ERIKSENSGLOBAL
Actuaries & Investment Strategists

MARKET PERFORMANCE AND COMMENTARY – AUGUST 2022

MARKET PERFORMANCE

Index	Index Level/Price	1 Month %	3 Month %	1 Year %
Global Equities				
MSCI World NR	6,330.14	-3.5	-3.9	-11.3
MSCI World NR (NZD)	13,082.76	-2.0	0.3	-2.5
MSCI Emerging Markets	649.78	1.2	-3.3	-15.8
S&P 500 (US)	3,955.00	-4.2	-4.3	-12.6
Nikkei 225 (Japan)	28,091.53	1.0	3.0	0.0
FTSE 100 (UK)	7,284.15	-1.9	-4.3	2.3
DAX (Germany)	12,834.96	-4.8	-10.8	-18.9
CAC 40 (France)	6,125.10	-5.0	-5.3	-8.3
Trans-Tasman Equities				
S&P/NZX 50	11,601.10	0.9	2.6	-12.2
S&P/ASX 300	82,316.21	1.2	-2.4	-3.7
Bonds				
S&P/NZX NZ Govt Stock	1,674.07	-3.1	-1.3	-10.4
S&P/NZX A Grade Corporate	5,479.33	-1.8	0.2	-6.0
Barclays Global Agg (Hedged to NZD)	386.40	-2.7	-1.7	-10.0
Oil				
West Texas Intermediate Crude	89.55	-9.2	-21.9	30.7
Brent Crude	95.71	-11.4	-20.1	34.3
NZD Foreign Exchange				
AUD	0.8943	-0.5	-1.4	-7.1
EUR	0.6097	-0.9	0.3	2.3
GBP	0.5269	2.3	2.0	3.0
JPY	84.9910	1.4	1.5	9.9
CNY	4.2264	-0.2	-2.8	-6.9
USD	0.6131	-2.2	-5.8	-12.9

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

Executive summary:

- Global equities fell in August. Australasian markets rose 1%
- Bond yields rose
- Geopolitical risks are still high with continuing war in Ukraine and instability in Middle East and Asia
- Climate change in the form of droughts and floods are disrupting economies in Europe and Asia
- Oil prices are below $100 per barrel
- New Zealand dollar depreciated against all major currencies except GBP and JPY.

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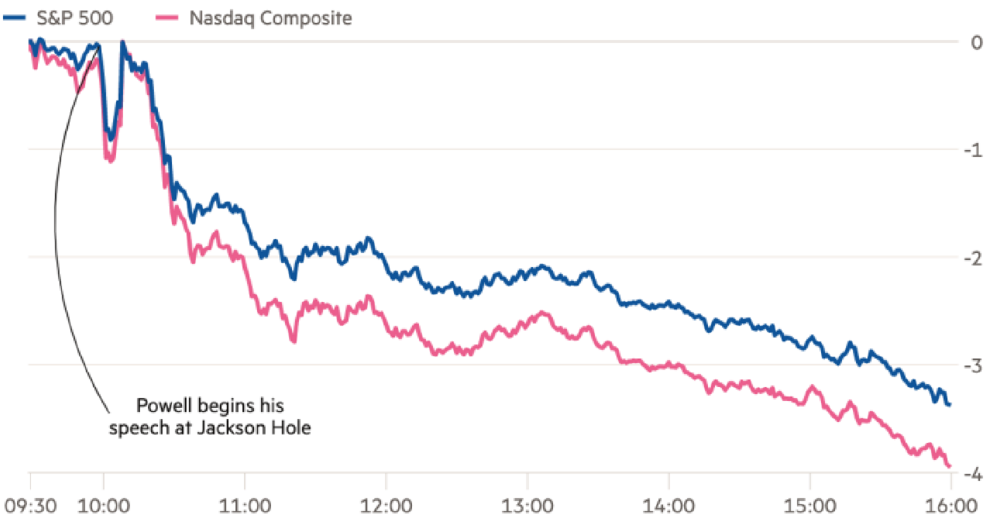
ECONOMIC COMMENTARY

GLOBAL SNAPSHOT

Inflation has appeared stickier than many analysts expected. Most prices rarely go down. Powell's speech at the Jackson Hole summit, scrapped all July gains for equities. The main thesis was fighting inflation. In response, 99% of the stocks in the S&P 500 fell that day (Figure 1, US stocks suffer biggest drawdown).

