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Economic Update: New Zealand
June 2023

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Summary

- Core inflation and headline inflation pressures are easing, but the former is glacial in pace and central banks are becoming more concerned that elevated inflation could be embedded in pricing behaviour.
- Fixed-income markets are gravitating towards central banks keeping interest rates higher for longer, though they still expect some modest relief in 2024.
- Equities have performed well, in part buoyed by economic resilience, artificial intelligence prospects, receding headline inflation, and liquidity.
- Weaker global growth looks set to extend into 2024, the sacrificial pawn to containing inflation. With liquidity set to tighten, equities buoyancy will be reliant on an anticipated recovery in earnings, which is at odds with growth prospects and productivity trends.
- The stickiness of core inflation and uncertainty over a soft or hard landing for regions and the global economy point to diversification in asset allocation.

New Zealand Cash and Fixed Interest—Review

The Reserve Bank of New Zealand appears comfortable it has raised the official cash rate sufficiently to return inflation to within its 1%-3% per year target range with a 25-basis-point hike in June flagged as potentially the last.

Ninety bank bill yields have stabilised around 5.7%, and New Zealand's 10-year bond yield has moved to the top of its recent 4.0%-4.5% trading range, taking leads from offshore. Inversion of the yield curve remains a feature, with the two-year bond trading approximately 50 basis points above the 10-year bond.

The New Zealand dollar underperformed following the RBNZ's move to an on-hold stance but has subsequently recovered to be around 0.62 versus the United States dollar. The New Zealand dollar has underperformed the Australian dollar, with the on-hold stance from the RBNZ differing from the Reserve Bank of Australia raising rates.

New Zealand Cash and Fixed Interest—Outlook

With headline inflation receding, two-year-ahead inflation expectations easing to 2.8% from 3.3%, data showing two consecutive quarterly declines in gross domestic product, and monetary policy working with lags, monetary policy has moved to watch and wait mode.

The RBNZ is flagging interest rates "remaining at a restrictive level for some time." However, financial markets are anticipating almost 100 basis points of interest rates easing over 2024. This is greater than rate reductions anticipated by the US Federal Reserve for the federal-funds rate.

Fiscal policy has been identified by the RBNZ as an inflationary risk. The International Monetary Fund noted in its Article IV Mission on New Zealand that persistently high inflation and wage growth could compel the RBNZ to lift the OCR even more, or keep it higher for longer, "especially if fiscal policy does not consolidate as planned."

Both the ANZ and Westpac Economics teams anticipate the RBNZ will resume tightening, putting weight on fiscal policy not turning restrictive and strength in the labour market.

Forecasts across various banks (economists) have New Zealand's 10-year government-bond stable to easing over 2023 and 2024. Westpac is projecting 4.1% by year-end and 3.7% by the end of 2024. Forecasts are heavily dictated by the US equivalent bond.

Projections for the New Zealand dollar versus the United States dollar across the banks is generally higher. This reflects what appears a general consensus the NZD/USD is slightly below fair value and will be dragged higher as the USD returns to notions of fair value.

New Zealand needs a low currency and high interest-rate mix to monetary conditions given external imbalances. This required mix does not really feature in economist expectations.

Standard & Poor's Global Ratings remains concerned over New Zealand's external imbalances, recently warning that New Zealand's near-record trade deficit remains the country's "key credit risk." "A combination of higher fiscal and current account deficits, if they were to eventuate, could lead to downward pressure on New Zealand's 'AA+' foreign-currency rating."

New Zealand Property—Review

The listed property sector declined slightly in May (down 0.7%) coming in slightly ahead of the broader NZX 50 (gross).

Reported results for the listed property vehicles were largely in line with expectations. Key themes included strong tenant demand, but higher interest costs and noncore assets are being divested to strengthen balance sheets. Bank nonperforming loans for commercial property remain low at 0.3% of total commercial property loans ($139 million nonperforming versus $43.6 billion of loans).

New Zealand Property—Outlook

With the peak in interest rates potentially locked in or around the corner, signs the residential property market has bottomed, some encouragement can be taken that the commercial property market's adjustment, which has been mild, could be within reach.

