Monthly View as at 31 August 2022

High Inflation Environment

There has been a lot of commentary about whether the current high inflation environment means that financial markets will experience a repeat of what happened in the 1970s. This was an extended period when there were poor returns from both fixed interest and shares. While it is possible to draw parallels between today and the 1970s, it is also important to note that there are significant differences.

In the late 1960s and early 1970s the United States experienced large fiscal deficits due to the introduction of several social welfare programmes and the ongoing cost of the Vietnam War. This resulted in the United States dollar's linkage to the price of gold being removed without a replacement regime being put in place. The global economy also experienced an energy crisis in 1973-74 due to the Yom Kippur War and resulting OAPEC (Organisation of Arab Petroleum Exporting Countries) oil embargo and price rises.

Inflation rose sharply and, in an attempt to reduce inflation without pushing the economy further into recession, governments introduced regulations including price and wage freezes. These measures were largely unsuccessful, and it was not until 1979 when President Carter appointed Paul Volker as the Federal Reserve Chair and interest rates were increased sharply, that inflation finally fell and remained low. But this was not without costs, with unemployment also rising sharply and the United States experiencing two recessions in the early 1980s. It is fair to say that most people did not believe inflation would fall. This meant interest rates needed to go higher and stay high until behaviour changed. This is why inflation expectations are so important.

New Zealand followed a similar path. The energy crisis occurred at the same time as the United Kingdom entered the European Union. Respective governments experimented with rationing, fiscal deficits, an overvalued New Zealand dollar and price and wage freezes. These policies were also unsuccessful and inflation in New Zealand remained high through the 1980s. It was only after the introduction of the 1989 Reserve Bank Act that inflation finally fell and remained low.

The 1970s and 1980s proved to be an important lesson for governments and central banks. Central banks became more independent and inflation targeting became popular. The independence of central banks means they can make the hard decisions without worrying about electoral cycles or opinion polls. Luckily, these hard-won gains have not been forgotten by central banks and this is why the 2020s are unlikely to be a repeat of the 1970s.

In a recent speech to global central bankers in Jackson Hole in the United States, Federal Reserve Chair, Jerome Powell, reaffirmed the Federal Reserve's commitment to fighting the current high inflation rate. He noted the Federal Reserve would increase interest rates and keep them high until inflation fell, even though this would result in below average economic growth and increased unemployment levels. The Reserve Bank of New Zealand has made similar statements.

Central banks are committed to getting inflation lower and the sooner we get there the better.

Despite the expected pain in the short term, returning to a low inflationary environment is positive for fixed interest investments, share markets and consequently long-term investors.

New Zealand Share Market

The New Zealand share market appreciated by 1.0% over August as market participants focused on the company reporting season. While company results and updates were better than expected, the number of companies beating expectations was lower than in previous reporting seasons. Companies to beat expectations included Fletcher Building and Spark. However, some companies did report lower than expected profits including Mercury and Auckland Airport. In addition, Fisher and Paykel Healthcare provided a market update which pointed to lower-than-expected earnings.

Over the past 12 months, the New Zealand share market has fallen 11.6%. This fall reflects the rise in interest rates and the situation that 12 months ago, the New Zealand market was trading on very expensive valuations. Today, valuations are more reasonable. Interestingly, in their outlook statements, companies were on average positive about the future. This is despite the weak business confidence. However, analysts have taken a more cautious approach and have generally revised down their 2023 forecasts.

Australian Share Market

The Australian share market was also positive over the month, appreciating by 1.2%. The positive performance reflected the strong performance from resource companies including BHP and Woodside. Technology and growth companies performed poorly over the month as long-term interest rates rose. These shares are more sensitive to interest rate rises as their profits can be many years into the future.

In the 12 months to 31 August, the Australian share markets has declined 3.4% in Australian dollar terms. Over the same period, the New Zealand dollar has fallen from A$0.96 to A$0.90. This decline has meant that in New Zealand dollar terms the Australian market has risen by 4.1%, making it one of the few asset classes to have experienced a positive return over the last 12 months. Looking forward, the performance of the resource sector will be very dependent on the Chinese economy. This economy is currently experiencing weak economic growth but the Chinese central bank, the People's Bank of China, is one of a few central banks in the world to be cutting interest rates.

Global Share Markets

Global share markets were generally positive during the first half of August. However, Powell's speech in late August significantly changed market sentiment. Not only did Powell confirm that the Federal Reserve would raise interest rates, he also noted that rates will remain high until inflation falls. The market had been toying with the view that interest rates would decline if the United States economy entered a recession. Powell noted that this was one of the lessons they had learnt from the 1970s – remain resolute until inflation is under control. The S&P 500 ended the month 4.1% lower and has declined 11.2% in the 12 months to 31 August.

European share markets were also weak over the month. This partly reflected Powell's comments and similar comments by European Central Bank board members.

Europe is experiencing even more of an inflation problem than the United States with energy prices including electricity prices up sharply due to the Ukraine War and Russia closing natural gas pipelines.

Inflation in Germany is currently 7.9% but this is widely expected to reach over 10% by the end of the year. Inflation in the United Kingdom is already over 10% and forecast to go even higher. In August, the Euro Stoxx 50 declined by 5.1% and has declined by 13.3% over the past 12 months. In the United Kingdom, the FTSE 250, which better reflects the domestic economy, is down 18.7% over the last 12 months

Summary

The 1970s was a difficult period for investors. The global economy suffered external shocks and the initial fiscal and monetary policy response to these shocks was proven to be flawed and prolonged the downturn. While the fiscal response to the COVID pandemic in the form of wage subsidies was appropriate, arguably the monetary policy response was wrong and interest rates declined too far. Central banks have now reversed course and are undertaking the most aggressive interest rate rises seen since the 1970s. This is likely to result in some short-term pain with unemployment rising and the more speculative parts of the economy experiencing price declines.

However, long-term inflation expectations remain low and most listed companies have very conservative balance sheets and are well positioned to weather the downturn. Given the forward-looking nature of financial markets, the recent declines in share markets should be seen as an opportunity rather than a concern. The 1980s taught us that once inflation was under control, both fixed interest and share markets experienced strong and sustainable long-term returns

Indices for Key Markets

As at 31 August 2022	1 Month	3 Months	1 Year	3 Years p.a.	5 Years p.a.
S&P/NZX 50 Index	1.0%	2.7%	-11.6%	3.2%	9.1%
S&P/ASX 200 Accumulation Index (NZD)	1.2%	-2.4%	-3.4%	5.5%	8.1%
MSCI ACWI Index (NZD)	-1.3%	0.4%	-3.3%	9.2%	10.4%
S&P/NZX 90 Day bank bill Total Return	0.2%	0.6%	1.2%	0.8%	1.3%