Rede Advisers Autumn Update

January – March 2025

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Market Commentary

Fresh off the back of an excellent year in 2024, the first three months of 2025 ushered in a more difficult investment environment. While some markets performed creditably, others, including the influential US share market, were down for the quarter, contributing to reduced portfolio valuations for many investors.

Investor sentiment was put to the test as the quarter progressed with much of the uncertainty centred on key policy initiatives within the globally important US economy.

While it often takes more than one country, or one leader, to unsettle markets, the directives coming out of the White House in early 2025 clearly contributed to the market wobbles throughout the first quarter and into April. The most telling of these was the adverse global reaction to the US's ever-evolving plans to implement widespread new international trade tariffs.

President Trump initially announced tariffs on certain countries (notably Mexico and Canada) and on some goods (cars, steel and aluminium). However, as the quarter progressed, investors were left nervously awaiting 2 April, dubbed 'Liberation Day' by President Trump, and the announcement of a more comprehensive range of tariffs.

Investors feared that new tariffs, plus the widespread public sector job cuts planned by Elon Musk's new Department of Government Efficiency, could put significant pressure on US consumers and accelerate the US economy towards a possible recession.

Although Republican supporters of the tariffs claimed they would be in the US's best interests, the market response was much less complimentary. Tangible evidence of this was seen in widespread price weakness and heightened volatility across the US (and many other) share markets from mid-February, which intensified further following the Liberation Day announcements.

The truth about tariffs

If you've listened to some of the arguments for and against tariffs, there's a good chance you could be confused.

A tariff is simply a tax imposed by a government on imported goods. For example, if the US puts a tariff on foreign made cars, it effectively increases the price of the foreign cars when they are imported into the US.

Some of the main reasons for considering imposing tariffs are to protect domestic industries, encourage additional production locally, and for the government to generate additional tax revenue.

However, when a tariff imposed in the US raises the price of foreign goods, it is importers in the US (mainly US businesses) who pay the tax upfront, not the foreign producers. These higher costs are generally then passed on to US consumers in the form of higher prices.

Of course, some US consumers might decide to switch from buying a foreign car to a US made car. However, if they were originally buying the foreign car because it was cheaper, then the total cost to the US consumer will still go up. For an administration that campaigned on lowering prices to US consumers on "day 1", this is likely to be an unexpected and unwelcome outcome for most Americans.

It's important to note that this simple tariff example also ignores more complicated scenarios like - how will tariffs affect the price of US made cars, particularly if they include imported component parts which are also affected by tariffs? Answer – domestic car prices are very likely to go up as well.

And none of this factor in the potential for retaliatory tariffs being imposed by other countries on US exports.

Tariffs have been imposed in different forms since the 1600's so this isn't a new idea. However, since World War II, there has been a fairly successful global movement to reduce tariffs and increase free trade to promote economic growth. What is new is that the Trump administration, despite the mainly chequered historical evidence to date, seems to see only the potential benefits and none of the associated weaknesses of significantly increasing tariff rates.

First quarter returns in context

The S&P 500 index in the US tracks the performance of 500 of the largest publicly traded US companies. It is widely regarded as one of the best indicators of the overall health of the US share market and economy.

In 2024, the S&P 500 index delivered an outstanding return of +25.0% (in USD), making it one of the better performing markets around the world. Over the first three months of 2025 however, the US share market moved from leader to laggard, with the S&P 500 index delivering a return of -4.3% over this period.

In isolation, that three month return isn't particularly unusual. Yes, it's disappointing because it is a negative number, but if we look at all the rolling three month returns in the S&P 500 index since the beginning of 1926 (there are a total of 1,189 such periods), we can find 198 three monthly periods that delivered a worse return than -4.3%. That's one in every six rolling periods, so negative returns of this magnitude are far from rare.

It's also worth remembering that diversified investors aren't solely exposed to the performance of the US market, even if the media headlines tend to focus on it above all others.

> Diversifying across multiple international markets is a feature of any well-constructed investment portfolio, as investors will always have at least some exposure to the better performers, even if the markets overall are difficult.

Some other notable markets in the quarter delivered a variety of different returns, including a number that were better than the US market, such as Australia's ASX 200 index (-2.8%), the German DAX index (+11.3%), China's Shanghai Composite index (flat), and UK's FTSE 100 index (+5.0%).

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Ordinarily, with that point made, this article would move on to discussing other matters of economic interest. However, we think it is important to break with convention and comment further about some of the very short term market movements we have witnessed in the few days since the end of the March quarter.

Market reaction to new Trump tariffs

On 2 April, US President Donald Trump announced a series of international tariffs – a universal tariff of 10% effective from 5 April, and country-specific tariffs on approximately 60 countries effective from 9 April.

In the immediate aftermath of the announcement, global share markets dived. The S&P 500 index dropped -4.8% on 3 April and another -6.0% on 4 April. Other markets also reacted, with the two-day returns of the German DAX down about -8%, the Australian ASX 200 down -3.4% and the New Zealand NZX 50 index down -4.6%.

