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Economic Update: New Zealand
March 2024

Morningstar Research
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Summary

- New Zealand economic growth remains weak.
- Inflation is sticky outside of the Reserve Bank of New Zealand's 1-3% target range. US inflation is also proving sticker than previously thought, pushing up long-term yields.
- Future direction of NZ interest-rate decisions are still expected to be lower, given the restrictive nature of the current levels as evidenced by growth numbers.
- Property markets continue to struggle in the face of rising interest rates.
- NZ equities remain an underperformer—an outlier relative to other equity markets around the world—as economic weakness is revealed in company performance.
- Valuation dispersion across sectors within international equities is creating relative opportunities.

New Zealand Cash and Fixed Interest—Review

The New Zealand economy remains weak with growth contracting in four out of the last five quarters and monetary policy restraining demand.

Inflation remains well above the Reserve Bank's 1% to 3% target range. While some near-term price pressures exist, the RBNZ remains confident in maintaining the official cash rate, or OCR, at a restrictive level, thereby continuing to restrain demand, ensuring inflation returns to the 1% to 3% target range over time. The New Zealand economy continues to evolve as anticipated by the RBNZ.

This policy has seen cash and fixed-income instruments oscillate as opposed to trend. The gap between the yield on the NZ 10-year bond compared with the US equivalent has closed to less than 40 basis points, as US yields rise but NZ yields remain broadly unchanged, taking some directional lead from the US market, though remaining in a 4.5-5.0% range.

Markets and commentators continue to embrace that the next move in the OCR is lower as a theme, with divergence over the timing.

The NZD has weakened against the United States dollar, due to a weaker New Zealand economy and receding expectation that the US Federal Reserve will lower the federal-funds rate in 2024. Weakness in the NZ economy has been reflected in a lower NZD/AUD, though it remains at an elevated level, above 0.90.

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New Zealand Cash and Fixed Interest—Outlook

Weakness across the economy, a directional trend lower in inflation, the lagged impact of restrictive monetary policy with many fixed mortgages to refix in the coming year, and the actual OCR sitting well above the neutral OCR, support a bias toward lower rates.

Fixed-income yields also sit above estimates of fair value, though the magnitude is dependent on the estimate of the neutral OCR (anywhere from 2.5%-4.0%) and an appropriate term premium. Yield projections from Westpac, ANZ, and the RBNZ Survey of Expectations are congregated on the NZ 10-year yield easing toward 4.0%-4.5% in a year.

The potential for inflation to prove sticky, particularly across services, and large increases in noneconomically sensitive prices (local government rates, insurance, and utility costs), which will slow the decline in inflation, could yet challenge the consensus expectation.
Of note in the latest OCR decision the RBNZ stated, "limited tolerance to increase the time to achieve the inflation target."

In the near-term, NZ longer-term fixed-income yields remain susceptible to repricing risks out of the US (a key directional influence on all fixed-income markets), with US inflation showing stickiness four months in a row. NZ yields have somewhat decoupled recently, validated by a large economic divergence between the US and NZ. However, the NZ-US spread is now historically narrow.

The upcoming 2024 Budget (May) is likely to see expanded debt issuance, given a weaker economy, which is impacting current tax revenue and also the budget forecast years.

Projections by bank economists that the NZD/USD would lift back toward 0.70 have failed to eventuate. The consensus (according to the Reserve Bank Survey of Expectations) is that the NZD will be in at a low 0.60s now for a year.

While there are some cyclical reasons for current currency levels, such as relative interest rates, near-term (and long-term) risks surrounding China, and low commodity prices, a lower-than-normal NZD is necessary to help rebalance the NZ economy. It also partly reflects economic underperformance.

New Zealand Property—Review

The listed property sector performed well over March (gross return of 3.7%), outperforming the broader NZ market as speculation of higher interest rates subsided as economic data came in weak. The sector continues to trade at a modest discount to net tangible asset value. The sector remains sensitive to the trajectory for interest rates.

New Zealand Property—Outlook

Rising interest rates have not translated to a one-for-one increase in property yields or cap rates. Rather, interest-rate and property yield margins have compressed, suggesting ongoing pressure on values, and

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one reason the sector continues to trade at a discount. Property yields did not follow interest rates down one-for-one either, though, which expanded margins above historic norms.

On the assumption we have seen the top in the interest-rate cycle, and lower interest rates are around the corner, valuation pressure could be eased by rebuilding margin (yield to interest rates) by lowering interest rates. Or could falling interest rates translate outright into falling yields and rising values?

The outcome is critically dependent on what is the appropriate spread between property yields and interest rates, or the compensation for risk, which have diverged considerably over the past 30 years.

CBRE's Report "New Zealand Interest rate outlook and its property yield implications" notes good progress in the price discovery journey and expects yields to: "remain at current levels until late 2024 and then decline moderately once economic conditions turn more positive and interest rate falls are entrenched."

