Axiome Quarterly Update

April — June 2022

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Investment Market Review

War, pandemic, and inflation. Markets have been grappling with all three of these headwinds this year, and fell further across most asset classes in the June quarter. US and NZ equity markets are down around 20% from their peak, putting them into "bear market" territory. Bonds have also suffered large declines.

Equity markets fell into bear territory over the June quarter .

We don't know how much further markets could still fall - nobody does - but with the large decline in bonds and equity prices we can say that they offer investors much better value today, and as such, higher likely returns over the medium to longer term. To provide some indication, Figure 1 below shows that on average over the past century US equity markets have delivered a five-year cumulative return of over 70% (12% per annum) following a market decline of 20%. Investment grade bond fund yields are now around 4%, a large jump from the 1% or so yield offered a year ago.

Historically, investors have enjoyed outsized returns following a bear market.

The economic picture

The key economic determinant for markets forming a bottom and setting the stage for rallying will be whether inflation starts to moderate, and with it the quantum of interest rate increases central banks need to deliver. Global and NZ growth is no doubt slowing from the blistering pace that was achieved following the bounce from initial pandemic lockdowns, and with it, in theory, we should see inflation pressures and actual inflation decline.

But on top of the economic cycle, the pandemic and war in Ukraine present considerable uncertainty and both upside and downside risks. We can expect prices for manufactured goods to fall *if* global supply chains don't face further significant Covid and flu related interruptions.

The economic picture is very complicated, with upside and downside risks.

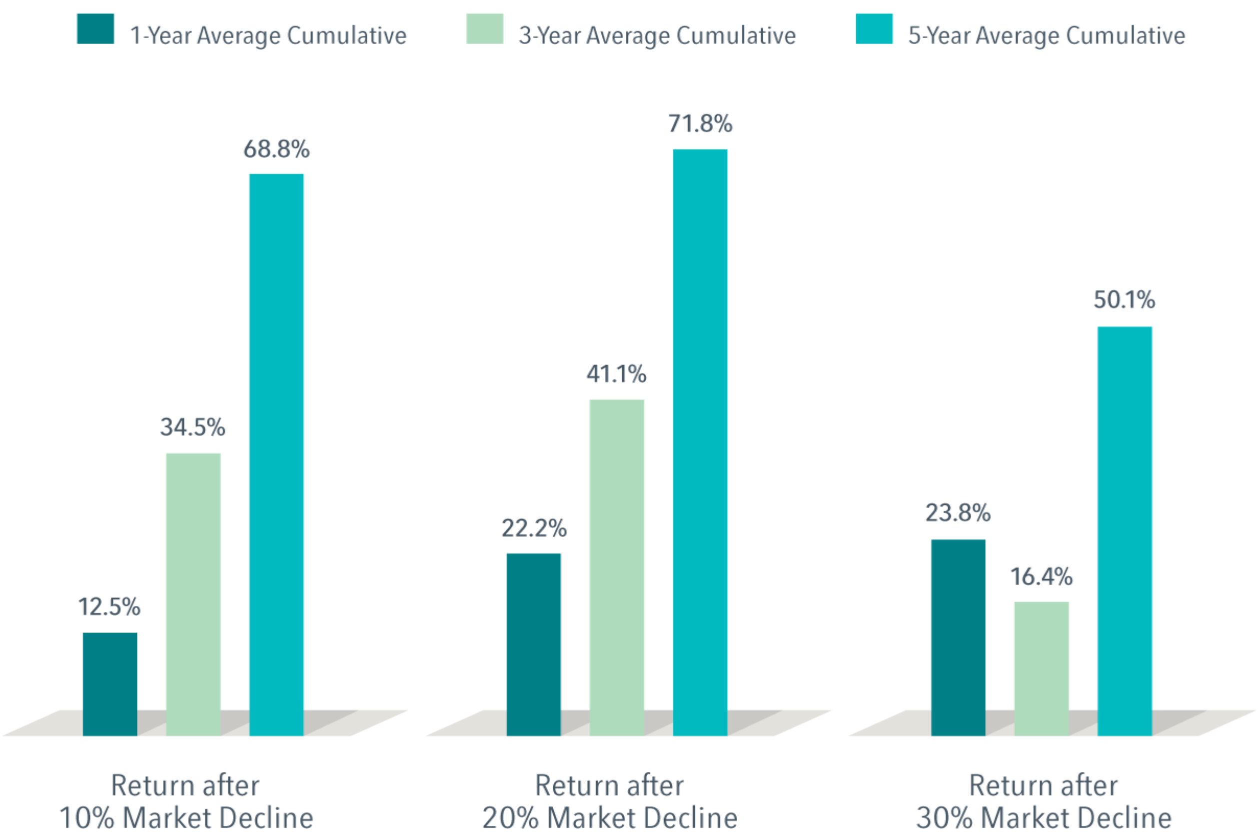
Despite the ongoing war, oil (and many commodity) prices at the time of writing are down over 10% from their peaks, as markets factor in slowing global growth. Any sign of war letting up in Ukraine would cause energy prices to plummet, and with it headline CPI inflation. Unfortunately, we would expect the opposite to occur if the war were to spread beyond Ukraine's borders.

