Market and Economic Review
February 2022

New year, new regime

January was a tough month for investors. We had expected volatility, and last month delivered more than we had experienced at any time last year.

Despite headlines ranging from potential conflict in the Ukraine to the ongoing Omicron outbreak, the root cause of this market upheaval was the realisation that central banks are serious about fighting inflation. Persistently low interest rates have stoked investor enthusiasm for share markets in the last 18 months, with speculative shares particularly sought after. But rates are set to increase with the US Federal Reserve expected to raise rates as many as five times this year. Our own RBNZ is expected to raise the official cash rate at every one of their seven meetings in 2022.

Higher interest rates raise the cost of borrowing for governments, businesses and households, stifling economic growth and reducing inflation. It also reduces valuation support for high-growth but unprofitable company share prices as the present value of their future cashflows are lower. Last month saw investors panic selling many of these more speculative investments, dragging down broader markets.

Such bouts of volatility are a common feature of investing and we had been expecting this turn of events. Our funds had taken measures to try and smooth the ride, for example we held a reduced exposure to shares and tilted portfolios to shares that are less susceptible to rising interest rates. In every difficult market there are still companies that perform, and Mastercard (up 7.7%), Virgin Money (up 8.2%) and Santos (up 13.2%) were key holdings that had standout performance last month.

Importantly, economic growth remains robust and while global interest rates will rise, they are not expected to rise significantly. For this reason, we are still avoiding significant bond market exposure, although New Zealand bonds are looking more attractive as yields here have already moved higher. We still think parts of the share market are carrying frothy valuations but conversely, we continue to find good quality companies on reasonable valuation metrics. The process of tightening financial conditions is likely to deliver further volatility, this can include swings both up and down for share prices. We view these swings as opportunities for us to reposition portfolios to reflect the prevailing outlook. We expect to continue to be highly active in our funds this year.

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