Headwinds

June 2022

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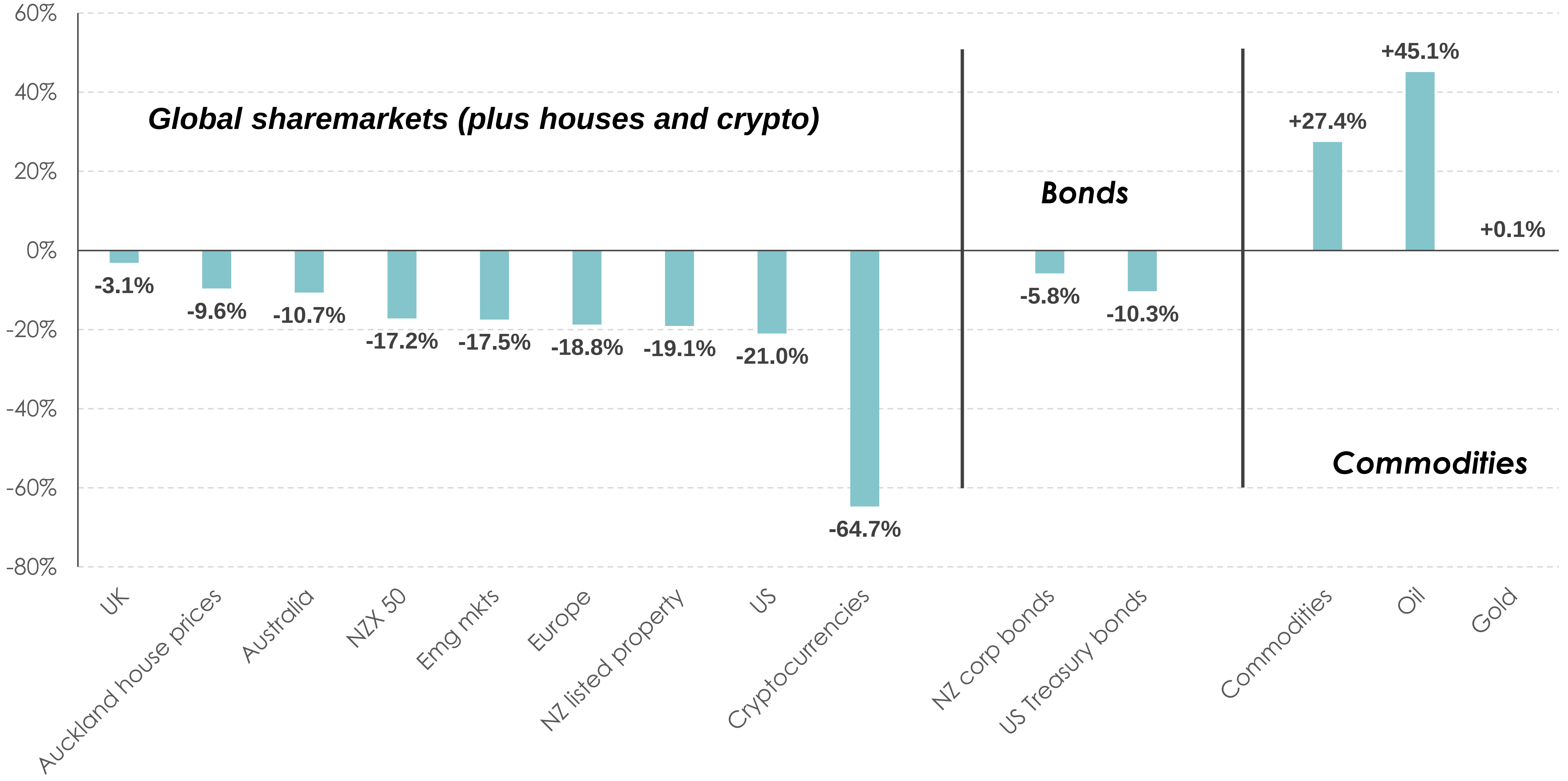
Private Wealth Research

Our economic, market and investment outlook, in a nutshell

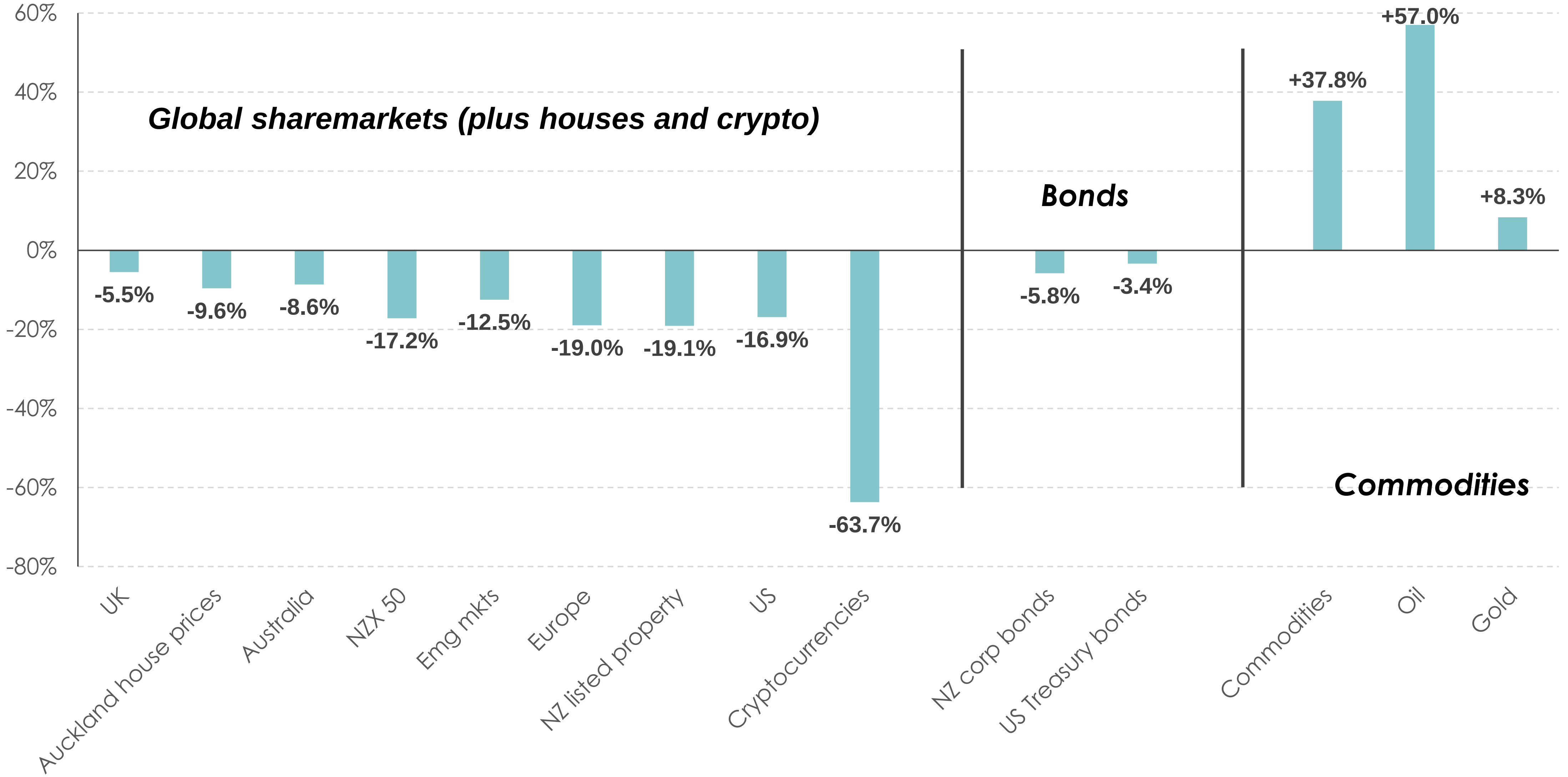
- **Economic growth has remained solid** and corporate earnings resilient, but supply chain disruptions, geopolitical tension and other issues mean **uncertainty remains high, and risks are to the downside.**
- **The local economy is steady**, supported by a strong labour market and robust commodity prices. However, we **expect rising mortgage rates will soon begin to bite**.
- Some inflation pressures relate to pandemic-related issues, while others look more persistent. **Central banks will continue to react strongly over the coming 12 months**, to rein in the price increases.
- **Rising interest rates will continue to impact valuations**, as well as investor sentiment, corporate earnings could come under pressure as economic activity slows and input costs rise.
- **Ensure asset allocations match your long-term objectives**, and portfolios are well-diversified. Don't be afraid to **take some risk off the table and rebalance into fixed income** (which looks more reasonable now).
- **Favour high quality businesses with long-term structural tailwinds**. However, ensure you are exposed to some of the less exciting sectors too. Highly-priced growth companies could remain under pressure as investors rethink what they are willing to pay for assets.
- **Apply a defensive tilt** (healthcare and consumer staples do well during uncertain periods) and include stable, dividend-paying equities in portfolios. Include companies, sectors and regions that have traditionally **proven resilient during periods of high inflation** (infrastructure, real estate and commodities).

It's been a volatile start to 2022 for most asset classes



Source: Bloomberg, CIP. All in local currencies.

After currency movements, things look a little better



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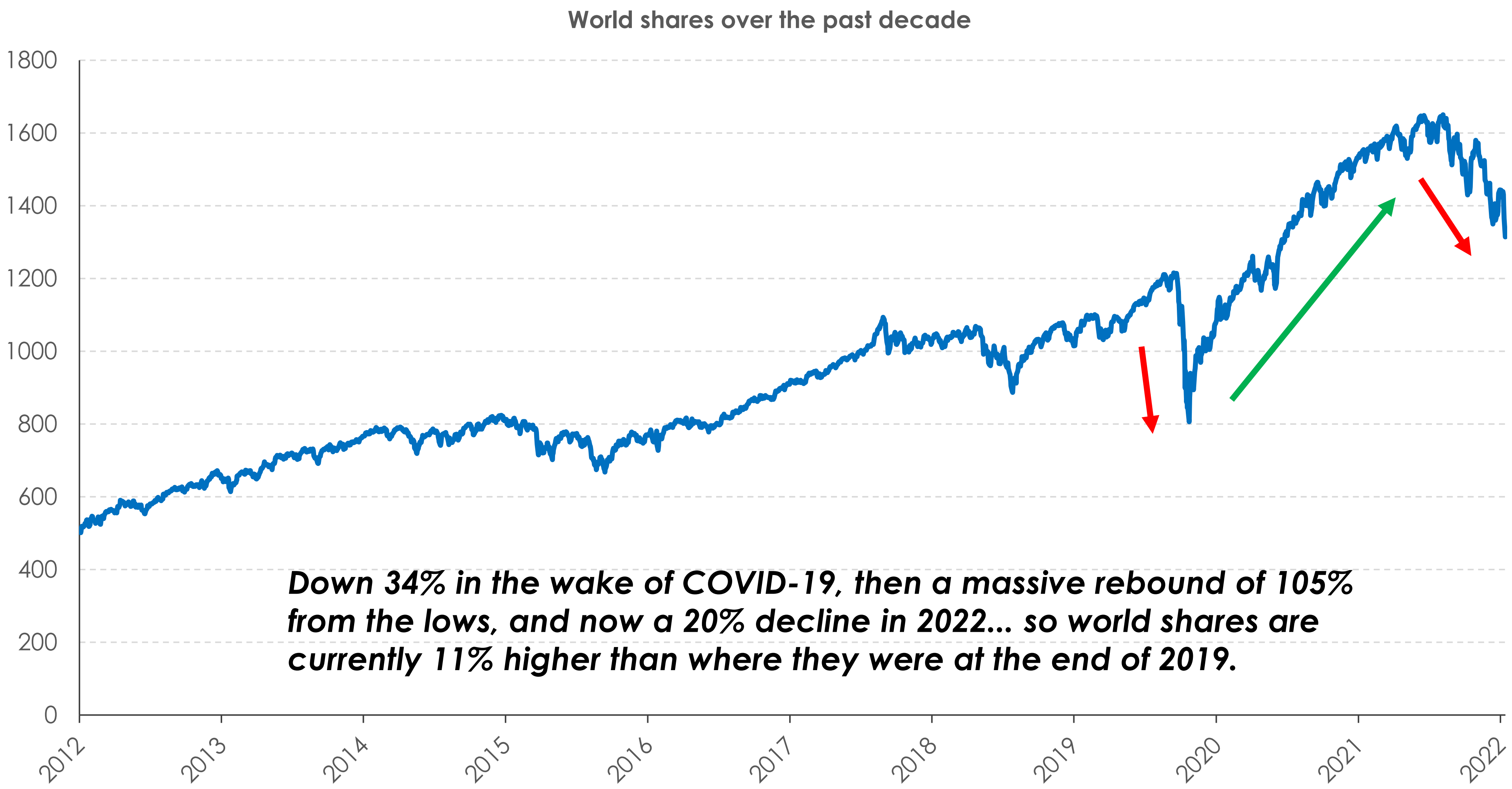
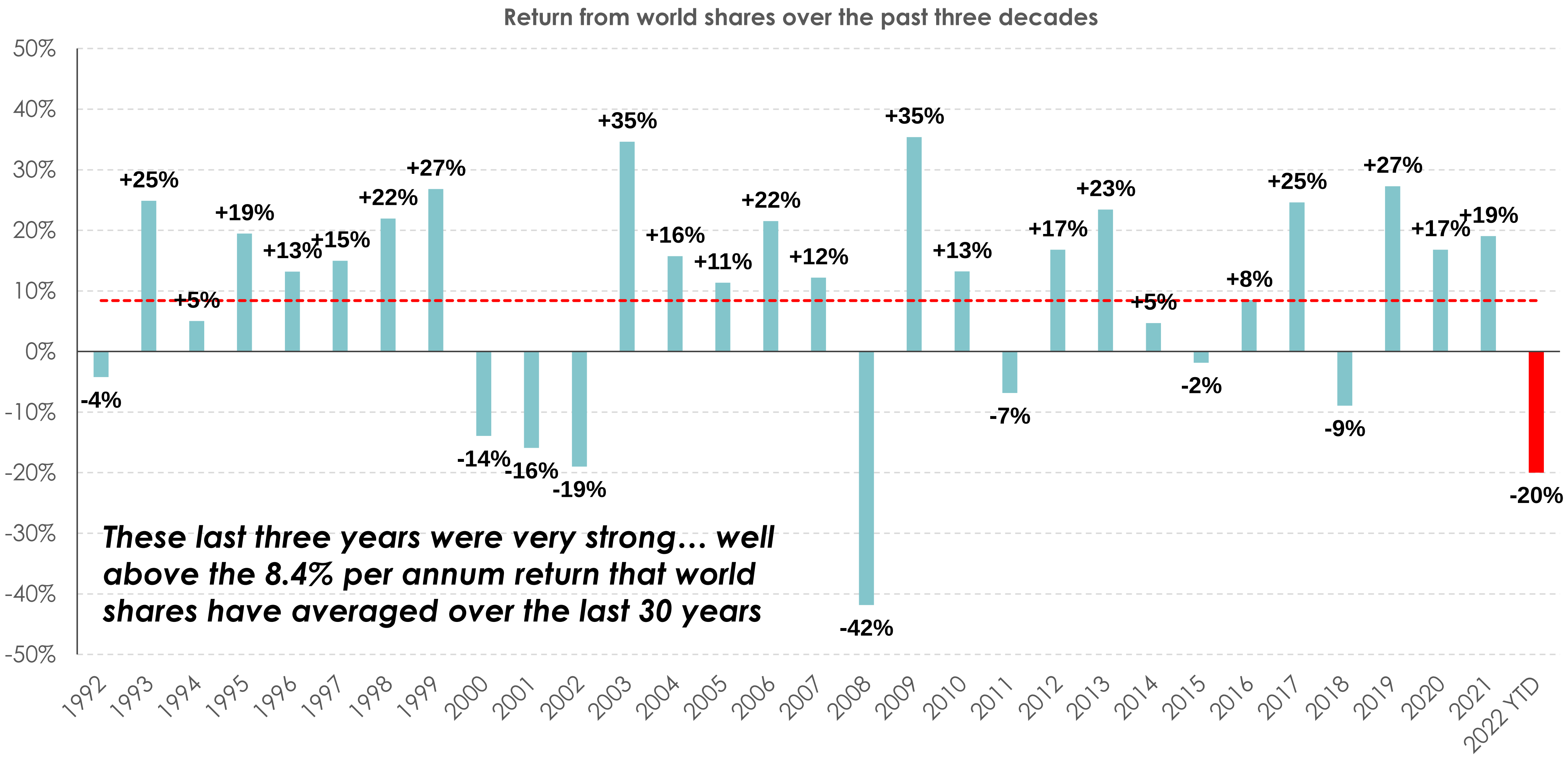
Putting the 2022 decline in perspective



