Economic Update: New Zealand
May 2022

Morningstar Research
May 17, 2022

Outlook for Investment Markets

Investment markets have continued to struggle. Year to date, global and domestic bonds, and global and domestic equities, have all gone backward. Returns from cash in the bank are slowly improving, global listed infrastructure has been a rare example of capital preservation. And investors have suffered portfolio losses. The factors that have weighed on returns are, unfortunately, still occurring. The ramifications of the Ukraine crisis are still playing out, the initial recovery from the coronavirus is losing some momentum, and, significantly, markets are bracing for further tightening of monetary policy in several major economies as central banks wrestle with inflation that has surged beyond acceptable limits. New Zealand looks likely to feel the effect of weaker consumer confidence as budgets are further eroded by inflation, and the outlook for the second half of this year is becoming more difficult. In an environment of ongoing uncertainty, prudent portfolio diversification remains a key defence, including in exposure to more defensive sectors and to inflation hedges in current conditions.

New Zealand Cash and Fixed Interest — Review

Short-term interest rates have continued to move higher as the Reserve Bank of New Zealand, or RBNZ, continues to tighten monetary policy, most recently on April 13 when it raised the official cash rate, or OCR, by 0.5% to 1.5%. The 90-day bank bill rate is now 2.1%, up 1.1% since the start of the year. Bond yields have also risen significantly, and the 10-year government bond yield is now 3.6%, up 1.2% year to date. The kiwi dollar has weakened, largely because of a global strengthening in the value of the U.S. dollar (up 8.0% in overall value year to date, on *The Wall Street Journal* index). At 62.4 U.S. cents the kiwi is down 8.7% in terms of its headline rate and is down 3.5% in overall trade-weighted value.

New Zealand Cash and Fixed Interest — Outlook

The RBNZ is in the same tough spot as many of the world's other central banks: inflation has risen to unacceptably high levels (the latest headline rate was 6.9% for the year to March) and has to be brought back under control. Forecasters expect that OCR increases are expected, with the OCR likely to be around the 3% to 3.5% mark in a year's time. The futures market has a similar view of short-term rates, with 90-day bills expected to be yielding 3.9% by next June. The only thing that might stay the RBNZ's hand would be any significant deterioration in economic activity, which remains a possibility given the recent darkening of the global economic outlook.

Bond yields have already risen significantly, and the likelihood is that the bulk of the capital losses suffered by bond investors is already behind us. The S&P New Zealand Aggregate Bond Index has lost 4.8% year to date. But with inflation domestically and globally still running higher than expected levels, it would not be surprising if bondholders required higher yields again to compensate for the threat to their purchasing power. And ANZ Bank, for example, expects that the 10-year yield will hit 4.25% in the second half of this year before starting to ease back in 2023.

Current forecasts suggest that the recent weakness of the kiwi dollar, linked to investors diving back into the U.S. dollar as a safe haven option in currently unsettled financial markets, will reverse during the rest of this year. Bank of New Zealand sees a modest pickup to U.S. $0.64, while the ANZ and Westpac see a stronger recovery, back up to $0.69. The assumption that the skies will clear and investors in a more upbeat frame of mind will return to risk-on currencies like the kiwi dollar is, however, somewhat questionable. The world's central banks have their hands full trying to tame inflation without causing recessions, and the geopolitical outlook (notably Ukraine and its ramifications) remains deeply unsettled. The more bullish predictions of a rapid recovery in the kiwi dollar may be premature.

New Zealand Property — Review

Year to date the S&P/NZX All Real Estate Index has modestly underperformed relative to the overall sharemarket, with a capital loss of 17.6% and a total loss of 16.8% including dividends, compared with the wider market's 15.1% capital loss and 14.3% loss with dividends.

