Bradley Nuttall Autumn Update

January – March 2024

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Bradley Nuttall Otago Limited
Level 10 John Wickliffe House
265 Princes Street, Dunedin
03 477 2316
andy@bnol.co.nz
www.bnol.co.nz

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Market Commentary

Diversified investors had more reasons to smile as the markets began this year exactly as they left off last year - with another strong gain by most international share markets.

In the absence of any major new economic or geopolitical shocks, investment sentiment continued to be closely linked to changes in the inflation and interest rate landscape. On that front, the first quarter of 2024 saw another discernible shift in inflation and interest rate expectations.

Initially, markets were anticipating central banks would act relatively quickly to begin lowering interest rates this year. However, these expectations were gradually scaled back. Despite indications of inflationary pressures generally easing, a stubborn inflation reading in the US tempered the US Federal Reserve's enthusiasm for interest rate cuts.

With inflation remaining a primary concern globally, the European Central Bank, the Bank of England, and the US Federal Reserve all proceeded with greater caution during the quarter. All were very careful to avoid making premature declarations of victory over inflation. At the same time, the Bank of Japan increased interest rates for the first time in 17 years, signalling an end to their negative interest rate settings.

Meanwhile, global economic activity was on the upswing. The US economy continued to outperform expectations, buoyed by sustained consumer spending. While the eurozone's progress was slower, there were reasons for optimism, with manufacturing showing signs of a revival.

As the quarter progressed, government bond yields adjusted in response to shifting market sentiment. Most 10-year government bond yields increased over the quarter which reduced the returns from most sovereign bond markets.

Japan on the rise

While large US information technology companies have attracted most of the media attention in recent quarters, the performance of the Japanese share market has been largely unheralded.

For decades, international investors have had a frustrating relationship with Japan's share market, whose subdued returns have mirrored the country's protracted economic stagnation.

However, these days, Japanese shares are viewed much more positively, with the Nikkei 225 index gaining more than 20% in the first quarter to reach a 34-year high.

After limping through Japan's "lost decades" following the collapse of a massive asset bubble in the 1990s, Tokyo's benchmark share market index has quadrupled in value over the last 12 years and doubled since March 2020.

For Japan, the world's third largest economy, it has been a timely reawakening.

Prime Minister Fumio Kishida's "new capitalism" drive, has sought to encourage a shift from saving towards investing, relaunching the government's Nippon Individual Savings Account (NISA) programme with higher annual investment limits and extended tax-exemption periods.

This has coincided with recent corporate governance reforms directed by the Tokyo Stock Exchange, that have led Japanese companies to seek to increase shareholder returns through share buybacks and higher dividend payouts.

A weak Japanese yen, hovering at its lowest levels since the 1990s, has helped boost corporate profits and made Japanese companies, already cheap by international standards, even better value.

While analyst views are mixed about the prospects for Japanese shares from here, the improved performance of the Japanese share market in recent years has been undeniable.

> Many assets will have their time in the sun and gold is certainly one of those at present.

Gold rush

What is going on with the price of gold? By the end of the first quarter of 2024, gold had hit a new all-time high of over USD2,200 an ounce.

From a valuation and expected returns perspective, making a case for gold as an investment asset is always challenging. The metal provides no cash flows, dividends, income or earnings of any kind. And yet, for thousands of years, gold has had a reputation of being valuable.

It is commonly seen as a store of value (often popular in a market crisis), and a potentially useful diversifier because it won't necessarily move up or down in synch with other investment assets.

However, to get a better understanding of how gold has performed as an investment, it's helpful to look at longer-term returns.

From 1928 to 2023 the compound annual returns for US shares (S&P 500), US Government bonds (10 year Treasuries), Cash (3 month Treasury Bills) and Gold have been as follows[1]:

US Shares	+9.8% p.a.
US Government Bonds	+4.6% p.a.
Cash	+3.3% p.a.
Gold	+4.9% p.a.

So, gold has performed better than bonds and cash but has trailed the share market by a significant margin. But even this long term data requires some further context.

The price of gold was essentially controlled by the US government until 1971 when President Nixon ended the gold standard of converting US dollars to gold at a fixed rate. Over the following decade from 1971 to 1980, gold delivered a ten-year annualised return of 31.8% per year.

