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Economic Update: New Zealand
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Morningstar Research
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Summary

- Markets were increasingly erring toward the United States Federal Reserve view of the trajectory for interest rates, namely higher for longer.
- When rates rise, something invariably breaks.
- Financial stability is now a consideration following the issues with Silicon Valley Bank (SVB) and others that has seen interest-rate-ascent expectations rescinded and driven fixed-income yields lower. While financial stability is a consideration for central banks, inflation signals remain sticky, making for a prickly environment.
- For now, SVB appears a sentiment issue rather than a systemic one, policymakers are working hard to make sure it remains that way, but market tentacles are very interlocked, as we know from the global financial crisis.
- The environment remains uncertain and unclear, which in a normal environment would urge caution favouring cash, infrastructure, and bonds over equities and property. Markets have not been normal for a long time though, and this is one of the challenges we face.

New Zealand Cash and Fixed Interest—Review

Short-term interest rates generally nudged higher on expectations of the same for the official cash rate. Ninety-day bank-bill yields rose to 5.2%, up 20 basis points from the start of February, before giving that up completely on financial stability and SVB ructions that forced a rethink over the path monetary policy will pursue.

New Zealand bond yields continue to take their lead from offshore, with the 10-year bond yield rising toward 4.6% at one stage, up from 4.1% at the start of February and 4.4% at the start of the year, and falling to 4.2% following SVB's collapse before rising to 4.4%.

The New Zealand dollar on a trade-weighted basis has fallen 0.8% since the start of February, dominated by a 3.4% decline in the New Zealand dollar versus the United States dollar. The New Zealand dollar firmed against the Australian dollar.

Term deposit rates remain above 5% with money being enticed to the yield, and bank term deposit balances rising $20.6 billion in the last six months. The chief economist of the Reserve Bank recently noted that banks are quick to hike mortgage rates and slow to raise deposit rates, concluding, "I think the banking sector would be an appropriate focus for a market study, should the Government wish to go there". There are growing calls for an inquiry into banks.

New Zealand Cash and Fixed Interest—Outlook

The Reserve Bank of New Zealand's February Monetary Policy projections for the official cash rate were almost identical to those released in November, with a projected peak of 5.5%. Market pricing was in

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line with central banking projections until SVB events and subsequently market expectations have been pulled back towards 5.2%.

In the Reserve Bank's own words, "While there are early signs of price pressure easing, core consumer price inflation remains too high, employment is still beyond its maximum sustainable level, and near-term inflation expectations remain elevated". However, those words are now at risk of being second fiddle to financial stability clarity.

Last month, we noted that, according to the Reserve Bank's Survey of Expectations, the closely watched two-year measure had eased to 3.3% from 3.6%, down but still outside the 1%-3% target. One-year-ahead inflation expectations according to the ANZ Business Outlook Survey eased to 5.9% in February from 6.2%; this is still very elevated. Consumer-based inflation expectations (according to the ANZ Roy Morgan Consumer Confidence gauge) sit just above 5%.

Monetary policy works with a lag, and considerable monetary-policy tightening remains in the pipeline, with the yield on bank mortgages at 4.4%, many borrowers refixing from rates below 3%, and almost half of all mortgages to reprice over the coming year, with fixed lending rates above 6%. This urges caution and raises the risk of an overengineered tightening cycle. However, elevated inflation expectations and core inflation measures argue for further tightening.

Various bank economic forecasts have missed the recent rise in New Zealand longer-term yields, led by their U.S. equivalent, and remain biased toward New Zealand's 10-year government-bond easing over 2023 and 2024. ASB is projecting back below 4% in a year. ANZ is forecasting just above 4%. Westpac is below 4%, and BNZ the same.

Government-bond issuance looks set to be far higher than signalled in the Half Year Economic and Fiscal Update adding to bond supply, reflecting the cost of recent storms and Cyclone Gabrielle. The latest Crown Financial Statements, for the seven months ended January, showed a larger residual cash deficit and net core crown debt (which excludes New Zealand Super Fund assets) slightly higher than projected (40% versus 39.4%).

