Saturn Advice
Creating a richer life

markets summary – September 2023

Asset class	Review	Outlook
International equities	Most share markets pulled back during the third quarter after a strong first half of the year. This was largely driven by investors pricing in the higher interest rates remaining high for longer than previously anticipated as inflation bucked the downward trend.	Most central banks are expected to maintain a restrictive policy stance until inflation drops to their respective target levels. We believe most economies will experience an economic slowdown but financial markets may have at least partially priced that in already. We believe that high-quality companies within financials, industrials, commodities and energy sectors offer good value. Geographically, the US economy looks more resilient and growth in the Indian economy looks promising.
Australasian equities	Both New Zealand and Australian shares had a materially negative quarter with New Zealand underperforming on relative basis. Both share markets were impacted by slowing of economic activity and a rise in rates.	The outlook for both New Zealand and Australia is for slower economic growth. New Zealand faces the risk of a relatively deeper recession if inflation doesn't decline fast enough. Australia's ecommerce, tourism and resources sectors continue to see resilient demand and RBA's somewhat less restrictive stance may provide relative support for valuations of quality companies particularly within healthcare.
International infrastructure	International infrastructure had a significantly negative quarter with valuations of infrastructure assets driven lower by rising yields.	The outlook for international infrastructure is mixed. Airports may see revenue normalisation. Energy infrastructure may also see revenue pressures over the medium term. Utilities infrastructure continue to offer investors diversification benefits with the potential for stable dividend yields.
Property	Listed property experienced a significantly negative quarter with property valuations pulling back due to rising yields. Global listed property was the worst performer.	Retail sector may see revenue pressure as consumer spending decreases in the coming months from higher cost of living. Modern office space will be in demand albeit overall office space demand will remain lower than pre-pandemic level. Technology-related property assets may continue to see high demand and revenue support.
International fixed interest	Bond yields rose during the quarter as central banks reiterated their restrictive policy stance. Accordingly, the asset class experienced a negative return for the quarter.	With the current interest hiking cycle peaking, we maintain our expectations of flat to declining yields over the medium term, which should provide support for bond valuations. With yields now approaching more normal levels after years at historical lows, bonds now offer better value and diversification benefits against short-term volatility in the share markets.
New Zealand cash and fixed interest	The RBNZ paused the OCR hikes, however, the 10-year yield rose sharply for the period following suit of rising yields overseas, which resulted in a subdued return by the asset class for the quarter. The New Zealand dollar was flat against the US dollar.	The RBNZ has cited commitment to bringing inflation within its target range via maintaining a restrictive policy. We expect the bond valuations to get support from declining yields as inflation drops over the medium term. The New Zealand dollar is likely to appreciate against the greenback over the medium-term with support for commodity currencies during the eventual economic recovery. Over the short-term, the currency movements will depend on the respective central bank's policy stance relative to each other.

world and local economies & markets

markets take a breather after a strong first half

Most share markets had a materially negative quarter after a strong first half of the year. This was largely driven by investors pricing in the higher rates remaining high for longer than previously anticipated as inflation appeared to be bucking the downward trend.

While most central banks appear to be near the peak of the current interest rate hiking cycle, they've maintained a restrictive policy narrative. This restrictive policy stance is expected to slow down economic growth for most developed economies.

It will be interesting to see if inflation continues to rise or starts falling again. This will determine the direction of interest rates or yields which in turn will impact asset valuations in the near term. Events like a geopolitical conflict often have the short-term impact of raising yields and a decline in share markets.

It is worth noting here that financial markets are forward-looking. This means that not only may they have priced in the oncoming economic slowdown already, they will also likely reflect the ensuing economic recovery before it eventuates.

All asset class returns except cash were negative for the quarter. The worst performing asset classes during the quarter were International listed property, New Zealand listed property and International infrastructure. In general, growth assets underperformed defensive assets over the quarter on relative basis.

