MARKET PERFORMANCE AND COMMENTARY – MARCH 2021

MARKET PERFORMANCE

Index	Index Level/Price	1 Month %	3 Month %	1 Year %
Global Equities				
MSCI Emerging Markets	773.92	-0.9	4.0	53.0
S&P 500 (US)	3972.89	4.2	5.8	53.7
Nikkei 225 (Japan)	29178.80	0.7	6.3	54.2
FTSE 100 (UK)	6713.63	3.6	3.9	18.4
DAX (Germany)	15008.34	8.9	9.4	51.1
CAC 40 (France)	6067.23	6.4	9.3	38.0
Trans-Tasman Equities				
S&P/NZX 50	12560.70	2.7	-4.1	28.2
S&P/ASX 300	75926.90	2.3	4.2	38.3
Bonds				
S&P/NZX NZ Govt Stock	1867.24	0.7	-3.4	-1.6
S&P/NZX A Grade Corporate	5847.69	0.2	-2.1	1.9
Barclays Global Agg (Hedged to NZD)	420.45	-0.4	-2.5	1.4
FTSE WGBI (Hedged to NZD)	3631.27	-0.2	-3.1	-1.1
Oil				
West Texas Intermediate Crude	59.16	-3.8	21.9	188.9
Brent Crude	62.41	-3.1	22.0	190.7
NZD Foreign Exchange				
AUD	0.9195	-2.1	-1.5	-5.1
EUR	0.5959	-0.5	1.3	10.3
GBP	0.5076	-2.4	-3.6	6.2
JPY	77.3887	-0.1	4.1	20.9
CNY	4.5951	-2.5	-1.8	9.3
USD	0.7004	-3.7	-2.7	18.1

Source: Nikko

Executive summary:

- Stock markets resumed their upward momentum
- Yield curves flattened out slightly
- NZ dollar, oil and gold weakened

ECONOMIC COMMENTARY

FINANCIAL MARKETS

The markets have become more complex in the last month. The New Zealand 10-year bond yield spent about a week below the US 10-year Treasury, on the back of the residential investment property tax announcement (see below section for more details). Also, the NZ dollar dropped 2 cents relative to the US dollar in response to the new measures, which suggests the demand for NZ investment from overseas buyers decreased. Only in the final few days of the month did the NZ 10-year bond rise above the US 10-year treasury. The Reserve Bank of New Zealand ("RBNZ") reduced its bond purchasing program from $630m to $440m per week during March. We expect short to medium term NZ government bonds to rise slightly in response to these measures in the near term. We are also seeing the long end of the yield curve rise more steeply which suggests that long term inflation pressures are increasing.

It has also been one year since the market plummet in March 2020 which has since spurred the largest 12-month rally in history of the S&P 500 (see Figure 1). This has been driven by Technology growth stocks popular during the 'COVID economy'. However, traditional value stocks which suffered during the March 2020 plunge are now beginning to be momentum-driven, replacing Technology as vaccination rates increase.

Figure 1: Distribution of S&P 500 1Y Returns

Source: Franklin Templeton

The selling pressure on Technology stocks may facilitate a rotation to Energy, Manufacturing, Consumables and Financials. Since most momentum models look back 12 months: starting next month, on a lookback basis, value stocks should have much stronger momentum. With inflation expectations rising and, by proxy, higher associated interest rates, value and defensive stocks may make a comeback.

There has been huge cash flow momentum into equities this month. According to Goldman Sachs, $58 billion flowed into equities during the week of 10 February which was an all-time record for a weekly inflow. Yet only a month later, this record was broken with $68 billion worth of inflows during the week of 10 March. In the last 19 weeks over $500bn has flowed into equities. This continues to be driven by passive ETFs and retail investors, whose persistence and intensity is a huge factor in modern equity markets.

Other lifelines to equity momentum include the US and UK ramping up the pace of their vaccine roll out. However, they need to beat the next wave of cases. The direction of future interest rates will likely depend on whether this is successful or not in the short term. The PMI for manufacturing, services and nonfarm payrolls were higher than expected, along with Biden's infrastructure package will only add momentum in the coming month.

BUBBLE, OR NO BUBBLE?