Waning risk appetites have negatively affected the NZD/USD, as interest-rate expectations rose in the United States though that has reversed more recently. The consensus across three of the major banks in New Zealand is that a firmer New Zealand dollar against the U.S. dollar is around the corner on the back of a weaker U.S. dollar as the Fed slows rate hikes. One bank is projecting the NZD/USD easing below 0.60. The New Zealand dollar is expected to underperform the Australian dollar. New Zealand's current account deficit has risen to 8.9% of gross domestic product and argues for a lower dollar, not a higher one, in a structural (long-term) sense.

Standard and Poor's Global Ratings has noted New Zealand's credit grades could come under pressure if the nation's current account deficit remains too big. Specifically, "We would need to see the current account deficit narrow over the next 12 to 18 months and if it doesn't there is going to be increased pressure on the AA+ rating."

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New Zealand Property—Review

Rising interest rates continue to weigh on the sector both via the direct cost and the need to shore up balance sheets. However, the listed property sector outperformed the NZX50 in February.

The S&P / NZX All Real Estate gross index has eased over the recent week, though down 4.3% for the month to date, with the year-to-date movement turning negative (negative 1.5%) and a minus 19.1% decline on a year ago.

Four companies reported in February: Precinct Properties, Property for Industry, Winton, and Vital Healthcare. Forsythe Barr noted, "The results were broadly in line with expectations, but higher interest costs are weighing on earnings and distribution outlook." Entities reported good operational metrics, underpinned by strong demand for Premium Office and Industrial.

New Zealand Property—Outlook

Rising interest rates continue to cast uncertainty over the commercial property sector with cap rates lagging interest-rate movements. Rising construction costs should be deterring investment; however, commercial building consent issuance remains strong with $9.5 billion of issuance in the past year. Education and health represent a fair proportion, but commercial consent issuance of $2.5 billion, including office of $1.7 billion, and $2.6 billion of factories, industrial, and storage buildings feature, the latter being supported by low vacancy rates.

Colliers latest Research Report notes that "Within the office sector, New Zealand leads the way particularly at the higher-quality end of the market. Within industrial markets though, Australian precincts have been the strongest performers despite New Zealand vacancy rates sitting at near-record lows."

CBRE Pacific Real Estate Market Outlook 2023 expects 2023 to see a reversion of history with "strong rent growth and weaker values compared to recent years of strong valuation and low-income growth." A quality aspect is also apparent, with CBRE noting, "Talent attraction and employee wellness incentives are a key driver in CBD occupiers upgrading their premises and favouring quality offices with the same or higher market rents".

Australian & International Property—Review

The S&P / ASX200 A-REITs Index has eased back after an initial strong start in 2023. The index is up 2.9% for the year to date (it was up 7.7% a month ago), though down 12.6% on a year ago.

The FTSE EPRA-NAREIT Global Index in U.S. dollars for the year to date is down 1% and 20.8% on a year ago. Month-to-date, the index is down 4.3%. Europe is down 7.2% for the month to date.

Australian & International Property—Outlook

Quality remains a dominant theme when soothsayers look to the years ahead for commercial property.

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Key questions also surround the impact of slower growth and remote work on vacancy rates. The challenges were laid bare in a recent Bloomberg article.[1]

The demise of SVB is naturally drawing attention to business models that could be exposed to recent rises in interest rates and the potential for those rises to be maintained to contain inflation.

A month ago, the major challenges for commercial property were interest rates and valuations. Cap rates were lagging interest-rate movements.

Now, attention will broaden and include the ability to refinance and access to credit. As one scribe noted, SVB and subsequent events looks like a "baby version" of the global financial crisis. Being a baby version does not mean you should underestimate the potential impact of debt becoming hard to access as refinancing at higher rates needs to take place.

A key message from the SVB saga is that business models conditioned to incredibly low interest rates could be exposed. The past year has seen a huge reshaping in both the level of interest rates and the yield curve. This has major impacts on government finances, financial institutions, corporate leverage, households, and bond portfolios.

The hope is that commercial property will navigate the challenges ahead. There are more concerns being expressed around commercial property or the leveraged loan market (think private equity) though. On some levels, this is natural as people look for the next weakest link. But when interest rates move up quickly, realignment occurs, and unfortunately some things—and sectors—break.

