Bradley Nuttall Nelson Autumn Update

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Investment Market Review

The phrase which we haven't heard for some years now "a perfect storm" aptly describes the March quarter.

As if Covid-19, rising interest rates, inflationary concerns, supply chain blockages weren't enough, Russia's invasion of the Ukraine in February proved to be the tipping point for financial markets. Headlines were dominated by the horrific war in Ukraine and the terrible humanitarian crisis continuing to unfold there.

The grave implications of the Ukraine conflict quickly fed through into increasingly volatile financial markets, with share markets declining and bond prices also generally falling over the quarter.

Conversely, commodity prices soared. Russia is a key producer of several important commodities including oil and gas. Ukraine is an agricultural powerhouse and a significant global exporter of wheat, corn and sunflower oil. With the conflict impacting supplies from both countries, this magnified existing supply chain disruptions and added further unwanted impetus to surging global inflation.

Elsewhere, the Chinese market was negatively affected by renewed Covid-19 outbreaks in the region, leading to new lockdowns in several major Chinese cities.

Market turbulence, as unpleasant as it is, will eventually ease. In fact, to the extent that lower share prices now imply a higher expected return for owning shares, current market prices could eventually be regarded as a buying signal for longer-term investors.

Whatever the markets may have in store for us in the coming months, heightened market volatility looks set to continue for some time to come.

While it was undoubtedly a tough period for investors, this financial turbulence paled in significance when compared to the devastation

Experience by the Ukraine people, and by their friends, families and loved ones around the world.

Inflation outlook

Inflation has risen sharply over recent months and what was initially projected to be a transitory phenomenon has become much more widespread and persistent.

This represents a real dilemma for policymakers. With inflation already much higher than forecast, central banks (including the Reserve Bank of New Zealand) have been backed into a corner and are now having to prioritise policy measures aimed at containing inflation. The primary tool at their disposal to achieve this is to raise interest rates.

The repercussions of this are already apparent in New Zealand with the Official Cash Rate (OCR) here having been raised three times (by a total of 0.75%) since 6 October 2021. With domestic interest rates already on the rise, and debt servicing costs rising along with them, this exacerbates the cost-of-living challenges already faced by many New Zealand families.

And, in a world still trying to consolidate after the last two Covid-impacted years, the immediate outlook for economic growth suddenly looks more fragile. Whilst this adds to uncertainties in the short term, investors should still be comforted that capitalism has a way of figuring out how to survive and thrive, even in challenging environments.

We can further be comforted in the fact that markets react significantly faster than economic indicators. The fall in share prices we saw during the most recent volatile period, is a result of market participants demanding a lower price for the known risks involved in these investments. This uncertainty and bad news have already been priced in and as we ease through this difficult period, we can - as long as we don't experience any further surprises - expect markets to deliver positive returns even if the economy is somewhat subdued.

Central Bank Policy

After more than two decades of successfully implementing monetary policy to carefully manage inflation expectations within a low and narrow band, central banks are now being compelled to act to ensure that inflation expectations don't suddenly become unanchored.

Unfortunately, this action is likely to have negative implications for economic activity. Central banks have become more determined to remove economic stimulus in recent weeks.

The European Central Bank surprised markets during the quarter by presenting plans for a faster-than-expected reduction in their bond buying programme. Their policy response suggested their concerns about inflation prevailed over all other considerations, including the war in Ukraine, and the deteriorating outlook for economic growth.

The New Zealand situation is particularly acute.

With inflation expectations now above the Reserve Bank's 1% to 3% target band and inflation itself still yet to peak, the bank is expected to progressively move the OCR to almost 3.5%; potentially using 50 percentage point increments in at least one of the next two meetings.

The implications of such an aggressive move with household incomes being eroded in real terms, rising mortgage interest rates and a tight labour market, taken together, these factors make a compelling counter argument for why the Reserve Bank could slow its projected fiscal tightening. However, for now, further rate rises are being anticipated by the markets.

Food ..the New Gold ?

Beyond the immense human suffering, the war in Ukraine and the sanctions imposed on Russia, has created broader issues related to global food production and supply.

At one end of the spectrum are countries with a significant dependency on essential commodities (including mineral products, chemicals, metals and soft commodities) that were imported from Russia and Ukraine.

At the opposite end, there are countries, many of them emerging markets, that could potentially position themselves to fill this gap by exporting more at higher prices.

