MARKET PERFORMANCE AND COMMENTARY – JUNE 2021

MARKET PERFORMANCE

Index	Index Level/Price	1 Month %	3 Month %	1 Year %
Global Equities				
MSCI Emerging Markets	803.58	0.8	3.8	36.1
S&P 500 (US)	4297.50	2.2	8.2	38.6
Nikkei 225 (Japan)	28791.53	-0.2	-1.3	29.2
FTSE 100 (UK)	7037.47	0.2	4.8	14.1
DAX (Germany)	15531.04	0.7	3.5	26.2
CAC 40 (France)	6507.83	0.9	7.3	31.8
Trans-Tasman Equities				
S&P/NZX 50	12654.60	2.7	0.7	10.5
S&P/ASX 300	82366.88	2.3	8.5	28.5
Bonds				
S&P/NZX NZ Govt Stock	1871.24	0.1	0.2	-3.6
S&P/NZX A Grade Corporate	5862.94	0.3	0.3	-1.2
Barclays Global Agg (Hedged to NZD)	424.70	0.5	1.0	0.0
FTSE WGBI (Hedged to NZD)	3659.71	0.6	0.8	-1.4
Oil				
West Texas Intermediate Crude	73.47	10.8	24.2	87.1
Brent Crude	75.12	9.3	20.4	83.7
NZD Foreign Exchange				
AUD	0.9307	-1.0	1.2	-0.5
EUR	0.5892	-1.0	-1.1	2.8
GBP	0.5058	-1.2	-0.4	-2.9
JPY	77.5543	-2.6	0.2	11.7
CNY	4.5145	-2.7	-1.8	-0.8
USD	0.6988	-4.0	-0.2	8.5

Source: Nikko

Executive summary:

- Equity markets continue to rise
- Inflation is the challenge
- Yield curves are flattening
- Volatility has been falling
- Markets becoming more complex

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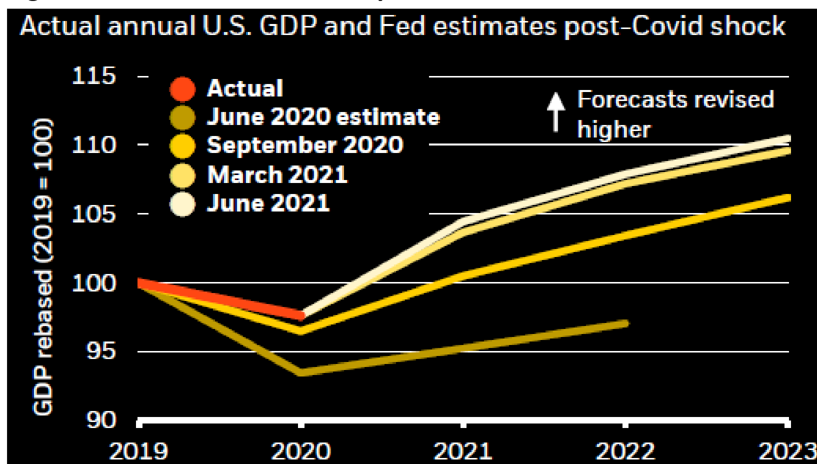
ECONOMIC COMMENTARY

GLOBAL SNAPSHOT

United States

The economic restart in the U.S. is outpacing expectations. The Fed has repeatedly revised its growth estimates for GDP upwards over the past 12 months to considerably higher than original estimates. In its latest projection, GDP is expected to surpass pre-Covid levels this year, rather than taking several years as initially expected. In contrast, growth forecasts were repeatedly revised down after the Global Financial Crisis (Figure 1).

Figure 1: US GDP - Actual vs Expected



Source: BlackRock

Europe

The European Union is planning to tighten its carbon market to cut emissions faster and put a price on pollution in new sectors. The EU's emissions trading system (ETS) is the bloc's central climate policy, forcing power plants, factories and airlines running European flights to buy permits when they emit CO2.

Free carbon permits would end for industries covered by the EU's planned carbon border levy - a move that could increase carbon costs for producers of steel, cement, aluminium and fertilisers. The report confirmed plans to expand the ETS to include shipping, and create a new, separate ETS for transport and heating systems in buildings.

