Investment Update – February2021

New Zealand Share Market Diverges from Other Markets

The New Zealand share market fell in the month of February in index terms by approximately 7%. This fall occurred despite New Zealand listed companies reporting very satisfactory results. The ratio of companies with profits exceeding consensus forecasts was 5:1. The headline fall is explained by the price movements of New Zealand's largest listed companies. Fisher Paykel Healthcare fell 15.6%, A2 Milk declined 16% and Meridian Energy was off 20.3%. A2 Milk continues to be impacted by the absence of the Daigou trade out of Melbourne. Meridian Energy has been falling post the iShares Global Clean Energy ETF establishing a significant shareholding. It appears that the ETF will reweight its holdings at the next portfolio rebalance and active investors are positioning for anticipated partial divestment by the ETF.

In contrast other share markets held up well during the month. The S&P 500 was up 2.8% in local terms and the S&P/ASX 200 index rose 1.5% in local terms. The divergence in performance between New Zealand and Australian share markets has been striking and reflects the differing composition of these markets. New Zealand with a higher proportion of defensive yield stocks whereas Australia has greater representation in resources and banking. The strength in banks was evident with dual listed banks ANZ and Westpac up 11% over February in NZD terms. Other global share markets also provided positive returns for the period. These markets were encouraged by the progress being made in vaccinating populations and the expectation that a bounce in activity will occur post the removal of quarantine constraints. Some of the gains made were evident in those companies sensitive to international borders reopening.

Exchange rate movements in the month were most evident in the NZD/USD pair. The United States dollar continued to depreciate over February with the NZD reaching 0.74 at one point. A sell off at month end saw the NZD up 0.6% for the month.

Interest Rate Outlook Dominates Debate

Interest rates continue to be a dominant consideration in investment markets and have staged a sharp turnaround in direction. The quantum and speed of interest rate rises has surprised markets. The increase in yields has so far been evident in the New Zealand, Australian and United States markets and is reflected in a steepening of the yield curve. This means that bonds with longer term maturities have progressively risen the further out the bond matures.

An example of this in the retail market is ASB lifting its five-year term deposit rate from 0.75% to 1.75%. The rise in rates has been driven by increasing fears of inflation in the next few years. Longer-term fixed income investors require a higher rate of return to compensate for erosion of future purchasing power. As concerns that the economic climate will further deteriorate abate the focus of fixed income investors is shifting from preservation of capital in nominal terms to preservation of capital in inflation adjusted terms.

This investment position has occurred despite central bank's policy remaining unchanged. Central banks remain concerned as to the level of economic activity and short-term interest rates are firmly anchored at or near zero.

New Zealand interest rates have increased more rapidly and to a greater extent than peers. The degree of rise can be attributed to New Zealand rates having overshot on the way down, falling to a greater extent, to levels below larger economies whereas traditionally New Zealand interest rates have exceeded those larger peers given the New Zealand economy's greater vulnerability to external factors.

The rise in rates has been pronounced given the very low base level prevailing prior to the upward movement. The effect has been marked given that within the last 6 months deflation as opposed to inflation was the concern. Given the rapidity of the increase some retracement from peak levels is likely but with a reset of base levels. In absolute terms the current rates remain at low levels in historical terms. The potential for further increases is likely to be capped by intervention employing mechanisms such as intertest rate controls where central banks focus bond buying on certain maturities. If this transpires then further upward pressure is likely to be at a less rapid clip and extended over a longer period. Key influences will be the rate at which economic recovery occurs measured by unemployment levels, availability of goods and services and the trend in input costs.

Implications of Rising Rates

Although a rapid rise in rates is damaging to the mark to market value of existing bond holdings and prospectively increases the cost of borrowing to conclude that rising rates is universally negative for investors could be an erroneous interpretation. Rising inflation from a recessionary environment signals that demand is present in the economy and activity levels are lifting. The International Monetary Fund has forecast the global economy to grow by 5.5% in 2021 and by a further 4.2% in 2022. Company earnings in these circumstances are likely to be improving. Only when inflation has been prolonged and has risen to a level which begins to significantly erode purchasing power do the negative effects begin the outweigh the positive.

For this reason, central banks generally target inflation in a 2-3 percent range and have expressed a reluctance to intervene until inflation at these levels or marginally above is well established.

Share markets have tended to rise in tandem with inflation around the 3-4% mark. Whether this continues to be the case should be carefully monitored given the much lower base from which the current cycle is emerging.

Effects Not Uniform

The effect of rising interest rates is not uniform amongst listed companies. Most sensitive to rising rates are:

• Companies which investors buy primarily for income purposes. Dividend yields are directly related to alternative fixed income yields. As certain fixed income yields rise potentially attractive returns from dividends diminish.

• Companies which investors have acquired based on very long-term growth potential. These companies which investors have acquired based on very long-term growth potential. These companies may not be cash flow positive, are continually reinvesting to increase revenues and do not make distributions to shareholders. The value of those long-term prospective cash flows diminishes in present value terms as interest rates rise.

• Companies that have very high levels of debt such that continuing financial viability is impacted by rising interest rates.

Conversely companies which may thrive in a modestly inflationary environment are those:

• Companies in cyclical businesses with established markets and sound balance sheets that experience increasing demand for products and services.

• Companies engaged in the production of raw materials for production processes experiencing increasing end demand. Following a recessionary period this is typically marked by a shortage of supply as expenditure on exploration and development has been reduced.

• Banks which have sound capital ratios, are adequately provisioned and are experiencing expanding interest rate margins as interest rates rise.

Summary

Volatility of returns is associated with increasingly variable macro-economic and sector specific factors. At a macro level the continuing influence of monetary stimulus is pervasive. When combined the impetus to be provided by consumers returning to normal patterns of consumption and continuing quantitative easing is likely to further energise markets.

New Zealand has been fortunate in being largely insulated to date from the effects of the COVID 19 epidemic. While this has cushioned the local markets from the worst effects potentially better returns may be offered externally in markets which are yet to adjust to more normal conditions

Key Market movements over February 2021

Share markets (unhedged)	1 Month	3 Months	1 Year
NZX 50 (New Zealand Shares)	-6.9%	-4.2%	8.6%
MSCI ACWI (Global Shares)	2.3%	5.9%	25.1%
S&P 500 (Top 500 US Listed Companies)	2.6%	5.2%	29.0%
NASDAQ 100 (US Technology Companies)	-0.1%	5.2%	52.6%
ASX 200 (Australian Shares)	1.0%	2.4%	3.6%
New Zealand Interest Rates	**Latest rate**	**1 month ago**	**12 months ago**
New Zealand's Official Cash Rate	0.25%	0.25%	1.0%
3 Month Deposit Rate	0.30%	0.25%	1.31%

Source: Bloomberg