ERIKSENSGLOBAL

Actuaries & Investment Strategists

MARKET PERFORMANCE AND COMMENTARY – JULY 2022

MARKET PERFORMANCE

Index	Index Level/Price	1 Month %	3 Month %	1 Year %
Global Equities				
MSCI World NR	6556.86	8.0	-0.7	-5.6
MSCI World NR (NZD)	13349.80	7.0	2.1	1.1
MSCI Emerging Markets	642.03	0.1	-4.6	-14.9
S&P 500 (US)	4130.29	9.1	0.0	-6.0
Nikkei 225 (Japan)	27801.64	5.3	3.6	1.9
FTSE 100 (UK)	7423.43	3.5	-1.6	5.6
DAX (Germany)	13484.05	5.5	-4.4	-13.3
CAC 40 (France)	6448.50	8.9	-1.3	-2.5
Trans-Tasman Equities				
S&P/NZX 50	11492.65	5.7	-3.3	-8.7
S&P/ASX 300	81358.09	6.0	-6.2	-2.3
Bonds				
S&P/NZX NZ Govt Stock	1727.37	2.9	2.0	-8.7
S&P/NZX A Grade Corporate	5578.07	2.1	2.3	-4.9
Barclays Global Agg (Hedged to NZD)	397.00	2.6	0.8	-7.7
Oil				
West Texas Intermediate Crude	98.62	-6.8	-5.8	33.4
Brent Crude	107.97	-6.1	1.3	43.2
NZD Foreign Exchange				
AUD	0.8986	-0.6	-1.6	-5.4
EUR	0.6150	3.4	0.0	4.5
GBP	0.5153	0.6	-0.3	2.6
JPY	83.8052	-0.8	-0.3	9.4
CNY	4.2343	1.6	-1.8	-6.2
USD	0.6271	0.9	-3.4	-10.2

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

Executive summary:

- Global and Australasian equities benefitted from rallies in July
- Geopolitical risks are on a peak after visit of senator Pelosi to Taiwan
- Small progress on food security supported by joint UN-Turkey efforts cresting safe corridor for Ukrainian wheat
- Oil prices have fallen from recent highs on fear of recession and slowing down activity in China
- Investors are turning down from emerging markets
- New Zealand dollar depreciated against AUD and JPY while appreciated against other major currencies.

Auckland
2 Burns Ave, Takapuna
PO Box 33-1318 Takapuna 0740
p: +64 9 486 3144
auckland@eriksensglobal.com

Wellington
Level 9, 111 The Terrace
PO Box 10-105 Wellington 6143
p: +64 4 470 6144
wellington@eriksensglobal.com

ECONOMIC COMMENTARY

GLOBAL SNAPSHOT

July saw more volatility in financial markets, driven by fears of recession and economic indicators. Investors were less concerned about rising inflation and interest rates and more optimistic which drove equities up in July. Another prominent theme over the month was climate change and the record high temperatures in the Northern hemisphere. Increased geopolitical tensions surfaced at the end of the month in Europe and Asia.

The Federal Reserve raised its benchmark interest rate by 0.75% in the last week of July. The Fed's decision was widely expected, though for many experts, Fed Chair Jerome Powell sounded dovish at the post-meeting press conference. The FOMC reported the economy had signs of softening in spending and manufacturing. This statement came after a strong earnings season for Alphabet and Amazon which led to a one-day rally for the Nasdaq index.