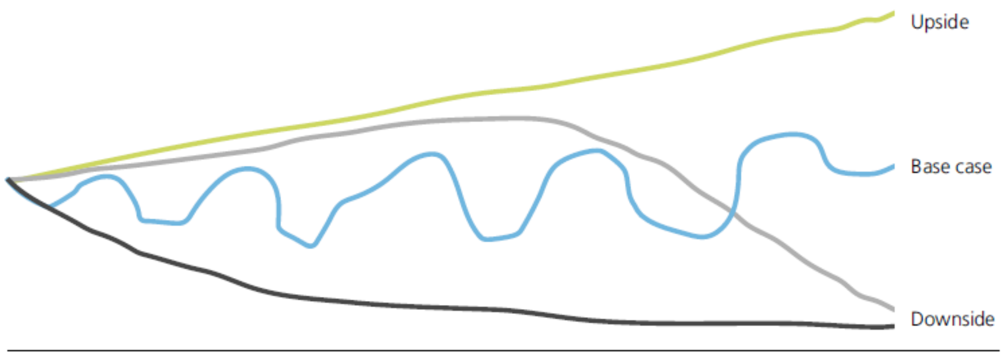
Figure 1, US stocks suffer biggest drawdown since June. Performance on August 26, 2022 (%)



Source: Bloomberg, FT.

Experts say that the previous market expectations of a Fed pivot (a pause from its current policy of raising interest rates) seemed premature, which led to an equity rally in July. But there are always several scenarios for markets. The most dangerous scenario for investors would be an inflation "head fake," in which lower-than-expected price data in the near term leads to overestimating of the Fed's intention to pivot or cut interest rates. Many one-off factors influence inflation data, so markets may misinterpret a one-off downshift for a change in the trend and "declare victory" too early. It would be worse if the Fed makes a policy error by cutting rates. Then being forced to change course and take policy rates much higher than it otherwise would have. The swings in sentiments and factors driving it are increasing both volatility and uncertainty in markets (Figure 2, Potential paths for markets over the next year).

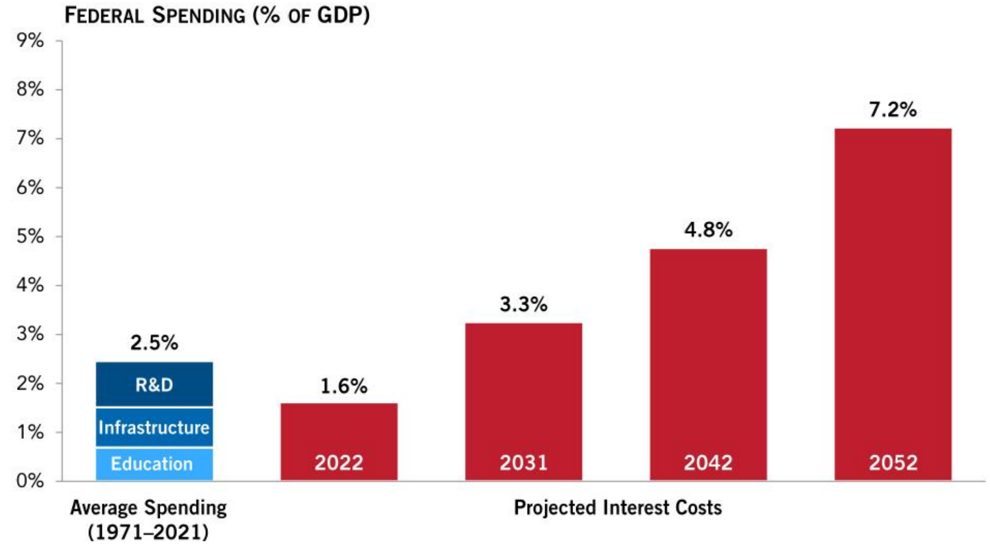
Figure 2, Potential paths for markets over the next year



Source: UBS, as of August 2022

Rising interest rates continues to increase the pressure on budgets. Larger sovereign debt payments squeeze spending on social needs. Pre-Covid, the size of debt was not a concern with low rates and cheap servicing costs. Now, central banks are raising interest rates to fight inflation and public debt is growing expensive. When interest rates exceed economic growth rates, debt becomes unstable, meaning borrowing costs can rise suddenly and sharply as financial markets quickly take notice (Figure 3). This scenario pushes governments to make large reforms to correct the problem. Either more austerity, more taxes, or both.

