October 2023

## SALT Global Outlook

Global GDP growth has passed its peak as the post-pandemic surge of inflation along with the subsequent rise in interest rates weighs on economic activity

**BEVAN GRAHAM**

## Outlook for New Zealand Equities

Weaker earnings and higher bond yields weigh on New Zealand equities

**MATTHEW GOODSON**

## Strategy Conclusions

Seeking out corporate staying power, and pricing power

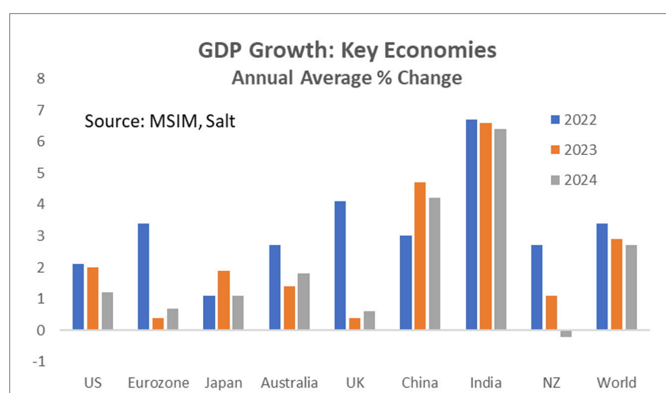
**GREG FLEMING**

SALT
Funds Management

## Global growth and inflation past their peak

Global GDP growth has passed its peak as the post-pandemic surge of inflation along with the subsequent rise in interest rates weighs on economic activity.

The U.S. soft landing scenario remains intact for now given the resilience of the labour market, though we still expect a period of softer growth by early 2024. Many European economies are already flirting with, or are already in, contraction. China's growth is stabilising but is expected to remain underwhelming given the only moderate policy response from authorities to date, and as the real estate sector continues to face challenges.



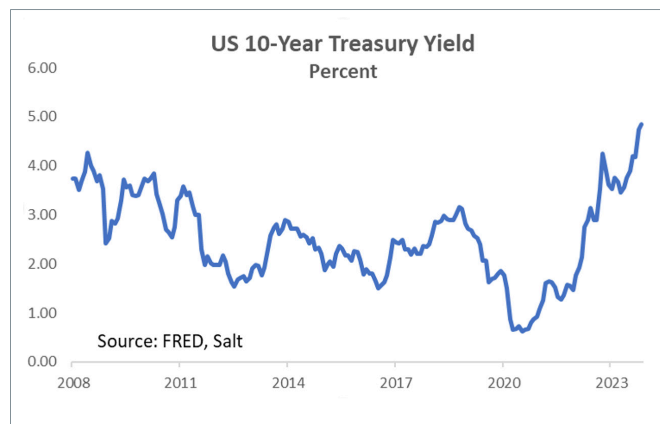

With the peak, or close to, in global policy interest rates upon us, attention has turned to how quickly global central banks might ease monetary policy. We have long been of the view that policy rates will stay high for a considerable period and that this peak in rates is probably better described as a plateau.

Furthermore, given that neutral policy rates are now higher than pre-pandemic, the next adjustment phase for markets is to understand that when the time comes for interest rate cuts, the scope for interest rate reductions may be limited.

## The three stages of bond market adjustment

2022 saw a sharp sell-off in bond markets as the transient vs permanent inflation result was resolved in favour of permanent and central banks, somewhat belatedly, began the process of withdrawing monetary stimulus and shifting settings into restrictive territory.

Bonds yields have continued to move higher in 2023 in the second stage of the sell-off, predominantly as core services inflation has proven to be stickier than expected. That has led to the growing realisation that interest rates will be at this level for a considerable period, at least relative to previous monetary policy cycles. The mantra of "higher for longer" has become de rigueur.




The third stage of adjustment for bond markets is not about even higher yields, but the likely limited scope for interest rate reductions when the time is right. We believe neutral policy rates are now considerably higher than they were pre-pandemic.

This is not just a result of the pandemic, but for several structural reasons that lead us to believe that inflation will prove to be harder to combat in the period ahead. These factors include the ongoing retreat of globalisation, ageing populations, low productivity, and looser fiscal settings.

## Fiscal sustainability matters too

While higher and likely more persistent inflation is behind much of the recent weakness in bond markets, it is not the only factor at play. In many countries fiscal sustainability is being challenged by already high and rising debt levels along with ever-increasing calls on Governments to meet an ever-rising list of challenges including meeting Net-Zero 2050 decarbonisation commitments, closing infrastructure deficits and building back stronger when existing infrastructure fails during extreme weather events, and closing inequality gaps.

The challenge for politicians is to meet these challenges within the constraints of maintaining prudent levels of debt and a globally competitive,

growth enhancing tax system, not to mention frequent calls for tax cuts. Furthermore, this pressure is coming while ageing populations are already threatening the quality of healthcare provision and challenging commitments to pension entitlements.

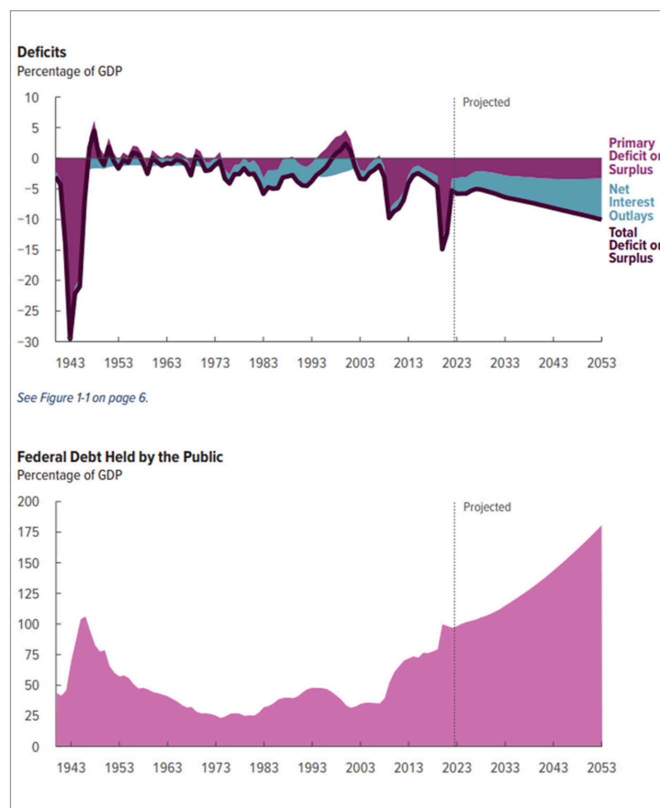
Higher interest rates are also raising debt servicing costs as interest rates return to more sustainable levels. The days of ultra-low interest rates have passed, and the willingness of investors to keep financing those governments who lack credible plans to fix their fiscal problems can diminish, leading to even higher debt servicing costs as bond yields become inflated by rising country risk premia.

It is crucial to avoid the vicious circle of higher government debt being issued and rolled over at ever-higher interest yields, as that can become a potent threat to both investment returns and to the provision of public services. As more money is allocated towards interest payments, it leaves less room for investment in other critical areas such as infrastructure, education, healthcare, and innovation. This can lead to a decline in productivity and competitiveness, hindering long-term economic growth.

The unsustainable trend of increasing public debt levels carries significant economic implications. It burdens government finances, raises borrowing costs, fuels inflation, dampens investor confidence, and exposes nations to financial vulnerabilities. Addressing this issue requires a comprehensive approach that combines prudent fiscal policies, structural reforms, and responsible debt management strategies to ensure sustainable economic growth and stability.

