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Economic Update: New Zealand
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Outlook for Investment Markets

Both equities and bonds have rallied in recent weeks, but the gains have not been enough to outweigh large losses earlier in the year, and many asset classes continue to show year-to-date losses. On the equity side, the recent rally more reflects an assessment that previous price falls may have overstated the cyclical and geopolitical challenges to the world economy, rather than any assessment that the underlying outlook has improved: the outlook remains clouded by higher interest rates, China's lockdowns, the Russia-Ukraine conflict (and potentially risks around Taiwan), and straitened household finances. On the bond side, investors have taken some comfort from clearer visibility of peak monetary policy tightness by the world's central banks, and from some evidence that unexpectedly high inflation may be beginning to ease back. At home, businesses have been performing well up to now, but, as overseas, a cyclical slowdown looms, and recent economic forecasts (including from the Reserve Bank) suggest that growth assets will be facing more difficult conditions.

New Zealand Cash and Fixed Interest — Review

Short-term interest rates have risen further, in line with further monetary policy tightening by the Reserve Bank of New Zealand: it raised the official cash rate, or OCR, by 0.5% on August 17, taking it to 3.0%. 90-day bank bills now yield 3.3%, up 2.3% for the year to date. Bond yields have followed the international pattern and eased back from their earlier peak: the 10-year government bond yield reached 4.27% in mid-June but is now down to 3.5%. The kiwi dollar is slightly lower in overall value for the year (down 0.9%) with falls against the US dollar (down 5.7%) and the Australian dollar (down 3.9%) roughly matched by rises against the yen (up 9.3%), the pound (up 5.0%), and the euro (up 4.2%).

New Zealand Cash and Fixed Interest — Outlook

With a June quarter inflation rate of 7.3%, way above the RBNZ's target range, further tightening was always in the cards, and the 17 Aug Monetary Policy Statement showed that the latest 0.5% increase is not likely to be the last. The bank's projections show that the OCR is likely to reach 4% or a tad more in mid-2023, which means the 90-day bank bill yield will be around the 4.5% mark in a year's time.

Recent lower bond yields reflect the fact that the financial markets are now less worried about the ultimate degree of RBNZ policy tightening; indeed, some forecasters are starting to look ahead to eventual easing. However, that still looks some considerable way down the track: The RBNZ's latest projections suggests that it will be late 2024 before the OCR starts to drift back down. There is also an expectation that inflation will come back under control within a reasonable time frame: The RBNZ's own view is that "Over 2023, annual headline inflation is projected to continue declining gradually, returning to the top of the 1%-3% target band by early 2024." Against that background, bond yields may well have peaked and may even be headed down: Westpac, for example, thinks the 10-year government bond yield will be back down close to 3% by the end of next year.

Forecasters continue to hold divergent views about the outlook for the kiwi dollar against the US dollar: averaging them out, the median forecast from the big banks is for the currency to trade at 64 US cents by mid-2023 and at 65 cents by end 2023, effectively unchanged from today's 64.5 cents. A stronger dollar would sit with historically high New Zealand commodity prices, and with the RBNZ's likely higher interest rates over coming months. On the downside, however, the wild card is any renewed market volatility, either because the global economic outlook surprises on the downside or geopolitical issues (particularly Ukraine and Taiwan) flare up worse: The kiwi dollar tends to sell off in riskier market conditions.

New Zealand Property — Review

For the year to date, New Zealand REITs have underperformed the wider equity market. The S&P/NZX All Real Estate Index has recorded a 13.4% capital loss and an overall loss including dividends of 11.6%, compared to the S&P/NZX 50's 10.8% capital loss and 9.6% overall loss.

