deal' addressing the Great Depression. In 1965, President Johnson introduced the most significant changes in US public policy and politics since the Civil War, passing legislation to establish Medicare and Medicaid and to enact landmark law via the Voting Rights Act and Civil Rights Act.

No president since, not even Ronald Reagan, has had the opportunity to enact his agenda to the extent now available to incoming President Trump.

What the Trump administration does with that power could very well have a significant impact on markets. The biggest unknown is how much of the pre-election campaign rhetoric will ultimately end up being pursued as policy.

As we saw during the first Trump presidency, making campaign promises was easy, while delivering the promised outcomes was rather more difficult.

Early indicators

Initially, many global share markets responded positively to the US election result, with the S&P 500 Index in the US rising 2.5% the very next day. US share prices were buoyed by expectations that the promised policies would result in lower taxes, reduced regulation and stronger growth.

Those would potentially all be positive outcomes, but the starting point for the new administration's policies, is a US economy that is already close to full capacity. Any significant increase in spending from here, due to tax cuts or increased business investment, runs an increased risk of being inflationary.

Mindful of this, the US Federal Reserve has already scaled back its projections of interest rate cuts in 2025 to just two. Of course, if inflation were to actually start heading higher again, the Federal Reserve wouldn't just slow down its rate cutting plans, it might stop cutting interest rates altogether, and need to consider increasing rates again.

That outcome becomes more likely if, as promised, widespread new tariffs are imposed on imports and the large-scale deportation of migrant workers occurs. Both of these initiatives would negatively impact economic output in the US which, again, would likely result in higher inflation.

Currency markets

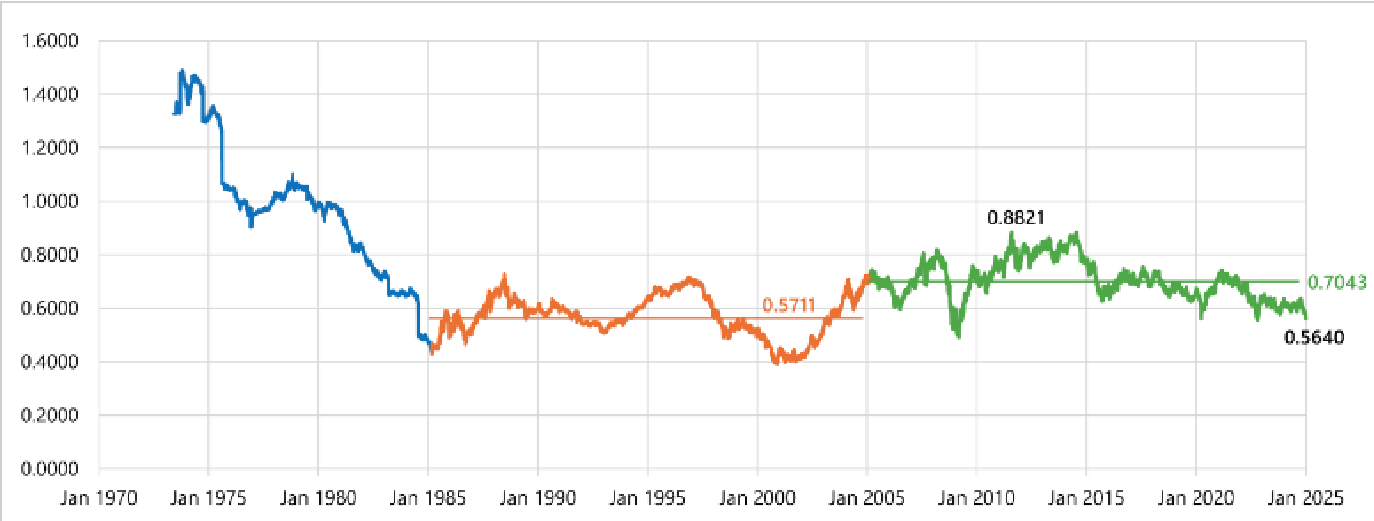
Following the Republican victory, the prospect of stronger growth, rising share prices and higher interest rates could potentially attract increased capital flows from abroad into the US. If inflows into US assets increase, this would be supportive of a strengthening US dollar.

If the US dollar does strengthen further against the NZ dollar, it will be extending a general downward trend for our own currency that began in July 2014 when the NZD/USD exchange rate touched 0.8821. At the end of 2024, this exchange rate was sitting at 0.5640, representing a decline of about 36% in nine and a half years.

That's a significant change over time but, if we take a look at the relationship between the US dollar and NZ dollar going back to 1973, it is far from unprecedented.

The fluctuating NZ dollar

The NZD/USD chart below is broken down into three time periods



The first **(blue line)** is a 12 year period from June 1973 to March 1985, which shows the NZ dollar weakening fast against the US dollar. At the start of this period one NZ dollar was worth about US $1.40 and by mid-1985, one NZ dollar was buying less than US $0.50.

For those who remember these times, it was a period of real economic stress in New Zealand. The oil shock of 1973 caused oil prices to soar and hurt global trade, which impacted New Zealand due to our reliance on agricultural exports. A period of very high inflation and low growth followed. This only began to be effectively addressed by the David Lange-led Labour government of 1984 which started to shift New Zealand towards a more open, market-oriented economy. Included amongst these changes was the floating of the NZ dollar on 4 March 1985.

