Axiome Quarterly Update

October- December 2022

IN THIS ISSUE

Visit us at our new office at 6 Victoria Rd, Devonport, Auckland

Economic and Market Commentary

So long and good riddance to 2022! War, inflation, rising interest rates, and supply-side hangovers from the pandemic drove poor performance by most asset classes over the year. This was most notably the case for bonds, which normally act as a "safe haven" when equity markets fall. In contrast, Aussie shares, value stocks and asset classes that offer some resilience to inflation, such as infrastructure and short-term credit, fared much better. The portfolios we design include these exposures and as such performed *relatively* well in the context of the large market declines.

Interest rate increases and the pandemic and war "shocks" hit returns hard over 2022.

Markets had to adjust to interest rates returning to more normal levels, and large cap growth stocks (such as Meta and Tesla), which had led the market on the upside, suffered much larger declines than the overall market. Purely speculative investments, such as digital currencies and NFTs, were harder hit still, with some suffering complete capital loss. These type of adjustments occur every cycle as speculative excesses are worked through (or, less euphemistically, as the naïve are parted from their money). Closer to home, we also saw residential property prices begin to fall - ending the myth that they can only rise!

Despite the seismic shift in interest rates and accompanying asset price declines, one welcome aspect of the 2022 declines was that we didn't see the type of stresses associated with the global financial crisis of 2008.

Purely speculative investments fared the worst, while inflation resilient assets and alternatives fared well.

Overall, the adjustment to higher rates globally has been fairly orderly, and, as discussed below, the silver lining is that we should now expect higher longer term returns from most asset classes given higher cash rates and income yields on offer. In our view, risks are now more evenly balanced. Although economic growth is expected to be quite weak in 2023, with many economies likely to experience recessionary conditions, this reduces the risk of core inflation moving higher still. Energy prices are now clearly off their peak, in part due to the good luck of a very warm European winter, which will reduce headline inflation rates.

Market roundup

Market performances are reported in Figure 1. International shares on an NZD hedged basis rallied around 7% in Q4, but fell by around 2% in NZD terms. The difference reflected that yet again currency volatility was a key feature of the quarter, with the NZD rallying as the shine came off the previously very strong USD.

The adjustment was not accompanied by financial crisis as in 2008.

For calendar 2022, international equities declined around 11% in NZD terms, which was in line with the return from NZ equities.

In contrast, Australian equities with their resource focus performed relatively well.

Currency movements again had a large impact on December quarter returns. NZD hedged international equities offered the best return, while unhedged equities fared poorly.

Within global equities, value stocks also outperformed, returning around 2.6% over the quarter and 1.2% over the year in NZD terms. However, higher risk small caps and emerging markets fared worse, with returns of -12% and -13.5% in 2022 respectively.

NZ and international investment grade bonds eked out small positive returns in the quarter bolstered by their now meaningful running yields.

Global bonds underperformed global equities over 2022 – one for the record books.

