Axiome Quarterly Update

October—December 2023

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

Economic and Market Commentary

Overview

Most asset classes performed well over the December quarter.

Markets reversed course – yet again – to rally strongly over the December quarter. Most asset classes enjoyed strong returns, including global and NZ equities, global and NZ fixed income, and listed property and infrastructure. Cash and short-term bonds also fared r elatively well given interest rate levels remain relatively high, as did select alternative asset classes.

The main factor behind the rally was a flip-flop on the view that interest rates need to remain high to reduce inflation to central bank target levels. Instead, as CPI inflation in the US and globally trended lower, markets priced in cuts over this year and a so-called 'soft landing' scenario – the reduction in inflation is no longer expected to be accompanied by global recessionary conditions.

Markets became more convinced that a global soft -landing scenario is the most likely outcome for the years ahead.

That said, the US economy has been a bright spot. New Zealand's most recent GDP release suggests our economy has been in mild recession over much of 2023. Chinese growth, while still positive, is at multi-decade lows and downside risks to their outlook remain given the massive debt levels that have been run-up to finance their residential and infrastructure spending. European growth has also been quite weak, with Germany also spending much of 2023 in mild recession. In part reflecting the differing macroeconomic conditions, the rally in equities was much stronger in US stocks than in most other markets.

Market roundup

Gains were strongest in US equites over the past year, in part reflecting the relative strength of the US economy.

Market performances are reported in Figure 1. All asset classes enjoyed positive returns in the quarter, with global property on an NZD hedged basis leading the pack (13% return) owing to listed commercial property bouncing back from quite depressed levels, and a rally of the NZD against the USD. NZ and global bonds also had very strong quarterly returns as long-term rate expectations fell, causing bond prices to rally. Short term credit and 'cash enhanced' funds benefited less from this 'marked-to-market' impact, but their annual returns have remained solid given their high current running yields.

Over the year to December international equities increased around 23%, more than offsetting their losses in 2022. Elsewhere, equity market performances were more subdued, with Australian equities returning around 13%, emerging markets (EMs) returning around 10%, and NZ equites returning only 3.5%. Our market's performance can be regarded as a 'reversion to the mean' – it is now performing in line with global equities over the past decade (around an 11% p.a. return) and is no longer regarded as over-valued compared to global markets. Over this longer time frame EM equites, however, remain in the doldrums with a decade return of only around 5.5%. They are cheap on conventional valuation metrics, but in our view are unlikely to recover the lost ground whilst various economic and political concerns remain with respect to China, which makes up around 40% of EM indexes.

The great re-set

Interest rates were slashed to historic lows in 2008/9 and remained at exceptionally low levels until late 2021.

Bloomberg terminals first flashed negative interest rates as central banks slashed rates to record lows in 2009 as the Global Financial Crisis (GFC) hit. In theory this should not ever happen – lenders should pay borrowers, rather than the other way around. Be that as it may, short and long-term interest rates remained at exceptionally low (even negative) levels all the way through to early 2021. In New Zealand, for example, the OCR averaged just over 2% from 2008 to 2019, and then was cut to near zero as the pandemic hit our shores in early 2020.

The key reason why rates stayed so low for so long was that central banks' main concern over much of the period was the risk of deflation (i.e. ongoing declines in prices and wages). Modern economies with high household, government and corporate debt levels are simply not equipped to deal with deflation. Deflation implies that the cost of servicing debt increases in real terms. As such, had global deflation set in we would have seen widespread debt defaults, bank failures, massive declines in housing and asset prices, and depressionary economic conditions potentially far worse than the 2008/9 GFC.