The 50 fastest growing companies in the US have displayed similar behavioural patterns and extreme valuations as those seen during the dotcom bubble, which is concerning. However if we stretch the analysis to the 100 fastest growing companies in the US, the overvaluation and volatility comparisons to the dotcom bubble appear much smoother and less comparable to the party in 1999. This suggests less headroom in the equity markets to keep moving up and it is on a knife edge. Logic would suggest a correction in the next year or two if sentiment swings from optimistic to pessimistic, but logic does not govern the markets.

This view is further supported by Figure 2 where the S&P 500 Index market cap has become a significantly bigger portion of the US Gross Domestic Product ("GDP") over the last 12 months. The recent increases in this ratio are also comparable to the dotcom bubble which raises our internal view that a correction is coming.

Figure 2: S&P 500 Market Cap vs. US GDP | S&P 500 P/E Ratio

Source: Schroders, Bloomberg

MARKET RISK

The collapse of Archegos Capital Management opened the curtain to backstage information about family offices. Archegos was little known until a drop in the value of its leveraged equity bets sparked a liquidity crisis at the fund which set off a scramble among Wall Street banks who financed the trades to start unwinding them. The margin calls on the derivatives triggered a sell off and caused massive losses to the banks who were the main losers – notably, Credit Suisse and Nomura, who appear to still be counting their losses. Is this the beginning of a systematic crisis or a one-off governance issue? There have been little signs thus far of any wider effects, but we imagine regulatory and legal scrutiny will increase for family offices after this incident.

RETAIL INVESTORS

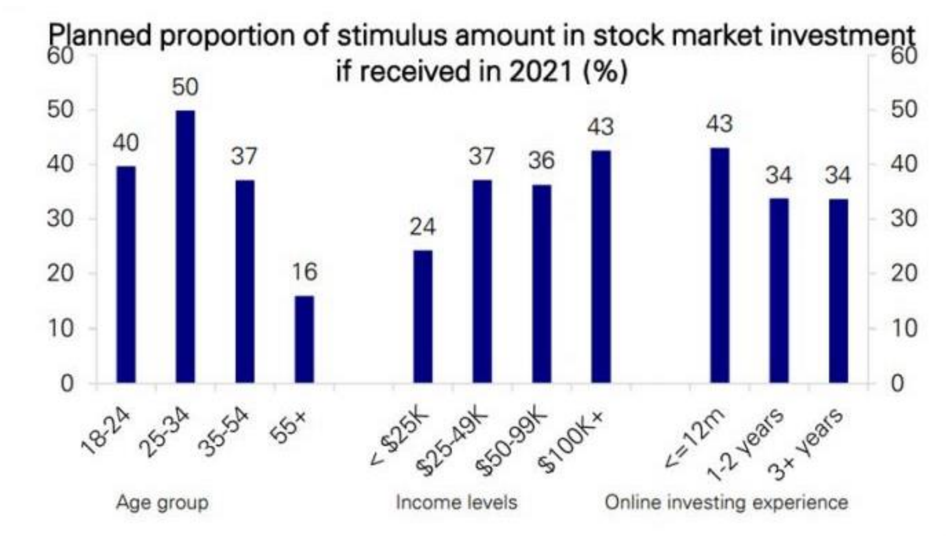
We saw what can be done two months ago with GameStop. Concerted retail investors are able to knock down funds or drive up share prices and distort the markets by collaborating via social media platforms. As Figure 3 shows, retail trading now accounts for as much trading volume as mutual funds and hedge funds combined.

Figure 3: Market Share of Overall US Equity Trading Volumes

Source: Schroders, Bloomberg, Financial Times

Also, it is highly likely that significant chunks of Americans' stimulus cheques will be sunk into the equity markets (see Figure 4). 18–34-year-olds are likely to invest between 40-50% of their stimulus money. Those earning less than $50k are looking to invest between 24-37% of their stimulus money. Overall, 43% of the investors have less than 12 months experience in the markets. We do not see this ending well, especially when they have only ever really known the biggest 12-month bull market in history.

Figure 4: Planned Proportion of Stimulus Amount in Stock Market if Received in 2021



Source: Schroders, Deutsche Bank

Michael Burry who successfully shorted the housing market in 2007-08 has expressed concerns particularly about index funds and is expecting a correction in the near term. The longer it goes on, the larger the crash will be, were his words.

