Axiome Summer Update

September — December 2020

Tongariro National Park

IN THIS ISSUE

Investment Market Review

Markets continued to climb over the December quarter, in line with our view that the environment, on balance, favours risk assets. Massive fiscal and monetary policy support, Covid-19 vaccine rollouts, and the search for yielding assets out-weighed concerns around a huge surge in Covid cases in Europe and the US. Into January the rally has continued at the time of writing, as has the rotation from large cap tech stocks to a much broader base of cyclical, small cap and value stocks.

Equity markets continued their climb over the December quarter, with all growth asset classes closing higher.

In part this has reflected the US election and Georgia Senate results, which gives the Democratic Party in the US a clearer pathway to enact large scale fiscal policy support whilst Covid-19 still ravages, as well as longer-term infrastructure spending programs.

Higher risk emerging market, small, and value stocks had a bumper quarter

International shares rose around 4.5% in the quarter in NZD terms, whilst NZD hedged shares increased around 11.7%. These results were sufficient to propel global markets to new highs – the very broad MSCI All Country World Index closing 2020 up over 15% (in USD terms). Within global equities, MSCI ESG indexes outperformed over the year principally because of their lower exposure to the oil and gas sector, while higher risk small and value stocks out-performed in the quarter.

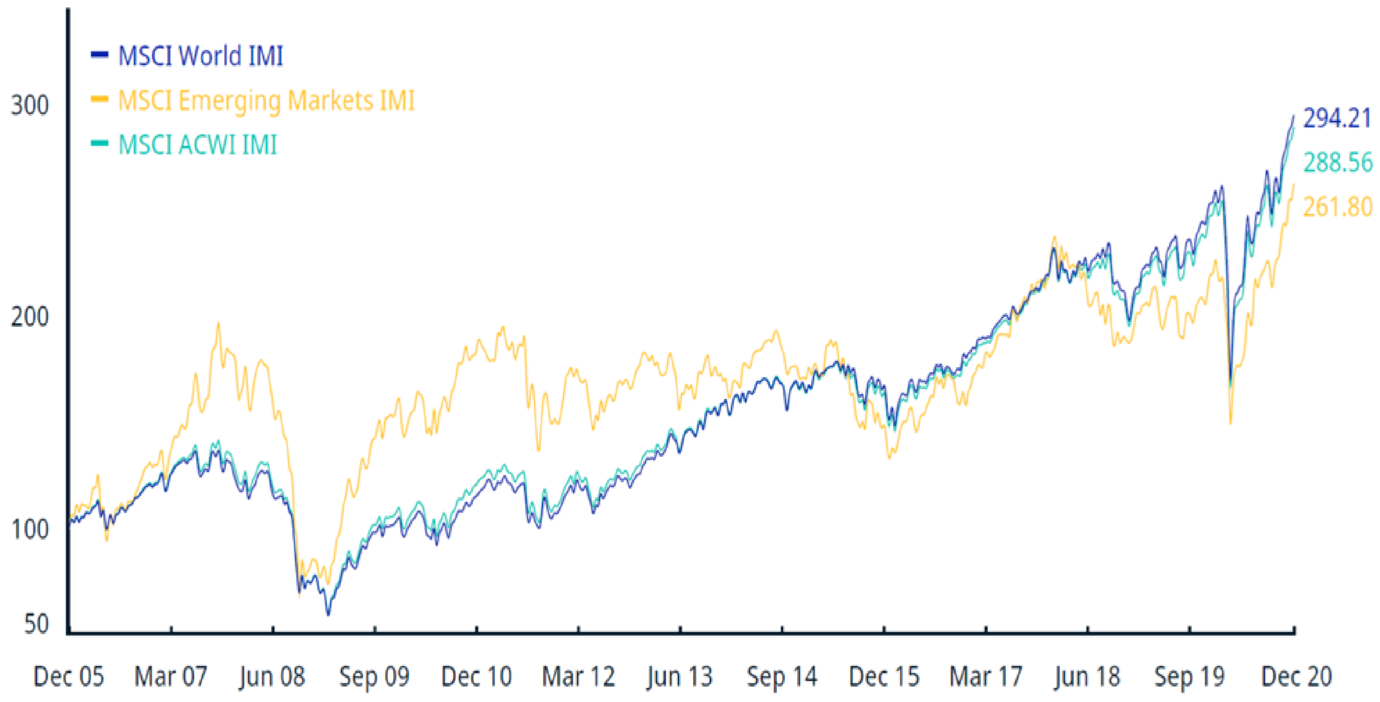


Figure. 1 Global Equities reach new peaks *Source: MSCI*

Small caps returned around 13.7% in the quarter, while value returned around 6.3% in NZD terms. Emerging Market equities increased around 10% in NZD terms, another strong performance.

