IWIinvestor
Pou Tiaki i Ngā Rawa
New Zealand's wealth advisers

IWIinvestor Investment Report:

Economic & Market Commentary, Quarter End – December 2020

Overview

8.8% p.a.	5.3%	1.0%	11.7%	0.1%	17	4
Balanced model portfolio 5-year return	Balanced model portfolio quarterly return	Balanced model portfolio 3-year excess return	Best performing asset Class: NZD hedged global equities	Worst performing asset class: NZ cash	Number of funds on the APL	Funds on watch

Key discussion points

- 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.
- The model portfolios largely performed well this quarter, especially the higher risk profiles. Across all risk profiles performance is at least as good as the Peer group we monitor over 3 and 5-year horizons.
- The majority of funds on the APL continue to perform well, only a few funds on watch which are highlighted in this report.
- Note this report includes new funds approved at the last IC meeting, but does not include reporting on model portfolio performances with the approved changes to NZ equities (addition of Simplicity, dropping of AMP), Australian equities (addition of Dimensional, dropping of BlackRock) and the inclusion of infrastructure (Kernel) managers. We will include these changes in the next March quarter monitoring report.

Financial Market Update

Markets had a strong finish to the year, with only NZ Fixed Income lagging. Property was the only negative contributor for 2020.

The chart shows asset class returns in local currency, i.e. for a 'global' investor except for Infrastructure and Property which are in USD and global equities which is in NZD. The returns experienced by your portfolio may differ from this depending on movements in the NZD and the amount of currency hedging of that asset class.
Source: Morningstar Direct

Market Commentary

The market rebound extended into Q4

Markets continued to climb over the December quarter, in line with our view that the environment, on balance, favours risk assets. 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.

- **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 (figure 1) – 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 outperformed in the quarter. 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 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 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.

- **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** 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.

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

- The economic 'shock' from Covid was much weaker than expected.
- Despite the rally, risky assets continued to offer materially higher yields than investment grade bond yields and cash yields, and the prospect of capital gains over the longer run.
- Markets are forward-looking and anticipated global mass Covid-19 inoculations.
- Businesses reliant on in-person patronage suffered, but the vast majority of businesses were able to survive; the tech sector thrived.
- Markets were relatively rational. For example, volatility remained higher than the exceptionally low levels it reached from 2014 to the end of 2019 (figure 2).

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 cyclicals, value and smaller cap stocks is likely to continue, with economic life returning to normal as mass scale inoculations are achieved over the coming months. Perhaps needless to say, we do not 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 raising rates in the medium term, or turn their attention to fiscal sustainability risks, we would expect to see significant sell-offs.

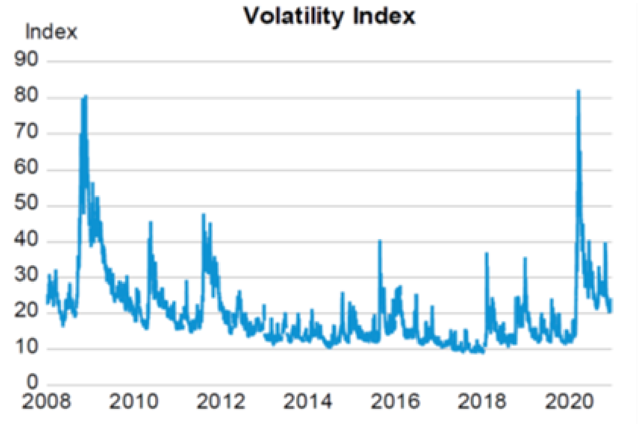
Our sanguine overall view also does not imply that all assets are priced rationally, or even consistently! Stocks like Tesla and digital currencies such as Bitcoin are likely caught in a wave of irrational exuberance (figure 3).

We also view it as unlikely that standard fixed income will deliver reasonable returns over the next few years. This has a material impact on portfolios because fixed income has continued to perform two key roles admirably - it has delivered a positive real return, and it has provided some protection during episodes of declining equities. It is now severely compromised in both aspects. There is no 'silver bullet', no one asset capable of fulfilling this role. We can find assets that enhance yields, but which don't offset equity market risk, and we can find potential risk mitigators that have no yield as such. We will be providing suggestions to enhance the effectiveness of your fixed income holdings over the coming quarters.

Fig 1: Global Equities reach new peaks

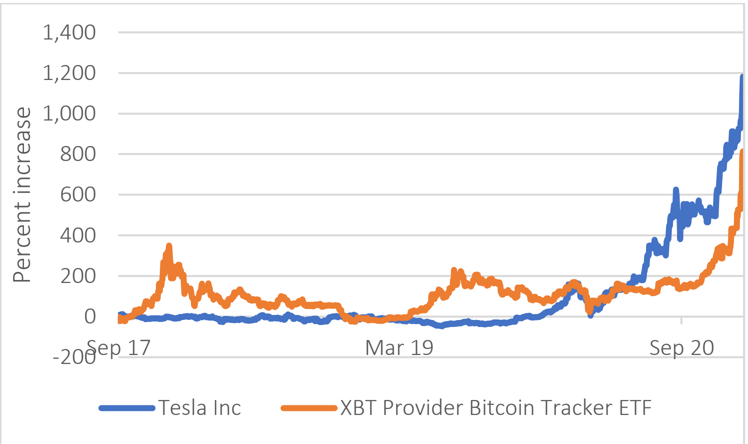
Source: MSCI

Fig 2: Market volatility remains elevated



Source: Haver

Fig 3: Tesla and bitcoin bubbles?



Source: Morningstar

Disclosure:

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