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Monthly View as at 30 June 2022

Introduction

The past six months have been a challenging period for all investors as interest rates have risen and share markets have declined. This has meant returns from most asset classes have been negative for investors. The losses from fixed interest portfolios has probably been the most troubling for investors but it reflects the fact that interest rates fell too far. For long-term investors, the unrealised losses today just offset some of the excess gains experienced when interest rates declined in 2020. Today, the level of interest rates is much more realistic. This is difficult for borrowers but does reward savers.

The reason interest rates have risen is that inflation is now at levels not seen since the 1970's. Central banks such as the Reserve Bank of New Zealand are tasked with keeping inflation low and consequently have signalled that short-term interest rates have to rise. This has seen long-term interest rates rise. While not the objective, increases in interest rates can push economies into recession. The threat of a recession and the impact of higher borrowing costs is the main reason share markets have declined. Most share markets have now declined 20% from their peaks. Declines of this magnitude are classified as 'bear' markets and typically occur around economic recessions.

Recessions are an important part of economic cycles and should be seen as part of a renewal process. Studies have shown that some of the most successful companies were established during a recession. This includes Disney (1929), Microsoft (1975) and Airbnb (2008). The more speculative areas of an economy also tend to deflate, and resources are reallocated to more productive parts of the economy.

Nevertheless, we accept that declines in wealth are difficult for all clients. It is therefore more important than ever to keep to your financial plan. Financial markets are predictive markets and have arguably already factored in a possible recession. At some point, markets will start to factor in a recovery. This change of view can occur quickly, as seen in 2020.

New Zealand Share Market

The NZ share market[1] declined 3.8% over the month taking the lead from international share markets that also declined sharply over the month. Over the past six months, the New Zealand market has declined by 16.3%. The New Zealand share market is one of the more interest rate sensitive markets in the world as many of the companies such as the gen-tailers (your electricity provider) and listed property companies pay high dividends. Many investors compare the dividend yield they receive from these companies to the return they would receive investing in corporate bonds. As the interest rates available on corporate bonds increase, the shares prices of dividend paying shares decline until the dividend yield is comparatively attractive compared to the yield on corporate bonds. This has been one of the main reasons the New Zealand share market has declined as most of the companies in the market remain profitable and should be able to withstand a slowing in economic growth.

Given the trend of increasing interest rates, company specific news tended to take a back seat over the month. Positive announcements by Fletcher Building and Sky City Entertainment were largely ignored by the market. However, company missteps were cruelly punished. Eroad declined nearly 40% over the month after the founding CEO unexpectedly resigned earlier this year. This month's move down reflected the markets unease with the replacement CEO being an internal appointment.

[1] S&P/NZX 50 Gross Index

Australian Share Market

The Australian share market[2] fell by 8.8% over the month. While the severity of the fall can be explained by individual events, it does highlight that the Australian market is more synchronised to the global share markets and will tend to decline when global equities fall sharply. That said, the actions by the Reserve Bank of Australia (RBA) to increase interest rates by more than expected was the major catalyst for the decline. This move was seen as a significant change in stance from the RBA and was perceived to be negative for the Australian banks. The consensus view is that residential property prices could fall, depressing demand for mortgages and placing pressure on bank profitability. The financial sector of the Australian market fell by 11.9% over the month. Resource companies (such as BHP) were also down sharply over the month as the prices for commodities unexpectedly fell. The fall in commodity prices is seen by some as the canary in the coal mine with respect to a possible global recession.

[2] S&P ASX 200 Accumulation Index

Global Share Markets

The theme of high inflation, rising interest rates and concern over the possibility of a recession saw global share markets decline sharply over the month. The All Country MSCI World index fell by 7.4% in local currency terms. Year-to-date, the global market has declined by 17.7% while the S&P 500 has declined by 20%. This decline in the S&P 500 is the worst first half of the year for 50 years.

While central banks have increased interest rates before, typically any increase has been to pre-emptively stop inflation increasing. The current rise in rates is in response to inflation already rising. Other things being equal this means central banks have to raise interest rates higher and further than normal. Similarly, in the past further interest rate rises have been conditional on data showing either growth was stronger than expected or inflation was higher. This year, central banks have projected further interest rate rises and these will be implemented unless either growth is weaker or inflation lower than expected.

This means financial markets have taken the central banks' actions as given. This is why share markets have fallen so sharply this year as markets have foreseen and priced in the interest rate moves.

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The other side to this phenomenon is that there are already signs that businesses and consumers are reacting to the higher interest rates. Both business and consumer confidence has declined to recessionary levels and retailers are starting to report excess inventories.

All of this means the current bear market could be much shorter than previous experiences.

Summary

Investment returns over the past six months have been disappointing. However, today we are in a much better position than 12 months ago. Interest rates have largely normalised back to long term averages. Assuming inflation falls, fixed interest investments will now provide savers a positive return after tax and inflation.

While share prices have fallen, most of the large companies remain profitable and, in many cases, have higher dividend yields than 12 months ago. We believe now is not the time to reduce your exposure to growth assets. In the short-term we are taking a wait and see approach, wary that the higher interest rates and decline in share markets could create problems in the more speculative or leveraged parts of the market. For long term investors, should share markets fall further we would see this as an opportunity to buy, rather than a concern.

Key Market movements as at June 30 2022 Source: Bloomberg

As at 30 June 2022	1 Month	3 Months	1 Year	3 Years p.a.	5 Years p.a.
S&P/NZX 50 Index	-3.8%	-10.2%	-13.5%	1.9%	8.3%
S&P/ASX 200 Accumulation Index (NZD)	-8.8%	-11.9%	-6.5%	3.3%	6.8%
MSCI ACWI Index (NZD)	-4.5%	-6.5%	-5.9%	8.8%	10.5%
S&P/NZX 90 Day bank bill Total Return	0.2%	0.4%	0.8%	0.8%	1.3%

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