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Economic Update: New Zealand
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Outlook for Investment Markets

Investment markets continue to face difficult conditions: Bonds and equities, both at home and overseas, have suffered significant declines, and there have been few places to shelter outside of cash, commodities, gold, and listed infrastructure. The main factors driving the poor outcomes have been the various impacts of rising interest rates, as central banks battle much higher than expected inflation, and there have been various ramifications of the Russia-Ukraine war. There appears to be no reprieve in sight, as interest rates have further to rise, consumer demand in particular is being battered by a loss of purchasing power, and the conflict in Ukraine remains both serious and potentially a precursor of further geopolitical instability. The big forecasting institutions have downgraded their expectations for the global economy, and fund managers are also more pessimistic. At home, reopening trade had been helping economic activity, but businesses have turned more pessimistic as economic conditions look to become more difficult as the year goes on. Markets are likely to remain challenging until investors have more confidence that bond yields have peaked and that Ukraine and other risks to local and global economic growth have started to recede.

New Zealand Cash and Fixed Interest — Review

The Reserve Bank of New Zealand, or RBNZ, has continued to tighten monetary policy, raising the official cash rate, or OCR, to 2.0% on May 25. Short-term interest rates are consequently well up from where they started the year, with the 90-day bank bill rate 1.6% higher, at just below 2.6%. Bond yields have reflected both the surge in inflation and the RBNZ policy tightening, and the 10-year government bond yield is now 1.65% higher for the year, at just over 4.0%. The kiwi dollar is lower, mainly due to depreciation against the globally strong U.S. dollar—at USD 63.25 cents it is down 7.4% against the greenback and down by 2.6% in overall trade-weighted value.

New Zealand Cash and Fixed Interest — Outlook

Short-term interest rates are likely to continue to increase as the RBNZ further tightens monetary policy to help bring inflation back to a more acceptable level. The big bank forecasters, for example, currently expect that the OCR will be around 3.5% by June next year, up a further 1.5%, and the futures market expects that the 90-day bank bill yield will be 2% higher, at 4.7%.

Forecasters are currently of the view that the peak in bond yields is not far away. The ANZ Bank, for example, sees the 10-year yield trading at 4.25% in September and December before starting a gradual decline back to 3.85% by September 2023. Investors who have taken a substantial hit year to date—the S&P Aggregate Bond Index is down by 6.7%—will be relieved if the forecast eventuates, but global inflation has proved to be more troublesome and persistent than forecasters had imagined, and the risk is that there may yet be some upside risk to bond yields.

The kiwi dollar is generally expected to appreciate against the U.S. dollar. The median forecast among the big banks is for the currency to be back up around USD 69.5 cents in a year's time. Presumably forecasters are expecting some unwind of the U.S. dollar's recent appreciation, and locally there are the supportive factors of progressively higher interest rates and an ongoing benefit from high world commodity prices. The current view, however, depends on financial markets returning to less-stressful conditions. The kiwi dollar tends not to do well when global investors are nervous, and it remains possible that the forecast appreciation will be derailed by ongoing volatility in the financial markets (especially if risks of recession continue to rise) and by the ongoing geopolitical uncertainties centred around Ukraine.

New Zealand Property — Review

The S&P/NZX All Real Estate Index is down by 19.3% in capital value and has returned an overall loss, including dividends, of 17.6%, modestly worse than the S&P/NZX 50's 17.2% capital loss and 16.2% overall loss.

New Zealand Property — Outlook

There are some positives in the sector: The operating results for the companies that reported for the March '22 fiscal year were generally solid, and commercial rents, which typically allow for adjustment in line with the consumer price index, are an effective hedge against the current surge in inflation. But investors have not been enthused, as interest-rate moves continue to dominate the outlook for the sector. It does not help that, even before the latest rise in bond yields, REIT dividend yields were on the thin side compared with their usual differential over bonds. And although one measure of valuation—share prices compared with the book value of the assets owned—is looking attractive (Standard & Poor's estimate that the REITs are trading at 87% of book value), the reality is that book values will eventually be downgraded as the "cap rates" used to value the properties are raised in line with the rise in other interest rates. The operating outlook is also softening—as noted in the New Zealand equities section, the second half of this year is likely to be more challenging for businesses, particularly in the retail space. If bond yields were to peak in the near future, the sector might draw more interest, but at the moment the outlook does not look good.