Source: Bloomberg, CIP.

Let's remind ourselves things can't always go one way



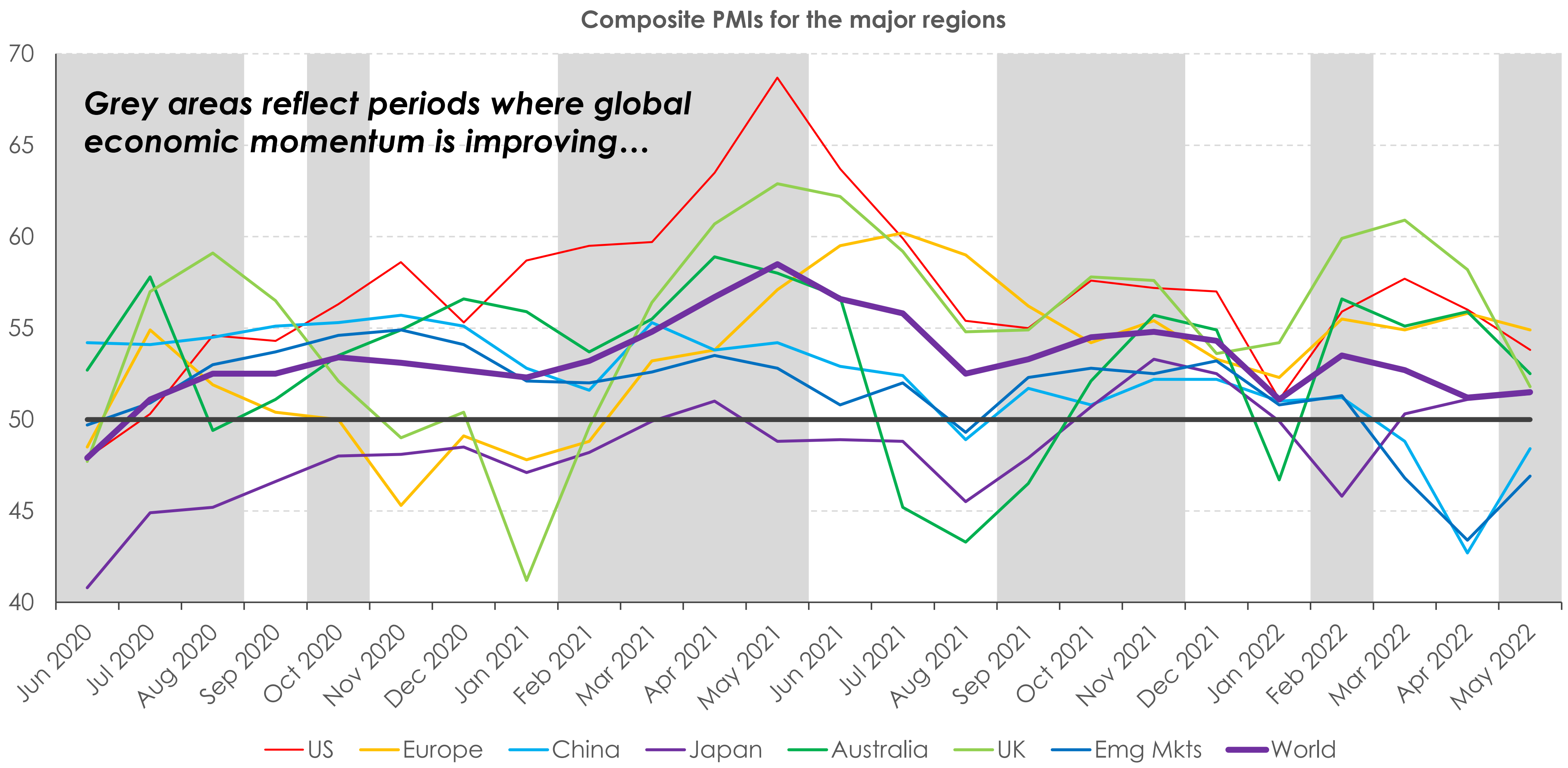
Source: Bloomberg, CIP. Returns include dividends.

A brief history of S&P 500 bear markets and recessions

	Period of market decline	S&P 500 decline	Duration (months)	NBER defined recession	Market return since bottom after: One month	Six months	12 months	Months to recover to previous peak
1	January 1960 - October 1960	-13.4%	10	Yes	7.3%	24.9%	30.7%	3
2	December 1961 - June 1962	-28.0%	7	No	8.5%	20.5%	32.7%	21
3	February 1966 - October 1966	-22.2%	8	Yes	10.3%	22.1%	33.2%	7
4	November 1968 - May 1970	-36.1%	19	Yes	6.0%	22.8%	43.7%	41
5	January 1973 - December 1974	-45.9%	21	Yes	9.3%	42.3%	33.9%	91
6	February 1980 - March 1980	-17.1%	2	Yes	7.6%	28.6%	37.1%	5
7	November 1980 - August 1982	-27.1%	22	Yes	19.4%	44.1%	58.3%	24
8	August 1987 - December 1987	-33.5%	5	No	14.3%	19.0%	22.8%	20
9	July 1990 - October 1990	-19.9%	4	Yes	8.1%	27.8%	29.1%	8
10	March 2000 - October 2002	-49.1%	32	Yes	15.2%	11.5%	33.7%	87
11	October 2007 - March 2009	-56.8%	15	Yes	26.6%	52.7%	68.6%	66
12	February 2020 – March 2020	-33.9%	1	Yes	25.0%	40.0%	74.8%	6
13	January 2022 - current	-23.4%	?	?	?	?	?	?
Average of all		**-31.3%**	**12**		**13.1%**	**29.7%**	**41.6%**	**32**

