Investment Update – July 2021

It is Difficult to Predict, Especially the Future

Economic statistics reported in July presented investors with a smorgasbord of data which was significant in a localised sense but also indicative of a prospective desynchronization of trends within different geographical markets.

New Zealand Capacity Compresses

The Quarterly Survey of Business Opinion reflected buoyant local conditions with shortages of labour a constraint for many businesses. TradeMe (80,000 vacancies) and Seek job advertising were both strong. Rising input costs and business confidence are such that 64% of businesses expect to increase their prices. New Zealand inflation for the year ended June printed at +3.3% compared to the RBNZ's May forecast of 2.6%. The economic data has led trading bank economists to bring forward their projections for the next increase in the Official Cash Rate (OCR) to August. Consistent with this outcome the RBNZ has started to wind down its Large-Scale Asset Purchase programme as a precursor to an increase in the OCR. An initial increase in the OCR appears to be likely to be followed by several further increases.

Although an increase in the OCR appears imminent it does not unlock the puzzle in relation to longer-term intertest rates. A range of outcomes are conceivable as to the direction of long-term rates depending on local and offshore conditions and the economic management response.

The cost of new dwellings is a significant component of the consumer price index, as is petrol. Existing housing prices remain elevated with May prices up 15% on last year and although there are signs that the price of existing housing is decelerating a supply response in the new housing market continues. 43,466 housing consents were issued in the year to May and this funnel will maintain demand for building products and construction labour. New Zealand supply chains continue to be constrained with the price of a 40-foot container quadrupling this year and increasing demurrage cost for logs at certain ports. Price increases in New Zealand may be more persistent given these pressures.

The New Zealand share market declined in July by 0.5% despite the underlying level of economic activity. It appears that interest rate sensitive stocks in the utility and infrastructure sector may be exhibiting some susceptibility to potential increases in rates as well as logistical constraints. The larger absolute falls in the NZX top 50 were Delta variant-related companies Kathmandu, SkyCity and Tourism Holdings.

Although the S&P/NZX 50 index was down for the month it remains +7.4% for the year ending 31 July. Mainfreight made the largest positive contribution to index performance as the company's global logistics activity benefits from increasing volumes. New Zealand in the 2021 year constituted less than 25% of Mainfreight's revenue. Restaurant Brands and Z Energy also made positive contributions in the month. Restaurant Brands sales are rebounding, and Z Energy provided an assurance that it expects to maintain dividends and attracted takeover speculation.

Australian Shares Untroubled by COVID

The suspension of scheduled air travel between New Zealand and Australia has had a far more negative implication for New Zealand shares than Australian. Australian shares have also been able to maintain value despite the continuing Delta variant outbreak prolonging restrictions on movement and activity internally. The Australian ASX 200 Accumulation index was up 1.3% in local terms in July.

Appreciation of the New Zealand dollar took some of the shine off this performance for New Zealand investors with the adjusted index down 0.9%. Labour availability in Australia continues to be tested with job vacancies 57% above February 2020 levels. The Australian trade surplus continues to swell with May the 41st consecutive month of surpluses. Commodities are the backbone of Australia's trade and although iron ore fell below US$200 per tonne at the end of July other commodities are resilient. Renewable energy commodities lithium and copper have exhibited increasing demand. Australia has had the same inflation experience as other markets with the Australian CPI up 3.8% for the year ended June increasing from an annual rate of 1.1% in the March quarter.

The vitality of the Australian economy is however under threat from the Delta Covid variant's virulence in New South Wales. The restrictions imposed because of the recent outbreak have increased in severity and extent. This has led to a re-evaluation of the degree of economic support required and as a result market pricing has shifted from tapering of monetary support in Australia to reflecting further monetary stimulus i.e. interest rates shift downwards again. Provided New Zealand remains largely untouched by Covid and the New Zealand economy retains its strength this could result in very divergent interest rate trends between the two countries.

China Markets Fall on Regulatory Intervention

The Chinese share markets fell into month end. The Hong Kong market fell 9.5% in New Zealand dollar terms. Chinese companies with overseas listings were worst affected by increasing regulatory intervention. This took a number of forms and included the removal of availability of the Didi ride hailing app for new users two days after the companies debut in the US equity market, the prohibition of profitability by private education services and loss of exclusivity in relation to musical intellectual property. Data security has been cited as one of the concerns leading to the interventions. Overseas investors therefore are losing confidence in Chinese equity markets with many considering the market uninvestable.

Additionally, further barriers to investment were mooted from the United States with some Chinese entities to be subject to further disclosure requirements. A slowing of Chinese economic activity and a Covid outbreak in Nanjing further contributed to the uncertainty. In response the Chinese authorities lowered the Reserve Ratio Requirement by 0.5% to assist small and medium enterprises but it may be sometime before confidence in the scope of opportunity for the very large technology companies is restored.

US Inflationary Pulse Quickens

The US recorded inflation of 5.4% in its June CPI report, the biggest 12-month increase since August 2008. Used cars were the biggest contributor to price increases, + 45% year on year. Core inflation for the period was lower at 3.1%. Contrary to normal expectations 10-year treasury interest rates in the United States have fallen from 1.7% to 1.25% despite the negative inflation adjusted return. The seemingly counter intuitive fall in interest rates has been attributed to various factors. These include uncertainty arising from the prevalence of the Delta strain and increasing vaccination resistance from a proportion of the population, together with some economic indicators suggesting that inflation will in fact be transitory as the Federal Reserve has projected. Reported US Gross Domestic Product growth for the June quarter came in at 6.5% (annual) but below forecasters 8.4% target.

The fall in interest rates has been in conjunction with the US company result reporting period. The reported results have largely exceeded expectations with Alphabet, Facebook and Microsoft again prominent in this respect. Tesla reported another quarter of profitability, exceeding US$1 billion for the first time. One tempering factor however is a slowdown in growth being signalled by Facebook and Amazon while Netflix subscriber growth was lower than anticipated. Nevertheless, the S&P500 gained 2.5% in the month in New Zealand dollars. The lower long-term rates suggest that technology and growth orientated segments of the US market may continue to have legs relative to the value trade apparent at the start of the year.

Summary

Previously investors have made positive gains in separate asset classes, geographies and investment styles with the differentiating factor being the extent of the gain. With Covid now emerging in differing countries at differing times and those countries having differing levels of preparedness compounded by differing stages of economic cyclicality the variation in returns is likely to increase. The potential outcomes arising from specific near-term strategies continue to be clouded although confidence in longer range positioning is more assured. Continuing low real income returns suggests that it continues to be appropriate to maintain exposure to shares across diversified portfolios.

Key Market movements over July 2021

	1 Month	3 Months	1 Year	3 Years p.a.	5 Years p.a.
S&P/NZX 50 Index	-0.5%	-1.1%	7.4%	13.1%	12.5%
S&P/ASX 200 Accumulation Index (AUD)	1.3%	6.1%	28.6%	9.5%	10.0%
MSCI ACWI Index (local currency)	1.7%	5.2%	34.8%	14.3%	14.3%
ANZ 90 Day bank bill Total Return	0.0%	0.1%	0.3%	1.1%	1.5%