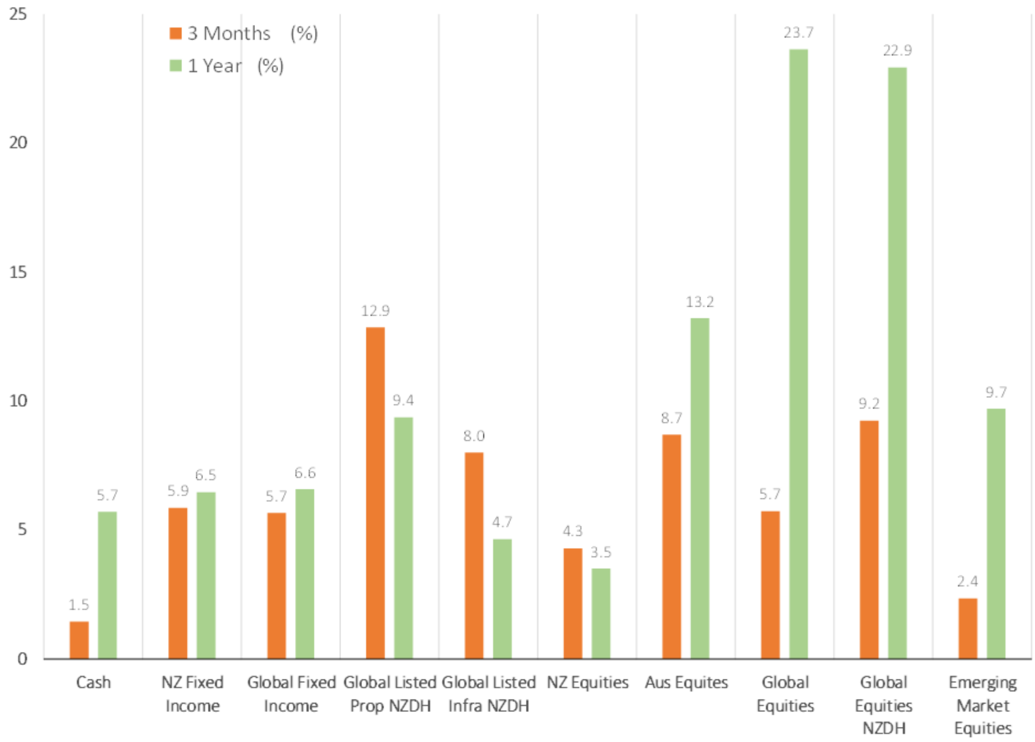

Figure 1:

Most asset classes rallied in the December quarter

Source: Morningstar Direct, MyFiduciary

Central banks believed until recently that the balance of inflation vs. deflationary risks favoured keeping rates low. It took CPI inflation surging past 5% to shift this view.

On the flip side of the coin, central banks do know how to deal with high inflation – they simply raise rates to curtail economic activity and wait for this to reduce inflationary pressures. As such, the balance of risks favoured rates remaining low long after the financial crisis in 2008/9.

Inflated asset prices are a direct consequence of having rates so low for so long.

One very real consequence of having rates so low for so long is that it inflated asset prices as markets and households came to believe that rates would more-or-less stay permanently low. In the event, they were wrong. Rate and rate expectations rose quickly over 2022 and into 2023 as inflation surged past 5%. This caused the large marked-to-market bond losses in 2022, and the associated re-pricing of bonds to levels that deliver more 'normal' yields of 5% or more (see figure 2 for US 10-year bond yields).

Equities (at least outside of the large cap tech stocks) and other listed asset classes such as infrastructure and property have also largely re-set to the higher interest rate levels. The good news inherent in this is that we no longer have the risk of large rate rises hanging as a cloud over asset prices. In addition, we no longer need to rely as much on capital gains – which are always uncertain over the short-term – to deliver an acceptable total return in a portfolio now that bond and dividend yields are at higher levels.

The increase in rates since 2022 has re-set asset prices, with the notable exception of residential property which may take a long time to adjust to more 'rational' levels.

Does this mean the great re-set is over? Not completely. Perhaps the main exception is residential property, where the 'maths' still doesn't add up for the property investor in New Zealand (and many other countries). One would need to believe in large ongoing capital gains (and associated further increases in house price-to-income levels) to justify today's price levels given net cash flow yields are very low, even if we factor in the re-introduction of mortgage interest rate deductibility. Could a long-term stagnation in house prices, as happened in Japan when its bubble burst in the early 1990s, be the enduring legacy of the low interest rate period?