Colliers New Zealand June 2023 Research Report notes, "While the Reserve Bank has signalled the peak in interest rates, further upward adjustments to property yields may occur over the next few months. This is a result of property valuations lagging the movement in interest rates due to sufficient numbers of

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sales taking place as well as reporting lags and therefore it takes time for the full extent of changes to crystalise. While, for many sectors, the risk premium between property yields and fixed interest-rate alternatives sit at below longer-term norms, much of the adjustment has seemingly been made indicating that under current expectations of the peak in the OCR, peak yields are not far away."

With the economy now clearly in an underperformance period, tenant risk is expected to become more of an issue, shifting rent negotiating power.

Segmentation and quality remain key themes with rental growth apparent within the prime grade subsector of the office market, driven by increased demand for high-quality office spaces to encourage employees back into the workplace. Conversely, the secondary office sector faces further downward rental pressure as vacancy rates increase. Industrial remains solid. Malls and large format centres are experiencing mild rental increases while strip retail assets face challenges, experiencing weaker demand.

The listed property sector is trading at a 26% discount to its net tangible assets according to Forsyth Barr research, which suggests a further 100-basis-point rise in cap rates.

Australian and International Property—Review

The S&P/ASX 200 A-REITs Index has given up gains reported last month. The year-to-date rise is now 0.5%, down from 6.4% last month with rising interest rates a headwind. The index is down 1.5% for the month to date, though up 2.3% on the year prior.

The FTSE EPRA-NAREIT Global Index in US dollars (total return) for the year to date is 1.7%, largely unchanged on the year prior. Europe has underperformed, down 1.5% for the year to date and 15.1% on the year prior.

Australian and International Property—Outlook

"Economic uncertainty remains high for commercial real estate through the rest of 2023," according to JPMorgan's 2023 Midyear Commercial Real Estate Outlook.

This uncertainty stems from many factors. Top of mind remains the outlook for interest rates with a peak likely in, but the experience of the Bank of Canada, which resumed its tightening cycle on concerns inflation could get stuck materially above the 2% target, is that the peak in interest rates might not yet be in.

With many central banks now pausing tightening cycles, they are entering that delicate judgment zone, hoping the lagged impact of previous tightenings are sufficient to return inflation to target. Meanwhile, the European Central Bank and Bank of England continue to lift rates.

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While the peak in interest rates might have arrived within some countries, refinancing challenges and the lagged impact of higher interest rates are yet to fully hit, and the economic outlook will have a major say over tenant demand and rent prospects. The commercial property sector faces challenges as interest-rate rises appear frequently across commentators.[1]

The future of office space is another uncertainty. JPMorgan notes some positives, including "Multifamily and industrial continue to perform well, and the industry may have underestimated the strength of neighbourhood retail."

Funding remains an issue. This was illustrated within CBRE's Australian commercial real estate lenders survey for the first half of 2023, which noted a moderate decrease in lending appetite since our second half of 2022 survey. However, 32% still want to grow their book, industrial remains a favoured asset class, and there are prospects for wider credit margins of approximately 20 basis points over the next three months.

Global Infrastructure—Review

The S&P Global Infrastructure Index in US dollars is up 1.5% for the year to date and 0.7% on a year ago. The index has had a solid June rising 2.5% so far.

The MSCI World Core Infrastructure Index (USD) net index reported a negative 3.3% return for the year to date (as at end of May). The dividend yield sits above the MSCI World Index (3.7% versus 2.1%). The infrastructure index has underperformed the MSCI World Index for the five months ended May (negative 3.3% versus positive 8.5%), and year on year (negative 11.7% versus positive 2.1%).

Global Infrastructure—Outlook

Underinvestment in infrastructure remains a global theme, and this was illustrated locally in the 2023 budget in New Zealand. The Infrastructure Commission assesses that New Zealand has a public infrastructure deficit of approximately $104 billion (against a $400 billion economy), which in the author's mind is conservative.

KPMG's 2023 Global Construction Survey noted "The Australian Government is undertaking an independent review of its 10-year $120 billion infrastructure pipeline under the Infrastructure Investment Program. For context, 10 years ago there were about 146 projects under this pipeline, and today there are 738."[2]

GI Hub estimates a $15 trillion investment global gap, with $94 of investment needed versus $79 trillion current investment trend.[3]

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1 Kehnscherper, L., & Sidders, J. 2023. "Europe's Commercial Property Slide Is Catching Up to UK Rout." Bloomberg News. https://www.bnnbloomberg.ca/europe-s-commercial-property-slide-is-catching-up-to-uk-rout-1.1931991

2 KPMG. 2023. "2023 Global Construction Survey." https://kpmg.com/au/en/home/insights/2023/06/global-construction-survey-trends-2023.html

3 https://outlook.gihub.org/. GI Hub is a not-for-profit organisation formed by the G20 that advances the delivery of sustainable, resilient, and inclusive infrastructure.

