MARKET PERFORMANCE AND COMMENTARY – SEPTEMBER 2022

MARKET PERFORMANCE

Index	Index Level/Price	1 Month %	3 Month %	1 Year %
Global Equities				
MSCI World NR	5,804.41	-8.3	-4.4	-15.5
MSCI World NR (NZD)	12,862.00	-1.7	3.1	-2.0
MSCI Emerging Markets	588.83	-9.4	-8.2	-21.5
S&P 500 (US)	3,585.62	-9.3	-5.3	-16.8
Nikkei 225 (Japan)	25,937.21	-7.7	-1.7	-11.9
FTSE 100 (UK)	6,893.81	-5.4	-3.8	-2.7
DAX (Germany)	12,114.36	-5.6	-5.2	-20.6
CAC 40 (France)	5,762.34	-5.9	-2.7	-11.6
Trans-Tasman Equities				
S&P/NZX 50	11,065.71	-4.6	1.8	-16.6
S&P/ASX 300	77,134.65	-6.3	0.5	-8.0
Bonds				
S&P/NZX NZ Govt Stock	1,647.42	-1.6	-1.9	-10.9
S&P/NZX A Grade Corporate	5,406.98	-1.3	-1.1	-6.6
Barclays Global Agg (Hedged to NZD)	372.88	-3.5	-3.7	-12.3
Oil				
West Texas Intermediate Crude	79.49	-11.2	-24.8	5.9
Brent Crude	86.15	-10.0	-25.1	9.4
NZD Foreign Exchange				
AUD	0.8798	-1.6	-2.7	-7.9
EUR	0.5774	-5.3	-2.9	-3.0
GBP	0.5067	-3.8	-1.0	-1.0
JPY	81.8750	-3.7	-3.1	6.4
CNY	4.0326	-4.6	-3.3	-9.4
USD	0.5656	-7.7	-9.0	-18.0

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

Executive summary:

- Equities continued to fall in September.
- The sell-off in global bonds continued.
- Risk of nuclear war reached its highest level ever.
- Oil traded around $90 per barrel.
- New Zealand dollar depreciated against all major currencies.

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ECONOMIC COMMENTARY

GLOBAL SNAPSHOT

Investors around the world focused on what Central Banks were doing during September. Various contradictory economic data and the actions of central banks have kept investors' sentiment swinging from positive to negative, causing increased volatility in markets.

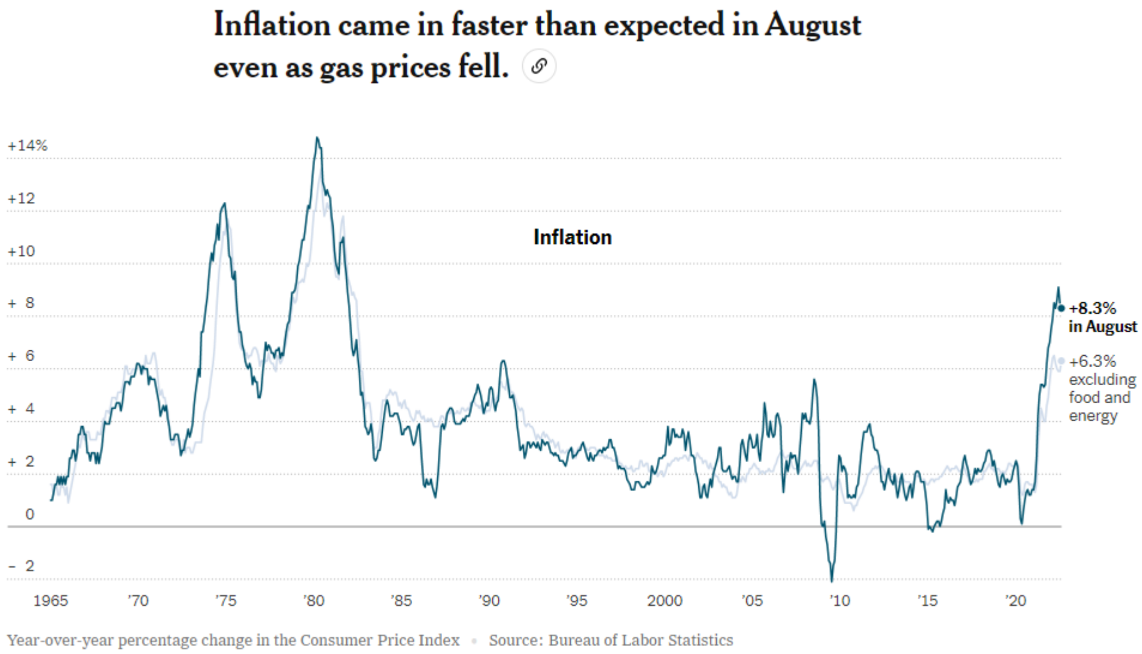
The Bank of England (BoE) started buying long dated bonds after 30-year yields rose by 1% over a couple of days. Unfunded tax cuts were the trigger, causing the general public and financial markets unrest. Bond prices dropped and pension funds faced margin calls, turning them into forced sellers. The contagion could have spread across the gilt curve rapidly, threatening the country's financial stability. It was a large negative reaction to an initiative that would have put more money into circulation through private spending. Public pressure and open criticism from the International Monetary Fund resulted in UK Finance Minister Kwasi Kwarteng announcing that the income tax rate for high earners will remain at 45%, which was the most contentious piece of the fiscal statement on 23 September.

