# Economic Update: New Zealand
September 2024

**Morningstar Research**
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## Summary


- New Zealand cash and fixed-interest markets saw a larger rate cut predicated on persistent economic weakness.
- New Zealand property still faces challenges from higher vacancy rates, but declining interest rates are a tailwind.
- Australian and international property were strong, as easing cycles changed perspectives on the sensitive sector.
- Global infrastructure outperformed equity markets on stimulus in China and the US.
- Australian equities rose; however, global and emerging markets are still preferred.
- New Zealand equities were weaker despite expansionary action.
- International fixed interest gained as lower yields prevailed.
- International equities had a stronger month, with mega-caps regaining momentum, but caution prevails.


### New Zealand Cash and Fixed Interest—Review

The Reserve Bank of New Zealand (RBNZ) has continued to lower the official cash rate (OCR) following up the first 25-basis-point move in August, with a 50-basis-point move in October. A weak economy is opening spare capacity, encouraging price and wage-setting to adjust to a low-inflation environment and toward the 2% midpoint of the inflation target band. Monetary policy remains in a restrictive policy stance, but progress in lowering inflation allows a larger step toward a more neutral policy setting.

Markets are of the view that another 50-basis-point move will be delivered before year-end. Monetary policy committee members are more confident "that inflation is converging to target," which fuels market expectations.

Longer-term fixed-income yields are 120-130 basis points below levels seen 12 months ago, delivering strong fixed-income returns. However, yields have retraced from their recent lows as markets have reassessed the magnitude of central bank easing cycles, and the bellwether US fixed-income yields have risen, giving direction for the New Zealand market to follow. New Zealand yields continue to compress with US equivalents, given the divergent trajectories for the two economies.

A period of NZD/USD strength over September and early October has been replaced by weakness, with the data challenging the narrative. The US Federal Reserve can continue with large (50-basis-point moves), whereas a weak economy has allowed the RBNZ to increase the size of OCR moves, putting the New Zealand dollar back down on a declining trajectory. More broadly, the New Zealand dollar has not really stepped too far away from a 0.59-0.63 trading range in the past year.

**New Zealand Cash and Fixed Interest—Outlook**

A weak economy and further signs of disinflation continue to pave the way for the OCR to move lower toward a terminal rate of around 3%, which is a rate the RBNZ believes is broadly consistent with 2% inflation and a neutral policy setting. Economic weakness has brought domestic price-setting behavior more into line with the RBNZ's inflation remit.

A quicker return to more-neutral policy settings is anticipated.

The RBNZ Survey of Expectations projects the OCR will be 3.2% in 10 years, which is broadly consistent with the market expectations, and 3.0% is providing an endpoint anchor for the easing cycle.

With the economy weak, unemployment expected to rise further, and the RBNZ Monetary Policy Committee expressing more confidence toward inflation outcomes, financial markets will continue to push for large (50 basis point) OCR reductions in the near term, which is a favorable backdrop for fixed-income markets.

Westpac and ANZ economist year-end projections for the New Zealand 10-year bond in both 2025 and 2026 are not dissimilar for current levels, which fits with the notion that long-term bond yields are not too far away from fair value. The RBNZ Survey of Expectations anticipates New Zealand's 10-year bond yield around 4% in a year's time. The recent rise in New Zealand's long-term yields following the US 10-year bond direction has pushed yields more toward the upper perception of fair value, assuming a neutral OCR of 3.0%-3.5% and a modest-term premium of 50-100 basis points.

Projections for the New Zealand dollar are bifurcated. There is stability, with mild upward bias potential for the NZD/USD over an 18-month horizon, with both the RBNZ and US Fed undertaking easing cycles. Continued strength in the US economy, which has remained more robust than the New Zealand economy, has recently challenged a firmer NZD/USD narrative, and while the NZD/USD has found itself still in the 0.59-0.63 range, it's headed lower of late.

