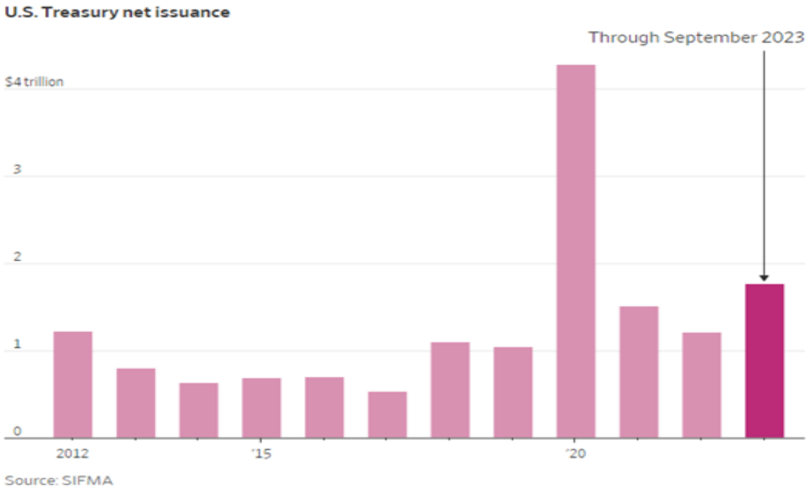
Monthly View as at 31 October 2023

Overview

Rising longer-term interest rates have been a dominant feature of global financial markets over recent months. Central banks have been saying that interest rates will have to remain high for longer, which has placed upward pressure on interest rates, however other factors have been at play.

The US 10-year Treasury yield has risen nearly one percentage point (1.0%) since the US Federal Reserve (Fed) last raised rates at the end of July, an unusually large increase in such a short time frame. The yield has climbed to a new 16-year high (pre-Global Financial Crisis levels).

Weighing on US fixed income markets have been concerns of an increase in issuance of government bonds given rising debt and deficits. Investors have been caught off guard after the US Treasury announced it would borrow $1 trillion in the third quarter of this year, a quarter trillion more than expectations. Already $1.76 trillion of Treasury bonds have been issued so far this year, higher than in any full year in the past decade, excluding 2020's pandemic surge.



Source: Wall Street Journal

At the same time the US is increasing bond issuance, key buyers have stepped away from the market, particularly Japan who have cut their US bond holdings to their lowest level since 2019.

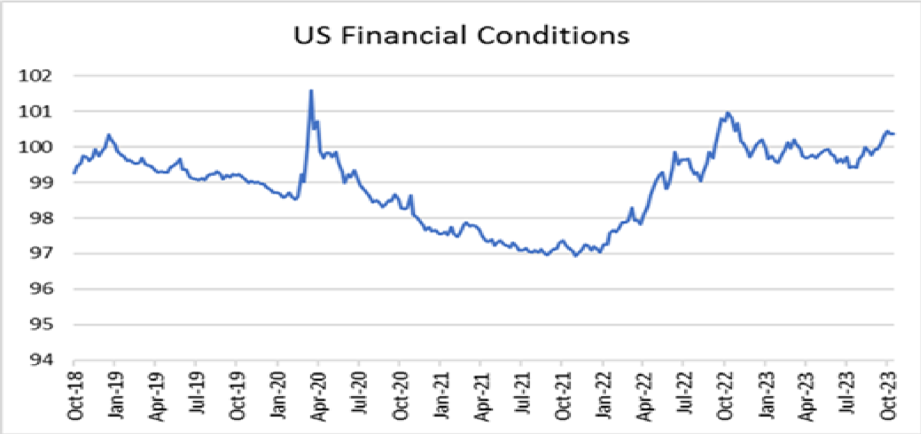
Lastly, better than expected US economic data has placed upward pressure on interest rates. The US economy is estimated to have grown at a 4.9% annualised rate over the third quarter of 2023, much higher than the 0.6% estimates in July. US retail sales and employment growth also surprised to the upside in September.

The strength in the US economy contrasts to weakness in Europe. European economic activity contracted -0.1% in the September quarter. Economic data continues to stabilise in China. For the third quarter, the Chinese economy grew 4.9% year-on-year, beating expectations of 4.5%. Industrial production and retails sale also surprised to the upside.

Tightening of US financial conditions

The rise in interest rates along with a stronger US dollar, wider credit spreads, and weaker share markets has resulted in a tightening of US financial conditions.

The tightening of financial conditions is doing some of the work for the Fed. Economists at Goldman Sachs estimate that if the tightening in financial conditions that began in late July is sustained, it could reduce economic output by one percentage point over the coming year.