Is economic recession inevitable? It's a very complex economic picture and economic forecasting is not something that is known for its accuracy.

While markets are pricing in a recession, it is not inevitable.

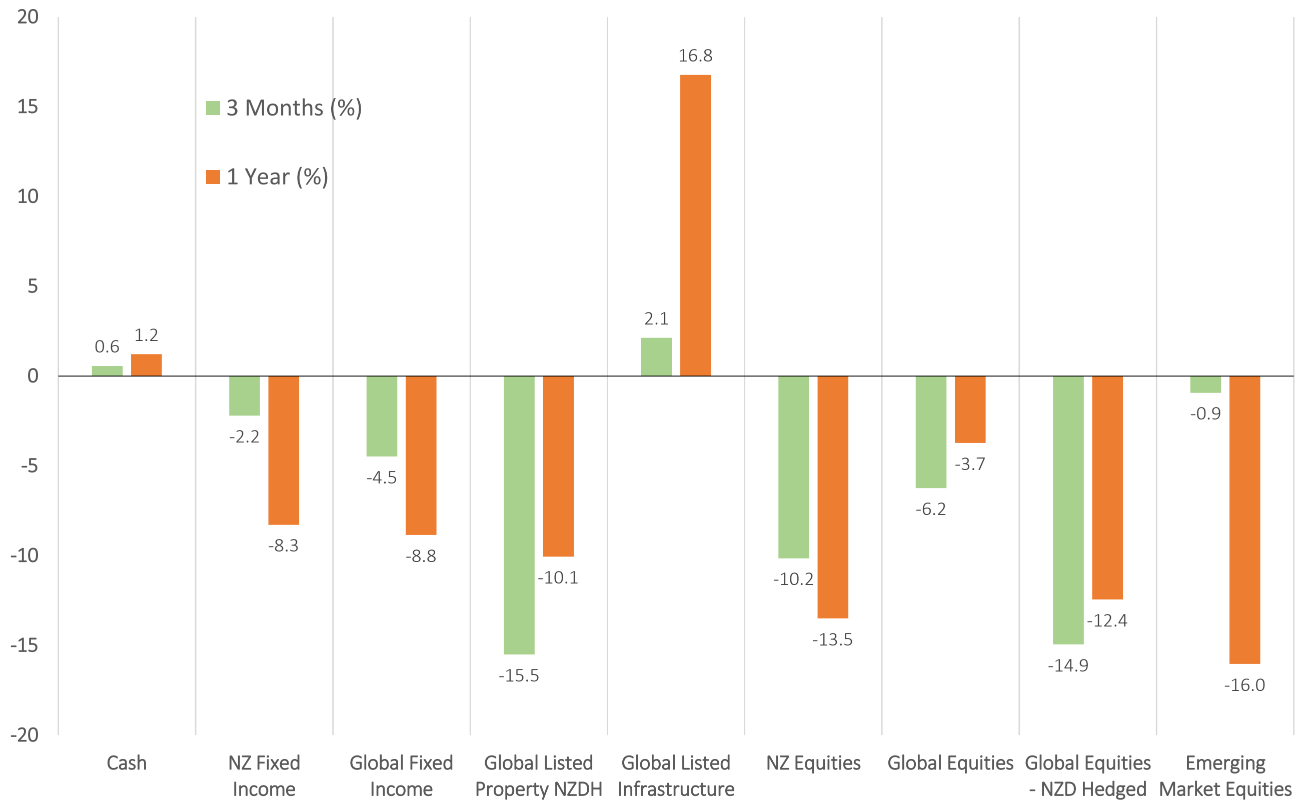
Equity markets have fallen to the extent that they are now "pricing in" an economic recession (i.e. at least 2 quarters of negative economic growth and a steep rise in unemployment rates.) Historically, however, markets have also not been very good at predicting recessions. They have forecast roughly twice as many recessions as have actually occurred. In contrast, the most recent June forecasts from the OECD still predict global GDP growth of 3%, and 2% growth for New Zealand. This is a large decline from the growth we have had recently but still far from recession. Time will tell.

