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Synergy
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Newsletter

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Market Commentary

When we reflect on the performance of global equity markets over the last 12 months, a picture really does tell a thousand words...

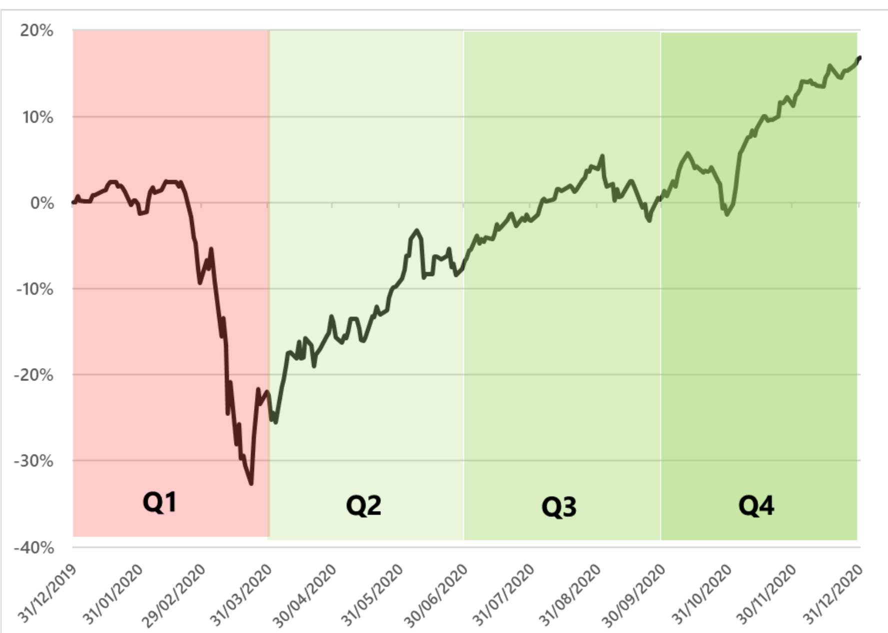
The following chart highlights the cumulative performance of the S&P Global Broad Market Index[1] (in USD) over the course of the tumultuous last 12 months. After falling over 30% during the first quarter when the initial wave of the global pandemic hit, the index then defied all expectations by, remarkably, closing out the year with a gain of +16.8%. From the low point on 23 March, this represented a global share market rebound of just over 73%!

When a year like 2020 comes along, it provides a stark reminder of the difficulties of forecasting. In January, almost no one was predicting a deadly global pandemic. And yet, before the quarter was out we were facing the unimaginable, and global shares had fallen in a heap. In late March, the world was struggling to come to terms with what had occurred. We were besieged by escalating Covid-19 infection rates, mounting deaths, border closures, country lockdowns and extreme economic uncertainty. In the midst of all of this, very few were predicting the extraordinary speed and strength of the market rebound soon to follow.

However, by the end of the year, even while second and third waves of the pandemic were battering the USA and Europe, and with a contested US presidential election where the sitting president was refusing to accept the results, global share markets were moving sharply back into positive territory.

The key difference now was that Covid-19 vaccines were beginning to be distributed in the northern hemisphere.

Figure 1: S&P Global Broad Market Index (BMI) cumulative total return in 2020



[1] A float-adjusted market capitalisation global share index measuring the US dollar performance of over 11,000 constituent companies across 25 developed and 25 emerging market countries.

And even though we still don't know how the post-Covid world will look or function (particularly in relation to international travel and tourism), the faster-than-expected arrival of the vaccines provided the impetus to push share markets to new heights.

In this most extraordinary year, it wasn't interest rates, inflation, growth rates or profitability that were the main drivers of returns. It was confidence. In the first quarter, confidence quickly evaporated as we collectively began to fear for our lives and our livelihoods. However, as we gradually readjusted to the idea that we had the capacity to protect ourselves and that governments everywhere were not going to stand idly by while their economies tanked, our fears slowly changed to hope and, finally, to optimism.