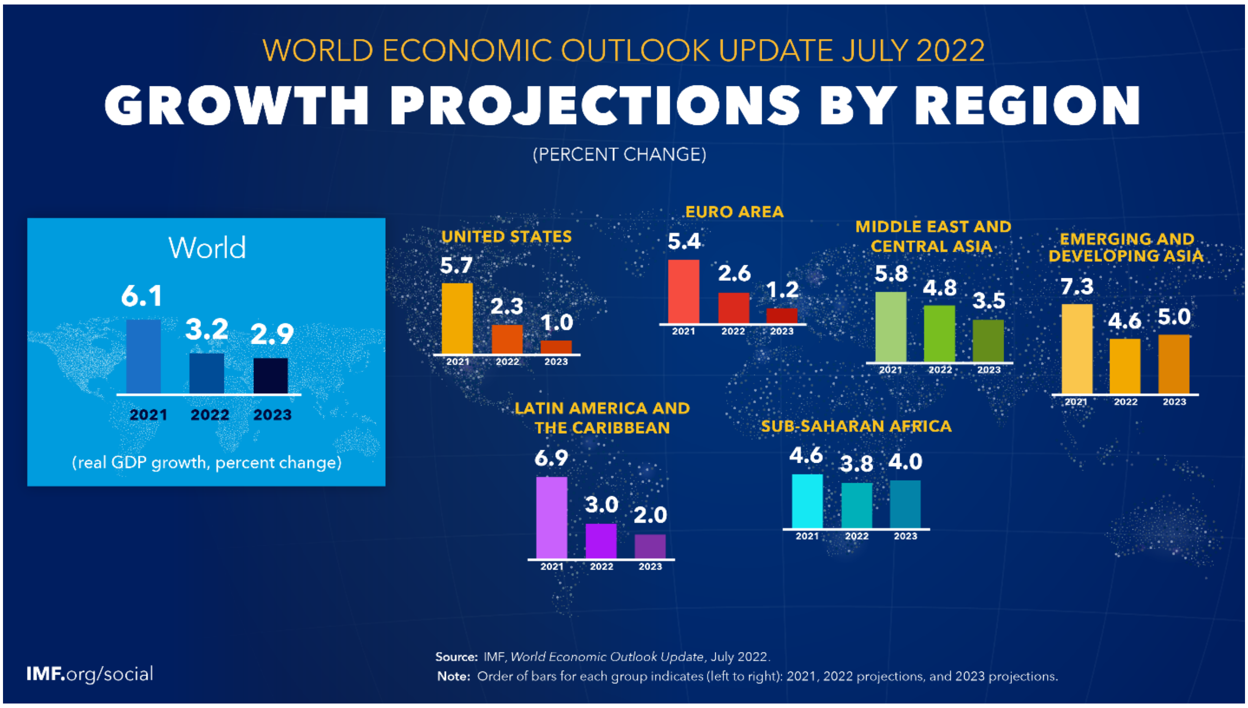
The last week of July also saw raw US GDP shrink in the second quarter of 2022 by 0.9% per annum however markets were expecting an increase of 0.5%. This puts the US into a technical recession. On the flip side, other indicators were strong such as job growth, which is primary indicator for the turning point of a business cycle. The University of Michigan Survey of Consumers revealed long-run inflation expectations fell to 2.8% per annum, down from 3.1% in June. The US 10-year breakeven inflation rates have declined from a peak of 3.1% in April to 2.5%. Year on Year Core CPI has also now declined for three consecutive months. The markets interpreted this as a sign that the Fed could slow or stop its rate hikes sooner than expected, extending the stock rally at the end of the month.

Europe is expected to reach another record level of inflation hitting 8.9% in July which is up from the 8.6% registered in June. The main drivers were food and energy prices. European natural gas prices rose after Russia reduced gas supplies from the Nord Stream pipeline to 20% of capacity. Officials stated that reason is the need for maintenance on another turbine. All EU energy ministers except Hungary agreed that member states would cut their natural gas use by 15% over the winter.

The Chinese property sector received a boost after Beijing announced the plan to set up a real estate fund worth CNY 200 billion to CNY 300 billion to support distressed developers. The government used a similar programme to buy between 5 million and 6 million units per year in 2016-2018. These steps cooled down the situation in the Chinese property market which has seen mortgage payment boycotts in response to suspended and delayed housing construction and the resurgence of COVID-19 in several cities.

