Monthly View – April 2022

Inflation Intensifies

Inflation rates have climbed further to multi-decade highs. In the United States consumer prices surged 8.5% from March 2021. Energy and food prices primarily contributed to the lift. The March month CPI was 1.24%, the biggest monthly increase in 42 years. The US producer price index recorded its highest outcome since inception at 11.2% for the year. Germany and the United Kingdom experienced similar CPI inflation of 7.3% and 7% respectively for the year to March. Germany's Producer Price Index came in at a 70-year record of 30.9% as German businesses experienced particularly high energy prices. Australian headline inflation jumped to 5.1%, surprising economists. Australia's inflation run-rate appears to be higher than the annual rate as the March quarterly rate was 2.14%. New Zealand was not immune even though the CPI for the March year came in below forecast at 6.9%. This was a 30-year high, with tradeables inflation lifting to 8.5% per annum.

Interest Rates Adjust

Markets have anticipated that central bankers will need to act decisively to quell inflation before inflation expectations become entrenched and fixed income investors require a higher nominal return to compensate for the erosive effect of general price appreciation. The Federal Reserve has increased its base rate by 0.25% and many but not all other central banks have moved in a similar fashion. The Reserve Bank of New Zealand (RBNZ) instituted an increase of 0.5% in the Official Cash Rate to 1.5% in its March Monetary Policy Review. This was the first 50 bps movement since 2000. The Reserve Bank of Australia has resisted increasing its base rate and the Bank of Japan has also been able to avoid rate increases. Fixed interest markets have revised interest rate pricing for maturities longer than base rates of their own accord. In the United States the 10- year Treasury bond interest rate has increased by 1.15% in the space of six weeks. A change of this magnitude within such a short time frame has only occurred twice over the last 30 years, during the GFC when rates were slashed and in 2003 at the end of the post dotcom easing cycle. The New Zealand 10-year government bond yield increased 0.42% over the course of the month.

The upward movement in interest rates has however not been proportional across all maturities. Longer term rates have lifted but not to the same extent as near-term or cash. This flattening of yields across time indicates that longer-term investors are more optimistic that inflation will be tamed in outer years. Breakeven inflation securities' pricing indicates a much lower level of inflation prevailing in outer years relative to current levels. New Zealand commenced its interest rate tightening cycle ahead of many other countries. To the extent that this tightening of monetary policy is effective, there may be less downside in New Zealand fixed income and New Zealand may be closer to a point where further interest rate increases are limited provided other circumstances do not intervene. Bond issuance has picked up in New Zealand as rates have risen. In part, this will be due to corporates seeking to lock in longer-term funding at advantageous costs. Recent examples and coupon rates include: Genesis Energy, 4.17%; Goodman Property Trust, 4.74%; and Precinct Properties, 5.2%. These coupons are increasingly attractive but at present the inflation adjusted return remains negative if the New Zealand inflation rate remains at 6.9%. If in fact the RBNZ is successful in subduing inflation, then a return to positive bond returns will be welcomed.

Rapidly rising interest rates can in some circumstances give rise to an inverted yield curve; that is, long-term interest rates are below short-term. This event occurred very briefly in April in the United States. This circumstance is a concern as it can presage an economic recession. The interpretation of the economic signal from yield curve inversion is dependent on which parts of the yield curve are inverted and does not herald an imminent recession. Following yield curve inversion, a recession can be 18 months to several years away. Clearly the probability of recession is related to the depth of inversion and the extent to which the curve remains inverted.

A key issue for investors is the likelihood that the yield curve across its length, both short and long-term, continues to rise. Accelerating and more persistent inflation has the potential to shift the yield curve above current levels (noting that the current yield curve has present inflation expectations priced in). There are reasons to believe that inflation may have peaked, allowing interest rates, particularly long-term, to stabilise. The first of these is the base effect i.e. if prices do not continue to rise at the same or a faster rate, then the initial rise drops out of the measurement period and the rate of inflation mechanically drops back. Secondary aspects to consider are the components of inflation. Fuel prices increased considerably with the rise in the oil price, although the initial price surge appears to have lost momentum and the removal of fuel taxes has lowered consumers effective cost. Similarly, components of the US Consumer Price Index such as the price of used vehicles have also retreated. On the other hand, prices have risen in other areas not the least of which is the cost of labour. The effect of rising labour costs will be accentuated as consumers move increasingly from consuming goods to services in a "post COVID" environment. There is a risk that if inflation expectations become embedded, then inflation becomes self-perpetuating.