During October there was a shift in several Fed official comments about the likely future direction of interest rate policy. They acknowledged that higher longer-term interest rates will have an impact on the US economy and that this needs to be considered when setting policy.

This view was reiterated in a speech delivered by Fed Chair Jerome Powell. Powell noted the Fed will proceed "carefully" in setting short-term interest rates and he was pleased with the recent decline in inflation. Although US inflation was slightly higher than expected in September, the overall trend is down. US Core annual inflation, which excludes food and energy, has fallen to 4.1%, a two-year low and compares to 6.6% last year.

The tightening of financial conditions weakens the case for the Fed to raise interest rates later this year and supports expectations that the Fed has likely ended hiking interest rates in this cycle. This is a positive development for markets.

New Zealand Share Market

On an annual basis New Zealand's headline inflation fell to 5.6% in the September quarter from 6.0% in June, well below expectations of 6.0%. The lower inflation outcome supports the scenario that the Reserve Bank of New Zealand (RBNZ) has finished raising interest rates. The RBNZ left the Official Cash Rate at 5.5% at its October meeting. The RBNZ's accompanying commentary noted "interest rates may need to stay at restrictive levels for a more sustained period of time", echoing the higher for longer mantra expressed by most global central banks currently. New Zealand voted for a change of government in October and there was very little financial market reaction.

The New Zealand share market fell -4.8% in October. The market fell because of a weaker global backdrop, higher interest rates, and disappointing earnings guidance from companies, which highlighted the challenging local economic conditions.

Ports of Tauranga (-13.3%) and Freightways (-8.7%) both provided disappointing updates that reflected falling volumes indicative of the weak economic environment. Sky TV outperformed (+16.1%) after the company received a takeover offer from an unnamed third party.

Australian Share Market

The Australian share market fell -3.8% in October on weak global share markets and higher interest rates. The Australian 10-year government bond yield rose 44 basis points (0.44%) over October to 4.92% on higher-than-expected inflation. Australian headline inflation lifted 1.2% over the third quarter, a re-acceleration from 0.8% in the June Quarter.

Stock performance was mixed. The larger resource companies outperformed e.g., Rio Tinto +4.2% and BHP Group +1.9% on stability in commodity prices, particularly Iron Ore. Property stocks underperformed in a rising interest rate environment, Mirvac Group fell -13.9% and Dexus Property Group -13.7%.

Global Share Markets

Global share markets fell -2.7% in October on higher longer-term interest rates, rising geo-political risks given the outbreak of conflict in the Middle East, and mixed US earnings results. At the mid-point of the US third quarter earnings season, 78% of companies have beaten estimates, by 7.7% on average.

A weaker New Zealand dollar in October boosted returns from global equities. In New Zealand dollar terms global equities rose +0.1% over the month. Global uncertainty and a decline in the relative attractiveness of domestic interest rates to the rest of the world drove the weakness in the New Zealand dollar.

Summary

Recent interest rate volatility has unsettled global financial markets. Although high interest rates may be warranted to a degree, interest rate relief from current levels is likely given declining inflation, an expected slowing of US economic activity, easing of labour market conditions, and a weak global economic backdrop.

Recent developments are likely to bring stability to global fixed income markets. This includes the Fed signalling concerns about the potential impacts of rising longer-term interests and that financial conditions have tightened. This supports the case the Fed is unlikely to hike interest rates again. Meanwhile, the US Treasury surprised with a lowering of forecasted bond issuance, indicating they are likely to take a more measured approach going forward.

The risk return outlook for global and domestic fixed income is attractive. Fixed income offers an attractive yield with the potential for capital gains as inflation falls further and central banks end hiking interest rates.

Interest rate stability and an ending of interest rate hikes by central banks would be positive for global equity markets. Although risks remain, particularly the ongoing conflict in the Middle East, a constructive view on equities can be developed given the above and the recent falls in markets have made valuation measures more appealing.

Focusing on your long-term goals while acknowledging that in the short-term, returns may be volatile, should reward investors.

Indices for Key Markets

As at 31 October 2023	1 Month	3 Months	6 Months	1 Year	3 Years p.a.	5 Years p.a.
S&P/NZX 50 Index	-4.8%	-10.4%	-10.1%	-4.3%	-3.1%	5.0%
S&P/ASX 200 Accumulation Index (AUD)	-3.8%	-7.2%	-5.3%	3.0%	8.9%	7.2%
MSCI ACWI Index (Local Currency)	-2.7%	-8.1%	-0.3%	9.5%	8.3%	8.3%
MSCI ACWI Index (NZD)	0.1%	-3.4%	4.3%	10.5%	11.3%	9.9%
S&P/NZX 90 Day bank bill Total Return	0.5%	1.4%	2.8%	5.1%	2.3%	1.9%