Investment Update – November 2021

Rising Inflation Expectations

Inflation reports globally indicate generally rising prices consistent with the monetary expansion undertaken in 2020. In New Zealand, third quarter CPI inflation was recorded at 2.2% and annual inflation at 4.9%, ahead of market expectations. Significantly, annual inflation for the next quarter is anticipated to reach around 5.4%. Other countries' inflation reports echo this trend. Increasingly central bankers are beginning to acknowledge that inflation could be higher than initially forecast and last longer. Following on from the monetary impulse and logistical constraints contributing to inflation, oil prices have risen and remain at elevated levels as does natural gas. Wage pressures look likely to further fuel the inflationary outlook while demand remains robust.

Central Bank Tightening Commences

New Zealand has been one of the first countries in the developed world to tighten monetary policy through lifting the Official Cash Rate (OCR) from 0.25% to 0.5%. Although the increase is small in absolute terms it appears to be the first of multiple increases with the market now forecasting that the OCR will exceed 2.0% within 2 years. The first step also represents a 100% increase on the prior rate in an environment where low rates have persisted for some time, therefore increasing the economic sensitivity to rate rises. The increase was reflected in bond markets which have also increased longer term wholesale rates. This has translated in mortgage rates and to a lesser extent returns from term deposits. Canada has also moved quickly to tighten monetary policy. The United Kingdom and United States central banks are also signalling that monetary policy tightening is becoming increasingly likely. Tapering of monetary policy in the US may commence this month. Global monetary policy is not as synchronised as it has been in the past, as both the European Central Bank and Bank of Japan are showing little inclination to alter policy.

New Zealand Economy Resilient

Despite the continuing effect of Covid 19 imposed quarantine in the northern North Island, the New Zealand economy has continued to be resistant to sharp slowdown. Although Auckland is an economic engine and the effects of Covid are uneven, the rest of the economy has continued to function sufficiently that the New Zealand Activity Index is at the same level as last year and gradual normalisation is allowing the Auckland economy to revive. Export prices for dairy products have risen and Fonterra's milk fat pay-out is now forecast to exceed $7.90. Meat prices have also been strong.

A Free Trade Agreement with the United Kingdom was reached in October and although initial benefits will be limited, this contributes to a positive outlook for primary exports. Employment levels have been supported by additional government subsidy and consumer demand has also been sound. Some signs of nascent wage pressure are evident in sectors with labour shortages. Housing prices have continued to defy gravity as housing supply has remained low. This in turn has contributed to a general consumer wealth effect. Some caution in respect of housing may be warranted however with rising mortgage rates, increased supply and specifically in the Auckland market a population outflow.

Despite the underlying economy performing better than anticipated the New Zealand share market had a negative month with the S&P/NZX 50 index down 1.3%., underperforming international peers. This trend has been evident for most of this year, with the New Zealand S&P/NZX 50 market up 8.4 % on annual basis. With the reality of interest rates rising rapidly in October, it could reasonably be expected that interest rate sensitive stocks would be the worst affected. However, price movements were not consistent with this hypothesis. Returns from yield-driven companies were mixed. A number of property companies provided positive returns whereas power companies and other utility returns were poor.

Electricity companies' prices may have also been driven by the Electricity Authority enquiry and weather, with high levels of rainfall corroding the electricity price outlook. As the month progressed the prospect of increasing international travel grew and travel reopening companies Auckland International Airport, Tourism Holdings and Air New Zealand all had a positive month. Air New Zealand continues to be associated with the prospect of a large dilutive capital raising and increasing reliance on government loan support has not improved the capital outlook. Skellerup (a niche manufacturer) was the best performing company in the S&P/NZX 50 index over the month and the company reported further profit growth in the first quarter at its shareholders meeting. Infratil was the largest positive contributor to the index. This company announced further initiatives in renewable energy and cloud computing infrastructure which was well received by investors. Mainfreight, which has had very strong share price growth in prior months, fell 7.2% in October. The company has been a beneficiary of logistical demand and high prices within its markets. Signs are emerging that prices may have peaked, and this may have influenced investor sentiment.

