JMI Wealth

Monthly View

June 2021

Australian Share Market Continues to Outperform

The Australian share market continued to outperform the New Zealand market. The ASX 200 Accumulation index was up 1.1% in NZD whereas the NZX 50 index declined 3.2% in May. Australian shares have now provided a higher rate of return than New Zealand shares on a 12-month basis. The defensive characteristics of the New Zealand market, in particular dividend yield, are no longer as attractive as interest rates appear to have bottomed. The New Zealand share market has a much narrower base and this has also impacted performance with fewer companies exercising a disproportionate influence. The largest three companies, which are Fisher & Paykel Healthcare, Spark and Auckland International Airport make up approximately 27% of the NZX 50. One of those companies, Fisher & Paykel Healthcare, reported record revenue and profitability in May but disappointed investor expectation and was marked down as a consequence. As the largest contributor to the New Zealand index this dragged down overall market performance. A2 Milk also continued to disappoint as it announced a further profit downgrade and substantial inventory write-downs. The stock declined 23.4% in the month. In contrast other New Zealand companies reporting March results were strong. Mainfreight continues to thrive with revenue up $448 million and profitability plus 27%. Fletcher Building provided a positive outlook and guided to earnings at the higher end of previous guidance. Fletcher Building will also undertake a $300 million on-market share buyback.

Although the Australian index increased there were few short-term trends evident. CBA lifted by 12% in Australian dollars outpacing the other large Australian banks which gained more modestly. Resource companies generally provided positive returns but varied considerably in the extent of returns. The large iron ore miners monthly gain was modest whereas Whitehaven Coal made a 23% gain. Treasury Wines Estates which has been a recipient of the fractured China Australia relationship rose 14.5%. Innovative payments technology companies Afterpay (-21%), which rose 300% in 2020, and EML (-42%) illustrated how quickly share values can decline.

New Zealand Budget & Monetary Policy

New Zealand had two significant macroeconomic events in May, being the reading of the Labour government's first non-coalition budget and subsequently the latest RBNZ monetary policy statement. Although the budget was clearly directed towards beneficiary wellbeing and increased core crown net debt, the extent of debt on this metric remains below levels in many other comparable countries. Government bond issuance will increase in the short-term as a result of the budget but to a lesser extent than markets anticipated over the next few years. The RBNZ's announcement kept current monetary policy settings unchanged. However, the Reserve Bank did reintroduce interest rate forecasts and this included the Official Cash Rate increasing by 0.25% in June/September 2022. This is the first time that the bank has acknowledged that rates may rise in the foreseeable future and therefore sends a strong signal to fixed interest investors that the period of exceptionally low rates may have ended.

Fixed interest index returns were marginally negative for May. Interest rate swaps increased between 0.1% and 0.25% along the interest rate curve depending on maturity. The swap rate is used for setting mortgage rates and the major banks have commenced minor upward tweaks to longer term (3 years plus) fixed mortgage rates. Some minor upward revisions to term deposit rates have also been made. The inflation outlook and the extent to which an increase in inflation persists is key to the current interest rate settings. The consensus amongst central bankers currently is that inflation will be temporary and will fall back in 2022.

Potentially a distinction can be made between 'good inflation' and 'bad inflation'. Good inflation is associated with higher demand for goods and service and share markets are in a 'risk on' mood, that is an optimistic outlook prevails. In contrast 'bad inflation' is when supply is curtailed and shortages impact on the overall level of activity. Just like the three bears porridge too little or too much inflation is a negative for investment markets. Historical observations suggest that inflation can rise further before share markets are significantly impaired as a result of inflation alone. What is not clear at this point is whether inflation is good or bad. Supply constraints are apparent, but the level of demand is strong and likely to increase as economies continue to normalise. We also see labour markets are improving and the ability to find staff in many industries difficult. Given these conditions an important consideration will be the rapidity with which prices increase and whether increases will be steady or disorderly. The impact on individual companies of inflation will also vary. Companies with pricing power that are able to adjust prices upward should be relatively unaffected. In contrast high growth companies without current cash flow whose valuations are reliant on the interest rate will be adversely impacted. For fixed interest investors the transition from low yield to a higher yield environment can bring some initial pain, through capital losses, but these losses can be eventually offset by a greater income stream from new bonds purchased at a higher yield.

US Budget

The US budget proposals have also been formally presented although not yet ratified. The US budget, like New Zealand, also sees a substantial increase in government spending. Potentially this will be accompanied by increases in company and high net worth individual taxation. The extent of tax increases is yet to be confirmed but potentially is a hurdle to further earnings improvement. Even with a tax increase the US government will incur annual deficits of more than US$1.3 trillion annually for the entire forecast period to 2031. The ratio of the annual deficit to US GDP is lower in 2022 than 2021 and 2020 but public debt to GDP remains over 100% through the forecast period. The US budget therefore continues to provide fiscal stimulus and in conjunction with the unprecedented expansion of the money supply looks set incubate further inflation.

Trade Relations

US China relations continue to be tense despite the advent of the Biden Presidency. The US has expanded the ban on US investment in Chinese corporations to over 50. Most of these companies are engaged in communications and aerospace. Similarly, Australia China trade tension also continues to escalate. China's 80% tariff on Australian barley is now being challenged by Australia through the World Trade Organisation. Trade flows between Australia and China in some commodities however remain robust due to global supply shortages and the lack of alternatives. The iron ore price remains elevated above US$200/tonne having increased from under US$180 per tonne at the beginning of the month. Copper, which has also experienced strong gains, has weakened a little but remains well above levels in March and April. Even if commodity prices have peaked the currently pricing translates into solid profitability for materials companies.

Conclusion

On balance the outlook for share investment continues to be encouraging considering the lack of palatable alternatives with reasonable return for risk. Interest rates are increasing in response to rising inflation expectations. The increase is not yet sufficient for the return to compensate for potential capital erosion for bonds or match the opportunity for capital growth from shares. Nevertheless, fixed income does have a capital preservation and liquidity role particularly in the event of unanticipated market correction and should remain part of portfolio construction.

Share investment is also not without risk and some sectors will prosper more than others both on a geographic and sector basis. It appears that New Zealand shares are unlikely to continue to perform as strongly as they have done, and further international diversification is warranted. Similarly, the momentum within growth companies has faltered to a degree and cyclical companies in the near-term may offer better capital gains.

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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 May 2021	1 Mth	3 Mth	1 Yr	3 Yrs p.a.	5 Yrs p.a.
S&P/NZX 50 Index	-3.2	0.8	13.1	12.5	11.8
S&P/ASX 200 Accumulation Index (NZD)	1.1	8.2	26.8	9.3	10.0
MSCI ACWI Index (NZD)	0.0	8.5	21.0	12.9	13.1
S&P/NZX 90 Day bank bill Total Return	0.0	0.1	0.3	1.2	1.6

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