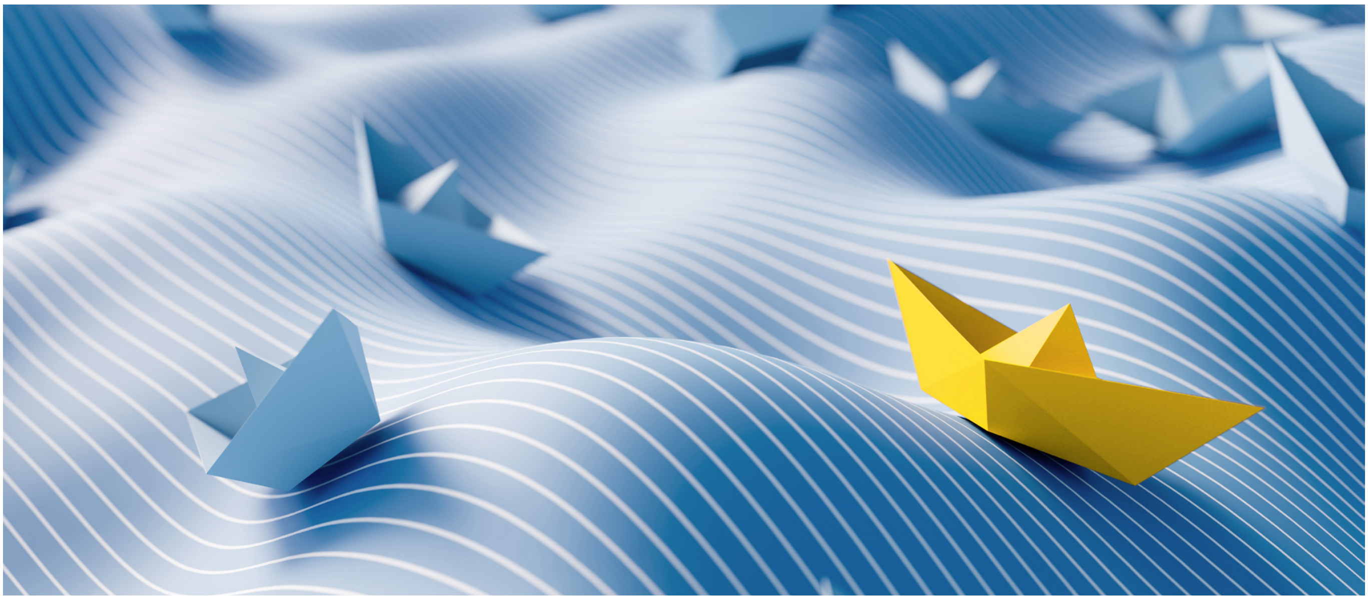
Synergy Investments
Newsletter

INVESTMENT REPORT
FOR QUARTER ENDING 30 JUNE 2022

Synergy
INVESTMENTS

www.synergyinvestments.co.nz

Market Commentary



Whether you own a TV or radio, read a newspaper, or get your news online, it's a fairly safe bet that the bulk of the economic news you are receiving at the moment sounds fairly gloomy.

Even if we could ignore the news, which is often more noisy than informative, we can't easily ignore that the price of food, petrol and many other essential goods have been rising sharply in recent months, putting pressure on household budgets.

This comes at a time when New Zealand house prices also seem to have peaked. After having accelerated strongly throughout much of 2021, helping homeowners at least 'feel' wealthier, housing market indicators now suggest prices could be easing in many regions. And, while the housing market begins to cool, mortgage rates are heading in the other direction (higher), which will only serve to crimp discretionary spending even further.

While New Zealand's official unemployment rate is at record lows, and our exporters continue to perform fairly well supplying a world still scrambling to satisfy widespread food and commodity shortages, these appear to be isolated rays of sunshine peeking out from behind a thickening bank of economic cloud.

Consumers and businesses have shown great resilience over the last few years. But the economic environment continues to be challenging and the pathway towards a sustainable economic recovery (perhaps with an initial period of low or negative growth), is unlikely to be smooth.

