Economic Update: New Zealand
January 2024

Morningstar Research
Jan. 18, 2023

Summary

- Markets continue to embrace moderating inflation trends, allowing scope for central banks to lower interest rates modestly while delivering a soft landing for the global economy. That sentiment is vulnerable to challenge.
- The onus will be on inflation outcomes to validate market expectations, with core inflation measures globally still elevated and slow to return to target.
- Growth in New Zealand is weak, and inflation pressures are receding, allowing scope of an eventual loosening of monetary policy. Timing remains uncertain.
- Election and political risk are expected to become more relevant internationally, with half the world's population and around 60 countries going to the polls in 2024.
- The diversion of sea traffic from the Red Sea to around the Cape of Good Hope is a reminder of geopolitical frictions, which have lifted freight rates, and represent another small "supply shock" on top of what is becoming repeating supply shocks.
- The path returning inflation to target still faces geopolitical challenges, and labor markets remain very tight adding to service inflation.
- There appear a wider than normal array of views over the macroeconomic outlook in 2024, which supports diversification in portfolios, and increasing attention to microeconomics such as business fundamentals and valuations.

New Zealand Cash and Fixed Interest—Review

Despite guarded nuances from the Reserve Bank of New Zealand toward interest rates falling, with the November 2023 Monetary Policy Statement having a hawkish tone, global sentiment that lower inflation globally will allow central banks to reduce interest rates has flowed into the New Zealand market.

A negative third quarter gross domestic product result in NZ late December reinforced expectations that the next move in the Official Cash Rate will be lower.

Bond direction continues to be dictated by offshore and the United States Treasury market. The yield on a NZ 10-year bond has settled in a 4.5%-5.0% range after hitting 5.6% in October 2023 and below 4.5% in December.

After rising in November, courtesy of U.S. dollar weakness, the NZ dollar has stabilized over December and January. The NZD on a trade-weighted basis has been broadly stable over the past month.

New Zealand Cash and Fixed Interest—Outlook

Market direction is being driven by offshore markets and the U.S. Expectations that the world's most influential central bank, the U.S. Federal Reserve, will lower the federal-funds rate 150 basis points in 2024, has carried into the NZ market.

Market pricing points to the RBNZ lowering the OCR by 150 basis points over the coming 18 months, around 50 basis points less than the Fed but still a reasonable easing in monetary policy conditions. This would still leave monetary policy and the OCR in a restrictive policy setting and above the neutral OCR. Thus, the market still has potentially further to go, though market expectations are already well ahead of economist views, front-running receding inflation projections, which are forecasts which carry uncertainty, not outcomes.

The consumer price inflation figures due late January will be influential, endorsing or challenging market views, with expectations that headline inflation will continue to recede. Attention will be on nontradable (domestic) inflation, which sits at 6.3%, and signs of impetus from housing-related inflation pressures given stimulus to the economy from strong migration inflows (equivalent to more than 2% of the population).

Projections for interest rates, including long-term yields such as the NZ 10-year bond, are lower, mirroring the U.S. Treasury market with disinflation and expectations of a modest central bank easing cycle the key drivers.

The NZD is expected to remain contained with a slight upward trend as 2024 progresses but shows a weaker bias against other currencies. With the current account 7.6% of gross domestic product, a continued period of currency weakness is likely to be needed. The NZD is not in that zone at present, and a weak current account position could challenge projections for a higher NZD. USD direction and China remain influential.

New Zealand Property—Review

The end of 2023 was a strong period for real estate stocks (and the NZX) with the S&P/NZX All Real Estate Index rising more than 7% in December 2023 and into positive territory over the calendar year as expectations firmed toward lower interest rates. The movement reinforced the interest-rate-sensitive nature of the NZ market. The year 2024 has seen a more cautious beginning, with the index down 1.3% for the year to date.

New Zealand Property—Outlook

With financial markets and commentators becoming more confident that lower interest rates are around the corner, and longer-term interest rates having already fallen, the outlook for the commercial property sector has improved.

Legacy issues, including the lagged effect of higher interest rates, continue to feature. Rent growth continues to ease, and a more competitive leasing market is appearing, reflecting slow economic growth. Continued cap rate expansion is expected in 2024, with cap rates lagging movements in interest rates over 2022 and 2023. CBRE is projecting double-digit commercial property returns, but not until 2026-27, and 2024 looks to be another year of negative capital returns driven by rising cap rates.

BNZ General Manager of Property Finance summed up the situation, noting you can't have the OCR go up by 500 basis points and not expect there to be an impact in terms of people's ability to service debt. "As a rule of thumb, the yield on a building should be 2% above the risk-free interest rate (a bank 12-month deposit or 10-year-bond).[1] The market has yet to converge to that rule of thumb.

