insights

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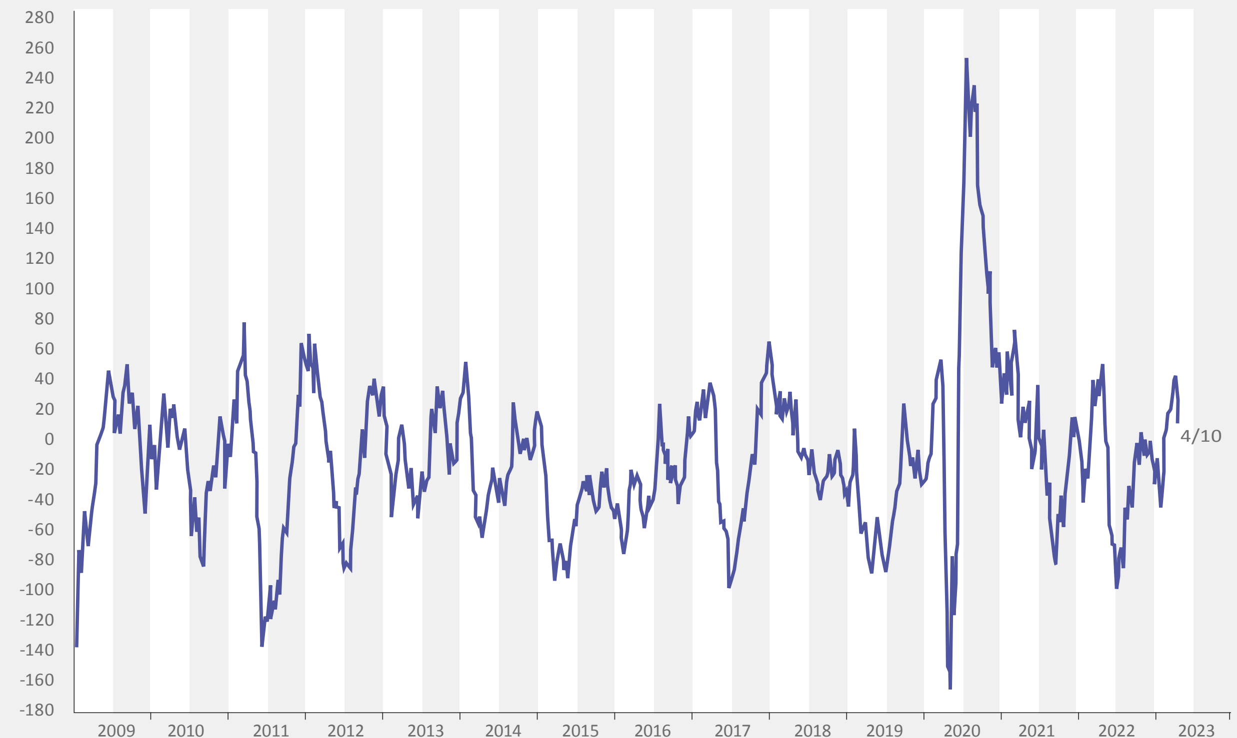
ECONOMIC & MARKET COMMENTARY

MARCH QUARTER 2023



Overview

Markets climbed higher over the March quarter despite monthly volatility and wobbles in the banking sector.

Both equity and bond markets bounced higher in the March quarter, following increasing signs that central banks are getting on top of inflationary pressures. However, the pattern of returns was quite volatile. Equity markets surged in January on the back of reducing interest rate expectations, only to sell-off most of this gain in February and into early March as the banking sector particularly, came under pressure with the failure of Silicon Valley Bank. Later in March markets rose again as banking contagion risks receded, and macroeconomic data, in general, reported better than expected (see Figure 1 for the US economy).

Market roundup

Global equities had the strongest returns, followed by emerging markets.

Market performances are reported in Figure 2. Global equities rallied strongly over the quarter, by around 9% in NZD terms and 7.2% in NZD hedged terms. Within global equities, value stocks took a breather and returned only 2% over the quarter, but they still outperformed over the year, returning 5.6% in NZD terms. Small caps have fared worse, returning around 5.5% in the quarter, but only 0.7% in the year to March 2023.

