Monthly View – May 2022

Investment markets have been dominated by four issues.
- Has inflation peaked?
- Has China overcome its Covid outbreak?
- Will energy prices continue to rise?
- How will central banks respond?

Has inflation peaked?

Reported inflation data remains at levels higher than that experienced for decades, but most recent reports are marginally below those for March. Inflation is measured using differing baskets of goods and services and the outcomes can vary and are of differing significance. United States CPI inflation came in at 8.3% but the PCE inflation rate favoured by the Federal Reserve recorded 6.3% yoy for April down from 6.6% yoy in March. This measure excluding energy and food fell to 4.9% yoy from 5.3%. New Zealand's inflation to March 31 was reported at 6.9% but the Reserve Bank of New Zealand (RBNZ) inflation expectations survey has this falling to 4.6% in two years. In contrast the Bank of England expects United Kingdom inflation to accelerate and exceed 10% by year end.

For inflation to be maintained or accelerate, prices must continue to increase at a faster rate. As time moves forward the effects of an initial price surge tend to drop out of the data, and this results in a decline in the rate if inflationary pressures abate. There are some signs of this occurring as supply chain constraints unwind and demand for goods such as used cars is satisfied. Inflation itself tends to lessen the pressure as consumer demand and confidence is eroded by the reduced ability to pay higher prices.

Has China overcome its Covid outbreak?

China has experienced a second wave of COVID 19 and imposed restrictions on the population in key trading cities Shanghai and Beijing. This has contributed to global supply shortages and increased supply chain friction, pushing up prices. There is cause for optimism that the disruption to China will be temporary. The lowest level of COVID cases was recorded in three months and the Chinese authorities have begun to remove some of the restrictions previously imposed to limit the outbreak.

Energy prices

Energy prices have been a significant contributor to inflation. Supply of oil and gas to Europe has been disrupted by the Ukraine conflict exacerbating already tight supply conditions due to low levels of exploration spending. Europe has resolved to ban most Russian crude imports by year end, and this will require alternative supplies to be secured, competing with existing demand or rapid switching to generally more expensive sources of alternative energy (at least in the short-term). China's prospective normalisation is also affecting prospective oil demand which should also contribute to price pressure.

How will central banks respond?

The inflation outlook remains key to monetary policy with most central banks committed to continuing to raise interest rates and progressively restrict money supply while inflation remains outside target bands.

The RBNZ delivered a further 0.5% increase in the Official Cash Rate (OCR) and has lifted the peak OCR to 4% in 2023 in its most recent monetary policy statement. This implies that further 0.5% increases in the OCR are in prospect. Similarly, the US Federal Reserve also lifted its federal funds rate by 0.5% but only to 1%. The Australian Reserve Bank has finally acknowledged inflation is an issue and increased its cash rate to 0.35%. The variation in timing and magnitude of rate increases is indicative of differing cycle timing and the extent of inflationary pressure.

Fixed Income

Fixed income investors appear to be discerning between the immediate inflation outlook and the longer-term inflation prospects. Short-term interest rates are pushing up in response to central bank tightening, but longer-term rates have not moved proportionately. Having increased prior to May, New Zealand long-term rates in fact retraced over the month as markets reassessed whether inflation would continue to accelerate and whether the RBNZ would in fact implement the full forecast increase in the OCR. In the domestic fixed interest market, the case for further rises in interest rates is less compelling than previously given where rates currently sit although there continues to be risk that inflationary drivers such as wage costs continue to exert upward force

Global Shares

Share market weakness was prevalent in May. The extent of decline was more muted in international markets than locally. The MSCI World index was marginally positive in May as was the S&P500, but NZ currency appreciation resulted in a negative return for the month. Interest rate sensitive stocks were impacted by rising rates and growth companies continued to languish. Energy, utilities and financials tended to be the better performing sectors in global share markets.