Food prices and food availability will increasingly be a global economic and political issue. For example, the expected decrease in food production due to reduced spring plantings in Ukraine quickly lifted global wheat prices by over 15% since the start of the war.

Higher grain prices will have a disproportionate impact on low-income countries, particularly some countries in Africa, and even India, where spending on food makes up a relatively high proportion of their income. Pressure will mount on these countries to either find alternate sources of supply or to ramp up their domestic production.

Adding to the complexities, Russia and Ukraine have been significant suppliers of fertilizer to the world, ramping up production, even by other agricultural powerhouses, may be easier said than done.

For example, Brazil, which is currently the leading exporter of soybeans, corn, sugar, meat and coffee, imports about 80-85% of its fertilizer needs, with almost a third of this coming from Russia, Belarus and Ukraine. Whilst Brazil is now launching a national fertilizer plan to reduce its dependency on fertilizer imports, this will likely take several years to make a significant difference.

Assuming other regions recognise this opportunity to step up their own food production to fill the void, it will take considerable time to plan, sow, grow and harvest meaningful replacement crops. Quickly replacing the 40 million metric ton supply of Ukrainian wheat will be no small feat.

What can we do?

People are generally hard wired to try and solve or resolve problems, perceived or otherwise. We just have to do something, make changes to feel as though the problem or concern is being addressed.

Active fund managers and share brokers adopt this practice to varying degrees despite there being a plethora of research evidence showing that active management, on average, will underperform the market. The longer active management is employed the higher the likelihood of underperforming and by increasing levels.

In contrast, our approach is less active, rather focusing our attention on aspects that are persistent across all market sectors which have a higher probability of outperforming

A good example being our weighting within equities to small and value companies, as opposed to large and growth.

Academic evidence clearly shows that value companies, those that own assets in a high proportion to their respective share prices, have a higher probability of outperforming, large, small or growth companies over time.

In less favourable markets, such as we are currently experiencing, value companies tend to be less adversely affected. Not always, but more often than not.

The below table records the various returns for the March quarter from funds held in our client portfolios. The

	3 Months Ending 31 March 2022		
Funds	Australia	International	Emerging Markets
DFA Large	5.0%	-6.1%	
DFA Small	-1.4%	-7.2%	-0.4%
DFA Value	10.8%	-0.4%	0.2%
Emerging Markets MSCI Index			-7.9%

relative returns, over this short period, strongly bears this out Emerging markets Index fund is also held and is made up most of large company shares.

What we can and need to do is maintain perspective and stay patient.

Uncertainty is a constant. We don't know what the weather will be next week, and we certainly don't know what might happen to change the current conflict in Ukraine, global travel and trade, supply chain pressures, concerns about inflation or the ongoing evolution of Covid-19. But we do know that *all* of these unknowns are factored into market prices.

And even though we may not know when or how, history tells us categorically that conflicts always end, pandemics run their course, consumerism and trade generally flourish (on average), and inflation is more commonly able to be controlled within targeted ranges.

We don't see anything in the world to suggest that this time is any different.

While the returns this quarter have been poor, they (thankfully) bear no relation to the returns of the comparable quarter in March 2020 when Covid first arrived in the world.

It's useful to look back at that time because the best strategy then was the same as it is today – 'don't panic and stick to your plan'.

Country	Index	3 Mths ending Mar 2020	27 Mths Jan 2020- Mar 2022
USA	S&P 500	-19.6%	45.0%
New Zealand	NZX 50	-14.8%	5.4%
Australia	ASX 200	-23.1%	21.5%

The third column shows how three key market indices performed (in total returns in their local currencies) during that awful first quarter in 2020. Sadly, a number of unadvised investors unfortunately exited the markets at this point.

The fourth column shows the performance of those same indexes over a longer period (*note:* this longer period includes *both* the dismal returns in the first three months of 2020 *and* the poor returns in the recent quarter).

Holding on to your investments through these periods of heightened market volatility wouldn't have felt like much fun, but the overall outcome was well worth the effort.

If history is any guide, that's a conversation we will be having.

Key Market movements For the Quarter

With the prospect of US interest rate hikes and simmering tensions at the Russia/Ukraine border, there were few places for investors to hide in January as bond yields spiked and share markets waned. Growth-tilted sectors such as information technology and consumer discretionary bore the brunt of the pain, while the energy sector generally performed strongly. Following Russia's invasion of Ukraine in late February, investors, shocked by the significant humanitarian impact they were witnessing, became increasingly concerned. Markets tumbled as investors reassessed the potential economic impact of sanctions on Russia and on further supply chain upheavals.