Some might argue that meant gold was an amazing inflation hedge during that time. Others might say those massive returns were simply the gold price "catching-up" from the earlier decades in which the government artificially held the price down.

If you look at the gold price performance since 1980, it tells a very different story. From 1981-2023, gold has delivered an annualised return of just 3.0% per year, lagging the returns of US shares (+11.3%), US Government bonds (+6.7%) and Cash (+3.8%).

Even worse, since the US inflation rate over the same period has also been 3.0%, it means gold has delivered a real return over the last 43 calendar years of precisely zero. Not such a great inflation hedge after all.

Many assets will have their time in the sun and gold is certainly one of those at present. However, it is always important not to overemphasise great short term performance if there is no sound rationale for why those returns should persist over the long term.

New Zealand Incorporated

The first corporate reporting season of the year in New Zealand was mixed with more companies missing profit expectations than beating them and more post-result forecast earnings reductions than increases.

In general, these earnings downgrades reflect the difficult economic conditions facing many local businesses at present – their input costs (including labour and debt servicing) are increasing, while revenue is slowing.

With a negative GDP growth rate confirmed for the December quarter (confirming a return to a technical recession in the second half of 2023), the Reserve Bank of New Zealand (RBNZ) left domestic interest rates unchanged at its 28 February meeting.

However, its updated forecast interest rate path implied interest rate cuts starting slightly earlier than before – now in the first half of 2025. Previously it was projecting rate cuts beginning in the second half of that year.

The RBNZ is of the view that the current tight monetary policy settings are starting to work as core inflation and most inflation expectations have declined. However, with inflation still above the bank's target band, the RBNZs tolerance for any future inflation surprises remains very low. In other words, if inflation indicators were to start moving up again, the RBNZ have clearly signalled it is prepared to raise rates further.

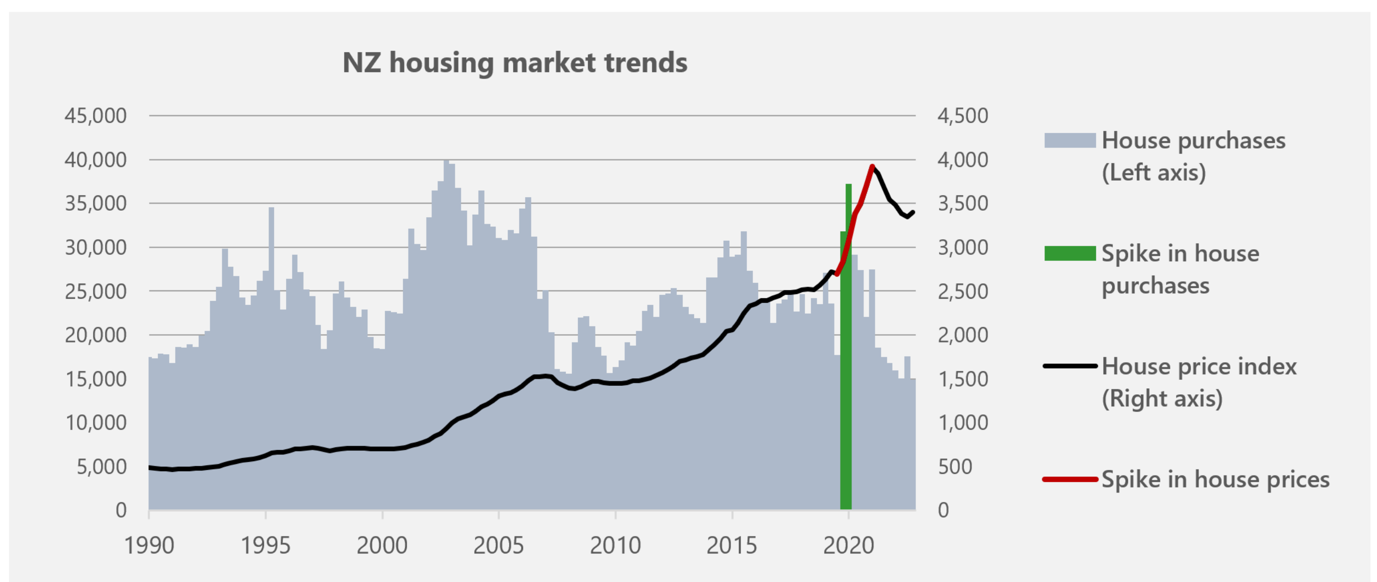
In the meantime, the pathway to lower interest rates in New Zealand seems to have edged just a little closer, hopefully providing a little comfort for stretched businesses and homeowners.