Figure 1: Over the past 100 years large gains have followed large falls



Source: [History Shows That Stock Gains Can Add Up after Big Declines | Dimensional Fund Advisors]

Figure 2: Infrastructure offered the highest returns over the year



Source: Morningstar Direct, MyFiduciary

Market Roundup:

Market performances are reported in Figure 2. Developed market equities fell around 6.5% over the June quarter in NZD terms while NZD hedged equities fell around 15%. The difference in performance reflected the large decline in the NZD over the quarter, something we typically see in a "risk off" environment, where investors seek safety in safe-haven currencies. We have significant allocations to unhedged equities that in part reflects the shock absorbing role the NZD can play in times of stress. Within global equities, higher risk small caps fell around 7.5%, while value stocks again outperformed (falling around 1% in the quarter, and up 4% over the year) as the rotation towards companies with lower valuations and hence less reliance on future growth conditions continued.

Global, NZ and Australian equity markets fell over the quarter, with value and emerging market stocks falling less.

Listed infrastructure was a bright spot.

Emerging Markets outperformed most other equity markets in the quarter, falling by "only" around 1%. This reflects that they bore the brunt of the sell-off as war broke out in Ukraine in the March quarter. On an annual basis, returns were poor at around -16% in NZD terms. NZ and Australian equity markets both declined around 10% in the quarter as the RBNZ and RBA lifted interest rates. Over the year to June, however, the resource-sensitive Australian equity market has fared better, with it down around 4% compared to around 13.5% in New Zealand.

Fixed income returns were also poor as market interest rate curves steepened. NZ bonds fell around 3% and global investment grade bonds fell around 4.5%. Over the year to June, bond declines are close to 10%.

As featured in our last update, international infrastructure is expected to be more resilient to inflation risks, and this has been the case over the past year. It increased around 2% in the quarter and 17% over the year to June in NZD terms. Global listed property returned around -3% in NZD terms over the year, also a relatively strong result in the context of the large declines in global equities and bonds.

Key Market Movements for the Quarter

Quarter	Past year	
-10.2%	-13.5%	**New Zealand Shares** *New Zealand shares fell around 10% in the quarter as the Russian invasion of Ukraine, higher inflation, and interest rate rises all weighed on returns. This meant a negative return for the year, although our market's 5-year performance remains strong with an annual average return of around 8% over the period.* *Source of Figures: S&P/NZX 50 Total Return Index with Imputation Credits*
-3.0%	-9.8%	**New Zealand Fixed Interest** *New Zealand investment grade corporate bonds fell around 3% in the quarter and returned around -10% for the year ended June 2022. The poor result reflected NZ markets pricing in materially higher interest rates and inflation, which causes bonds to suffer a short-term capital loss. The silver lining is that NZ bond yields are now much higher at over 4% per annum.* *Source of Figures: S&P/NZX Investment Grade Corporate Bond Index*
-10.1%	-4.0%	**Australian Shares** *Australian shares were less resilient this quarter, with the market down around 10% as in New Zealand. Within Australian equities, higher risk small cap stocks fell further, while value stocks outperformed and have been around flat over the year to June.* *Source of Figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries*
-6.2% (-14.9% hedged)	-3.7% (-12.4% hedged)	**International Shares** *International shares fell by around 6% in the quarter in NZD terms and almost 15% in NZD hedged terms. The difference in performance reflects that the NZD declined materially over the quarter, as it usually does in a "risk off" environment. Within global equities, higher risk small caps fell further, while value stocks outperformed, returning around -1.1% over the quarter and 5% over the year in NZD terms.* *Source of Figures: MSCI World Index; Morningstar Developed Markets NZD hedged, MSCI World Value MSCI World Small Cap in NZD terms.*
-0.9%	-16.0%	**Emerging Markets** *Emerging Markets outperformed most other equity markets in the quarter, falling by "only" around 1%. This reflects that they bore the brunt of the sell-off as war broke out in Ukraine in the previous March quarter. On an annual basis returns were poor at around -16% in NZD terms.* *Source of Figures: MSCI Emerging Markets Index*
-4.5%	-8.8%	**International Fixed Interest** *Global investment grade bonds fell 4.5% in the quarter and around 8.8% over 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 surging inflation and expectations that central banks need to continue increasing interest rates.* *Source of Figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)*
-7.7%	-2.7%	**International Property and Infrastructure** *International property stocks fell around 7% in the quarter in NZD terms while global infrastructure increased around 2.1%. On an annual basis infrastructure increased around 17%, while global property returned around -2.7%., in NZD terms. These asset classes have been relatively resilient to higher inflation, as should be expected given their income streams do typically rise with inflation.* *Source of Figures: FTSE EPRA NAREIT, FTSE Dvlp Core Infrastructure TR USD*

Investment Markets and the Jellybean Principle

A lot of people talk about 'the market' but what is it? The financial market is made up of millions of participants, many just like you. Buyers and sellers voluntarily agree to trade shares of companies all over the world. Every year millions of trades take place each day totaling trillions of dollars. In the 4th quarter of 2021 alone, $41 trillion dollars were traded in the global equity markets. The collective knowledge of all those participants to set prices based on known information is powerful.

