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Economic Update: New Zealand
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Outlook for Investment Markets

Year-to-date outcomes continue to look poor across many asset classes as markets have responded to unexpectedly high inflation; central banks' monetary policy tightening response to it; ongoing pandemic-related production disruptions including staff away ill and China's lockdowns; and the manifold impacts of Russia's invasion of Ukraine, which have included trade sanctions, spikes in commodity and energy prices, and heightened investor risk aversion. Both domestically and overseas, the cyclical outlook has become more challenging, with twin threads of increased pressure on corporate profitability in the face of sharply higher input costs, and likely weaker consumer demand as household budgets are squeezed by higher-interest bills and more-expensive food and energy bills. Both bond and equity prices have risen in recent weeks from their lows in June, and it is possible that much of the bad news and weaker outlook is already reflected in asset prices as markets look ahead to central banks reaching peak tightening and to inflation dropping back in 2023, but the immediate cyclical outlook remains hard to read. Markets are likely to remain sensitive to economic, financial, or geopolitical surprises.

New Zealand Cash and Fixed Interest—Review

Monetary policy has been tightened further: As fully expected, on 13 July the Reserve Bank of New Zealand raised the official cash rate by a further 0.5% to 2.5%. The 90-day bank bill yield is now 2.94%, up by almost 2% since the start of the year. Bond yields have risen reflecting both much higher inflation and the RBNZ's tightening cycle, and the 10-year government bond yield is 3.8%, up 1.4% for the year. The kiwi dollar has weakened, and for the year to date it is down by 2.9% in overall value, largely influenced by an 8.9% decline against the strong US dollar.

New Zealand Cash and Fixed Interest—Outlook

The June quarter inflation news was poor: At 7.3%, inflation was higher than market forecasters and the RBNZ had expected, and details of its composition also contained worrying news. Nontradable or "domestic" inflation, for example, came in at 6.3%, showing that a good chunk of the outcome was not simply the effect of higher imported commodity prices. The RBNZ was right to say at its 13 July decision that "it remains appropriate to continue to tighten monetary conditions at pace": Currently, the futures market thinks this will mean a peak OCR of around 4% by end-year, which means the 90-day bank bill yield will get up to around 4.4%.

With the financial markets now having a clearer view of the likely peak level of the OCR, bond yields are less exposed than before to the risk of further RBNZ tightening, and it is also possible that inflation is at or near its peak and will gradually drop back through 2023. For both reasons, forecasters think that the peak in bond yields is also here or hereabouts (and may even be behind us, looking at the retreat to today's levels from the 4.25% level of mid-June). ASB and BNZ, for example, think the 10-year yield will be down to 3.5%-3.6% by mid-2023. After their recent setbacks–the S&P New Zealand Aggregate Bond

Index has lost 5.2% in the year to date—bond investors will be hoping the latest forecasts are proved correct, but they are not home free just yet. As the latest inflation data again showed, inflation has tended to turn out somewhat worse than anticipated.

Forecasters have mixed views on the outlook for the kiwi dollar. On one line of thought, global US dollar strength could persist, if the US Federal Reserve keeps vigorously raising US interest rates and investors remain keen on risk-off US dollar sanctuary from ongoing financial market volatility: ASB, for example, sees the kiwi as low as USD 0.56 by the middle of next year, down further from its current USD 0.62 cents. Other big banks, however, see things differently and to greater or lesser degrees expect a stronger kiwi dollar, which would be consistent with the RBNZ tightening, high New Zealand export commodity prices, and more risk-on investor interest in the kiwi if market conditions settle down. BNZ, for example, sees only a slight rise, to USD 0.63 cents by mid-2023, while Westpac expects a strong rebound back up to USD 0.71. For want of a better guide, picking the median of these various views is likely as good as anything else, and suggests the kiwi trading at around USD 0.65 cents by next June.

New Zealand Property—Review

As in many overseas listed property markets, New Zealand REITs have fared a bit worse than equities as a whole. The S&P/NZX All Real Estate Index has lost 17.2% in capital value and returned an overall loss including dividends of 15.5%, compared with the S&P/NZX 50's 14.7% capital loss and 13.5% overall loss.