Projections are lower for the NZD/AUD as the interest-rate differential narrows, with the New Zealand economy in a weaker position. Projected declines in New Zealand's current account deficit, which is currently 6.7% of the gross domestic product and unchanged in the previous quarter, have been slower than expected, considering the extent of weakness in the domestic economy. A sustained period of undervaluation for the New Zealand dollar is required.

**New Zealand Property—Review**

Following strength over July and August, outperforming the broader market, and buoyed by lower interest rates, the listed property sector gave up gains over September, falling 4.4%. October has seen a positive return, and this will be likely accentuated by the recent lowering of the OCR by 50 basis points.

The S&P/NZX All Real Estate Index is down to around 4% year to date, reflecting tough trading conditions over April, May, and June, partly offset by the strength over the first two months of the third quarter and now has a falling interest-rate tailwind.

**New Zealand Property—Outlook**

Two key influences on the market are falling interest rates and a weak economic backdrop. This increases vacancy rates and dampens rental growth. The latter has been a necessary precursor to the former.

With an interest-rate easing cycle underway, and expectations the OCR will fall to around 3% and the yield on a New Zealand 10-year bond down around 120-130 basis points from its peak, some key headlines for the sector remain favorable. The 10-year bond yield tends to be the preferred interest-rate gauge for the property.

The degree of favorability is tempered by a challenging occupancy and rental environment, though many forward indicators are signaling the New Zealand economy has reached an inflection point, and momentum is slowly building. With the economy opening a negative output gap of around 2 percentage points, considerable excess capacity exists across the economy, and it could take many years to absorb. This suggests it will take time for material rental growth to return, and we are likely to see rising vacancy rates with tenant quality key.

While interest rates have fallen, commercial gross yields compared with long bond rates are still lower than those after the global financial crisis average, although this is largely in line with a longer sample, including before the crisis. This creates some uncertainty whether gross yields have yet adjusted sufficiently and can follow interest rates materially lower in the near term.

Business encouragement for staff to return to the office continues to influence the prime-grade office demand, with an emphasis on quality premises. The retailing environment remains challenging, given the economic backdrop, resulting in higher vacancy rates. However, both the New Zealand Institute of Economic Research's Quarterly Survey of Business Opinion and ANZ Business Outlook Survey have seen a material rise in activity outlook expectations. Industrial vacancy rates are rising, albeit from very low levels, with weak activity and excess capacity flowing into rising sublease options.

History, such as during and after the global financial crisis, suggests the economic environment will have a larger impact on vacancy rates and rental growth in the secondary market than prime. Forsyth Barr Research (Real Estate Reflections–Snakes and Ladders) notes that:

- "Listed company portfolios are generally made up of higher-quality assets leased to strong tenants."
- "A lot of A-grading of portfolios was undertaken by listed property companies after prior economic cycles, and as a result, portfolio fundamentals have thus far remained strong."

- "Occupancy has held up better this time around, compared to 2008 and the years following, with large vacancy numbers yet to impact listed portfolios."

Hence, fundamentals look better. Bank nonperforming loans for commercial property remain low at 1.0% of total commercial loans, down from a February peak of 1.2%, a sign of limited stress. It is notable that banks are not seeing stresses apparent during previous periods of economic weakness.

**Australian and International Property—Review**

The Australian REIT and global REIT markets rose strongly in September, with the S&P/ASX 200 A-REIT Total Return in Australian dollars finishing up at 3.25% and the FTSE EPRA Nareit Global REITs Total Return in US dollar finishing up at 6.58%. A high-level view of the asset class saw self-storage as the best-performing property type and shopping centers underperform. Micro-caps were the only market-cap segment to finish in the negative for the month. REIT markets appear to be undergoing a correction from a position of significant discounts to the net asset value. The AREIT market continues to suffer from high levels of concentration, with the Goodman Group accounting for almost 40% of assets in the market.

**Australian and International Property—Outlook**

Australian and international real estate remain dually exposed to economic conditions—both from a top-line rental growth perspective and 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. Australian and international REITs offer returns in line with equities, though they remain highly leveraged to interest-rate normalization as a key determinant of funding costs.