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So, the demand and need are obvious.

Beyond demand, the attraction of infrastructure stems from stability in cash flows, less cyclicality or defensive characteristics, and inflation protection. GI Hub also notes that "Infrastructure sits at the nexus of all we want to achieve, and we often refer to it as the backbone of our economies and communities."

Despite the obvious attractions, challenges remain. Higher interest rates have lifted hurdle investment rates. Government balance sheets across the OECD are becoming progressively more stretched, meaning alternate private and public sector partnership models are needed. Rapidly increasing labour costs, high inflation, and longer waiting times for equipment and material mean successful project delivery faces significant challenges.

Like many industries, infrastructure will need to embrace robotics, AI, and data analytics to improve productivity and supply-side capacity to meet demand.

Australasian Equities—Review

The S&P/NZX 50 gross index is up 0.6% for the year to date, though it is down 1.7% in the month of May 2023. The one-year return is 6.2%.

The S&P/ASX 200 Index is up 1.9% for the year to date, and 8.7% on a year ago. May was a tough month, with Australian equities falling on global growth factors (China) as well as a hawkish turn (hike) by the RBA. The ASX 200 Index was down 2.5% for the month. IT outperformed (following global trends) and consumer discretionary underperformed. Valuations are in line with historical averages. June has seen the S&P/ASX 200 Index lift slightly (to date).

Australasian Equities—Outlook

According to the IMF's recent Article IV Mission on New Zealand, "The [NZ] economy is expected to continue slowing as monetary tightening takes hold." The economist fraternity is projecting the same. The latest data shows two successive quarters of decline in GDP, though some one-offs can account for some of that, and annual growth at 2.2% provides a clearer picture. "Risks to the outlook stem from the external environment and a potential need for stronger tightening of monetary and financial conditions."

The IMF said that if the government did not tighten its purse strings as planned, and the RBNZ had to keep raising the OCR, the impact on growth, household consumption, and house prices could be "significant." Put simply, risks of a hard landing for the economy are real.

Recent new dwelling consent figures point to a further moderation in construction activity, though strength in migration (net inflows equivalent to 1.4% of the population) offer hope of a rebound and house prices have started to stabilise after falling in the preceding 18 months.

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Company tax revenue is progressively undershooting expectations, coming in 6% below prior-year levels in the 10 months ended April 2023 driven by lower terminal and provisional tax. This points to growing challenges on the earnings front as would be expected given the combination of slower growth, high costs, labour shortages, and higher borrowing costs. Listed companies, with more scale, have proved somewhat resilient.

According to Standard & Poor's estimates, the trailing P/E of the S&P/NZX 50 is 25.6 (last month 23.2), and the forward P/E is 22.7 with an indicated dividend yield of 3.3%. Valuations remain well above average.

The Australian economy is slowing, but not of sufficient magnitude to deter the RBA from raising interest rates and signalling a preparedness to do more. Growth in the Australian economy has eased, and pressures on the labour market have moderated slightly, with the unemployment rate rising to 3.6%. However, employment surged in May (76,000 versus expectations of a 17,500 rise), reinforcing that wage growth risks are to the upside.

The RBA is attuned to the damage associated with inflation and risks that higher inflation expectations and a prolonged period of elevated inflation may become entrenched in price-setting behaviour. Of note was that the June decision statement omitted a key line that "Medium-term inflation expectations remain well anchored …" The inflation pressure from the housing market as well as higher wages are expected to keep core rates of inflation above target for some time. Hence, the need for higher interest rates, which means a deeper economic adjustment on the other side.

Economists have been lifting their forecasts for the RBA's cash rate. National Australia Bank economists lifted their peak RBA cash rate forecast to 4.6%. Goldman Sachs and Capital Economics are projecting 4.85%. Higher rates mean less growth, particularly from interest-sensitive sectors.

The economy grew by an anaemic 0.2% in the March quarter 2023, a material slowing on the 0.6% gain in the December quarter. Annual growth is now 2.3% and struggling to outpace population growth. Growth projections for the Australian economy remain positive, though largely population-driven, with migration providing a big boost. Productivity growth remains subdued, and unit labour costs are rising.