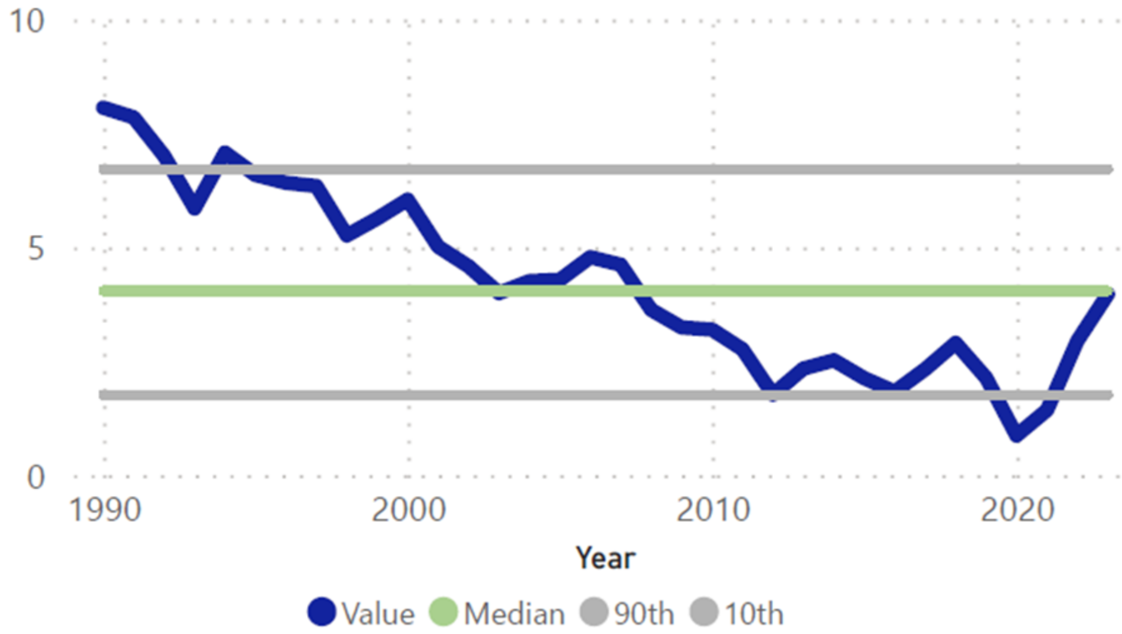

Figure 2:

US 10-year bond yields – the great re-set

Source: MyFiduciary

Key Market Movements for the Quarter

Quarter	Past Year	
+4.3%	+3.5%	**New Zealand Shares** *New Zealand shares increased 4.3% over the quarter, and 3.5% over calendar 2023. This is a soft result compared to offshore equities, but our market remains a top performer over the last decade with a return of 10.6% per annum.* *Source of Figures: S&P/NZX 50 Total Return Index with Imputation Credits*
+5.0%	+7.5%	**New Zealand Fixed Interest** *New Zealand investment grade corporate bonds increased 5% in the quarter as longer-term rates fell on the back of NZ GDP coming in much weaker than expected. The annual return was around 7.5%, well ahead of prevailing cash rates.* *Source of Figures: S&P/NZX Investment Grade Corporate Bond Index*
+8.8%	+13.0%	**Australian Shares** *Australian shares rose 8.8% in the quarter, lifting the annual return to a very solid 13%. Australian value and small cap stocks had similar quarterly performances, while value outperformed over the year and small caps under-performed.* *Source of Figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries*
+5.7% (+9.2% hedged)	+23.7% (+22.9% hedged)	**International Shares** *International shares also rallied over the quarter, by around 5.7% in NZD terms and 9.2% in NZD hedged terms. This brought the annual results to around 23.7% in NZD terms, while NZD hedged returns were around 23% over calendar 2023. Small caps returned 6.7% in the quarter and 15.6% over the year, while value stocks returned 2.4% in the quarter and 9.7% over the year. The under-performance of small and value in part reflects that the largest gains in the December quarter were from large cap US tech stocks, with the broader market lagging.* *Source of Figures: MSCI World Index; Morningstar Developed Markets NZD hedged, MSCI World Value MSCI World Small Cap in NZD terms.*
+2.4%	+9.7%	**Emerging Markets** *Emerging Markets rose by around 2.4% over the quarter and a respectable 9.7% over the year to December in NZD terms. Although this was less than developed markets overall, it was consistent with global shares if we exclude large cap US growth stocks.* *Source of Figures: MSCI Emerging Markets Index*
+5.7%	+6.6%	**International Fixed Interest** *Global investment grade bonds rose by around 5.7% in the quarter as markets increased their conviction that rates will be cut over 2024. This boosted the annual return to 6.6%, slightly above the current running yields on global bonds (which are around 6%).* *Source of Figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)*
+12.9%	+9.4%	**International Property and Infrastructure** *International property stocks rose by around 13% in the quarter in NZD hedged terms (6.8% unhedged), while global infrastructure increased around 8% on a NZD hedged basis (3.2% unhedged). Over the year, infrastructure increased around 5% and global property 9.4% on a NZD hedged basis.* Source of Figures: FTSE EPRA NAREIT NZD, FTSE Dvlp Core Infra 50/50 TR NZD

Swan spotting in the 2024 crystal ball

As we start a new year there is a natural tendency to look both back and forward. Back on the events of the last year and forward to what we imagine the coming year to hold. There is a natural assumption that we have reached a transition point with the new year. Of course, this is entirely arbitrary, events are always unfolding in real time and what happens in one 12-month block has no automatic bearing on what happens in the next. But little things like reality are no roadblocks to professional forecasters who are particularly prevalent this time of year.

At the start of 2023 analysts predicted everything from an "unavoidable hard economic landing" to a "surprise in the resiliency of the global economy" and all scenarios in between. If there was anything close to a consensus opinion, it was the increasing risk of a global recession.

Looking back at 2023 some of the major headlines included:

- Central banks scaling back interest rate rises as inflation eased.
- A regional bank crisis in the United States.
- The World Health Organisation declaring an official end to the pandemic.
- A new conflict in the Middle East after Hamas attacked Israel civilians.

