Thorners

solutions for you

Investment Update – February 2022

Inflation takes hold

Inflation is clearly evident in developed western economies. The United States recorded an annual inflation rate of 7%, the highest in 39 years. Australian CPI inflation is annualising at 3.5% higher than the Reserve Bank of Australia's target. In New Zealand the annual rate of consumer price inflation is now 5.9%, a 31 year high and well in excess of target levels. Inflation at these levels and recognition by the Federal Reserve that inflation is persistent rather than transitory has led to other central banks following New Zealand's early shifting from monetary easing to imminent tightening.

In conjunction with the surge in inflation, central banks dual objective of maximum employment is also being achieved. US unemployment has fallen to 4.2%, enabling the "great resignation" phenomenon with large numbers of Americans voluntarily leaving existing employment. Employment levels in Australia and New Zealand similarly remain healthy despite the disruptive impact of Covid 19 variants.

Interest rates rising

Rising inflation has translated to fixed interest markets anticipating increases in short-term rates over the next 12 months. The Reserve Bank of New Zealand (RBNZ) has explicitly forecast increases in the Official Cash Rate (OCR) from the current level of 0.75% to greater than 2.5% over the next 18 months. The US Federal Reserve has indicated it will further reduce monetary stimulus, reducing bond purchases from US$40 billion per month to nil in coming months and that it will soon be appropriate to raise the Federal Funds Rate. Markets in response are anticipating the Federal Funds Rate to potentially increase at least four times this year. With the recent inflation outturn in Australia, markets anticipate the Reserve Bank of Australia also abandoning holding its official base rate. To reinforce this trend, Germany's 10-year Bund which has provided a negative yield since 2019 recently moved into positive territory.

Although increasing interest rates are now expected, real yields (that is yields after adjusting for inflation) remain negative. A key issue going forward is the extent to which interest rates now adequately reflect forward inflation expectations. The ANZ Bank has reassessed the NZ OCR outlook and now forecasts an increase to 3%, above RBNZ projection if all other assumptions remain unchanged. Should inflationary pressures persist longer than currently anticipated, even if some of the headline pressure alleviates, it may result in longer-term interest rates lifting from present levels to maintain some term premium. Upward pressure from offshore long-term interest rates is also likely to influence prevailing long-term rates in New Zealand.

The increase in New Zealand wholesale interest rates has already translated to consumer lending and deposit rates. Local mortgage rates have moved up more quickly than term deposit rates. Three-year fixed mortgage rates were at 2.7% in April 2021. The equivalent three-year fixed mortgage rate is now 4.6%.

Although residential housing prices surged through 2021 there are now signs that values may have peaked and ANZ Bank has forecast that home values could fall by 7% this year. Such an outcome will not only slow the rate of residential construction but will also have a broader wealth effect as the sense of financial wellbeing and propensity to borrow diminishes.

China in contrast to Western markets has seen fit to undertake some monetary easing and to marginally reduce its interest rates. The desynchronization of economies represents a significant shift from recent trends where most economies were moving in tandem.

China property developer Evergrande remains in financial distress and although Evergrande appears to be undergoing a managed restructuring other property development companies are at risk.

United States share market downrates

Share markets are not immune to events in the fixed interest markets and have become increasingly sensitised as rates and share prices have moved to more extreme levels. This has been particularly apparent in the United States share market as the Santa Claus rally faded. Companies not currently profitable with continuing capital requirements have been down rated in response to rising interest rates. This fall in valuation for segments of the market has in fact been occurring over several months and in part camouflaged by the ongoing performance of the major capitalisation market leaders and continuing cash inflows (US ETF inflows exceeded US$1 trillion during 2021). The US market returned to a relatively narrow base over the latter part of the 2021 calendar year with Apple, Microsoft, Nvidia, Tesla and Alphabet providing 51% of the market return since April. Examples of weakness in the US market include Netflix, and many of the recent listings such as Rivian.

In contrast companies that “make stuff”, e.g. Johnson and Johnson and General Electric, have been much less affected. Energy has been one of the strongest segments of the US market. Energy stocks prices have responded to increasing oil and gas prices with Brent crude back to levels last seen in 2014. Financials are also holding up in the face of rising interest rates and are likely to be net beneficiaries of expanding interest rate margins. Bank of America has stated that its net interest income will increase US$6.5 billion with four 0.25% rate rises.

