ERIKSENSGLOBAL
Actuaries & Investment Strategists

MARKET PERFORMANCE AND COMMENTARY – NOVEMBER 2022

MARKET PERFORMANCE

Index	Index Level/Price	1 Month %	3 Month %	1 Year %
Global Equities				
MSCI World NR	6,570.72	5.7	3.8	-8.0
MSCI World NR (NZD)	13,427.87	0.0	2.6	-2.6
MSCI Emerging Markets	640.34	11.7	-1.5	-12.5
S&P 500 (US)	4,080.11	5.4	3.2	-10.7
Nikkei 225 (Japan)	27,968.99	1.4	-0.4	0.5
FTSE 100 (UK)	7,573.05	6.7	4.0	7.3
DAX (Germany)	14,397.04	8.6	12.2	-4.7
CAC 40 (France)	6,738.55	7.5	10.0	0.3
Trans-Tasman Equities				
S&P/NZX 50	11,552.04	1.9	-0.4	-9.2
S&P/ASX 300	87,039.80	6.5	5.7	4.3
Bonds				
S&P/NZX NZ Govt Stock	1673.37	0.6	0.0	-7.3
S&P/NZX A Grade Corporate	5,459.58	1.2	-0.4	-3.9
Barclays Global Agg (Hedged to NZD)	380.43	2.4	-1.5	-11.0
Oil				
West Texas Intermediate Crude	80.55	-6.9	-10.1	21.7
Brent Crude	86.56	-7.2	-9.6	24.1
NZD Foreign Exchange				
AUD	0.9274	2.1	3.7	-3.1
EUR	0.6032	2.6	-1.1	0.0
GBP	0.5215	3.4	-1.0	1.7
JPY	86.6683	0.4	2.0	12.5
CNY	4.3996	3.3	4.1	1.7
USD	0.6211	6.9	1.3	-8.5

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

Executive summary:

- Equities continued their rally in November.
- Global bonds were sold-off on higher-than-expected inflation data.
- The gap between West and East is increasing, with Iran joining the China-Russia alliance.
- Oil dived below $90 per barrel, driven by fears of a slowing global economy.
- The New Zealand dollar appreciated against all major currencies.

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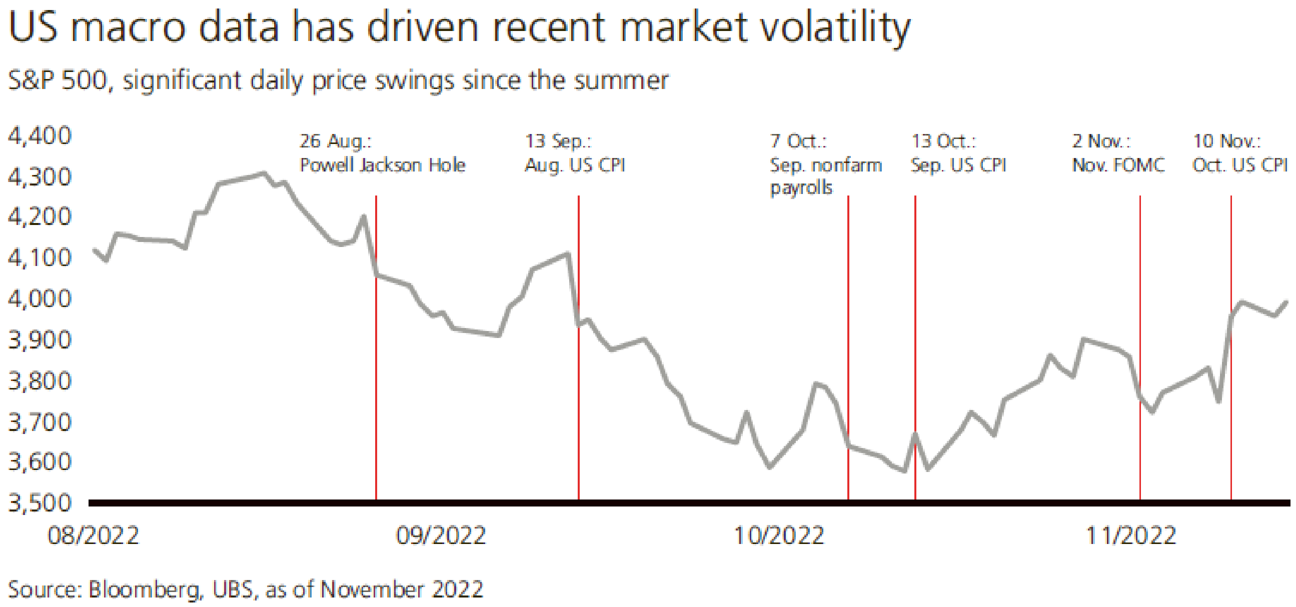
ECONOMIC COMMENTARY

