Global challenges – no respite

The challenges facing the global economy are significant. Covid is continuing to make its presence felt, especially in China where commitment to a Covid elimination strategy has seen continued regional lockdowns with ongoing global supply-chain implications.

Vladimir Putin's war in Ukraine is exacerbating supply constraints, especially for energy and food, and has ushered in the potential for a new period of cold war-style factionalism and fragmentation. This will exacerbate the already established unwinding of globalisation.

Having only belatedly realised the persistent nature of the recent burst of inflation, central banks are now tightening monetary conditions aggressively. Having missed the opportunity to act early and get ahead of the problem, most are now racing to neutral with many also signalling the need for conditions to become outright contractionary.

As monetary conditions have tightened and terminal rates have been revised up, fears of a sharp economic slowdown, stagflation and even recession, have grown. While in most cases recession isn't inevitable, it is more likely in some countries than others.

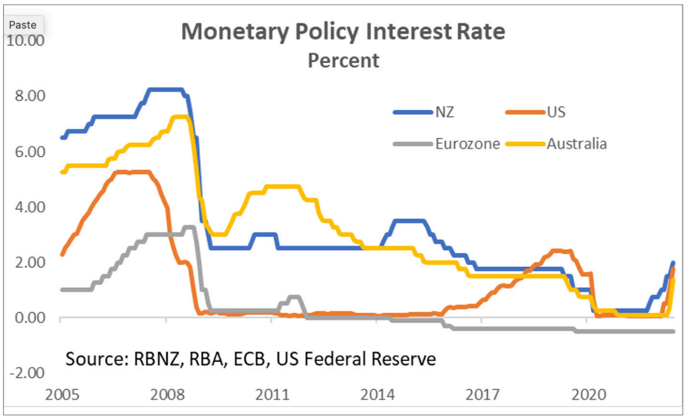
The race to neutral....and beyond!

For the first time since the 1970's, the global economy is facing a significant inflation problem. Also, this has come following a more recent period of 15-years since the Global Financial Crisis in which central banks were generally fighting disinflationary forces and pushing monetary policy to its stimulatory limits with the use of negative interest rates and quantitative easing.

In believing that inflationary pressures would prove transitory, all developed economy central banks were late to the tightening party. Most are now tightening monetary conditions more expeditiously.

In the US the Federal Open Market Committee (FOMC) has raised the Fed funds rate a total of 150 basis points (bp), with each of its three hikes larger than the one before, culminating in a 75bp hike in June.

We think they will follow that up with another 75bp in July which will take the Fed funds rate to 2.5%, close to the average "long-run" (neutral) rate from the FOMC's Summary of Economic Projections (SEP). The famous dot-plot from the SEP suggests a terminal rate of 3.8%.



Here in New Zealand the Reserve Bank (RBNZ) has also increased the pace of tightening with two consecutive 50bp hikes which has taken the Official Cash Rate (OCR) to 2.0%, its assumed neutral rate.

We expect another 50bp hike in July, after which we expect they will drop the pace back to 25bp until they reach a terminal rate of 3.5%, lower than the level the RBNZ itself is currently projecting. We will take a deeper looks at the New Zealand economic and policy outlook later in the report.

Elsewhere around the world the Bank of England is continuing to tighten, though at a 25bp pace, the European Central Bank (ECB) has ended its asset purchase program and "pre-announced" a first interest rate hike for July. Its negative interest rate policy will likely end in September.

Even in Australia, where we think the Reserve Bank missed an opportunity to get a head of the curve by witnessing the experience of others, is now tightening at a 50bp per meeting pace with more to come.

The inflation vs growth trade-off

Stagflation and recession are the terms de jour. With respect to stagflation, if one was to be nit-picky, there are significant differences between what was experienced in the 1970s and today, the most significant of which is the fact that central banks now have the tools to fight inflation. Unemployment rates are also significantly lower.

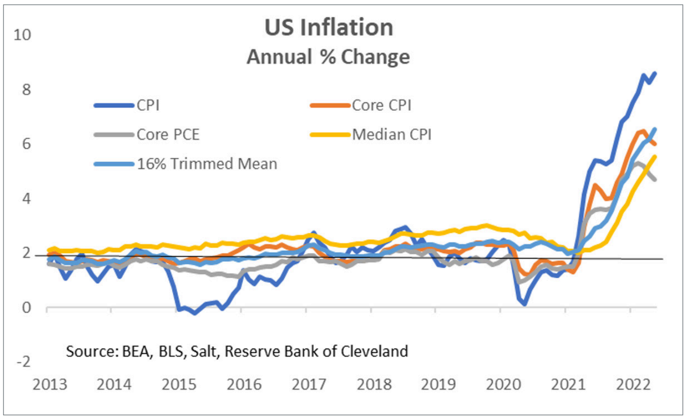
That said, the fact that we are still operating in an environment of severe supply constraints and that potential growth in many countries has trended lower over recent years, reflecting stagnant or declining working age populations alongside moribund productivity growth, certainly give the current environment a "stagflation-esque" feel.

In our last report we argued that as commodity prices stabilised, headline inflation would recede. The qualification on receding headline inflation was the uncertain outlook for commodity prices, especially for food and energy as the war in Ukraine continues to play out. As headline inflation moderated, this would, however, expose the strength and stubbornness of the core inflation problem.

As it has turned out, headline inflation continues to make new highs, reflecting higher food and energy prices. At the same time, core inflation measures are rolling over, albeit slowly.

In the United States, annual headline CPI hit a new high of 8.6% in May, with consensus forecasts expecting it to move closer to 9% in the year to June. At the same time, the core personal consumption expenditure deflator (or core PCE, the Fed's preferred inflation measure) peaked at 5.3% in February and has since slowed to 4.7%, so lower, but still significantly above the Fed's 2% mandate.

The likely only gradual retreat in core inflation means central banks will continue to prioritise taming inflation over supporting growth. In taming inflation, central banks need to reduce demand to below trend, generate negative output gaps, and raise unemployment rates back closer to their estimates of NAIRU (Non-accelerating inflation rate of unemployment).



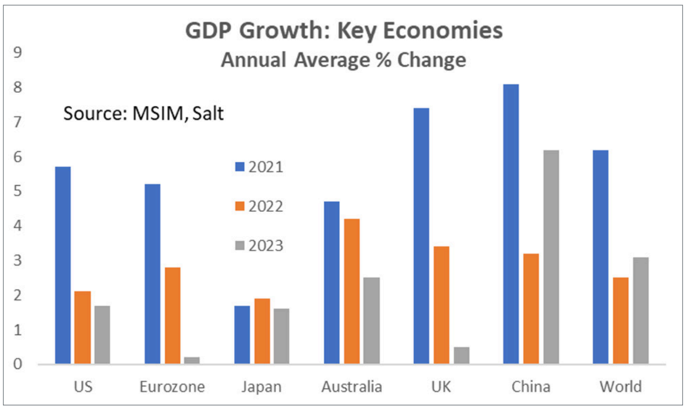
As central banks continue to fight a rear-guard action, we expect they will continue to tighten until there are clear signs of sufficiently cooler demand, at which point they will likely pause. However, they won't start easing conditions until there are clear signs that inflation is on a downward trajectory and likely to return to target.

Some at greater risk of recession than others

Recession isn't inevitable, but risks are higher in some areas than others, especially as respective economic cycles bottom out during 2023.

Around the developed world consumer confidence has plummeted as households face the double whammy of a significant increase in the cost of living, especially for basic items such as food and energy, along with rising borrowing costs.

We continue to believe recession risk is greater in Europe than it is in the US.

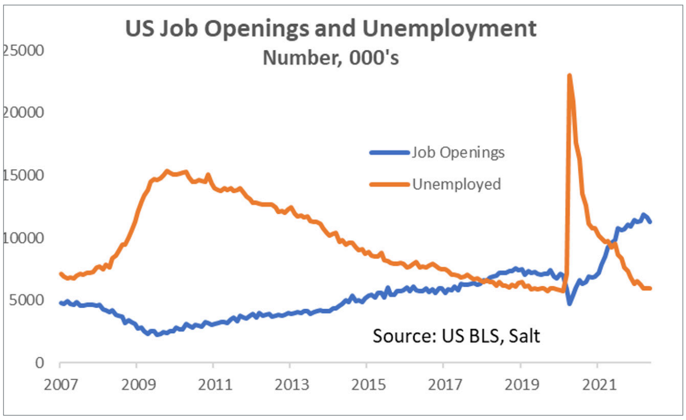


In the US recent consumer spending data has been decidedly on the soft side. Retail sales are soft, though we believe there is also a transition currently underway from spending on goods to services which will accelerate over the summer months and support overall consumer spending.

