Economic & Investment Market Review

February 2021

Are Markets in a Bubble ?

COVID 19 has had a global resurgence with new mutations of the virus adding to the second wave impact. This resurgence has delayed the reopening/normalisation of economies. Although a setback, investors have continued to look through current conditions and expect company revenues and earnings to improve as vaccination programmes take hold. Pent-up demand and increased savings will provide a boost to immediate consumption. Expectations are for global GDP to grow over 2021 and 2022, providing a positive backdrop for investors.

New Zealand and international share markets recorded further gains through December but were more subdued in January. The S&P/ASX 200 index was up 3% when adjusted to NZ$. World share markets also contributed positively over the period in NZ$ despite dipping a little at January month end. Global bonds were unable to hold the gains of December and were marginally down over the two months. New Zealand bond funds were also impacted as interest rates lifted resulting in small negative returns over December/January.

The usually quiet holiday period in the New Zealand share market was interrupted by a very strong performance between 21 December and 29 December with the S&P/NZX 50 Gross index rising approximately 5%. A large portion of this return is attributable to Meridian Energy (MEL) and Contact Energy (CEN) surging in response to demand from a global renewable energy ETF. Renewable investing has gained momentum over 2020 and qualifying companies are in short supply. Meridian became New Zealand's largest company by market capitalisation over this period before Fisher Paykel Healthcare reasserted its dominance. MEL and CEN have subsequently retreated as equity trading normalised. The episode illustrates the impact offshore buyers can have on a relatively small NZ share market. The growth in MEL and CEN share prices appear to have been almost entirely driven by forces unrelated to the companies' own operating performance although Rio Tinto advised a delayed withdrawal from Tiwai Point in mid-January.

Share Investor Sentiment Still Strong

Investor enthusiasm is very high and has been persistent despite further waves of COVID 19 and the events surrounding the transfer of political power in the United States. Investors with a longer-term investment horizon and lower tolerance to market volatility need to assess whether the current conditions mark a period of irrational exuberance or are a reasonable response to unprecedented economic drivers.

Tesla has rapidly grown in market capitalisation entering the S&P 500 in a top 10 position despite marginal profitability and a valuation greater than much of the global car manufacturing industry combined. This has occurred despite established automotive companies developing their own electric vehicles. Tesla enthusiasts respond that the company is much more than a conventional automotive manufacturer with autonomous taxi services the ultimate objective.

North America has experienced a spate of SPAC capital raisings. A SPAC is a Special Purpose Acquisition Company. Essentially investors subscribe capital in a company that has no established business but undertakes to locate an operating business which can be backed into the listed company. Investors effectively provide the SPAC promoters with a blank cheque to locate and buy a business at an attractive price.

The SPAC strategy is adding momentum to initial public offerings (IPOs). New listings are very active in the United States and Australia. Even New Zealand is experiencing some new listings. The market response to new listings has been to drive prices up further from the initial issue price, the most prominent example being Airbnb which has risen from US$146 to over US$200 in the first month since listing.

Improved access to markets, at lower cost combined with the availability of information and the ability of small investors to exchange investment ideas has contributed to the strong market for some share prices. In the United States brokerages such as Robinhood have contributed to this. Recently retail investors appear to have counter-acted institutional shorting in companies GameStop and AMC in a massive short squeeze (those managers who have shorted the stock are now having to buy back to recover substantial "out of the money" positions). GameStop is a bricks and mortar retailer selling game software and AMC a US theatre chain. Both have challenged business models. In New Zealand the emergence of Sharesies and Hatch Wealth is enabling kiwi retail investors to also participate.

Optimism from new investors is also apparent in frontier investment classes such as Bitcoin which experienced one of its periodic surges over late December/early January reaching a peak price of US$40,519, up 100% from 1 December. Increasing institutional recognition of Bitcoin added to its credibility. Subsequently this lift has deflated to around US$32,500.

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The quantification of this energetic support for share investment is measurable through price earnings (PE) ratios. Undoubtedly US market PEs are at high level relative to recent history. The S&P 500 on average trades on a forward PE of about 22 and the NASDAQ market at more than 33 times. If the US markets are adjusted for cyclicality (CAPE) then US share markets have only been higher in 1929 and 1999-2000. Similarly, the New Zealand share markets PE is elevated and has been for some time with the S&P/NZX 50 at a forward multiple at over 22 times. The market capitalisation average forward PE is even higher at over 31 times. Care needs to be taken in interpreting these headline level multiples. Historically low interest rates mean that relevant comparisons on historical values can be distorted. Also, the averages are pulled up by the extremely high PE's enjoyed by technology companies in the United States and in New Zealand similarly by a few highly rated growth companies.

Interest Rates Rise

New Zealand Government Bond 10-year rates have increased from less than 0.5% to current levels of over 1.0%. While low still in absolute terms this is a 100% increase. At current levels prevailing interest rates are unlikely to impinge on the performance of shares which would require interest rates to lift to 3-4% before being impacted.

Scope for interest rates to rise significantly from current levels appears limited. The bias in longer term rates is for slight rises, but this is expected in the latter part of the current year. The recent inflation read-out in New Zealand surprised on the upside at 1.4% annual. Discretionary items were responsible for the rise with spending items such as domestic travel and accommodation surprising. Factors that could contribute to further inflation are the increase in the minimum wage, supply chain constriction, increased oil prices, a booming construction sector and continuing easy money. Notably the increased availability of credit appears to solely be focused on the housing market with minimal credit expansion in other sectors of the economy.

New Zealand house prices have an indirect impact on the headline inflation rate, but the influence of rising house prices is relevant in terms of the wealth effect, impact on rental accommodation and availability of funds for alternative (non-mortgage) spending. House prices continued to make new records throughout New Zealand into the end of the year. The New Zealand housing stock was valued at $1.28 trillion in the September quarter a 10.7% increase on the prior year.

The Federal Reserve remains committed to quantitative easing and this will cap the extent to which US rates can rise. The accession of President Biden marks a probable change in fiscal policy with additional stimulus to be provided to the US economy. Initial proposals are for further Federal assistance equivalent to US$1.9 trillion or 9% of US GDP. This stimulus will require funding and places further upward pressure on US market rates. Former Federal Reserve Chairwoman Janet Yellen has been appointed Treasury Secretary and has similarly committed to increased government spending. Current US breakeven inflation pricing suggests higher interest rates are required for investors to preserve purchasing power, that is the rate of inflation exceeds the interest rate eroding the purchasing power of the bond plus income over time.

Conclusion

While interest rates remain at current levels, the probability of a steep decline in the equity market appears low and a reduction in equity exposure may be premature given the opportunity cost of not participating in current gains. However, pockets of over exuberance do exist. Investors need to aware of these risks, attempt to navigate around them and recognise that continuing uncertainty will result in volatility.

The prevailing interest rate environment is unique in recent experience and the reasonableness of current pricing must be judged in this context. Higher equity pricing can be justified in response to low income yields. Diversified quality portfolios remain appropriate.