MARKET PERFORMANCE AND COMMENTARY – JANUARY 2022

MARKET PERFORMANCE

Index	Index Level/Price	1 Month %	3 Month %	1 Year %
Global Equities				
MSCI Emerging Markets	729.70	-1.8	-3.5	-5.6
S&P 500 (US)	4515.55	-5.3	-2.0	21.6
Nikkei 225 (Japan)	27001.98	-6.2	-6.5	-2.4
FTSE 100 (UK)	7464.37	1.1	3.1	16.5
DAX (Germany)	15471.20	-2.6	-1.4	15.2
CAC 40 (France)	6999.20	-2.2	2.5	29.6
Trans-Tasman Equities				
S&P/NZX 50	11889.40	-8.8	-9.2	-9.4
S&P/ASX 300	80157.43	-6.5	-4.5	9.6
Bonds				
S&P/NZX NZ Govt Stock	1795.02	-1.1	0.5	-6.7
S&P/NZX A Grade Corporate	5670.86	-0.6	0.3	-4.8
Barclays Global Agg (Hedged to NZD)	419.03	-1.6	-1.2	-2.3
FTSE WGBI (Hedged to NZD)	3612.84	-1.5	-1.1	-2.8
Oil				
West Texas Intermediate Crude	88.15	14.5	5.5	68.9
Brent Crude	90.95	17.4	8.4	65.8
NZD Foreign Exchange				
AUD	0.9322	-1.0	-2.2	-0.8
EUR	0.5859	-2.7	-5.3	-1.2
GBP	0.4895	-3.2	-6.2	-6.7
JPY	75.6740	-4.0	-7.3	0.3
CNY	4.1892	-3.8	-8.6	-9.8
USD	0.6568	-4.1	-8.2	-8.9

Source: Nikko, indices are in the local currency of the asset unless otherwise indicated.

Executive summary:

- Equity markets sold off sharply
- Rotation from growth stocks, especially tech, to value
- Interest rates rose at shorter end
- New Zealand dollar weakened
- Oil prices kept rising

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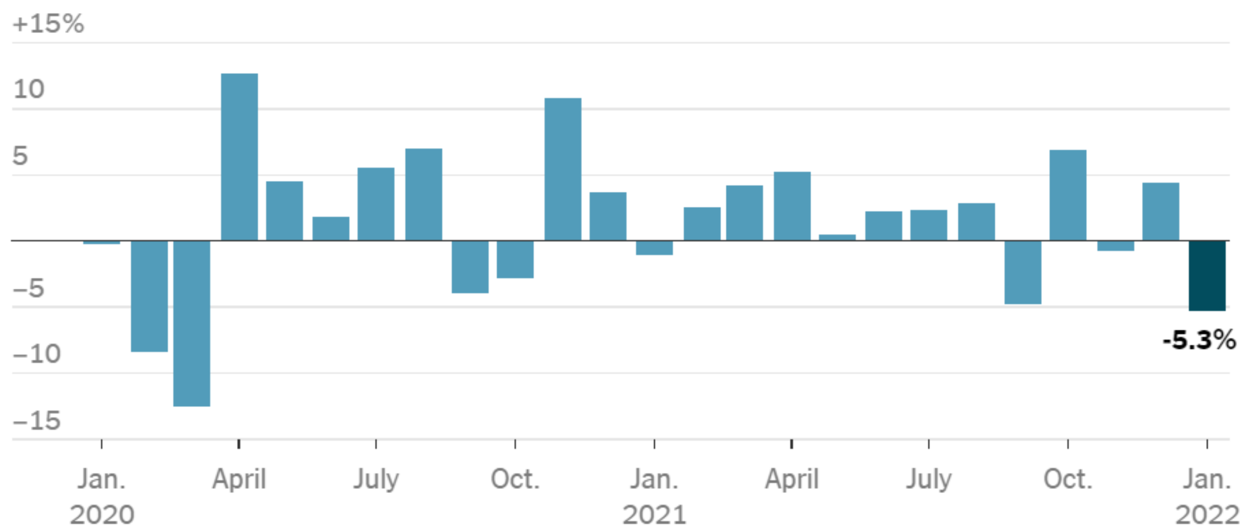
ECONOMIC COMMENTARY