Inflation pressures

One of the elements that will have a bearing on the shape and speed of the recovery will be what happens with inflation.

The roots of the current surge in global inflation can be traced all the way back to the start of the Covid-19 pandemic, when a large imbalance between the supply and demand for goods emerged. The global economy contracted sharply in the first half of 2020 as lockdowns were imposed, but what followed was a highly unusual recession as households were largely shielded from economic pain. Many were able to continue to work from home on full pay, while others had their balance sheets protected by various government payments and employment subsidies such that, in aggregate, net savings rose sharply.

With consumers relatively flush with cash and most parts of the global economy still closed, notably the services sector, this pent-up demand was directed into the goods sector and, in New Zealand's case, the housing market.

However, inflation has begun to show some tentative signs of softening, even if the official (backward looking) figures still look strong.

Global shipping rates, which skyrocketed when the global supply chain issues first emerged, have fallen about 40% in the last seven months. Likewise, oil and several other important industrial commodities have, more recently, also been experiencing falling prices.

These more recent price trends help reinforce the idea that inflation, whilst continuing to be problematic now, may begin to ease over the remainder of 2022.

Economic growth

As central banks have been steadily revising their inflation expectations upwards, these have been accompanied by downward revisions in projections for global GDP growth.

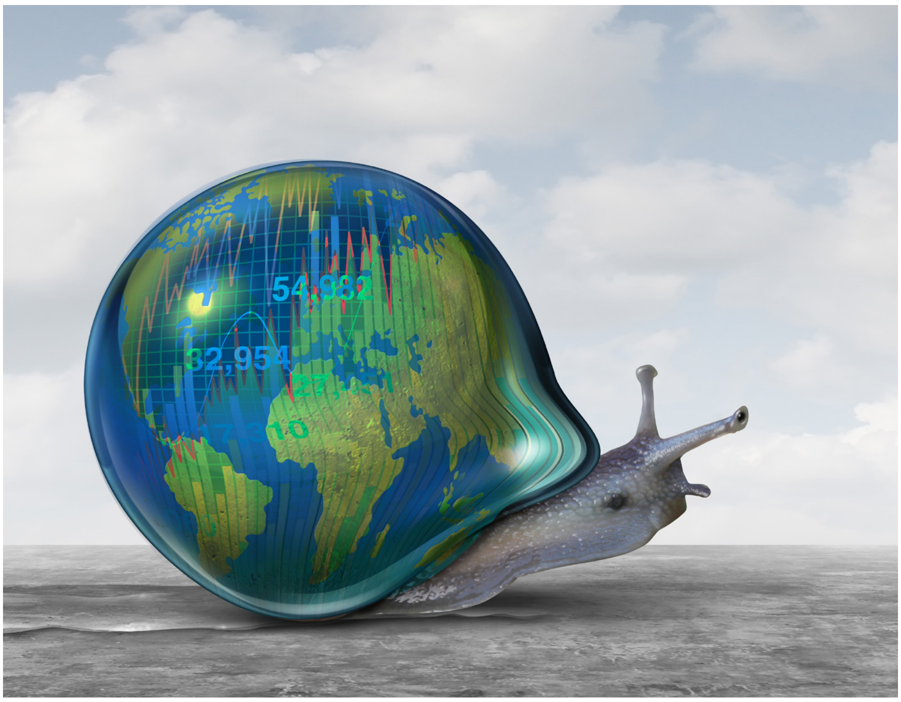
Economic activity has so far been relatively robust as consumers have shown an ability to absorb higher prices, in part due to running down the savings they accumulated during the initial phase of the pandemic. The subsequent tight labour market and pick-up in wage growth has also helped. While these factors should remain supportive for a time, some cracks have begun to emerge on the demand side of the global economy.

With inflation outstripping wage growth in most countries, a squeeze on real incomes has started to erode consumer confidence. Some measures of consumer confidence in the US and UK have fallen to levels not seen since the 2007-2009 global financial crisis, while confidence is declining in Europe. It's the same in New Zealand with the 'cost of living crisis' now widely recognised as the number one issue facing households.