Although history will record 2020 as a year like no other, there were still a few lessons to take from this highly unusual year:

1. **Investing when the outlook looks bleak remains a profitable strategy.** The share market is forward looking and if we always wait for the reassurance of improving news headlines, then it is likely the best gains have already been made. Anyone that bought shares while the market was going down in March ended up with a great return for the year.
2. **A weak economy doesn't necessarily mean a weak share market.** As economies were shutting down and the business outlook was nosediving in March, there were projections both here and overseas about possible double digit unemployment rates. That can't possibly be a good time to invest, right? Wrong. Figure 2 below summarises the performance of US shares over the last 73 years (1948–2020), based on the prevailing unemployment rate:

Figure 2: US unemployment vs S&P 500 index returns

US unemployment	Frequency	S&P 500 annualised returns
>9%	5%	34.7%
7% - 9%	17%	16.9%
5% - 7%	45%	10.6%
<5%	33%	6.9%

Although US unemployment exceeds 9% relatively infrequently (around 5% of the time), these periods have, counterintuitively, coincided with the best average US share market returns. We saw a continuation of this pattern in 2020. The US economy hit 14.7% unemployment in April, just as the share market there commenced its strong upswing.

3. **Outcomes always seem obvious in hindsight.** Looking back and seeing the global share market having rallied over 73% off its low, it's tempting to tell ourselves that we knew this would happen. But on 23 March, no one could have predicted the timing, size and speed of this market recovery. Governments around the world played a very significant hand in this by collectively pumping trillions of dollars of stimulus towards businesses and individuals.

   While this flood of financial support could not stop the virus, it was able to steer us away from an economic depression. And the impact this has had on investor confidence, and asset prices, is all too apparent from the share market performances witnessed over the last nine months of 2020.

After what we all went through in 2020, it would be a truly brave (or foolhardy?) person who attempted to provide a detailed roadmap for the year ahead. Although the arrival of several Covid-19 vaccines gives us cause for renewed optimism, the list of reasons for investor uncertainty heading into 2021 remains long.

For starters, we still have a global pandemic. We still have intermittent lockdowns, travel restrictions, volatile markets and extreme political turbulence.

We have considerable uncertainty over large parts of the economy and of job sustainability. We also now have new record levels of government debt, and questions over how it will ever be repaid. In the meantime, we continue to have historically low interest rates and the likelihood these will stay low for an extended period. It's a sobering list. But before we get too despondent, we should remember that most of these issues, in one form or another, were also present in 2020 and, for the last nine months of that year, investors enjoyed great returns.

We don't know what 2021 will bring, but we do know it will bring its own unique set of challenges. If 2020 taught us anything it was that, through no fault of our own, we can sometimes be in situations that we are uncertain how to handle. And when those situations have the potential to severely impact our investment or retirement plans, then we really need to be able to make the smartest decisions possible.

The idea that share prices can sometimes fall significantly and yet still manage to rebound is not new. In fact, on average, we expect share market returns to be negative once every three or four years. But we continue to allocate to shares because it's in the share markets that we expect the bulk of our long term returns to be generated.

It never stops being uncomfortable when share prices are falling but the best advice, even at those times, is to stick to your plan. For all long term investors who experienced the awful first quarter in 2020, the decision to stay invested was very likely their best investment decision of the year.

Key Market Movements

In a remarkable achievement by medical researchers, several Covid-19 vaccines displayed extremely positive trial results during the final quarter of 2020. These results were both sooner than expected, and with high efficacy rates, which fuelled expectations of a quicker return to social and economic normality. In December, initial vaccines were approved for international distribution and the global inoculation against Covid-19 commenced.

This was very positive for markets, with expectations of an increase in near term economic output and revenues driving share prices higher almost across the board, even as a 'second wave' of Covid was causing increasing infection and mortality rates around the world.

Overall returns through the quarter were generally positive for riskier assets, and many share markets posted significant gains to close out an unforgettable year with solid returns. This is an outcome few of us would have dared dream of in late March.

INTERNATIONAL SHARES

+11.7% (hedged to NZD)

+4.6% (unhedged)

The final quarter of 2020 started similar to the rest of the year, with high levels of uncertainty resulting in heightened volatility for risky assets.