However, as if to confound many forecasters, World Markets performed very strongly in 2023 with every sector finishing in the green and many strongly so, with International Shares in particular rallying strongly over the last quarter to finish the year up 23.7%.

So what does this mean for 2024? While the onslaught of forecasts over the coming months predicting what will happen with unemployment, inflation, interest rates, economic growth are interesting (and often entertaining) they are not a basis from which we can build an investment strategy.

A Black Swan in finance is an unpredictable event that is beyond what is normally expected in a situation and has potentially severe consequences.

So what can we do? We know that the average equity risk premium (excess return of shares over fixed interest) for the last few decades has been around 6%. This does not happen in a linear fashion and there will be both good and bad years for your portfolio. Those returns are only achievable for diversified and disciplined long-term investors who count on human innovation to help solve many of life's big challenges such as biomedical breakthroughs, the energy transition or the alleviation of global poverty. By staying away from attempting to time the market and instead being a long-term investor will allow you to have the best opportunity to share in the wealth created by that innovation.

Figure 3 below illustrates the impact that being out of the market even for a short time can have on your portfolio. Let us take a theoretical $1,000 invested in the Russell 3000 Index, a broad US stock market benchmark from January 1998. After 25 years on 31 December 2022 that initial investment would be worth $6,356. Over that time if you had missed the best performing week of the Russell 3000 (24th to 28th November 2008) your investment would now only be worth $5,304. If you were particularly unlucky and missed the best three months your total return would be $4,480.

As investors we have no proven way of timing the market by withdrawing our money at the market peak and reinvesting when the market bottoms. Evidence suggests that the best course of action is to stay put through both the good and bad times. Tune out the noise of the day to day market volatility and focus on your long term financial goals.

In 2024 there will be many things that will be out of our control. Fear of the unknown can leave investors on the sidelines. However, the advantage of having a financial plan is that it gives you have a guiding structure to help you both weather financial volatility and reap the benefits of the finest aspects of human innovation.

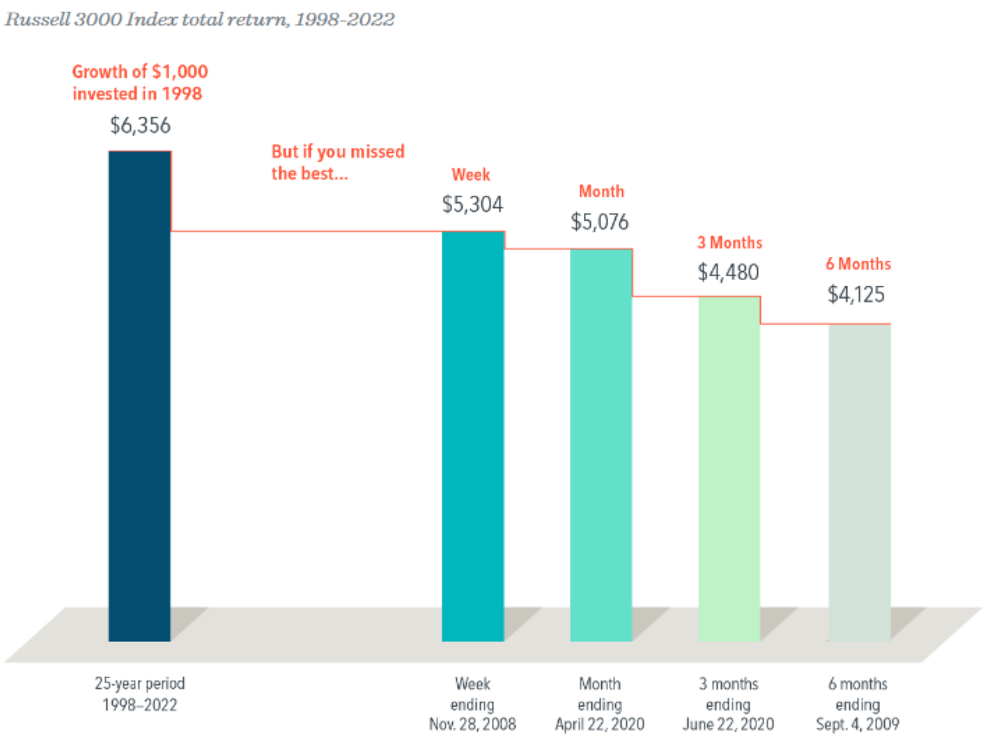

Figure 3:

The perils of sitting on the sidelines swan spotting

Past performance, including hypothetical performance, is not a guarantee of future results.

Source: Dimensional Fund Advisers LP

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Phone: 09 445 2134 Email: info@axiome.co.nz