Economic and Market Commentary September Quarter 2024

Overview

Markets rallied across the board in the September quarter as interest rates were cut by central banks.

Everything everywhere all at once. To borrow from the title of the 2022 Oscar winning film, almost every asset class enjoyed strong returns in the September quarter (see Figure 1). The lead role in this performance was played by central bankers. The RBNZ cut the OCR by 25bps on August 14th, the ECB also cut by 25bps on September 12th, while the US Federal Reserve cut by 50bps on September 23rd. Markets cheered on and proceeded to bake in the view that the world is entering into a materially lower interest environment over the next few years.

Playing a key supporting role in market strength was the US economy, whose equity market now represents around 65% of global equity market capitalisation. US GDP growth came in at around 3% for the year to June, and current indicators suggest that their economy is at least maintaining this pace of growth, whilst US CPI inflation continues to trend lower and is now around 2.5%. While some commentators still think there is recessionary risk in the US, our view is that perhaps the main risk now to this 'goldilocks economy' is that US rates will be cut too far too quickly. In the meantime, the US consumer is enjoying the show (Figure 2).

The US economy has continued to perform well whilst in NZ and many other countries growth remains weak.

US economic strength is in stark contrast to the situation here at home where NZ GDP growth was a miserly -0.2% for the quarter and year ended June, and NZ Bank economists do not expect a material rebound in activity anytime soon. Outside of the US, economic activity in much of the world also remains patchy, and geo-political tensions have continued to rise as the conflict between Israel and Hamas has spread. Our feature this month steps back a bit to ask what does the evidence suggest is the relationship between geo-political risk and returns?

Market roundup

Global equities on a NZD hedged basis had the strongest return at around 30% in the year to June, followed by global listed property and infrastructure.

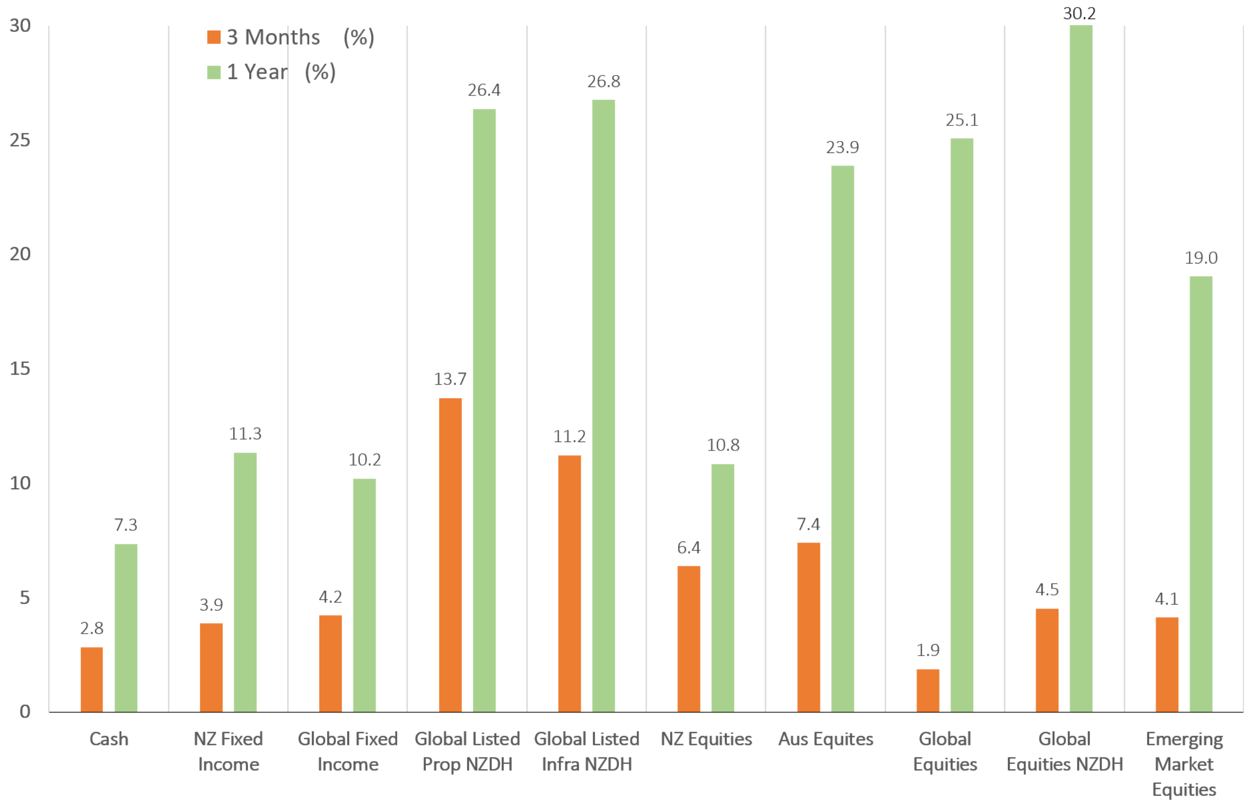
Asset class performances were strong over the quarter. Global equities rose by around 2% on a local currency and 4.5% on an NZD hedged basis, bringing the annual returns to just over 30% on an NZD hedged basis, and 25% on an unhedged basis. Emerging markets outperformed unhedged global equities in the quarter, but still lag in the year to June with a return of 'only' 19%. This performance is however broadly in line with developed market equities outside of the US-large cap tech sector.

