SALT GLOBAL OUTLOOK

July, 2021

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Vaccines, re-openings and the Delta variant

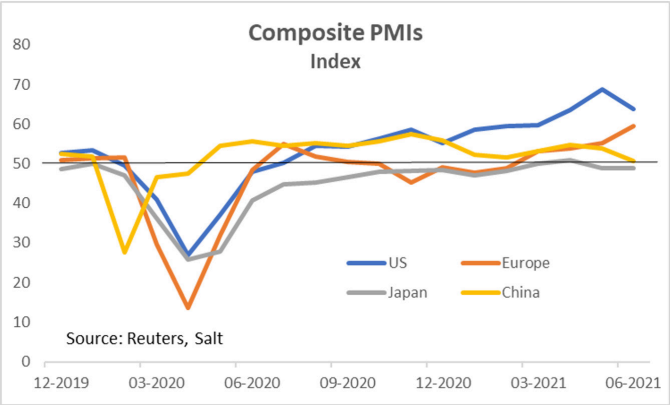
After a tumultuous 18-months, deployment of the various vaccines around the world is allowing Covid-related social and economic restrictions to be gradually eased. Global growth is picking up pace, aided by aggressive monetary and fiscal support.

Performance by country remains mixed depending on success or otherwise in containment of the virus and the speed of deployment of the vaccines. Countries such as New Zealand and Australia, which managed the initial spread of the virus well, are in relatively good shape. In both countries, levels of economic activity are now above pre-Covid levels.

In the United States and the United Kingdom, where control of the virus has been more problematic but vaccine deployment has been swift, are now showing the fastest recoveries.

Others, typically emerging but none-the-less significant global economies, are facing ongoing disruption due to on-going outbreaks of the virus and low vaccination rates. This includes South Africa and India. In India, the recent out-break of the Delta variant has been difficult to contain, and it is no exaggeration to say it brought the Indian health system to its knees.

In general, and despite the differing pace, all the world's major developed economies are heading in the right direction. This is mostly being driven by the release of pent-up domestic demand of initially goods but increasingly also services as populations can get out and about more.



The recovery of demand has run ahead of firms' ability to gear up production. Supply shortages, soaring freight costs and sharply higher commodity prices are fueling higher producer and consumer inflation. Most central banks are, at least to some degree, attributing the higher inflation to transitory factors.

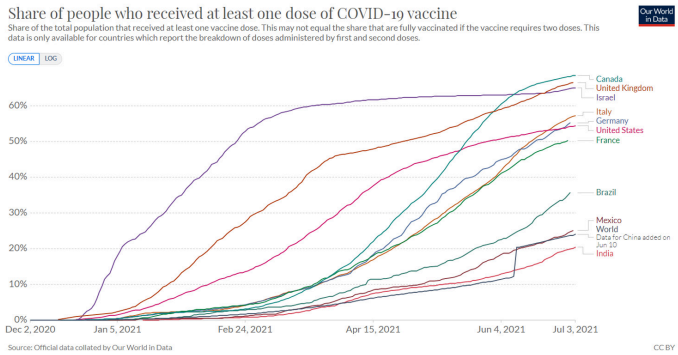
We are not convinced. We think labour market tightness will become a dominating factor for central banks and will lead many to tighten conditions earlier than they are currently signaling. That said, timing will vary from country-to-country.

Supply constraints and labour shortages are expected to herald in a fresh uplift in capital expenditure. While the consumption recovery is close to peaking in some countries, we expect increased capital expenditure to support still strong levels of GDP growth in the period ahead. At risk of getting ahead of ourselves, this could be the harbinger of a global productivity renaissance.

The biggest risk always has been a resurgence in the virus, particularly the possibility of the mutation of the virus into a variant that is resistant to the new vaccines. We have come closer than is comfortable to the manifestation of that risk with the delta variant.

Vaccination levels still short of "herd immunity"

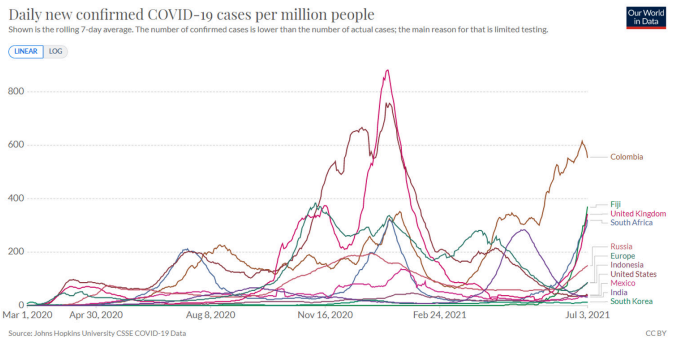
Vaccines continue to be deployed but even in countries that have had relatively rapid starts including Israel and the United States, the curve seems to be levelling off to some degree. This is at levels well short of so-called herd immunity leaving countries still vulnerable to fresh viral outbreaks.