With this adding further fuel to a developing global inflation problem, bond yields rose markedly over the quarter as central banks quickly signalled their intention to not let inflation expectations get out of control.
Unfortunately, with equity markets generally falling and bond yields rising (meaning falling bond prices), the first quarter of 2022 was a challenging environment, even for well diversified investors.

-6.8%	**New Zealand Shares** New Zealand was again one of the poorer performing global developed share markets over the quarter with the S&P/NZX 50 Index returning -6.8%. There was a wide divergence in sectoral returns over the quarter, with Utilities and Financial Services firms generally outperforming, while Healthcare and Technology companies dominated the list of poorer performers. New Zealand-based travel and expense management provider Serko Ltd declined -33.4% for the quarter as business travel volumes reduced during the important December and January period due to disruption caused by the Omicron variant, impacting Serko's revenue expectations for the year. Healthcare companies Ryman Healthcare, Fisher & Paykel Healthcare and Pacific Edge Ltd all fell between -23.4% and -27.8%. With the generally lower respiratory intervention requirements of the Omicron variant, as well as a relatively mild flu season in the Northern Hemisphere, some of tailwinds that had propelled Fisher & Paykel's strong share price performance throughout much of 2020 and into 2021, dissipated in the first quarter of 2022. Although the list of companies delivering positive returns were in the minority, Utilities firms with greater pricing power performed relatively well. Contact Energy, Vector, Genesis Energy, Spark, Chorus and Meridian Energy all returned between +2.4% and +5.3%, to help prop up the local market index. Source: S&P/NZX 50 Index (gross with imputation credits)
+3.9%	**Australian Shares** The Australian share market (ASX 200 Total Return Index) bucked the trend by eking out a +2.2% return for the quarter in local currency terms. Returns to unhedged New Zealand investors were higher at +3.9% due to an appreciation in the value of the Australian dollar over the quarter. Once again, the dispersion in sectoral returns was a feature of the market, with the Energy, Materials, Utilities and Financials sectors all performing positively, while Consumer Discretionary, Healthcare and Information Technology companies were the notable laggards. Also notable was the generally strong performance of the large capitalisation firms, with top 20 companies Woodside Petroleum (+52.5%), BHP Group (+29.7%), Rio Tinto (+25.6%) and Santos (+24.5%) all benefiting strongly from increases in energy and/or key commodities prices. At the other end of the spectrum, Hutchison Telecommunications fell -32.5% and Reece Group, a leading distributor of plumbing products to commercial and residential customers in Australia, New Zealand and the United States, experienced a decline of -29.2% in spite of posting a solid half year announcement. *Source: S&P/ASX 200 Index (total return)*

-4.9% (hedged to NZD)

-6.5% (unhedged)

International Shares

International developed share markets were confronted by a difficult start to the year.
Russia's invasion of Ukraine drew widespread condemnation and elicited significant economic sanctions from democratic nations. This amplified existing concerns over inflation pressures, particularly in energy and food products.

In the USA, the flagship S&P 500 Index (total returns in USD) declined -4.6% in spite of US economic data otherwise remaining relatively stable and unemployment reducing to a low 3.6%.

Eurozone shares fell more sharply. The region, naturally, has closer economic ties with both Ukraine and Russia, particularly when it comes to a reliance on Russian oil and gas. Worries over consumer spending led to declines for retailers, while the conflict also exacerbated supply chain disruptions by stifling the availability of a wide range of parts. This impacted the information technology sector, in particular.

UK equities were more resilient as investors began to price in the additional inflationary shock of the Russian invasion. Large cap equities tracked by the FTSE 100 index even managed a small gain over the quarter, driven by the oil, mining, healthcare and banking sectors.

In New Zealand dollar terms, the MSCI World ex-Australia Index delivered a quarterly return of -4.9% on a hedged basis and -6.5% unhedged. This meant the rolling 12 month return for the New Zealand dollar hedged index is still a healthy +11.3% while the unhedged index has gained +10.9%. *Source: MSCI World ex-Australia Index (net div.)*

-8.0%

Emerging Markets

Emerging market equities were firmly down in the first quarter as geopolitical tensions took centre stage following Russia's invasion of Ukraine. US and its Western allies responded with a raft of sanctions and commodity prices moved significantly higher in response, raising concerns over the impact on inflation, the pace of policy tightening and the outlook for growth.