Asset Returns (NZD)

Asset Class	QTR	1yr	3yr	5yr
New Zealand Cash	1.4	4.9	2.2	1.9
New Zealand Fixed Income	-2.1	-0.4	-5.4	-0.5
International Fixed Income	-1.8	1.7	-3.9	0.2
New Zealand listed property	-5.7	-4.5	-4.9	2.1
Australian listed property	-4.1	5.8	4.6	2.5
International listed property	-6.3	-5.9	0.8	-2.0
International Infrastructure	-5.7	-0.3	9.9	5.2
New Zealand Equities	-5.2	2.1	-1.3	3.9
Australian Equities	-2.0	6.7	10.4	6.3
International Equities	-1.6	14.8	11.6	9.4

Returns are shown as %. 3yr and 5yr returns are per annum (annualised). As at 30 September 2023.

international equities

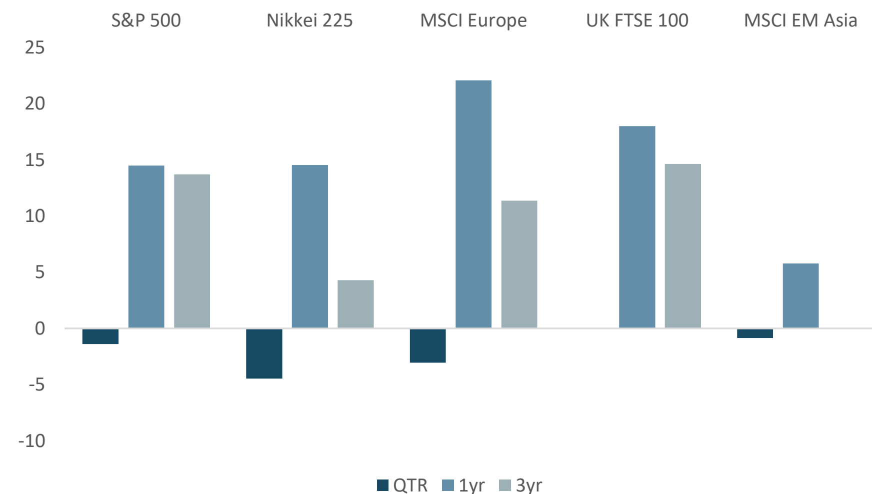
review

As mentioned earlier, most share markets had a negative quarter after two consecutive positive quarters this year. There was some profit taking behind the pull back but the main reason was rising yields. Yields rose as investors priced in interest rates remaining high for longer than previously expected due to inflation appearing to resurface and a persistently strong labour market which in theory fuels inflation.

For the quarter, the Nikkei 225 index was the worst performer dropping by 4.5% followed by the MSCI Europe which declined by 3.0% over the period. The S&P 500 declined by 1.4% while the FTSE 100 was flat for the quarter.

Emerging markets also declined in line with the developed markets. The MSCI EM Asia reported a decline of 0.9% for the quarter. While some emerging markets like India performed well, China underperformed amid concerns of slowing economic growth and credit concerns in the real estate sector.

Regional Indices (NZD) – Trailing Returns (%)



As at 30 September 2023. 3yr returns are per annum (annualised).

outlook

The IMF in its latest World Economic Outlook maintained its global growth forecast for 2023 at 3.0% however, cut the forecast for 2024 to 2.9% from 3.0% previously. The slight decline in expected global growth is cited to be from the impact of restrictive monetary policies implemented by most central banks.

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Central banks are expected to maintain the restrictive policy stance at least until inflation is within the respective target levels. For some quarters previously, we had maintained that most developed economies will experience a mild recession which will help bring down inflation structurally. In the last commentary we softened our tone to suggest that there was the goldilocks scenario of getting inflation down to target without respective economies experiencing a recession. We now revert back to our expectation of a mild recession.

We do not anticipate a deep or prolonged recession because once inflation is deemed to be structurally at or below target, the central banks can be expected to ease their respective monetary policy stance. In theory, this monetary easing will support asset valuations while encouraging economic growth.