Inflation in many countries is still close to 10% including Sweden (9.8% in August), Denmark (8.9%), and Mexico (8.8%). Germany and the UK inflation rates in September jumped to 10.9% and 10.1% respectively. Eurostat estimation has energy inflation at 40.8%, up over 2% compared with 38.6% in August.

Brazil experienced the slowest inflation increase as transport and communication costs dropped over the past two months. Experts are saying that inflation has peaked; inflation figures have since confirmed that the monetary tightening cycle is over. However, the Brazilian Central Bank will probably hold current interest rates at the same level (13.75%) till mid next year.

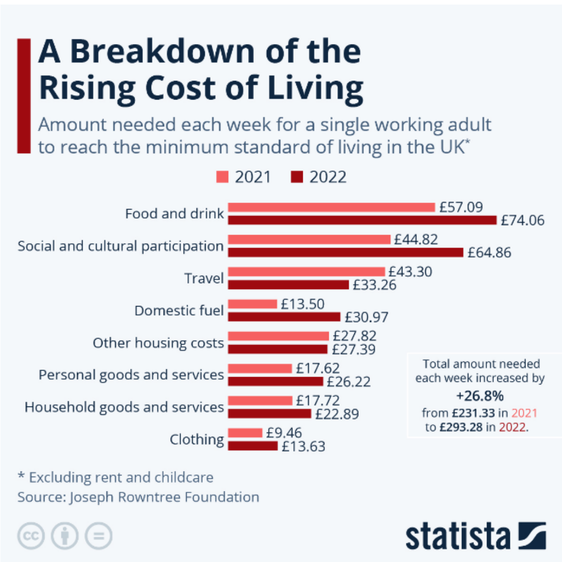
US inflation was 8.3% at the end of August (Figure 1). Fed Vice Chair Lael Brainard stressed the need to tackle inflation in her speech in New York on 30 September, with the following comments: "Monetary policy will need to be restrictive for some time to have confidence that inflation is moving back to target. For these reasons, we are committed to avoiding pulling back prematurely". Her comments make sense, considering the equity market rally in July where investors got too far ahead of themselves and mistakenly thought that inflation was behind them. Better to proceed with caution than jump the gun!