A lack of sales activity in 2023 was indicative of a gap between vendors and purchasers. This gap is expected to close over 2024 as the lagged impact of higher interest rates forces more market activity. Nonperforming loans across the banking sector for commercial property loans have risen from 0.2% of all commercial loans to 0.7%. While vacancy rates in aggregate remain low, particularly for industrial property, a continued weak economic outlook could see vacancy rates rise, encouraging vendors to be more active.

A flight to quality has been a solid theme in 2023, with bifurcation of office space supporting prime rents at the expense of lower quality space. The same applies with demand for buildings with strong sustainability features and good transport connections. These themes are expected to continue. Strong population growth, which is currently being boosted by migration equivalent to more than 2% of the population, should support commercial property demand as well as residential housing over time.

Australian and International Property—Review

Real estate led the Australian market in December. It surged 11.3%, buoyed by lower interest-rate expectations, and recorded a double-digit gain over the calendar year. Some caution has prevailed so far in 2024, with the S&P/ASX 200 A-REIT Index down 1.6%.

International property indexes have likewise performed strongly over recent months as a lower interest-rate theme has taken hold and broadened, led by Europe and the U.K., with Japan lagging. The FTSE EPRA Nareit Global Real Estate Index in USD (total return) has risen 13.7% in the past three months.

Australian and International Property—Outlook

Expectations of lower interest rates have provided much-needed support to a sector that faced a material realignment and move higher in cap rates over 2023, following a 300-400 rise in long-term interest rates over a three-year period. This realignment continues, but lower long-term interest rates (10-year bond yields) have helped support sector sentiment and helped close aggressive equity discounts to net tangible asset backing.

[1] Verboeket, A. 2023. "Interest Rates Biting Commercial Landlords." Newsroom.co.nz. https://newsroom.co.nz/2023/09/06/interest-rates-biting-commercial-landlords-2/?utm_source=facebook&utm_medium=paid&utm_campaign=bnz-partnership&utm_content=newsroom-content-3&dclid=CPPyvYHbrYMDFZ6nZgIdfWMGmw

Amidst expectations that interest rates will be lowered to less restrictive or more neutral levels over 2024 and 2025, the commercial property market continues to navigate significant changes and economic uncertainties.

Even if the Fed follows market expectations of 150 basis points of policy easing over 2024, the overall cost of capital will likely remain relatively elevated relative to the past decade, and banks are likely to remain conservative. The refinancing of debt and real estate credit strategies will remain in focus given a continued elevated interest-rate environment.

Global growth is expected to be weaker in 2024 relative to 2023 as the lagged impact of higher interest rates diffuse through the world economy, adding to tenant risk. However, economic growth performance differs by region, with fundamentals uneven and market specific forces in play.

Nationally, the vacancy rate for offices in the U.S. rose above 19% in the third quarter of 2023, a consequence of hybrid working models and reinforcing the importance of structural trends amidst cyclical changes in economic conditions.

CBRE's "The outlook for commercial real estate in 2024" noted an expected improvement in commercial real estate capital markets later in the year and "tremendous opportunities will emerge for well-capitalized investors with an appetite for prudent risk."

J.P. Morgan's 2024 Commercial Real Estate Outlook noted, "While the 2024 commercial real estate outlook is muted, it's important to keep your eyes and ears open. As many asset classes moderate, investors should have liquidity to pounce when there's an opportunity—and there will be some." The current year looks like a year of two halves, with improvement over the second half.

Capital Economics is expecting continued declines in property values, projecting a 10% decline in commercial real estate values in 2024. This appears factored into valuations, and expectations of interest-rate relief have seen many listed property entity prices close relative to net tangible asset backing.

Global Infrastructure—Review

Infrastructure recorded strong performance over the final quarter of 2023, with the MSCI World Core Infrastructure Index (USD net index) up more than 13%, exceeding the performance of the MSCI World Index by around 2 percentage points. While outperforming late in the year, 2023 was still a period when infrastructure underperformed lacking the benefit of the "Magnificent Seven."

The new year has seen infrastructure move largely sideways, with the S&P Global Infrastructure Index (USD) largely unchanged compared with the end of 2023.

Global Infrastructure—Outlook

Good fundamentals including secular drivers and defensive qualities were insufficient to protect infrastructure in 2023 from rising interest rates. The sector underperformed broad equity markets, with 2023 a slow transaction year as well.

