

Axiome Quarterly Update

June – September 2022



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Economic and Market Commentary

The headwinds from war, inflation, and supply-side hangovers from the pandemic continued over the September quarter. Performances were, however, more nuanced than the broad sell-off across almost all asset classes in the June quarter. Bonds suffered amongst the largest losses they have seen since records began as central banks stepped up their tightening of monetary policy and communicated that rates may need to be higher for longer to reduce inflation back to target levels. Equities rallied over much of July and August, only to fall back in the month of September.

Markets experienced further turmoil over the quarter, with large declines in currencies versus the US dollar

A particular feature over the quarter was very large currency market swings, with the US dollar ap-

proaching record highs on a trade-weighted basis. The NZD in contrast fell around 8% over the quarter, which helped cushion returns on offshore assets held on an unhedged basis. Even more dramatically, the UK pound fell around 10% intraday to record lows against the US dollar following the release of a budget seen by the market as being fiscally unsound.

Historically, investors have enjoyed outsized returns following a bear market, and cash yields on bonds are now back to around pre-GFC levels

As in our previous update, we don't know how much further markets could still fall - nobody does - but the large decline over the year implies much better value today, and as such, higher likely returns over the medium to longer term.

In addition, cash yields on various asset classes are now back to levels last enjoyed in pre-GFC days. For example, running yields on global and NZ investment grade bonds are now around 4-5%, compared to under 1% only a year or so ago. Dividend yields are also higher. This means investors do not need to rely as much on uncertain (over the short-term) capital gains to earn a return.

The economic picture

We reiterate our previous commentary that the economic picture remains very complicated, with upside and downside risks. Recently released OECD projections suggest that global growth will fall to just over 2% in calendar 2023 – well below long-term trend growth of around 3.5% per annum. Outright recession is forecast for much of Europe. But

it also projects inflation to moderate significantly, with US CPI inflation falling to around 3%. Inflation is the key economic determinant for markets forming a bottom and rallying from their depressed levels. Weaker growth should feed into weaker inflation outcomes, and it is encouraging in this regard that global supply

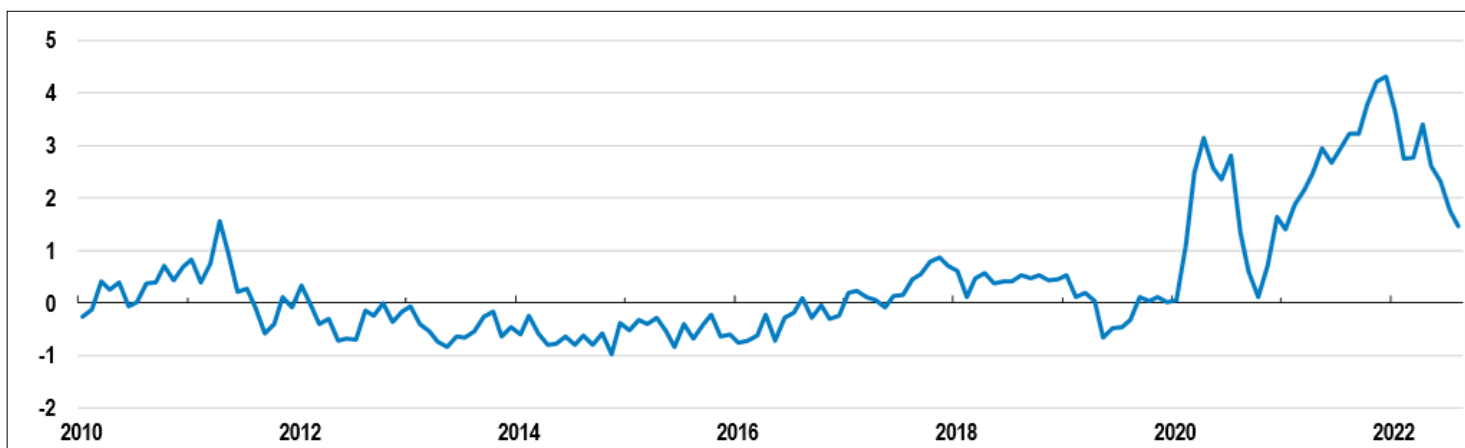
Global growth prospects have been revised down further, but so has the outlook for CPI inflation which is the key catalyst for markets to stage a rebound

chain pressures continue to moderate (Figure 1), which will very likely flow through to declines in headline CPI inflation rates over the next year.

