MARKET PERFORMANCE AND COMMENTARY – JUNE 2022

MARKET PERFORMANCE

Index	Index Level/Price	1 Month %	3 Month %	1 Year %
Global Equities				
MSCI World NR	6,072.56	-7.8	-14.3	-11.1
MSCI World NR (NZD)	12,473.23	-4.4	-6.2	-3.7
MSCI Emerging Markets	641.32	-4.6	-8.1	-20.2
S&P 500 (US)	3,785.38	-8.4	-16.4	-11.9
Nikkei 225 (Japan)	26,393.04	-3.3	-5.1	-8.3
FTSE 100 (UK)	7,169.28	-5.8	-4.6	1.9
DAX (Germany)	12,783.77	-11.2	-11.3	-17.7
CAC 40 (France)	5,922.86	-8.4	-11.1	-9.0
Trans-Tasman Equities				
S&P/NZX 50	10,868.70	-3.9	-10.3	-14.1
S&P/ASX 300	76,785.88	-9.0	-12.2	-6.8
Bonds				
S&P/NZX NZ Govt Stock	1,679.22	-1.0	-3.2	-10.3
S&P/NZX A Grade Corporate	5,465.14	-0.1	-1.4	-6.8
Barclays Global Agg (Hedged to NZD)	387.13	-1.5	-4.5	-8.8
Oil				
West Texas Intermediate Crude	105.76	-7.8	5.5	43.9
Brent Crude	115.04	-4.0	7.9	53.1
NZD Foreign Exchange				
AUD	0.9042	-0.4	-2.4	-2.9
EUR	0.5947	-2.1	-4.9	0.9
GBP	0.5120	-0.9	-3.1	1.2
JPY	84.4679	0.9	0.1	8.9
CNY	4.1683	-4.1	-5.6	-7.7
USD	0.6218	-4.5	-10.6	-11.0

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

Executive summary:

- Global and Australasian stock markets sold off
- Interest rates rose, lowering bond prices
- Geopolitical risks are still high
- Food security is a priority on the global agenda
- Oil prices have fallen from recent highs back nearer to $100 a barrel
- Inflation is at record high levels causing problems for developed and emerging markets
- New Zealand dollar depreciated against most currencies.

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ECONOMIC COMMENTARY

GLOBAL SNAPSHOT

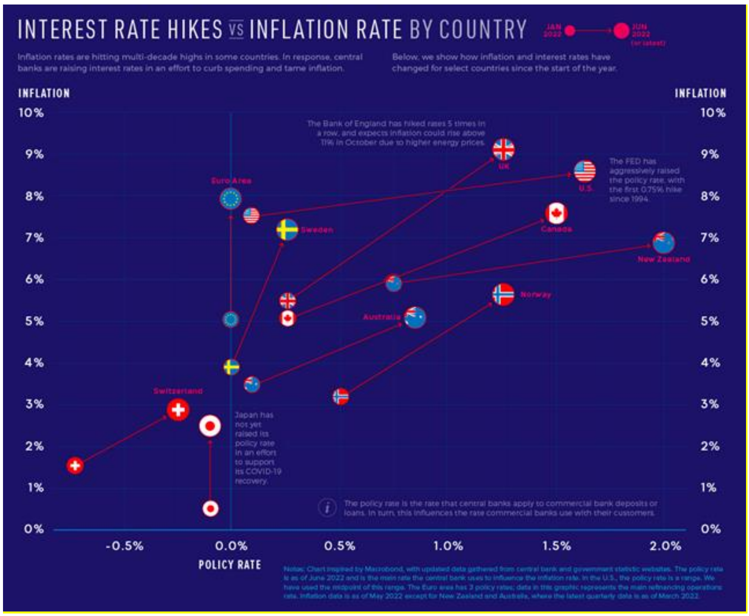
Inflation took centre stage in investors’ agenda. Central banks are unlikely to come to the rescue to halt a growth slowdown by cutting rates. The risk of unanchored inflation expectations (where long-run inflation expectations change significantly) is increasing as inflation becomes more persistent. Inflation expectations have risen sharply over the past year, partly driven by higher oil prices, but also reflecting tighter labour markets and higher wages (Figure 1).