Infrastructure nonetheless continues to be a significant diversifier within a portfolio.

Key factors behind a potentially good growth profile for infrastructure include:

- Legacy underinvestment. The most cited figure, from Global Infrastructure Hub, says that the gap between what governments spend on infrastructure and the amount needed will reach NZD 15 trillion by 2040.
- The need to lift the resilience of networks to natural disasters, and climate change.
- More social urgency for limiting global warming.
- Secular trends including the 4 D's: decarbonization, digitization, deglobalization and demographic change. Reshoring requires certainty and reliability of infrastructure including energy supply, transportation, utility services, and high-speed internet. Advancements in artificial intelligence and the internet of things are not just groundbreaking for the technology sector but also the infrastructure around it.
- Governments and business continue to prioritize environmentally friendly projects such as renewable energy, green buildings, and efficient transport systems. The upcoming year is an election year in many countries and could add a tailwind of public policy.

While inflation protection can be noted as a strength of infrastructure assets, the passthrough from inflation can also take time to fully affect any infrastructure companies' financials. Utilities are often subject to regulators, which can take time to negotiate and can drive initial valuation compression before upticks. Higher bond yields for regulated sectors translate into higher allowed returns.

Project financing remains a key issue for the provision of infrastructure, and many governments, including the U.S., face fiscal consolidation challenges. The need to decarbonize is also facing pushback as the costs to the end consumer are realized. Economic, interest-rate and geopolitical uncertainty have an impact on investor confidence and hinder finance availability. Resourcing for projects both in terms of skills and capital, and the reliability of costs for long-term projects can be a challenge. Such issues reinforce infrastructure as a long-term investment requiring patience.

Australasian Equities—Review

The end of 2023 was a strong period for Australasian equities, helping close a period of underperformance over 2023.

The S&P/NZX50 gross index returned 3.9% in December, following November's strong rise. Information technology was the standout over December (up 18.1%), followed by real estate, with defensive yield outperforming structural growth and cyclicals.

Following a 5% gain in November, the S&P ASX 200 added a further 7.3% in December. All 11 sectors recorded gains in December, led by real estate (up 11.3%), healthcare (up 9.1%), and utilities (up 1.5%). The late run in 2023 helped close the gap to global peers on a calendar basis.

The start to 2024 has been more cautious for the S&P ASX 200 (down 1.3% year to date) as markets pause and look for directional leads from inflation, earnings, growth, geopolitics, and central banks.

Australasian Equities—Outlook

After underperforming many equity market global peers in 2023, the question naturally arises: Will it be time in 2024 for the Australasian equity markets to shine?

The NZ economy delivered a reality check with the release of the September 2023 quarter GDP figures showing the third contraction in growth in four quarters and annual growth dropping 0.6%. Adjusting for population growth, the economy has shrunk in per capita terms four quarters in a row and 3.1% in 12 months.

This fits with the negative earnings downgrades seen in the second half of the year from consumer cyclical companies as households tightened the belt. It appears monetary policy is working more powerfully than previously thought. The good news behind more economic pain in the near term is that it hastens the potential for interest-rate relief.

Impetus from migration remains supportive (equivalent to more than 2% population growth), which is manifesting in housing activity and rents, those not yet in dwelling consents. Overall per capita spending remains weak, with monetary policy dominating.

Economic growth is expected to remain somber over 2024 before momentum builds over 2025. Given the composition of the NZX, as a relatively interest rate sensitive market, monetary policy will play a key role driving sentiment. Upcoming fourth quarter 2023 inflation figures and the February Monetary Policy from the RBNZ will be influential, and markets are priced for further signs of disinflation, allowing the RBNZ to begin easing policy in 2024. Nontradable inflation—not just headline inflation— needs to fall further to validate that view.

The new government has helped buoyed business confidence and firms' own activity expectations (a better gauge of growth than business confidence). The 2024 budget is shaping as important to ascertain the policy substance behind the political rhetoric.

Normalization could emerge as a theme as interest rates and inflation return to more friendly levels and rates. This is likely to put more attention on microeconomic factors including company valuations and fundamentals rather than macro factors such as growth.

Cheaper valuations for the Australian market remain a key support variable, amidst an economic outlook for Australia that remains challenging, experiencing sluggish economic growth and negative per capita growth, a by-product and function of restrictive monetary policy. Consumer spending remains subdued and consumer sentiment gloomy, though supported by low unemployment and savings buffers.

