RUTHERFORD REDE

insights

SUMMER 2024
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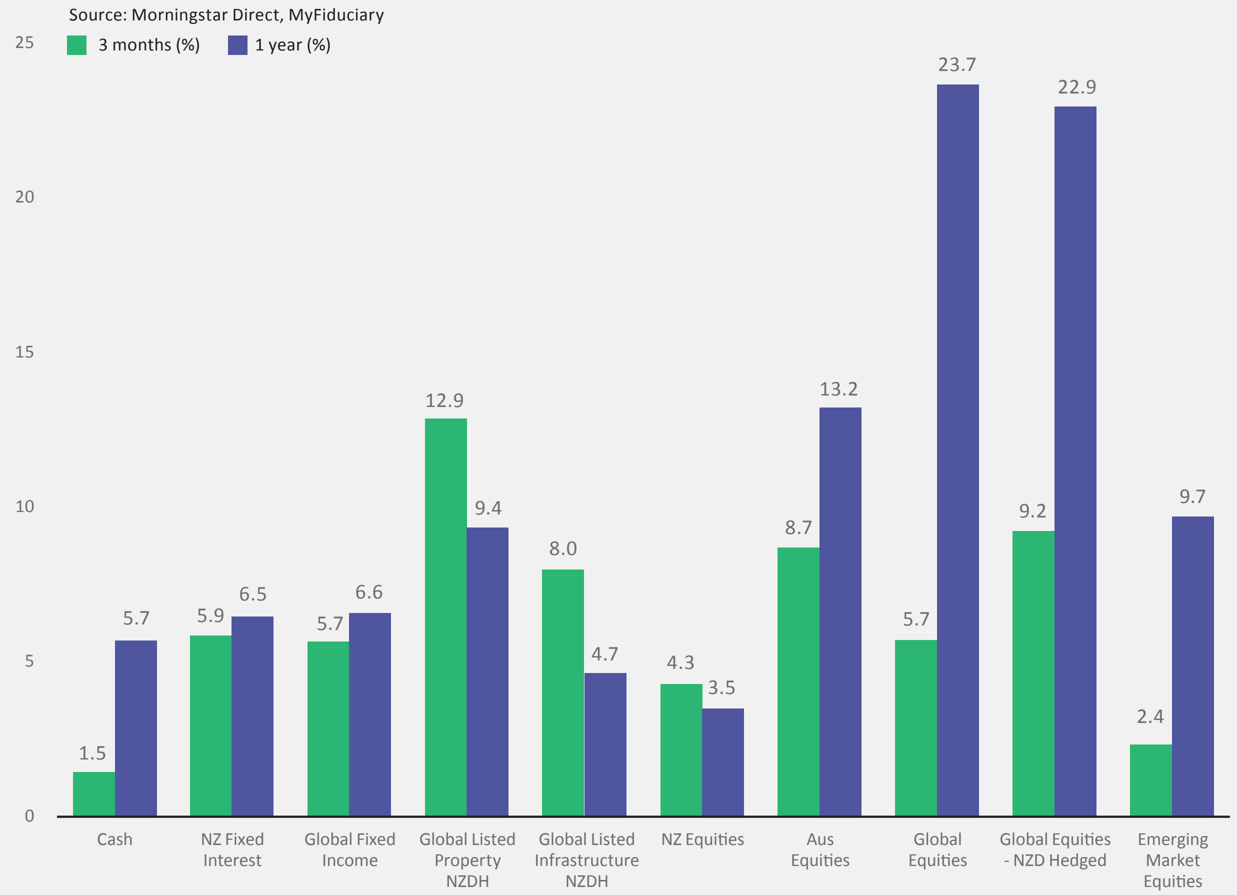
ECONOMIC & MARKET COMMENTARY

DECEMBER QUARTER 2023

Figure 1: Most asset classes rallied in the December quarter



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 relatively 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 not expected to be accompanied by global recessionary conditions.

…as 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.