Trans-Tasman equity markets sung from the same song sheet in the December quarter. Australian shares increased around 12.5% in NZD terms, while NZ shares rose around 11.5%. In calendar 2020,

Australian equity market performance lagged in 2020, as did global property and infrastructure.

Australian shares still had a relatively weak performance returning around 4.5% in NZD terms. Concerns around bank profitability, and tensions with China impacting resource stocks, clearly weighed on Aussie market returns. In contrast, the NZ equity market returned around 14.5% over the year, bringing the 5-year performance to around 17% per annum – an exceptional result. The gains in our market were also broad-based, with the NZ 50 portfolio index (which caps a company's weight at around 5%) outperforming the NZ 50 Index (which has a large weight on A2 Milk and Fisher & Paykel Healthcare).

International property stocks rose by around 10.7% in the quarter, but are still down around 14% year-to-date, reflecting ongoing uncertainty around how much lower longer-term tenancy demand may be in the post-Covid world. International infrastructure has been more resilient, with returns broadly flat over the past year.

Fixed income returns were mixed.

Fixed income had mixed fortunes. New Zealand investment grade (IG) bonds fell around 2% in the quarter, with government bonds declining around 2.8% and corporate bonds 1%. This reflected strong NZ economic data and a pull-back in expectations for negative rates. Despite the quarterly fall, they still returned around 5.5% over the year, which is in line with NZD hedged global IG bonds. These returns are materially higher than the return to cash over the period. However, running yields are now very low, implying returns from fixed income are likely to be much lower going forward.

Key Market Movements for the Quarter

Quarter	Past year	
+11.5%	+14.6%	**New Zealand Shares** *New Zealand shares returned 11.5% in the quarter, a very strong result that boosted the calendar 2020 return to around 14.5%. Over the past 5-years performance remains exceptional at around 17% per annum.* *Source of Figures: S&P/NZX 50 Total Return Index with Imputation Credits*
-1.0%	+5.4%	**New Zealand Fixed Interest** *New Zealand investment grade corporate bonds fell 1% in the quarter and returned around 5.4% for the year. This return is both comfortably higher than 90-day NZ bank bill and term deposit rates, showing that NZ corporate bonds have delivered a premium over the year.* *Source of Figures: S&P/NZX Investment Grade Corporate Bond Index*
+12.5%	+4.6%	**Australian Shares** *Australian shares performed strongly over the December quarter, bringing the annual return to around 4.6%. Within Australian equities, small cap stocks performed in-line with large caps, while value stocks out-performed rising around 17% in the quarter. Overall, while a strong bounce, the Australian market remains lower than many other equity markets over the year.* *Source of Figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries*
+4.6% (11.7% hedged)	+8.6% (11.1% hedged)	**International Shares** *International shares rose around 4.6% in the quarter in NZD terms, whilst NZD hedged shares increased around 11.7%. These results were sufficient to lift returns into double digit territory for calendar 2020 on an NZD hedged basis. Within global equities, higher risk small and value stocks out-performed. Small caps returned around 13.7% in the quarter, while value returned around 6.3% in NZD terms.* *Source of Figures: MSCI World Index; Morningstar Developed Markets NZD hedged, MSCI World Value, MSCI World Small Cap in NZD terms.*
+9.9%	+10.9%	**Emerging Markets** *Emerging Market equities rose around 10% in the quarter in NZD terms, bringing the annual return to around 11%. Returns were even stronger in local currency terms at around 20% for the year, with the difference reflecting the NZD appreciation versus EM currencies.* *Source of Figures: MSCI Emerging Markets Index*
+0.8%	+5.4%	**International Fixed Interest** *Global bonds returned 0.8% in the quarter and 5.4% for the year (in line with the NZ investment grade bond return). The annual return remains strong given their low income yields, and reflects bonds being re-priced higher as longer-term interest rates fell on the back of global growth concerns.* *Source of Figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)*
+10.7%	-13.2%	**International Property and Infrastructure** *International property stocks rose by around 10.7% in the quarter but still closed down 13% for the year. This is perhaps still a remarkable result given this asset class has been hit hard by Covid-19. International infrastructure has been a more resilient asset class, with returns broadly flat in 2020.* *Source of Figures: FTSE EPRA NAREIT NZD Hedged*