Figure 1



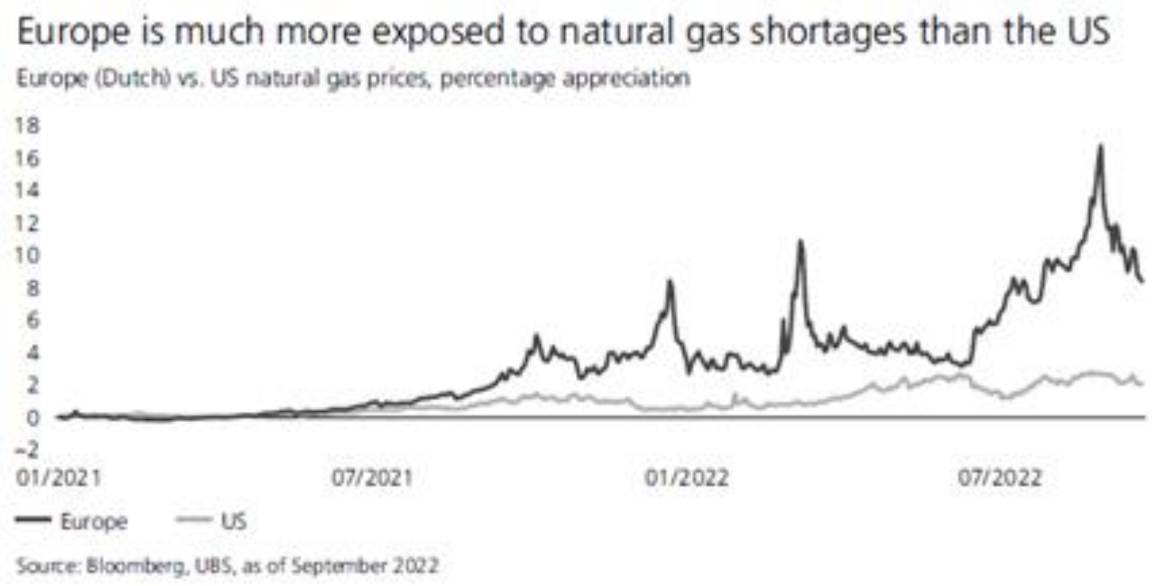
The cost of living has increased globally, and European countries are seeing the worst among developed markets. Baltic countries and Moldova have been hit the hardest by increasing energy and food prices. The UK average cost of living increased by 26.8% annually, pushing more people to poverty (Figure2). Many European governments announced their budget program to cap power bills for their citizens. These steps have increased the level of sovereign debt, and it will create an additional tax burden to taxpayers. Another protest called "Czech Republic in the First Place" happened in Prague in September (after another in August) against rising cost of living. Paris also joined in protesting against high energy and food prices.

Figure 2



Europe banned the import of Russian gas just as winter approached. Over the last two decades, Europe has reduced domestic gas production resulting in gas imports now comprising 83% of consumption. The war in Ukraine and the ban pushed prices to record level (Figure 3). Despite the poor economic consequences, mounting pressure from ecological movements and the "greens" is pushing European leaders to pursue greener policies: the Netherlands announced continuing to reduce gas production at Groningen field (the largest natural gas field in Europe), Germany is sticking to its fracking ban and nuclear phaseout, Belgium shut down a nuclear power plant (one of four) in September that provides a significant share of the country's electricity needs. Meanwhile the Czech Ministry of Health suggested lowering the temperature in schools to battle the energy crisis in the country.

Figure 3



Despite a tough market environment, Volkswagen Group made the largest IPO in Europe, offering shares in Porsche. In terms of capitalisation, the IPO marked €78 billion which set a new benchmark.

Russia announced a partial mobilisation to support its offense in the Eastern and Southern regions of Ukraine. The heavy losses in manpower triggered this highly unpopular move, and thousands of people took to the streets to demonstrate against mobilisation and the war. Some activists were calling for the resignation of President Putin. This was soon followed by annexation referenda on four occupied Ukrainian provinces with many citing their illegitimacy due to reports of voting taking place at gunpoint.

