ERIKSENSGLOBAL
Actuaries & Investment Strategists

MARKET PERFORMANCE AND COMMENTARY – FEBRUARY 2022

MARKET PERFORMANCE

Index	Index Level/Price	1 Month %	3 Month %	1 Year %
Global Equities				
MSCI World Price Index (NZD)	4405.91	-5.3	-3.3	17.5
MSCI Emerging Markets	712.31	-2.4	-2.7	-8.8
S&P 500 (US)	4373.94	-3.1	-4.2	14.8
Nikkei 225 (Japan)	26526.82	-1.8	-4.7	-8.4
FTSE 100 (UK)	7458.25	-0.1	5.6	15.0
DAX (Germany)	14461.02	-6.5	-4.2	4.9
CAC 40 (France)	6658.83	-4.9	-0.9	16.8
Trans-Tasman Equities				
S&P/NZX 50	11977.77	0.7	-5.8	-2.0
S&P/ASX 300	81830.23	2.1	-2.0	10.2
Bonds				
S&P/NZX NZ Govt Stock	1779.52	-0.9	-1.4	-4.0
S&P/NZX A Grade Corporate	5631.06	-0.7	-0.9	-3.5
Barclays Global Agg (Hedged to NZD)	413.81	-1.2	-3.2	-2.0
FTSE WGBI (Hedged to NZD)	3573.77	-1.1	-3.4	-1.8
Oil				
West Texas Intermediate Crude	95.72	8.6	44.6	55.6
Brent Crude	100.83	10.9	44.6	56.5
NZD Foreign Exchange				
AUD	0.9326	0.0	-2.6	-0.7
EUR	0.6025	2.8	-0.1	0.6
GBP	0.5044	3.0	-1.7	-3.0
JPY	77.9447	3.0	1.1	0.6
CNY	4.2703	1.9	-1.3	-9.4
USD	0.6767	3.0	-0.3	-6.9

Source: Nikko, indices are in the local currency of the asset unless otherwise indicated.

Executive summary:

- Geopolitical risks are high
- Equity markets are under pressure
- Oil prices have climbed beyond $100 per barrel
- New Zealand dollar appreciated

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ECONOMIC COMMENTARY

GLOBAL SNAPSHOT

The relatively positive start of the month with equity markets bouncing back after the January sell-off was clouded by Russia's “special military operation” in Ukraine. Geopolitics took a front seat, and economic factors shifted to the background. Inflation has continued to rise, and price pressures are broadening. The Fed has shifted its focus from stimulating economic recovery to managing prices. A flattening yield curve has heightened fears of recession.

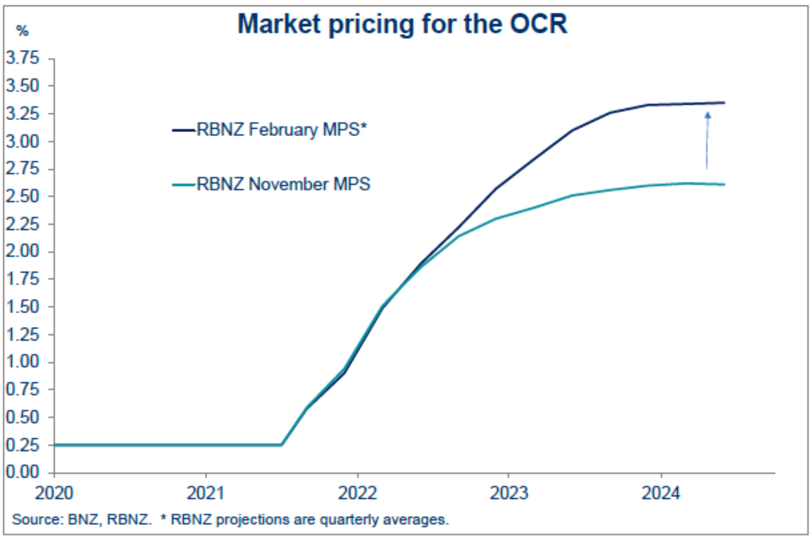
Supply chain pressures were easing, but it is too early to assess the implication of the effect of sanctions on Russia.

