Monthly View as at 31 July 2022

Markets rebound in July

Undoubtedly 2022 has been a challenging period for investors. The United States share market experienced its worst start to the year since Richard Nixon was in the White House. United States long-term interest rates increased to levels not seen since 2011. Similarly, interest rates in New Zealand have increased back to levels last seen when John Key was New Zealand prime minister. This rise in long-term interest rates has resulted in negative fixed income returns as existing securities are revalued.

In the first half of 2022, the New Zealand share market was unable to maintain its prior good performance. Despite its defensive qualities, the share market fell 11.5% in the seven months to 31 July and is now back at levels not seen since the start of the pandemic. The month of July represented a pause in this downward trend and may mark a turning point. Both share and bond markets generated positive returns in July. The New Zealand fixed interest market gained 1.8% and New Zealand shares were up 5.7%. Largest positive contributors were Fisher & Paykel Healthcare, Mainfreight and Spark. Inflation sensitive stocks Sky City, Restaurant Brands and The Warehouse lagged the New Zealand market.

The Australian share market made similar gains to New Zealand and the Australian Small Ordinaries index had its third best performance since 2000, up 11.4% in Australian dollars. Previously beaten down technology companies experienced rebounds during the month whereas the large mining companies weighed on the index in response to falling commodity prices.

Global markets echoed these returns. The MSCI ACWI (the common All World index used) was up 6.5% in New Zealand dollar terms while the Bloomberg Barclays Global Aggregate bond index (NZD hedged) gained 2.6%.

Macro drivers

Share market pricing is based on investors assessing all of the information available to the market and pricing securities based on known information. Markets are not always coldly objective in analysing value and pricing securities appropriately. Factors such as sentiment and momentum can lead to excessive optimism or pessimism being incorporated into the price the market is willing to transact at. For example, the negative sentiment investors currently have is weighing on current pricing of shares and bonds.

The reasons for the falls in market values have been well articulated. The primary driver of current performance is inflation. Higher inflation has been a global phenomenon and has reached levels last experienced in the 1980s. Few would suggest that excessive inflation is positive for the general economic wellbeing. Not only does inflation impact on the current level of economic activity it also reduces the purchasing power of consumers, especially the vulnerable, and consequently demand declines. The profitability of firms is eroded if costs rise more rapidly than revenues and the threshold for the viability of new projects is increased.

In response to inflation, central banks (after initial inertia) are responding by raising interest rates. This year we have seen some of the most aggressive interest rates rises in history. Markets have responded not only to the actual rises in rates but also to the expectation that central banks will raise rates to an even greater extent to quell inflation. The actual increases implemented have resulted in downward pricing of existing bonds. Rising interest rates have also impacted share values. Valuations are affected by the rising cost of capital, and in order for dividend yields to remain attractive share prices have to decline.

The causes of inflation have been both demand and supply side based. Logistical disruptions, quarantine restrictions and worker absence due to COVID have contributed to supply chain disruption. The Ukraine war has also impeded supply chain efficiency and is disrupting the availability of a large number of commodities, most notably natural gas supplies and grain.

The difficulty in sourcing products and finished goods has resulted in the bullwhip effect wherein companies are stock piling inventory in anticipation of demand. This phenomenon initially overstates demand and places upward pressure on inflation, but this additional demand is illusory, and prices should revert back to their previous levels once the additional supply is received. In New Zealand the ‘gib crisis’ may be a classic example of this bullwhip effect.

Inflation is a rate rather than a static measure. Examples where prices have risen are clearly identifiable. However, this trend now appears to be reversing. A number of foodstuffs (e.g. wheat and milk) have declined in price after the initial surge earlier in the year. Similarly metals (e.g. copper) have dropped from earlier peaks. Importantly oil prices have dropped back from peak levels although the fall has been less pronounced than other commodities. These factors suggest inflation may have peaked and will decline in the coming months.

However, inflation may not decline back to central bank target ranges. This is between 1 – 3% p.a. in New Zealand. Salary and wage costs are rising and this wage inflation is likely to be more persistent than that for goods. The war in the Ukraine and lock downs in China remain a risk. If inflation remains above central banks’ target then interest rates will have to remain high, but not necessarily move higher.

Yield curve inverted

The unequivocal messaging from central banks as to their objective of reducing inflation has impacted on interest rate yield curves. Both the US and New Zealand yield curves have become inverted where the 10-year interest rate is below the prevailing 2-year rate.

This indicates two things; fixed interest investors believe over the long-term that the central banks will be successful in reducing the level of inflation and secondly there is a strong probability that the economy will fall into recession.

Inverted yield curves have preceded the last six recessions in the United States. What is uncertain is how far off a recession is. Some economists suggest that the United States is already in a recession (typically defined as two quarters of negative GDP). Share markets typically fall prior to a recession and start recovering halfway through the recession.

However, recessions are not uniformly alike, and the depth of recession and its duration will be a function of underlying conditions and the policy response. Unfortunately given the high level of inflation (and their past mistake of cutting interest rates too much), central banks will be hesitant to cut interest rates until they are confident that inflation is trending back to their target ranges.

