MARKET PERFORMANCE AND COMMENTARY – OCTOBER 2022

MARKET PERFORMANCE

Index	Index Level/Price	1 Month %	3 Month %	1 Year %
Global Equities				
MSCI World NR	6,219.08	7.1	-5.2	-14.2
MSCI World NR (NZD)	13,422.59	4.4	0.5	0.4
MSCI Emerging Markets	573.36	-2.6	-10.7	-24.2
S&P 500 (US)	3,871.98	8.0	-6.3	-15.9
Nikkei 225 (Japan)	27,587.46	6.4	-0.8	-4.5
FTSE 100 (UK)	7,094.53	2.9	-4.4	-2.0
DAX (Germany)	13,253.74	9.4	-1.7	-15.5
CAC 40 (France)	6,266.77	8.8	-2.8	-8.3
Trans-Tasman Equities				
S&P/NZX 50	11,338.43	2.5	-1.3	-13.4
S&P/ASX 300	81,734.67	6.0	0.5	-2.6
Bonds				
S&P/NZX NZ Govt Stock	1,662.80	0.9	-3.7	-6.9
S&P/NZX A Grade Corporate	5,393.15	-0.3	-3.3	-4.6
Barclays Global Agg (Hedged to NZD)	371.65	-0.3	-6.4	-12.4
Oil				
West Texas Intermediate Crude	86.53	8.9	-12.3	3.5
Brent Crude	93.26	8.3	-13.6	11.1
NZD Foreign Exchange				
AUD	0.9085	3.3	1.1	-4.6
EUR	0.5878	1.8	-4.4	-4.9
GBP	0.5046	-0.4	-2.1	-3.4
JPY	86.3495	5.5	3.0	5.8
CNY	4.2584	5.6	0.6	-7.1
USD	0.5809	2.7	-7.4	-18.8

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

Executive summary:

- Equities rallied in October.
- Global bonds recovered some of their losses from the September sell-off.
- Ukraine is heading into winter with half of their critical infrastructure having been destroyed by Russian drones.
- Oil climbed above $90 per barrel, driven by fears of low US strategic reserves.
- New Zealand dollar appreciated against all major currencies except GBP.

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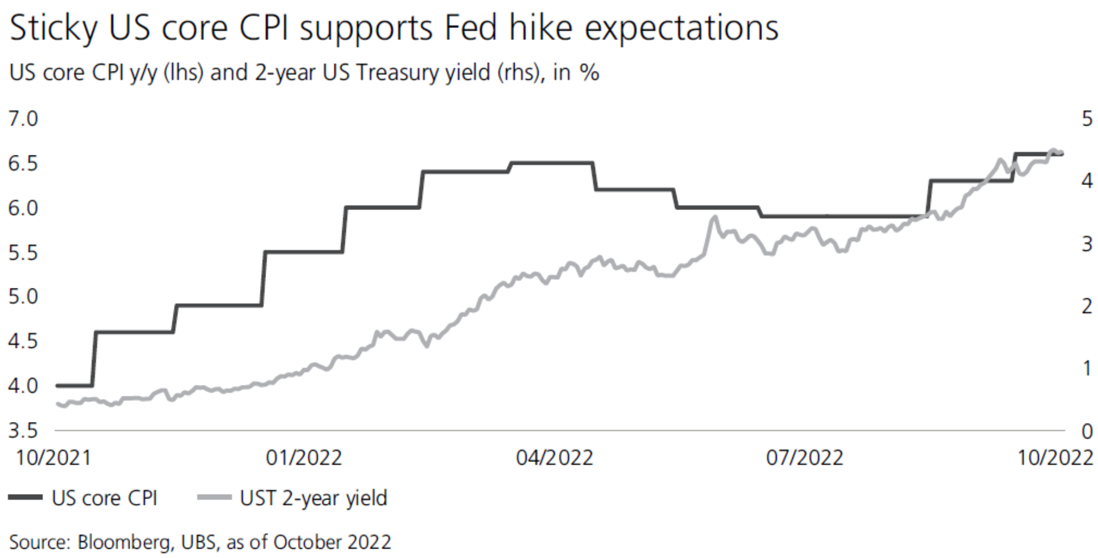
ECONOMIC COMMENTARY