Indeed, the number of new daily cases is on the rise in many countries again. This is mostly due to the spread of new variants, such as Delta and Beta, in countries with low levels of vaccination. This includes countries such as South Africa, Russia, Columbia, Fiji and Indonesia. However, case numbers are also on the rise in more highly vaccinated populations such as Europe, the United Kingdom and the United States where a number of states are reporting rising numbers.

There are also increasing reports of people who have been fully vaccinated contracting the virus, especially of the more contagious Delta variant. That is not overly concerning in the sense that a vaccination does not necessarily stop a person contracting the virus, but if they do, it should reduce the severity of symptoms and the need for hospitalisation. It is important to note that while daily case numbers are rising in countries such as the UK, the number of hospitalisations and deaths continue to fall.

Vaccinations are well short of "herd immunity", which has been estimated as a vaccination rate of 70-80% (which always seemed too low to me, though I am not an epidemiologist!). Even in countries with the highest rate of at least one does of the vaccine, the proportion of people who have been fully vaccinated is only around 50% in the United Kingdom and 40% in Israel. That leaves even those countries vulnerable to further outbreaks.

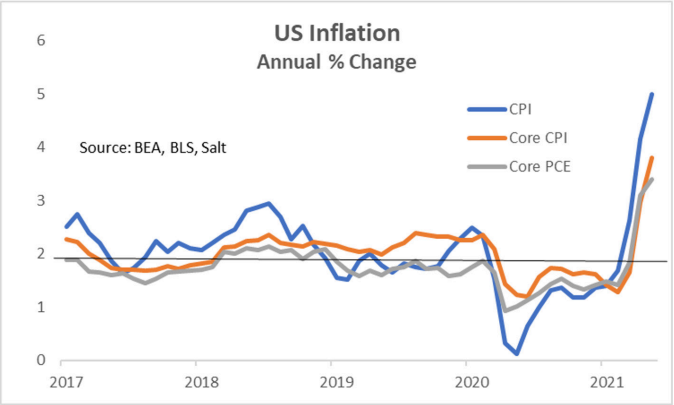


Here in New Zealand the Government continues to do an excellent job of virus control. A recent risk event pushed Wellington into a higher alert level for a few days, though no community cases presented. That said, vaccination progress remains slow, largely due to our reliance on one vaccine. This clearly has an impact of any further moves to open borders more fully.

Growth pressures, supply chain blockages and inflation

In many economies, spending has recovered faster than many businesses have been able to open and restart production. This has led to situation of excess demand which, combined with rising commodity prices, rising freight charges, shortage of labour and rising wages has contributed to a sharp rise in cost of production which is flowing into higher commodity prices.

Both producer and consumer price indices have moved sharply higher as a result. Business surveys are pointing to rising costs and increased intentions to raise prices, so there is more inflation in the pipeline.



Central bankers have generally been convinced of the transitory nature of this inflation. However, the scale of the increase, increasing evidence these supply issues may persist for a longer period than initially assumed, along with signs of tightening labour markets have led a few central banks to become more circumspect about the risks of more persistent inflation.

Jay Powell, Chairman at the US Federal Reserve has consistently argued the transitory nature of the inflation but has recently qualified those statements. In the Q&A following the latest Federal Open Market Committee (FOMC) meeting, Powell suggested inflation could turn out to be higher and more persistent than currently expected. However, he also said that the bringing forward of the two rate hikes into 2023 should be taken "with a big grain of salt".

The complicating factor for many central banks, the Fed included, is they also have employment mandates to achieve. While the Fed may be becoming more concerned about the inflation outlook, they face a labour market that still has some way to go before it is back to

pre-Covid health. The June US labour market report saw a healthy 850,000 gain in employment, though remains 6.5 million jobs lower than pre-Covid levels.

The Fed has brought themselves greater flexibility on the inflation front by recently tweaking their policy framework to "flexible average inflation targeting". The addition of "average" is meaningful in the sense that inflation history is no longer just history. The Federal Open Market Committee will now consider their policy response to emerging higher inflation because inflation has run below their mandated 2% for a considerable period. That means they will now be prepared to let inflation run higher than 2% until the average is restored. How this will operate in practice is yet to be determined.

It also carries considerable risk. Allowing inflation to run hot could see the need for more aggressive policy tightening down the line which would be more disruptive to the economy and the labour market than a considered, earlier, tightening now.

Some central banks facing the same inflation pressures but with admittedly greater progress on their labour market mandates are already taking baby steps towards withdrawing stimulus. The central banks of England, Canada and, more recently Australia, have all taken steps to reduce the quantitative easing programs. However, all continue to present guidance that suggests interest rate increases are a considerable time away.

Labour markets will provide answers to inflation durability

While we continue to believe some supply chain disruptions will ultimately prove to be more permanent in nature, the necessary condition for durable inflation is a tight labour market and rising wage inflation.