Global Infrastructure—Review

The S&P Global Infrastructure Index in U.S. dollars is largely flat so far for the month of March, up 1.3% for the year to date and down 1.4% on last year.

The MSCI World Core Infrastructure Index (USD) reported a negative 4.2% gross return in February.

Global Infrastructure—Outlook

The infrastructure sector remains favoured, backed by the drive toward reducing emissions, clean energy investment needs, and investment in renewables.

The basics of risk management are also coming back into play, with the crisis in Ukraine reinforcing supply-chain dependency and forcing a rethink on supply chains and self-sufficiency.

Infrastructure is aligned with the digital age. The World Economic Forum has been noting the need for inclusive, secure, and equitable digital infrastructure for the world. This includes data centres, fibre optic

[1] https://www.bloomberg.com/news/articles/2023-03-09/work-from-home-shift-spurs-office-building-defaults

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networks, and servers with the United Nations projecting that two thirds of the world's population will live in urban areas by 2050.

Around the corner is the Global Infrastructure Summit for 2023, being held in Berlin. “Navigating energy insecurity, market volatility and geopolitical tensions: an infrastructure roadmap” is an apt description of many factors in play.

With government finances under rising pressure to cover the operational basics such as healthcare, education, pensions, and cost-of-living pressures, it seems inevitable the private sector will become a stronger partner to fund critical infrastructure needs.

With inflation taking time to come down, this backdrop may provide a further push to infrastructure fundraising, as these assets often have longer-term inflation-linked contracts and offer a degree of protection.

Many countries face tough trade-offs over the decades ahead, with huge operational and capital spending needs and climate change demands, with some countries having greater flexibility (less debt) than others. Attention could turn more and more toward raising taxes.

Australasian Equities—Review

Australian equities are largely following global trends. After a buoyant start to 2023, gains have been eliminated. The S&P / NZX50 gross index rose by 4.3% in January, led by healthcare, industrials, and consumer discretionary, but has subsequently given up gains for the year to date, as March was a tough month. The index is down 4.8% on last year.

The S&P / ASX200 Index is down 2.6% on a year ago; this was somewhat helped by strong gains in January and February offsetting movements in 2022. Initial gains have all but been eliminated in March (down 3.4%) leaving the index down 0.4% for the year to date.

Over the month of February, utilities was the strongest performer (3.4%), followed by IT (2.7%), industrials (1.5%) and consumer staples (1.1%), thought February appears a long time ago given recent developments.

Australasian Equities—Outlook

The latest gross domestic product figures show the New Zealand economy going backward. This is naturally setting off recessionary alarm bells, though a sense of perspective is needed. The economy recorded a 2% quarterly rise in activity in the September 2022 quarter, and December’s pullback appears to be a combination of an underlying slowdown and data noise.

The economic scorecard remains mixed. Various sentiment indicators including consumer confidence and business confidence measures are pointing to negative growth. House prices continue to fall. Nominal retail sales are up, but volumes down.

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Conversely, migration has turned from being negative to positive (a loss of 17,500 is now a gain of 33,200, or 0.6% of the population). Building consent figures issuance has eased, but a strong pipeline of construction work remains, and this will be supported by reconstruction demands to address Cyclone Gabrielle damage.

Forsyth Barr noted the New Zealand reporting season was a tad weak, primarily driven by higher operating costs and finance expenses. It noted the median net profit after tax as being up 7% versus last year, 2% under its profit estimate. On the positive side, revenues were generally higher and coming amid views of the economic cycle turning down. It also estimates that the 12-month forward weighted P/E for the New Zealand market is currently 20.5, which is 6% above the five-year average.

Producer price inflation (inputs) has eased somewhat— to 8.0% from 9.7%—but that rate continues to pressure firms' bottom lines and margins.

According to Standard & Poor's estimates, the trailing P/E of the S&P / NZX50 is 22.6, and the forward P/E is 22.8 with an indicated dividend yield of 3.1%. Valuations are not cheap.

Events overseas have overtaken domestic considerations in both New Zealand and Australia, though some specifics are worthy of note in Australia.