## US fiscal politics

In the United States, projections from the Congressional Budget Office show a long-term deterioration in the US fiscal position. Budget deficits are rising, largely as debt servicing costs rise leading to a self-fulfilling loop of higher debt and higher debt issuance. Rising issuance is also compounded the US Federal Reserve reducing the size of its balance sheet via Quantitative Tightening.




We are not as dismissive as the consensus that the recent downgrade of US sovereign debt by the rating agency Fitch was unwarranted. From our perspective, with fiscal policy on an unsustainable path and politicians seemingly either unable (the generous depiction) or unwilling (the probably more correct depiction) to do anything about it.

The downgrade of US debt held significance due to its potential impact on borrowing costs, investor confidence, and global financial stability. This credit rating downgrade signalled concerns about the US government's fiscal trajectory, influencing market perceptions, and potentially affecting interest rates and economic growth.

House Speaker Kevin McCarthy paid a high price for being the adult in the room as the latest debt ceiling impasse was resolved, but only in the form of a Continuing Resolution that expires on November 17th.

It remains to be seen who Republicans will elect to be the next Speaker of the House of Representatives. Regardless of who it is, the next Speaker will face some of the same challenges that vexed Speaker McCarthy. House Republicans' wafer-thin four seat majority leaves less room to manoeuvre, particularly when negotiating with the Senate and White House, both of which are under Democratic control.

In a cloud of uncertainty, one thing seems certain: more federal fiscal drama seems likely as we enter the final months of the year.

## BoJ – still in control of the yield curve

Speculation about monetary policy in Japan has also been underpinning bond yields. After two "tweaks" to the BoJ Yield Curve Control policy since December last year, speculation has been high that there would soon be further steps to normalise monetary policy.

The BoJ left settings unchanged at its early October meeting and the statement was at the dovish end of expectations. However, at the press conference, Governor Ueda declined to push back on speculation that further normalisation is nigh.

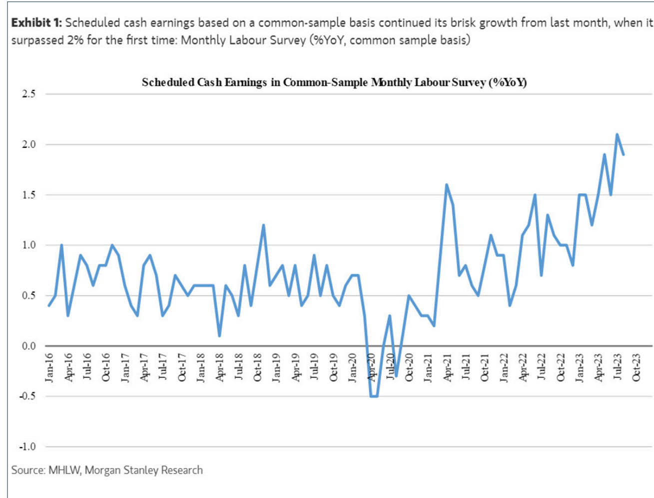
As elsewhere, it's all about wage growth moving to a state in which the BoJ can be more certain of achieving 2% inflation on a sustainable basis. Recent inflation and wage data has been encouraging, at least for a country with a central bank that has long struggled to generate sustainably higher inflation.

Headline inflation peaked at 4.3% in January and has since moderated to just over 3%. While some moderation was expected, recent data has come in on the upside relative to BoJ expectations and the Central Bank has revised its own forecasts up recently.

The BoJ and Ueda himself has stressed the importance of services inflation to the monetary policy outlook. That's for much the same reason we have tended to focus on services inflation everywhere in the developed markets recently – the biggest input into services prices is wages. Here too, recent trends have looked less reassuring, as core services inflation has picked up, despite stable rent growth.

To look at wage data itself, nominal wage growth hit a recent high of 2.9% in May but has since slowed to 1.3%. However, a closer look at the data reveals that on a "common sample" basis, the series we think the BoJ will pay closer attention to, wage growth is trending higher. The 2.1% recorded for the year to July is the first time this series has surpassed 2%, though this survey only goes back to 2016.

**Exhibit 1:** Scheduled cash earnings based on a common-sample basis continued its brisk growth from last month, when it surpassed 2% for the first time: Monthly Labour Survey (%YoY, common sample basis)




Source: MHLW, Morgan Stanley Research

Furthermore, the latest shunto, or "Spring wage offensive" showed wage gains of around 3.5%, a large increase compared to offensives in recent years. The shunto is held every year in Japan in Spring and plays a key role in shaping wage increases for workers.

Negotiations typically take place between February and April, so the next shunto in early 2024 will be critically important in shaping the wage outlook. While it is still a few months away, Governor Ueda's recent comments in the media that they may have enough information about how that is shaping up by the end of the year have not escaped market attention.

Developments in the labour market, particularly wages, are critical in determining the BoJ's next steps. The market consensus was that the BoJ would likely exit YCC and shift from NIRP to ZIRP (Zero Interest Rtae Policy) sometime in 2024. Those expectations are now being brought forward to early in 2024 and may move to even sooner than that, depending on the data.

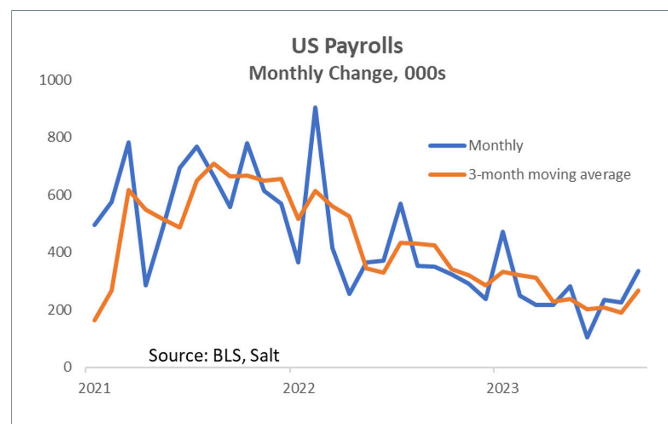
The cautionary note is that the BoJ will only move when they are confident of a likely sustained move in wages and inflation. We estimate the BoJ will be looking for sustained wage growth of 3% before it would be confident about sustained 2% inflation. And given Japan's history, structurally stronger wage growth requires as much a cultural shift as an economic one.

## United States economic resilience

Recent stronger labour market and retail spending points to stronger momentum in the US economy,

just at the time when we would expect tighter monetary policy to have its greatest impact.

September payrolls were unequivocally strong at 336k and came with an unexpected upward revision of 119k to prior months. The other side of the Fed's mandate – inflation – has been decelerating faster than Fed forecasts, but continued strength in job gains should fuel doubts that the pace of deceleration in inflation will be sustained. Stronger jobs, therefore, should lower the bar for the Fed to act on the inflation side.




The September retail sales report was stronger than expectations and paired with some upward revisions to July and August. This report confirms that there was more momentum in consumer spending throughout the third quarter of the year and more underlying strength that may carry into the end of the year. We still expect to see downside in fourth quarter consumption due to the 0.8pp headwind from the student loan moratorium ending, higher gasoline prices, and more softening in the labour market and credit availability.

Since the last FOMC minutes, we've seen stronger than expected payrolls plus a tightening in financial conditions. The FOMC minutes for the September meeting increased the emphasis on downside risks, including an emphasis on risks from tightening in financial conditions.

"Participants discussed several risk-management considerations that could bear on future policy decisions. Participants generally judged that, with the stance of monetary policy in restrictive territory, risks to the achievement of the Committee's goals had become more two sided."

In short, these minutes allowed for a more cautious Fed if financial conditions tightened… as they have. Since the September FOMC meeting, more FOMC members have shown more concern about tighter financial conditions and that the tightening in financial conditions is doing the Fed's work for it.