GLOBAL SNAPSHOT

The US Federal Reserve Chair Jerome Powell's speech at the Federal Open Market Committee (FOMC) and geopolitical tensions triggered an equity sell off in January. Investors now expect rates to be hiked as soon as March, and this expectation was confirmed at the last FOMC meeting. Escalating tensions between the US and Russia over Ukraine added to worries, weighing markets down. S&P 500 saw its worst month since March 2020 (Figure 1), whilst for the Nasdaq it was the worst January since 2008.

Figure 1



Jerome Powell said "reducing our balance sheet will occur after the process of raising interest rates has begun. Reductions will occur over time in a predictable manner primarily through adjustments to reinvestments so that securities roll off our balance sheet." The balance sheet will continue decreasing from the maturation of existing held securities, despite the latest FOMC statement confirming the Fed will buy at least $30 billion more worth of Treasury securities and Agency mortgage-backed securities (MBS) per month starting in February 2022.

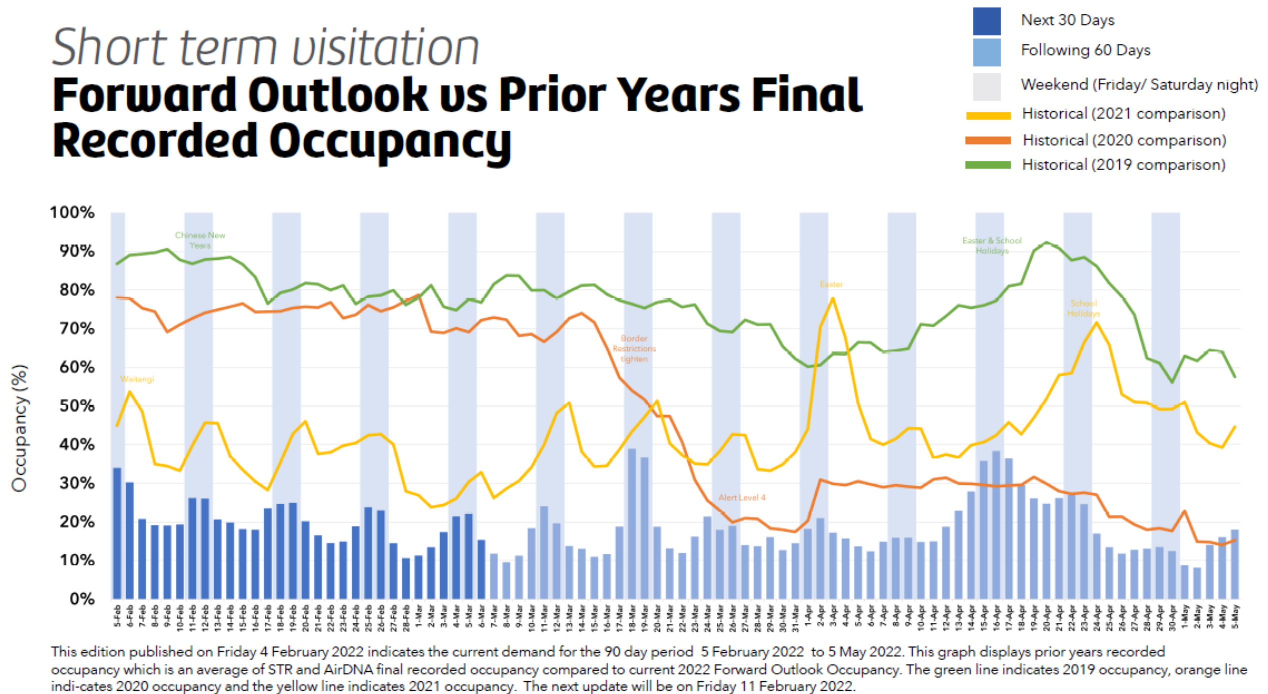
The potential for sanctions intended to deter Russian activity in the Ukraine raised demand for energy stocks. Most other sectors fell, especially consumer discretionary, real estate and tech stocks as inflation concerns outweighed short-term optimism in respect of future earnings and upcoming dividends.