NEW ZEALAND ECONOMY

Negative GDP in Q4 2020 was disappointing and less anticipated. A sharp change in residential property investments policy subdued expectations of interest rates and the OCR heading north.

The labour market is tight. According to the BNZ, an increasing number of businesses are reporting heightened difficulty finding staff and roughly one in six reports that labour is the single biggest constraint on increasing output. At 4.9% the unemployment rate remains comfortably off its lows, but the key issues are likely skill mismatches and low churn. This suggests labour market issues are more deeply rooted than headline numbers suggest. However, the announced Trans-Tasman bubble should provide the tourism and hospitality sector with a boost in demand.

Broadly, the New Zealand economy is currently treading water. Indeed, in a technical sense, New Zealand may be re-entering a recession. In Q4 2020, GDP declined 1.0% and there is a strong chance Q1 will be negative as well. We are experiencing the full effects of no international tourists during the peak tourism season. While the outlook for tourism is brightening, progress will be slow. However, there remains plenty of momentum in the economy, particularly from exports and soaring house prices which have supported retail spending.

The national timber shortage is causing more problems for housing policy. The construction industry has had a strong rebound after the March lockdown fuelled by the existing high demand for residential houses.

NEW ZEALAND HOUSING POLICY

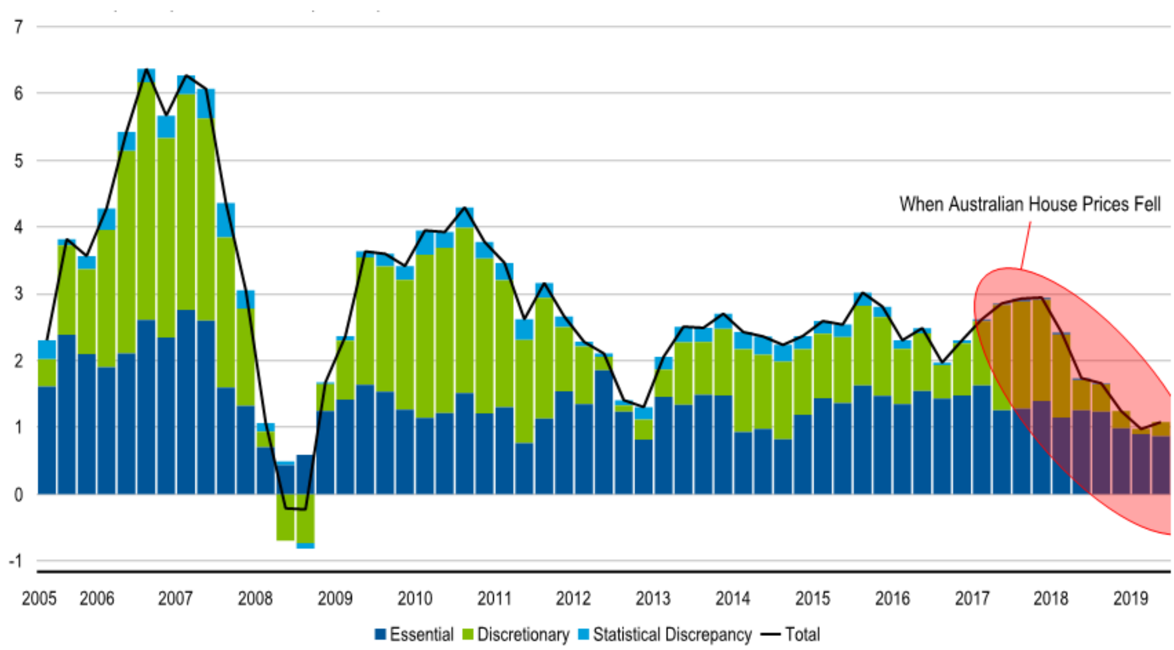
The recent new residential investment property tax policies announced by the New Zealand Government included:

- Limiting the interest deductibility for rental properties; and
- Extending the bright line test to 10 years.

These measures were brought into effect in response to cool New Zealand house prices which have increased 25% since January 2020. Investors total borrowings according to the RBNZ have been double that of first home buyers in recent months.