New Zealand Property — Outlook

The simple story about the New Zealand REITs is that, at least for now, interest-rate differentials are the key moving part. The 10-year government bond yield has risen substantially and rapidly, and listed property's positive yield differential over bonds has narrowed significantly over a short period. Other factors that might have supported the sector are taking a back seat: The reopening trade may well be underway for offices and shops as the disruptions from COVID-19 diminish, REIT prices are currently at a discount to the book value of the assets they hold, and progressive repricing of rentals provides some degree of inflation hedging, but the relative yield story remains dominant for now. If the forecasters who think bond yields are close to peak are correct, investors may start to think more warmly about the prospects for the sector, but for now the outlook remains difficult. Its prospects will not be helped if (as noted in the New Zealand equities section) the New Zealand economy weakens in the second half of this year.

Australian & International Property — Review

The A-REITs have significantly underperformed the wider Australian sharemarket, and the S&P/ASX200 A-REITs Index has delivered a capital loss of 16.9% and an overall loss of 16.4% including dividends, compared with the ASX 200's capital loss of 5.0% and overall loss of 3.3%.

Overseas REITs have also done badly in absolute terms but have fared slightly better than overseas equities as a whole. The FTSE EPRA/NAREIT Global Index in U.S. dollars including dividends has returned a loss of 14.5%, slightly better than the equivalent 15.7% loss for the MSCI World Index.

Australian & International Property — Outlook

As in New Zealand, the impact of the recent rise in bond yields, and the prospect of more to come, remain the key influence on performance. In reality, the effect of rising interest rates on A-REIT performance may be more nuanced than it looks on the surface. Shopping centre operator Scentre, in its March quarter operational update, for example, said that if you looked at its debt as of January 2023, some two thirds will have been hedged against rate rises, locking in an average cost of debt of only 1.9%. Scentre also said that shoppers have been returning to its malls as COVID-19 dissipates, and that its rental agreements provide strong inflation protection: "Approximately 80% of our speciality leases are inflation linked with average annual rent escalations of CPI + 2%, the remaining 20% of speciality leases have fixed annual rent escalations with an average escalation of 4%." These positives are, however, not currently getting much of a look as investors continue to draw simple comparisons of the yields available from bonds and from property, and the sector may well continue under the weather as bond yields rise further. A secondary medium-term issue will be the health of the office subsector. Although in general the impact of COVID-19 is waning, the rate of return to the office still remains low. The Property Council of Australia's late-April estimates are that in Sydney, office occupancy was still only 42% of prepandemic levels, and in Melbourne, it was only 36%.

Until very recently, the global business cycle had been performing well, and the improved business conditions flowed through to global commercial property. The March quarter global survey of commercial property run by the Royal Institution of Chartered Surveyors, or RICS, saw both tenant demand and investor demand pick up in the quarter. Respondents were expecting increases in valuations and rentals in the vast majority of markets (excluding China, Hong Kong, and Japan). But that was then, and in the interim, Ukraine, and the prospect of globally higher interest rates, have darkened the outlook. It is not helpful that property goes into a prospective slowdown and looks expensive. RICS found that "At a global level, close to 50% of contributors to the GCPM [Global Commercial Property Monitor] concluded that real estate could currently be viewed as either expensive or very expensive … By contrast, only around 10% judge the real estate market to be either cheap or very cheap." RICS rightly commented that "The shift in policy from central bankers across much of the globe could be seen as exacerbating the risk to real estate," and despite some helpful inflation-hedging characteristics, global REITs look likely to face ongoing headwinds.

Global Infrastructure — Review

Global listed infrastructure continues to be a rare example of an equity sector that is ahead for the year, albeit only modestly. The S&P Global Infrastructure Index in U.S. dollars has made a small capital gain of 1.0% and delivered a net return (including taxed dividends) of 1.9%. Hedging the net return increased it to 5.5% in kiwi dollar terms.

Global Infrastructure — Outlook

The key attraction of the asset class for investors has been portfolio protection in unsettled markets. Infrastructure tends to share in the upside of cyclical expansions, but it is relatively protected from the downside of cyclical setbacks thanks to the ongoing demand for essential services like gas, electricity, and water utilities. Data and other telecom services have also increasingly come to share the characteristics of essentials relatively unaffected by the business cycle. The combination proved well suited to the year so far, as threats to growth have risen from both Ukraine-linked disruption and tighter global monetary policy. Infrastructure also has had some appeal as an inflation hedge, either through renegotiation of regulated utility charges or through inflation-linked terms in user-pays contracts for the likes of toll roads, which have been one of the better subsector performers. The asset class is not wholly immune to the impact of rising bond yields, and absolute returns may remain low as income-sensitive investors seek opportunities elsewhere, but the sector remains well placed to continue to perform well in relative terms.

