Synergy Investments
Newsletter

INVESTMENT REPORT
FOR QUARTER ENDING 30 JUNE 2021

Synergy
INVESTMENTS

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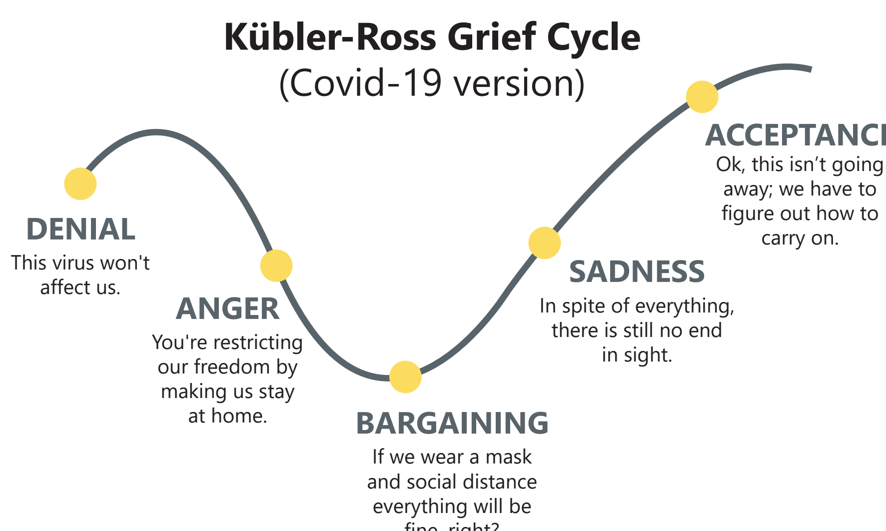
Market Commentary

It still seems extraordinary that something we knew virtually nothing about just 18 months ago, has so utterly dominated global news, our feelings of economic and personal wellbeing, and the normal functioning of our daily lives, ever since.



Of course, we are talking about Covid-19.

Given the highly unusual circumstances surrounding the pandemic, the evolution of our collective response to it has conformed quite closely to the five stages of grief outlined in the Kübler-Ross Grief Cycle[1] chart above.

While individual countries have been wrestling with various approaches to Covid-19 suppression or elimination, an emerging international theme in recent weeks has been a move towards Stage 5 – Acceptance. This theme, propelled by rapidly advancing vaccination programmes internationally, marks another important step on the global road to recovery.

As this mindset increasingly takes hold, our current 'blunt instruments' of rolling lockdowns and blanket travel bans will eventually be replaced by measured pragmatism. As vaccination rates continue to grow and the global economy continues to turn its attention towards living more effectively with Covid-19, it also reinforces the likelihood that the global recovery currently underway, may have more upside to come.

The strong global economic growth evident in recent quarters is not difficult to understand. Fiscal policy (government spending) and monetary policy (interest rate management) are both still highly stimulatory, and households in many countries have also had access to increased cash reserves, resulting from lower spending due to lockdowns and reduced travel. These factors, in conjunction with supply constraints has, in recent months, seen demand comfortably outstripping supply. This has resulted in sharp price increases around the globe, with average inflation in May across the 37 OECD[2] countries reported to be growing at its fastest pace since October 2008.

As we write this, the debate continues between central bankers and the general market about whether these recent price hikes are likely to be transitory or something more permanent. For the moment at least, the argument is being won by the central bankers who maintain that today's inflation spurt is due to nothing more than the unleashing of considerable pent up demand, which is likely to be temporary, and will gradually revert back to a more reasonable level.

[1] The Kübler-Ross Grief Cycle model was originally used to describe the common stages of grief that applied to terminally ill patients.

[2] Organisation for Economic Co-operation and Development.

What's been conspicuous over the most recent quarter is that share market investors don't appear to have been remotely distracted by this debate. Even if there may be a little more inflation on the horizon, it generally means the prices most businesses are charging for their goods and services are going up.

That's not necessarily a bad thing for future business profitability! Of course, it's not quite that simple. Cost pressures, supply constraints and other factors will all have a role to play in influencing corporate profitability, but a small uptick in prices does not, in itself, mark the death-knell for shares.

Indications are also growing that interest rates may be more likely to increase earlier than initially projected (particularly in New Zealand), although this doesn't dramatically alter the outlook for fixed income assets. However, if and when interest rates do eventually rise, our expected future returns from this asset class will also tend to rise.