GLOBAL SNAPSHOT

Investors saw markets rally in July and October on hopes of a policy pivot by the Federal Reserve and an economic “soft landing,” fuelled by cash on the side lines. Wall Street ended sharply higher on 30 November after Federal Reserve Chair Jerome Powell said the central bank might scale back the pace of its interest rate hikes as soon as December. The past couple of months have provided a clear illustration of the kind of dynamics to expect in the year ahead, with markets torn between grim present realities and hopes of a better future (Figure 1).

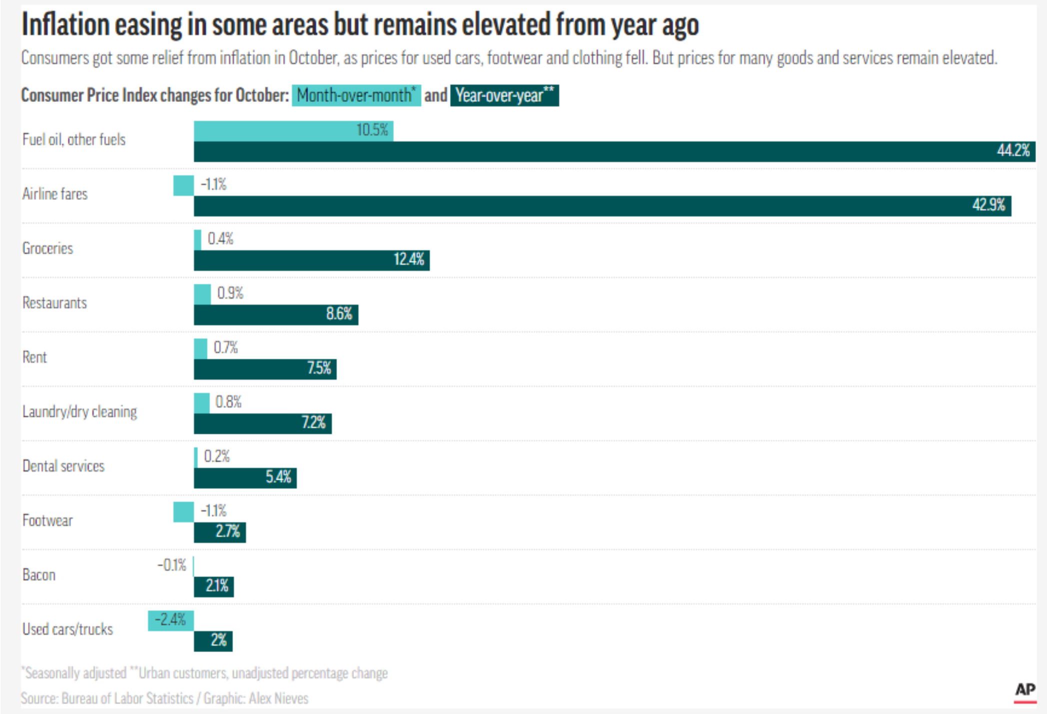
Figure 1



At the same time Powell cautioned that the fight against inflation was not over and that key questions remain unanswered, including how high rates will ultimately need to rise and for how long.

Some analysts suggest that living with inflation will be normalised. Inflation appears to be stickier than many experts and central banks expected because of major spending shifts, production constraints and elevated energy prices (Figure 2). Another driver of high inflation is increased wages. Production constraints are rooted in the pandemic and have been exacerbated by the energy shock and China’s lockdowns.

Figure 2



Central banks are engineering recessions rather than coming to the rescue in order to curb inflation. The Federal Reserve hiked by 75bps during the month, as expected. The Bank of England has acknowledged a recession is necessary to get inflation down, yet like other central banks, it is failing to acknowledge the scale of the recession needed to get it all the way down to target. On November 29 the ECB warned that inflation in the eurozone had not peaked and risked rising even higher than predicted, fuelling expectations of further rate hikes. However, preliminary data has shown some easing signs: eurozone annual CPI dropped by 0.6% in November which bolstered European equity markets.