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 c/f 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.

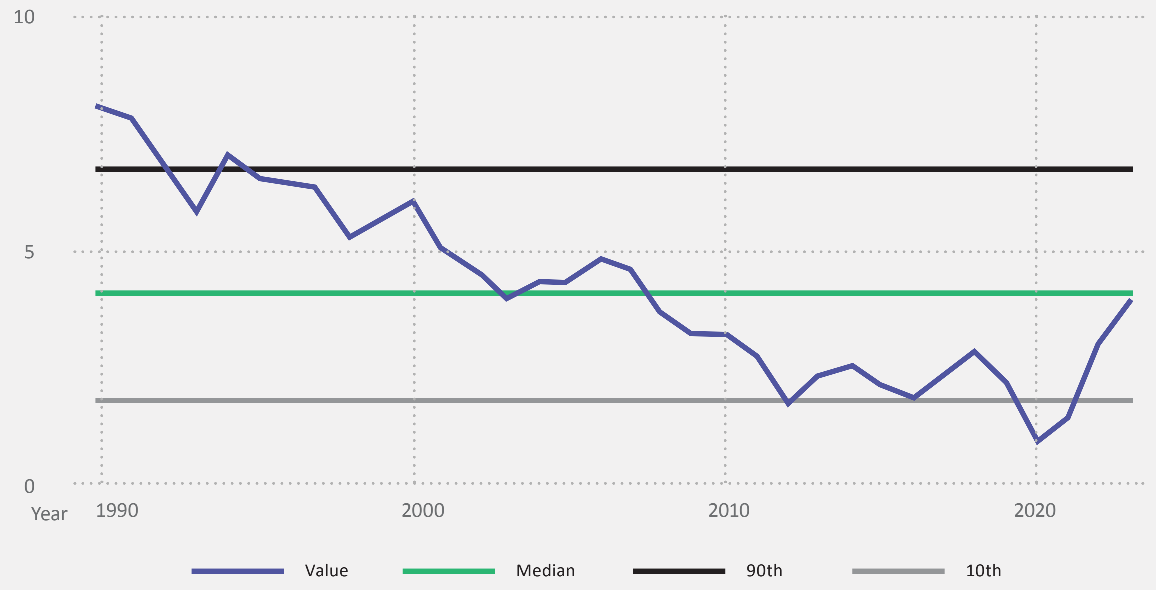
Interest rates were slashed to historic lows in 2008/9 and remained at exceptionally low levels until late 2021.

Indelibly etched into this author's mind is the moment when 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.

Figure 2: US 10-year bond yields – the great re-set

Source: Datastream, MyFiduciary



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.

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.

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).

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.

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.

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?

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 + 4.3%
PAST YEAR + 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

QTRLY RETURN + 5.0%
PAST YEAR + 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

QTRLY RETURN + 8.8%
PAST YEAR + 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 200, S&P Australia BMI Value, S&P/ASX Small Ordinaries

QTRLY RETURN + 5.7% (9.2% hedged)
PAST YEAR + 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

QTRLY RETURN + 2.4%
PAST YEAR + 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

QTRLY RETURN + 5.7%
PAST YEAR + 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)

QTRLY RETURN + 12.9%
PAST YEAR + 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, FTSE Dvlp Core Infra 50/50; NZD & NZD hedged basis

Q&A WITH JOCELYN WEATHERALL

Insights introduces people that we work closely with so that you can understand the wider team that provides our services.

How long has it been since you founded Rutherford Rede and what motivated you to be a founder?

The conception of the now Rutherford Rede took shape in the early months of 1992, marking a span of 32 years. At that time, independent financial planning practices were scarce (and has done full circle and now even more scarce!) and our motivation was to create a leading independent firm who could make choices motivated by client interests and owned by its participants—akin to legal, accounting, and other professional practices—rather than adopting a corporate model.