## Europe: monetary policy transmission firmly taking place

At its last meeting the European Central Bank agreed that monetary policy transmission to financing conditions and real economy was firmly taking place. The weakening of the euro area economy as well as the deterioration of the external environment were discussed extensively.

The inflation forecast was revised slightly upwards in the short term, while the risks around the inflation outlook became more balanced due to weaker demand and the restrictiveness of monetary policy. Risks around energy prices and second-round effects from wages were acknowledged to remain present. So far, wage dynamics were seen as in line with the staff projections. Lower unit profits than projected were seen as suggesting that rising wage pressures could to some extent be absorbed by firms over time.

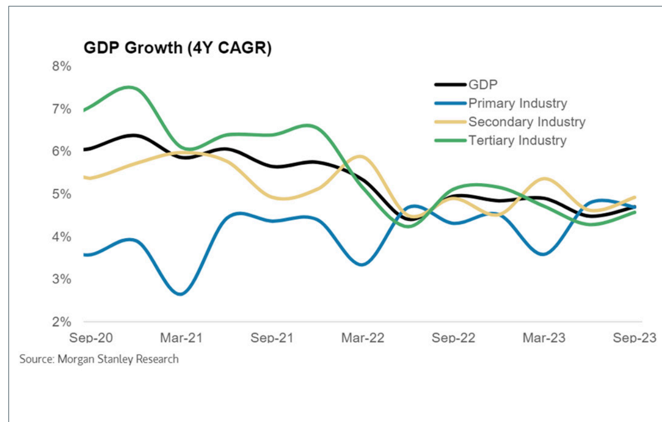
The ECB was clearly torn between a hike and a pause, and the decision was generally seen as a "close call". Inflation was still deemed as too high for too long. A hike got majority support as it was seen as reinforcing the determination to bring inflation to the target and to maintain focus on inflation. The decision to bring rates to 4% was also seen as taking out some insurance against having to raise rates further later.

Overall, the framing of the ECB discussion was very much in terms of peak rate. Some governors felt the data available since July did not justify another hike (inflation broadly in line with projections, but a significantly weaker economy). Concerns were raised that a lot of the monetary policy pass-through is yet to come, implying significant downside risks to the growth outlook, making a pause the preferred choice for this group.

From now on, rate discussions are likely confined to the projection meetings (with December being the next one). As long as inflation data come in line with ECB short-term projections, the bar for an additional hike in December is extraordinarily high. We think that 4.0% is the terminal rate, and there will be no hike in December.

## China Stabilising

China's September quarter GDP was stronger than the market expected with annual growth of 4.9% (consensus forecast 4.5%), and its seasonally adjusted quarterly growth rebounded by 80bps to 1.3%. Looking at the expenditure break down, the growth uptick was led by consumption, but investment growth stayed subdued, dragged by a deeper contraction in property investment.




Turning to more forward-looking indicators, China's manufacturing PMI rose by 50bps to 50.2 in September, returning to expansionary territory for the first time since March. Meanwhile, the services PMI edged up by 40bps to 50.9, with a rebound in wholesale and financial services outweighing fading summer travel-related service demand.

The key drivers of the improvement in manufacturing appeared to be slower industrial destocking, a modest rebound in construction activity, and a slowing of the rate of decline in external demand.

Given that the current economic downturn is caused by a reversal of an overextended credit-fuelled growth model, deleveraging will continue, and the 'impulse response' from policy easing might be more transient than before. This means Beijing will need to further step-up reflationary policy and local debt resolution.

## Australia – another hike still likely

The Reserve Bank of Australia (RBA) kept the cash rate on hold at 4.1% at its October meeting, as was broadly expected. This marks the fourth consecutive on hold decision from the RBA. This was also the first meeting of the new Governor, Michele Bullock (who was previously on the Board as a Deputy Governor) – a continuity of message was clearly prioritised, with notably few changes in the statement relative to prior months, despite what has been a relatively eventful month both globally and locally.

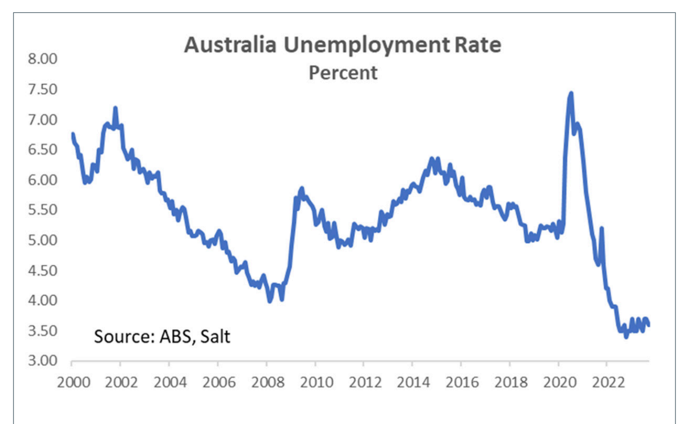
The Statement did acknowledge the stronger data over the past month, although mostly tried to play it down. The Statement characterised growth over the first half of 2023 as having been "a little stronger than expected", despite what was a relatively sizable June quarter GDP beat relative to the RBA's August forecast (2.1% vs 1.6%).

Through the rest of the statement there were effectively no changes to the RBA's messaging. A tightening bias was retained, but hikes will depend on "the data and the evolving assessment of risks", and it retained the view that "recent data are consistent with inflation returning to the 2-3 per cent target range over the forecast period".

We continue to see another rate hike as likely over coming months, with the November meeting the favoured timing, largely driven by a view that:

1) the RBA will have to raise its inflation path as part of its forecast update, given a mark-to-market upgrade of both inflation and GDP growth; and
2) given it already does not have inflation coming back to target until "late 2025", and this is conditioned on further monetary tightening, the RBA will feel compelled to respond to this with a hike.

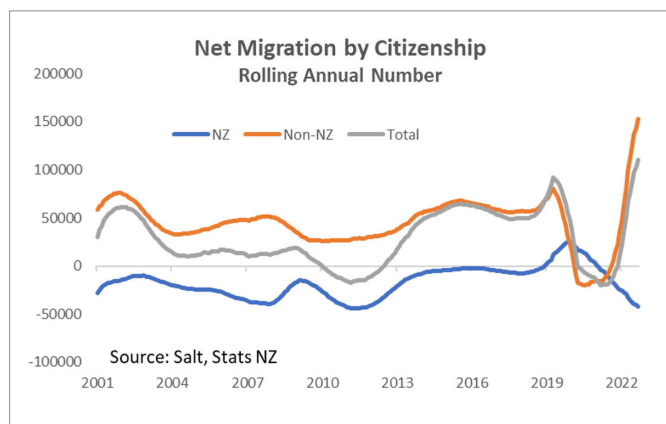
However, the October Statement is a good demonstration that the RBA Board's bias is toward remaining on hold, in our view. The key risk to our forecast for a rate hike is that there is some deterioration in data over the next few weeks that the Board can point to, particularly across inflation or the labour market.



## New Zealand economy slowing despite strong second quarter

GDP growth was surprisingly strong in the second quarter of the year, continuing the recent trend of volatile quarterly results. In that environment we think there is more insight to be gleaned from the trajectory of the annual rate of growth which slowed from 2.2% in the year to March to 1.8% in the year to June and is expected to be close to zero by the end of the September quarter.

The economy is clearly slowing, and we expect that trend to continue for a few months yet. That reflects the accumulating negatives for the New Zealand economy. Higher interest rates are continuing to percolate through the economy, weaker export commodity prices combined with rising import prices is generating a deterioration in our terms of trade, global growth is past its peak, weaker profits are impacting business investment and employment growth is slowing. Population growth via net migration is providing a strong positive offset to these negatives.