New Zealand Property — Outlook

On the plus side, the recent downward move in bond yields is helpful for the sector: At its peak level of close to 4.3% in June, the yield on the 10-year government bond made the yield from property unattractive. On today's comparison–a bond yield of 3.5% compared with the REITs' yield of 4.5% (on Standard & Poor's estimates)–the REITs are more on investors' radar, even though the pickup in yield from the REITs is still below its historical average. On the downside, despite the recent pullback in bond yields, interest rates are still higher than at the start of the year, with associated pressures on valuations and debt costs. And the operating outlook is becoming tougher, particularly for the retail subsector, where consumer budgets are likely to be under stress from multiple directions (higher mortgage, food, and petrol costs at a time when wages and salaries are not keeping pace with inflation). Offices have their own difficulties: In the key Auckland market, other than for what Colliers in its August research report called "prime grade premises located within waterfront precincts and the northern part of the CBD Core precinct," market conditions have become tougher and vacancy rates have risen, reflecting increased supply of space, reduced demand from remote working, and less occupier appetite for older, less classy properties. At the moment, the outlook is not looking conducive to any immediate turnaround in the REITs' fortunes.

Australian & International Property — Review

The A-REITs have substantially underperformed the wider share market. The S&P/ASX 200 A-REITs Index has lost 16.7% in capital value and registered an overall loss of 14.6% including dividends, compared to the 5.1% capital loss and 3.0% overall loss for the S&P/ASX 200.

Globally, REITs have also underperformed, but not by much. The FTSE EPRA-NAREIT Global Index in US dollars is down by 14.2% (12.4% including dividends), compared to the MSCI World Index's capital loss of 12.0% (10.8% with dividends). In terms of total return in US dollars including dividend income, the Asia-Pacific region fared best (a loss of 9.2%) and the key US market had a loss of 10.3%: Overall asset class returns were held back by large losses in the eurozone (down 26.2%) and the United Kingdom. (down 21.6%).

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Australian & International Property — Outlook

The latest (June quarter) NAB Commercial Property survey unsurprisingly found declines in sentiment and confidence compared with the March quarter as the economic outlook changed from the upswing out of Omicron variant lockdowns to a world of higher interest rates and a likely cyclical slowdown. There was the usual tiering of sectoral conditions. Industrials remains by far the strongest sector, with industrial capital values expected to rise by around 2.7% a year over the next two years and industrial rents to rise by around 3.5% a year. Hotels are starting to become more optimistic, particularly on a two-year horizon where occupancy is likely to have returned closer to pre-pandemic levels. But offices and retail are weak: Office values are expected to move a tad lower over the next two years, and rents will be flat, while in retail both capital values and rents are expected to continue to show small declines. On the latest data, the answer to the big question about office property–were pandemic-induced changes to work practices transitory or permanent?–looks to be that at least some will be permanent. NAB asked a special question about how many will go back to the office: the latest answer was 72.9%, down from the 75.3% expected in late 2021 and from the 77.4% expected in late 2020. The yield on the sector (4.2% according to Standard & Poor's) has some attraction, but investors may otherwise be unimpressed by the likely operating performance of the REITs (ex the still strong industrial ones).

A similar weakening in sentiment, for similar reasons, is evident in global property, where the latest (June quarter) Royal Institution of Chartered Surveyors commercial property survey found that "The headline Global Property Sentiment Index edged back marginally into negative territory in the latest survey (negative 6 versus positive 3 previously). Although this does not imply a major shift in tone, it is reflective on the ongoing tightening in monetary policy by key central banks (led by the US Federal Reserve) and the acceleration in inflation, which does not, as yet, appear to have run its course." The weaker economic outlook was reflected in the RICS question about where respondents felt they were in the business cycle: "the proportion of respondents who view their market to be in the early stage of a downturn has climbed from 11% to 30%, while the share seeing their market
in the middle of a downturn has risen from 15% to 18%. In all, around one half of respondents now view real estate as being in a downturn phase (the highest share since the fourth quarter of 2020)." There may well be opportunities at a sectoral level–"Data centres, multifamily and prime industrials are seen as likely to continue to deliver the strongest returns … with secondary office and retail projected to be the backmarkers"–and the global yield of 3.6% may have some appeal, but otherwise the economic backdrop looks unattractive.

Global Infrastructure — Review

Global listed infrastructure has continued to hold up well in what has been a difficult 2022 for equities. The S&P Global Infrastructure Index in US dollars has made a small capital gain of 3.4% and delivered an overall net return including taxed dividends of 5.5%: Hedged back into New Zealand dollars, the net return was 9.4%.

