MARKET PERFORMANCE AND COMMENTARY – MAY 2021

MARKET PERFORMANCE

Index	Index Level/Price	1 Month %	3 Month %	1 Year %
Global Equities				
MSCI Emerging Markets	796.93	1.4	2.1	43.9
S&P 500 (US)	4,204.11	0.6	10.3	38.1
Nikkei 225 (Japan)	28,860.08	0.2	-0.4	31.9
FTSE 100 (UK)	7,022.61	0.8	8.3	15.6
DAX (Germany)	15,421.13	1.9	11.9	33.1
CAC 40 (France)	6,447.17	2.8	13.0	37.3
Trans-Tasman Equities				
S&P/NZX 50	12,320.72	-3.2	0.8	13.2
S&P/ASX 300	80,551.52	2.3	8.5	28.7
Bonds				
S&P/NZX NZ Govt Stock	1,869.52	-0.7	0.8	-4.3
S&P/NZX A Grade Corporate	5,847.07	-0.5	0.2	-1.4
Barclays Global Agg (Hedged to NZD)	422.53	0.2	0.1	0.0
FTSE WGBI (Hedged to NZD)	3,638.82	0.2	0.0	-1.7
Oil				
West Texas Intermediate Crude	66.32	4.3	7.8	86.9
Brent Crude	68.73	3.3	6.7	87.6
NZD Foreign Exchange				
AUD	0.9405	1.3	0.1	0.8
EUR	0.5954	-0.1	-0.6	7.0
GBP	0.5121	-1.2	-1.5	2.3
JPY	79.6396	1.6	2.8	19.4
CNY	4.6393	0.0	-1.5	4.6
USD	0.7280	1.5	0.1	17.6

Source: Nikko

Executive summary:

- New Zealand equities and bonds had negative returns in May
- The NZX is one of the worst performing stock markets this year as A2 Milk and Fisher and Paykel Healthcare fell sharply
- US markets around record highs
- 10 year bond yields have stabilised

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ECONOMIC COMMENTARY

WORLD SNAPSHOT

Overview

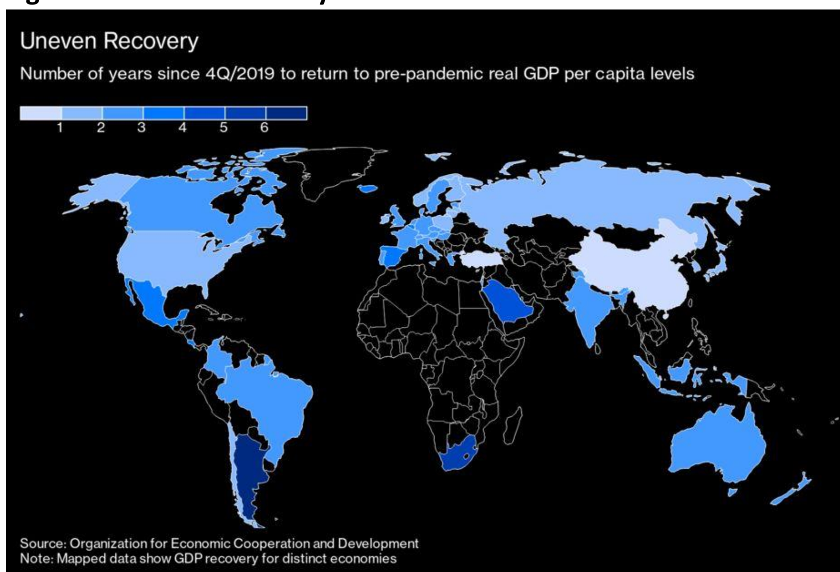
Across the world's three largest economies (United States, China, and Europe), there are three different narratives progressing around how the world economy is evolving:

- United States – very strong stimulus-fuelled demand, combined with temporary supply constraints, has led to a temporary surge in inflation which has dampened some investors' outlooks.
- Europe – strengthening demand, combined with an easing of economic restrictions, is likely causing an acceleration in growth and inflation.
- China – the economic growth appears to be softening, a trend first evident in the GDP growth numbers for Q1 2021 then further confirmed with the release of economic indicators for April and high commodity costs in May.