The war in Ukraine presents considerable uncertainty and both upside and downside risks. 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. Russian capitulation is now being discussed as a real possibility given Ukraine's rapid repossession of its territory in Eastern Ukraine.

Figure 1: Global supply side pressures continue to fall



Source: Source: Bureau of Labour Statistics; Harper Petersen Holding GmbH; Baltic Exchange; IHS Markit; Institute for Supply Management; Haver Analytics; Refinitiv. Calculations by the Federal Reserve Bank of New York.

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 increased around 3% over the quarter in NZD terms while NZD hedged equities fell around 5%. The difference in performance reflected the large decline in the NZD over the quarter, something we typically see in a “risk off” environment. The significant allocations in place to unhedged equities in part reflects the shock absorbing role the NZD can play in times of stress.

Within global equities, higher risk small caps increased around 4%. Please see below for a feature on small caps and the rationale for their exposure in your portfolio. Value stocks also rose around 2% and are up around 6.5% over the year – materially ahead of markets overall.

New Zealand and Australian markets also fared relatively well, rising by around 2% and 3.5% respectively. Over the year however there has been a large divergence, with NZ equities declining 16% and Australian equities showing a positive yearly return of +2.2%. Bond














Bonds had another torrid quarter while listed infrastructure remains a bright spot

returns continued their poor run as market interest rate curves steepened further. NZ bonds fell around 1% and global investment grade bonds fell around 3.7% in the quarter. Over the year to September, international investment grade bonds declined over 12% – the worst result since 1842 if the records are to be believed. The silver lining is that now, their cash yields are back to around ‘normal’

pre-GFC levels. This means we can expect bonds to play their traditional diversification role should inflation and growth turn out to be weaker than the market is currently pricing in.

Rounding out the market update, international property stocks fell around 2.8% in the quarter in NZD terms while global infrastructure fell around 1.2%. On an annual basis, infrastructure increased around 14%, while global property returned around -5.8% in NZD terms. These asset classes have been relatively resilient to higher inflation, as should be expected given their income streams typically rise with inflation.

Key Market Movements for the Quarter

Quarter	Past Year	
 +2.2%	 -16.0%	<p>New Zealand Shares</p> <p>New Zealand shares increased around 2% in the quarter despite the challenging market environment. Over the year to September returns were -16%, although our market's 5-year performance remains strong with an annual average return of around 8% over the period.</p> <p><i>Source of Figures: S&P/NZX 50 Total Return Index with Imputation Credits</i></p>
 -1.0%	 -6.6%	<p>New Zealand Fixed Interest</p> <p>New Zealand investment grade corporate bonds fell around 1% in the quarter and returned around -6.5% for the year ended September 2022. The poor result reflected 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 4.5% per annum.</p> <p><i>Source of Figures: S&P/NZX Investment Grade Corporate Bond Index</i></p>
 +3.4%	 +2.2%	<p>Australian Shares</p> <p>Australian shares were a bright spot, returning 3.4% in the quarter and 2.2% over the year in NZD terms. Over the past 5 years the Australian market has returned around 8% per annum, in line with the NZ market outcome.</p> <p><i>Source of Figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries</i></p>
 +3.4%	 -2.0%	<p>International Shares</p> <p>International shares increased by around 3% in the quarter in NZD terms, although this was due to a large decline in the NZD over the period. In NZD hedged terms the return was around -5%, in line with the decline in offshore markets. Within global equities, higher risk small caps increased 4%, while value stocks returned around 2% over the quarter and 6.5% over the year in NZD terms.</p> <p><i>Source of Figures: MSCI World Index; Morningstar Developed Markets NZD hedged, MSCI World Value MSCI World Small Cap in NZD terms.</i></p>
(-5.1% hedged)	(-17.4% hedged)	
 -2.8%	 -12.3%	<p>Emerging Markets</p> <p>Emerging Markets underperformed in the quarter, falling by around 3% in NZD terms. On an annual basis returns were around -12.3% in NZD terms, ahead of the performance of NZ markets but behind that of developed markets on an unhedged basis.</p> <p><i>Source of Figures: MSCI Emerging Markets Index</i></p>
 -3.7%	 -12.3%	<p>International Fixed Interest</p> <p>Global investment grade bonds fell -3.7% in the quarter and down around -12.3% over the year – the worst result since 1842 if the records are to be believed. This reflected bonds being repriced significantly lower as central banks stepped up tightening of monetary policy and communication that rates may need to be higher for longer to reduce inflation back to target levels. As with NZ bonds, the silver lining is that yields are now back to much more attractive levels, at around 4-5%.</p> <p><i>Source of Figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)</i></p>
 -1.2%	 +14.0%	<p>International Property and Infrastructure</p> <p>International property stocks fell around 2.8% in the quarter in NZD terms while global infrastructure fell around 1.2%. On an annual basis infrastructure increased around 14%, while global property returned around -5.8% in NZD terms. Ignoring currency effects, these asset classes have been relatively resilient to higher inflation, as should be expected given their income streams do typically rise with inflation.</p> <p><i>Source of Figures: FTSE EPRA NAREIT NZD, FTSE Dvlp Core Infra 50/50 TR NZD</i></p>

