phwealth Autumn Update

January – March 2021

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Share markets have generally spent much of the last 12 months going from strength to strength.

In a global context, we are still a long way from being "back to normal". Vaccination programmes are being implemented, economic growth rates are recovering, and the recent announcement of a travel bubble with Australia are all reasons for improving optimism.

But, if we scratch a little deeper, we see that unemployment rates remain high, global supply lines are stretched, international travel is still challenging for many, and a significant third wave of the coronavirus is currently sweeping Europe and many emerging nations.

Some of these issues may take months or years to settle, but forward-looking share markets are not sitting around - quite the contrary. Share markets have generally spent much of the last 12 months going from strength to strength.

Over the three months ending 31 March 2021, the highly influential US[1] market recorded a strong gain of 6%. For the 12 month period from 1 April 2020 to 31 March 2021, this rounded out an almost unimaginable 56% return.

This performance, along with the returns of many other global share markets over the last year, is unusually high because it began from a very low base after the Covid-19 shock and it includes the big bounce-back. Investors who stayed committed to their long term investment plans, reaped their rewards.

Returns were similarly impressive across other international developed markets. Over the first quarter of 2021, Japan[2] recorded a substantial jump of 9%, and Europe (excluding the UK)[2] gained 8%. The UK[2], although continuing to be a relative laggard within the major developed market region, still delivered a solid 5% return.

While developed market returns were almost unanimously positive in the first quarter, the performances of emerging market nations were a little less consistent. Of the four largest emerging market constituents, China[2] was virtually flat, returning -0.2%, while South Korea[2], Taiwan[2] and India[2] posted excellent quarterly results of 6%, 13%, and 5%, respectively. In aggregate, the emerging markets asset class delivered around 2%[3].

Closer to home, the returns of the New Zealand and Australian markets also diverged for the quarter. In recent years, the New Zealand share market has tended to outperform the Australian share market in local currency terms. However, in the three months ending March 2021, Australia[4] was clearly the stronger market gaining +4.3% compared with the New Zealand[5] market return of -3.9%. This represented the largest quarterly outperformance by the Australian share market since the final three months of 2016, a whopping 8.2% difference for the quarter!

In New Zealand, listed bank shares did well, and Fletcher Building, which reported strong half year improvements in margins and profits, gained 22%. However, it was quarterly weakness from other market heavyweights such as Contact Energy (-20%), Meridian Energy (-27%), and the a2 Milk Company (-29%), which dragged the overall market return into the negatives.

Although the performance of most share markets was generally strong for the quarter, fixed interest markets struggled as government bond interest rates rose quite sharply during the quarter.

The general belief behind these increased interest rates seems to be that the coronavirus will be conquered, the world will get back to "normal", and the combination of a growth surge and ongoing government stimulus will lead to increased growth, increased inflation and, ultimately, higher interest rates.

It's a plausible enough scenario, but 'plausible' does not mean 'guaranteed', and history repeatedly tells us that inflation and interest rates are notoriously difficult to predict.

> Having said all that, the markets continually express their view of the future by the way they price investments every minute of every day, and that collective view generally sent government bond rates higher in the first quarter.

For any doubters, it might be worthwhile to reflect on what happened just over a decade ago.

Coming out of the Global Financial Crisis (GFC), market commentators predicted a significant inflation risk that would surely result from central banks' printing money. This view was based on the dramatic easing in interest rates and the age-old printing of money during 2008/09.

However, in the 10 years that followed, despite records being set in terms of the subsequent economic recovery and the record low unemployment rates, inflation stayed persistently below market expectations.

The average annual US inflation rate from 2000 to 2009 was 2.6% per annum, but in the ten years that followed the GFC it actually reduced to 1.8% per annum. It was a very similar story here in New Zealand as inflation rose an average of 2.7% per annum in the decade leading up to the GFC and only 1.6% per annum in the decade following it.

In the meantime, the best strategy, as always, is to stick to your plan.

Will it be different this time? Will inflation come roaring back, or will it be contained? We will only find out in the future as nothing is certain.

Having said all that, the markets continually express their view of the future by the way they price investments every minute of every day, and that collective view generally sent government bond rates higher in the first quarter.

Bond yields and bond prices have an inverse relationship (meaning bond prices decline when bond interest rates increase), so the rising interest rate environment created negative returns for the quarter.