COVID

The pandemic has increased the gap between rich and poor. OECD revised up its 2021 global growth forecast to 5.8% from 5.6% and warned of gaping differences that mean living standards for some people won't return to pre-crisis levels for an extended period.

Figure 1: Uneven Recovery



The evidence so far is that the countries with the most successful vaccination programs—Israel, the United Kingdom and the United States—are experiencing downtrends in new infections and hospitalization rates. But for the majority of African, South-Asian and Latin American countries the recovery may take more than five years.

KEY THEMES IN MAJOR ECONOMIES

United States

Over 38% of Americans have been fully vaccinated and the country is preparing for reopening. Some analysts are suggesting consumer spending in the US is likely to turbocharge global economic growth. American households saved nearly 10% of GDP over the past 14 months. This has grown from 7.5% in the 2010s to a remarkable 18% since the Covid pandemic. These savings worth over $3 trillion dollars are the source of supposed pent up demand. Whether this demand materializes in spending on goods/services, crypto speculation or Robin Hood financial market gambling remains to be seen.

US corporate earnings are growing at a much faster-than-expected pace. S&P 500 first quarter earnings per share growth is on track to exceed 45%—more than twice the growth expectations on the eve of earnings season and the fastest pace since Q1 2010.

Europe

The next phase of value outperformance in equity markets is likely to have more leadership from non-U.S. markets. Europe has had less yield curve steepening than the United States which has held back the relative performance of its financial stocks. One theory (yet to be proven) is with vaccine rollout and the lifting of lockdowns in the second half of 2021 will put northern pressure on Euro bond yields, giving value stocks a potential boost.

Given a higher dependency on global trade, the European economy may be more susceptible to inflationary pressures than the more consumer-dependent US economy. Central banks continue to argue current inflation pressures are temporary, with ECB chief economist Lane saying the recent increases have “nearly zero connection” to underlying economic trends (??!!).

Australia

The crushing new superannuation regulation will be a key factor in the future of the Australian institutional investment space. If managers do not beat the passive index for two years in a row, they will have to inform their investors they are no good at their job and cannot take on new customers. This signals a key shift to passive investing in Australia. One concerning element for us is the lack of multi-dimensional performance review – returns are just one aspect. What about a market return for less volatility, low beta products? Patient 5+ year investment horizons? The added risk managers will take to beat the index? Credit risk in bond portfolios? The questions are endless.

NEW ZEALAND ECONOMY

Budget

The New Zealand government announced in the budget, amongst other things, a significant increase in infrastructure spending and “the biggest lift in benefit payments in more than a generation”. The

infrastructure spend will likely to put pressure on an already capacity-constrained construction sector, sending inflation pressures north. We expect the increase to benefit payments will support spending. Both are fiscal stimulus measures which likely supports a view the Reserve Bank of New Zealand ("RBNZ") will raise the OCR mid to late 2022, which is supported by Adrian Orr's general sentiment.

There have been few times in history when the government has announced a boost in both capital and operating expenditure while, at the same time, lowering the deficit and debt outlook. Somehow this is the position the Government are in due to an economy which has refused to yield to COVID in the manner that most of us feared back in that first level 4 lockdown.

The main worry is the Government will not execute the investment in infrastructure and housing and especially not in the timeframes set, given its dicey track record of getting big projects done, i.e. Kiwibuild, Transmission Gully, Otaki to Levin, 'Three waters', RMA reform, Zero Carbon Act… When Treasury put together its forecasts and the RBNZ agreed, the unemployment rate would go north of 5.0% and stay there – but it did not, instead it fell to 4.7% and may even fall further. Labour shortages are handbraking activity across the country; now the government will be another/stronger competitor for this scarce resource. Is it time to turn on the immigration tap again? Forget internships for students; pick fruit or grab a shovel?

Housing

Treasury is forecasting annual house price inflation will fall to near zero. However, there should be no surprises because if Treasury forecast anything else, it would infer the Government will fail in its objectives of bringing house price growth under control, which is likely not in Treasury's interest. It's conceivable the combined actions of Government, RBNZ, increased supply, low population growth and higher interest rates produce a fall in house prices. This needs to be managed carefully as it is possible but unlikely. The vast majority of Kiwis' net wealth is in their home so when that drops so does consumer spending, sucking key oxygen from the economy (as seen with Australia in 2016).

