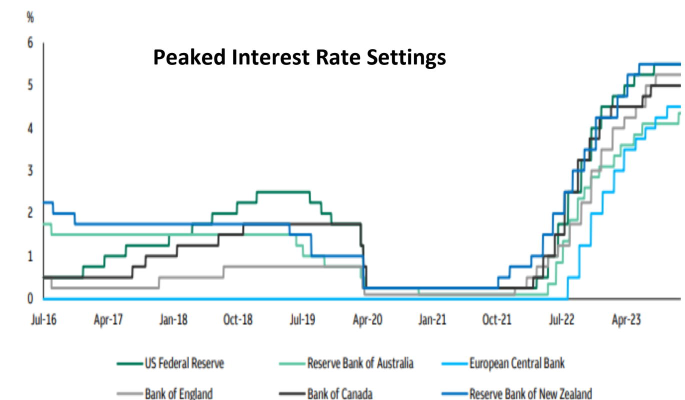
Investor Update

The last two years have been defined by the awkward economic recovery from the chaotic pandemic mess, the resultant rocket inflation and record interest rate rises by central banks to slow demand and slowing economies. We may never know whether the inflation peak and now disinflationary run has simply been a function of a longer term successful covid world to new-normal world transition or whether the sharply higher interest rate settings really did the work of slowing demand. When we look at the resilient global consumption to date and still stimulatory fiscal spending by governments, history may well judge that the supply side merely worked itself out. As we look out on the new year, we can look at the risks / challenges and opportunities/positives for the world and its economies.

Risks and Challenges

Easy and cheap money is over. The post GFC easy money era is over and we are unlikely to see ultra-low or zero interest rate settings being applied again now that cash rates have been 'renormalized'. Except in crises, future monetary stimulus is also unlikely to require non-conventional quantitative easing measures. The new higher price for capital may permanently lower the valuation for risky assets and change capital allocations. Highly indebted and low returning sectors will be the most impacted (commercial real estate?).



Central bank overcooking. Despite inflation falling quickly it is not back to target ranges for many economies and central banks are still talking tough about sticky inflation. Keeping rates too high for too long risks more substantial recession and hard landing. Recent signs for easing labour conditions should soften their stance and we expect rate cuts will be brought forward from current indications and possibly as early as March for the US.

Fiscal Constraints. Governments have been running substantial and often record budget deficits. With also record public debt levels and higher interest servicing costs some countries risk ratings downgrades. We expect significant withdrawal of government spending in most economies. This will be disinflationary but will also deliver a negative impulse for growth when economies are grappling with recession.

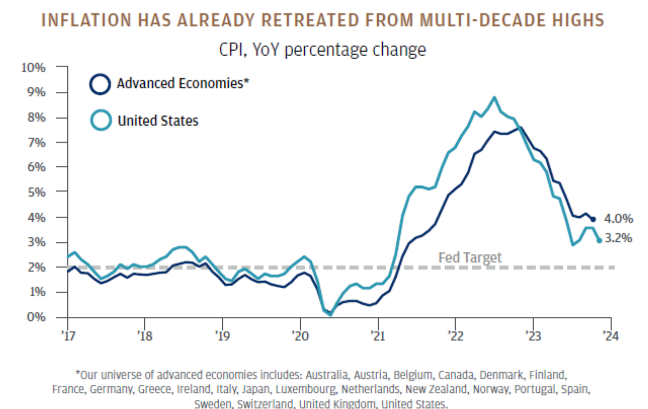
Deglobalization. Covid conditions, now security concerns are changing global supply chains. Re-homing of critical manufacturing and trade restrictions in sensitive tech is forcing a rearrangement in supply. This is likely to be inflationary in the short term and place additional stress on superpower relationships. Walmart recently reported the portion of its shipments from China have reduced from 80% to 2018 to 60% this year. Imports from India now make up 25%, compared to just 2% in 2018. (Reuters).

Rising Conflict. Global instability will continue to rise this year. The grinding, deadly Ukraine / Russian war deteriorates. Intelligence reports (Reuters Reported) have Russia's losses at 315,000 dead or wounded. Meanwhile the Israel / Hamas war reports suggest as many as 30,000 may have died and is risking wider regional contagion. The Red Sea security crisis is already impacting trade as a global economic consequence. The US/China relationship has recently slightly improved with better military communications but it is unlikely to reverse course and global security partitioning will continue. China spending on its military has risen to 7% of its GDP. The US faces highly divisive and distracting federal elections that may also have significant implications for international stability. A tricky year ahead.