Australian & International Property — Review

The A-REITs have been hit very hard by the events of 2022, and the S&P/ASX 200 A-REITs Index year to date has lost 25.2% in capital value and recorded an overall loss of 24.7%, including dividends. The sector has underperformed the wider share market by a wide margin, with the S&P/ASX 200 down in capital value by 10.2%.

Overseas, the REITs and equities as a whole have sold off by similar amounts, with the FTSE EPRA-NAREIT Global Index in U.S. dollars returning an overall loss (including dividends) of 21.0%, compared with the MSCI World's equivalent loss of 20.4%. All regions went backward, with the Asia-Pacific region doing less badly than most (negative 10.5%), and the eurozone performing the worst (negative 28.9%). The key U.S. market (59% of the global index) was down by 23.5%.

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Australian & International Property — Outlook

At first look, NAB's latest (March quarter) commercial property survey should have encouraged investors. Sentiment about current operating conditions improved as coronavirus restrictions were partially lifted, and forward-looking sentiment for the next two years also took a turn for the better, "driven by a very strong outlook for Industrial property, with confidence in Office & CBD Hotels markets also lifting." Operators in the industry also expected reasonable growth in rentals and capital value for an ongoing hot industrial sector, as well as modest increases in rents and values for offices, but still weak conditions in retail (where values and rents were expected to fall slightly). These expectations may have been a bit on the rosy side—the office sector, for example, was expected to have an oversupply of space relative to demand over the next three years, which suggests that capital gains may not come to hand as easily as respondents thought. But in any event, the "reopening" trade looked well-established. More recently, however, the economic outlook has deteriorated, in particular as household finances have come under pressure, and interest rates have started on a rising path that has some way to go. The A-REITs were particularly exposed to the new direction for interest rates, as the RBA had been suggesting that interest-rate increases would not happen till 2023 or even beyond, whereas overseas REITs had factored in the likelihood of central bank monetary policy tightening earlier. For now, A-REIT investor apprehension over higher interest rates looks likely to be the dominant influence.

Overseas, higher interest rates have also been the most important driving factor. In the U.S. market, for example, even the very strong industrial market has been swept away. American industrial REITs are down 31.1% year to date. At these lower price levels, there is an argument that the asset class has now fully priced in the on fears of the impact of higher rates. The latest (June) *Global Real Estate Insights* report from Colliers Global Capital Markets has an interesting analysis, where it assumes that bond yields will keep rising until the end of 2023: "The positive news is that the global real estate market has been quick to react, with many locations witnessing an adjustment in pricing to higher interest rates. Current 'live' pricing adjustments as of May 2022 show yields have shifted to sustain a healthy risk-free spread to anticipated government bond rates as of year-end 2023. Given that the risk-free spread has fluctuated between a 1.5 - 3.5 % range globally over time, (typically sitting around 2 - 2.5% as a broad benchmark), the majority of locations sit above and around this threshold. This should enable the market to settle quickly." Even if the impact of interest rates has largely been taken on board, however, the asset class also faces the same issue confronting the wider global equity market. The cyclical outlook looks to be deteriorating, and prices may continue to slide as the economic fundamentals get tougher.

Global Infrastructure — Review

Global listed infrastructure has been a rare island of stability in this year's otherwise roiled markets. The S&P Global Infrastructure index in U.S. dollars has made a small capital loss of 1.0%, but including taxed dividends, it has delivered a small positive net return of 0.3%. Hedged back into New Zealand dollars the net return was 3.8%.

Global Infrastructure — Outlook

Market conditions in 2022 have played to the asset class' strength: Infrastructure historically has experienced less volatility than equities as a whole, and in particular has provided protection against

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downside risk, typically falling less than equities in bear markets. These defensive characteristics have been highly valued, and may even have been enhanced, by the nature of this year's troubled markets. Infrastructure tends to provide some hedging protection against both a surge in inflation (via escalation clauses in users' contracts) and higher interest rates (regulated utilities, for example, have their prices reset to allow them to pay their higher interest bills). The more-cyclical patronage-dependent subsectors in the asset class may find the going harder later this year as the global business cycle weakens; but otherwise, the defensiveness of the asset class is likely to see it to continue to outperform.

