Axiome Spring Update

July—September 2021

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Markets continue to climb to record highs in the June quarter

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Investment Market Review

Market performances were mixed in the September quarter. Bonds performed poorly, particularly in New Zealand, yet New Zealand equities enjoyed a very strong performance. Emerging market equities had a poor quarter, but developed large cap equities performed well.

Market performances were mixed over the quarter given difference economic conditions and risks

The performance differences reflected cross-currents in macroeconomic conditions and country or sector specific factors. Global growth is still strong, but rising inflation and the prospect of central banks increasing interest rates weighed down fixed income. Emerging market equities were hit by concerns around the solvency of one of China's largest property developers, Evergrande, its ability to meet its debt obligations, and the flow-on effect to markets and Chinese growth. This also impacted Australian stocks. In contrast, and despite our Covid outbreak, New Zealand's economic conditions are expected to remain firm and inflation risks are to the upside. As discussed below, the RBNZ lifted the OCR in early October, ending a seven-year period of easing.

Market Roundup:

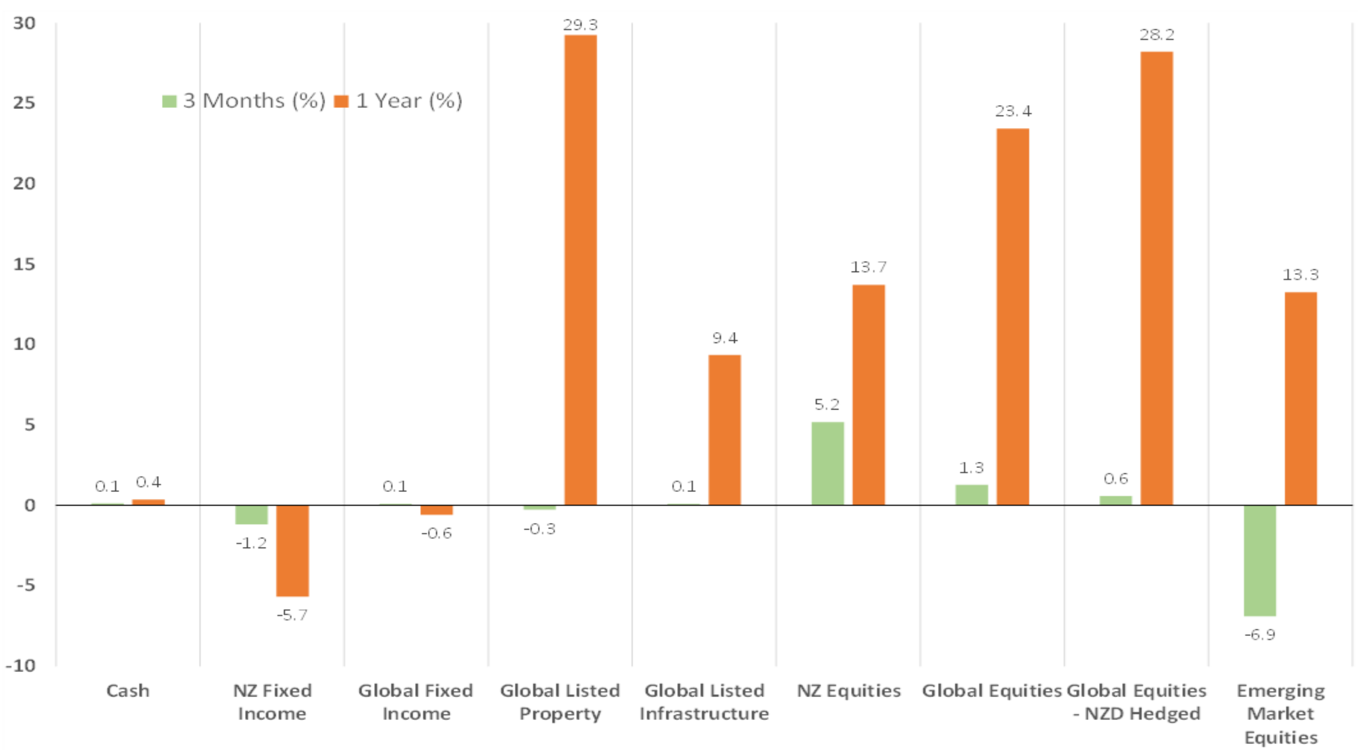
Developed market equities climbed further over the September quarter, by around 1.5% in NZD terms.

