This is going to hurt

Headline inflation may have peaked in many countries around the world, but the battle is far from won. Core inflation is proving to be stubborn as second and subsequent rounds of price increases continue to flow through respective economies, while labour markets remain generally tight.

Central banks still have more work to do to constrain demand, though some are closer to being done than others. A brief market flirtation of a pivot from the US Federal Reserve was quickly put to bed by Chairman Jay Powell's speech at the annual monetary policy summit at Jackson Hole where he reasserted his and the Federal Open Market Committee's commitment to winning the battle against inflation. This was a consistent message across all speakers at the summit.

The FOMC reiterated it hawkish stance at its September meeting by delivering a "dot plot" in the Summary of Economic Projections (SEP) that was more aggressive than the market was expecting, adding 0.8 percentage points to the terminal Fed funds rate in 2023.

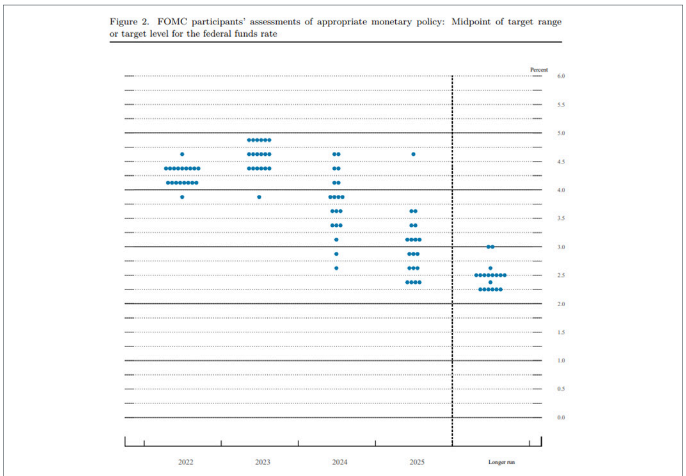


Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate

Similar dynamics exist in other monetary policy jurisdictions as central banks in the Eurozone, the UK and here in New Zealand continue to deliver aggressive rate hikes- even in the face of weakening demand conditions. Having made one serious mistake in dismissing the likely persistence of inflation early on, central banks seem determined not to make another one by being too timid. That of course raises the prospects of tightening too far and causing unnecessary disruption to the real economy.

Central banks are necessarily prioritising the achievement of their inflation mandates over supporting growth. As they continue to up the aggression, the prospect of achieving a soft landing in a number of countries, continues to diminish. We continue to see the weakest point in the economic cycle across a range of countries around mid-to-late 2023, assuming interest rates are peaking later this year or early next year.

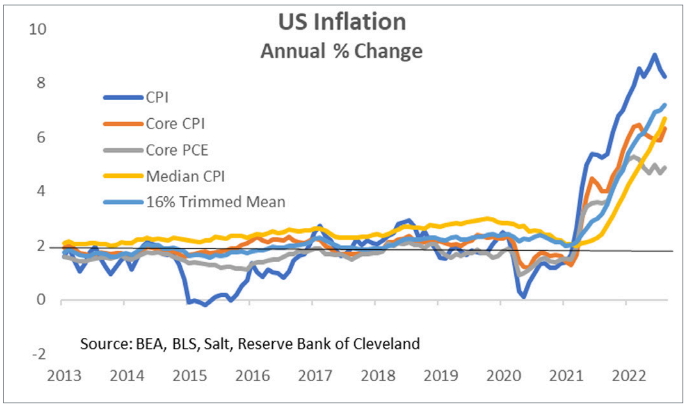
Too early for a "pivot" from the FOMC

One of the key moments of last few months was the July rally in both bonds and equities following the expectation that lower growth and the "roll-over" of headline inflation might be about to lead to a pivot to a less aggressive stance by the Federal Open Market Committee (FOMC).

This was only ever wishful thinking. For a start, the recession caused by the two consecutive quarters of GDP contraction in the March and June quarters of 2022 was purely technical in nature. The decline in activity was narrowly based with key components of real final demand continuing to expand.

Given this and the fact that the labour market was continuing to show robust jobs growth, the recession would therefore never meet the definition of an economic recession as defined by the US cycle dating agency, the National Bureau of Economic Research.

But more importantly, while the August US CPI result saw a further softening in the annual rate of headline inflation, the annual rate of core inflation rose. This supports our view that while headline rates of inflation around the world may receded quite quickly over the next few months, core inflation will prove to be more "sticky" and difficult to get back under control.



Odds of US recession rising

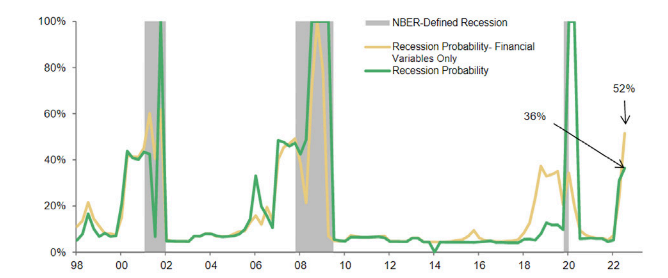
The FOMC's hawkishness is being driven by the fact that outside the core interest rate sensitive sectors of the economy, there has been little sign of the real economy responding to the interest rate increases to date. And while the growth environment has softened somewhat, inflation has proven more resilient, especially core inflation.

With the now more hawkish stance of the FOMC, and the fact that much of the tightening to date is still yet to impact on the real economy, the economic environment looks weaker in 2023 with sub-1% GDP growth now likely next year.

The extra tightening means the weakness in the economy will be more broadly felt. Consumption will weaken further with the most significant weakness felt in the interest rate sensitive durable goods sector. Business investment is also likely to turn negative around mid-2023.

Research from our partners at Morgan Stanley Investment Management shows the odds of recession in the US remains sticky at 36%, while the financial-variables-only version has jumped to 52%, the highest reading since March 2020. The difference between the two readings is explained by two things. Firstly, policy uncertainty in the US and across global financial markets has reached nail-biting heights. Secondly, economic variables are providing an important counterbalance. Strong job gains, lower jobless claims, and recent improvement in consumer sentiment have kept the overall recession probability from rising alongside financial market turmoil.

Exhibit 2: Tighter Financial Conditions Have Moved Our Financial Variables-Only Model Higher



Note: Variables included in the full model (MSRIREC): Yield Curve Slope, 10Y Treasury 3y differential, ISM Mfg New Orders, Single-Family Housing Permits, Initial Jobless Claims, Unemployment Rate, PCE Inflation, Michigan Consumer Confidence, S&P 500, Vehicle Sales, and CRB Metals Index. Variables included in the financial variables-only model (MSRIRECF) include the Yield Curve Slope, 10Y Treasury 3y differential, S&P 500, and CRB Metals Index.
Source: Morgan Stanley Research

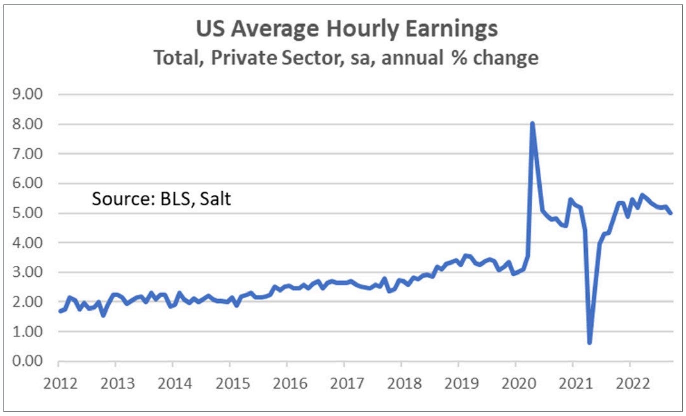
But all of that can change quite quickly as the lagged effects of prior tightening's, let alone tightening's still to come, impact on the economy.

Inflation is driving the tightening, the labour market will drive the pivot

Central banks key objective right now is to bring their respective economies back into balance so that demand is more in line with the economy's ability to supply.

Tight labour markets, or more precisely strong wage growth, is the key driver of generalised inflation pressure right now. To bring core inflation back to target, wage growth needs to be brought back to a level consistent with mandated inflation targets.