Markets have been quick to jump onto some comments from RBA Governor Lowe that insinuated that a pause in the hiking cycle could take place in April, and more recently global developments have accentuated that view. Some economists including Westpac are now calling a pause in the tightening cycle though resuming tightening in May. Specifically, Lowe noted "with monetary policy now in restrictive territory, we are closer to the point where it will be appropriate to pause interest rate increases to allow more time to assess the state of the economy". The Bank of Canada has hit the pause button, and markets are keen on signals that others may follow suit.

Softer-than-expected data in Australia adds some conviction to that view as well. Consumer sentiment is near a 30-year low. The RBA noted that "The monthly CPI indicator suggests that inflation has peaked in Australia." "Growth over the next couple of years is expected to be below trend. Household consumption growth has slowed due to the tighter financial conditions and the outlook for housing construction has softened." "At the aggregate level, wages growth is still consistent with the inflation target and recent data suggest a lower risk of a cycle in which prices and wages chase one another."

Seek job ads decreased 1.6% month on month in February and are down 12.2% year on year. House prices are down 9% from their peak, and monetary policy has a more direct effect given the prevalence of floating loans compared with fixed-rate loans in New Zealand.

While any central bank's potential pivot is encouraging for risk assets and equities, we should not lose sight of the fact that a tightening bias remains, and that inflation is not projected to return to the 2%-3% target until mid-2025.

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The Australian earnings (and US) reporting season contained some consistent themes. Overall companies delivered reasonable revenue figures but pressure on earnings. Nominal growth continues to support the top line, but the bottom line and margins are being eaten into by costs which are proving more difficult to pass on. Themes are expected to persist through 2023.

According to Standard & Poor's estimates, the trailing P/E of the S&P / ASX 200 is 15.4 (last month 15.2), and the forward P/E is 14.1 (last month 14.5) with a dividend yield of 4.4% (previous 4.4%).

International Fixed Interest—Review

To say the last month has been one of contrasting developments is an understatement.

Last month's noted tug-of-war between the U.S. Federal Reserve and markets over the trajectory for interest rates progressively erred more toward the Federal Reserve (and beyond) view—a higher terminal rate for the U.S. federal-funds rate and for an extended period. Successively strong payrolls figures, in both January and February (311,000 in February alone), a sticky private consumption expenditure deflator read, and general health across the overall economy contributed to the U.S. 10-year bond yield rising to 4%.

Construction employment, which is driven by the procyclical construction sector, continued to increase. The industry added 24,000 jobs in February, even amid a decline in the housing market. In aggregate, more mixed signals are appearing from the labour market. Payrolls remain strong, and businesses are struggling to find staff, but wages are cooling as is gross income.

Curves continued to invert (higher two-year rate relative to the 10-year) on expectations of tighter monetary policy and growth bumps.

The collapse of SVB, a specialist in tech industry banking, and the biggest failure since 2008 saw the U.S. 10-year bond yield drop back to 3.5% and the two-year yield drop close to 100 basis points, as systemic risks were contemplated. Whilst SVB is exposed to the tech industry, the failure underscores the impact that rapid rises in interest rates are having on small lenders, and it follows crypto-friendly Silvergate Capital liquidating and winding down operations. Signature Bank was seized after regulators lost confidence in management, and a recent Bloomberg article noted the organisation faced a criminal probe prior to the collapse. Another has noted SVB did not have a chief risk officer for most of last year. It appears mismanagement could be a common theme.

The S&P Global Developed Sovereign Bond Index has delivered a year-to-date return of 2.5% (with 2.1% for the month to date) but a negative 7.5% return over the year.

International Fixed Interest—Outlook

Global bonds will continue to take their lead from U.S. development, the U.S. Federal Reserve, and the more recent financial stability concerns, with the reaction to the latter improving after a large risk-off initial reaction.

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Chairman Jerome Powell's recent semiannual Monetary Policy Report provided a useful summary of the economic side, though it was recorded prior to financial stability concerns emerging.