Australasian Equities — Review

New Zealand equities have done badly year to date. The S&P/NZX 50 Index is down 17.2% in capital value and has delivered an overall loss including dividend income of 16.2%. The setback has been marketwide: The top 10 are down by 16.6%, the mid-caps by 18.3%, and the small caps by 18.0%. Among the big names, only Spark (up a marginal 0.4%) is ahead for the year, while the largest losers have been Fisher & Paykel Healthcare (negative 36.4%), Fletcher Building (negative 30.7%), and Ryman Healthcare (negative 30.1%). The defensive utilities sector has escaped with relatively minor damage (down 6.6%).

Australian shares have also lost ground but not to the same extent as major markets overseas. The S&P/ASX 200 Index is down by 10.2% and by 8.4% including dividend income. The IT sector has been worst hit (down 37.2%) in the midst of a global selloff of tech stocks, and the prospect of more difficult times ahead has also been a strong headwind for consumer discretionary stocks (down 24.4%). Investors have also started to question the outlook for the banks as the housing market slows, and the financials, excluding the A-REITs, are down by 12.2%. The relatively defensive consumer staples sector has held up a bit better than most (down by 8.6%). On the plus side, the resources sector has benefited from the global strength of commodity prices, and the S&P/ASX 300 Index of metals and mining is up by 3.6%.

Australasian Equities — Outlook

In New Zealand, the latest gross domestic product numbers for the March quarter showed a small 0.2% dip in activity. The drop principally reflected the evolution of COVID-19 restrictions, and the June quarter is likely to see some recovery as restrictions eased, but the outlook beyond the June quarter is getting more challenging. Businesses are finding the going progressively difficult, as firms' expectations for their own levels of activity in the latest (May) ANZ business survey dropped back into negative territory. As ANZ noted, there were some positives in the survey: cost pressures, while intense, may be showing the first signs of easing, and in a very tight labour market, firms are still keen to hire whoever is available. But, overall, it was a weak report, especially for businesses close to the rapidly weakening housing market, and the key takeaway for investors had to be the very weak level of expected profitability, which is now down to the levels seen in the grim global financial crisis of 2007-08.

Beyond internal cost pressures, the other problem ahead for business is very weak consumer demand. The latest (May) ANZ/Roy Morgan survey of consumer confidence was, as ANZ summarised it, "dire": "Perceptions of current personal financial situations fell 2 points to -17%. A net 1% expect to be worse

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off this time next year, down 5 points. It's very unusual for this series to be negative. Households think it's a very bad time to buy a major household item (-30%, down 7 points). Remarkably, this is much lower than in the recession following the Global Financial Crisis." Households, though still secure in their jobs, are clearly feeling the triple whammy of rising mortgage rates, falling house prices, and family finances not matching the rate of inflation. At face value, the combined readings from ANZ's business and consumer surveys would suggest GDP is riding for a fall of some 2%. ANZ itself does not think a fall of that order will actually occur, but it remains "a real possibility", and local equity prices are unlikely to rally until there is a sign of better times beyond the immediate headwinds.

Australian business conditions are stronger. The latest employment data, for example, showed that in May, employers were in robust hiring mode: There were just over 60,000 extra jobs created in the month. NAB's May business survey also showed generally solid results: Overall business conditions (a mix of trading, hiring, and profitability) remained in good shape and well above their long-run average. NAB summarised the results as showing that "the economy has maintained its momentum into Q2 and most businesses are in a strong position despite the inflation headwinds, with the lift-off in official interest rates and global growth risks yet to significantly impact Australia's economic trajectory." Solid domestic operating conditions help explain Australia's relatively resilient equity outcome year to date.