In the US, the annual rate of wage inflation is running at 5%. That is inconsistent with a 2% inflation target. Assuming productivity growth of 1% per annum, we believe the FOMC would be more comfortable with wage growth running at around 3% per annum.



Achieving that level will require a significant softening in the labour market, where "softening" is euphemistic for a necessary rise in the unemployment rate. The FOMC, on average, sees the longer-run unemployment rate that is consistent with achieving its mandate at 4.5%. That's a considerable distance from the current rate of 3.5% recorded in September.

So, the unemployment rate needs to rise. But there's two ways that can happen: either employment falls as people lose their jobs, or the rate of employment growth slows to below that of the growth in the supply of labour. We recently saw the latter scenario briefly in action as the August employment report recorded solid jobs growth, while the unemployment rate rose as the participation rate recovered.

For most households, the defining of the slowdown as a hard or soft landing will depend on which of these labour force dynamics proves the dominant force.

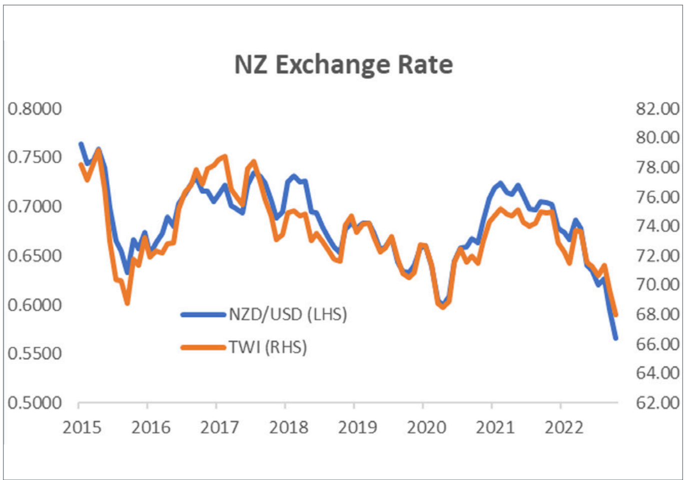
USD strength = NZD weakness

As the FOMC has become more aggressive, the US dollar has continued to rise. While it is starting to look a little stretched, it's hard to see any imminent catalyst for a retreat in the "big dollar".

Of course, the strength of the USD is just not monetary policy related. The USD continues to play its role as a safe-haven currency, which has seen the USD rise on the back of several factors including the ongoing conflict in Ukraine as well as the now partly reversed, but still ill-advised, fiscal package announced by the new UK Prime Minister and Chancellor.

The strength of the USD is not causing US policy makers any concern, making any intervention unlikely. It's recent trade-weighted strength is not excessive when compared with previous periods of strength and is in line with the broad tightening in financial conditions the FOMC is seeking. It will, however, add to concerns over corporate earnings for those that earn their revenue abroad.

But USD strength means exchange rate weakness for most of the rest of the world, and higher imported inflation. This is problematic in an environment of already high and generalised inflation. On the plus side, weaker exchange rates provide a growth buffer for export-oriented economies as global growth continues to slow into next year.



The NZD has already weakened considerably as the USD has risen. Since the start of the year, the NZD has declined 17% against the USD, while the Trade Weighted Index (more important from the RBNZ's perspective) is down 8.3%. But with the FOMC only recently flagging a higher terminal Fed funds rate than the RBNZ is projecting for the OCR, interest rate differentials and further NZD weakness may have implications for domestic interest rates.

So, when will enough be enough?

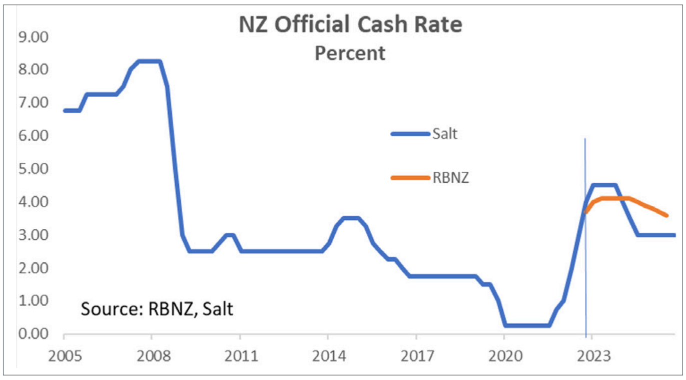
Over recent meetings, many central banks have signalled their intention to raise rates further than they have signalled previously. That has seen markets price in terminal monetary policy rates of 4.5% in the US, 3.5% in Europe, 5.75% in the UK and 4.8% here in New Zealand.

Whether that is too much, or not enough, remains to be seen. But such has been the scale of the increase that a new risk has emerged recently – the risk of overtightening and causing unnecessary damage to the real economy.

What we do know is that such is the generalised nature of current inflationary pressures that monetary conditions need to become restrictive, meaning that interest rates need to move above their neutral level.

New Zealand is most advanced in that journey. While all central banks were late to recognise the persistent nature of inflation as it emerged, the RBNZ was first to pivot. At 3.5%, the Official Cash Rate (OCR) is already higher than the RBNZ's assumed neutral rate of 2.0%. In the US, with an assumed neutral rate of 2.5%, monetary conditions have only just become restrictive.

There is an inherent lag in the setting of monetary policy. Actions taken today only have their full impact on the economy 12-18 months out. There is, therefore, a lot of tightening that has already happened and is still yet to have its full influence on the real economy. At some point central banks will need to pause and allow the data to catch up.



In New Zealand, there is a scheduled pause not too far away. The RBNZ's last meeting for the year is in November. They are not scheduled to meet again until February.

We expect the RBNZ to hike a further 50 basis points in November, taking the OCR to 4.0%. We also expect them to raise the projected terminal rate from 4.1% to around 4.5%. That would be in line with our forecasts. We have pencilled in a further 50bp hike in February next year for a terminal rate of 4.5%, based on the likely persistence of USD strength and NZD weakness, and brings the previously upside risks around our OCR forecasts more into balance.

Recession most likely in Europe

The energy crisis continues to dominate the headlines in Europe as Russia halted all gas flows through the Nord Stream 1 pipeline in early September, though this did not lead to a further spike in gas prices as above average imports of liquefied natural gas is helping fill the shortage ahead of winter. Proposed measures from the European Commission including a plan for EU-wide energy savings are also reducing market tensions.

Activity data has continued to weaken, and recession now appears more likely than not. PMIs are in contractionary territory; industrial production is falling, and consumer confidence dropped to an all-time low in September.

However, with inflation still stubbornly high, the ECB will continue to hike interest rates. CPI inflation reached 9.1% in August and is expected to reach 10% in the next few months. The ECB hiked interest rates 0.75% in September and is expected to deliver another 1.00-1.25% by the year, confirming the prioritising of achieving its inflation mandate over supporting growth.

UK economy losing momentum

Recent UK activity has shown the expected loss of momentum as consumer confidence hit an all-time low in September and PMIs moved further into contractionary territory. The labour market remains a bright spot with the unemployment rate falling to 3.6% in July, its lowest level since 1974. However, in a now somewhat familiar story around the world, that tightness in the labour market continues to put upward pressure on private sector wages with the annual rate of increase now at 5.5%.

It's therefore not surprising that inflation remains problematic. While the annual rate of headline inflation dipped back below 10% in August, the annual rate of core inflation rose from 6.2% to 6.3%, again exposing the stubbornness of core inflation pressures.

The Bank of England therefore still has work to do, a situation that has only been exacerbated by fiscal policy developments.

UK fiscal policy shambles

When Donald Trump was elected US President in 2016, there was widespread concern about what policies a populist US President might enact. At that time, we made the point that markets would provide a strong discipline on misguided policy initiatives, especially when it came to monetary and fiscal policy.

That point is just as true for the UK in 2022. The announcement of a significant package of unfunded tax cuts by the new UK Prime Minister and Chancellor were met with a violent but entirely appropriate reaction from financial markets.

The tax cut package was surprising for a number of reasons:

- It ignored the Bank of England is already hiking interest rates to rein in rampant inflation. Tax cuts could only add fuel to the fire the Chief Economist at the Bank of England quickly asserting that the package will mean higher interest rates.
- The package came with no plan for long-term fiscal sustainability. That, apparently, was going to come later. It was the very lack of long-term fiscal plans that fuelled the flames of the Eurozone debt crisis a decade ago.
- The announcement was tone deaf to rising inequality, arguably the biggest political challenge of our age and the greatest threat to capitalism. Lower taxes for the rich and higher mortgage rate for middle-income UK was never going to be a political winner.

