Monthly View as at 31 January 2023

Overview

January has been marked by a recovery in share markets that has been rapid and significant in magnitude. While investors will enjoy the strong returns, the question remains whether there has been a fundamental change in the macroeconomic outlook to justify the improvement in investment values. The economic and market cycles are more advanced, and, in this sense, markets are closer to rebalancing. Investors remain forward-looking and markets are responding in anticipation of an improved economic environment later in the year. Reported inflation readings indicate that inflation is decelerating internationally. However, the level of inflation generally remains above central bank target levels and central bankers remain firm in their resolve to combat inflation. As a result, the bias in base policy rates has remained upward but increasingly it is becoming apparent that policy rates are close to peak levels.

Tight monetary policy is increasingly impacting activity levels in economies. At present, GDP growth (with some exceptions) continues to be positive but the likelihood of moving to recession is increasing. Recessions are negative for company earnings, and this has been recognised in share prices. Values and multiples have retreated over the last year to near fair value if not cheap. The key issue in allocating capital is whether recession is inevitable, and if realised, the extent and depth of recessionary conditions. Clearly central banks are seeking to slow economies but in a manner that creates a soft landing. The capital allocation decision is further nuanced in that market experience will vary from region to region based on stage in the economic cycle and aggressiveness of policy.

Bond Markets make gains

Gains were made in bond markets over January, as long rates fell in response to an improved inflationary outlook and anticipated weakness in economic activity levels. The yield curves in the United States and New Zealand continued to be inverted with long rates below short term interest rates. There was a hiatus in central bank policy announcements over the Christmas and New Year period. Resumption in tightening monetary policy is expected. The US Federal Reserve has further increased its base rate to 4.75% to kick off economic conditions (for example, a rapid increase in unemployment) and a reduction in rates currently looks overly optimistic.

Rest of the world outshines United States

Since October the Rest of the World has made stronger gains than the dominant United States market. European and Emerging Markets have outperformed the United States market over this period. The European winter has not been as severe as anticipated and energy prices have fallen, giving some relief to this geography. Emerging Markets are dominated by China. The comparative valuations of Chinese companies are much lower than those prevailing elsewhere. The measures being taken to stabilise the Chinese property market appear to be enabling an orderly unwind of the sector, and most importantly China has revised its COVID policy which has given confidence that Chinese activity levels will pick up. The Hong Kong Hang Seng Index lifted 10.4 % in January.

United States share market returns were positive in January, but notably market leadership has moved outside of the large capitalisation technology sector to sectors such as energy which are experiencing a more favourable environment. Exxon Mobil, the United States' largest petroleum company, posted a record US$56 billion profit. United States GDP growth remains positive with annualised GDP growth of 2.9% in the last quarter of 2022, and employment levels continue to be healthy. The national figures are in contrast to certain sectors of the United States economy which have lost some momentum.

The housing market has experienced multiple quarters of declining prices and building activity. United States technology firms are reducing staffing levels in contrast to the broader economy. Cost reduction will assist firms such as Salesforce to mitigate slowing revenue growth. Offsetting headcount reductions in technology, other companies are expanding. Quick service restaurant company Chipotle intends to increase employee numbers by 15,000 across North America. Share price volatility has been evident in the emerging technology sector of which Tesla is the exemplar. The stock fell by greater than 70% over the course of 2022 but has made a 40% gain in 2023 thus far.

Australian again the lucky country

The Australian share market has been one of the best performing equity markets, benefiting from international demand for commodities and a domestic economy that is proving more resilient. Australian investors' recessionary fears receded over the month. The breadth of the commodity market to some degree insulates the Australian resources sector. Oil prices have weakened but domestic natural gas prices have been capped by the Australian government at A$12 per Gj. Iron ore gained US$11.5 per Mt to US$129 per Mt.

Monetary policy has been less aggressive in Australia although there are some signs of fractures, with falling house prices and a decline in retail sales in December. Consumer Discretionary was the best performing sector (+9.9%) as recessionary fears faded, followed by Materials (+8.9%). Energy gained 1.3% in the month, and Utilities fell 3% despite the Australian 10-year bond yield falling 0.5%. The largest gain in the ASX 200 came from Lithium miner Pilbara Minerals.

New Zealand share market resilience

The New Zealand share market is not overly exposed to cyclical companies and therefore drivers of performance differ from markets with broader economic underpinnings. Those segments of the New Zealand share market which are clearly identifiable as cyclical in nature (examples being retailing and construction) have already adjusted to a potentially lower demand environment. This was evident in companies such as The Warehouse falling over the course of 2022. Prospectively in an environment where interest rates are no longer increasing and share prices already reflect revenue and profit declines, the market may exhibit more resilience as dividend income again supports value and pockets of secular growth emerge.

The commencement of 2023 has been marked by a change in the political leadership within the Labour government. Uncertainty is generally not welcomed by markets. It is not yet apparent whether the change of leadership will result in meaningful changes to economic policy and as such, investor positioning seems unlikely to materially modify in response to political change.

The start of the year has also seen Auckland impacted by flooding assessed to be New Zealand's largest natural disaster outside of an earthquake event, given the wide impact across the city. The insurance industry, with the exception of Tower Insurance, is Australian-owned and the immediate cost to New Zealand investors is limited in extent. Tower Insurance itself at this stage appears to be adequately reinsured such that the event is within normal operating assumptions. While immediately disruptive, flood damage will require repair and remediation, redirecting expenditure. To the extent that spending is non-discretionary, this may result in demand in the construction sector holding up better than expected and price pressure continuing in a constrained market.

The S&P/NZX 50 gross index lifted 4.3% in January and is now marginally positive for the 12 months, up 0.7%. The best performing companies during January were retirement village operators Ryman Healthcare and Oceania Healthcare. Both of these companies have been impacted by the slowing residential property market and appear to have rebounded as investors reassessed the degree of decline implied in their share prices. Similarly, Fisher & Paykel Healthcare was the largest contributor to the index, and although the company continues to trade at a high earnings multiple, the company received a tailwind from the continuing COVID epidemic and higher incidence of influenza in the Northern hemisphere.

Summary

Uncertainty continues as to the economic outlook. Defensive yields have improved over the last year in fixed income, and if there is a deterioration in economic conditions, allocation to quality fixed income will provide capital preservation and income. Share market gains have been rapid in the past month and although anticipatory, may prove premature. Nevertheless, the fact that equities have repriced emphasises that investors should retain exposure to shares to enable capture of improved valuations and longer-term growth. A diversified and balanced approach remains appropriate.

Indices for Key Markets

As at 31 January 2023	1 Month	3 Months	1 Year	3 Years p.a.	5 Years p.a.
S&P/NZX 50 Index	4.3%	5.7%	4.6%	1.5%	1.4%
S&P/ASX 200 Index (in AUD	6.2%	9.6%	10.3%	12.2%	6.0%
MSCI ACWI Index (local currency)	6.5%	7.8%	1.6%	-6.2%	7.5%
MSCI ACWI Index (NZD)	5.5%	-0.1%	-0.5%	-6.3%	6.9%
S&P/NZX 90 Day bank bill Index	0.4%	1.0%	1.8%	2.5%	1.2%