All of this suggests that consumers may soon be less willing (or able) to tolerate higher prices in the future and that makes for a very difficult environment for policymakers. Faced with widespread pricing pressures, central banks have determined that tackling inflation is their highest priority, and higher interest rates are the primary tool at their disposal to achieve it. Therefore, as long as inflation remains a concern, central banks will likely continue raising interest rates while maintaining cautionary forward guidance, in an effort to cool economic activity.

Bear markets

As if this escalating inflation and weakening economic growth environment wasn't enough, the ongoing war in the Ukraine and the drawn-out global impact of Covid, are other factors continuing to create uncertainty or unease in the minds of many investors.



In general, when investors are feeling happy and confident, they are often more comfortable allocating to higher risk investments. However, when they are lacking in confidence, they are less inclined to take higher risks. Market commentators have a specific phrase for this general investor attitude, they refer to it as 'investor sentiment', either positive or negative.

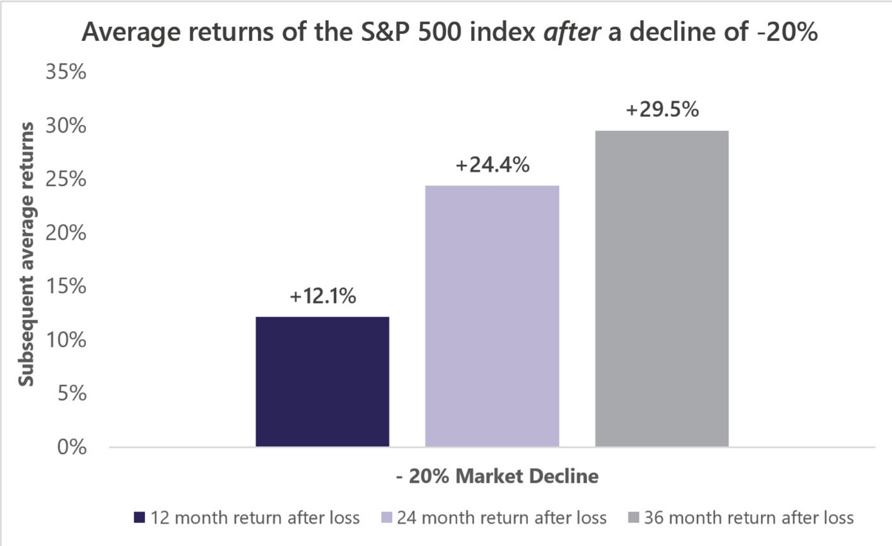
Recently, investor sentiment has been more consistently negative. And it is with this backdrop that global share markets have been struggling over recent months.

On 14 June, the main New Zealand share market (the S&P/NZX 50 Total Return Index) slipped into official 'bear market' territory. A bear market is generally defined as a decline of at least -20% from the prior market peak, which in New Zealand's case was on 4 October 2021. At time of writing, the S&P/NZX 50 had since rallied a little, reducing the size of this decline, but nevertheless it reflects a very tough period for local share market investors.

This is not an issue unique to New Zealand. The globally significant US share market has had it even worse. The headline S&P 500 Index similarly fell into bear market territory on 13 June, while experiencing its worst first half of the year since 1970. The other high profile US index, the Nasdaq 100 which includes all the large technology companies, ended June over -30% below its peak of 27 December 2021.

These returns are reflective of markets that are facing a range of uncertainties and they are therefore pricing in a high degree of caution or pessimism. But that doesn't mean that the returns outlook for the months ahead is necessarily poor.

When we review historical data (back to 1940) using the leading US share market index (the S&P 500 index) as our reference, the chart below summarises the average one, two and three year performance of the S&P 500 after all previous bear market declines of -20%.



Note: the calculated returns figures (for declines and recoveries) are all based on month end pricing data.

As the chart shows, the average return after a decline of -20% is positive in all analysed time periods, and strongly positive over the subsequent two and three year periods. As challenging as things may seem now, this is a timely reminder that the share market is a leading indicator for the economy, meaning it is always much more focused on where the economy is going, and not where it has been.

