ERIKSENSGLOBAL
Actuaries & Investment Strategists

MARKET PERFORMANCE AND COMMENTARY – FEBRUARY 2023

MARKET PERFORMANCE

Index	Index Level/Price	1 Month %	3 Month %	1 Year %
Global Equities				
MSCI World NR	6,538.3	-1.6	-0.5	-4.9
MSCI World NR (NZD)	13,470.0	1.8	0.3	1.2
MSCI Emerging Markets	637.5	-4.7	-0.4	-10.5
S&P 500 (US)	3,970.2	-2.6	-2.7	-9.2
Nikkei 225 (Japan)	27,445.6	0.4	-1.9	3.5
FTSE 100 (UK)	7,876.3	1.3	4.0	5.6
DAX (Germany)	15,365.1	1.6	6.7	6.3
CAC 40 (France)	7,267.9	2.6	7.9	9.1
Trans-Tasman Equities				
S&P/NZX 50	11,894.6	-0.6	3.0	-0.7
S&P/ASX 300	87,185.5	-2.5	0.2	6.5
Bonds				
S&P/NZX NZ Govt Stock	1,651.9	-1.9	-1.3	-7.2
S&P/NZX A Grade Corporate	5,466.2	-1.1	0.1	-2.9
Barclays Global Agg (Hedged to NZD)	377.6	-1.7	-0.7	-8.7
Oil and Gold				
West Texas Intermediate Crude	77.1	-2.3	-4.3	-19.5
Brent Crude	82.5	-3.4	-4.7	-18.2
Gold	1,826.9	-5.3	3.3	-4.2
NZD Foreign Exchange				
AUD	0.9	0.1	-1.0	-1.5
EUR	0.6	-1.8	-3.2	-3.1
GBP	0.5	-2.6	-1.9	1.4
JPY	84.4	0.4	-2.7	8.2
CNY	4.3	-1.4	-2.2	0.8
USD	0.6	-4.1	-0.3	-8.5

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

Executive summary:

- Equities in the US sold off on the Fed's hawkish note, whereas in Europe they went up due to signs of easing inflation.
- Bonds sold off too.
- Commodities including oil and gold had negative returns.
- Geopolitical tensions are still elevated.

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ECONOMIC COMMENTARY

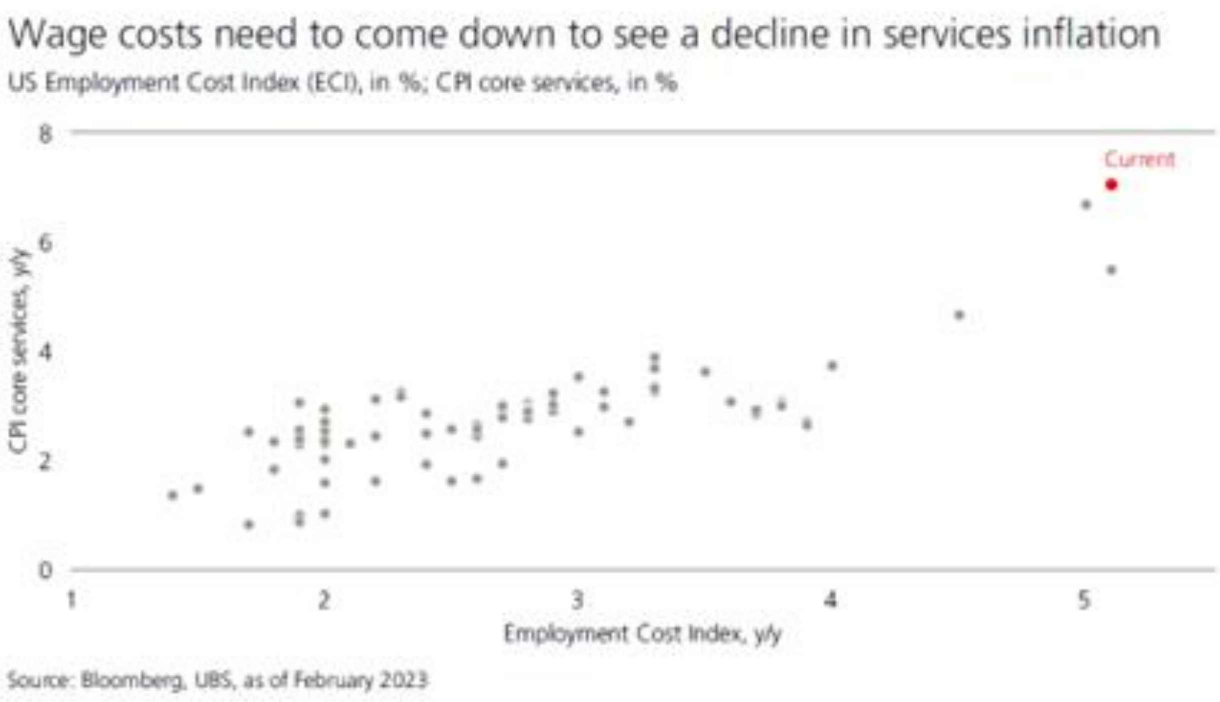
Authored by Janibek Issagulov and Amy Lewis
7 March 2023

