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ECONOMIC & MARKET COMMENTARY

SEPTEMBER QUARTER 2022

Overview

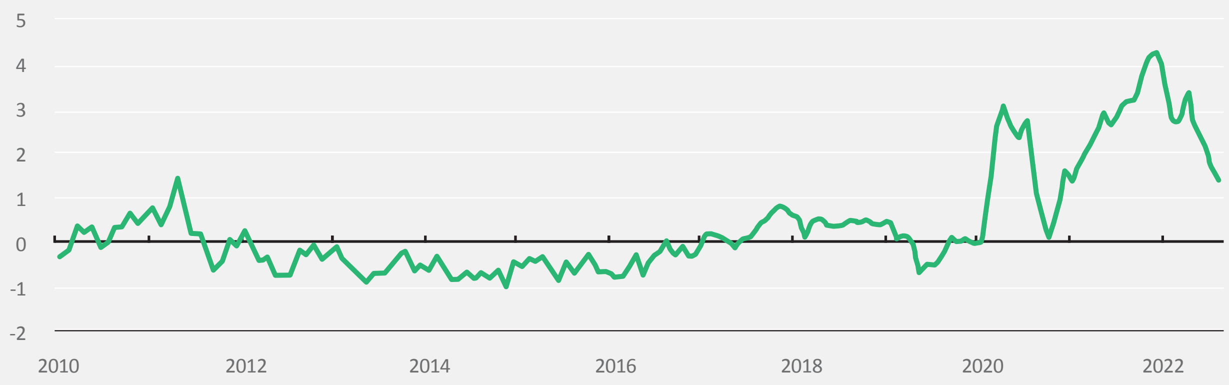
Markets experienced further turmoil over the quarter, with large declines in currencies versus the US dollar.

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 tightening of monetary policy and communication 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.

A particular feature over the quarter was very large currency market swings, with the US dollar approaching record highs on its 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.

Figure 1: Global supply side pressures continue to fall

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.



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

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

We reiterate our previous commentary that the economic picture remains very complex, 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 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 to weaker inflation outcomes, and it is encouraging in this regard that global supply-chain pressures continue to moderate (figure 1), which will very likely flow through to declines in headline CPI inflation rates over the next year.

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 re-taking of its territory in Eastern Ukraine.

Market roundup

Equity market performances were mixed. NZ, Australian and unhedged global equities increased while NZD hedged and EM equities fell.

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%. Further on in *Insights* is 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 up around 2% in NZD terms. Emerging Markets under-performed in the quarter, falling by around 3% in NZD terms. On an annual basis returns were -12.3% in NZD terms, ahead of the performance of NZ markets, but behind that of developed markets on an unhedged basis.

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

Bond 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%.

