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Investment Update – August 2021

Covid 19 Reasserts as Dominant factor in NZ.

New Zealand's Covid 19 defences were breached by the Delta variant on August 17. The re-emergence of the virus immediately changed the investment playing field with the whole country plunged back into the strictest internal quarantine regime. Prevalence of infection levels and the length of time that quarantine levels persist has become the key factor in assessing the forward economic outlook.

New Zealand Interest Rates Primed to Rise

Prior to the resurgence in Covid infections market pricing implied a near certainty that the Reserve Bank (RBNZ) would increase the Official Cash Rate (OCR) at the scheduled RBNZ announcement in August. Covid uncertainty however has resulted in the RBNZ deferring an increase. The RBNZ in subsequent communications has indicated that its decision to not increase the OCR was due to communication uncertainty rather than prevailing economic circumstances. The RBNZ's messaging continues to be those economic conditions (i.e. inflation at target levels, near full employment, and rising house prices) warrant an increase in rates and that monetary tightening will be implemented by raising interest rates rather than changes to the RBNZ's bond buying activity. Significantly there is no suggestion any longer that rates need to fall or remain at current levels. A delay in the implementation of this policy direction only seems likely if the extent of infection worsens, prolonging the period which Auckland remains in lockdown and limits the extent to which the rest of New Zealand can normalise economic activity.

If it is accepted that short-term rates are about to rise, then the investment focus is on the extent to which short-term interest rates should rise and to what degree longer term interest rates will be impacted by the short-term increase. The sensitivity and ability of the economy to absorb increases in short-term rates is constrained. The neutral interest rate is currently estimated around 2% and this in tandem with inflation at similar level (implying no real return) suggests that the OCR could rise to this level from the current 0.25% rate. However, the RBNZ will be reluctant to disrupt economic activity and demand by moving too precipitously (unless demanded by the data) and a 1% target rate seems more likely over the next year. In this scenario there are competing views as to whether longer term rates will similarly rise or remain flat given the increase in longer term rates that has already occurred. Prevailing overseas interest rates will continue to dampen the outlook and this in turn is a function of the extent to which inflation is temporary or persistent.

Offshore the prevailing position appears to be that inflationary pressure will be temporary and this is reflected in long-term bond rates which have resisted the pressure to rise and have fallen back to levels prior to March. In contrast New Zealand's inflation outlook may differ. New Zealand is a small, isolated country with capacity constraints. Logistical bottlenecks look set to linger longer than on major trade routes, continuing to put pressure on prices. Prior to Delta's emergence New Zealand's labour markets had limited capacity with wages increasing. Inability to source labour from offshore continues to constrain the labour supply. Price inflation evident in New Zealand has been widespread and has not been limited to a few specific factors.

Counter to economists' expectations, house prices have risen 30% in the last year with this phenomenon not confined to Auckland. Continuing housing demand is contributing to rising building costs. It would not be unreasonable to conclude that long-term interest rates therefore need to be at a higher level to compensate investors in real terms. However, the scope for interest rates to be lifted will be moderate given that a large proportion of borrowers have been acclimatised to low rates and may have difficulty maintaining viability in a higher rate environment, particularly highly leveraged mortgagors. Nevertheless, research suggests that most housing borrowers could continue to service debt in the 4.5%-5.5% range.

US and Australia Interest Rates Potentially Lag New Zealand

Although a number of central banks located in smaller countries (e.g. South Korea, Iceland and Chile) have already increased the equivalent of the OCR it seems likely that key economies will take longer to normalise interest rates. The Reserve Bank of Australia (RBA) has stated that it will keep borrowing costs low until mid-2024. Covid 19 conditions in NSW are a factor for the RBA which also is contending with a very strong housing market.

US Federal Reserve Governor Powell in his most recent Jackson Hole speech has indicated that the Federal Reserve will consider tapering of monetary stimulus later this year and does not intend to directly increase interest rates until the twin objectives of inflation and aggregate employment are exceeded for a period. This suggests that it may be post 2022 before the Federal Reserve acts to explicitly increase interest rates. Given different potential timeframes for interest rate increases one wonders what impact that will have on currencies.

