Economic Update: New Zealand
October 2023

Morningstar Research
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Summary

- Higher-for-longer interest-rate policy settings from central banks have been accentuated by widening term premiums lifting longer-term interest rates.
- Interest rates are not high relative to their longer-term history, but the recent rise is the most significant increase over a three-year period since 1980.
- Growth and labor market conditions continue to support a soft landing.
- Given the material lift in interest rates of late, and lags between monetary policy and the real economy, late-cycle risks, including earnings, growth, and credit, have risen.
- These risks are being accentuated by geostrategic and geopolitical shifts. Some have been positive for U.S. growth, such as reshoring at the expense of China. However, recent Middle East tension and higher oil prices add additional complexity to the required disinflation process.
- While some risks have receded, the International Monetary Fund notes the balance of risks as being tilted toward the downside. This supports caution and diversification in portfolio allocation and construction.

New Zealand Cash and Fixed Interest—Review

The Reserve Bank of New Zealand retained the Official Cash Rate, or OCR, at 5.5% in October. Policy settings were noted as "constraining economic activity and reducing inflationary pressure as required", with the growth outlook "subdued."

While the policy stance was unchanged, it was noted that "interest rates may need to remain at a restrictive level for a more sustained period of time," a similar stance to other central banks.

Longer-term term interest rates have followed offshore direction, rising around 50 basis points, with the New Zealand 10-year bond rising to 5.5%.

The New Zealand dollar has been broadly stable over the past month at just below NZD 0.59 against the U.S. dollar at the time of writing and the 17-currency trade-weighted basket is just below 70 (index). Risk sentiment, central bank policy settings, and China are key drivers.

New Zealand Cash and Fixed Interest—Outlook

Markets continue to embrace higher for longer interest rates by pushing out expectations of lower interest rates in 2024, as opposed to anticipating further rises in the OCR.

In the near term, upside risks to demand from migration and fiscal policy could add to domestic demand and slow the expected pace of disinflation. This is somewhat countered by downside risks to global growth.

The annual rate of inflation undershot expectations in the September quarter (5.6% versus 6% expected), though domestic non-tradable inflation remained strong at 6.3%.

Market commentators and bank economists are split over whether the RBNZ will need to hike again (ANZ and Westpac are saying yes) and others taking more neutral views. Risks appear skewed toward a resumption in the tightening cycle despite the most recent inflation print.

Higher-for-longer is now manifesting in bond projections, which have risen in tandem with the rise in actual yields. Westpac has lifted its year-end 2024 projection for the New Zealand 10-year bond to 5.2%, roughly 1 percentage point higher than a few months ago. ANZ's projection has also risen, but more marginally from 4.75% to 5%. Uplifts appear to reflect, not only altered expectations for central bank policy rates, but increased term premiums for long-term yields.

With a new government being formed, and prospects for a mini-budget pre-Christmas, expect fiscal policy, updated government financial projections and debt issuance to receive attention.

Conviction toward a higher New Zealand dollar/U.S. dollar has waned. Early in 2023, the consensus was for a firmer New Zealand dollar/U.S. dollar above 0.65 over the coming years. Some firming is still expected but Westpac and ANZ economists are now picking the 0.60-0.65 zone over the next 18 months. The downgrade reflects expectations the U.S. dollar will remain elevated for longer. Prospects for a materially higher New Zealand dollar are also constrained by a wide current account deficit.

New Zealand Property—Review

The NZ listed property vehicle sector (S&P/NZX All Real Estate Gross) fell 3.2% in September, following a 6.6% decline in August, underperforming the NZX50, which was down 2.2%.

Higher interest rates are putting a focus on valuations, interest costs, and the potential for lower dividends.

The S&P/NZX All Real Estate Index is down 4.4% year to date and marginally so far in October. The index is down 3.4% on a year ago.

New Zealand Property—Outlook

Interest rates continue to pressure property sector valuations. The recent rise in the New Zealand 10-year yield to around 5.5% (+50 basis points over the month) has put downward pressure on the book value of property assets across LPVs and is a key force driving cap rates higher.

Forsyth Barr Research notes that "Historically asset cap rates have been around 300–400bps above long bond yields."[1] On this basis cap rates would need to adjust by a further 200-300 basis points to return to historical spreads, and one reason the sector is trading at a large discount to net tangible asset value.