First quarter US GDP was revised lower. While the overall magnitude was insignificant, the makeup was more noteworthy. Consumer spending was revised down so that real final demand came in below trend, suggesting spending wasn't as robust at the start of the year as we initially thought.

It's not all bad news for households, however. Many households accumulated significant cash balances through the pandemic and while some of this has undoubtedly been spent, we think there is still more in the pipeline.

The US labour market also remains strong. The Job Openings and Labour Turnover Survey (JOLTS) continues to point to a greater number of job openings that there are unemployed people to fill them – there are currently 1.9 jobs available for each unemployed person. That will continue to put upward pressure on wages.



Of course, strong wage growth is a twin-edged sword. Higher wages are helpful in taking the rough edges off the inflation induced squeeze on household budgets, but also make the Federal Reserve's job of taming inflation harder.

We are also not seeing some of the classic precursors to recession in the US, including excesses in business investment or housing construction that have preceded significant recessions in the past.

It remains the case that the greatest risk of recession comes next year as the economic cycle bottoms. If the US does slip into recession, we expect it will be of the short and shallow variety. This is more palatable than the longer, deeper recession that would eventuate should the Fed remain behind the curve and allow inflation expectations to become unanchored, necessitating a more disruptive adjustment.

Recession risk greater in Europe

The news is not so great, however, in Europe where recession appears more likely.

Recent high frequency data out of Europe has disappointed on the downside. This includes key sentiment data such as recent manufacturing and services, PMIs, and other business confidence data. In large part this seems to reflect the ongoing war in Ukraine and growing concerns over the security of energy supplies including the potential for a cut-off of gas supplies from Russia which has continued to push gas prices higher.

As headline inflation moves inexorably higher, household disposable income is squeezed. At the same time, higher business input costs are squeezing margins. The prospect of some form of rationing is also causing concern over the potential for disruption to production processes, adding to already severe supply chain challenges.

This puts the European Central Bank (ECB) in a difficult position. While it could be argued that a recession will make the ECB's job easier, that's not the case if the recession emanates from the supply side, as seems likely. While recession risks are building, the ECB cannot resile from its mission to contain inflation.

The next interminable inflation debate: Structural or cyclical?

Having suffered through the interminable transitory vs durable inflation debate earlier this year, another, in our view more important debate is brewing.

As we face into the period of strongest inflation since the 1970's there is a valid question about the extent to which we are heading into a period of structurally higher inflation, or whether once central banks have brought the current bust of inflation under control, we return to the relative calm of the "great moderation".

The outcome of this debate has implications for interest rates. Specifically, the period of the great moderation has seen a structural decline in interest rates play out over several decades. If we are heading into a period of structurally higher inflation, it follows that we may also be heading into a period of structurally higher interest rates.

We have already nailed our colours to the mast. In 2020, as we were looking to build out the construct of our Salt diversified funds, the first task we did was identify the key themes we though would play out over the next few years.

A number of those pointed us in the direction of higher structural inflation in the period ahead. It was this combination of factors that led us to construct our diversified funds with a significantly lower allocation to bonds than "normal", offset by greater exposures to real assets.

The factors that we saw as contributing to structurally higher inflation ahead included:

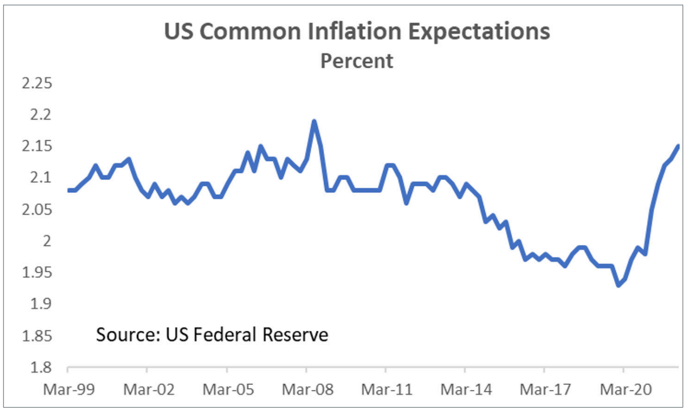
1. The retreat of globalisation
2. Moribund productivity growth
3. Demographics and ageing populations
4. The end of the era of China as a source of global disinflation

The pandemic and the war in Ukraine have exacerbated the reversal of globalisation. Covid-related supply shocks have helped businesses realise the fragility of global supply chains. Cheaper may not always be better if that fragility gets exposed. Perhaps it's better to source inputs into production or final goods from closer to home, even if it's more expensive.

The war in Ukraine has broken the rules-based geo-political orthodoxy that has been in place since WWII. This has already resulted in indications of greater militarisation of Germany and Japan, and Switzerland has dropped its long-held neutrality. Sweden and Finland have now applied for NATO membership.

The likely result is a return to cold-war style factionalism and fragmentation. That fragmentation will be political and economic and will have significant implications for global trade.

It's also the case that much of the disinflation of the past two decades has been the result of the lack of a mutually reinforcing cycle of higher inflation fuelling inflation expectations, leading to wage increases which in turn fuel higher inflation.



The world is arguably on the cusp of an emergence of a new wage price spiral as inflation, particularly for key household expenditure items as food and energy, squeezes household disposable incomes leading to heightened wage demands which then feeds back into higher inflation.

If we are indeed heading into a period of structurally higher inflation, it also means the era of the structural decline in interest rates observed over the last three decades may not only be at end but may, in fact, be set to reverse.

Higher debt levels a significant vulnerability

The structural trend lower in interest rates over many years has reduced debt servicing costs and allowed a continued rise in debt levels. Across many measures, debt levels are higher today than they were in the leadup to the Global Financial Crisis (GFC).

The good news is that following significant financial reforms, the banking sector is in far better shape than it was at the time of the GFC.

The bad news is that if inflation is set to move structurally higher and the trend decline in interest rates reverses, high debt levels and the servicing of that debt will once again become a critical vulnerability.

For governments, that means prioritising the normalising of fiscal policy and rebuilding crisis buffers, especially now that we are through the period of fiscal support being a key tool to manage economies through the worst of the pandemic.

This will not be an easy task. Given rising geo-political tensions we are seeing the reversal of the "peace dividend" as many countries shore up their spending on security and defence. This is happening at a time when public calls for action on climate change and reducing inequality have never been stronger.

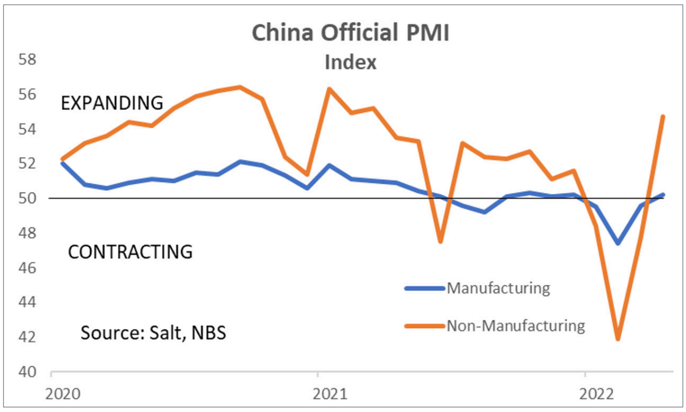
China running against the tide

The biggest growth challenge facing China is its continued commitment to a Covid-elimination strategy, though some small relaxations of restrictions are beginning to play out. The authorities are trying to strike a better balance between growth and pandemic containment, including halving the 14-day quarantine for inbound travellers and close contacts of Covid patients to seven days.

A more comprehensive shift away from Covid-zero appears unlikely before the Communist Party National Congress in October/November this year and will require ongoing progress with vaccination rates and the deployment of treatment kits to take the pressure off the hospital system.

There has been steady progress in some of these requirements. The booster ratio for the elderly (aged 60+) stood at 65% as of June 27, compared to around 50% prior to the Omicron outbreak. Furthermore, domestic Covid treatment kits could be ready for distribution by end-2022, allowing China to weather resurgences with substantially lower costs and reduced dependence on imported supply.

The recent relaxation of restrictions, especially in the economic powerhouse of Shanghai, along with continued incremental policy easing and a stabilising of the "regulatory reset" has already seen a rebound in key data, including the manufacturing and service PMIs. GDP growth should record a notable improvement in the third quarter of the year, though we expect the recovery will be more gradual than V-shaped.