Conditions Favour US Company Earnings

The US share market continued to rise in August with the S&P500 up 3% in local currency. Although the likelihood of a prolonged period of continuing low interest rates was not evident until late in the month the large technology companies continued to do well. Alphabet (the owner of Google) has increased 65% plus year to date. August was a key reporting month. In aggregate, company earnings are above those prior to the Covid 19 epidemic by approximately 30%. US companies had multi decade high profit margins, approaching 14%. When combined with interest payments as a percentage of disposable income at 8% versus 10% previously, supply constraints and continuing easy monetary policy, the outlook for US shares is favourable. As always obstacles may arise and managing input costs going forward will be a key consideration. The impact of the current computer chip shortage is one example.

Australia Continues to Overcome Obstacles

The Australian share market continued to rise overall despite the large mining companies losing some lustre. BHP and Fortescue, despite announcing hefty dividends, both lost around 15% as the iron ore price rapidly declined. Chinese steel demand, which weakened, drives iron ore prices and demonstrates how interlinked the two economies are. BHP also announced a restructuring which will result in the company having a single share class, collapsing the long-standing dual share structure. The overall Materials sector of which these companies are part declined 7.3% in August.

Information technology continued to lead the Australian market with the sector up 17% for the month. Australia's largest buy now pay later stock Afterpay announced agreement for the company to be absorbed by US payments company Square for A$39 billion.

Dividends and capital distributions into the Australian market will be very significant in the next few months exceeding A$32 billion; Commonwealth Bank alone will return A$10 billion in dividends and buybacks.

New Zealand Shares Beat Expectation

The New Zealand market, up 5%, shook off its lethargy in the August reporting period and outpaced the Australian market. Company earnings again echoed the economic resurgence with actual outcomes exceeding analyst forecasts. Company outlook statements overall remain balanced, reflecting the challenges ahead as the labour supply remains constrained and supply chains constricted. Retirement villages operators rode the tailwind of house price growth with Summerset and Ryman both up over 17% for August. Z Energy was the recipient of a conditional offer at $3.78 and was the best large cap performer, plus 19%. Mainfreight appears to be a beneficiary of the current logistical challenges and continued its upward trajectory. A2 Milk's report again disappointed investors and this company continued to weaken. The outlook for tourism stocks continues to be muted as trans-Tasman travel was halted.

Caution: A Mid Cycle Pause?

Morgan Stanley note that share markets have risen consistently for the past year. Most 12-month periods have a 5% or 10% decline at some stage, even if the overall direction is upwards. In 2021 this could be caused by some tightening of monetary policies or by a slight downgrade in earnings expectations in response to Covid impacts or supply difficulties. Share markets do not rise indefinitely.

Summary

The reintroduction of quarantine in New Zealand is undoubtedly damaging to company earnings and the length of time that commerce remains impeded will impinge on near-term profitability. However, businesses are better equipped to navigate the current lockdown phase. Previously shares experienced a sharp V shape price recovery in the aftermath of the initial lockdown. This round has been nowhere as severe in terms of price destabilisation. Under the assumption that New Zealand follows a similar path to other vaccinated economies, investment divers prevailing pre lockdown will reassert. The probability of modestly rising interest rates driven by underly inflation continues to tilt investment weightings in favour of shares.

Key Market movements over August 2021 Source: Bloomberg

Share market returns in their own currency	1 Month	3 Months	1 Year
NZX 50 (New Zealand Shares)	5.0%	7.3%	10.7%
MSCI ACWI (Global Shares)	2.5%	5.2%	26.7%
S&P 500 (Top 500 US Listed Companies)	2.9%	7.6%	29.2%
NASDAQ 100 (US Technology Companies)	4.2%	13.9%	28.7%
ASX 200 (Australian Shares)	1.9%	5.2%	24.3%
New Zealand Interest Rates	**Latest rate**	**1 month ago**	**1 year ago**
New Zealand's Official Cash Rate	0.25%	0.25%	0.25%
3 Month Deposit Rate	0.35%	0.39%	0.34%

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