Labour markets in general have come through the Covid experience better than expected. That is largely thanks to significant fiscal support directed towards businesses, most notably wage subsidies.

This staved off the darkest unemployment premonitions. Some projections had the US unemployment rate reaching 30%, while in New Zealand, there were many forecasters expecting the unemployment rate to head well north of 10%.

That is not to trivialise the cost, which has been significant. In the United States the unemployment rate peaked at 14% and has since fallen to 5.9%, still higher than pre-Covid levels and up slightly on the month before. In New Zealand, the unemployment rate rose from a pre-crisis low of 4.1% to a peak of 5.3% in September 2020. It has since fallen back to 4.7% as at March 2021. In Australia, the latest labour market report had the unemployment rate falling to 5.1%, lower than before the pandemic started.

It is these labour market dynamics that will ultimately determine the timing of individual central bank moves to withdraw stimulus. It is no surprise then that the central banks of Canada and Australia have been amongst the first to start tweaking policy settings. If labour market conditions continue to improve, both are likely to expedite the end of their asset purchase programs and bring forward expectations of interest rate increases.

Here in New Zealand the labour market improvement has been quite spectacular considering the absence of the economic boost from foreign tourist market but has at the same time closed borders to migrant workers, a key source of skilled and unskilled labour that has been quite critical for the New Zealand economy in recent times. We will explore the New Zealand situation in more detail in the section below.

The labour market situation in the US is a bit more complex. Firms seem to be crying out for labour, job openings are at a record high, wage growth is picking up, yet employment levels remain well below pre-Covid levels.

The answer lies in the participation rate (the proportion of the workforce that is either employed or unemployed but actively seeking work). The participation rate fell sharply during the pandemic. It has since recovered, but at 61.6% it remains below pre-pandemic levels.

The critical question is why the participation rate remains low and even more critically, whether this is a permanent or temporary phenomenon. If people have left the labour force permanently (no longer need or want to work, changes in family situation) the pool of available labour is smaller and wage inflation will emerge more quickly.

If the low participation rate is temporary (emergency unemployment benefits, people still living on savings accrued during the pandemic, stimulus cheques still in the bank account) we'd expect those people to eventually come back into the labour market and delay

the need for monetary policy tightening. That remains to be seen.

The bottom line is we think the Fed was right to bring forward the timing of rate hikes at their last meeting. Furthermore, we think they will be prepared to announce their readiness to start tapering their asset purchase program from the start of next year. We expect indications of interest rate increases to increasingly move into 2022.

The emerging capex cycle

With supply constraints possibly ongoing and labour shortages, we look to capital spending to become a significant contributor to GDP growth over the next couple of years.

This is a normal cyclical phenomenon. As the growth cycle continues to mature, labour become more difficult to find and businesses turn to investment in plant and equipment to resource the ongoing growth for their goods and services. This has the added benefit of contributing to late cycle improvements in productivity.

Indeed, in most recent March quarter GDP data, there were instances of a pickup in capital spending by businesses. This was most notable in the United States with a similar outcome here in New Zealand. It is also notable that while many business sentiment surveys are showing growing pains, its not unusual to see employment intentions falling, but investment intentions rising.

The Covid pandemic has also resulted in an acceleration of or emergence of new structural trends, all requiring new public and private sector investment. This includes larger and stronger data centres and cybersecurity as more people work from home, and different retail infrastructure as people have become accustomed to working and shopping from home.

Investment in semi-conductor production is also rising as manufacturers accept they went into the pandemic with too little spare capacity. Also, infrastructure for pandemic management is on the radar as many countries look to build purpose-designed quarantine centres.

The significant fiscal response to the pandemic is supporting climate change mitigation and adaptation efforts. It is important that this stimulus lines up with long-term strategic priorities. Some fiscal spending is aimed at incentivising private sector investment in this important area.

A quick trip around the world:

- In the **United States** we expect the recovery from Covid will be at its peak in the second quarter of this year, the same time that growth consumer spending peaks. The ongoing easing of restrictions and further release of pent-up demand will keep consumer spending relatively robust. At the same time, business investment is in the early stages of recovery, and we expect that momentum to continue to build over the remainder of this year and into next. GDP growth is likely to print at over 7% for the calendar year. The labour market has performed generally better than expected during Covid though the recovery in jobs has slowed somewhat in recent months, though the unemployment rate has continued to decline. Inflation has surged with the latest reading indicating headline CPI inflation at 5.0% for the year to May. With inflation running higher than expected supply constraints likely to persist for longer and the tightening in the labour market, the Fed has brought forward the timing of the first hike in interest rates to 2023. We think the FOMC will announce the tapering of its asset purchase program around September of this year to begin early next year and for interest rates to begin rising from late 2022.

- **Europe's** recovery has become more meaningful but still more subdued than that of the United States. That reflects tighter Covid restriction still being in place across the region. However, as the economy is gradually opened, the recovery appears to be broadening from manufacturing to services. Private sector forecasts of GDP for this year are around 4.0-4.5%. Inflation trends are likewise more subdued than in the US with the European Central Bank maintaining its overall dovish position at its June meeting. The ECB is likely to announce a reduction in its bond purchase activities later this year, but interest rate increases are unlikely until 2023.

