# Axiome Quarterly Update

April—June 2023

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Visit us at our office at 6 Victoria Rd, Devonport, Auckland 0624


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# Economic and Market Commentary

## Overview

**Markets climbed higher over the June quarter, led by the tech sector.**

Global equity markets bounced higher again in the June quarter. This was in part due to continued evidence of CPI inflation moderating, but mainly because larger cap tech stocks rallied on the prospect that they will see another surge in profitability as machine learning and related Artificial Intelligence algorithms are integrated into their core products and services.

### Market roundup

**Global equities had the strongest returns, whilst elsewhere performances were subdued.**

Market performances are reported in Figure 1. International shares rallied strongly by around 7.5% in the June quarter, but elsewhere performances were more subdued. Australian and Emerging Market equities and global listed property increased a little over 1%, NZ equities rose around 0.5%, while bonds were flat to slightly declining, as was global infrastructure.

Over the year to June, performances are very strong for most equity markets, with global equities in NZD terms leading the pack being up 22%. This gain more than offsets the decline over 2022. However, in part this reflects that the NZ dollar also plummeted over 2022, and has not bounced back nearly as much. On a local currency basis, global equities are still slightly below the peak levels they had at the end of 2021.

**Global equities are now back around the peaks reached in 2021, but NZ equities and bonds still have ground to make up.**

In contrast to global equites, NZ equities are still around 11% lower than their 2021 peak levels. Bonds have a similar amount of ground to recover given the large marked-to-market declines they suffered in 2022. The good news in this regard is that with running yields now around 6% for investment grade funds, and with inflation trending lower, we can reasonably expect this ground to be made up over the next year or two assuming that the macroeconomic picture evolves broadly in line with what is expected.

## Reading the tea leaves

**Central banks appear to be getting on top of inflation, but it is too early to declare victory just yet.**

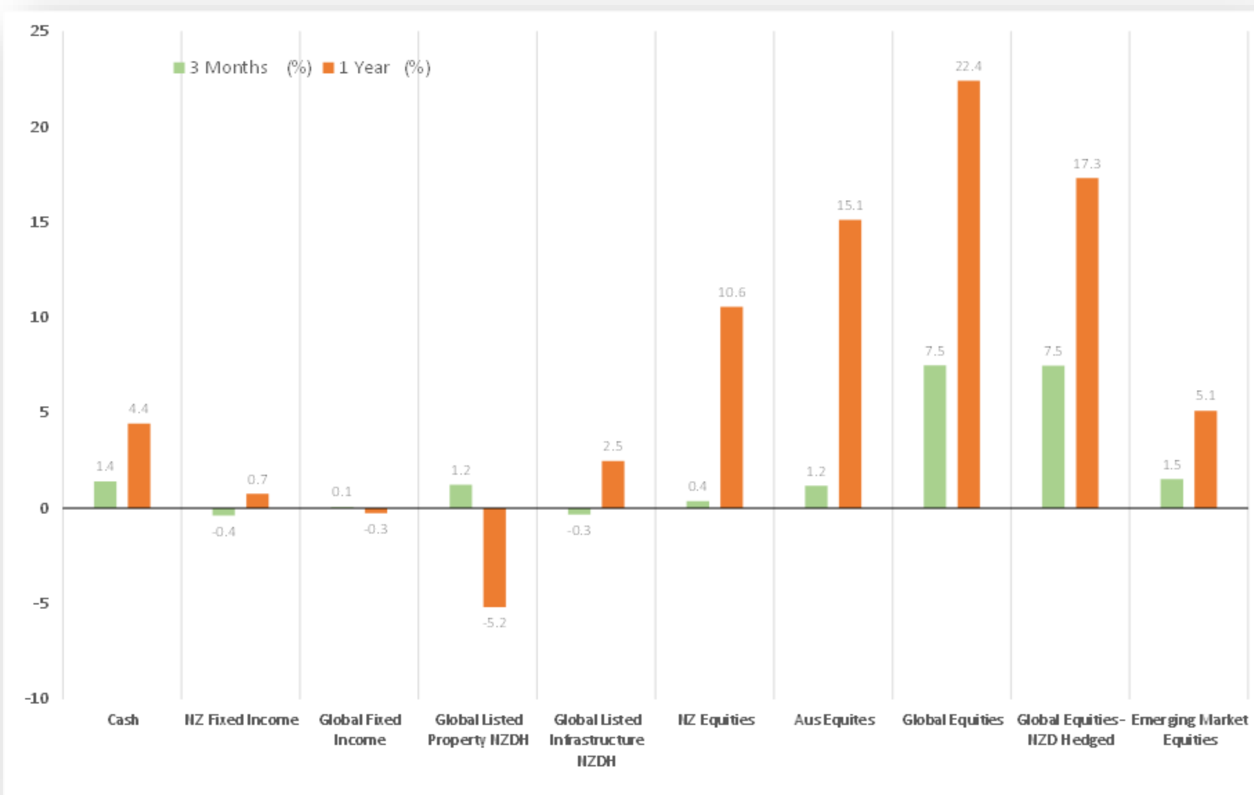
There is now little doubt that inflation rates and economic activity are declining both in New Zealand and globally. This is welcome news for central bankers trying to return CPI inflation back to their target levels, but cold comfort for almost everyone else. The key question remains have they done enough?