Since then, markets have had bursts of both strength and weakness – sometimes in the same day – as the volatility associated with share market trading escalated markedly. At the time of writing, following an announcement that many of the higher tariffs above a universal 10% level would now be deferred for 90 days, the markets rebounded significantly.

Given the heightened market volatility, reporting the valuation of the markets on any given day is challenging as share prices may have already moved by the time this report is published. All we know is the white-knuckle market ride that kicked off on 2 April, is showing no signs of slowing down and probably needs more consistent messaging from the White House in order to do so.

While the 9 April news of the tariff deferral was clearly a positive sign, many questions still remain. The overarching question is where this all leads. If higher tariffs are to be the norm for global trade involving the US, what does this mean for inflation, interest rates, consumer demand and economic growth?

Right now, the ultimate long-term impact is uncertain, and markets dislike uncertainty. That's what has been behind the highly volatile price movements seen in early April.

> Observers have been left wondering if this is primarily a trade negotiation tactic, one that might be quickly reversable, or if it is closer to a large-scale economic experiment rather than a highly tuned strategy.

So far, the various announcements and messaging around the tariffs have been disjointed. It's not that the US couldn't present a cogent case for revising tariff settings (at least in certain instances), it's that their rationale has so far been conveyed in such a haphazard manner. The confusion has led to critics pointing to a lack of logic and cohesion, with the overall approach only fuelling the market uncertainty.

Until there is more clarity, observers have been left wondering if this is primarily a trade negotiation tactic, one that might be quickly reversable, or if it is closer to a large-scale economic experiment rather than a highly tuned strategy.

Time will inevitably tell, but for now the rest of the world are scrambling to grasp its implications and the markets are scrambling to find an equilibrium amidst the upheaval.

Both of these elements will hopefully become much clearer as the second quarter progresses.

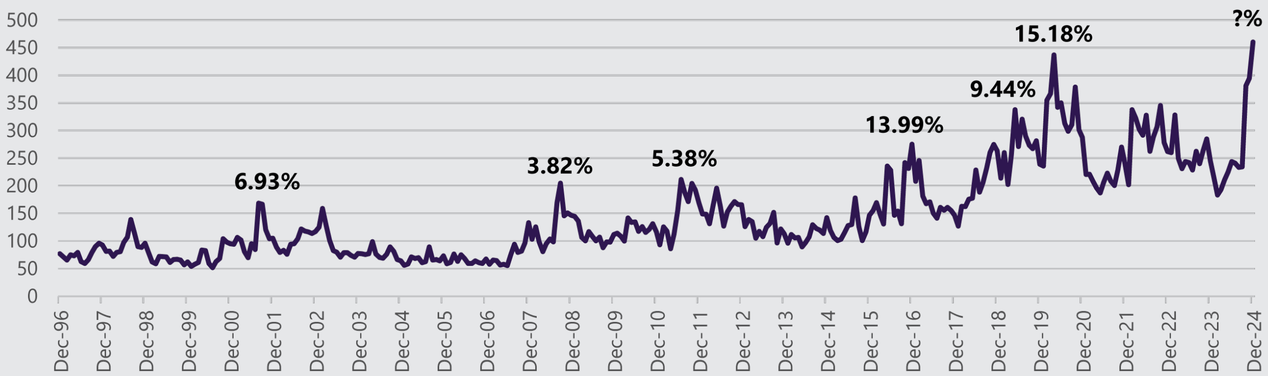
Pessimism is a positive

In the meantime, while it may seem counterintuitive, investors should actually take some heart from the spike in uncertainty.

Three professors from Stanford and Northwestern universities have developed a mechanism for objectively measuring economic uncertainty. They mainly utilise newspaper searches measuring the volume of news articles discussing economic policy uncertainty. For the US component of their data, they also uniquely measure uncertainty related to US tax settings, and differences in the predictions of economic forecasters about key macroeconomic variables.

From the mid 1990's, their overall measurement of global economic uncertainty can be summarised by the following line graph.

Global economic policy uncertainty index and subsequent five year returns for MSCI ACWI



Source: Baker, Bloom, Davis; Economic Policy Uncertainty

At a glance, we can quickly note a couple of things. Firstly, global uncertainty (as measured by these academics) has, on average, been increasing over time. Secondly, by the end of 2024 (the latest data point we have), global uncertainty had spiked to the highest point in their database. It's not unreasonable to assume that number is likely to be even higher today.

> When uncertainty is greatest, individual investors are behaviourally more susceptible to selling their shares at larger price discounts (to put an end to their fears about an unknown future).

Renowned investor, Warren Buffett once famously commented that, to be successful investors needed to "be fearful when others are greedy and greedy when others are fearful." It's a reflection of Buffett's own tendencies of wanting to pay a fair price for a great business rather than paying a high price that had been excessively bid up by greedy investors. And, as Buffett found over much of his investment career, it was far easier to pick up bargains when sellers were concerned about the future, than when they were highly confident.