Assuming further, albeit incremental, policy support alongside the shift away from Covid-zero as the year progresses, the recovery will become more solid and balanced. Our partners at Morgan Stanley expect GDP growth of 3.2% this year and 6.2% in 2023.

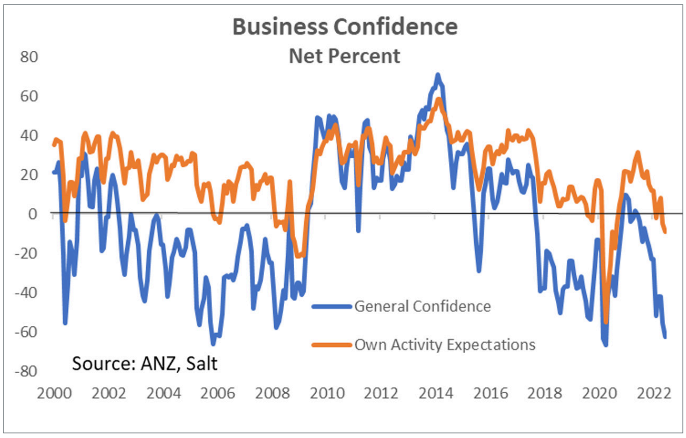
New Zealand: mild recession more likely than not

The New Zealand economy contracted in the first quarter of 2022. This was not surprising given the Omicron "virtual" lockdown we put ourselves in during the early months of the year, and the weakness in both consumer and business confidence.

With respect to business confidence, we tend to watch the long-standing ANZ Business Outlook Survey. Furthermore, we tend to ignore the general confidence index which has been sharply negative for a number on months now.

The index we watch most closely is the so-called firms "Own Activity" index. Over a long period of time, it is the index derived from this question that has the closest relationship to economic activity. Think about it this way – it is possible to be negative on the outlook for the economy, but positive on the outlook for your own firm. The converse is, of course, also possible.

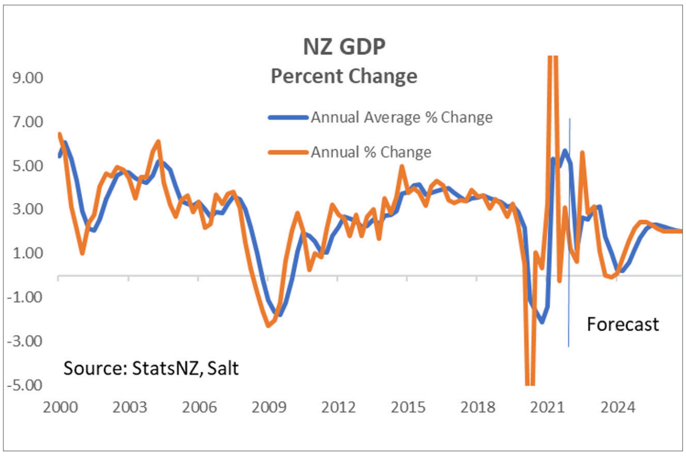
In the near term, we believe the reopening of borders and the return of tourists to New Zealand will see the economy perform more strongly than in the first quarter of the year – we have solid growth pencilled in for both the second and third quarters of 2022.



That is supported by other positive factors in the economy right now. The terms of trade are at a near record high, there is a strong pipeline of residential construction activity (although suffering supply issues), the exchange rate has fallen, and the labour market is tight.

But given the deeply entrenched consumer pessimism, the renewed deterioration in firms outlook for their own activity, an expected peak-to-trough decline in house prices in the range of 15-20%, lower global growth and higher interest rates, the underlying growth impulse is weak, though it won't be exposed until later in the year as the border re-opening impact masks the underlying weakness.

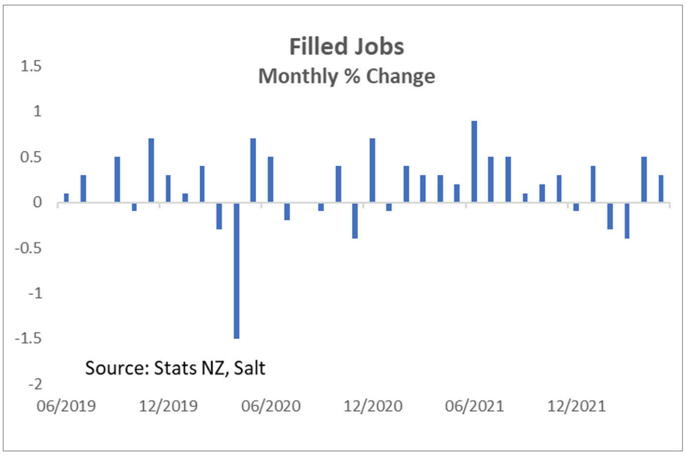
We previously saw the cycle bottoming out around mid-2023 with modest positive growth. We now expect a modest contraction in activity through the middle quarters of next year.



Labour market tightens further before easing up

Latest data shows a bounce back in filled jobs occurring during the June quarter. That follows the omicron-related contraction observed during the first quarter which has already fully reversed. This serves to support our expectations of stronger activity during the middle quarters of the year.

The labour market is also expected to tighten further due to supply issues. While borders being open to tourists is great for employment and higher activity, they are also open to inward and outward migration. We continue to believe that over the next few months, outward migration will exceed inward, the available supply (which is already tight) will diminish further, resulting in a period of the unemployment rate tracking below 3%.

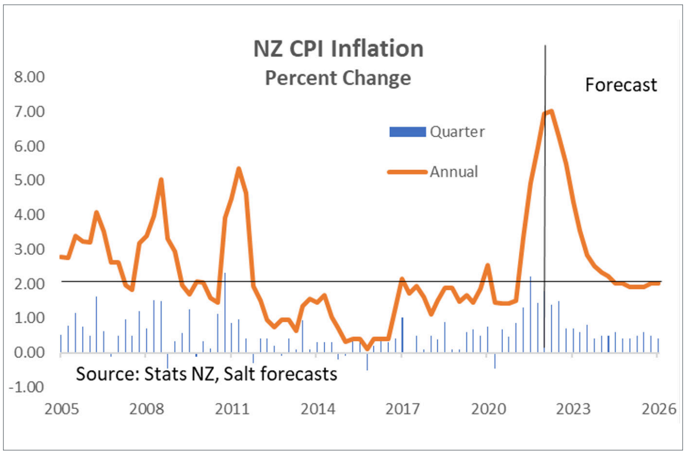


The unemployment rate then starts to rise as net migration turns positive and economic activity slows. Given our expectations of a modest contract in activity in the first half of next year, employment will likely also fall, generating a faster return to NAIRU than we had previously expected.

Inflation and monetary policy

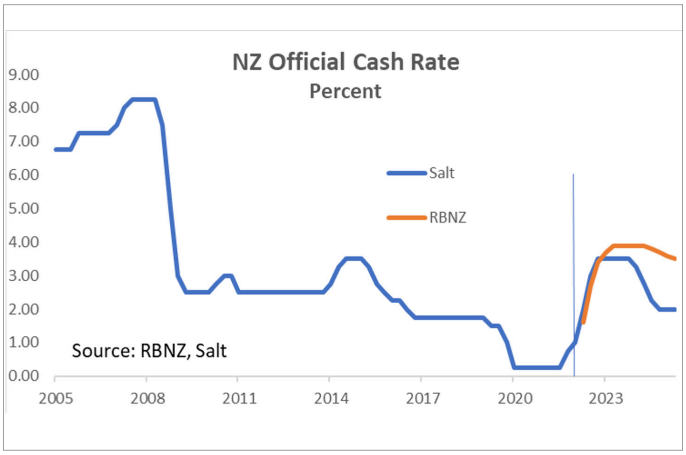
Headline inflation reached 6.9% in the year to March and is expected to nudge higher in the year to June, largely reflecting higher fuel prices.

The headline rate is expected to be lower by the end of the year, but still around 5.5%, still well outside the RBNZ's target range of 1-3%. In fact, we don't see it back inside the target range until the third quarter of 2023.



That is predicated on our assumption of continued tightening in monetary conditions. The RBNZ has raised the OCR 175bp since October last year, including two 50bp hikes in April and May. We expect they will deliver another 50bp hike at its July Monetary Policy Review.

That will take the OCR to 2.5%, higher than the RBNZ's assumed neutral rate of 2.0% and therefore acting as a handbrake on activity. From here we believe the bank will ease back the pace of tightening to 25bp until they get to a terminal rate of 3.5%.