GLOBAL SNAPSHOT

Recent economic data from the US is split between indicating a "hard landing" and indicating a "soft landing" for the economy. Despite interest rate challenges, the headline retail sales, job growth, and services sentiment remained strong. There was a slight decrease in US inflation in January. Combined with the tight labour market, this suggests the Federal Reserve will need to increase rates considerably to reach its target inflation level. The US economy is faring better than expected by many analysts post-COVID, with over 500,000 new jobs created in January, the unemployment rate at its lowest in 53 years, and a 3% rise in retail sales compared to December.

Additionally, the service sector had a surprising rebound. The ISM (Institute for Supply Management) services index rising to 55.2 in January after a previous dip below 50 (Figure 1). The presence of both a strong economy and excess inflation (relative to target) will likely strengthen the Federal Reserve's resolve to increase interest rates. This shift in policy has been reflected in the markets with futures now indicating a peak rate of 5.3% in August, compared to 4.8% in the beginning of February. The recent appointment of dovish Lael Brainard as head of the National Economic Council, leaving the Vice Chair role at the Federal Reserve Board role, also suggests a more hawkish composition of the rate-setting committee.

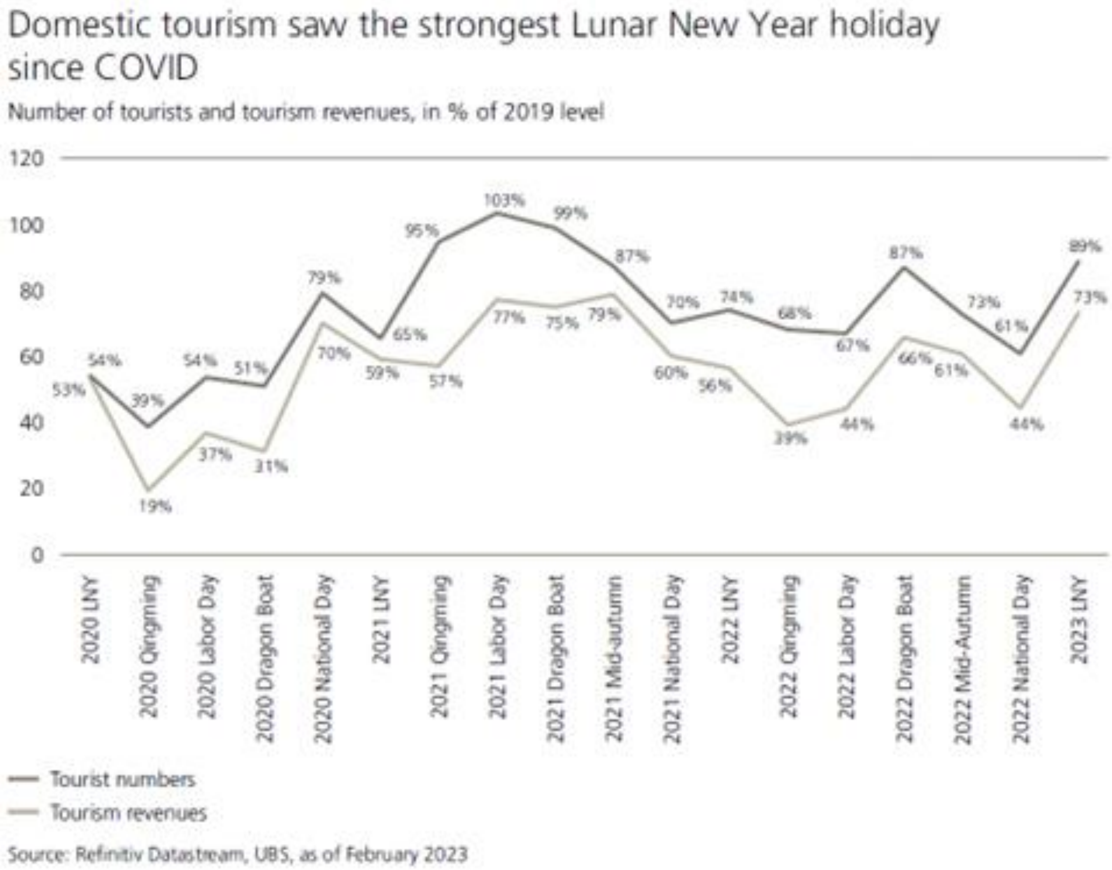
Figure 1



At the beginning of the year, Europe's growth was constrained by soaring gas prices, and China was negatively affected by zero-COVID policies. But due to a significant decrease in energy prices stemming from less demand during a milder winter in Europe, and the termination of zero-COVID policies, growth in both regions is rebounding sooner than anticipated. Analysts predict the Eurozone economy will avoid going into recession this year. But inflation rates remain high, with a marginal decline to 8.6% in January from 9.2% the previous month. Underlying price pressures are increasing and the core inflation measure has risen to 5.3%. Already the German economy has contracted more than anticipated in Q4, with GDP falling by 0.4% compared to the previous quarter. Data from Germany shows that household consumption and capital investment remain weaker than initial estimates, which fuels recession fears.