Underlying inflation in Australia remains higher than several economic peers, and the Reserve Bank of Australia has warned there was a risk of inflation taking longer than expected to fall to its target of 2.5%. Moderating inflation in November (4.3% annual compared with 4.9% in October) has provided comfort that progress continues to be made, helping validate expectations the cash rate will fall. Expectations of falling interest rates have already buoyed interest-rate-sensitive sectors, including commercial real estate.

The combination of somber growth and continued elevated inflation presents challenges to delivering growth in earnings. Weak productivity growth is exacerbating this. Continued weakness in productivity growth is a key risk to the growth and inflation outlook, with the RBA's December cash rate decision noting, "Wages growth…remains consistent with the inflation target, provided productivity growth picks up."

With the RBA one of the last central banks to tighten monetary policy, and the lags between monetary policy still working through amidst sticky inflation, any prospective interest-rate relief over 2024 is less than in other developed markets. A further hike cannot be ruled out.

Despite weakness in global industrial production, demand in the resources and mining sector appears robust, helped by policy mechanisms to support China's growth. However, China continues to face the triple D challenges: demographics, deleveraging, and deflation.

While near-term challenges and risks persist, 2024 looks set to be another year of weak growth for the Australian economy. Australia's growth performance is expected to exceed the OECD average over the coming three years.

International Fixed Interest—Review

Bond markets ended 2023 strongly with the rally (fall) in interest rates (yields) over November extending into December, led by the U.S. Treasury market, as inflation moderated and the Fed endorsed market sentiment that lower interest rates are in prospect for 2024. The debate is now to what degree and speed by which rates come down, and the timing.

The Bloomberg Global Aggregate Bond Index rose by 4.2% in December and 8.1% for the quarter (total return expressed in local currency).

The beginning of a new calendar year has seen late 2023 bond- and rate-cut optimism pared back slightly, with stronger-than-expected December 2023 U.S. monthly inflation figures a reminder the inflation war is not yet won. U.S. nonfarm payrolls also surprised on the upside for December. Fed members have pushed back somewhat on the magnitude of rate reductions anticipated by financial markets.

International Fixed Interest—Outlook

Long-term interest rates across the developed world appear to have passed their peak for the cycle in October 2023, supported by moderating inflation trends, emerging risks to global growth, and endorsed by the Fed's pivot. Short-term interest rate expectations are pricing in modest easing cycles, anticipating returning central bank policy rates toward more neutral policy settings over the coming two years.

Despite the recent sharp decline in long-term bond yields, the case can be argued that rates still sit above fair value. For example, a real rate of around 1.5%-2.0% plus 2.0% inflation equates to 3.5%-4.0% for the U.S. 10-year Treasury yield. Elevated yields above this zone manifest as elevated yield returns and a strategic buy.

In the near term, given the magnitude of anticipated easing by central banks in 2024 (150 basis points or so in the U.S. and Europe), markets could be vulnerable to higher-than-expected growth or inflation outcomes. December's Consumer Price Index report for the U.S. showed progress toward the inflation target but a continued underlying sticky inflation element amidst a tight labor market.

The onus will be on inflation outcomes to validate market expectations over the coming months. Central banks are likely to remain cautious, wary of service sector inflation, labor market trends, and the potential for a continued period of elevated core inflation flowing into inflation expectations. Inflation expectations, for now, remain consistent with market expectations of interest-rate relief. The debate is about the magnitude of rate cuts.

While a sizable loosening in monetary policy is anticipated in the U.S., Europe, Canada, and the U.K., rates are still expected to be above neutral in two years. This suggests markets could push further if growth underwhelms and reverses what occurred in 2023 adding to the allure of bonds, as protection to the modest risk of a recession.

Politics is set to be more influential over the coming year, with a record 4 billion people or around 60 countries facing elections, including the U.S., U.K., India, Indonesia, Mexico, and Russia. Many nations face difficult fiscal consolidation paths and tough decisions amidst populism. The IMF October forecasts noted that "fiscal policy everywhere should focus on rebuilding fiscal buffers," but further fiscal expansions could follow elections. Governments are grappling with core service delivery, climate mitigation, defense spending needs, demographic aging costs, and slower labor force growth, which pressures fiscal durability. A failure to address fiscal trajectories, in combination with quantitative tightening from central banks, are structural factors arguing for higher bond yields.

The trajectory for inflation also remains dependent on the supply side of the global economy, an area vulnerable to geopolitics, with recent rises in freight rates as shipping is redirected from the Red Sea around the Cape of Good Hope, likely to add to goods inflation.

While continued disinflation remains the central scenario allowing lower interest rates, these factors, in combination with continued tight labor markets provide some balance, with disinflation from growth risks against renewed pressure from supply chain bottlenecks or commodity price rises and the impact of traditional bond fundamentals such as supply.