The Fed has made clear it is ready to dampen growth. It has projected a large and rapid increase in rates, raising rates by 0.75% in June, the largest increase since 1994. This combination of rising rates and steadily rising oil prices has raised concerns that the US economy may be at risk of overheating.

The Bank of England warned of the poisonous combination of recession and high inflation as it raised interest rates further to 1.25% in June. This may indicate the start of a dovish pivot. The BoE appears increasingly concerned about weak growth prospects for 2022, even though it expects inflation to rise above its target rate over this period.

The European Central Bank announced plans to end asset purchases and implement a rapid series of rate hikes in an effort to stabilize peripheral bond yields. Analysts think the ECB and markets underappreciate the risk of the energy crunch pushing the euro area into recession, which could cause them to rethink their policy path at some point.

Figure 1



Source: visualcapitalist.com

The U.S. economy is experiencing a period of high inflation and rising interest rates, shaky economic activity and volatile markets that has raised the probability that the country will slip into a recession, according to economists.

But while there is some consensus on what might occur, forecasts vary widely in their predictions of how bad it might get. Those who say the recession will be avoided emphasize that they might be too optimistic, while those who are confident that the economy will shrink are quick to say the recession won't be that bad.

Some views and comments of economists, analysts and strategists across the globe:

- Deloitte puts the chance of a recession at about 15 percent, "less likely than some analysts would have you believe."
- Morgan Stanley notes that "accelerating inflation has been a common precursor to recessions."
- TD Bank in Canada is not expecting a U.S. recession, although "with growth close to stall speed, there is a very thin margin for error if another shock hits economies."
- Credit Suisse' view is that the U.S. economy is on "the edge of a recession", but there are "buffers" that should shield the economy from "spiralling into a broader downturn."
- Berenberg, the German bank, expect the U.S. economy to stagnate in late 2022 and shrink in the first three quarters of 2023, but only by a "relatively modest" 0.4 percent for the year. "With luck, the recession will be a shallow one," they write.
- Fitch Ratings expects that economic growth will slow to just 0.1 percent per quarter in the second through fourth quarters next year, a pace that will put the economy "perilously close to the risk of technical recession."

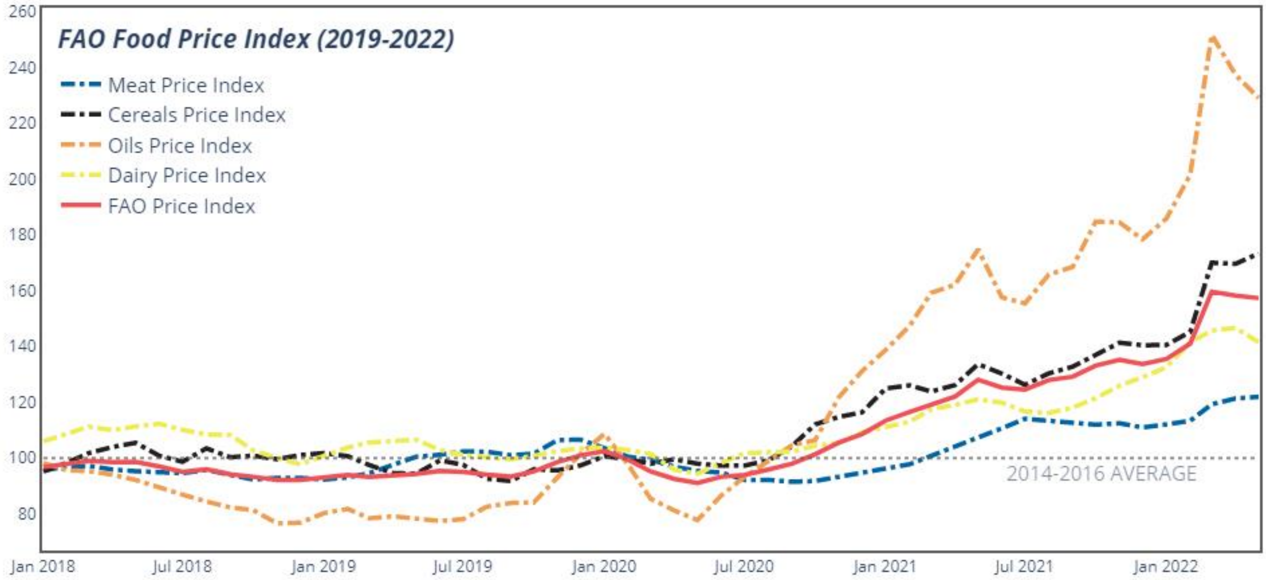
The latest inflation figures show that households are bearing the brunt of rising prices, with food prices – particularly fresh items such as cheese – accelerating steeply in the last month.