That's lower than the Bank's projected terminal rate of nearly 4% and market pricing of 4.5% at times through June, although market price has more recently pulled back to more realistic levels of 3.8%.

Lower consumer confidence and declining house prices is already doing a lot of the work for the RBNZ in curtailing demand. If we are right, the Bank will have evidence of that soon and will be prepared to at least pause the tightening cycle sooner, at a level lower than their currently projected terminal rate.

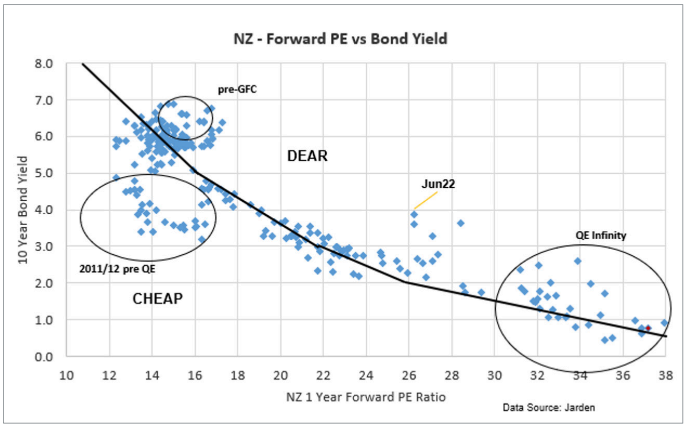
Having sufficient comfort to start lowering interest rates again will take longer. For that, the RBNZ will want clear incontrovertible evidence that inflation is returning to the mid-point of the target. That's most likely a story for 2024.

Outlook for New Zealand Equities

The NZ equity market experienced another difficult quarter in June, declining by -10.3%, to make a decline so far of -16.6% in what has been the annus horribilis of 2022. We were not alone, with our Australian counterparts declining by -8.8% and the MSCI World falling -16.2%.

The quarter saw the continuation of a nasty cocktail of negative fundamental drivers. Firstly, 10-year bond yields rose from 3.22% to 3.88% as the reality of higher for longer inflation rates became priced in. Have we seen the worst yet? Perhaps but consider that NZ has experienced real interest rates in the 1.0%-2.0% region over the long run. Add 2.5%-3.0% stabilised inflation to this and bond yields of 3.5%-5.0% are perfectly feasible and indeed have been the case for much of the last several decades.

The difficulty for equity valuations is that a higher bond yield, without a concomitant rise in earnings forecasts, implies a lower fair value for the market. This is shown in the chart below which looks at the forward PE versus the 10-year bond yield for every month since 2001.



A couple of factors are clear from this chart. Firstly, markets tend to get stuck in certain paradigms until a shock arrives which moves them to a new set of bond yields and valuation multiples. NZ (and indeed most global equity markets) have clearly departed from the funny money era of "QE Infinity" but the destination is still in progress.

Secondly, as at end-June, the "fair" PE for the core market (ex property and investment companies) based on a 10-year yield of 4% is a PE of around 19x. At just over 26x, we appear very expensive.

However, the composition of the NZ market has changed over time to include companies with higher PE multiples because they have very strong long term growth (eg F&P Healthcare) or the earnings understate the cashflows (such as the gentailers).

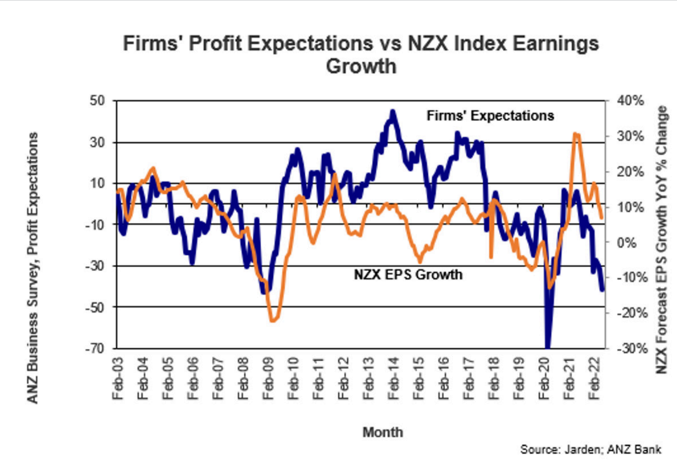
If we look at the 1-year forward median PE, that now stands at around 16-18x depending on which set of broker estimates are used. Valuations at this level are supportable at current bond yields and compare to recent QE-era highs for the median PE in the 21x region.

As a simple cross-check, we can use the old "Rule Of 20". This has fallen out of favour in recent years but can be used as a very basic valuation sense check. It states that fair value for the sum of the forward PE and expected inflation should be 20x. Right now, if we use a median PE of 16-18x and a forward CPI projection of say 3%, we have a range of 19-21x for the Rule Of 20.

Salt's view therefore is that the key to the equity market outlook from here is neither valuation (now relatively fair albeit no bargain) nor the future track of bond yields (may have a little further to go but the impact of higher inflation is now largely priced in). What will matter from here are the risks around earnings forecasts. Can we trust them?

The median PE quoted above uses 1-year forward growth estimates of around 10%. We would suggest that these are heroic and that the upcoming earnings season in August may be notable for the downgrades to future years' earnings that come out of it.

The chart below looks at the loose relationship between NZX company earnings growth and firms' profit expectations from the monthly ANZ Business Survey. The concern is that recent answers from this survey have been very weak. A net 41.5% of firms now expect their profits to decline over the next 12 months. Aside from the brief Covid-lockdown blip, this is the weakest since the -42.9% recorded at the height of the GFC panic.



Putting all this together, while valuations are close to fair and bond yields have possibly seen most of their sell-off, the period ahead may still be treacherous as a bevy of companies will likely downgrade earnings. This is the reverse of the strong performance by markets and especially by cyclical stocks as economies opened up post-Covid. A fair degree of this cyclical concern/fear has been priced by the market already over the June quarter but whether it is enough will be revealed.

This can be seen by how a number of key cyclical names underperformed in the June quarter in expectation of potential future downgrades. Key examples included Freightways (FRE, -26%), Fletcher Building (FBU, -21%) and Mainfreight (MFT, -17%). The retirement village sector performed largely in line with the market in the quarter but has been very weak over the last year due to its highly leveraged exposure to sales and prices in the slowing NZ housing market. We remain cautious.

Outperformance has tended to come from companies whose earnings have little cyclicality. In the June quarter, this saw the likes of Spark (SPK, +4.8%), Vector (VCT, +3.2%), Port Of Tauranga (POT, +0.6%), Chorus (CNU, -2.4%) and Tower (TWR, -3.6%) do far better than the -10.3% turned in by the market. Property stocks are often viewed as defensive against inflation but fell by a sharp -12.4% in the quarter as the headwinds of likely higher cap rates and vacancies outweighed the prospect of higher rental inflation.

Australia (+2.2%) had sharply outperformed NZ (-4.9%) back in the March quarter thanks to its oil, iron ore, and coal stocks but this began to reverse late in the June quarter as these exposures began to fall sharply as fears of a recession mounted not just in NZ but globally.

Implications for Investors

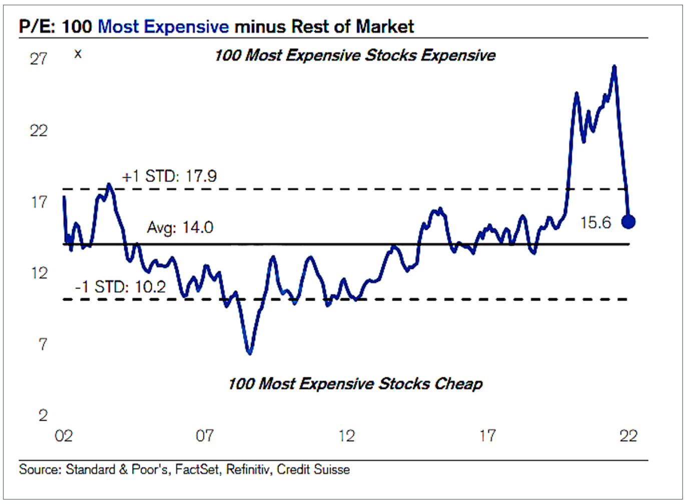
Bears savage Bonds and scratch Equities

The first half of 2022 demonstrated the speed with which changing economic and geopolitical circumstances can rapidly alter the tone and direction of investment markets. That is particularly true if assets have reached stretched or over-optimistic valuation levels, as was the case at the end of 2021. Barely had this year begun, when the combination of faster and more extended prospective rises in global interest rates, and the energy price and security shocks unleashed by Russia's invasion of Ukraine, set off a sharp fall in asset values. While equities entered a technical "bear market" in June, having fallen by 20% from their January peak, the decline has arrested, and overall direction is uncertain. It is important not to interpret the re-pricing seen over the last six months as a "death-knell" for a positive investment environment. The sharp adjustments underway in assets were overdue, and the artificial impact of unprecedented central bank stimulus needs to be drained from markets. Otherwise, not only would high inflation become entrenched, but investors could lose track of the actual risk characteristics of those assets which performed very strongly in the 2020 pandemic period. Return, without risk, is unsustainable.