New Zealand Property—Outlook

The operating outlook is mixed. As Colliers' July research report notes, retail faces various challenges, and despite the reopening of the borders will be handicapped by deteriorating household finances. Offices are a two-tier market, with the highest-quality space likely to be in demand but secondary locations less so. Industrial remains the bright spot, where at least for now, "Rental growth in the industrial sector will be one of the standout trends for 2022 and 2023, as limited supply and ongoing demand continues to impact the sector," although recent building consent data suggest that an eventual expansion of industrial space is in the pipeline.

Operating considerations have however taken a back seat in investors' recent assessment of the sector as interest rate rises have dominated everything else. On that score, CBRE New Zealand feels that the outlook may be improving: "Bond yields … are close to their peak. Economist forecasts indicate only 25 to 50 basis point rises in the next few quarters based on moderating medium-term inflation expectations, with rates starting to fall by mid-2023." If that forecast does indeed come to hand, then the 4.85% yield on the sector (on Standard & Poor's estimate) ought to attract greater investor interest in the sector.

Australian & International Property—Review

The A-REITs for the year to date have significantly underperformed the broader equity market. The S&P/ASX200 A-REITs Index has dropped by 20.2% in capital value and delivered an overall loss of 18.3% including dividends, compared with the 8.7% capital loss and 6.8% overall loss for the S&P/ASX 200.

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Overseas, REITs have also underperformed, but by a smaller margin. The FTSE EPRA-NAREIT Global Index in US dollars has registered an overall loss (including dividends) of 18.2%, compared with the MSCI World Index's equivalent loss of 16.5%. The key US market lost 17.6%: Among the other major regions, Asia-Pacific was relatively resilient with a 12.2% loss, while the eurozone fared worst with a 32.0% loss, a mix of asset price falls and a lower currency (the euro dropped by 10.1% against the US dollar).

Australian & International Property—Outlook

The A-REIT sector has been especially hard hit by rising interest rates, as for some time it had been sheltered by the Reserve Bank of Australia's stance that any interest-rate rises lay well down the track, and possibly not before 2023. The extent to which sentiment turned in the sector, with the RBA's subsequent change of tack towards early and significant tightening, was shown in the ANZ/Property Council of Australia commercial property survey. In the March survey, respondents had expected that the RBA's target cash rate in February 2023 would be 1.3%, but in the June survey the forecast had rocketed to 4.2%. In the circumstances it was no surprise that sector confidence took a big hit, expectations for economic growth slumped, and capital value expectations worsened significantly for offices, retail, and residential (industrial remained positive, though markedly less than before, while tourist-related property held up well as travel restrictions eased). In the meantime, market conditions have moved on yet again, the RBA's likely policy moves are now fully built into valuations, and there may even be upside if (as some forecasters reckon) bond yields have already peaked. It may be too early to talk about positive returns, given a tough outlook for retail spending and the real question marks over the office sector as (on the Property Council's latest data) the return to the office appears to have stalled, but at a minimum, further significant underperformance looks less likely, and the yield on the sector (4.8% according to Standard & Poor's) may find more takers.

Many of the same considerations apply overseas. Unexpectedly large and rapid interest-rate increases across most major markets ex Japan had been a major headwind but now look to be largely incorporated into REIT prices; this should mean that the global REIT sector should not underperform to anything like the same extent. But if interest-rate concerns have abated, the cyclical outlook has darkened. As the US trade group NAREIT put it in its midyear roundup (and it also applies to other major markets), "Economists are increasingly skeptical that a soft landing is feasible; consensus growth forecasts for 2022 have fallen by one third since January, while the probability of recession has more than doubled to over 35%. While labor markets continue to look strong, with 2.7 million jobs created over the past three months and 1.7 job openings per unemployed worker, consumer sentiment is negative and retail sales are starting to sag, reflecting high energy prices and concerns about the economy." From here, the outlook is likely to mirror the broader equity outlook: Investors may have largely priced in the prospect of a deteriorating global economy, but the eventual outcome will depend on whether investors have made the right call on its scale and duration, and there is potential for both positive and negative surprises.