Trading in Russian companies (both inside Russia and on international exchanges) became fraught as investors sought to exit these exposures en-masse and their share prices crumbled. Russia was officially removed from the MSCI Emerging Markets Index on 9 March, at a price that was effectively zero.

Egypt, a major wheat importer, was one of the weakest markets in the MSCI Emerging Markets index, due in part to a 14% currency devaluation relative to the US dollar. China also lagged the index by a wide margin as daily new cases of Covid-19 spiked, and lockdowns were imposed in several major cities, including Shanghai. Regulatory concerns relating to US-listed Chinese shares also contributed to market volatility.

Conversely, the Latin American markets all generated strong gains, led higher by Brazil. Other net commodity exporters also posted sizeable gains, including Kuwait, Qatar, the UAE, Saudi Arabia and South Africa.

In unhedged New Zealand dollar terms, the MSCI Emerging Markets Index produced a quarterly return of -8.0%, contributing to a -10.4% return over the last 12 months. *Source: MSCI Emerging Markets Index (gross div.)*

-6.8%

New Zealand Property

This quarter saw an across the board easing in New Zealand Listed Property Trusts values for companies investing solely in New Zealand assets. One trust bucked the trend, Vital Healthcare, holds over 80% of its investments in Australia and is a speciality property company investing in medical service facilities and hospitals.

Vital healthcare was the highest returning 4.0% for the quarter, Stride properties being the next -4.3% and Argosy the lowest returning at -12.7%.

Office vacancy rates in Auckland have risen over the past two years more than doubling to approach 11.0%. The Wellington market being underpinned by government tenancies has faired somewhat better with the vacancy rate peaking around 6.3%. The indications are that the worst of the vacancy rate hicks are over and 2022 is likely to be a pivotal year for this sector.

In contract to the office sector, demand in the industrial sector has strengthened with vacancy rates in Auckland and Wellington running at historically low levels below 2.0%.

The retail sector is varied being made up of retail strips in the suburbs, CBD outlets and bulk retail complexes. They have all shown some resilience with there having occurred, modest reductions in vacancy rates. Auckland's retail strip vacancy rates are around 8.5%, while Auckland retail CBD is 14.0% and Wellington 5.0%.

While the majority of Goodman and Property For Industry's holding are commercial and industry properties for this quarter both inflationary pressures and rising interest rates meant that their quarters return of -7.9% and -5.6% respectively straddled the Index. *Source: S&P/NZX All Real Estate Index.*

-2.2%

International fixed interest

The narrative that inflation was transitory began to change at the beginning of the year and central banks increasingly signalled their inflation concerns which drove bond yields higher. The start of the war between Russia and Ukraine and the resulting commodity supply shock posed a dilemma for central banks who were suddenly forced to choose between trying to tame inflation or support growth.

While acknowledging the uncertainties related to the geopolitical situation and its economic implications, central banks have so far suggested that unless the growth outlook were to markedly deteriorate, they view inflation as the more pressing problem.

Euro area inflation was revised up to 5.9% in February and inflation in the UK accelerated to 6.2%. In the US, inflation reached a 40 year high of 7.9% and is expected to remain elevated over the coming quarters.

With this backdrop, the European Central Bank confirmed that the tapering of the pandemic emergency purchase programme will now conclude in June.

The US Federal Reserve, as expected, raised the Federal Funds rate by 0.25%, making it clear that further increases will be appropriate. Committee members now expect seven hikes this year, and four next year, implying interest rates could end this cycle higher than the committee's perceived neutral rate of 2.4%.

After an initial rate hike in December, the Bank of England raised its policy rate by 0.25% twice in the first quarter, reaching 0.75%. At their March meeting, the bank described geopolitical risks as having accentuated its prior expectations for weak growth and high inflation this year, before noting that their monetary policy "will act to ensure that longer-term inflation expectations remain well anchored".

With investors now expecting rate hikes at a swifter pace, global bond yields rose notably through the quarter. The US 10-year Treasury yield increased from 1.51% to 2.35%, while the UK 10-year yield climbed from 0.97% to 1.61%.

While rising yields are a headwind for short term sovereign bond returns, corporate bonds generally performed even worse as credit spreads widened due to a worsening economic outlook.