The European economy remains in good stead for 2022. The labour market has continued to improve and there is a strong basis for wage growth. Growth in headline inflation is largely due to increases in energy prices and the ECB expects its first hike to occur in the last quarter of 2022. In contrast, the Bank of England will be looking to continue lifting rates over 2022 as the UK recovers from the Omicron outbreak.

LOCAL SNAPSHOT

New Zealand remains at the Red level of its COVID Protection Framework to control the community transmission of Omicron. Lockdowns are said to be a thing of the past, however hospitality and tourism sectors are still under pressure and a sizeable protest against vaccine mandates is taking place in Wellington at the time of writing (9 February 2022). With limited government support for businesses, small businesses are wary of increasing inflation and skills shortages. Queenstown, which has year round tourism providers, is projecting an occupancy rate for the next ninety days of below 30%. It's a gloomy picture compared with pre-COVID 2019 occupancy averaging 90% (Figure 2) and is reflected in tourist centres around New Zealand.

Figure 2



Source: www.queenstownnz.co.nz

Consumer price inflation rose for the second quarter in a row and reached 5.9% for 31 December 2021, its highest level since 1990. Inflation pressures are spread widely, and in almost all sectors we have seen strong demand and rising cost pressures including supply chain issues. We expect inflation to remain elevated this year for the same reasons.

The New Zealand labour market remained resilient despite COVID restrictions during the second half of 2021. The unemployment rate fell to 3.2% in the December quarter, from a downwardly revised 3.3% in September 2021. These figures are the lowest on record since the Household Labour Force Survey began in 1986. Commensurately, the pace of wage growth has picked up over the last year. But it hasn't really gone beyond a catch-up after little or no wage growth in the wake of COVID in 2020. Neither labour shortages nor demands for cost-of-living adjustments appear to have led to a widespread breakout in wage inflation yet.

Financial markets have been exploring the idea that the RBNZ could accelerate the pace of monetary tightening with a 50 basis point hike later this month, rather than 25. We think this is unlikely and believe the RBNZ will hike the rates gradually and consistently with clear ongoing signalling.

WORLD FINANCIAL MARKETS

Equities

U.S. stocks ended a volatile month with the biggest two-day rally since 2020, with knocked-down tech shares powering a rebound.

The S&P 500 rallied almost 2% for its best back-to-back performance since April 2020, paring a monthly loss that at one point exceeded 10% to 5.3% -- still the worst drop since the pandemic's start. The Nasdaq 100's rebound was even sturdier, a 6.6% surge in two sessions.

The huge month-end rallies continued a trend of volatility that has gripped markets since the Federal Reserve signalled earlier in January its intention to tamp down inflation that had swelled to the fastest since the early 1980s. In one session, the Nasdaq 100 fought back a loss of almost 5%, while the S&P 500 staged three straight days with a 3% gain.

Strong earnings from Apple supported the market last week of January, easing fears that the tech industry's period of fast growth may be coming to an end.

Sectors that are tied closely to the economy, such as financial stocks and industrials, have done better than the market as a whole. Shares of General Electric are down only about 2.5 percent since the start of the year. Wells Fargo's stock price is up about 2.5 percent in 2022.

Eight out of eleven Australian sectors contributed negatively to January returns, with financials being the largest detractor, responsible for close to a third of the S&P/ASX 200's decline for the month. Commodity-related energy and materials, and utilities advanced, but their combined 0.4% contribution was only enough to limit the benchmark's losses for the month.

