DecisionMakers
Investment Advisers & Portfolio Managers

MyFiduciary
Governance & Investment Support

Economic and Market Commentary September Quarter 2023

Overview

Most asset classes suffered negative returns in the September quarter.

The strong first half of calendar 2023 gave way to a pull back in the September quarter. Most conventional asset classes suffered negative returns, including global and NZ equities, global and NZ fixed income, and listed property and infrastructure. In contrast, cash and short-term bonds fared relatively well, as did select alternative asset classes.

The short end of the yield curve is offering compelling opportunities for bonds.

The main factor behind the sell-off is concern that interest rates need to be higher for longer. While inflation has been trending lower, it is still higher than central bank targets. Economic growth and employment levels have also stayed stronger than anticipated in many countries, including New Zealand, Australia and the United States. The silver lining is that this has reduced the chances of a large slump in economic activity, which is ultimately much worse for asset prices than a pull-back caused by activity being stronger than expected. In addition, higher interest rates mean that the portfolios now have much higher income yields than they had a year or two ago. This source of return is much more certain (less risky) over the short term than the return from capital gains.

Market roundup

Market performances are reported in Figure 1. New Zealand investment grade corporate bonds fell -0.5% in the quarter as longer-term rates rose, partly due to NZ GDP coming in stronger than expected. The annual return was around 2.5%, and with current yields on NZ corporate bonds now around 6.5% we can expect higher returns going forward.

Global investment grade bonds fell by around 1.8% in the quarter as the US Federal Reserve signalled interest rates need to be higher for longer. With interest rates now back to more ‘normal’ levels, like NZ bonds, risk is now much more evenly balanced, and bonds offer the prospect of solid future returns.

Global equities have the strongest returns YTD; elsewhere performance is modest.

New Zealand shares fell by 5% and Australian shares fell by 2% (in NZD) over the quarter. Australian shares have been much stronger over 1- and 3-years, while New Zealand shares are now showing a negative return over 3-years, significantly under-performing most other equity markets (global equities by comparison are up more than 10% per annum over this time). International shares also fell in the quarter, by around 1.5% in NZD terms and 2.5% in NZD hedged terms. Over the year to September, performances remain very strong for international equities, particularly on an NZD hedged basis, with returns of over 20%. The hedged performance is however flattered by the fact that September 2022 was a low point for our currency, and around 6% of the return is due to the NZ dollar appreciating against the US dollar from that point.

Global property and listed infrastructure were the worst performers over the quarter. Global property has been under significant pressure, especially within commercial property which has been a key driver in the under-performance.

Short duration and alternatives have been key contributors to portfolio returns.

Short duration and alternatives continue to add value

There were some bright spots. Cash enhanced funds and short-term bonds performed well in the quarter given their high running yields of 6% or more. Alternative strategies also performed well this quarter, including insurance linked securities, trend-following and multi-strategy alternatives.

The market is expecting short term interest rates to have not just peaked but to begin declining. Our portfolios continue to include short duration / cash and have exposure to defensive alternatives, which have added value over the last two years. Anticipated rate cuts (OCR) have been pushed back, however locking in longer term rates provides certainty. The alternatives exposures also provide diversification benefits, which are further discussed below.

Diversification and correlations between asset classes

Asset class diversification reduces portfolio risk for a given return.

While a soft quarter is never comfortable, from an overall portfolio design point of view we are perhaps most uncomfortable whenever we see everything going strongly up or down at once. Mixed performances over the short term indicate that *portfolio diversification* is working.

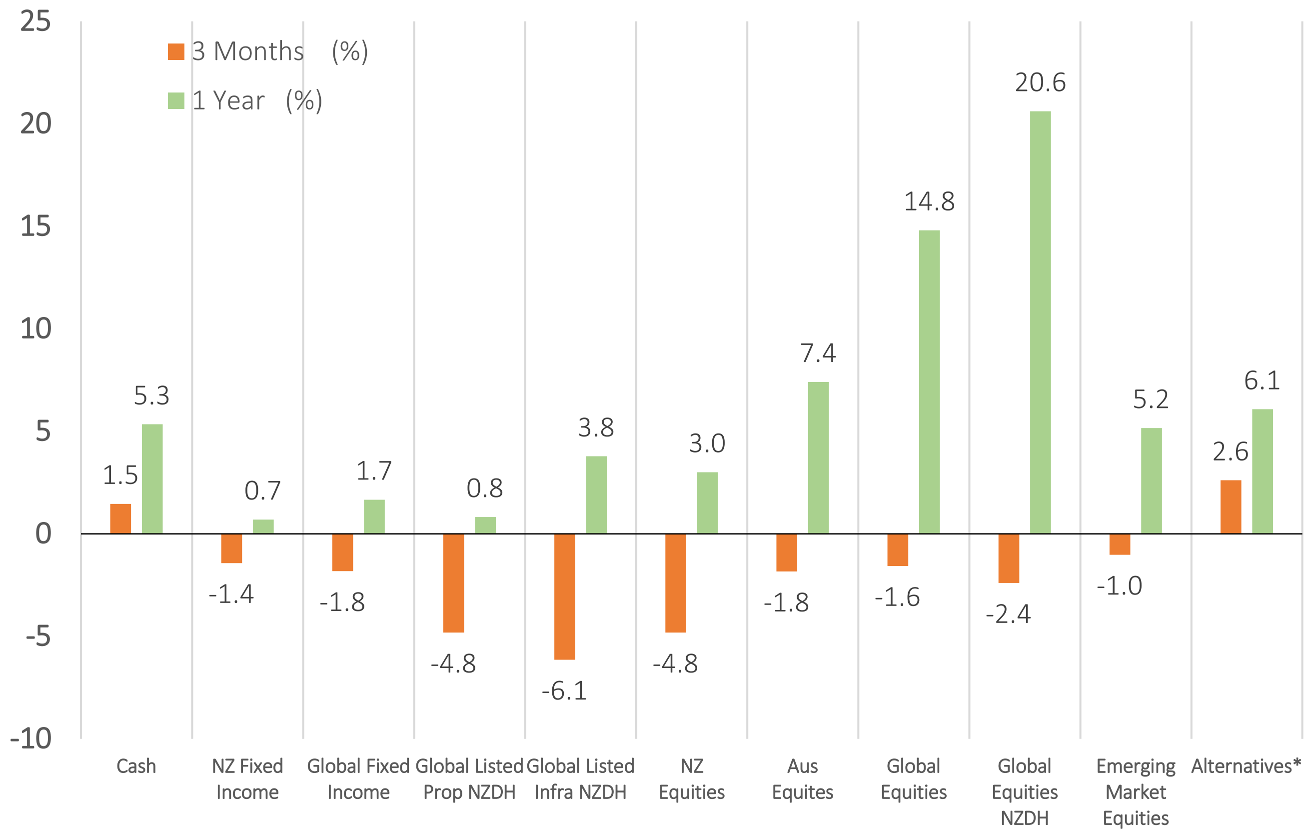
Diversification occurs because markets have different drivers of return, they are not perfectly correlated.