Where interest rates and inflation go from here is anyone's guess. Although the market has only a patchy record in accurately predicting future movements, it is currently pricing-in a higher inflation risk. However, the policy makers that actually decide the short term interest rate settings, like the Reserve Bank of NZ and the Federal Reserve in the USA, are less confident about the sustainability of the recovery. We must wait and see who is right, central banks, or the market.

In the meantime, the best strategy, as always, is to stick to your plan. It proved to be the right decision last April 2020 when the market fallout from Covid-19 was still fresh and it's the right decision now. Interest rates are already expected to gradually increase in the future. That's the expectation we see today, and it's also reinforced by government policies that are designed to relentlessly pursue greater economic growth. But whether these future interest rate increases happen faster or slower than the market currently expects, is really anyone's guess.

Although we can't expect another 12 months of strong double-digit share returns, well diversified portfolios nevertheless remain well placed to deliver the returns that the markets will ultimately make available.

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[1] *S&P 500 Index (total return in USD)*
[2] *MSCI Country and regional indices (gross dividend in local currency)*
[3] *MSCI Emerging Markets Index (gross dividend in USD)*
[4] *S&P/ASX 200 Index (total return in AUD)*
[5] *S&P/NZX 50 Index (gross with imputation)*

Key market movements for the quarter

One of the most interesting stories of the quarter was the price action of several small US companies, most notably GameStop, a brick-and-mortar retailer of video games. An internet forum targeted GameStop's share price, pushing it up by as much as 30 times in early January. Their aim was to hurt hedge funds that were known to be betting against this firm. The initial price rise had its intended consequence as hedge funds were forced to exit their positions crystalising significant losses.

The first quarter also saw the anniversary of the fastest market correction ever seen - during February and March 2020. The subsequent recovery provides a forceful reminder of the merits of a disciplined long-term investment approach.

+6.2% *(hedged to NZD)*

+8.1% *(unhedged)*

International shares

Small companies generally outperformed larger companies in the quarter and also posted higher returns over the last 12 months. Industries such as energy, industrials, and financials (typically 'value' companies) were the best performing as the prospect of strong economic growth drove their prices higher. Healthcare and information technology – sectors that had thrived through the pandemic – lagged through the quarter, although information technology remains near the top over the last 12 months.

The New Zealand dollar was generally weak versus foreign currencies and this meant that unhedged foreign assets outperformed.

Source: MSCI World ex-Australia Index (net div.)

+5.4%

Emerging markets shares

Emerging market shares generated gains as well, albeit less than developed markets. The vaccine roll out in these nations has been slower than in developed nations, and high infection rates again meant social restrictions in some countries. Oil heavy economies such as Russia and Saudi Arabia were among the best performing nations as renewed global demand for oil pushed prices up. Taiwan was also strong, led by large semiconductor producers who produced good results.

Korea and India produced small gains while regional heavyweight, China, struggled in the face of ongoing US-China tensions, even under the new US administration.

Source: MSCI Emerging Markets Index (gross div.)

-3.9%

New Zealand shares

Although the Royal New Zealand Yacht Squadron proved to be world beaters, local shares took on a little water in the first quarter of 2021. It was a handful of disappointing results from the larger firms and the announcement of a 1 percent drop in our GDP during the last quarter of 2020 (worse than expectations) that knocked us right off our foils. In aggregate, the broad market index declined -3.9%.

Dairy companies Synlait Milk and a2 Milk were among the poorest performers as multiple earnings downgrades soured investor demand. Synlait's largest client is a2 Milk, and a2 has seen demand for their infant powder dry up through the latter half of last year, negatively impacting both firms' reported profit expectations.

Meridian and Contact Energy also had volatile quarters, and each ended down more than -20%. Both had enjoyed a strong end to 2020 as high demand for these clean energy companies from international investors had pushed their prices up. However, during the first quarter, Standard and Poors signalled the expansion of their global clean energy index from 30 holdings up to 100, slashing Meridian and Contact's weightings. Investors tracking this index reduced their holdings in both companies which pushed each firm's price well down.

At the other end of the spectrum, Fletcher Building enjoyed another strong quarter, as did The Warehouse Group, which reported a record profit late in the quarter.

Source: S&P/NZX 50 Index (gross with imputation credits)

+5.8%

Australian shares

Australian share market returns were strong over the quarter. Over the last 12 months, small capitalisation companies have been very strong, with the S&P/ASX Small Ordinaries Index up +52% versus +37% for the top 100 companies.