China's reopening after the COVID-19 pandemic was smooth, causing both manufacturing and services PMI (Purchasing Manager’s Index) data to exceed expectations in January. Mobility data over the Lunar New Year holiday indicated a positive revival in travel and consumption. As a result, analysts anticipate that China's GDP will increase by 5% this year, compared to 3% in the previous year, driven by a rise in consumption.

Figure 2



The People's Bank of China (PBOC) has kept its one-year and five-year loan prime rates unchanged for the sixth consecutive month. Signs of economic growth reduced the need to ease monetary policy following the removal of pandemic restrictions in December. Some analysts anticipate that the central bank will continue to support the economy given the sluggish property market, declining exports, and vulnerable consumer confidence. But the PBOC has already told lenders to slow the pace of new loans after they reached an all-time high in January. This high of new lending was due to state-backed infrastructure projects, as data shows weak demand from businesses.

The US government hit its legal limit for borrowing money on January 19, reaching its current ceiling of $31.381 trillion of debt. This limit has been raised 78 times since being enacted 63 years ago as it is not inflation adjusted. When the ceiling is reached the Department of the Treasury enacts “extraordinary measures,” freezing contributions and redemptions for government workers’ retirement and healthcare, to fund its expenses until Congress agrees to increase it. President Biden has called for an increase, but its not known whether the Democratic-led Senate and the Republican-led House of Representatives will reach agreement before funds run out. If the debt ceiling is not increased, the US may default on its obligations, which would have serious repercussions for the global economy and markets.

A severe earthquake struck Turkey and Syria on 6 February, resulting in the death of around 52,000 people, and causing millions to be homeless in almost a dozen cities. According to the World Bank the immediate damage was estimated at $34 billion, equivalent to roughly 4% of the country's GDP. The Turkish Enterprise and Business Confederation estimates the overall cost of the earthquake at $84.1 billion, with most of the expense, $70.8 billion, being spent on housing. The lost national income is estimated at $10.4 billion, and lost working days are estimated at $2.91 billion. President Erdogan is under enormous pressure to rebuild Turkey or face losing re-election, and will need international support in the coming months, likely softening his anti-NATO stance.