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[1] Real Estate Reflections October 2023.

That historical average might be considered a top-end or worse case number, but any movement toward it requires price adjustments, some of which are already factored in. Whether it is sufficient continues to be debated.

Asset protection from rental growth appears more difficult to achieve with the economy remaining in an under-performance phase.

Sectors with greater perceived long-term upside such as healthcare and industrials are trading at narrower spreads to bond yields. A flight to quality and trading off themes such as sustainability and connectivity to transport remain key influences.

Given pressure on valuations it is not surprising to see transaction volumes low, and differing expectations between vendors and purchaser. CBRE's latest New Zealand Transaction Monitor notes that during H1 2023, the total value of commercial and industrial investment transactions reached $1,278 million across 59 sales in the three main centres. It was down by $374 million compared to the previous six months. Low sales volumes reflect below average levels of buy side liquidity compounded by the continued stickiness of a wide bid ask gap."

Bank non-performing loans for commercial property have risen to 0.5% of total loans, while up, this is still a low proportion of total loans. Access to credit, along with the pricing of it, is becoming more difficult, with commercial lending down 3.5% from a year ago.

Australian and International Property—Review

The S&P/ASX200 A-REITs Index is up 7.6% on a year ago, though down 1.1% this year to date. October has seen a small rise so far. September saw the index fall substantially.

The FTSE EPRA Nareit Global Real Estate Index in U.S. dollars (total return) has fallen 5.7% over the past month, and marginally over October. The index is down 4.9% this year to date, but is up 6% from a year ago. Weakness has been apparent over the past month across the Americas, Europe, Japan, and Asia-Pacific.

Australian and International Property—Outlook

Commercial property values continue to face pressure by rising interest rates, which have increased borrowing costs and the cost of capital, and placed upward pressure on cap rates.

Uncertainty remains a key theme, with rising interest rates restraining demand and forcing cap rates to rise and values to fall, coupled with higher inflation/construction costs, which restrain supply, and structural shifts in demand accentuated initially by the coronavirus pandemic but also wider trends including working from home, sustainability, and e-commerce.

According to one of Bloomberg's Markets Pulse surveys, the commercial real estate market faces at least another nine months of decline, and the office market is not expected to trough until the second half of 2024 or later.[2]

The RICS Global Commercial Property Monitor reported negative sentiment in the second quarter of 2023 and since then interest rates have continued to rise and credit availability tighten.

The IMF's latest assessment noted that "the real estate crisis could deepen further in China, an important risk for the global economy," and the economy needs to pivot away from a credit-driven real estate model of growth.

Within a challenging environment for a sector heavily linked to the trajectory for interest rates, segmentation and bifurcation continue to feature. Building quality and accessibility (transport), along with sustainability, is affecting returning-to-office work patterns. Industrial property and logistics in some countries remains attuned to structural shifts, including near-shoring, friend-shoring, and onshoring.

While the central scenario for the global economy remains for a soft landing, risks surrounding this have risen as interest rates have pushed higher and inflation proven to be stickier. Asset protection from rent growth is more difficult to achieve and there is greater tenant risk. Elevated construction costs and interest rates will also affect supply, which will eventually help restore balance to the market, which is currently skewed in favor of buyers. Questions remain as to whether the sector and valuations have fully adjusted to the higher interest-rate world.

Global Infrastructure—Review

The S&P Global Infrastructure Index in U.S. dollars is down slightly this month to date in October, and down 8% this year to date, though up 3.6% on last year.

The MSCI World Core Infrastructure Index (USD net index) underperformed broader indexes in September 2023 (down 5.3% versus down 4.3%). Infrastructure returns have been flat on a year ago according to this infrastructure measure, below double-digit returns seen across the MSCI World Index.

Global Infrastructure—Outlook

Infrastructure remains caught between cyclical headwinds and a combination of long-term challenges and opportunities. It is an asset class that appears to have a more balanced risk-return scorecard around it compared with others in a rising interest-rate and sticky inflation environment. However, it has struggled relative to broad equity indexes over the past year, the latter somewhat boosted by enthusiasm related to artificial intelligence.