Emerging markets returned around 5% over the quarter, slightly stronger than the 3.9% and 3.3% returns posted by the NZ and Australian markets respectively. Over the year to March, however, all performed quite similarly returning around -1%.

Bonds also rose over the quarter, in part because they now offer +5% running yields.

NZ and international investment grade bonds returned around 2.5% in the quarter with some of this gain reflecting a paring back of future rate rise expectations. Over the year to March NZ investment grade bonds bonds fell around 1%, while international investment grade bonds bonds fell around 5%. This difference in performance largely reflects that the RBNZ was generally quicker than offshore central banks to raise rates, and hence the marked-to-market capital losses were incurred earlier in our bond market than most offshore markets.

International property stocks again struggled in the quarter, increasing only 0.6% in the quarter in NZD hedged terms. In contrast, global infrastructure performed well once again, returning a handy 2.6% for the quarter and 3% for the year to March 2023.

Bonds and their role in your portfolio

Bonds are held in your portfolio because of their income stream and risk diversification potential.

Bonds play an important role in all but the highest risk portfolios. They provide a predictable income stream, and typically rally in times of stress, providing a portfolio diversification benefit.

These benefits are more certain today than they were a year or so ago now that both short-term interest rates and bond yields have risen to more normal levels. We can expect a return of 5% p.a. or more from most bond funds in your portfolio given their current yields.

When an investor buys a bond, they essentially lend to the issuer of the bond (a government, company or other type of organisation), who promises to pay back the amount borrowed plus interest over a specified period of time. Their predictable income stream is why bonds are considered less risky than stocks, where neither the dividend income stream nor the capital return are certain.

While increasing rates in 2022 caused significant marked-to-market losses the upside is now bonds offer higher yields and enhanced potential to cushion returns should equity markets sell off.

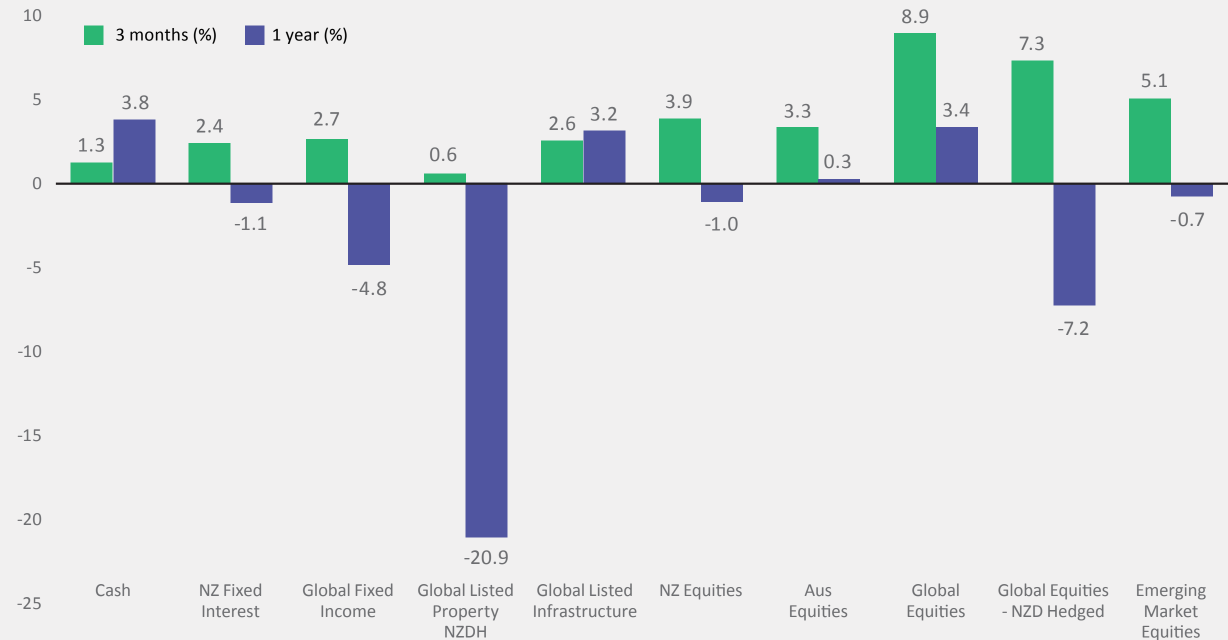
Bonds issued by governments – at least those in the most advanced economies - are considered the lowest risk because they are backed by the ability of governments to raise taxes to pay their debt obligations. Bonds issued by corporates are considered riskier as there is some chance that a business will fail. This is why corporate bonds typically offer higher yields than government bonds. Credit rating agencies essentially assess the risk that an issuer may fail in its obligations to repay lenders. Investment grade bonds, which comprise most of the bonds in your portfolios, are assessed to have the highest probability of meeting debt obligations.