It was largely anticipated that Joe Biden would prevail in the US presidential election, yet a risk of a disorderly transition of power weighed on the economic outlook. This also led to delays in finalising US government support packages which stifled investor sentiment as October drew to a close.

The November election delivered a comfortable margin of victory (eventually) for Biden, which was followed closely by positive vaccine news and the finalisation of US government support packages in late December. This triple dose of good news "Trumped" the incumbent's claims of election fraud, driving very strong share market performance through November and December pushing all major developed markets equity indices to strongly positive returns for the quarter. The S&P 500 Index (total returns in USD) advanced +12.1% for the quarter, closing out a remarkable +18.4% return for the year.

In Europe, share market performance was also very strong. This was largely due to the positive vaccine news, the approval of further recovery packages by the European Union, and the finalisation of the Brexit trade deal in late December. For the quarter, the MSCI Europe ex UK Index (in local currency) gained +10.2%, dragging the 2020 return into the black at +2.1%.

The same themes drove the British FTSE 100 index up by +10.9% to close the year down -11.5% (in GBP terms). Japanese shares also participated in the rally with the MSCI Japan Index advancing +12.8% for the quarter to lift its annual return back into the positives.

The New Zealand dollar was generally strong versus foreign currencies and this meant that hedged foreign assets outperformed. In New Zealand dollar terms, the MSCI World ex Australia Index delivered a quarterly return of +11.7% on a hedged basis and +4.6% unhedged. For the complete 2020 calendar year the New Zealand dollar hedged index ended up +11.4% and the unhedged index up +8.6%.

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

EMERGING MARKETS SHARES

+10.1%

Emerging market shares generated their strongest quarterly return in over a decade, with Korea and Brazil both notable outperformers. Conversely, Egypt - where new daily Covid cases accelerated, posted the lone negative return across the entire emerging markets region. Overall, the MSCI Emerging Markets Index (gross return in USD) advanced +19.8% over the quarter to return +18.7% for the year.

Positive vaccine news lifted hopes for a global economic recovery in 2021. This helped bolster commodity prices, which was generally very supportive for emerging market net exporters. US dollar weakness during the quarter was also a positive, as the debt servicing burden for many emerging market nations holding USD denominated debts was reduced.

Regional heavyweight, China, produced a solid positive return for the quarter, but lagged the regional average. The launch of an anti-trust investigation into Alibaba and a further escalation in US-China tensions both dragged on sentiment.

In unhedged New Zealand dollar terms, the MSCI Emerging Markets Index produced a quarterly return of +10.1%, for a +11.0% calendar year return.

Source: MSCI Emerging Markets Index (gross div.)

NEW ZEALAND SHARES

+11.5%

The New Zealand stock exchange rode the fourth quarter surge in global share markets by delivering an excellent +11.5% over the quarter as the local index posted a +14.6% gain for the year; a result scarcely believable nine months earlier.

During December, New Zealand's GDP for the third quarter of the year was released. The reported growth rate of +14.0% represented the largest quarterly rise in growth on record, confirming the strong recovery of the domestic economy post Covid lockdowns. This strong economic performance was reflected in domestic business confidence, with the ANZ business survey indicating a very positive outlook for profit expansion and investment intentions in the year ahead.

This improving sentiment added to a growing sense that a 'return to normality' might be possible some time in 2021, and saw a number local firms' share prices jump appreciably in the final quarter of the year.

Notable firms amongst the better performers during the quarter were Fletcher Building (+53.2%), Mainfreight (+51.7%) and Meridian Energy (+49.9%), with all generally citing improving trading conditions and profitability expectations.

Towards the other end of the spectrum, in mid-December the a2 Milk Company announced a downward revision to their August guidance, now stating that their full 2021 financial year revenue was forecast to be $350m to $500m lower than previously advised. This resulted in a swift -22.1% daily price decline on 18 December and led the firm to significantly underperform the overall market, posting a -21.3% return for the fourth quarter and a disappointing -19.6% for the full year.

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

AUSTRALIAN SHARES

+10.1%

Australian share market returns were very strong and remarkably evenly dispersed over the quarter. The large capitalisation S&P/ASX 100 returned +13.78% in Australian dollar terms, while the small capitalisation S&P/ASX Small Ordinaries Index delivered +13.83%. Over the full year, small outperformed large by a sizable 8.41%.