Australasian Equities — Review

New Zealand equities have fared poorly year to date. The S&P/NZX 50 Index has lost 15.1% in capital value and delivered an overall loss including dividend income of 14.3%. Losses have been spread widely across the market, with the Top 10 down 14.8%, the Mid Caps down 16.0%, and the Small Caps down 14.9%. Among the largest caps, only Spark (up 8.4%) is ahead for the year, while there have been sizable setbacks for Fisher & Paykel Healthcare (negative 35.7%), A2 Milk (negative 25.0%), Ryman Healthcare (negative 23.4%), and Mainfreight (negative 23.1%).

Australian shares are also down year to date but have been relatively resilient compared with overseas markets, with the S&P/ASX 200 Index down by a relatively modest 5.0% (3.3% including dividend income). Performance has been helped by the miners (the S&P/ASX 300 index of metals and mining is marginally up, by 0.4%), the stability of the banks (the Financials ex the A-REITs are effectively unchanged), and the defensive appeal of consumer staples (marginal loss of 0.7%). The big losses have been in IT (negative 32.4%), echoing the global weakness of tech stocks, and in consumer discretionary (negative 17.6%).

Australasian Equities — Outlook

In New Zealand, the economy is still growing at a modest pace. The BNZ/BusinessNZ Indexes of activity in manufacturing and services for April showed ongoing increases in activity, helped by a gradual recovery from COVID-19 restrictions and disruptions. But from here the outlook is distinctly more problematic. The latest (April) business survey run by the ANZ Bank showed that, while firms believe the outlook for their own activity has picked up a bit recently, likely reflecting the gradual waning of COVID-19, businesses are otherwise strongly downbeat. In particular, they are deeply pessimistic about the outlook for their profitability, where they are reporting levels of pessimism not seen since the global financial crisis in 2008. This is unsurprising given the intense pressure on a broad range of input costs, including wages.

Another significant headwind is the prospect of weakening consumer demand. The April ANZ/Roy Morgan survey of consumer confidence showed a modest bounceback from its record low level in March, but consumers are still very wary. The key indicator in the survey about the outlook for retail sales is households' assessment of whether it is a good time to buy a major item—they remain deeply reluctant to buy. Although job security is high in the current tight labour market, households are being battered by a combination of wage increases not matching price increases, higher mortgage costs (and the prospects of further increases as the RBNZ tightens further), and the effects of this year's setbacks to both the financial markets and the housing market. ANZ has a composite indicator that combines elements of its business and consumer surveys, which is a good predictor of future GDP growth.

Currently it is signaling a recession ahead, with the gross domestic product likely to fall by some 2%. ANZ points out that a recession is not its own view, but it indicates the current scale of downside risk, and suggests that there is no immediate turnaround in local equity fortunes on the horizon.

In Australia, businesses are doing better. The latest (April) Ai Group indexes of business activity showed that manufacturing and services had already been growing at a robust rate, and both grew a bit faster again in April. Even though the pace of growth in the construction trade eased back a tad in the month, it too was still enjoying solid growth. NAB's April business survey also picked up strengthening business conditions (a composite measure including trading, profits, and hiring). It has helped that the recreational and personal services sector, which had been especially hard-hit by COVID-19 restrictions and by people's avoidance of the risk of infection, is also strongly on the mend. And despite the input cost and wage squeeze that firms all over the Western world are currently experiencing, Australian firms are reporting good levels of profitability, which are now above the levels they were reporting in 2019 before COVID-19 hit. The relative resilience of Australian shares versus their overseas counterparts makes sense in these conditions.