One way of showing the peculiar nature of the current equity market leadership change is the chart below, which highlights both how very expensive the top 20% of US S&P stocks became by late-2021 (when they were trading at Price Earnings multiples above 25x) to the present level, not markedly above the historical average of 14x for that cohort. The "healthy revaluation" aspect of the Bear equity phase is central to its character and its likely future path, though this fact is overlooked in pan-pessimistic commentaries.

How the mightily expensive have fallen

So, if an overdue re-assessment of what is a reasonable price for an investor to pay for a particular company is well underway, that does not necessarily imply a returns-unfriendly few years ahead. Rather, it means that better-valued companies and industries may again come into their own, as the highly flattering effect of ultra-loose monetary policies fade away and fundamental valuation basics can resume. It now seems clear that the stock price "multiple expansion" years saw unsustainable extremes and bred excessive optimism, which is now being purged.



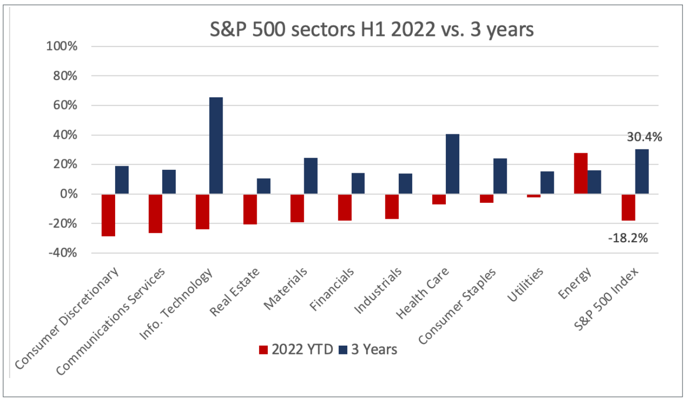
For bonds, the picture is more complex. The current bond bear market is the worst ever recorded, in terms of negative total returns logged on securities. The equity bear market, in contrast, remains moderate by historical standards and indeed, fluctuates above and below the -20% value loss threshold from week to week. Equities will recover, given time, but bonds face a more fundamental challenge due to yield levels still being inadequate given inflation and credit risk, and a new environment of terminated QE support and nascent steps towards QT.

Defensive sectors bear up

With this in mind, it is revealing to compare the S&P 500's 2022 sectoral returns with their 3-year cumulative returns to July 2022. While this year, Energy has remained the strongest sector, followed up by small declines in Utilities and Consumer Staples, the picture changes when viewed from a 3-year standpoint. Since July 2019, Information Technology's performance is still the strongest, with the sector's return leading its runner-up, Health Care, by

25% (+65.7% for IT versus + 40.5% for HC.) Materials and Consumer Staples were next-best performers over 3 years, with similar gains for both the more cyclical sector (Materials, +24.5%) and the more defensive sector (Staples. +24.1%.) This suggests a tug-of-war between scenarios of economic expansion and contraction remains unresolved. However, over the last 12 months, the bias has moved more toward the defensive end of the spectrum, with Utilities (+8%) Staples (+5%) and Health Care (+2%) the only sectors besides Energy to have recorded positive returns.

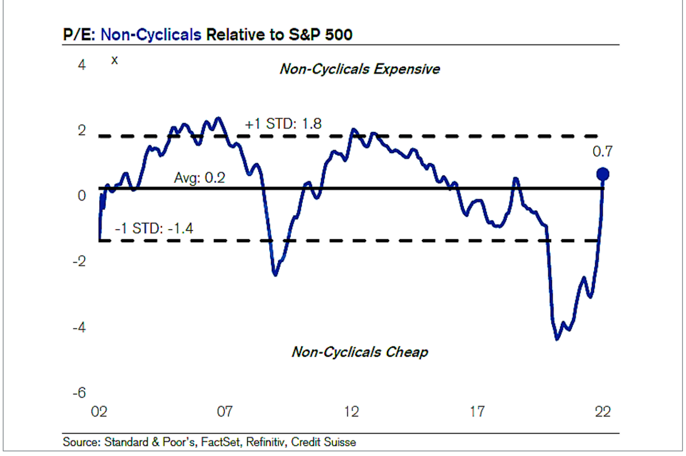
H1 2022 gains in Energy also aided Utilities



Source: Bloomberg, Fidelity. Last data point 7.7.2022

These sector returns patterns are also broadly true, with regional variations, for other main global markets. Neither Financials nor Industrials, sectors that are usually bellwethers for growth, seem to be pricing in a clear macroeconomic path ahead. This is to be expected, as uncertainty is extreme and investor conviction in any given outcome, low. So, the medium-term equity investors' focus appears to be in transition, away from the companies which profited from the long downward path in interest rates combined with sustained economic expansion, toward those less reliant on operating in a beneficent economic cycle. As a result, the relative valuations of some of the "all-weather" or defensively oriented sectors have adjusted upwards, as is shown below.

As after 2008, from 2020 Defensive (non-cyclical) sectors became cheap



What is taking place in markets this year is fundamentally, a re-orientation of global portfolios to better suit the inflation-prone and risk-laden world that we now expect to persist for several years. Safer sectors have been benefiting, and we expect that to continue for the remainder of this year, and into 2023.

The Consumer Staples, Health Care and Utilities companies listed on main international exchanges have shown an aligned pattern of defensive out-performance. For instance, the Consumer Staples sectors in Europe, the US, Japan and Emerging Markets for H1 2022 logged returns ranging from -3% (Japan) to -9% (Emerging Markets.) While negative, such drops are meaningfully less than has afflicted the "growth sensitive" sectors. Holding these Staples, Health, Utilities and Telecoms (SHUT) companies assists investors to remain exposed to the equity asset class, without experiencing intolerable volatility for their own level of risk tolerance.

For those with a very high appetite for risk, although this year there have been downward re-valuations of 50% or more in some assets at the more speculative end of the future technologies theme set, there remains sufficient liquidity and leverage in markets to present apparent opportunities for short-term gain. Day traders and bottom-fishers are still in evidence and can muster followers online to reverse the price direction of sharply-cheaper stocks that catch their eye.

In a parallel to the increasingly polarized political communities we are witnessing around the world, there is a growing bifurcation amongst equity market participants. One group is evidently preparing for a multi-year period of economic stagnation accompanied by uncomfortably elevated inflation, and is moving ever-more defensively into the most reliable all-weather industries or even into Cash. The other group is hailing the deep recent falls in the prices of their favoured securities as an opportunity to position for a rebound.

For investors with no risk tolerance at all, Cash has strongly outperformed bonds and shares so far this year, but Cash is also offering negative real returns in most jurisdictions. The appeal of Cash also depends on an investor's base currency. For New Zealand investors, there are significant diversification benefits in allocating to the major world currencies, in a period of heightened global uncertainty and asset risk.

Multi-Asset: a half-year of extremes

The first and the second quarters saw negative returns across all global asset classes, except commodities. It is very rare for only a single asset type to log price gains across a full six-month period. This indicates how thorough the re-pricing of most assets, due to markedly higher interest rates and growing recession risks, has become.

The table above shows the after-inflation (real) returns for a range of international assets over the last five years. The inflation rate used below is US headline CPI, for ease of comparison.