Global growth remains above trend, and various economies are lifting COVID-19 restrictions. China has started adding more stimulus. Financial conditions are still loose, and market expectations are for Fed policy rates to peak only at around 2%. We remember the “Volcker shock” that occurred when the Fed hiked rates to 20% to subdue inflation in the 1980s, and don’t expect a repeat of that policy experiment either.

LOCAL SNAPSHOT

The RBNZ raised the OCR by 25bps, to 1%, at its last quarterly publishing of the Monetary Policy Statement in February, as widely expected by economists and financial markets. However, the statement's tone was more hawkish than many experts had anticipated (Figure 1). Inflation is well above the 2% midpoint of the RBNZ’s target range and is expected to remain at this level for several years. The labour market is extremely tight, with the unemployment rate at 3.2%, the lowest unemployment rate since the Household Labour Force Survey began in 1986. The RBNZ is concerned about the risk that above-target inflation could become entrenched in wage and price expectations, making inflation harder to control and subdue in the long term.

Figure 1



In response to high vaccination rates and mounting public pressure, New Zealand has now lifted the restrictions for vaccinated travellers from Australia. While this comes as a relief to many individuals, we wonder if it will help the hospitality and tourism sectors, considering more and more businesses are temporarily closing their doors due to self-isolation rules at Red under the COVID-19 Protection Framework.

WORLD FINANCIAL MARKETS

Equities

US stocks were mostly lower on the last day of February, ending a big two-day winning streak for the markets. The major indexes fell more than 3% over the month, their second straight month of losses.

As one example of market volatility, Tesla added USD100 billion to its market capitalisation in one day (24 February) but declined roughly 5.5% over the week as a whole.

The consumer discretionary sector generally underperformed within the S&P 500 as the turmoil in Europe depressed travel-related equities. Conversely, resilience in internet giants Alphabet (the parent company of Google) and Meta Platforms (the parent company of Facebook) supported the market value of communications companies, and healthcare shares were also strong.

European indexes fell between -1% and -4% as Russia’s invasion of Ukraine fuelled fears of higher inflation and an economic slowdown. In the UK, the FTSE 100 was flat, and the FTSE 250 slipped -2.1%.

Australian equities staged a rebound in February following January's losses as the S&P/ASX 200 rallied 2%. New Zealand’s S&P/NZX 50 also advanced, adding 1%, with the largest companies rising the most - the S&P/NZX 10 alone climbed 2%. The gains on either side of the Tasman Sea offered a contrast to equities in the rest of the world, which largely declined in search for safety after the Russian invasion of Ukraine.

Fixed Interest

The last Friday of February saw a rally that pushed the US 10-year Treasury yield slightly higher for the week, ending at 1.96%, up to three basis points from 1.93%.

Core eurozone bond yields fell after Russia’s invasion of Ukraine drove a flight to safety but rose on the last Friday.

US investment-grade corporate bonds traded lower at the end of the month alongside headlines regarding the Russia-Ukraine conflict. Relatively light overnight activity from Asia, coupled with active primary issuance in the face of the weakened macroeconomic tone, contributed to the weakness. Despite the issuers' elevated new issue premiums, demand for the new deals was relatively subdued.

The high yield bond market also struggled under the risk-off sentiment, but buyers who were looking to source high-quality BB-rated paper took advantage of the weakness. Due to the recent modest new issuance, elevated cash balances also contributed to the strong demand for higher-quality bonds. Similarly, the bank loan market traded lower amid the Russia-Ukraine conflict's uncertainty, while some opportunistic buyers stepped in at lower levels. Primary market activity continued to be light, with only a few new deals announced through the month.

Australian bonds continued to sell off, with yields rising across the yield curve. The broad-based S&P/ASX Fixed Interest declined 1.3%, while our broad indices for investment grade and sovereign bonds across the Tasman Sea also finished the month down by 1.1% and 1.2%, respectively. The performance of inflation-linked bonds was mixed, as they declined by 0.8% in Australia but gained 0.4% in New Zealand.