Fixed Interest

Government bond yields rose higher in January, while stock markets fell sharply and corporate bonds also declined, as investors focused on continued elevated inflation and impending tightening from the Fed.

Fed Chair Powell's comments during the month indicated the US central bank would consider all options for the future path of policy. Markets took this as paving the way to potentially a more aggressive tightening trajectory.

The German 10-year yield rose from -0.2% to just over 0% for the first time since May 2019. Concerns over the Omicron variant started to fade and numerous European countries eased lockdown measures. The Italian 10-year yield increased from 1.18% to 1.37%. The country's presidential election saw incumbent

Sergio Mattarella returned to office, which the market took as a positive outcome and spreads tightened to core markets.

The UK 10-year yield increased from 0.97% to 1.31% and the 2-year yield from 0.68% to 1%. UK consumer inflation hit a 30-year high of 5.4% in December and raised expectations for a further rate hike in February. Corporate bonds had a difficult month, registering negative total returns and underperforming government bonds as spreads widened. Europe performed well relative to the US. The European transportation sector did relatively well as numerous countries lifted lockdown measures.

Emerging market (EM) debt saw negative returns. Local currency bond yields rose further, while EM currencies broadly performed well especially in Latin America. EM corporate bonds outperformed global credit markets.

INFLATION

Q4 2021 inflation figures in New Zealand were about as ugly as expected. Consumer prices rose by 1.4% in the December quarter. That lifted the annual inflation rate to 5.9%, the highest rate going back to 1990.

The worldwide effects of COVID have led to disruptions in manufacturing and supply chains, abnormally high demand for physical goods over services, rising materials costs and extreme pressure on global shipping capacity. Prices of tradable goods have risen by 6.9% over the last year.

The supply-side factors have collided with strong domestic demand. The New Zealand economy rebounded quickly after the initial COVID lockdown in 2020, and by mid-2021 activity was running well above pre-pandemic levels. As a result, domestic prices are being pressured higher, and the demand for workers has surged even as the border closure has constrained growth in the workforce.

The surge in inflation underscores one of the biggest lessons of the last year: the COVID shock was not like a 'typical' recession, where the economy suffers a shortfall in demand. Policymakers certainly acted under the view that they would need to stimulate demand, and that support was particularly valuable during the periods of lockdown. But for the most part the pandemic has been a productivity shock, which has weighed on the economy's operating capacity.

New Zealand has been far from alone in terms of the inflationary consequences – indeed, we've noted that our economic situation is different from the rest of the world only by a matter of degree. New Zealand successful COVID elimination strategy in 2020 saw economic activity rebound faster than in most economies, and this was bolstered by generous monetary policy and one of the largest government spending packages in the world. As a result, by 2021 there was growing evidence that country had reached the point of overheating. But it was only a question of time as to when other countries would reach that point as well.

The US Federal Reserve acknowledged that it will need to start raising interest rates soon, with annual inflation reaching 7% and proving to be less 'transitory' than hoped. And a stronger than expected inflation print in Australia means that the RBA is now expected to change its tune and signal rate hikes in 2022 after the Federal election in May.

GEOPOLITICS

Russia-Ukraine tensions are still on the rise. Hysteria from the US that Russia will attack Ukraine "tomorrow" was taken calmly by the Ukrainian intelligence office. After all, stated Ukrainian intelligence, it will take a couple of weeks for Russian troops to be ready for invasion. France and the UK are trying to play mediator, but only President Macron managed to sit with President Putin at the same table. Prime Minister Johnson lost the opportunity and is still busy trying to solve issues with his cabinet of ministers and the UK's COVID strategy.

Europe and the US were never so weak on the political stage at the same time. There was always a balance between East and West, but not this time. The last leader who could oppose Russia was Chancellor Angela Merkel, who last year retired, after 16 years leading Germany and largely steering the European Union.
The threats from the US and Europe of imposing sanctions has never worked and with Russia will probably not work this time. It did not make any difference in 2008 (in the invasion in Georgia and the occupation of territories Abkhazia and South Ossetia) and 2014 (in the annexing of Crimea).

