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# Economic Update: New Zealand
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## Outlook for Investment Markets

A rally in both equity and bonds in July and the first half of August did not last, and prices resumed their slide in the second half of August and into September. With the exceptions of cash and infrastructure, most asset classes are now showing hefty losses for the year. The prime reason has been the likelihood that monetary policy will tighten more than previously expected, as inflation in a range of countries has proved to be more troublesome to corral than central banks thought. It has not helped that the global economy was weakening as the initial post-coronavirus rebound wore off and the various ramifications of the war in Ukraine (particularly very high energy prices) continue to weigh on the world economy. Market conditions are likely to remain problematic until investors can see their way to friendlier growth prospects on the other side of the current monetary policy tightening cycle. At home, the economy has been in good shape, with, for example, a solid rise in the gross domestic product in the June quarter. But New Zealand faces the same monetary policy challenge as many other countries, and business conditions are likely to get tougher over the coming year.

## New Zealand Cash and Fixed Interest — Review

Short-term interest rates have continued to rise, reflecting both actual and anticipated interest-rate hikes from the Reserve Bank of New Zealand, or RBNZ, and the 90-day bank bill yield is now 3.6%, up 2.6% for the year. Bond yields have followed the global pattern, peaking in June, dropping in mid-August, but then rising again in more recent weeks. The 10-year government bond yield is back up to 4.0%—its 1.6% rise year to date has meant capital losses for the asset class. The S&P New Zealand aggregate bond index is down 5.6% for the year. The kiwi dollar is 4.4% lower for the year in overall value. A large decline of 12.1% against the U.S. dollar was partly counterbalanced by a 10.4% gain against the Japanese yen.

## New Zealand Cash and Fixed Interest — Outlook

Further rate increases look likely from the RBNZ as it brings further pressure on unacceptably high inflation. On its own projections, annual inflation will be 5.8% at the end of this year and will still be 3.8% at the end of 2023, well above the 2% the bank targets. Forecasters and the futures market expect the official cash rate, or OCR, to increase to 4.0%-4.25%, up from today's 3.0%.

The recent rise in bond yields partly reflects the influence of higher U.S. bond yields, which have risen in response to poor inflation news in America. But it also reflects domestic circumstances, with the New Zealand economy generating its own local inflationary pressures—the economy is still growing at a robust rate at a time when the labour market remains tight and input costs are rising rapidly. Some forecasters expect that bond yields have risen enough to compensate for this inflationary environment and could even decline in late 2023 as inflation progressively abates. Inflation globally, however, has

proved unexpectedly stubborn, and ASB's view that yields will still be around current levels in a year's time may well be more realistic.

The value of the kiwi dollar has largely been a byproduct of wider global trends, notably this year's surge in the U.S. dollar: The greenback is up by 13.1% in overall value, buoyed by the relatively aggressive monetary policy track of the Fed, geopolitical demand for a safe haven currency, and the ongoing strength of the U.S. economy. The kiwi's value has also been affected by the slump in the yen, which is down by 19.6% against the U.S. dollar, largely due to Japan's still very low interest rates at a time when rates everywhere else have been rising. Japanese government-bond yields are still negative all the way out to four years, and low beyond that (the 10-year yield is only 0.26%). The U.S. dollar impact may well reverse in coming months. The median view of the big bank forecasters, for example, is that the kiwi will recover ground against the U.S. dollar, rising from $0.60 now to 63.5 cents in a year's time. Rising domestic interest rates as the RBNZ tightens further and ongoing good prices for New Zealand's commodity exports could also come into play and support the value of the kiwi in coming months.

**New Zealand Property — Review**

It has been a tough year for the New Zealand REITs, which continue to underperform the wider share market. The S&P/NZX All Real Estate Index year to date has made a 17.0% capital loss and returned an overall loss including dividends of 14.4%, compared with the S&P/NZX 50's 12.3% capital loss and 10.6% overall loss.

**New Zealand Property — Outlook**

As an income-oriented equity option, the New Zealand REITs, like their counterparts overseas, have been hit harder than most by the recent realisation that interest rates now look likely to head higher than initially anticipated. The spread between the yield on the REITs and the yield on a 10-year bond is now well below its historical average and could narrow further. It has not helped that the immediate cyclical outlook is weakening, which will be a headwind for the retail subsector in particular. The operating outlook is not all doom and gloom, however. In its September research report, Colliers points out that the reopening of the borders to tourists and students could provide a boost, citing forecasts from the Tourism Export Council that tourist numbers could be back up to pre-COVID-19 levels by mid-2026. REITs also provide some inflation-hedging value from rents that are typically adjusted in line with consumer prices. But any positives look likely to remain in the background while investors remain worried about further rises in interest rates.