GLOBAL SNAPSHOT

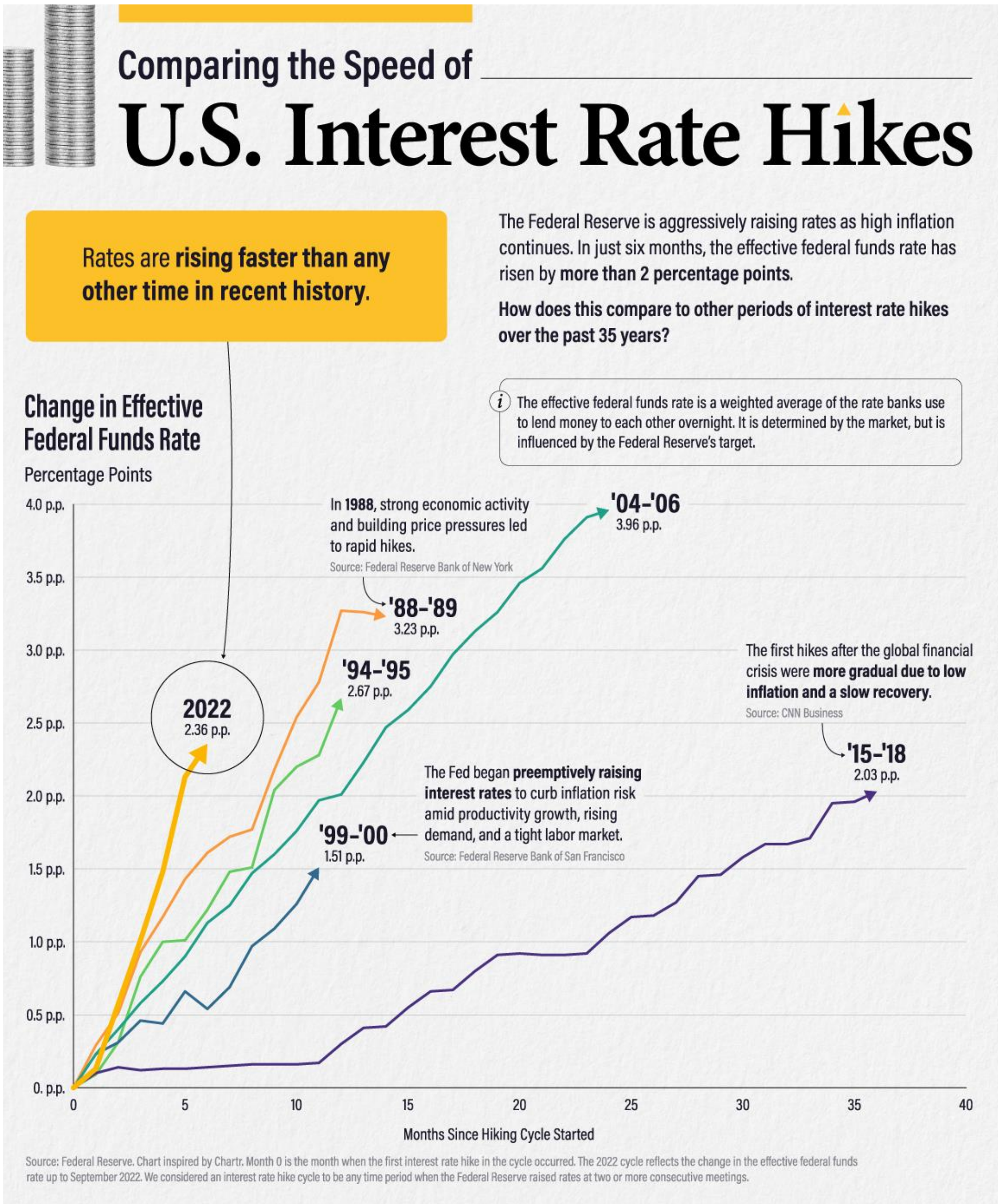
The main theme over the month was the question to central banks: are we there yet? Many analysts believe the answer to be “not yet”, due to sticky inflation and the pace of rate hikes expected to remain unchanged this year (Figure 1). However, inflation data released on 28 October showed that while prices remained uncomfortably high in September, a slowdown in wage growth indicates some relief may be in sight. That’s an encouraging development for the Federal Reserve, which is battling to bring down the highest inflation in 40 years.