The founding team comprised six partners, joined shortly thereafter by like-minded individuals who shared our vision of providing independent advice and building a network of specialists, including professionals from global practices, tax, and law, economists, portfolio designers, and fund managers.

What qualifications do you hold that support your skill as an adviser?

I am a keen learner who embarked on tertiary education at the age of 16 at Auckland University. I began with a Bachelor of Arts in Psychology and Geography, laying a solid foundation for my subsequent degree in Commerce with a focus on Accounting and Marketing.

My passion for Trusts and Charitable Foundations, those who are stewards of money, led me to work with CEFEX (the Global organisation that’s provides for excellence in Fiduciary matters), where I obtained the Accredited Investment Fiduciary (AIF) designation and pursued Auditor training (AIFA).

As regulatory expectations evolved, we prioritise upskilling. This included proving competency through the National Certificate and participating in ongoing professional planning, aligned with our individualized plans at RR. If there were spare capacity in my schedule, my next academic pursuit would likely be in some aspect of Behavioural Finance. I find the various reactions to financial matters intriguing, recognizing that we are all wired uniquely.

What are the big changes you have seen over your time as an adviser?

To begin with technology! The advent of laptops; the ubiquity of cell phones and smarter custodial administration systems represent significant changes. While the fundamental principles of advisory services have endured, there has been a noteworthy expansion in the network of specialists available for our choice of consultation. This growth has been mirrored by a surge in information flow and way more media noise! Regulatory oversight has grown and now a substantial part of our daily routine.

Moreover, there has been a noticeable positive impact stemming from an increased understanding among individuals about the value of financial planning. There's a growing trend where people actively seek advice and express a genuine interest in comprehending the principles of financial planning and investment. This shift signifies a broader appreciation for the importance of thoughtful planning in achieving financial goals.

Tell us about your family?

Family means a lot to me, I have a bit of a nurturing spirit and I've noticed it's a common thread among long term advisers. That family vibe isn't just at home but also here at Rutherford Rede. We've been lucky to build a culture that cares about each other and helps everyone be their best throughout the life of the firm. Personally, I've got a super supportive husband, three awesome adult kids, and a couple of seriously amazing grandkids. They've been a big part of my journey.

Image: View over Routeburn Flats,
Routeburn Track, Mt Aspiring National Park

Tell us about what you enjoy doing for recreation?

I'm quite the nature enthusiast myself, and the whole COVID situation really nudged us to appreciate the beauty in our immediate surroundings. This led us to embark on some incredible journeys, including the Milford, Routeburn, Hollyford, and Abel Tasman walks, not to mention exploring the renowned Otago rail trail and Clyde bike trails. Now, I've got my trusty hiking boots, walking poles, and ventured into the world of e-bikes, with the expectation of more adventures to come.

Balancing the outdoor escapades, I've got the daily routine of early walks with my two furry friends to maintain their equilibrium. On the home front, we reside in a 1909 villa, and anyone who's lived in one knows that maintenance is a perpetual task. There's always something to be done, but the charm makes it all worthwhile.

While some might not label it as recreation, some of my time outside of work is dedicated to serving as the Chairperson of Dementia New Zealand and the Chairperson of the Northern Service Region of Dementia New Zealand. In these roles, I contribute to advocacy and direct services for individuals and families affected by dementia. It's a commitment that holds significant importance in my life and allows me to make a meaningful impact beyond the financial advisory realm.

What continues to motivate you to be a financial adviser?

It's all about the people and the learnings. The sheer diversity of individuals, each with their own incredible life stories, wishes, and needs, makes my job endlessly fascinating. Witnessing the fruition of a well-crafted plan, celebrating the successes as goals are achieved—that's the real reward. After three decades in the business, I've encountered numerous situations and devised just as many solutions. There's a genuine satisfaction in bringing things to a successful conclusion.

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

+64 9 361 3670

rutherfordrede.co.nz

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Assets are held via bare trust structure with ownership being retained at all times by the owners of the portfolio. Valuations are independently sourced and recorded by Adminis.