Company specifics also a factor

While some companies, including Meta (Facebook), Walmart and Target have reported lower than expected profits, in aggregate second quarter earnings announcements out of the United States were better than expected. Companies also remain confident that they will achieve third and fourth quarter estimates. This implies that due to the high levels of employment, demand is robust. It would also suggest that companies have adapted to the higher interest rate environment. This would imply that if the United States experiences a recession, it will be relatively mild.

Summary

Financial markets appear to be pricing a fairly bleak outlook given the declines seen in the first half of the year. Investors are cognisant of the numerous market influences that are depressing sentiment. These influences are well known and baked into valuations. The unknown is if the impact of these influences are reasonable and whether investors have fallen victim to over/underestimating the actual impacts.

Surveys are suggesting that institutional investors are particularly nervous and holding larger than normal cash balances. Financial markets are also not reacting negatively to bad news. Both of these factors suggest a lot of negative news is already priced into current valuations. In this environment, positive surprises can result in significant upward moves in markets. In a weak investment climate picking the bottom is the preserve of a few bold (and possibly lucky) investors.

Key Market movements as at 31 July 2022 Source: Bloomberg

Share markets

	Index Level	Performance – local			Performance – NZD		
		1mth	3mth	1yr	1mth	3mth	1yr
MSCI All Country World Index	767.3	6.9%	-1.6%	-8.3%	6.5%	0.5%	-2.1%
NZX 50 Index (New Zealand)	11,492.7	5.7%	-3.3%	-8.7%	5.7%	-3.3%	-8.7%
ASX 200 (Australia)	6,945.2	5.7%	-6.6%	-6.1%	6.3%	-5.1%	-0.9%
S&P 500 (US)	4,130.3	9.1%	0.0%	-6.0%	8.5%	2.8%	4.4%
NASDAQ 100 (US Technology)	12,948.0	12.6%	0.7%	-13.4%	11.9%	3.6%	-3.9%
Euro Stoxx 50 (Eurozone)	3,708.1	7.3%	-2.5%	-9.3%	3.9%	-3.0%	-13.4%
Nikkei 225 (Japan)	27,801.6	5.3%	3.6%	1.9%	6.7%	3.7%	-6.8%
FTSE 100 (UK)	7,423.4	3.5%	-1.6%	5.6%	2.8%	-2.1%	2.6%
Shanghai Composite (China)	3,253.2	-4.3%	6.8%	-4.2%	6.5%	0.5%	-2.1%

Currencies

	Rate v NZD	1mth ago	3mth ago	1yr ago	NZD Performance*		
					1mth	3mth	1yr
Australian dollar	0.900	0.905	0.914	0.949	-0.5%	-1.6%	-5.2%
US dollar	0.628	0.624	0.646	0.697	0.5%	-2.8%	-10.0%
Euro	0.615	0.595	0.612	0.588	3.3%	0.5%	4.7%
UK pound	0.516	0.513	0.514	0.502	0.7%	0.5%	2.9%
Japanese yen	83.674	84.743	83.776	76.515	-1.3%	-0.1%	9.4%
Chinese renminbi	4.244	4.184	4.266	4.506	1.4%	-0.5%	-5.8%

* Positive number means NZD has risen

Interest rates

	Official Cash Rate %			3mth Deposit Rate %			10yr Govt Bond Yield %		
	Latest rate	1mth ago	1yr ago	Latest rate	1mth ago	1yr ago	Latest rate	1mth ago	1yr ago
New Zealand	2.50	2.00	0.25	3.08	2.81	0.39	3.42	3.86	1.65
Australia	1.31	0.81	0.03	2.41	2.01	0.03	3.06	3.66	1.18
US	2.50	1.75	0.25	2.79	2.29	0.12	2.65	3.01	1.22
Euro	-0.01	-0.54	-0.55	0.23	-0.20	-0.54	0.82	1.34	-0.46
UK	1.25	1.25	0.10	1.94	1.67	0.07	1.86	2.23	0.57
Japan**	-0.01	-0.04	-0.04	-0.01	-0.03	-0.10	0.19	0.23	0.02
China	1.62	1.62	1.62	1.10	1.10	1.10	2.77	2.82	2.86

** Changed from target to actual

New Zealand bonds

	Total returns		
	1mth	3mth	12mth
Government	2.9%	2.0%	-8.7%
Corporate A	2.1%	2.3%	-4.9%
Corp Inv Grade	2.0%	2.2%	-4.9%
Call Deposits	0.2%	0.5%	1.0%
90D Bank Bills	0.2%	0.5%	1.0%

Global Govt bonds (7-10yr)

	Total returns		
	1mth	3mth	12mth
US	3.1%	2.8%	-9.6%
Eurozone	4.5%	0.9%	-10.8%
Japan	1.1%	0.8%	-0.9%
UK	3.2%	1.1%	-7.7%
Australia	5.2%	1.4%	-12.1%