# MAS
# Investment Update

**18 October 2021**

## Markets Outlook: Climbing a wall of worry

After an extended period where nothing really seemed to phase investors, and global equity markets continued to march ever higher, a few cracks seem to have emerged in the market's armour recently. For example, the S&P 500 fell by close to 5% over September, which was its weakest monthly performance since the initial COVID-19 shock back in early 2020. Overall market volatility has increased.

Given the strength of the equity market rally seen, especially since the announcement of highly effective COVID-19 vaccines back in November 2020, perhaps it is to be expected that at some point markets were going to pause for breath. That said, there are indeed several factors that have led to a few more investor jitters recently. These include China growth concerns and worries over some highly leverage property developers; global supply chain disruptions that are proving more persistent than expected and resulting in heightened inflation worries; extreme volatility in global energy markets; fears over a US government shutdown and potential default; rising bond yields as central banks move towards less accommodative settings; or the elevated level that equity market valuations have reached. It feels like investors are being forced to face into a wall of worry at present.

We are certainly not surprised that more cross-currents have emerged and that they are gaining more attention in investors' eyes. This is a completely natural and common feature as the market moves to a new phase of the cycle. At the initial stages of a market recovery, central bank liquidity is typically abundant and economic activity has often stabilised and is starting to accelerate. These are powerful macro tailwinds that allow investors to look through perceived risks more easily. But as these tailwinds begin to wane, the acceleration in economic growth matures and liquidity conditions tighten, perceived risks and uncertainties begin to have a greater influence over investor mindset and market price action. This is where we are right now in our view.

Some of these investor concerns have the potential to linger for a while yet. Some we are less worried about. But it sets up what we expect to be a reasonably choppy end to the year for global financial markets.

Ultimately, however, we expect investors to climb this wall of worry allowing for further upside in global equity markets. In fact, the performance in global equity markets over October to date has been more positive. But the main reason we expect investors to climb this wall of worry is that we expect a more favourable growth and inflation mix to emerge next year.

Right now, growth risks are largely perceived to be to the downside, while inflation risks are skewed upwards. But this “stagflationary” type backdrop is not something we see persisting. Stronger growth outcomes, at least relative to expectations, are expected as Chinese authorities deliver modest stimulus to support growth, households continue to run down pent-up saving built up over the past year or so and firms look to rebuild depleted inventories. Inflation pressures are expected to remain elevated for a time yet, but we are still of the view that these pressures largely reflect forces that should wane as global supply conditions normalise. In fact, elevated prices are the very signal necessary to eventually drive this supply response. Most importantly, while inflation expectations have risen off depressed levels, they remain contained overall, keeping medium-term risks in check.

## MAS Portfolio Implications

We believe the Funds within the MAS KiwiSaver Scheme and the MAS Retirement Savings Scheme (the MAS Funds) are positioned appropriately for the economic and markets backdrop described above. That is, one where markets experience higher levels of volatility and the risk-reward for equity markets, while not negative by any means, is less positively skewed than it was, say, six months ago. From a Tactical Asset Allocation perspective, the MAS Funds are currently sitting at a broadly neutral position for equities versus their strategic targets. This is a position that we have maintained for roughly the past quarter. The Funds are also broadly neutral versus target in fixed interest and cash, although we intend to use these asset classes as funding sources to add back to equities exposure on any meaningful market weakness going forward. We continue to maintain high levels of diversification both across and within asset classes, which should provide a reasonable buffer to returns from this modestly higher volatility backdrop that we expect to continue.

While rising interest rates and bond yields are a headwind for capital returns in fixed interest portfolios, our ‘barbell’ credit spread mix of longer-dated AAA Government risk and short-dated BBB+ or lower risk continues to offset some of the impact of higher rates, on portfolio values. We remain comfortable with this approach.

And finally, within the Australasian equities portfolio, after a busy June quarter, where we introduced some new key holdings across the Healthcare and Technology sectors (**Summerset Group**, **Oceania Healthcare**, **Ramsay Healthcare** and **Xero**), it was a quieter September quarter, with us remaining comfortable with how the portfolios are positioned. The changes made over the quarter were more selective, as we took advantage of liquidity opportunities and/or share price volatility. Specifically, we were comfortable adding to the holdings mentioned above, as well as the likes of **NEXTDC** and **Ebos**, which both experienced periods of unjustified share price weakness. We expect this opportunistic approach to continue to be our broad strategy over the coming few months.

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