Access to energy resources has become one of the key goals for many countries. China secured a supply of liquefied natural gas (LNG) from Qatar by signing a 27-year sales and purchase agreement between QatarEnergy and Sinopec. It is the longest contract term in the history of LNG deals. Germany had earlier signed only a 10-year deal with Qatar. Qatar prefers longer term contracts to justify heavy investments into the sector, thus has tilted towards Chinese businesses.

Standard & Poor's "How Heavy Is the World's Debt Burden" report predicts painful times ahead for corporate borrowers at the low end of the credit spectrum, along with some governments who have loaded up with low-interest debt. The main challenge for the government sector is expected to be in 2023 as geopolitical tensions worsen.

Several analysts expect growth in Europe should start to improve in mid-2023 as the continent's energy crisis begins to ease after the winter. In China, economic growth should also improve, contingent upon a midyear reopening. In the US, a trough is likely to come later given the current momentum in the economy and the lagged impact of tighter monetary policy. But during the second half, consumption and investment should find some support provided inflation is lower and financial conditions are looser.

One of the main outcomes from COP27 was an agreement to fund the needs of developing countries. This included the rebuild of physical and social infrastructure in countries that have been devastated by extreme weather for decades (predominantly African and Asian countries). However, there is no agreement yet on how the finance should be provided and where it should come from. The final text of COP27 contained a provision to boost “low-emissions energy”. That could mean many things, from wind and solar farms to nuclear reactors, and coal-fired power stations fitted with carbon capture and storage. It could also be interpreted to mean gas, which has lower emissions than coal, but is still a major fossil fuel. Many countries at COP27, particularly those from Africa with large reserves to exploit, came to Egypt hoping to strike lucrative gas deals.

Chinese police is identifying and detaining the protesters of COVID restrictions, as authorities continue clamping down. Citizens were surprised at the ability of police to discover their identities, but with the number of surveillance cameras with facial recognition capabilities now in operation, identification is very easy and efficient for authorities. Ethics is another question.

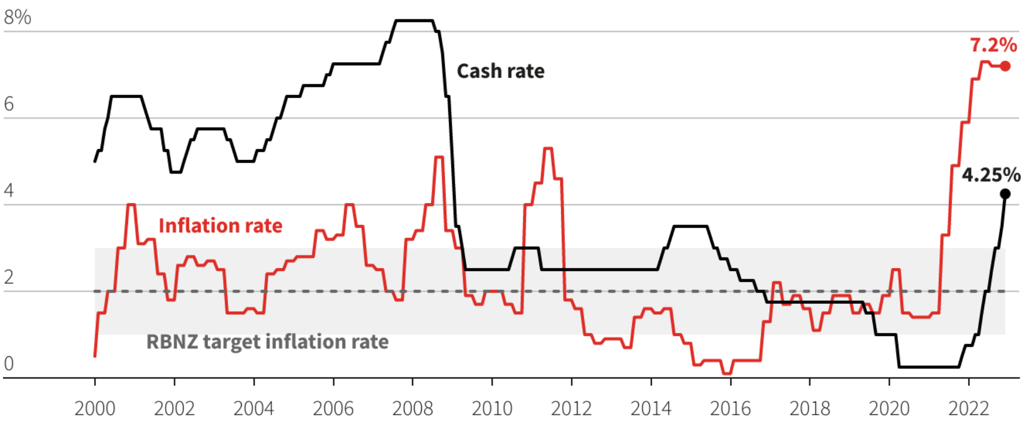
LOCAL SNAPSHOT

The RBNZ raised the OCR by a record (since the GFC) 75 basis points to 4.25% in November and crucially now see rates peaking at 5.5%, compared with a previous forecast of 4.1% (Figure 3).

Figure 3

New Zealand's record rate hike

New Zealand's central bank has lifted the cash rate by a record 75 basis points to 4.25%.



Source: Refinitiv Datastream | Reuters, Nov. 23, 2022 | By Riddhima Talwani

A rental crisis has triggered activity from market players. The Property Investors Federation has gained some political traction on its proposals to fix the current crisis. Earlier this year it made seven proposals, including a long-term tenancy option, the return of mortgage interest costs as a tax-deductible expense, the return of the Brightline test to two years, the right for landlords to issue 90-day notices to unruly tenants and the reform of the Tenancy Tribunal.

The NZ Transport Agency is developing a plan with proposed speed limit changes to more than 500km of state highways in 440 locations across the country. Multiple business associations have accused the authority of not considering the effect on businesses while supporting their efforts to reduce mortality on the roads. Their view is that safety should consider not only speed limits but the quality of the roads, drivers' skills, and vehicles' compliance with standards. Lower speed limits will cause a higher cost of goods, increasing delivery time, labour and likely fuel costs.