The housing market

New Zealand consumers are feeling the pressure at present and some of this is linked to changes in the housing market.

As the chart below shows[2], the New Zealand housing market experienced a notable spike in purchases over the second half of 2020 (green bars). This was back when we were emerging from the initial Covid lockdown, flush with extra savings and facing historically low interest rates. For many New Zealanders, whose DNA is steeped in property ownership, this represented an opportunity too appealing to pass up. The significant positive impact this subsequently had on house prices (orange line) is equally revealing.

More recently however, not only has the volume of house purchases progressively declined, so too has the New Zealand house price index. In fact, since its peak in December 2021, the house price index has declined -13.3%.



> For New Zealanders more established in their careers or even in retirement, this is simply the 2024 version of economic uncertainty they have witnessed countless times before.

In just 18 months the mood of potential home buyers shifted from FOMO (fear of missing out) to FOOP (fear of over-paying), and part of that readjustment related to the swift increase in mortgage interest rates.

Most mortgage borrowers are now exposed to materially higher mortgage rates than those available only 2-3 years ago. For example, 1-year special mortgage rates have increased from a low of 2.2% in June 2021 to around 7.2% today. The average outstanding home mortgage rate has also increased from below 3% in September 2021 to almost 6% today and is likely to increase further.

While this increase in average mortgage rates has been accompanied by an increase in the number of home loans in arrears (credit reporting agency Centrix noted an increase from less than 1% of mortgages in arrears in 2022, to more than 1.5% today) it is not yet at concerning levels.

However, the trend suggests that New Zealand consumers, on average, are starting to feel the effects of the current monetary policy settings, and it is something the RBNZ will be keeping a close watch on when they make their future interest rate decisions.

Long term perspective

For younger New Zealanders looking to start their careers or secure their place on the property ladder, the immediate outlook likely feels uncertain – particularly in respect of the economic environment (business health and job opportunities), and level of interest rates (mortgage costs).

For New Zealanders more established in their careers or even in retirement, this is simply the 2024 version of economic uncertainty they have witnessed countless times before.

Historically, each of these previous versions has plotted its own unique course but the eventual outcomes have many characteristics in common – stronger economic performance, business growth, increased corporate profitability, house price gains, and long-term positive investment returns.

These outcomes aren't necessarily all delivered at exactly the same time, as we have seen in the last six months, with share markets reaching new highs in spite of some less than stellar economic news. However, they can be expected on average, over time. This is why investors accustomed to investing for the long term can continue to have confidence in the progress they are making towards achieving their investment goals.

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(1) Source: https://pages.stern.nyu.edu/~adamodar/. Historical Returns on Stocks, Bonds, Real Estate and Gold (for historical risk premiums). All returns referenced in the 'Gold Rush' section are in US Dollars.

(2) Source: Reserve Bank of New Zealand database and CoreLogic House Price Index data.

Key market movements for the quarter

International share markets registered further strong gains in the first three months of 2024. A resilient US economy and ongoing investment enthusiasm for companies associated with artificial intelligence technologies were two of the key drivers.

US Federal Reserve Chairman, Jerome Powell, attempted to cool expectations of imminent interest rate cuts, but with the latest "dot plot" detailing US policymakers' expectations of three rate cuts later this year, share market investors were undeterred.

Global economic activity remained positive with the US economy continuing to lead the way. With easing US inflation contributing to rising real wages there, this has boosted US consumer spending and growth. Other regions are emerging from their post-Covid weakness at different rates. The Eurozone is seeing fledgling signs of a recovery in their services sector and manufacturing, while China's recovery also remains broadly intact, although the Chinese property sector continues to struggle.

A cautionary approach from most central banks reinforced the likelihood that interest rate cuts are now only expected to commence later this year (in some regions). This contributed to a period of low returns for bond markets as most long term government bond yields rose over the quarter.

+10.5% *(hedged to NZD)*

+15.4% *(unhedged)*

International shares

US and Eurozone share markets delivered strong gains in the first quarter of the year.