Bond markets have also experienced a poor start to the year, with interest rates in many countries having increased and with further rate rises projected. It is a unique aspect of bond pricing that when interest rates rise, two things happen –

1. The **prices** of existing bonds go down (which happens immediately)
2. The **expected future returns** of those existing bonds go up (with these higher returns being delivered over time)

In this regard, falling bond prices are felt immediately in portfolio valuations, while the higher expected future returns are only received in the months that follow. One small comfort from this is that with current bond yields now much higher than they have been for several years, the expected future returns from bonds are looking increasingly attractive.

This too shall pass

Even if New Zealand or any other countries enter a technical recession this year (two or more consecutive quarters of negative growth), recessions don't tend to last for very long and don't necessarily impact asset prices. As we have already noted, if demand and inflation show more obvious signs of reducing, central bank policies can also be expected to eventually pivot from fighting inflation to supporting growth.

For now, uncertainties are elevated and these uncertainties have been fully priced into markets. While this has been a big factor in the poor share market returns year to date, it doesn't tell us anything about the returns we should expect for the remainder of this year.

Markets are relentlessly forward-looking. They don't only calibrate the information that is known today, they also calibrate all the fears, hopes and expectations of every market participant. Whilst investor sentiment has been very negative, and this has weighed heavily on market prices, we know that sentiment and markets can turn very quickly. Just the prospect of better economic times ahead can be a catalyst that can help move markets higher, and it can happen well before the benefits are readily observable in the economy around us.

Given the current low market starting point, if sentiment was to begin to improve in the coming weeks and months around any one or more of the current uncertainties (inflation, central bank policy, economic growth, Covid or the Ukraine conflict), then share markets at these lower prices might suddenly look a lot more appealing.

As always, in periods like this where the market has been challenging, it is best not to try and 'time' your exposure. Whilst it might be tempting to think that you could just sit out of the markets and wait for the current storm to blow over, the forward-looking markets will always go up, and sometimes strongly, well before the economic clouds have cleared. And given the speed that markets can react, being on the sidelines and missing the recovery can often be far more detrimental to a long term plan, than absorbing the current lower valuations and higher volatility of returns.

The most reliable advice is always to maintain the risk exposure that you set, and considered appropriate, when the skies were clearer. Investing more when prices are cheaper is usually an even better option, but that may not be an option that is available to everybody. If it isn't, just batten down the hatches and wait this one out. The skies always clear and the markets always recover. We just don't ever quite know the timing.

Whilst it might be tempting to think that you could just sit out of the markets and wait for the current storm to blow over, the forward-looking markets will always go up, and sometimes strongly, well before the economic clouds have cleared.

Key Market Movements

Shares and bonds across the board were under pressure in the second quarter of 2022, as markets priced in further increases in interest rates as well as an increased risk of recession. Amongst equities returns, which were generally poor, the MSCI World Value index significantly outperformed its Growth counterpart, although both registered double-digit declines. The Chinese share market provided a rare highlight as prolonged lockdowns were lifted in some major cities, allowing macroeconomic indicators there to show some improvement.

Inflation rates in major economies continued to persist at multi-decade highs, with various central banks raising interest rates and others clearly signalling their intention to do so soon. The quarter also saw mounting concerns over global economic growth prospects, with the fight to tame inflation likely to result in monetary policy settings that would be less supportive than the global economy has enjoyed in recent years.

The potential for economies to experience a recession later this year became more widely contemplated and, towards the end of the quarter, economic indicators began to reflect a general moderating or slowing in economic activity.

INTERNATIONAL SHARES

-15.1% (hedged to NZD)

-6.9% (unhedged)

In the US, investor focus was on inflation and the policy response from the US Federal Reserve. The bank enacted initial rate hikes during the quarter and signalled that there would be more to come. Even so, they admitted the task of bringing inflation down without triggering a recession would be a challenging balancing act.

While weak sentiment affected all sectors, consumer staples and utilities companies were comparatively resilient. However, there were some dramatic declines for some companies, most notably in the media, entertainment and auto sectors.

Further steep declines were common for eurozone shares, as the war in Ukraine continued and concerns mounted over potential gas shortages, with supplies to Germany in particular being a point of concern. Higher inflation also dented consumer confidence, with the European Central Bank (ECB) poised to raise interest rates in July.

