

# Economic Commentary

January 2021

The final quarter of 2020 was very strong for international sharemarkets, driven by the approval and rollout of the first Covid-19 vaccines and the culmination of some long-standing geopolitical issues. Joe Biden is being sworn as the 46<sup>th</sup> US President and is likely to introduce both greater fiscal stimulus and more stability in the political world, and the UK and EU reached agreement on a Brexit trade deal after compromises on both sides. Most global sharemarkets were up by 10-15% for the 3 months, although some of this was offset by a strengthening NZ Dollar. Short-term interest rates remain at all-time lows, but there has been a lift in longer term wholesale rates due to the possibility of stronger economic growth in the medium term. This has reduced capital values in the bond markets (to which portfolios have little exposure). The speed and effectiveness of the vaccine rollout and the extent to which Covid can be brought under control in the US and Europe are going to be key factors in determining market performance in the coming months.

Democrat Joe Biden is now the US President Elect and will be sworn in this month, despite the refusal of President Trump to concede and the incredible riot which overran the US Capitol buildings. Biden's position is now strengthened as, following Senate elections in Georgia, the Democrats will control both the US House of Representatives and the Senate for the next two years. This will allow the Biden administration greater scope to implement their agenda which initially includes attempts to pass a new \$1.9 trillion stimulus plan. Many Americans would be in line for a direct government cheque. Markets are obviously happy with this and have reacted well, but there are other parts of the Biden economic agenda (notably the removal of the Trump corporate tax cuts) which may create some volatility as the year progresses. Getting on top of Covid is rightly the new administration's first priority, and the regime is also looking to implement long overdue infrastructure spending. The US is a country with significant internal problems and these are increasingly being exploited by their international rivals including China, Russia, and recently Iran (restarting their nuclear programme).

In New Zealand, the virus remains well-contained, but there has been a huge resurgence in cases in both the US and Europe. This resurgence vastly exceeds the initial wave in March/April last year and the tightest restrictions yet are being implemented in the UK, including at the border. The initial rollout of vaccination programmes is being carried out following the approval of several versions late last year. Vaccines will take some time to be manufactured and distributed and it is going to continue to be a long, hard and tragic winter for many northern hemisphere countries. The latest analysis is that the global economy will still recover as the year progresses, and there have been some promising developments, but risks remain. Strong fiscal and monetary policy support will continue

to be necessary. The world's central banks will be keeping interest rates extremely low for some time and this means that term deposit and mortgage rates will remain suppressed.

While there are people beginning to worry about the longer-term inflationary consequences of ultra-low interest rates for long periods of time, for the foreseeable future support to the world economy will continue to dominate. At this point, the concern is that too much cheap money is finding its way into assets, including shares, commercial and residential property. The housing market is rapidly becoming out of control. Latest figures from REINZ show that median house prices across the country increased by 19% in 2020, and the median price of a house in the Auckland region is now \$1.04 million! Clearly, there is a lot of money being moved from term deposits and bank savings into residential property especially, but also into the sharemarket. From a historical perspective and based on fundamental valuation methods, asset prices are high and appear overvalued in many areas. The factor supporting such extended valuations is low interest rates. While these low rates persist, the rationale for such high asset prices remains. When rates rise, as they must at some point, this rationale falls away and the repricing of assets will begin. For this reason, it remains important to hold cash and fixed interest despite their negative real returns.

What are some of the key themes and areas that we will be watching as 2021 progresses?

- *Covid and vaccinations*: how efficiently the vaccine programmes are rolled out will have a major effect on financial markets over the year. New, more contagious, variants continue to emerge and these threaten to overwhelm health systems in many countries.
- *Inflation and interest rates*: it is likely that inflation will remain suppressed and short-term interest rates will be correspondingly low. Longer-term rates have already risen as the medium-term outlook has improved, and if this continues it may impact market valuations for certain asset classes (eg. listed property, dividend stocks and bonds). If inflation surprises on the upside, there may be more dramatic effects.
- *Housing market*: is at crisis point in terms of affordability, but unless NZ unemployment rates increase significantly is likely to be supported by low rates. Reintroduction of loan-to-value ratios by the Reserve Bank may slow the market somewhat. Again, if inflation were to surprise on the upside and unemployment increase, there may be some more major impacts on the housing market.

In current risky conditions, extensive diversification and appropriate portfolio positioning remains a high priority. Over recent years, with markets relatively stable and volatility low, funds have flowed into passive investment strategies and produced good results. However, active management of portfolios is going to be key in controlling risk and generating acceptable risk-adjusted returns over the coming year and into the future. There are many variables in the markets at present. We will continue to find the best managers to meet these challenges, and to ensure that the construction and balance of your portfolio is best matched to your circumstances as the year progresses.