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ECONOMIC & MARKET COMMENTARY

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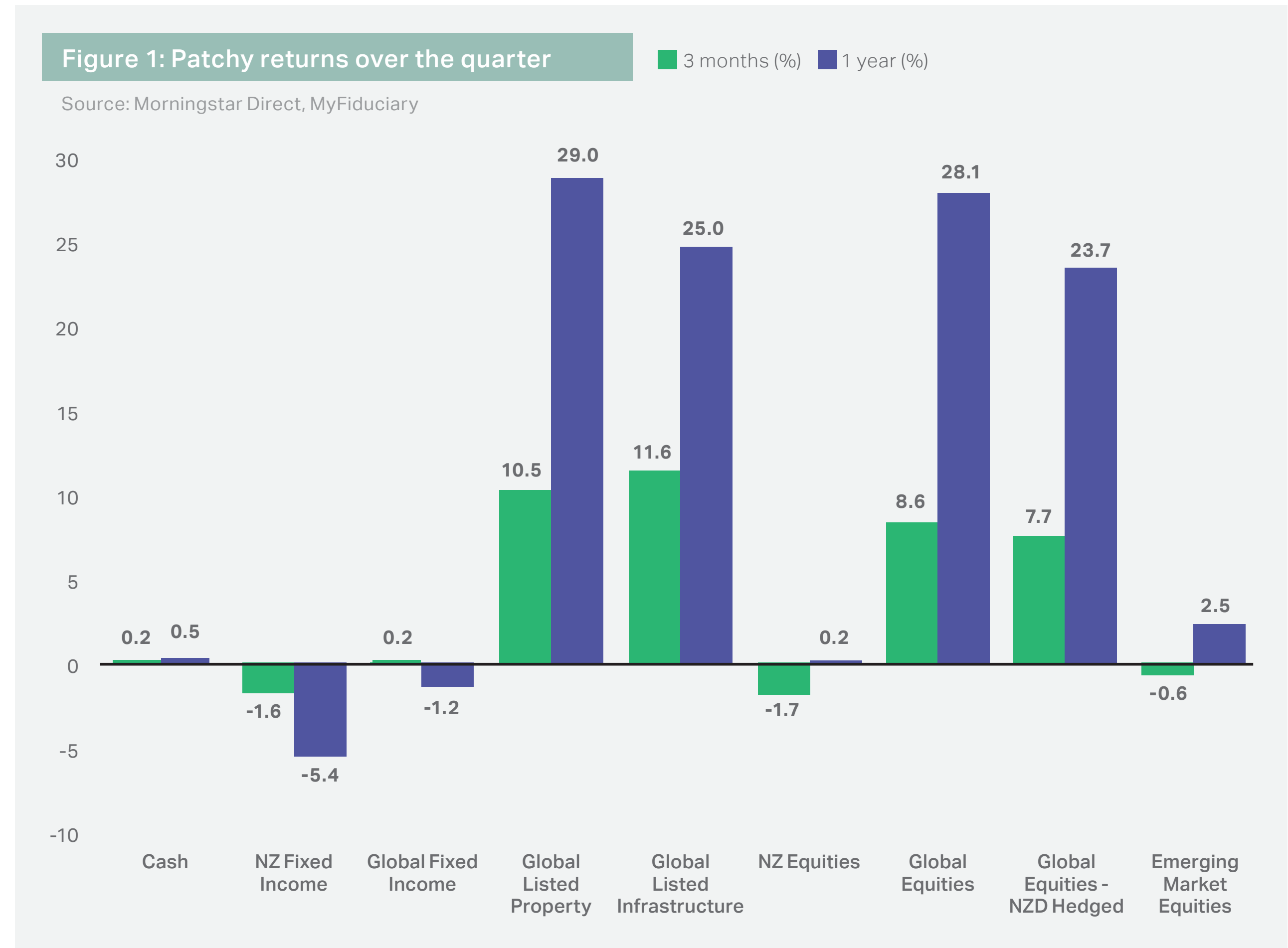


Market performances

Performances were mixed over the quarter given different economic conditions and risks..

Market performances were mixed in the December quarter. Bonds again performed poorly, and New Zealand equities couldn't repeat their September quarter strength. Emerging market equities treaded water, while developed large cap equities performed well. At the other end of the spectrum property and infrastructure enjoyed exceptionally strong returns.

The performance differences reflected cross-currents in macroeconomic conditions and country or sector specific factors. Rising inflation and the prospect of central banks increasing interest rates weighed down fixed income but led strong support to "real asset" classes such as listed infrastructure and property. Developed market equities were propelled by solid corporate earnings and (still) strong growth conditions, while Emerging Market equities were held back by lingering concerns around Chinese risks.