Bond markets seem to think so. Interest rate yield curves are inverted, meaning that short term interest rates are higher than expectations of future short term rates. This is shown in Figure 2 for New Zealand, which is expected to be amongst the first countries to start cutting. Interest rates in one year's time are expected to be around 0.5% lower, and in 5 years' time over 1% lower. But bond markets, like macroeconomists, are not great at forecasting. The chart also shows that the level of the curve has jumped up from its levels of just one month ago. This reflects that while inflation is coming down, core inflation rates (which excludes fuel and food which have volatile prices) are still too high for central banks to declare victory just yet, and hence interest rates may stay higher for longer. Time will tell.

**AI software advances are poised to unleash a surge in productivity.**

Global geopolitical risks around the Russian-Ukraine War, the tussle between the US and China, and now the divide between the so called

**Figure 1: Global equities performed well, other markets were more subdued**

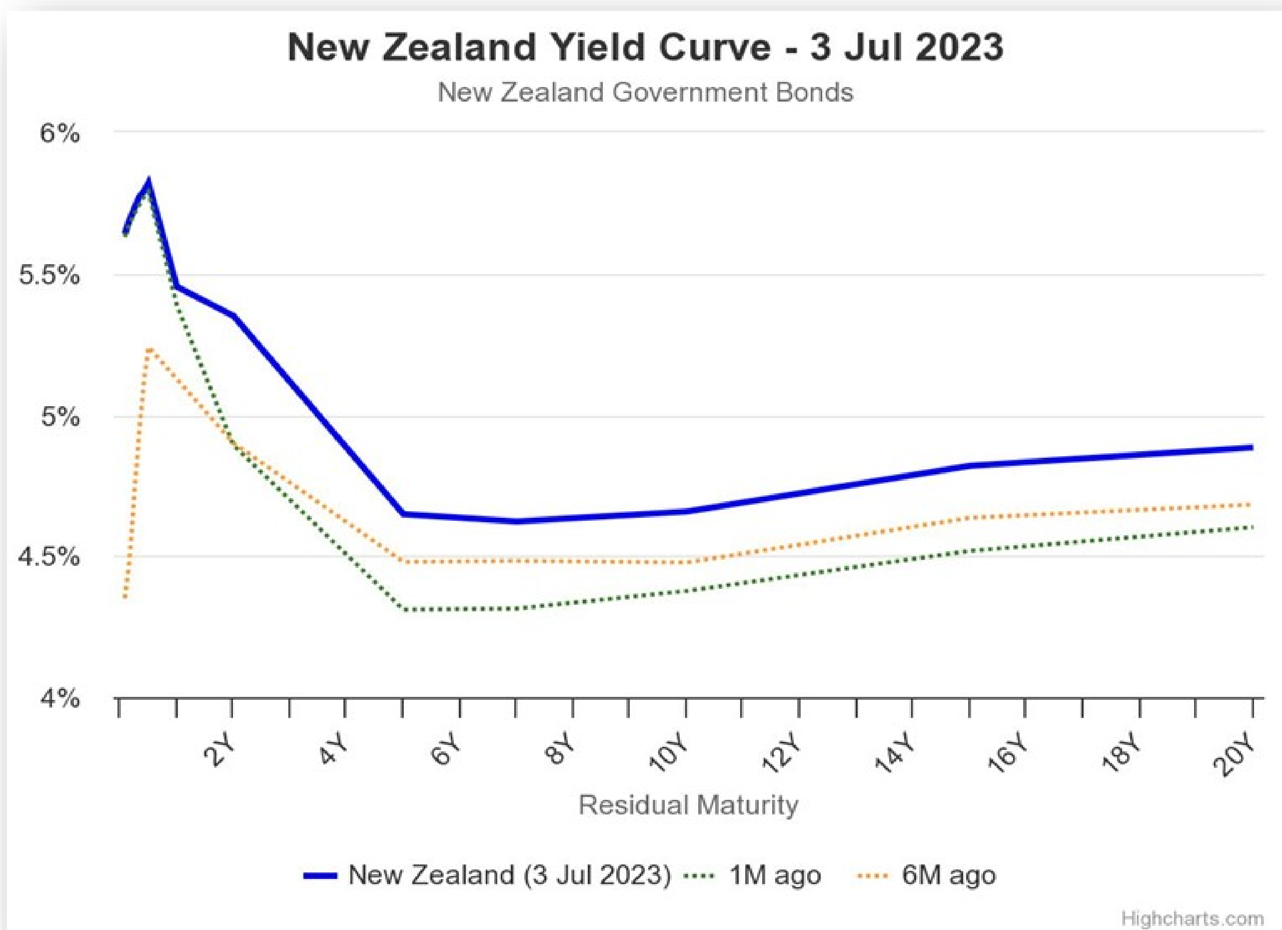



Source: Morningstar Direct, MyFiduciary

BRICS and the West remain on the radar. The increasing severity of extreme weather events as climate change gathers pace is adding to the burden of risk.

But to end on a potentially more positive note, the AI tools rolling out across a range of applications do present a large upside potential to economic growth and productivity levels, and in that sense the surge in selected tech stocks may not be all pie in the sky. Goldman Sachs estimates that AI could lift global GDP by 7% and productivity by 15% over the next decade – a simply enormous gain of more than double average annual global GDP growth. While we should treat these estimates with a healthy pinch of salt, it is also worth remembering that ultimately productivity is most of what propels livings standards and equity markets higher. As uncomfortable as they are at the time, interest rate cycles and most other 'shocks' just cause blips along the way.

**Figure 2: Bond markets think the RBNZ has done more than enough**




Source: Highcharts.com

# Key Market Movements for the Quarter

Quarter | Past Year

## New Zealand Shares

+0.4% | +10.6%

*New Zealand shares increased marginally over the quarter. Over the year to June, returns were around 10.5%, reflecting the rally off the low point reached in June last year.*

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

## New Zealand Fixed Interest

+0.4% | +2.0%