LOCAL SNAPSHOT

Recent developments in the economy have been mixed but are showing ongoing resilience in activity. GDP grew by 1.7% in the June quarter. The main contributor to growth was a surge across the services sectors, as New Zealand reopened its borders to overseas tourists. That pace of growth is unlikely to be repeated, but it's a potent reminder that key parts of the economy are still in recovery mode.

House prices have continued to soften in the face of higher mortgage rates and are now down around 9% from their peak last November. The effective average mortgage rate paid by homeowners has continued to push higher and is set to continue rising over the coming months.

There are positive developments in country's export sectors. Prices for commodity exports have held firm, with world dairy prices rising 7% over the past month alone. At the same time, international visitor arrivals have been climbing rapidly since the reopening of the borders.

The RBNZ raised the cash rate to 3.5% on 5 October to help battle record high inflation. Markets expect that the OCR will be between 4% and 4.5% by mid-2023.

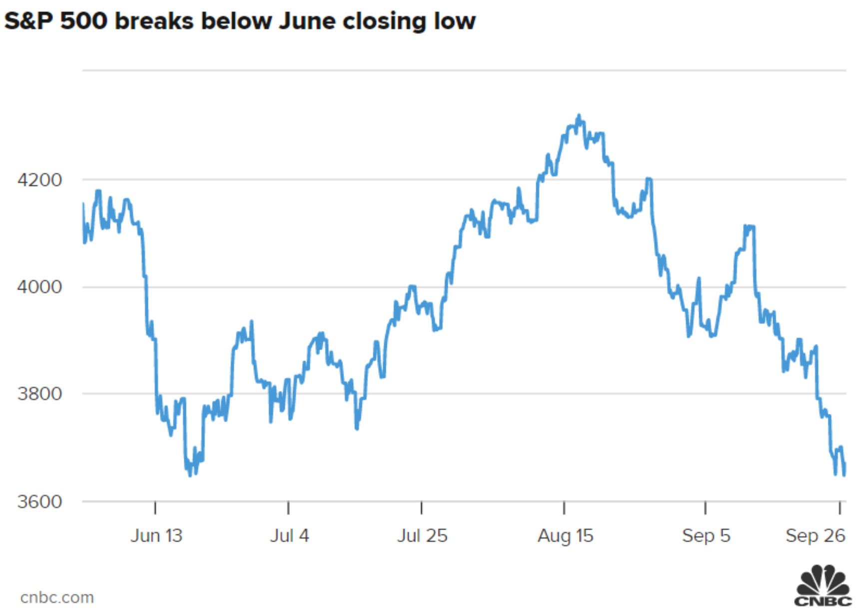
WORLD FINANCIAL MARKETS

Equities

The MSCI World Index returned -8.3% and MSCI Emerging Markets returned -9.4% in September in local currency terms.

The S&P 500 fell sharply (down 9.3%) in September. Turmoil in UK financial markets and signs that the Fed still has some way to go in its efforts to temper inflation sent stocks to their third consecutive weekly decline in September, while the yield on the benchmark 10-year US Treasury note briefly breached 4% for the first time since 2008. The S&P 500 Index broke below its mid-June lows and fell back to November 2020 levels (Figure 4). The week closed out a third consecutive quarter of declines for the index for the first time since 2009. US growth stocks fared worse than value stocks, while large-caps finished behind small-cap shares.

Figure 4



Source: CNBC

The Euro STOXX 50 Index lost -5.5% in September amid disappointing corporate earnings and fears of recession. The major stock indexes posted losses. Germany's DAX Index slid -5.6%, France's CAC 40 retreated -5.9%. The FTSE 100 decreased -5.4% in September.

China's stock markets fell as currency weakness and signs of a flagging economy fuelled concerns about the outlook. The broad, capitalisation-weighted Shanghai Composite Index pulled back -5.4% in September.

