Axiome Winter Update

April—June 2021

Winter off-season: Marlborough Sounds

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Investment Market Review

Most equity markets continued to climb over the June quarter, extending their record highs. Robust economic growth, vaccine roll-outs and ongoing or newly promised stimulus programs far outweighed concerns around resurging Covid cases and lockdowns in some countries. However, it wasn't plain sailing across all asset classes. Fixed income returns were again weak as cost pressures and inflation risk concerns continued to mount. As discussed at the end of this update, this is perhaps nowhere more evident than in New Zealand where there has been a complete U-turn in the RBNZ's outlook for interest rates – from cutting rates to increasing them late this year or early 2022.

Equity markets climbed to record highs over the June quarter

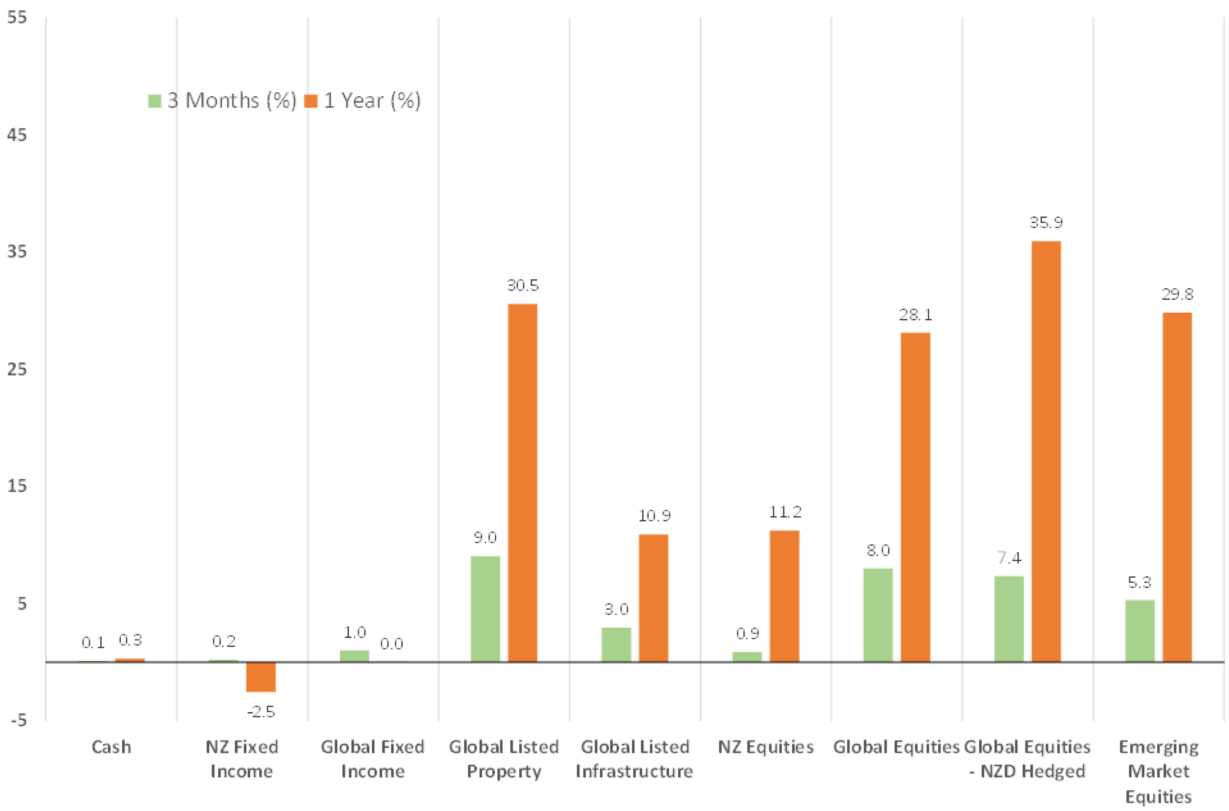
Equity markets are now clearly higher than the levels reached before the Covid pandemic hit. International shares rose around 8% in the quarter in NZD terms and around 27% for the year to June. NZD hedged shares increased around 7.5% in the quarter, and over 35% for the year (see Figure 1).