*New Zealand investment grade corporate bonds increased 0.4% in the quarter and 2.0% for the year ended March 2023. The positive annual result is a marked turnaround from prior negative results and reflects that interest rate increases made by the RBNZ are now likely to be priced in.*

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

## Australian Shares

+1.0% | +14.8%

*Australian shares increased around 1.0% in the quarter and 14.8% over the year to June in NZD terms. Australian value stocks have had a similar performance over the year, but small cap stocks have underperformed, returning around 8.5% over the year*.

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

## International Shares

+7.5% (+7.5% hedged) | +22.5% (17.3% hedged)

*International shares rallied strongly again over the quarter, by around 7.5% in both NZD terms and in NZD hedged terms. This brought the annual result to around 22.5% in NZD terms, implying global equities are now back to the level they were at in March 2022. Much of the recent rally has focused on larger cap tech stocks. As a consequence, value and small caps underperformed. Small caps returned 3.9% in the quarter and 16.7% over the year, while value stocks returned 3% in the quarter and 10.7% over the year.*

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

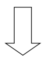
## Emerging Markets

+1.5% | +5.1%

*Emerging Markets also increased over the quarter by around 1.5% in NZD terms. On an annual basis, returns were around 5.1% in NZD terms, which was behind the returns of developed, NZ and Australian markets.*

*Source of Figures: MSCI Emerging Markets Index*

## International Fixed Interest

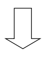


+0.1% | -0.3%

*Global investment grade bonds returned around 0.1% in the quarter, and ended the year to June slightly down by around 0.3%. With interest rates now back to more “normal” levels, interest rate risk is now much more evenly balanced, and bonds offer the prospect of solid returns given their high running yields of around 6%.*

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

## International Property and Infrastructure



+1.2% | -5.2%

*International property stocks increased by around 1.2% in the quarter in NZD hedged terms, while global infrastructure fell around -0.3%. Over the year infrastructure returned around 2.5%, and global property returned around -5.2% on an NZD hedged basis.*

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

# The Quality Factor

Along with exposure to small and value factors, in some funds we also have an exposure to the so-called "quality" factor. Below we outline what this factor is, why we choose to select for it, and our approach to capturing this factor.