The outlook from here, though, is more debatable. The biggest challenge, again mirroring the global picture of inflation outpacing household income, is the threat of weak consumer spending ahead, which the equity markets have identified with the very weak performance year to date of shares linked to the consumer's discretionary dollar. The April Westpac/Melbourne Institute consumer survey saw a further decline in consumer confidence: Westpac said that "The Index is now at its lowest level since August 2020 when households were unnerved by the 'second wave' lockdown in Victoria. The weakness in this survey is not related to another pandemic shock but to the combination of rising cost of living pressures and the prospect of rising interest rates." Consumers are reporting that they are more pessimistic about the outlook over the coming year for their own family finances and for the economy as a whole. Australian shares may continue to outperform overseas equities, but the headwinds facing the consumer mean that share prices will remain under some pressure.

International Fixed Interest — Review

Conditions have remained very difficult for investors in bonds, as bond yields have continued to rise, inflicting further capital losses. For example, in the key U.S. market, the benchmark 10-year Treasury yield is now just over 2.9% and is up 1.4% for the year. As a result, the Bloomberg Global Aggregate in U.S. dollars year to date has returned an overall loss of 12.2%, with global government bonds losing 12.6% and global corporate debt losing 9.9%. Investors hoping to gain some protection in higher-yielding subsectors have also lost out. Global high yield (low credit quality) has lost 12.3%, while emerging-markets debt has lost 14.6%.

International Fixed Interest — Outlook

Inflation continues to run at levels that are unacceptably high for many of the major central banks. In April, for example, consumer price inflation in the U.S. was 8.3%, only marginally lower than March's 8.5% rate, and it does not help that what little improvement occurred during the month was down to a temporary fall in petrol prices, which has since reversed. And while a lot of attention is paid to the U.S.

market, the reality is that the problem is prevalent across much of the developed world. The OECD has reported that "Year-on-year consumer prices in the OECD area have leapt from 7.8% in February to 8.8% in March 2022 (having stood at just 2.4% in March 2021), the sharpest increase since October 1988."

The relatively good news is that some of the inflation pressure appears to be temporary. As the OECD said, "The fallout from Russia's invasion of Ukraine in February has led to a fresh supply shock in energy and other commodities, resulting in further inflationary pressure this year." And while the conflict may yet have some way to go, it is possible to envision an eventual endgame where political disruptions to energy and commodity markets wind down. Similarly, the large COVID-19 disruptions to supply chains will also eventually dispel, even if, for now, China continues to maintain strict lockdown controls.

But the relatively bad news is that some of the inflation appears that it will last longer, particularly in the U.S., where stimulatory fiscal and monetary policies have added to the cyclical upswing out of COVID-19. Excluding food and energy, inflation in the U.S. is now 6.2%, and in the OECD as a whole was 5.9% in March. It has become evident, admittedly only with hindsight, that the degree of vigorous monetary policy support after the pandemic was maintained for too long in many economies, adding to the inflationary pressures.

The end result is that excluding Japan, where monetary policy is likely to remain stimulatory (inflation in March was only 1.2% and core inflation, excluding food and energy, was still negative, with prices dropping by 1.5%), the central banks in the U.S., the U.K., and the eurozone, among others, will all be moving to raise interest rates and to withdraw previous programmes of bond-buying that had kept bond yields low. On May 4, for example, the Fed in the U.S. raised the target range for the Fed fund rate by 0.5%, to a new range of 0.75% to 1.0%, its first 0.5% increase since 2000, and it started to run down its stock of bonds. Further rate increases are on the way in the U.S.—the futures market currently expects that the target range will be 2% higher, at 2.75% to 3.0%, by the end of this year—and elsewhere in a wide range of other major economies. Bonds will remain in a difficult place while the central banks continue to tighten and until investors have some confidence that the current inflationary pressures have been brought back under control.