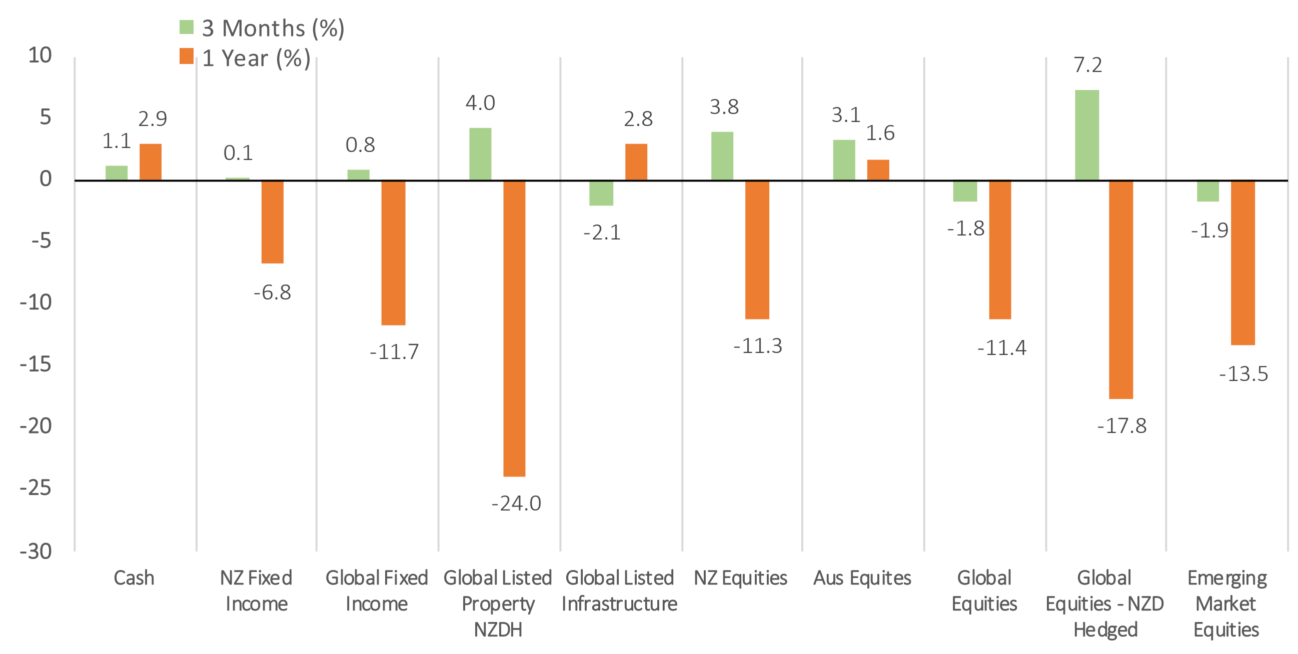
But quite strikingly, over 2022 as a whole, international bonds fared marginally worse than international equities.

This is very unusual in financial history. The silver lining is that their cash yields, at +5%, are back to around “normal” pre-GFC levels. This means that we can expect bonds to play their traditional diversification role should inflation and growth outturns be weaker than is currently being priced by the market.

Value stocks had a relatively strong year, as did global infrastructure.

International property stocks increased 4% in the quarter in NZD hedged terms, but performance over 2022 was very weak on both a hedged and unhedged basis as the office segment in particular priced in much lower tenancy demand. In contrast, global infrastructure performed well once again, returning a handy 3% for calendar 2022 on an unhedged basis.