After-inflation returns from major assets 2018- Jun.22

2018	2019	2020	2021	2022 YTD
USD Cash (0%)	S&P 500 (29%)	MSCI CN (28%)	REITS (32%)	Commod. (9%)
US 2yr (0%)	REITS (26%)	US Small (18%)	S&P 500 (20%)	USD Cash (-4%)
US 10yr (-1%)	US Small (23%)	MSCI EM (17%)	Commod. (18%)	US 2yr (-7%)
US Agg (-2%)	MSCI EU (22%)	S&P 500 (17%)	MSCI EU (9%)	TIPS (-13%)
TIPS (-3%)	MSCI CN (21%)	MSCI JP (13%)	US Small (7%)	EM Local (-13%)
US HY (-4%)	MSCI JP (17%)	Commod. (10%)	TIPS (-1%)	US Agg (-14%)
US IG (-4%)	MSCI EM (16%)	TIPS (10%)	US HY (-2%)	US 10yr (-15%)
EM Local (-5%)	US IG (12%)	US 10yr (9%)	MSCI JP (-5%)	MSCI CN (-15%)
Global HY (-6%)	US HY (12%)	US IG (8%)	Global HY (-6%)	US HY (-18%)
REITS (-6%)	EM$ Sov. (11%)	US Agg (6%)	USD Cash (-7%)	US IG (-18%)
EM$ Sov. (-6%)	Global HY (10%)	US HY (6%)	US 2yr (-7%)	Global HY (-21%)
S&P 500 (-6%)	Commod. (8%)	Global HY (6%)	US IG (-8%)	MSCI EM (-21%)
Commod. (-12%)	EM Local (7%)	MSCI EU (5%)	US Agg (-8%)	REITS (-23%)
US Small (-13%)	US Agg (6%)	EM Local (4%)	EM Local (-8%)	S&P 500 (-24%)
MSCI JP (-14%)	US 10yr (6%)	EM$ Sov. (4%)	MSCI EM (-9%)	MSCI JP (-24%)
MSCI EM (-16%)	TIPS (6%)	US 2yr (2%)	EM$ Sov. (-9%)	EM$ Sov. (-24%)
MSCI EU (-16%)	US 2yr (1%)	USD Cash (-1%)	US 10yr (-9%)	MSCI EU (-24%)
MSCI CN (-20%)	USD Cash (0%)	REITS (-6%)	MSCI CN (-27%)	US Small (-27%)

Source: Morgan Stanley Research, July 2022

Some of the more notable value moves recently experienced have attracted headlines: the worst first-half return for the US S&P 500 (-20%) since 1962, for US High Yield bonds (-10.2%) since 1989, for the Japanese Yen JPY/USD (-15.2%) since 1989, and for US 10-Year government bonds (-10.5% nominal -15% real returns) since the 1970s.

In commodities, energy saw its best first half year performance since the 1980s (Brent crude gained 63% and Natural Gas, 107%) while by contrast, industrial metals in aggregate ended the six-month period lower by -12%, with the price weakness being concentrated in June month. Interestingly, the precious metals grouping has proved relatively resilient, but gold is little changed year-to-date and -2% lower for the full year (in USD terms.) That suggests that investors are seeking other stores-of-value in inflationary times.

With broad international investment indices weak, the importance of active management cannot be underestimated. Both the avoidance of assets which may become more vulnerable, and the acquisition of those that have become unjustifiably cheap, requires active choice, as does aligning portfolios with major multi-decade trends and staying on top of environmental, social and sustainability improvements.

Equities price in slowing profits, as USD soars

The USA was the weakest developed market in the second quarter. The S&P 500 Index recorded a -16.1% quarterly total return (in USD) bringing its 2022 year-to-date (YTD) total return to a round -20%. Half of the US benchmark's quarterly drop was logged in June month alone, as equities fell -8% on mounting concern about the impact of Federal Reserve monetary tightening on the economy and on future corporate earnings, should a recession eventuate. Some economic indicators raised that probability.

The drop in the S&P 500 lowered its one-year return (in USD) to -10.6% and the Index value, back to its level of Christmas, 2020. In NZ dollar terms, the downward move in the key US equity index has been largely offset over the one-year timeframe, as NZD/USD depreciated by -10.7% for the period and so an unhedged, NZD-based investor could potentially have experienced an almost flat return for the year.

Even after factoring in this year's swift decline, the 3-year annualized total return of the S&P is a robust +10.6% p.a. The 5-year total return for the US Index was +11% p.a. and the 10-year return, +13% p.a. as at June 30th. Interestingly, the 5-year return is thus close to the recent average annualized norm.

Widespread valuation corrections are underway

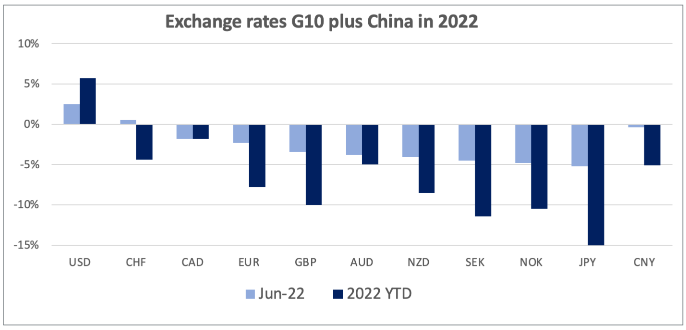
The vulnerability of technology and other "growth" stocks to higher interest rates persisted throughout the period. The NASDAQ-100 Index thus underperformed the broader US market in the second quarter, falling by 22.5% over the three months and closing June 29.5% below its end-2021 level. In an analogous trend, the formerly-popular "cryptocurrency nexus" entered into severe decline in the June quarter.

The Financial Times' "Digital Assets Dashboard," which tracks the total circulating value of the ten largest cryptocurrencies peaked last November at USD 3.2 trillion. Since then, it has fallen to USD 2.2 trillion on March 31st (-31%) and dropped again to USD 0.94 trillion (-57%) as at June 30th, making a total peak-to-present value loss of -70%. Those who touted crypto's diversification benefits are looking premature.

Riskier equity regions and currencies remain out of favour

Emerging Markets weakened again in the second quarter, by 11.3%, which brought their year-to-date decline to -17.5% in USD terms. As with European equities, Emerging Market shares' local currency returns were somewhat less "strictly bearlike" in local currency terms: -13.1% YTD for MSCI Europe and -13.5% YTD for MSCI Emerging Markets.

The foreign exchange markets also reflected the much-diminished risk appetite, with widespread weakness in cross-rates despite the advancing monetary tightening programmes and with only the US and Canadian dollars and the Swiss Franc showing their defensive merits, in 2022 to date. The Canadian has of course been aided by high energy prices. The Japanese yen, a traditional haven in times of turbulence, has been pushed sharply lower by the insistence of the Bank of Japan to continue extreme stimulus and bond yield repression, being the sole major global central bank to defend this stance as inflation roars.



Source: Morgan Stanley. Data to 30 June 2022. For USD, Fed Broad Trade-weighted USD is shown.

The strong US dollar throughout the 2022 market volatility has also assisted New Zealand-based investors in unhedged or partially-hedged international equity vehicles. In June month, the NZ dollar fully reversed its May bounce against the greenback, falling 4.1% for the month and by 8.5% YTD.

This depreciation of NZD/USD during a period of global adjustment to central banks' policy interest rates (and thus, to interest rate differentials between currencies) suggests that despite the Reserve Bank of New Zealand turning noisily hawkish, there will be little respite for NZD while US inflation is so firmly in the Federal Reserve's crosshairs. The robust appetite for USD has been a key theme of the post-pandemic era, and will affect investment strategy profoundly in the 3-5 years ahead.

At present, however, the prospect of declining exchange rates for non-US Developed exporting economies may help to shore up their economic growth as 2023 proceeds. The picture is darker for commodity importing countries, where key global prices have shifted sharply upwards and their currencies have dropped, increasing the burden on their balance of payments and in some cases, triggering social unrest.

Closer to home (no social unrest here!) from the NZ exporters' point of view, the US only has a 13% weighting in our Trade Weighted Index (TWI) so while most of our exports are priced in USD, not many actually go to the USA. We would not therefore expect a major boost to goods and services sales in the US, although it is quite possible that US corporations, flush with cash, may go on an international acquisition trail and that well-positioned NZ listed and private companies should continue to benefit. Consolidation waves often occur during periods of economic malaise, and this can support equity prices, albeit selectively and erratically.

EU, UK & Japan's returns hurt less in home currencies

For Europe and Japan, the June quarter was less damaging than it was in US assets, with the MSCI Europe Index falling by 8% and Japan by 4% over the three-month period. Sharply weaker currencies helped exporters in both Japan and the Euro zone, and the greater "value" orientation of those markets' listed equities universe also contributed to their relative resilience. It was a similar story for the UK's FTSE 100 Index, which closed the first half year down by just 1% in British Pound terms, but 11% weaker in US dollar terms (as the exchange rate shifted decisively in favour of the US currency.) In Pound terms, the FTSE is even showing a small positive one-year return. Given the "Boris-troika" political turmoil, this suggests leadership and policy clarity is not always the determining factors for investment market performance.