The second period **(orange line)** is the first 20 years since the NZ dollar was floated, from early 1985 to early 2005. The significant economic and regulatory reforms of the late 1980's ultimately led to a period of sustained growth in the 1990's. The NZD/USD rate averaged 0.5711 over this 20 year period (fluctuating widely) and, by the end of the period, was slightly above US $0.72.

The third period **(green line)** covers the last 20 years from early 2005 to the end of 2024. A series of crises including the Global Financial Crisis (2007 to 2009), the Christchurch earthquakes (2010/11 and aftermath) and Covid-19 pandemic (2019 to 2022) contributed different stresses to the New Zealand economy. The most recent leaving a legacy of high inflation and low growth which the New Zealand government continues to wrestle with today. Although the NZ dollar has fallen well below its 2014 high, the NZD/USD exchange rate averaged 0.7043 over this 20 year period (again, fluctuating widely) and, by the end of December 2024, was sitting at US $0.56.

What all of the above should reinforce (bearing in mind we only commented on factors from a New

Zealand perspective) is the myriad of influences that can impact exchange rates. The assumed policies of the new Trump-led administration, while potentially significant, are only one of many.

Where the exchange rate may go over the next 20 days, let alone the next 20 years, is anyone's guess.

Digital currencies

On the subject of currency, it seems appropriate to comment again on the recent rise in popularity of digital or cryptocurrencies, with the 'flagbearer' for this cohort being Bitcoin.

While we can easily tell you the current market price of Bitcoin, it is almost impossible to determine its true value. The distinction is subtle. No one knows the actual worth of Bitcoin. It's a completely digital asset with no physical backing and no expected future cashflows. Its value is primarily determined by what other people are willing to pay for it, based on a speculative 'belief' around its potential future value. This is why Bitcoin, or any other cryptocurrency, doesn't form part of a traditional diversified portfolio. Without being able to accurately value these assets, we do not have a forward-looking expected return rationale for holding them.

Unfortunately, the absence of clear investment fundamentals means investors can justify (to themselves) paying almost anything for Bitcoin if they really want to. And, as speculative assets go, Bitcoin has certainly experienced a remarkable run. In the five years from January 2020 to the end of December 2024, the Bitcoin price has increased by a factor of 13x (approximately 1,200%). As a comparison, the S&P 500 Index in the US went up by about 80% over the same period.

Ardent fans like to argue that cryptocurrencies are the ultimate hedge against US dollar debasement or even the collapse of our entire economic structure (assuming, of course, that we will still have functioning internet!). By that logic, some have attempted to portray cryptocurrencies as some kind of 'safe' asset. The problem with this argument is that Bitcoin, as pack leader, is monumentally volatile (part of the reason it has achieved such high returns so far) and it defies logic to claim that something so volatile can be regarded as a safe asset.

As long-term investors, most of us know how volatile shares are and how uncomfortable it can be to continue to hold on to them when share markets are experiencing weakness. But the volatility of shares pales in comparison with the volatility of Bitcoin.

Volatility (or risk) is often best understood when we think of the propensity for making a loss which, as human beings, we rather dislike. In the table below, we summarise a breakdown of the largest **negative daily returns** for both Bitcoin and the S&P 500 Index over the last 12 years (1 January 2013 to 31 December 2024).

The comparison is stark:

SINGLE DAY PRICE FALLS	BITCOIN	S&P 500 INDEX
-5% or worse	296	5
-10% or worse	71	1
-20% or worse	10	-
-50% or worse	1	-

Source: Investing.com. Returns presented are in US Dollar terms

The S&P 500 Index has fallen 5% or more on a single day on just five occasions over this period. Bitcoin managed that on a staggering 296 occasions.

We suggest that any asset that has demonstrated an ability to lose more than 50% of its value **in a single day** (as Bitcoin has) cannot seriously be considered safe.

However, if people enjoy investing in cryptocurrency, and are not putting at risk more than they can afford to lose, then their financial downsides are at least being managed.

First and foremost, it's important to understand it for what it is – a highly speculative asset that should not be regarded as a reliable hedge against anything.

The more things change, the more things stay the same

Big changes in the US political landscape could usher in significant new policy settings and potentially lead to an altered growth profile for the US economy. This might be good for investors and give a boost to the US dollar. But it could also be inflationary. As we know in New Zealand, addressing rising inflation can lead to some less favourable outcomes like rising interest rates and higher mortgage costs.

In the short run, it's hard to know exactly what changes to expect in the US, and over what timeframe. However, what we can reasonably expect is that President Trump – first and foremost a businessman – will not be looking to derail corporate America.

While short term noise and uncertainty has increased, we can be confident that good businesses that generate returns and profits, creating employment and growth, will continue to thrive under this administration and into the future. We can expect this in the US, in New Zealand and around the world.

And although Bitcoin promoters might like to suggest otherwise, we are not standing on the edge of a systemic collapse, where only guns and butter (and Bitcoin!) can provide us with any meaningful protection.

As always, the best investment strategy in the face of uncertainty is to be aware of your ability to take and withstand risk and to stay well diversified across good quality assets.

The long-term benefit of that approach never changes.