A weak economy brings more tenant risk into play, implying that above-average compensation for risk should be required. Nonperforming loans across the banking sector for commercial property loans have risen from 0.2% of all commercial loans to 1.2% in less than a year. While still low, that rate of change signifies a different market and operating environment, and one where transaction power shifts to buyers at the expense of vendors.

The coming year is expected to bring more transactions, with the ongoing process of price discovery and economic weakness bringing greater vendor motivation and weighing toward upward pressure on yields. Some pending sales in particular will be closely watched for the benchmarks they set.

Economic developments continue to influence sectors by varying degrees. The environment for retail remains difficult, with sales volumes falling sharply. Industrial property has been heavily favored, but manufacturing momentum has slowed, and more industrial capacity has emerged. Office space has been challenged by employees working from home, but changing labor market conditions could change that. Quality and locality remain key themes. Strong population growth, driven by migration inflows, will support both commercial and residential properties over time.

Australian and International Property—Review

Australian and international property diverged significantly over the month of March with the S&P/ASX 200 A-REIT index up a staggering 9.7%. The EPRA Nareit Global Real Estate Index in US dollars only rose 2.8% (2.6% AUD) in comparison. This means over the quarter, Australian property is up 16.8% in AUD while international property is down 0.9% in USD (3.6% AUD).

Australian and International Property—Outlook

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Real estate was one of the worst-performing sectors in the quarter, finishing modestly in the negative after rallying strongly in late 2023. During 2024, the market's expectations regarding central banks' interest-rate cuts have moderated both in terms of timing (now expected to be later) and magnitude (less cuts)

The real estate asset class continues to make plenty of headlines, mostly tied to office assets in urban city centers that have been underperforming due to employees working from home, tenant bankruptcies, and/or debt-funding concerns. But it's important to remember, real estate is a large category and office assets represent only a small slice of a much larger pie.

Global real estate had been an underweight across our portfolios for several years, but recent negative sentiment has created better relative value.

Australian real estate continues to remain dually exposed to economic conditions—both from a top-line rental growth perspective and also from a funding-conditions perspective. As trusts that pay out high levels of earnings as dividends, REITs rely heavily on debt (and equity) markets to fund their highly capital-intensive operations. While we see better relative value in listed property, investors need to tread carefully. With debt-funding costs and construction costs on the rise, investors need to be wary of trusts exhibiting highly leveraged balance sheets and/or large property development exposure increasing the chances of dilutive and discounted equity increases.

Global Infrastructure—Review

Global infrastructure finished off March in positive territory as the S&P Global Infrastructure Index rose 4.33% in AUD. Growth in construction as commented on in the latest US Purchasing Managers Index put some wind behind the sails of global infrastructure through the month.

Global Infrastructure—Outlook

As an income-focused asset class, we continue to see the outlook for infrastructure as being strongly influenced by the outlook for interest rates. Utilities comprise a significant weight within infrastructure. We see utilities as presenting better relative value today, particularly when compared with more cyclical and higher growth areas of the market, which have done well over the past year. Yet we still see an uncertain road ahead for utilities as companies balance their renewable energy infrastructure spending plans against ensuring they receive attractive returns on these new investments in the face of higher interest rates, construction costs, and electricity bills for customers.

Australasian Equities—Review

The ASX 200 capped off the month with a 3.3% increase driven by a big gain in the real estate sector, as favorable interest-rate moves helped buoy the interest-rate-sensitive sector. This was followed by utilities, resources, and energy. Consumer discretionary and healthcare lagged on the month.

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The NZX 50 continues to lag the Australian market with a 1.96% increase on the month. The economic slowdown continues to pressure New Zealand equities relative to the global counterparts where economic growth has not been impacted as heavily.

Australasian Equities—Outlook

A weaker economy is presenting a challenging environment for NZ equities. Whereas many global markets have hit highs, the NZ market has struggled, and the economy is a major factor behind it. Taxes paid by companies have been lower than projected within the Crown Financial Statements by 5.8% in the eight months ended February 2024. Income measure of gross domestic product shows gross operating surplus and gross mixed income falling 2.9% between December 2022 and December 2023. These outcomes are being reflected in earnings.

Mixed performance within industries have reinforced the importance of fundamentals and the microeconomics of any business, a theme likely to continue over 2024 given expectations of subtrend growth.

Demand, epitomized by actual GDP growth figures, shows an economy contracting in four out of the last five quarters and annual growth down 0.3% on a year ago. Both The Treasury and RBNZ have also openly acknowledged that the productive capacity of the economy is lower than previously thought, which elongates the economic adjustment required to bring demand back into line with the economy's capacity to meet it. Negative productivity growth has added to unit labor costs and threatens the disinflation process. Producer price index inflation, after peaking at 9.7%, has eased to 1.9% year over year and is now tracking below consumer inflation, providing some cost respite.