Equities on both sides of the Tasman Sea managed to hold on to their Q3 gains despite steep losses in September. The S&P ASX 200 slumped 6.2% in September giving back most of its Q3 gains to finish the quarter up 0.4%. While all S&P ASX 200 sectors dropped in September, six out of 11 ended the quarter in the black, with energy the best performer, up 5.9% in Q3. Utilities pulled at the rear for both the month and the quarter, down 13.8% and 12.5% for September and Q3, respectively. The S&P/NZX 50 Portfolio Index fared slightly better than its large-cap peer in Australia both for the month and the quarter, as it shed 4.5% in September and gained 2.3% in Q3.

Fixed Interest

Prices of US Treasuries rallied after the BoE intervened to stabilise the UK government bond market, leaving the 10-year US Treasury note yield modestly higher. The closely watched 2-year/10-year segment of the Treasury yield curve remained inverted – a common signal of a coming recession.

The UK 10-year gilt yield increased to 4.08%, after surpassing 4.5% on 27 September, before easing following the intervention of the BoE.

Core eurozone bond yields fluctuated, ending broadly higher, mostly tracking moves in UK gilts. Higher-than-expected inflation in Germany also added some upward pressure on yields later in the week. The German 10-year bund yield rose to 2.11%. Peripheral eurozone bond yields broadly tracked core markets.

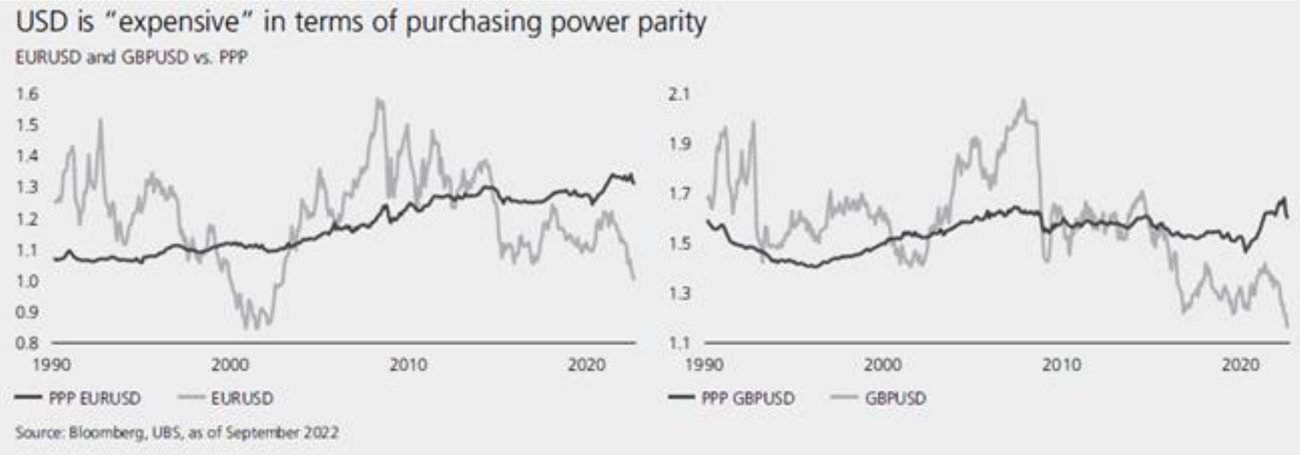
US investment-grade corporate bonds suffered from the weaker macro backdrop. The sell-off in Treasuries pressured high yield bonds and bank loans as the market continued to assess the Fed's hiking trajectory and its impact on growth. As expected, no new high yield bond issues were announced in the last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

IS THE "GREEN BACK" PUSHING THE WORLD DOWN?

One of the significant market trends over the past few months was the strengthening US dollar, which has reached multi-decade highs against the British pound, euro, and Japanese yen, as well as a number of emerging market currencies, sparking discussions about intervention.

The dollar is now highly valued. Real effective exchange rates are close to their highs from the year 2000, and the currency is "expensive" in purchasing power parity terms, in particular relative to the euro, pound, and Swedish krona (Figure 5).