Markets are already on edge, fretting over high inflation and rising interest rates, the probability that those high interest rates will tip a number of economies into recession next year, the UK included, and high and rising public debt levels. It's not surprising that markets reacted the way they did, with a drop in the UK pound, sharp falls in equity markets (which extended beyond UK shores) and a sharp spike in bond yields.

Markets were only calmed by the Bank of England's announcement of its intention to buy UK gilts in whatever quantity is required, a move that is completely the opposite direction of their current policy positioning to tame inflation.

More recently there has been a backdown of sorts as Chancellor Kwarteng ditched the part of the plan that saw a lowering of the top marginal tax rate. While this part of the package was probably the most insignificant in fiscal terms, it was the most politically contentious and its political fallout was deeply damaging to the Government. A recent YouGov poll put the opposition Labour party 33 percentage points ahead of the ruling Conservative party.

This is not the 1980s, Prime Minister

UK Prime Minister Liz Truss has made no secret of her admiration for former UK Prime Minister Margaret Thatcher. That makes the recent mini budget more surprising, as Truss has not followed the same policy path as her- hero, even in a glaringly similar set of circumstances.

In the early Thatcher years, the UK was suffering much the same problems as the UK of 2022. Inflation was high, interest rates were rising and there was an uncomfortably large budget deficit. But rather than cut taxes as Truss and Kwarteng have proposed, the Thatcher Government RAISED taxes in 1981, which set the UK on a firm path towards fiscal consolidation.

While there are some similarities between today's UK and that of the 1980's, there are also some stark differences. In the 1980s, the key macro-economic challenge was achieving a better balance of power between workers and the owners of capital. Many would argue that in 2022, that balance has shifted too far and is in dire need of some rebalancing as wide inequality gaps have opened up, both in terms of income and wealth. Trickle-down has been found wanting.

Today, the primary policy challenge for most developed economies is achieving higher rates of productivity growth. This is important in a world of falling working age populations and rising dependency ratios, especially if we want to at least maintain current living standards.

But there is no silver bullet answer to achieving higher productivity. The answer will inevitably be the result of an accumulation of thoughtful and nuanced policy decisions across a range of areas. Therein lies the challenge for today's political leaders.

China still fragile

Cast your minds back to the darkest days of the Global Financial Crisis. You will recall that as the developed world entered recession, China played a key role in supporting global demand. Here we are now in 2022 with aggressive tightening from developed world central banks and rising recession risks in a number of key developed economies. Can we rely on China again?

Despite better economic data recently, the Chinese economy remains fragile as it confronts several headwinds including its zero-Covid policy, weather-related disruptions, and weakness in the housing market.

Given the benign inflation environment, the PBoC has eased monetary policy further and the State Council has announced new fiscal measures to support the economy. Towards the end of September Beijing announced new easing measures for housing and infrastructure, though these actions remain small and incremental.

There is still work to do on housing and Covid-restriction, which will hopefully manifest after the Party Congress in a few weeks. Failure to deal with these issues will perpetuate the fragile growth environment with little chance of China helping the global growth environment as it has done in the past.

RBNZ with work still to do

As mentioned above we recently raised our terminal OCR forecast to 4.5% by February. This is on the back of the recent weakness in the NZD (strength of the USD) at least some of which can be sheeted home to the "dot plot" increase in hiking expectation by the US Federal Reserve. With nothing on the horizon to change the story, we think that weakness (strength) is likely to persist, if not intensify.

The RBNZ delivered the latest instalment in the hiking cycle at its monetary policy review in early October, raising to the OCR by 50bp to 3.5%.

It was a "hawkish hike" in the sense that the summary record of the meeting stated explicitly there was contemplation of hiking 75bp. The debate around those options highlighted the looming judgment challenge for the Monetary Policy Committee: what impact will the interest rate increases already delivered have on the economy, and how much more do they have to do.

As stated above, we expect a further 50bp hike in the OCR to 4.0% in November and an increase in the projected terminal rate to around 4.5%. That means the RBNZ can go into the "summer hiatus" with a hawkish bias. Three months is a long time for interest rate markets to navel gaze without guidance from the central bank.

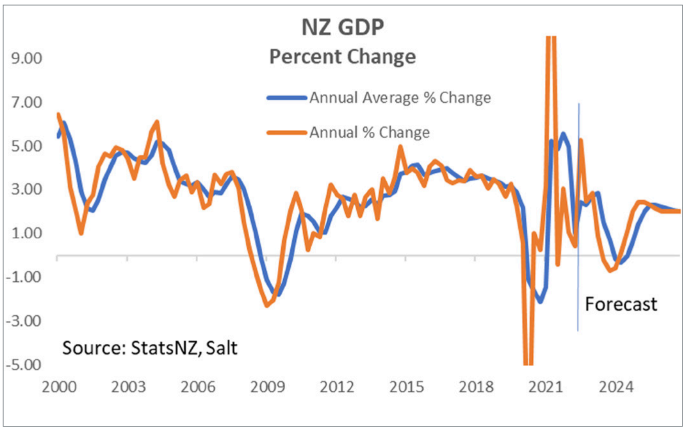
NZ growth data – underlying trend hard to discern

In New Zealand second quarter GDP data came in stronger than expected, though the underlying detail was soft as consumer spending dropped sharply. The 1.7% increase in the quarter followed -0.2% in the first quarter of the year with Covid-disruptions mostly responsible for the volatility.

While the March overstated the weakness in the economy, the June quarter overstated its strength. Taking the two quarters together for 1.5% over six months is probably a better indication of how the economy was performing over the first half of the year.

It's not until we get the end of the year that we will have a clearer picture of the underlying strength, or otherwise, of demand. In general, we expect the greatest weakness will emerge in consumer spending as the pivot from goods to services proves insufficient to offset the weakness induced by higher interest rates and falling house prices. That said, with borders now fully open, tourist flows will continue to provide some buffer. We also expect a sharp slowdown in residential construction to emerge in the coming months.

We continue to see the weakest part of the growth cycle from mid to late next year where we have pencilled in several negative GDP quarters from June 2023 until the RBNZ start to ease monetary policy in the early months of 2024. This reflects a number of factors: the erosion of real incomes by high inflation, higher interest rates, the slowing global economy and flat-lining population growth.



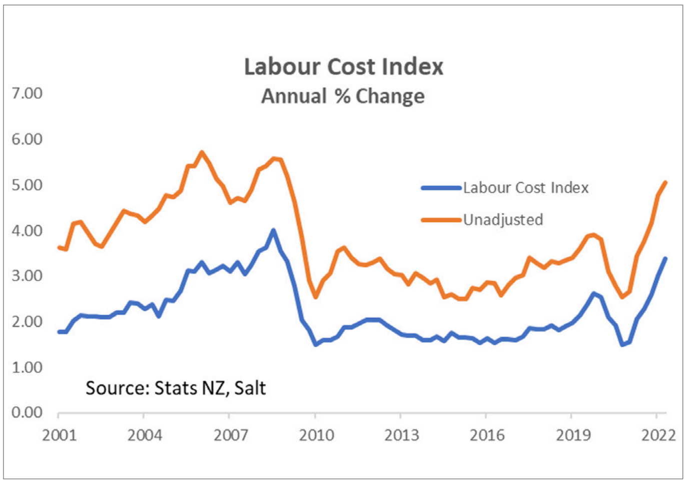
The labour market holds all the cards

We believe we have seen the peak in headline inflation at 7.3% and expect it to recede rapidly as last year's commodity price fuelled increases are not repeated and more recent commodity price falls are captured.

But as with other countries, we expect the lower headline rate to expose the stubbornness of non-tradeable or domestic inflationary pressures. This more generalised core inflation is being fuelled by the tight labour market and wage increases that are running at a level inconsistent with a 2% inflation mandate.

There has been no employment growth in New Zealand for three-quarters. This is mostly a function of the lack of supply. We know, albeit from anecdotal evidence from companies we talk to, that there is still strong demand for both skilled and unskilled workers.