Global corn supplies have been tight since the pandemic started in 2020, due to transportation problems and strong demand, and are expected to fall further. The U.S. Department of Agriculture (USDA) expects end-of-season U.S. corn stocks to be down 33% from pre-pandemic levels in September before this year's harvest, and down 37% in September 2023.

Ahead of a crucial North American harvest, grain seeding delays from Manitoba to Indiana have sparked worries about lower production. A smaller corn crop in the top-producing United States will ripple through the supply chain and leave consumers paying even more for meat than they already are, as corn is a key source of livestock feed.

The global food import bill is on course to hit a new record of US$1.8 trillion in 2022, but higher prices and transport costs rather than volumes account for the bulk of the expected increase, according to the latest report released by the Food and Agriculture Organization of the United Nations (FAO). Animal fats and vegetable oils are the single biggest contributor to the higher import bills expected to be reached in 2022, although cereals are not far behind for developed countries. Developing countries, as a whole, are reducing imports of cereals, oilseeds and meat, which reflects their inability to cover the increase in prices (Figure 2).

Figure 2



Source: geopoliticalmonitor.com

LOCAL SNAPSHOT

Indicators of economic activity softened across the board. But inflation measures barely budged from stratospheric levels. Such is the reality of an acutely supply-constrained economy but with a central bank waging war on demand as the only path to lower inflation.

The Reserve Bank of New Zealand (RBNZ) has spent the past year trying to combat rising inflation expectations, which have been driven by a surge in firms' cost expectations and price intentions. Inflation expectations are now rising at rates close to 7%, but recent data suggests that firms' pricing intentions, cost expectations, and inflation expectations may be stabilising after their first half surge. This provides a bit more comfort that inflation may be peaking around now at rates close to 7%.

The New Zealand Government has announced the conclusion of negotiations of a free trade agreement with the European Union. New Zealand exported $3.9bn worth of goods to the EU in 2021. For comparison, the EU bloc of countries and ASEAN bloc of countries accounted for 6.4% and 10.1%, respectively, of New Zealand's exports over the same period.

Bloomberg ranked New Zealand as the riskiest housing market in their list – vulnerable to a price crash. "There are going to be house buyers who have entered the market in the past year or so who started off with a mortgage rate of 2.5% and all of a sudden, they are rolling off onto a mortgage rate closer to 6%. There is going to be some pain for sure." The median dwelling price has already plunged 9.2% from the November 2021 peak, with the stock of unsold homes also ballooning.

WORLD FINANCIAL MARKETS

Equities

MSCI World Index returned -7.8% and MSCI Emerging Markets returned -4.6% in June.

S&P 500 lost -8.4% in June, surrendering a portion of the previous strong gains, as worries grew that the Fed's fight against inflation would push the economy into recession. The S&P 500 closed out its worst first half of the year since 1962, although the decline was amplified by the index reaching its all-time high on 3 January. Typically, defensive segments within the index, such as utilities and consumer staples, held up best, while consumer discretionary and information technology shares were particularly weak. Growth stocks lagged value stocks over the year to date, while small-caps finished ahead of large-caps.