**Australian & International Property — Review**

The A-REITs have also significantly underperformed the wider share market. The S&P/ASX200 A-REITs Index is down by 22.8% in capital value and has delivered an overall loss of 20.7% including dividends, compared with the 8.3% capital loss and 4.7% overall loss for the S&P/ASX 200.

Global listed property modestly underperformed global equities as a whole. The FTSE EPRA-NAREIT Global Index in U.S. dollars has lost 22.3% (20.3% including dividends), compared with the MSCI World's capital loss of 19.0% (17.7% with dividends). In U.S. dollars, the Asia-Pacific (negative 12.9%) and

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emerging markets (negative 13.1%) fared least badly, the key American market was in the middle of the bunch (negative 17.9%), while there were large losses in the eurozone (negative 40.0%) and the U.K. (negative 35.2%) due to a combo of poor underlying asset performance and weakening local currencies.

**Australian & International Property — Outlook**

The A-REITs have struggled from the same combination of issues that has confronted listed property everywhere, which are that interest rates are rising faster than expected along with an impending cyclical slowdown and structural change to retail spending and working practices in the wake of COVID-19. Office occupancy rates, for example, as compiled by the Property Council of Australia, have been improving from their lockdown lows but are still well adrift of where they were before the pandemic. In Sydney, for instance, occupancy in August was only 53% of pre-COVID-19 levels, and the difference between occupancy on the peak day (67%) and the lowest day (35%) shows that there is now an entrenched culture of working from home (typically Mondays and Fridays). After the recent substantial price declines, valuations are better than they were, but potential investors may stay on the sidelines until they are more confident that bond yields are nearer a peak.

Conditions are more difficult again in overseas REIT markets. The J.P. Morgan Composite indicator of business activity showed that in August the real estate industry was the second-weakest sector out of the 21 sectors surveyed (only cars were worse), while the September S&P Global survey of fund managers found that real estate was the second-least-preferred option out of the 11 sectors in the survey (with only consumer discretionary more out of favour). CBRE, in an end-of-August report, acknowledged that the immediate cyclical outlook is not encouraging: "macroeconomic headwinds are raising fears of a broad-based downturn as central banks address persistent high inflation"— but nonetheless felt that there could be some investment opportunities. One was inflation hedging: apartments, industrial, hotels and self-storage "can be repriced relatively quickly, making them particularly attractive in an inflationary environment." Another was bottom-fishing in a cheaper market: While "owners are increasingly mindful of the potential for falling values and profit erosion … buyers with dry powder are now evaluating how to purchase assets that were previously out of their valuation range." They may yet be right, but for now the headwind of tighter monetary policy continues to crowd out other drivers of performance.

**Global Infrastructure — Review**

Global listed infrastructure has proved a rare haven of stability in this year's roiled bond and equity markets. Year to date the S&P Global Infrastructure Index in U.S. dollars is effectively unchanged (positive 0.1%) in capital value, and with net (aftertax) dividends has returned 2.2%. Hedged back into New Zealand dollars the net return increased to 7.6%.

**Global Infrastructure — Outlook**

Infrastructure has outperformed for a variety of reasons, and some are subsector specific. Midstream energy facilities like pipelines and fuel storage have been beneficiaries of high energy prices; airports are beginning to recover from their COVID-19 setbacks; and alternative energy, both as a response to climate change and to high prices of carbon-based fuels, has also been resilient. In U.S. dollars the FTSE

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Global Index of alternative energy companies is down by a marginal 1.2% year to date, compared with the FTSE World's 16.2% decline. But much of the outperformance comes from two broad themes: Much of the asset class is acyclic at a time when investors have become more concerned about the immediate economic outlook, and the ability of many infrastructure operators to raise their prices (either through renegotiated regulated rates or through commercial contracts) and pass on costs in a more inflationary world. The likes of electricity utilities (up 1.8% year to date) have consequently been largely insulated from market volatility. The yield on the asset class is not especially generous—3.65% according to S&P, only a tad more than the yield on a 10-year U.S. Treasury bond and less than the 4.0% on offer from global property—but investors are likely to continue to favour the sector while downside cyclical risks remain top of mind.

**Australasian Equities — Review**

Once again local equities have followed the global trend: a large fall in the first half of the year, some recovery in July and the first half of August, but further losses since then. Year to date the S&P/NZX 50 Index is down by 12.3% in capital value and has returned an overall loss of 10.6% including dividends. The large caps (down 12.0%) have fared a bit better than the mid-caps (negative 13.0%) while the small caps (negative 18.7%) have sold off more heavily. Among the large caps, the biggest losers have been Fisher & Paykel Healthcare (negative 38.3%) and Ryman Healthcare (negative 26.6%) while the best performers have had a defensive infrastructural orientation (Spark positive17.7% and Infratil positive 15.3%).