Interestingly, the new rental property tax rules have resulted in some people restructuring their mortgages to hold debt elsewhere, rather than with their rental so there would be no interest deduction anyway. The vast majority of landlords (~80%) have just one rental property so their options are limited because they have to pay the interest somewhere on minimal income earning assets. Thus, hitting them hardest. For people with multiple properties or that own a business, restructuring debt is a great option because they can take a deduction against other income earning assets, such as on commercial properties or on the family farm, etc, paying off the rental in the process. We worry the legislation is impacting the wrong people the most, as usual.

EQUITY MARKETS

New Zealand

The New Zealand equity markets had a tough month in May, trending down. The ASX 200 gained slightly, as did the S&P 500, but both bounced around, closing barely above the beginning of the month. The listed markets are pretty wobbly and if you're trading on momentum, there is a finite/minimal amount of head

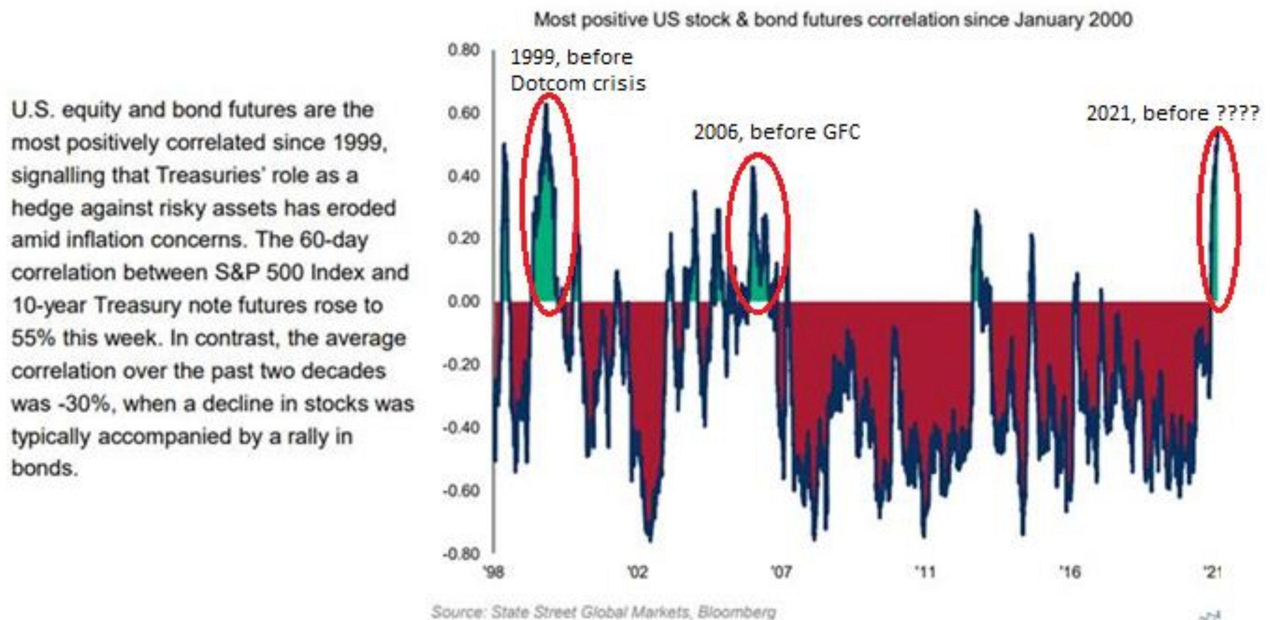
room left for it to run. In times like this, we recommend being very clear about every stock, fund or financial product you hold and know exactly why it's in your portfolio. If you're high conviction and have a long-term horizon, you might simply buy more if there is a dip – but without these clear reasons, that's where you get panicked sellers.

Broader

Does the equity rally have fuel to run further? It's likely being driven by the broadening economic recovery. US jobless claims continue to fall and wage pressures are rising due to an increased demand for labour. Meanwhile, core capital spending jumped 2.4% in April as businesses stepped up investments. Also, over 40% of US households hold stocks which is an all-time high, surpassing the previous record of 38% in the late 90s (JP Morgan).