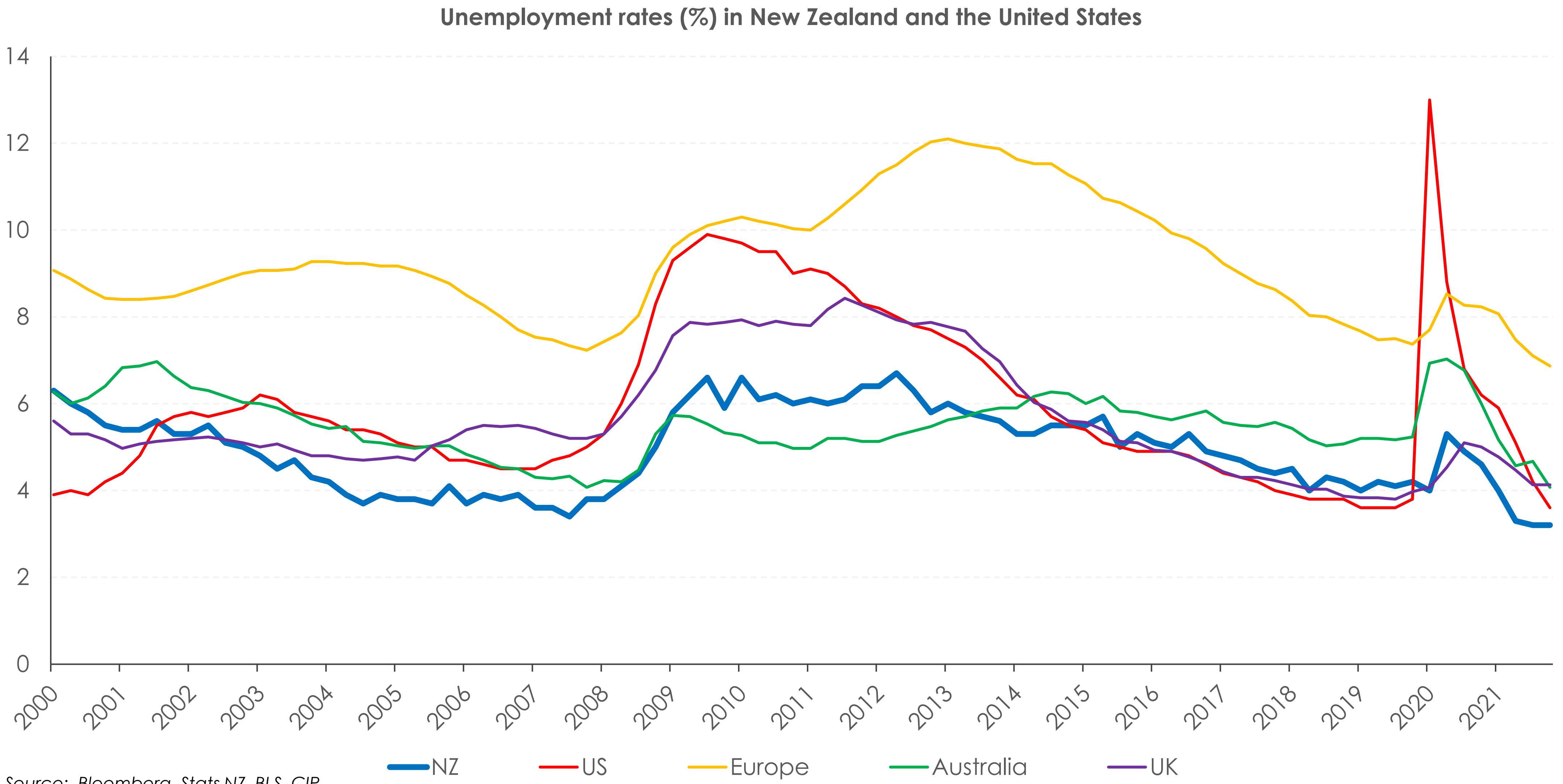
The global economy

A few cracks, but growth has generally remained solid



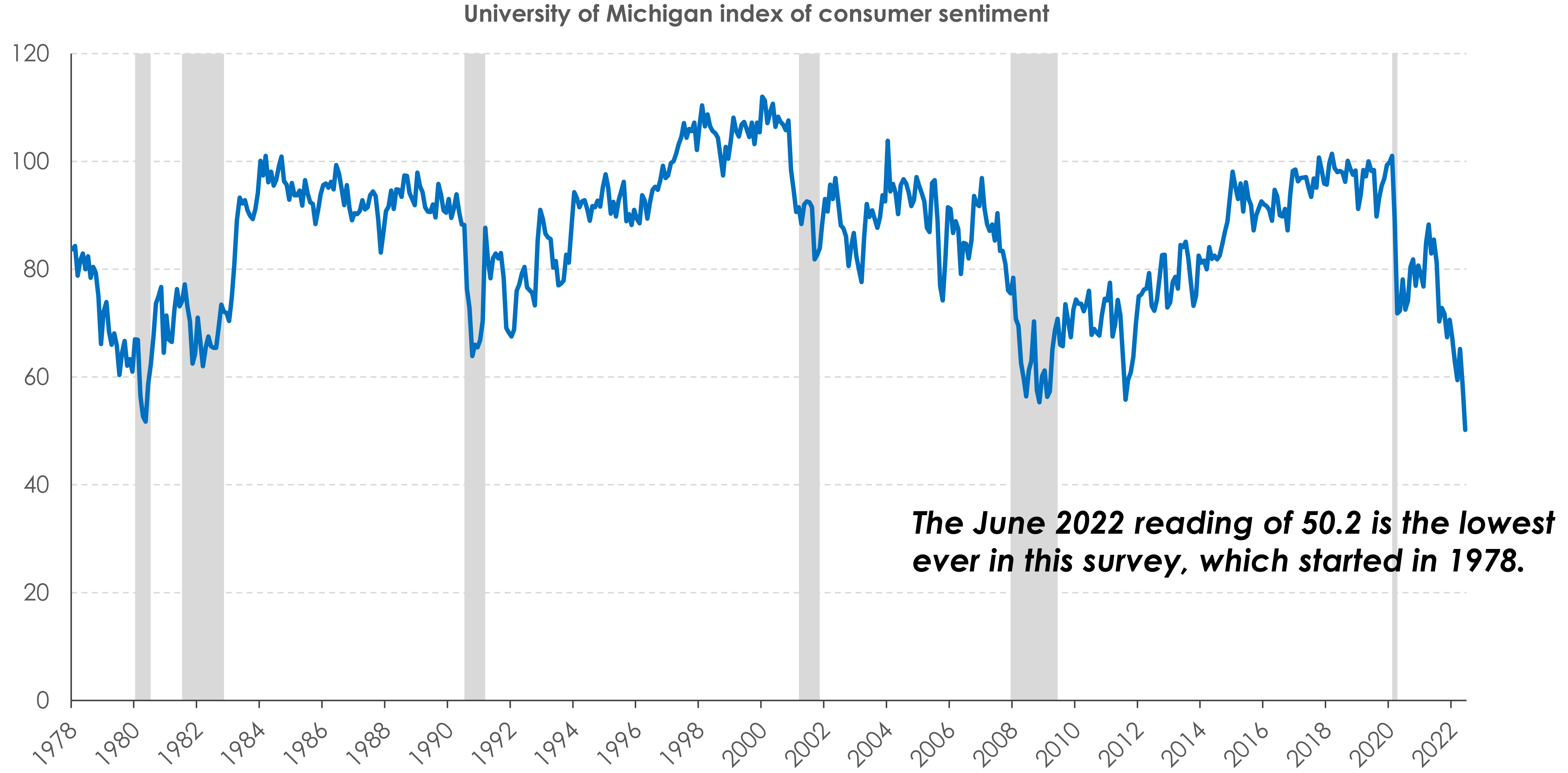
Source: Bloomberg, JP Morgan, CIP.

Labour markets are still extremely tight, to an "unhealthy level"



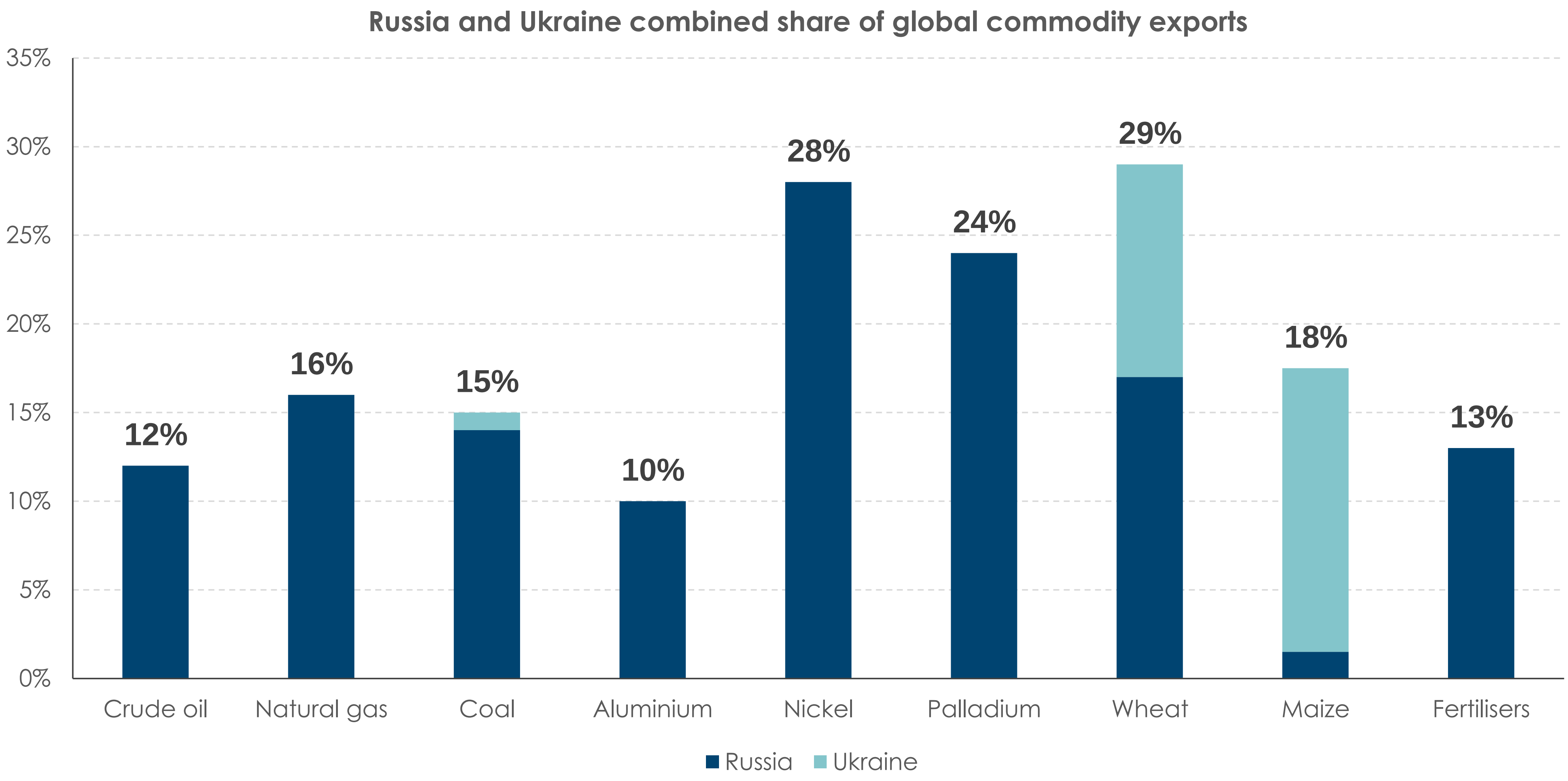
Source: Bloomberg, Stats NZ, BLS, CIP.

However, high inflation is starting to take its toll on consumers



Source: Bloomberg, CIP, University of Michigan, NBER. Greay areas are US recessions.

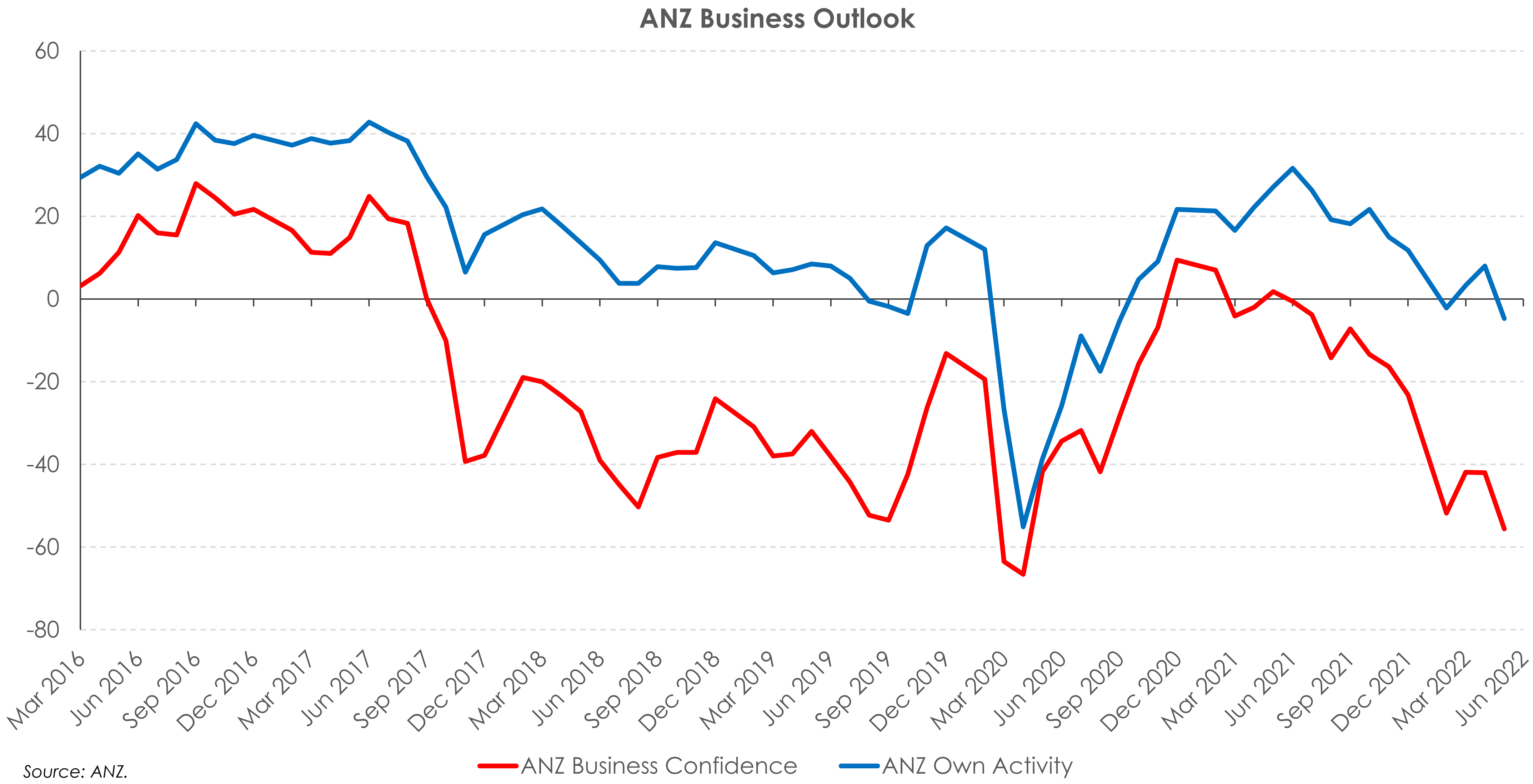
The Ukraine war has had a major impact on commodities



Source: Bloomberg, RBNZ, CIP.