With debt-funding and construction costs elevated relative to recent history, investors need to be wary of trusts exhibiting highly leveraged balance sheets and/or large property-development exposure. Trusts with these characteristics have increased risks of dilutive- and discounted-equity increases that may permanently impair the principal value. Additionally, a compression of the opportunities across the regions suggests that greater care needs to be taken in active management within the asset class.

**Global Infrastructure—Review**

Global listed infrastructure was equally strong, returning 3.75% in September, as measured by the S&P Global Infrastructure Net Return in US dollars. The five years to date have seen the asset class barely outperform cash and substantially underperform equities. This was despite good performance during the bond-bear market of 2022, owing to built-in inflation-protection mechanisms. Strong returns for the month are tethered to the turn in the interest-rate cycle in the US, supportive of the communications and electric utilities subsectors that are particularly sensitive. Gas distribution stocks were also positive, following China's long-awaited announcement of economic stimulus measures.

**Global Infrastructure—Outlook**

As infrastructure is an income-focused asset class, we continue to see its outlook as being strongly influenced by the outlook for interest rates. We see utilities (a major component of listed infrastructure) as presenting reasonable relative value today, particularly when compared with more cyclical and higher growth areas of the market. We continue to 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**

Australia's equity-market proxy S&P/ASX 200 total return in the Australian dollar was strongly positive in September, outperforming global equities in local terms while finishing up at 2.97%. Broad-based reductions in forward earnings and flat-bond yields did not limit performance in the Australian market, with P/E valuations increasing. Energy and basic materials were weak, leading into the month. However, the announcement of economic stimulus drove a rotation out of financials and into resources in September.

New Zealand equity markets were weak in local terms, with the S&P/NZX 50 total return in the New Zealand dollar down 19 basis points for September. The RBNZ's decision to lower interest rates during the month failed to have an adverse effect on sentiment; however, Fisher & Paykel Healthcare Corporation Limited, which accounts for a large proportion of the concentrated market's assets, was stronger by more than 1%.

**Australasian Equities—Outlook**

**New Zealand**

New Zealand has experienced a deep and pronounced period of economic weakness, with the GDP per capita falling almost by 5%, and a rolling series of recessions over the past two years. This has been driven by high interest rates, and compounded by weak productivity, elevated costs, structural weaknesses, and an uncertain policy environment. This has made the settings for earnings difficult. Spark and Fletcher Building's recent results reinforced a negative economic tone and were representative of a weak earnings reporting season.

The conditions for an economic recovery are moving into place, and with it, there is hope we will see the earnings' low point. Importantly, inflation pressures continue to ease, and key cost pressures from areas such as the labor market are being damped as the unemployment rate rises and labor becomes easier to find.

While rising unemployment is suppressing consumption, lower inflation has allowed the beginning of a sustained interest-rate easing cycle, with the expectation that the OCR could return to a neutral level of around 3%. This has already appeared in forward indicators such as ANZ's Business Outlook Survey and the New Zealand Institute of Economic Research's Quarterly Survey of Business Opinion. There is rising confidence toward activity in the future, compared with the weakness experienced in the past.

The recent earnings reporting season also showed several cost-out programs being undertaken, a precursor to boosting productivity, which was noted by the Reserve Bank in their latest assessment as a restraining growth. Government initiatives are largely constructive as more discipline around spending is put in place. Fiscal policy is stimulatory over the coming year, courtesy of tax cuts, but restrictive overall, acting as an economic headwind. The recently announced fast-track approval process for 149 projects has the potential to accelerate growth but also specific sectors, including, housing, transport, infrastructure, aquaculture, mining, and renewable energy. A key beneficiary is also likely to be construction, with all projects requiring construction materials.

Migration inflows, as a key influence on overall population growth, remain supportive, with a net migration gain of 67,200 in the July 2024, year, equivalent to 1.3% of the population. This is well down from its peak of 136,700 in the October 2023 year. New Zealand's net migration rate of 13 per 1,000 in 2024, while down from 2023, remains high by international standards.