According to the RBA, "The Board is still seeking to keep the economy on an even keel as inflation returns to the 2%-3% target range, but the path to achieving a soft landing remains a narrow one." If so, the risks of a hard landing are nontrivial, and that signifies risks to earnings.

Over the past year, the RBA's Index of Commodity prices has decreased by 22.2% in SDR (special drawing rights or international reserve asset) terms and decreased by 17.5% in Australian dollar terms. That recoil is coming from elevated levels, though it still shows a rapid reversal and another earnings risk to a commodity-dependent nation.

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A slowing economy has encouraged China's central bank to cut interest rates, with industrial production, retail sales, and fixed-asset investment data undershooting expectations. While potentially helpful for nations such as Australia with material China trade linkages, concerns remain over high debt levels in China and worries about financial stability.

According to Standard & Poor's estimates, the trailing P/E of the S&P/ASX 200 Index is 14.2, and the forward P/E is 14.3 with a dividend yield of 4.8%, valuations in line with averages.

International Fixed Interest—Review

Global bonds yields have generally nudged higher, led by the bellwether US 10-year bond.

Markets remain attuned to growth and US banking risks. This has served to cap the upside of long-dated bond movements, with the US Fed striking a balancing act noting in June "The US banking system is sound and resilient. Tighter credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation. The extent of these effects remains uncertain."

A resumption of the tightening cycle by the Bank of Canada, and hawkish overtures by the US Fed and RBA, have helped push short-term rates higher and more inversion of yield curves. Central banks are wary of how long it is taking core inflation pressures to subside. US core inflation has now been above 5% since the start of 2022, though at 5.3% it is down from its 6.6% peak.

The S&P Global Developed Sovereign Bond Index has delivered a year-to-date return of 1.9%, though a negative 0.6% return over the year. Bond returns are down slightly in June.

International Fixed Interest—Outlook

Are we there yet? That is the question markets continue to ask of central banks in their taming inflation/higher interest-rate crusade. The answer is maybe for some central banks (RBNZ) and no for others (Bank of England). The European Central Bank recently lifted interest rates by another fourth of a point, with President Christine Lagarde describing a further hike in July as "very likely." High wage settlements are now replacing energy as the biggest threat to Europe's inflation outlook.

Central banks that paused raising rates (Bank of Canada, RBA) have had to resume tightening cycles. The US Fed paused in June but left the door open to resuming the tightening cycle, lifting the median rate forecast to 5.6% in 2023. The forecasts imply that officials expect two additional 0.25-point rate hikes before the end of the year. The inflation fight is not over.

The script is the same. The Bank of Canada noted "concerns have increased that CPI inflation could get stuck materially above the 2% target." The RBA said, "Recent data indicate that the upside risks to the inflation outlook have increased, and the Board has responded to this." Chairman Powell from the US Fed pointed out that there had not been a lot of progress when it came to core inflation. Labour markets

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are showing extraordinary resilience: "Inflation pressures continue to run high and the process of getting inflation back down to 2% has a long way to go."

The IMF recently encouraged the US Fed and other global central banks to "stay the course" on monetary policy and remain vigilant in combating inflation.

The past month has also been notable for the pushing out of expectations that lower rates could be around the corner and markets embracing the central bank's view. Last month we noted a disconnect between what markets thought would happen with interest rates and what central banks were saying. A month ago, the market was saying the federal-funds rate could be lowered 120 basis points over the coming 12 months. That has now been reined in to 60 basis points.

There are some encouraging signs on the inflation front, particularly when it comes to goods inflation, with pricing pressure dissipating as global supply chain pressures ease. However, service sector inflation is still very high around the globe and proving to be persistent. Unit labour costs globally are on the rise. US core inflation is receding, but at a glacial pace, and at 5.3% it remains more than 150% above target.

Meanwhile, global growth, while slowing, is reasonable, consistent with the fabled soft landing. Sticky inflation, prospects for higher interest rates, or rates remaining higher for longer do not eliminate the path to a soft landing, but they do make it more difficult to engineer. The enemy of bonds has always been inflation, and central banks are firm in their disinflationary rhetoric and following it up with action. This adds to the attraction of long-dated bonds in portfolios.