Is this all too good to be true? Equities continue to march north; countries are recovering from the pandemic and the pace of vaccine rollout is increasing. Figure 2 shows the correlation between US stocks and bonds since January 2000. In normal market conditions, equities and bonds are negatively correlated, which means combining them in a portfolio provides diversification benefits and can lower the volatility of returns. If equities fall, the bond portion of the portfolio will rise, and vice versa. The chart shows that equities and bonds are currently positively correlated, just as they were in 1999 and 2006. During both of these financial market crises, both bonds and equities plummeted. Is the same story repeating itself in 2021?

Figure 2: US Stock and Bond Futures Correlation



FIXED INTEREST MARKETS

New Zealand

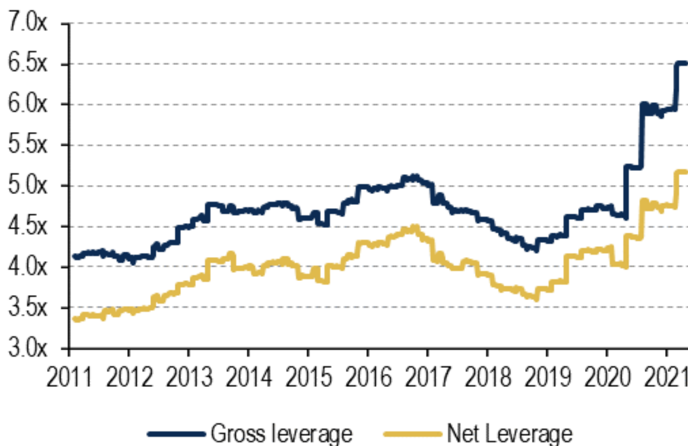
The surprise in May was the New Zealand bond programme went unchanged for the next fiscal year, remaining at $30b which was contrary to market expectations anticipating a reduction. The $30b bond

programme is consistent with an increase in nominal bond tender issuance from the current $300m/week to around $500m/week from July onwards. It's unlikely the RBNZ will increase its quantitative easing purchase pace (currently $350m/week) to match the new issuance, so the market will probably need to absorb ~150m of bond issuance on a weekly basis. Whether this has an impact on interest rates trending higher remains to be seen, but the major forces being the US Fed and the OCR outlook is likely to remain the key drivers of rates.

Junk Bonds

The High Yield Bond (aka Junk Bond) market is increasingly looking overvalued on almost every measure. Companies in this rating category are highly leveraged and materially weaker than investment grade borrowers. The junk bond market is the apex of credit risk and sets the tone for the broader credit markets. Interestingly, the average spread between High Yield bonds and US Treasuries is only ~288bps, which is ~40bps off its post-GFC record low. For perspective, the longer-term average spread is around 500bps, twice the current level. Low interest rates mean the payoff for the US high yield index is at a record low of 3.88%. If US treasuries move north of 2% from the current ~1.6%, that could unsettle the junk bond market. Why take 3.88% when leverage is north of 6.5% (Figure 3) when you can get ~2% risk free from Uncle Sam?

Figure 3: Total Debt / EBITDA (US High Yield)



Source: Franklin Templeton, Bank of America/Merrill Lynch.

Friendly monetary policy and improving fundamentals could keep the party going, but for how long? For ~6.5% leverage and <4% return, investors are not getting compensated for the real risks being taken. Our concern is bond managers trying to squeeze out returns by taking on more credit risk than they can handle. But the alternative is to earn a virtually negative real return with government bonds in low interest rate environments.

INFLATION

For the US, the core month-on-month CPI reading jumped to the highest in 39 years. Of course, this surge partly reflected the base effect of very low inflation a year ago at the start of the pandemic.

The devil is in the details, as always:

- Used car prices were up a staggering 10.0% from March to April and up 21.0% from a year earlier. This was not a case of general inflation. These included rental car companies making massive purchases of used vehicles after having sold much of their fleet early in the pandemic. Indeed, the cost of renting a car increased 16.2% from March to April; it was up 82.2% from a year earlier due to a shortage of rental vehicles.
- Prices at restaurants increased as vaccinated consumers returned to eating out, putting pressure on an industry not prepared to meet increased demand.
- Prices of airline tickets and hotel stays increased as consumers chose to boost travel.
- Prices of apparel increased after a prolonged period of stagnation.

If there is still doubt about raising inflation, the below chart (Figure 4) shows the cost of shipping over time.