Figure 1: Annus Horribilis



Source: Morningstar Direct, MyFiduciary

The outlook ahead

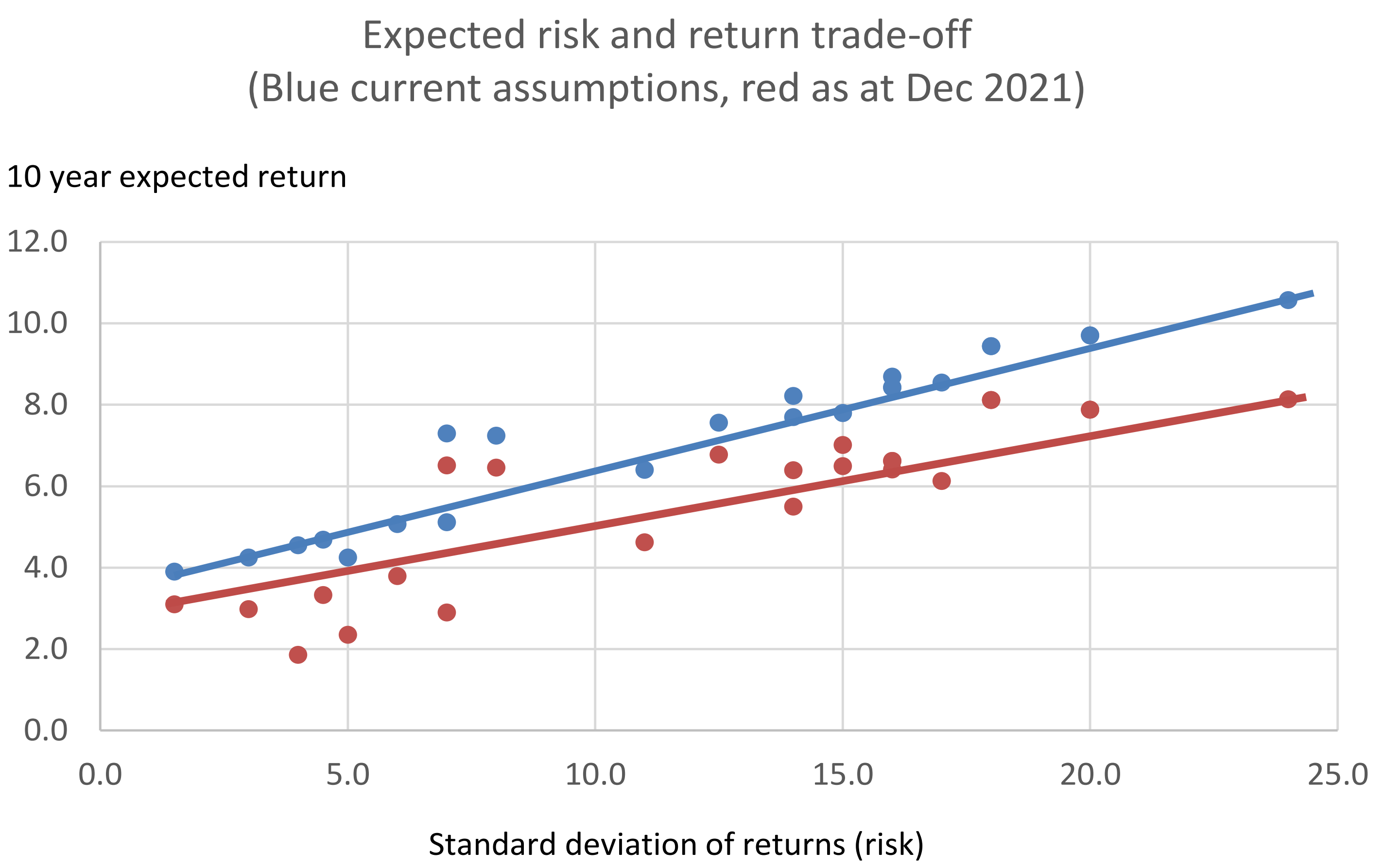
No one can consistently forecast short-term market movements, though, as per our last update, we believe that inflation is the key economic determinant for markets to be able to form a bottom and to rally from current levels. In our view, current and forecast interest rate levels should be sufficient to reduce inflationary pressures, though the surge in Covid in China may reignite short-term supply-side challenges. Of course we also need to take into account the war in Ukraine, which presents considerable uncertainty and both upside and downside risks.

One thing we are more confident about given both long term financial history and basic investment logic is that over the medium to longer term markets offer a premium, or excess return, to cash to compensate for their higher level of investment risk. It follows that with central banks now having finally done their jobs and raised rates to more normal levels, we should expect higher longer term returns. To take a simple example, NZ investment grade bonds now offer running yields over 5% per annum (a 1% or so premium to the OCR), compared to under 2% a couple of years ago.

We expect higher longer term returns given higher cash rates and the market declines over 2022.

Figure 2 over the page presents our updated long-term forecasts for a range of asset classes taking into account higher cash rates and the sell-off in markets over 2022. These are compared to the same forecasts made in 2021. We see that there is an increase in the level of returns expected for the risk borne across all the asset classes we consider (compare the blue line to the red line). Further, we see that most assets classes lie close to the blue line, indicating that they are now around "fair value". This is a marked change from 2021 where we saw more variability with low risk assets classes (ie bonds) being particularly expensive, as indicated by the red dots lying well below the red line in the bottom left.

Figure 2: The longer term risk return trade-off has improved



Source: MyFiduciary

Key Market Movements for the Quarter

Quarter	Past Year

New Zealand Shares

Quarter	Past Year
+3.8%	-11.3%

New Zealand shares increased around 4% in the quarter despite the ongoing challenging market environment. Over the year to September returns were -11.3%, but remain very solid over the past 5 years and decade with annual returns of around 7.5% and 12% respectively.

