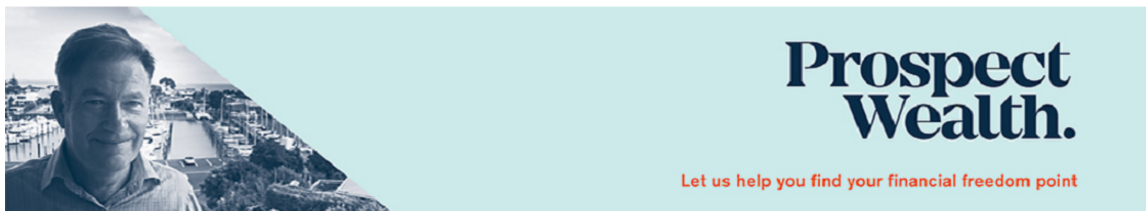


Dear Client

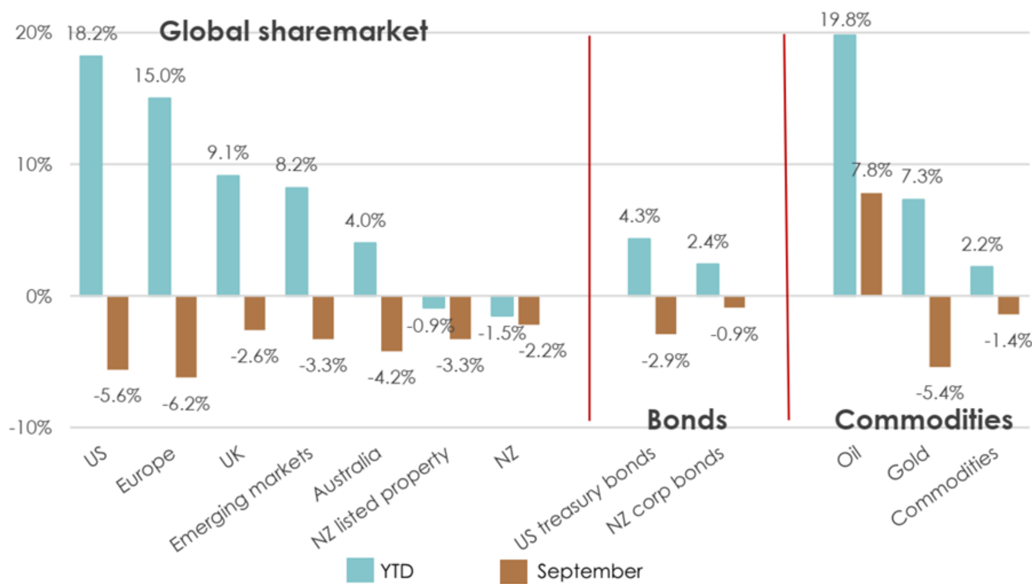
As interest rates approach their peaks, an historic investor opportunity may begin

So far, this sure has been an interesting year in investment markets. Over the year, shares have been stronger than most expected, and bonds prices have fallen as the yields have risen in line with the expectations from Reserve Banks that interest rates will stay higher for longer.

Investment Markets Recap – September

Despite the weaker performance of share markets over recent months, returns from global shares remain positive for the year.

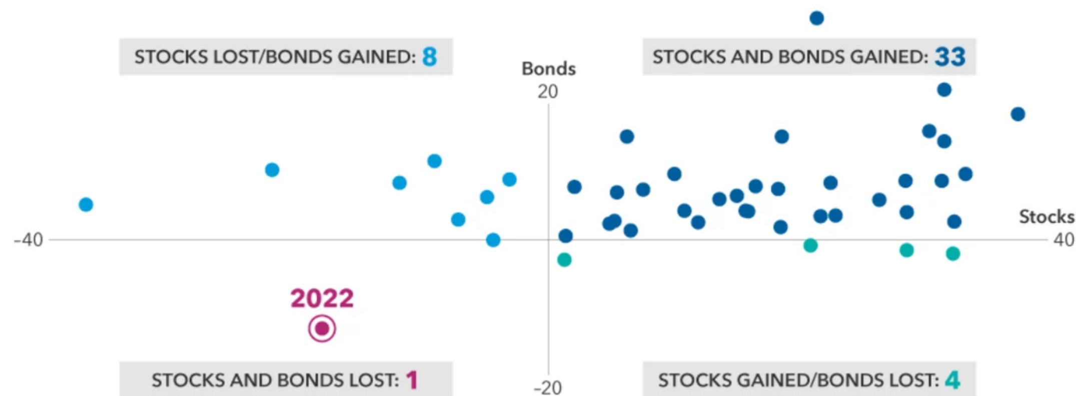
In New Zealand, the interest-rate sensitive nature of our share market, limited exposure to technology and energy, and investor malaise ahead of the general election, have resulted in lower returns from shares.



