JMI Wealth

Economic & Investment Market Review

December 2020/January 2021

COVID 19 Developments

The COVID 19 virus is having an enduring impact on investment markets. The virus continues to spread in the Third World, while the United States and Europe have experienced second waves of infection. The degree of infection in Europe instigated a second round of quarantine/social distancing which has in turn delayed a return to normal economic functioning within those markets. Although the effects of the virus have been persistent in those countries unable to implement social distancing and border closure, considerable progress has been made in both the development of vaccines and treatments. Efficacy of vaccination against the virus has been reported from 3 Western companies and a Russian research project.

The favourable outcomes have resulted in accelerated roll-out with inoculation commencing in December in some countries. Improved treatments are also being implemented and this is reducing the mortality rate associated with the virus. The development of successful vaccines has had a positive effect on share markets in that certainty of return to an environment where economies can function normally has improved. Markets are forward looking and although there is no fixed date for normalisation the probability has lifted and the length of time before this outcome is achieved truncated.

United States Presidential Ballot

The United States completed its voting process. Although the polling process is complete there has been some lingering electoral legal challenges which are progressively being resolved and a Presidential transition has commenced. A remaining electoral issue is the composition of the US Senate which is reliant on the outcome of the Georgia Senate runoff elections. These are scheduled to occur on January 5. All states contribute 2 Senators and dependent on the election outcome the control of the US Senate will be established for the next 2 years (it takes 6 years to cycle through all Senate elections). If the US Senate continues to be dominated by Republicans, this will constrain the ability of a Democratic Party led government to implement policy change.

The ability to instigate policy change has considerable implications for bond and share markets. Primarily policy instruments impacted are:

- the level of fiscal stimulus injected into the economy,
- the extent of any taxation increases,
- international trade policy.

If Democratic control of the US government is less than absolute, then the application of measures will be diluted from what otherwise may have been implemented. The share market impacts of the measures are mixed. Fiscal stimulus is positive for share markets as the support provided underpins consumer confidence and lifts the level of trading across the economy. To the extent that the level of stimulus is reduced the degree of buoyancy will be moderated. Increased taxation directly impacts the profitability of firms reducing earnings and prospectively reducing share values. Trade conflict has increased the level of tariffs and other trade barriers. This has the effect of impeding trade volumes and represents an economic drag on the performance of the economy.

New Zealand Monetary Policy Changes

The implementation of monetary policy is key to investment outcomes. The clearest expression of this is the level of interest rates prevailing in the economy. Recent changes to New Zealand monetary policy are leading to a reassessment of investment positioning. The introduction of the Funding for Lending Programme (FLP) is designed to reduce interest rates at a retail level for term investments. This is intended to encourage consumer spending rather than saving, reduce costs of business borrowing and encourage further business investment. Concurrent with the introduction of the FLP has been no increase in quantitative easing in the form of bond purchasing. Generally economic indicators have been not as bad as the Reserve Bank had forecast. Houses throughout New Zealand have experienced a surge in values. The extent of the increases has resulted in the government introducing a further dimension to the RBNZ's mandate with the bank now expressly required to consider house price stability in managing monetary policy. The express housing objective is in addition to the reintroduction of loan to value ratios which the RBNZ has indicated it will reintroduce to curb house price inflation. In combination these factors have led the interest rate markets to reprice the likelihood of negative interest rates and the probability of this has now receded. Additionally, the more optimistic outlook has caused a reassessment of the longer-term inflation outlook and this has resulted in some moderate repricing of the yield curve with interest rates rising modestly in absolute terms and to a greater extent in relative terms from earlier in the year. For example, the 10-year government bond has risen from a yield of 0.44% in September to 0.89% in November.

Although long-term interest rates have risen and therefore provided a negative driver for both bonds and shares, the effect continues to be tempered by the volume of quantitative easing and the degree to which excess capacity remains in the economy

Economic & Investment Market Review Continued

December 2020/January 2021

(noting also that excess capacity is unevenly distributed), for example tourism and hospitality.

Relative to historical levels interest rates remain very low and therefore supportive to share values. Any further increases in rates from present levels are likely to be moderate and occur over a protracted time period unless inflation was to suddenly reassert itself. A sharp increase in inflation does not form a central scenario at this point in time.

Australian Share Market Outperforms New Zealand

Australia's share market had one of its strongest monthly performances for many years. One analyst suggests the best monthly return in 103 years. Australian banks which represent a significant proportion of the Australian market staged a strong recovery as the degree of loss provisioning may prove to be excessive. Resources were also buoyant over the month. Iron ore prices have continued to hold up and the dividend outlook for miners is encouraging. Other segments of the Australian market have also contributed, and a number of initial public offerings are occurring.

The improvement in Australian share values has occurred against a background of escalating trade tension with China and a deteriorating political relationship. The trade impediments have extended to Australian coal exports to China with an estimated 60 vessels at sea prevented from entering China ports as issues in respect to coal quality are addressed. Similarly, the trade tensions have extended to wine exports with tariffs of between 107% and 200% imposed on all Australian wine imports into China. These measures are impacting individual companies thus far but have the potential to generate headwinds for the Australian equity market over coming months.

New Zealand Shares Record Another Positive Month

New Zealand listed companies continued to provide investors with strong returns through November. The NZX50 gross index lifted 5.7% despite A2 Milk essentially ending the month where it started. Fisher & Paykel Healthcare reported a record half year profit up 86% exceeding expectations and this enabled the company to recover price weakness earlier in the month. The impetus to the share market was provided from surprising quarters. Fletcher Building (+36% in November) is benefiting from the residential construction boom and has significantly reduced costs. Air New Zealand improved 28% with the announcement of vaccine efficacy even though the airline remains in cash burn mode. Highly priced Meridian Energy rebounded 21% as renewable energy funds bought the stock. The weakest stock in the index was Pushpay down 8.1%.

International Shares Recover

Gains from international shares were even more pronounced than those in the Australasian share markets. The Japanese share market in local terms gained 15%. The US equity indices looked beyond the worsening COVID 19 infection rate and US S&P 500 index lifted almost 11% in the month. Price signals suggest that an investment rotation from growth stocks to cyclical and value shares may be emerging. Given the impact of COVID 19, any reduction in social distancing restrictions will be positive for companies in the banking, entertainment, airline, cruise and hotel sectors. Notably within this sector grouping Airbnb has registered documentation with the SEC to enable its deferred flotation to proceed this year.

Conclusions

There are reasons interest rates could increase in the near-term and if this occurs it will impact the returns on bond portfolios. Although rising rates are a prospect, it is unlikely increases in rates will be large enough to diminish the attraction of shares. From a New Zealand retail investors perspective, the FLP programme will continue to anchor term deposit rates. Any lift in interest rates may be associated with longer term maturities.

Generally low rates for longer continues to be the overarching precept. Within this context COVID 19 is likely to diminish as a constraint on activity as vaccines are distributed and sentiment improves. This should be reflected in the earnings of cyclical companies. The risk/return outlook for shares continues to be favourable, compared to fixed interest.