The root of the current conflict goes back to 1994 when President Clinton's administration declared that the NATO would accept former Soviet republics and countries from the Warsaw Treaty Organization (Eastern Europe). President Yeltsin had no political power to stop this process. The next round of Russia-NATO relations started under President Putin's ruling in 2008. During the negotiating of security in Europe western leaders verbally promised to stop further expansion to the East. However, NATO accepted more countries into the block reaching the Russian borders. All former Soviet republics are considered by President Putin to be part of the modern Russian empire, and any 'trespassing' is interpreted as a direct threat to Moscow.

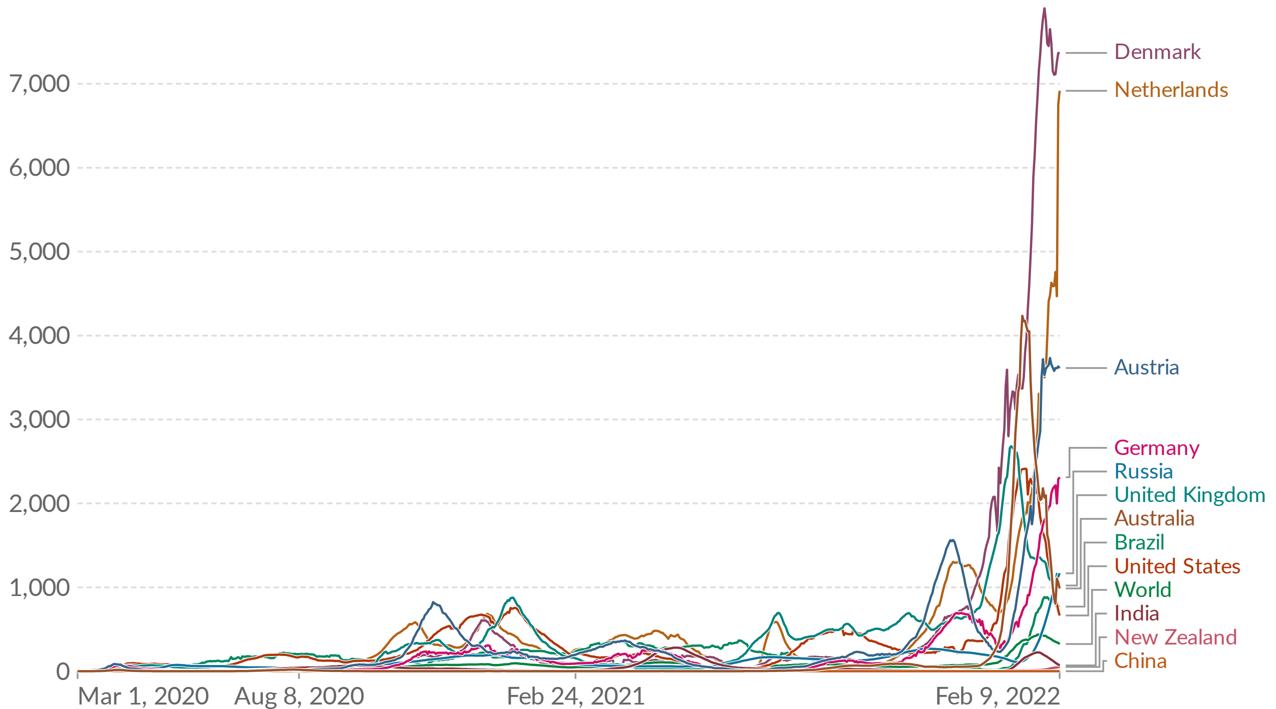
The main nuance of the Ukrainian scenario is that Crimea is annexed by Russia now. Ukrainian President Zelensky's statement that the Ukraine will recover Crimea by any means puts Russia in a position of war with NATO. Strategically, it is easier to fight with the Ukraine rather than with the rest of Europe. So this story is not about sanctions and economic effects, such as the possible freeze of the $11 billion Nord Stream 2 pipeline project; it is instead about preventing a major global conflict.