Figure 4: Shipping Costs – Container Freight Rates

Source: Schroders

We expect this is supporting current arguments for inflation being transitory. However, we do remain concerned that the CPI basket does not include the likes of land values, asset prices and other shipping indexes, reflecting likely uncaptured inflationary pressures. However, it does depend on the ability for businesses to meet increased demand as consumers return to normal over the next year (two, or three). Thankfully, such price increases are not a reflection of sharply rising wages, which would suggest a sustained bout of higher inflation. Rather, it probably reflects dramatic shifts in demand patterns combined with supply disruption.

Shrinkflation also continues to be prevalent in retail and supermarkets which is a hidden form of inflation.

COMMODITIES

Key themes in commodities include:

- The shortage of microchips has extended, with delays now taking up to ~17 weeks between order and delivery. Recall that delays have previously been estimated to cost the US alone ~0.5% of global GDP, since the shortage impacts over 100 industries.
- Iran can bring 3.5 MM B/D (million barrels per day) of oil to market within 3 months which is equivalent of ~3.5% of global production. Pent up demand from reopening should help absorb additional supply, if the rest of OPEC+ holds production steady…
- Gold hit the $1900 (USD) mark amid inflation chatter.
- Oil hit its highest price since 2018 late in the month.
- US Housing Starts decelerated materially in April, falling 9% below expectations. Such a significant miss is likely related to the shortage of lumber and labor since applications for building permits remained consistent with the prior month. In other words, housing supply is falling short of housing demand – what's new. With lumber prices rising significantly since November 2020, despite slightly correcting in May, it may be telling us that the situation with housing is rapidly changing… Maybe money does grow on trees (see below for technical graph explanation).

Figure 5: New Strain of Tree that Grows $$

Source: Eriksens Secret Location Holding Supply of Lumber

CRYPTO-CURRENCY

It has been overwhelming with all the crypto headlines which have appeared in the press recently. China has been advancing its Digital Yuan project and most importantly is its application in developing markets. Through the Belt and Road Initiative, China has built relationships with many developing nations, many of which have unstable currencies, underdeveloped payments infrastructure, and a dependency on USD.

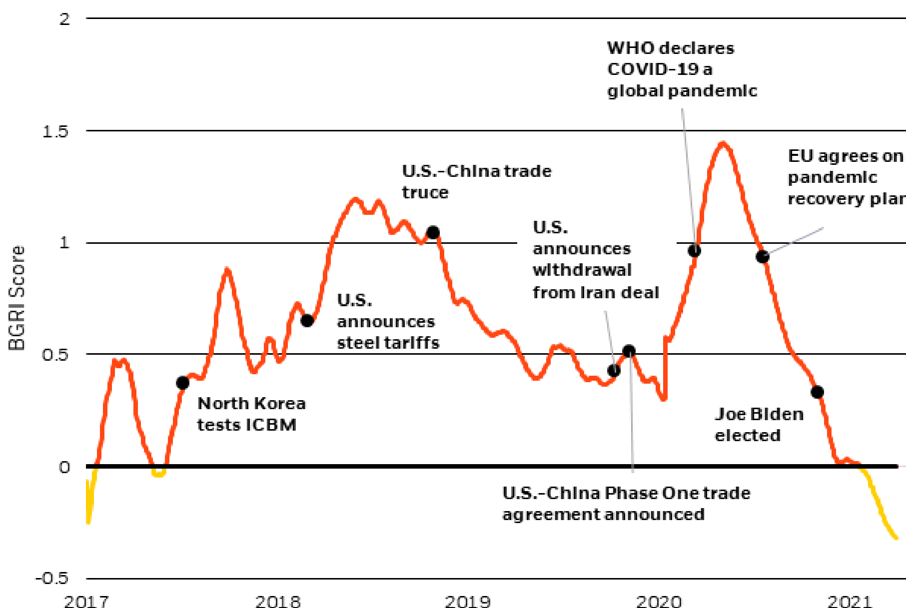
Maybe, various developing countries, either through choice or coercion, will leverage Chinese ecommerce/payments technology (Alibaba/Tencent) backed by a Chinese digital coin that facilitates consumer transactions.