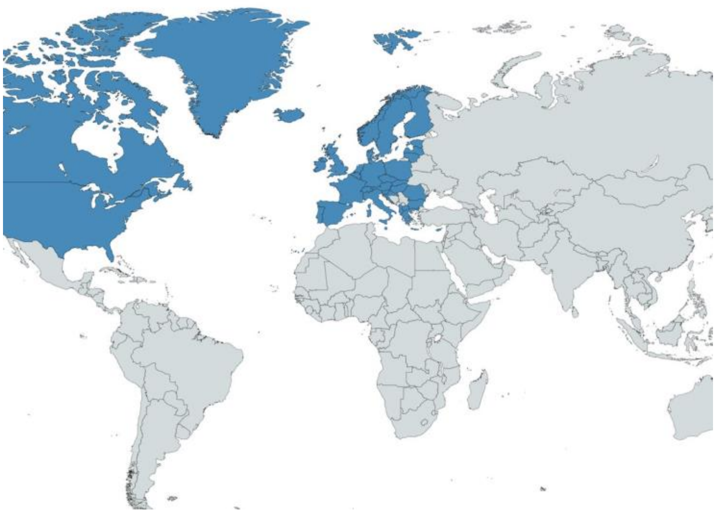
GEOPOLITICS

From our resident (Kazakh and Russian speaking) international relations expert Janibek Issagulov

Unfortunately, one of the geopolitical risks we discussed last month was realised in February. Russia started its so-called "special military operation" in Ukraine on 24 February straight after its Defender of the Fatherland Day (23 February is a public holiday in Russia). This step surprised the opposition in Russia despite ongoing military mobilisation and warnings from intelligence services.

The start of the war has resulted in Russia's isolation from financial markets in the US and Europe and blockage from access to European technologies and markets, mainly semiconductors and other high tech. Several banks have banned Russia from the SWIFT financial system except for Sberbank and Gazprombank, which use it for transactions necessary for gas and oil supply. Another measure to pressure Russia is the closure of airspace for Russian aeroplanes by 33 countries in Europe and America (Figure 2).

Figure 2



Source: www.businessinsider.com

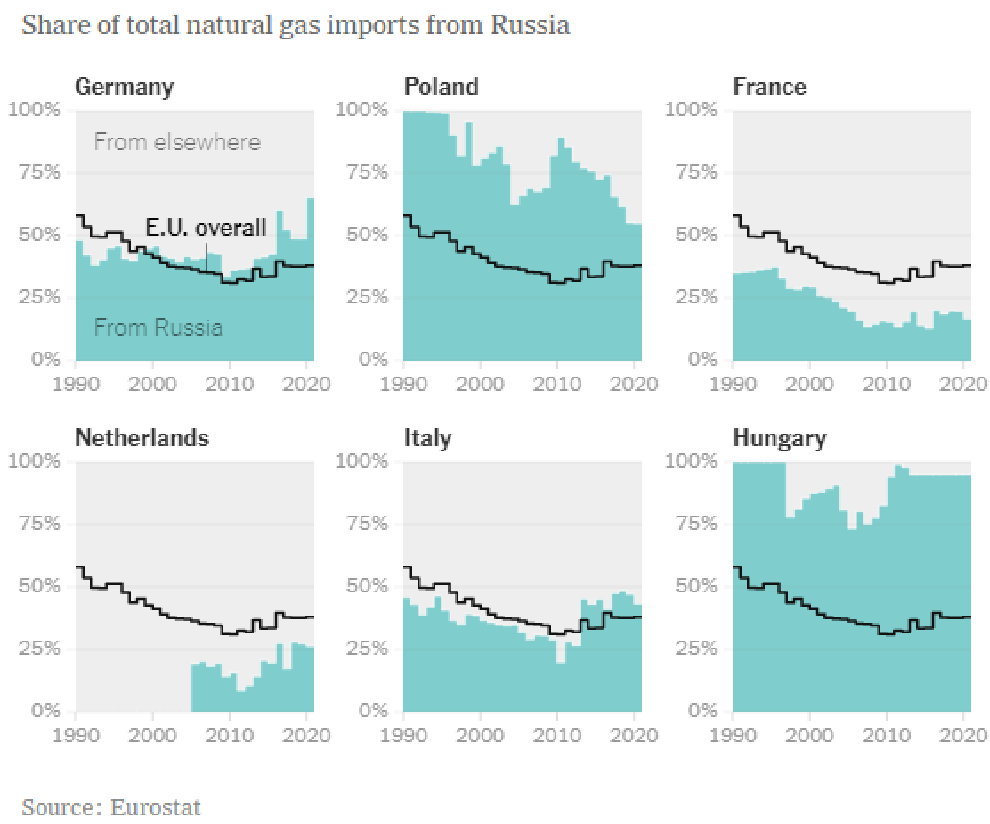
The military actions are still ongoing, bringing civilian and military casualties. Significant battles are going on, both on Ukrainian soil and in the global media. The West seems to be winning the war of public opinion, gaining more countries into the coalition. But both sides use the same photos and video materials, and blame the other side for bombing civilians. Meanwhile, food and drinking water supplies are dwindling in Ukraine due to the ongoing fighting, and Russia still has another wave of troops and armaments to come.