In Europe, the Euro Stoxx 50 fell -8.7% in June on fears that soaring inflation and rising interest rates could hit earnings and tip economies into a recession. Major indices were negative. France's CAC 40 gave up -8.4%, Germany's DAX retreated -11.2%.

Fixed Interest

Along with the sluggish economic data, signs of moderating inflation appeared to help push the yield on the benchmark 10-year US Treasury Note as low as 2.89% on the last day of June, its lowest level for the month.

Core eurozone bond yields decreased. Yields increased initially amid inflation concerns and ahead of speeches by central bank officials at the ECB annual meeting, but lower-than-expected German inflation calmed fears, leading yields lower overall. The 10-year gilt yield ended the month at 2.24%.

US high yield bonds traded lower along with equities. Buyers adjusting positions ahead of quarter-end and sellers raising cash drove most the market's activity. One anticipated new deal was announced before the primary market shut down ahead of the holiday weekend, while the retail segment experienced weakness after a disappointing earnings report from Bed Bath & Beyond increased negative sentiment across the sector.

Broad risk-off sentiment weighed on the performance of bank loans. Investors appear to be expecting a 75-basis-point rate hike at the late-July Fed meeting and then another 50-basis-point increase at the September meeting. Higher-rated loans held up better amid limited support for lower-quality paper. Negative flows from the asset class drove most of the loan market's selling activity.

GEOPOLITICS

The main events during June on geopolitical arena were the NATO summit in Spain, virtual summit of BRICS's leaders and the US initiative in APAC region.

The war in Ukraine is unfortunately escalating with Russia gaining control of more territory, despite weaponry support from Europe and America. As a result, Norway and Finland declared their intent to join

NATO to confront the Russian aggression in Europe. Turkey had initially opposed this but has since consented, after Norway and Finland agreed to stop supporting the Kurdish Labour Party. Turkey also requested the extradition of more than 30 suspects from both countries. However, it reserved the right to block entry if Finland and Norway do not keep their promises.

If both Finland and Sweden joined NATO, it would bring the total number of military personnel in the alliance to nearly 3.57 million. This figure is lower than what Ukraine would have added to NATO at pre-war levels. However, if reserves are included it would bring it to nearly 4.5 million. Overall, the alliance would have just over 15,000 tanks if the two Nordic countries were members. Russia and Belarus agreed to place nuclear missiles on the latter's territory as a countermeasure to NATO's expansion.

BRICS (Brazil, Russia, India, China and South Africa) held a virtual summit on 23-24 June where the members discussed a new reserve currency (bucket of BRICS's national currencies) as an alternative to the US dollar and Euro which are both being used as mechanisms in US and EU sanctions. The summit promoted "multilateral cooperation with non-Western styles, forms and principles". Expansion was another topic which was supported by China and Russia to oppose the increasing number of NATO members. Iran started its formal process joining the organization. China also invited to join other countries such as Saudi Arabia, Argentina, Egypt, Indonesia, Kazakhstan, Nigeria, Senegal, Thailand and the UAE.