While investment grade bonds bonds have the highest credit ratings, and issuers of investment grade bonds bonds very rarely default on their debt obligations, this does not mean that they are risk-free. Bonds can still suffer negative returns even when there is no default, because:

- The assessed creditworthiness of the issuer deteriorates, causing the value of the bond to decrease. An example would be if the NZ government has a credit rating downgrade.
- Interest rates rise by more than is factored into bond prices when they are bought. This is the main reason why bonds suffered a large decline in 2022, and why we allocated to "short duration" bonds to reduce this risk.
- Some bonds may be difficult to sell during times of market stress. In these circumstances the investor may have to sell them at a lower price.

Figure 2: Markets bounced higher in March 2023

Source: Citigroup, Yardeni Research Inc.



- Finally, most bonds pay a coupon that is fixed and does not adjust for inflation. As such real returns will fall when inflation rises, as it has over the past year.

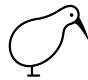
Your exposure to bonds comes in the form of well-diversified bond funds that have been selected in part to mitigate the risks above, and in part because of the strong conviction we have in the selected fund managers (Dimensional, Harbour, Nikko, Daintree and Simplicity) based on their track records, SRI credentials, business stability, and operational risk controls.

Your bond investments are mainly in investment grade bond funds diversified across government, country, term and country issuances to mitigate individual bond risks.

Finally, while bonds are not risk-free, they still may be preferred to term deposits (TDs) for several reasons. Firstly, because they typically offer higher yields than TD rates. Secondly, because an investor can, in most circumstances, sell their holdings at any time without financial penalty, unlike with TDs where "break fees" apply. And thirdly, because a diversified portfolio of bonds may in fact be lower risk than putting money "in the bank". The GFC in 2008, and the more recent wobbles in US banks, serve to illustrate that bank deposits are not risk-free. Furthermore, NZ does not have a deposit guarantee scheme, and the scheme expected to be enacted later this year will only guarantee up to $100,000 per investor, per bank.

HOW THE MARKETS FARED

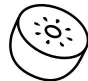
All returns are expressed in NZD. We assume Australian Shares and International Property are invested on an unhedged basis, and therefore returns from these sectors are susceptible to movement in the value of the NZD.



QTRLY RETURN + 3.9%
PAST YEAR − 1.0%

New Zealand Shares: New Zealand shares bounced around 4% higher in the quarter. Over the year to March returns were -1.0%, but remain very solid over the past 5-years and decade with annual returns of around 7.4% and 8.3% respectively.

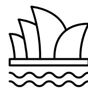
Source of figures: S&P/NZX 50 Total Return Index with Imputation Credits



QTRLY RETURN + 2.4%
PAST YEAR + 0.1%

New Zealand Fixed Interest: New Zealand investment grade corporate bonds increased 2.4% in the quarter and were flat for the year ended March 2023. This is a marked turn-around from negative results over 2022, and reflects that interest rate increases made by the RBNZ are now likely “priced in”.

