Investment Update

Market conditions and outlook

JBWere

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Market backdrop

The speed and magnitude that broad-based inflation pressures have emerged over the last 12 months has surprised many, especially central banks. After viewing the initial rise in inflation as largely the result of “transitory” factors, that interpretation became far more difficult as inflation pressures strengthened and broadened, and labour markets tightened rapidly. Inflation is proving far more troublesome and persistent than first thought.

Due to this inflation miscalculation, central banks are turning even more aggressive in their monetary policy tightening plans. And it is becoming increasingly apparent that to get on top of inflation, policymakers appear willing to accept an even larger demand and employment trade-off. This in turn is leading to increased economic growth fears and further weakness in financial markets. There have been few places for investors to hide so far this year, with both equity and fixed interest asset classes suffering under this ‘stagflationary’ type backdrop.

So what could be in store for the second half of this year?

Whether or not markets are able stabilise and post a better performance from here or instead face ongoing weakness and volatility, ultimately comes down to whether the challenging macroeconomic headwinds faced this year are going to start to wane or instead intensify further. To us, there are three broad conditions required for markets to stabilise, especially equity markets: 1) inflation peaks and begins to moderate; 2) pricing for central bank tightening stabilises or even reverses; and 3) the economic growth picture holds together, at least relative to expectations.

We believe there is some, admittedly tentative, evidence to support the first two conditions. Measures of global supply chain stress have begun to improve and there are signs that the extreme tightness in the labour market, especially in the US, has started to ease. Durable goods price inflation, which surged in the aftermath of the pandemic, is falling as households shift their spending back to services. With some evidence that the inflation outlook is improving (or is at least looking less bad), markets have started to pare back expectations for future tightening from central banks like the Federal Reserve and the Reserve Bank of New Zealand.

Where there are perhaps more questions right now is in relation to the economic growth outlook. Tighter financial conditions, geopolitical conflicts, ongoing COVID disruptions, cost of living strains, etc all leave the risks for the global economy skewed to the downside, which then brings the sustainability of corporate earnings into focus. Some regions and countries face greater threats than others.

We still believe there are plausible ways a recession (at least in the US) can be avoided. However, we acknowledge that the path for this ‘soft-landing’ type outcome is quickly narrowing. What we would add though is that while recessions come in all shapes and sizes (and are a natural part of the business cycle), what typically makes them more painful is when they coincide with the build-up of large economic and financial imbalances, like strained private sector balance sheets or credit misallocation for example. The Global Financial Crisis is a case in point. Neither we, nor our research partners, detect the degree of imbalances in the US that would usually require a more lengthy and painful economic adjustment to purge them, which suggests that if a recession was to eventuate, it is likely to be relatively shallow and mild. In fact, we’d argue that such an outcome is now already priced into some key markets.

MAS Fund Implications

Given market moves this year, we believe a reasonable amount of negativity is now priced in. Still, it is this tango between inflation, central banks and economic growth that will determine how financial markets fare over the months ahead. It is fair to say that the outlook is delicately poised, and we expect volatility to persist, reinforcing the requirement to maintain highly diversified portfolios, which is a hallmark of JBWere's investment approach.

At the broad asset class level, the MAS Funds continue to sit at broadly neutral levels relative to strategic asset allocation targets. That feels appropriate to us, especially in the context of the moves already seen in financial markets this year. We can see both plausible upside and downside scenarios from here. That said, in a landscape where risks to economic growth (and hence corporate earnings) have risen, across the equity asset classes, JBWere now has a modest tactical preference to the relatively defensive New Zealand equity market as opposed to the more cyclical Australian and international equity markets, and where appropriate are looking to selectively increase the relative exposure to New Zealand equities within the funds.

This defensive shift is also evident elsewhere within the Funds. Given heightened uncertainty and risks, we retain a preference for companies and sectors that offer a greater degree of earnings and margin stability at present. Within the International equities portfolio, we have increased our exposure to our direct 'quality' theme, which accesses companies that have a consistent track record of dividend growth through all types of economic cycles. We have also used this year's price weakness to increase the exposure to US Technology, which is a sector that has attractive attributes of strong balance sheets, good free cash flow generation, pricing power and margin resilience. We believe the sector is now more attractively valued.

Within the Australasian equities portfolio, the June quarter is one where we have again used share price volatility as an opportunity to selectively add or reduce positions, but with again an overall focus on earnings stability and quality. Through the quarter we reduced underweight positions in both Auckland Airport, Fisher & Paykel Healthcare and Summerset Group, funded through a reduction in some Australian positions. We also took the opportunity to exit a small position held in My Food Bag. Despite their solid result, share price performance has been disappointing since being listed last year.

Across New Zealand fixed interest, we have been using rate increases as an opportunity to extend duration and increase portfolio 'carry'. This has mainly been achieved through targeting new quality issuance and that remains a focus.

Ultimately, our investment philosophy continues to be to seek high quality, long-term investment ideas, and we think this focus on quality will serve the MAS Funds well in what is likely to be a turbulent and tricky investment backdrop for some time yet.

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