UK equities also fell over the quarter, with economically sensitive areas of the market performing poorly towards the end of the period amidst rising recessionary risks.

In New Zealand dollar terms, the MSCI World ex-Australia Index delivered a quarterly return of -15.1% on a hedged basis and -6.9% unhedged. This meant the rolling 12 month return for the New Zealand dollar hedged index reduced to -12.2% while the unhedged index was down -4.2%.

Source: MSCI World ex-Australia Index (net div.)

EMERGING MARKETS SHARES

-1.6%

In a quarter where global share markets generally slumped, it was somewhat against the usual trend to see the relative outperformance of the emerging markets region (as a whole). When investors are wary of exposure to higher risk assets, emerging markets are often harder hit. But not this quarter.

That said, plenty of emerging market share markets did post declines. The South Korea share market struggled, with financials, technology and energy stocks hit particularly hard amid growing fears of a global recession. Taiwan was also significantly lower, on fears that rising inflation and global supply chain problems would weaken demand for its technology products.

The Latin American markets of Colombia, Peru and Brazil were amongst the weakest in the MSCI Emerging Markets Index. A combination of rising concerns about a global recession, domestic policy uncertainty and weaker industrial metals prices later in the quarter, all contributed to the declines.

The emerging European markets of Poland and Hungary both underperformed by a wide margin, as geopolitical risks stemming from Russia's invasion of neighbouring Ukraine persisted.

The shining light for the region was China which managed to deliver a solid positive return for the quarter. With lockdown measures in certain Chinese cities being eased, this prompted a recovery in economic activity.

As the largest constituent in the emerging markets region, China's positive result was a major driver to the mild loss for this asset class in the quarter, with the MSCI Emerging Markets Index producing a quarterly return of -1.6% in unhedged New Zealand dollar terms.

Source: MSCI Emerging Markets Index (gross div.)

NEW ZEALAND SHARES

-10.2%

The New Zealand market endured a difficult quarter with the S&P/NZX 50 Index returning -10.2%. Whilst at the individual company level there was 'red ink' almost across the board for the quarter, it was the industrials and health care sectors that contributed the largest drag on the performance of the index.

The two worst affected firms in the industrials sector, Air New Zealand and Freightways, were down -27.9% and -25.9% respectively for the quarter, as the prospect of weaker economic growth weighed heavily on their prices. Building materials firm Fletcher Building fell -21.0% as sentiment around the domestic building and construction sector continued to cool.

With only six firms in the top 50 delivering a positive return in the quarter, it was software firm Pushpay that enjoyed the strongest performance, gaining 11.4%. This followed news that two existing shareholders (BGH Capital and Sixth Street) were intending to make a takeover bid for the firm.

Source: S&P/NZX 50 Index (gross with imputation credits)

AUSTRALIAN SHARES

-9.8%

The Australian share market (ASX 200 Total Return Index) had a similarly tough time sliding -11.9% over the quarter in local currency terms. Returns to unhedged New Zealand investors were slightly better at -9.8%, due to an appreciation in the value of the Australian dollar over the quarter.

Once again, the dispersion in sectoral returns was a feature of the market, with the utilities and energy sectors standing apart from the rest by delivering small gains. At the other end of the spectrum, the information technology sector suffered a very poor quarter as growth company valuations came under increasing pressure due to the expectation of faster rate hikes. The real estate and materials sectors were also very weak.

With only a little over one in ten companies in the ASX 200 delivering positive returns during the quarter, infrastructure firm Atlas Arteria (+23.1%) and small energy company Viva Energy Group (+23.0%) were the clear standouts.

At the other end of the standings, there were 21 companies within the ASX 200 that delivered returns of -35% or worse for the quarter. This list was littered with small capitalisation firms in the technology and basic materials sectors, as valuation concerns and general negative sentiment during the quarter impacted these companies the most.