Climate Change. This potentially existential risk gets pushed aside in the melee of other crises and economic and political necessities. The December Cop28 Climate Summit saw a commitment to keep the global temperature limit of 1.5°C within reach but the transition cost to renewable energy means any short-term action and results will remain limited. The US has just hit a record high in oil production while India recently announced it would triple underground coal mining.

Opportunities and Positives

Lower Inflation and Lower Interest Rates. Not yet back into target ranges but very close in the US with others to follow. Against a backdrop of slowing economic growth and recession we expect central banks to ease faster and earlier which will be supportive for borrowers and assist growth later in 2024. A lower rate trend will also be supportive for investment markets.



Improving labour Markets. Global full employment has prevented global recession. Labour is now easing up, assisting disinflation. This is a function of slowing activity and technology but also improved global labour movement as covid restrictions continue to unwind and countries re-open to migrant workers. Over fifty-fives in the US continue to head back to work after 'retiring' during Covid.

Covid Savings Still in Play. While nearly expended in some economies, excess global savings (totaled USD$5 trillion) are still being used to support household finances and consumption.

Lower Energy Costs. Will support global growth. While some would argue it is not great for green energy transition, oil prices have pulled back a long way to a little over $US72bbl from $US120bbl in 2022. Primarily driven by the unexpected recovery of US supply and recent price cuts from Saudi Arabia. Disinflationary and reduced input costs for manufacturing and supportive for energy import dependent countries (Japan).

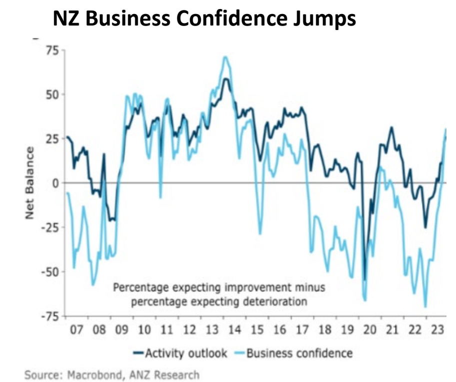
Chinese Growth to Improve. After a very tricky year exiting Covid and dealing with their property based financial crises, authorities are once again focused on achieving faster growth recently announcing easier financial conditions. They are also targeting support for 'high quality' activity as they seek to move their economy up the value chain. China is the world's dominant manufacturing power with more output than Europe and Japan combined and critically needed for world growth.

Technology Adoption. It is hard to believe that Chat GPT was released just over 1 year ago and had one million users in just 5 days. Since then, upgraded versions and other AI software are quickly finding their way into everyday use in all areas of life. Combined with faster data processing (Nvidia) and convergence with other technologies (robotics, sciences, healthcare) we are in a new era for productivity gains and healthcare. This includes hope for Alzheimer's disease with a 2024 launch of newly approved therapies, Eisai/Biogen's Lecanemab and Eli Lilly's Donanemab.