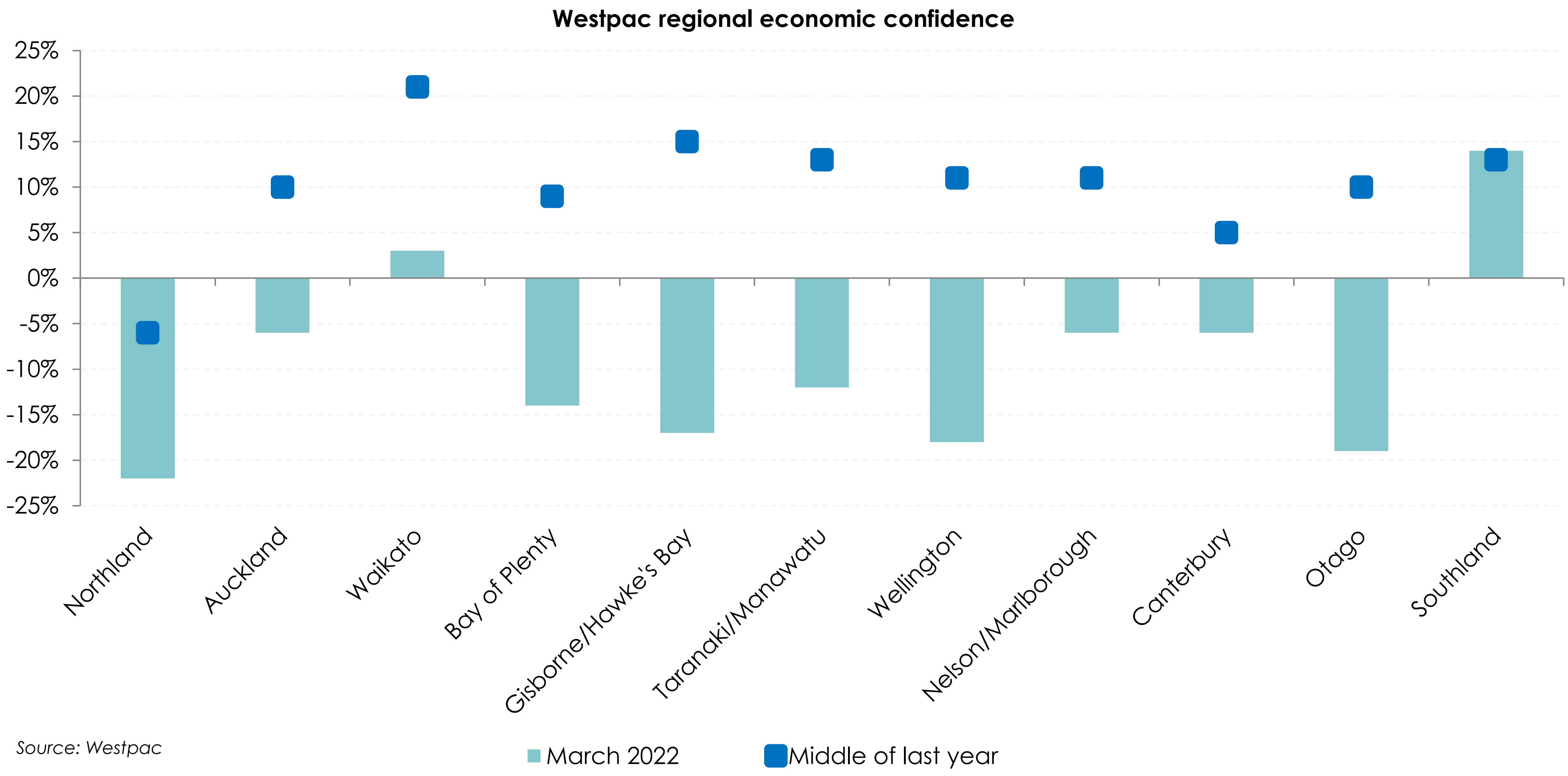
We’re still luckier than most

NZ businesses have been resilient, but cracks are appearing



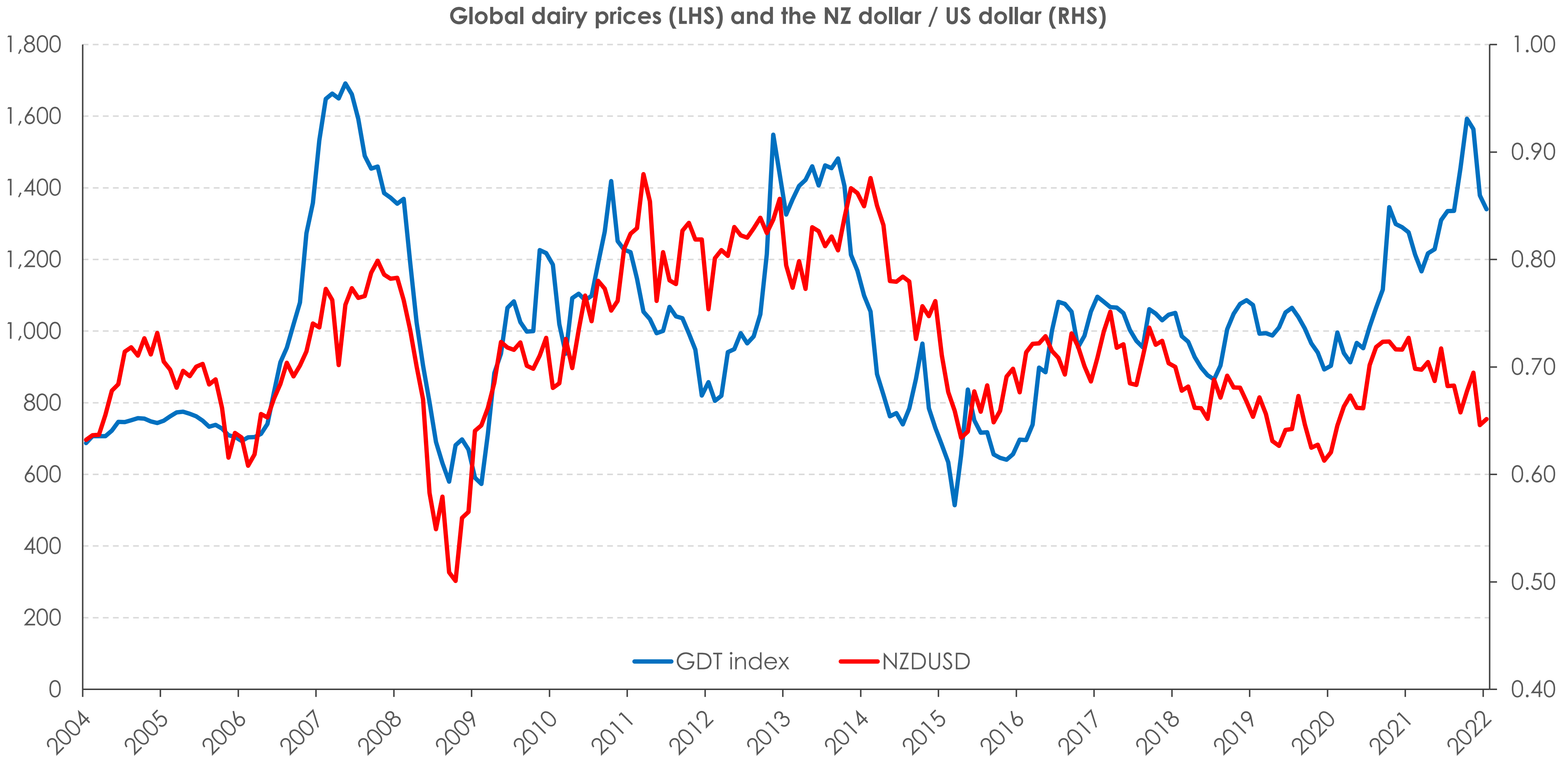
Source: ANZ.

Confidence has taken a knock, with rural regions holding up best



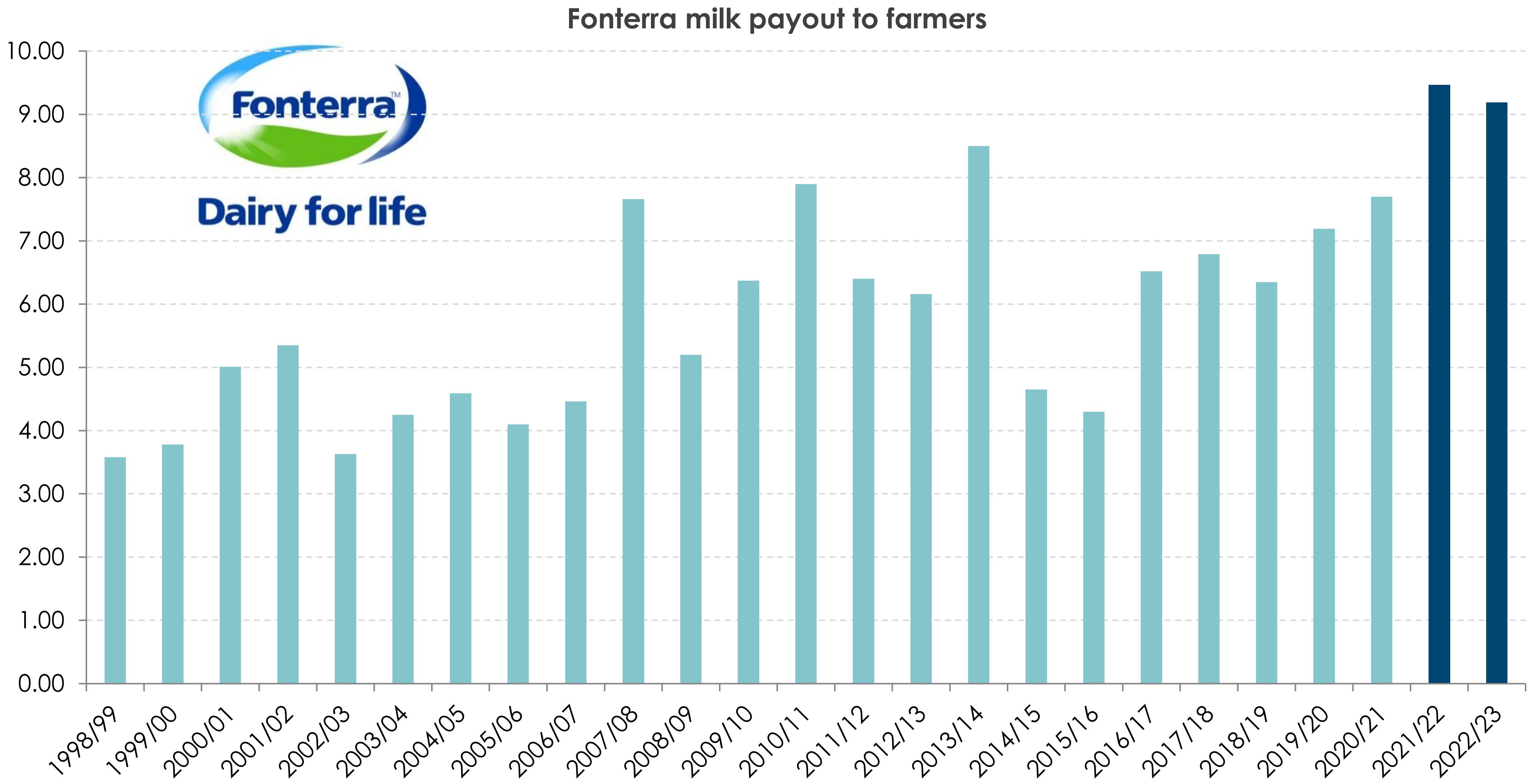
Source: Westpac

Despite some recent weakness, dairy prices are still high



Source: GDT, Bloomberg, CIP.

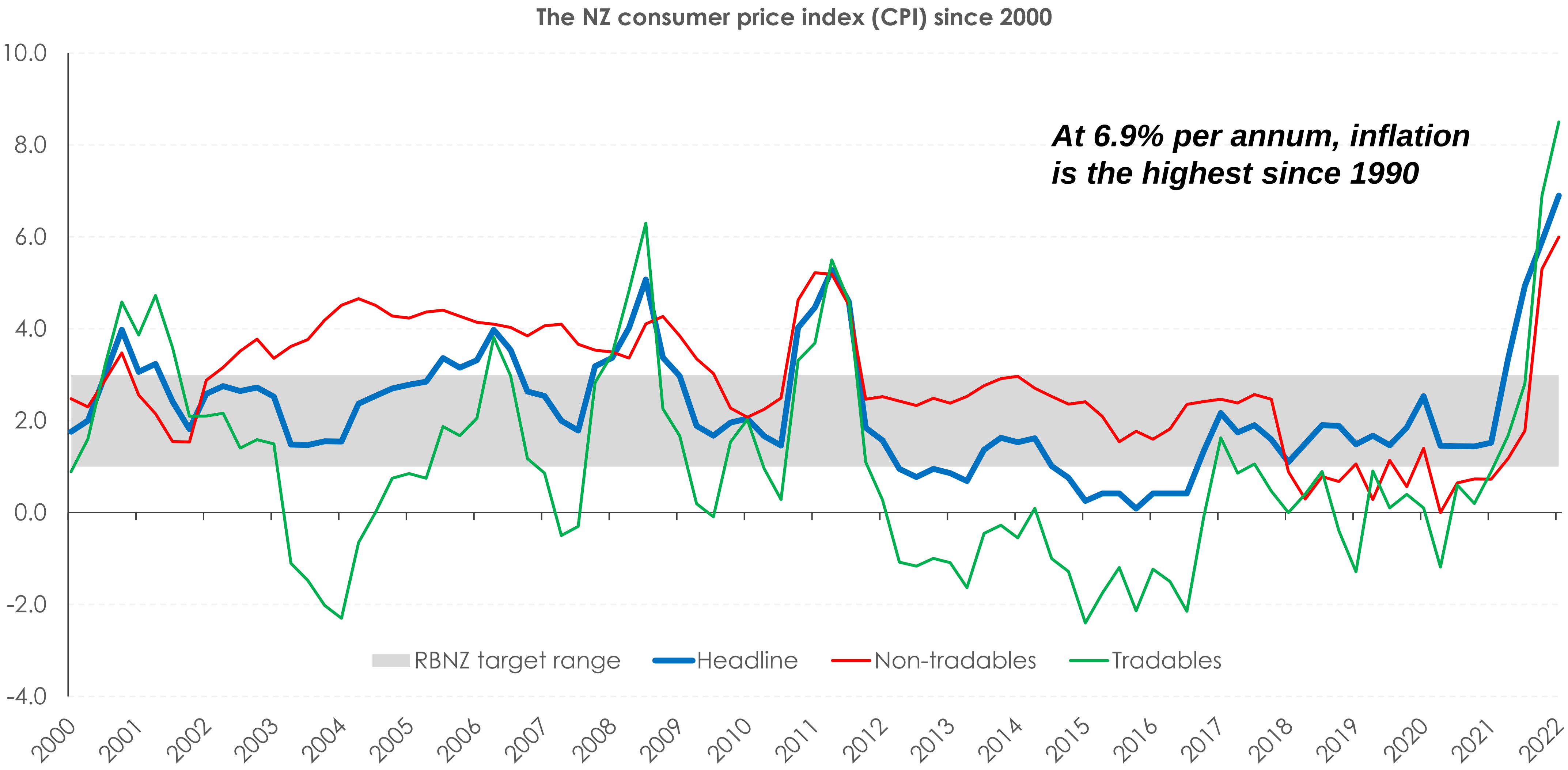
This should see the Fonterra payout at its highest ever level



Source: Fonterra, CIP. Payout includes dividend.