Source: S&P/ASX 200 Index (total return)

INTERNATIONAL FIXED INTEREST

-1.0%

Global bonds saw their prices continue to decline during the quarter, with yields markedly higher due to elevated inflation data, increasingly 'hawkish' central bank statements and rising interest rates. There was a small bond rally (price gains) towards the end of the quarter as economic growth concerns began to rise.

With inflation data in major economies at multi-decade highs, the quarter was characterised by various central banks raising interest rates and others signalling their intention to do so. The quarter also saw mounting concerns over future economic growth prospects, including the possibility of a recession later this year.

In the US, the Federal Reserve implemented a series of interest rate hikes, raising the US policy rate by 0.50% in May and a further 0.75% in June, their largest single rate hike since 1994. At the same time, Federal officials cut their 2022 growth forecasts. In response, the US 10 year bond yield rose from 2.35% to 3.02% over the quarter.

European bond yields were volatile as the European Central Bank indicated it would end asset purchases early in the third quarter and raise interest rates soon after. With this backdrop, the German 10 year bond yield increased from 0.55% to 1.37% over the quarter.

In the UK, the Bank of England implemented further interest rate hikes, bringing the total to five in the current cycle, as well as raising its inflation forecast to a staggering 11%. This helped push the UK 10 year bond yield up from 1.61% to 2.24%.

Corporate bonds also suffered in the broad bond market sell off, and generally underperformed government bonds as credit spreads widened markedly. With mounting concerns over the economic outlook, high yield credit securities (i.e lower credit quality) were hit particularly hard.

The FTSE World Government Bond Index 1-5 Years (hedged to NZD) returned -1.0% for the quarter, while the broader Bloomberg Global Aggregate Bond Index (hedged to NZD) returned -4.5%.

Source: FTSE World Government Bond Index 1-5 Years (hedged to NZD)

NEW ZEALAND FIXED INTEREST

-1.4%

The Reserve Bank of New Zealand (RBNZ) elected to increase the Official Cash Rate (OCR) by a further 0.50% on 14 April and again by another 0.50% on 26 May, taking this benchmark rate from 1.00% to 2.00% by the end of the quarter.

In its accompanying statement, the RBNZ noted that "the level of global economic activity is generating rising inflation pressures that are being exacerbated by ongoing supply disruptions driven by both Covid-19 persistence and the Russian invasion of Ukraine. The latter continues to cause very high prices for food and energy commodities."

The Monetary Policy Committee also reconfirmed it planned to continue to lift the OCR "at pace" to a level that will confidently bring consumer price inflation to within its 1-3% target range.

In effect, this confirms the expectations of the RBNZ are for interest rates to continue to rise, for the time being at least.

Given this outlook, the New Zealand 10 year government bond yield climbed from 3.25% at the end of the first quarter to 3.87% at the end of June. The New Zealand 2 year government bond yield followed an entirely similar pattern, beginning the quarter at 2.92% and ending the June quarter at 3.51%, a yield increase of 0.59%.

Similar to the effects seen overseas, these rising bond yields generally resulted in negative short term returns for bonds of all durations.

The S&P/NZX A-Grade Corporate Bond Index fell -1.4% for the quarter, while the longer duration but higher quality S&P/NZX NZ Government Bond Index fell -3.2%.

Source: S&P/NZX A-Grade Corporate Bond Index

Table 1: Asset class returns to 30 June 2022

ASSET CLASS	INDEX NAME	3 MONTHS	1 YEAR	3 YEARS	5 YEARS	10 YEARS
New Zealand shares	S&P/NZX 50 Index (gross with imputation credits)	-10.2%	-13.5%	+1.9%	+8.3%	+13.5%
Australian shares	S&P/ASX 200 Index (total return)	-9.8%	-3.7%	+5.3%	+8.0%	+7.7%
International shares	MSCI World ex Australia Index (net div., hedged to NZD)	-15.1%	-12.2%	+6.8%	+7.7%	+11.6%
	MSCI World ex Australia Index (net div.)	-6.9%	-4.2%	+9.7%	+11.2%	+12.4%
Emerging markets shares	MSCI Emerging Markets Index (gross div.)	-1.6%	-16.1%	+3.4%	+5.9%	+6.0%
New Zealand fixed interest	S&P/NZX A-Grade Corporate Bond Index	-1.4%	-6.8%	-0.9%	+1.7%	+3.4%
International fixed interest	FTSE World Government Bond Index 1-5 Years (hedged to NZD)	-1.0%	-3.5%	+0.0%	+1.1%	+2.5%
New Zealand cash	New Zealand One-Month Bank Bill Yields Index	+0.5%	+1.0%	+0.7%	+1.2%	+2.0%