Diversification benefits occur when different asset classes move in . NZ equity returns, for example, do not always move in lock-step with global equities. Local companies are much more impacted by domestic economic conditions. Similarly, global listed property and infrastructure tend to be less impacted by global growth conditions but are more sensitive to interest rate changes than global equities overall. And NZ and global government bonds have historically had a very low, often negative, correlation with equities (government bonds have typically rallied when equities have fallen).

While we can expect diversification to occur from having a mix of assets classes in the portfolio, we can't expect it to work perfectly all the time. Over 2022, and in the current quarter, longer term bonds and equities both fell (i.e. were positively correlated) given the effect on both of rates being higher for longer. In addition, there are potential limits to diversification. Adding an asset class to the portfolio that is very volatile and highly correlated with equities could raise, rather than reduce, overall portfolio risk, as illustrated in the final box of figure 2.

The best source of diversification is time, which is why having a long term horizon is so important.

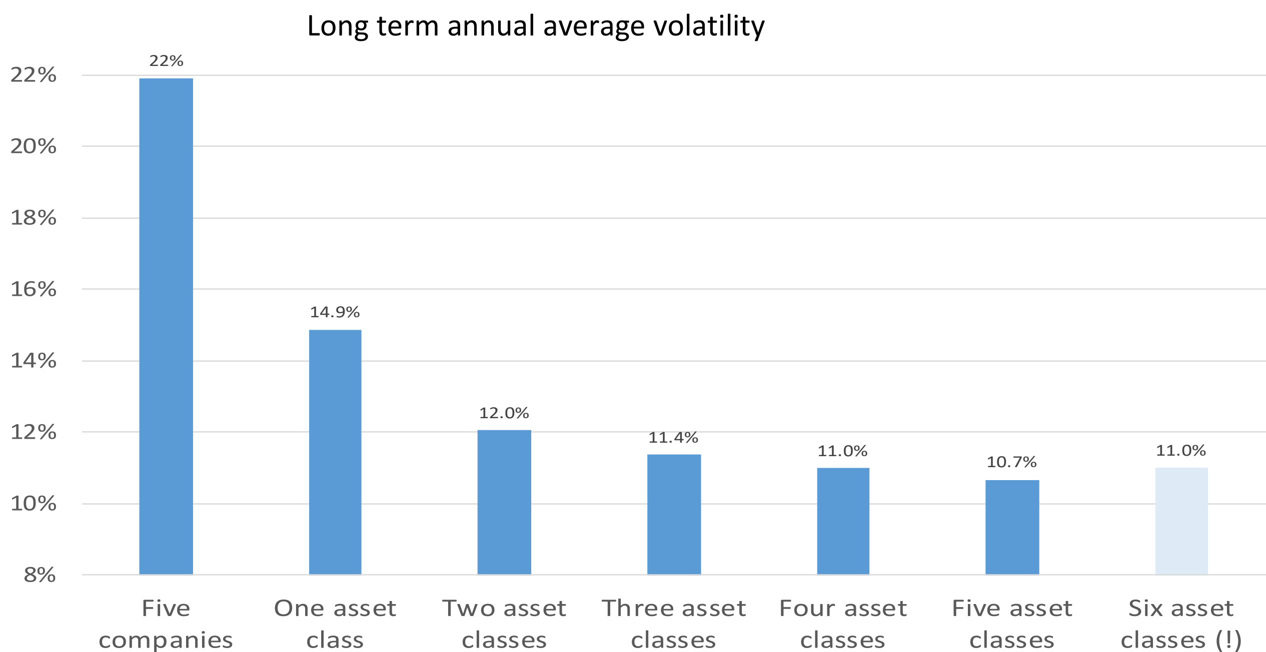
In designing portfolios, we are mindful of the fact that correlations can vary over time depending on economic conditions and the source of 'shocks' to markets. Given this, our focus is on adding classes, such as alternatives, that should help diversify risk under a range of scenarios. And as always, the most important factor is *time* – bad outcomes tend to be unwound with time, and assets are more certain of earning a premium over cash the longer the time horizon. For this reason, we can regard time as the ultimate source of diversification.



*Alternatives exposure is gold, insurance linked securities and trend following.

Source: Morningstar Direct, MyFiduciary

Figure 2: The benefits of diversification



Source: MyFiduciary