- "The data from January on employment, consumer spending, manufacturing production, and inflation have partly reversed the softening trends that we had seen in the data just a month ago.
- From a broader perspective, inflation has moderated somewhat since the middle of last year but remains well above the FOMC's longer-run objective of 2 percent.
- That said, there is little sign of disinflation thus far in the category of core services excluding housing, which accounts for more than half of core consumer expenditures.
- Despite the slowdown in growth, the labour market remains extremely tight.
- We continue to anticipate that ongoing increases in the target range for the federal funds rate will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time. In addition, we are continuing the process of significantly reducing the size of our balance sheet.
- Although inflation has been moderating in recent months, the process of getting inflation back down to 2 percent has a long way to go and is likely to be bumpy.
- As I mentioned, the latest economic data have come in stronger than expected, which suggests that the ultimate level of interest rates is likely to be higher than previously anticipated.
- Restoring price stability will likely require that we maintain a restrictive stance of monetary policy for some time."

Market expectations prior to SVB developments were that the U.S. fed-funds rate will rise beyond 5.5% (up 20-30 basis points on a month ago) and the projected easing in policy continues to be pushed out. Some commentators were calling 6% for the fed-funds rate ("the 6% club"). Expectations toward the trajectory for the European Central Bank had likewise risen around 30 basis points.

Economic data continues to support the case for higher rates with the U.S. Consumer Price Index excluding food and energy prices rising 0.5% in February, or 5.5% on a year ago. Service sector inflation rose 7.6% and remains sticky.

However, when rates rise—and the past year has seen one of the most aggressive tightening cycles in history—something invariably breaks. We may have hit that moment with SVB and rising financial and credit stresses being closely watched. This reinforces the tightrope that the U.S. Federal Reserve is walking, as possible systemic issues start to emerge and need to be balanced against broader economic developments. While this does not appear to be a systemic issue, it is a certainly a sentiment one, and regional banks, nonbank finance providers, commercial property, and leveraged loans are seen as possible candidates for difficulties given the impact of higher interest rates.

Market expectations are that the U.S. Federal Reserve will continue to raise interest rates, but the mood has shifted from 25 or 50 basis points to 0 or 25 basis points, a lower terminal rate, and markets are back to pricing in lower rates in late 2023 and 2024 with financial stability swatting aside chairman Powell's statements. Look no further than the roller-coaster two-year Treasury yield, which after breaking through 5% for the first time since 2007, dropped to 4% and is now back to 4.3%.

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The ECB did however plough ahead amidst financial sector ructions and raise rates and sentiment is divided over what the U.S. Federal Reserve should do with many still arguing for higher rates to contain inflation.

The drop in the U.S. 10-year bond to 3.5% from 4% serves to reinforce both the yield and income value on offer across fixed-income markets but also the liquidity the market offers in an environment Powell notes as "bumpy". The SVB situation is a reminder that Fed hikes are having an effect, even if the economy has held up so far, which in turn limits prospects to interest rates rising much further.

Attention will be on credit markets as potential harbingers of deeper problems. Banks share sentiment has improved in recent days before taking further hits as more concerns emerged. Ratings agency Moody's downgraded the debt rating of collapsed New York-based Signature Bank deep into junk territory and placed the ratings of six other U.S. banks under review for a downgrade.

While financial stability concerns are dominating narratives and commentary at the time of writing, two other issues are worth mentioning. The first is U.S.-debt-ceiling haggling. Many countries face difficult choices ahead, with elevated debt levels and tough spending/tax choices. President Joseph Biden has presented a plan to raise taxes. That will be hotly debated, but it is a potential narrative that other countries will need to pursue to maintain prudent or non-excessive debt levels. The second is the challenges the Bank of Japan faces going forward. Prior to financial stability ructions, Japan's 10-year bond crossed the Bank of Japan's policy cap. It has subsequently subsided to 0.3%, but questions remain how the Bank of Japan will normalise monetary policy.

International Equities—Review

The year so far has been bumpy. Positivity has been replaced by caution. Year-to-date gains have largely been eliminated as a myriad challenges remain on the horizon including the economic and earnings cost of taming inflation and more recent financial stability ructions.

Europe has outperformed the United States.

The S&P 500 has risen 0.4% for the year to date, though recorded an annual loss of 8.3%. The S&P Global BMI (broad market index) is up 1.4% for the year to date but down 7.9% on the prior year. The S&P Europe BMI is up 4.8% for the year to date and down marginally on a year ago. The S&P Global ex U.S BMI is up 2.7% for the year to date but down 6.1% a year ago.