Figure 1



The Personal Consumption Expenditures Index, which measures prices paid by consumers for goods and services, climbed by 0.3% from August to September but remained unchanged at 6.2% for the year, according to the latest report from the Bureau of Economic Analysis. Separately, the Bureau of Labour Statistics released its latest Employment Cost Index, which shows a slowdown in wage and salary growth in quarterly labour costs. The central bank keeps a close eye on the ECI report to monitor the extent to which skyrocketing inflation is boosting wages. Moody’s Analytics believe some of the underlying metrics that indicate a slowdown is on the horizon could mean that November’s rate increase (which is expected to be the fourth-consecutive 75 basis-point hike) may be that last one of that size. The current pace of rate hikes is the fastest seen for a century. (Figure 2).

Figure 2



The US held their midterm Senate elections on 8 November, the results of which will shape any future polices of President Biden. Historically, the President's party has lost all except four midterm elections over the last 150 years. The latest results showed that the Democrats were able to hold control over the Senate, however lost the control over the House of Representatives to the Republicans.

Over to the UK, Rishi Sunak took over as Prime Minister from Liz Truss in October. She is the shortest-serving prime minster in British history, after her flagship economic plan, the so-called "mini-budget" was rejected by investors, causing a meltdown in financial markets. Truss fired her finance minister Kwasi Kwarteng, in a move intended to save her premiership, appointing Jeremy Hunt in his place. Hunt reversed most of Truss's fiscal plans before she resigned, ahead of Rishi Sunak's formal ascent to prime minister. The markets reacted positively to Sunak's victory. But the former chancellor now has the task of trying to stabilize the UK economy after a period of intense market volatility, warning of a "profound economic challenge" that requires "stability and unity." Economists expect the combination of a sentiment shock and a significant tightening in fiscal policy will result in a deeper and longer recession followed by a very weak period of growth in the next few years.

Grain supplies being exported from the Ukraine to (mostly) African countries via shipping fleets were frozen by Russia after a massive drone attack on Russia's Black Sea fleet in Crimea. Russia has accused Ukraine of using the trade fleet to carry drones and weapons used against Russian troops. The majority of ships with wheat and corn were shipped to EU nations and Turkey, however the countries most in need of these supplies only received circa 8% of the total supply. This pause in the grain deal has pushed wheat prices to record highs again (Figure 3). The Russian Defence Minister has since made a U-turn after negotiations with UN and Turkey resulted in assurances that the shipping corridor was not being utilised by Ukraine for military use. The negotiations also resulted in Russian fertilizer exports being allowed via the same route.

Figure 3

China held a week-long Communist Party Congress in October, during which Xi Jinping secured his third term. Their Covid zero-tolerance policy and position regarding Taiwan stood unchanged, spooking investors in Chinese markets.

Lula da Silva's comeback as Brazilian President divided the country. There was just 1.8% between da Silva and the incumbent President Bolsonaro. Left wing da Silva was elected on promises to boost social spending, however, it will be a challenging task due to lack of available funds.

LOCAL SNAPSHOT

The local landscape has experienced similar problems: hot labour markets, record high inflation, rising interest rates and a falling property market.

The tight labour market and surging wages is one factor leading to economic pessimism amongst New Zealand businesses. The ANZ business survey for October showed that a net 43% of businesses now expect that economic conditions will weaken over the coming year. That's a deterioration from the already weak level that we saw in September.