NZ and Australian equities enjoyed a very strong quarter, increasing by around 6.5% and 7% respectively. Interest-rate sensitive listed property and infrastructure also performed very well, boosting their annual returns to over 26% on an NZD hedged basis, and around 22% on an unhedged basis.

Bond market performances were also strong with returns over 10%.

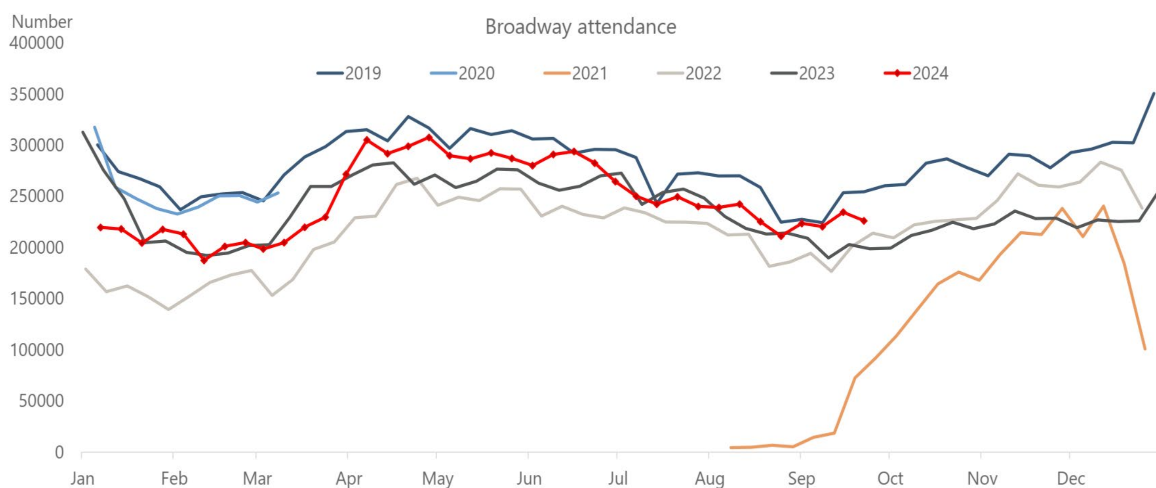
Bond market performances were also strong as large rate cuts were priced in over the rest of this year and through 2025. New Zealand investment grade bonds increased 3.9% in the quarter, and around 11.5% over the year. International investment grade bond returns were slightly softer at around 4.2% in the quarter and 10.2% over the year. Last, but not least, gold prices (in NZD terms) increased 8% in the quarter and 33% over the year, reaching record prices.

Figure 1: Strong performances in the September quarter



Source: Morningstar Direct, MyFiduciary

Figure 2: US consumer spending around historic averages, as illustrated by Broadway show attendances



Geo-political risk and returns

Geo-political risks are ever present

Overview

Geo-political risks, both perceived and real—such as wars, terrorist attacks, political instability, and trade tensions—are a staple of our news and, at times, completely dominate the headlines. While such events can have profound impacts on the lives of individuals, communities and nations impacted, do they matter for long term asset returns? Below we address what the empirical literature suggests, and the implications for investors.

They can cause large short-term declines in markets but are very difficult to forecast.

Geo-political risk impacts in principle

As with most things in markets it is useful to distinguish between the short and longer terms. Over the short-term the literature suggests geo-political events can lead to abrupt equity market sell-offs, and increased volatility and market risk premiums. But crucial in this is the proximity of the event to the market concerned, the magnitude of the event, and the impact across different sectors and countries.

The literature also suggests that such events are at best co-incident with volatility and short-term declines in equity markets. In other words, it is exceedingly difficult to *forecast* future returns given geo-political risks.

Over the longer-term markets recover even though there can be enduring economic and sectoral impacts.

The longer-term impacts depend on how the 'shock' is resolved and whether it has an enduring influence on economic growth, corporate earnings and profitability. In general, we can say that over time markets recover even from the largest of such events like World Wars. The figure below shows the long - term march upward of markets as a whole through geo-political and other hits to markets. But that is not to say there aren't enduring impacts on specific companies, sectors or even countries and regions.

Case study – Russian invasion of Ukraine

Russia's invasion of Ukraine had a larger initial impact on equity markets, but excepting Russia, they have now more than recovered.