Global equities

marched higher...

This resulted in a return of 23% for the year to September, while NZD hedged shares increased around over 28% (see Figure 1).

Figure 1: Patchy returns over the quarter



Source: Morningstar Direct, MyFiduciary

Within global equities, higher risk small and value stocks mildly underperformed. Value stocks returned around 0.4%, and small caps fell slightly in NZD terms. Over the year, however, global small caps outperformed, returning around 35%, and value stocks also outperformed, returning 26%.

Emerging markets fell and Australian stocks treaded water

As noted in the introduction, emerging markets had a poor quarter, falling by around 7%. At the time of writing the Chinese property developer Evergrande is likely to declare bankruptcy and bond holders are expected to suffer large losses, but it is not expected that this "shock" will transmit to a full-blown financial crisis. On the other hand, the Chinese government willingness to let one of its largest developers fold is seen as a strong signal that they are serious about curbing rampant property development and construction, which has long been an important driver of Chinese growth.

This in turn led to falls in iron ore and a range of other commodity prices. This negatively impacted Australian equities which declined around 1% in the September quarter.

NZ shares had a stand-out performance, largely due to the replenishment of hydro lakes

In contrast, New Zealand shares increased around 5% in the quarter and are up around 14% for the year to September 2021. This outperformance occurred despite the Chinese growth risks, New Zealand being moved to alert level 4 on the 17th August (and Auckland remaining at level 4 until the 21st September), and a firm market consensus that the RBNZ would lift interest rates. A large contributor to the outperformance was from the energy sector, which increased 25% in the quarter! This sector benefited from high electricity prices, and from high rainfall levels replenishing hydro lake catchments.

International infrastructure and property stocks were flat in the quarter, but on an annual basis returns were around 10% and 30% respectively. In contrast, fixed income returns were poor. New Zealand investment grade (IG) bonds fell 1.2% in the quarter and 3.8% over the year. International IG bonds fared a little better, being flat in the quarter and falling around 0.5% over the year. Finally, NZ cash fared better still, increasing by around 0.5% over the year.

In previous commentary we have highlighted our concern around raising interest rates and the risks that this present to bonds. For this reason, your portfolios have materially reduced their exposure to bond funds with relatively "standard" maturity terms (or

duration) to bonds and related instruments with relatively short durations. These bond and "cash enhanced" funds have performed relatively well over the quarter and year, being comfortably ahead of both standard bond fund returns and the returns from cash.

New Zealand is the first OECD country to lift rates:

Despite the current Covid outbreak, New Zealand's economic recovery is seen as well established and the RBNZ's focus has shifted to inflation.

Fixed income returns were generally poor as markets priced in higher interest rates levels, but shore term bond funds outperformed

As mentioned in our previous update, the big question is whether the surge in costs seen this year will be temporary, or instead lead to a sustained increase in CPI inflation rates. Survey measures suggests risks point to the latter, with inflation expectation measures running at multi-year highs.

The Reserve Bank expects NZ economic performance to remain robust despite the Covid restrictions

Since our last update, growth prospects have dimmed (particularly in China) but unfortunately cost pressures have not. Supply chain issues have become more acute, with the fuel shortages in the UK being just one notable example.