Overall, it continues to be an excellent time to be a diversified investor, and particularly so if you have a reasonable exposure to growth assets.

While residential property prices seem to have dominated local headlines recently, those keeping an eye on other traditional (and more liquid) asset classes, like shares, will have noticed some stunning returns coming from these markets as well. For example, in local currency terms, the highly influential US share market (the S&P 500 total return index in USD) delivered 40.8% in the last 12 months alone; by any measure a very significant return.

What's perhaps more surprising than the strength of these returns, is that they have occurred in a global environment which is still very much focused on waging a war against Covid-19. As nations progressively turn their energies towards constructively managing the ongoing threat of Covid-19 whilst getting on with life, it will be interesting to see how this may further influence investment market returns in the months ahead.

Key Market Movements

The second quarter of 2021 again saw generally positive returns for riskier assets. Many developed nations saw falling rates of Covid-19 infection, resulting in a loosening of restrictions which helped propel economic output and consumer spending. These, in turn, strengthened the outlook for future economic growth and pushed markets higher.

Although the global supply chain remains stretched (e.g. new car production has been held back by a global semiconductor shortage), corporate reporting and economic indicators through the quarter were generally positive and in line with market expectations.

Fears of runaway inflation dominated the headlines early in the quarter. The reopening of economies following the relaxation of lockdowns in the US in particular, unleashed pent up consumer demand. Coupled with a generally higher supply of money through government spending programmes, and very low interest rates, this spike in demand quickly translated into higher prices. Central banks largely signalled they expect this inflationary pulse to be transitory, rather than a significant and persistent issue.

+7.6% (hedged to NZD)

+7.7% (unhedged)

INTERNATIONAL SHARES

The US's flagship S&P 500 Index (total returns in USD) enjoyed another strong quarter, advancing +8.5% for the quarter for a remarkable +40.8% return over the past 12 months.

In Europe, share market performance was also very strong. The MSCI Europe ex UK Index (in local currency) gained +7.1% through the quarter led by Switzerland (+10.0%) and France (+8.6%). The MSCI Europe ex UK Index has gained +30.3% over the last 12 months.

British shares were also strong, although did not increase at the same rate as their neighbours. In GBP terms, the FTSE 100 advanced +4.8% for the quarter, with most of the gains generated in April and May as concerns about the delta variant began to weigh on growth expectations in June.

Japanese equities lagged developed markets peers, as their state of emergency continued until late June. With the Tokyo Olympic games set to commence 23 July, these protective measures were considered a necessity. The MSCI Japan Index increased by +0.2%.

The performance of small capitalisation companies generally lagged larger companies in the quarter, although still held the upper hand over the last 12 months. Economically sensitive industries such as telecommunications and energy were among the best, while utilities struggled. The real estate sector enjoyed a good quarter after generally lagging since the emergence of Covid in early 2020.

In New Zealand dollar terms, the MSCI World ex Australia Index delivered a quarterly return of +7.6% on a hedged basis and +7.7% unhedged. The rolling 12 month return for the New Zealand dollar hedged index was +36.2%, while the unhedged index gained 'just' +28.3%.

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

+5.0%

EMERGING MARKETS SHARES

Emerging market equities generated gains as well, albeit lower than developed markets. A relatively strong US dollar and the prospect of increasing interest rates also had a negative impact, as most companies in these nations issue debt in US dollars. Both of these contribute to increasing debt servicing costs, which will impact profits.

In spite of these impediments, most emerging share markets delivered gains. Brazil and Russia were the best performing as the recovering global demand for oil pushed crude prices up, enhancing profit expectations for companies (and countries) more exposed to this sector. Korea, Taiwan and India all had middling gains, while China lagged the group as internal regulators increased scrutiny on many of the larger companies there.

In unhedged New Zealand dollar terms, the MSCI Emerging Markets Index produced a quarterly return of +5.0%, for a +30.5% return over the last 12 months.

Source: MSCI Emerging Markets Index (gross div.)

+0.9%

NEW ZEALAND SHARES

Domestic equities again lagged other markets through the quarter, with the broad S&P/NXZ 50 Index returning +0.9%. This result was directly due to a relative underperformance of the larger companies on the exchange.

a2 Milk continued its recent slide, down -25% for the quarter and now a phenomenal -70% lower than its share price high of only 12 months ago. Other large companies Ryman (-13.3%), Auckland Airport (-7.1%), and Air New Zealand (-7.2%) struggled, with their corporate earnings announcements generally falling short of market expectations. Air New Zealand continues to battle in this challenging environment and is clearly hampered by the lack of clarity about the prospects for a general reopening of our border.