Inflation Also a Headwind for Shares

Inflation represents a headwind to shares as the cost of capital is driven up in response to rising interest rates, reducing share values. Rapidly rising inflation in costs also has the potential to squeeze profitability and free cash flows, resulting in a downward effect on share prices. Inflation concern has translated into negative April returns. The S&P 500 lost 8.7% and the MSCI World accumulation index was down 8.3% in local terms. Australian and the United Kingdom markets however achieved positive gains. The New Zealand dollar generally weakened over April, and this had the effect of improving returns from overseas investments for unhedged New Zealand share investors. Another United States quarterly reporting period is in process. Microsoft continues to report strong revenue and earnings and Meta (Facebook) surprised investors with a return to user growth.

The major US company reports were more mixed than in the past with Amazon reporting weak guidance and suffering its largest one day fall since 2006. Netflix subscriber numbers underwhelmed, and the company's share price fell sharply. The technology segment of the US market was also notable for the launch of a takeover offer for Twitter by billionaire Elon Musk. Musk offered to buy the company for US$44 billion.

China Disrupted by Covid

The Chinese equity market, although of less direct relevance to Australasian equity investors, remains important for the wellbeing of the general economy. China's equity markets continued to experience weakness over April. China's Performance of Manufacturing Index contracted. This reflected the impact of COVID lockdowns. Further global supply chain disruption is likely to be a continuing consequence of health protection measures. Although China has relatively low vaccination rates compared to Australasia and the Chinese vaccine appears to be less effective than those available in the West, based on Western experience economic disruption is likely to be short-term. Chinese company valuations are inexpensive, and this could provide the foundation for a recovery in Chinse equity values as COVID is addressed.

Australian Share Market Remain Resilient

The Australian share market has exhibited resilience in the face of rising global inflation, supply chain disruption and geo-political upheaval. To a degree Australia has been insulated from quantitative tightening measures as the Reserve Bank of Australia has not yet implemented inflation fighting measures. Australian bond market pricing suggests that a tightening response is inevitable but with an Australian Federal Election in May the bank has so far held off. The election is yet to reveal any substantive policy changes influencing the outlook for Australian shares. The Australian banking sector continues to add stability to the Australian share market.

Advancement of Australian quantitative tightening will likely assist bank earnings provided that this benefit is not competed away. Despite China's immediate demand ebbing somewhat, commodity prices remain elevated which is supporting the Australian resources sector. One area of possible vulnerability within the Australian market is consumer demand-focused stocks. Consumer confidence has softened but Australian households remain well positioned with strong employment and higher savings.

New Zealand Less Defensive

The New Zealand share market has proven more defensive than markets dominated by high growth companies but year to date returns have been poor. Like international markets, price weakness has been most evident in high multiple 'growth' companies. A potential offer for Pushpay represents an exception to this. Border reopening beneficiaries strengthened in April and Air New Zealand successfully completed its large rights issue.

Summary

In response to macroeconomic conditions, it may be prudent to position portfolios to be at the strategic asset allocation or slightly conservative in some cases. Increasing cash holdings from both growth and fixed income provides some buffer from potential further underperformance. Although the returns from cash remain meagre, increasing cash provides some optionality and improved nominal income relative to recent history. Modest underweighting of growth assets may be prudent given the rapidity with which rates have risen and the absolute level rates reached from historical lows. A case can still be made for a bounce back in growth assets if central banks are successful and the consumer remains robust, however caution suggests that mildly defensive positioning could be the course of least regret.

Monthly View continued – April 2022

Key Market movements over April 2022 Source: Bloomberg

Share market returns in their own currency	1 Month	3 Months	1 Year
NZX 50 (New Zealand Shares)	-1.9%	0.0%	-6.7%
MSCI ACWI (Global Shares)	-6.7%	-7.1%	-3.4%
S&P 500 (Top 500 US Listed Companies)	-8.8%	-8.5%	-1.2%
NASDAQ 100 (US Technology Companies)	-13.4%	-13.9%	-7.3%
ASX 200 (Australian Shares)	-0.9%	6.6%	5.8%
New Zealand Interest Rates	**Latest rate**	**3 months ago**	**1 year ago**
New Zealand's Official Cash Rate	1.50%	1.00%	0.25%
3 Month Deposit Rate	1.73%	1.55%	0.31%

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NASDAQ 100 (US Technology Companies)	-13.4%	-13.9%	-7.3%
ASX 200 (Australian Shares)	-0.9%	6.6%	5.8%
New Zealand Interest Rates	**Latest rate**	**3 months ago**	**1 year ago**
New Zealand's Official Cash Rate	1.50%	1.00%	0.25%
3 Month Deposit Rate	1.73%	1.55%	0.31%