In Australia, headwinds exist, but performance in the last year relative to the major global indexes was subdued. Australian shares retain a medium conviction, in line with many major global peers, according to our analysis. While opportunities do exist at a more granular level—especially for those willing to invest differently to the index—we continue to see greater merit in global exposure, including Chinese equities on valuation grounds and other select emerging markets.

International Fixed Interest—Review

US bond yields were slightly higher on the month, although direction wasn't as obvious, as future interest-rate decisions from the US Federal Reserve remained uncertain. The Bloomberg Global Bond Aggregate Index finished slightly positive with a 0.36% increase in March. This brings the quarters total return to 2.4% in AUD.

International Fixed Interest—Outlook

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The material increase in bond yields has improved forward-looking prospects, which applies positively to the US, UK, and Australia. Europe is also rising from a very low base, although absolute yields remain broadly unattractive. Yields now cover inflation in many instances, offering positive real yields.

The ability to add income to portfolios while mitigating duration/default risk looks attractive to us. Healthy government bond yields are a positive for future return generation, and we expect this asset class to continue playing a role for investors. Overall, we feel that managing duration risk makes sense in most scenarios. We are cognizant of the potentially sizable drawdown risk from longer-duration assets and adjusting our bond allocations higher at a moderate pace. Adding materially to duration might make sense at some point, but any changes should be measured and deliberate, given the fast-changing response from central banks and the threat of stickier inflation. The key risk for fixed income is that interest rates fail to sufficiently slow economic growth and inflation.

For corporates, many firms are using free cash flow to fund capital expenditures, not debt, and service-oriented firms are less reliant on debt financing than industrials. At the consumer level, most mortgages have locked in lower rates and while we are seeing signs of slowing housing activity, the risk of a collapse is relatively contained. In this sense, government bonds are in an odd spot. On the one hand, the global macro environment is widely uncertain with a range of outcomes. The domestic economy is challenged with slowing growth and persistent inflation that has the potential to reduce aggregate demand. To complicate matters, central banks have been late to make decisions to address inflation that could ultimately lead them to a tough bridge—balancing between a hard and soft landing. Further, given the delicate nature of both the domestic and global economy, long-term sovereign bonds seem appropriate to hedge against risks, whether that is aggressive central bank action, a weakening of demand, or both.

International Equities—Review

Global equity markets continue their march higher through the month as a 3% increase in the MSCI World Index in AUD took place. The German equity market continues to perform with a 4.2% increase in March in AUD. The S&P 500 rose 3%, in line with the World Index, although this was not driven by the Nasdaq, which only increased 1%, again in AUD.

On the quarter, the S&P 500 (15.6%) was the top performer, followed closely by Europe (15.35%). Emerging markets (7.1%) continue to lag developed markets.

International Equities—Outlook

It's important to note that our conviction for the US equity market remains at a medium overall conviction—which implies a balanced approach is warranted. The scores across two key pillars—absolute valuation and relative valuation—have improved moderately, while scores for contrarian indicators and fundamental risk remained unchanged. This is not to say that we consider US equities to be an outright bargain—we don't. But our process tells us that the situation has moderately improved, which is reflected in our conviction.

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At a deeper level, valuation spreads—the disparity in valuation levels between sectors—is where we see opportunity. In 2020-21, we identified opportunities clustered in more cyclical (or economically sensitive) areas of the market. Specifically, regarding energy stocks: Our valuation approach incorporates a mean-reversion framework for energy prices longer term, which leads us to conclude that energy producers in particular have become more fully valued. However, we acknowledge that a prolonged period of structurally higher commodity prices has not been fully priced into these shares and also that companies have shown fairly strong capital discipline even as pricing has firmed, which is a significant, positive departure from previous cycles. Energy infrastructure shares remain relatively appealing within the energy sector.

On financials, our research leads us to believe that large US banks are still relatively attractive, though not without risk. The last area on our radar is defensive sectors, most notably healthcare, which have improved in our relative rankings and could help offset equity risk as it is not highly correlated with economic cycles. Regarding technology stocks, we don't assess these stocks with a broad brush, though we are wary of the potential for a crowding situation in the sector, which, in aggregate, has been overearning relative to its own history (meaning, profit margins recently have been elevated versus long-term averages). So, care is required in this space, especially with interest-rate rises and valuation, and there have been multiple implications from those increases.

We have recently updated our work on the communication services sector in the US. Despite excellent share returns—most notably, Meta—our updated work suggests that while not as compelling as was the case at year-end 2022, valuations in the sector are still reasonable on an absolute basis and, when compared with other equity asset classes (particularly those in more growth-oriented sectors), they are relatively appealing.

Performance refers to the period ended March 31, 2024, unless otherwise stated.

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