RIVAL WEALTH

Market Update - July 2024

Drive to the conditions and not the speed limit. This means driving at a speed that is safe and ensures that we are in full control. It is interesting how this same principle carries over to investing.

Broken record

Believe it or not, even we tire of hearing ourselves saying the same thing repeatedly. Nevertheless, we remind ourselves that investing is a discipline of patience. The current cycle differs by being the most protracted on record.

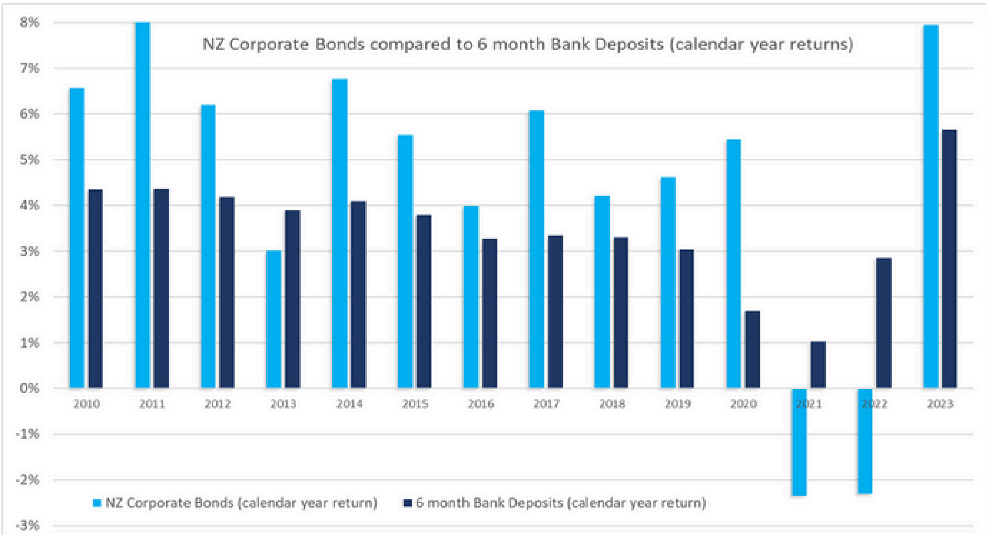
When central banks raise short-term interest rates to get inflation under control, it puts pressure on the cash flow of households and businesses. This results in reduced spending, which slows the economy and leads to falling inflation – mostly as a result of rising unemployment and an economic recession - all things that no one enjoys. U.S. long-term interest rates have now been below short-term interest rates for almost 2 years, which is the longest period on record. Europe and Canada started their rate cuts in June, and financial relief is likely to come soon for mortgage holders, with the first reduction in interest rates by the U.S. Federal Reserve forecast in September 2024. New Zealand economists anticipate cutting interest rates in late 2024, which will be welcome news for our investment clients as this increases the value of their bonds and makes bank deposits more unattractive.

The time for bonds is finally back

In the last 13 years, bank deposits have only delivered a higher return than corporate bonds 20% of the time which has been 34 of 158 months, 28 of those months have been recent which were between July 2021 and October 2023, when inflation was high and interest rates had to rise to combat it.

This means that corporate bonds beat bank deposits 10 of the last 13 years and shows why they are a better long term investment option.

Over that time the excess return was 15% above bank deposits, which on a $500,000 investment resulted in approximately $100,000 difference after compound interest does its magic.



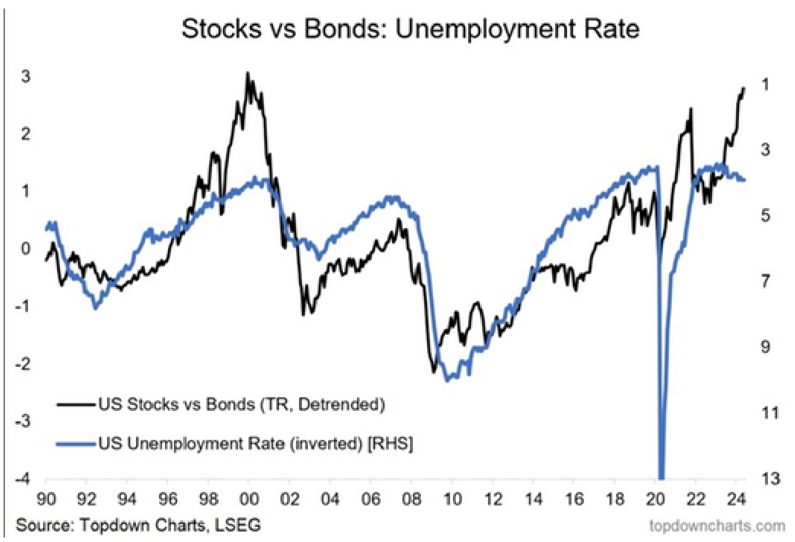
These returns are before tax and don't show the difference in tax treatment.