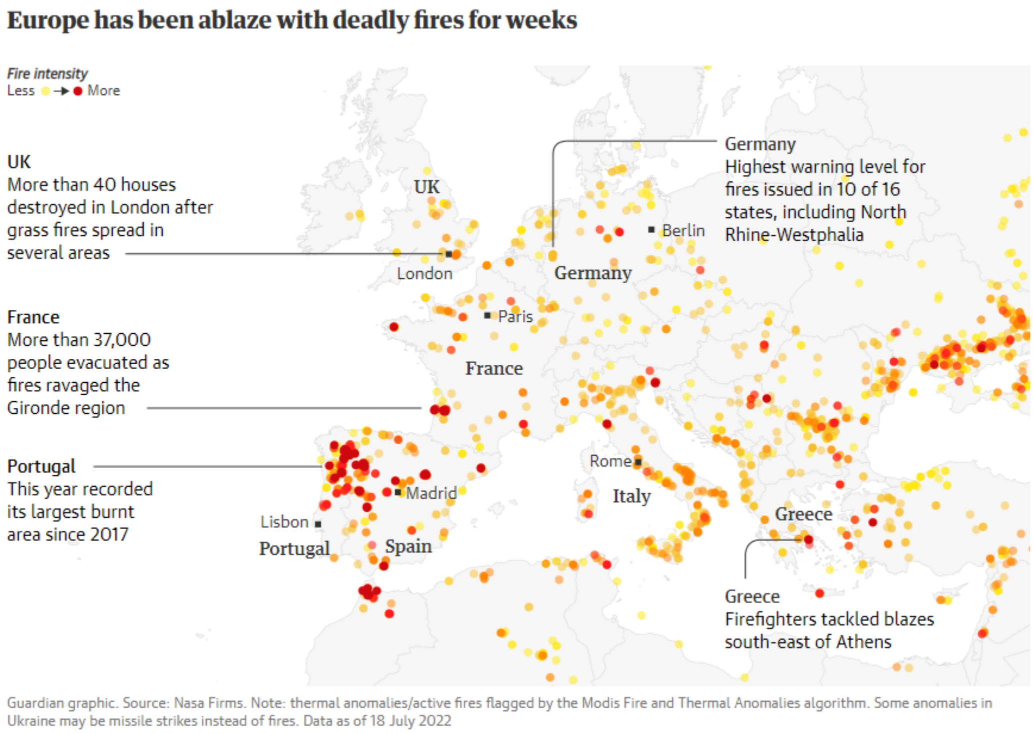
The IMF issued the World Economy Outlook Update in July, showing a slowdown from 6.1% last year to 3.2% in 2022 (Figure 1). The global economy was already weakened by the pandemic, and now several shocks have hit it: high inflation worldwide, especially in the United States and major European economies, triggering tighter financial conditions; a slowdown in China, reflecting COVID- 19 outbreaks and lockdowns; and further negative spill overs from the war in Ukraine translated to higher food and energy prices. These developments have contributed to widespread concerns about the outlook for growth and inflation risks in advanced economies.

Figure 1



Not only the cost of living but also temperatures have risen in Europe, causing forest fires across thousands of hectares (Figure 2). The high temperatures have forced an increase in electric power consumption to cool the air in the homes of millions of Europeans. This has undermined efforts to cut power consumption to minimise the amount imported from Russia. Heading into winter, Germany reported that the plan to reach 95% in gas storage facilities by 1 November from the current 68% is impossible without additional measures.

Figure 2



Source: theguardian.com

The wheat export corridor running from Ukrainian ports to Africa saw its first shipment in July, due to joint efforts from Turkey and the UN. This is helping to ease the shortage of basic foods in dependent regions of Africa and Asia.

The unified European coalition is falling apart after resignation of two PMs – Johnson in the UK and Dragi in Italy. Rising negative sentiment in Europe has forced politicians to focus on domestic issues rather than international (such as the war in Ukraine).

LOCAL SNAPSHOT

The unemployment rate in New Zealand increased slightly in the second quarter of 2022 but the labour market is still extremely tight with employment above its maximum sustainable level. Labour costs in New Zealand have grown to their highest level since the global financial crisis and are expected to continue to rise as workers seek compensation for the rising cost of living in a tight labour market.

The inflation rate in New Zealand increased to 7.3% in the second quarter of 2022, following a 6.9% gain in the previous period. This is the highest inflation rate since the second quarter of 1990. Prices increased faster for housing and utilities, transportation, recreation and culture and alcoholic beverages and tobacco.

The RBNZ raised interest rates for the sixth consecutive time in mid-July and signalled that it was still comfortable with its planned aggressive tightening path, in an effort to reduce the second-round effects of runaway inflation.

Despite a strong desire by Kiwis to invest ethically, the FMA's research has revealed that investment managers are not doing enough to make it easy for investors to compare and choose ethical funds. The regulator surveyed 14 KiwiSaver and other managed funds to get an understanding of how well the industry was meeting guidance it issued in December 2020. The key findings were despite a strong desire by New Zealanders to invest ethically, it was hard for them to navigate the sector and they were not confident of what to look for. The main obstacle is the technical jargons used in the description of products.

The ANZ New Zealand Business Outlook revealed that business confidence gained 6 points in July up to -56.7, while expected business activity was flat at -8.7.

New Zealand fully opened its borders on 31 July for the first time since the first lockdown in March 2020. Immigration New Zealand has reported increased numbers of applications for visitor and student visas. Hopefully this will improve the situation in the tourism and education sectors.

WORLD FINANCIAL MARKETS

Equities

The MSCI World Index returned 8.0% and MSCI Emerging Markets returned 0.1% in July in local currency terms.

The S&P 500 posted a solid gain of 9.1% in July despite another outsized 75bp rate hike from the Fed and news that the economy contracted at a 0.9% annual rate in the second quarter. A "bad news is good news" dynamic appeared to have taken hold, with investors seemingly pencilling in a lower terminal federal funds rate after the second-quarter economic contraction. Growth stocks outperformed value stocks on weakness in the retail sector, while small-caps finished broadly in line with their large-cap counterparts.

