JMI Wealth

Monthly View

August 2021

New Zealand and Australia Continue to Diverge

While the New Zealand and Australian economies are experiencing the same macroeconomic conditions (rising inflationary pressure, unemployment at low levels and rising house prices as key examples), the performance of the respective share markets is diverging. New Zealand shares had another poor month (-0.50%) whereas Australia continued to lift (+1.1%). On a six-month basis the difference is even more pronounced with the NZX 50 Index down -4.1% and the Australian 200 Index +14.4%. This is counterintuitive to the respective Covid experiences, with New Zealand remaining Covid free (at least for now) and Australia experiencing continuing lockdowns. The New Zealand share market did have a very strong 2020 and some of this comparative underperformance is the Australian market playing catch up. Another factor in the divergence is the New Zealand Covid recovery, which saw the Reserve Bank of New Zealand (RBNZ) announce that it may look to raise New Zealand's Official Cash Rate, leading to higher interest rates, whereas Australia remains committed to maintaining its current easy monetary policy.

The largest falls in the New Zealand share market were in Covid vulnerable companies Kathmandu, Sky City and Tourism Holdings. Mainfreight was the largest positive contributor in July as its international logistics business benefits from economic reopening. Materials and Industrials were the best performing Australian sectors with Information Technology the largest negative contributor. Takeovers provided the best individual company returns for Australian stocks with a bid for Sydney Airport. Crown suffered the largest fall amongst ASX 100 stocks as it risks losing its casino licence.

US Market Resilient

Although the US economic data was mixed, US shares continued to be supported with the mid-year reporting season underway. Halfway through reporting, 92% of companies managed to beat earnings estimates. Facebook, Alphabet, Amazon and Microsoft had strong earnings growth, but Facebook and Amazon warned of a slowing growth trajectory. Netflix continued to grow subscribers but at a lower rate than had been projected. Tesla continued its growth progress with profit for the quarter surpassing US$1 billion. A sign of how strongly the US economy has rebounded was the annual GDP growth for the second quarter, coming in at 6.5%, but this was below economists' 8.4% expectation.

State Intervention Impacts China

Chinese authorities continued to implement a range of measures which has undermined offshore investors' confidence in Chinese stocks. Didi (a ride hailing company) has been prevented from making its app available to new users, days after the company's US listing. Private education companies in China have been prohibited from profiting from tuition services and the availability of video games to youth is also under review, impacting Tencent. Whether the measures are coincidental or part of a plan is unclear, but foreign investors will take time to regain confidence. Most of the share price falls were in overseas listed companies but the Hong Kong market declined over 9% in July.

New Zealand Interest Rates to Change Course

New Zealand economic indicators continue to surprise with the economy in a healthier state than previously anticipated. The Quarterly Survey of Business Opinion indicated the worst ever shortage of labour, and furthermore 64% of businesses intending to increase prices. This data was followed by the June quarter inflation outcome which saw the annual rate of inflation increase from 1.5% to 3.3%. This was followed by unemployment dropping to 4% compared to 4.8% expected. In response the RBNZ has ceased its Large-Scale Asset Purchase programme, an initial step toward normalising monetary policy. Fixed interest markets now expect the Official Cash Rate to increase 0.25% this month followed by further 0.25% increases.

The extent to which the RBNZ is successful in quelling inflation, and whether the current inflationary surge is temporary, are key to the direction of longer-term interest rates. Although short-term rate rises appear imminent, New Zealand long-term rates fell in July, resulting in small positive returns from Government bonds and breakeven in corporate bonds.

International Bond Markets Less Confident

Inflationary pressures have been building elsewhere with the United States the most influential. The US inflation outcome for June was 5.4%, the highest level since August 2008. Despite it being clearly evident that inflation is eroding the return from bonds, yields continued to fall. The US ten-year Treasury bond rate fell from a high of 1.7% a few months ago to 1.25% currently. The global aggregate bond index return for July was positive reflecting this fall. This was counter to expectations, implying that fixed income investors are less confident in the longer-term outlook. Possible factors are the continuing disruptive impact of the Delta variant, particularly evident in Australia, markets accepting central bank projections of inflation being a temporary phenomenon and a judgement that the post Covid economic recovery has peaked and that activity will fall away from here.

Conclusion

Unlike previous waves of Covid, the number of deaths and hospitalisations is lower. Provided that the virus does not mutate further, continuing opening up of economies is probable. This will continue to support the earnings of international companies although the rate of earnings growth may slow from recent levels. Inflation is rising globally but is not yet at levels where interest rates need to rise dramatically to choke off demand. New Zealand is further along the path in terms of its positioning in the economic cycle due to its closed border approach but still has upside if inflation can be managed and further gains can be made from the reopening of those segments of the economy which are externally facing (e.g. tourism). Continuing low but moderately rising interest rates and growing company earnings imply that portfolios should continue to have a bias to shares.

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Allocation to long-term benchmarks

Sector	Position	Comment
Cash	Underweight	Reduce cash, negligible return
Fixed Interest	Underweight	Returns expected to be low in short to medium term
Australasian shares	Overweight	Slight overweight preferring Australian cyclicals
Global Shares	Overweight	Slight overweight relative to strategic asset allocation
Property	Neutral	Monitor exposure to interest sensitive investments

Indices for Key Markets

As at 31 July 2021	1 Mth	3 Mth	1 Yr	3 Yrs p.a.	5 Yrs p.a.
S&P/NZX 50 Index	-0.5	-1.1	7.4	12.2	11.4
S&P/ASX 200 Accumulation Index (NZD)	-0.9	3.6	25.8	8.2	10.0
MSCI ACWI Index (NZD)	0.8	6.6	27.3	13.4	15.1
S&P/NZX 90 Day bank bill Total Return	0.0	0.1	0.3	1.1	1.5

If you have any questions please contact us on +64 9 308 1450 or visit our website www.jmiwealth.co.nz