Within global equities, higher risk small and value stocks mildly underperformed in the quarter, returning around 5% in NZD terms. Over the year, however, global small caps outperformed, returning around 40% while value stocks performed in line with the market overall. Emerging Market and Australian equities also performed well, with both up around 30% for the year to June.

Small cap stocks did well while NZ equities lagged

In contrast, New Zealand shares only returned around 1% in the quarter and are up around 11% for the year to June 2021. Their performance has slipped from

Figure 1: Double digit returns across growth assets



Source: Morningstar Direct, MyFiduciary

being ahead of the pack to slightly below global market returns over the past three and five years. This illustrates the importance of diversification within equity market holdings, and that we should not expect a single market to continue to outperform.

International infrastructure rose around 3% in the quarter while international property stocks increased by around 9%. On an annual basis returns were around 20% and 30% respectively. Concern that Covid would permanently reduce tenancy demand has clearly waned for the property sector overall, with sub-sectors such as industrial property surging on the back of very strong manufacturing activity and low vacancy levels.

Fixed income returns continued to languish

Fixed income posted small positive returns over the June quarter. New Zealand investment grade (IG) bonds rose around 0.3%, resulting in an annal performance of -1%. International investment grade bonds have fared a little better, increasing by around 1% in the quarter with flat performance over the past year.

Economic growth has been strong as economies rebound after Covid

In our last update we highlighted that economic agencies are predicting growth over the next few years to be at multi-decade highs as life "gets back to normal" and as fiscal spending programs turbo-charge growth.

Actual data points of economic activity over the June quarter have been broadly in line with this theme. Global manufacturing activity is firmly in expansionary mode, unemployment rates continue to fall, and consumer spending is surging.

In NZ, data released in mid-June by Statistics New Zealand showed GDP in the March quarter rose 1.6%, well ahead of most forecasters' expectations and firmly putting to rest any concern that our economy might experience a technical recession.

With New Zealand's economic recovery well established and global growth on steroids, focus has shifted to rising costs and inflation. The big question is whether the surge in commodity, freight, construction, and a range of other costs seen this year will be temporary, or instead lead to a sustained increase in CPI inflation rates. Survey measures of business and households suggest risks point to the latter, with inflation expectation measures running at multi-year highs.