Amazon and Alphabet jumped on the last Wednesday of July after posting better-than-feared earnings results after the market closed the day before. The Nasdaq Composite Index rallied 12.4% in July, its best July ever.

In Europe, the Euro STOXX 50 Index returned 7.5% in July boosted by data showing that the eurozone economy expanded at a higher-than-expected rate of 0.7% in the second quarter. Markets largely shrugged off concerns about rising natural gas prices due to reduced Russian supply. Germany's DAX Index gained 1.7%, France's CAC 40 rose 3.7%.

Fixed Interest

Sparked by Powell's dovish post-FOMC meeting comments, the US Treasury yield curve steepened, with intermediate- and short-term yields decreasing and long-maturity rates holding generally steady. Confirmation that GDP contracted over the first two quarters of the year also fuelled demand for short- and intermediate-term Treasuries. The closely watched 2-year/10-year segment of the Treasury yield curve remained inverted – a common, if imperfect, signal of a coming recession. The US 10-year Treasury yield fell by 10bp over the following week from 2.75% to 2.65%.

Core eurozone bond yields fell as concerns about global growth increased after Russia reduced its gas supplies into Europe. Over the week, the German 10-year bund yield decreased by 22bp to 0.81% from 1.03%. Peripheral government bond yields broadly tracked core markets.

UK gilt yields also largely followed core markets but ended the week broadly level. The 10-year gilt yield decreased 8bp, down from 1.94% to 1.86%.

ENERGY RESOURCES AND ESG

Demand for coal is expected to rise in India and China in 2022. In India, demand is expected to rise by 7% due to economic growth and the expansion of electricity use. In China, coal demand is estimated to have declined by 3% in the first half of the year due to Covid lockdowns, but is expected to increase in the second half, bringing coal consumption for the full year back to the same levels as last year. Together, China and India consume double the amount of coal as the rest of the world combined. Coal consumption in the European Union is expected to rise by 7% in 2022, due to increased demand from the electricity sector, limitations being placed on imported gas from Russia and a lack of other alternatives to substitute it in the near future. Germany is preparing its old coal plant for winter in Bexbach in the southwestern state of Saarland.

ESG themes and responsible investment have gained popularity in recent years. It is hard to find an investment manager without any sustainable or responsible fund in its product range, but you might be surprised at what these funds actually hold these days.

According to data from the Bank of America (BofA), 6% of ESG funds in Europe currently invest in Shell, one of the largest oil and gas companies globally. A standard exclusion list does not permit (or applies limits) to investment in fossil fuels, and it was hard to find an ESG fund invested in this company.

BofA's strategist Menka Bajaj explained that "ESG funds are revisiting the cost of exclusion given their underperformance in the first half of 2022 or waiting for regulations to be finalised amid greenwashing fears".

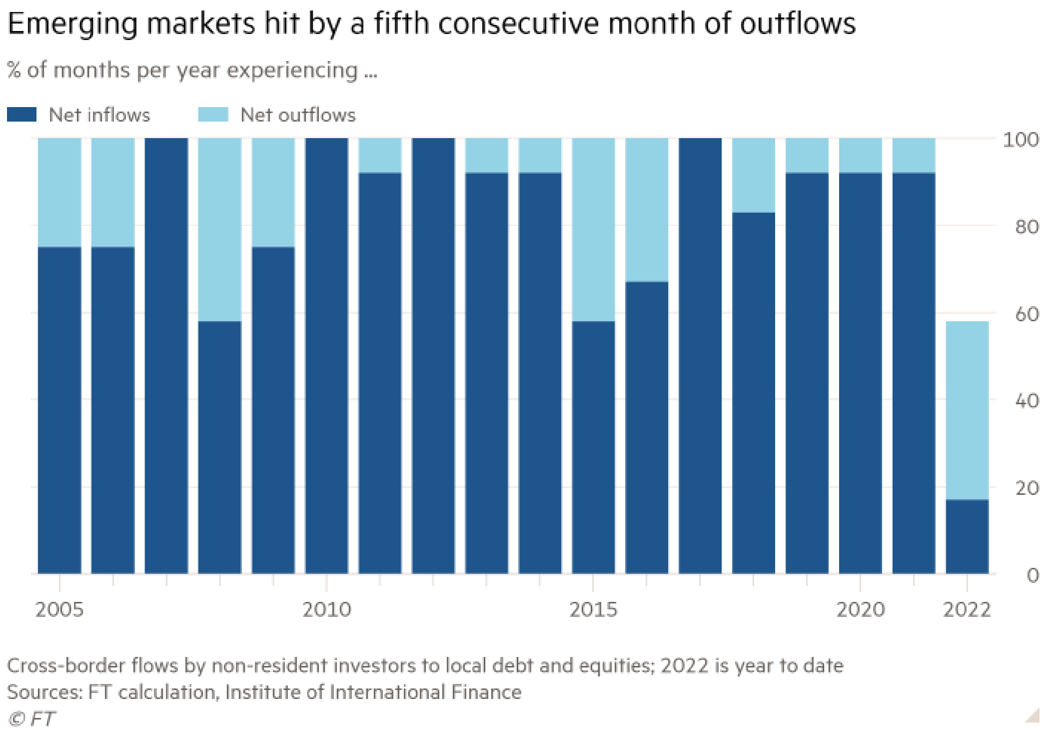
With strong oil prices, traditional energy stocks showed high returns over last six months compared to the S&P 500's 17% decline over the same period.