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Global Infrastructure — Review

Global listed infrastructure has held up remarkably well in otherwise very difficult equity market conditions. The S&P Global Infrastructure Index in US dollars has made a small capital loss of 2.8%, and including taxed dividends has made a small net return loss of 1.1%. New Zealand investors who typically hedge the net return back into kiwi dollars are modestly ahead for the year, with a net return of 3.0%.

Global Infrastructure — Outlook

The global economy is at a point where several outcomes are possible. Investors, as shown by various fund manager surveys, are seriously concerned about two main risks: the prevalence of higher-than-expected inflation and the possibility of global recession. Inflation might respond to the global dose of tighter monetary policy currently being administered, and the price pressures caused by coronavirus and Ukraine disruptions might ease back, but equally there is a real risk that inflation will continue to surprise on the upside. Similarly, on the cyclical outlook, fund managers are well dug in for difficult trading conditions ahead, but there is scope for the cycle to turn out worse or better than anticipated: Some recent developments point to upside risks (better economic performance in China), others to the downside (worsening household finances). In these circumstances, the middle-of-the-road positioning of infrastructure is likely to retain appeal: Reviews of regulated rates of return allow scope for hedging against the inflation risk, and the defensiveness of some infrastructural assets such as utilities allow scope for avoiding cyclical spending risk. The popularity of the asset class for the year to date means that yields are not especially appealing (3.5% according to Standard & Poor's), and some of the energy-related infrastructure assets may give up some gains (the world oil price is down from around USD 120 a barrel to around USD 95 now), but the each-way bet of the asset class should provide ongoing support.

Australasian Equities — Review

The global equity bear market has not spared New Zealand, where the S&P/NZX 50 Index has lost 14.7% year to date in capital value and lost 13.5% including the value of dividends.

The top 10 are down by 14.3% in capital terms, the mid-caps by 15.4%, and the small caps by 18.4%. Among the biggest caps, there were large losses for Fisher & Paykel Healthcare (down 33.9%), Fletcher Building (down 28.0%) and Ryman Healthcare (down 27.8%). The best of the big names has been Spark (up 10.6%) while there were slight gains for Meridian (up 1.0%) and Infratil (up 0.8%).

Australian shares have also sold off, and for the year to date the S&P/ASX 200 Index is down by 8.7% in capital value and by 6.8% including dividend income. Tech has been sharply sold off worldwide, and unsurprisingly the local IT sector has been the weakest of the major sectors and is down 28.1%. The darkening cyclical outlook has favoured defensive consumer staples (down only 0.9%) over the more cyclically sensitive consumer discretionary (down 16.7%). The financials ex A-REITs are also lower and are down 6.4%. The resources sector had help up well earlier in the year, but a sag in commodity prices in recent weeks–the Bloomberg Commodity Price Index dropped by some 17% between early June and early July–means that the miners are now also in the red for the year, and the S&P/ASX 300 Index of metals and mining is down by 11.1%.

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Australasian Equities—Outlook

In New Zealand, the economy still seems to be growing, albeit slowly: In particular, the services sector (as shown in May and June's positive readings for the BNZ/BusinessNZ performance of services index) is still benefiting from the unwinding of pandemic restrictions and the reopening of the borders. But the outlook beyond the post-opening-up boost is looking difficult: The New Zealand Institute of Economic Research's June quarter Quarterly Survey of Business Opinion found that "a net 62% of businesses expect a deterioration in general economic conditions over the coming months–a marked increase from the net 34 percent of businesses who felt pessimistic in the previous quarter," and ANZ's June business survey said that "firms are increasingly pessimistic about the outlook for activity and profitability. Investment intentions are slipping. Employment intentions are holding up pretty well, but with the profitability outlook so pessimistic, one does wonder for how long this can remain the case."

It is possible that the equity selloff to date has fully taken on board the challenging conditions for corporate profitability: Like many other equity markets, New Zealand shares have rallied in late June and into July on hopes that the worst of the surge in inflation is behind us, that supply chain shortages will ease over time, and that there is clearer visibility of how high the Reserve Bank is likely to take interest rates. Whether this more upbeat view is correct is, however, still an open question: In particular, consumer spending power is still under severe pressure. The June ANZ/Roy Morgan consumer confidence survey found that "A net 3% expect to be worse off this time next year, down 2 points. It's very unusual for this series to be negative." There may yet be earnings disappointments down the line.