International Equities — Review

A temporary equity market recovery in March after the initial Ukraine selloff was followed by a renewed selloff through April and into May, and year to date the MSCI World Index of developed economy sharemarkets is now down by 16.4% in U.S. dollars. The weakness has been widespread. In the U.S., the S&P 500 is down by 15.6% while the tech-heavy Nasdaq is down by 24.5%; Germany's DAX is down by 11.7%; European shares are more generally down by 10.2% (FTSE Eurofirst 300 Index); and Japan's Nikkei by 8.2%, aggravated for overseas investors by a lower yen (the kiwi dollar has appreciated against the yen by 2.4%). Only the U.K., the listing domicile of some major global energy and commodity firms that have done well as resource prices have boomed, is ahead for the year. But even then, the FTSE 100 Index has managed only a marginal 0.5% increase in sterling terms.

Emerging markets have been weaker again, with the MSCI Emerging Markets Index in U.S. dollars now down by 18.5%. Brazil remains the only major country in emerging markets to repay investors' attention, thanks to commodity revenues. The MSCI Brazil is up by 10.3% and the Bovespa by 12.3% (both in U.S. dollars). The other key economies have recorded large losses, headed, unsurprisingly, by Russia, where shares are down by some 30% in U.S. dollars (RTS Index is negative 29.0%, and FTSE Russia is negative 31.3%).

International Equities — Outlook

The latest slide in share prices reflects increasing concerns about the global economic outlook. The J.P. Morgan Global Composite Index of world business activity in April slipped a bit further, with the world economy now growing at a slower pace and businesses becoming more downbeat about their prospects: "The outlook also became more subdued, with business optimism slipping to a 19-month low." Much of the latest slowdown is related to strict anti-COVID-19 controls on activity in China, which will hopefully dissipate in time. But there are also other concerns: "More broadly, a lockdown-driven downturn in mainland China, the war in Ukraine and disruption caused by stretched supply chains and rising inflationary pressure have all sapped much of the vigour from the upturn. On the prices front, output charges rose to a record high rate and input costs to one of the greatest degrees on record."

Rising interest rates are seen as a particularly serious threat to the global economy. S&P Global Investment Manager Index for May showed that the big institutional fund managers are currently worried about central bank policy, which they see as the biggest immediate threat to equity performance (geopolitical risks linked to Ukraine and a deteriorating global macroeconomic environment also rated highly on their threat radar).

As one illustration of the potential impact, Goldman Sachs recently reckoned that, on their baseline scenario, the S&P 500 could finish this year at 4,300, which would be a 7% gain from its current level. But if interest rates were to rise more than Goldman Sachs currently expects, the S&P 500 could be 3,800 by year-end, which would be a 5.6% loss. And if the interest-rate increases were to tip the U.S. into recession, the S&P 500 could drop to 3,600, a 10.5% loss. Along the same lines, American business news TV channel CNBC runs a regular survey of U.S. fund managers and economists. In May it found that 57% of the respondents believe the Fed's rate increases will cause a U.S. recession (33% said no; 10% were not sure), with mid-2023 the most likely starting point. The only good news in the survey was that the recession was not expected to be severe (53% picked "moderate; 43% picked "mild").

On the plus side, the extent of the share price setbacks year to date means that there has been an appreciable improvement in valuation. The forward-looking P/E ratio on the MSCI World Index, for example, has dropped from around 22 times expected earnings in 2021 to around 16 times earnings now, and valuation as a concern has dropped down the list of risks reported in the S&P Global survey. It is also possible that a lot of the potential bad news is already factored into equity prices, and arguably may even have gone too far. The American Association of Individual Investors, or AAII, runs a regular poll of individual investor sentiment. Its latest results show that "At current levels, bullish sentiment and the bull-bear spread (bullish minus bearish sentiment) are all unusually low … Historically, the S&P 500 index has gone on to realize above-average and above-median returns during the six- and 12-month periods following unusually low readings for bullish sentiment and for the bull-bear spread." Current levels of investor apprehension may be a contrarian indicator that prices already more than adequately incorporate whatever the global economy will eventually deliver.

However events unfold, fund managers for now are taking a defensive approach. The S&P Global survey showed that they are particularly keen on energy shares, given high oil prices, and on healthcare. They are highly averse to consumer discretionary stocks, and to a lesser degree the industrials, which are the areas most exposed to weak consumer spending and a global economic slowdown.

Performance periods, unless otherwise stated, generally refer to periods ended Friday, May 13, 2022.

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