**What is the quality factor and how does it contribute to investment returns?**

A listed company is judged to be high quality if some combination of its profitability, after tax cash-flows, balance sheet strength, earnings and dividend history, and governance are better than market averages. While there are a lot of ways of measuring these attributes, in essence a quality company is more likely to be profitable over an economic cycle, and less prone to suffer stress in a recession, than the 'average' company. As such sometimes the quality factor is also referred to as a profitability factor.

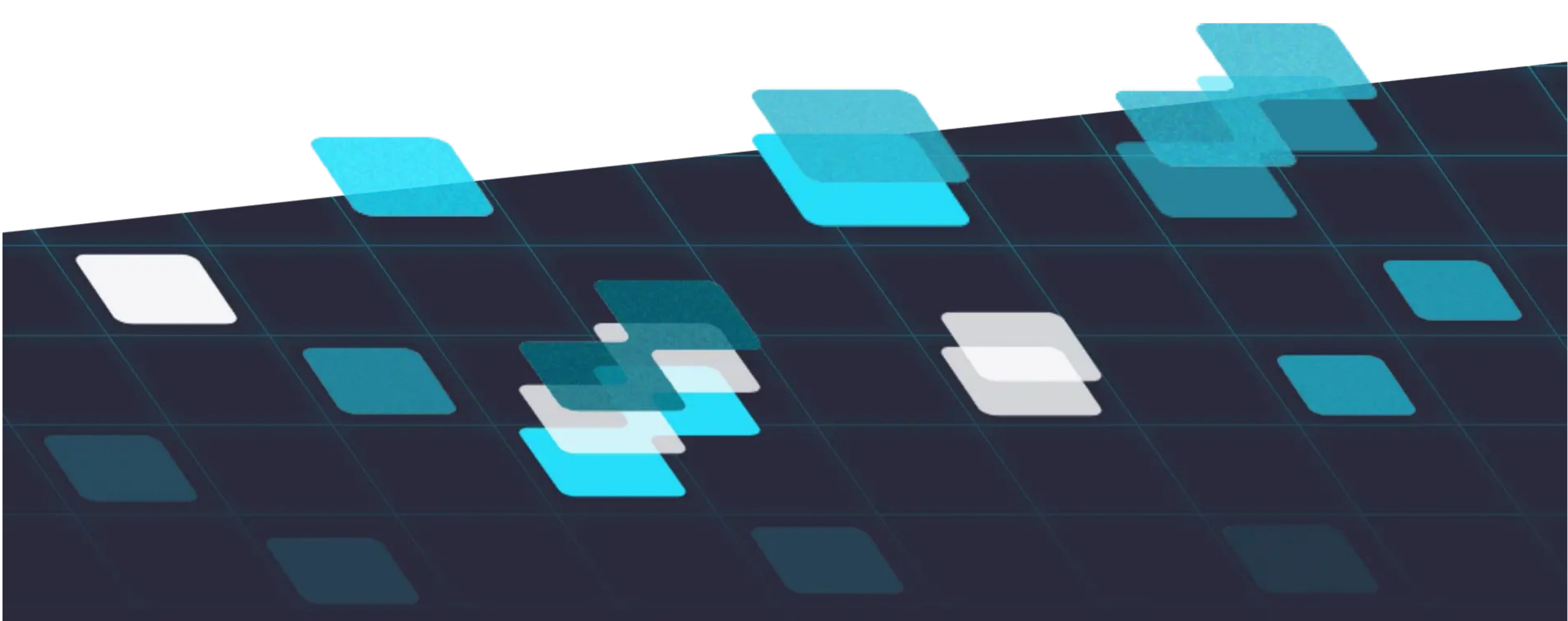
Investing in the quality factor relies on a belief that stocks that are more consistently profitable and resilient to adverse economic conditions are likely to outperform stocks that have less consistent profitability over time. This outperformance is more likely to be realised in stressed market conditions, which may help meaningfully reduce the size of losses an investor faces when equity markets decline.