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Global Infrastructure — Outlook

The conventional argument for global infrastructure is that it provides some downside protection to equity setbacks, as essential infrastructure such as water and electricity is largely noncyclical, but shares to some degree in stronger conditions as patronage-dependent infrastructure like airports and toll roads respond to higher levels of economic activity. For the year to date, the defensiveness has been the key attribute: With the exception of a very small number of obvious beneficiaries from current markets (anything to do with oil and gas, as well as aerospace and defence), virtually all of the FTSE Global Equity sectoral indexes are underwater for the year to date. But infrastructure has held up remarkably well: The S&P index is ahead for the year, and while the FTSE indexes do not split out infrastructure in its own right, they show that some components are either slightly ahead for the year in US dollars (alternative energy up 0.7%, electricity up 0.4%) or have experienced much lower losses than equities in general (utilities down 0.9%, gas, water, and multiutilities down 4.0%). It has also helped that infrastructure tends to provide a degree of inflation hedging through various channels: pricing power of well-placed incumbents, revision of regulated rates of return, or explicit inclusion in the likes of toll road operating contracts. Defensiveness against cyclical risk and inflation protection could well continue to be a successful combination.

Australasian Equities — Review

Local equities have followed the global pattern and rallied from their June lows, but the rally still leaves shares well underwater for the year to date. The S&P/NZX 50 Index is down by 10.8% in capital value and has returned an overall loss of 9.6% including dividends. The small caps have done rather worse (16.2% capital loss) than the top 10 (10.6% loss) and the mid-caps (down 11.3%). In the otherwise weak environment, the cyclical defensiveness of the utilities has been attractive, and the sector is up 5.8%. Among the big cap names, the best performers have been Infratil (up 12.6%), Spark (up 12.4%) and Meridian (up 8.5%), while the biggest losers have been Fisher & Paykel Healthcare (down 34.8%), Fletcher Building (down 26.3%), and Ryman Healthcare (down 23.3%).

Australian shares have also recovered from their June lows, but again the rally has not been enough to regain all the ground lost earlier in the year. The S&P/ASX 200 Index is down by 5.1% in capital value and by 3.0% including dividends. IT stocks have been worst affected: Despite a strong 23.4% rise from its June 17 low, the sector is still down by 26.8% for the year. Consumer discretionary stocks have also taken a hit, given the stresses on household budgets, and are down by 16.0%, but the more defensive consumer staples are marginally ahead for the year (up 0.8%). The financials ex the A-REITs are down by 2.5%, and the miners, reflecting the recent decline in global commodity prices, are down by 2.7%.

Australasian Equities — Outlook

The economy thus far has been holding up reasonably well: The RBNZ said at its 17 Aug Statement that "Demand in the New Zealand economy has remained resilient to global and domestic headwinds to date." But that looks likely to change for the worse. The latest surveys of both business and consumer confidence have shown very low levels of sentiment, and the RBNZ itself is set on a course to slow the economy down: "a period of more moderate growth is needed to better match demand with production

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capacity in New Zealand. Higher interest rates are intended to slow the pace of household and business spending growth, with the usual lag of several quarters."

The RBNZ is forecasting that GDP growth, which was 4.1% in the year to March, will slow to 2.5% in the year to March 2023 and will barely grow, by 0.9%, in the year to March 2024. Growth at that pace would mean a noticeable rise in unemployment: the RBNZ is picking that it will increase from 3.2% in March 2022 to 4.6% in March 2024. Other forecasters have pencilled in similar scenarios of slower growth and higher unemployment, with the BNZ for example expecting an unemployment rate of 5.0% in March 2024. These will not be easy conditions for companies to do well in, with revenue growth slowing and ongoing pressures on input costs. Recent investor preference for the more defensive end of the equity market looks a sensible assessment of the outlook.