Market roundup

Global equities marched higher...

Developed market equities climbed further over the December quarter, by around 8.5% in NZD terms. This resulted in an annual return of 28%, while NZD hedged shares increased around 24% (see Figure 1). Within global equities, higher risk small caps had a weaker annual return (18.5%) while value stocks performed in line with the market.

...while Emerging Markets fell and Australian stocks rebounded..

Emerging Markets had a softer quarter, falling by around 0.5%. This reflected ongoing geo-political tension with China and concerns around the surprisingly heavy-handed approach that the Chinese authorities have taken to reign in "excess profits" in its tech sector and related listed companies such as 'Alibaba' and 'Tencent'. That said, Chinese growth has remained relatively firm and concerns around property developer, Evergrande's, failure severely denting this, have dissipated. Australian equities reflected this diminished risk, increasing around 3.7% in the quarter and have returned 17% over the year.

As mentioned above, International Infrastructure and Property stocks had a very strong quarter. International Property rose 10.5% in the quarter and around 30% for calendar 2022. International infrastructure returned around 11.5% in the quarter and 25% over the year. Both of these asset classes have in part benefited from rising inflation and inflation risks, as they are expected to be relatively resilient to a higher inflation environment.

Listed Property and Infrastructure had a standout performance..

On the flip-side, bonds are less resilient to rising inflation and interest rates. As a consequence, New Zealand investment grade (IG) bonds fell 1.4% in the quarter and 4.2% over the year. International IG bonds fared a little better, being flat in the quarter and falling around 1.4% over the year. Finally, NZ Cash fared better still, increasing by around 0.5% over the year.

Outlook for the years ahead

Fixed income returns were generally poor as markets priced-in higher interest rate levels, but short term bonds funds out-performed.

We do not have a crystal ball to predict what will happen to markets in the months ahead – nobody does of course. But we have recently updated our long-term asset class expected return forecasts, in which we take into consideration the very strong run in growth asset classes over the past 5 years and more, and the exit we are now seeing from ultra-supportive monetary policy and interest rate levels.

The RBNZ expects NZ's economic performance to remain robust despite the COVID restrictions.

A summary of our numbers is provided (see figure 2), alongside a forecast range from industry "experts" including global asset managers, investment organisations and consultants. Key points are that:

- We expect lower long-term returns from most asset classes than we have seen over the past decade, in line with our previous commentary.
- We expect to see cash rates continue to lift towards levels that are higher than today but still quite moderate compared to longer-term history. This lift should provide some relief to savers relying on the income streams from their portfolios.
- We expect to see equities and other growth assets offer a premium (higher return) than cash over the long term. This is in line with the majority of experts and long-term financial history which suggests it is both rare and fleeting to see equity markets (across most countries) under-performing cash over two or three decade horizons.
- We expect bonds to only offer a very modest excess return to cash, and there is a chance that this may be negative over a more medium-term time horizon. This reflects that while we think cash rates should and will head higher over the next few years or so, markets are yet to fully factor this into bond prices. For this reason, your portfolios have materially reduced their exposure to bond funds with relatively "standard" maturity terms (or duration) to bonds and related instruments with relatively short duration.
- We expect reasonable returns from listed property and infrastructure.

Figure 2: Expected long term returns

Source: Morningstar Direct, MyFiduciary

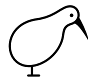
Asset Class	Expected long-term return	Industry average	Industry low	Industry high
NZ Cash	3.5%	n.a	n.a	n.a
NZ Bonds	4.0%	n.a	n.a	n.a
Global Bonds	3.7%	3.3%	3.0%	4.9%
NZ equities	7.4%	6.8%	5.5%	8.0%
Australian equities	7.6%	7.1%	6.1%	7.7%
Global equities hedged	7.5%	6.9%	5.6%	8.3%
Emerging market equities	9.2%	8.0%	6.9%	10.1%
Global listed property	6.2%	6.2%	4.7%	6.5%
Global listed infrastructure	6.2%	6.5%	6.3%	8.3%

In summary, as always, we can point to a laundry list of risks that may present challenges to markets at some stage: the ongoing pandemic, supply-chain issues, rising inflation and interest rates, geo-political tensions between the Western nations, China and Russia, huge national debt levels, over-priced housing markets, etc. We can also point to the fact that global growth has remained robust through the stops-and-starts to activity and should the current Omicron wave mark an end to the pandemic, growth should bounce higher still.

Through the ups and downs, we are confident that your portfolios are well-designed to manage inflation and other risks, and that they will continue to offer a better return than cash over the medium to longer term.

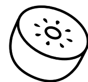
HOW THE MARKETS FARED

All returns are expressed in NZD. We assume Australian Shares and International Property are invested on an unhedged basis, and therefore returns from these sectors are susceptible to movement in the value of the NZD.