While many cyclical factors are either turning more favorable (interest rates, labor rates) or continue to be supportive overall (migration), the economy and economic backdrop face challenges. The recent NZ Herald Mood of the boardroom revealed considerable concern over energy, with rising energy prices and security of energy supply both top-tier issues. The extent of economic weakness and earnings downgrades has also flowed into the forward years, and the RBNZ's August projections showed a negative output gap throughout the three-year forecast period and cited weak productivity.

The OECD's 2022 Economic Survey of New Zealand drew attention to the "Weakness in management skills has prevented managers from recognising the return from digital take-up and identifying which digital technologies they should adopt" and "Management boards in New Zealand's firms are often more focused on preserving existing value and regulatory compliance than on growth strategies." The recent earnings reporting season was notable for positive (Fonterra) and negative surprises (Fletcher Building), and there is a rising scrutiny on management/board performance. This highlights the importance of microeconomic fundamentals in portfolio construction.

Prospects for lower interest rates will support an interest-sensitive market such as the NZX. An improving growth trajectory paves the way for stronger earnings, but the substance and quality around it will be determined by the productivity behind the growth.

**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 exist at a more granular level—especially for those willing to invest differently from 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**

Global bond markets were stronger, driven mainly by the easing monetary cycle in the US. The Fed decided to drop the target federal funds rate by 50 basis points as opposed to the traditional 25-basis-point notch. The bigger quantum of change served to reverse the inversion of the middle part of the yield curve. Currency appreciation versus the US dollar, which was common across most developed currencies, ravaged returns in the Australian dollar with asset-class proxy Bloomberg Global Aggregate Total Return in local terms returning negative 53 basis points.

**International Fixed Interest—Outlook**

Healthy government-bond yields are a positive for future-return generations, 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 have been adjusting our bond allocations higher at a moderate pace. The key risk for fixed income is that interest rates fail to sufficiently slow economic growth and inflation. If yields continue to shift upward, adding materially to duration might make sense, but any changes should be measured and deliberate, given the fast-changing response from central banks and the threat of stickier inflation.

With moderating yet robust economic growth in the US and an expectation of rate cuts in 2024, fundamentals for corporate bonds look strong. Markets, however, have already reflected this potential reality, with credit spreads across all maturities at tight levels relative to history. We believe macro-outcomes are still uncertain and thus see little additional compensation for the credit risk, particularly in US corporate bonds. Greater economic concerns in Europe and the UK see higher credit spreads in these regions. Unfortunately, these spreads are not enough to compensate for lower-base Treasury yields in each region, and their corporate bonds do not appear as attractive opportunities.

**International Equities—Review**

Global equities moved broadly higher in September, with China being a standout performer. Economic stimulus motivated the previously depressed regional indexes higher, with the CSI 300 and Hang Seng returning more than 15% each. These markets represent top performers in 2024, following the sharp recovery in September. In the US, the Nasdaq and S&P 500 expectedly moved upward based on the Fed's move to cut interest rates. Performance in the US also featured a recovery for mega-cap names following poorer showings in July and August. Again, the strength of the Australian dollar beleaguered returns in local terms, however, with the representative MSCI World Net Return in the Australian dollar generating negative 41 basis points.

**International Equities—Outlook**

It's important to note that our conviction for the US equity market has fallen to low/medium overall—which implies a cautious approach is warranted. The scores across two key "pillars"—absolute valuation and relative valuation—fell 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 danger—we don't. But our process tells us that the situation requires a careful eye, which is reflected in our conviction.

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 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.

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 of late have been elevated versus long-term averages). So, care is required in this space, especially with interest-rate rises and the valuation of 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 from Meta platforms—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), are relatively appealing.

All this to say—a long-term perspective remains a critical ingredient for investor success. This is perhaps even more relevant during periods of market volatility.

***Performance refers to the period ended Sep. 30, 2024, unless otherwise stated.***

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