To illustrate this with a recent example, the full-scale Russian invasion of Ukraine in February 2022 had the largest short-term impact on neighbouring countries. Poland and Hungary's equity markets fell around 40% and European equity markets overall initially fared worse than the US.[1] But in the year following the invasion European equities had fully recovered while the US market was down around 9%, even though European economies were much more negatively impacted by rising energy prices. And now, some 2.5 years on, most equity markets have reached new highs, with the US leading the pack. In contrast, Russian equity markets have become un-investable following the dropping of their markets from indexes and funds.

Nevertheless, there have been enduring impacts. Energy markets have been completely re-configured within Europe and some commentators suggest the war has hastened transition away from fossil fuels. Defence industry spending has rocketed up[2]. In contrast, most Western companies with Russian ties have essentially had to write-off their business and assets held within Russia.

[1] See https://www.msci.com/www/blog-posts/global-markets-one-year-after/03668219477

[2] This (ppor) pun was unintended.

For investors, diversification and time are the key tools for managing geo-political risks.

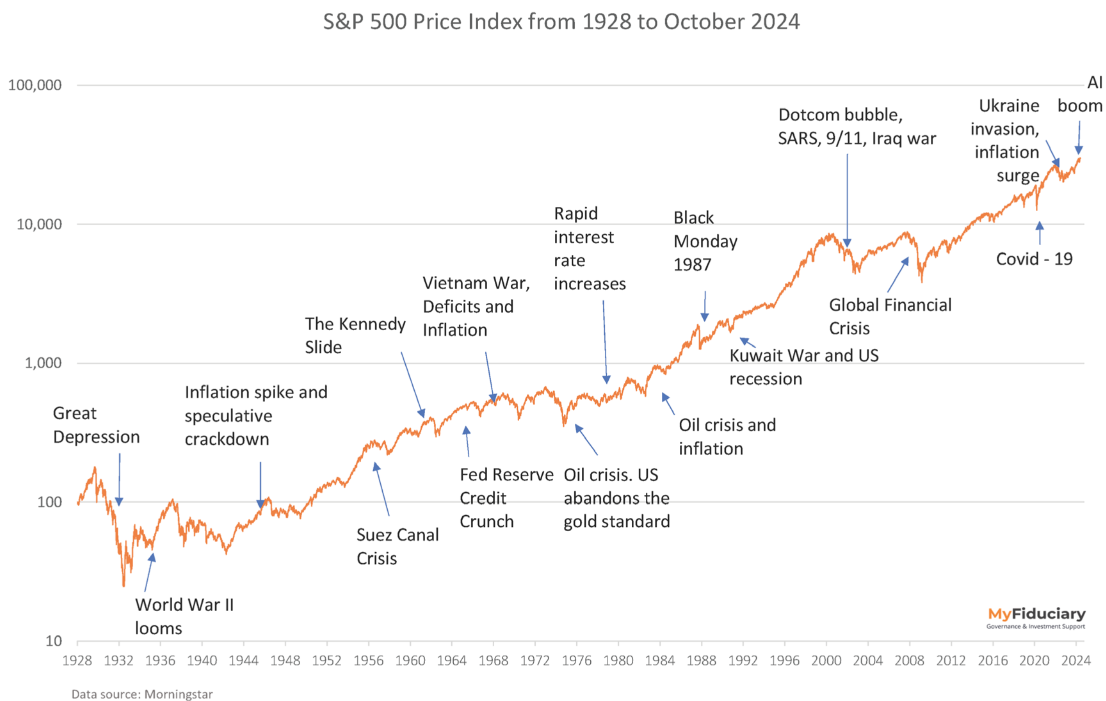
Implications for investors

For investors diversification across markets and asset classes is essential for managing geo-political event risk, in line with managing market risk in general. Bonds and asset classes such as gold typically rally when there is an increase in short-term global uncertainty and equity market volatility. A 'shock' that has an enduring negative impact on a country or sector can be mitigated by holding broadly diversified exposures across different sectors and countries. And time, as always, is the ultimate diversifier. Most markets, most of the time, recover.

Another implication of the literature is that it is likely unfruitful and potentially counter-productive to adjust portfolios in response to geo-political risk. Markets are impacted by many forces, and as discussed above the medium and longer run impacts are very uncertain. An investor selling European stocks after the Russian invasion to buy, say, US stocks on the view that the European economy would be more at risk, would have been right on the economic impact, but wrong on the impact on markets over 2022. Defence spending has massively increased since the invasion, but defence stocks overall have not outperformed.

Finally, while we caution against reducing exposure to risky assets because of concern that geo-political risk will impact future investment returns, there may still be good reasons to adjust based on Responsible Investment (RI) considerations, subject to materiality and the practicality of making any adjustments. Many investors sold (or wrote off) their holdings of Russian stocks on RI grounds following the Ukrainian invasion, which in the event was facilitated by fund managers and index providers dropping these exposures in response to Western government sanctions.

The benefit of having a long time horizon:
S&P 500 Price Index from 1928 to October 2024



Source: Morningstar Direct, MyFiduciary