LOCAL SNAPSHOT

Australia

The recent COVID-19 outbreaks are placing continued pressure on businesses now that JobKeeper payments have ceased. Notably, retail spending rose 0.1% in Australia in May, remaining well above the pre-pandemic

trend. Australia's composite output Purchase Managing Index (PMI) eased in June but remained expansionary, suggesting that growth may continue but could begin to slow as the economy nears a full recovery. In the long term, new data has suggested Australia's population is forecast to grow slower and age faster than expected, exacerbating current demographic trends.

New Zealand

The New Zealand stock market had a strong month moving up 2.7% but still negative year to date. The 10-Year Government Bonds opened the month at $1.80 and only shifted down to $1.78 which indicates a firming in prices. The OCR remains at 0.25% for now. The OECD is forecasting economic growth will pick up gradually in the second half of 2021, boosted by the progressive reopening of the border. Private consumption is likely to remain robust for now, supported by the minimum wage increase and a wealth effect from rising house prices. There is a record high issuance of building permits and public infrastructure projects are gaining momentum – whether they are completed on time and budget remains to be seen. Inflation pressure will likely increase over the medium term.

KEY ECONOMIC DRIVERS?

Many analysts are bullish on the key drivers in the economy on the ground. Not that we necessarily agree but some of their arguments in favour include:

- The pandemic accelerated existing productivity trends, forcing people to adopt new technology. This is not the first-time businesses innovated quickly. The post-World War II economic boom owes a lot to the financial pressures of the Great Depression and supply chain pressures of World War II, which forced businesses to adopt previously existing innovative technologies. Is this a repeat?

- Business finances are generally healthy. Most previous recessions had financial causes, and businesses had to take time to rebuild their balance sheets. The current recession, by contrast, was met with firm government action that bolstered the financial system and balance sheets. Those that survived are ready and able to spend once they can do so safely.

- Higher-income households are sitting on a large pile of savings, US$2.8 trillion more than we had expected under "normal" circumstances before the pandemic. Since consumers in aggregate did not take on more debt, balance sheets are healthy, and consumers have money to spend.

- Government spending will continue to support growth. This will continue beyond the impact of the latest US relief bill if an infrastructure package becomes law. The main short-run impact of this spending impulse will be to get the economy back to full employment faster than would occur otherwise and, perhaps, allow the US Federal Reserve (The Fed) to renormalize financial markets earlier than expected. The long-run impact would be to raise potential GDP and allow more productivity growth.

We use the fear and greed index from CNN as a quick litmus test of where the financial markets are sitting, which suggests a different picture, showing a disconnect between the economy and financial markets:

- During the last five trading days of the month, volume in put options[*] have lagged volume in call options[†] by 61.05% as investors make bullish bets. This is among the lowest levels of put buying seen during the last two years, indicating extreme greed on the part of investors.

- Investors in low quality junk bonds are accepting 2.00 percentage points in additional yield over safer investment grade corporate bonds. This spread is down from recent levels and indicates investors are pursuing higher risk strategies.

- The S&P 500 is 6.77% above its 125-day average. This is further above the typical average during the last two years and indicates greed on the part of investors.

- Stocks have outperformed bonds by 1.40 percentage points during the last 20 trading days. However, this is close to the weakest performance for stocks relative to bonds in the past two years and indicates investors are starting to flee risky stocks for the safety of bonds.

Figure 2: Fear & Greed Index

Source: CNN

FINANCIAL MARKETS

We think the financial markets are resting on some potentially rocky assumptions including:

- That the vaccine can cope with an ever-increasing threat of new variants.
- Herd immunity can be achieved. Recent research in New Zealand suggested that to achieve this we would need between 85% and 97% of all people to get their jabs to get close which is unlikely.
- Interest rates stay low for the next 3-5 years which is challenging if inflation gets out of hand.
- Geopolitics remain stable.

[*] Put options are a bet against a security – it will pay off if the price drops.
[†] Call options are a bet for a security – it will pay off if the price increases.

If any of the above do not happen, market sentiment is likely to be challenged, undermining the economic data and current assumptions bolstering positive investor attitudes.

WORLD FIXED INTEREST MARKETS

Since last August/September, the US 10 Year Treasury Bond has been increasing until March this year. It increased to $1.77 and has now pulled back to $1.25 on 9th July. The Australian and New Zealand 10 Year Bond yields are ~$1.3 and $1.6 respectively which suggests more than just the Central Banks are investing in bonds to de-risk from equities.

PROMINENT THEME: GROWTH VS VALUE

The growth[‡] and value[§] swings are getting harder to read. The last decade has seen growth significantly outperform value. This trend accelerated when the pandemic hit as large-cap, technology stocks of companies best suited to take advantage of the pandemic soared as more cyclically (i.e., value) oriented companies and sectors suffered from the global economic shutdown.