Annual inflation rose to 7.2% and was just under the 7.3% recorded at the end of June. The main drivers of inflation were food, housing and household utilities and transport. The cost of vegetables hit its highest level in 23 years. Domestic (non-tradable) inflation has risen, while imported (tradable) inflation has started to recede. Many economists are confident that inflation has passed its peak.

The RBNZ lifted the cash rate by 50 basis points to 3.5 percent, the highest level in more than seven years. After the still-hot inflation figures came out, markets are pricing a 75 basis-point rise in November which will bring OCR to 4.25% by the end of the year.

According to CoreLogic New Zealand, property prices were down 1.3% over the month and 0.6% over the year. It is the first year-on-year drop since June 2011.

New Zealand government bond yields experienced further sizeable falls on the last Friday of October, with the market bracing for large offshore inflows into the bond market before government bonds are set to join the World Global Bond index. The inclusion of these into the global index may provide a short-term boost to the NZD.

WORLD FINANCIAL MARKETS

Equities

The MSCI World Index was up 7.1% and MSCI Emerging Markets returned -2.6% in October in local currency terms.

The S&P 500 rallied 8.0% in October. Stocks rose but offered widely divergent returns, as investors reacted to a busy calendar of third-quarter earnings reports. The Energy and industrial sectors and value stocks heavily outperformed growth shares, with the latter weighed down by steep declines in several mega-cap technology and internet-related stocks, including Microsoft, Amazon, Alphabet, and especially Meta Platforms, following earnings misses and lowered outlooks. The Cboe Volatility Index (VIX) widely considered as Wall Street's "fear gauge," fell below its 50-day moving average on 28 October – only the fourth time that has happened since February.

The Euro STOXX 50 Index rose strongly by 9.0% on hopes that central banks might slow the pace of interest rate increases. Major indices surged. Germany's DAX Index gained 9.4% while France's CAC 40 increased 8.8%. The FTSE 100 was up 2.9% in October.

China's stock markets pulled back, as investor sentiment was dampened by new COVID-related lockdowns in several parts of China. Several Chinese cities doubled down on COVID-19 curbs after the country reported three straight days of more than 1,000 new cases nationwide. Data also showed that profits at China's industrial firms declined at a faster pace in September. The broad, capitalisation-weighted Shanghai Composite Index fell -4.3%. Reports emerged that major Chinese state-owned banks sold US dollars in both onshore and offshore markets during the week after the yuan's recent slide.

The S&P/NZX 50 index was up 2.5% in October. Microcaps lagged, with the S&P/NZX Emerging Opportunities Index shedding 1.7%. S&P/ASX 200 Financials was the star performer among Australian sectors this month, jumping 12.2%, while at the other end of the spectrum, Consumer Staples slipped 0.2%.

Fixed Interest

In the last week of October, a rally in Treasuries sent the benchmark 10-year US Treasury note yield back below 4.00%, before rising again on 31 October. In addition to the Bank of Canada's smaller-than-expected rate hike, technical indicators were a catalyst for the rally. The closely watched 2-year/10-year segment of the Treasury yield curve remained inverted – a common signal of a coming recession.

European government bond yields softened across the board. The German 10-year bund yield decreased to 2.10%.

UK gilts enjoyed a week of calm at the end of month amid hopes the new conservative government could offer more stability. The 10-year gilt yield decreased to 3.47%, slipping to a five-week low.