So where are we now as we head into the homestretch of 2023?

I believe we're on the cusp of a major transition, one where long-term investors can find attractive returns from bonds as central banks pivot from increasing interest rates to maintaining what some are calling a 'hawkish pause' – not increasing rates but maintaining the threat to do so.

Last year was shocking to many investors: it marked the first time in at least 45 years that both stocks and bonds posted negative returns in a calendar year. Battling high inflation, the reserve banks raised interest rates aggressively. Those hikes hurt both bond and share returns. The usual role of high-quality bonds to provide diversification from stock market volatility — something investors rely on — broke down.



Sources: Capital Group, Bloomberg Index Services Ltd., Standard & Poor's. Each dot represents an annual stock and bond market return from 1977 through 2022. Stock returns represented by the S&P 500 Index. Bond returns represented by the Bloomberg U.S. Aggregate Index. Past results are not predictive of results in future periods.

So, in 2023, the turbulent markets in 2022, plus the prospect of relatively high returns from bonds and cash, has led investors to flock to cash-like investments. Sitting in short term deposits today may feel comfortable with a roughly 5% yield, but the benefit of remaining in cash at current interest rates is eroded by today's inflation. Also, these cash-like holdings don't provide the valuation upside as the rate hiking finishes.

However, the major factor against remaining in cash and short-term deposits is that the reserve banks around the world appear to be nearing a turning point in their interest rate movements. History teaches us that this may be an opportune time to shift back to shares and, particularly, bonds.

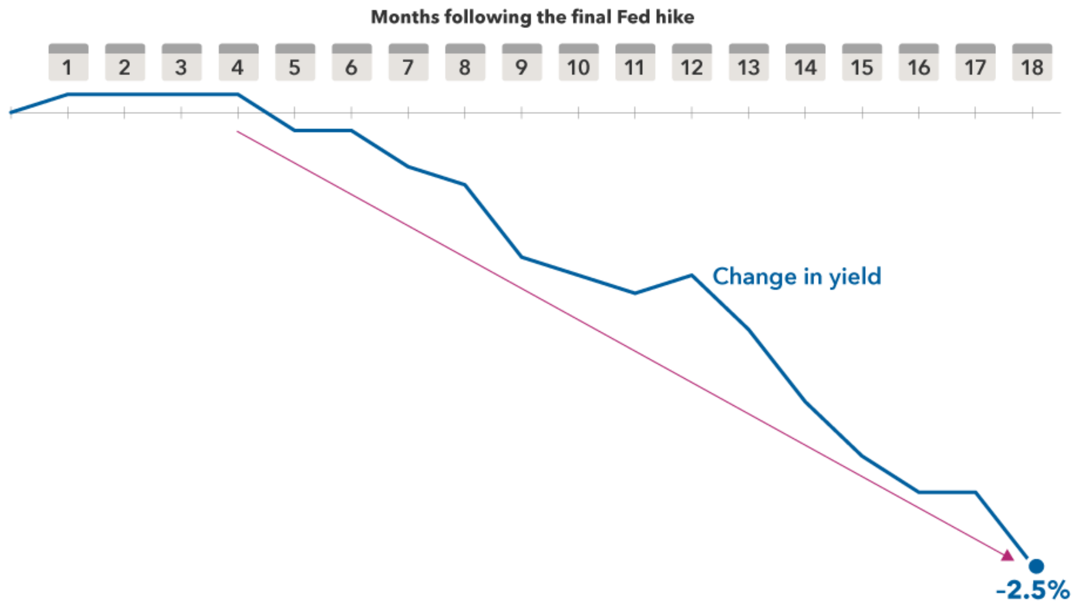
Will the Reserve Banks raise interest rates again?