As noted earlier, most share markets experienced a negative quarter. We believe this and any further downside provide buying opportunities. We do not expect a significant across-the-board fall in asset valuations due to the potential of an economic recession in the near future. Share markets are forward looking and we believe a material part of the downside risk is already priced in current asset valuations. The strong share market performance in the first half of the year was largely driven by the technology sector expected to benefit from the advent of artificial intelligence. While it can be argued that a potential sell-off in the technology sector could drag down the wider share markets, we would point out that most of the technology companies at the forefront of this year's rally are high cashflow generating businesses with low debt levels on their balance sheets. This places these technology companies in a uniquely advantageous position to weather a potential economically challenging period. More importantly, most other sectors have not meaningfully participated in the rally this year. This means the valuations across most sectors are still priced for an economic downturn thereby limiting further downside.

Accordingly, we believe that high-quality companies within financials, industrials, commodities and energy sectors offer good value over the medium term. Geographically, the US economy looks more resilient than Europe and growth in the Indian economy looks promising amongst emerging markets.

australasian equities

review

The New Zealand share market underperformed major international share markets with the S&P/NZX50 Index declining by 5.2% for the quarter. Notable underperformers included Vista Group (16.8%), A2 Milk (14.8%), Fletcher Building (13.3%) and KMD Brands (13.0%). The primary reason was companies lowering respective earnings guidance prompted by slowing of economic activity which then lowered expected valuations.

Across the Tasman, the Australian share market also had a negative quarter albeit it outperformed New Zealand with the S&P/ASX300 Index declining 2.0% for the period. Energy and miners were the outperforming sectors while retail struggled with slowing economic activity and healthcare underperformed as higher rates hurt valuations of growth companies in the sector.

Australasian Equities (NZD) – Trailing Returns (%)

As at 30 September 2023. 3yr returns are per annum (annualised).

outlook

As per our previous forecast, consumers and businesses are feeling the pinch from the rising cost of living and higher cost of borrowing. We expect that consumer and business spending may drop further over the coming months which may slowdown the economy further. In theory, an economic slowdown should lower inflation. The labour market is now showing signs of easing with a decline in job listings which may ease wage inflation, however, inflationary impact from higher net migration remains to be seen. We expect the RBNZ to hold the rates at a restrictive level until inflation falls to be within the target range. New Zealand's primary commodity exports are expected to see further downside as global demand slows. Tourism got a boost from the Women FIFA World Cup but that was a one-off.

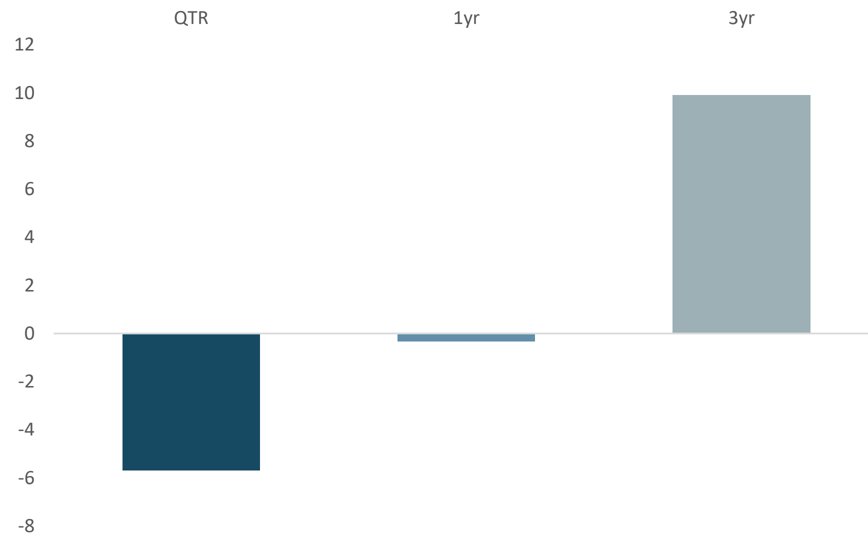
The Australian economy is in a slightly better place than New Zealand. Consumer spending remains resilient across ecommerce and tourism while the energy and mining sectors are expected to see increased revenues due to higher oil and commodity prices. That said, inflation is still higher than target albeit on the decline. This means the RBA will maintain a restrictive monetary policy stance at least for the near term. This can subdue economic growth, however, if consumer spending remains persistent the restrictive policy effects on economic growth may be offset at least to some extent. High quality defensive companies, particularly in the healthcare sector which have recently seen valuation downgrades from rising yields offer good value over the medium term.