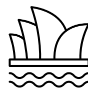
QTRLY RETURN − 1.7%
PAST YEAR + 0.2%

New Zealand Shares: New Zealand shares had a soft quarter, falling 1.7%. This meant a fairly flat return for calendar 2022, although our market's 5 year performance remained very strong with an annual average return of around 15% over the period.
Source of Figures: S&P/NZX 50 Total Return Index with Imputation Credits



QTRLY RETURN − 1.6%
PAST YEAR − 5.4%

New Zealand Fixed Interest: New Zealand investment grade corporate bonds fell around 1.6% in the quarter and returned around -5.4% for the year ended December 2021. The soft result reflected NZ markets pricing in materially higher interest rates and inflation, which causes bonds to suffer a short-term capital loss. Source of Figures: S&P/NZX Investment Grade Corporate Bond Index

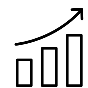


QTRLY RETURN + 3.7%
PAST YEAR + 16.5%

Australian Shares: Australian shares finished the year strongly, returning 3.7% in the quarter. This brought the annual result to around 16.5%. Within Australian equities, small cap stocks performed in-line with the market, while value stocks out-performed in 2022, returning around 18.7% in NZD terms.
Source of Figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries

QTRLY RETURN + 8.6% (7.7% hedged)
PAST YEAR + 28.1% (23.7% hedged)

International Shares: International shares had a very strong finish to 2022. They rose 8.6% in the quarter in NZD terms, whilst NZD hedged shares increased around 7.7%. Annual results were similarly strong, with unhedged returns out-performing, given the decline in the kiwi vs. the US dollar over the year. Within global equities, higher risk small caps had a weaker annual return (18.5%) while value stocks performed in line with the market.
Source of Figures: MSCI World Index; Morningstar Developed Markets NZD hedged, MSCI World Value MSCI World Small Cap in NZD terms.



QTRLY RETURN − 0.6%
PAST YEAR + 2.5%

Emerging Markets: Following a poor September quarter, Emerging Market equities had another soft quarter given lingering concerns around Chinese growth and risks. This reduced the annual return to a relatively low figure of 2.5%. Source of Figures: MSCI Emerging Markets Index

QTRLY RETURN + 0.2%
PAST YEAR − 1.2%

International Fixed Interest: Global investment grade bonds increased 0.2% in the quarter and fell around -1.2% for calendar 2022. 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 increasing global growth and inflation expectations. Source of Figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)

QTRLY RETURN + 10.5%
PAST YEAR + 29.0%

International Property and Infrastructure: International property stocks increased 10.5% in the quarter and around 29% for the year. International infrastructure also enjoyed a strong end of year bounce, returning around 11.5% over the quarter and 25% over the year. Both of these asset classes have benefited from rising inflation risks as they are expected to be relatively resilient to a higher inflation environment.
Source of Figures: FTSE EPRA NAREIT NZD Hedged, FTSE Dvlp Core Infrastructure TR USD

OUT OF THE SHADOWS

Inflation makes its presence felt

Inflation. It's a word and an issue that has been "out of sight, therefore out of mind" for many economies, and therefore many people, over the past decade. It's now firmly back on the agenda. Why? And what implications does this have for investors?

What is inflation?

When inflation is talked about people are usually referring to general inflation – when the prices for just about everything go up at the same time.

Inflation in an economy is measured by adding up the prices of thousands of goods and services and comparing them to the prices for the same items in a previous period.

Economists argue about what causes inflation. The traditional view is that it is caused by governments printing too much money. It can also become an issue when there are constraints to the availability of resources, goods or services. Either way it is a warning about imbalances in an economy.

Why does it matter?

It is problematic for a number of reasons.

- If things are costing more but you have only a fixed amount of money it means that the value of your money (what you can buy) is declining.
- This changes behaviours. People may be inclined to spend more, now, knowing that if they delay then the money will not be enough to make the selected purchase at a later date. This increased motivation to spend can fuel further inflation.

What has happened in New Zealand?

New Zealand's Reserve Bank expected the COVID-19 pandemic to create a recession by restricting growth opportunities (restrictions to trade and migration, no inbound tourism etc.).

To counteract expectations, it pushed a lot of money into the economy through mechanisms including infrastructure spending and providing support such as wage subsidies over lockdown periods.

However, while major impacts were felt, some businesses and sectors proved more resilient than anticipated and got back to growth mode more quickly than expected.

The lockdowns also stopped people who had savings from spending money travelling overseas. They redirected that spending locally. Unemployment rates are at historically low levels.

New Zealand has also had problems importing many items (such as building materials and electronic goods). In some ways New Zealand stopped being part of the international shopping market because of shipping delays.