LOCAL SNAPSHOT

Cyclone Gabrielle hit parts of New Zealand in February causing significant damage resulting in floods that trapped individuals on rooftops, displaced thousands, and landslides that destroyed houses. Officials are referring to this event as an "unprecedented" natural disaster, but for decades climate change scientists have warned of increasing severity in weather patterns.

The insurance sector is anticipating that the floods that occurred in the East Coast and upper North Island will exceed $1 billion in cost. Additionally, there are approximately 30,000 claims have been submitted for damage caused by Cyclone Gabrielle. The number of claims from the two natural disasters is roughly double the amount reported after the Kaikoura earthquake in 2016. According to the Insurance Council it may take years to settle all the claims for flood-damaged homes, cars, and belongings following Auckland's January floods.

On 22 February, the RBNZ raised cash rate by 50 bps to a more than 14-year high of 4.75%, indicating that it expects to tighten further as inflation remains too high. The RBNZ stated that it is too early to assess the policy implications of the cyclone and floods that have devastated the North Island and anticipates disregarding the short-term price pressures caused by the "extreme weather events". The latest monetary policy statement indicated that the RBNZ still expects the OCR to reach a peak of 5.5% in 2023. This would represent the most aggressive policy tightening cycle since the official cash rate was introduced in 1999.

A recent report commissioned by BusinessNZ suggests that New Zealand is likely to face an even tighter labour market in the coming years due to an ageing population, resulting in a shortage of workers. The report on the future of workforce supply stated that if current trends continue, the country will experience a shortfall of 250,000 workers by 2048. The report explains that due to a declining birth rate and an ageing population, New Zealand will soon have more individuals approaching retirement age than joining the workforce. But a “simple, open and permissive” immigration policy can reverse this demographics issue.

Late submissions for the Census are being accepted until 1 June 2023. At the end of the Census Day just 2.8 million people had been accounted for. We urge all our clients and friends to complete theirs at the official website https://www.census.govt.nz/ if they haven’t already.

WORLD FINANCIAL MARKETS

Equities

The MSCI World Index went down by 1.9% and MSCI Emerging Markets returned -4.7% in February in local currency terms.

The S&P 500 declined by -2.6%. A cascade of upside inflation and growth surprises pushed the S&P 500 Index to lows not seen since early December. The index had lost roughly 35% of the rally that began in October and the declines pushed the Dow Jones Industrial Average into negative territory for 2023. Communication services and consumer discretionary stocks performed worst within the S&P 500, but declines were widespread. Growth stocks fell slightly more than value shares, while small caps dropped slightly more than large cap values.

The Euro STOXX 50 Index was up 1.8% as economic data and corporate earnings outperformed expectations. Globally several major stock indexes went up. Germany’s DAX Index increased 1.6%, France’s CAC 40 was up 2.6% and the UK’s FTSE 100 rose 1.3% over the month.

In February, Australian stocks fell -2.5%, still resulting in year-to-date gains of 3.6%, and mid and small cap stocks underperformed the blue-chip stocks. The ASX MidCap 50 and the ASX Small Ordinaries went down -3.2% and -3.7% respectively. The ASX 200 utilities performed the best, gaining 3.4% in February, after being the worst-performing sector in January. Materials were the worst-performing sector, losing -6.6% and accounting for over two-thirds of the S&P/ASX 200’s losses. Six out of the 11 Australian sectors contributed negatively to February returns.

The NZX 50 Portfolio Index also finished February in the red, declining by -1.1%. Microcaps continued to lag, with the NZX Emerging Opportunities Index dropping -3.5%.

Chinese stocks advanced after three weeks of losses as hopes for stepped-up regulatory support offset concerns about elevated US tensions. The broad, capitalisation-weighted Shanghai Composite Index rose 1.3%.