Commodity prices generally experienced a resurgence in the final quarter of 2020, and this was very positive for materials and resources companies in iron ore. Chinese economic stimulus to combat Covid impacts, coinciding with an interruption in Brazilian supply, drove the iron ore price up 27.5% in the last three months of the year. While this helped Rio Tinto and BHP advance 20.7% and 19.2% respectively for the quarter, Fortescue Metals delivered by far the greatest gains in the sector, up 43.7% for the quarter and 151.0% for the year.

In a quarter of strong returns across a range of sectors, some of the previous sector laggards – namely financials, real estate and energy - finally found some strong support. Information technology, the sector that appeared to benefit most from Covid, also finished the year strongly. For the full 12 months, it delivered more than triple the return of the next best performing Australian market sector.

Returns to unhedged New Zealand investors were slightly reduced by a small appreciation in the New Zealand dollar over the quarter.

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

INTERNATIONAL FIXED INTEREST

+0.2%

Government bond yields diverged quite markedly during the quarter. The US 10 year yield was 0.23% higher, ending the year at 0.91%. Investors appeared to be buoyed by the curtain closing on an erratic Trump administration and looking forward to a fresh start - and the prospect of a significant new spending programme – under President-elect Biden.

German yields were flat while Italian and Spanish 10-year yields saw declines as the European Central Bank increased quantitative easing. Across the English Channel, the UK 10-year yield was little changed as growing vaccine optimism was tempered by Brexit uncertainty (i.e. what the trade deal really means for the UK) and new lockdown measures.

Corporate bonds also enjoyed a good quarter, generally outperforming government bonds, with both investment grade and lower credit quality bonds delivering strong positive total returns.

The FTSE World Government Bond Index 1-5 Years (hedged to NZD) posted a +0.2% gain to take its 12-month return to +3.2%, while the broader Bloomberg Barclays Global Aggregate Bond Index (hedged to NZD) returned +0.8% for the quarter for a +5.4% return in 2020.

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

NEW ZEALAND FIXED INTEREST

-1.0%

Domestic bond returns were the only negative asset class over the fourth quarter as stronger economic data and improving investor sentiment brought an abrupt end to the trend of falling interest rates.

The sharpest rise in yields occurred in November driven by a combination of factors. New Zealand economic data had mostly been outperforming expectations, with sectors such as housing, employment, and exports all surprisingly robust. However, this had largely been ignored until the news of viable Covid-19 vaccines hit global headlines in October and November. Further upward pressure was added with the government's renewed focus on house price inflation and a 'walking-back' in the rate cut rhetoric from the Reserve Bank at their November meeting, which resulted in a jump in domestic yields.

By the end of the quarter, the 10-year New Zealand government bond yield finished 0.49% higher at 1.02%. It was a poor month overall for domestic fixed interest strategies.

Although credit securities generally outperformed government bonds, the rise in local bond yields was negative for bond prices and resulted in a -1.0% return for the S&P/NZX A-Grade Corporate Bond Index over the quarter, although the full year return was still a healthy +5.4%. The longer duration, but higher quality S&P/NZX NZ Government Bond Index declined -2.8% for the quarter while also delivering +5.4% for the year.

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

Table 1: Asset class returns to 31 December 2020

ASSET CLASS	INDEX NAME	3 MONTHS	1 YEAR	3 YEARS	5 YEARS	10 YEARS
New Zealand shares	S&P/NZX 50 Index (gross with imputation credits)	+11.5%	+14.6%	+17.0%	+16.8%	+16.1%
Australian shares	S&P/ASX 200 Index (total return)	+12.5%	+4.2%	+5.8%	+8.9%	+5.7%
International shares	MSCI World ex Australia Index (net div., hedged to NZD)	+11.7%	+11.4%	+9.4%	+11.8%	+11.8%
International shares	MSCI World ex Australia Index (net div.)	+4.6%	+8.6%	+10.1%	+11.1%	+10.9%
Emerging markets shares	MSCI Emerging Markets Index (gross div.)	+10.1%	+11.0%	+6.0%	+12.1%	+4.8%
New Zealand fixed interest	S&P/NZX A-Grade Corporate Bond Index	-1.0%	+5.4%	+5.0%	+5.0%	+5.6%
International fixed interest	FTSE World Government Bond Index 1-5 Years (hedged to NZD)	+0.2%	+3.2%	+2.8%	+2.8%	+3.6%
New Zealand cash	New Zealand One-Month Bank Bill Yields Index	+0.1%	+0.4%	+1.3%	+1.6%	+2.3%

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 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.