The FTSE World Government Bond Index 1-5 Years (hedged to NZD) returned -2.2% for the quarter, while the broader Bloomberg Global Aggregate Bond Index (hedged to NZD) returned -4.8%. *Source: FTSE World Government Bond Index 1-5 Years (hedged to NZD.)*

-2.9%

New Zealand fixed interest

The Reserve Bank of New Zealand (RBNZ) elected to increase the official cash rate (OCR) by a further 0.25% on 23 February, moving this benchmark rate from 0.75% back to its pre-Covid level of 1.00%.

In making this adjustment the Monetary Policy Committee noted that the most significant risk to be avoided at present was for longer term inflation expectations rising above the bank's target and becoming embedded in future price setting.

The Committee stated that while higher interest rates are necessary, households and firms may have become more sensitive to interest rate changes as their debt levels have risen. For the time being, the RBNZ are currently projecting the OCR hitting 3.4% by late 2024, however they acknowledge the pathway towards that level could well include individual rate hikes of larger than 0.25%, if deemed necessary.

Given this outlook, the New Zealand 10 year government bond yield climbed from 2.33% at the end of 2021 to 3.25% at the end of March; an increase of 0.92% over the quarter. The New Zealand 2 year government bond yield followed a similar pattern, beginning the year at 1.98% and ending the March quarter at 2.92%, a yield increase of 0.94%.

Similar to the effects seen overseas, these rising bond yields generally resulted in negative short term returns for bonds of all durations. The S&P/NZX A-Grade Corporate Bond Index fell -2.9% for the quarter, while the longer duration but higher quality S&P/NZX NZ Government Bond Index fell -4.3%.

Asset Class Returns To 31 March2022

Asset Class	Index Name	3 mths	1 year	3 years	5 years	10 years
New Zealand shares	S&P/NZX 50 Index, (gross with imputation credits)	-6.8%	-2.9%	+7.9%	+11.9%	+14.4%
New Zealand property	S&P /NZX All Real Estate Index (Gross)	-6.2%	+0.8	+6.8%	+10.1%	+10.8%
Australian shares	S&P/ASX 200 Index (total return)	+3.9%	+11.3%	+14.1%	12.0%	+12.9%
International shares	MSCI World ex Australia Index (net div., hedged to NZD)	-4.9%	+24.3%	+12.0%	+13.8%	+14.7%
	MSCI World ex Australia Index (net div.)	-6.5%	+10.9%	+14.4%	+12.8%	+12.9%
Emerging markets shares	MSCI Emerging Markets Index (gross div.)	-8.0%	-10.4%	+4.7%	+6.6%	+5.5%
International property	S&P Global REIT Index (Gross div.)	-4.8%	+20.9%	+7.9%	+8.5%	+10.5%
New Zealand fixed interest	S&P/NZX A-Grade Corporate Bond Index	-2.9%	-5.2%	+0.2%	+2.3%	+3.8%
International fixed interest	FTSE World Government Bond Index 1-5 Years (hedged to NZD)	-2.2%	-2.5%	+0.8%	+1.4%	+2.7%

Unless otherwise specified, all returns are expressed in NZD. We assume Australian shares and emerging market shares are invested on an unhedged basis, and therefore returns from these asset classes are susceptible to movement in the value of the NZD. Index returns are before all costs and tax. Returns are annualised for time periods greater than one year.

Inflation is back, that's why you own shares

We're not exactly sure of the recipe required to bake fast rising prices into the economy, but we're pretty sure of the ingredients. You will commonly need:

- disruptions in free-flowing trade
- shortages in goods
- surplus money in the economy, such as that provided by financial stimulus packages

Between the effects of Covid-19, logistical challenges, worldwide massive government stimulus and now the war in the Ukraine, accompanied by sanctions, we can easily see why prices are increasing. There is just too much money chasing goods that are becoming rarer and more difficult to acquire.

The effects are everywhere and by no means unique to New Zealand. Petrol prices are up, food prices are up, rental prices are up. Interest rates have also gone up and markets are factoring in more rate increases in the months ahead.

You don't need us to remind you that inflation is here. But if you own a diversified investment portfolio you are probably already prepared for inflation.

So, what do we mean by 'already prepared'?

It means that unlike many Kiwis, especially many senior citizens, you are not just invested in cash and term deposits which tend to perform poorly when inflation is high. You are instead invested in a range of different assets that, over time, will generally do much better than inflation.