The United States' reaction to the 'Digital Yuan' appears muted. The Federal Reserve of Boston is working on a pilot program to design a hypothetical 'Digital Dollar'. As the 'digital yuan' becomes more widely used, we expect other nations will follow suit in issuing their own digital currencies. The key point is knowing ahead of time which cryptocurrencies will survive is exceptionally difficult. In the 20th century, there were hundreds of car manufacturers and most failed. Ultimately, we believe digital and crypto currencies have a future, but also stress caution for those who are speculating for a quick return.

GEOPOLITICAL TENSIONS

Geopolitics has been pushed out of the spotlight by concerns about inflation and supply chain issues, with the geopolitical risk indicator at its lowest level since 2017 (Figure 8).

Figure 6: BlackRock Geopolitical Risk Indicator



Source: BlackRock

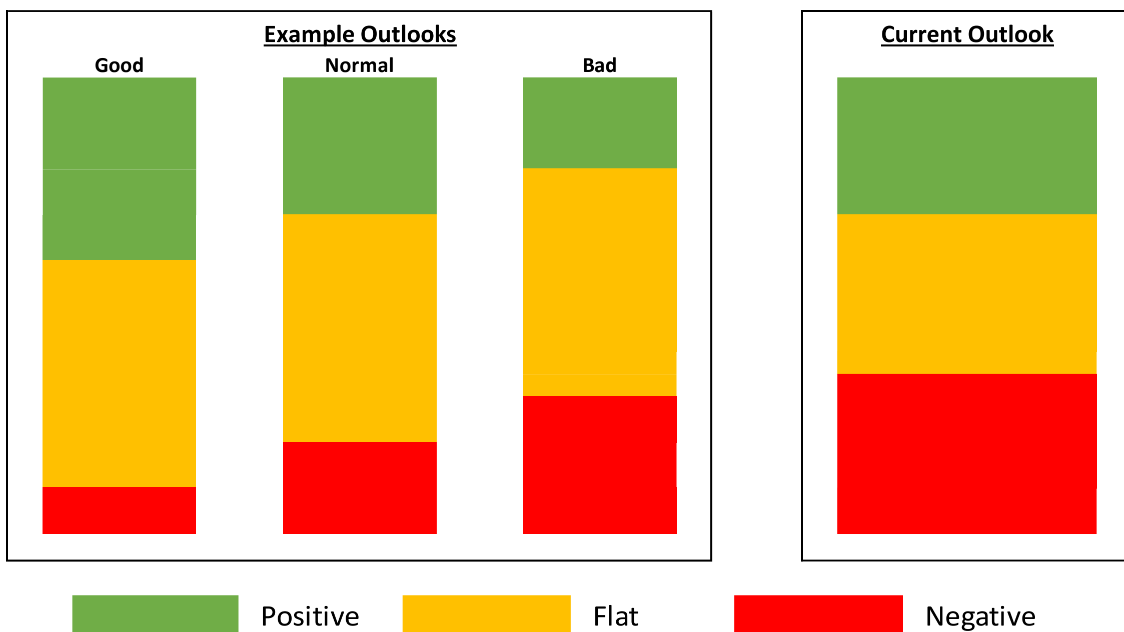
US-China relations are hardly friendly but at the same time there is less fundamentalist rhetoric. The topic of human rights continues to arise. The Chinese air force are testing their readiness of Taiwanese defence, maintaining tension in the region. BlackRock do not see these tensions resulting in a military showdown in

2021, but there is a significant medium- and long-term risk. Antagonism between China and Taiwan is shifting to technology competition.

Australia-China relations are around tariffs and the origin of Covid-19. Trade conflict started in February 2020 and it has been amplified during the pandemic when China banned the import of meat, wine, barley, and coal from Australia as a response to Australia's claim of Chinese origin of Covid-19.

The hijacking of Ryanair flight from Athens to Vilnius by Belarusian air forces has added tension between the EU and Russia. The flight was forced to land in Minsk airport where Roman Protasevich, journalist of the opposition to President Lukashenko, was arrested. After the incident, EU air space was closed for Belarusian flights and European air companies were suggested to adjust the routes. In protest against EU sanctions against Belarus, Russia closed their air space for Austrian Airlines and Air France.

MARKET OUTLOOK



The current market is less likely to have a good return (green) as an average return (amber) over the next two to three years. It is a little more likely to have a bad return (red).