GLOBAL COVID

So far, 2022 has brought mostly good news around the Omicron variant, which you'll remember caused a market drop in late 2021. Although uncertainty remains about potential supply chain disruptions in China, restrictions on movement are being eased in many developed markets and there is growing evidence that healthcare systems can now cope with the highly transmissible yet relatively mild variant of COVID.

The situation globally is not as bright. According to the WHO many countries have not reached forecast peak cases of the Omicron variant of the coronavirus. Measures imposed to curb its spread should be eased slowly, but some have not taken it as seriously. Denmark and Austria last week became the latest countries to relax COVID restrictions, after similar moves by Britain, Ireland and the Netherlands, though other European nations planned new curbs to battle record numbers of infections. Figure 3 shows the impact of this on confirmed case numbers per million.

Figure 3



BEHAVIOURAL FINANCE

Retail investors became a significant player in financial markets in 2020, and their sentiment is more transparent than institutional investors, and often contrarian.

For example, the latest survey from the American Association of Individual Investors showed that only 21% of respondents expect stocks to rise over the next six months. This is lower than 97% of all readings since 1987. When ISM's Manufacturing PMI is higher than 55— and the latest reading was 58.7—and less than 25% of respondents in the AAII survey are confident of rising share prices, stocks have on average risen 19% over the following year.

But on the other side the Bank of America wrote in a research note that its retail clients, as a group, had put more money into the stock market than they had pulled out. In the first three weeks of the year, individuals with accounts at Bank of America bought $2.3 billion more in stocks than they sold.

At the same time hedge funds that use Bank of America to trade sold nearly $3 billion more in stock and bond funds than they bought. “Retail clients remained the biggest buyers,” Jill Carey Hall, a Bank of America strategist, wrote in the note. “Clients bought the dip.”

In a timely manoeuvre that will increase liquidity and trading, Alphabet announced that they will do a 20:1 share split. It would make a $2,700 share an appealing $135 option for retail investors.

HUMANS VS ROBOTS

North America is poised for a robot industrial revolution this year, as orders for robots hit a record of over $2 billion, or almost 40,000 robots, in 2021. The pandemic-fuelled labour shortage prompted companies to shell out 28% more for advanced machinery than the previous year. Automakers have historically dominated the use of robotics in their assembly line. But sectors like metals, food, construction and healthcare will increase their share of these machines by 2025.