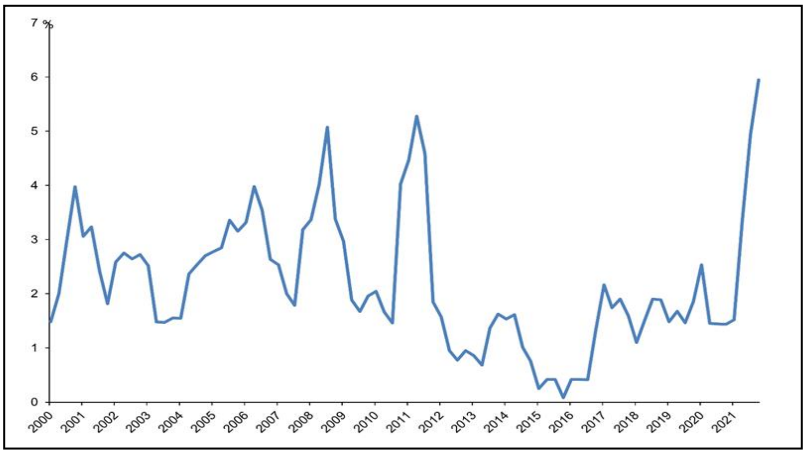
Up until 6 months ago we were regularly receiving calls from people had all their investment monies deposited in bank term deposits. Why you might ask …because its "safe".

It may be safe from criminals, nowadays that's not necessarily the case, but if there's one thing that demonstrates that investing in cash is *not* safe, it's the corroding effects of inflation.

As we write this, inflation, according to the Reserve Bank of New Zealand, is at 5.9% (Q4 2020 through 2021 Q4). But even that doesn't tell the whole story. It's widely reported that in Q1 2022 inflation has progressively worsened.

The graph below from Stats NZ shows that inflation is currently at its highest rate in over 20 years.

New Zealand Annualised Inflation



Source: Stats NZ. Notes: Latest data (Dec quarter 2021)

It's clear from this data that people relying on their bank savings, to meet their household and discretionary spend needs will be loosing every day.

Inflation has accurately been described as a silent thief. If With inflation currently running around the 6.0% p.a. mark, the thief is not invisible or silent now.

By contrast, our clients very rarely have most of their assets in cash. Extra cash is held for short term, definitive purchases. Future purchases, which are the ones most influenced by rising prices, are generally funded through a portfolio.

Although a portfolio's value can go up and down, it typically provides good insulation from the long-term effects of inflation for very logical reasons. If the prices that businesses charge for their goods and services increase, so do their nominal revenues. Over time, that increase in revenue pushes up the value of their share prices.

Shares, unlike cash, have a long history of *outperforming* inflation as the chart below demonstrates. It shows inflation in the United States back to 1927 and the data tells us that $1 in 1927 was worth the same as $16 in 2021 (i.e. $1 adjusted for inflation each year). However, $1 invested in large US companies was worth $11,182 by year end 2021 before tax and costs.

Other assets also outperformed inflation over this period, including bonds and residential property, although not by as much.
The main point, however, is that an investor that owns a diversified portfolio of shares, some bonds and property, is already well positioned to withstand inflation over any reasonable time horizon. And for that reason, our investors should feel comfortable.

What about alternative investments?

We are sometimes asked about other securities that are promoted to reduce the effects of inflation. The one brought up most often is commodities. In case you were curious, commodities present three main challenges within the context of a portfolio:

1. They are traditionally dominated by energy products such as oil, which environmentally conscience investors want to avoid.
2. Commodities are very price volatile; about 20 times as volatile as inflation itself. Trying to dampen inflation with something 20 times more volatile is like cracking a nut with a sledgehammer. It could get messy.
3. The long term returns of commodities are about 3% to 4%, just a little more than the return on inflation itself.

We aren't sure how much longer inflation will be with us. The answer may depend on being able to predict Covid-19 mutations, the geopolitical moves of Russia, the counter measures of OPEC and NATO, and Central Bank policy - all at the same time. However, we are sure that inflation will show over time, the wisdom of owning a portfolio as opposed to other 'safe' alternatives, such as cash.

In today's environment, losing purchasing power with cash is inevitable.

Even though we can't predict the future, history tells us that beating inflation over the long term in a prudently diversified investment portfolio, is probably also inevitable.

The takeout is that investors owning a diversified portfolio of shares, bonds and property are well positioned to withstand inflation over any reasonable time horizon

Long term growth of wealth – shares, bonds, bills and inflation 1927 -2021