Figure 5



Some analysts think the US dollar bull market is not over yet. The US is in the singular position of having both high inflation and more resilient economic growth than some of its peers, meaning the Fed has a cause to increase interest rates further and faster than other major central banks, expanding the US dollar's interest rate advantage.

US importers and travellers are benefiting from the strong US dollar decreasing their costs on imported goods from overseas and paying less for accommodation and flights to Europe as a main destination in particular. The rest of the world and US exporters are the losers in this currency game. With higher costs, an appreciating US dollar has fuelled already high inflation in many countries. More than 50% of international trade is invoiced in USD and 60% of central banks foreign exchange reserves are in USD and any movements in exchange rate affects local trade balances too.

GEOPOLITICS

The partial mobilization announced in Russia was unwelcomed by the majority of the population. The Kremlin declared the need for 300,000 recruits to assist holding occupied territories in the East and South of Ukraine. At the same time, President Putin replaced several generals, blaming the previous ones for their incompetence particularly with respect to the lack of supply of ammunition to the frontlines. The annexation of four occupied provinces on the last day of September was the final move to justify the mobilisation. Military experts say that majority of fresh recruited troops will be sent to these new territories to resist rampaging Ukrainian forces. Many males fled from Russia, not willing to be killed by professional Ukrainian army personnel. The central government made changes to legislation to prevent an exodus by classifying the avoidance of military service as a criminal offence, with an imprisonment term of five or more years. As of the end of September, more than 200 thousand people had fled Russia.

The annual summit of the Shanghai Cooperation Organization (SCO) was held on 15-16 September in Uzbekistan. President Putin and Premier Xi met face to face for the first time since the war in Ukraine started. Many analysts were observing this meeting closely to find out the position of China in the conflict. As expected, the Chinese leader did not make any direct comments, however, he blamed the US and its allies of pushing Ukraine into the fire. Importantly, Iran signed a memorandum of obligations and became the nineth full member. Turkey announced a goal of membership in the SCO after negotiations over the nuclear power plant in Turkish Akkuyu with Russia got the green light. The regionalisation is steaming up with leadership of Eastern powers – China, India, Russia and now Iran.

The newly gained ally, Iran, was caught up in civil protests caused by the death of Mahsa Amini, another Iranian woman arrested by the morality police and beaten to death in custody. More than 100 people have been killed since the beginning of the protests. Iranian leaders accused the US and Israel of supporting the protesters. Iran has not only become a partner of Russia from an economic standpoint but also as a supplier of military drones. Russia is reported to have ordered 46 drones from Iran and deployed these to the battlefield in Ukraine.

Some geopolitical hot spots were re-activated in September. The Azerbaijan and Armenia border conflict resurfaced after a ceasefire agreement was reached with the mediation of Russia. The last border fight triggered Armenia's dissatisfaction and caused protests in the capital due to the rejection of Yerevan's plea to the Collective Security Treaty Organization to defend the country against Azerbaijan's aggression and execute their obligations. All members voted to resolve the conflict by diplomatic means. US senator Pelosi (who nearly provoked a conflict between China and the US visiting Taiwan in July) made a visit to Armenia "by coincidence" during the conflict and made a statement to support Armenians in exchange for breaking away from Russia and Russia-led organisations (CSTO, Eurasian Economic Union). Armenia has no common border with any CSTO members (surrounded by Georgia, Turkey, Iran and Azerbaijan) which makes it difficult for Russian troops to access Armenian territory. Another border firearm conflict between Kyrgyzstan and Tajikistan caused 100 casualties, mainly civilians.

The US changed its position on Taiwan-China relations. The Senate passed a bill providing $4.5 billion in weapons and security assistance to Taiwan over the next four years. Increasing tensions between the US and China reached their highest level and could potentially lead to a direct confrontation of the two biggest economies.

The Nord stream pipeline network has been leaking gas into the Baltic Sea. The cause remains unidentified.