Source of Figures: S&P/NZX 50 Total Return Index with Imputation Credits

New Zealand Fixed Interest

Quarter	Past Year
+0.2%	-5.1%

New Zealand investment grade corporate bonds increased in the quarter and returned around -5.1% in 2022. The negative annual 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 5% per annum.

Source of Figures: S&P/NZX Investment Grade Corporate Bond Index

Australian Shares

Quarter	Past Year
+3.2%	-0.2%

Australian shares remained a bright spot, returning around 3% in the quarter, and a fairly flat performance over the year in NZD terms. Value stocks outperformed, returning 4.2% over 2022, while small caps significantly underperformed with a 17.6% return over 2022.

Source of Figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries

International Shares

Quarter	Past Year
-1.8%	-11.4%
(=7.2% hedged)	(-17.8% hedged)

International shares fell by around 2% in the quarter in NZD terms, although this was due to a large rally in the NZD (fall in the USD) over the period. In NZD hedged terms the return was around +7.2%, in line with the rally in offshore markets. Within global equities, value stocks returned around 2.6% over the quarter and 1.2% over the year in NZD terms. Small caps fared worse, returning around -12% in 2022.

Source of Figures: MSCI World Index; Morningstar Developed Markets NZD hedged, MSCI World Value MSCI World Small Cap in NZD terms.

Emerging Markets

Quarter	Past Year
-1.9%	-13.5%

Emerging Markets underperformed in the quarter, falling by around 2% in NZD terms. On an annual basis returns were around -13.5% in NZD terms, mildly behind returns of developed markets on an unhedged basis.

Source of Figures: MSCI Emerging Markets Index

International Fixed Interest

Quarter	Past Year
+0.8%	-11.7%

Global investment grade bonds slightly increased in the quarter, but ended the year down 11.7% – a worse result than those of NZ and global equities (unhedged basis). This reflected central banks finally moving away from an ultra-loose monetary policy on the back of surging inflation. With interest rates now back to more "normal" levels, interest rate risk is now much more evenly balanced and bonds over the prospect of solid returns given their high running yields.

Source of Figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)

International Property and Infrastructure

Quarter	Past Year
+4.0%	-24.0%

International property stocks increased around 4% in the quarter in NZD hedged terms while global infrastructure increased around 7% on a NZD hedged basis. Over 2022 infrastructure returned -3% and global property returned around -24% on a NZD hedged basis. On an unhedged basis annual returns were better at around -19% for property and +3% for infrastructure.

Source of Figures: FTSE EPRA NAREIT NZD, FTSE Dvlp Core Infra 50/50 TR NZD

A Reset for Crypto and FAANG Stocks

If the market decline of 2022 taught investors anything, it's that what goes up can also come down. Some of the most hyped investments of the past two years did just that. Cryptocurrencies and FAANG stocks[1] were all hit hard, with bitcoin falling below US$17,000, about 75% lower than its high of nearly US$68,000 in November 2021. As investors have learned by now, cryptocurrencies can be extremely volatile. From a distance, bitcoin might appear to have enjoyed a steady climb through much of its existence. There were, however, major slumps: On three occasions since 2017, bitcoin has fallen by more than 50%, including the decline that extended into 2022.