[2] https://www.bloomberg.com/news/articles/2023-10-02/us-office-market-is-poised-for-a-crash-investors-say-in-survey

A higher cost of capital expressed by higher world global 10-year bond yields raises financing costs and hurdle rates for investment, including infrastructure. Inflation is adding to construction risk. For instance, in May the Australian government announced a review of the country's Infrastructure Investment Program, saying cost overruns mean some previously announced projects would not be able to be delivered. Some positive attributes of infrastructure, including strong cash flows and typically inflation-protected pricing, help to offset these challenges.

Governments are facing pressure on finances, and the IMF recently urged governments everywhere to focus on rebuilding fiscal buffers. Some nations such as the U.S. are receiving more attention over the trajectory for debt. That means constraining spending. The hope is that it takes place via slowing or reducing operating spending as opposed to capital spending.

Long-term needs are well documented. They include:

- The importance of infrastructure for a well-functioning economy and society.
- Addressing under-investment.
- New infrastructure to cover modern needs, including:
    - Climate change and a massive energy transition.
    - Urbanization, demographic shifts, cyber needs, and digitization.
    - The need to protect supply chains and make then more resilient in a fracturing global economy.

Security spending is rising as an investment theme, and critical infrastructure stocks could be beneficiaries.

Australasian Equities—Review

The S&P/NZX50 Index is down 5.0% this year to date, but up 0.6% on a year ago. September was another difficult month, following on the heels of weakness in August. Industrials outperformed in September while materials and consumer discretionary underperformed.

The S&P/ASX200 Index is up 0.3% this year to date and 5.9% on a year ago. The index is largely flat so far in October.

The ASX 200 fell in September, mirroring global movements, with small caps underperforming and 10 of 11 sectors declining, the exception being energy. Real estate, IT, and healthcare led the declines. While down, the ASX outperformed many global markets, partly due to having less IT influence.

Australasian Equities—Outlook

The NZ economy bounced back in the June quarter and while economic signals are mixed, underlying demand growth is expected to remain somber.

The economy is receiving a major boost from net migration, equivalent to 2.5 percentage points of the population in the past year. That is supporting views the economy will avoid a technical recession, though expectations for a per-capita or population-adjusted recession remain. The RBNZ expects to see further declines in per-capita spending and for gross domestic product growth to be subdued. New Zealand is expected to be one of the weakest performers around the globe over the coming year according to the IMF's projections for per-capita or population-adjusted growth. New Zealand also has one of the largest current account deficits across the world which requires a significant domestic spending adjustment and uplift in export performance.

A difficult environment for business profitability was affirmed in the 2022/23 Crown Financial Statements, which showed company tax down 10% compared with the year prior.

The election result delivered a new government with a clear shift to the right of the political spectrum, traditionally more business-friendly. Business confidence is likely to bounce in the near term, but ultimately policy substance will be required if that is to manifest in economic outcomes. With the government requiring capital to fund necessary investment, more partial listings of quasi-government or state-owned enterprises could occur over the coming years.

Producer price inflation has fallen below consumer inflation, which could help margins, though cost pressures continue to feature in earnings announcements.

Higher interest rates remain a key influence on the market due in part to market composition. While the New Zealand economy may avert a double-dip recession—and that is the central scenario—interest rates have a material impact on cyclical parts of the economy such as discretionary spending and LPVs.

Given Australia's sensitivity to the global economic cycle, caution appears prudent in a highly uncertain and fragmented world.

With interest rates in a higher-than-normal phase relative to recent history, and world growth in an underperformance stage, the backdrop is challenging, particularly when overlaid with specific risks, including China's economic trajectory, with ongoing stresses in the property market and geopolitical fragmentation.

The IMF has revised GDP growth for Australia in 2024 down from a projected 1.7% in April down to 1.2% in October. The IMF does not expect Australia to achieve annual growth greater than 2.3% out to 2028, a similar story to other nations also facing a lower trend rate of growth over the medium term and forewarning of the need for structural reform.

Countries that embrace structural reform could be re-rated, as improved microeconomic foundations not only lift growth, but they also help alleviate inflation from the bottom up (supply), thereby limiting damage from the top down and hits to demand required from higher interest rates.

Bank economists are projecting GDP growth in 2023 barely above 1%, and negative on a per-capita basis, with consumer spending at the epicenter of the slowdown as disposable income comes under pressure due to higher interest rates and elevated cost of living expenses. Discretionary spending sectors of the economy are already seeing the impact and that is expected to continue.