Unless otherwise specified, all returns are expressed in NZD. We assume Australian shares and emerging markets shares are invested on an unhedged basis, and therefore returns from these asset classes are susceptible to movement in the value of the NZD. Index returns are before all costs and tax. Returns are annualised for time periods greater than one year.

Worried About Stocks? Why Long Term Investing Is Crucial

We are living in a time of extreme uncertainty and the anxiety that comes along with it. Against the backdrop of war, humanitarian crisis, and economic hardship, it's natural to wonder what effect these world events will have on our long-term investment performance.

While these challenges certainly warrant our attention and deep concern, they don't have to be a reason to panic about markets when you're focused on long term investing.

Imagine it's 25 years ago, 1997:

- J.K. Rowling just published the first Harry Potter book.
- General Motors is releasing the EV1, an electric car with a range of 60 miles.

The internet is in its infancy, Y2K looms, and everyone is worried about the Russian financial crisis.

A stranger offers to tell you what's going to happen over the course of the next 25 years. Here's the big question: Would you invest in the stock market knowing the following events were going to happen? And could you stay invested?

- Asian contagion
- Russian default
- Tech collapse
- 9/11
- Stocks' "lost decade"
- Great Recession
- Global pandemic
- Second Russian default

With everything I just mentioned, what would you have done? Gotten into the market? Gotten out? Increased your equity holdings? Decreased them?

Well, let's look at what happened.

From January of 1997 to December of 2021, the US stock market returned, on average, 9.8% a year(1). A dollar invested at the beginning of the period would be worth about $10.25 at the end of the period(2). These returns are very much in line with what returns have been over the history of the stock market. How can that be? The market is doing its job. It's science.

Investing in markets is uncertain. The role of markets is to price in that uncertainty.

Investing in markets is uncertain. The role of markets is to price in that uncertainty. There were a lot of negative surprises over the past 25 years, but there were a lot of positive ones as well. The net result was a stock market return that seems very reasonable, even generous. It's a tribute to human ingenuity that when negative forces pop up, people and companies respond and mobilise to get things back on track.

Human ingenuity created incredible innovations over the past 25 years. Plenty of things went wrong, but plenty of things went right. There's always opportunity out there. Think about how different life is from the way it was in 1999: the way we work, the way we communicate, the way we live. For example, the gross domestic product of the US in 1997 was $8.6 trillion and grew to $23 trillion in 2021.

I am an eternal optimist, because I believe in people. I have an unshakable faith in human beings' ability to deal with tough times. In 1997, few would have forecast a nearly 10% average return for the stock market. But that remarkable return was available to anyone who could open an investment account, buy a broad market portfolio, and let the market do its job.

Investing in the stock market is always uncertain. Uncertainty never goes away. If it did, there wouldn't be a stock market. It's because of uncertainty that we have a positive premium when investing in stocks vs. relatively riskless assets. In my opinion, reaping the benefits of the stock market requires being a long term investor.

By investing in a market portfolio, you're not trying to figure out which stocks are going to thrive, and which aren't going to be able to recover. **You're betting on human ingenuity to solve problems.**

The pandemic was a big blow to the economy. But people, companies and markets adapt. That's my worldview. Whatever the next blow we face, I have faith that we will meet the challenge in ways we can't forecast.

I would never try to predict what might happen in the next 25 years. But I do believe the best investment strategy going forward is to keep in mind the lesson learned from that stranger back in 1997: **Don't panic. Invest for the long term.**

Source: https://au.dimensional.com/

Synergy Investments

info@synergyinvestments.co.nz
www.synergyinvestments.co.nz
0800 4 synergy

209 Cambridge Terrace
PO Box 1106
Christchurch 8140