PERSONAL INVESTMENTCENTRE
FINANCIAL PLANNERS AND INVESTMENT ADVISERS

Economic Commentary

15th February 2024

Following the sharp downturn from August to October, financial markets bounced back strongly in the last couple of months of the year and into January. The year-end rally resulted in a much better outcome in 2023 for portfolios than we expected, albeit with a high level of volatility along the way. The year was dominated by the ongoing "push-pull" effect of economic data, inflation, and interest rates. Looking into 2024, the key questions remain how inflation develops, the potential timing of interest rate reductions, and the extent to which the global economy moves toward or into recession. These factors will largely determine the prospects for investment performance as the year progresses. However, there are always unknown factors which can make economic predictions look foolhardy.

Share markets	Performance – NZD	
	3m	12m
NZX 50 (NZ)	10.4%	-0.8%
ASX 200 (Aus)	12.5%	5.0%
S&P 500 (USA)	10.5%	27.2%
Shanghai (China)	-10.1%	-12.7%
Euro 50 (Euro)	11.8%	20.1%

Interest Rates	10-yr Govt Bonds	
	Jan 24	12m ago
NZ	4.56%	4.17%
US	3.91%	3.51%

The strong rally which we have seen since the beginning of November provided welcome relief following the downturn in the preceding quarter. In August/September, economic data indicated that inflation was not reducing as quickly as hoped, and in turn this indicated that interest rates would need to remain higher for longer. The picture reversed when new data in late October showed a much more optimistic picture. Financial markets were given another boost in mid-December at the final US Federal Reserve meeting of the year. The "Fed" surprised most watchers by moving forward their projections for the start of cuts to their official interest rates from late 2024 to around May. The commentary to their decision suggested that further interest rate increases were completely off the table, that the US economy was slowing down but not to the point of recession, and that as a result interest rates would likely start to come down sooner than previously expected. The market reacted strongly to this news and continued to rally through into the New Year. Our view is that the market has been overreacting on both sides during this period, moving too negative from August to October, and partly as a consequence becoming too optimistic in the last couple of months. There is always a debate in the investment industry around the efficiency of the market in adjusting to news and economic developments, and in reflecting these in asset prices (for shares, bonds etc). There are those who argue that the market is very efficient. We would suggest that the last six months demonstrates again that the market overreacts, swinging from pessimistic to optimistic too quickly and severely, opening up opportunities for active investors.

Compared to the US, the picture in NZ is not quite so positive. The latest information suggests that the economy is slowing rapidly, contracting by 0.3% in the September quarter (the latest for which we have figures). Given that the NZ population has grown rapidly over the last 12 months due to high levels of net migration, the contraction in GDP per capita (per person) is significantly worse than the headline figure. Annual inflation in the December quarter was 4.7%. While this is gradually moving in the right direction, it is certainly at a slower pace than hoped. The headline figure includes both "tradeable" and "non-tradeable" inflation, which roughly correspond to price changes for imported goods vs local inflation. The concern is that, while imported inflation is declining, the non-tradeable part which is generated domestically is still high at 5.9% over the 12 months. Locally, we believe that

it will take longer than many expect for inflation to come back to acceptable levels. In fact, economists at the ANZ are now predicting increases of 0.25% to the Official Cash Rate in both February and April, to a peak of 6.0%. Time will tell, but we certainly don't anticipate interest rate cuts to come before the end of 2024. We continue to be underweight NZ shares and would expect the local market to continue to struggle as it has done for several years.

At this time of year, there are always economists and commentators making predictions about the coming 12 months. Often these turn out to be largely wrong, but it is an interesting exercise, nonetheless. Most economists expect that economic growth will continue to slow around the world, perhaps triggering mild recessions in some countries but not leading to deeper recessionary conditions. Inflation will continue to decline, gradually moving back toward target ranges of around 1-3% per annum over the next 18 months. Central banks may start to reduce official interest rates over the next 6-12 months, depending on the country, level of inflation and economic position. Overall, there is clear evidence that inflation is coming down, and if this continues it will ultimately result in interest rates also declining (although the timing is unclear). In the big picture, this is good news for financial markets. However, these processes certainly won't move entirely in one direction, and there will definitely be significant bumps along the way. What could upset these predictions?

- Conflict in Ukraine and the Middle East could spread, creating nervousness and new sources of inflation. For example, the attacks on shipping going through the Red Sea and Suez Canal are already causing increases in shipping costs.
- Economies slow up more than expected and move into deeper recessions than anticipated. This may affect company earnings and result in share price declines.
- There are multiple elections around the world this year, including in the US. It is looking more likely that former President Donald Trump will be the Republican candidate and, generally, this makes for an unsettled time.
- An unknown factor which nobody has thought about!

Although we are cautiously optimistic about the medium term, we still remain somewhat defensive at present. We have been positioning over the last 18 months to protect against downside risk and prepare for a market recovery in time. Fixed interest continues to be attractive, and we have been adding bonds to portfolios as appropriate. These will provide good income streams over the coming years and benefit should interest rates fall as expected over the next 18 months. We anticipate bumpy sharemarkets in the short-term, but there are some areas of attractiveness, and the underlying fundamentals are more positive than they have been for several years.

"Predictions are very difficult, especially about the future" – Niels Bohr

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