Australia benefits from commodity complex

Australian shares exhibited strength over the course of 2021 but gave back gains in January 2022. Raw material companies are benefiting from a recovery in iron ore and very strong prices in other commodities. BHP undertook a share unification process which will result in significant index reweighting. Lithium carbonate has leapt to record levels of 367,500 CNY/T in China. Australian oil companies have been actively acquiring and have benefited from rising oil prices. Woodside was up 14% in January. Normally robust healthcare companies gave ground in January as the effect of rising costs and supply disruptions became apparent. Unsurprisingly, Information Technology was the poorest performing sector in Australia. Xero, now primarily listed in Australia, fell 20% in the month.

New Zealand shares underperform

New Zealand has not been insulated from the global market weakness in January despite the defensive nature of many New Zealand companies and the earlier commencement of monetary tightening. Similar thematics to the US were prominent in the New Zealand share market. Core goods and services held up whereas long dated investment return assets were marked down (Serko, Ryman). New Zealand’s largest company by market capitalisation, Fisher & Paykel Healthcare (FPH 14.9% of index), fell 15%. FPH is internationally held and falls into the category of highly priced growth. These factors together with a possible line of sight into the peak of the Omicron outbreak saw FPH decline.

Geopolitical tension adds to market volatility

During January, Russia continued to amass troops at the border of Ukraine, raising fears that it may be on the verge of invading the Eastern European nation. The move saw NATO (North Atlantic Treaty Organisation) deliver military equipment to Ukraine, saying they see every indication that Vladimir Putin intends to use military force soon. The heightened geopolitical risk added to market volatility, which saw the VIX Index – a measure of market volatility – hit its highest level in more than a year.

Summary

Experience in countries already afflicted by Omicron suggests that although the virus' spread is exponential the impact is not long lasting. Vaccination and treatment post infection has been significant in curbing disruption. Economies are quickly reverting to pre-lockdown freedoms.

The most significant driver of markets at present is the interest rate outlook. To a degree bond and share prices already embed expectations of rising rates. The inflation outlook is fluid and already has proved more persistent than central banks hoped. There is a continuing risk that inflation and by implication interest rates rise above current expectations. The currently projected increase (although from a low base) is not large in absolute terms. Therefore bonds (particularly longer duration) have limited appeal although capital stability remains a redeeming characteristic. Rising rates are increasing the attraction of fixed income, but the real return remains negative. In a rising inflation environment, provided the rate of inflation does not accelerate too quickly and to unsustainable levels, real assets (and their proxies shares) tend to perform well at least in the initial stages of an inflation cycle.

The current weakness in the share markets is not correlated with a major disruption in economic growth. Employment and demand remain robust. Supply constraints are contributing inflationary pressure, but this is also enabling earnings growth. There is a marked rotation apparent in share markets from profitless growth stocks to value companies.

The present volatility is undeniable but in context is not unusual with index movement of 5% or more typically occurring twice a year. Market dynamics are accentuated at present and evolving in response to changing financial conditions. A diversified and balanced approach to portfolios remains appropriate

Key Market movements over January 2022 Source: Bloomberg

Share market returns in their own currency	**1 Month**	**3 Months**	**1 Year**
NZX 50 (New Zealand Shares)	-8.8%	-9.2%	-9.4%
MSCI ACWI (Global Shares)	-4.6%	-2.9%	13.9%
S&P 500 (Top 500 US Listed Companies)	-5.3%	-2.0%	21.6%
NASDAQ 100 (US Technology Companies)	-8.5%	5.8%	15.5%
ASX 200 (Australian Shares)	-6.4%	-4.8%	5.5%
New Zealand Interest Rates	**Latest rate**	**1 month ago**	**1 year ago**
New Zealand's Official Cash Rate	0.75%	0.75%	0.25%
3 Month Deposit Rate	1.11%	0.87%	0.25%

Information and Disclaimer: This report is for information purposes only. It does not take into account your investment needs or personal circumstances and so isnot intended to be viewed as investment or financial advice. If you require financial advice you should always speak to your Financial Adviser. The price, value and income derived from investments may fluctuate because values can go down as well as up and investors may get back less than originally invested. Past performance is not indicative of future results and no representation or warranty, express or implied, is made regarding future performance. This report has been prepared from published information and other sources believed to be reliable, accurate and complete at the time of preparation. While every effort has been made to ensure accuracy Thorner Investment Services Ltd nor any person involved in this publication, accept any liability for any errors or omission, nor accepts liability for loss or damage as a result of any reliance on the information presented. Disclosure statements are available on request and free of charge.