The Case for Small Caps

While global equity markets contain thousands of listed companies, the largest 10 companies make up around 20% of the markets' capitalisation. In New Zealand, the largest companies also comprise a large chunk of the market index. Small cap investing is an approach that essentially looks to diversify company holdings and add value compared to a market capitalisation weighted exposure by investing into companies with smaller than average capitalisations. Such companies tend to be riskier, but with that comes a higher return potential. As with any asset class, the small cap premium is not consistently observed but tends to present sporadically.

Performance of small caps and markets overall

Period	Global Small Caps ¹	Global Market Overall ²	Annual return difference
Since 2000 to August 2022	7.1%	3.9%	3.2%
Last 3 years	8.1%	9.8%	-1.7%
Last year	-7.1%	-2.5%	-4.5%
Year to August 2022	-8.7%	-8.2%	-0.5%

1. MSCI World Small Cap index, measured in NZD 2. MSCI World, measured in NZD.

What is the small cap factor and why are we confident the small factor will deliver a premium?

Small cap investing relies on a belief that stocks that have a smaller market capitalisation will outperform those that are large. Investing in small caps means putting more weight on stocks that have a lower market capitalisation than the market overall, and less weight on stocks that are larger in size.

There are several reasons why small cap stocks could outperform larger ones. Smaller companies tend to include the most innovative businesses on the market with the highest earnings growth potential. In contrast, as companies mature, their earnings growth tapers off. Smaller cap companies also tend to attract less coverage from equity analysts, so can offer more value.

However, smaller companies also tend to be riskier, and small cap stocks usually decline much more in a market sell-off than the market overall. For this reason, investors should also require a higher risk premium from taking smaller cap exposures. Academic studies back this up - over the long-term and across many equity markets, small caps deliver a premium, but suffer more in a downturn. This outperformance is illustrated on the table on the following page.

Performance of small cap funds

Period	Dimensional Global Small Cap Trust	Global Market Benchmark ¹	Annual return difference
Past 3 years to Sept 2022	7.5%	7.3%	0.2%
Year to Sept 2022	-7.2%	-9.5%	2.3%
Period	Dimensional Australian Small Company Trust	Australian Market Benchmark ²	Annual return difference
Past 3 years to Sept 2022	4.9%	1.2%	3.7%
Year to Sept 2022	-11.0%	-18.3%	7.3%

1. MSCI World Small Cap index, measured in NZD 2. S&P/ASX Small Ordinaries Index, measured in NZD.

How do we obtain exposure to smaller caps?

Your portfolios obtain exposure to small cap stocks in several ways. First, we allocate around 20% of our equity exposure to New Zealand's equity market which is a small cap market on a global scale. Second, some of the equity managers that we employ tend to underweight the largest stocks by market capitalisation because such stocks tend to be more expensive (have higher price-to-earnings or price-to-book ratios) compared to the market overall. For example, the Dimensional Value Fund discussed in our last update has lower allocations to the largest cap stocks. And third, we have in place dedicated small cap funds.

The main small cap funds we use include the Dimensional Global Small Company Trust for global equity markets, and the Dimensional Australian Small Company Trust (or the Australian Core Equity Trust, the latter of which has an increased weighting to small and value companies). As shown above, both of these funds have performed well relative to the small cap indexes they are benchmarked against, and particularly well in the weak market this year. This is because both of these managers don't just allocate to small cap stocks according to market benchmarks. They consider company profitability (amongst other factors), which means that they tend to avoid the riskiest smaller companies that suffer the largest falls in the type of market conditions we are currently experiencing. The combination of choosing small caps as a group overall, and then excluding the riskiest companies and weighting towards the more profitable companies, plus patient trading, is what contributes to the overall superior performance.

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