International Equities—Outlook

Global growth revisions have generally been positive, though as noted last month, revisions have been of the less-bad variety as opposed to fundamentally good. Upgrades reflect China's reopening after coronavirus lockdowns, the easing in Europe's gas crisis, and buoyant U.S. consumer demand, all solid developments though amid an environment of inflation and tough-talking central banks.

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Fitch, for example, has revised up China's 2023 growth forecast to 5.2% from 4.1%, eurozone growth to 0.8% from 0.2%, and U.S. growth to 1.0% from 0.2%. However, growth estimates for 2024 have been lowered, reflecting the lagged impact of Fed and ECB interest-rate hikes.

The Organization for Economic Cooperation and Development (OECD) raised its global economic growth forecast recently but warned of vulnerabilities as seen in the US financial sector turmoil. The OECD said it now expects the global economy to grow by 2.6 percent this year compared to 2.2 percent in its previous forecast in November and titled it's latest projections "A Fragile Recovery".

Among a modest improvement in growth prospects, inflation pressures remain, with the latest U.S. core inflation (ex-food and energy prices) figures dipping to 5.5% from 5.6% but showing persistence across many other core measures and particular across services.

Markets, trying to juggle the dilemma over central banks will solve an inflation problem without causing a recession which would include a large rise in unemployment, crushing the consumer. Another factor is now in the mix, namely, financial stability. Higher rates are needed to fight inflation, but higher rates could spark financial, financier, and banking system problems.

Investors started the year hoping the worst had passed with inflation easing. Headline inflation in the United States has dropped to 6% from 9.1%. Euro area inflation has eased to 8.5%, the lowest read since May 2022 but above market expectations of 8.2%.

Inflation is clearly remaining sticky, though, according to various core measures, which makes for a prospective volatile year ahead and a tough balancing act for central banks who neither want to engineer a recession nor pause the tightening cycle only to be forced to resume tightening on persistent inflation pressures.

Containing inflation puts pressure on earnings both through slower growth and margins, which needs to compress to stop cost-push pressures from flowing into final goods prices. Moreover, inflation risks remain from an incredibly tight labour market around the globe. While inflation risks and pressures need to be read in the context of better economic news, it remains a negative factor for risk assets, not a positive one.

Fourth-quarter earnings figures were not good, but not bad either. S&P 500 companies reported a 4.8% year-over-year decline according to Forbes Advisor. An earnings recession is upon us, with analysts projecting S&P 500 earnings will drop 5.7% year over year in the first quarter and another 3.7% in the second quarter. While negative, those declines are modest and possibly one reason that large-cap stocks have remained somewhat resilient.

Recessionary concerns linger, one sacrificial pawn to containing inflation and, with that, fluctuating earning estimates. FactSet notes that:

- Analysts have lowered earnings-per-share estimates for the first quarter by a larger margin than average. The first-quarter bottom-up EPS estimate decreased by 5.7%.

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- "The decline in the bottom-up EPS estimate recorded during the first two months of the first quarter was larger than the 5-year average, the 10-year average, the 15-year average, and the 20-year average."
- Estimates for all of 2023 also declined, by 3.4%, partly reflecting lower estimates for the first quarter of 2023 but also other quarters.
- "The forward 12-month P/E ratio for the S&P 500 has increased to 17.5 from 16.7 since December 31, as the price of the index has increased while EPS estimates for CY 2023 have decreased during this time."

While SVB might not be a systemic event and might be contained for now, the potential for sentiment contagion remains real, and those with long memories will recall how 2008 unfolded. Optimists note SVB did not have a diversified source of depositors; it was a special type of financial institution with customers being startups, venture capital, and tech founders; and its problems were a function of industry exposure to a sector that has been hit hard from higher interest rates.

Nonetheless, some nervousness will remain. Quality will count, and deposit flows are already benefitting the majors over the minors. Money will likely shift from the periphery into the core. It is a reminder that business models that have been conditioned on low or effectively "free" money are going to be vulnerable in a higher-cost-of-capital world.

Uncertainty is high on many levels including what the U.S. Federal Reserve and other central banks will do or should do as they weigh up inflation and financial stability challenges. That suggests lower multiples, not higher ones, at least until we have more clarity.

Performance periods unless otherwise stated generally refer to periods ended Wednesday, 15 March 2023.

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