Source: S&P/ASX 200 Index (total return)

-0.4%

International fixed interest

Longer term interest rates rose as the market priced in prospects of an improving economic growth outlook.

The US 10 year yield – the yardstick for global rates – increased to 1.7%, effectively returning it to pre-Covid levels. These rates are now at the lower end of the broad range observed in the ten years following the GFC.

It should also be noted that although the increase in yields contributed to a negative quarter for bonds, it also serves to increase the expected return of these same assets in the future.

Source: FTSE World Government Bond Index 1-5 Years (hedged to NZD)

-2.1%

New Zealand fixed interest

Rates in New Zealand followed the global trend and spiked with the NZ 10 year rate closing the quarter at 1.8%, 0.8% above its starting point. The impact was negative on performance, although generally less so here than overseas, as our market has a relatively shorter average time until maturity.

Source: S&P/NZX A-Grade Corporate Bond Index

Table 1: Asset class returns to 31 March 2021

Asset Class	Index Name	3 months	1 year	3 years	5 years	10 years
New Zealand shares	S&P/NZX 50 Index (gross with imputation credits)	-3.9%	+28.9%	+15.7%	+14.3%	+15.2%
Australian shares	S&P/ASX 200 Index (total return)	+5.8%	+45.0%	+10.5%	+9.8%	+5.6%
International shares	MSCI World ex Australia Index (net div., hedged to NZD)	+6.2%	+49.7%	+12.4%	+13.6%	+12.0%
	MSCI World ex Australia Index (net div.)	+8.1%	+31.4%	+14.2%	+13.2%	+11.0%
Emerging markets shares	MSCI Emerging Markets Index (gross div.)	+5.4%	+35.8%	+8.1%	+12.2%	+4.9%
New Zealand fixed interest	S&P/NZX A-Grade Corporate Bond Index	-2.1%	+1.9%	+4.0%	+4.0%	+5.0%
International fixed interest	FTSE World Government Bond Index 1-5 Years (hedged to NZD)	-0.4%	+0.6%	+2.6%	+2.3%	+3.5%
New Zealand cash	New Zealand One-Month Bank Bill Yields Index	+0.1%	+0.3%	+1.1%	+1.5%	+2.2%

Unless otherwise specified, all returns are expressed in NZD. We assume Australian shares and emerging market shares are invested on an unhedged basis, and therefore, returns from these asset classes are susceptible to movement in the value of the NZD. Index returns are before all costs and tax. Returns are annualised for time periods greater than one year.

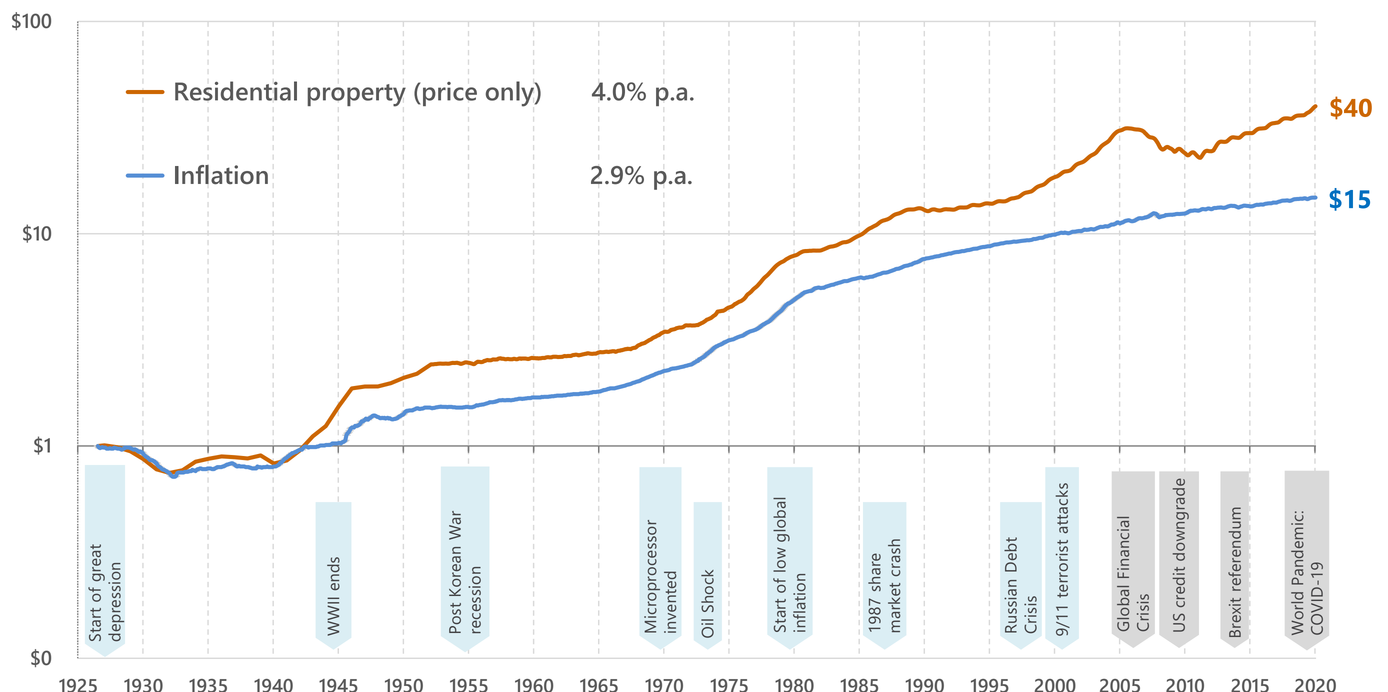
Housing affordability... where to from here?