EMERGING MARKETS AND DEBT CRISIS

Emerging markets are facing a growing financial crisis, as foreign investors continue to pull funds out of these regions.

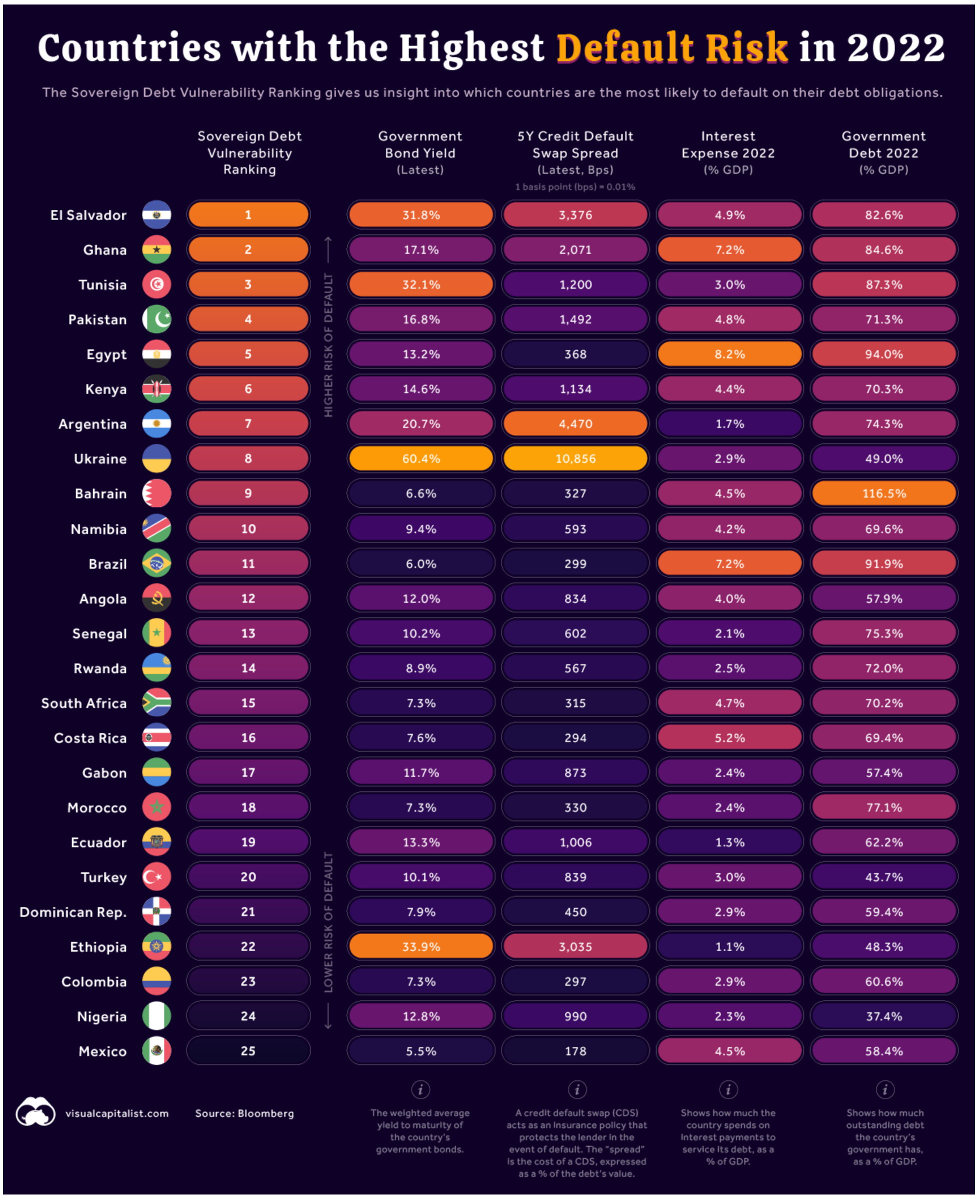
According to data compiled by the Institute of International Finance, cross-border outflows by international investors in EM stocks and domestic bonds reached $10.5 billion in July. That brought total outflows over the past five months to more than $38 billion—the longest period of net outflows since records began in 2005 (Figure 3).