Inflation is moderating faster than expected, albeit at the headline level. September quarter CPI came in at 5.6%, below Reserve Bank expectations of 6.0%. Despite the most significant increases coming through it fuel prices, the downside surprise came through in the tradeables side of the equation.

Non-tradeable, or domestic inflationary pressures were in line with expectations at an annual rate of 6.3%. This is the measure that most concerns the RBNZ as it is the part of inflation that they have most direct control over with domestic monetary policy settings. So, the overall September quarter inflation result wasn't quite as good as it looked at first blush.

We still look to a softening labour market to provide the necessary pull back in wage growth that would make the RBNZ more comfortable that inflation is likely to return to target on a sustainable basis.

The unemployment rate is off its lows, and we expect the next few quarters to see a more marked softening in labour market conditions as strong migration collides with slowing demand in activity and for labour.

That is still expected to take some time. We continue to believe the RBNZ has tightened enough, though will retain a tightening bias. In fact, if they do anything in the next 6 months it is most likely to be another hike. We don't expect conditions to be right for interest rate cuts until late next year, the risk to that view is cuts are pushed out into 2025.

*Bevan Graham.*

# Outlook for New Zealand Equities

In what was a difficult period for almost all financial assets, NZ equities declined by-5.2% in the September quarter. In contrast to NZ's traditional low beta nature, this was worse than the-3.5% (USD) return for the MSCI World Index and a-0.8% decline by the S&P/ASX200 Accumulation Index.

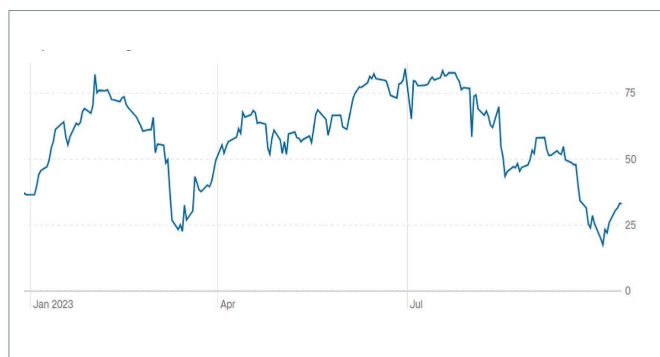
The key issue globally was higher bond yields, with the NZ 10-year yield rising from 4.62% to 5.26%. By lifting the discount rate, the valuation for all financial assets is theoretically lowered. The driver of higher yields was ostensibly a sudden realisation by markets that inflation is proving somewhat persistent, with this requiring monetary policy settings that will remain higher for longer.

Normally equities are a reasonable hedge against moderately high inflation because this also lifts earnings forecasts. However, it was far from just a lift in inflation expectations that was at play, with the NZ 12-year inflation-adjusted "real" bond yield rising from 2.13% to 2.87% in the period. Factors such as QT, high fiscal deficits and general uncertainty were among the likely drivers of this. This move in real yields indubitably hurts equities.

Aside from a higher denominator due to higher bond yields, NZ equities also faced moderate headwinds from a weakening numerator in the form of lower earnings forecasts as the NZ economy continued to struggle. More on the key findings from earnings season shortly.

One stand-out bright-spot for global equities in the period was the sudden emergence of artificial intelligence as an investment theme, with considerable optimism being priced in, even though widespread use-cases may take time to emerge. In the US market, this saw extreme outperformance by a small group of exposed mega caps- aka the "magnificent seven" or the "seven horsemen of the apocalypse". This saw the S&P500 decline by-3.3% in the quarter, whereas the S&P equal-weighted index fell by a sharper-5.4%. Year-to-date, the S&P500 Index is +11.7%, while the S&P500 Equal-Weighted Index is up a mere +0.3%. NZ has few exposures to this AI comfort blanket although the large cap, Infratil (IFT, +0.6%) does have about 30% of its valuation from CDC Data Centres.

The quarter was notable for some quite extreme sentiment shifts between bullishness and bearishness. We show this below using the well-known CNN Fear & Greed Index, which combines 7 widely accepted sentiment indicators. Above 75 is "extreme greed" and equities unprecedentedly spent every day of July in this territory bar one. Late-September however, saw a brief excursion into "extreme fear" below 25. This can be a good contrarian indicator – NZ equities actually rose +1.2% in July before falling-6.4% in the next two months.



Earnings season in August was the key event of the quarter for NZ equities from a bottom-up perspective. While well-managed guidance meant that actual outcomes for the June 2023 year were not full of surprises, the same could not be said for notably weak June 2024 year guidance across the board. Indeed, according to Forsyth Barr analysis, we actually saw the largest proportion of downgrades and the lowest proportion of upgrades in the last two decades. This weakness came from cost inflation, softer revenues leveraging through to lower profits and also from a sharp lift in interest rates beginning to feed through to financing costs.

This earnings weakness is obviously bad news for valuations and performance, but it is interesting to consider that previous soft earnings periods have tended to see subsequent outperformance as the economy and thence earnings rebounded from their lows. The current economic weakness feels shallower but perhaps likely to be of longer duration than those in the past but we shall see.

The strongest performers in the quarter were an array of small-mid cap stocks which had their own unique drivers or whose results and/or outlooks were less bad than had been feared by investors. In the former category were Pacific Edge Biotechnology (PEB, +39.1%) where the Novitas denial of Medicare reimbursement for their test is being reviewed; Fonterra Shareholders' Fund (FSF, +15.3%) who paid large special dividends and which benefits from declining milk input prices; and Serko (SKO, +14.7%) the travel software business where there was optimism regarding the performance of their business bookings deal with bookings.com.

Those who outperformed on the basis of their results and outlooks were led by Heartland Group (HGH, +9.8%) whose profit and guidance were within expectations and where doubtful debts remain muted to this point; Summerset Group (SUM, +7.6%) whose sales and development margins were solid, with limited signs of any inventory build-up despite a weak housing market; and Skellerup Holdings (SKL, +5.0%) which continues to perform solidly across its diversified range of manufacturing businesses.

The most notable laggards were a2Milk (ATM, -14.8%) and Synlait Milk (SML,-13.9%). ATM's result disappointed. Despite doing well in relative terms in the Chinese infant formula market, it is coming under intense pressure from very weak birth numbers. There was also some disappointment at their continued commitment to the heavily loss-making US business. This was a headwind for their manufacturer, Synlait, and this company was further hit by ATM seeking to remove their manufacturing exclusivity. Synlait's balance sheet leaves little room for error.

Vista Group (VGL,-16.8%) pulled back from a previous sharp run due to concerns that earnings recovery hopes that may prove overblown. KMD Brands (KMD,-13.0%) underperformed a surprisingly robust quarter for most discretionary retailers across NZ/Australia as their result was a touch weak due to lower margins and the outlook remains somewhat challenged. Weakness in the heavyweight Fisher & Paykel Healthcare (FPH, -11.9%) can be attributed to valuation sensitivity from its long-dated growth to higher bond yields and a cut in expectations for its sleep apnoea business from the sudden emergence of effective weight-loss drugs. Fletcher Building (FBU, -9.1%) contained some modest quality issues in its operating result, made additional product provisions and guided to higher interest expenses.

A final key consideration for NZ equities is the election outcome in the weekend just gone. We see no revolutionary changes for the NZ economy with knock-on equities impacts. Rather, a path of slightly lower government spending and lower taxes appears likely, with the net impact of these on inflation and thence interest rates unclear.

In terms of sector and stock-specific impacts, the property sector will be easily the most impacted due to the well-signalled removal of the ability to tax depreciate building structures. Precinct Property's Wellington exposure may be affected by potentially sharp mooted cuts in the number of government employees. The retirement village sector may perhaps see some support if a stronger housing market results from a less penal tax regime for housing investors. However, this may be swamped by the impact of mortgage rates, which appear to be set to stay higher for longer than earlier expectations.

