

STUART-CARLYON

Financial advisers for your lifetime goals

Remember inflation? It's back!

This bear had been hibernating for years. But in 2022 inflation is back and it is stalking the world economy.

Inflation was the dominant topic of discussion at the recent 2022 Markets Summit conference held in Sydney and attended by our advisers on-line. We heard very timely analysis and up to date information from a range of speakers. Many expounded on the effects of inflation.

We've mentioned in previous newsletters the thinking of Jonathan Pain, who publishes the drolly titled the Pain Report, and he identified inflation as the single biggest challenge for nations and investors alike. He listed three main reasons for his pessimism.

Inflation is a problem with no available fiscal bandages. Where in the Global Financial Crisis of 2008 the US Government intervened and propped up Wall Street and the automotive industry, with inflation there is no fiscal remedy available.

The only way interest rates can go is up. Central banks such as the Reserve Bank have in recent years whittled their interest rates lower and lower in order to make borrowing affordable and in turn stimulate the economy. Low interest rates also eased inflationary pressures. But now the direction is upwards at least in the near term. The central banks are implementing the only tool left in the toolchest available to dampen borrowing and take some heat out of the market. The tool: interest rate hikes in order to back off from pumping money in the system.

Also, the cost of any economic activity is going up due to several macro forces. These range from the cost of climate change to Covid-related supply chain difficulties as well as a long overdue demand to do something about languishing salaries and wages. In 1970 the US middle class took home 62% of all household income. By 2014 their share had subsided to 43% of the household income pie. Similar shifts have occurred in most Western nations.

So, the pressure is on, and we can see that in inflation rates world-wide. Inflation in US is 7.5%, in Eurozone 5% and in NZ it is 5.9% but projected to edge toward 7-8% before the year is through. And we should note, the Ukraine war had not broken out at time of the Markets Summit and inflation was already the leading economic concern. The war is certainly fueling the inflationary flames further. The sanctions against Russia will also be felt by the rest of the world.

Russia's most significant export to Europe and UK is oil and natural

gas, and this had jumped to its highest level in more than 7 years. And that was before the war. Europe is now over an inflationary barrel with supplies cut-off. As anyone who has been to a gas station lately will know, we are seeing an oil price shock not dissimilar to that of 1973.

Food costs will go up. Ukraine and Russia used to export approximately one quarter of the world's wheat. Now it will be in short supply, pushing up prices.

Russia also supplies the world with metals: aluminium, copper, nickel and palladium. In retaliation to sanctions, Putin could permanently cut off these supplies. Everyday goods will be affected, from canned goods to automobiles.

Already share markets have reacted to recent events, reflecting not only the general uncertainty but also the real dip in business that will be experienced by those who previously sold goods to Russia. (On these terms, New Zealand's exposure is \$270m of annual exports, most of which is butter, mutton and lamb.) For now, even without sanctions, exports cannot be flown into Russia.

Highly exposed homeowners with large mortgages will need to brace themselves with the rise in mortgage repayments. Inflation has the strongest negative effect on low-income households. Some of our clients may find that they are leaned-on to open up the bank of mum and dad once more.

Paradoxically, the Reserve Bank may not need to increase interest rates too aggressively before it crimps household spending.

Investment-wise how are we affected in NZ?

Make no mistake, the next 12 months will be a bumpy ride for investors and savers. If you have recently checked your KiwiSaver balance, you'll see that even conservative funds with a strong weighting to bonds will have fallen. (See our next article on diversification.) The pandemic has already affected our economy and it's hard to escape escalating costs. Labour shortages are dampening output, and also increasing the wages bill.

Mortgage rates may be rising but that's good news for investors with term deposits: interest rates are coming off their low. On the flip side, homeowners with a mortgage should focus on reducing it.



We gleaned six main pieces of advice from the presenters at the 2022 Markets Summit that are relevant to our client portfolios.

- Passive styles of investment will give way to a more active approach which favours stock pickers. Our portfolios will have a blend of styles, so we are not exposed greatly one way or the other.
- Seeking share funds that invest in undervalued companies, companies with sustainable cashflows and dividend growth as well as cyclical stocks. Growth stocks (e.g. tech companies) remain expensive, with future cashflows discounted as interest rates rise.
- Easing back on US shares – many are at high prices and subject to profit weakness. We have been adopting this stance over the last 3 years or so.
- Government bonds with long durations will be less attractive. We have been keeping shorter maturities than normally.
- Keeping the average term of fixed interest holdings around 2-3 years. So, we may have a combination of one and 5 year terms.
- Cash – once unloved - will now benefit as cash rates goes up.

At Stuart Carlyon we have seen plenty of bearish times before, and our overriding advice is not to panic. The fund managers we use have already been actively on the case, adjusting their portfolio weightings in order to reduce risk and to be open to opportunities. New Zealand investors have had a good run in the past couple of years and while a bear market may give us lower returns, it does give us opportunities.