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



QTRLY RETURN + 3.3%
PAST YEAR − 0.8%

Australian Shares: Australian shares increased around 3.3% in the quarter, and fell by around 0.8% over the year in NZD terms. Much of the recent gain was concentrated in large cap banking and commodity stocks. In contrast, value and small cap stocks underperformed, returning around 1.5% in the quarter.

Source of figures: S&P/ASX 200, S&P Australia BMI Value, S&P/ASX Small Ordinaries

QTRLY RETURN + 8.9% (+7.3% hedged)
PAST YEAR + 3.4% (-7.2% hedged)

Global Equities: Global equities rallied strongly over the quarter, by around 9% in NZD terms and 7.2% in NZD hedged terms. Within global equities, value stocks returned 2.0% over the quarter, but outperformed over the year, returning 5.6% in NZD terms. Small caps fared worse, returning around 5.5% in the quarter, but only 0.7% in the year to March 2023.

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

QTRLY RETURN + 5.1%
PAST YEAR − 0.7%

Emerging Markets: Emerging Markets also performed well in the quarter, rallying by around 5% in NZD terms. On an annual basis returns were around -0.7% in NZD terms, mildly behind returns of developed markets on an unhedged basis, but in line with the returns on the NZ and Australian markets.

Source of figures: MSCI Emerging Markets Index

QTRLY RETURN + 2.7%
PAST YEAR − 4.8%

International Fixed Interest: Global investment grade bonds returned around 2.7% in the quarter, but still ended the year down around 5%. This reflected central banks finally moving away from 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 offer the prospect of solid returns given their high running yields.

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

QTRLY RETURN + 0.6%
PAST YEAR − 20.9%

International Property and Infrastructure: International property stocks increased around 0.6% in the quarter in NZD hedged terms while global infrastructure increased around 2.6% on an NZD hedged basis. Over the year infrastructure returned 3.2% and global property returned around -21% on an NZD hedged basis. On an unhedged basis, annual returns were better at around -13% for property and +4% for global infrastructure.

Source of figures: FTSE EPRA NAREIT, FTSE Dvlp Core Infra 50/50; NZD & NZD hedged basis

Q&A WITH JOY MARSLIN

Insights introduces people that we work closely with so that you can understand the wider team that provides our services. This edition introduces Joy Marslin, an investment professional who has been a member of our Investment Committee since 2022.

Tell us about where you live and why you live there.

Eddy and I moved to Riwaka in the sunny region of Tasman during 2020. Riwaka sits between two of New Zealand's most beautiful and popular National Park's, Kahurangi and Abel Tasman. We enjoy wonderful weather, high sunshine hours, stunning scenery, and outdoor pursuits from the sea to alpine lakes and mountain walks. Our local towns, including Nelson, provide all the services, arts and culture and activities you would find in most large cities, and the region is a food bowl full of orchards and vineyards.

I have been fortunate that work opportunities have meant we have lived in 7 regions around New Zealand and have loved each one. It was pure chance (and good luck) that we now live in Riwaka. We had sold our home in St Heliers and were looking for a smaller property, still in the Auckland region, when we took a break from house hunting and had a holiday with friends in Tasman. The house next door was on the market and the rest is history.

What is your investing experience?

My initial career choice was teaching but I recognised very early it had been a default choice rather than a passion, so when I returned from a year overseas I was lucky to work for an extremely successful entrepreneur with a broad portfolio of businesses and investments, which helped create my passion for investment markets.

I completed my New Zealand Stock Exchange diploma in the early 1990's and took an investment role with an advisory business before joining National Bank in 1992 as a founding member of the inaugural Private Banking service. My career specialised in the private banking and wealth segments of the banking sector as an adviser, investment committee member and in leadership and governance roles.

What is the most important thing to you in achieving a successful investment?

It is difficult to identify the one most important thing. However, if I was to identify two key principles, they would be discipline and seeking professional advice you can trust. This helps you understand what you are seeking from your investments, your time horizon, and your tolerance for volatility (or fluctuating returns).