To summarise, recent weakness in NZ equities has been driven by a pincer movement of higher bond yields and weaker earnings growth forecasts. The

slightly stagflationary nature of the NZ economy has seen equities unable to fulfil their normal role of being a reasonable inflation hedge. Our assessment of valuations is that they are not yet cheap with the overall forward PE of c26x being very expensive at current 5.3% bond yields. The median PE of 16-17x is moderately expensive. While there is certainly potential for a sharp rebound at some point, this will require lower inflation outcomes and thence lower interest rates.

*Matt Goodson.*

# Implications for Investors

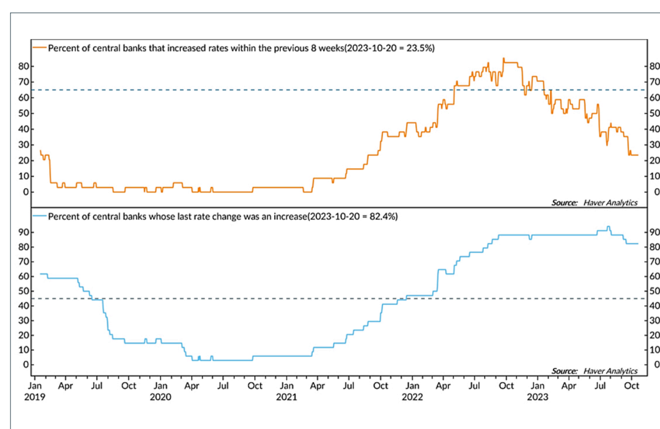
The "tug-of-war" in markets between the positive forces that have allowed international equities to notch up year-to-date gains, and the negative ones, which have driven up interest rates and oil prices, continues with undiminished intensity into the closing months of 2023.  A bout of weakness in shares and bonds alike characterised the Third Quarter and markets remain very choppy, as was our expectation.

Investment returns patterns have been highly uncertain throughout this year. This is partly because the more bearish forecasts prevailing as the year began have so far failed to materialise. After one of the most aggressive global tightening cycles in history, most central banks have paused, with inflation having moved lower, and overdue stimulus withdrawal is being achieved without inducing a severe global recession. The pause in central bank tightening provides some reprieve to equity markets, when viewed medium-term. However, shrinking central bank balance sheets have historically been associated with weaker equity performance and higher long-term bond yields. This is what we are currently traversing in portfolios.

As if the competing market influences arising within the global financial system were not enough, investors have now been confronted by a new geo-political shock in the Middle East, which (while localized for now) runs the risk of re-intensifying energy inflation processes which will come through in upward general price pressures in the course of 2024. That is unwelcome to the central banks as they calibrate the completion of their period of restrictive monetary policy.

The key question remains whether the impact of rapid rises in interest rates on the world economy has been lower this cycle than in the past, or whether more of a negative impetus is yet to come through. Historically, since 1950, it has taken an average period of between two and three years after rate hikes begin, for the US economy to slow to recession. So, given that the US Fed began tightening policy rates only last March, it is plausible that the full impacts will not be felt until 2024 and suppress activity at a time when many costs to consumers (mortgage and loan interest rates, energy prices) remain a burden.

**Few central banks are still tightening policy rates**



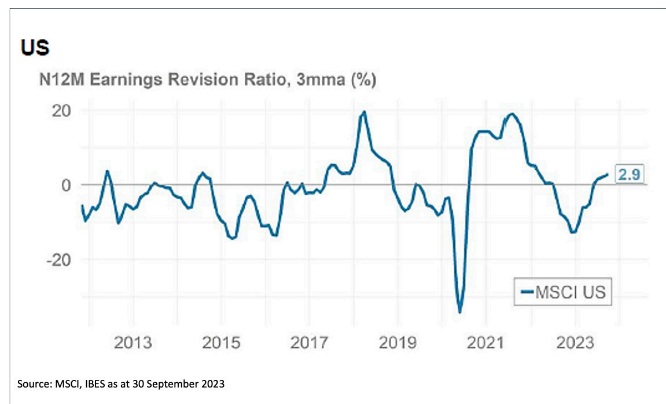

Source: BCA/NDR Research data to 20 October 2023

It is now clear that the remainder 2023 will not see the "rapid-slide recession" previously priced in by markets, but it is also unlikely to deliver conclusive evidence of a soft landing. The elevated uncertainty allows equities to continue a jagged sideways path despite many challenges. The real slowdown in the US and other Anglophone countries could begin to hit around year-end (at a point when investors may be complacently expecting a continuing "soft landing" although Middle East news has added a new shadow to the mix.) That is why late-2023 is an opportune time for more fixed interest orientation within our diversified funds. Within equities, Quality companies would finally become more clearly distinguishable for their stability and comparative efficiency, in a market environment where profits are hard won.

This all implies that agility will be required as

2024 draws closer, as next year's profit growth track, whilst improving in most analyst forecasts, is unlikely to support significant further valuation expansions.

**Year-ahead profit growth forecasts improved for US and Japan**




Source: MSCI, IBES as at 30 September 2023

## Selling in bond markets derails equity advance, for now

The US S&P 500 equity index made its high for 2023 (so far) on 31 July. In the stronger performance phase for global equities seen earlier in 2023, investors had the capacity to reward the "better-than-expected" news flows as they unfolded. At its high point, the S&P 500 had gained 21% in the first seven months of 2023. This exceptional gain proved unsustainable and the market is now up "just" 10% year-to-date.

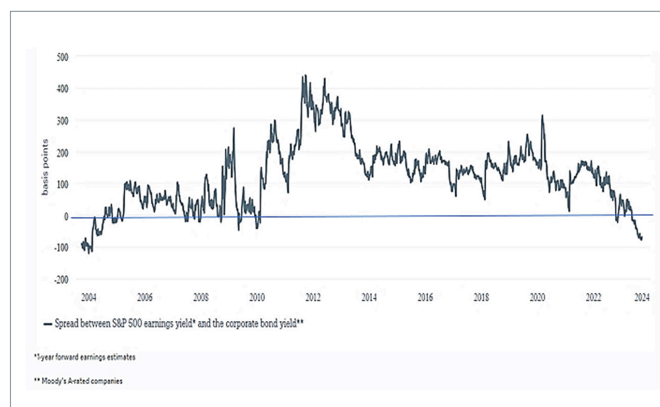
Since 31 July, the market has taken a more realistic turn, and has been correcting for the "worse-than-expected" news which has unfolded in the subsequent three months. Principal among these negative shocks has of course been the resumed upward march in bond yields, especially in the US but thence spreading throughout the developed world.

Early 2023 had seen range-trading bond yields, which in the US saw the 10-year government Treasury note yield moving between 3.5% and 4%, fluctuating on fragments of inflation news and central bank signalling. However, from August onwards a more distinctly negative market aversion to sovereign bonds took hold. The US 10 Year yield crossed above 4.1% in the first week of that month, and kept rising through September and October until touching 5.0% on an intraday basis on October 23rd.

Coming after last year's record losses endured in many international bond markets, this renewed weakness in the still highly-rated (and putatively risk-free) US Government Treasury security universe has led some equity investors to reconsider whether their capital is best deployed in volatile share markets that may well be affected by cooling trade demand or domestic profit headwinds. The Earnings Yield from equities, compared to Treasury bonds, has compacted, and this inevitably saps risk appetite.

Furthermore, though, the spread between the forward earnings yield on US equities and the comparable Investment Grade Corporate bond yield has shrunk to 20-year lows. Investment Grade and quality corporates are therefore more attractive compared to equities, and we are lifting our exposure accordingly. However, the more defensive equities still have upside potential and should not be shunned.

