JMI Wealth

Economic & Investment Market Review

October 2021

Investment Focus Broadens

There was no shortage of issues for investors to consider in September. In addition to the perennial conundrums of the persistence of inflation, the extent to which interest rates will rise and the impact this will have on investments, investors have also to consider:

- The impact of Covid 19 restrictions in the near and longer term,
- Logistics bottlenecks and shortages of production inputs,
- Reverberations from the likely demise of China property developer Evergrande,
- Effects of increasing intervention in Chinese markets,
- Fluctuation in commodity prices,
- Potential effects of decarbonisation,
- Increasing international energy shortages,
- Response to renewed US debt ceiling,
- Prospect of further taxation increases.

Covid 19 New Zealand Impacts

Auckland has been subject to its most prolonged period of lockdown while the rest of New Zealand has experienced the relative freedom of Level II Covid 19 restrictions. Auckland remains the economic engine for much of the New Zealand economy and the restrictions are being felt in terms of reduced sales for retailers and generally lower consumption, rent concessions and reduced availability of goods sourced from the city. Factors of this type will be evident in company earnings in the year ahead with the extent a function of how long the economy remains restrained. Given offshore experience however it seems reasonable to assume that eventually conditions will return to normality and provided that businesses have robust balance sheets and cash flow there will be a high degree of survivorship. In this scenario markets are likely to look-through near-term pain and continue to value businesses based on their longer-term cash flows. It is not unreasonable to expect that post the current wave of Covid 19 a resurgence of spending will occur which will favour recovery stocks as opposed to “stay at home” companies.

Logistics Bottlenecks

Congestion in supply chains continues and is evident globally. Petrol and gas distribution in the United Kingdom were strangled, as the month closed. Natural gas prices in Europe have soared to all-time highs. Off the coast of Southern California 95 ships were queued in late September waiting to unload. In New Zealand the wait time for a new truck is in excess of nine months. These delays are contributing to rising costs and reduced profitability in some circumstances. Transaction volumes are less than potential and unexpected further consequences arise. For example, a lack of gas in Europe has diminished fertiliser production, availability of carbon dioxide and chicken supplies.

Energy Shortages

It’s not only the United Kingdom which has been impacted by an energy shortage. China is also subject to lack of energy supplies, notably coal used to produce electricity. This disruption is affecting China’s GDP growth. Further supply reverberations are occurring in steel production and consequently the iron ore price and Australian resource companies’ share prices.

Decarbonisation

The decarbonisation of economies is now gaining real momentum, and this is a contributor to disruption in energy supplies as renewable fuels are typically less reliable than prior energy sources. In addition to creating volatility in energy prices the decarbonisation movement is creating new investment assets. Carbon credits are increasingly recognised and required to offset emissions. This saw a surge in the New Zealand carbon price in September and is likely a trend that will occur in other markets. Resources such as lithium, rare earths, copper and nickel are also benefiting from the renewables trend.

Evergrande

The prospect of Evergrande (China’s largest property developer) being unable to service its debt has also been a concern. The uncertainty in respect to Evergrande follows negative investment implications arising from new regulatory supervision in China. The company is very substantial with around US$300 billion of liabilities. Markets have been worried that a failure of Evergrande would lead to systematic contagion within the Chinese banking system similar to the collapse of Lehmann Brothers in the United States. It appears that China’s financial system is capable of managing a default by Evergrande but there will be knock on effects in terms of the Chinese property and bond markets. This could affect Chinese demand for commodities, but financial implications look to be confined to China.

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The Evergrande situation was however cited as a reason for deferring a local property initial public offering.

US Debt Ceiling and Probability of Taxation Hikes

The periodic problem of the US government exceeding its debt ceiling has re-emerged. The government will run out of funding by October 18 on current projections if this cannot be resolved in time. In the past last-ditch measures have enabled the funding crisis to be resolved and it would be extraordinary if a solution was not implemented in time to avoid a total shutdown of the US government. Related to the debt ceiling is the level of taxation. As wider context, the United Kingdom has already instituted additional taxation measures to gather some GBP12 billion of additional funding to help meet health expenditures. The magnitude and probability of taxation increases and where they might fall continues to lurk in relation to US equity markets and represents one of the greatest fears for US investors.

Interest Rate Environment

Both global and local interest rates rose over September. The US ten-year government bond is currently around 1.5% but below its March highs of 1.75%. In New Zealand long-term rates have also risen to breach 2% at month end. Market pricing recognises an increase in the New Zealand cash rate as almost certain in October and prices further increases in short-term rates thereafter. Logistics bottlenecks and commodity price rises are supporting the view that inflation may be more persistent than central banks initially assumed. This being the case, central bankers have a delicate path to walk if they are to effectively combat inflation and maintain employment. Rising interest rates will have a mixed impact as will inflation, with some sectors beneficiaries (financials as one example).

Australia Takeovers and Distributions

In addition to the liquidity arising from central bank stimulus, further cash redeployment is occurring in Australia from takeover offers, share buybacks (A$18 billion) and increased dividends (A$38 billion from the recent reporting season). Notable takeover offers in the last month include Sydney Airport (A$23.6 billion), Ausnet (A$10 billion) and Spark Infrastructure Group (A$5.2 billion). Some of this capital will be absorbed by current initial public offerings (eight with a combined value of approximately A$8 billion) but the majority is likely to find its way back into existing listings.

New Zealand Shares

The New Zealand share market concluded the quarter with a 5% gain although the market was up only 0.4% in September. Gains were made in primary resources-related companies over the month, while the interest sensitive property and electricity companies faded.

Conclusion

Statistically September tends to be a difficult month for shareholder returns. Although October can also be volatile some of the above hurdles/opportunities will be better clarified. An unbridled and disorderly increase in interest rates has the potential to disrupt share markets. In contrast a 'baked in' lift in rates can be accommodated provided the absolute level of rates is not punitive. Share markets appear to be adjusting to this latter scenario. Increasingly confidence is returning to northern hemisphere markets. Covid reopening versus stay at home thematics are evolving. Australasian markets are likely to repeat this process. Similarly, it is likely in the short-term that value versus growth will also tend to migrate in response to interest rate trends. The 'rising tide lifts all boats' approach to investment is unlikely to be applicable and investors will need to be discriminating in portfolio management. Specific sector opportunities will emerge with renewable energy prominent and traditional energy a latent opportunity. Other commodity-based opportunities resulting from inadequate reinvestment and supply shortages are also likely to present. Nor should the uneven impact of inflation be ignored. Companies with pricing power should continue to prosper and financial institutions are likely to benefit from widening net interest margins.

Encouragingly medical research in the fight against Covid 19 is continuing to progress. The recent Merck announcement of an oral anti -viral drug may represent a major step towards normalisation.