This is continuing to put upward pressure on wages. The latest Quarterly Employment Survey showed private sector wages rising at an annual pace of 7.0%, while the Labour Cost Index (closer to measure of unit labour costs) rose at annual rate of 3.4%. The latter measure needs to fall back to 2% to be consistent with the RBNZ's mandate.



This situation may get worse before it gets better. While borders are now fully open again, it will take inward migration a while to fire up again. In the meantime, we expect to continue to see a backlog of young Kiwi's heading offshore for their OE. It appears the unemployment rate may have bottomed, but we wouldn't be surprised to see a further dip lower before it starts to head back to the RBNZ's desired 4.5%.

Having waxed lyrical on productivity above, it would be remiss of me not to point out (again) that net inward migration is not a solution to our broader economic challenges. The strong net gains of migrants of recent years certainly helped boost GDP growth but did not help us solve our primary challenge of poor productivity and low per-capita GDP growth. That requires a different plan which will be the subject of an upcoming Salt Insights paper.

Outlook for New Zealand Equities

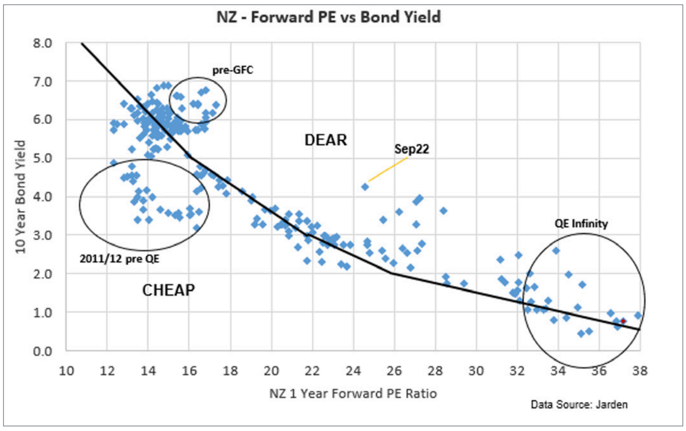
The NZ equity market defied a difficult economic backdrop to post a +2.0% advance in the September quarter. This moderately outperformed the flat Australian market which rose by +0.4% and was well in advance of the MSCI World Index, which declined by -6.2%.

In an overall context, earnings season during August was not as bad as feared, with it perhaps being a touch early for the results of many NZ companies to reflect deteriorating demand conditions and incessant cost pressures, which can only be passed on to varying degrees. It is fair to say that the jury remains out on the earnings path from here but risks to broker forecasts would appear even more skewed to the downside than is generally the case.

The other key factor driving markets were on again, off again expectations regarding whether central banks in NZ and globally may pivot and pause rate hikes, or conversely, whether they need to go harder. This saw NZ 10-year bond yields fluctuate from 3.89% at end-June to a low of 3.33% during August, before ending the quarter at 4.24%.

The RBNZ moved twice to lift its OCR target from 2.5% to 3.5%, with the move in September being more hawkish than expected given the revelation that they debated making a 75bp move. This was in stark contrast to the rather erratic RBA, which only tightened by 25bp despite a plethora of inflationary evidence. The weakness in the NZDAUD was a support for NZ equities given many companies have operations in that country. It has weakened from 0.955 to 0.874 over the last year and from 0.905 to 0.874 in the quarter.

So far this year, the NZ equity market has declined by -15.1% but this has been accompanied by NZ 10-year bond yields rising from 2.37% to 4.34%. As shown in the chart below, this means it is somewhat cloudy as to whether the NZ market has become any cheaper.



Above chart looks at the one-year forward PE ratio for the "core" market (ex-property companies and Air NZ). The inverse relationship with bond yields is clear-cut. As at end-September, the forward PE appeared somewhat expensive relative to history, being well to the right of the fair value line. However, the composition of the NZ market has changed in recent years, with the large gentailers having PE ratios that dramatically understate their free cashflow.

Using the median PE ratio of circa 16x places the market at around fair value at current bond yields. This also lines up with the old-fashioned rule of thumb of the "rule of 20". This states that the PE + inflation is fair value at 20x. If we project that forward inflation will stabilise in the 3%-4% region (from the current 7.3%) then a median PE of 16x is about where it should be.

This leads us to reiterate our view from last quarter that the key to the equity market outlook from here is earnings forecasts. Long bond yields in the low-mid 4% region are perfectly consistent with an inflation rate that has peaked but which looks likely to be sticky at or above the top end of the RBNZ's target range.

There were certainly fears around how the August earnings season would play out, but companies were a little more resilient than expected. However, cost pressures are only intensifying and the ability for companies to recoup these and maintain margins against a backdrop of a slowing economy is unclear. In the latest ANZ Business Outlook

Survey, a staggering net 89.8% of firms expect to face higher costs over the next year, 68.0% expect to lift their selling prices and a net -24.3% expect their profits to decline.

A major theme across equity markets at present is to look for stocks with pricing power, on the basis that they can recover these cost pressures. This seems sensible but a fascinating Wall St Journal article in September by well-known columnist, Jason Zweig examined which sorts of companies fared well in the last stagflationary episode in the USA.

He looked at the best US performers from early 1966 to late 1982 and two quite disparate themes became apparent. The major outperformers were stocks that were i) very cheap; or ii) had secular growth drivers completely unrelated to the stagnant economy. This had nothing to do with pricing power, it was all about being too cheap (insurers and some banks) or having growth irrespective of the tough backdrop (nascent personal computer companies). This may hold interesting lessons for investing over the period ahead as it looks more and more like a mini repeat of the 1970's.

NZ equities are not easy to analyse by sector as frequently the sectors are dominated by just one or two companies which move according to their own individual drivers. However, there are some clear potential winners and losers.

After years of very strong performance, the property sector has lagged, with a return of -19.4% in 2022 versus -15.1% for the market. It takes time for inflation to be captured in rent increases, but cap rates are on the cusp of expanding quite quickly and the market has rapidly priced in the consequent lowering of NTA's and lifting in gearing. Industrial property remains the strongest sub-sector, while retail property should in theory capture inflationary rent increases soonest. However, an absence of population growth and an ongoing move to online is leaving them somewhat exposed.

Companies' exposure to the rapidly weakening NZ$ need to be assessed with care. Negatives are the likes of Air NZ, Sky TV and domestic-centric retailers such as The Warehouse. Positives are exporters such as Fisher & Paykel Healthcare (albeit with long hedging lags), Delegats, Comvita et al.

A key question at present is assessing the fair value of companies who benefitted enormously from Covid disruptions. Rampant transport costs (Mainfreight) and a building boom (Fletcher Building) have now peaked and are turning down. The market is forward-looking and these two key names are now 30% and 35% below their recent highs respectively. Consensus earnings expectations still appear too high but even on Salt's own lower forecasts, some value is apparent.

A sector which is significantly off its highs but where caution is still needed is that of retirement villages. Housing sector transactions have dried up and prices have fallen sharply from their bubbly highs of 2021. This hurts the retirement villages in terms of the price they can on-sell units for and in their ability for potential residents to sell their house. To date, most villages have reported surprisingly robust sales, but the future holds significant risk. Meanwhile, care costs are rampant and insufficiently funded by the Government.

Finally, here, in light of the WSJ article highlighting those names that outperformed in the stagflationary 1970's, what NZ names might be similarly poised today? The most obvious acyclical secular growth stock is Fisher & Paykel Healthcare, which has been sailing in very choppy waters post-Covid. Taking a medium-term view, FPH should pass through this turbulence from temporary overstocking. Names with long, albeit slightly cyclical, growth runways include Ports of Tauranga and Mainfreight. In terms of stocks that are simply too cheap, the most obvious contender in the Salt portfolios is Tower, whose forward PE path reads 10.4x, 8.0x and 6.9x on consensus numbers.

To conclude, the NZ market has retraced sharply in 2022 but its return of -15.1% has outperformed the MSCI World's decline of -25.4%. Sharply higher bond yields make sense given the inflation outlook and equities appear to be around fair value given the bond yield move. The key risk from here is that we see earnings downgrades as NZ and many economies may be entering a stagflationary economic period. The lesson from the 1970's was to own secular growth stocks and companies which were simply too cheap – a true growth and value bar-bell!