**A-rated corporate bonds more attractive than S&P 500 stocks?**




Source: DWS Research October 2023

## Not all bonds are created equal

The improving relative attractiveness of bonds should be interpreted with great care. Unlike the case for much of the last half century, the rising yields on Sovereign (Government-issued or backed) debt securities is this time reflecting mounting concern about the long-term sustainability of many countries' fiscal settings. Put simply, there is insufficient projected tax revenue to adequately cover the projected track of government expenses

(including debt servicing) and rising transfer payments due to demographics and political considerations. That means that simply buying government bonds is not a panacea for portfolio stability in the decade ahead.

By contrast, the advantageous spreads available by taking on highly selective corporate and supranational debt securities are not subject to the same structural risks. While such bonds are sensitive to the economic cycle, they have the advantage of superior status in the capital structure compared to common equity, and of better backing by the reserves of the issuing entity (which may be less "pre-spent" than government revenues and reserves, and therefore are available for investment in growth projects.

Since mid-May 2023 the earnings yield in the US and elsewhere has been below the corporate bond yield. The last times this happened were in the aftermath of the internet bubble and financial crises, in 2003 and again 2009-10. What does this mean? The most obvious conclusion is, firstly, that equities are currently more expensive than bonds. However, it does not imply that equities should necessarily fall further. History suggests that the last 18 months of generally sub-par returns in bonds and equities alike have improved their value.

While expensiveness still afflicts many assets (outside listed property) the valuation situation for bonds and also, for the many equities that have not participated in the rather narrow, MegaCap dominated rebound after 2022's bear market, is less vulnerable. The "left-behind" sectors may now recover some performance, but the trigger for that needs to be demonstrable earnings resilience in 2024.

Finally, it is important to recall that although many government-backed bonds now have the highest yields (and more crucially, the highest ***real*** yields) in years, that does not mean they are adequate to the difficult task of preserving investors purchasing power in the period to come. An after-expected-inflation (prospective real) yield of the 2.5% p.a. available from government debt is not going to build much wealth.

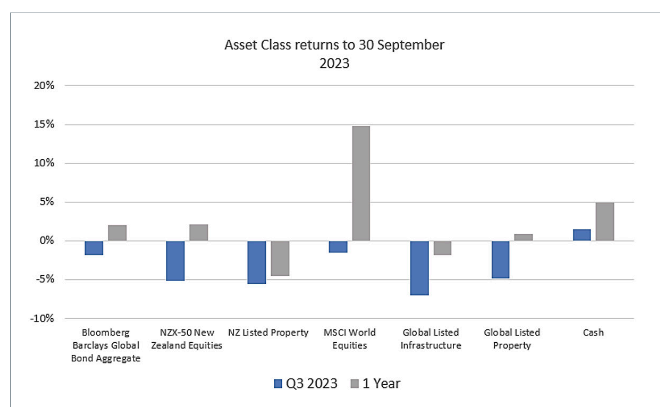
Because Cash deposits are now yielding interest levels very close to those available in sovereign bonds, this has led to a "profit taking" after this year's earlier share market strength and a "safety first" parking of proceeds in low-risk Cash, pending greater clarity. However, as ever, the risk with simply placing funds on term deposit or cycling through very short duration commercial paper is that if inflation does persist at a more elevated level than prevailed in recent decade, the illiquidity and embedded costs in holding funds on deposit could deliver a very anaemic outcome for investors, while preventing or restraining them from taking up opportunities to purchase "growth"-type assets at improved valuation levels.

## Cash had a kingly Third Quarter

The implications of sharply higher bond yields percolated through the other investment asset classes from August 2023 onwards. Most evidently, that suppressed returns from Infrastructure and Property, but broader equities (particularly dividend yield-advantaged share markets like New Zealand's) also saw "risk rethinks" and resulting capital outflows.

The chart below shows that the negative returns from asset classes other than Cash in Q3 2023 had the effect of diminishing (and in some cases, erasing) the positive returns that had been building up on a 1-year basis across several equity categories, prior to the latest yield shock.

**Only unhedged global shares beat NZD Cash for the year**




Source: S&P Global Indices, Salt

## "Duration" a disadvantage in Fixed Income

Since the start of June, the US 10-year bond yield has jumped from 3.60% to 4.86% (as at the time of

writing, a 2023 high) and the New Zealand 10-year yield, from 4.33% to 5.51%. In other words, yields have surged higher by around 1.2% in the last five months. Returns from government bonds have thus been negative.

With the Reserve Bank of New Zealand keeping the Official Cash Rate at 5.5% which we think it its cyclical peak, shorter-term bonds in New Zealand managed a slightly less severe period with the 2-year NZ government yield up from 4.80% on 1 June but stabilizing at around 5.60% over the last month.

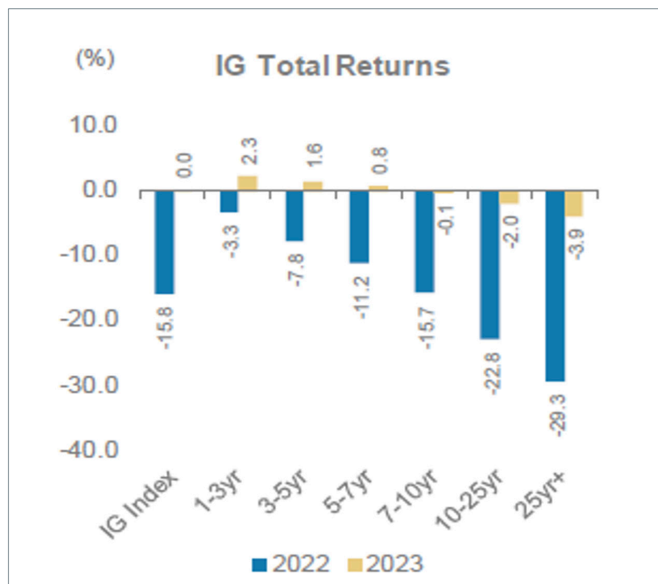
While that level of bond yields is problematic for other assets that compete on a running-yield basis with bonds, it may indicate that a plateau has now been reached and that as 2024 gets underway, a modest downward shift in yield levels will again become possible.

Investors who prematurely rushed into Sovereign bonds at the beginning of this year, after enjoying a short period of positive returns, have now seen much of those returns evaporate in the latest sell-off.

We expected range-trading bond yields for this year as a whole rather than forecasting a "cycle peak and succeeding rally" in the fixed interest markets. Next year could see a better dynamic in place if inflation does not re-surface in a range of second-round impacts. There is still some risk of erratic inflation news ahead, however – it is decidedly not a case of "all downhill from here."

That is why we invest in a highly selective global bond portfolio: we do not believe that the years ahead will simply reward bond investors automatically for holding an index-like set of debt instruments through economic slowdowns.

Looked at in the International Fixed Income context, the chart below shows that while in 2023, all Investment Grade bonds have been challenged in achieving positive returns, it has been only the shorter-duration bonds that have managed a non-negative total return. This is likely to persist, as long as global yield curves remain somewhat inverted and debt issuers are avoiding excessive long-term coupon risks.