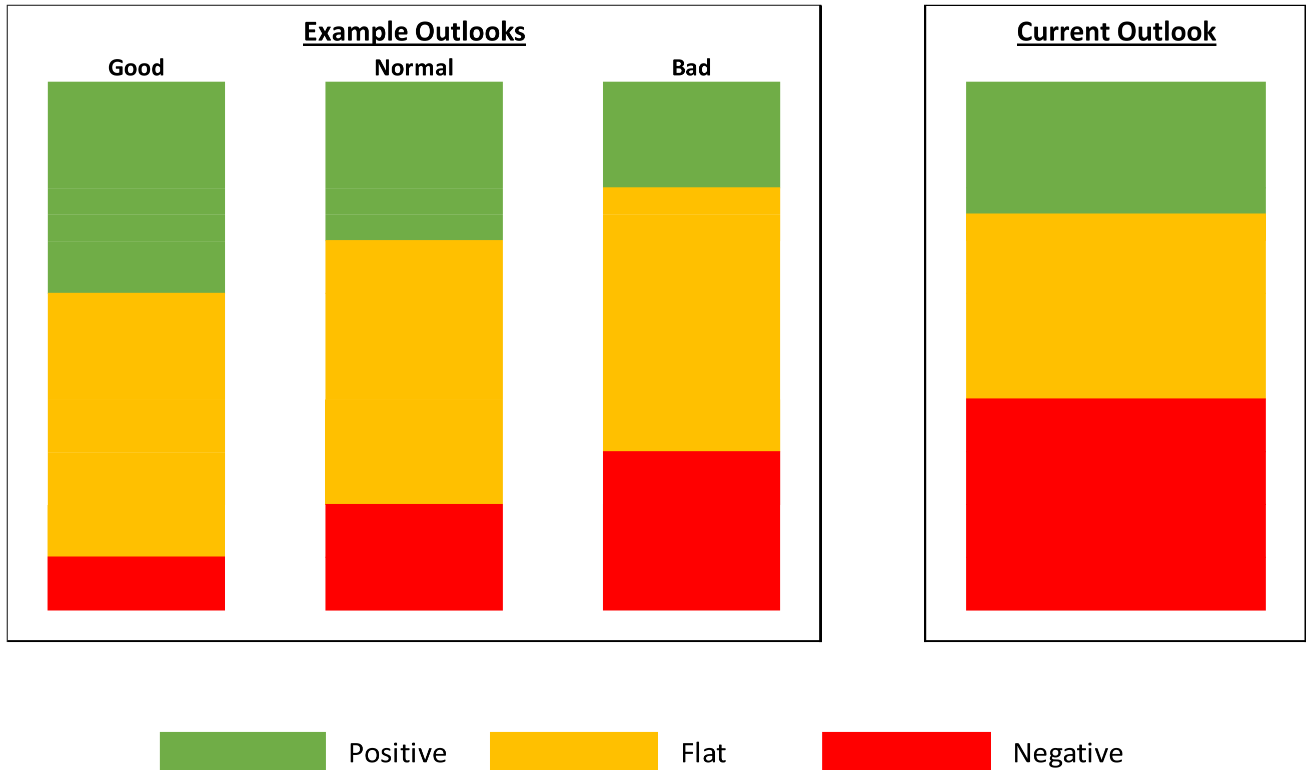
From e-commerce fulfilment warehouses to big box stores, companies aim to automate routine tasks. Sam's Club will trial using cameras on its robot scrubbers to scan inventory and flag shelves that need to be restocked. Walgreens acquired the majority stake of iA, a pharmaceutical fulfilment tech company to help fill prescriptions for 550 pharmacies. It currently operates two centralised autonomous hubs and plans to open nine more by the end of 2022.

Experts estimate around 2,000 Baby Boomers in manufacturing retire every day. That leaves a gap of experienced personnel on factory floors, but ushers in a new breed of "cobots," designed to work alongside humans. Cobots may also be useful in construction, where only about 50% of businesses have embraced automation. One firm used robot arms from Universal Robots to install gib board in large building projects. And the 2022 Winter Olympics feature a cornucopia of robot chefs, servers and bartenders at the main media centre. Since the US now has 1.7 open jobs for every unemployed worker, cobots could make an efficient addition to the labour force and even help emerging industries reach price parity sooner, increasing competition.

A new report by Salesforce reveals a huge gap between the current workforce and the technical skills needed to advance in the digital age. The Global Digital Skills Index surveyed 23,000 people in 19 countries and only 28% said they actively learn new digital skills. As staffing shortages plague companies and more turn to AI, the skills gap in most of the G20 nations could result in a loss of $11.5 trillion in cumulative GDP growth over the next few years.

As the post-war period between the 1950s and 1980s showed us, education and automation need to work in tandem to boost human capability and productivity. Some of the most in-demand skillsets of the future currently have less than 10 qualified candidates available per job posting. But these skills are in areas such as data science, information security, AI/machine learning, and robotic process automation. If governments and companies don’t up-skill employees, workers will need to pursue their own training, and given the type of training and the impacts of COVID, this training is only accessible online. As advertising, social media and streaming services expand ever further, it is increasingly challenging for those who are reliant on the internet for training to truly learn, and not just scroll.

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 more likely to have a bad return (red). The risk of a correction has increased marginally compared to the last scenario.