Australian shares have followed a similar pattern, and the S&P/ASX 200 Index is down by 8.3% in capital value and has returned an overall loss of 4.7% including dividends. IT stocks continue to be the weakest sector and are down by 29.2%. The cyclically exposed consumer discretionary stocks have also suffered (negative 19.6%) whereas the more defensive consumer staples have returned (negative 5.0%). The financials, excluding the A-REITs, are down by 7.0%, and the miners have done relatively well. Although global commodity prices are down from their peak, they are still high by historical standards, and the sector has outperformed shares as a whole with a modest 3.4% loss.

**Australasian Equities — Outlook**

One bit of good news is that the economy is still doing well. The GDP data showed that the economy grew by 1.7% in the June quarter, faster than the 1.0% forecasters had expected. The sectoral breakdown showed large increases in activity in the areas that had previously been hardest hit by COVID-19 restrictions. From one perspective, the robust growth had an implicit downside—it makes it more likely that the RBNZ will need to keep tightening monetary policy—but in the meantime it helps to get the cash crossing the tills. Another is that companies are not quite as downbeat as they were previously: In the latest (August) ANZ business survey, companies were a bit more hopeful about the outlook for their own levels of activity.

But it still looks likely that there is an economic slowdown ahead. The RBNZ is aiming to reduce the current degree of inflationary pressure, and there may also be headwinds from a global economy that is weakening. In the latest (September quarter) New Zealand Institute of Economic Research poll of

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forecasters, the consensus view is that the economy will grow by 2.5% in the year to next March, but will slow down to anaemic levels of growth in the following two March years (1.0% in March 2024 year and 1.5% in March 2025). Low rates of growth along those lines mean that unemployment would rise from its current 3.3% to 4.7% in March 2025. With ongoing pressures on input costs and likely slower growing sales, profit growth will be difficult to achieve. In the latest ANZ survey, it was noticeable that firms remained very pessimistic by historical standards about their expected profitability.

In Australia, the latest data has also been supportive. The economy grew by 0.9% in the June quarter, for a 3.6% year-on-year growth rate, much in line with forecasters' expectations, helped by the latter stages of spending by consumers who had been saving more than usual during lockdowns and who are still catching up with their deferred purchases. Businesses are also in good standing. The latest (August) National Australia Bank business survey found that business conditions remained strong across the various states and across most industries (excluding construction), and that "Overall, the survey showed no signs that the strong conditions of recent months—including the strength seen in official consumption and retail sales data—had begun to moderate yet." CommSec's roundup of the June company reporting season also showed good company performance, with profits (excluding BHP, which would exaggerate the numbers) up by 36.5% on a year earlier.

But these indicators are for the most part backward-looking. In the future, many companies in other countries will be feeling stronger cost pressures from rising input costs and more expensive financing, while consumers will be tightening their belts as petrol, mortgages, and wage increases—not yet matching price increases in the shops—combine to crimp their finances. The latest (September) Westpac/Melbourne Institute survey of consumer sentiment showed it slightly better, but still deeply apprehensive and close to historic lows. CommSec's take is that, although "Research analysts are expecting weaker earnings growth this financial year and next as the economy slows and profit margins are squeezed by higher costs," improved P/E ratios and a 4.6% dividend yield could help the S&P/ASX200 Index to a 7,100-7,400 range by June next year, which at its midpoint would be a rise of some 6% from current levels. That, however, was on an assumption that the RBA would take the cash rate up to only 2.6% between now and the middle of next year. As with other central banks, the risk to eventual equity performance is that interest rates will rise faster than first thought.

**International Fixed Interest — Review**

After dropping in July and August on hopes of inflation easing and central banks consequently under less pressure to raise interest rates, bond yields have changed tack in recent weeks and have headed higher. In the U.S., for example, the benchmark 10-year Treasury yield had dipped below 2.6% in early August and is now back up to 3.4%. The associated capital losses mean that bond market performance has been poor, and year to date the Bloomberg Global Aggregate in U.S dollars is down by 16.9%.

**International Fixed Interest — Outlook**

The big news for the asset class has been the unexpectedly poor inflation outcome in the U.S. in August. At first sight, the headline news had looked good: The overall annual inflation rate dropped from June's 9.1% and July's 8.5% to 8.3%. But when unpacked in more detail, the data showed that "core"

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annual inflation, excluding food and energy, had actually accelerated—it had been 5.9% in both June and July, but picked up to 6.3% in August. The month-on-month increase in "core" inflation was also bad news—at 0.6% in August, it was up from 0.3% in July.

The conclusions that the bond (and equity) markets drew from the news was that inflation was a bigger issue than previously thought, and that the Fed would have to react more forcefully with tougher monetary policy than the markets had previously allowed for—bond and equities consequently both sold off heavily after the data was released. Before the latest news, futures-market thinking (as summarised by the Chicago Mercantile Exchange's FedWatch tool) was that the target Fed funds range (currently 2.25% to 2.5%) would peak at 3.5% to 3.75%. Now, there are roughly equal probabilities of a 4.0% to 4.25% range, and a 4.25% to 4.5% range. Earlier expectations that the Fed would start easing in the future have also gone out the window, as the futures market thinks the target range will still be in the 4.0% to 4.25%/4.25% to 4.5% area at the Fed's meeting in July next year.