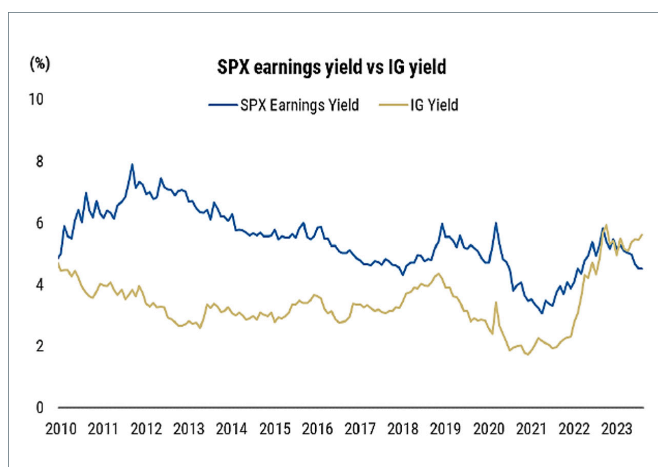



Source: Morgan Stanley. Data to October 2023

## Corporate bonds still have performance scope

The multi-year credit cycle – which in the medium-term is as strong an influence on bonds' total returns as the level of interest rates – is only beginning to turn more problematic for issuers and investors alike. There are still several quarters of choppy market conditions ahead for bonds. Credit rating downgrades, debt deferrals or restructuring risks, set against much less central bank support, are the shoals to be navigated in the fixed income portfolio components and cooling global economic activity will reveal problem areas that have been screened by the ample liquidity of the last fifteen years.

**Cooling growth and inflation make Investment Grade credit attractive**




Source: Morgan Stanley. Data to October 2023

## Seeking out corporate staying power, and pricing power

Even if as 2023 concludes, the majority of the value gains from equities for this year prove to be behind us, that does not mean that the equities in our own portfolios have deteriorating expected returns. Quite the contrary. Many of the selections in our funds (both domestic and international) are chosen with particular attention to their capacity to weather economic downturn. Balance sheet strength, pricing power and technical adaptability to new market segments are crucial distinguishing qualities and tend to be common factors among securities that ride out low-growth and borderline-recessionary periods best.

As we highlighted in our last "Investment Outlook" in July, defensive characteristics to look for in companies within the US investment universe include:

- **Low volatility.** Stocks that have not seen a sustained decline of more than 30% in the last 10 years, based on daily closing prices and adjusted for dividends. Only 87 stocks traded on major US exchanges meet this volatility criteria—most US stocks have seen much bigger declines.
- **Steady profits.** These companies have had positive earnings for at least seven years.
- **Earnings growth.** Stocks with a minimum of 3% annual EPS growth over the last five years.
- **Expected future growth.** Stocks which had at least 3% annual EPS growth expectations over the next five years.

Immediate news flows are often a distraction to investors, because they reflect often unforeseeable or idiosyncratic risks.  The key is not to lose focus on the 5-10 year investment time horizon, and acquire holdings in the enterprises with staying power and pricing power. However, at present, it is important both to retain the best defensive portfolio elements for near-term protection, without forgoing the most inflation-resilient growth companies which will retain market leadership for years to come, regardless of the "depth" of the economic cooling or recession phase which lies in the immediate future, for many key economies. Defensive equities are still comparatively "cheap" when ranked against the technology giants.

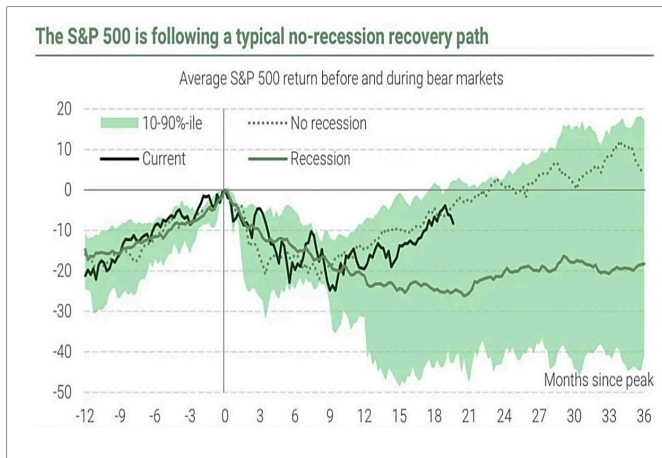
The other clear message is that US market leadership urgently needs to broaden further from the Mega-Capitalisation technology companies and encompass more reliable, quality companies which are nonetheless better positioned to weather economic storms if the economy finally responds to the weight of tight monetary conditions and weakens into a second dip in the early part of 2024. That scenario is quite plausible, given the lagged effects of high interest rates and energy prices discussed throughout this report.

There is no doubt that corporate earnings are presently, and will continue to be, meaningfully challenged at least for the rest of this calendar year.  This statement is as apposite for New Zealand as it is for the USA and European equity markets. However, genuinely defensive, and/or quality companies have scope to ride out the current mix of high costs alongside diminution in customer spending power and retain their value. Inflation-resilient companies are already passing through cost pressures and at present, many are succeeding in re-contracting at higher prices which their customers have grudgingly accepted. In many cases, enterprises are disinclined to trigger the disruptions of replacing a supplier with another (who may only offer a pricing advantage which cannot be relied upon for multi-year planning) or, of moving premises or facilities when attractive facilities remain in short supply.

## Wobbly post-bear market dynamics

A "new" and potentially confusing influence is that the 2022 bear market in global equities and bonds was not truncated by global monetary intervention, as has been the case in recent years. Rather, because inflation levels have tied the hands of policy-makers and continue to do so, the periods of negative asset returns are now being allowed to run their course. This may well be unnerving at times, as it appears that the central bank "backstop" for market gains has left the ball-park.

However, the erratic path of the US equity market since the peak achieved in the fourth quarter of 2021 has been toward the top of the range, based on historical experience. A downside test could still occur.



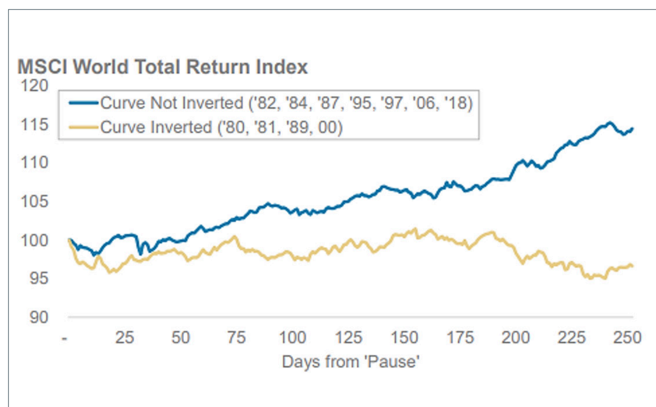

Source: TS Lombard Research

This suggests that investors have been reluctant to rush to position for outright recession – correctly, so far. The more cautionary implication, though, is that to keep the market's rolling returns in the upper segment of a typical recovery range, a fair number of things have to continue going right. Corporate earnings achieving their predicted expansions in Q4 2023 and Q1 2024 is one major condition for improving equity performance. So far, this seems plausible as earnings are holding up well.

Another condition would be stabilisation in both bond yields and in the oil price. Here, recent developments are concerning. The deteriorating political situation with tensions rising in the Middle East is weighing on many investors' appetite to invest, and that is realistically unlikely to change in the immediate near-term.

However, when these points of elevated risk resolve, the market should begin to focus on the supportive elements which should properly kick in from late next year. Increasingly, market participants will anticipate a tentative downward shift in policy interest rates. In that scenario, the securities that have re-priced negatively in the last year will be revisited and some will be considered bargains.