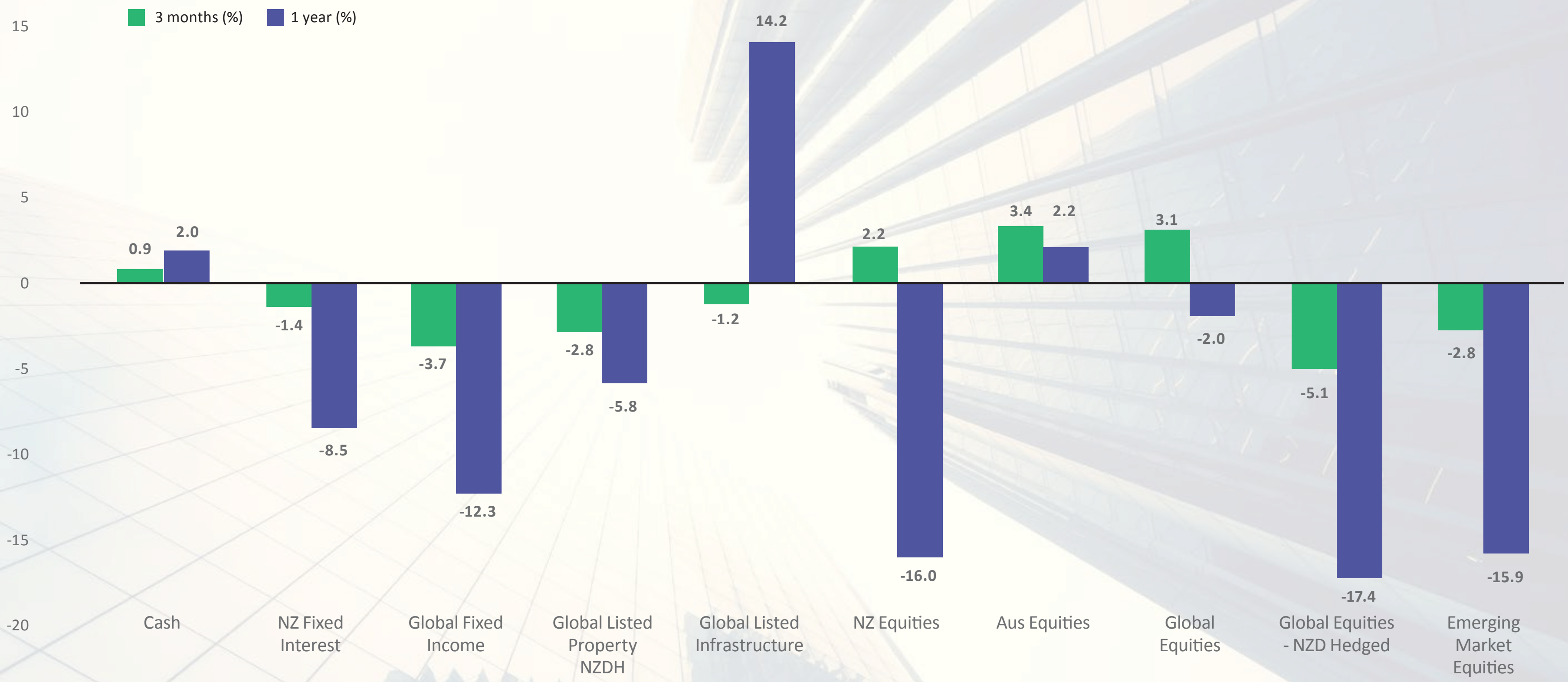
Over the year to September, international investment-grade bonds declined over 12% – the worst result since 1842 if the records are to be believed! As mentioned, the silver lining is now that their cash yields are back to around 'normal' pre-GFC levels. This means we can expect bonds to play their traditional diversification role should inflation and growth outturns 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.

As featured in our last update, international infrastructure is expected to be more resilient to inflation risks, and this has been the case over the past year. It increased around 2% in the quarter and 17% over the year to June in NZD terms. Global listed property returned around -3% in NZD terms over the year, also a relatively strong result in the context of the large declines in global equities and bonds.

Figure 2: Infrastructure again offered the highest returns over the year

Source: Morningstar Direct, MyFiduciary



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 + 2.2%
PAST YEAR - 16.0%

New Zealand Shares: 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.

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

QTRLY RETURN - 1.0%
PAST YEAR - 6.6%

New Zealand Fixed Interest: New Zealand investment grade corporate bonds fell around 1% in the quarter and returned around -6.6% 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.

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

QTRLY RETURN + 3.4%
PAST YEAR + 2.2%

Australian Shares: 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 returned around 8% per annum, in-line with the NZ market outcome.

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

QTRLY RETURN + 3.1% (-5.1% hedged)
PAST YEAR - 2.0% (-17.4% hedged)

International Shares: 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.

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

QTRLY RETURN - 2.8%
PAST YEAR - 12.3%

Emerging Markets: Emerging Markets under-performed 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.

Source of figures: MSCI Emerging Markets Index

QTRLY RETURN - 3.7%
PAST YEAR - 12.3%

International Fixed Interest: 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 re-priced 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 reasonable levels, at around 4-5%.

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

QTRLY RETURN - 1.2%
PAST YEAR + 14.0%

International Property and Infrastructure: 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.

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

In investing, what is comfortable is rarely profitable. Robert Arnott

Q&A WITH CRAIG OFFWOOD

We would like to introduce you to Craig Offwood who joined the Rutherford Rede team as an adviser in August this year.

Where did you grow up and what have you done with your career?

I was born in Rarotonga, Cook Islands, in the late 1960's, when my father was the country manager there for the Union Steam Ship Company. If you've ever dined at the Tamarind Restaurant in Rarotonga, that is the old USSCo home where we lived. The next posting took the family to Apia, Western Samoa for 3 years, before we settled in Wellington for 10 years. I started my secondary schooling at Wellington College, but after 2 years Dad was shifted to Auckland for work, so my fifth and sixth form years were completed at Westlake Boys High School.