**Why are we confident the quality factor will deliver a premium?**

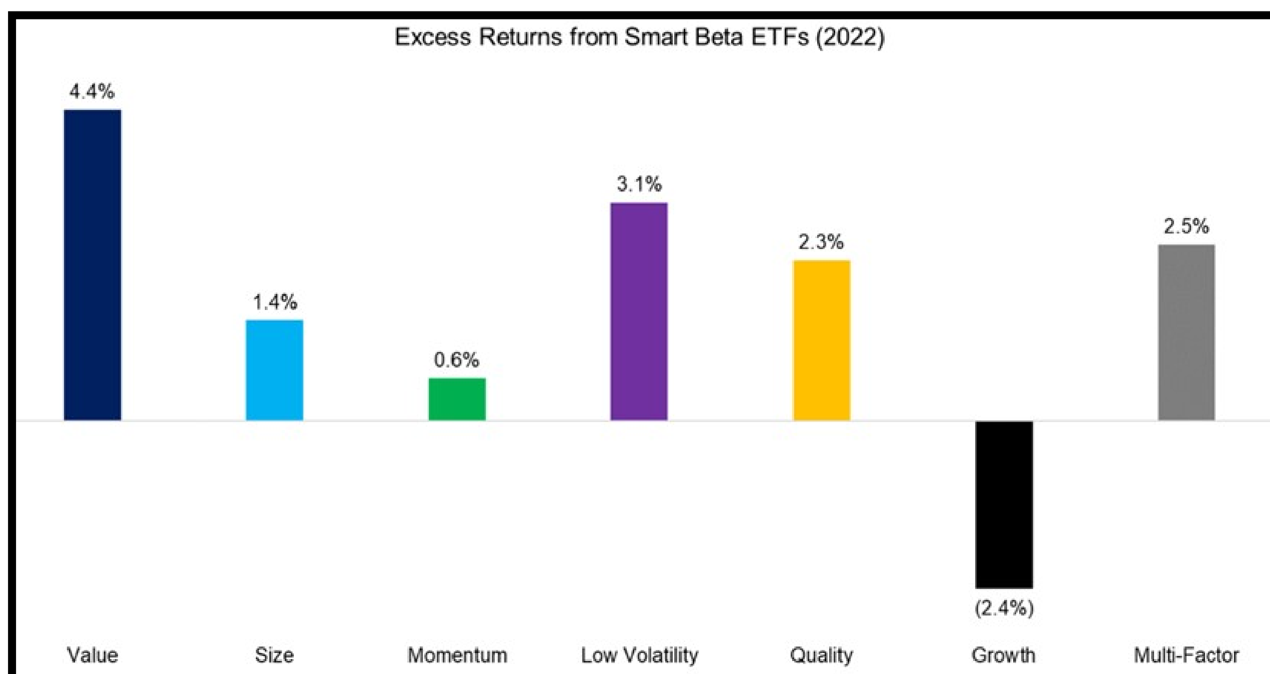
Intuitively it is reasonable to think that higher quality stocks should outperform lower quality stocks in times of stress. But given this, we might think this advantage is "priced in" and as such, no long-term premium or extra return from investing should exist from the quality factor. Academic studies, however, suggest this is not the case. Quality companies are estimated to outperform lower quality companies by around 1-3% per annum on average across global equity markets. In 2022, a study of quality ETFs found that they outperformed the market on average by 2.3%, in line with the longer term academic estimates. This is seen in the chart below, which also shows that value stocks handily outperformed over calendar 2022.

**How do we gain exposure to the quality factor?**

While we have no funds dedicated to capturing the quality factor in isolation in our portfolios, several equity funds include quality as a factor, alongside other factors that the manager targets. In particular, Dimensional Fund Advisors, whose funds are included in our clients' portfolios, includes the quality factor in its global core and small cap funds. This inclusion is consistent with a *multi-factor* approach to capturing factors,



which reduces the risk of any single factor not delivering in any given year. Over calendar 2022, when global equities fell around 11.5% in NZD terms, this was put to the test. Dimensional's Global Core and Global Small funds both outperformed global equities (MSCI World basis) by 3.7%, cushioning the large fall in markets.




**Source: Finomial**

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