- In the **United Kingdom** the economy has staged a strong recovery since the start of the year though the recent decision by the Government to delay the final stage of the easing of Covid restrictions could see a temporary pause in the improvement. Still, the economy is on track to generate GDP growth of around 7% for calendar 2021. Inflation trends are more akin to Europe than the United States with the annual rate of CPI increase running at 2.1%. The Bank of England is thus striking a cautionary dovish stance. However, given the improving underlying fundamentals, the Bank appears likely to announce a further tapering of its asset purchase program, most likely at their August meeting. Interest rate increases are unlikely before 2023.

- **Japan** has been the main laggard amongst the major developed economies. Japan has experienced a rise

in Covid cases during the first half of 2021. That has meant a state of emergency and increased restriction on activity in Tokyo, Osaka and other areas. This was only lifted towards the end of June. Economic activity has reflected the heightened restrictions with April month retail sales down 4.5% on the previous month. Industrial activity has fared better as demand for Japanese exports is strengthening as economic conditions improve elsewhere. GDP is expected to come in at around 2.5%. The Bank of Japan is unlikely to make any change to its main policy settings in the foreseeable future.

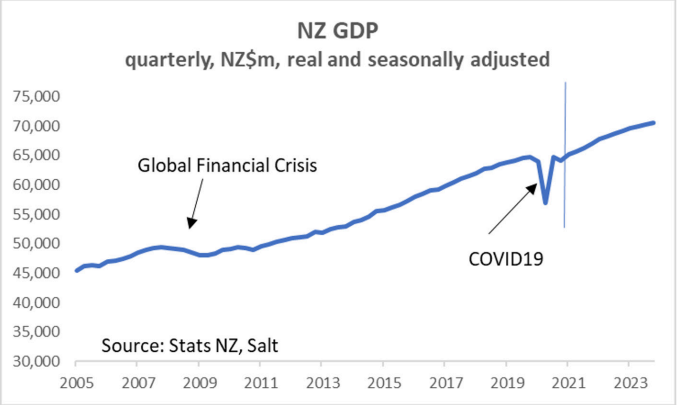
- The **Chinese** economy has been performing strongly over the last year or so. China was first to experience the impact of the Covid pandemic, the first to get the spread of the virus under control and the first to start re-opening its economy. More recently there has been a notable slowdown in growth of the key activity indicators including industrial production, retail sales and investment activity. There is more going on here than just the impact of Covid on the economy. China is navigating a complex structural reform process. Indeed, in an earlier Insights paper we argued that ongoing strength in consumption activity required more in the way of policy intervention. GDP growth is still expected to come in at around 8.5% in calendar 2021, but that's now lower than earlier estimates. Despite the emerging softness in the activity data, the central bank is continuing to allow higher market interest rates, reflecting their concern about over-speculation and asset bubbles.
- In **Australia** GDP activity has recovered to above pre-Covid levels. The labour market is also performing well with the latest read on the unemployment rate of 5.1% now lower than pre-Covid levels. The only negative has been the emergence of several Covid clusters in the last few weeks, most notably in Melbourne followed by Sydney. But given the broader economic environment it was no surprise to us that at its most recent meeting the Reserve Bank of Australia announced its intention to reduce the weekly purchases from $5 billion to $4 billion and not to extend its Yield Curve Target from the April 2024 bonds to the November 2024 bonds. We expect interest rate increases will follow in 2022.

New Zealand – no need to delay tightening

New Zealand GDP grew a massive 1.6% in the March quarter and 2.4% for the March year. The quarterly number was well above market expectations of a rise of 0.5%, but even further ahead of the RBNZ latest estimate of -0.6% though, to be fair, the RBNZ did not have the benefit of all the recent partial indicator releases when they last published their forecasts.

As with most recent data from around the world, private consumption led the charge, while business investment also made a positive contribution.

Along with positive revisions to prior quarters, that means the annual rate of growth was 2.6% higher than where the RBNZ expected it would be at the time of the last MPS.



From a monetary policy perspective, the strength of the number will have the RBNZ rethinking the next few quarters of growth, but even if they shave a bit off the June quarter forecast of 1.0%, most of this upside surprise in this number should get baked in.

That means a previously negative output gap that is now more than likely closed, if not into positive territory. And of course, we also have a labour market with an unemployment rate that is within touching distance of the bank's estimate of NAIRU – that is the unemployment rate consistent with their 2% inflation target.

We expect the economy to continue to perform well over the rest of the year. We expect private consumption to remain solid, investment spending to continue to rise, strong commodity prices to support especially rural incomes and a very strong residential construction market.

