Select WEALTH MANAGEMENT

Thorners solutions for you

Investment Market Review February 2022

Convergence of Negative Factors

Investors experienced further declines in February as the three drivers of market weakness gathered strength. Inflationary pressures continued to be widespread geographically and across most goods and services. Interest rates recognised this and anticipated the need for rates to rise to dampen inflation. Finally, the threatened invasion of Ukraine became a reality with Russian troops crossing the border and active warfare breaking out. While it is tempting to focus on the negative news flow there are positive influences mitigating downside, the effects of Omicron are fading globally, and recent company reporting has provided generally stronger earnings.

Geo-Politics Seizes Market Attention

The full-scale invasion of Ukraine has dominated markets and has created reverberations that are not limited to the local conflict. Apart from the awful human toll this conflict is having, other key issues going forward are whether the fighting spills over the combatants' borders, the intensity of damage and the time taken to resolve the conflict. The most immediate economic effects have been expressed in the prices of commodities, Russian stocks and currency and increased volatility across global share markets. The value of Russian companies has fallen dramatically but these companies are not widely held by western investors, except for a few direct corporate holdings. Russia is a significant supplier of natural gas into Europe with several pipelines running across Ukrainian territory. Similarly, Russia supplies roughly 10% of global oil output with around 40% exported. Russia is also a major producer of aluminium and nickel. Russia and Ukraine are major exporters of wheat and corn. All of these commodities face disruption of supply with prices lifting.

At a strategic level the Russian action has brought forth the rapid introduction of economic sanctions, most notably the exclusion of certain Russian banks from the Swift interbank settlement system. These sanctions will likely persist for a long period beyond that of military action. Political relations are likely to remain frosty and effectively the economic relationship likely reverts to that prevailing during the Cold War. Trade in goods and services will need to adjust to a world where Russia is not as active a participant, with economic friction lifting prices and constraining economic potential.

The response of investment markets to the advent of a military crisis typically is to generate a decline in prices as uncertainty prevails over the extent and persistence of the event i.e. fear, uncertainty and doubt dominates. This period is usually followed by a rebound in values as these concerns are mitigated. Acknowledging that the scale and extent of the conflict is a variable factor prima facie, local economic drivers are likely to reassert themselves as key determinants of investment outcomes.

Inflation Gains Momentum

Reported inflation globally has risen substantially; the European Union's CPI inflation rate pushed up to 5.1% in January, the Bank of England warned inflation would top 7% in April, the United States Personal Consumption Expenditures Index rose by 5.2% year on year in January with other inflation indicators much higher. The Reserve Bank of Australia maintains a more modest forecast of underlying inflation printing at 3.25% by mid-2022.

New Zealand is not immune with an annual CPI rate of 5.9% recorded for the year to 31 December 2021. Central banks have abandoned the assumption that inflationary will be transitory. Logistical costs remain elevated, recent commodity price trends are accentuating inflation and there is little current sign of demand destruction.

These factors tend to suggest that inflation will continue to persist at higher levels than in the past and there is more likelihood of higher inflation expectations becoming anchored.

Reset in Interest Rate Outlook

The effect of higher and more persistent inflation has been to mobilise central bank resolve. The Reserve Bank of New Zealand (RBNZ) was the first to act and has now implemented its third increase in the Official Cash Rate, taking the rate to 1.0%. Moreover, the RBNZ has lifted its forecast of rate increases to 3.3% by mid-2023. Similar action and projections have been made for other central banks, most importantly the US Federal Reserve which is now projected to increase the Federal Funds Rate from March with at least five increases to follow. The debate has shifted from whether base rates increases will occur, to whether increases will be of 0.25% or 0.5%. However, accompanying increasing conviction that short-term rates must increase has been a flattening of the intertest rate; that is, the gap between long-term interest rates and short-term rates has closed.

This interest rate scenario at current inflation rates provides fixed interest investors with strongly negative real returns. Long-term interest rates must rise or the inflation rate fall (or a combination of both factors).

The immediate response to the developing Ukrainian situation has been a flight to the safety of government bonds with bond buyers assuming that the Ukrainian conflict will not be resolved short-term and inflation pressures are quick to dissipate.

Omicron to Peak in New Zealand

Overseas experience has been that that Omicron has resulted in a rapid rise in infection rates but the wave of infection although steep has peaked after several months. Europe, the United States and Australia have exhibited this pattern. Disruption to normal economic activity over this period has been severe but truncated. New Zealand is expected to follow the same pattern although it is behind other developed countries in its Covid progress. The effects of Covid on business has been mixed depending on the nature of the business. A consumer strike because of self-imposed quarantine may result in the final collapse of some struggling operations. Overall these have tended to be small businesses and larger companies with public shareholdings have coped much better.

Should the Omicron surge prove to be short-lived and subsequently fade, this may presage progressive normalisation in Covid-impacted sectors although the rate of normalisation for example in travel related businesses may not be as rapid as hoped.

Economic Growth and Company Earnings Remain Robust

Global economic growth has not been undermined thus far by inflation, epidemics or war. US gross domestic product grew by 6.9% (annual) in the last quarter of 2021. Caution needs to be adopted in interpreting the GDP data due to prior period volatility, but the overall trend is positive. The outlook for the US in 2022 currently is more moderate with a consensus projection of 3.8% GDP growth. Higher oil prices and trade disruption will weaken activity versus potential but currently US performance indices continue to be expansionary.

The strength in commodity prices at present is likely to have positive implications for Australian energy and metal producers. Rio Tinto, having already had the tailwind of iron ore prices, is a significant aluminium producer with 14 smelters. Australia is a major source of Liquefied Natural Gas (LNG) imports into Asia. These gains will translate directly into corporate earnings. New Zealand’s soft commodities are also experiencing price strength, with dairy products a beneficiary of rising grain prices which is supportive for demand in New Zealand as a whole. The most recently reported earnings season has reflected generally supportive conditions. Approximately 67% of Australian companies reporting increased profits, above the 60% long-term average.

75% of companies in the S&P 500 in the recent quarterly reporting recorded earnings beats. In New Zealand over 40% of reporting companies had earnings expectations upgraded by broker Jarden. This has had the effect of improving the overall market valuation metrics.

Summary

Investors may be tempted to re-evaluate portfolio positioning but should remain cautious in respect of taking precipitous action. Conflicting signals exist as to the short-term and longer-term implications of current macro events. It seems likely that the current drivers of markets will abate, and short-term reactions have been excessive. Historically the market response to geopolitical events after an initial sharp sell-off has been a period of recovery over an extended period of time. In this bounce-back phase longer-term drivers reassert themselves. We continue to believe that high inflation, the changing monetary outlook and rising interest rates are the most important factors facing markets.

Key Market movements over February 2022 Source: Bloomberg

Share market returns in their own currency	1 Month	3 Months	1 Year
NZX 50 (New Zealand Shares)	0.7%	-5.8%	-2.0%
MSCI ACWI (Global Shares)	-2.7%	-3.9%	8.2%
S&P 500 (Top 500 US Listed Companies)	-3.1%	-4.2%	14.8%
NASDAQ 100 (US Technology Companies)	-4.6%	-11.8%	10.3%
ASX 200 (Australian Shares)	1.1%	-2.9%	5.6%
New Zealand Interest Rates	**Latest rate**	**1 month ago**	**1 year ago**
New Zealand's Official Cash Rate	1.00%	0.75%	0.25%
3 Month Deposit Rate	1.23%	1.11%	0.30%