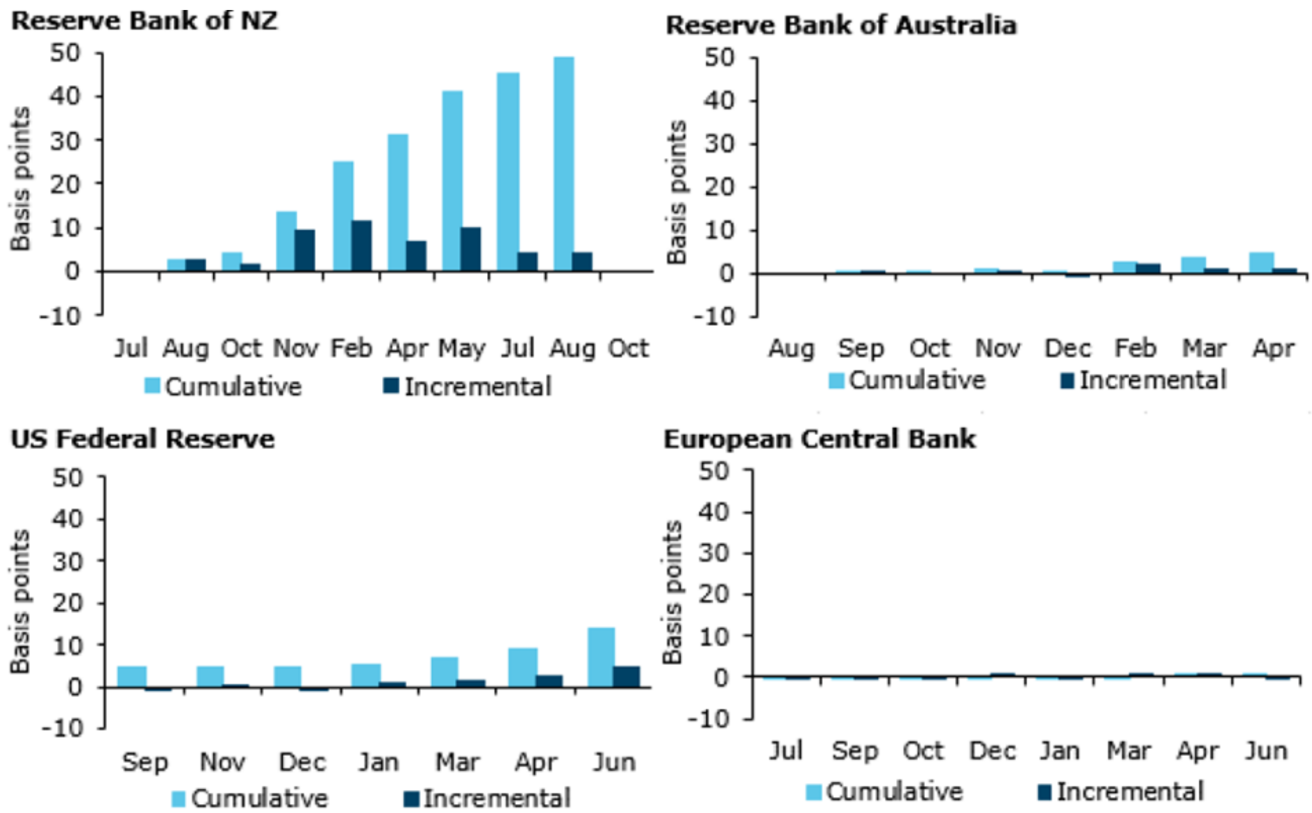
In this environment it is perhaps not surprising that central banks have begun to change their tune. No central banker wants to win the economic battle with Covid only to fight an inflationary war. In the US, a number of senior officials at the Federal Reserve have begun to call for an explicit timeframe for raising rates. In its May update the RBNZ signalled that it will lift interest rates from mid-next year, possibly sooner, if the economy and inflation continue to run ahead of expectations. In this respect the RBNZ is leading the pack – rates are expected to rise here ahead of other major economies (see Figure 2).

Will increasing rates comes to pass next year? Perhaps, but perhaps not if conditions turn out to be weaker than the RBNZ currently forecasts.

The recent lockdowns in parts of Australia are a reminder that we are not out of the woods yet. Regardless, in our view the balance between risk and reward for bonds remains poor, and one or two small changes in short-term rates is unlikely to change this. We need to see a sustained increase to make bonds an attractive asset class again. This isn't going to happen any time soon.