Figure 3



The outflows risk exacerbating a mounting financial crisis across developing economies (Figure 4). In the past three months Sri Lanka has defaulted on its sovereign debt and Bangladesh and Pakistan have both approached the IMF for help. Investors fear that a growing number of other issuers across emerging markets are also at risk.

Figure 4



Countries with the Highest Default Risk in 2022

The Sovereign Debt Vulnerability Ranking gives us insight into which countries are the most likely to default on their debt obligations.

	Sovereign Debt Vulnerability Ranking	Government Bond Yield (Latest)	5Y Credit Default Swap Spread (Latest, Bps) 1 basis point (bps) = 0.01%	Interest Expense 2022 (% GDP)	Government Debt 2022 (% GDP)
El Salvador	1	31.8%	3,376	4.9%	82.6%
Ghana	2	17.1%	2,071	7.2%	84.6%
Tunisia	3	32.1%	1,200	3.0%	87.3%
Pakistan	4	16.8%	1,492	4.8%	71.3%
Egypt	5	13.2%	368	8.2%	94.0%
Kenya	6	14.6%	1,134	4.4%	70.3%
Argentina	7	20.7%	4,470	1.7%	74.3%
Ukraine	8	60.4%	10,856	2.9%	49.0%
Bahrain	9	6.6%	327	4.5%	116.5%
Namibia	10	9.4%	593	4.2%	69.6%
Brazil	11	6.0%	299	7.2%	91.9%
Angola	12	12.0%	834	4.0%	57.9%
Senegal	13	10.2%	602	2.1%	75.3%
Rwanda	14	8.9%	567	2.5%	72.0%
South Africa	15	7.3%	315	4.7%	70.2%
Costa Rica	16	7.6%	294	5.2%	69.4%
Gabon	17	11.7%	873	2.4%	57.4%
Morocco	18	7.3%	330	2.4%	77.1%
Ecuador	19	13.3%	1,006	1.3%	62.2%
Turkey	20	10.1%	839	3.0%	43.7%
Dominican Rep.	21	7.9%	450	2.9%	59.4%
Ethiopia	22	33.9%	3,035	1.1%	48.3%
Colombia	23	7.3%	297	2.9%	60.6%
Nigeria	24	12.8%	990	2.3%	37.4%
Mexico	25	5.5%	178	4.5%	58.4%

HIGHER RISK OF DEFAULT / LOWER RISK OF DEFAULT

Government Bond Yield: The weighted average yield to maturity of the country's government bonds.

5Y Credit Default Swap Spread: A credit default swap (CDS) acts as an insurance policy that protects the lender in the event of default. The "spread" is the cost of a CDS, expressed as a % of the debt's value.

Interest Expense 2022: Shows how much the country spends on interest payments to service its debt, as a % of GDP.

Government Debt 2022: Shows how much outstanding debt the country's government has, as a % of GDP.

visualcapitalist.com Source: Bloomberg

GEOPOLITICS

Geopolitical tensions are not going down. Unfortunately, the war in Ukraine is continuing, and, after more than five months, has devastated the lives of millions in Ukraine and Russia. The Russian army is enforcing their positions in occupied territories while Ukrainian forces have destroyed the bridge connecting Kherson city with the rest of the occupied territory, thus creating a supply chain challenge for the Russian army to move forward.