I do think we are experiencing a shift in investor sentiment with investors expecting more accountability alongside their return. Increasingly investors are questioning how their investment returns are being generated, and expect their investment advisers to ensure the conduct and culture of the companies are acceptable, and in many cases they want to understand the positive and negative impact those companies make. Discipline and seeking good advice help investors to achieve their goals, minimise the risk of emotive decisions while aligning to their values.

What else do you do besides working with Rutherford Rede?

I have had a fabulous career which has given me the opportunity to transition into holding a number of governance and committee roles. When I left corporate life I wanted to focus on giving back while continuing to work within the financial sector. Currently I am a non-executive director with a Kiwisaver provider, a compliance and education business, the shareholders' association, the financial ombudsman service and an impact investment fund. In addition, I have spent some years supporting the growth of 'place-based giving' through the community foundation model at Auckland Foundation.

Outside of work I love to garden, cook and hike. Every three or four years we visit my sister and family in Italy and every year we try to discover somewhere new to visit in New Zealand.

THE BENEFITS OF BONDS:
A CRUCIAL ASSET IN YOUR INVESTMENT PORTFOLIO

What are bonds?

Bonds are a type of financial instrument used by governments, corporations, and other organisations to borrow money from investors. When an investor buys a bond, they are essentially lending money to the issuer of the bond, who promises to pay back the amount borrowed plus interest, typically, over a specified period of time. Bonds usually have a fixed interest rate and a maturity date, at which point the principal amount is repaid to the investor. Bonds are generally considered less risky than stocks because they offer a predictable stream of income and are typically backed by the issuer's creditworthiness. However, there are still risks associated with investing in bonds, such as the possibility of default by the issuer, changes in interest rates that can affect the value of the bond, and the fact that some bonds (e.g. preference shares) are perpetual, offering no set maturity date.

What are government and corporate bonds and how are they different?

Government bonds and corporate bonds are two types of bonds that are issued by different entities and have different risk and return characteristics.

Government bonds, also known as sovereign bonds, are issued by national governments to finance their activities and pay off debts. These bonds are considered low-risk investments because they are backed by the full faith and credit of the government. In other words, investors can rely on the government to repay the principal and interest on the bond. Government bonds are often used as a benchmark for other types of bonds because they are typically viewed as the safest investment option. Examples of government bonds include U.S. Treasury bonds and German government bonds.

Corporate bonds, on the other hand, are issued by corporations to raise capital for their business activities. These bonds are generally riskier than government bonds because they are not backed by a sovereign government. Instead, investors rely on the creditworthiness of the corporation to repay the principal and interest on the bond. Corporate bonds offer higher returns than government bonds to compensate for the higher risk. Examples of corporate bonds include bonds issued by companies such as Apple, Microsoft, and Coca-Cola.

Overall, the key difference between government and corporate bonds is that government bonds are generally considered to be low-risk, low-return investments, while corporate bonds are higher risk, higher-return investments.

How is their level of risk assessed?

The level of risk associated with a bond is assessed using credit ratings. Credit ratings are provided by credit rating agencies such as Moody's, Standard & Poor's, and Fitch Ratings, and are based on an assessment of the issuer's ability to repay its debt. The credit rating agencies evaluate the issuer's financial strength, credit history, and other factors to determine the creditworthiness of the issuer.

Government bonds are typically considered to be low-risk investments because they are issued by a sovereign government, which is generally considered to be highly creditworthy. However, even government bonds can carry varying degrees of risk, depending on the country's economic and political stability. Corporate bonds are generally considered to be higher risk than government bonds because they are issued by companies that may be subject to financial or market risks. Credit rating agencies assess the creditworthiness of corporate bond issuers by evaluating their financial performance, management quality, industry conditions, and other factors. Corporate bonds with higher credit ratings are considered to be lower risk, while those with lower credit ratings are considered to be higher risk.

Investors can use credit ratings as a tool to assess the risk of a bond and make informed investment decisions. However, it is important to note that credit ratings are not foolproof and can sometimes be subject to errors or biases. Therefore, investors should also conduct their own research and analysis before making investment decisions.

Can I lose money on a bond? How?

