JMI Wealth

Economic & Investment Market Review

April 2021

Inflation Outlook Dominates

Inflation and interest rate outlooks continue to dominate investor strategy. Greater optimism as to the economic outlook outside of New Zealand has led to an increase in inflation expectations and with it a lift in long-term interest rates despite Central Banks leaning against this by continuing loose monetary policy. US 10-year Treasury bonds broke through the 1.5% threshold and continued to rise into month end. The Bloomberg Barclays Global Aggregate index which measures the return from global bonds recorded a negative month as a consequence. New Zealand bond investors were less certain as to the interest rate outlook locally and the local bond index returned to positive territory for March but still suffered a negative quarter.

Vaccination programmes in the US and Britain (but not Europe) gained further momentum and GDP forecasts improved. Corporate earnings should benefit as a result. The primary issue is whether the anticipated inflationary uplift will be short-term or whether this represents the start of an extended period of higher inflation. Central banks appear to be committed to allowing inflation to run ahead of target levels and this has a knock-on effect for the shape of the yield curve. That is mid and longer-term maturity yields will rise to a greater extent than short term rates that will continue to be anchored around current levels.

Although fixed income markets are anticipating inflation the extent of the lift in interest rates is modest in absolute terms. Investor consensus is for an increase in the US 10-year rate to around 2% by the end of this year with various opinions as to the speed at which rates may rise and the extent this level is exceeded. However, as markets have become acclimatised to low rates and a historically low base level the impact of these rises may be accentuated. Conversely if rising rates is a consensus investment position and is baked into investors assumptions then any adverse impact will be partially mitigated for example owners of growth stocks may already be assuming that interest rates rise above current levels and recognise this in their valuation of growth companies.

Supply Chain Events Impacting Profitability

The impact of COVID 19 continues to resonate locally despite New Zealand being relatively insulated from the worst effects. Reported December quarter 2020 GDP growth was -1%, surprising many economists. In contrast the equivalent Australian GDP outcome was +3.3% quarter on quarter. The effects of the absence of tourism and disruptive lockdowns has been uneven across the economy. While some sectors experience buoyant trading, others struggle to gain traction. The markets have generally looked through the poor GDP outcome although it is possible New Zealand could be in a technical recession. The opening of a travel bubble with Australia has been hoped for by businesses that are direct beneficiaries. This seemed like a waiting for Godot experience prior to the government's recent announcement. Clear beneficiaries will be airlines and airports. The window is not fully open and provides only partial relief. Also prominent in terms of the effects of COVID 19 is the disruption to global supply chains. The Evergrande Suez Canal incident is indicative of the vulnerability of international supply chains but perhaps more significant are issues such as the lack of containers, particularly reefers, for New Zealand exporters. Costs of supply have risen from the container shortage and the increased cost of shipping generally (The Baltic Dry shipping index is at an 18-month high and has increased approximately 3x from pre-pandemic levels). These effects compound the difficulties of intermittent delivery and is seen increasingly in the profitability of companies with international trade. Conditions such as these add to the inflationary impulse. The interdependence of businesses internationally is also illustrated by the current semi-conductor chip shortage. Demand for semi-conductors has grown rapidly as the world becomes more connected. As a result, many car manufacturers are reporting an inability to meet demand for new vehicles as insufficient chips are available to supply manufacturing schedules.

Commodity prices have remained strong despite COVID induced conditions. A new commodities super cycle has been suggested for Australian miners with the copper price showing particular strength. Fiscal spending by the US Government will likely build on this pre-existing demand. Most importantly for New Zealand the primary commodity milk has exhibited increased demand. Whole Milk Powder rose 21% in a recent auction to the highest level in seven years. Fonterra Shareholders Fund has responded positively to buoyancy in its markets but Synlait and A2 Milk continue to struggle due to their own idiosyncratic issues.

Property Framework Changes

The most contentious economic event in the last month locally has been the changes to the investment framework for residential property. The effects of removal of interest tax deductibility and further extension of the bright line

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test on investment markets more broadly is uncertain. At a headline level it would seem that additional support for residential new build will be supportive for residential developers such as Fletcher Building and suppliers of building materials. More broadly diversion of capital away from the residential property market, potentially to share markets may also provide further demand for shares. Conversely dampening of growth in house prices will limit the wealth effect and any forced selling would be adverse to sentiment and broad consumer demand. Supply chain disruption is also evident in the domestic building sector with the availability of timber severely constrained.

Enthusiasm for Renewables Undimmed

Renewable energy continues to find favour amongst investors with substantial premiums being paid for renewable assets. This manifested itself for local investors via a scheme of arrangement announced in relation to Tilt Renewables. The company will be taken over by a consortium of Australasian investors including Mercury Energy at a price of $7.80 per share. This is more than double the share price 6 months ago. Despite the seemingly unpropitious headlines the New Zealand share market was able to generate a positive return for March with most of the gain in smaller companies. Australia continued to provide better returns for New Zealand investors with the ASX200 up almost 5% in New Zealand dollar terms.

Corporate Failures do not Undermine Sentiment

The last month also saw its share of corporate implosion at a global level. Greensill Capital an Australian and UK financial services company tipped into insolvency. Greensill provided supply chain financing and its demise has raised concern as to the reverberations, specifically in Australia in relation to insurance companies. Investment bank Credit Suisse froze US$10 billion of funds that provided financing to Greensill. The investment bank has also been involved in the Archegos Capital collapse. Archegos a US hedge fund has had to meet margin calls on highly leveraged equity positions, notably in Discovery Communications and ViacomCBS. Credit Suisse was a margin lender to Archegos and has had to advise of “highly significant” losses. These events are isolated incidents however, and investors globally were optimistic enough to push share prices higher. The MSCI ACWI index climbed 2.7% and the S&P 500 4.4% in local currency. New Zealand investors in overseas shares benefited from the further tailwind of a weakening New Zealand dollar through March.

Conclusion

If interest rates continue to lift but remain at low levels, then the appeal of this asset class remains muted. Potential for mark to market losses continues but perhaps to a lesser degree than that experienced earlier this year. Nevertheless, fixed income retains its role as a portfolio stabiliser. In these circumstances shares continue to provide the greatest potential for gains but will require careful selection to optimise risk and return. A reversion trade appears to be occurring wherein prior laggards like energy and financials are rallying. The improving economic outlook gives more favourable conditions for these companies and is resulting in outperformance versus previous market preferences in growth and technology sectors as the structural underpinning for these types of companies continues.

Rising yields are not necessarily correlated with poor returns from shares. In the last 25 years there has been 10 periods in which the 10-year treasury yield has risen by more than 100 bps. In all instances returns from global equities were flat or positive. Pent up demand and increased savings suggest that shares will be well supported into 2022. A diversified portfolio continues to remain appropriate.