Inflation through the roof

Inflation pressures have been increasingly broad-based



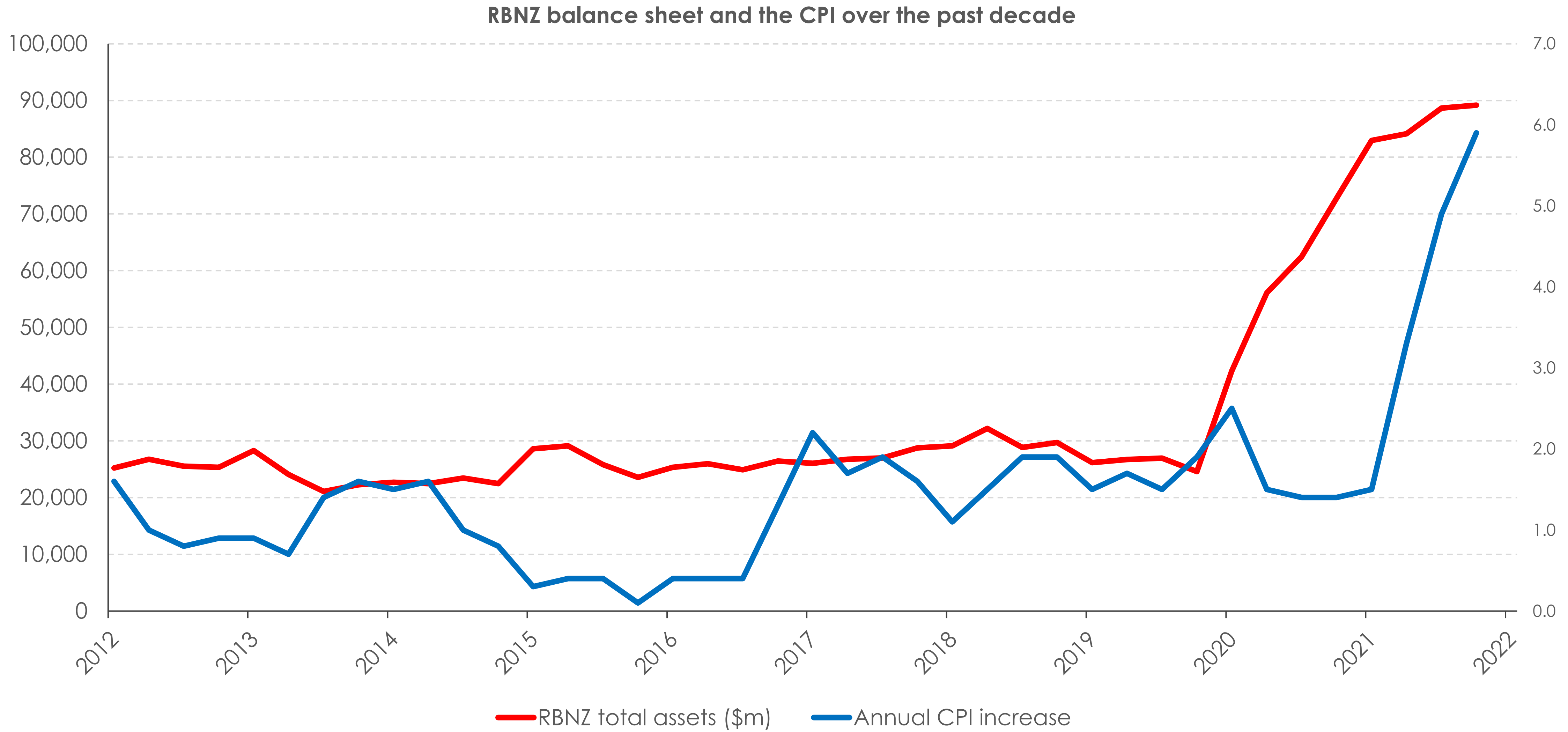
Source: Stats NZ, RBNZ, CPI.

Yes, it is a global issue, rather than one unique to New Zealand

Region	Headline inflation rate	CB preferred measure (if different)	Cycle high strongest since	Central bank target
New Zealand	6.9%		1990	1-3% range
Australia	5.1%	3.7%	2001 / 2009	2-3% range
United States	8.6%	4.9%	1981 / 1983	2% target
Europe	8.1%		Since the EU began in 1997	2% target
United Kingdom	9.0%		1982	2% target

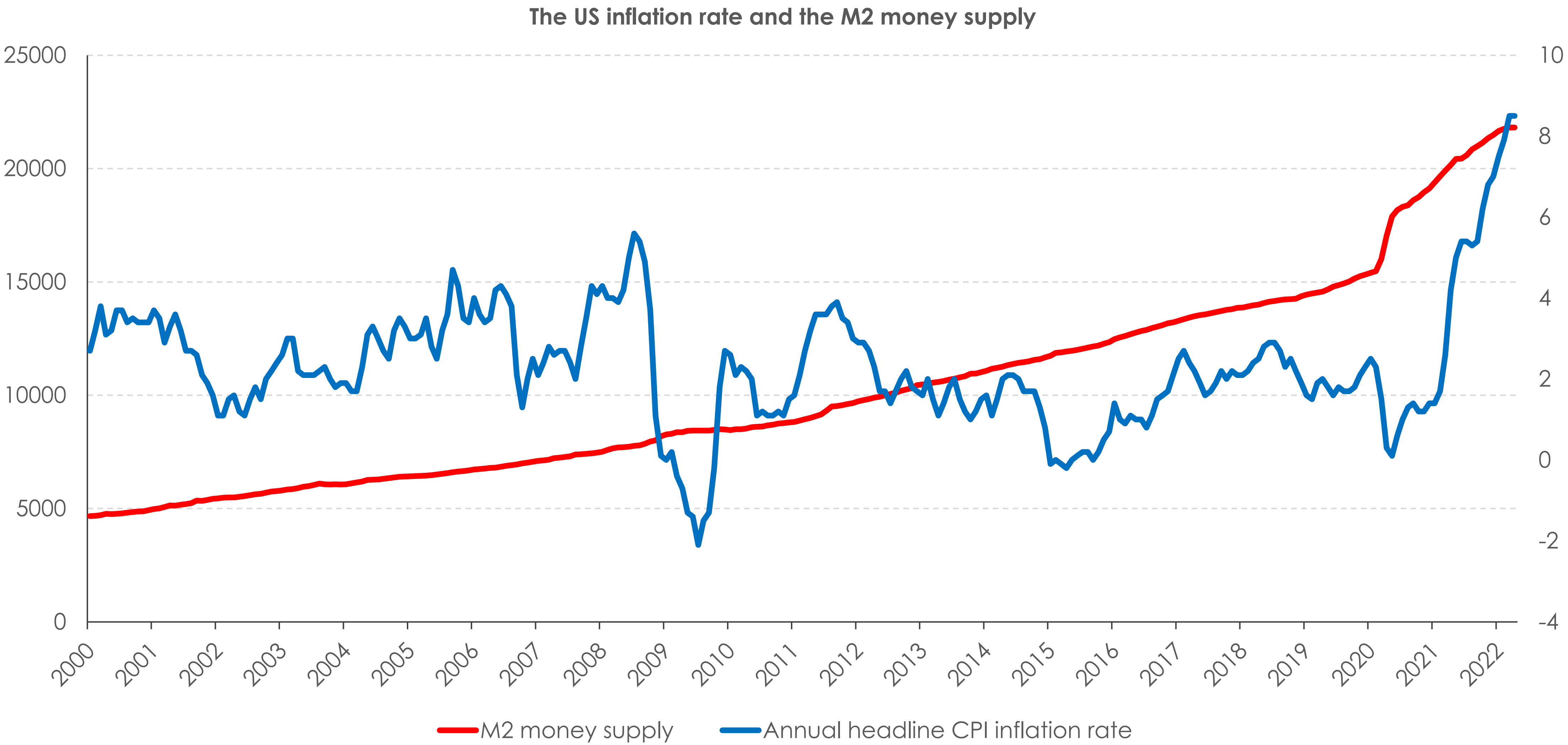
Source: Central bank websites, Bloomberg, Stats NZ, CIP estimates.

Having said that, it's also partly self-inflicted, to some degree



Source: RBNZ, Stats NZ, CIP estimates.

After all, inflation is always a monetary phenomenon, isn't it?



Source: BEA, Bloomberg, Federal Reserve, CIP.

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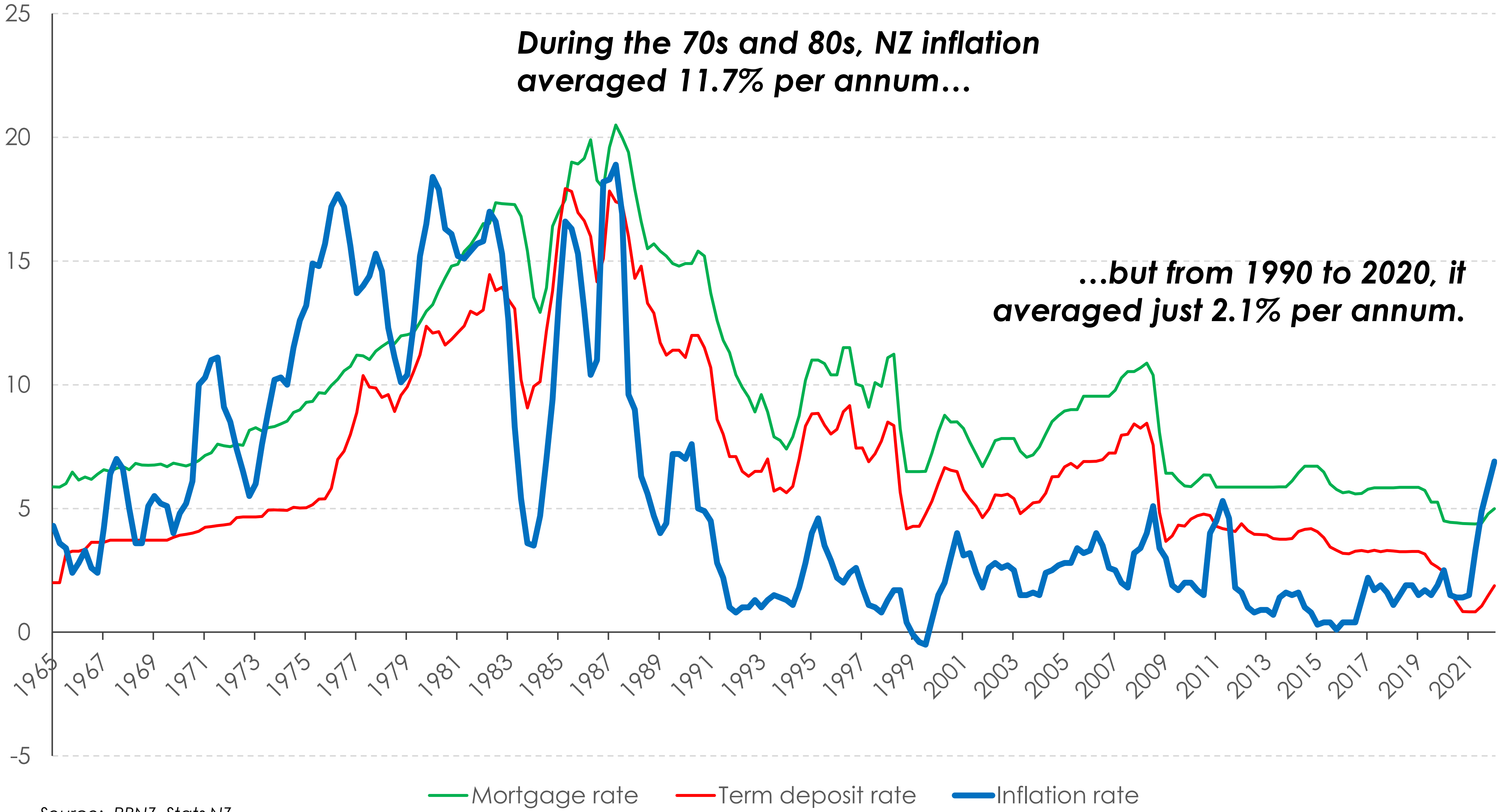
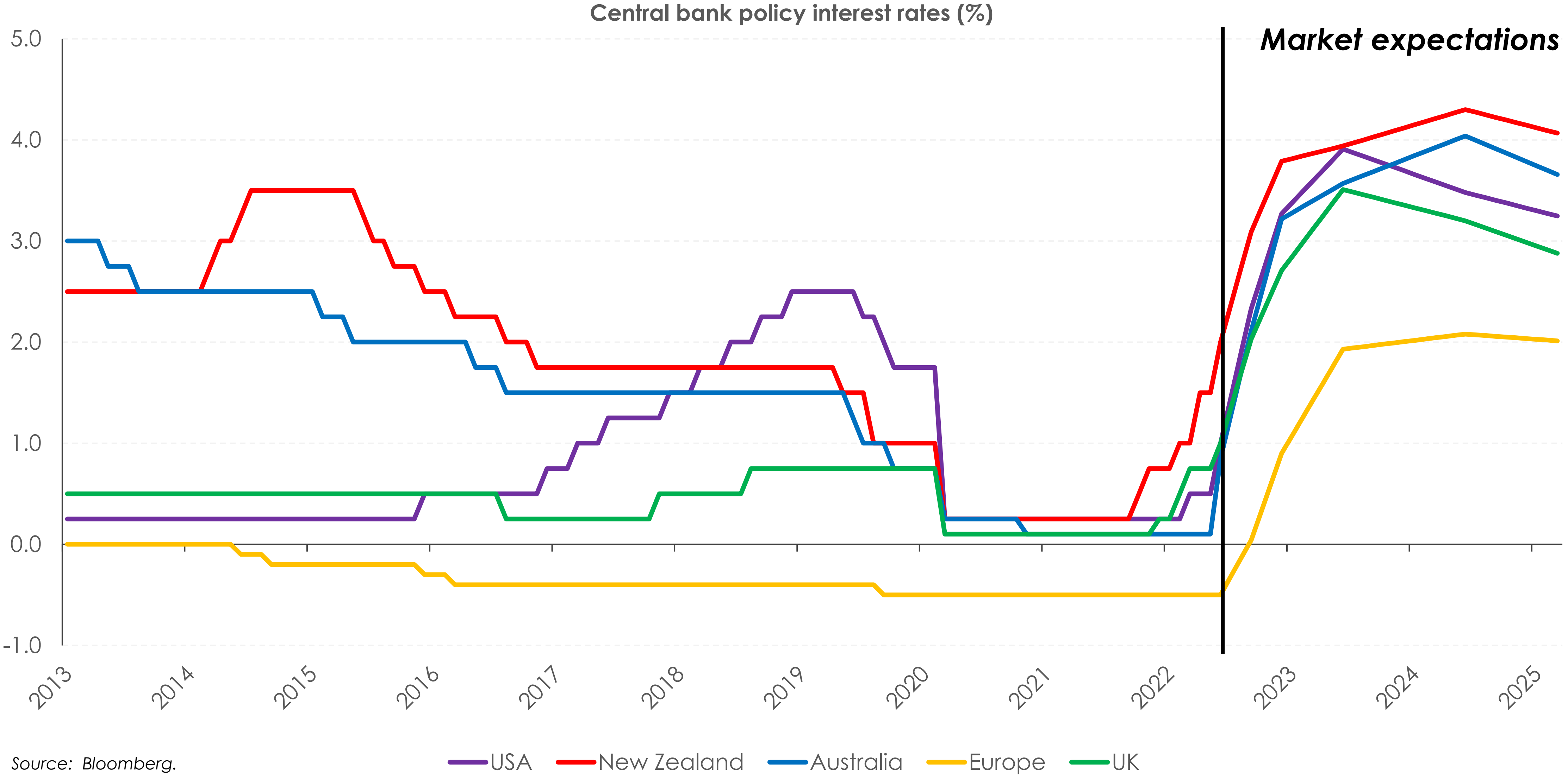
A rock and a hard place