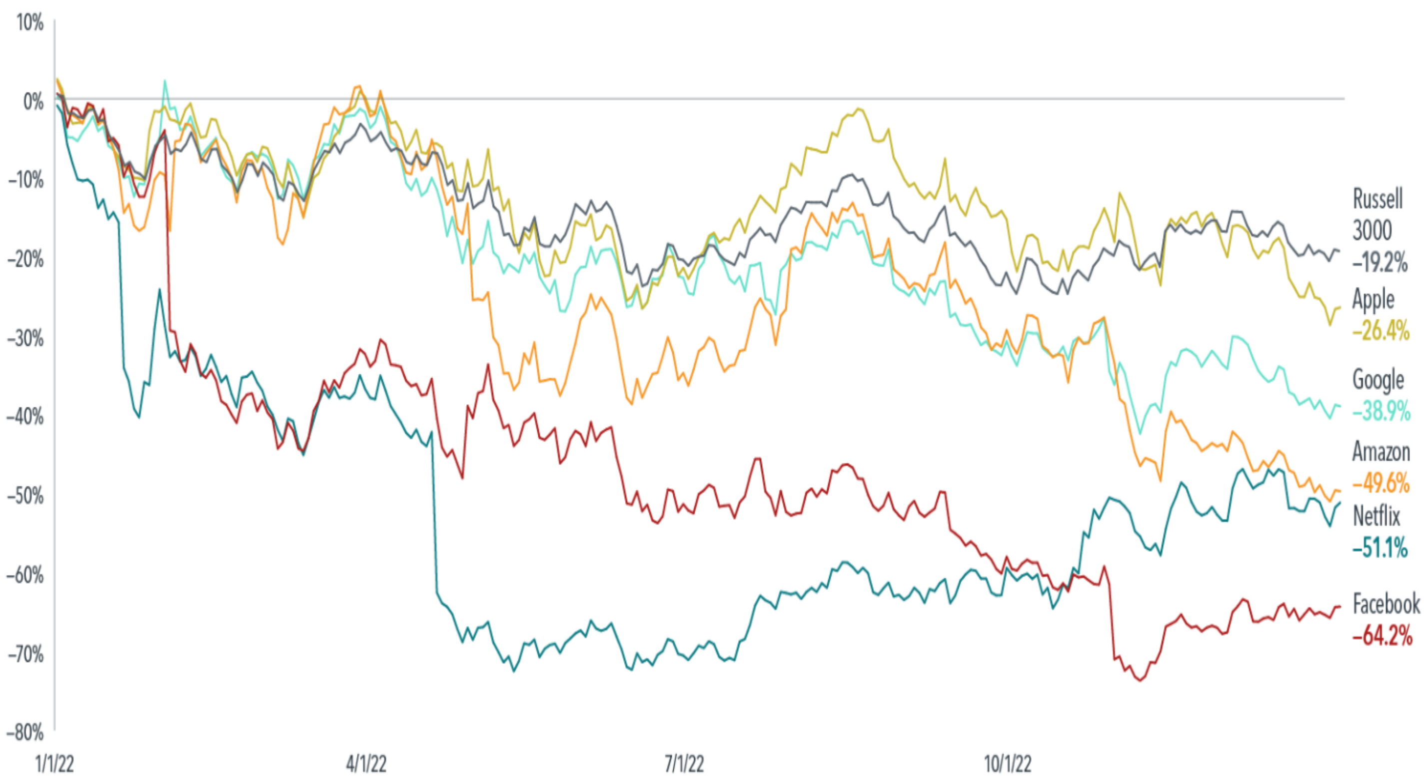
The FAANGs also saw notable declines in 2022 (see **Figure 3**). This group of tech stocks lost a combined $3.2 trillion in market value. Facebook parent Meta Platforms, Amazon, Apple, Netflix, and Google parent Alphabet all lagged the broad US market, with Facebook and Netflix suffering particularly sharp losses. The group collectively underperformed the Russell 3000 Index by more than 20 percentage points. The slump came on the heels of a stellar decade—the FAANGs returned 28% per year from 2012 to 2021.

That reversal is a reminder that investors should be cautious about assuming past returns will continue. Even if a company with a track record of strong stock returns remains broadly successful, that may not translate to spectacular future returns. This point is borne out by looking back at stocks as they grew to become among the top 10 largest by market cap. On average, their performance lagged the performance of the broader market within a few years of entering the top 10.

Our final article on the following page and **Figure 4** provide further insight on this topic.

[1] *FAANG stocks refer to the tech giants of **Facebook** (now Meta); **Amazon**; **Apple**; **Netflix**; and **Google** (listing name Alphabet)*

Figure 3: Tech Giant Performance 2022



Why investors might think twice about chasing the biggest stocks...