US shares were boosted by good corporate earnings announcements, including from some of the large technology companies. Economic data generally demonstrated the ongoing resilience of the economy with annualised GDP growth for the December quarter revised up to 3.4%.

Eurozone shares also posted strong gains in the first quarter. AI-related technologies continued to benefit from strong investor sentiment while financials, consumer discretionary and industrial companies also generally performed well. With signs of improving business activity and inflation continuing to moderate (the consumer price index moved from 2.9% in December to 2.4% in March), there were reasons for optimism.

UK shares also rose over the quarter in spite of official data showing the economy had entered a technical recession in the second half of 2023. The Japanese share market experienced an exceptionally strong rally with the Nikkei 225 index surpassing the 40,000 yen level and reaching a new all-time high.

Against most major currencies, the New Zealand dollar was weaker through the quarter which meant higher reported returns for investors holding unhedged foreign assets.

The MSCI World ex-Australia Index returned +10.5% for the quarter hedged to the New Zealand dollar and +15.4% for the unhedged index.

Source: MSCI World ex-Australia Index (net div.)

+8.4%

Emerging markets shares

Emerging markets shares delivered solid returns to unhedged investors, with the weaker New Zealand dollar helping amplify returns.

Despite rallying a little in the middle of the period, Chinese shares ended the quarter modestly lower as some caution remains about the outlook for the Chinese economy. However, investors in Taiwan, India and the Philippines saw share prices bouncing back from recent lows amidst cautious optimism that the period of gloom surrounding China may be slowly starting to lift.

Index heavyweight Taiwan outperformed strongly on the back of continued investor enthusiasm about artificial intelligence and the technology sector. January's presidential election saw the ruling Democratic Progressive party remain in power but lose its majority in parliament. The markets took this news in their stride as it makes continuation of the status quo more likely.

India also outperformed, helped by local currency strength ahead of April's general election, in which incumbent Prime Minister Modi seeks a third term. Korea posted a positive return but underperformed broader emerging markets due to weakness in speculative AI and battery companies.

While it was a moderate quarter overall for the underlying emerging markets group, with the MSCI Emerging Markets Index producing a quarterly return of +4.6% in local currency terms, the weaker New Zealand dollar magnified the gains to unhedged investors.

Source: MSCI Emerging Markets Index (gross div.)

+3.1%

New Zealand shares

The New Zealand share market, as measured by the S&P/NZX 50 Index, delivered a good return for the first quarter, even if it tended to lag the returns of a number of global peers.

The local share market has been facing slightly stronger 'headwinds' as inflation has stayed more elevated here necessitating a stronger monetary policy response. This, in turn, has brought with it some additional uncertainty and the potential for a larger slowdown in economic activity.

We received some initial insight into this when New Zealand's fourth quarter GDP figure came in below expectations at -0.1%. This signalled a return to a technical recession in New Zealand following a negative third quarter in 2023. The surprise in this data was that the significant injection of new migrants to New Zealand over recent months was still not enough to drag New Zealand's nominal GDP growth into the positives, as many had expected.

From within the top 50 companies, the best results came from a2 Milk (+47.4%) on the back of reported growth in revenue and profits, and cleantech solutions provider Gentrack Group (+34.4%), also on the back of very strong reported growth figures.

Unfortunately, a few notable companies didn't fare quite so well during the quarter with Fletcher Building (-13.8%), Tourism Holdings (-16.2%) and Ryman Healthcare (-22.9%) all feeling the effects of New Zealand's tighter economic conditions.

Source: S&P/NZX 50 Index (gross with imputation credits)

+6.6%

Australian shares

The Australian share market (S&P/ASX 200 Total Return Index) recorded a strong gain in the fourth quarter, rising +5.3% in Australian dollar terms.

Returns tended to be stronger in some of the lesser-known company names, with smaller companies, on average, delivering higher returns than larger companies. The global hype behind AI (and information technology companies more generally) resulted in information technology being the clear best performing sector over the quarter, albeit only representing 3% of the Australian market. Real estate, consumer discretionary and the important financials sector also performed well.

The materials sector was the only sector to decline over the quarter, dragged down by industry heavyweights BHP (-10.0%) and Rio Tinto (-7.4%), as iron ore prices fell by around 20% over the three months. The price of the mineral has drifted lower this year following a period of lower global economic growth and weaker demand from key markets, such as China.