Some markets are verging on bear market territory, being a fall from peak of over 20%. Broad index aggregates however tend to obscure those falls have been uneven. Many of the growth companies yet to produce sustainable discretionary free cash flow have fallen by more than 50%. Whether these falls are justified or not in terms of the long-term potential of these stocks is yet to be established. We can be relatively certain that only a small proportion will produce long-term shareholder value gains. We can also be certain that the rebasing at lower levels provides a more favourable risk return trade-off for those investments that do emerge as long-term value creators. Aspects of the current macro-economic backdrop are favourable to some companies e.g. energy.

Companies that are able to navigate increasing input costs, have assets or sell commodities that are inflation adjusted or financing fixed in nominal terms are likely inflation beneficiaries. In real terms these offer both opportunity for real growth and a hedge against diminishing purchasing power.

Australasian Shares

In New Zealand both defensive yield and growth companies have been trading on extended multiples when compared to international peers. Yields have become less attractive as domestic interest rates have risen and this has seen prices of property and other income stocks such as gentailers fall. The NZ All Real Estate index declined 6.5% in May. Although there is scope for further interest rate sensitivity, income yields have improved substantially and are above bond yields for the same companies naturally reflecting security structure.

The NZX 50 Gross index fell 4.8% in May. Poorest performing stocks echoed international trends with loss making technology companies Serko, Eroad and Pacific Edge all falling more than 20%. The retreat in share prices has also underlined the potential for some companies as acquisition candidates. Three stocks have recently emerged as possible takeovers targets; Pushpay, Sky Entertainment and Comvita. Pushpay was the best NZX 50 stock in May, up 11%.

Australian shares have experienced some downside but the falls in large capitalisation stocks has not been as severe as elsewhere. The ASX 200 Accumulation index fell 3% in AUD terms.

The Australian market continues to have attractive characteristics. Key exports of agricultural commodities, iron ore, natural gas and coal continue to experience high prices. Australia continues to experience population growth; the Australian dollar is supportive and both federal and state governments are undertaking ongoing fiscal stimulus.
The materials sector was flat in May. Property proved interest rate sensitive, with the Australian REITs index falling 8.7% (declines coming in Charterhall and Goodman Group). Similarly, the Australian technology sector was weak.

Summary

It appears likely that inflationary momentum will soften near-term, but that inflation will remain elevated relative to recent levels. Despite the epidemic and military conflict, GDP growth has also been strong but may also have peaked. There is a risk that the interest rate brake central banks are currently applying generates a hard landing/recession. Profit margins are already under pressure from inflation and the resultant profit squeeze will restrain earnings growth and may be accompanied by further price earnings multiple deratings. Valuations have fallen and are now more reasonable.

In this scenario domestic fixed income at current yields has more appeal than in the past. Domestic fixed income offers some shelter at current yields from an economic downturn and increasing exposure to this asset class may be prudent. International interest rates look to be vulnerable to further rate increases particularly in Europe.

Equity prices have fallen substantially and are factoring in a more pessimistic outlook. This does not preclude opportunity as share price performance will not be uniform across sectors or geographies. Markets tend to be short-term focused and to overreach on both the upside and downside. A diversified and balanced approach to investing remains appropriate.

Key Market movements over May 2022 Source: Bloomberg

Share market returns in their own currency	**1 Month**	**3 Months**	**1 Year**
NZX 50 (New Zealand Shares)	-4.8%	-5.6%	-8.2%
MSCI ACWI (Global Shares)	-0.5%	-5.0%	-4.7%
S&P 500 (Top 500 US Listed Companies)	0.00%	-5.5%	-1.7%
NASDAQ 100 (US Technology Companies)	-1.7%	-11.2%	-7.6%
ASX 200 (Australian Shares)	-3.0%	2.3%	0.7%
New Zealand Interest Rates	**Latest rate**	**1 month ago**	**1 year ago**
New Zealand’s Official Cash Rate	2.00%	1.50%	0.25%
3 Month Deposit Rate	2.15%	1.73%	0.23%