Stop playing market whack-a-mole

You're sitting in your favourite restaurant, feeling famished. The waiter arrives and reads out a long list of mouth-watering specials. Yet the moment he walks away, you find you can recall only the last item on the list.

Congratulations, you've been struck by the recency effect.

In psychology, the recency effect refers to a human tendency, when asked to remember a long list of items, to have a sharper recall of the last items on the list. No doubt you've experienced this at a party. When introduced to ten people, you only recall the name of the last one or two.

Recency in finance

The recency effect occurs in finance, too, although the consequences can be more serious than forgetting whether the potatoes were roasted or fired or who the man in the blue shirt was.

Quite simply, if you are making investment decisions based on what happened in markets in the last week or the last day, you risk chasing past winners or perceiving as the greatest risk something that has already occurred and been priced in.

We have seen that in dramatic terms in recent months with many people turning defensive in March at the peak of the coronavirus crisis, only to see risk assets bouncing back in equally dramatic fashion in the second quarter of the year.

Our cave brain

There is an evolutionary reason for the recency effect. Just as we did when we were hunter gatherers more than ten thousand years ago, our brains are programmed to respond to what we perceive as the most immediate threats. Equally, we are likely to see as the best opportunities those that proved themselves in the immediate prior period.

During particularly traumatic markets, or alternatively, during rampant bull markets, this effect can be magnified. Our short-term memories (the human equivalent of computer RAM) dominate our decision-making process, extrapolating recent returns into the future.

The consequences of this behaviour too often are that people buy stocks at or near the top of the cycle or sell them at or near the bottom. In bull markets, this equates to fear of missing out, while in bear markets the overwhelming imperative is loss aversion.

"This time is different"

Of course, the most common response to those who warn of the recency effect is to observe that this time is different. The view here is that something fundamentally has changed in markets and a more tactical approach is required when everything is so unsettled.

The problem with that argument is that while every crisis is certainly different in one way or another, that doesn't make it any wiser for investors to base their strategy on what might have been a good approach to the last one.

This ends up resembling a game of whack-a-mole where the participant tries, usually in vain, to push rapidly appearing individual moles back into a hole by hitting them over the head with a mallet. As each mole withdraws, another one pops up somewhere else.

How to respond

So, if this is human nature, how do we resist the impulse to put the greatest weight in our investment decision-making on what happened last?

The answer is in asset allocation and rebalancing. By far the biggest influence in your investment outcomes is how you distribute your money across growth and defensive assets. That allocation in turn is driven by your risk appetite, your goals and your circumstances.

If you have decided at your most rational moments, that your desired allocation is 50% growth (shares, property) and 50% defensive (bonds, cash), then that's what you should stick with. If shares fall 30%, your allocation may look more like 45-55. If you respond to the market fall by selling down shares and buying bonds, you might end up with 40-60.

In other words, the recency effect can drive you away from your target portfolio by encouraging you to change your strategy based on a small sample size over a short period. This is like a pilot who responds to turbulence by completely changing course.

The value of rebalancing

A better response is to rebalance. If stocks have fallen sharply during the intervening rebalancing period, the adviser at the next opportunity will sell some bonds and buy stocks to bring your desired asset allocation back on target. Likewise, if stocks have done very well, he may sell some stocks and buy bonds.

The important point is your investment decisions are based this way on your risk appetite, goals and circumstances, not on what happened in markets in the past quarter.

So put the mallet away. There will always be a mole popping up somewhere. Just leave the little rascals alone.

Source: The Evidence-based Investor (TEBI) www.evidenceinvestor.com

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