Property investors account for over 25% of total housing credit in New Zealand which makes them a key player in the housing market. Approximately 40% of investment properties are interest only which will be utilising interest deductibility heavily. It is likely many investors are operating with small safety nets. Remaining investment properties that carry debt will be forced to raise rents. If house prices drop, we know from Australia that consumer spending falls with it (see below). The wealth effect of rising house prices supports retail confidence.

Figure 5: Australia Private Consumption



Source: Franklin Templeton, ABS

Introducing the limitation of interest deductibility now is smart due current low interest rates, rather than bringing it in during a period of high interest rates. However, there could be a possibility that low interest rates are held for longer, despite the rising bond yields and inflation expectations. If consumer spending suffocates after a dip, the RBNZ is likely to keep the OCR low to cushion concerns of lower consumer spending.

But more importantly, the Government would be paying less interest on their COVID debt and by letting inflation go above the target, will likely erode some of that debt as well.

Some of the risks that the new housing tax policies will not cool the housing market include:

- Supply continues to be challenged with limited timber, construction materials and labour availability.
- For investment properties with minimal debt, they will be held until after the 10-year period before selling which will have the potential impact of condensing the housing supply for an additional 5 years.
- More informal rent arrangements.
- Other deductions will be utilised now that the interest is now non-deductible, such as overzealous repairs and maintenance. This will keep the tax bill similar and minimise the need to sell.
- Given the housing demand backlog from first home buyers, it is possible demand could meet any increased supply and not necessarily decrease prices.
- Local government debt ceilings don't move, i.e., Auckland Council's debt to rates cap is 265%. If they take on further debt to build property, their credit rating will decrease having a knock-on effect for the smaller councils who will also have to downgrade their ratings in response to changes to Auckland. This has the overall impact of limiting council's ability to build.
- Building consent processes are non-centralised, inefficient and RMA reforms are too slow.

It is likely a step in the right direction for first home buyers, although time will tell how effective a step it has been. For generation rent and long-term renters, they will potentially face a squeeze on rental supply and prices, keeping them from saving for a deposit. The runoff implications are unknown but may help given the current state of homelessness and social issues in rural towns like Gisborne, where house prices have increased 43% in 2020. Pressure on rental costs, supply, and tenant's wages if rents increase will be squeezed, especially outside main centres where opportunities for work are limited given the poor state of tourism and hospitality. As always, it will impact the lowest socio-economic rung the most.

GEOPOLITICAL

The US-China tensions remain a key part of the geopolitical agenda. Tariffs imposed by Trump and the subsequent trade war remain a restraining factor in current relations. US Trade Representative Katherine Tai commented that the US is not ready to withdraw tariffs but is open for discussions and will use it as leverage in negotiations to increase the presence of US made goods. Expect to see trade battles continue.

The rise of Chinese influence throughout the Indo-Pacific region forced the US, Australia, Japan and India to set up the Quadrilateral Security Dialogue in the late 2000s. Recent tensions between China and Quad members have revived this platform. Each member has their own reasoning to participate but with a common aim to limit China's influence. The US want to minimize their dependency on the supply of rare earth metals that are critical materials for tech development, evident in the recent silicon and copper shortages. Australia suffered significantly from tariff battles with China, seen with a decline of coal exports and heavy duties on wines that came into force last week. Japan is seeing an exodus of Japanese manufacturers out of mainland China and looking for new partners building multilateral agreements in the region. India is the second largest market in the region and is also looking for partners to limit China's presence. The Chinese 2050 plan is well in motion.

SUPPLY CHAIN DISRUPTIONS

The recent blockage of the Suez Canal caused a raft (pun intended) of disruptions, including:

- $9.6bn of goods per day;
- Delay of 12% of the global trade;
- 1 million barrels of oil per day; and
- 8% of all the world's traded liquified natural gas.

This incident showed how vulnerable world trade is, as it halted thousands of suppliers and buyers. Consider other waterways such as the Straits of Malacca, Strait of Hormuz and the Panama Canal – how well stress tested are these areas for similar issues such as piracy, traffic, weather, crew or political risk? It only takes one episode to trigger a worldwide choking point as we have learned recently. Interesting times ahead!

MARKETS OUTLOOK