Implications for Investors

Inflation angst and Russian roulette

With only 3 months remaining, 2022 has demonstrated the speed with which changing economic and geopolitical circumstances can alter the tone and direction of investment markets. That is particularly true if assets earlier 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 in the energy price, and security shocks unleashed by Russia's invasion of Ukraine, set off a sharp fall in asset values. With brief respites, most markets, whether they be equities, bonds or metals, or non-USD currencies have endured a grind downwards which has few precedents for breadth.

The bigger picture is that since the early days of the secular (i.e., measured over a decades-span) bull market which started in 2009, equities have benefited consistently from QE (quantitative easing) and zero interest rate policies (ZIRP). As persistent inflation arrived in 2022, markets have been rattled by reversals in those highly accommodative and supportive policies, worried about the economic and earnings impact of quantitative tightening and central bank rate hikes designed to quell the rising prices by initiating an extended phase of positive real interest rates. Within this post-GFC secular bull period, there have been both short-lived corrections and mini- or cyclical bear phases. However, until this present year, the widespread investor judgment was that whether because of corporate health or government assistance, the key investment asset classes were secure and "buying the dips" remained the successful strategy.

Astute commentators now agree that the outlook for asset market returns has likely entered a "new era," where widely dispersed returns outcomes are probable for at least the next decade. The end of the monetary back-stop years, when central banks underwrote a range of risks and adjusted interest rates very cautiously - for fear of causing capital value losses in portfolios - now seem finished. This is not because the world's monetary authorities have lost their taste for managing investors' expectations and preventing sharp re-valuations periodically occurring in markets, but rather because the reality of substantial and "sticky" inflation pressure no longer makes paramedic-style monetary interventions useful for insulating the economy as a whole.

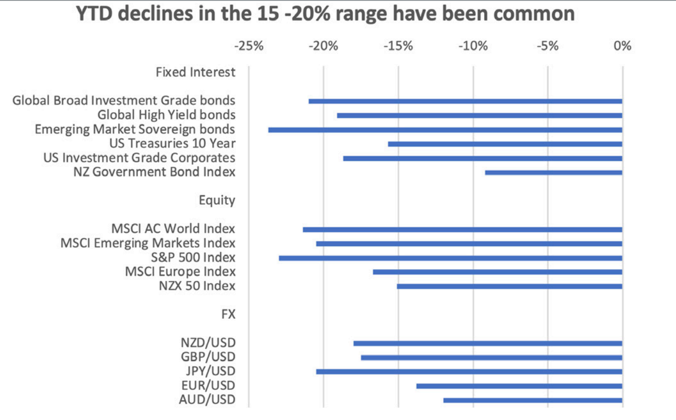
This has many implications. The first is that wholesale dip-buying is no longer to be encouraged. Instead, it is better to identify a set of very good quality securities and allocate funds to them at times when their prices are too low given their longer-term favourable fundamentals. Choppy markets like those prevailing in 2022 are usually more fertile for active management approaches and staying positioned too close to an asset class benchmark can be seriously deleterious to absolute returns.

The second implication is that investors now have to plan portfolios in the knowledge that in future years, global monetary authorities will proceed more carefully with both interest-rate suppression through ultra-low policy interest rate and with offering the extreme balance sheet expansions at crisis moments that have muddied the meaning of "risky securities." Central Banks appear to have needed an outbreak of serious inflation to appreciate that undercutting the market-set risk premia for freely traded assets should not be allowed to persist for several years at a time. No market-believing macroeconomist would consider it desirable for activist Central Banks to retain as much influence on the prices of large swathes of the investment landscape as they have had in the last few years.

2022's Twenty-percent Tumbles

While equities first entered a technical "bear market" in June, having fallen by 20% from their January peak, the decline arrested temporarily in July, and a premature belief in a Central Bank pause in the rate-hiking agenda (the notorious "pivot") held sway for a few weeks. However, August's and especially September's data and pronouncements have put paid to the view that the corrections that took place during the First Half Year are the end of the story.

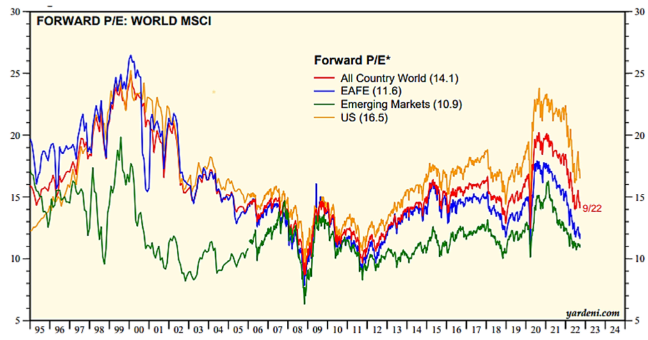
As the Third Quarter closed, a remarkable range of investment indices and exchange rates had logged declines of up to 20%, on a Year-to-Date (YTD) basis, as the chart below shows.



Source: Morgan Stanley, S&P Global (data to 30 September 2022, shown in local currency terms)

As at the beginning of October, while extreme moves have already occurred across a range of asset classes, overall direction is uncertain. It is important not to interpret the re-pricing seen over the last nine months as a "death-knell" for a navigable investment environment. The adjustments underway this year 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. Nevertheless, the unneeded complications of a global energy shortage arising from both geopolitical and climate risks have made the year particularly challenging and unclear. So, while a re-pricing of uncertainty would have been a healthy development, the risk now is a self-reinforcing cycle developing of "price pessimism" which anticipates a failure on the part of monetary authorities to contain inflation without inducing a deeper global downturn than desired.

Darkest hour right before the Dawn?



Source: Yardeni Research, I/B/E/S, Refinitiv, MSCI

The valuation level of the MSCI AC World Equity Index (shown in red, below) has now returned very close to its long-run average level of 14 times earnings (on a 12-month forward consensus EPS basis.)

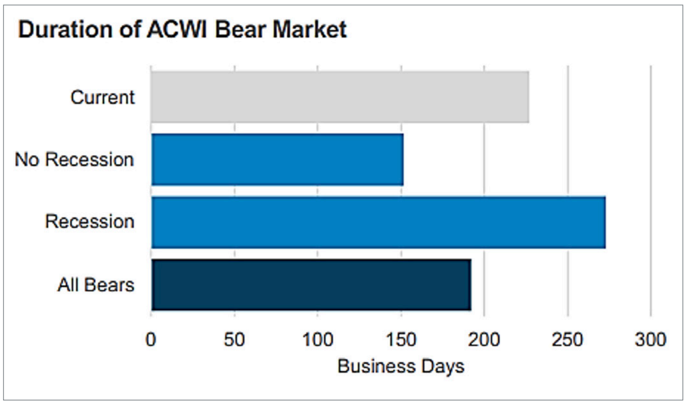
The degree of restored "reasonableness" in current equity valuations is concealed somewhat by the still above-average level prevailing for the US market, because Europe and the UK, not to mention China and many Emerging Markets, are now trading at forward P/E ratios of around 10 times, at the low end of their historical ranges. Of course, prospective corporate earnings may be still overstated, were a deep recession to develop in the course of 2023. Nevertheless, that risk is increasingly visible in market pricing, and so far, earnings have been mildly better than expected despite a range of cost and efficiency headwinds.

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. Our global equities partner Morgan Stanley Investment Management (MSIM) has been among the most cautious of the major international houses regarding this year's equity market prospects, with consistently bottom-of-pack year-end Index targets, and skepticism about short lived market rebounds. However, the MSIM team have recently noted that over the next six months, more signposts will emerge that can determine the scope for a recovery in 2023 for international share markets. They take a balanced view of the likely dynamics, as there are two scenarios depending on whether a recession is allowed to develop with growth a casualty in the fight to lower inflation levels. In Morgan Stanley's view, there are both positive and negative risks at this juncture.

Patience is endurance fortified by memory

Global equities' sell-off looks 'long-in-the-tooth' compared to an average bear market. Historically, bear markets tend to last around 9-10 months (or, almost 200 business days) but there is quite a difference between non-recession episodes and episodes accompanied by recessions (as subsequently defined by the National Bureau of Economic Research, the US cycle dating agency) tend to last four months longer. 2022's bear turned 9 months old as October began.