Fixed Interest

Growth and inflation data sparked a sell-off in US Treasuries, with the yield on the benchmark 10-year US Treasury note nearing 4.00% for the first time since mid-November.

The German 10-year bund yield increased to 2.64%. Yields on 10-year UK gilts increased to 3.86%.

US investment-grade corporate bonds traded lower after some prominent retailers reported earnings and some concerns about the health of the US consumer gained traction. Risk appetite was reduced by the release of the Fed's last policy meeting minutes.

In the US high yield bond market volumes were below average as elevated cash balances led to less aggressive selling. The sector also saw very light primary market activity as most issuers appeared to be waiting for the market's tone to improve. In the bank loan market, investors seemed to be somewhat more risk averse and sought to reduce exposure to lower-quality loans.

The performance of fixed income in Australia and New Zealand was poor in February, with only short-term bills showing gains. The biggest losses were seen in inflation-linked bonds, with the ASX Government Inflation-Linked Bond 0+ Index dropping -2.2% and the NZX Inflation Indexed Government Bonds Index falling -3.8%.

GEOPOLITICS

February marked one year since Russia's invasion of Ukraine. On 23 February, the United Nations General Assembly passed a non-binding resolution, with a vote of 141-7 and 32 abstentions, urging Russia to cease its aggressive actions in Ukraine and remove its military forces. Due to Russia's veto power, the Security Council is paralyzed, making the General Assembly the most significant UN body concerned with Ukraine. Although General Assembly resolutions are not legally binding, unlike Security Council resolutions, they reflect global opinion and are an indicator of world sentiment. In March 2022 the same number of states voted for a similar resolution with 5 countries against and 35 abstained. Mali and Nicaragua are now backing Russia in exchange for military support. Russian mercenary organization Wagner Group is helping central government to fight against Islamist militants. Among those that abstained were China, India and South Africa which are members of BRICS with Russia. Pakistan also took a neutral position.

China's Foreign Ministry, in its position on the political state of the Ukraine crisis, urged for peace talks to be resumed and an end to unilateral sanctions. Additionally, they emphasized their opposition to the use of nuclear weapons. The 12-point document produced by the Foreign Ministry is part of Beijing's recent attempts to depict itself as a mediator for peace, as they strive to maintain a "no-limits" relationship with Moscow while simultaneously dealing with strained relations with the West due to the ongoing war. The wording of the document seems to be directed towards the West, with potential criticism towards the broad economic sanctions imposed by Western countries and the US on Russia. US officials swiftly criticized the document, and US National Security Advisor Jake Sullivan bluntly stated "this war could end tomorrow, if Russia stopped attacking Ukraine and withdrew its forces."

Several sources including US officials have stated that the US is in the initial stages of discussing with its close allies the potential imposition of fresh sanctions on China if it offers military assistance to Russia in its war against Ukraine. The objective of these consultations is to rally support from multiple nations, particularly those in the wealthy G7, to coordinate and agree upon any possible limitations. The US has recently shifted its attention towards preventing sanctions evasion, as indicated by the blacklisting of 86 groups from various countries including Russia and China, barring them from purchasing US technology. Among the companies affected is China Head Aerospace Technology, which provides satellite data processing systems.

Furthermore, the White House has announced that G7 countries will keep Russia's sovereign assets "frozen" until the conflict is resolved and Russia has addressed its breach of Ukraine's sovereignty and territorial integrity. This move aims to hold Moscow accountable for Ukraine's prolonged reconstruction.