The outlook is similar in Australia. The economy is still growing: The early (flash) results from the July S&P Global Australia Composite output index "marked a sixth consecutive month of Australian private sector growth, albeit one that was only mild and the slowest in the current sequence of expansion." The National Australia Bank June quarterly business survey showed a rather stronger picture: "Conditions strengthened in Q2 as the disruptions related to the virus receded. Trading, profitability, and employment were all higher with conditions approaching the high levels seen in early 2021." Either way, businesses are still making progress.

But there are still strong profitability headwinds. NAB's survey found that the three factors weighing most on business confidence are wage costs, availability of staff, and pressure on profit margins. While firms have some room to raise prices to restore profitability, their ability to pass on costs has limits. As NAB put it, "So far, it appears demand has held up in the face of higher prices but how long this can be sustained is a question we will be watching closely over coming months." Consumer demand could well disappoint: The latest (June) Westpac/Melbourne Institute consumer confidence survey found that consumer confidence has dropped to low levels "that, since the beginning of the survey in 1974, had only been seen during periods of major disruption in the Australian economy." Shares have rallied in recent weeks and may be looking through the current monetary policy tightening cycle and this year's supply chain cost surge to better times in 2023, but households facing higher mortgage costs and other strong pressures on the family budget may yet have a word to put into the debate.

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International Fixed Interest—Review

A market backdrop of unexpectedly high global inflation and of widespread and vigorous central bank monetary policy tightening has created difficult conditions for bonds, and for the year to date the Bloomberg Global Aggregate Bond Index in US dollars is down by 14.0%. Global government bonds have lost 15.3%, and global corporate bonds have lost 10.2%.

Higher yielding subsectors have also performed poorly, with global high yield (lower credit quality) down by 15.6% and emerging-markets debt down by 17.5%.

International Fixed Interest—Outlook

At first sight the news for global fixed-interest has continued to be very poor. Inflation has continued to rage at levels not seen in a very long time. Most attention has focused on the US, where June's 9.1% inflation rate was the highest since November 1981, but the problem is widespread across the developed world. The OECD said that inflation in the OECD area in May was 9.6%, a tad worse than April's 9.2%, and was the highest inflation rate since August 1988. Nor is it just surging petrol and food prices that have been the culprit: Ex energy and ex food, prices in the OECD area were 6.4% up on a year ago, and again a bit worse than April's 6.2%.

In response, many central banks have not only been tightening monetary policy but have been forced to tighten by faster than the financial markets had been expecting. The most notable has been the US Fed, which raised the target range for the fed funds rate by 0.75% in June, its first 0.75% move since 1994, and which is expected to do it again at its 27 July meeting. But others have been backed into the same corner. The European Central Bank had been expected to raise its key policy rate by 0.25% at its July meeting: In the end it hiked by 0.5%. And the Bank of Canada at its July meeting raised its key rate by a full 1%, its largest move since 1998, when markets had been expecting a 0.75% increase.

Yet despite what look like ongoing macroeconomic headwinds, global bonds have rallied in recent weeks. The Global Aggregate Index bottomed out on 14 June, at which point it had lost 15.6% for the year and has since staged a modest rally: At time of writing, it was up 1.2% from its June low point. The most likely interpretations are that financial markets are now more confident that they can see how far central banks are likely to go; that central banks might have to ease the pace of tightening from now on as the global economic business cycle deteriorates; that the surge in COVID-19 cases and Ukraine-related supply chain and commodity price costs will start to ease back (for example, as Chinese lockdowns are lifted or Ukraine food exports are allowed to leave port); or some combination of all of these strands of thought. For the time being, in sum, bond investors are feeling that the worst is past, but there is still the potential for reality checks further down the road. The yield on the JPMorgan Global Government Bond Index is still only 2.16%: Inflation will have to recede quickly and significantly to make the yield attractive in post-inflation terms.