Inflation and interest rates are intrinsically tied together



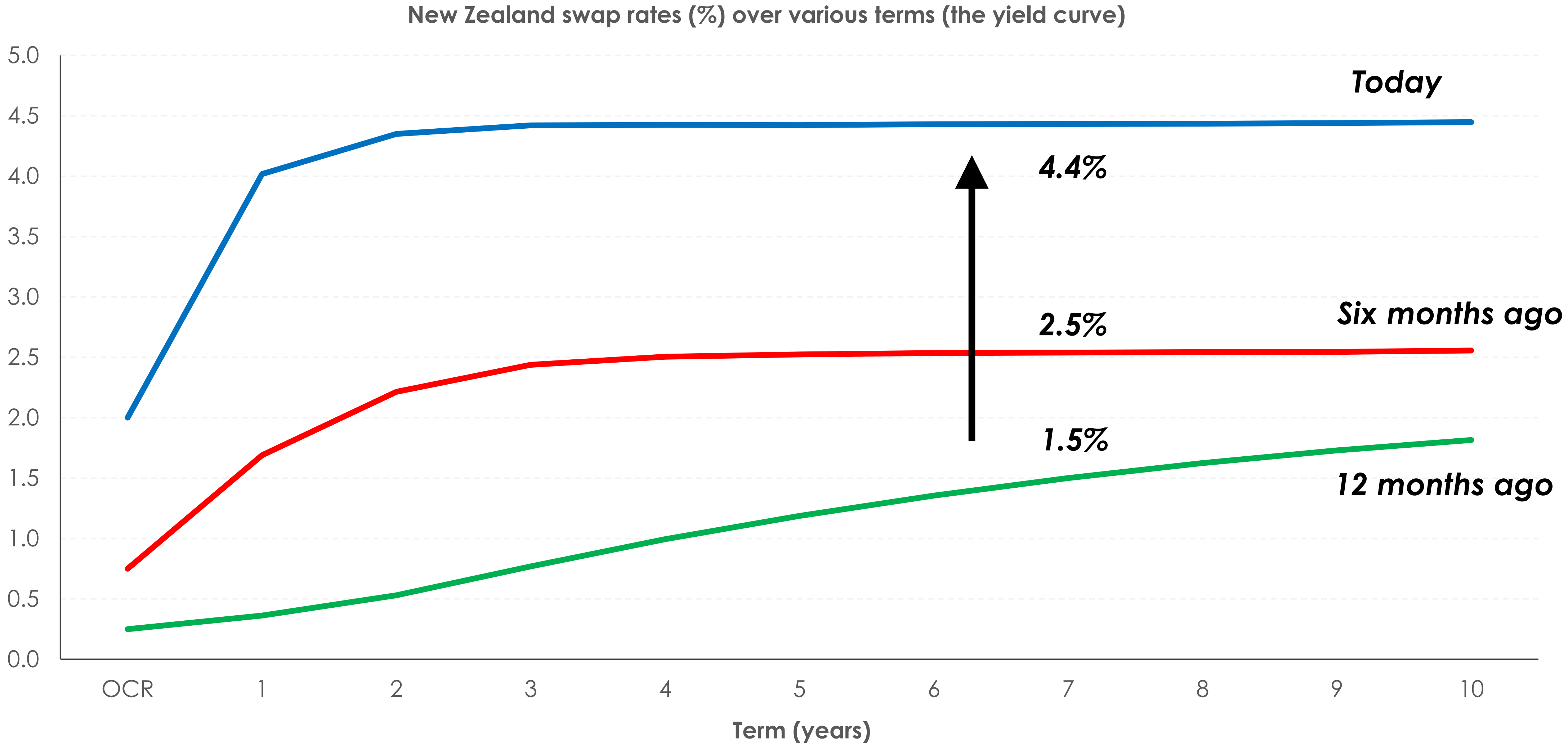
Source: RBNZ, Stats NZ.

Central banks are expected to keep acting in response



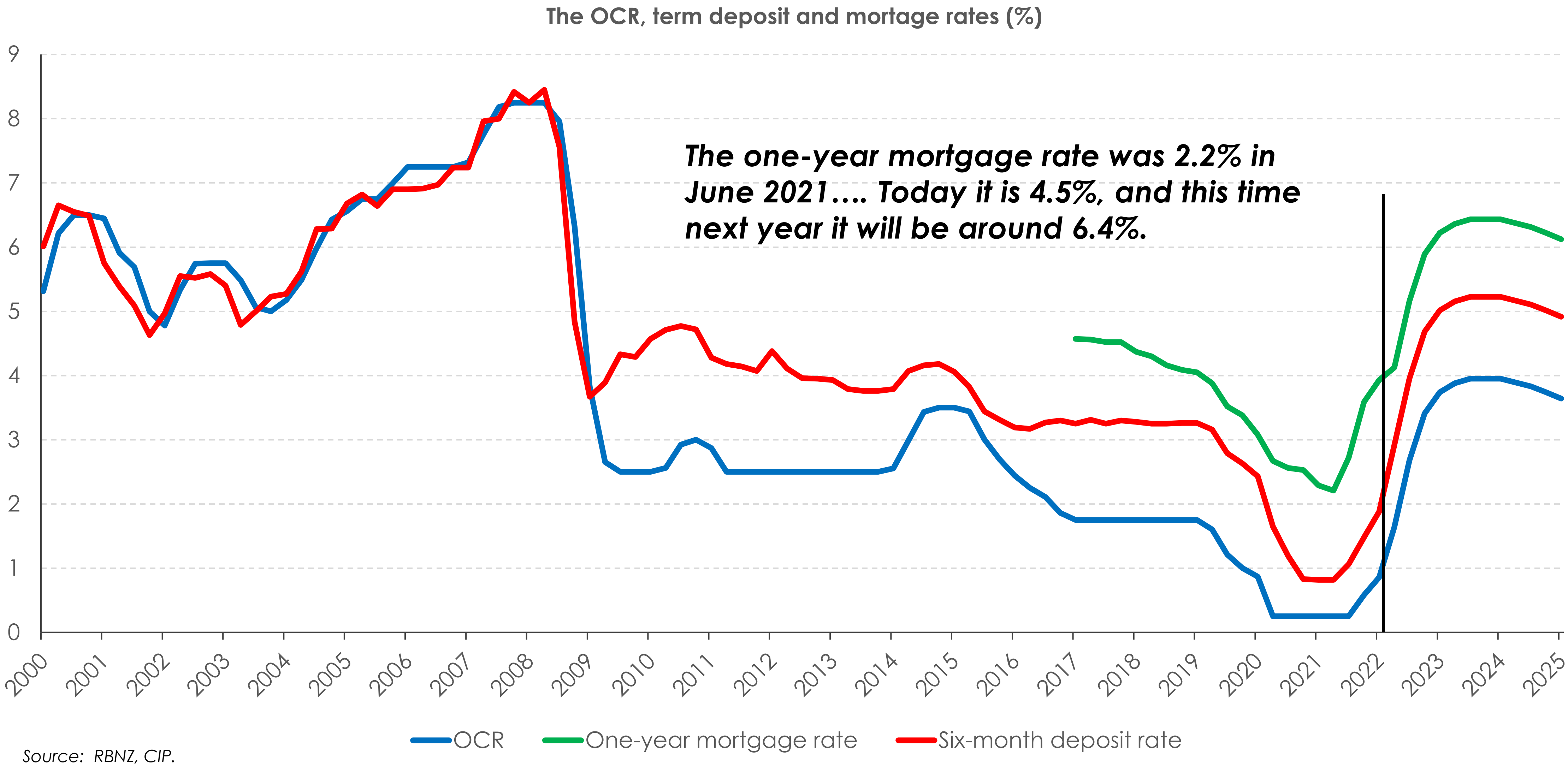
Source: Bloomberg.

Hence the big moves in yields, both here and offshore



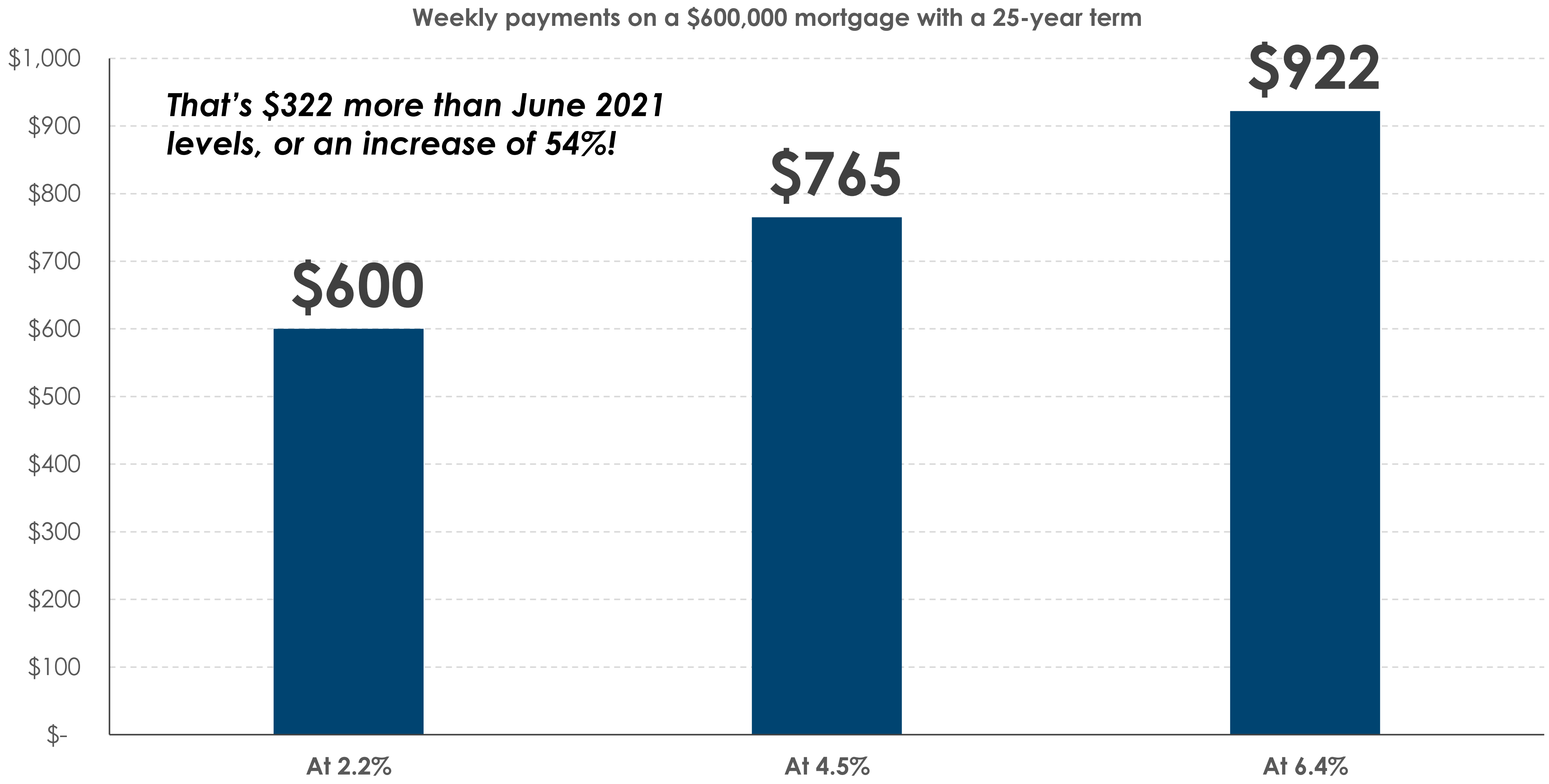
Source: Central bank websites, Blomberg, Stats NZ, CIP estimates.