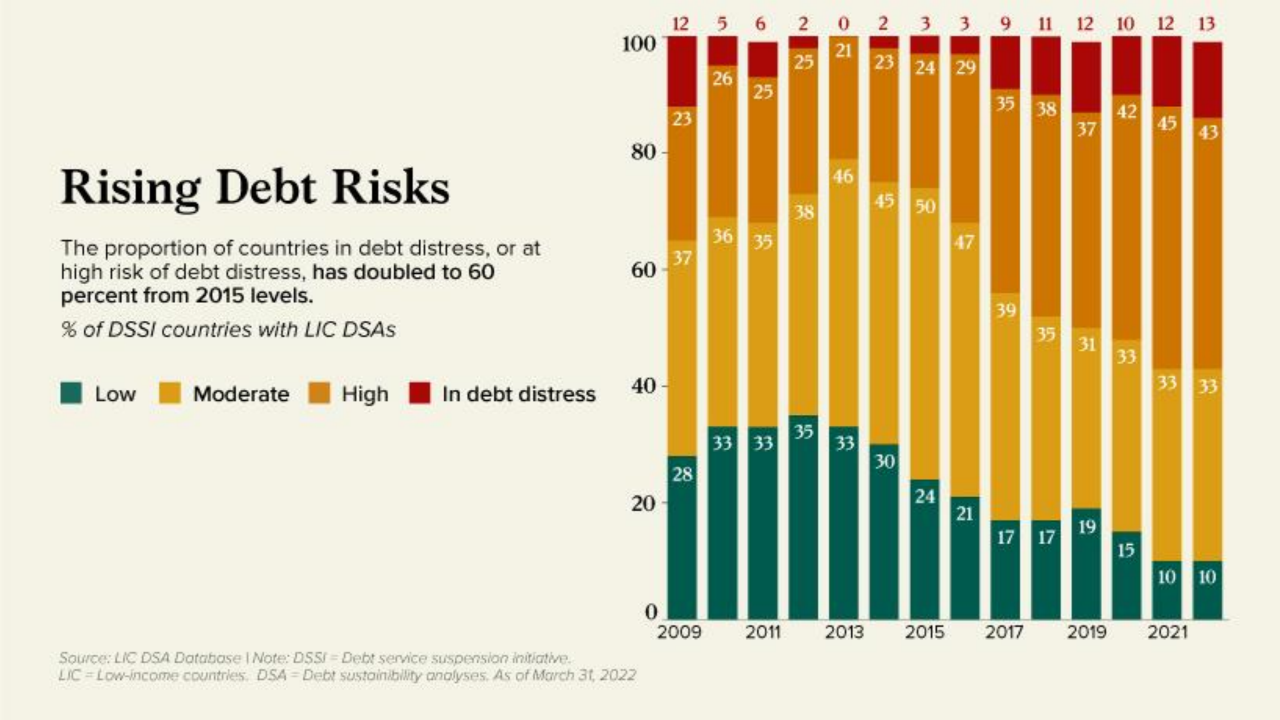
The US launched their initiative in APAC region called Partners in the Blue Pacific (PBP) announced on 24 June. This bloc includes the USA, the UK, Australia, New Zealand, and Japan. The official statement from the White House declared the common goal of members "to support prosperity, resilience, and security in the Pacific". This initiative also known as "AUKUS plus" focuses to prevent the increasing Chinese influence in Pacific islands. What will be the next move from China on the global chess board?

Geoeconomics were focused on the expansion of the EU. Ukraine and Moldova both were granted EU candidate status during the summit in Brussels on 24 June while Georgia, another post-Soviet country suffered from Russian invasion in 2008, was declined. However, being granted candidate status is not a guarantee from the EU that full member status will be awarded. There are still a number of candidates who have been knocking at the EU doors for decades – Turkey has been a candidate for 23 years, North Macedonia 17 years and Albania eight. Other candidates are Montenegro and Serbia. Kosovo and Bosnia & Herzegovina have status as potential candidates.

Higher inflation, increasing food and energy resource prices and rising interest rates triggered defaults for sovereign debts in emerging markets. The first victim was Sri Lanka when it defaulted on its international bonds in May after its grace period lapsed.

Russia defaulted on its sovereign debt in June, however, it is a technical default due to sanctions imposed by the US and allies. The situation in Sri Lanka is an ominous preview of what's coming in other low- and middle-income countries as the risk of debt distress continues to rise globally (Figure 3). Pakistan and Argentina are the next probable candidates to default on sovereign debt.