But as NAB mentioned, there are potential hits on the way as interest rates continue to rise and the international outlook becomes more problematic. Even if these challenges are not showing up yet in businesses' results, consumers are highly aware of what lies down the track. The latest (June) Westpac – Melbourne Institute consumer survey was very weak: Westpac commented that "The level is comparable with some of the big periods of economic dislocation that we've seen going back to the early 1980s. That includes the Covid pandemic, the global financial crisis, the deep recession of the early nineties, the slowdown in the mid-eighties and the recession of the early eighties." There is similar gloom in the latest (June 7) weekly ANZ – Roy Morgan survey, where, as ANZ said: "Consumer confidence dropped 4.1% last week, most likely on cost-of-living concerns as inflation expectations rose to 5.7%, its highest weekly reading since early April. Consumers are especially pessimistic about the current economic outlook and their current financial circumstances." Only 8% of respondents expect "good times" for the Australian economy over the next 12 months, the lowest level reported since October 2020. An economic slowdown is clearly on the cards—Westpac expects 2022's likely 4% growth to slow to 2% next year—and equities (other than the resources stocks, buoyed by strong world prices) are likely to remain weak as investors come to terms with the forthcoming challenges to corporate earnings.

International Fixed Interest — Review

Bonds have fared very badly in an environment of surging inflation and tightening of monetary policy. Year to date the Bloomberg Global Aggregate in U.S. dollars has lost 15.0%, with global government bonds down 15.7% and global corporate bonds down 12.5%. Higher-yielding subsectors have also been swept away in the current, with global "high-yield" (low credit quality) down by 14.9% and emerging-markets debt down by 16.4%. Capital losses have been magnified for investors taking on relatively long

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duration risk. Investors in "long" U.S. Treasuries (maturities of 20 years plus) have suffered a 24.2% year-to-date loss.

International Fixed Interest — Outlook

The news on world inflation has continued to be bad. The most prominent example was the 8.6% increase in consumer prices in the U.S. in May, the highest rate of inflation since December 1981. There was a tiny crumb of comfort in the data. The "core" rate of inflation, excluding food and energy, dropped back slightly: it hit 6.5% in March, 6.2% in April, and dropped a little further to 6.0% in May. But even after allowing for these volatile items, inflation remains far above the Fed's preferred level. Inflation in many other countries also continues to run at rates that have not been seen in decades. In the U.K., for example, inflation in April, at 9.0%, was the highest it has been since January 1997.

Other than in Japan, where the core inflation rate in April was a modest 2.1% and in line with the Bank of Japan's 2% inflation target, many central banks clearly will be required to keep tightening monetary policy to bring unacceptably high rates of inflation back under control. In the U.S., for example, May's poor inflation outcome led to speculation ahead of its policy meeting on June 14-15 that the Fed might start raising interest rates at a faster clip than previously. The speculation proved correct when the Fed raised its target range for the Fed funds rate by 0.75%, to a range of 1.5% to 1.75%. It was the first time it had hiked interest rates by 0.75% since 1994, and further increases are likely. In its own economic projections, the Fed said that the Fed funds rate would be around 3.4% by the end of this year, and the futures market is currently picking that it could be a bit higher again.

The likelihood is that bond yields (excluding Japan) will rise further during the rest of this year. Not only are central banks pushing interest rates higher, but bondholders, of their own volition, would have been likely to hold out for higher yields in an environment where headline inflation in the OECD area is currently (April) running at 9.2% and core inflation at 6.3%. The bond markets will remain unfriendly until investors have greater confidence that inflation has peaked. The pain will not be confined to bondholders, though; higher yields will also remain bad news for the equity markets, with tighter monetary policy raising the risk of global recession as well as undermining the valuation of corporate earnings.

International Equities — Review

World shares have had a torrid time. Year to date the MSCI World Index of developed economy share markets is down by 21.2%. While there is no formal rhyme or reason to it, some commentators like to call declines of 20% or more a "bear market," and this year certainly qualifies. All the major markets have made large losses, with (for example) the S&P 500 in the U.S. down by 21.3% and the tech-oriented Nasdaq down by 30.9%. By sector, going by the USD FTSE Global sectoral indexes, the only major categories ahead for the year are oil and gas companies (oil and gas producers are up 31.6%), mining (up 9.5%), tobacco (up 6.0%), and fixed-line telecoms (up 1.6%). On the other hand, IT has been heavily battered—technology, negative 27.8%; software and computer services, negative 29.2%; tech hardware and equipment, negative 26.1%—as have the media (negative 35.3%), and areas cyclically

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exposed to weakening consumer spending (consumer services, negative 25.7%; general retailers, negative 27.1%; cars, negative 25.7%).