GREEN ECONOMY: EXPECTATION VS REALITY

Europe has been at the frontline for a transition to a green economy by reducing its carbon emissions over last decade. The emphasis has been on renewable sources of power – wind, solar and hydro. The definition of green energy changed in 2021 during the COP26 in November 2021 where nuclear energy was recognized as an essential component of the decarbonization strategy. Is this an oxymoron or just a substitution of definitions?

Plans to reduce carbon emissions to zero by 2050 now seem more challenging since the Ukraine invasion. Europe's reliance on cheap Russian gas has allowed spare funds to be invested into transitioning to green energy. A vast part of Germany's economy was built around Russian gas including automotive, energy and chemical industries. The chemical giant BASF production and energy supply depends on Russian gas and diversion from this source could cause significant losses and even collapse. Considering the range of BASF products from toothpaste to vitamins, from building insulation to nappies, from drugs (biggest producer of Ibuprofen) to rubber parts for car makers, its demise would trigger a domino effect across Europe and the globe. Now Europe is prolonging the lifetime of coal fire plants or converting gas plants into coal which are the largest and dirtiest emitters of carbon dioxide.

Transport electrification is another dilemma. The main obstacle to supply enough EV is battery production capacity and costs of main resources – lithium, cobalt and nickel. According to Piedmont Lithium's CEO, there is not enough lithium in the world to turn that much production in the world by 2035. The ecological aspect of lithium mining is omitted from discussions as well as efficient recycling of used EV batteries. Increasing electric energy consumption is the matter to debate – whether the cities have the capacity to generate enough energy, store and transfer it to consumers.

ALTERNATIVE ASSETS

The volatility in financial markets and sell-offs in 2022 have turned investors' interest to alternative investments such as hedge funds and private equity.

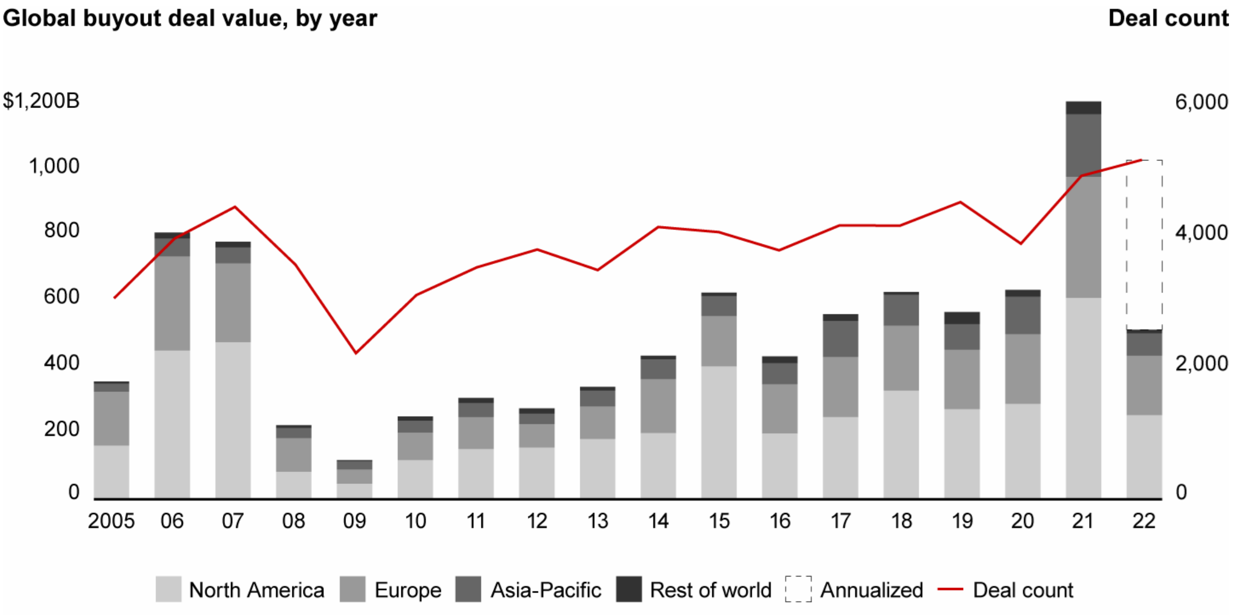
A report on the U.S. market this year from Javelin Strategy and Research found that nearly half (45%) of registered investment advisors plan to allocate 5% or more of client assets to alternatives in the next two years, up from about one in five who currently allocate that proportion.