Figure 3, By 2052, interest costs are projected to be nearly three times the amount the federal government has historically spent on R & D, infrastructure and education combined



SOURCES: Congressional Budget Office, *The Budget and Economic Outlook: 2022 to 2032*, May 2022; and Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2023*, March 2022.
NOTE: Infrastructure excludes defense.
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Energy resources prices sent the EU heading towards recession, with Germany among the most affected from a reduction in gas supply. European power prices reached a record high of 1,050 euros per megawatt hour after Russian Gazprom announced a shutdown of the Nord Stream 1 pipeline for maintenance servicing between 31 August and 2 September. We note that the sanctions against Russia are not having their desired effect. Three predictions on the Russian economy that have not come to pass are:

1. JP Morgan predicted that GDP would fall 35% after the West imposed sanctions while Goldman Sachs said it would the worst fall since 1990. In fact, Russia's GDP contracted by just 4% with stronger than expected exports of oil, gas and commodities helping to support the economy.
2. The oil ban would hurt the export sector. This assumption was made on the basis of the Russian Central Bank's expulsion from SWIFT payments. However, China and India stepped in to allow payments via alternative methods and assist the physical movement of oil which offset the decline in the EU import of Russian oil.
3. Russian manufacturing and service sectors would contract and decline for a long period of time, due to limited access to imported components and goods from the EU. But since April, the PMI has risen back into growth territory.

Mikhail Gorbachev, the last secretary and first president of the USSR, passed away after an ongoing illness. His political legacy left mixed views and feelings inside the former Soviet republics and overseas. Many former Soviets blamed him for the collapse and the years of turmoil that ensued but in the West he was widely respected. Critics say the current conflict in Ukraine is part of his legacy after refraining to put NATO non-expansion guarantees on paper.

LOCAL SNAPSHOT

Many analysts consider headline inflation has peaked. Fuel prices are down from their extremes and supply chain disruptions and freight costs are easing. On the other hand, the labour market is likely to remain in the red-hot zone. Immigration is unlikely to boost the pool of workers sufficiently until attitudes change.

The outlook for economic growth is weak. The hit to households' purchasing power this year, combined with steady increases in debt servicing costs, is a key drag on the economy. Building activity is likely to decrease in light of the property market downturn. Global growth is slowing under the weight of rising interest rates and energy costs. Global food supply challenges might boost export earnings.

The RBNZ increased the OCR by another 50bps (the fourth hike in a row) from 2.5% to 3% in August. Analysts expect another 50bps rise in October and a follow up 25bps rise in November, lifting the rate to 3.75% by Christmas.

The Crown purchased Kiwibank, one of the remaining assets of Kiwi Group Holdings, after they closed a deal to sell Kiwi Wealth to Fisher Funds in August. The trading platform Hatch and insurance business had previously been sold off. The Bank's CEO reported that public ownership would enable growth plans.

The government proposed to apply GST on KiwiSaver management fees in August, nicknamed "retirement tax" by the opposition. A petition initiated by the National Party received massive support from New Zealanders which forced the government to step back and withdraw the proposal.

The crisis in education has pushed foreign investors to leave the sector. Australian childcare operator Evolve Education is selling their New Zealand arm of its preschool business (more than 100 centres) due to its deteriorating performance caused by low occupancy rates and a shortage of teachers over the past couple of years. One of the biggest New Zealand universities, AUT, is laying off circa two hundred teachers because of the significant drop in international students and increasing economic pressure.

WORLD FINANCIAL MARKETS

Equities

The MSCI World Index returned -2.0% and MSCI Emerging Markets returned 1.2% in July in local currency terms.

The S&P 500 tumbled -4.2% in August, as investors continued to digest the implications of hawkish messages from Fed officials. The S&P 500 Index extended its daily losing streak that began with Fed Chair Jerome Powell's 26 August speech at the central bank's Jackson Hole conference. Value stocks continued to outperform high-valuation growth stocks, and large-caps held up significantly better than small-cap shares.

The Euro STOXX 50 Index retreated -5.2% in August on fears that central banks could tighten monetary policy aggressively for an extended period. Worries that Russia might stop natural gas supplies to Europe (which it has since done via the Nord Stream 1 pipeline) also weighed on sentiment. The major stock indices were mixed. Germany's DAX Index returned -4.8% and France's CAC 40 slipped -4.7%. The FTSE 100 slid -1.7% in August.