The euro has fallen to close to parity with the greenback, while the pound is touching historical lows below USD 1.20, and the yen is at a 25-year nadir versus USD. The table of returns for a range of international equity markets since their peak highlights the impact base currency exposure can have on global share returns:

Global Equity Returns Including Dividends (%)

Country	Currency	Fr. Jan 22 Peak	Jun-22	QTD	YTD	1 Yr	3 Yr	5 Yr	10 Yr
TSX	US$	-11.7	-10.5	-15.9	-11.7	-7.7	8.4	7.8	5.7
	Local	-9.9	-8.7	-13.2	-9.9	-3.9	8.0	7.6	8.2
EAFE	US$	-19.1	-9.3	-14.3	-19.3	-17.3	1.5	2.7	5.9
	Local	-11.2	-6.3	-7.6	-10.9	-6.1	4.9	4.8	8.8
Euro ex-UK	US$	-23.6	-10.4	-15.3	-23.6	-20.7	2.0	2.9	7.1
	Local	-17.8	-8.5	-10.0	-17.3	-11.3	4.3	4.5	9.0
UK	US$	-8.2	-8.6	-10.5	-8.8	-4.0	1.3	2.3	3.8
	Local	1.7	-5.2	-2.9	1.7	9.2	2.8	3.7	6.5
Pac ex-Japan	US$	-10.3	-8.3	-14.1	-10.8	-14.8	0.0	3.3	5.1
	Local	-7.2	-5.6	-8.6	-7.1	-9.3	0.6	4.7	7.8
Japan	US$	-20.0	-7.9	-14.6	-20.1	-19.6	1.4	2.1	5.9
	Local	-5.7	-2.7	-4.4	-5.7	-1.6	9.5	6.1	11.7
EME	US$	-17.6	-6.6	-11.3	-17.5	-25.0	0.9	2.5	3.4
	Local	-13.7	-4.5	-8.0	-13.5	-19.9	3.6	4.7	6.3
S&P 500		-20.5	-8.3	-16.1	-20.0	-10.6	10.6	11.3	13.0

Source: Credit Suisse, Salt

US dollar strength also indicative of risk aversion

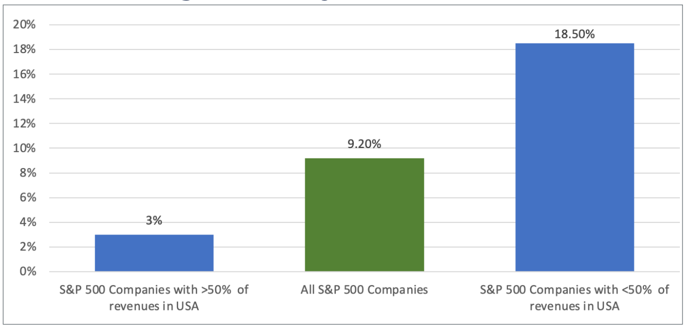
The continuing and powerful rally in the US dollar this year (which had not been the forecast of many commentators) has sent American tourists flooding into Europe and the UK for the northern summer, with their spending power boosted by exchange rate shifts. This is assisting the global tourism industry and supporting activity despite the raft of geopolitical crises causing investor risk aversion at present.

Currencies and exchange rates are also at times important influences on asset market returns. It is important to note the US equity and bond markets are the largest in the world. For companies domiciled in the USA but with global distribution networks, a strong dollar can undermine their total international revenue streams and thus, impact on their earnings. As shown below, much US profit growth recently has been derived from American multinational enterprises. The largest three industry sectors, with 45%

or more of their revenues deriving from outside the US, are Information Technology (58%,) Materials (56%) and Consumer Staples (45%.)

In aggregate, 40% of the S&P 500 companies' revenues are sourced outside the United States. Many corporates fully hedge their currency exposures, but the more anaemic level of earnings growth recently observed from the US domestic marketplace is of some concern. On the other hand, this pattern indicates certain US products may retain pricing advantages in international markets, even as the US dollar strengthens. Active management can focus on such firms- frequently "wide moat" businesses with loyal or locked-in customer bases, superior free cash flow, and organically-growing global franchises.

S&P 500 Earnings Growth by Revenue Source Q1 2022



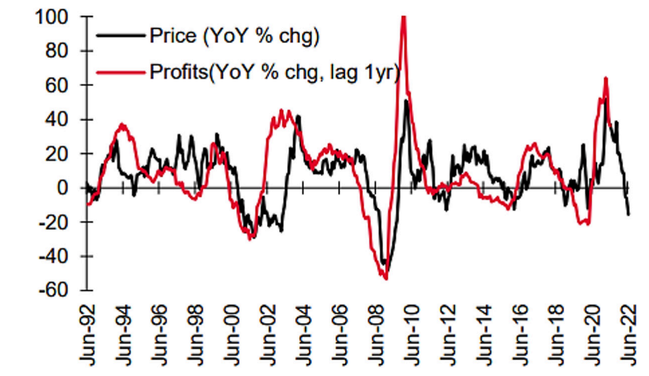
Source: FactSet, July 2022

So, significant gains in the US dollar against other key currencies force US corporate treasurers to hedge extensively, to buy offshore assets, or retain their operating profits offshore (which has become an increasingly thorny political issue on tax fairness grounds.) No country presently has the will to push for a modern-day "Plaza Accord" – the 1985 international agreement to lower the USD exchange rate, considered by many to be a factor in the build-up to the Wall Street Crash of 1987 and the Japanese asset price bubble and crash of 1990-92. Yet, the causes of USD strength forty years ago find some echoes now.

The complication is that the strong US dollar creates problems elsewhere. As central banks fight inflation, they're already trying to extract excess liquidity from their financial systems. Making less money available will help to rein in inflation and slow the economy. As many countries around the world, particularly in emerging markets, rely on dollar-denominated liquidity, that means that even tighter conditions will develop outside the US than within. Central Banks need to be very careful not to reverse more than inflation pressure and be aware that confidence is a critical element in retaining project financing viability.

Global profits are still reasonable, but diminishing:

MSCI World is highly correlated to near-term profits



Source: SG Cross Asset Research/Equity Quant, Factset, Bloomberg

The MSCI World index of stocks in the developed world tends to be strongly correlated to profits growth, with a fall in the Index generally presaging an imminent tumble in profits. That certainly seems to imply that the market is now braced for lower profits, even if the analysts in brokers' research departments don't say so. The Second Quarter profits season about to unfold will be of huge moment, in determining sentiment one way or the other. At present, the S&P 500 is expected to report year over-year earnings growth of 4.5% for the second quarter and full-year 2022 earnings growth of 10.2%. These are not consistent either with recession or enduring bear market conditions, so a resolution is required: either forecast profits need to be sharply lower or investors need more evidence that the US economy is not in fact on the verge of recession. The robust June non-farm payrolls report was a piece of evidence for the latter scenario. The continuing strong labour market supports the Federal Reserve in raising interest rates on their indicated programme in coming months, which has truncated an incipient move lower in bond yields.

Bonds: still "No Time to Buy" but getting closer

We began this year with the warning that Bonds risked substantial further negative returns, even following the impact of rising interest rates in later 2021. Even so, the scale of investor flight from Fixed Interest in the First Half of 2022 has been unprecedented, with substantial negative impact on traditional Diversified Fund models with substantial strategic (benchmark) weightings to both international and domestic bond securities. Break-out inflation and resolute central bank rhetoric has led US bonds to experience their worst six months of performance ever, with the longer-maturity bonds being worst hit.

The total return of US 10 Year Treasuries fell by -10.8% in the first half of 2022, while US Investment Grade (IG) Corporate Bonds lost -14.4% and their Global IG equivalents, -15.5%. Global High Yield (sub-investment grade) bonds have dropped -16.9% in the last six months and Emerging Market Sovereign bonds, by -20% (both on a USD basis). These losses erase years of coupon income and render transitory the mark-to-market capital gains the broad Fixed Interest sector achieved in 2020.