The latest BDO Global Risk Landscape report highlights that geopolitical tensions, economic uncertainty, supply chains and ESG are all combining to create a perfect storm of risk for NZ businesses. The report indicates that both globally and here in New Zealand, businesses are not prepared for the higher levels of organisational risk they are facing.

WORLD FINANCIAL MARKETS

Equities

The MSCI World Index was up 5.7% and MSCI Emerging Markets returned 11.7% in November in local currency terms.

The S&P 500 gained 5.4% in November. The major equity indices ended higher, buoyed by the possibility that the Fed may slow the pace of its interest rate increases. Growth stocks outperformed their value counterparts and small capitalisation stocks finished ahead of large ones. The technology-heavy Nasdaq Composite Index posted solid gains of 4.5% in November.

The Euro STOXX 50 Index was up 9.7% in November, as lower inflation spurred hopes that central banks could slow the pace at which they are tightening monetary policy. Signs that China was relaxing some coronavirus restrictions also buoyed sentiment. Major stock indices were positive. Germany's DAX Index was up 8.6%, France's CAC 40 returned 7.5%. UK's FTSE 100 advanced 6.7% in November.

Fixed Interest

Over the last week of the month, the US 10-year Treasury yield decreased 19 basis points from 3.68% to 3.49% (down 44bp in November).

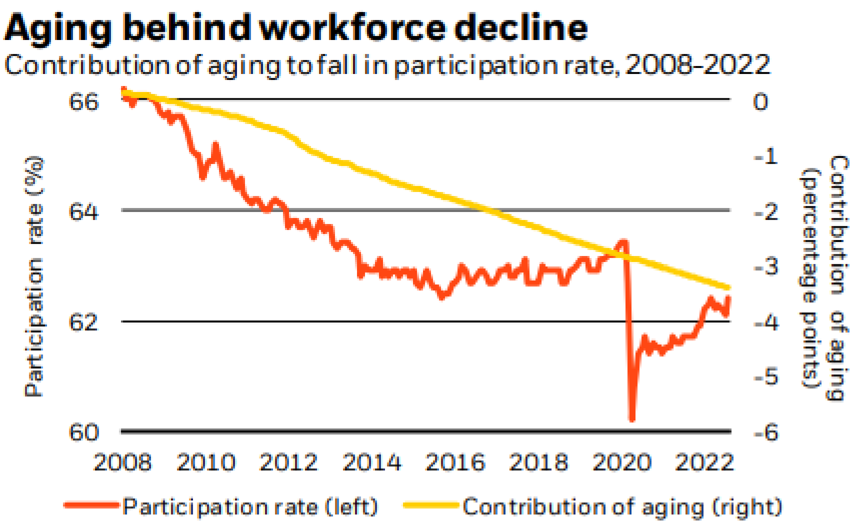
European government bond yields fell after data showed that euro area inflation slowed more than expected in November. Comments by US Fed Chair Jerome Powell suggesting that the central bank might slow the pace of its rate increases fuelled a broader rally in bond markets, with Italian, French and Swiss yields also declining. The German 10-year bund yield down 21bp in November.

In the UK, 10-year gilt yields ended little changed. The 10-year gilt yield ended down 35bp in November.

LABOUR SHORTAGE – LONG-TERM TREND

A smaller share of the US population is in the workforce than pre-Covid. That's unlikely to change, due to the participation rate (the share of people aged 16 and over that have or are looking for work) nosedived when the pandemic hit and people left the workforce. Some of that sharp decline has been made up as people return. But there is no recovering further because the effects of an aging population account for most of the remaining shortfall. More people have reached the retirement age (64 or older). That's taken 1.3 million out of the workforce as of October. Another 630,000 left as the pandemic caused fewer people to work past retirement age and hastened retirement for people coming up to 64. An aging population is increasingly cutting into the participation rate and shrinking the labour force (Figure 4). That makes it hard for the economy to operate at current activity levels without fuelling inflation.