China's stock markets fell as coronavirus outbreaks in major cities triggered renewed lockdowns and dampened the economic outlook. The broad, capitalisation-weighted Shanghai Composite Index dipped by -1.4% in August.

Fixed Interest

Tightness in the labour market helped push US Treasury yields higher, with the two-year Treasury yield reaching levels not seen since late 2007. Stronger-than-expected Institute for Supply Management manufacturing data, which showed steady expansion in the sector last month, supported upward yield moves. The closely watched 2-year/10-year segment of the Treasury yield curve remained inverted – a common signal of a coming recession.

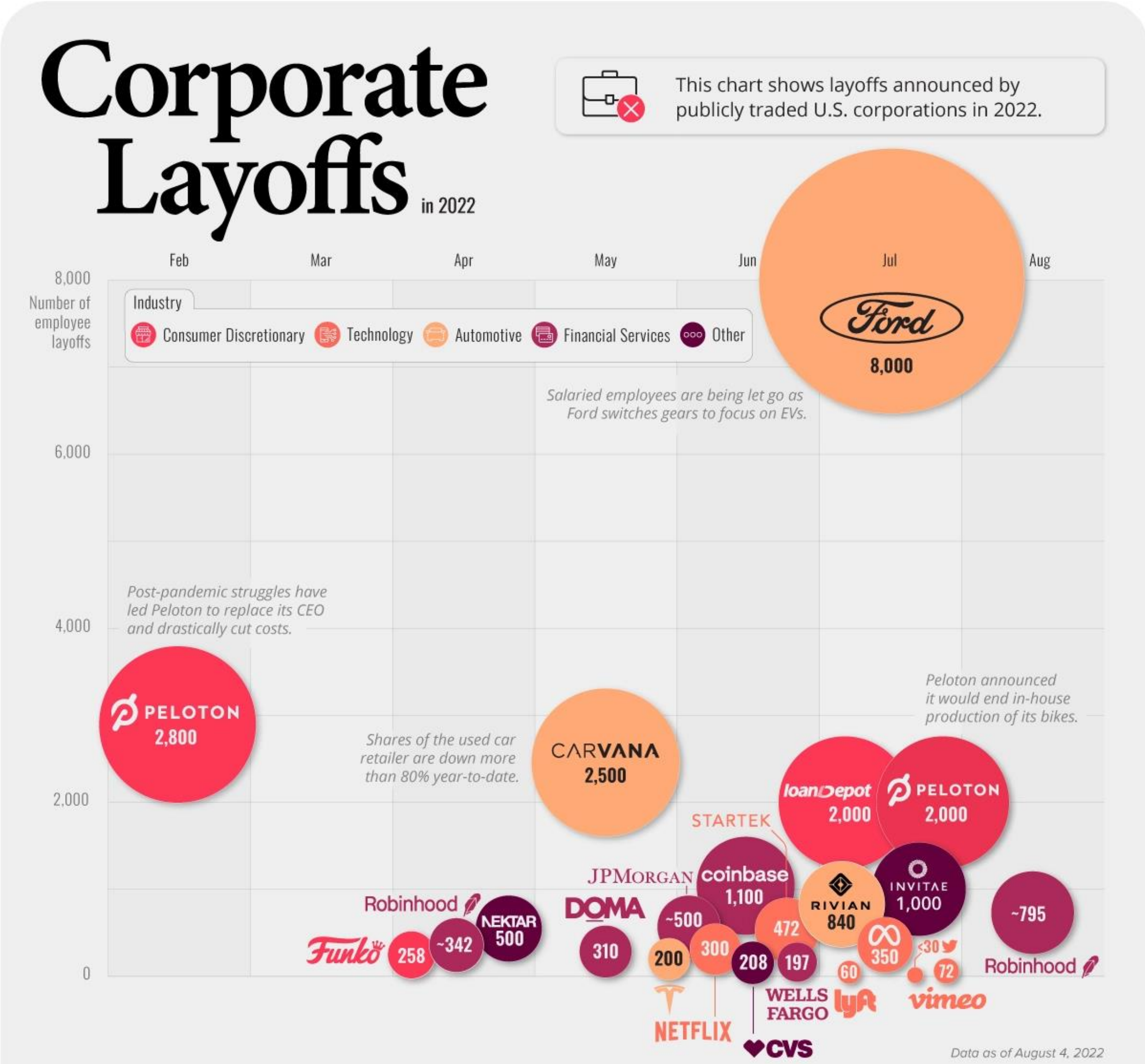
Core eurozone government bond yields rose on hawkish central bank comments and record high inflation. Peripheral eurozone bond yields broadly tracked core markets. The UK 10-year gilt yield increased 95bps in August.