Global economic assessments and fixed-income allocations need country-specific overlays, an example being an anticipated end of the zero-interest-rate policy by the Bank of Japan in the first half of 2024.

International Equities—Review

Global equity measures closed 2023 on a strong note, with the MSCI World Index up 4.2% in December and 10% over the quarter.

The S&P 500 increased by 4.5% in December, Nasdaq by 5.6%, and German Dax by 3.3%. Gains over the quarter and at the end of 2023 were strong as support emerged from lower global inflation trends, firming expectations of lower interest rates, earnings, and continued belief in a soft landing for the global economy.

The start to 2024 has been more cautious as investors weigh what is already priced in, including rate reductions, a solid uplift in earnings, versus the ability to deliver, with geopolitics and politics adding layers of uncertainty. Markets are starting to reassess how quickly central banks can lower interest rates.

International Equities—Outlook

With enthusiasm and optimism, such as the way equity markets ended 2023, comes a challenge. Can sentiment be maintained? To what extent are expectations in the price, and how much room is there for error? Views are varied.

There is much to be positive about, and markets appear to be anticipating a relatively smooth landing in 2024. Inflation is easing, and a soft landing has been achieved for the global economy, so far, allowing scope for modest interest rate relief.

AI has galvanized investors backing a technology paradigm shift with the potential to bring about major boosts in productivity and profitability, reflected in the Magnificent Seven stocks rising to more than a fourth of the S&P 500's market cap. AI benefits can be expected to diffuse across industries and businesses, too. The IMF has identified that almost 40% of global employment is exposed to AI, presenting huge cost potential savings.

Expectations are that there is sufficient disinflationary momentum to allow interest rates to return to a more neutral or less restrictive policy setting. But every region faces unique growth, pricing, monetary, fiscal, political, and geopolitical circumstances, which means alternate trajectories for inflation. Some central banks will have greater flexibility than others to alter interest-rate settings to a less restrictive stance. More dynamic economies with greater economic flexibility within the labor and goods markets top that list.

Productivity will be a critical factor linking disinflation, a soft landing for any economy and profitability uplifts, both at the macro and micro levels. A stronger focus on the latter supports more selective and fundamental approaches to investing, rather than investing based on macroeconomics.

FactSet reports that analysts expect the S&P 500 to report double-digit earnings growth in calendar 2024. According to the World Bank's latest Global Economic Prospects report, global GDP is likely to grow 2.4% this year, positive, but slow and consistent with a soft landing. That compares with 2.6% in 2023, 3.0% in 2022, and 6.2% in 2021. Excluding the coronavirus pandemic contraction of 2020, growth in 2024 is still set to be the weakest since the 2008 global financial crisis. The pending IMF forecasts (due end of January) has been reported by Reuters as expected to show a resilient global economy in 2024.

Those taking a more circumspect approach point to the combination of:

- Rich valuations.
- The lagged effect of monetary policy in combination with less fiscal stimulus and reduced support from savings buffers weighing on U.S. and global growth in 2024. The risk is that the U.S. economy will underwhelm after overwhelming in 2023.
- China risks, with deflation taking hold.
- Disinflationary forces make it more difficult for companies to maintain pricing power than when inflation was rising. Margins are a typical compression variable as part of the disinflation process.
- Stubborn inflation requiring interest rates to be higher for longer. Those who are more cautious point to significantly higher economic costs getting core inflation from 4% to 2% relative to from 6% to 4%.
- Geopolitical developments add frictions to commodity prices (cost pressures) and inflation, weighing on global trade and impact financial flows.
- A disconnect between double-digit earnings and subdued nominal growth in 2024.
- Narrow equity risk premium–the reward for stocks over risk-free Treasuries.

These risk factors leave the market, following the 2023 rally, with limited room for error.

This leaves the outlook offering a range of outcomes. If 2023 reminded us of one thing, it is that consensus views should be treated with caution. Macro uncertainty in association with micro dispersion across business fundamentals and the ability to strategically deliver lean toward an active investment strategy as opposed to passive.

Performance periods unless otherwise stated generally refer to the period ended Tuesday, Jan. 16, 2023.

More Information
If you wish to obtain further information regarding this report, licensing and our services, please contact us on:

Morningstar.com.au subscribers Advisers/Institutions/Others
Tel: 1800 03 44 55 Tel: +61 2 9276 4446
Email: help.au@morningstar.com Email: helpdesk.au@morningstar.com

For further information on our analysts and research methodologies, we recommend you visit:
www.global.morningstar.com/au/researchdocuments