That means emergency policy settings that were implemented to support the economy through covid are no longer required. We believe there is no reason why the RBNZ shouldn't end its Large-Scale Asset Purchase Program now and move to interest rate increases before the end of this year. Any delay risks an inflation overshoot and a messier process of bringing runaway inflation back under control.

Implications for Investors

Diminishing anxiety

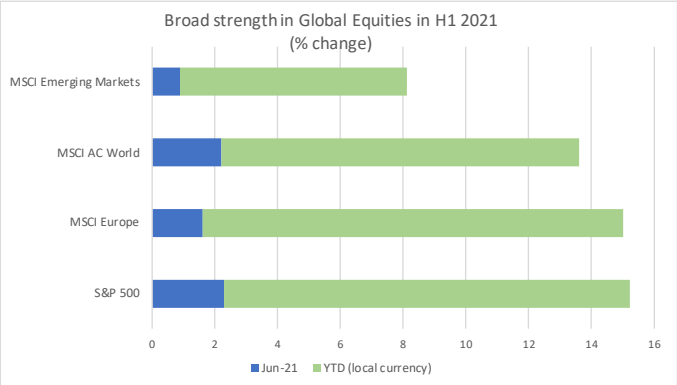
The First Half of 2021 was a very robust period for returns from growth-sensitive assets, despite a sharp uptick in bond yields during the February-March period.

Indeed, the US 10 Year benchmark bond yield touched 1.75% on 31st March, but it has worked its way down by "-0.4% since, and sits at 1.35% as of 10 July. Bond yields, in the last month, have declined for longer US maturities by a meaningful quantum, with the 10 Year yield falling 20 basis points, and the 30 Year yield, by 26 basis points. Shorter-maturity sovereign bonds have remained at more elevated yields, and yield curves have flattened as the result. At the same time, the spread above the relevant sovereign yield at which corporate bonds attract investors continue to eke our historical lows, at a meagre +0.8% in the US and Europe for investment grade securities, while the risk reflected in the spread of High Yield (non-investment grade) securities is very low, at +2.7% for the US and +2.8% for European credits. This is reflective of optimistic investors who may be overlooking the risks that are masked by near-boom demand conditions in some countries accompanied by continued very easy credit.

The New Zealand bond market has benefited, with our 10 year sovereign maturity's market yield declining by almost 0.3% from 1.83% at the beginning of April, to 1.55% on July 11.

With the immediate threat of higher bond interest rates receding, at least for now, there have been several international market records achieved. Major US stock indices are extending all-time highs. US Energy and Financial stocks enjoyed their best First Half in index history. European banks delivered their best performance for that period, since H1 1998 – in the optimistic lead up to the euro superseding 11 major national currencies in 1999. Corporate bond issuance attained new highs, by value of funds raised, even as sovereign bonds experienced one of their weakest concentrated periods during the months to mid-May.

The proverbial "wall of worry" that assists bull market longevity does seem to be lower, currently. That is not to downplay the pandemic, but the investing community has clearly decided that the health sector challenges are ultimately surmountable, and that global shortages may bring positive innovations and profit opportunities, as supply chains are re-configured both due to CoVid and to US-China tensions.



Source: Salt, Morgan Stanley investment Management

Bond yields moving helpfully lower

The US Independence Day holiday saw the key global Government bond yield log a "celebratory" 5-month low. The bond market has been buoyed by mixed economic signals, including retail sales reports that fell, at times, short of expectations, and by disappointingly slow job creation accompanied by somewhat lower wage gains than expected. Any indications that the economic resurgence may be entering a hiatus, and that key cost increases may indeed prove patchy or transitory, will tend to drive yields lower and prices higher. After a weak period for bonds, a consolidation phase was more likely than an upward acceleration in yields, at least until inflationary and geopolitical risks are more clearly-defined.

Many global financial institutions are "natural buyers" of US Treasuries, and the period of sharply higher yields seen in the first part of this year has provided a rationale for some re-entering the market enthusiastically. Investors are, in essence, behaving in an inflation-tolerant manner, mainly because global central banks have trained them to do so, and investing alongside (rather than fighting) the Fed. is a simple strategy. It is widely appreciated that central banks do not wish bond yields to rise pre-emptively, and as they have collectively proven they possess ample powers to repress yields as desired, contrarian investors must pick their battles with great care. At present, there is limited incentive to position for a significant bond bear market developing, within the next six months. On occasions where more "hawkish" central bank commentary has been seized upon in markets, the authorities in question have been quick to dilute any impression that any significant tightening in financial conditions is planned or would be tolerated.

Summertime, and investing looks easy?

This "don't stray far from the herd" approach has a particular appeal, when the data is inconclusive, long holidays begin, and the northern hemisphere weather (when very hot, as presently) can lead to a degree of torpor in markets. In the absence of major shocks or catalysts, investors may be unwilling to implement strategy shifts, or will defer them until the September return. The market consequence is frequently, a sideways drift, with a mildly positive bias in asset prices.