When I left school, I immediately got a job with the National Bank working initially at the Takapuna branch before being transferred to the Birkenhead branch. Then after a little more than 3 years I headed to the UK and Europe on my Big OE with my brother. I was away for around 18 months, covering a good part of Europe and parts of the USA. It was exciting times – I happened to be in the north of West Germany (as it was known at the time) when the Cold War started to come to an end, with the Berlin Wall coming down. There was partying on the streets with a flood of people from East Germany coming across the border with a huge sense of relief.

Returning to New Zealand in late 1990, my career has largely revolved around the financial services sector. Through this time I have worked in various operations, product, relationship management and management roles in various firms across the Funds Management, Corporate Trustee, Investment Banking and Banking sectors. I also had a two-year break from the big lights of the city 19 years ago, when my wife and I moved to Dannevirke and I worked on a friends' dairy farm. We returned to Auckland in late 2004.

Around 2009, I was working for a funds management firm managing the relationship with external investment advisers. This role and the interactions I had with the advisers is what led me to wanting to complete my Investment Adviser qualifications, both through Massey University and the Open Polytechnic. In 2011 I joined National Bank Private (later to become ANZ Private) as a Senior Private Banker, managing a team of staff but also looking after the investment and banking needs of around 60 high-value investment clients. For the last 5 years at ANZ Private, I was regional manager for Auckland and Northland, leading a team of around 50 staff.

Tell me about your family

I have been married to Ange for 26 years and we have two teenage daughters, Ella 19 and Gemma 17. Ella is in her first year at AUT studying International Tourism and Management, whilst Gemma is finishing her last year at Rangitoto College and has enrolled at AUT to study Sports and Recreation in 2023. We have lived in the same house in Mairangi Bay for the past 17.5 years.

What made you leave a nice safe job in the ANZ and work for an independent financial planning business?

As noted above, I worked for ANZ Private. Whilst I worked in a bank, I never really saw myself as a banker. My core experience has been in investment advice, and leading teams who manage client relationships. I felt there had been a lot of change in the banking sector over the last few years, and the 'banking' part of the role was taking over from the area I knew best and enjoyed the most, client relationships and investment advice.

I therefore reached out to my network, and asked around about different financial planning businesses. Rutherford Rede was a name that came up more than once. Right from the first meeting I felt there was a very strong values alignment between the business and the team and myself.

What do you like doing most at work?

I love connecting with people, understanding their situation and background, and help guide them to make great decisions to ensure they make the most of their lives.

What do you like doing when you are not at work?

I started playing golf around the age of 15 and played regularly through into my early 30's. Then the clubs gathered a bit of dust for a few years but I'm now back and enjoying playing social golf with friends – last year I joined the relatively new Wainui Golf Club.

I also love getting out on the paddle-board and exploring the East Coast Bays coastline. In the Summer, we often holiday as a family on Waiheke Island so I have paddled a fair bit of the coast at the western end of the island.

For the last 3+ years I have been on the Board of Trustees at Rangitoto College – this has been a great experience, giving back some time to the community and a college that has offered so much to our daughters.

THE CASE FOR SMALL CAPS

While global equity markets contain thousands of listed companies the largest 10 companies make up around 20% of the market's 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 cap' weighted exposure by investing into companies with smaller than average capitalisation weights. Such companies tend to be riskier, but with it comes a higher return potential. Below we outline our approach to investing into smaller cap companies.

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 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 earning 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.

But smaller companies also tend to be riskier, and 'small cap' stocks usually decline much further 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. The figures to the right illustrate these points.

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 includes the Dimensional Global Small Company Trust for global equity markets, and Allan Gray Australia Equity Fund for obtaining exposure to Australian smaller cap stocks. As shown over page, both of these funds have performed well relative to the 'small cap' indexes they are benchmarked against, and particularly well in the down 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 down market we have had this year, so far.

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.

Performance of 'small caps' funds relative to the funds we use

Period	Dimensional Global Small Cap Trust	Global Market Benchmark[1]	Annual return difference
Past 3 years to August 2022	9.3%	8.1%	1.1%
Year to August 2022	-5.8 %	-8.7%	2.9%
Period	**Allan Gray Equity Trust**	**Australian Market Benchmark[2]**	**Annual return difference**
Past 3 years to August 2022	7.3%	5.7%	1.6%
Year to August 2022	12.0%	-10.0%	22.0%

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

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