While a number of very small Australian firms posted some significant gains, the most notable gains from firms inside the top 100 came from software applications firm Altium Ltd (+39.9%) and diversified real estate company Goodman Group (+33.6%).

With the Australian dollar relatively strong against the New Zealand dollar over the quarter, the reported returns to unhedged New Zealand investors rose to +6.6%.

Source: S&P/ASX 200 Index (total return)

+0.2%

International fixed interest

The first quarter of 2024 saw yet another 'topographical change' in the landscape of inflation and interest rate expectations.

Inflation continues to be the central concern for bond markets and, initially, the markets were anticipating faster central bank action to lower interest rates globally. However, these expectations were generally scaled back during the quarter with the major central banks all adopting a more overt "proceed with caution" approach.

In general, the central banks don't want to be seen to be premature in dropping interest rates and risking the embarrassment - and adverse economic impact - of potentially having to quickly backtrack by putting interest rates back up again. While this might only delay broader based interest rate reductions (in some regions) until later in the year, it was enough to send government bond yields higher over the first quarter.

The US 10 year bond yield climbed from 3.87% to 4.21%, with the two year bond yield moving from 4.25% to 4.63%. Germany's 10 year bond yield rose from 2.03% to 2.29%, while the UK 10 year yield moved from 3.54% to 3.98%.

The FTSE World Government Bond Index 1-5 Years (hedged to NZD) returned +0.2% for the quarter, while the broader Bloomberg Global Aggregate Bond Index (hedged to NZD) was unchanged over the quarter.

Source: FTSE World Government Bond Index 1-5 Years (hedged to NZD)

+0.6%

New Zealand fixed interest

The Reserve Bank of New Zealand (RBNZ) shocked no-one by leaving interest rates unchanged in its 28 February meeting (and again, at time of writing, on 10 April).

Maintaining the same 'cautious' approach being adopted by many major central banks overseas, the RBNZ has made it clear they want to see inflation come back into their target band before considering interest rate reductions.

While the approach is understandable, it has established an informal game of 'monetary policy chicken', whereby the RBNZ are projecting that interest rate reductions won't start before 2025, while an increasing number of market commentators are predicting, based on continuing weakness in the economy, that rate cuts could start as early as August this year.

While there is still time for the RBNZ to modify their view to align with the wider market, it has a clear risk aversion to the idea of cutting interest rates too early. While all participants are broadly in agreement the next rate movement is more likely to be downwards, for now we can only watch and wait (and guess) as to the likely timing.

On the back of the general trend of rising bond yields internationally, the New Zealand 10 year bond yield increased from 4.39% to 4.64% over the quarter.

The S&P/NZX A-Grade Corporate Bond Index gained +0.6% for the quarter, while the longer duration but higher quality S&P/NZX NZ Government Bond Index declined -0.2%.

Source: S&P/NZX A-Grade Corporate Bond Index

Table 1: Asset class returns to 31 March 2024

Asset Class	Index Name	3 months	1 year	3 years	5 years	10 years
International shares	MSCI World ex Australia Index (net div., hedged to NZD)	10.5%	26.6%	9.3%	11.7%	10.9%
	MSCI World ex Australia Index (net div.)	15.4%	31.2%	14.5%	15.1%	13.7%
Emerging markets shares	MSCI Emerging Markets Index (gross div.)	8.4%	13.7%	0.4%	5.3%	7.3%
New Zealand shares	S&P/NZX 50 Index (gross with imputation credits)	3.1%	2.7%	-0.4%	5.0%	10.0%
Australian shares	S&P/ASX 200 Index (total return)	6.6%	16.8%	9.7%	10.1%	8.5%
International fixed interest	FTSE World Government Bond Index 1-5 years (hedged to NZD)	0.2%	3.6%	0.0%	1.0%	2.2%
	Bloomberg Global Aggregate Bond Index (hedged to NZD)	0.0%	3.8%	-1.6%	0.5%	2.9%
New Zealand fixed interest	S&P/NZX A-Grade Corporate Bond Index	0.6%	5.5%	0.0%	1.2%	3.4%
New Zealand cash	New Zealand One-Month Bank Bill Yields Index	1.4%	5.7%	3.3%	2.3%	2.4%

Unless otherwise specified, all returns are expressed in NZD. We assume Australian shares and emerging markets shares are invested on an unhedged basis, and therefore reported 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.