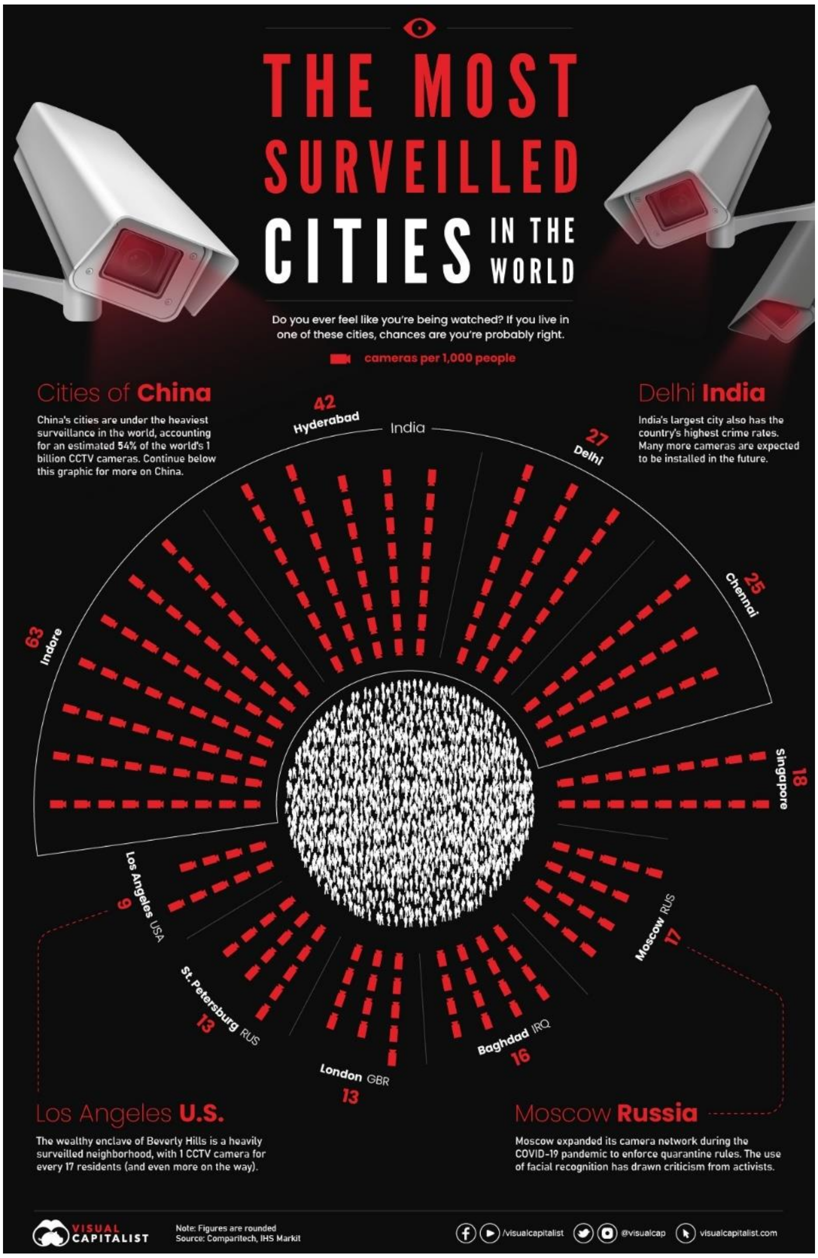
US investment-grade corporate bonds posted gains as risk assets rallied. Corporate credit spreads tightened, although spread movements were varied across issuers, with earnings releases and new issuance serving as drivers. The market calendar was active throughout the week, with the level of new deals surpassing weekly expectations.

IS BIG BROTHER WATCHING YOU?

The growth of urban populations and technology developments has resulted in countless security cameras being installed in cities for various purposes, including crime protection.

The top four cities (excluding China) are in India, which is the world's second-largest country by population (Figure 4), with the surveillance cameras playing a significant role in reducing crimes against women in the country. Russia's Moscow is in sixth place, which has expanded its use of surveillance cameras in recent years. These cameras helped to identify participants in the demonstrations against the war in Ukraine and, more recently, the mobilisation. Human rights organisations are concerned that facial recognition technology could become a tool of oppression. Unfortunately, these fears are being realised.

Figure 4



China's expansive use of cameras and facial recognition technology has assisted with the country's social credit program (joint credit reward and punishment mechanism across multiple departments and regions), giving local governments unprecedented oversight over its citizens. According to the program, people can lose points by spreading rumours on the internet or not visiting aging parents regularly. Chinese camera networks can verify ATM withdrawals, permit access into homes, and even publicly shame people for minor offences like jaywalking. This level of oversight sounds unacceptable for Western countries, but, in China, 80% of respondents support social credit systems.