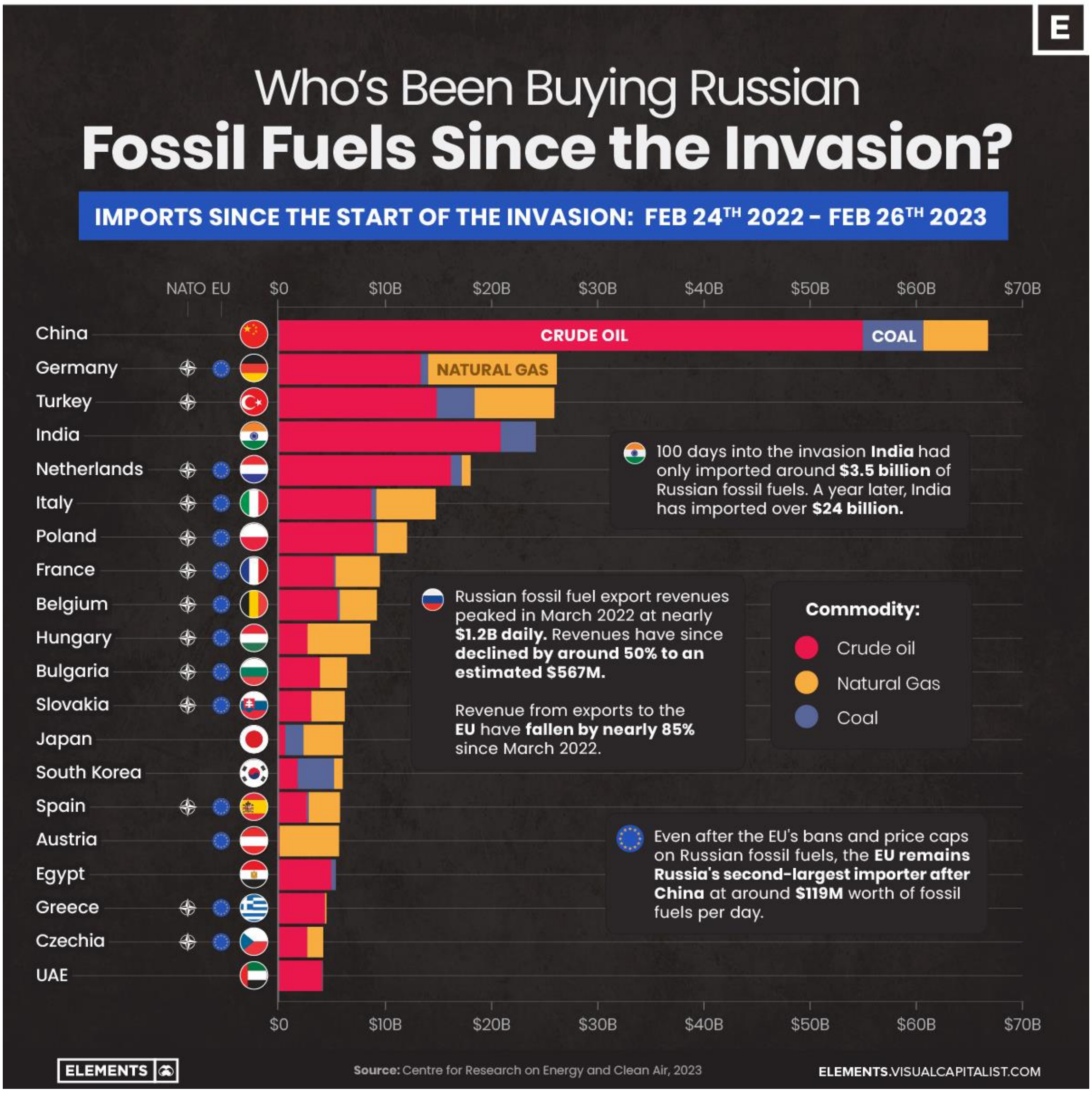
OIL WARS

On 5 February, the European Union imposed a ban on Russian oil imports. G7 countries, along with the EU and Australia, set a price cap of $60 for nations outside of the coalition buying seaborne Russian diesel and refined petroleum products. In response, Russian officials declared they will sell the entire volume of oil they produce, but not to those who support the price cap, instead reducing production by 5% come March.

A group of researchers from Columbia University, the University of California, and the Institute of International Finance, estimate that the average selling price of Russian oil has $74 per barrel when the price cap of $60 was first implemented. Exports from Russia's Pacific Ocean hubs, which are critical for trade with China, had an even higher average price of $82 per barrel. But many experts in the industry have expressed doubts about the effectiveness of the price cap, which is challenging to enforce as around 50% of Russia's oil is transported using its 'shadow fleet,' a group of oil tankers that aim to circumvent western sanctions.