US investment-grade corporate bonds suffered from the weaker macro backdrop. The sell-off in Treasuries pressured high yield bonds and bank loans as the market continued to assess the Fed's hiking trajectory and its impact on growth. As expected, no new high yield bond issues were announced this week, but several financing deals were anticipated after Labour Day.

GREAT LAYOFF

After the "great resignation," comes the "great layoff," amid recession fears and a slowing global economy. In February this year a major staff layoff of thousands of employees was announced by Peloton in the US. This was followed by others mainly in technology, automotive and financial services sectors (Figure 4).

Figure 4



Source: visualcapitalist.com

Staff cutting is expected to continue throughout the rest of 2022 as automation and offshore manufacturing becomes more viable after COVID. Rising interest rates, which make it more expensive for businesses to service current and get new debt, are also having a negative impact on growth. Even traditionally layoff-resistant companies like Netflix have made cuts, and now companies that saw a pandemic-era boom, like Shopify, are cutting hundreds of jobs.

The last in series of big cuts is trading platform Robinhood which announced it would lay off 23% of its staff in August. After accounting for its previous layoffs in April (9% of the workforce), we estimate this round will impact nearly 800 people.

Surprisingly the number of job openings in the US rose by 199,000 from a month earlier to 11.2 million in July of 2022, while markets had expected it to drop to 10.45 million. It was the first increase in job openings after three consecutive months of slight declines, reflecting persistent tightness in the labour market amid worker shortages. Are these layoffs just a rebalancing of the workforce across industry sectors?

GEOPOLITICS

The West is confronted by both China and Russia jointly representing the East. The increasing influence of Russia and China among emerging market countries is undermining the position of the US as leader of the West in African, Asian and Pacific regions. The recent incident with the US and UK ships being denied access to the Solomon Islands port indirectly confirms this. But as usual, the official reason was a delay in paperwork. China announced the write-off of debt for 17 African countries, increasing its own influence.

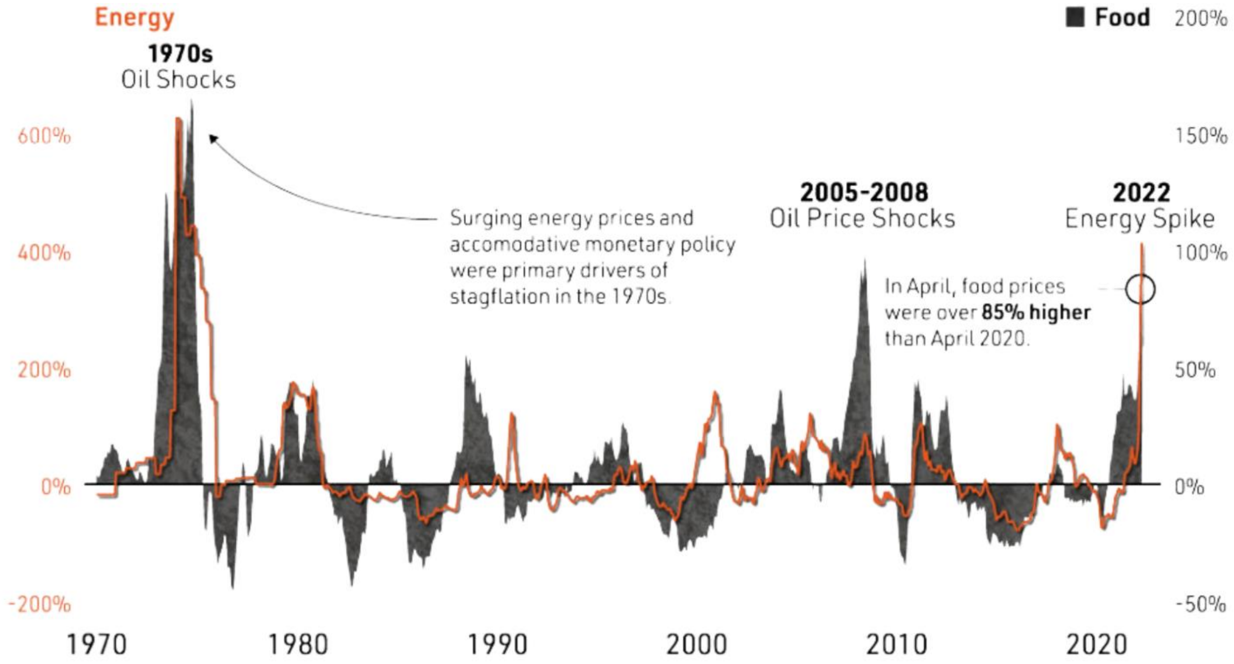
Russia is now using India and China to sell its oil, gas and commodities to other markets. China sells their excess of Australian gas at a premium to Europe, while using Russian gas for domestic use. Sanctioned Russian diamonds have found a way back to global markets through India: now everyone can buy them, but they have to pay in rupees. American and European corporations are again seeking Turkey's assistance to get into Russia's market after abandoning this approach earlier this year.