The bear market in MSCI All Country World equities has now lasted longer, and been more severe, than in prior episodes over the last 30 years. This latest (September) sell-off looks especially mature outside the US. This indicates that for World equities, the greater part of the concentrated negative-returns period may be already passed, conveniently the downturn can be dated to the index peak on 4 January this year



Source: Morgan Stanley Research

The divergence of the bear market duration is more extreme is we consider just US equities, for example the S&P 500 Index. Recessionary bear markets for US stocks last much longer (26 months on average) than non-recession bears (which have just a 6 months' average duration) in the key US Index's historical performance. Furthermore, the peak-to-trough market decline in value terms is around 8% weaker in the recessionary episodes, than in the non-recessionary ones. In round numbers, were the recession-confirmation repricing to repeat over the 2022-23 timeframe, one could see a bottom on the S&P 500 of 3,400 which is 10% below its value as of October 7th. Note, though, this is simply an extrapolation from historical averages rather than a prediction, as all market cycles have substantially different drivers.

Another way of gauging the degree to which the recession risk is already "in the price" of equity markets is to look at the typical fall in Price/Earnings ratios during bear market episodes that are harbingers of recessions. Bear markets associated with US recessions tend to see more severe de-rating than an average bear market: specifically, -25% versus -19%. The current episode has seen MSCI All Country P/E ratios drop by roughly 24%, which is in line with historical recession-associated bear markets. As MSIM analysts succinctly summarized at the end of the turbulent Third Quarter, "markets have actually already seen the degree of multiple de-rating and decline in consensus growth that's typical in recessionary bear markets. However, we've still not seen the negative earnings revisions or Equity Risk Premia widening that signals a 'normal' bear market, let alone a slowdown-related one."

Recession case is gaining traction

The clear determination of the preponderance of central banks not to allow inflation expectations to assume a rising future path has increased the possibility of a "policy error" – an over-tightening triggering recession. However, while this is undeniably gaining traction, it is not yet a fait accompli and investors have on the whole been unwilling to drive share prices down more than -20% from their cycle peaks for multi-week periods. Somewhat bizarrely, the bear market we are currently in remains long but shallow by historical standards. The jury is still out, and the labour market will ultimately tip the balance.

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. The low interest rate / stock price multiple expansion years saw unsustainable extremes and bred bouts of euphoria, which has now fully reversed into almost unprecedented pessimism (at least, as expressed in the low current global fund managers' weighting to Equities, where a net 30% are underweight.)

Source: Bank of America, Financial Times

Defensive sectors still bearing up

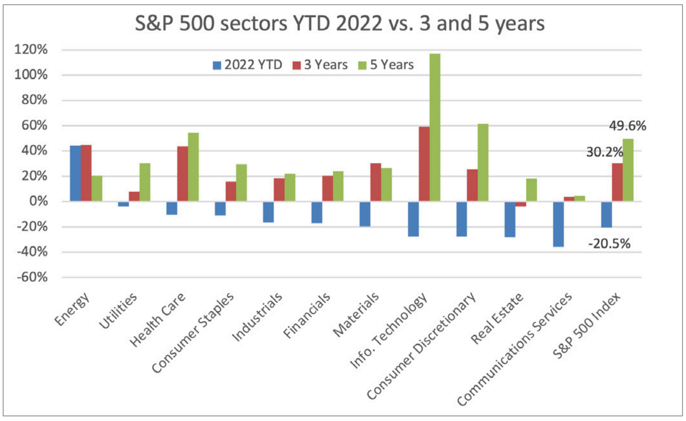
With this in mind, it is revealing to compare the S&P 500's 2022 sectoral returns with their 3-year and 5- year cumulative returns to October 2022. While this year, Energy has remained the strongest sector, followed up by declines in Utilities, Health Care and Consumer Staples, the picture changes when viewed from a 3-year standpoint. Since October 2019, Information Technology's performance is still the strongest, with the sector's return leading its runner-up, Health Care, by 16% (+59.4% for IT versus + 43.6% for HC.)

Over 5 years, IT still substantially leads cumulative returns, with close to double the return from Consumer Discretionary and Health Care stocks within the S&P 500 Index.

Moving the focus back to 2022, there is a marked underperformance of sectors that are highly sensitive to interest rates and forward discount assumptions – notably, Communications Services, IT and Real Estate. That is entirely consistent with an equity market rapidly coming to terms with monetary tightening.

The fact that Industrials and Financials, while negative this year, are placed in the performance mid-field suggests a tug-of-war between scenarios of economic expansion and contraction remains unresolved. So far this year, Health Care and Staples have declined by around half that of the broader index. Over the last 12 months, the bias has moved more toward the defensive end of the spectrum, with Utilities (+8%) along with Staples and Health Care the only sectors besides Energy to have recorded (low) positive returns.

Gains in Energy aided Utilities while Health Care and Staples are resilient



Source: Bloomberg, Fidelity. Last data point 4.10.2022

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, though the latter has weakened in September. This is to be expected, as uncertainty is extreme and investor conviction in any given outcome, low. So, the medium-term equity investors' focus is evidently in transition, away from the companies which profited from the long downward path in interest rates combined with sustained global economic expansion, toward those less reliant on operating in a beneficent economic cycle. Similarly, companies with global supply-chain exposures or the need for a large international / export sales share are being viewed more skeptically than those with large domestic customer bases and greater security of supply.

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: the "Classic Portfolio" challenged

The first three quarters of this year saw negative real 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 nine-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 first table below shows the after-inflation (real) returns for a range of international assets over the last five years. while the second table shows the nominal annual returns from the typical US-based balanced portfolio. Severe losses on bonds this year impact markedly.

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

2018	2019	2020	2021	2022 YTD
USD Cash (0%)	S&P 500 (29%)	MSCI CN (28%)	REITS (32%)	Commod. (1%)
US 2yr (0%)	REITS (26%)	US Small (18%)	S&P 500 (20%)	USD Cash (-5%)
US 10yr (-1%)	US Small (23%)	MSCI EM (17%)	Commod. (18%)	US 2yr (-10%)
US Agg (-2%)	MSCI EU (22%)	S&P 500 (17%)	MSCI EU (9%)	EM Local (-19%)
TIPS (-3%)	MSCI CN (21%)	MSCI JP (13%)	US Small (7%)	TIPS (-19%)
US HY (-4%)	MSCI JP (17%)	Commod. (10%)	TIPS (-1%)	US Agg (-20%)
US IG (-4%)	MSCI EM (16%)	TIPS (10%)	US HY (-2%)	US HY (-20%)
EM Local (-5%)	US IG (12%)	US 10yr (9%)	MSCI JP (-5%)	US 10yr (-21%)
Global HY (-6%)	US HY (12%)	US IG (8%)	Global HY (-6%)	US IG (-23%)
REITS (-6%)	EM$ Sov. (11%)	US Agg (6%)	USD Cash (-7%)	Global HY (-24%)
EM$ Sov. (-6%)	Global HY (10%)	US HY (6%)	US 2yr (-7%)	EM$ Sov. (-28%)
S&P 500 (-6%)	Commod. (8%)	Global HY (6%)	US IG (-8%)	S&P 500 (-28%)
Commod. (-12%)	EM Local (7%)	MSCI EU (5%)	US Agg (-8%)	US Small (-30%)
US Small (-13%)	US Agg (6%)	EM Local (4%)	EM Local (-8%)	MSCI JP (-30%)
MSCI JP (-14%)	US 10yr (6%)	EM$ Sov. (4%)	MSCI EM (-9%)	MSCI EM (-31%)
MSCI EM (-16%)	TIPS (6%)	US 2yr (2%)	EM$ Sov. (-9%)	REITS (-32%)
MSCI EU (-16%)	US 2yr (1%)	USD Cash (-1%)	US 10yr (-9%)	MSCI EU (-33%)
MSCI CN (-20%)	USD Cash (0%)	REITS (-6%)	MSCI CN (-27%)	MSCI CN (-35%)

Source: Morgan Stanley Research, as at 30 Sep. 2022

Nominal annual portfolio returns for a classic "balanced" mix

60/40 Portfolio: S&P 500/US 10-Year Treasury (Total Returns, 1928 - 2022)