Providing additional support to those investors who anticipate a renewed long bull market in equities, the news on CoVid-19 prevention remains broadly reassuring, with major existing vaccines evidently effective to some degree, against the latest viral variants such as the "Delta strain." It is likely that there is now a high degree of complacency present in many investors'

view that the re-expansion of growth will seamlessly translate into stable or higher profits, in a corporate world untroubled by debt servicing costs. The periodic rumblings from the US Democratic leadership that taxes will be lifted for the business sector, have (so far) caused no lasting damage to sentiment or share prices. While political intervention in modifying the business models of certain controversial US multinationals has been proposed, most of the larger enterprises have enjoyed exceptional share price gains in the six months that the Biden - Harris Administration has been at the helm of US policy.

Three examples should suffice: the stock prices of 3M, and Amazon Inc have gained around 15% in 2021 to date. This is a creditable performance, for a half-year return, but must be put in the context that Facebook Inc shares have gained double that quantum over the same period, and attained an all-time high in early July. The social media juggernaut has delivered almost double the stock price performance of the NASDAQ 100 Index (+31% versus+16% YTD) in spite of a continuing show of Congressional hostility and concerns that the company may be ultimately forced to divest assets and thus, enter a period of comparative profit decay. Thus, investors remain unconvinced that very successful companies will suffer significant disadvantage, by the shift in the US political barometer to a more interventionist, Democratic policy agenda. Selective, nationalistic actions undertaken for geopolitical reasons will affect specific multi-nationals, but the consensus is that in uncertain times, radical policy shifts toward imposing higher costs on business would be simply too risky and could easily backfire, or add little except another inflation-driver.

Energy and the Consumer in the driving seat

The general optimism prevailing on themes beyond the CoVid 19 pandemic, has driven substantial gains in the sectors most aligned with resurgent demand. Energy stocks have been the strongest performers in the First Half, both in the US with a 45% sector return, and globally, recording a 29.5% rally on the MSCI All Country World Index (ACWI.) As the table below shows, within the US S&P 500 Index, six of the ten highest returns have come from the Energy sector, with selected Consumer Discretionary companies also performing well. A 50% surge in the oil price this year, coming on top of last year's gain, is a major plank of mounting inflationary pressure, as cost increases in manufacturing and transportation will ultimately be reflected in consumer prices. However, at present, producers are harvesting strong profits. There is some irony in this, as energy transition away from hydrocarbons is simultaneously accelerating, given the pressure on governments to act faster against climate change and the US' re-entry into the Paris Accord.

Company name	H1 2021 price return (top 10 S&P 500)	Sector
Marathon Oil Corp.	104.2%	Energy
Diamondback Energy Inc.	94.0%	Energy
L Brands Inc.	93.8%	Consumer Discretionary
Devon Energy Corp.	87.5%	Energy
Occidental Petroleum Corp.	80.7%	Energy
Nucor Corp.	80.4%	Materials
Ford Motor Co.	69.1%	Consumer Discretionary
EOG Resources Inc.	67.3%	Energy
Gap Inc.	66.7%	Consumer Discretionary
Hess Corp.	65.4%	Energy

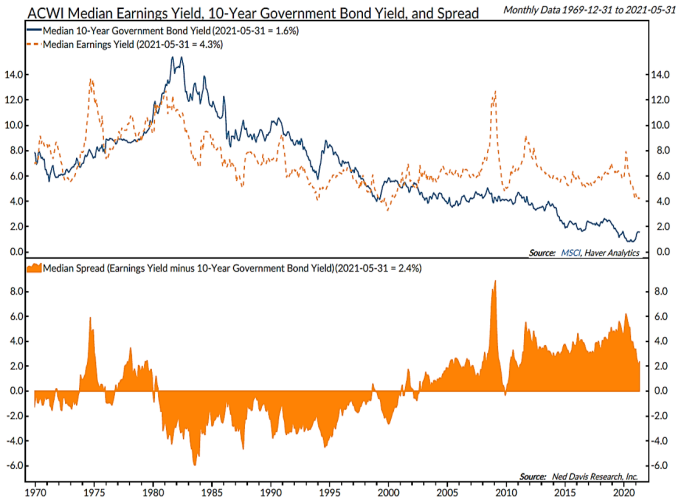
Source: Bloomberg

Other economic sectors which have delivered strong returns in June month were Information Technology and Health Care. These equities had lagged more interest-rate sensitive Financials and normalization-assisted Real Estate companies until the last month, but as investors refined their expectations for the path of interest rates, the opportunity to gain exposure to a rising wave of capital expenditure via technology has proven attractive.