If interest rates rise as expected, it'll be tough for some households



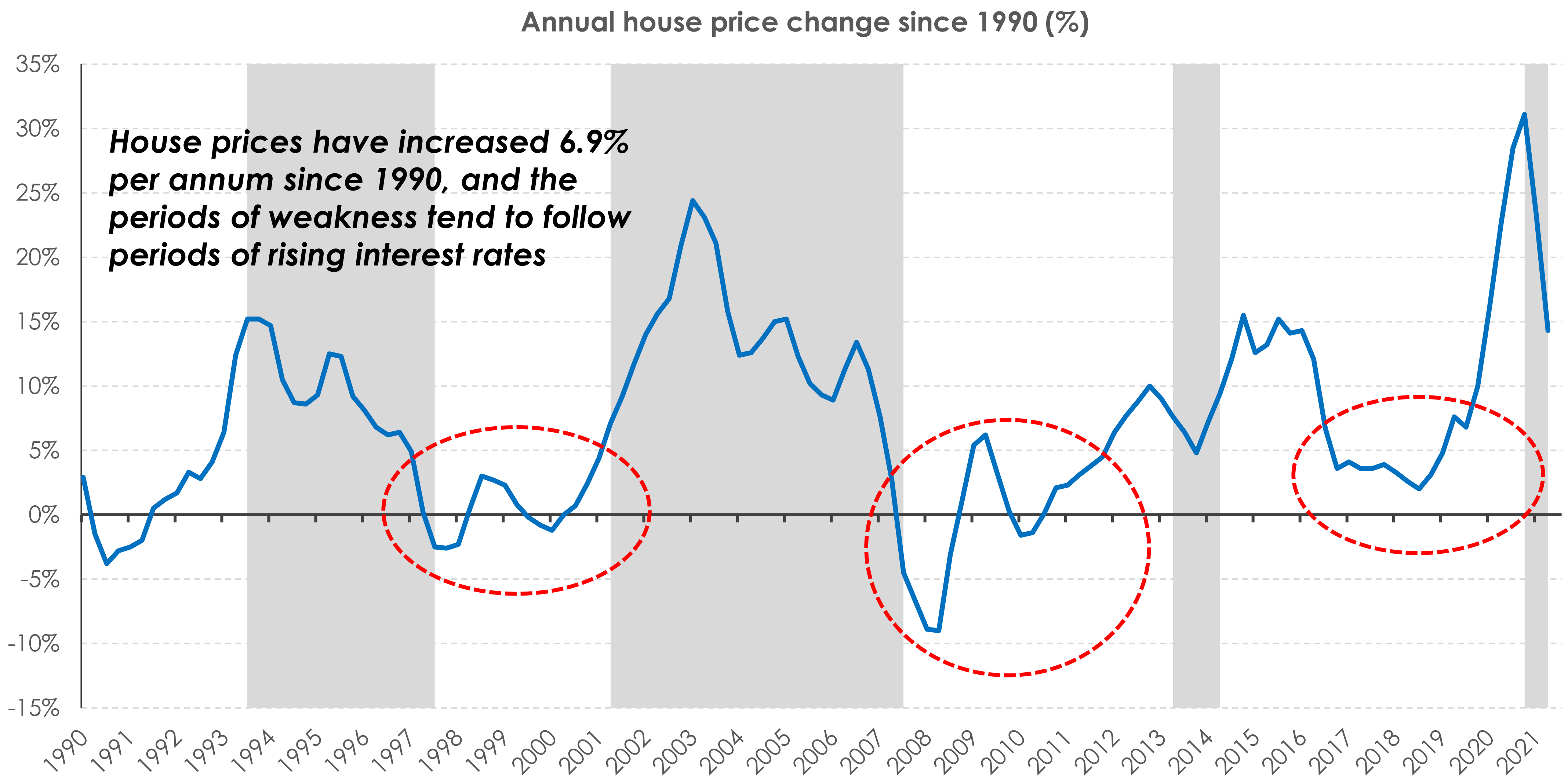
Source: RBNZ, CIP.

What will those changes mean for weekly mortgage payments?



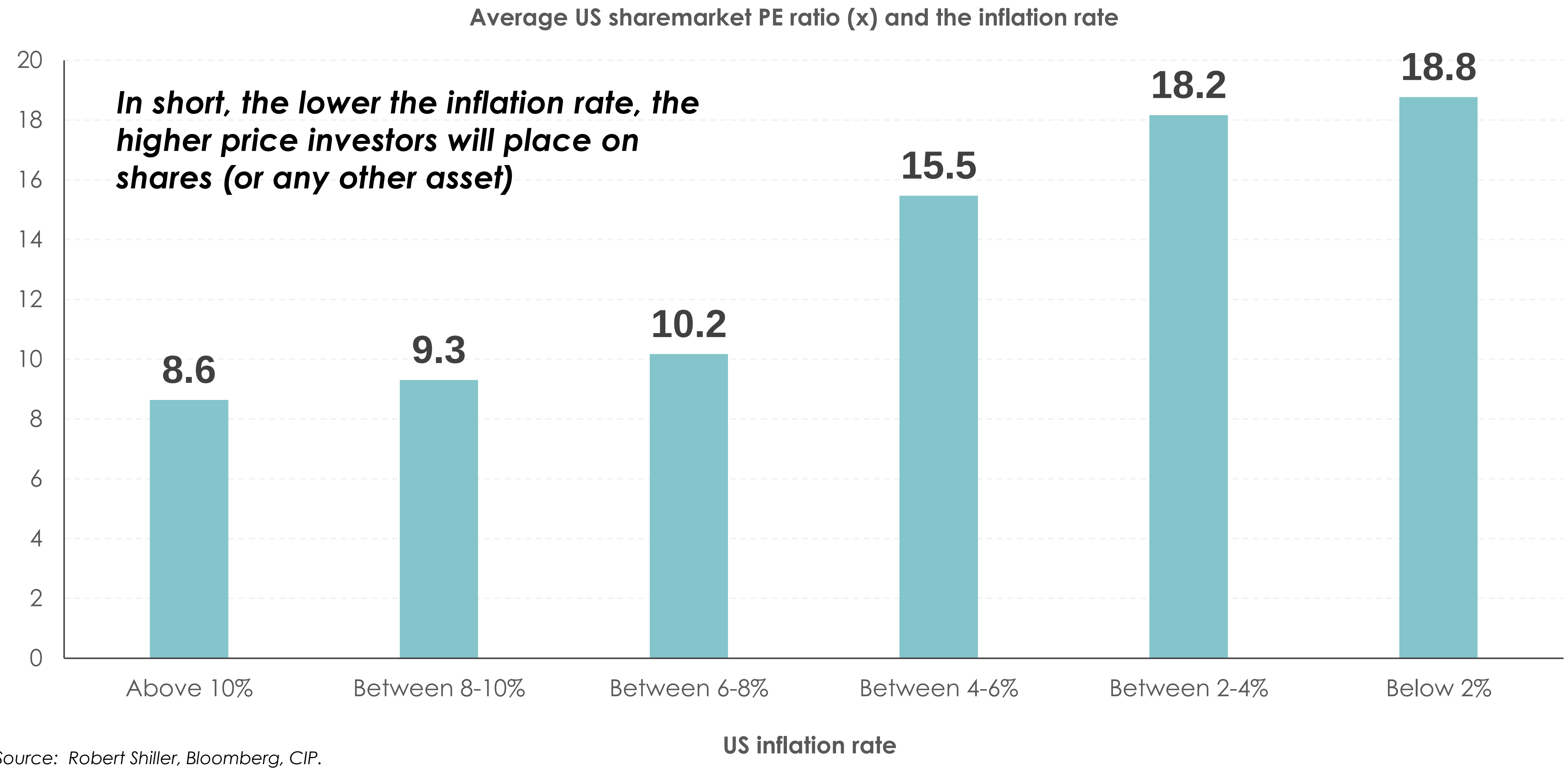
Source: RBNZ, CIP.

The housing market has turned, and will weaken further



Source: RBNZ, CIP.

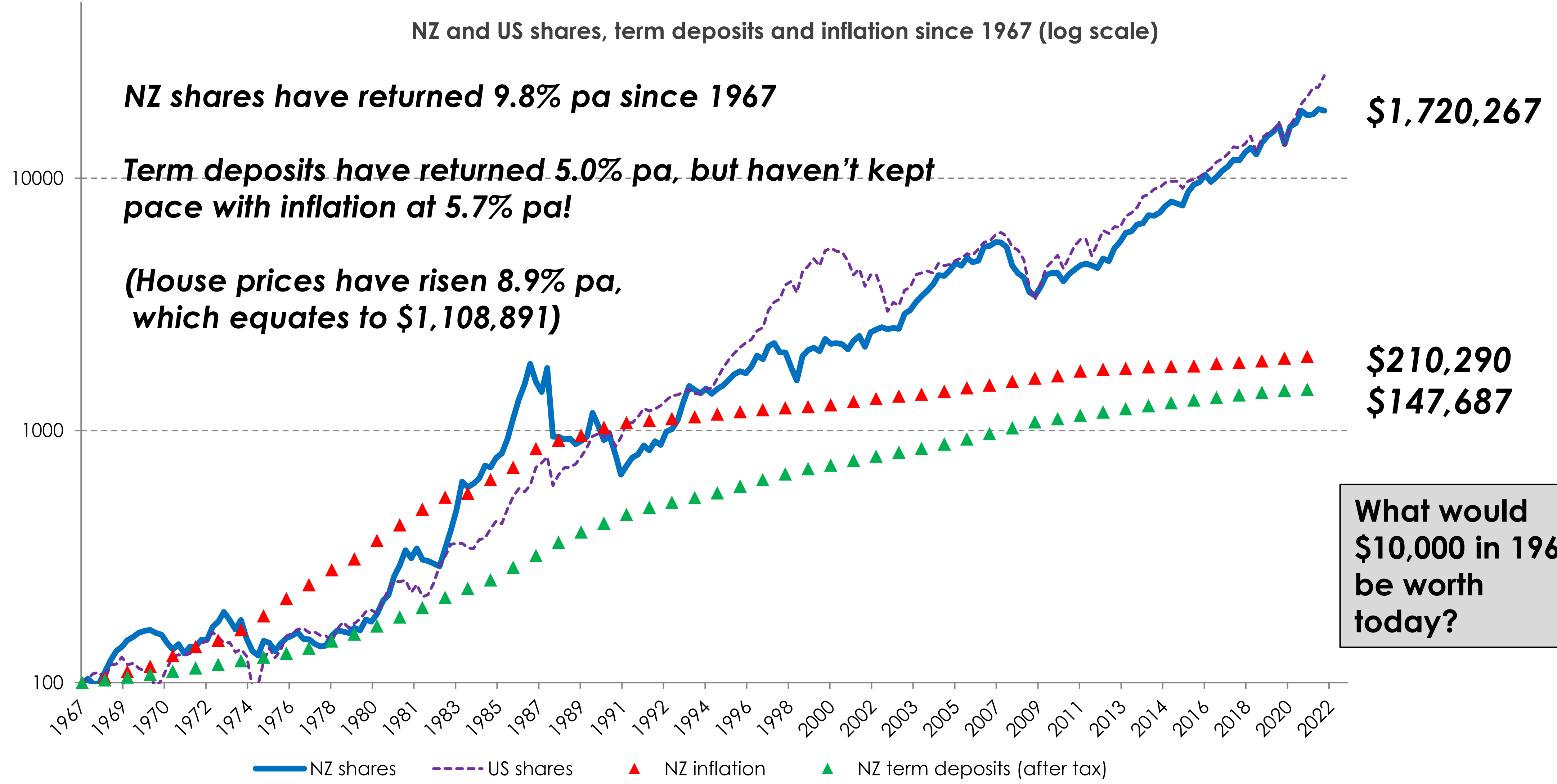
Higher interest rates will remain a headwind for stocks too



Source: Robert Shiller, Bloomberg, CIP.

Investing 101

Shares are a very good wealth creator over the long-term...



What would $10,000 in 1967 be worth today?

Source: CIP, RBNZ, Robert Shiller, Bloomberg. Barclays Capital Index from 1967 to July 1986, NZSE Gross Index from July 1986 to current. S&P 500 including dividends for US shares. As at March 2022. Tax considerations ignored for shares and house prices (given imputation regime etc), and term deposit income taxed at 30% per annum over entire period.

However, there is plenty of volatility along the way

	Period of market decline	S&P 500 decline	Length (months)	Recession?	Period of recession
1	January 1960 - October 1960	-13.4%	10	Yes	April 1960 - February 1961
2	December 1961 - June 1962	-28.0%	7		
3	August 1962 - October 1962	-10.5%	2		
4	February 1966 - October 1966	-22.2%	8		
5	September 1967 - March 1968	-10.1%	5		
6	November 1968 - May 1970	-36.1%	19	Yes	December 1969 - November 1970
7	April 1971 - November 1971	-13.9%	7		
8	January 1973 - October 1974	-48.2%	21	Yes	November 1973 - March 1975
9	November 1974 - December 1974	-13.6%	1		
10	July 1975 - September 1975	-14.1%	2		
11	September 1975 - March 1978	-19.4%	18		
12	September 1978 - November 1978	-13.6%	2		
13	October 1979 - November 1979	-10.2%	1		
14	February 1980 - March 1980	-17.1%	2	Yes	January 1980 - July 1980
15	November 1980 - August 1982	-27.1%	22	Yes	July 1981 - November 1982
16	October 1983 - July 1984	-14.4%	10		
17	August 1987 - December 1987	-33.5%	5		
18	January 1990	-10.5%	1		
19	July 1990 - October 1990	-19.9%	4	Yes	July 1990 - March 1991
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28	November 2015 - February 2016	-13.3%	3		
29	January 2018 - February 2018	-10.2%	1		
30	September 2018 - December 2018	-19.8%	3		
31	February 2020 - March 2020	-33.9%	1	Yes	February 2020 - April 2020
32	January 2022 - current	-21.9%	6		
	Average of all declines	**-21.0%**	**7**		

Source: CIP, Bloomberg, NBER.