It has not helped that other central banks are also having to scramble hard to get on top of surging inflation. The European Central Bank raised its policy rate by 0.75% this month and indicated that there are several more hikes in the pipeline, and understandably so, given that the bank expects eurozone inflation of 8.1% this year and 5.5% in 2023. Inflation is likely even worse in the U.K., where some recent private sector forecasts are picking up that inflation will be even worse than the 13.3% the Bank of England expects. Goldman Sachs, for example, thinks it could hit 22.4% if gas prices remain high and 14.8% even if gas prices ease back.

There is a significant global economic slowdown on the horizon, and it is still possible that inflationary pressures might drop away faster than forecasters and central banks currently expect. Although inflation is still too high, the latest (August) J.P. Morgan Global Composite indicator of economic activity picked up some moderation in the rate of increase of input and output costs. But the more likely outcome is that inflation is proving tougher to control than people had anticipated, and the bond markets' optimism in June and July that the macroeconomic headwinds were easing now looks premature.

**International Equities — Review**

After a poor first half of the year, when the war in Ukraine, rising energy and other input costs, and tighter monetary policy had combined to drive equity prices sharply lower, prices recovered in July and the first half of August. The recovery has not lasted, though, as prices have resumed their slide, and year to date the MSCI World Index of developed markets in U.S. dollars is down by 19.0%. All the major markets are showing significant losses In U.S. dollars for the year: S&P 500, negative 17.2%; Nikkei, negative 22.3%; Eurofirst 300, negative 23.4%. The kiwi dollar's weakness against the U.S. dollar has cushioned some of the impact, but even so the MSCI World in kiwi dollars is down 7.8% year to date.

Emerging markets have followed a similar pattern, with prices also falling since mid-August, and the MSCI Emerging Markets Index in U.S. dollars has lost 21.9%. The only good news has come from commodity-buoyed Brazil, where the local Bovespa benchmark is up by 5.5% in reais and by 13.8% in U.S. dollars, thanks to the reais' 7.9% appreciation against the dollar.

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**International Equities — Outlook**

The issue that has been top of mind for global equity investors in recent weeks has been the potential impact of higher-than-anticipated interest rates. A number of major central banks (excluding Japan) are being forced to raise rates faster and further than expected as inflation has soared well above the banks' inflation target ranges. This has had a particularly large impact on growth industries where profits mostly lie in the future, and where the effect of present value discounting of future profits at now higher discount rates is largest. The tech sector in particular has been hit hard: The FTSE Global sectoral indexes in U.S. dollars show that software and computer services equities are down by 28.0% year to date, and technology hardware and equipment shares are down by 24.8%.

The braking impact of higher interest rates on economic activity will mostly hit in 2023, but it does not help that global business activity has already slowed down significantly. The August J.P. Morgan Composite indicator "saw global economic activity contract for the first time since June 2020, as new order inflows declined, international trade volumes fell and signs of excess capacity grew … August data signalled that weaknesses in the global economy were becoming more widespread. Five out of the six subindustries covered saw downturns – business services, consumer goods, consumer services, intermediate goods and investment goods. In contrast, the financial services sector saw a mild upturn following July's contraction."

There are a number of reasons, including the first effects of the central banks' monetary policy tightening, China's ongoing COVID-19 lockdowns, and, perhaps most importantly, the transfer of purchasing power from consumers of energy to producers in the wake of the war in Ukraine's impact on natural gas supplies in particular. Western Europe, which has been impacted the most, faces an unpleasant outlook of ongoing high prices and potential supply shortages. The more-cyclically sensitive equity sectors have already priced in the likely impact of consumers retrenching. The FTSE sector indexes show large setbacks for discretionary spending, such as on leisure goods (negative 23.5%) and personal goods (negative 23.1%).

Given the circumstances, it is not surprising that global fund managers have become more concerned and more conservative. September's S&P Global survey of institutional investors found, for example, that 79% of them expect a U.S. recession in the coming year, albeit not a severe one. They reported high levels of concern about the global macroeconomic environment, about central bank policy, and about the political environment—probably meaning Ukraine, where despite the recent good news of a successful Ukraine offensive, it is not clear what happens next, and some of the possibilities (for example, a Russian counteroffensive) could be even more unsettling. By a wide margin, the surveyed fund managers have chosen two sectoral options to cope with these risks: energy, on the assumption that the war in Ukraine will keep prices high; and the health sector, which should be relatively sheltered from cyclical pressures on consumer spending.

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