For generations, property has been the preferred investment of many New Zealanders. Those of us fortunate enough to own our own homes take great pride in doing so. But, for many, the attraction runs deeper than simply having a roof over our own heads. We understand property. We trust property. We also know that over a long period of time, investors in residential real estate have often been able to generate a very good return from property.

When we look at property markets overseas, residential property generally represents a solid if unspectacular investment. For example, in the chart below, we can see that the average price of residential property in the United States has increased by only 1.1% above the rate of inflation over the last 93 years. This price series excludes the effects of capital upgrades that occur when you spend additional money to maintain or make improvements to your property.

This makes intuitive sense because if the price of property (excluding capital improvements) were to increase much faster than the rate of inflation, it would eventually outpace most people's ability to purchase it!

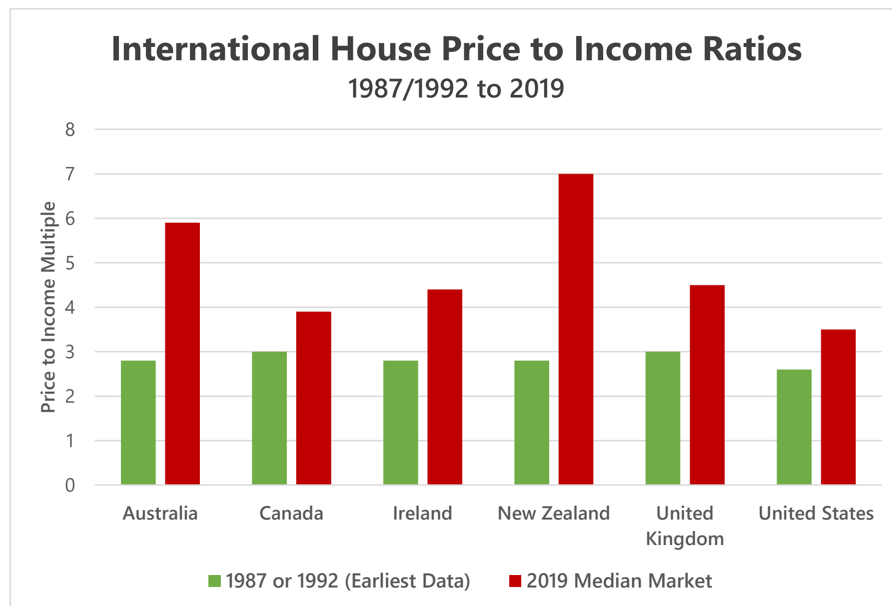
Long term growth of US residential property and inflation 1927 - 2020



Analysis period is for June 1927 to December 2020. All returns are in US dollars

Sources: **Residential property:** 01/1920 to present - Shiller Home Price Index (source: Grebler, Five-CityMedian, PHCPI, FHFA, S&P/Case-Shiller). **Inflation:** US Consumer Price Index (source: Stocks, Bonds, Bills and Inflation, Chicago: Ibbotson and Sinquefield, 1986. Represented by Consumer Price Index for All Urban Consumer (CPI–U), not seasonally adjusted. The CPI is updated with a one month lag).