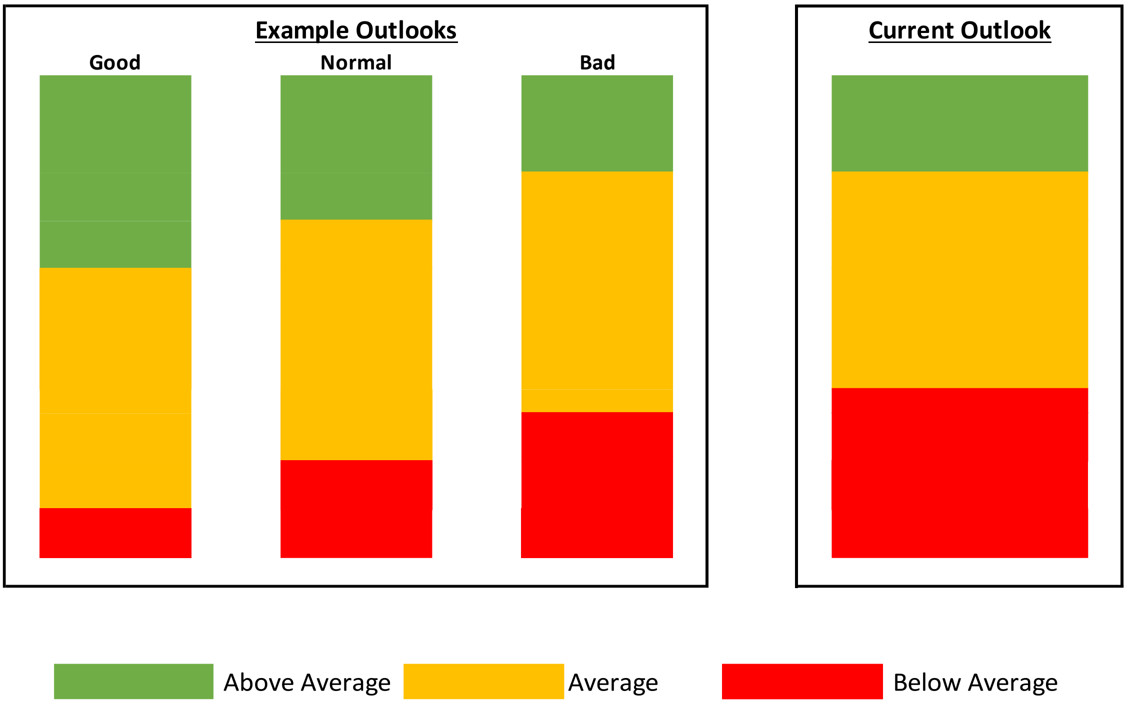
According to an unnamed US Treasury official, it was "reasonable" for Russia to continue exporting around 80% to 90% of its oil, as demand for Russian oil outside of the EU is high. Even with all the sanctions and a ban of energy resources the EU remains dependent on Russia’s supply (Figure 3). The EU is the second largest importer of Russian energy resources after China. India is expected to take third place since increasing the import of heavily discounted oil. In effect what was supposed to have decreased oil revenue by 20% has instead constrained Russia’s supply to the world by 5%, reminding policy makers that those with the resources hold the power.

Figure 3



These sales will continue. Rio Tinto has said what every realist is thinking, that while the world has set ambitious targets regarding climate change, the development of renewable energy is not progressing quickly enough. The company stated that although there is an abundance of energy available using fossil fuels, the challenge lies in how quickly they can be phased out. As one of the largest electricity users and heaviest emitters of carbon dioxide in Australia, it has planned additional projects to reduce its CO_2 emissions by 10% through a $600 million investment into renewable energy, as part of an estimated $1 billion commitment to renewable energy production and emission reduction projects. Slow progress is still progress, but glaciers are outpacing this transition. We expect significant climate change and have prepared our portfolios for this.

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).