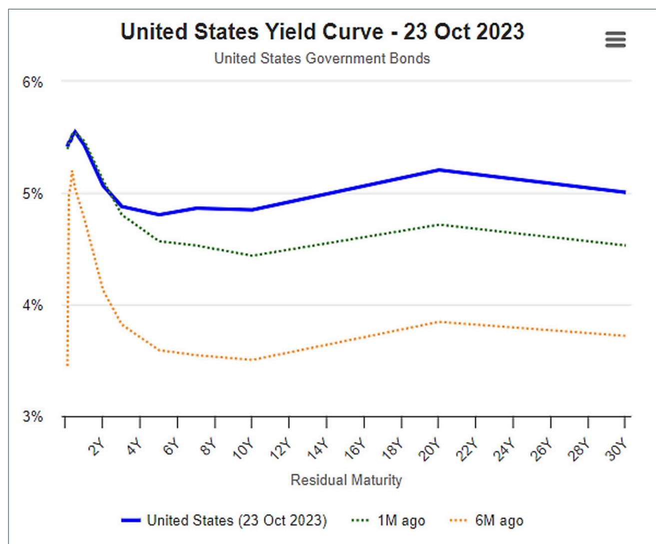
**After the final rate hike, equities do better when yield curve is positive**




Source: FactSet Research, data to 7 July 2023

Once it is clear to market participants that monetary conditions can be very gradually eased without catalysing a deep contraction, the historical pattern shows scope for renewed positive market returns.

A silver lining in the recent sell-off in government bonds is that it has "dis-inverted the yield curve" to a significant degree. While the short-term yields in the US are still in excess of medium- and long-term bond yields, the yield curve has recently flattened markedly, as can be seen in the chart below.




Source: Salt, World Government Bonds data to 23 October

In summary, the testing period we have entered in later 2023 should see more positively differentiated returns performance from the Quality-assessed selections in our international portfolios, and a greater investor appetite for the traditionally defensive or recession-resilient types of equity. It is increasingly likely that the performance of the main headline equity indices will be lower than

the returns accumulated by these more resilient companies over the next 12-18 months.

## A cooling economy is a time for care

Industrial output, PMIs, leading indicators, and credit conditions all support our view that developed market growth is slowing toward stall-speed. Tighter credit conditions are especially germane as a risk, given US banking and mortgage market stress, and acts as another form of lagged policy tightening on the US economy. Economies may avoid recession, but near-zero GDP growth is on the cards and until monetary conditions can be allowed to ease once again, few catalysts are visible to recharge activity.

Specifically, we are concerned that five tests for anticipating weakening equity market returns are currently satisfied:

1) US Forward earnings estimates falling;
2) a substantial prior US Treasury yield curve inversion;
3) a sub-50 level on the US Manufacturing Purchasing Managers Index (September's reading of 49% at least improved on the six-month low of 46% which was recorded in June 2023 );
4) below-average unemployment; and
5) over 40% of bank senior loan officers tightening lending standards.

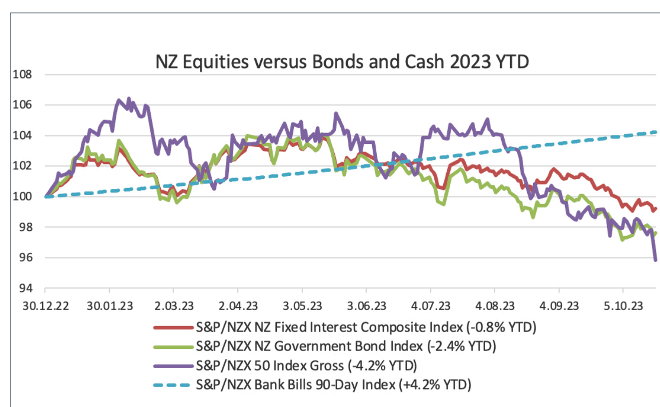
That said, the implied below-average returns outlook for equities does not (as we noted in our last edition) argue for a re-allocation away from shares and into bonds. Fixed Interest recorded a positive returns profile earlier this year, in anticipation of earlier monetary policy down the track. Much of those gains reversed in the mid-year period. Additionally, the magnitude of bond market returns that were experienced during the Quantitative Easing – low inflation epoch are a historical outlier and cannot form a credible expected return from the asset class going forward. Indeed, the old rule of thumb that a bond securities' current yield is a robust proxy for its expected total return should apply, leading to a 5% per annum best-case nominal returns outlook for broad Fixed Interest indices. For corporate bonds, returns in the 6-7% range are viable but probably only for the next 3 years at best.

The Equity Risk Premium is obviously very low at present. However, until inflation is running sustainably below 4%, there is an argument to tolerate equity volatility, in the service of purchasing power preservation. Put simply, both shares and bonds real yields may be low, but shares offer the potential for capital gain over the medium-term (3-4 year) period similar to the duration of a typical bond portfolio.

## NZ shares falling behind fixed interest' returns

In New Zealand, whilst NZ government bond securities have offered higher yields, they have not overtaken the total return from cash. We do not anticipate an enduring NZ bond rally in the near future and continue to expect range-trading with a mild further upside bias for domestic bond yields.

The domestic share market, despite holding a substantial weight of traditionally defensive utilities and health care services companies, has succumbed to the pressure of interest rates and political cross-winds as well as a set of stock-specific shocks covered in the NZ equity section of this report.




Source: S&P Global Indices data to 20 October 2023

What we do expect to see in late 2023-24 is much more differentiation between returns from different credit qualities, as borrowers are strained by low- or nil-growth economies and persisting higher costs.

Thus, we are again able to slightly increase our allocations to the fixed interest asset class in October, but with an important caveat. We require our bond holdings to be differentiated by issuer objectives, structures and sustainability-linked

outcomes, instead of scaling holdings by the size of an entity's rolling deficit or re-financing obligations. To this end, we introduced the Salt Sustainable Global Fixed Income Opportunities Fund which is now incorporated in both the Salt Sustainable Income and Salt Sustainable Growth Funds. The Fund is specifically focused on low carbon and climate-friendly bond issuers, as well as those agencies involved with projects aligned with the UN Sustainable Development agenda, in addition to broader acceptable corporate and sovereign issuers.

# Strategy conclusions

We retain our central market views for late-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 such 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, in a fraught macroeconomic and geopolitical phase. Real Asset's historical sensitivity to bond yields (as they trend down) may be supplemented by their cashflow surety, inflation-hedging qualities and (for Infrastructure) non-cyclical defensive merit. Bond yields have adjusted well, and may now plateau, which is positive for Real Estate looking forward one year, while Infrastructure has already benefited.
- 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.
- Expect more M&A based on strong USD "war-chests" and also some abandoned corporate courtships as conditions shift and distressed firms multiply into 2024.
- After the global bond sell-off of 2022-3, we see better compensation for duration risk.
- An additional sell-off in yields in mid-2023 has, as expected, reinforced this improved situation.
- 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 now on the radar and are likely to become a market focus in mid-late 2024 and set off portfolio re-allocations within and beyond bonds.

We are now entering the expected global slowdown as the lagged impacts of 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. International assets are broadly preferred to New Zealand counterparts, where viable, as the key northern hemisphere trading economies have more diversified defensive industries and often, more adaptive economic regulation (whist allowing that electoral / policy change risk is ever with us and will intensify next year with the US Presidential election in November 2024.)

***Greg Fleming.***

**IMPORTANT INFORMATION**

The information in this publication has been prepared from sources believed to be reliable and accurate at the time of preparation but Salt Funds Management Limited, its officers and directors, make no representation or warranty as to the accuracy or completeness of any of the information contained within. All analysis, opinions and views reflect a judgment at the date of publication and are subject to change without notice. This publication is provided for general information purposes only. To the extent that any of the information in this publication does constitute advice, it does not take into account an investor's financial situation or goals. An investor should, before making any investment decisions, seek professional advice, having regard to the investor's financial situation and goals. Past performance is not a reliable indicator of future performance and no representation or warranty, express or implied, is made regarding future performance. This presentation is solely for the use of the person or persons to whom it is provided and must not be distributed or copied, in part or in whole, without the permission of Salt Funds Management Limited. Salt Investment Funds Limited is the issuer of units in the funds comprising the Salt Investment Funds Scheme. The Product Disclosure Statement is available from saltfunds.co.nz