Year	Return	Year	Return	Year	Return	Year	Return	Year	Return
1928	26.6%	1947	3.5%	1966	-4.8%	1985	29.0%	2004	8.2%
1929	-3.3%	1948	4.2%	1967	13.6%	1986	20.8%	2005	4.0%
1930	-13.3%	1949	12.8%	1968	7.8%	1987	1.5%	2006	10.2%
1931	-27.3%	1950	18.7%	1969	-7.0%	1988	13.2%	2007	7.4%
1932	-1.7%	1951	14.1%	1970	8.8%	1989	26.0%	2008	-13.9%
1933	30.7%	1952	11.8%	1971	12.4%	1990	0.7%	2009	11.1%
1934	2.5%	1953	0.9%	1972	12.4%	1991	24.1%	2010	12.3%
1935	29.8%	1954	32.9%	1973	-7.1%	1992	8.2%	2011	7.7%
1936	21.2%	1955	19.0%	1974	-14.7%	1993	11.7%	2012	10.7%
1937	-20.7%	1956	3.6%	1975	23.6%	1994	-2.4%	2013	15.6%
1938	19.3%	1957	-3.6%	1976	20.7%	1995	31.7%	2014	12.4%
1939	1.1%	1958	25.4%	1977	-3.7%	1996	14.2%	2015	1.3%
1940	-4.2%	1959	6.2%	1978	3.6%	1997	23.8%	2016	7.3%
1941	-8.5%	1960	4.9%	1979	11.4%	1998	23.0%	2017	14.1%
1942	12.4%	1961	16.8%	1980	17.8%	1999	9.2%	2018	-2.5%
1943	16.0%	1962	-3.0%	1981	0.5%	2000	1.2%	2019	22.6%
1944	12.4%	1963	14.2%	1982	25.4%	2001	-4.9%	2020	15.3%
1945	23.0%	1964	11.3%	1983	14.7%	2002	-7.1%	2021	15.3%
1946	-3.8%	1965	7.7%	1984	9.2%	2003	17.2%	2022*	-19.3%

Source: Morningstar, Salt * data to 30 September 2022

There are thus clear problems in recommending the so called "classic balanced" asset mix of 60% Equities to 40%

Bonds under current market conditions. Note that while the bottom table above shows nominal portfolio returns, real (inflation adjusted) US classic portfolios would likely have seen a decline in value of -26% or more in the first nine months of this year: the worst single year's outcome since 1931 (when the real return was -31% for the full, depths-of-Depression year.) The next two or three years will likely determine whether this asset mix will revert to a beneficial diversification structure or will be found wanting (the most likely way that could occur is if inflation remains much higher for longer than most analysts currently are forecasting.)

Equities price in slowing profits

The USA was the weakest developed market in both the Second and the Third quarters. The S&P 500 Index recorded a -13.2% quarterly total return (in USD) bringing its 2022 year-to-date (YTD) total return as of September 30 to -23.9%. Mounting concern about the impact of Federal Reserve monetary tightening on the economy and on future corporate earnings, should a recession eventuate intensified, following the Federal Reserve's Jackson Hole symposium for global central bankers in August.

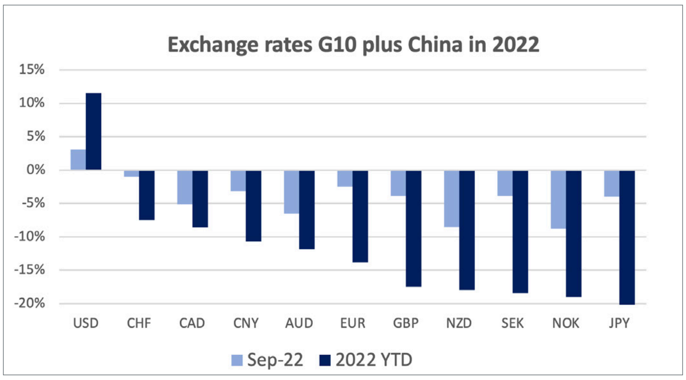
The drop in the S&P 500 lowered its one-year return (in USD) to -16.8% and took the Index value back down to its level of January, 2021. In NZ dollar terms, the downward move in the key US equity index has been largely offset over the one-year timeframe, as NZD/USD depreciated by -18.5% for the period and so an unhedged, NZD-based investor could potentially have experienced virtually 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 +10.4% p.a. with 8.6% p.a. from price growth and 1.8% p.a. from dividends The 5-year total return for the US Index was above +10% p.a. and the 10-year return, +12% p.a. as at the date of writing. Interestingly, the longer-term returns thus remain close to the compound average annual growth rate over the last three decades. From 1992-2021 the average was 10.7% per year. During those thirty years, the worst single year was 2008 (-37% S&P 500 return) while the best was 1995 (+37.6% return.) It may be suggestive that the strong 1995 followed the flat equity performance in 1994 during a notorious year in which bond markets were routed, with the US Treasury bond losing 8% in value. This year, of course, the US bond market' value loss is two times greater than in 1994, because yields have surged from near-zero starting points attained in the pandemic months. Back in 1994, the yield increase in the US long bond was a 2% rise from 6.2% to 8.2%.

Riskier equity regions and currencies remain out of favour

Emerging Markets weakened once again in the third quarter, which brought their year-to-date decline to -26.9% in USD terms. As with European equities, Emerging Market shares' local currency returns were somewhat less "strictly bearlike" in local currency terms: -16.7% YTD for MSCI Europe and -20.5% YTD for MSCI Emerging Markets as at 30 September. Nevertheless, investor excursions into the cheaper equity regions when measured against the comparatively expensive US have clearly been premature.

The foreign exchange markets also reflected much-diminished risk appetite, with widespread weakness in cross-rates despite the advancing monetary tightening programs and with only the US and Canadian dollars and the Swiss Franc showing their defensive merits, in 2022 to date. The Canadian dollar had of course until September 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. Commentary on the historic weakness in the UK pound has been widespread, but on a year-to-date basis to end-September, four other G10 currencies (including NZD) have actually been weaker than sterling against the rampant USD. The pound's slide accelerated in October, on fiscal policy controversy, confusion and back-tracking under the new Conservative Party leadership raising international institutional criticism and perturbed Bank of England commentary along with a proffered GBP 65 billion willingness to buy UK sovereign bonds to maintain confidence and prevent contagion.



Source: Morgan Stanley. Data to 30 September 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 the September month the NZ dollar slid by 8% against the greenback, falling by 18% 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 committedly hawkish, there will be only modest 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 approaches. 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 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.

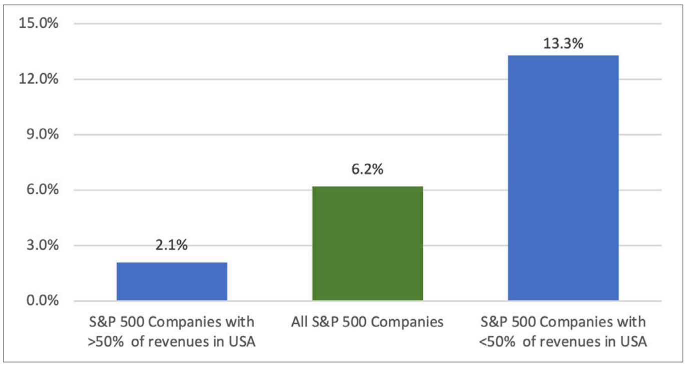
US dollar strength primarily shows global risk aversion

The 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. US companies are also on the acquisition trail, looking for innovative global firms in which to take stakes with their cash reserves of super-charged greenbacks now going a long way. A global EY survey this month has shown a majority of CEOs intend to use M&A to strengthen their enterprises and weather a period of geopolitical hazards.

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 by Revenue Source Q2 2022



Source: FactSet, 30 September 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.

Corporate profits move lower

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 ahead. The Third Quarter profits announcement season about to unfold will be of major 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 just 2.9%. This is well below the 5-year average earnings growth rate of 14.6% and below the 10-year average earnings growth rate of 8.8%. If 2.9% is the actual growth rate for the third quarter, it will mark the lowest (year-over-year) earnings growth rate reported by the companies comprising the Index in two years (-5.7% in Q3 2020) which was affected by the early waves of the Covid-19 pandemic.