The man who helped us understand the pain of losing

Recently we mourned the passing of a man who almost single handedly helped us make our clients better investors.

His name was Professor Daniel Kahneman, a Holocaust survivor, who won the Nobel Prize in Economics in 2002. But.... he wasn't an economist. He was a behavioural psychologist. His insights have been summarised by the Washington Post this way, **"He found that people rely on shortcuts that often lead them to make wrongheaded decisions that go against their own best interests."**

What does that mean exactly, and what does it have to do with investing?

Well, imagine that your bank emailed saying there was an error in their interest calculations and they were depositing $20 into your account. How would you feel? You might be mildly happy.

But how would you feel if you got back to your car and saw a parking ticket that cost you $20? It's likely that the parking ticket would feel far worse than the bank error in your favour felt good.

It was Daniel Kahneman that not only measured this phenomenon, but he gave it a name - "Loss Aversion".

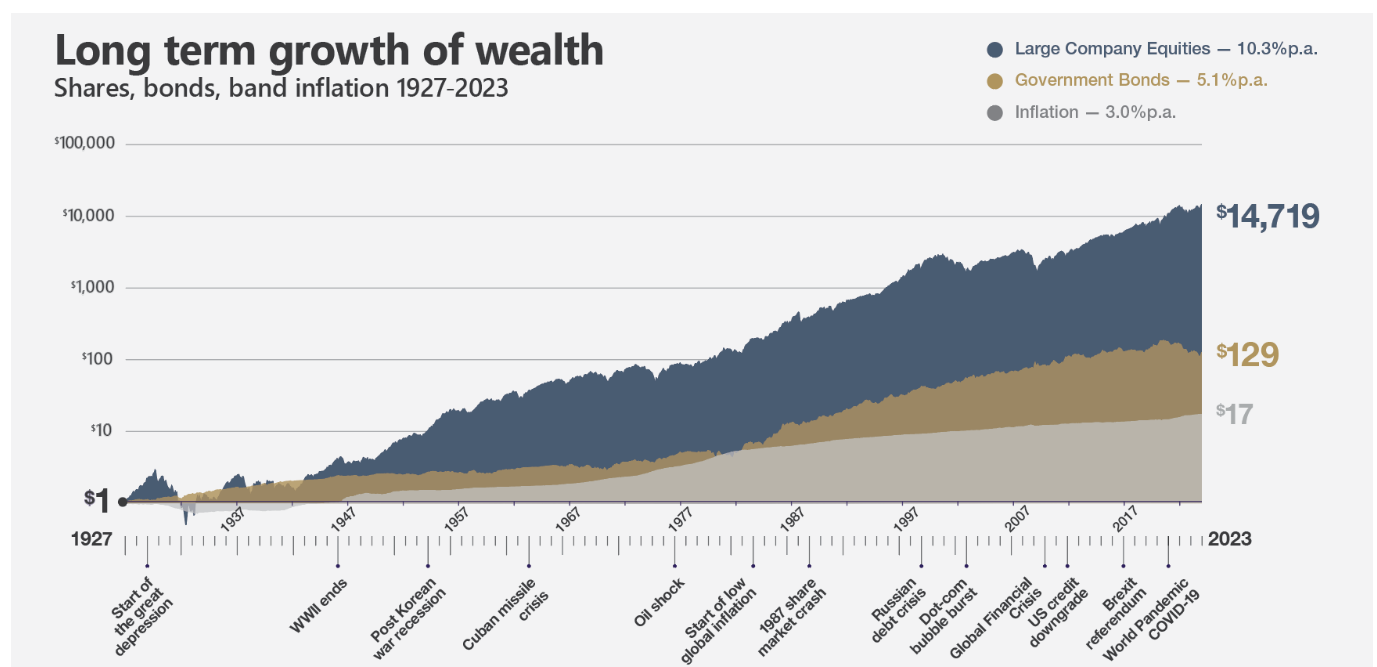
The question Kahneman helped answer is to what extent do equivalent losses hurt more than gains feel good? The answer is, losses feel between 2 and 3 times worse than equivalent gains.