That aspect is hinted at by the other piece of information contained in the above chart. Above six of the temporary uncertainty 'peaks' in the line chart (i.e. where uncertainty was temporarily higher than usual) we have identified the subsequent five year annualised return of the MSCI All Country World Index (USD).

In other words, the numbers above each of these peaks reflect the subsequent five year return on global shares. In later peaks (2016 to 2019) the subsequent five year returns have averaged more than double-digits, so these have generally been great points to move into the share market, not great points to exit it.

This makes intuitive sense. When uncertainty is greatest, individual investors are behaviourally more susceptible to selling their shares at larger price discounts (to put an end to their fears about an unknown future). However, the more discounted those share prices become, the higher their future expected returns will usually be.

At the latest uncertainty peak, we have placed a question mark. We don't know (and won't know for another five years) what the subsequent returns on shares traded today are. However, if history, and Warren Buffett, is any guide, there is a very good chance those returns will turn out to be highly attractive.

For anyone even remotely considering selling growth assets in times of increased uncertainty, this chart alone should act as a significant deterrent.

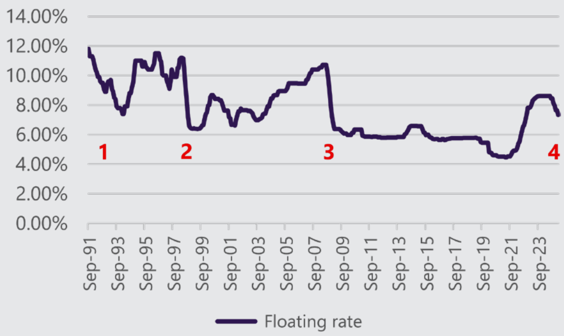
Home is where the heart is

With mortgage interest rates having peaked in the middle of 2024 and currently on the decline, is there anything we can conclude about the likely impact of lower mortgage rates on the domestic housing market?

The short answer is, it's usually been a very positive sign.

A longer answer requires us to look back over the last 35 years of housing data supplied by the Reserve Bank of New Zealand (RBNZ). To that end, we have included two charts below. The first is the change in floating mortgage rates since 1991 and the second is the annual performance of the house price index.

Residential floating mortgage rates



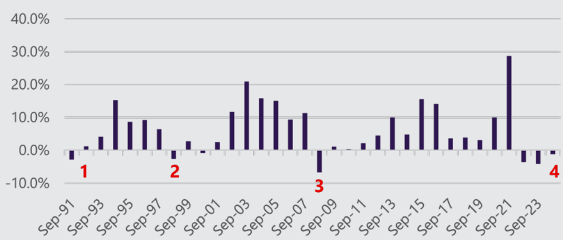
Source: RBNZ

On the floating mortgage rate history above, we've numerically highlighted four separate dates - in 1992, 1998, 2008 and the end of 2024, which is the latest data available from the RBNZ. These dates all share strong similarities. At points 2 and 3 (1998 and 2008) this coincided with a steep fall in floating mortgage rates. At point 1 (1992) mortgage rates were already well on the way down, and at point 4 (the end of 2024), mortgage rates had already started declining.

What's more interesting is when we line these same dates up on our second chart, to see what happened to house prices in the years following these sizable reductions in floating mortgage rates.

The chart below exhibits a surprisingly clear pattern.

Annual change in house price index



Source: RBNZ

Following the large floating mortgage rate declines at points 1, 2 and 3 (in 1992, 1998 and 2008) the New Zealand house price index experienced extended periods of strong gains on each occasion.

With floating rate mortgages currently on the decline in late 2024 but not yet bottomed out, we don't have any observed data to suggest that house prices (post point 4) may be about to improve. However, history suggests there are good reasons for optimism.

Stick to good behaviours

When equity markets are strong, it's easy to adhere to the good behaviours required of a successful long term investor.

However, when markets have fallen and uncertainty is rising, we need to stay disciplined. If we succumb to emotionally charged thinking at these times, we only increase our chances of underachieving our long term plans.

It can be hard to hide from the daily news, but always remember - most media commentators are neither economists nor market experts and they are often looking to promote a sensationalised angle. So, try not to let scary media headlines lure you into focusing too closely on your daily portfolio balance.

In more volatile times, like now, your portfolio will be moving up and down more noticeably. However, if your investment time horizon is years into the future, then greater price volatility over the coming days or weeks will have next to no bearing on the successful outcome of a sound long term strategy.

In fact, when you work with an adviser, not checking your portfolio balance at all is probably the best strategy. There is no useful information to be found in short term portfolio value fluctuations, so it's better to just ignore them if you can.

Your adviser, who is continually monitoring your investments, will tell you everything you need to know in respect of your plan.