At the other end of the spectrum, Contact Energy (+18.2%) saw positive price action as their clean energy solutions stimulated investment inflows from foreign investors and, along with Mainfreight (+10.9%) and Infratil (+10.1%), managed to keep the index in the black.

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

+6.8%

AUSTRALIAN SHARES

Australian share market returns were strong over the quarter. The S&P/ASX 100 (the largest 100 companies in the Australian market) and the S&P/ASX Small Ordinaries Index (the companies ranked 101 to 300 in the Australian share market) both returned +8.5% in Australian dollar terms. Over the last 12 months small capitalisation companies have been a bit stronger, with the S&P/ASX Small Ordinaries Index up +33.2% versus +27.9% for the top 100 companies.

Among the top performers were Rio Tinto (+14.4%), which benefited from continued increases in global demand for the industrial metals it mines, and Commonwealth Bank (+16.0%), who is set to write more (and larger) loans due to a strong rebound in the Australian residential property market.

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

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

INTERNATIONAL FIXED INTEREST

+0.1%

Of interest was how the US Federal Reserve would react to increasing inflationary pressures. The US consumer price index had been persistently low following the global financial crisis in 2008. This year, however, due to the economic resurgence brought about by the reduction in many Covid restrictions, prices have been trending upwards and inflation clocked in at +5% for the year ended May 2021. This was the largest 12 month increase since 2008.

The fiscal stimulus pumped into the economy (relief packages) and record low interest rates have resulted in consumers having access to more money, and – with restrictions relaxing – a greater inclination to spend it. Add in some supply side constraints (raw material shortages, shipping delays etc), and prices for many goods have been squeezed higher.

In the short term, central banks have sought to stimulate an economy wounded by Covid, but in the long term, the management of inflation risks will increasingly be their focus. The US Federal Reserve has kept its official interest rate at the current record low but signalled an expectation to raise interest rates sooner than previously expected.

This announcement caused shorter term yields to spike – the US 2 year yield rose to 0.25% from 0.16%, where it has been sitting since the crisis began. The longer term US 10 year yield actually declined from 1.74% to 1.47%, as the notion that above target inflation in the future might be tolerated was quashed in the Federal Reserve's June update.

Broadly, this meant longer duration bonds outperformed shorter duration bonds. Credit spreads narrowed and are now on average tighter than pre-Covid levels, helping corporate bonds outperform government bonds.

The FTSE World Government Bond Index 1-5 Years (hedged to NZD) made +0.1% for the quarter and the same return over 12 months. The broader Bloomberg Barclays Global Aggregate Bond Index (hedged to NZD) returned +1.0% for the quarter but is flat over the 12 months to the end of June.

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

NEW ZEALAND FIXED INTEREST

+0.3%

With an eye to its dual mandate of stable 2% inflation and maximum sustainable employment, the Reserve Bank of New Zealand (RBNZ) again elected to leave the Official Cash Rate (OCR) at 0.25%. With inflation nearing the mid-point of the target 1% - 3% range, and the unemployment rate having pulled back to 4.7% (very near to pre-lockdown levels), it is easy to conclude the existing policy settings are fulfilling those objectives. In its most recent announcements, the bank has signalled an expectation of hikes in the OCR commencing as soon as this year, and continuing through to a level of around 2% in 2024.

Yields in New Zealand were relatively unchanged through the quarter. The New Zealand 10 year yield closed the quarter at 1.80%, 0.04% below its starting point, which meant very small gains for this asset class this quarter.

Government bonds underperformed corporate bonds, while longer maturity bonds outperformed shorter maturity bonds, but generally all parts of this asset class posted negligible returns through the quarter.

The S&P/NZX A-Grade Corporate Bond Index rose +0.3% for the quarter and is the only asset class with a negative 12 month return, at -1.2%. Longer term performance remains robust, with both the 3 and 5 year annualised average returns coming in at +3.7% and the 10 year return at +4.9% per annum.

The longer duration, but higher quality, S&P/NZX NZ Government Bond Index rose +0.2% for the quarter but has retreated -3.6% over the preceding 12 months.