We are investing to the conditions

The impact of rising interest rates over the last 2 years by central banks around the world has still not had its full effect. Certainly, here in New Zealand, we have begun seeing the impact of a slowing economy through rising unemployment, but it is typically when the U.S. experiences it that it is recognised as a global concern.

In this environment, a higher allocation to fixed interest investments is a proven strategy. The chart to the right shows that historically, when unemployment begins to rise as it is doing now, bonds have outperformed growth assets.

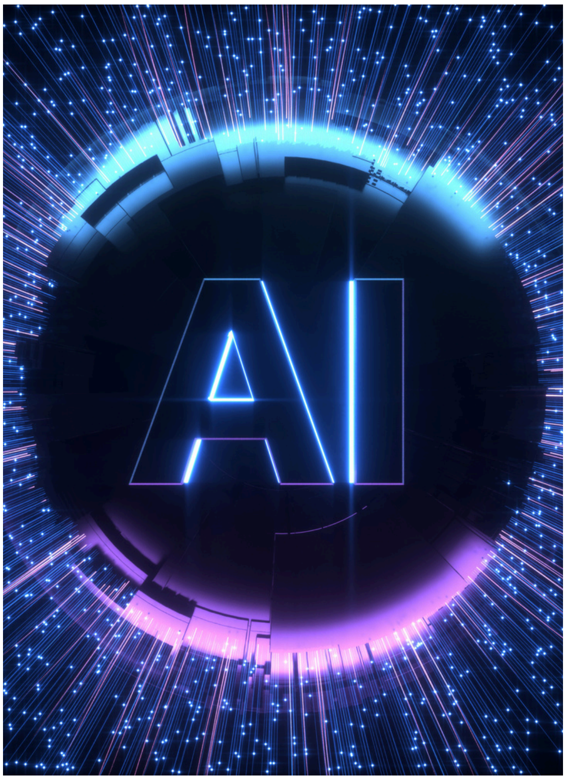
Additionally, bonds are currently delivering a higher rate of income than dividends received on shares, and they do so with less volatility in portfolio returns. They also allow investors to capture capital gains when interest rates ultimately return to lower levels.



18 months of Artificial Intelligence (AI) [Source: MIT Technology Review]

When OpenAI launched a free web app called ChatGPT in November 2022, nobody knew what was coming. But that low-key release changed everything.

By January, ChatGPT had become the fastest-growing web app ever, offering anyone with a browser access to one of the most powerful neural networks ever built. And that was only the start. In February, Microsoft and Google revealed rival plans to combine chatbots with search - plans that reimagined our daily interactions with the internet. Google's new phones now use AI to let you edit photos to a degree never seen before, exchanging sad faces for happy ones and overcast afternoons for perfect sunsets.



Never has such radical new technology gone from experimental prototype to consumer product so fast and at such scale. What's clear is that we haven't even begun to make sense of it all, let alone reckon with its impact. With each release, the astonishing becomes more mundane. But 2023's legacy is clear: billions have now looked AI in the face. Next the market needs to figure out exactly what's looking back.

Market outlook

In the U.S. there is growing recognition that, as interest rates remain higher for longer, the economic resilience experienced thus far may falter. More major investment firms are revising their outlook from a "soft landing" scenario, where the economy readily absorbs the cost of higher interest rates, to the possibility of a "recession". In June, one of the world's largest investment firms, Pacific Investment Management Company (PIMCO), offered the following implications for investment markets:

"For investors, the early 2020s inflation shock and steep policy rate hikes produced a generational reset higher in bond yields. There is an attractive long-term outlook for fixed income returns as inflation recedes, particularly on a risk-adjusted basis relative to other assets. Opportunities across global bond markets also appear uncommonly attractive."

There is potentially a corner coming for shares that have increased significantly in the last 2 years, fuelled by the AI boom. Most are still going at full speed into this corner. For us, rather than staying invested overweight in growth assets that do fluctuate at times, we have pivoted to more fixed income which does well when markets fall. We have braked into the corner, driving to the conditions.

Get in touch

If you have any questions about the world of investments, just get in touch as we are here to help.

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