Loss aversion is a mental shortcut. Everyone has it and without advice it generally results in investors acting against their own best interests.

As financial advisers we regularly live the reality of loss aversion. If a portfolio drops by 15%, we often hear from investors. When markets rise by 15%, no one calls us. The losses hurt, but the gains don't produce the same reaction.

Over time, markets have gone up, and given enough time they've gone up substantially. In fact, looking at the gains over time in the chart below, where $1 invested in large company shares in 1927 turned into $14,719 by 2023, one really has to ask, "How could any investor mess this up?"

The biggest reason investors can mess this up is loss aversion. A leading example would be making a very poor investment decision when faced with difficult markets. The chart below summarises nearly 100 years of investing, but those little downward squiggles can be terrifying.



Analysis period is January 1927 to December 2023. All returns are in New Zealand dollars.

Countering loss aversion is so important that, to this day, we measure how sensitive clients are to potential losses and use that to guide our portfolio recommendations. We educate clients by showing them appropriate long-term data to encourage better decision-making when they are going to need it the most (i.e. when markets are going down).

Loss aversion affects investors in other ways. For example, let's say that you come across someone that just purchased a lotto ticket for $1 and you offered to buy that ticket off them for $3. Now, with $3 they could purchase 3 more lotto tickets and triple their chance of winning. But when given this offer, what do you think will most lotto players do? That's right, they'll hold their ticket thank you very much. Why? Loss aversion. They know intuitively that if that ticket was the winner and they sold it, they would never forgive themselves. The 'loss' would be too high.

We often come across investors that hold a few poor 'legacy' investments including individual shares or properties. Do they want to sell them? No. But do they really want to keep them? Not really as they often have no strategic value. So, why not sell them? Because what if those shares go up after they sold? Loss aversion will often keep these investors holding something they shouldn't, rather than investing in something they should.

Loss aversion is also responsible for the difficulty many have in setting goals.

Kahneman said, "Loss aversion refers to the relative strength of two motives: we are driven more strongly to avoid losses than to achieve gains. A reference point is sometimes the status quo, but it can also be a goal in the future: not achieving a goal is a loss, exceeding the goal is a gain."

It's true that a question many investors dread is "what are your financial goals?" One reason investors don't like that question is that once you set a 'goal', you make achieving that goal the norm, or as Kahneman puts it, 'the status quo'. You will only feel good if you achieve or exceed the goal. If you do worse than the goal, you'll feel badly. The intuitive solution? Just don't set goals or else set very short-term but less meaningful goals that you are likely to achieve. That way you can't be disappointed.

Unfortunately, by not identifying clear financial goals, it often results in a lack of coherent financial strategy and predictably underwhelming results.

As we've highlighted here, a 'loss' can be many things and we have an aversion to all of them. But the most important and potent losses we come across are negative portfolio returns that occur during challenging down markets. But here's the secret, articulated well by Ben Carlson, an adviser in the United States, "The ability to deal with losses is what separates successful investors from unsuccessful investors. You're in trouble if losses cause you to overreact or make big mistakes at the worst possible moments. You cannot make it in the (share) market if you don't have the ability to deal with losses on occasion."

> The single best way to create a great investor is to help them recognise their silent enemy – loss aversion.

It's our job to arm you with the information and confidence to deal with temporary financial losses.

We're grateful for the brilliant insights offered by Professor Kahneman through his storied career. We've long thought it more important to create great investors than to select great investments. It's our way of saying that investments should be boring, diversified, low cost, and do what they say on the tin. Speculating on the next great investment is a fool's errand. But creating great investors, that's something worth focusing on.

The single best way to create a great investor is to help them recognise their silent enemy – loss aversion. If they can understand and acknowledge it, and be willing to work through the uncomfortable feelings it produces, it will dramatically improve their chances of achieving their future goals (there's that word again!).

Daniel Kahneman has been in our corner for every part of that effort. We are thankful for him and confident his legacy will shine brightly for years to come.

If you have any interest in learning more about Daniel Kahneman and his brilliant insights into human behaviour, we recommend reading his book 'Thinking Fast and Slow'. *https://www.amazon.com.au/Thinking-Fast-Slow-Daniel-Kahneman/dp/0374533555.*