Profit gains, set against lower bond yields, refresh the equity rally

Equity markets have been boosted by three simultaneous positive factors: a milder CoVid-19 trajectory due to vaccine roll-outs; a super-supportive set of central banks, and a very strong US economic expansion currently in full swing, assisting the corporate profit outlook. On the latter point, because of the high number of companies issuing positive earnings guidance and analysts' upward revisions to earnings estimates, the estimated earnings growth rate for Q2 2021 is rising. As of today, the S&P 500 is expected to report (year-over-year) earnings growth of 63.6%, Such an outcome would mark the largest year-over-year growth in earnings reported by the index since Q4 2009 (which was 108.9%, reflecting GFC recovery dynamics). The unusually high growth rate is due to a combination of higher earnings for Q2 2021 and a comparison to unusually weak earnings one year ago due to the negative impact of CoVid-19. All eleven sectors are projected to report year-over-year earnings growth, led by the Energy, Industrials, Consumer Discretionary, Financials, and Materials sectors. Unsurprisingly, stocks within these sectors have been some of the stronger performers already, in 2021.

Equally important in underwriting the current robust returns from equity markets, is their advantageous earnings yield when compared with bond yields. While this is not a new development and has been present to a greater or lesser extent for the last two decades, the high compensation for taking equity risk remains a powerful motivation for investors to "buy the dips" in markets and play down negative factors.



Source: NDR Research

Durability is the dilemma

How long this benevolent regime can remain in place is questionable, given indications by the US Federal Reserve that 2023 will likely see some moves underway, both to lower the extent of Quantitative Easing (QE) support, and to begin tentative upward adjustment in the policy interest rate. As discussed earlier in this report, the lowering of QE support may begin earlier, and persistent inflation will be a test for both central banks' and investors' confidence in the stability of this expansion, determining whether a new, secular bull market is in fact underway, or whether the special conditions of the post-pandemic stimulus-backed rebound have generated excessive confidence in perceptions. Our view is that while there are considerable grounds for current positivity, the earnings gains being factored into current equity prices are likely near-fully reflected. As the profit reports come in across the second half of this year, the confirmation of constructive expectations typically sees a more measured rate of increase in valuations. Put simply, additional major equity market gains would likely need a fresh catalyst, as the earnings resurgence is already largely priced in.

For now, the equity market "bull" narrative remains intact: Economies are opening up as the pandemic is being managed with all possible means. Significant pent-up demand from government support programs, alongside the wealth effect of ongoing increases in asset prices, is being unleashed on a supply constrained global economy, though the resulting inflation is not yet clearly persistent. Fiscal policy will provide an extra boost to growth as fiscal policy eases and special government capacity building programs get properly underway. There are several quarters ahead in which these supportive factors will provide tailwinds to growth assets.

Investor complacency supports tilting toward quality assets now

As Recovery remains the dominant story, it is likely that equities will continue to outperform other assets. But there are reasons to be wary. Inflation remains the biggest threat, and any multi-year persistence of high inflation will signal the end of central banks continuing to underwrite risk-taking by keeping interest rates artificially low, and by constantly providing new liquidity to the market.

Arguably, investors have become too complacent that any adverse global development will be rapidly offset by the central bank "monetary paramedics" pushing exceptionally-cheap lines of credit out to restore confidence. However, it must be said that there has been scarcely any serious reversal in markets or economies in recent years, that have not been quickly cauterized by very active monetary counter-measures. The protection of accumulated wealth gains appears to be a clear priority for government and central bank leaders, with debt sustainability and fiscal impacts taking being de-prioritized.

The downward shift in developed market longer-bond yields is a welcome development, in that it is more reflective of demand for bonds and yield in portfolios, than a harbinger of economic downturn. Further, these yields are crucial variables in making investment choices for Real Assets, namely listed Infrastructure and Property. As we favor the inflation-hedging and defensive characteristics of both these sectors, a pause in the rising track of sovereign bond yields is supportive for the "competing" long-duration assets in the infrastructure and real estate investment pool.

We consider it is prudent to take account of the high current investor risk appetite, to orient our portfolios towards the quality and in places, more defensive companies and sectors where over-valuation is less challenging and which would be likely beneficiaries of any disappointments ahead, whether on the future course of the global pandemic, or on the precise timing of a global shift to lowering policy accommodation.

Risks lying ahead in late 2021

Our main scenario is still, that the key policy setting figures at the US Fed, the ECB, and elsewhere have ample time to signal a slowing of the extraordinary stimulus level of the last year. However, it is possible that, with the degree of vigor presently in the US economy, Jerome Powell at the Fed might be expected to build on the June Federal Open Market Committee (FOMC) shift in tone, and to tentatively advance signaling later this year. Although the Fed is an independent actor, this stance is potentially backed by Treasury Secretary Janet Yellen, who was Powell's predecessor as Fed Chair. Yellen has a focus on addressing labour and inequality issues, so will be cautious, but has recently hinted that interest rates should rise somewhat. Yellen's Keynesian and dovish monetary policy record suggest, however, that in office now as a key part of the Administration, she will be a political force for protracted (though moderating) stimulus, whether fiscal or monetary in nature.