Nobody knows exactly when the reserve banks around the world will stop raising rates. However, both markets and the banks themselves say that interest rates are near to peak - so it follows that they will decline. When, is the question? Economists are saying early reserve banks could reduce the official cash rates in late 2024 or early 2025 but the market could drive down longer-term rates during 2024.

Cash and short-term interest rates have fallen sharply when central banks stop increasing rates

History shows that in the 18 months after the Fed ended hikes in the last four cycles, yields on cash-like investments have traditionally fallen rapidly. The 3-month Treasury yield fell an average of 2.5%. If history were to repeat itself, cash and short-term deposits would decline, and investors would be better served by being actively invested in stocks and, in particular, bonds. This way investors get to lock in the high interest rates right through the decline in rates.

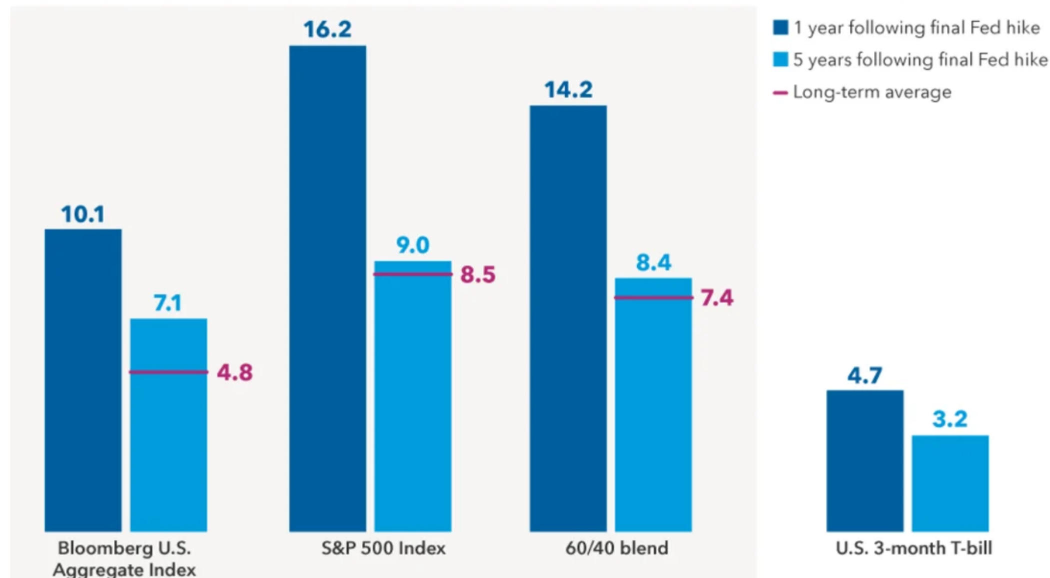
3-month Treasury-bill yields declined sharply following the Federal Reserve's final hike in the last four cycles



Where to invest cash today?

After Fed hikes ended, long-term results outpaced cash, with the first year contributing most

Results have been front-loaded following the final Federal Reserve hike in the last four cycles (%)



Sources: Capital Group, Morningstar. Chart represents the average returns across respective sector proxies in a forward extending window starting in the month of the last Fed hike in the last four transition cycles from 1995 to 2018 with data through 6/30/23. The 60/40 blend represents 60% S&P 500 Index and 40% Bloomberg U.S. Aggregate Index, rebalanced monthly. Long-term averages represented by the average five-year annualized rolling returns from 1995. Past results are not predictive of results in future periods.

If you agree that the Fed and other reserve banks are nearly finished hiking interest rates, and that cash yields may decline over time, the question is: where to invest today? After the Fed's final hike in the last four cycles, both share and fixed income/bond returns were strong in the year that followed. Importantly, for long-term investors, these sectors maintained relative strength over a five-year period.

How do you take advantage of the end of the interest rate hiking cycle?

It takes courage to take action. Inertia can be a very powerful force, especially when you are earning a healthy 5% on your savings. But as investors, we know that investment markets don't stay idle for long. Investors could become stuck in cash if they wait too long to get back into the market, as better potential opportunities emerge – sometimes very quickly.

You should ensure you have sufficient allocation to fixed interest/bonds. If you are in a Conservative Balanced or Balanced portfolio you will have between 40-60% allocated to bonds. If you are unsure, or you want to discuss the opportunities for you, please contact me and we can discuss what's best for you so you can take advantage of the transition occurring in the market.

Best regards

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