There are several ways that an investor can lose money on a bond investment:

1. **Default risk:** If the issuer of the bond fails to make the required interest payments or repay the principal amount when the bond matures, the investor can lose money.
2. **Credit risk:** Even if the issuer does not default, there is still a risk that the creditworthiness of the issuer may deteriorate, leading to a downgrade in the bond's credit rating. This can cause the value of the bond to decrease, and the investor may have to sell the bond at a loss.
3. **Interest rate risk:** If interest rates rise after the investor has purchased the bond, the value of the bond may decrease, as investors demand higher yields to compensate for the higher interest rates. If the investor needs to sell the bond before it matures, they may have to sell it at a price lower than cost, resulting in a loss.
4. **Inflation risk:** If the rate of inflation is higher than the interest rate on the bond, the purchasing power of the interest and principal payments will decrease over time, resulting in a loss in real terms.
5. **Liquidity risk:** Some bonds may be difficult to sell in the secondary market, especially during times of market stress or if the bond has a low trading volume. If the investor needs to sell the bond but cannot find a buyer, they may have to sell it at a price lower than the cost.

Overall, while bonds are generally considered to be less risky than stocks, they are not risk-free investments. It is important for investors to understand the risks associated with bonds and to diversify their portfolio to mitigate these risks.

How are they different from term deposits?

Bonds and term deposits are both investment options that offer a fixed rate of return, but they differ in several ways:

1. **Issuer:** Bonds are typically issued by governments or corporations, while term deposits are issued by banks.
2. **Maturity:** Bonds usually have a specific maturity date, at which point the principal amount is repaid to the investor. Term deposits also have a maturity date, but it is typically shorter than that of a bond, ranging from a few months to a few years. Be wary of bonds that do not offer a firm maturity date. These are referred to as perpetual bonds and mature only when the issuer decides.
3. **Liquidity:** Bonds can generally be bought and sold in the secondary market, providing investors with liquidity. Term deposits, on the other hand, are locked in for the duration of the term and cannot be withdrawn early without penalty.
4. **Risk:** Bonds carry some level of risk, such as credit risk or interest rate risk, depending on the issuer and the terms of the bond. Term deposits, on the other hand, are generally considered to be low-risk investments because the NZ banking sector is well-regulated, and the big banks carry strong credit ratings. However, investors need to be wary of second-tier banks where risks are greater.
5. **Return:** Bonds typically offer a higher rate of return than term deposits, to compensate for the higher risk. Overall, bonds and term deposits are both fixed-income investments that offer a predictable stream of income, but they differ in terms of issuer, maturity, liquidity, risk, and return. Investors should consider their investment goals, risk tolerance, and other factors when choosing between these two investment options.

What are the advantageous on holding bonds in a fund?

Holding bonds in a fund can offer several advantages to investors:

1. **Diversification:** Bond funds hold a variety of different bonds, issued by various governments and corporations. By investing in a bond fund, investors can achieve a higher level of diversification than they would by investing in individual bonds. This can help to mitigate the risk of default and credit downgrades associated with individual bonds.
2. **Professional management:** Bond funds are managed by professional portfolio managers who have expertise in analysing credit risk, interest rate risk, and other factors that can affect the performance of bonds. These managers can make strategic decisions about which bonds to buy and sell to optimize the fund's performance.
3. **Accessibility:** Investing in a bond fund can be more accessible and affordable than investing in individual bonds, as it allows investors to buy into a diversified portfolio with a relatively small amount of money.
4. **Liquidity:** Bond funds are typically more liquid than individual bonds, as they can be bought and sold on an exchange at any time during market hours. This can provide investors with greater flexibility and ease of trading.
5. **Income:** Bond funds typically generate regular income in the form of interest payments, which are distributed to investors. This can provide investors with a predictable stream of income, which can be particularly valuable for those who are retired or seeking steady income.

Overall, holding bonds in a fund can offer investors a range of advantages, including diversification, professional management, accessibility, liquidity, and income. However, investors should be aware of the risks associated with bond funds, such as interest rate risk, credit risk, and market volatility, and should carefully consider their investment goals and risk tolerance before investing.

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