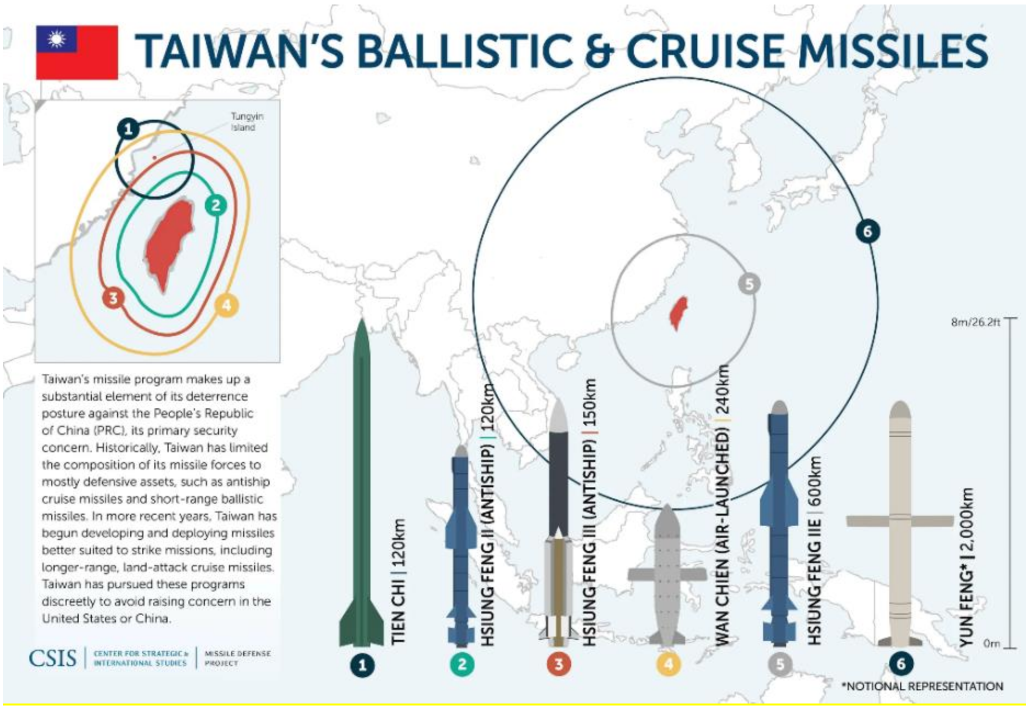
Tensions increased in other former Soviet republics during the month of July. Moldovan officials have refused to pass Russian peace-keeping troops to the rebellion region of Pridnestrovian for rotation, for fear of invasion. Border fire has also renewed between Azerbaijan and Armenia, supported by Russia.

The end of the month also saw clashes between the Iranian military and Taliban forces in Afghanistan. At the same time, a political crisis in Iraq escalated to its highest level since parliamentary elections in October 2021. The elections brought to power the ayatollah Moqtada al-Sadr, the Iraqi political kingmaker, and his supporters. However, since November 2021, the parliament could not form a government and appoint the Prime Minister. It led to a political deadlock since every parliamentary bloc voted for its candidates. The nomination of a pro-Iranian candidate to the Prime Minister post by an alliance of Iran-backed parties triggered the crisis. The military operation of Turkey in Iraqi Kurdistan fuelled the tensions between the political elite, which led to Al-Sadr's supporters rallying over the parliament and demonstrations in Baghdad at the end of July.

In the last days of July, attention in Europe shifted from Ukraine to the Serbia and Kosovo conflict. Kosovo is an autonomous province of Serbia which has declared its independence twice, first in September 1990 and again in February 2008, with its independence officially recognised by 97 countries. However, Serbia has never recognised Kosovo's independence which has resulted in increased tensions between Serbia and Albania (the majority of Kosovo's population are Albanians). Kosovo authorities have recently ruled that Serbian identity documentation is no longer valid within their territory from 1 August. This was not received well by Serbia, with officials highlighting the enormous problems this will cause for Serbian minorities still living in the province. Military forces and police from both sides were gathered to the administrative borders on the night of 31 July, in readiness for battle. Luckily, the situation was de-escalated after the US Ambassador became involved and acted as mediator, resulting in the Bill having now been postponed to 1 September. Tensions are likely to flare up again in the coming weeks.

The visit of US House speaker Nancy Pelosi to Taiwan increased tensions between the US and China. Chinese officials warned the White House that "there would be consequences" if Pelosi landed in Taiwan, including a military response. Before the start of Pelosi's tour to Asian countries, President Biden and Premier Xi held a two-hour phone conversation where the US President was told to not to play with fire over Taiwan. Both China and Taiwan brought their armed forces to alert and that could potentially turn the visit into a global conflict. Experts have compared China-Taiwan tensions to the Russia-Ukraine conflict. However, Taiwan would not be an easy target and would require massive fire force, due to the structure of the island with a limited number of bays for landing troops and equipped with heavy air defence systems (Figure 5). In the case of direct involvement from the US in the conflict, the Chinese could utilise their missile weapons to close the sky over Taiwan (Figure 6).