Two of the largest companies with access to over a billion users profiles in China, Tencent and Alibaba, were enlisted by the People's Bank of China to play an important role in the credit system, raising the issue of third-party data security. Tencent-owned WeChat, the Chinese equivalent to WhatsApp, tracks behaviour and ranks users accordingly, while displaying their location in real-time.

On the other side of the coin is oppression of dissidents and limitations on the freedom of speech. China has invested immense resources in its domestic security capabilities. In 2017 domestic security spending in Xinjiang alone was around $8 billion. Unsurprisingly, millions of Muslim Uyghurs have been sent to detention camps in the region over the past decade.

The US seems to be following China's example but in a light "democratic" version. San Francisco approved a 15-month pilot allowing police to monitor live footage from surveillance cameras owned by consenting businesses and civilians without a warrant. The coalition of civil liberties groups argued the move would give police unprecedented surveillance powers. It also marked a departure from the progressive stance on surveillance the city's leadership had previously maintained. The "I know what you did last summer" expression would not surprise anyone now.

GEOPOLITICS

China has changed dramatically under Xi's ruling over the past decade. Premier Xi took all credit for his administration's success in ending extreme poverty, tackling climate change, curbing corruption, and, at least until recently, growing the economy. China's zero-Covid policy limited mortality from Covid compared to many other countries despite the internal and external opposition. However, that success has come with serious economic and political side effects. China also transformed its foreign policy and became the world's largest creditor for Asian and African countries with the One Belt One Road Initiative.

Under Xi, China has become more nationalist, authoritarian, and repressive. The government has engaged in what many critics, including the United States, have called genocide toward the Uyghurs and other Muslim ethnic minority groups in Xinjian and crushed any semblance of autonomy in Hong Kong. China's foreign policy has become more assertive of territorial claims in the East and South China Seas, engaged in border skirmishes with India, and ratcheted up military action and threatened to use force for "unification" with Taiwan.

Geopolitics experts see Xi's third term as the acceleration of his plan to annex Taiwan that would lead to global economic disruption. The US Secretary of State has warned that Taiwan remains at the core to Xi's plans of China's "rejuvenation".
The US has once again changed favourites in the Indian region. After years of favouring New Delhi, the US has now turned back to Pakistan. Relations between Washington and Islamabad are like a rollercoaster, with the most recent "down" occurring after the US' invasion of Afghanistan in 2001 where the US accused Pakistan of supporting the Taliban in Afghanistan. However, Pakistan's position has not actually changed since the late 1980s when they (and the US!) supported and trained the Taliban against the Soviets.

The cool down in US-Pakistan relations marked a tilt toward China with massive investment project CPEC. It shaped Washington's policy in the region as anti-China India is 'in' and an autocratic, pro-China Pakistan is 'out' of the American camp (until recently). After the start of the war in Ukraine, India was betting on Russia and bargaining discounted oil and increasing exports to Russia. India's policy undermined the efforts of the West to isolate Russia. In addition, India has refused to back the US on every UN resolution tabled against Russian aggression towards Ukraine.

Pakistan is experiencing political and economic hardship, fuelled by protests supporting former Prime Minister Khan, natural disasters such as floods and global inflation hitting lower income populations of the country. Will the US be able to offer more to Islamabad than China?

Sadly, the situation in Ukraine has worsened after the assignment of a new Russian Chief Commander. Using Iranian drones, Russia has destroyed almost half of their critical infrastructure – power and telecommunications - leaving millions of people unable to light and warm their homes. This has created a humanitarian crisis across the country, with overnight temperatures near zero.