Attention is shifting to rising costs and inflationary risks

Figure 2: Markets predict the RBNZ will lift rates first



Source: ANZ Research

Key Market Movements for the Quarter

Quarter	Past year	
+0.9%	+11.2%	**New Zealand Shares** *New Zealand shares increased around 1% in the quarter, a weaker result than for global markets. Despite the soft quarter, returns were still reasonable for the year ended June 2021, at around 11%. Over the past 3 and 5 years NZ equity returns are now broadly in line with global markets.* *Source of Figures: S&P/NZX 50 Total Return Index with Imputation Credits*
+0.3%	-1.0%	**New Zealand Fixed Interest** *New Zealand investment grade corporate bonds increased slightly in the quarter and returned around -1% for the year ended June 2021. The soft result reflected NZ and global markets starting to price in higher rates and inflation over the medium-term, which causes bonds to suffer a short-term capital loss.* *Source of Figures: S&P/NZX Investment Grade Corporate Bond Index*
+7.2%	+29%	**Australian Shares** *Australian shares performed well over the June quarter, bringing the annual return to around 30%. This annual result is, however, flattered by the fact it is measured against the Covid sell-off, a theme we also see in the other markets as reported below.* *Source of Figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries*
+8.0% (7.4% hedged)	+28.4% (35.9% hedged)	**International Shares** *International shares rose around 8% in the quarter in NZD terms, whilst NZD hedged shares increased around 7.5%. Annual results reflect the bounce from the Covid-lows, 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 under-performed in the quarter, both returning around 5% in NZD terms.* *Source of Figures: MSCI World Index; Morningstar Developed Markets NZD hedged, MSCI World Value MSCI World Small Cap in NZD terms.*
+5.3%	+29.8%	**Emerging Markets** *Emerging Market equities rose around 5% in the quarter in NZD terms, bringing the annual return to around 30%. As with developed market equities, EM equities are benefiting from the Covid pandemic recovery.* *Source of Figures: MSCI Emerging Markets Index*
+1.0%	0%	**International Fixed Interest** *Global bonds increased around 1% in the quarter and had a flat return for the year. As with the NZ result, this soft annual performance reflected bonds being re-priced 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)*
+9.0%	+30.5%	**International Property and Infrastructure** *International property stocks rose by around 9% in the quarter and closed up over 30% for the year ended June. International infrastructure returned around 20% of the year (in local currency terms), also a strong result.* *Source of Figures: FTSE EPRA NAREIT NZD Hedged*

Geographic Diversification

Our grandparents may not have been talking about their share portfolios when they said, "Don't put all your eggs in one basket" but they were making an important point with enduring relevance for investors.

Diversification across asset classes and geographies has long been recognised as crucial to reducing risk in investment portfolios.

As a New Zealand investor, it may seem to make sense to keep your money in our home market – after all, the New Zealand economy is rebounding well from the Covid shock and investing at home gets rid of any currency risk. There is also a comfort factor when you invest in companies you see around you in your daily life. Further, the New Zealand equity market has had an excellent performance over recent years, coming in the top 2 best performing markets in 3 out of the last 5 years.

However, last quarter, New Zealand equities showed a gain of just 0.9% vs a gain of 7.4% in global equities, hedged to the NZ dollar.