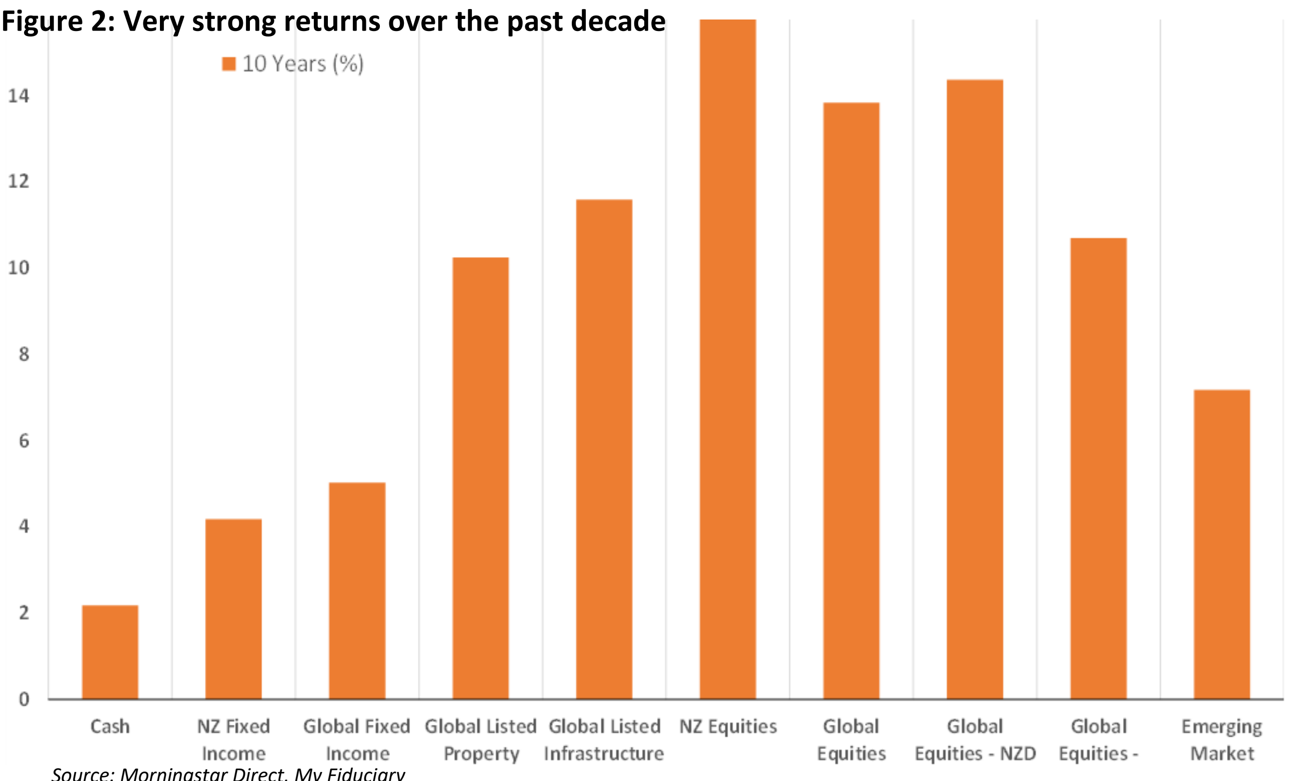
In this environment it is perhaps not surprising that the RBNZ lifted the OCR from 0.25% to 0.5%. This marked the first increase in the OCR since June 2014 – ending a seven year period of easing. The RBNZ's view was that the current COVID-19 related restrictions have not materially changed the medium-term outlook for inflation and employment, and as such further rate rises will be forthcoming.

Interest rate levels in NZ and globally of course remain extremely low by historical standards, but in our view the OCR change marks an important turning point. Markets have enjoyed a long period of flat or declining rates, which tends to support asset values through for example lower discounting of their future cash-flows, and enabling higher levels of leverage. Figure 2 below provides longer term market performances. These drivers of course have also mattered for the huge run up in house prices since the GFC slump in 2009.