ENERGY RESOURCES AS WEAPONS – MODERN SIEGES

As a result of Western nations imposing sanctions on the Kremlin following the invasion of Ukraine, Russia has significantly reduced its natural gas flow to Europe. Russia initially shut down the Nord Stream 1 pipeline for three days from 30 August to 2 September but have now extended the shutdown indefinitely. EU leaders were not convinced by this official reason and accused Russia of weaponizing energy resources. We agree that it is a weaponization, and predicted Putin would retaliate against the imposed sanctions and weaponizing of the financial system against Russia.

The ban of oil imports from Russia and limited exports of gas to Europe as a countermeasure pushed energy prices to record levels. Several emerging markets have already defaulted or are on the edge of defaulting on debt as a result of high prices and rising inflation. In addition to the worsening economic situation, political instability has increased which has led to mass protests, political violence and riots. Sri Lanka and Peru were the first to see heightened riots; Turkey and Egypt are also at risk as the cost of living accelerates and food insecurity worsens (Figure 5).

Figure 5, Energy and food price shocks



Source: visualcapitalist.com

European countries are also experiencing pressure in their budgets. Italy's expenses on energy imports will double in 2022, reaching 100 billion euros (AUD148 billion, NZD165 billion). Germany is going to spend an additional 65 billion euros (AUD96 billion, NZD107 billion, in addition to the 40 billion euros already announced earlier this year) to soften the impact of the energy crisis. Sweden and Finland announced relief packages to help their power companies who have been affected by the closure of Nord Stream 1 pipeline. Finland is planning to provide 10 billion euros and Sweden 250 billion krona (AUD35 billion, NZD38 billion) in liquidity guarantees. An unpopular consequence of this spending will be further inflation.

All these measures and spending packages, plus military help to Ukraine, will lay on the shoulders of populations through increasing food and transport prices and new or higher taxes. In the Czech Republic, Prague saw its first mass protest on the first weekend of September against the rising cost of living caused by the energy crisis. Nearly 2,000 protesters in German Cologne were marching the city's streets to urge authorities to stabilize energy prices.

Uncertainty in the Middle East, a region that supplies big volumes of oil, continues. Iraq is still in political turmoil following the retirement of al-Sadr as a leader. The instability threatens supply of around 5 million barrel of oil per day, adding volatility to the commodity markets. The nuclear deal between the US and Iran may offset any negative impact from Iraqi supply if the leaders of Iran and the US find a consensus and sign the deal. It is still unclear as there are many interrelated parts that need to be agreed upon. In case of success Iranian oil will have free access to global markets and would be a relief for soaring prices.

CLIMATE CHANGE

Climate change continues to impact this year, with droughts and floods all over the world. Two-thirds of Europe is experiencing its worst drought in 500 years. Many rivers and lakes became shallow, worsening already disrupted supply chains and increasing pressure on land transport (Figure 6). High oil and gas prices were not helpful, neither for transportation nor for cooling houses. According to the European Drought Observatory, droughts are likely to become more frequent, even as hurricanes and other large storms bring flooding to other places around the globe.

Figure 6, Europe, river-discharge* anomaly, June to August 2022 compared with 1980 – 2021 average, %

Source: The Economist

North America is also seeing high temperatures this summer. According to the National Centers for Environmental Information, July 2022 was the third hottest on record for the US. The US Department of Agriculture reported that high temperatures and drought caused depleted topsoil moisture and significantly stressed rangeland, pastures, and various summer crops. This year's drought conditions are taking a harder toll than last year's, as 37% of US farmers said they are killing existing crops that won't reach maturity because of dry conditions.