The western world has refused to fight on the Ukrainian side against Russia and stop the bloodshed, either by enforcing a no-fly zone or by providing troops, which proves our earlier statement of the weakness of political will in Europe and the US. While the Russia-Ukraine war has attracted all the world's attention, Asia might become the next conflict point on the map.

GLOBAL SUPPLY CHAIN – WHO IS A WINNER?

The conflict in Ukraine led oil prices to surge as high as $105 a barrel. Oil futures cooled back down after the US said it would work with other major countries to coordinate the strategic release of petroleum reserves. Newly announced economic sanctions have not yet targeted Russian oil, and in fact, shipments of crude oil from Russia reached their highest level since June. Between an extended conflict in Ukraine and the turbulent energy transition, oil and gas price volatility will likely continue at record levels for the foreseeable future. The most brutal hit will be on the EU and mainly Germany as a primary importer of Russian gas (approximately 40% of imports are from Russia, see Figure 3). Germany made a statement that it would move away from Russian oil to American, but it is unclear if the volumes will be enough and what price they will have to pay.

Figure 3



If oil stays above $100 this year, it could increase energy costs in US households by $750 annually for 2022, based on last year's energy consumption records. OPEC+'s reluctance to lower prices may also signal a desire to squeeze profit out of oil production before the commodity becomes obsolete. The global use of oil for energy has declined consistently since 1989. Even as renewable investments grow, they are 3x short of the level needed to meet expected energy demand by 2030, so oil and gas will remain an essential part of the energy mix.

High oil prices will likely persist as the crisis unfolds. If the conflict in Eastern Europe hampers Russia's supply lines, oil could even hit $130 or higher. Conversely, the potential release and production of 103 million new barrels from Iran could deflate prices once again. With so many variables, only one thing is sure — wild swings in the price of oil will remain a staple of this decade's energy transition.

Disruptions in other resources will also be affected, such as aluminium, copper, and nickel. These are critical materials for the automotive industry and 'green energy' transitions. Supply and prices of soft commodities, such as wheat, soy and corn, also stand to fluctuate significantly in response to sanctions and conflict. According to the US Department of Agriculture, Russia and Ukraine together account for a third of the world's wheat exports, a fifth of its corn trade, and almost eighty per cent of global sunflower oil production.

The war has led to a ban on all commercial vessels in the inland sea of Azov, which connects to the Black Sea, and the closure of Ukrainian ports. Some 90 per cent of Ukrainian grain exports are transported by sea, and the disruption is expected to wreak havoc on food supply flows, said analysts.

Since the start of the 2022 corn prices have already risen 15 per cent, while wheat prices have risen by more than a fifth to almost GFC levels (Figure 4).

Figure 4

IS THE AGE OF GLOBALISATION DEAD?