One area to watch over the second half of 2023 is Treasury Bill issuance, as the US government rebuilds cash in the Treasury General Account. With the Fed continuing with quantitative tightening, and the European Central Bank and Bank of England following suit, bonds could see some temporary gestation issues.

International Equities—Review

Equity returns have been strong in 2023, and returns have generally turned positive year-on-year across markets. Key influences have been a better-performing global economy and some narrow strength with a few names across the technology sector, with enthusiasm around AI. While AI is getting attention, market strength has recently broadened beyond the tech mega-cap industry.

Divergences were notable in May, though, with the MSCI All Country World Index dropping by 1.3% on the month. Developed markets (down 0.1%) outperformed emerging ones (down 1.0%), which were weighed down by China. Japan's TOPIX rose to a 33-year high by gaining another 3.6% in May.

International Equities—Outlook

Can the market remain resilient? The S&P 500 officially entered a bull market mid-month.

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Certainly, some factors, such as prospects for AI, could drive a new wave of investment and select opportunities. Global growth has surprised in 2023, despite some regions such as Europe entering a recession. Better growth has been against a backdrop of low investor sentiment; positioning was wrong for positive surprises. Liquidity remained supportive, with the Bank of Japan continuing to expand its balance sheet and central banks aiding banks following the collapse of Silicon Valley Bank and follow-on ructions to avert financial stability problems. Equities have remained somewhat immune to a gradual repricing of central bank actions and a higher-for-longer interest-rate narrative.

Morgan Stanley's Global Strategy Mid-Year Outlook was aptly titled "Crunch Time" and possibly signals a turning point (if correct). Others are more sanguine on prospects.

More resilient growth in 2023 is now being offset by prospects of lower growth in 2024, with commodity prices, bank lending conditions, and the yield curve all pointing to another year of subdued growth. The World Bank lifted growth forecasts for 2023 to 2.1% from 1.7% but cut its 2024 global growth forecast to 2.4% from 2.7% in its latest Global Economic Prospects report. Central bank monetary tightening and increasingly restrictive credit conditions were key factors in the cut. World Bank chief economist Indermit Gill said 2023 would still mark one of the slowest growth years for advanced economies in the past five decades, but the real story was one of successive years of subdued growth.

Sticky inflation and rates remaining higher for longer bring into play an L-shaped cycle. With inflation persistent, global unemployment rates low, real interest rates barely positive in some jurisdictions and still negative in many countries, fiscal and monetary policy facing coordination challenges, and liquidity set to be withdrawn by central banks, this is not a set of circumstances pointing to a conventional V- or U-shaped cycle. The levels of activity matter just as much as the change in activity. Liquidity pumped up the level, and it will take time for liquidity to be withdrawn.

Upside economic surprises are now becoming less common and downside surprises more common. Commodity prices point to weaker growth. Oil prices are a case in point, with reduced prospects for supply from some nations failing to materially affect prices.

With markets now embracing higher-for-longer interest rates, two key factors to watch over the coming months are liquidity and earnings.

The US Fed continues to reduce liquidity via its quantitative tightening program of $95 billion per month. Morgan Stanley expects a large (more than USD 1 trillion) increase in US T-Bill issuance over the months following debt-ceiling resolution. Liquidity is set to tighten in Europe, with a EUR 480 billion targeted longer-term refinancing operation repayment due in June. QT starts the following month.

Corporate earnings are projected to fall around 6% in the June quarter according to FactSet. Containing inflation involves an inevitable contraction in margins. Earnings are, however, expected to turn around in the second half of the year, increasing 8% in the fourth quarter. This would be the highest year-over-year

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earnings growth rate reported since since the first quarter of 2022. Leading that rebound expectation are communication services, utilities, consumer discretionary, information technology, and financials. Stripping out communication services and IT decreases the rebound to 3.9% from 8.2%.

The consensus is the worst of the earnings recession is largely behind us, at a time core inflation remains above 5% and bond markets are erring towards rates being higher for longer. Hence "crunch time," and Morgan Stanley projects a deeper earnings recession in 2023 of a 16% decline, followed by a strong earnings rebound in 2024-25, conditioned on a more accommodative policy in 2024.

Economic and specific conditions have somewhat supported surprisingly resilient equity markets. Fixed-income markets have moved towards central banks' view of inflation. Equity markets do not appear to share the same view, and whether there are real reasons for that dichotomy remains open to debate. M

Performance periods unless otherwise stated generally refer to periods ended Friday, 16 June 2023.

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