international infrastructure

review

International infrastructure had a significantly negative quarter with the S&P Global Infrastructure Index recording a loss of 5.7% for the period as rising yields impacted the infrastructure asset valuations.

International Infrastructure (NZD) – Trailing Returns (%)



As at 30 September 2023. 3yr returns are per annum (annualised).

outlook

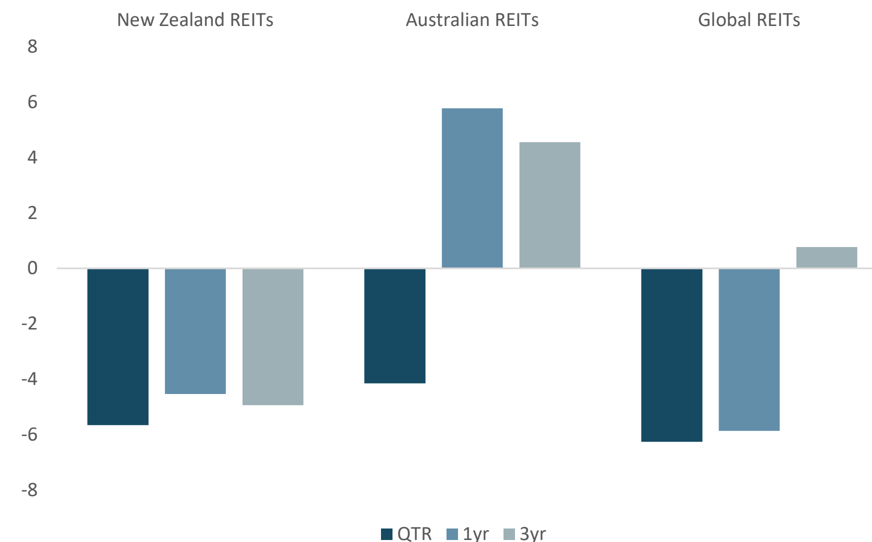
The outlook for international infrastructure as an asset class looks mixed. Airports continue to see healthy aeronautical revenues driven by international travel, however, international travel demand may cool off as a slowdown in global economic activity translates to lower discretionary spending. Toll roads and bridges should continue to see strong traffic and thereby revenue support. The price of oil has been supported by the extension of production cuts by Saudi Arabia and Russia but the outlook looks a bit uncertain against the backdrop of a slowing Chinese economy, the largest importer of the commodity in the world. Accordingly, although energy infrastructure assets may continue to see revenue support for now, the medium-term outlook appears to be more uncertain. Lastly, utilities infrastructure offers investors diversification benefits through a stable dividend yield during heightened volatility in other share market sectors.

property

review

New Zealand and global listed property also suffered during the quarter with property asset valuations declining due to rising yields. The NZX All Real Estate Index declined 5.7% for the period while the S&P/ASX300 A-REITs Index recorded a loss of 4.1% over the quarter. The global listed property was the relative underperformer. The FTSE EPRA Nareit Index decreased by 6.3% for the quarter.

Listed Property (NZD) – Trailing Returns (%)



As at 30 September 2023. 3yr returns are per annum (annualised).

outlook

While property asset valuations have been materially affected due to rising yields, we believe the yields will not rise significantly further. That said, the valuations may remain suppressed until the yields start to normalise.