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Source: CIP, Bloomberg, NBER.

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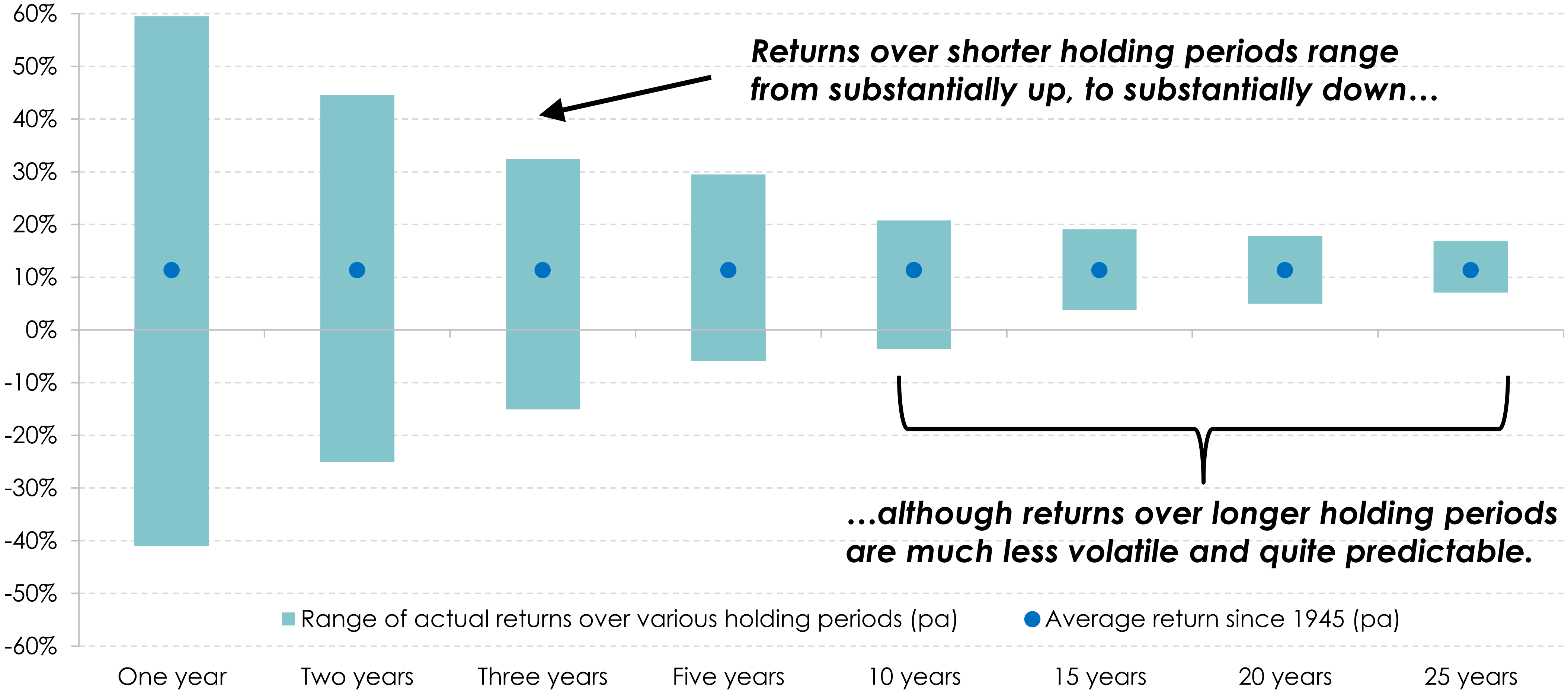
What does this history lesson teach us as investors?

- Corrections (falls of 10%+) are a normal part of investing
- There have been 32 corrections since 1960
- That equates to one every two years or so, on average
- There have been ten bear markets (falls of 20%+) since 1960
- That equates to one every six or seven years, on average
- Six of those ten bear markets (as well as the worst five) came during (or just before) recessionary periods

Remember, the market has a 100% success rate of recovering from its declines - no matter how big - and going on to reach new highs!

The longer your time horizon, the better you'll do



Proportion of positive returns	**78%**	**88%**	**89%**	**92%**	**97%**	**100%**	**100%**	**100%**

Source: CIP, Robert Shiller, Bloomberg. Based on S&P 500 monthly total returns since 1945.

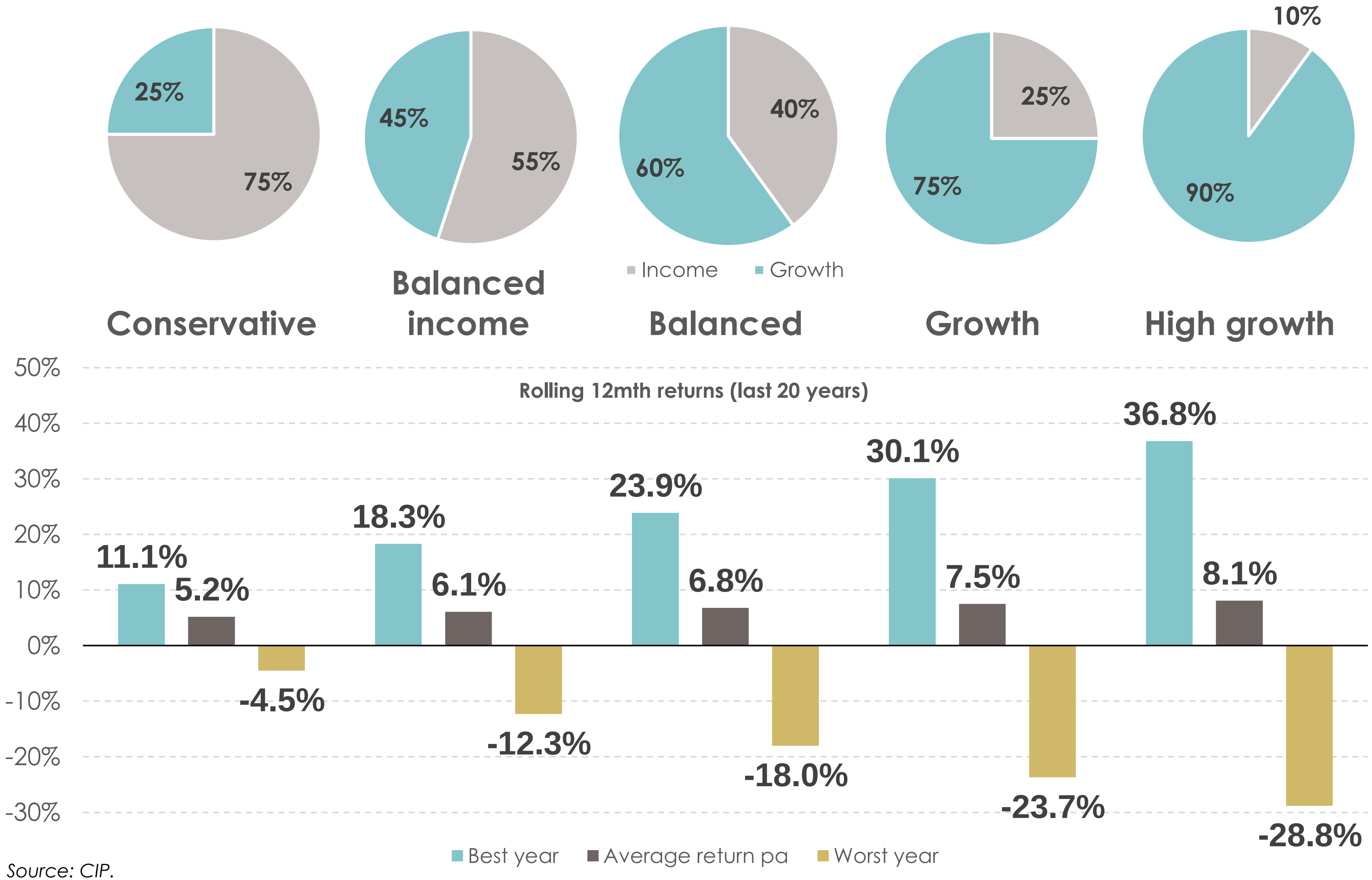
Diversification still makes for a great "free lunch"

Year	NZ shares	Aust shares (NZD)	NZ listed property	US shares (NZD)	CIP balanced portfolio	Gold (NZD)	Auckland house price	NZ Govt bonds	NZ cash
1998	-3.3%	15.2%	4.8%	41.1%	9.7%	9.5%	-2.1%	14.1%	8.1%
1999	17.0%	26.0%	-6.4%	22.5%	13.7%	1.1%	2.2%	0.1%	4.8%
2000	-9.1%	4.1%	7.3%	7.1%	10.3%	11.4%	2.1%	11.1%	6.5%
2001	16.7%	6.5%	12.1%	-6.2%	5.2%	9.1%	6.3%	4.8%	6.1%
2002	4.2%	-19.4%	10.4%	-38.1%	-4.7%	-0.9%	5.0%	8.7%	5.7%
2003	26.5%	24.3%	13.4%	3.0%	10.3%	-4.5%	21.4%	6.4%	5.6%
2004	28.0%	20.7%	20.0%	1.1%	17.8%	-3.7%	7.7%	5.5%	6.1%
2005	9.0%	19.7%	19.7%	10.3%	10.4%	24.0%	12.9%	7.0%	7.2%
2006	18.7%	30.2%	24.9%	12.3%	19.2%	19.4%	7.0%	4.2%	7.8%
2007	-0.3%	20.4%	-4.3%	-3.0%	4.2%	20.4%	8.9%	3.8%	8.4%
2008	-33.7%	-36.7%	-20.8%	-16.7%	-12.3%	40.0%	-4.3%	15.8%	8.8%
2009	19.4%	42.8%	11.8%	1.3%	11.7%	-0.3%	6.8%	1.7%	3.4%
2010	3.1%	9.2%	3.4%	6.6%	4.3%	20.0%	-3.2%	7.0%	3.0%
2011	1.4%	-11.2%	11.2%	2.4%	1.6%	10.4%	6.5%	13.3%	2.9%
2012	27.2%	13.4%	20.5%	8.9%	11.6%	0.5%	10.5%	4.8%	2.7%
2013	18.3%	3.4%	3.9%	33.4%	7.0%	-27.7%	12.1%	-2.0%	2.7%
2014	17.2%	1.5%	24.2%	19.9%	9.4%	4.0%	13.0%	7.8%	3.4%
2015	13.6%	5.7%	14.6%	15.8%	9.5%	2.3%	13.6%	5.4%	3.4%
2016	9.6%	8.7%	2.7%	10.3%	5.4%	6.6%	9.1%	3.4%	2.5%
2017	22.6%	19.1%	12.8%	19.0%	13.2%	10.9%	3.6%	5.5%	2.0%
2018	4.9%	-7.9%	9.8%	1.0%	4.8%	4.0%	-1.1%	4.6%	2.0%
2019	30.0%	23.2%	31.3%	31.2%	17.5%	18.0%	3.0%	4.9%	1.7%
2020	14.5%	6.4%	4.4%	10.9%	10.8%	17.2%	15.7%	5.4%	0.6%
2021	0.2%	16.7%	2.9%	35.5%	5.9%	1.4%	24.9%	-6.2%	0.4%
2022 YTD	-9.0%	3.9%	-9.5%	-8.0%	-6.3%	9.6%	-8.6%	-6.6%	0.3%
Return pa	**9.1%**	**8.7%**	**8.6%**	**7.7%**	**7.6%**	**7.6%**	**6.8%**	**5.2%**	**4.3%**

Source: Bloomberg, REINZ, CIP. All equity returns include dividends.

All YTD returns to end of April 2022.

Revisit your asset allocation and objectives



Source: CIP.

Our economic, market and investment outlook, in a nutshell

- **Economic growth has remained solid** and corporate earnings resilient, but supply chain disruptions, geopolitical tension and other issues mean **uncertainty remains high, and risks are to the downside.**
- **The local economy is steady**, supported by a strong labour market and robust commodity prices. However, we **expect rising mortgage rates will soon begin to bite**.
- Some inflation pressures relate to pandemic-related issues, while others look more persistent. **Central banks will continue to react strongly over the coming 12 months**, to rein in the price increases.
- **Rising interest rates will continue to impact valuations**, as well as investor sentiment, while corporate earnings could come under pressure as economic activity slows and input costs rise.
- **Ensure asset allocations match your long-term objectives**, and portfolios are well-diversified. Don’t be afraid to **take some risk off the table and rebalance into fixed income** (which looks more reasonable now).
- **Favour high quality businesses with long-term structural tailwinds**. However, ensure you are exposed to some of the less exciting sectors too. Highly-priced growth companies could remain under pressure as investors rethink what they are willing to pay for assets.
- **Apply a defensive tilt** (healthcare and consumer staples do well during uncertain periods) and include stable, dividend-paying equities in portfolios. Include companies, sectors and regions that have traditionally **proven resilient during periods of high inflation** (infrastructure, real estate and commodities).

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