Figure 4



Source: Blackrock

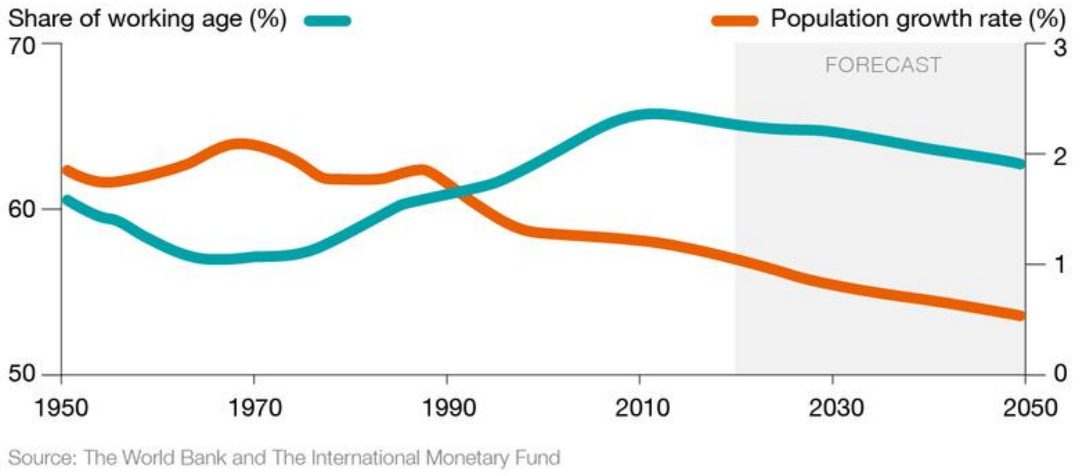
These trends explain why the US participation rate is below its pre-Covid level and yet unemployment is still at a 50-year low. The share of the population aged over 64 has been increasing since 2010 and it's set to keep rising. The effect of this demographic shift on participation won't reverse without massive structural changes in workforce behaviour over time. That implies the workforce will keep shrinking relative to the population. Economic activity will need to run at a lower level to avoid persistent wage and price inflation, especially in the labour-heavy services sector. Interest rate hikes can't cure production constraints like labour shortages. So the Fed and other central banks in most developed countries today face a sharp trade-off between either creating a recession to slam economic activity down to levels that the economy can more comfortably sustain, or living with more persistent inflation.

An aging population will hurt the US economy's ability to grow without creating inflation longer term. A lower birth rate may eventually offset some of that effect as household formation and housing demand fall but only after the costs tied to the aging baby boom generation play out. Demographic trends also suggest the labour pool will expand much more slowly in the next twenty years than it did in the past twenty. If individual worker productivity keeps rising at the same rate, annual GDP growth would average just 1.8% what is about two-thirds the average from 1980-2020 and the slowest 20-year period since data began.

Europe and the rest of the western world (except Australia and New Zealand – mostly due to higher numbers of younger immigrants) are facing similar problems. Lower fertility rates, coupled with increased life expectancies around the world, are creating an aging population. Since 1950, the global median age has grown from 25 years to 33 years. An older population comes with a number of economic risks, including rising healthcare costs and a smaller global workforce.

According to a report by the World Bank, the world's working-age population peaked back in 2012. Since then, it's been on the decline (Figure 5).

Figure 5



GEOPOLITICS

Unfortunately, there are no signs of easing in geopolitical tensions. The war in Ukraine is affecting the lives of millions of people who are at risk over the coming cold winter months after the majority of critical infrastructure was destroyed or damaged by Russian missiles. A Ukrainian air defence missile (initial reports claimed it as a Russian missile) mistakenly entered Polish territory and killed 2 villagers near the Ukraine-Poland border on 15 November. The world was on the brink of a direct Russia-NATO confrontation and potentially the start of World War III.

The European Union has agreed to ban Russian crude oil as a measure to cut money flow into Moscow. From 5 December, EU tankers are prohibited from transporting, insuring and financing Russian oil shipments. This will increase Russia's dependence on Asian markets, meaning deliveries to alternative buyers could take 10 times as long compared to European routes. This also increases dependence on oil from the Middle East and the US. With Saudi Arabia's recent swing to cut production output, volumes and prices will be less certain going forward.

The Ukrainian army has been winning local battles and re-gained territories in Eastern regions, with the support of NATO countries. Unfortunately, Ukraine needs more to defend themselves, with the Ukrainian Foreign Minister Dmytro Kuleba urging NATO countries to boost weapons production.

With all eyes on the confrontation of Russia and the West, China has quietly been increasing its nuclear arsenal. Washington's and Moscow's nuclear forces are limited by the New Strategic Arms Reduction Treaty, which the two countries agreed in 2021 to extend for five years. Russia postponed scheduled arms control talks with the United States set to take place in Cairo on 29 November, with neither side giving a reason. China has refused to join the talks from the beginning, arguing that Russia's and the US' arsenals are much larger than its own and the two nuclear superpowers have primary responsibility for arms control. But Beijing's expansion "raises some questions about their intent" according to a speaker of the US Department of Defence.