Among the subsectors, retail faces the risk of slower consumer spending as the higher cost of living continues to bite. High-quality modern office space may be sought after but at the expense of existing office space as the total demand is expected to stay lower than pre-pandemic levels. Within the industrial subsector, demand for warehouses and

logistics assets will persist medium to long-term due to the continued advent of ecommerce. Lastly, technology-related property assets such as Datacentres and Telecom towers will also see resilient demand and revenue support.

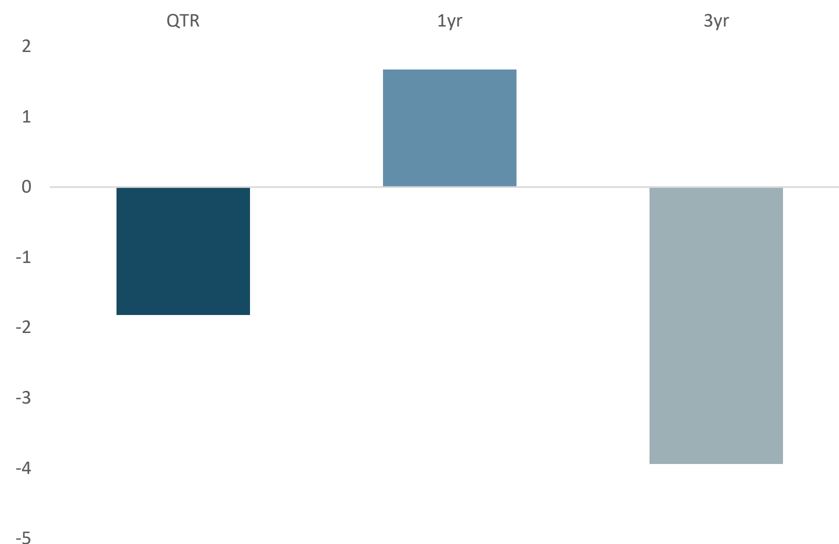
As mentioned earlier, we feel the impact of an economic slowdown may become more pronounced in New Zealand later this year. A worsening of economic conditions presents a headwind because rental yields may be compromised due to business failures and sluggish lease renewal activity.

international fixed interest

review

Most central banks appear to be at or near the peak of the current interest rate hiking cycle. However, bond yields rose across most major economies as central banks persisted with their narrative to maintain a restrictive stance for longer. The US 10-year treasury rate rose sharply from 3.82% to 4.57% during the quarter. The yield on the British 10-year Gilt increased marginally from 4.39% to 4.46% over the period. While Japan remains an outlier among developed economies due to its persistence with an expansive policy, its 10-year yield shot up from 0.40% to 0.77% during the quarter due to the Bank of Japan indicating flexibility in its yield curve control to tackle higher-than-expected inflation. With the rise in yields during the quarter, the Barclays Global Aggregate Index reported a loss of 1.8% for the period. The longer-term return is still unusually negative at 3.9% for the last 3 years due to the aggressive rise in yields over the last 18 months. The 12-month return was positive at 1.7% as a result of normalisation of yields earlier in the year.

International Fixed Interest (NZD) – Trailing Returns (%)



outlook

The near-term outlook is somewhat uncertain given the recent uptick in inflation and increased geopolitical tensions pushing yields up. Higher yields are negative for valuations.

However, we maintain that inflation has peaked and therefore most central banks are near or at the peak of the current interest rate hiking cycle. Accordingly, we maintain our forecast of flat to declining yields over the medium term notwithstanding shorter-term spikes due to unexpected events e.g. a geopolitical conflict.

This means the valuations for the asset class may see support over the medium term. Again, there may be further valuation downside in the short-term if there is a further spike in yields.