Population growth (up 2.4%, a 50-year high) continues to support headline growth and some sectors including construction, though interest rates act as an offset.

With the timing of interest-rate relief from central banks being pushed out more and more, including the RBA, and rising bond yields now a global headwind for stock prices given narrowing earnings/bond yield spreads, equities continue to face challenges.

Inflation may be past its peak in Australia but remains too high, with service sector inflation rising briskly and fuel prices increasing considerably of late. This does not suggest any potential for the RBA—like other central banks—to pivot any time soon. The most recent RBA Minutes noted a "low tolerance for a slower return of inflation to target than currently expected," putting another rate hike on the table.

Like many markets, it is not easy to identify a catalyst to drive the Australian market higher in the near term given inflation (cost), growth and interest rate headwinds, and an overlay of geopolitical risks.

International Fixed Interest—Review
Bond markets continue to embrace a higher-for-longer narrative.

The catalysts include tough-talking central banks, including the most recent U.S. Federal Reserve Minutes, which included a further interest-rate hike; central banks that continue to point to core inflation stickiness; inflation outcomes which support central bank concerns; and the tenor of data, particularly across labor markets. Recent rises in oil prices are adding to headline inflation pressure and risk becoming embedded in pricing behavior and shifting inflation expectations.

The higher-for-longer narrative is being accentuated across longer-term interest rates by a greater focus on fiscal positions, including bond supply and issuance.

The yield on a U.S. 10-year bond—a widely used benchmark for the global cost of capital or risk-free interest rate—has risen 50 basis points in the past month. Bond bulls can point to some turn in the tenor of data and positive inflation signs, but this is far from conclusive.

The Bloomberg Global-Aggregate Total Return Index (unhedged U.S. dollar) is down 2.7% for the year to date and up 3.2% on last year. The S&P Global Developed Sovereign Bond Index has delivered a year-to-date return of negative 0.6%. The return has been slightly positive over the year. Bond returns are down in October.

International Fixed Interest—Outlook

Fixed-income markets and commentators have moved from the level of peak interest rates, to how long policy needs to remain restrictive, with a higher-for-longer narrative dominating as inflation's potential persistence continues.

The impact of tighter monetary policy over the past 18 months has been somewhat offset by coronavirus-era stimulus overhang, including quantitative easing, and government spending tied to climate, building supply chain resilience, and infrastructure in the U.S., which has supported growth and worked against the conventional impact of monetary policy. Central banks such as the U.S. Fed continue to embrace higher-for-longer narratives via higher member Fed-funds rate dot plot projections, but also wary that monetary policy works with long lags.

The IMF's latest projections noted that, "With many countries near the peak of their tightening cycles, little additional tightening is warranted. However, easing prematurely would squander the gains achieved in the past 18 months. With tight labor markets, ample excess savings in some countries, and adverse energy price developments, inflation could become more entrenched, requiring even more forceful action from central banks."

The IMF is projecting real-long-term (10-year) interest rates averaging 1.3% from 2025 to 2028, slightly above the average of 1.2% from 2005-14, and well above the negative 0.7 average from 2015-24.[3] This serves to reinforce the real income derived from fixed-income investing in a higher-for-longer environment and structural shift in fixed-income market pricing.

Goldman Sachs Asset Management has a view that policy rates in the U.S., Eurozone, and United Kingdom have likely peaked, a view in line with financial markets, which are pricing in the possibility of higher rates from central banks, but not an overwhelming probability.

While there has been progress in the disinflation battle, the recent surge in oil prices has added another layer of challenge to the broad disinflation trend seen over 2023. Recent inflation figures in the U.S. have had both encouraging and warning signs, with the annual rate of core inflation heading in the right direction, cooling for the sixth month in a row, but super core inflation rose 0.5% in the month, a timely reminder of inflation's stickiness amid a continued tight labor market. Measures of inflation expectations will be closely watched given oil prices' near-term impact on inflation.

Inflation's persistence and the higher-for-longer narrative go some way to explain higher interest-rate settings. There are numerous other considerations adding to fixed-income premiums. These include larger fiscal deficits, particularly in the U.S., and concerns over debt issuance. Fiscal policy settings face intense spending pressures to address income inequalities and assist energy and digital transitions. The process of quantitative tightening has replaced quantitative easing, with the Bank of England to shrink its balance sheet by GBP 100 billion annually from October. Policy normalization is being eyed by the

[3] GDP weighted across Canada, France, Germany, Italy, Japan, the U.K., and the U.S.