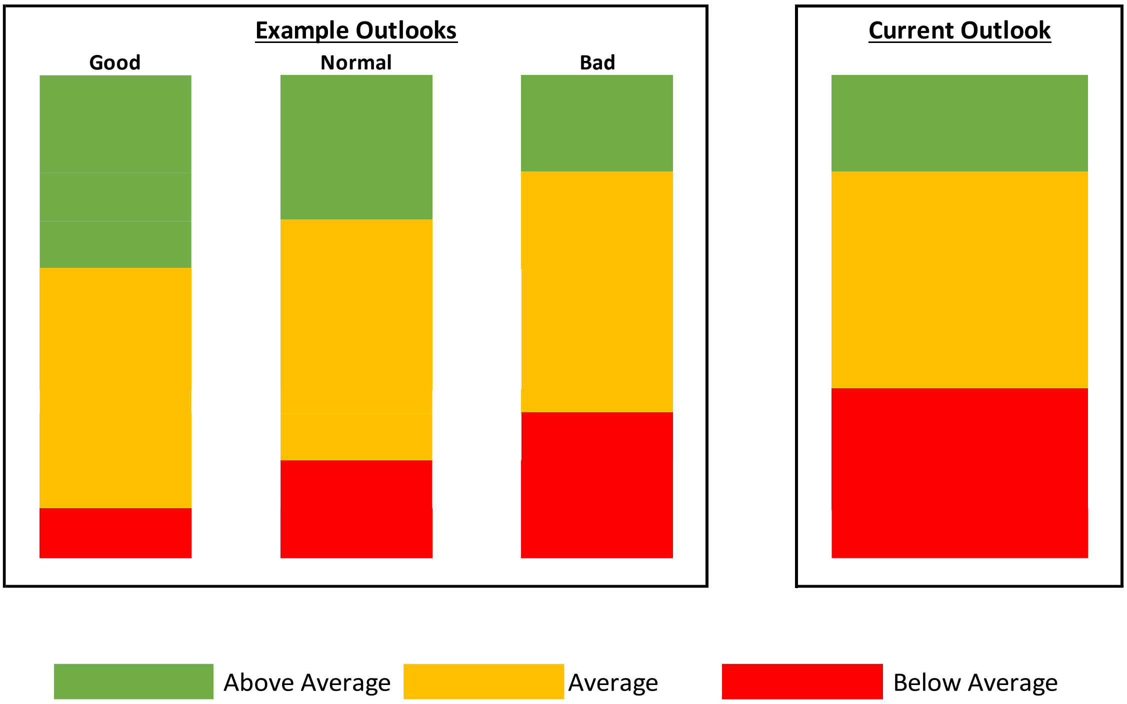
A FRIEND IN NEED IS A FRIEND INDEED

Covid changed the international trade landscape and policy of "just in time" to "just in case". The economical sense of competitive trade routes has been taken over by political reasoning due to the pressures of uncertainty in deliveries, and onshoring is ramping up. Geopolitical tensions have therefore added complexity into supply chain mapping. The most recent cases of cutting gas supply to Europe changed Germany's economy which was heavily reliant on Russian gas. Furthermore, the US CHIP Act created difficulties for Asian semiconductor manufacturers with a choice between "friendship" and economic benefit. This situation challenges economic resilience and underscores the difficulties of so-called onshoring and "friend-shoring." Securitization of trade will be a key driver in decision-making for the foreseeable future.

The camp "East" officially got a new member after 203 medjlis members (Iranian parliament) ratified an agreement to become a full member of the Shanghai Cooperation Organization (SCO). The passed bill allows Iran to sign and accept dozens of the SCO agreements and documents. It is uncertain how members of the SCO will evade US and European sanctions to increase trade volumes with Iran. China and Russia however, are already using their national currency in bilateral trades with Iran, so it highly likely that the yuan or rouble will be used in transactions with Iranian businesses.

China-US tensions have expanded into relations with a third country - Germany. Chinese officials have accused the US of interfering in Chinese cooperation with Germany. The US cautioned Germany against Beijing getting a controlling stake in Hamburg's port terminal. Chinese foreign ministry spokesman Zhao Lijian stated that US interference is symptomatic of its practice of coercive diplomacy. China is the biggest trade partner while the US is the third for Germany. "Friend-shoring" will not be beneficial for Germany.

MARKET OUTLOOK



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