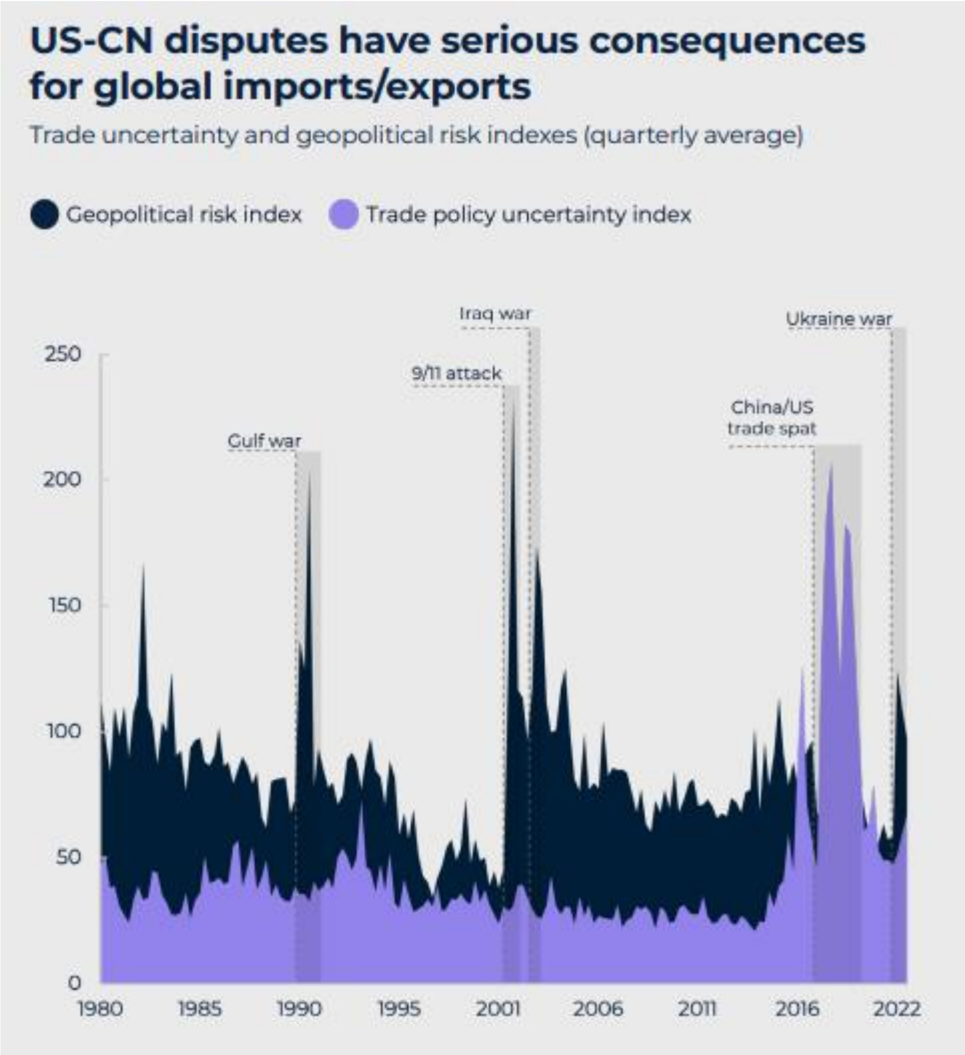
Many analysts were closely watching and listening to President Putin's speech at the annual Valdai forum. The main thesis of Russia's foreign policy remains unchanged, with the aim of special military operations is to protect the people of Donbass, although nothing was mentioned about protecting the people of annexed Kherson and Zaporozhe regions. The Russian budget caught the attention of experts which indicated increased expenditure on internal security up by 50% from RUB 2.8 trillion in 2022 to 4.4 trillion in 2023. Defence expenditure share will remain unchanged at 25% of the budget.

TRADE VS POLITICS

International trade was hammered by Covid and lockdowns last year. Some early signs of relief seen late last year were hit by geopolitical tensions. Freight costs are still above pre-pandemic levels, high energy resources and food prices are the result of political decisions rather than the "invisible hand of the market". The political will of global leaders that bolstered globalisation and supply chain efficiency has turned and now favours national security and regionalisation.