Bank of Japan. Trade decoupling—which is becoming more apparent in U.S. and China trade figures—could have flow-on consequences for capital flows, and China's currency is facing pressure, which could lead to China selling U.S. Treasuries. China remains a focus for economic weakness, especially in real estate.

While recent months have been difficult months for bond investors, analysis from J.P. Morgan demonstrates that following the end of a U.S. Federal Reserve tightening cycle, "US Treasuries have delivered more consistently positive performance relative to their equity counterparts."[4] The path to lower rates tends to be higher rates.

International Equities—Review

September was a tough month for equities as prospects for higher-for-longer interest rates set in, and a sharp repricing in bond markets contributed to the same across equities, with the correlation between the two turning positive again in a similar fashion to 2022.

Caution has been accentuated by rising geopolitical and geostrategic tension, the latest being the situation in Israel and Gaza.

The MSCI World Index declined by 3.7% in September. Heavy-weighted IT names weighed on the NASDAQ and S&P 500. Europe markets also fell however the UK FTSE 100 recorded a rise. October has seen ongoing volatility.

International Equities—Outlook

The outlook for risk-based assets including equities is becoming more challenging.

Inflation and interest rates are front and center, and a sticky inflation dynamic has now become embedded in higher-for-longer interest-rate expectations. We have seen aggressive movements higher in bond yields before but the sequence of movements over the past three years is the highest movement in the US 10-year bond yield over three years since 1980. Interest rates, borrowing costs, and the cost of capital are not high in a historical sense, but the re-rating is nonetheless significant. A 4-percentage-point movement in three years is almost an unprecedented rise in a proxy for the risk-free interest rate.

The wider geopolitical situation is becoming more challenging, which adds to risk, and the CEO of J.P. Morgan recently described the situation as the most dangerous in decades. Security in trade is now trumping the economics of trade. Efficiency is being replaced by the need for supply chain resilience, which has helped boost growth in the U.S. in the near term at the expense of China as trade decoupling and reshoring takes place. The world is shifting from rules to power, characterized by rules more contested and relative power more influential in shaping international affairs and the global economy. The latest Middle East tension adds to the list of geopolitical and geostrategic hot spots.

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[4] Beyond the pause: What happens after peak rates?

The recent forecasts from the IMF noted "slow and uneven growth with growing global divergences," commodity prices could be more volatile under renewed geopolitical tension, and a "darker" medium term picture. With "slower growth, higher interest rates, and reduced fiscal space, structural reforms become key." Structural reform requires real political leadership and populism is widespread.

Some encouragement can be taken from:

- The growth outlook, which continues to be supported by robust labor market conditions and continued expectations of a soft landing according to the IMF's latest projections.
- Some signs of improving earnings growth with Factset noting the S&P 500 is reporting year-on-year earnings growth of 0.4% for the third quarter, the first quarter of positive growth since third-quarter 2022.
- Excitement around AI, although IT has underperformed of late. Tight labor markets will accelerate technology uptake.
- Earnings-revision momentum (a gauge of upward to downward changes to expected per-share earnings over the coming 12 months) has turned positive according to data prepared by Bloomberg Intelligence.[5]

Against this backdrop of encouragement, questions will remain how long companies can pass on price increases before demand is curbed sufficiently to affect pricing, with margins a key disinflation compression variable. The disinflation process requires also wage restraint and higher unemployment, which pressures the consumer. Questions surround whether central banks have yet done enough to sufficiently alter the price setting. This is where soft landing prospects face a reality test: Is the projected soft landing going to be sufficient to squeeze and alter pricing behavior?

Growth divergences including the U.S. surprising on the upside, and growing risks across real estate in China, highlight the need for diversification as an investment theme, and active strategies as opposed to passive. An encouraging aspect to recent market moves is that the narrow market that dominated in the first half of 2023, with seven stocks ruling the S&P 500, has broadened. This is healthy and conducive to stock-picking and identifying value opportunities.

Performance periods unless otherwise stated generally refer to periods ended Wednesday, Oct. 18, 2023.

[5] https://www.bloomberg.com/news/articles/2023-10-11/wall-street-is-marking-up-forecasts-as-profit-downturn-nears-end

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