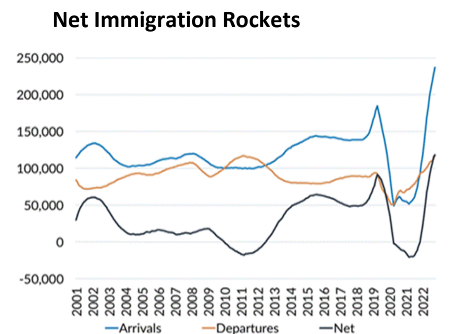
New Zealand

The November change in government significantly lifted business confidence (ANZ) to its highest level since March 2015. Tourism has continued to improve in the quarter and is 85% back to pre-covid levels and air travel at 90%. Labour pressures have also been easing on record net immigration (129,000 in 12 months and the largest since 1947) with unemployment edging out to 3.9% (from 3.6%) and businesses finding access to workers markedly improving. On the flip side consumer confidence was weaker on higher interest costs and greater job uncertainty as the economy slows. The economy confirmed its contraction for the third quarter at -0.3% and weaker than RBNZ forecasts. Revisions to prior quarters growth was also lower showing 2023 has been a much weaker year. BNZ calculates that without the massive immigration levels that the economy contracted on an annual per capita basis -3.1% and as bad as during the GFC. Michael Redell writes that the 2024 IMF forecasts have New Zealand real per capita GDP growth at 0.0 per cent, ranking us 177th of 190 countries. Our public finances have also been completely trashed. We are running an account balance at -7.6% of GDP. More government debt issuance will also be required ($7bn) to cover these deficits, cover lower tax takes and higher interest rate payments. Some commentators now worry about a NZ credit ratings downgrade. The new coalition Government will certainly have its work cut out balancing policy aims against its fiscal constraints. The overall lower level of economic activity (we may currently be in recession) and weakening household spending (mortgage resets still coming) suggests the RBNZ may not need to raise rates again and could ease earlier this year rather than most have been forecasting in 2025. They will be reluctant to move too soon though given inflation remains stubbornly high for our economy. The RBNZ will now also pursue a single price stability objective (1%-3% inflation rate) removing its needs to support maximum sustainable employment. The new the inflow of migrants may reduce labour pressures but, they will also add to inflationary concerns through higher net demand and particularly rents. New home consents remain low and -14% down on last year only adding to housing concerns. Forecast growth in 2024 is 1.0%.

NZ Business Confidence Jumps

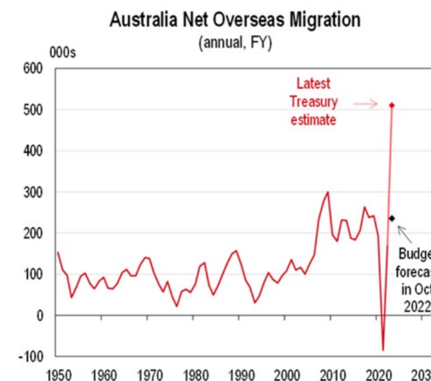


Net Immigration Rockets



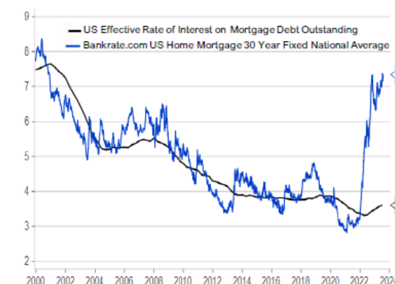
Australia

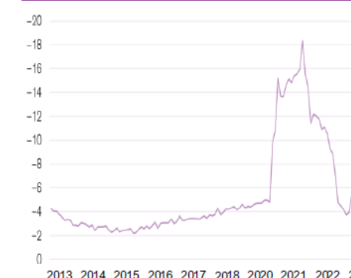
Like NZ, the Australian economy likely avoided recession in 2023 due to record net immigration levels of 520,000 which saw their population rise by 2.4% in the year. International students were the biggest contributor. The rate of immigration is expected to slow from here but still be over 300,000 in 2024 and contributing to improved labour resources. Unemployment lifted to 3.9% and is expected to rise further this year to 4.5%. At the same time wages, are rising due to higher minimum wage settings. Q3 GDP growth came in at 0.2% and lower than expected. Household spending continues to slump as rising costs particularly higher mortgage rates eat into discretionary spending. With inflation declining from a peak of 8.4% in December 2022 to 4.3% in November and expected to reach 3.5% by the end of the year the RBA will pause and start cutting rates late 2024. Future household spending will be muted though Government infrastructure spending is expanding and mining and agriculture export activity improving on better Chinese demand (should accelerate) and higher commodity prices. House prices remain firm on lower construction activity (poor economics) and new migrant demand despite higher mortgage costs. Forecast growth in 2024 is 1.5%.