There is a comparable situation in Australia. Again, the starting point is quite solid. The RBA, in its latest minutes, said that "The domestic economy had grown strongly over the first half of 2022, showing resilience to disruptions caused by the Omicron outbreak and the floods on the east coast. Timely indicators suggested that domestic demand had grown strongly in the June quarter, supported by consumer spending. Spending on discretionary services had continued to recover, while spending on goods had held up. Growth in consumption was expected to remain strong over the second half of the year, reflecting current strong labour income, still-high saving rates and strengthened household balance sheets." The latest (July) NAB business survey was also strong: while there were strong input cost pressures, "Business conditions remain well above average … with trading conditions, profitability, and employment all higher."

But there is a slowdown in prospect. It may not be as significant as in some other economies: Local monetary policy may not need to be tightened as much as will be required in countries where inflation has risen to higher levels than it has in Australia. But monetary policy will nonetheless be applying the brakes to some extent, and the RBA reckons that the 3.2% GDP growth likely in 2022 will slow down to 1.8% in 2023 and to 1.7% in 2024. A slowdown of that order would mean that unemployment will gradually start to rise, on the RBA's projections from 3.4% at the end of this year to 4.0% by the end of 2024. Private sector forecasters tend to agree: NAB, for example, has GDP growth slowing from 3.6% this year to 1.7% in 2024, and the unemployment rate rising from 3.7% to 4.2%. By current international standards that would be a reasonably good outcome, and the share market may attract some support on its relative performance. In absolute terms, though, the outlook is getting harder for companies to maintain profitability, and as in New Zealand the recent outperformance of more defensive sectors looks like a good advance signal of cyclical pressures to come.

International Fixed Interest — Review

This year has been a game of two halves for bonds. In the US, for example, the yield on the benchmark 10-year Treasury bond rose steadily to a peak of just under 3.5% in mid-June but has fallen steadily since to its current 2.8%. The benchmark German bond followed a similar trajectory, peaking at 1.78% in June and then dropping to today's 0.9%. The recent declines in yields and associated capital gains have improved the performance of the asset class, but the capital losses earlier in the year mean that fixed

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interest has still done badly for the year to date, with the Bloomberg Global Aggregate Bond Index in U.S dollars down by 12.3%.

International Fixed Interest — Outlook

The recent decline in yields reflects two factors. One is an expectation that inflation may be at or past its peak. The chief evidence for this view is that annual US inflation, which reached 9.1% in June, unexpectedly dropped back to 8.5% in July, and even after stripping out the effect of lower energy prices, the "core" rate of inflation was also unexpectedly low. And some other indicators are also pointing in the same direction, notably world commodity prices: The Bloomberg Commodity Index, for example, is now down 11.1% from its mid-June peak level.

The second factor is that bond markets are less worried than previously about the potential scale of monetary policy tightening. The financial markets have even begun to look beyond the current tightening phase and to anticipate an eventual easing by the big central banks. In the US, for example, the financial futures market currently expects that the target Fed fund range (currently a range of 2.25%-2.5%) will peak at 3.5%-3.75%, and that there is a chance that policy will start easing in the second half of next year. The pricing around the Fed's policy meeting on 23 July next year, for example, has almost equal probabilities of the range staying at 3.5%-3.75% or being cut to 3.25%-3.5%.

While investors will be hoping that this bond market optimism proves correct, it is far from a given. The Bank of England, for example, is not convinced that the worst of the current inflationary surge is behind us: In its August monetary policy report, the bank expected UK inflation to hit a remarkable 13% in the final quarter of this year, and while the bulk of it was down to higher fuel prices, the bank also said that "Though responsible for much less of the rise in headline inflation, domestic inflationary pressures have also increased and are projected to remain strong in the near term." The same might well happen elsewhere, particularly in the US, where the unemployment rate has dropped to 3.5%. There might also be further inflationary pressures if, for example, Russia were to restrict its energy or other exports as part of its pressure over Ukraine. A final consideration is that, even if inflation does drop back rapidly, the yield available on global government bonds (2.17% going by the J.P. Morgan index) offers little value in aftertax after-inflation terms. All that said, there looks to be a realistic chance that the previously strong headwinds for the bond markets have eased.

