JMI Wealth

Economic & Investment Market Review

December 2021

2021 A Tumultuous Period

The 2021 calendar year has been a year of desynchronization where the effects of Covid 19 have dominated and the economic responses to the virus have continued to reverberate. Investment outcomes have diverged depending on asset class, geography and investment style. The wide range in investment returns demonstrates the benefits of having a diversified portfolio to reduce volatility and capture positive returns. New Zealand, and more specifically Auckland, passed into a period of extended quarantine that has disrupted the domestic economy and reduced relative earnings growth. Continuing easy monetary policy and logistical constraints have fuelled New Zealand inflation and resulted in steep increases in interest rates relative to last year. In combination with these factors, growth from the New Zealand share market has been elusive and the New Zealand fixed interest market has recorded negative mark to market returns. In contrast international fixed income returns have not been as poor, despite lower yields and longer duration and overseas shares have generally recorded good gains. The Australian share market has been a more rewarding market than New Zealand in contrast with most of the last decade and the United States share market has continued to experience strong value appreciation. Markets are forward looking and although recent performance can inform the current outlook it is not the only factor that investors should take into account.

Investment Cycle

Most share markets experienced one of the sharpest recoveries on record in 2020. In general, the momentum from 2020 has continued into 2021 with one or two moderate pullbacks. Although equity markets tend to rise over time this trend can be punctuated by sharp falls. The equity market generally anticipates the economic cycle. A number of indicators suggest that markets are approaching but are not necessarily at their zenith. Commodity prices are rising indicative of strong demand and supply constraints, and company valuations and market indices are near highs. There is a large number of initial public offerings (at least in Australia) and takeover activity has been elevated. These factors signal that there is potential for a pull-back but are not timing tools in themselves. Liquidity in share markets is good and Covid-affected segments of the share market are expected to have upside when the prospect of international travel becomes a reality.

Fixed Income Desynchronization

The rate at which central banks have moved to address inflationary pressures has varied considerably as have underlying economic drivers. New Zealand and other small peripheral economies have been first to lift interest rates. The RBNZ has lifted the Official Cash Rate to 0.75% and has projected a smooth path to a rate in excess of 2.5%. The RBNZ's decision was relatively clear cut given other economic objectives of full employment and house price stability also warranted an increase in rates. Other economies are not subject to as pressing drivers and can 'afford' to allow inflation to run hotter for longer. The United States is about to embark on tapering its bond buying programme (US$10 billion per month for Treasuries and US$5 billion per month for mortgage backed securities) and the Bank of England surprised by not moving its key rate up at its last meeting. In contrast the European Central Bank (ECB) and Bank of Japan currently show little inclination to raise interest rates. Japan seems uniquely unaffected by inflationary pressures. The ECB may be less immune with Germany's most recent harmonised inflation reading at 6%.

The non-uniformity of policy making is likely to persist into 2022. Those countries which have moved rapidly are unlikely to have to accelerate quantitative tightening and it is conceivable that markets have over reached in terms of rate pricing and in some markets a decline in rates occurs. This was the experience in the immediate aftermath of the RBNZ's most recent policy statement (although it may not be a sustained trend). In contrast a measured and carefully communicated approach from the Federal Reserve is probable. This likely results in an upward drift in US interest rates even if inflation is quelled/transitory as the bias remains to normalisation of monetary policy and an ultimate return to positive real interest rates. The monetary laggards in all probability remain late to the party and it is difficult to anticipate a change in Japanese monetary conditions given these pre-date the onset of Covid.

China remains an outlier with its economic cycle increasingly domestically driven. A continuing slowdown in China would invoke further monetary stimulus in a rate environment where it is likely to have greater effect. Monetary conditions in China tend to affect Chinese share prices and international end demand for goods and services rather than global fixed income returns.

Economic & Investment Market Review Continued

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US Shares Valuation Metrics Continue to Improve

US companies have recently reported very strong earnings growth as a result of reopening of the American and global economies. The outlook for 2022 earnings growth is for a deceleration on 2021 but for still creditable growth of 9%. One investment bank expects earnings growth to be 9-10% above consensus estimates. If this growth transpires and all other factors remain equal, then the US market PE should improve to a still elevated but not stretched multiple of around 20x.

Within the US share market, performance of individual sectors is likely to be mixed and data driven. If inflation persists at relatively higher levels, a scenario that is becoming more prominent, then stocks with pricing power are better positioned. Financials in particular are well placed to benefit from increasing interest rates and are reasonably valued at current levels. Low interest rates or a clear intent to act decisively to calm inflation will tend to support long duration companies i.e. those that are priced on the basis of long-term growth in profitability. Inevitably the performance of such companies is closely monitored and if there is hint that long-term objectives may not be achievable commensurate with market expectations then share prices can be severely punished. Traditional energy companies have had a tough period but the rapid turnaround in oil prices demonstrates how quickly these stocks can appreciate in favourable conditions.

Australasian Outcomes to Diverge

New Zealand shares' defensive qualities have served investors well, but these same characteristics may not be as beneficial going forward. Even if domestic interest rates remain around current levels there is less of an incentive to park capital in companies that offer modest profit growth. Genuine growth opportunities that do not have earnings growth already reflected in share prices in New Zealand's small and closely monitored market are infrequent. In this sense macro-economics are a key driver of annual returns and caution is likely to persist in relation to interest rate headwinds. Capacity constraints however (unless alleviated) are supportive of domestic businesses' pricing power.

Australian shares appear to offer more diversity and more genuine growth opportunities. The market is large with much greater depth and it is possible to uncover smaller companies with identifiable growth at reasonable price. Many of Australia's larger companies in reality cater to international markets and are globally competitive in areas such as healthcare. Both countries do have a high exposure to China, and this represents a further area where performance could diverge as a result of foreign policy.

ESG to Exert Greater Influence

Environmental, Social and Governance factors are becoming increasingly more prominent in investment management. This trend is likely to gain even further traction in the coming year, to the degree that capital flows into certain areas as a result of ESG will influence returns. A specific example was the spike in some New Zealand renewable energy companies' prices and subsequent slide. Several large Australian superannuation funds have withdrawn oil company Woodside from their investible universe.

Conclusion

Investors generally appear to be complacent although that optimism remains fragile and subject to events such as further Covid mutation. Investor exuberance has been evident in some specific 'assets' such as the SPAC listings in the United States but this is not indicative of system-wide imbalance. The current year has demonstrated that some investments will be more rewarding than others and this is likely to be the case looking ahead. Returns will depend on unknowable factors such as the spread of Covid and the path of inflation and interest rates. A diversified and prudent approach to investment remains appropriate.