History suggests that September-October can be dangerous months for sharp shifts in market sentiment, a fact that we would hope policy authorities bear in mind. It would be better to begin a long lead-in of central banker hints that such massive stimulus may not be extended beyond 2022, so that investors can progressively digest the implications of a medium-term change for their portfolio holdings, and can reallocate their exposures over a two-year horizon. Perhaps this is what the Fed was attempting in its June meeting. It remains to be seen whether the NZ central banks will attempt to walk the same sentiment tightrope in the months ahead. Delicacy is required, in the process of suggesting the credit-conducive deep monetary "punchbowl" is not a permanent feature, but an extended emergency measure. The concern is, that government measures introduced as temporary, often prove in practice to be difficult to wind down, and the pandemic response may ultimately be incorporated into an economic cycle management toolkit.

Without careful communications, backed up by small but credible incremental steps in the direction of normalization, arranged into a transparent timeline by the authorities, the extended equity valuations and pockets of outright speculation in some stocks and sectors could reverse disruptively late in the year. Were such a choppier climate to develop, agility in active portfolio management will be critical in preserving and protecting the wealth gains of recent years. Similarly, securing a valuable real income stream from investment assets, in an increasingly inflation-prone period, is a challenge that active funds managers are best equipped to meet.

New Zealand Equities

The NZ equity market struggled relative to its global peers in the June quarter, with the S&P/NZX50 Gross Index rising just +0.8% in the quarter and +10.5% for the year. This was well behind the strong performance by the MSCI World Index, which rose +7.7% in USD terms over the quarter to be +39.0% over the year.

While some of NZ's relative torpor was due to the high weight of defensive stocks in our market, a large impact also came from the large cap A2 Milk, which fell a sharp -25.3% as growth expectations were rapidly removed from its valuation. Cyclicals did very well relative to defensives during April and May but this reversed a little in June as yield curves flattened somewhat around the world.

NZ's tepid performance came despite a welter of evidence showing gathering strength in both the NZ and global economies. The issue is that booming demand is meeting relatively inelastic supply, with the supply difficulties being further disrupted by Covid-19 restrictions and supply chain dislocations.

Inflationary pressure is therefore rising and the key debate has moved to whether such inflation is "transitory" or rather more "embedded". The answer to this will dictate the speed at which central banks remove historically unprecedented degrees of monetary accommodation. In turn, this will dictate which styles and segments of the NZ equity market perform well and which areas struggle.

Globally, central banks have moved to a "data dependent" rather than "forward looking" monetary policy stance, which means they may need to tighten surprisingly quickly and dramatically if/when there is an inflation data surprise. In our view, equity markets are not positioned for this.

The ANZ Bank Business Outlook survey for June showed pressures continuing to intensify. A remarkable 86.5% (81.3% in May) of firms expect costs to rise over the next year; 62.8% (57.4%) expect to lift their selling prices; and CPI inflation expectations lifted from 2.22% to 2.41% in just one month. In our view, the RBNZ is now way behind the curve and market expectations are rapidly changing to see the first rate hike this year.

The most vulnerable companies in a rising rate environment are the "GAAP" (growth at any price) companies which have been quite volatile in recent months, swinging wildly as long-term bond yields move in relatively narrow ranges. Vapour-ware tech companies epitomise this group of stocks.

Another obvious segment at risk are the TINA stocks (there is no alternative) as investors have been forced out of derisory term deposit rates and into seductive but

higher risk dividend yields. Skilful active stock selection is critical in investing in companies whose yields are sustainable versus those that are not.

The NZ market is heavily weighted to high yielding companies across sectors such as electricity, telecommunications and property. The latter is perhaps the most vulnerable here although one would not know it currently as a frenzy of investor activity is seeing cap rates collapse across most segments of physical property markets. This may be a last hurrah.

The final group of stocks to be wary of in a rising rate environment is perhaps slightly surprising and comprises the high-quality dependable growth names. This group of companies have been extremely strong performers in recent years. Their valuation multiples have logically expended dramatically as discount rates have fallen and as investors have been willing to pay for the relative earnings growth certainty against an uncertain economic backdrop.

The obvious relative beneficiary of the likely change in monetary policy paradigms is the cyclical segment. As a group, their top-line revenue growth from volumes and prices offsets the negative impact of their discount rate rising. Historically, these stocks have tended to perform until well into the tightening cycle. Building materials and transport companies are classic examples of this genre. The NZ market has only a very small bank weighting but these are also key winners in this environment. It is important to contrast them with pure value names, who typically have operationally and/or financially levered business models and which are often in sunset industries.

One final matter to consider as the clock moves towards mid-night in the era of free money is what that has meant for investor flows. Anecdotal stories abound of heavy retail interest in equities and heavy allocations to the asset class in search of yield and returns. In a global context, BAML research published just after month-end showed that the June half was the fifth best for global equity returns in the past 100 years. They found that an important driver of this was that annualised equity inflows in those six months exceeded the cumulative inflows for the entire 20 years prior. This is an interesting backdrop against which central banks may begin to tighten.