Note: These materials are only prepared for client education purposes. Consilium has taken every care in preparing this information. Although the data has been sourced from publicly available information and/or provided by the investment managers, we are not able to guarantee its accuracy. Past performance, whether actual or simulated, is no guarantee of future performance.



The overall result is that New Zealand housing is much more unaffordable than it was 30 years ago, and it is much more unaffordable, on a relative basis, compared to other countries.

But that's not what seems to have happened in New Zealand.

The chart above shows data from the Demographia 2021 study on international housing affordability and compares housing affordability from about 30 years ago to today.

The measure of affordability is the national average home price as a multiple of the national average income. This measure helps us make an easier comparison between countries with different income levels.

As can be seen quite clearly above, the red bar is twice the height for New Zealand as the green bar. That means it takes almost twice the income to purchase a house now compared to 30 years ago. This chart was based on 2019 data, so with the recent strength in the housing market, it's very likely to be even worse today. We also observe that the red bar for New Zealand is higher than comparable English-speaking countries. The overall result is that New Zealand housing is much more unaffordable than it was 30 years ago, and it is much more unaffordable, on a relative basis, compared to other countries.

This probably helps explain why the New Zealand government felt compelled to introduce some changes to the tax regime faced by residential property investors.

The two main changes announced in March include:

1. The extension of the 'bright line test' to 10 years for existing residential property (maintained at 5 years for new builds). This means an effective tax on any capital gains made on properties sold earlier.
2. The removal of tax deductibility of interest expenses for homes purchased from 27 March 2021, with deductibility to be phased out entirely over the next four years.

It seems these changes have been introduced with the intention of reducing the profitability, and therefore the incentive, of investing in existing residential property. And, if it removes the incentive for property investors to purchase the existing housing stock, then it might just make more room for the ubiquitous 'first home buyer' that the government spends so much time trying to figure out how to help.

It is far too early to tell whether these policy changes will have that desired effect, because at least part of what's driving New Zealand's relatively unaffordable housing market is a supply side issue. House prices are already high; but if these high prices aren't inducing sufficient investment into new property developments, then there must be some constraint either on the supply of land, materials or labour. Solving these issues isn't anywhere near as simple as creating or extending a 'bright line test' for capital gains.

[1] *http://www.demographia.com/dhi2020.pdf*

Disclosure statements are available on request and free of charge.

In the Demographia study, former Prime Minister Bill English is quoted as saying:

> ***Housing affordability is complex in the detail — governments intervene in many ways — but is conceptually simple. It costs too much and takes too long to build a house in New Zealand. Land has been made artificially scarce by regulation that locks up land for development. This regulation has made land supply unresponsive to demand.***

From an investment point of view, we've traditionally told clients that have wanted to pursue residential property investment that they needed to treat it like a business — their own property business.

They can hope for (but can't guarantee) that house prices will rise. Therefore, they need to ensure they have a property that makes sense from a rent and cashflow perspective. They need to consider the time and cost of capital improvement and realise that they don't own the "median house". They own a physical property that renters use and inevitably damage, and their property will depreciate and will need maintenance to improve it. Some who have undertaken residential property investment on this basis and approached it thoughtfully, like a business owner, have done very well.

But the government is now saying that investing in residential real estate is not a business, so interest expenses will not be an allowable deduction like it is in any other business. Additionally, turning over a property investment within 10 years might also have significant additional tax consequences. The end result is likely to be that the smaller and more leveraged investors might increasingly begin to look elsewhere to grow their wealth, like the sharemarket.

New Zealanders are unlikely to suddenly lose their love-affair with residential property. Those feelings have been nurtured by generations of New Zealanders being able to successfully gain leveraged exposure to an asset class that has, over time, steadily appreciated in value. Critically, those leveraged capital gains have historically been 'tax free' and with interest rate deductibility benefits!

The bricks and mortar appeal of investing in housing has, for a long time, resonated with Kiwis in a way that better performing assets classes have never been able to match.

However, in light of the recent tax changes, it is possible the rate of future capital appreciation in this space might slow. That's certainly what the government will be hoping. Some investors may think twice before investing and some may change their strategy entirely. But it would be a brave person to suggest that this will mark the end of residential property investing.

The bricks and mortar appeal of investing in housing has, for a long time, resonated with Kiwis in a way that better performing assets classes have never been able to match. While that might change, we wouldn't bet my house on it.

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