International Equities — Review

World equity prices dropped steadily through to mid-June–at its low point on 16 June, the MSCI World Index of developed markets was down 23.1% in US dollars for the year–and then traded sideways till mid-July. In more recent weeks, however, share prices have regained some ground, up by 14.3% from their mid-June lows. Despite the recent rally, the scale of the earlier losses means that global equities are still showing large losses for the year to date, with the MSCI World Index down by 12.0%. Nearly all major markets have lost ground: In US dollars, the S&P 500 is down 9.8%, the Nikkei in Japan is down 13.4%, the FTSE Eurofirst Index of European shares is down 17.9%, and the FTSE 100 Index in the UK is down 9.4%. The weakness of the kiwi dollar against the US dollar helped mitigate some of the losses, with the MSCI World Index in kiwi dollars down by 6.8%.

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Emerging markets have fared worse than the developed markets. While the MSCI Emerging Markets Index in US dollars had a similar sized selloff in the first half of the year–it dropped by 21.9% to its low point on 14 July–it has not matched the scale of the recent rally in the advanced economies, and for the year to date it is down 17.6%. The one bright spot among the core developing markets has been Brazil, which has benefited from strong commodity prices, and the Bovespa index is up 17.9% in US dollars. The other big emerging markets have recorded sizeable losses, with the worst outcome in Russia, where shares have lost roughly a third of their value (the FTSE Russia Index is down 31.4%, and the RTS Index is down 36.3%).

International Equities — Outlook

There are mixed conditions across different regions, but overall global economic activity looks to be headed for a weak patch. Going by the J.P. Morgan Global Composite indicator of business activity, "July saw the rate of global economic growth ease to its weakest during the current 25-month sequence of expansion. The slowdown was mainly centred on developed nations, where output contracted (on average) for the first time since June 2020. Emerging markets showed greater resilience in comparison, with growth staying close to June's 11.5 year high."

The data are not completely clear-cut. On paper, official figures for the US economy, for example, show that the American economy contracted in both the March quarter (at an annualised rate of 1.6%) and the June quarter at (an annualised rate of 0.9%). These numbers do not line up with the boom figures coming out of the US labour market, where there were far more jobs created in July (528,000) than the 250,000 forecasters had expected, and where the unemployment rate dropped to a new low of 3.5% (the forecasters had picked it would stay at 3.6%).

That said, the J.P. Morgan index tends to track world gross domestic product quite closely, and even if the US may actually be more resilient than its official numbers say, the probability is that the near-term outlook is downbeat. The main immediate challenges have been the ongoing pressures from supply shortages and price rises for commodities affected by the conflict in Ukraine, wage pressures in tight labour markets, and recent weakness in the Chinese economy, where a raft of recent indicators have fallen short of expectations as China continues to run a coronavirus-elimination policy of tight lockdowns. Beyond the immediate issues, there is the eventual impact of the monetary policy tightening that many central banks have already carried out, and the likelihood of further hikes in interest rates still to come.

One might well wonder why equity markets have rallied in the face of the likely prospect of a cyclical slowdown ahead, and the answer appears to be that investors had already discounted the worst, and events look to be unfolding a bit better than they had previously expected. As Bank of America said in its latest (August) survey of global fund managers, "Sentiment remains bearish, but no longer apocalyptically bearish as hopes rise that inflation and rates shocks end in coming quarters." The same pattern of still bearish sentiment, but not quite as depressed as before, also came through in the latest (August) S&P Global survey of institutional investors: "of the 11 monitored sectors, 10 recorded improving sentiment on a monthly basis with only communications services registering a deterioration

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since July. That said, eight of the 11 monitored sectors are reporting a negative outlook, with real estate and consumer discretionary stocks at the bottom of the rankings."

The good news is that the outlook is not quite as difficult as first feared. The bad news is that there are still many challenges ahead. For the Bank of America panel, the three biggest risks are inflation remaining high (mentioned as their top risk by 39%), a global recession (24%), and central bank interest-rate hikes (16%). The S&P panel had a similar set of issues that they saw as the drivers of the US equity market in the near term: the global macroeconomic environment, the political environment, and central bank policy.

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