In the September quarter of 2022, four of the eleven sectors are projected to report year-over-year earnings growth, led by the Energy and Industrials sectors. On the other hand, seven sectors are predicted to report a year-over-year decline in earnings, led by the Communication Services and Financials sectors

Upcoming expectations slow, but no profits disaster (yet)

Projecting through to year-end, 2022 full-year earnings growth of 7.4% is now expected by consensus analysts, and a slight pickup to 7.9% is now anticipated for all of 2023. At the end of June, the growth rate of EPS this year was forecast at 9.6%. So, the marked deterioration in sentiment that unfolded in the Third Quarter is reflected in a diminution in forecast profits of 2.2% compared to the prior estimate. S&P 500 revenue growth of 10.7% is expected this year, and just 4.4% for calendar 2023.

At the sector level, the Consumer Discretionary sector has the highest forward 12-month P/E ratio, at 23.4x while, notwithstanding the market strength in Energy stocks, the Energy sector as a whole has the lowest forward 12-month P/E ratio at 8.0%.

Interestingly, bottom-up analyst price targets for the S&P 500 over the next 12 months aggregate to 4,700 (+24%) which suggests there is a degree of double-think regarding just how much weaker the main global equity market needs to be, given the diminution in the profits outlook, where signals are still mixed. These estimates 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. Earnings forecasts have indeed been cut, beginning with Q3 2022 EPS falling over 6% during the last three months. Costs are biting into profits, rather than companies reporting any significant fall in consumer demand. Manufacturing confidence has dipped, but on the other hand, 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 and led to a resumption of significant mark-to-market losses in bonds in the last month.

Bond market is both perpetrator and victim

For bonds, the picture is more complex. The extremely rapid ascent in global interest rates during recent months has triggered the deflation in equity valuations described above. However, the global equity market now appears to be in a "testing phase" where investors are assembling evidence on whether 4% US bond yields, and inflation next year moving back below 4%, are compatible with still positive corporate profit growth and a more sustainable rate of economic expansion. The Federal Reserve has suggested that positive real yields (i.e. interest rates after an expected inflation adjustment) need to persist for several quarters, to tamp down the capacity pressures underpinning US inflation persistence. So, investors can bid farewell to a market era where negative real yields flattered most asset prices and led to distortions. However, that is not to say that modestly positive real yields are by themselves going to trigger a contraction and that equity investors need to position for a multi-year economic "winter season."

The current bond bear market is the worst ever recorded, in terms of negative total returns logged on a wide range of debt securities. The equity bear market, in contrast, remains moderate by historical standards and indeed, still fluctuates above and below the -20% value loss threshold from month to month. 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.

Fixed Interest: the worst year in history for returns

Total Returns

WORLD	September-22 (%)		YTD (%)	
	Local Ccy	in USD	Local Ccy	in USD
EM Sovs	0.0	-6.5	0.0	-23.7
Asia $ Broad IG	-0.6	-0.6	3.4	3.4
EUR Broad IG	-3.7	-3.7	-16.2	-16.2
US Broad IG	-4.3	-4.3	-14.6	-14.6
Global HY (USD)	-5.1	-5.1	-19.1	-19.1
Global Broad IG (USD)	-5.5	-5.5	-21.0	-21.0
US Fixed Income	**September-22 (%)**		**YTD (%)**	
		in USD		in USD
HY Corporates		-4.0		-14.7
Treasuries 10yr		-4.7		-15.7
Securitised		-4.9		-13.4
IG Corporates		-5.3		-18.7

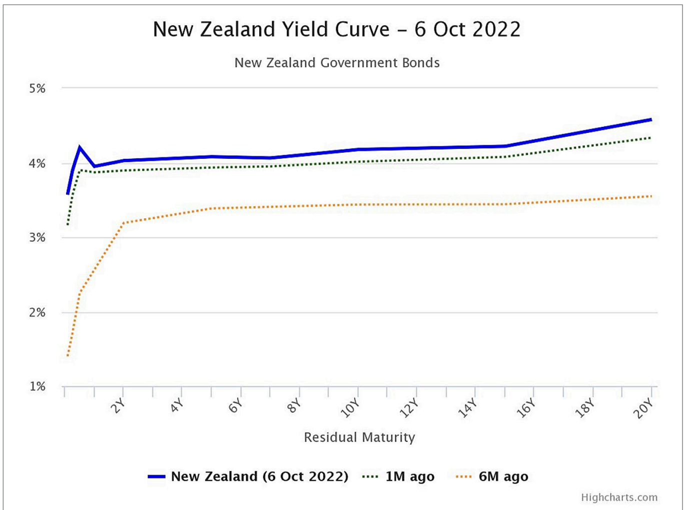
Source: Morgan Stanley, data to 30 September 2022

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 during 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 nine months of performance ever, with the longer-maturity bonds being worst hit.

The total return of US 10-Year Treasuries fell by -15.7% in 2022 YTD, while US Investment Grade (IG) Corporate Bonds lost -18.7% and their Global IG equivalents, -21%. Global High Yield (sub-investment grade) bonds have dropped -19% in the last nine months and Emerging Market Sovereign bonds, by -24% (both on a USD basis). These losses erased years of coupon income and rendered transitory the mark-to-market capital gains the broad Fixed Interest sector achieved in 2019-2020.

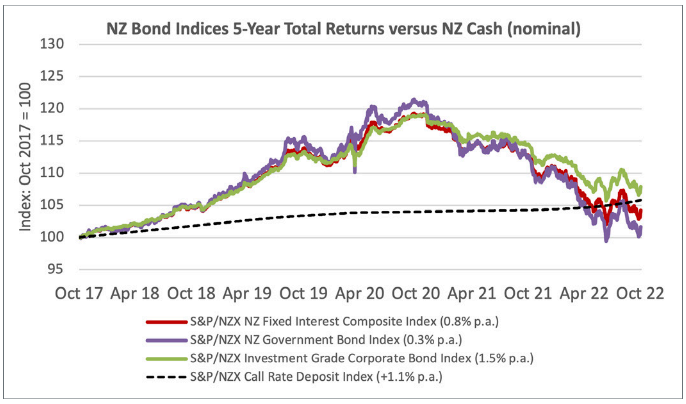
NZ bonds not markedly weaker than International debt

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 4.2% two-and-a-half years later. This performance (for a single maturity) compares to the US 10-Year benchmark yield's rise from 0.6% to 3.8% now. The comparison can be said to be reasonably favourable, given the relative scale of the NZ versus the US markets and the country-risk premium historically associated with small, open economies such as ours. In this regard, October saw the announcement that the US National Debt had exceeded USD 31 trillion for the first time and is moving toward the current Federal Debt Ceiling of USD 31.4 trillion just at a time of deeply partisan politics in Congress and a mid-term election cycle in under a month's time, on 8th November.



Following the RBNZ's early-October Official Cash Rate rise of 0.5%, to 3.5%, investor positioning has resulted in a strikingly flat yield curve, with almost identical yields of 4.2% applying from 6-month maturities right out to 10-year bonds. 4% nominal yields and 3.5% inflation might be in sight here later next year, as well as in the Federal Reserve's sights in the USA. The term premium in bond yields remains low, which is pushing the yield-hungry but inflation-shy back toward Term Deposit accounts in droves.

While the June yield spike on global and NZ bonds has been surpassed over September, the upside risk to yields can 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; however, as bond and equity markets are forward-looking it may become more evident by the end of this year or early 2023.



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 2017-2018 level. The annualised 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 0.3% - 1.5% per annum, whilst over shorter periods such as 3 years, the annualized return remains negative (in a range of -1.6% for Investment Grade Corporates to -4.2% p.a. for NZ Government bonds.) 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 over the medium, 5-year term, it is evident that bonds became very severely overvalued, and their subsequent fall from grace was fully warranted.

We believe that 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 program 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 focus on inflation and political risks (both, high)

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, 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 continue to 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. We are comfortable with that scenario for 2023. 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 program of Federal Funds Rate increases in 2022-24, is compatible with moderating economic expansion. However, the 0.75% tightening increments now underway risk moving market conditions into the equity-unfriendly zone and we have clearly had a preview of this in the Third Quarter.

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.

In our last edition of Salt Global Outlook in July, we noted the risks have shifted toward the second scenario of rapid, destabilising monetary policy adjustment toward a restrictive level, risking mild recession, and 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 remainder of 2022 and early-2023, 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.
- Expect more M&A based on strong USD "war-chests" and also, some 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 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.
- 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.