Over the last year, the picture was similar, with NZ equities returning

Figure 3: Equity Returns of Developed Markets in NZD

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Highest Return	Ireland 13.9	Belgium 32.0	Finland 46.4	USA 18.7	Denmark 40.9	Canada 22.3	Austria 55.2	Finland 2.4	NZ 37.4	Denmark 34.7
	NZ 5.7	Denmark 24.1	Ireland 41.5	NZ 13.0	Ireland 33.0	NZ 16.2	Hong Kong 33.5	NZ 1.9	Ireland 36.6	Nether. 16.3
	USA 1.5	Singapore 23.8	USA 32.1	Denmark 11.8	Belgium 28.0	Norway 11.2	Singapore 32.9	USA 0.7	Switz. 31.5	Sweden 16.1
	UK -2.4	Germany 23.8	Germany 31.7	Hong Kong 10.6	Japan 25.1	Australia 9.4	Denmark 32.1	Hong Kong -2.2	Nether. 31.3	USA 13.1
	Switz. -6.6	NZ 22.2	Spain 31.6	Belgium 9.6	Austria 18.1	Austria 9.2	Nether. 29.6	Norway -3.1	USA 30.1	Finland 12.8
	Norway -9.9	Hong Kong 21.3	Nether. 31.6	Singapore 8.5	Italy 16.8	USA 8.9	France 26.2	Switz. -3.6	Denmark 27.4	NZ 12.3
	Belgium -10.5	Austria 19.1	Belgium 27.9	Ireland 7.7	Finland 16.5	France 3.0	Italy 25.9	Singapore -3.9	Canada 26.7	Ireland 7.8
	Australia -10.8	Australia 15.4	Japan 27.5	Canada 6.9	Nether. 15.7	Nether. 2.9	Norway 25.8	Portugal -5.7	Italy 26.6	Japan 7.3
	Nether. -12.0	Sweden 15.3	Switz. 26.9	Switz. 5.2	Portugal 15.2	Portugal 1.7	Germany 25.2	Australia -6.7	France 25.0	Portugal 7.2
	Spain -12.2	France 14.7	France 26.6	Finland 4.6	USA 15.0	Germany 0.9	Spain 24.6	France -7.5	Portugal 22.9	Switz. 4.6
	Canada -12.6	Nether. 14.0	Denmark 25.5	Australia 1.7	Switz. 14.7	Japan 0.5	Japan 21.6	Japan -7.6	Australia 22.2	Germany 4.5
	Japan -14.2	Switz. 13.8	Sweden 24.8	Nether. 1.7	France 14.0	Hong Kong 0.4	Portugal 21.4	Nether. -7.8	Sweden 20.4	Australia 1.9
	Sweden -15.9	Norway 12.2	UK 21.0	Japan 1.1	Hong Kong 13.6	Singapore -0.4	Switz. 20.1	Sweden -8.4	UK 20.3	Hong Kong -0.8
	Denmark -15.9	USA 9.1	Italy 20.7	Spain 0.4	Germany 12.0	Sweden -1.2	Finland 20.1	UK -9.0	Germany 20.0	Canada -1.3
	Hong Kong -15.9	UK 9.0	Austria 13.7	UK -0.4	Sweden 8.4	UK -1.9	UK 19.9	Denmark -10.3	Belgium 19.6	France -2.5
	France -16.8	Finland 8.3	NZ 11.5	Sweden -2.6	NZ 7.0	Spain -2.8	USA 18.8	Spain -11.1	Japan 18.9	Italy -4.6
	Singapore -17.8	Italy 6.4	Hong Kong 11.4	Italy -4.7	UK 5.5	Finland -6.4	Sweden 18.2	Canada -12.2	Singapore 14.3	Norway -8.0
	Germany -18.0	Canada 3.2	Portugal 11.3	France -5.1	Australia 2.8	Switz. -6.6	Australia 17.6	Italy -12.8	Austria 13.8	Austria -9.4
	Portugal -22.9	Japan 2.3	Norway 9.7	Germany -5.6	Norway -2.9	Ireland -8.8	Belgium 16.2	Germany -17.5	Spain 11.3	Spain -10.8
	Italy -23.1	Ireland -0.0	Canada 5.9	Norway -17.9	Spain -3.7	Belgium -9.3	Ireland 15.8	Ireland -20.8	Norway 9.7	Singapore -13.3
	Finland -31.8	Portugal -2.1	Australia 4.4	Austria -26.0	Singapore -6.1	Italy -12.1	Canada 13.8	Belgium -22.5	Hong Kong 9.7	Belgium -13.9
Lowest Return	Austria -36.3	Spain -2.6	Singapore 1.9	Portugal -35.0	Canada -13.4	Denmark -17.3	NZ 9.5	Austria -23.0	Finland 8.8	UK -16.1

Source: Dimensional Fund Advisers

11.2% vs 35.9% for global equities, hedged to the NZD. This may be just a temporary pause for the NZ share market as performance has been so stellar of late, but there is no way of knowing. Diversification is your insurance against this uncertainty.

The chart above highlights this. The geographical markets with the highest return appear one year high in the table but the next year can easily be at the bottom of the table. This is the randomness of returns which is seen in all markets.

Investment opportunities exist globally – there are over 15,000 publicly traded companies in the world today. Predicting which of these will be the best is difficult at best. Past returns do not provide a guide to the future.

The optimal strategy to take advantage of the returns available is to be invested across geographies and market segments in a well-structured, globally diversified portfolio.

An additional benefit is lower volatility than investing in individual countries, which is helpful from a psychological perspective for an individual investor, as well as assisting with staying on track to achieve financial goals.

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