Importantly, International Fixed Interest as an asset class continues to provide diversification benefits due to its relatively lower volatility compared to shares. Finally, the significant increases in yields over the last year or so mean there are increasing opportunities to invest in good quality (investment-grade) bonds paying a reasonable yield which is a useful buffer against higher short-term volatility in share markets.

new zealand fixed interest and cash

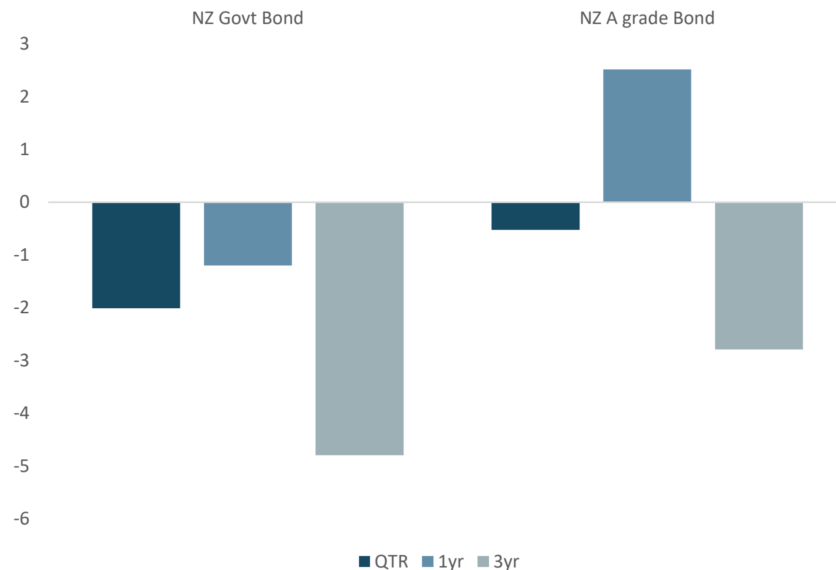
review

As per our forecast, the RBNZ paused its interest rate hiking cycle maintaining its official cash rate at 5.5%. However, the rise in global yields saw the New Zealand 10-year government bond yield rising sharply from 4.65% to 5.34% during the quarter.

The rise in yields resulted in the asset class providing a subdued return with the New Zealand Government Bond Index posting a material loss of 2.0% for the quarter while the New Zealand A-grade Corporate Bond Index also experienced a marginal decline of 0.5% for the period. Similar to international fixed interest, the asset class has experienced unusually high negative returns over the past 3 years on the back of a significant rise in bond yields over the past two years.

With a similar rise in yields during the quarter and similarly restrictive monetary policies by the RBNZ and the US Fed, the New Zealand dollar closed the quarter flat against the US dollar.

New Zealand Fixed Interest (NZD) – Trailing Returns (%)



As at 30 September 2023. 3yr returns are per annum (annualised).

outlook

At its latest monetary policy review, the RBNZ noted economic growth to be slowing due to the higher borrowing costs for consumers and businesses creating a negative wealth effect. As mentioned earlier, we expect the recessionary impacts to become more pronounced over the coming months because the RBNZ appears committed to maintaining interest rates at a restrictive level until inflation (5.6% as at September '23) comes down to the mid of the target range (1-3%). Our outlook for a more pronounced recession in New Zealand is supported by the RBNZ's conclusion that the current employment level remains unsustainably high, which means unemployment may be allowed to rise to help ease inflation. As inflation eases, we expect yields to drop in anticipation of the RBNZ lowering the OCR from restrictive levels. In theory, this backdrop may provide support for bond valuations over the medium term. Near term, yields may be swayed by movement in global yields.

Additionally, New Zealand fixed interest is increasingly offering decent yields and offers a buffer against heightened volatility in the share market.

The medium to longer term outlook for the New Zealand dollar will depend on the global economic recovery beyond the oncoming slowdown. Being a commodity currency, the New Zealand dollar tends to appreciate against the US dollar during periods of global economic recovery. Over the short-term the currencies will continue to reflect the respective central bank policies with the more restrictive central bank potentially resulting in relative appreciation of its currency.