Globally, alternative assets under management are expected to grow from US$12.5 trillion last year to more than US$23 trillion by 2025, according to U.K.-based alternative data analytics company Preqin.

According to Bain, private equity generated $512 billion in buyout deal value during the first half of 2022, putting it on pace to produce the second-highest annual total ever (behind 2021's all-time record). The 18-month total of $1.7 trillion is by far the strongest year and a half in the industry's history (Figure 6). Average deal size remained close to $1 billion in the first half. The deal count was robust.

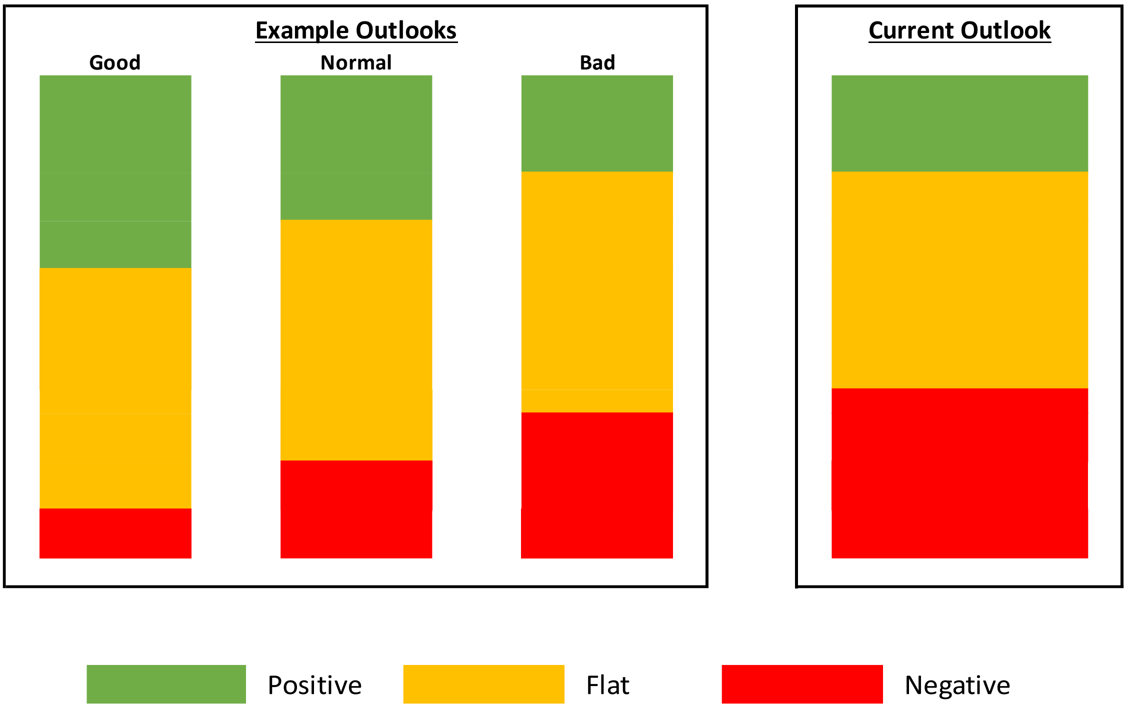
Figure 6

Global buyout deal value, by year



Notes: Includes add-ons; excludes loan-to-own transactions and acquisitions of bankrupt assets; based on announcement date; includes announced deals that are completed or pending, with data subject to change; geography based on target's location; deal count shown is annualized for 2022
Source: Dealogic

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).