Figure 3

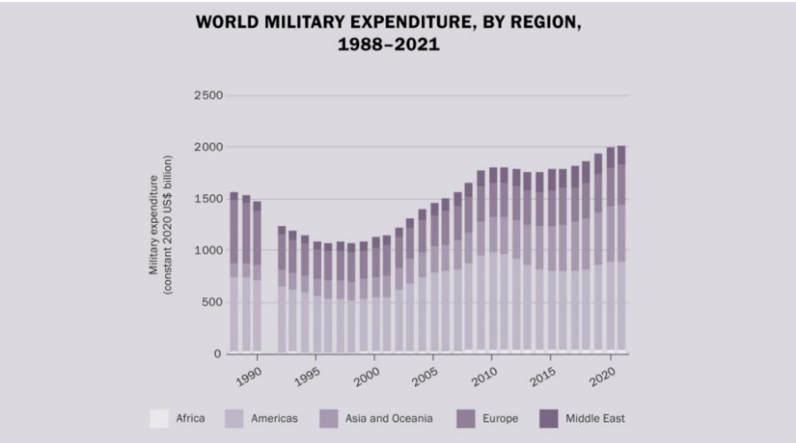


Source: visualcapitalist.com

ARMS PRODUCERS – GOOD OR BAD

The conflict in Ukraine launched a new round of arms race that the world hasn't seen since the end of the Cold War (Figure 4).

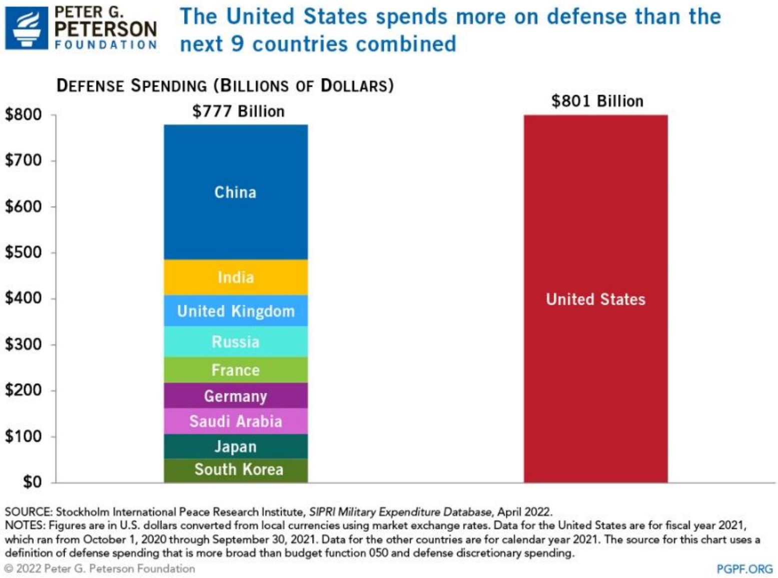
Figure 4



Source: www.sipri.org

The US alone spent more on defence than the next nine countries combined in 2021 (Figure 5).

Figure 5



Spending on arms and defence is increasing rapidly in Europe; Germany approved €100 billion to modernise their armed forces and a big chunk will be spent on American fighter jets and helicopters. This will also allow Germany to reach the NATO threshold of 2% of national GDP. Overall global defence spending will exceed $2 trillion in 2022 and onwards.

Arms manufacturers are the main beneficiaries of upwards spiralling defence budgets. Lockheed Martin shares, the largest arms manufacturer, has returned 22% YTD. Raytheon Technologies, the largest producer of guided missiles, returned 12.7% YTD. The S&P500 has returned -19% YTD – this outperformance against the index clearly shows where the money is going.

CAN AI FEED THE WORLD?

Using a fully automated process, Chinese researchers from Nankai University's College of Artificial Intelligence have developed pig cloning. Seven healthy cloned piglets were born to a surrogate mother for the first time without any human assistance. The trials began in March 2022.