The lift in the OCR marks a turning point in the support that asset prices have enjoyed from flat to declining interest rates

Will the seven years of plenty be followed by seven years of famine? No one knows, but in our view, it is very unlikely that the feast will continue another seven years. And one thing we are confident about is that well-diversified portfolios will continue to offer a better return than cash over the medium to longer term.

Figure 2: Very strong returns over the past decade



Source: Morningstar Direct, My Fiduciary

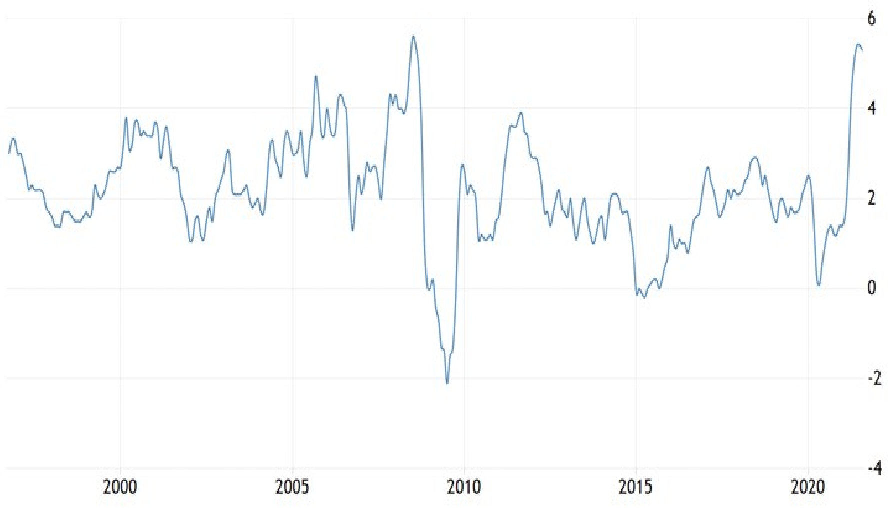
Key Market Movements for the Quarter

Quarter	Past year	New Zealand Shares
+5.2%	+13.7%	*Bouncing back from a soft June quarter, New Zealand shares enjoyed a strong performance in the September quarter, increasing around 5%. This lifted the annual return to around 14%.* *Source of Figures: S&P/NZX 50 Total Return Index with Imputation Credits*
-1.2%	-3.8%	**New Zealand Fixed Interest** *New Zealand investment grade corporate bonds fell around 1% in the quarter and returned around -4% for the year ended September 2021. The soft result reflected NZ markets pricing in materially higher interest rates and inflation, which causes bonds to suffer a short-term capital loss.* *Source of Figures: S&P/NZX Investment Grade Corporate Bond Index*
-0.8%	+26.4%	**Australian Shares** *Australian shares had a soft September quarter, reflecting concern around the Chinese growth outlook and demand for commodities. The broad market fell around 1%, although the annual return to September remained strong at over 26%. Within Australian equities, value and small cap stocks mildly outperformed.* *Source of Figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries*
+1.3% (0.6% hedged)	+23.4% (28.2% hedged)	**International Shares** *International shares rose around 1.3% in the quarter in NZD terms, whilst NZD hedged shares increased around 0.6%. Annual results reflect the bounce from the Covid sell off, particularly for NZD hedged equities which also benefited from the strong performance of the NZ dollar over the year. Within global equities, higher risk small and value stocks underperformed in the quarter. Value returned around 0.4% and small caps fell slightly in NZD terms.* *Source of Figures: MSCI World Index; Morningstar Developed Markets NZD hedged, MSCI World Value* *MSCI World Small Cap in NZD terms.*
-6.9%	+13.3%	**Emerging Markets** *Emerging Market equities were weighed down with concerns around the solvency of one of China's largest property developer, Evergrande, its ability to service its debt obligations, and the flow-on effect to Chinese growth. EM stocks fell around 7%, reducing the annual return to around 13%.* *Source of Figures: MSCI Emerging Markets Index*
+0.1%	-0.6%	**International Fixed Interest** *Global investment grade bonds increased were flat in the quarter and fell around 0.6% for the year to September. As with the NZ result, this soft annual performance reflected bonds being repriced lower as longer term interest rates rose on the back of increasing global growth and inflation expectations.* *Source of Figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)*
-0.3%	+29.3%	**International Property and Infrastructure** *International property stocks slightly fell in the quarter but still closed up around 30% for the year ended September. International infrastructure returned around 10% over the year (in local currency terms).* *Source of Figures: FTSE EPRA NAREIT NZD Hedged, FTSE Dvlp Core Infrastructure TR USD*