Diversification is the best defence for uncertain times

We thought it might be timely to review the past ten calendar years and remind ourselves about how different assets perform year by year. The ups and downs of each sector have been driven by events that occurred in each year. This will be no different for 2022.

The chart attached shows that at present fixed interest bonds are having a hard time. There they are on the ocean floor in 2021 and this is because of their inverse relationship with interest rates. When these go up bond funds suffer because the promissory worth of the bonds (reflecting previously low interest rates,) is now worth less.

Meanwhile, look at the ups and downs in the ranking of other different investment classes over the previous decade. Some types of investment are really volatile. Emerging markets shares have mostly bounced from being at the very top to the very bottom. The best investor strategy is simple: diversification.

Our message in times when markets drop is to hold on.

Clients that have been with us know the story. New investors will find it unsettling to see their portfolios drop in value, but you will only crystallise a loss if you sell out. We encourage you to talk to your adviser if you have concerns.

Whale tales – an ongoing story

We were planning to have an informal gathering to celebrate the Whale Tail that we sponsored to support the work of WWF with Bryde's whales in the Hauraki Gulf. However, with Omicron in full swing, we have decided yet again to delay any functions.

Artists have put their stamp on 80 big outdoor whale tail sculptures and 80 mini ones that are spread across Auckland. Take the opportunity to enjoy them by walking the Art Trails. Also, they will be on display together at Silo Park from 29 April to 1 May then auctioned off with the proceeds to WWF.

Jeff Thomson was the only artist given the opportunity to create the sculpture from scratch (others applied their artwork to a blank polystyrene base), and he has used his signature stamp of repurposing corrugated iron.

Our whale tail is located at Fraser Park, at the top of Parnell Rise.

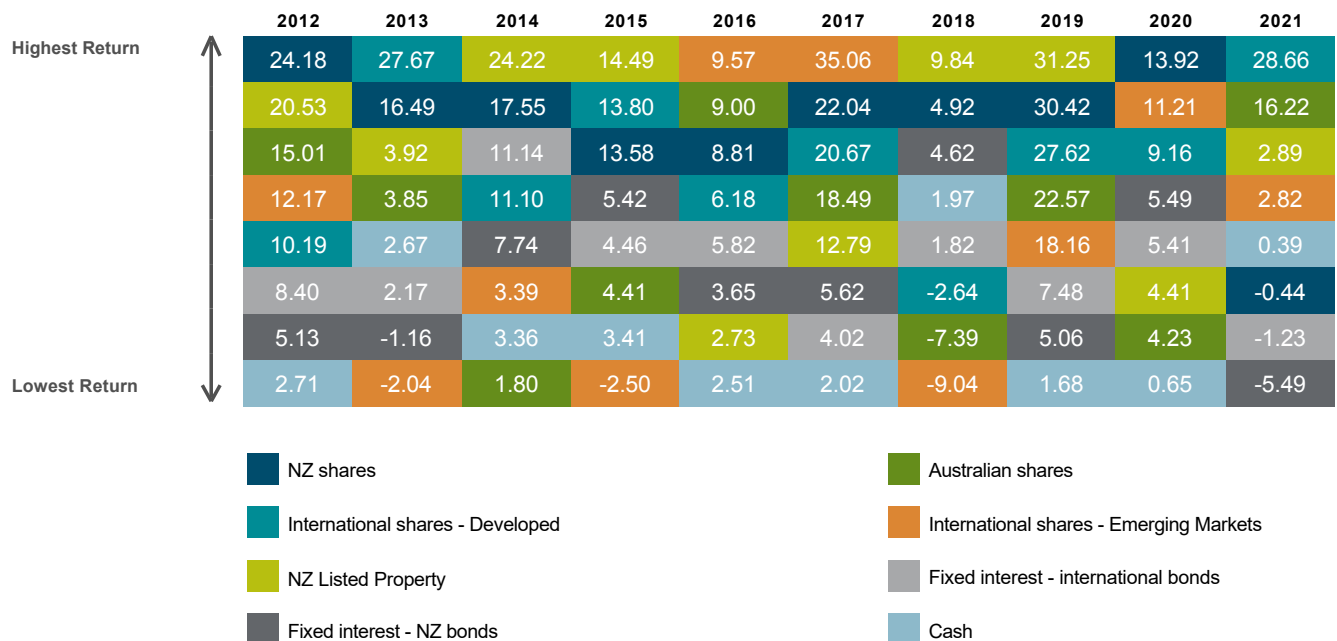


Jeff Thomson's repurposed corrugated iron Whale Tail

Randomness of Returns

Calendar years 2012 to 2021

In NZD terms



Source: Dimensional Returns Program

The ups and downs of each investment sector have been driven by events that occurred in each year. This will be no different in the future.

The best investor strategy is simple: diversification.