The idea of globalisation was the central theme on a different platform from local as a part of election campaigns to global as World Economic Forum in 20th century. However, practice has shown that the bigger organisation is usually less efficient. After WWII, there were a lot of trade and military conflicts that the UN failed to handle, and this tendency was intensified after the collapse of the USSR. The major ones are:

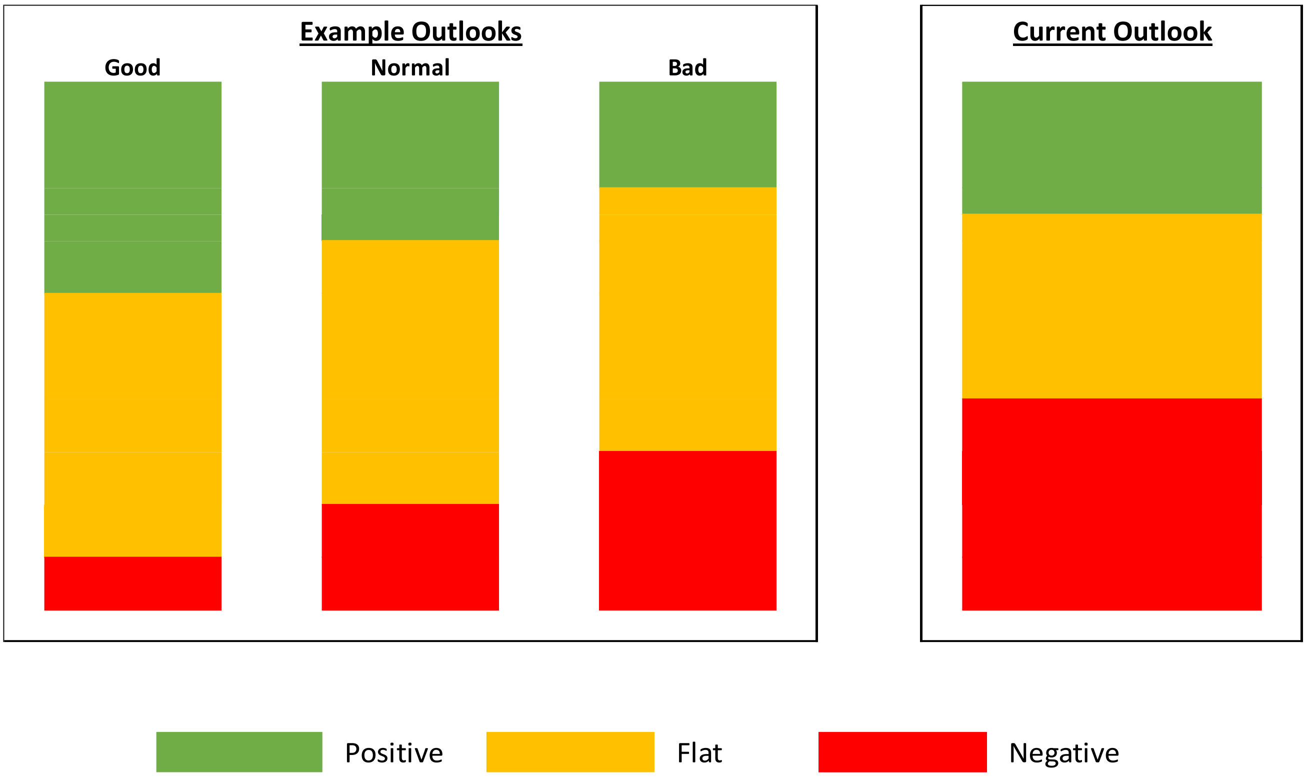
- The Yugoslavian crisis
- The NATO missions in Iraq
- Libya and Syria
- The intervention of Russia in Georgia
- War in the Nagorno-Karabakh region

A fair question would be, what is the role of the UN and its General Assembly and Security Council if the conflicts are resolved in favour of the strongest nations and not its own mandate?

In the economic sector, trade conflicts turned into long-lasting wars that affected conflicting parties and the rest of the world - sanctions against the companies and industry sectors. Still live examples of trade wars are between the US and China with disruptions to IT and telecom industries, and the China-Australia trade wars that involved coal, iron ore and , soberingly, wine exports.

The spread of COVID only increased the velocity of centrifugal forces within global international originations. We have witnessed rising regionalization in recent years, the creation of smaller ‘clubs’ that represent the national interests of a few countries, and increasing numbers of bilateral trade agreements. We believe this trend will continue in the near future since it is easier to find the consensus between two than 193. But should World War III break out, there will only be two (or three) sides to take, and with this in mind smaller nations are continuing to choose trading partners, and potential allies, carefully.

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 more likely to have a bad return (red).