2020 Vision

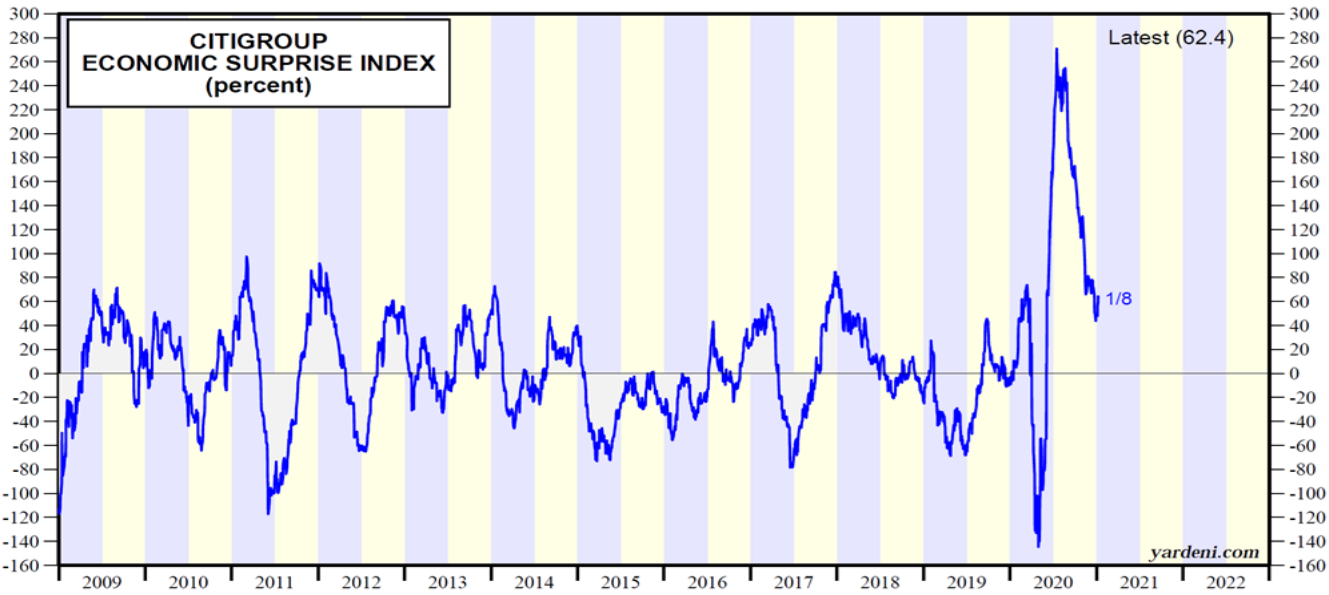
With markets continuing to rally despite the surge in Covid, and re-imposition of lockdowns in many countries, questions around whether we are now in 'a bubble' have certainly not gone away.

In our view the 2020 rally is justified by policy support measures and economic conditions being better than initially feared.

Our 2020 view was that the rally could be justified because:

- The economic 'shock' from Covid was much weaker than expected (figure 2). New Zealand provides a very clear example. While GDP fell over 12% in the June quarter of 2020 it rose 14% in September, and a positive gain for calendar 2020 GDP is not implausible. This is a far cry from calls that we were entering the worst economic conditions since the Great Depression! As we have highlighted in previous commentary, short-term market movements tend to be much more driven by how conditions evolve relative to expectations, rather than levels of activity *per se*.
- Despite the rally, risky assets continued to offer materially higher yields than investment grade bond yields and cash yields, plus the prospect of capital gains over the longer run.
- Markets are forward-looking and could see that global mass Covid-19 vaccinations were soon to begin, as indeed they have.
- Underneath the surface, it was also a "tale of two Covids". Businesses reliant on in-person patronage suffered, as did communities reliant on, say, international tourism. But the vast majority of businesses were able to "get by" with remote working, as was government and sectors such as agriculture. At the other end of the spectrum, the tech sector thrived.
- We also took some comfort from the fact that through the rally, markets were applying some level of discrimination. While the tech sector boomed, those most exposed to Covid such as office property and energy under-performed. Market volatility also remained higher than the exceptionally low levels it reached from 2014 to the end of 2019 (figure 3).