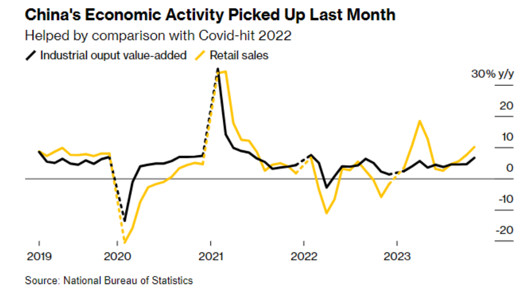
US

The US economy surprised everyone last year. After fears of near term recession, the economy delivered a Q3 growth rate of 5.2% (annualised) and well above expectations. Consumer spending accelerated supported by full employment, strong house prices and excess covid period savings. The long term fixed nature of their mortgage market means that higher interest rates have not transmitted to households yet with aggregate net borrowing costs around 3.6% when 30 year mortgage rates are at 7.5%. Additionally, Government spending (6% fiscal deficit) has been supportive, particularly for parts of the economy (CHIPS Act) though overall business investment remains weak and manufacturing flat but no longer contracting. Services activity continues to expand (ISM 52.7 in November) and productivity is also rising. North American Truck orders rose to a 5 year high. The unemployment rate lifted to 3.9% in the period and slowing wage growth has assisted (along with the drop in energy prices) bringing inflation down to near target range for the Fed Reserve. The market believes rate hikes have now been completed and are now pricing in 1.3% of rate cuts this year. With their economy slowing the Fed may cut sooner and as early as March declaring they were "we much focussed" on the risk of keeping rates too high for too long. A cut in borrowing costs would provide some welcome but possibly too late relief for over leveraged areas of the economy including commercial real estate. From here US growth is likely to slow through the first 2 quarters of the year then build as monetary conditions are eased. Current polls show (subject to legal challenges) Trump is likely to regain Presidency over Biden. Why both parties have not found better candidates remains a puzzle. Apart from the divisive impact the elections will have on their nation, a Republican win would bring more fiscal constraint to the economy. Forecast growth in 2024 is 1.5%.





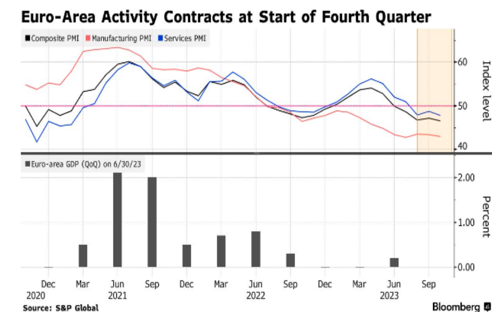
China



After risking stalling, the Chinese economy is now showing signs of stabilizing. Xi has had his hands full embracing greater central control to help balance his increasingly complex cultural, political and economic agendas. Q3 GDP growth came in at 4.9% annualised vs 6.3% in Q2. Consumers failed to engage post Covid lockdown restrictions and amidst falling property prices, rising unemployment (25% youth unemployment) and restrictive credit conditions. Manufacturing also contracted in the period though more recently retail sales and industrial activity have slightly improved. Previously a significant growth driver, highly leveraged and oversupplied property development is creating a drag on activity and threatening financial system stability. This has impacted both consumer and business confidence. Rodney Jones (Wigram Capital) estimates Chinese excess house construction at 70m units of US$10 trillion in value that will take 10 years to absorb. Much development funding has come from the shadow bank system (Investment Trusts) with several larger players defaulting, liquidating or collapsing. This is leading to a 'balance sheet recession' and requiring central intervention to prevent contagion risk. Xi has been keen to ensure developers and lenders equity has been sufficiently impacted to avoid bailing out the rich. Looking ahead, China needs to build back foreign direct investment which has collapsed following regulatory intervention and interference. To date, this has not been successful with additional restrictions and demands on foreigners. At two recent high-level party meetings, top leaders committed to seek progress and strengthen fiscal policy appropriately suggesting a new drive for greater economic growth this year. In December, commercial lenders received $111bn in central bank loans and also conducted open market operations to provide additional funding support. A further stimulus package equating to 0.8% of GDP has also been announced. Forecast growth in 2024 is 5.5%.

Europe & UK

After the post-Covid spending boom, growth rates in Europe declined sharply from the energy shock, sharp decline in export demand (China), on higher interest rates to combat inflation and subdued confidence. Much tighter credit conditions have also impacted business and property investment while consumer spending is now slowing including for services. This reduced activity and sharply lower energy costs has now seen Eurozone inflation fall from 11.5% a year ago to 2.9% in December providing an encouraging outlook for easier money conditions in 2024. The EU slowed in Q3 and recent data suggests the EU may have contracted in Q4 and entering a technical recession. The ECB expects growth to accelerate modestly through 2024 underpinned by record low unemployment levels, improving exports and improving household spending capacity (better real wages). Forecast growth in 2024 is 0.8%.