Total Returns

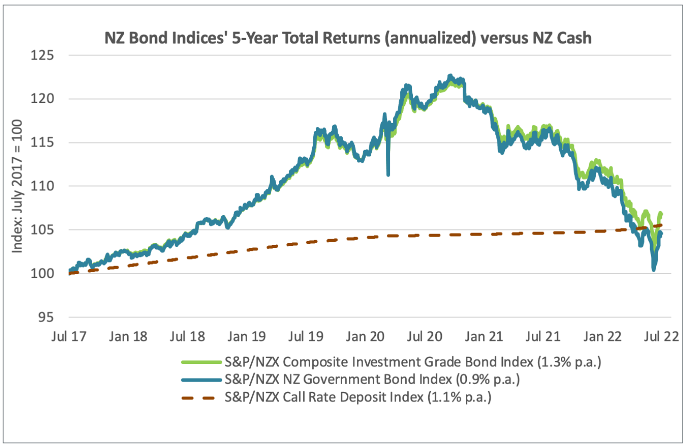
WORLD	June-22 (%) Local Ccy	June-22 (%) in USD	YTD (%) Local Ccy	YTD (%) in USD
Asia $ Broad IG	1.2	1.2	3.2	3.2
EM Sovs	0.0	-6.3	0.0	-20.1
US Broad IG	-1.6	-1.6	-10.3	-10.3
EUR Broad IG	-2.3	-2.3	-12.1	-12.1
Global Broad IG (USD)	-3.6	-3.6	-15.5	-15.5
Global HY (USD)	-7.5	-7.5	-16.9	-16.9

US Fixed Income	June-22 (%) in USD	YTD (%) in USD
Treasuries 10yr	-1.0	-10.8
Securitised	-1.5	-8.7
IG Corporates	-2.8	-14.4
HY Corporates	-6.7	-14.2

Source: Morgan Stanley

On a timeframe out to five years, going back to mid-2017, the annualized nominal returns from bonds have not demonstrated a strong advantage over Cash, and that is due to the artificially low yields that QE induced, which have then seriously hampered total returns since the associated inflation build-up developed. In New Zealand, the Fixed Interest market has also weakened markedly. As is also the case for international government bonds, the recent sharp rises in bond yields have more than erased the returns earned during the Covid shock in 2020.

It is remarkable to note that the NZ 10-Year benchmark yield, which reached a historical low of 0.5% in May 2020, is now yielding 3.6% two years later. While the June yield spike on global and NZ bonds has dissipated somewhat, the upside risk to yields will persist until such a time as either broad consumer prices or labour markets definitively enter multi-month softening periods. That is not yet the case.



Source: S&P Dow Jones Indices, Salt

The domestic bond indices used to track performance across a range of maturities and high-quality debt issuers are back at their late-2018 level. The annualized return over the last 5 years from such bonds as the NZ Fixed Interest Composite and the NZ Government Bond Index is in a range of 0.9% - 2.0% per annum, whilst over shorter periods such as 3 years, the annualized return has turned negative (in a range of -0.5% to -2.5% p.a.) These returns are stated in nominal terms, so once inflation is taken into account, bonds have not preserved purchasing power for investors in recent quarters (even if they have diluted overall portfolio volatility.)

However, whilst not markedly underperforming Cash – particularly after a mini-rally during the last month – it is evident that bonds were very severely overvalued, and their subsequent fall was warranted.

We believe than in years to come, investors will still wish (or need) to purchase both government and corporate bonds and debt securities. However, having learned in 2021-22 that rising yields hit undifferentiated or index-bound Fixed Interest portfolios rapidly, their appetite is likely to become much more selective. One area that we anticipate will see greater interest from both institutional and retail investors is the "sustainable fixed income" domain. For many years, bonds have been a blind spot in otherwise nominally ESG-focused portfolios, with little attention paid to the activities of debt issuers compared to the scrutiny directed at the equity market components. This is now changing, and we will be reflecting this positive and overdue development in our recommendations from later this year onward.

In terms of the outlook for global yields, we do not see a comparable upward surge later in 2022 as was experienced in the last year or so. Nevertheless, there are unusual supply dynamics coming into play this year. Bloomberg has estimated that global government treasuries will issue less bonds by value, but that QE reduction programme dynamics still ensures a rising supply in the market for private investors to absorb. Other things being equal, that implies higher sovereign bond interest rates will be consistent this year and that the tendency will be reinforced by investors seeking yield compensation for inflation risk.

Markets will focus on inflation and political risks

Legitimate concerns about inflation and the prospect of tightening monetary conditions world-wide have triggered phases of "choppy and deteriorating market conditions" entering a technical Bear Market during June, and this may continue for some months longer. Persistent weakness in bond markets, as interest rates across the yield curve increasingly reflect both enduring inflation and more active central banks, eroded a support for the high valuations that US equities achieved. However, a critical point is that equity vulnerability does not equal bond desirability. Bonds may well be the catalyst of erratic equity market returns, but equity markets have the capacity to recover value more quickly and to a greater quantum, than do bonds. We shall therefore only allocate more to Fixed Interest incrementally, and not to broad or over-diversified bond aggregate exposures while future asset class characteristics are being transformed.

History suggests that while interest rate hikes are undertaken to slow overheating economies and bring down incipient or current inflation, as long as they are not initiated too late in the cycle, certain industry segments can continue to accrue positive returns as their earnings increase. The graphic below indicates that as rate-hike cycles are undertaken during non-recessionary periods, but that an economic slow-down is implicit in the tightening process, US market returns in the order of 8% p.a. are still consistent.

We are comfortable with that scenario for 2022-23. Nevertheless, in the rarer instances where economic contraction becomes self-sustaining, such as the early 1990s or 2001-02, it has been prudent to build portfolio exposures in industries where demand is inelastic, such as Health Care and Staples. At present, a well-telegraphed programme of Federal Funds Rate increases in 2022-23, is compatible with moderating economic expansion. However, the 0.75% tightening increments now underway risk moving market conditions into the equity-unfriendly zone

The "slow and systematic" tightening cycle which in US market history (e.g. 1977, 2015) have been consistent with first-year market gains post-initiation of +10% and second-year gains of +2%.

By contrast, investors have historically been unnerved by "fast and furious" interest rate hiking cycles (e.g. 1987, 1994, 1999) wherein first-year returns have averaged -3% and second year returns, +4%. The net returns outcome of the two years' fast-tightening periods is thus, on average, a zero total market return.

Since our last edition of Salt Global Outlook in April, the risks have shifted toward the second scenario of rapid, destabilizing monetary policy adjustment toward a restrictive level, increasing the likely duration of weaker market returns overall. Safer sectors will remain resilient, and quality remains key.

Strategy conclusions

We retain our central market views for the current year, and these are reprised below:

- Equities (as a whole) will potentially see average annual returns close to their long-term norms in the next 3 years with interim weaker periods as presently; selected Equity sectors and markets still have scope for resilience and desirable investment features. There are all-weather stocks that have lagged in recent years.
- For instance, listed real assets have superior, defensible yields and cyclical tailwinds, in a fraught political phase. Real Asset's historical sensitivity to rising bond yields may be counterbalanced by their cashflow surety, inflation-hedging qualities and (for Infrastructure) non-cyclical defensive merit. Bond yields have risen a long way and may now plateau, which is positive for Real Estate.
- Within the broader market sectors, thematic and valuation support in Utilities and Consumer Staples, Healthcare, and Software as a Service (SaaS) Information Technology enjoy pricing power which assists them to ride out sentiment storms and hedge against economic slowdown
- De-rating in very overvalued equities (specific companies, rather than sectors) is now advanced as interest rates moved up substantially. A "hot stock" mentality will persist due to internet chatter, but this tends to be short-term in nature, calibrated for trader holding periods and prone to rapid reversal. Expect more M&A and also, abandoned corporate courtships as conditions shift.
- Despite anticipating volatility as market leadership changes continue, we still prefer equity to fixed income or cash exposure. The negative real (after-inflation) yields dogging fixed income will persist for at least eighteen months and keeps taking much higher fixed income asset class holdings inopportune.
- After the recent and severe global bond sell-off, we do now see a better compensation for duration risk, but it remains inadequate. Within fixed income, thematic support is ready to be a prime differentiator. We acknowledge sustainable or "green" bonds as a valuable emerging theme in this regard.
- Default risk and Credit Quality are likely to become a focus in 2023-4, and set off portfolio re-allocations within and beyond bonds.
- This will set the stage for a global slowdown in 2023 as the tightening of policy around the world continues to impact the real economy, and asset markets adapt to protect existing capital gains by allocating funds toward "all-weather" securities. Such desirable investments, which we are actively seeking out across all our asset classes, are resilient to both inflation and to profit challenges in a less stimulus-based, capital spending and productivity-led phase of economic growth.