More money was chasing fewer goods – a classic inflation recipe. And, for the first time in a long time, retailers could put prices up knowing that no one could easily import an alternative on-line.

The consequence?

Inflation is out of the shadows, and there is concern it is out and running.

Last year began with annual inflation of 1.5 per cent, but by June it hit a nearly 10-year high of 3.3 per cent, rising to 4.9 per cent three months later.

ASB Economist, Nathaniel Keall, has said there are signs inflation was at least 6 per cent in the December quarter. (Stats NZ will release new data on January 27).

What can be done about it?

From a government perspective, there are two generally accepted ways to tackle inflation.

1 Stop pushing new money into the economy.

2. Constrain consumer spending by raising interest rates. This makes holding cash more attractive and dampens demand.

Both actions can also slow economic activity. Done too strenuously, they can throw an economy into recession.

But action is forecast. Our government contracts the Reserve Bank to keep inflation under control. Economists in New Zealand expect the Reserve Bank to lift the official cash rate (OCR) over the year by about 150 basis points to 2.25 per cent, from the current level of 0.75 per cent. That's a big change, particularly for people unused to higher rates (such as those new to carrying high levels of debt that will be more expensive to service).

What does this mean for an investor?

Inflation can be destructive. It undermines confidence. Remember the story of the person in Zimbabwe who rushed from being paid at work to buy bread before their wages were not sufficient to afford the bread? We are nowhere near approaching that (hyper-inflation) scenario, but:

- To keep pace with inflation, the value of your money needs to increase at these same rates as general inflation just for you to stay in the same financial position. Maybe you would like to do better than that.
- This is very hard because income tax is paid on your total return on investment and no allowance is made for the fact that the value is being eroded. So, if you receive interest of 3% and are taxed at 33% then your return after tax is 2%. Applying the September inflation figure of 4.9% and your true return (after inflation) is negative 2.9%. With conventional investment techniques it is very hard to keep ahead of this.

There are strategies to consider, however.

For example, real assets like businesses (particularly well provisioned, well run and well positioned businesses) and property tend to hold their value over the long term. That can include through inflationary times.

As agreed by most commentators, with inflation out of the shadows, the investment landscape will likely look very different over the next two to four years to how it has looked over the recent past. It is therefore a very good time for investors to talk to their financial adviser and at least take stock of their finances to ensure they are best placed to navigate this challenging environment.

REDISCOVERING OUR BACKYARD

With COVID still making overseas travel uncertain or difficult, Kiwis continue to visit the incredible locations around Aotearoa. In this issue, we review places within our beautiful country, in the hope that you will discover them for yourself.

BIKING THE OTAGO RAILS

Written by Phil Ashton

Whilst we have been keen bikers for a long time, we had never biked NZ's oldest and most iconic bike trail that began its life in February 2000.

Prior to that it was a disused rail track that ran from Clyde to Middlemarch in Central Otago. By chance, when we had come off the trail and were dining with friends on the Octagon, in Dunedin, we met the foreman of the team that ripped up those rails and sleepers. Even then there was a sense of sadness that a vital piece of history was being desecrated.

The now bike trail can be approached from the East or West between Clyde and Middlemarch, with most tackling the 150km trail starting in Clyde as it offers a slight downhill advantage and usually a following wind. Pedallers and E-bikers will get through it with minimum training as long as an element of fitness pervades.

Those of you who know Central Otago will be familiar with the easy rolling countryside, the harsh dry climate and stunning rock formations that litter the landscape. Given it is a converted rail track, the gradients are easy, yes, for certain, there are some endless straight sections of track but these are well-overshadowed by the weaving nature of other sections, the high girders, and numerous tunnels that one encounters.

We were a group of nine. Two pedallers and seven E-bikers. Ages ranged from late 70s down to early 40s. We all comfortably completed the trail in the designated three and a half days and that included the birthday girl's mother who had barely bestrode any cycle at all until then.

This is luxury biking, typically 40km per day, frequent stops for coffee, to read the information boards and signs, and to partake of lunch. Overnight dinner and accommodation is offered by various providers and for different levels of comfort and different quality of meals. Needless to say all bikers would be well-catered for. Allow three overnight stops in your planning, bike pants add additional comfort but are not essential, bikes are hired, as are helmets, and your overnight luggage is ferried through to await your arrival. The bikes are designed to carry all your day-wear, water bottles and any nibbles and fruit you want to accompany you.

Otago is a gorgeous part of our country and the Rail Trail is one extraordinary way to see it.

Rutherford Rede Limited
91 College Hill, Ponsonby, Auckland, New Zealand
PO Box 147246

+64 9 361 3670

rutherfordrede.co.nz

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