Currently, China is the world's largest producer and consumer of pork. Over 400 million pigs are bred in the nation, and each person consumes between 30kg and 35kg of pork annually. Pork makes up a sizable portion of the meat consumed in China, and the country's supply can never keep up with demand. Due to this, China must import tens of millions of tonnes of costly pig meat every year.

This methodology using AI instead of humans minimizes the error in the cloning process significantly, resulting in efficiency gains and reduced costs. This process has huge potential once implemented to raise pork production, not only in China but throughout the world. The question is, what else can be cloned using AI – sheep, cows, fish…?

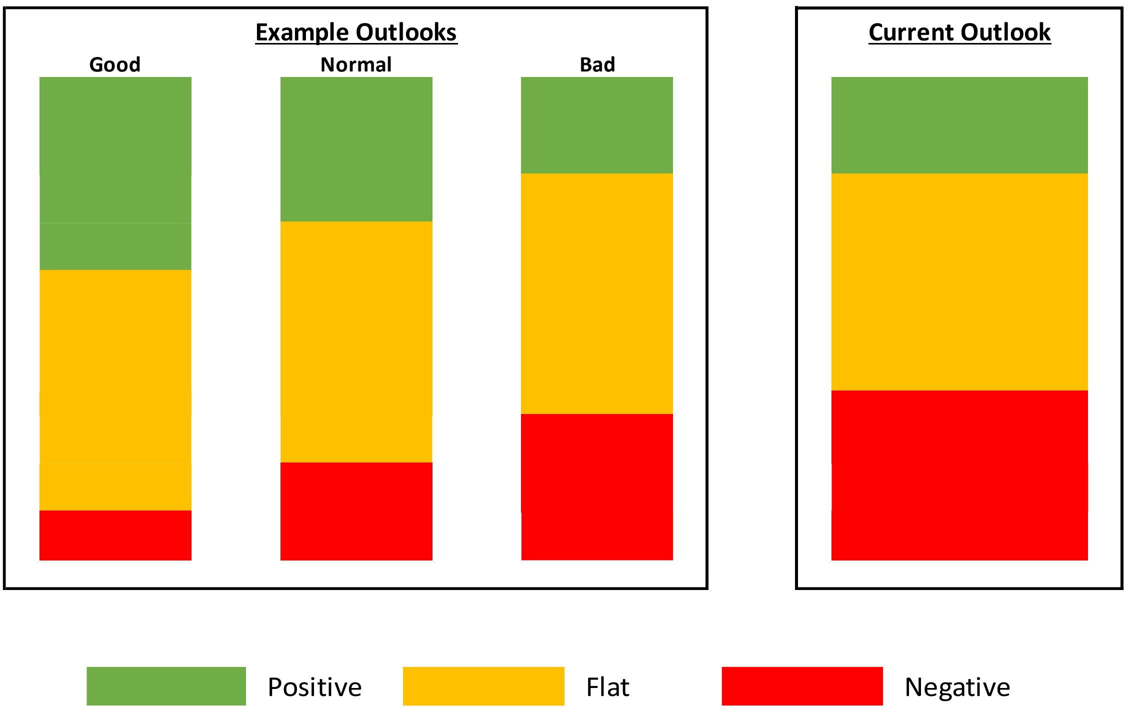
TO SPACE … AND BEYOND

The successful launch of South Korea's Nuri space launch vehicle, officially named Korea Space Launch Vehicle-II, on Tuesday made the country the seventh country in the world to develop a space launch vehicle capable of carrying a satellite weighing more than 1 ton. The list includes Russia, the United States, and France. China, Japan, and India became spacefaring nations later on.

This breakthrough was observed not only by competitors but neighbours as well. Japan is concerned of raising competition from South Korea in high-tech, IT and automobile industry. Now Koreans have an advantage in space technology that makes it more attractive even within the bloc of allies.

Another theoretically possible threat for Japan and China is united Korea with military potential of North and wealth and technology of South. Will we see united Korea on a map?

MARKET OUTLOOK



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