As companies grow to become some of the largest firms trading on the US stock market, the returns that push them there can be impressive. But not long after joining the Top 10 largest by market cap, these stocks, on average, lagged the market.

- From 1927 to 2020, the average annualised return for these stocks over the three years prior to joining the Top 10 was nearly 25% higher than the market. In the three years after, this edge was less than 1%.

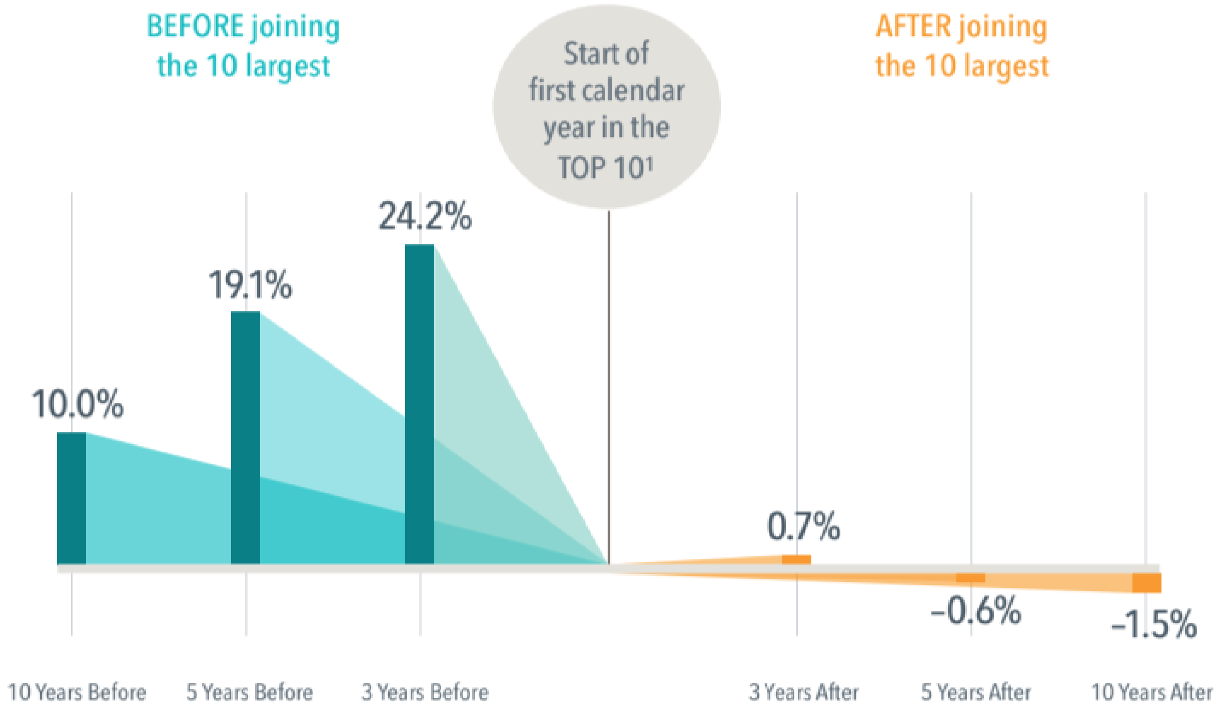
- Five years after joining the Top 10, these stocks were, on average, underperforming the market—a stark turnaround from their earlier advantage. The gap was even wider 10 years out.

- Intel is an illustrative example. The technology giant posted average annualised excess returns of 29% in the 10 years before the year it ascended to the Top 10 but, in the next decade, underperformed the broad market by nearly 6% per year. Similarly, the annualised excess return of Google five years before it hit the Top 10 dropped by about half in the five years after it joined the list.

Expectations about a firm's prospects are reflected in its current stock price. Positive news might lead to additional price appreciation, but those unexpected changes are not predictable.

Figure 4: Average annualised outperformance of companies before and after they became one of the 10 largest in the US

Compared to Fama/French total US market research index 1927-2020



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