Figure 2. US Economic bounce back surprise — the largest on record



Source: Citigroup, Yardeni Research

Where to for 2021?

Our view for 2021 is that the environment still favours risk assets given their yields, on average, remain higher than on cash and bonds. We also expect that the rotation towards value and smaller cap stocks will likely continue with economic life "returning to normal" as mass scale vaccinations are achieved over the coming months. Perhaps needless to say, we do not, however, expect returns to be as strong as the back half of 2020.

The major caveat to this view is that it depends on inflation and interest rates remaining low.

Should markets start pricing in central banks needing to raise rates in the medium term, or turn their attention to fiscal sustainability risks, we would expect to see significant sell-offs. This risk is perhaps most material in New Zealand, where, with the benefit of hindsight, it looks like the RBNZ pushed monetary and credit conditions too loose in 2020, and hence they may be forced to tighten financial conditions (starting with mortgage loan-to-value ratios) over the next few years.

Our overall view also does not imply that all assets are priced rationally, or even consistently!

In 2021 we expect much more modest returns to risk assets, with the risk of markets pricing in interest rate increases being the main caveat to our positive view.

Stocks like Tesla and digital currencies such as Bitcoin are likely caught in a wave of irrational exuberance (figure 4), while at the other end of the spectrum, government bonds in our view suffer from excessive pessimism over the medium to longer term economic outlook. Time as always will tell.

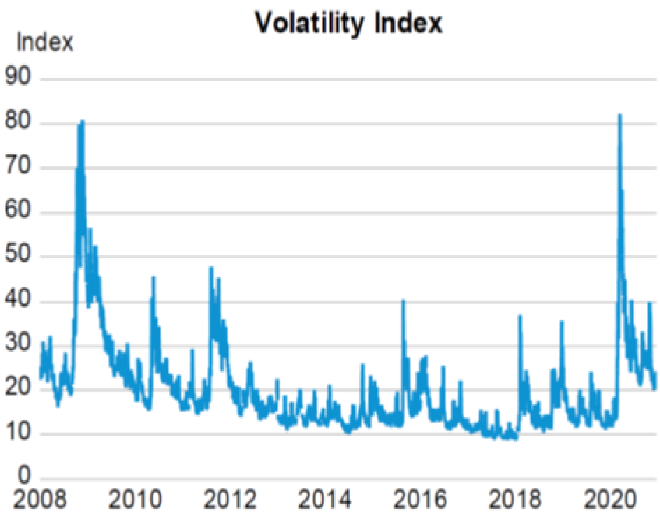


Figure 3. Market Volatility remains elevated
Source: Haver

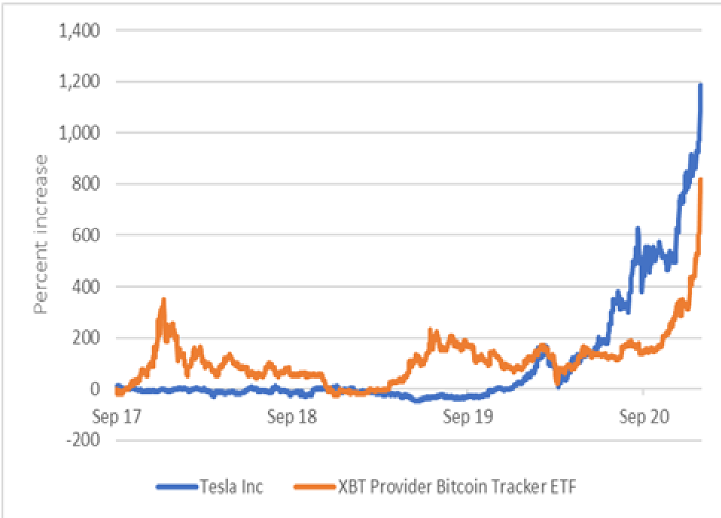


Figure 4. Tesla and bitcoin bubbles?
Source: Morningstar

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Phone: 09 445 2134 **Email:** info@axiome.co.nz