The script was re-written in Q4 2020 with the approval of vaccines and rising anticipation of an economic reopening, which sparked value to outperform growth for the first time in a decade. Rising U.S. Treasury yields between November and April 2021 was bad news for growth stocks, which are more sensitive to rising rates.

However, in yet another rotation, value's outperformance has stalled since April as bonds peaked and pulled back in May and June, allowing growth stocks to regain traction – it is all over the show! The market is undecided on which theme of value or growth it prefers. Maybe growth and value can co-exist better or are less binary going forward? These tensions exemplify the current complexity of the market with varying forces driving it in different directions.

Momentum factors for growth:

- The US 10-year Treasury has fallen in recent months.
- Retail investors buying technology companies.
- Fed sentiment that inflation is transitory, indicating lower interest rates for longer.

Momentum factors for value:

- Rhetoric of medium term rising central bank rates.
- If inflation is longer term and more permanent.

INFLATION

[‡] Growth stocks are companies that have their value in future earnings, which are typically technology and early-stage businesses such as Tesla.

[§] Value stocks are those which are undervalued relative to earnings, revenue or book value.

US Federal Reserve Chair Jerome Powell reiterated his view that the sharp rise in consumer price inflation will prove transitory, noting a return to double-digit inflation seen in the 1970s is "very, very unlikely". European Central Bank President Christine Lagarde played down the likelihood of US inflation spreading, stating any spill-over effect on the euro area inflation is expected to be moderate.

Sentiment potentially changed at the 16 June 2021 Fed meeting where Jerome Powell suggested it might have to raise rates earlier and higher than expected. This was in response to an acknowledgement by the Fed that inflation was tracking higher than expected and showing signs it may be more persistent – in line with our view over the past few months. The US CPI was up 5% year-over-year in May, the highest increase since 2008. However, in a twist, instead of longer-term rates increasing, they fell! It demonstrates the fickle nature of the markets, and a rational response is not necessarily the one we get – investors are emotional which drives the markets in funny directions.

In domestic data, the ANZ business outlook survey confirmed a key risk facing the economy was overheating and the selling pricing intentions indicator is running at a record high. This is indicative of annual inflation tracking above 5%. Firms indicated intense cost pressures which suggests it's only so long before selling prices must rise. This indicates a sooner, rather than later, start to the monetary policy tightening cycle, probably November 2021 for the RBNZ.

COMMODITIES

As the global economy emerges from the worst of the pandemic, the outlook for exports continues to improve. Surging commodity prices are a big driver, including oil reaching US$75 per barrel. As consumption is recovering from overseas, global supply has struggled to keep up with demand, boosting prices for dairy, meat, and forestry products by between 10%-30% each since January 2021.

There has been plenty of ink spilled discussing shipping bottlenecks and logistics disruption, but NZ export volumes are holding up well. After a relatively modest COVID dip, the strength in global dairy demand has seen dairy export volumes lift above pre-pandemic levels as of the March quarter, achieving their second highest ever level. Meat export volumes are back up at pre-pandemic levels. This is promising, considering that immediately before COVID the global protein shortage had pushed up demand for NZ beef and lamb.

CARBON POLICY

The Labour Government has confirmed the first details of its proposed 'feebate' scheme, designed to make electric cars more accessible by introducing a charge on high-emissions vehicles. From July 1, new electric car buyers will be able to get a taxpayer-funded rebate of up to $8,625 on their pure EV. New plug-in hybrid buyers will get up to $5,750. Each rebate can only be cashed in on cars priced under $80,000. Why plug-in hybrids only and not all HEV? It cuts off the majority of the hybrid cars available in the market.

This political movement is more populistic rather than rational, at least for now. There are three key reasons:

- The first, infrastructure, there are not enough EV charging stations across the country. Most popular (and affordable) EV car Nissan Leaf takes around 30 minutes to charge its battery up to 80%. According to NZTA, there were 3.3m passenger cars in 2019 and to charge all these cars (assuming it is all EVs) it will take 70,058 hours (!). How many EV charging stations do we need in addition to the approximate 300 we already have?

- The second is electricity supply. According to MBIE, net generation of electricity fell by 2.1% over the year to 31 March 2021, however, coal powered generation nearly doubled over same period (Figure 3). And this is without the wider use of EVs. Burning coal to charge EVs doesn't sound like an efficient plan to reduce CO2 emissions.