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

Table 1: Asset class returns to 30 June 2021

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)	+0.9%	+11.2%	+13.2%	+14.0%	+15.2%
Australian shares	S&P/ASX 200 Index (total return)	+6.8%	+28.2%	+8.9%	+11.8%	+7.2%
International shares	MSCI World ex Australia Index (net div., hedged to NZD)	+7.6%	+36.2%	+13.8%	+14.9%	+12.8%
	MSCI World ex Australia Index (net div.)	+7.7%	+28.3%	+13.9%	+15.4%	+12.7%
Emerging markets shares	MSCI Emerging Markets Index (gross div.)	+5.0%	+30.5%	+10.5%	+13.9%	+6.4%
New Zealand fixed interest	S&P/NZX A-Grade Corporate Bond Index	+0.3%	-1.2%	+3.7%	+3.7%	+4.9%
International fixed interest	FTSE World Government Bond Index 1-5 Years (hedged to NZD)	+0.1%	+0.1%	+2.5%	+2.1%	+3.4%
New Zealand cash	New Zealand One-Month Bank Bill Yields Index	+0.1%	+0.3%	+1.0%	+1.4%	+2.1%

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.

Responsible investing trends

New Zealand investors are continuing to show more interest in products with environmental and socially responsible considerations; more and more Kiwi investors want to know where their hard-earned savings are being invested, and that the companies they are investing in operate in a manner that is consistent with their values.

The same trend is being observed worldwide.

Socially responsible investing (SRI) is a general term used for an investment approach which seeks to consider a company's broader impact on society, and/or the environment in which it operates, in additional to seeking a financial return.

Continued interest in SRI drove assets with a responsible mandate 19% higher in the first quarter of 2021, to just below $US 2 trillion. Investments into SRI have reached record highs for four consecutive quarters.

The Synergy Investment Programme is proud to have been offering responsible investing solutions since 2017 and it continues to evolve as more options become available.

Synergy Consilium SRI portfolios are comprised of funds that have no indirect investments in companies with more than an incidental proportion of revenue generated by the production, manufacturing or significant sales of the following:

- Controversial weapons (such as anti-personnel landmines, cluster munitions, chemical, or biological weapons)
- Nuclear weapons, or of components developed or significantly modified for exclusive use in nuclear weapons or providing auxiliary services related to nuclear weapons
- Civilian firearms
- Tobacco

While the above represent minimum exclusions, most funds within our SRI portfolios also take into account additional factors when considering their investments. Where applicable, these additional factors may include some, or all, of the following:

- Human rights violations
- Child labour
- Alcohol
- Gambling
- Recreational cannabis
- Pornography
- Factory farming activities or other animal welfare violations
- Nuclear power

Recent changes to Consilium Synergy PIE portfolios

As the responsible investing space continues to evolve, some funds occasionally make changes to better meet their investors' needs.

During the last quarter, one such change was the global fixed interest fund in the PIE portfolios. As of 21 June 2021, the Hedged Global Fixed Interest Index Fund (managed by AMP Capital) changed its target benchmark to modify its mandate, placing greater emphasis towards SRI. The following PIE portfolios hold this fund:

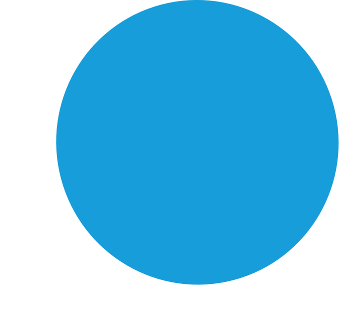
- Synergy Consilium PIE 30/70
- Synergy Consilium PIE 50/50
- Synergy Consilium PIE 80/20

The benchmark for this fund changed from the Bloomberg Barclays Global Aggregate Index to the Bloomberg Barclays MSCI Global Aggregate SRI Select ex-Fossil Fuels Index, and the fund's name changed to Ethical Leaders Hedged Global Fixed Interest Index Fund.

The Bloomberg Barclays MSCI Global Aggregate SRI Select ex Fossil Fuels Index is designed to integrate environmental, social and governance (ESG) considerations into the investment process by targeting companies with high ESG ratings and excluding companies whose products have negative social or environmental impacts.

The MSCI SRI Index excludes issuers with substantial revenue derived from sources such as alcohol, tobacco, controversial military weapons, nuclear power and genetically modified organisms (GMOs).

The impact of this change on the fund will be minimal. It has a very similar risk profile as it always had (namely, a very well-diversified portfolio of short to long term investment grade bonds), remains in the efficient PIE structure best suited to New Zealand investors and still charges the same low fund management fee.



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