International Equities—Review

The year-to-date outcomes for global equity markets make sorry reading: The MSCI World Index of developed economy sharemarkets is down by 17.6% in US dollars. New Zealand investors were

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providentially spared some of the pain by the kiwi dollar's weakness (the kiwi dropped by 8.9% against the US dollar). All major markets shared in the setback, with, in US dollar terms, American shares down by 16.1% (S&P 500), European shares by 20.6% (FTSE Eurofirst 300 Index), and Japanese shares by 19.1% (Nikkei). The only major sector clearly ahead for the year is oil and gas, while there have been especially large losses at the techier end of the asset class (for example, software and computer services down by 28.8%).

Emerging markets have been a bit weaker again, and the MSCI Emerging Markets Index in US dollars is down by 19.6%. In US dollars, among the key emerging economies, Brazil, supported by strong commodity prices, has done least badly (Bovespa down 4.3%), but there were larger losses in India (Sensex down 10.7%), China (Shanghai Composite Index down 15.6%) and Russia (RTS down 28.4%). Some countries closer to the Russia-Ukraine conflict fared notably badly (for example, MSCI Hungary Index down 41.1%, MSCI Poland Index down 37.2%).

International Equities — Outlook

Overall, world business activity picked up in June, according to the JPMorgan Global Composite Index, but the index results were a mixed bag. The upswing largely came from China, "where an easing of pandemic lockdowns underpinned a solid return to growth," but elsewhere the news was distinctly downbeat: "several survey indicators highlighted the ongoing fragility of the global economic upturn. New order growth eased to a near two-year low, international trade declined, and business confidence slumped to its lowest since September 2020." At time of writing the early (flash) estimate of the July US-specific Composite Index had just been released: It showed an unexpected drop in US output, which "signalled a further loss of momentum across the economy of a degree not seen outside of COVID-19 lockdowns since 2009."

Businesses are wary of what may lie down the track. The S&P Global Business Outlook is run three times a year: Its June results "signalled a sharp worsening of business confidence among companies worldwide as severe price pressures are anticipated to accompany an economic slowdown. There was little sign of any respite on the inflation front, with both staff and nonstaff costs set to continue to rise sharply. The combination of slowing activity and still-high inflation meant that firms globally predicted a near-stagnation of profits, in turn leading to a scaling back of plans for hiring and investment spending."

Fund managers, at least until very recently, have also been buckling down in anticipation of tougher business conditions ahead. The June Bank of America survey of global fund managers showed that a net 79% expect the global economy to weaken over the coming year, an all-time high level of pessimism. Managers are holding unusually high levels of cash and are taking unusually low levels of risk. They are particularly worried about ongoing high levels of inflation, and about a global recession. And they are taking a conservative approach to sector allocation, favouring defensive options like utilities, healthcare, and consumer staples, and avoiding banks, tech, and consumer discretionary; they are also less keen on resources stocks than they were before.

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Against this degree of bearishness, world equities have actually been rallying from their lows. The MSCI World Index in US dollars, for example, hit its low point for the year on 16 June and was down 23.1% at that point, but it has since gained 7.2% to its current trading level. One possibility is that the previous equity selloff had already priced in a lot of the bad news. The S&P Global Investment Manager Index in July showed many of the same fund manager behaviours as the Bank of America survey—they were equally risk-averse and concerned about the economic outlook—but the survey also asked a one-off question: whether recession had already been priced into US equities. Eighty percent of the fund managers thought that a mild US recession was already priced in.

The outlook for global equities is finely poised. It may be that the worst is already allowed for. It may be that there are potentially positive surprises that are not being given due weight (China's return to filling in the holes in global supply chains, the Russia/Ukraine food export agreement, people returning from COVID-19, and relieving the chaos at airports and other areas seriously short of staff). Or it may be that the high degrees of bearishness among fund managers are an accurate sign of worse to come. The outlook is likely to be, as central bankers like to say, data-dependent: It could go either way. In coming months, investors are likely to be paying particularly close attention to the latest profit guidance from corporates to get a feel for which way the cards are most likely to fall. M

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