Sanction and trade wars split the world and pushed production prices to record highs, adding to already high global inflation. Almost everywhere, onshoring and protectionism are now in place with the aim of securing supply chains and partly mitigating against possible sanctions imposed by global powers. Tech rivalry is another battle arena in international relations (Figure 5). The transition period from an open market will definitely create pain for customers via an increased cost of goods.

Figure 5



Source: Convera

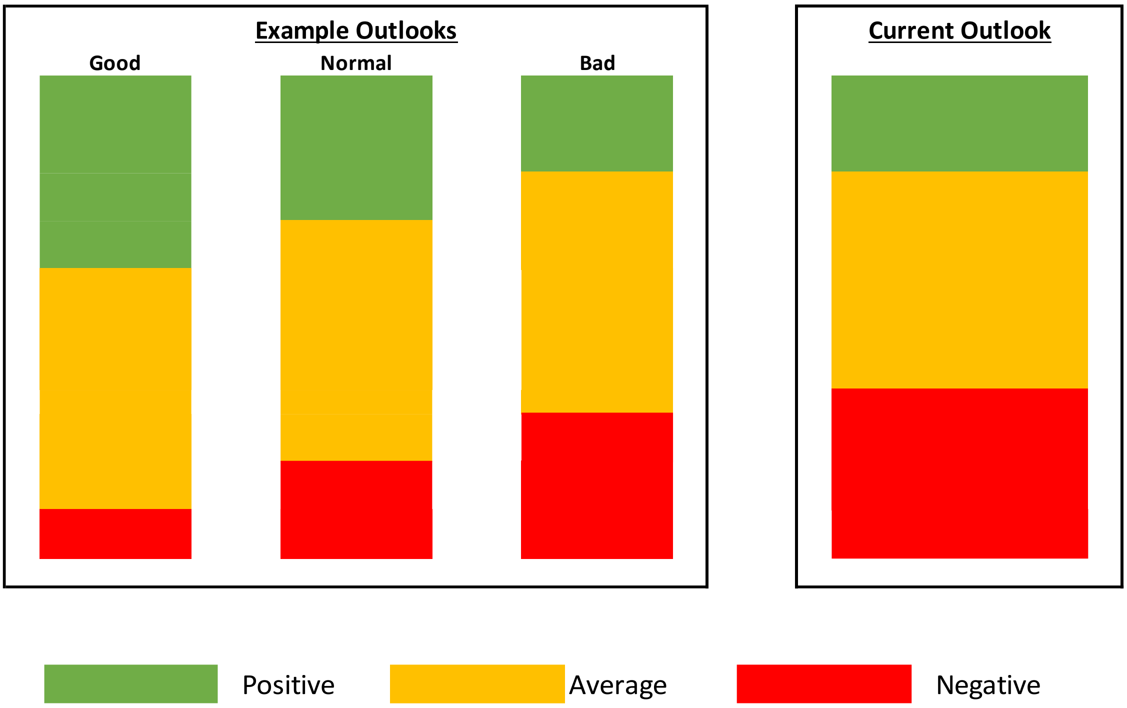
However, some industries and countries are beneficiaries of this process. Some analysts see an opportunity for the services trade to accelerate, as the global economy becomes more digitised and targets carbon neutrality by 2050.

Shell acquired a stake of almost 9.3 percent in North Field South (the world's largest proven gas reserves after Iran and Russia) in Qatar to use momentum of transition of export routes from cheap Russian gas to Qatari. Qatar is the largest LNG exporter in the world and there is now extra demand for it due to the war in Ukraine.

The project that Shell is now investing in should make it possible for the Gulf State to sell 16 million more tons of LNG annually from that gas field. This requires, among other things, drilling platforms and pipelines. In addition, new installations are being built that convert natural gas into liquid form. In the short term, this will not offer a solution to the gas shortage that has arisen since the Russian invasion of Ukraine. Qatar will probably be able to export the first cargo of gas from this expansion in 2027 at the earliest.

A shortage of chips pushed Toyota to sell their cars with basic keys. This was caused by supply chain bottlenecks lasting since Covid lockdowns. What would be the impact of a conflict in Taiwan, who produce half of the world's chip supply?

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).