The Return of Inflation

One of the main jobs of a central bank is the control of inflation through monetary policy with many of them having explicit targets. The Reserve Bank of New Zealand, for example, is committed to keeping inflation within a 1-3% band. After the runaway inflation of the 1970s, the focus on reining in inflation had great success with forecasts of the "death of inflation". Throughout the 1990s and most of the 2000s, inflation has looked fairly well under control. Recently, however, the numbers are telling a different story and households are beginning to feel the sting of higher housing costs, and food and fuel price rises.

Figure 3: Inflation has spiked



Source: Dimensional Fund Advisers

In New Zealand, these rises in prices pushed the consumer price index (CPI) 1.3% higher in the three months ended June. On an annual basis, inflation surged to 3.3%, the highest annual rate since late 2011. In Australia, the CPI rose 3.8% in the year to June 2021, the fastest rise in 13 years and in the US, consumer prices were up 5.4% over the same period. The problem with these numbers is that it is hard to quantify the effect of the coronavirus pandemic. There was a sharp dip in the oil price so there is the effect of a comparison to a low base. There have also been supply constraints, particularly in the construction industry, but also more widely, due to shipping and manufacturing delays as well as shocks to the labour markets. It is possible that these effects will disappear over the next year or so as the world recovers from Covid-19.

So inflation is back. Whether it persists or not, no one can predict. Short bursts of high inflation have a much lower impact on purchasing power than sustained periods of high inflation. What will this mean for investments? Even the relatively moderate inflation in the US of an average of 2.3% over the past three decades has reduced the purchasing power of an uninvested dollar by around half. It matters a lot whether the recent pickup in price rises is transitory, as the Federal Reserve Chairman Jerome Powell predicts, or more enduring.

Market measures of investors' inflation expectations point to a moderate pickup in consumer prices in the coming years but are aligned with Powell's view that a recent spike higher will prove transitory. For example, data from the Federal Reserve Bank of St. Louis show that five-year breakeven inflation, which reflects inflation expectations over the next five years, is 2.6% annually, or near its 30-year average.

Whether the market will turn out to be right about these relatively low inflation expectations may not matter in the long run. The good news is that inflation does not necessarily harm stock returns. The future is uncertain but it is precisely the willingness of investors to bear this uncertainty which creates the opportunity for return.

A look at equity performance in the past three decades (see chart below) does not show any reliable connection between periods of high (or low) inflation and US stock returns. Since 1991, one-year returns on US stocks have fluctuated widely. Yet weak returns occurred when inflation was low in some periods, and 23 of the past 30 years saw positive returns even after adjusting for the impact of inflation. That was

the case in the first six months of 2021, too.

Over the period charted, the S&P 500 posted an average annualized return of 8.5% after adjusting for inflation. Going all the way back to 1926, the annualized inflation-adjusted return on stocks was 7.3%. History shows that stocks tend to outpace inflation over the long term—a valuable reminder for investors concerned that today's rising prices will make it harder to reach their financial goals.

Figure 4: Annual inflation-adjusted returns of S&P500 index vs inflation, 1991—2020

Source: Dimensional Fund Advisors

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