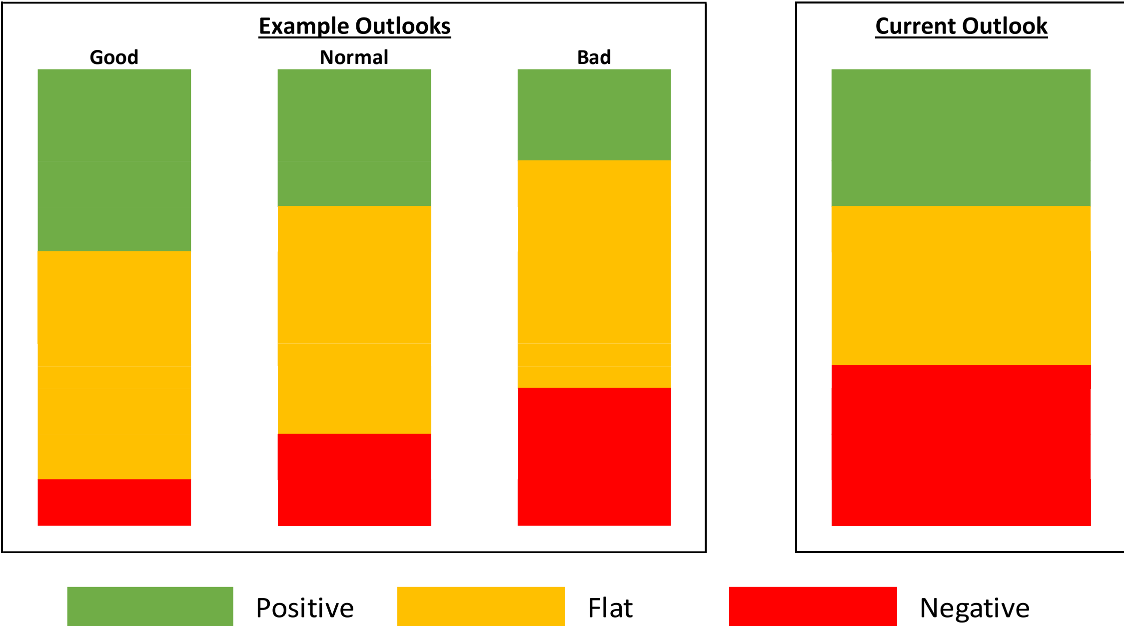
Figure 3: New Zealand Net Electricity Generation

	Mar 20	Jun 20	Sep 20	Dec 20	Mar 21	% change when compared to the same quarter of the previous year
Net Generation (GWh)	10,359	10,336	11,597	10,565	10,140	-2.1%
Hydro	5,858	5,670	6,217	6,246	5,325	-9.1%
Geothermal	1,908	1,957	1,926	1,819	1,947	2.0%
Biogas	64	65	66	66	63	-1.5%
Wood	83	81	80	76	90	8.6%
Wind	529	528	607	615	510	-3.7%
Solar[3]	44	30	35	49	54	22.2%
Oil	0	3	8	6	6	1219.6%
Coal	523	403	735	509	1,031	97.0%
Gas	1,337	1,589	1,912	1,168	1,103	-17.5%
Waste Heat[4]	11	11	11	11	11	0.0%
Renewable Share (%)	81.9%	80.6%	77.0%	84.0%	78.8%	-3.8%
Renewable Share (%) – Four-Quarter Moving Average	82.8%	82.2%	81.1%	80.8%	80.0%	

Source: MBIE

- The third is the supply of new replacement batteries and the utilisation of old ones. The supply of batteries is limited by official vehicle distributors. Could they handle the demand in next two-three years? But the worst part is utilization of old batteries. EV batteries are larger and heavier than those in regular cars and are made up of several hundred individual lithium-ion cells, all of which need dismantling. They contain hazardous materials and have an inconvenient tendency to explode if disassembled incorrectly. Currently, for example, much of the substance of a battery is reduced during the recycling process to what is called black mass - a mixture of lithium, manganese, cobalt and nickel - which needs further, energy-intensive processing to recover the materials in a usable form. Do we have a plan and resources for this? And is the government putting the cart before the horse?

MARKET OUTLOOK



The current market is less likely to have a good return (green) as an average return (amber) over the next two to three years. It is a little more likely to have a bad return (red).