While Europe and America are suffering from high temperatures and drought, Pakistan is suffering heavy rains and floods that have already taken the lives of thousands of people since mid-June. Pakistan declared a national emergency when more than 30 million people were affected by floods. In New Zealand, Nelson has been worst affected with more than 400 homes evacuated and some declared uninhabitable because of the rain.

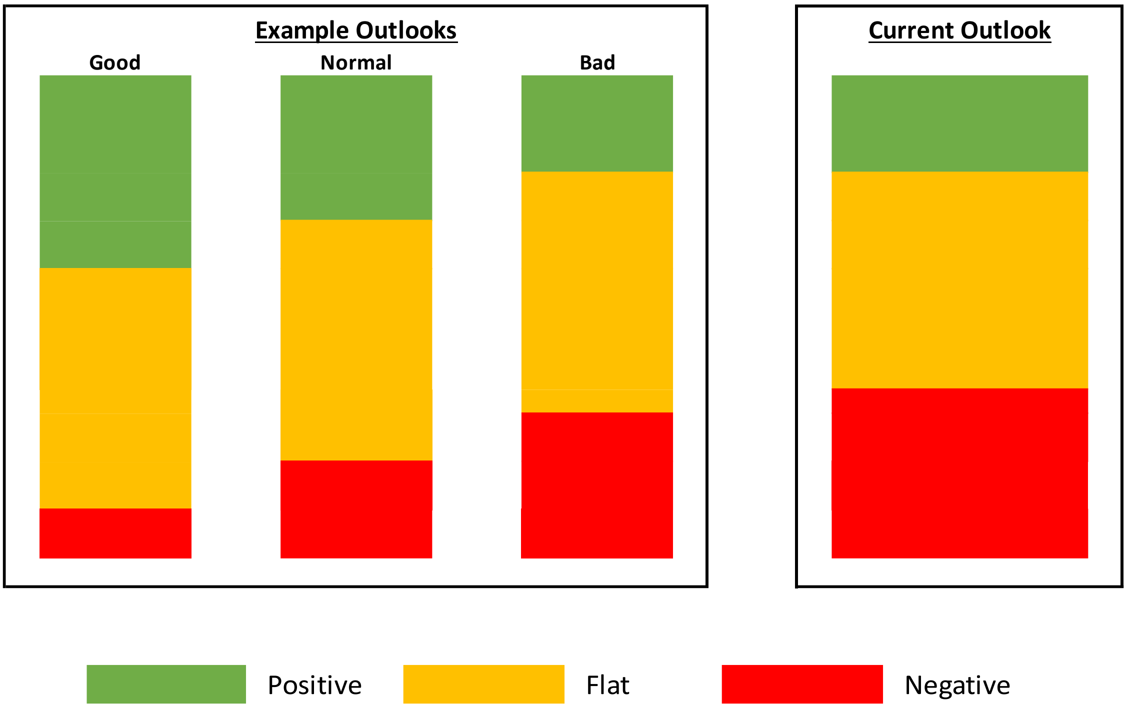
CHIP WAR

In July 2022, Congress passed the CHIPS Act of 2022 that officially is designed to protect domestic semiconductor production. However, China see this as a rivalry action to cut Chinese manufacturers from the global supply chain. All gadgets, from smartphones and microwaves to electric cars, use chips.

Supply chain disruptions of semiconductors during the Covid pandemic caused a slowdown in auto manufacturing and unprecedented inflation on used cars. The CHIPS Act will subsidise the expenses of companies which set up manufacturing and design facilities in the US. The US is working with Japan, South Korea and Taiwan (the so-called Chip 4 alliance) to facilitate their plans to minimize dependence on overseas suppliers.

China strongly opposes the alliance, and the Chinese foreign and commerce ministries criticized the move as a plot to exclude China from the semiconductor value chain and thus go against the free trade order. South Korea is heavily reliant on US technology and equipment for chip production and cannot ignore the US invitation to a chip alliance, despite Chinese opposition. Otherwise, Korean companies could face various barriers, like US levies on Chinese tech companies. Under the provisions of the Act, companies awarded with US chip subsidies cannot engage in any “signification transaction” involving “material expansion of semiconductor manufacturing” in China or any other foreign country of concern such as North Korea, Russia and Iran for 10 years. This is why China is furious about the Act and its implications on their economy.

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).