Emerging markets have also been beaten up, and the MSCI Emerging Markets Index in U.S. dollars is down by 17.5%. Brazil has benefited from strong world commodity prices, with the MSCI Brazil up 3.8% and the BOVESPA Index up 6.6% (both in USD). Also, India's Sensex is down 13.6%, and China's Shanghai Composite is down 15.9% (again all in USD). Russia has also been weak, with a USD decline of 20.5%, going by the RTS Index, or of 33.0%, if you follow the FTSE Russia measure.

International Equities — Outlook

So far, the world economy is continuing to recover from the pandemic and has been coping tolerably well with the residual impacts (ongoing supply chain disruption, staff shortages with ill people off work, and the effects of China's lockdowns). But the pace of growth has been slowing down from the initial lockdown bounceback. The J.P. Morgan Global Composite Index of world business activity in May suggested that global GNP in recent months was growing at something like a 3% pace, compared with a 5% to 6% pace in 2021.

The big international forecasting institutions are also of the view that the global business cycle is weakening. The World Bank in its June *Global Economic Prospects* report said that "Global growth is projected to slow from 5.7 percent in 2021 to 2.9 percent in 2022 and average 3 percent in 2023-24, as Russia's invasion of Ukraine significantly disrupts activity and trade in the near term, pent-up demand fades, and policy support is withdrawn amid high inflation."

The OECD's June *Economic Outlook* came to the same conclusion: "Prior to the outbreak of the war the outlook appeared broadly favourable over 2022-23, with growth and inflation returning to normality as the COVID-19 pandemic and supply-side constraints waned. The invasion of Ukraine, along with shutdowns in major cities and ports in China due to the zero-COVID policy, has generated a new set of adverse shocks. Global GDP growth is now projected to slow sharply this year to 3%, around 1½ percentage points weaker than projected in the December 2021 OECD Economic Outlook, and to remain at a similar subdued pace in 2023."

Both institutions feel that risks to this more subdued outlook are significant. For the OECD, "The uncertainty around this outlook is high, and there are a number of prominent risks. The effects of the war in Ukraine may be even greater than assumed … Inflationary pressures could also prove stronger than expected … Sharp increases in policy interest rates could also slow growth by more than projected … there are significant potential vulnerabilities from high debt levels and elevated asset prices. Challenges also remain for many emerging-market economies … Risks also remain from the evolution of the COVID-19 pandemic."

The World Bank had a similar catalogue of concerns: "The global outlook is subject to various interlinked downside risks. Intensifying geopolitical tensions could further disrupt economic activity, generate policy uncertainty and, if persistent, lead to fragmentation in global trade, investment, and financial systems.

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Supply disruptions from the pandemic and the war in Ukraine have led to a spike in commodity prices comparable to the oil shocks of 1973 and 1979-80 … Additional adverse shocks would increase the possibility that the global economy will experience a period of stagflation reminiscent of the 1970s, with low growth and high inflation … Central banks may be forced to tighten monetary policy more rapidly than currently expected … Financial stress could spread across countries … The pandemic could worsen due to the appearance of new, more virulent variants and lead to the reintroduction of disruptive control measures. The simultaneous materialization of
several downside risks could result in a much sharper and more prolonged global slowdown."

It is no surprise that equity investors have been alarmed and that equity prices have dropped sharply to reflect these new realities, particularly as many equity markets had been expensively priced before the latest shocks. In Bank of America's latest (June) global fund manager survey, respondents echoed the forecasters' concerns: a net 73% of fund managers expected a weaker global economy over the next 12 months, the highest level of pessimism since the survey started back in 1994. A net 72% expected corporate profits to fall, the lowest level since the depths of the global financial crisis in 2008. Fund managers said their two biggest risks are hawkish central banks and the threat of global recession. Equity prices may well remain under pressure until there is a clearer resolution in sight for the shape of the global business cycle over the next year and for the geopolitical endgame around Ukraine.

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