Figure 5



Source: Center for Strategic & International Studies

Figure 6

Source: Center for Strategic & International Studies

ROGUE CLUB

President Putin paid an official visit to Iran where one of the topics of discussion was a possible supply of Iranian military drones. The two heavily sanctioned countries showed signs of a tight alliance to global leaders, however, apart from the common goal of resisting US and European sanctions, the countries are competing to supply oil to China and India.

Analysts are considering whether Russia will use Iran's experience of living under sanctions for decades, since there is no sign that current sanctions would ever be lifted, even in the case of a ceasefire from the Russian side. The two countries have signed an agreement for Iranian companies to supply spare parts for Russian airplanes during the recent trip of President Putin to Teheran.

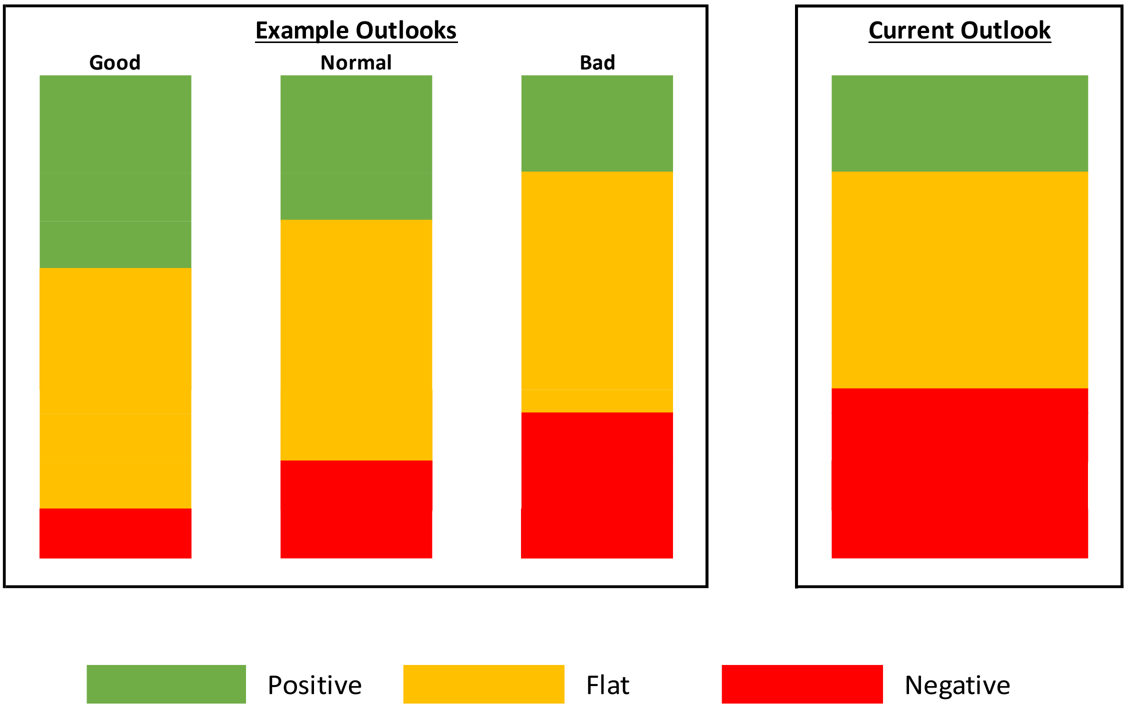
EV MARKET COMPETITION

Rivian's share saw a rise as Amazon started rolling out the first batch of 100 electric vans for delivery in the US. Amazon need 100,000 vans for its delivery operations to limit carbon emissions, according to their plans. It will also reduce the reliance on contractors such as UPS. The headwind to fulfil the needs are shortage of semiconductors reducing the production numbers.

Ford is going to start using lithium iron (LFP) batteries from Chinese CATL (the leader in EV battery production) in its electric pickups and SUVs. According to Ford Vice President Lisa Drake the automaker plans to secure LFP batteries from a new 40 GWh factory in North America starting in 2026 without mentioning it would be built by CATL. However earlier in May CATL was reported for looking at the US sites to build EV batteries to serve Ford and BMW. Ford said the chemistry can cut material costs by 10-15%. Ford's competitors such as Tesla is offering LFP batteries in some lower-priced Model 3 sedans and Rivian also intends to use LFP batteries.

Tesla has signed two deals with suppliers from China to secure the production of its electric vehicles. As the pandemic continues and as the materials to make EV looming becomes scarce, Tesla has signed a deal to continue its partnership with both CNGR Advanced Material Co and Zhejiang Huayou Cobalt Co. These two companies are intended to supply the EV company with the ample materials needed to produce its batteries.

MARKET OUTLOOK



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