This has been tested outside the world of high finance. A well-known experiment asked a gathering of people to guess how many jellybeans were in a jar. There were some guesses too high and some too low, but the average guess was remarkably close to the actual number of jellybeans.

Together, we know more than we do alone. Think of the stock market as a giant jar of jellybeans, where each bean represents information and opinions about the value of companies. All this information impacts the price of the stock. No one can really know if that price is right but thanks to the market's processing power, we can treat the current price as the best estimate of its actual value.

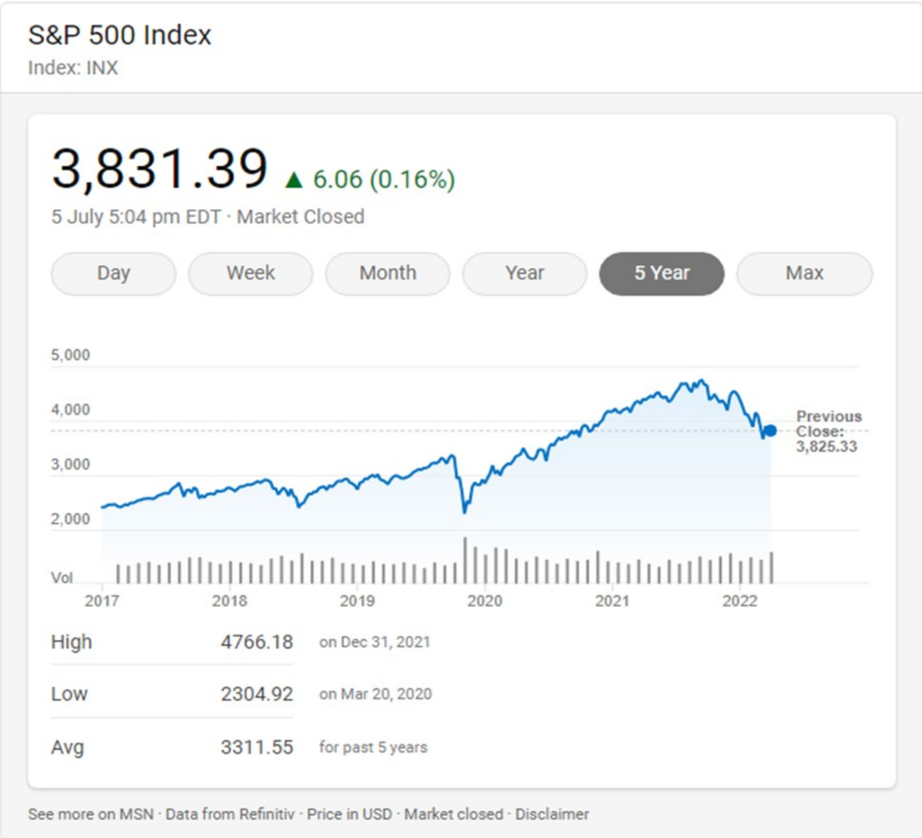
Stock and bond prices move up and down based on new information. Market participants quickly respond, and prices adjust. Trying to anticipate market movements merely adds anxiety and unnecessary risk. The point is, when you try to predict the market, you are competing against the collective knowledge of all those millions of buyers and sellers. Instead, harness that collective knowledge for your portfolio and get the power of the market to work for you by investing broadly in a well-diversified portfolio.

At times when uncertainty is high, as it has been of late, with war in the Ukraine, and the magnitude of interest rate rises and inflation, this translates to high volatility. The VIX index, shown below, is a popular measure of the stock market's expectation of volatility. Although volatility has settled down since the Covid pandemic, it is nonetheless higher than pre-Covid times as the market digests all the bad news. This volatility is uncomfortable but should be thought of as the cost of access to the returns of the capital markets. It is all part of the orderly functioning of a capital market.

In the second chart below, the spikes in volume traded (displayed as grey vertical lines at the bottom of the chart) indicate that as prices fall, buyers come in perhaps more slowly in volatile and uncertain times, but that when prices reach certain levels, a lot of trades are executed. Whilst this may not be comforting at the time of turmoil, it would be preferable to be a buyer rather than a seller at this point, given that over the long term, stocks remain the best long-term investment. They have generated annual returns of 10% or more over the past century, a period that has included a Great Depression, two world wars, commodity shocks, periods of high inflation, pandemics and other crises. But we also know stocks don't go up in a straight line and there will be negative periods.

Just as we can rely on any group of people, *on average*, guessing the right number of jellybeans in a jar, we can be confident that in an efficient market, prices accurately and fully reflect available information.

We do not know what tomorrow's news will bring, but investing in a well-diversified portfolio of equities and bonds remains the best long-term strategy to capture the value created by economic activity.



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