Australia Offers Greater Diversification

Australia has been more severely impacted than New Zealand in terms of the human cost of Covid and has had to confront population health management sooner than New Zealand. October marked the emergence of New South Wales and to a lesser extent Victoria from Covid induced lockdowns. Like New Zealand, inflation has been evident, but the Reserve Bank of Australia's market messaging has continued to propose that monetary tightening is not necessary. Fixed income investors have not accepted this prognosis and interest rates in the later part of October were bid up significantly.

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The Australian market however is more diversified and less defensive than that of New Zealand and therefore less interest rate sensitive. The ASX 200 Accumulation Index was marginally negative for the month in local currency terms.

Despite rate increases, the Information Technology sector in Australia was again the largest positive contributor to index performance followed by Financials. Australian banks recently commenced six monthly reporting, with marked contrast between the performance of ANZ (good) and Westpac (disappointing). The worst performing sectors in Australia for the month were Industrials (-3.2%) and Energy (-2.7%). Poor performance from the latter was surprising given high energy prices.

United States Exceptional Run Continues

The S&P 500 and the NASDAQ continued to provide investors with very strong returns both for the month and on an annual basis in local currency. Respectively for the month these were +7.0% and +7.3% and annually +43% and +43.2%. New Zealand dollar appreciation has eroded the return for New Zealand investors, which still remain exceptionally healthy for the period.

Most US companies provided quarterly reports in October. Apple and Amazon disappointed market expectations somewhat and as a result Microsoft supplanted Apple as the world's largest company by market capitalisation. Tesla's upward trajectory continued on the back of Hertz announcing an intention to purchase 100,000 vehicles.

President Biden's Build Back Better proposal appears to have been diluted somewhat through the legislative process. In particular corporate tax increases are likely to be lower than first feared and this will have contributed to investor confidence.

China Puzzle

China was the first country to be disrupted by Covid and the first to emerge from it. As such China's economy has been less synchronised with the economic fortunes of western economies. China remains of critical and increasing importance for the wellbeing of the New Zealand economy and an investment destination in its own right. The Chinese economy currently is more subdued than in the past. In recent quarters manufacturing activity has been flat, in part a function of sporadic Covid outbreaks and energy shortages in China.

China's third quarter annual GDP growth rate was +4.9%, below market expectations and a deceleration from past growth rates. Property development company defaults have multiplied in the last month and this is contributing to continuing equity market weakness. Increasing regulation of technology related companies is an ongoing theme although not as harsh as markets may have anticipated.

Western investors remain divided as to whether China is an investable market or not. The scale of opportunity remains massive and market pricing is inexpensive relative to developed markets. Political tensions remain a factor.

Conclusion

There is increasing conviction that global inflation will continue to force up interest rates in the near-term. Key will be how quickly, and the extent of interest rate rises. Rising rate momentum suggests that investors should continue to tilt their portfolios to shares. The impact of rising rates is uneven in terms of geography and effect on investment sectors. Companies that investors buy for the dividend yield are likely to face headwinds as the differential between low-risk term deposits and the dividends an investor receives reduces. Whereas companies with a degree of pricing power will be better positioned to ride out inflation in input prices.

Indices for Key Markets

As at 31 October 2021	1 Month	3 Months	1 Year	3 Years p.a.	5 Years p.a.
S&P/NZX 50 Index	-1.3%	4.0%	8.4%	14.4%	13.5%
S&P/ASX 200 Accumulation Index (NZD)	0.1%	0.2%	26.5%	10.7%	10.6%
MSCI ACWI Index (NZD)	1.2%	0.8%	27.4%	14.5%	15.3%
S&P/NZX 90 Day bank bill Total Return	0.0%	0.1%	0.3%	1.0%	1.4%