UK inflation is also dropping sharply and may reach target 2% as early as April provided there are no energy shocks. This paves the way for the BOE to make rate cuts this year with markets already pricing in 5 x 0.5% cuts in 2024. Strong employment, rising real wages (including a lift in the National Living Wage (£11.44 ph) and easier credit conditions should see an improvement in consumer spending that is currently weak. A better forecast for house prices will also support confidence. Though growth will be modest this year it appears the UK is turning the corner but still faces significant challenges including poor public finances and potential General Election chaos. Forecast growth in 2024 is 0.5%.

Japan

After peaking around 4.3% in early 2023 Japan's inflation rate fell back to 2.8% in November. Given the relatively softer inflation backdrop (particularly no wages growth) the BOJ saw no need to raise interest rates in 2022/23 and continues to provide the world's last negative interest rate. Growth has been steady if unspectacular supported by manufacturing exports and a weak Yen. Domestic demand remains weak and Prime Minister Fumio Kishida is set to announce further spending of around 21.8 trillion yen ($144 billion) in his latest stimulus package for growth. Japan continues to grind along needing much stronger and sustainable domestic demand and a solution to their weak demographics (immigration required) to achieve a different growth runway. Greater Chinese demand is expected this year including tourism which will assist. The Japanese share market just reached a 34-year high. Forecast growth in 2024 is 1%.

Emerging Markets

East-Asia ex China growth is forecast to come in around 5% in 2024 with strong contributions from Vietnam (Chinese surrogate manufacturing), Indonesia and the Philippines. India leads the ex-East Asia charge at 6.3% and continues to accelerate but is being restricted by energy access (Russia benefiting). South America and Eastern Europe growth in 2024 is forecast at 1-2%.

MARKETS

Investment markets ultimately delivered strong returns for the year and covering for the losses of a very tough 2022. It was volatile throughout the year however and investors needed to be patient and disciplined to get the best results. Markets tortuously followed every new inflation data point and sweated over every word delivered by central banks to ascertain whether the peak for policy interest rates had been reached, then worrying about when they may start to cut rates. We had to wait until the last quarter of the year when the US Federal Reserve delivered an unexpected change in language, "the Fed Pivot," which anticipated a scenario where recession was not required to tame inflation any longer and a "soft landing" possible. This pivot provided a boost in investor sentiment lifting both bond and share prices. With disinflation accelerating and core inflation moving closer to target ranges, investment markets are now pricing in several interest rate cuts in 2024 from the US Fed and others including the ECB, BOE and BOC. Investors have started to move money from record cash fund holdings into growth assets in anticipation that short term cash rates will quickly drop. Valuations for markets are still generally good with overvaluation concerns largely levelled at the very large and expensive tech sectors that have been driving so much of the recent share market returns. As cash rates are cut, we expect additional wider market returns will be validated and further supported throughout 2024 particularly if inflation continues to retrace (a risk with energy prices) at its present rate.

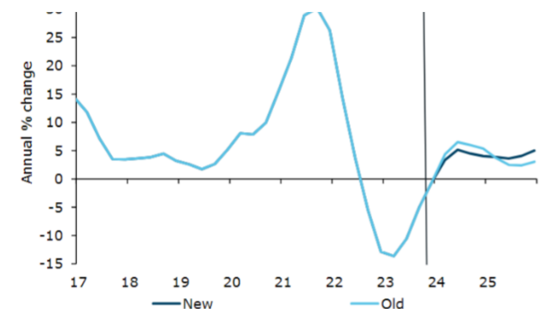
Australasian

Supported by reasonable economic growth and a less hawkish reserve bank, the Australian market performed well rising +8.5% for the quarter (+12.4% for the year). Our local market provided a positive contribution up +4.2% for the quarter but was only just positive over the year (+2.6%) and lagging most other share markets as we continue to linger in or near recession and business and consumer confidence took a significant battering leading up to the NZ General Election. We also had a surprise economic contraction in Q3 (and despite strong immigration growth) which unsettled investor confidence. Meanwhile NZ inflation has also been much stickier (ongoing wage pressures) and our Reserve Bank continues to talk tough about this and pushing out any rate cuts to 2025.

Property

Globally, the property sector remains under pressure as higher interest rates impact valuations and affordability while raising the cost for leverage property investments including development activities. Property values have fallen significantly but likely have not yet bottomed with most commentators expecting additional declines in retail, commercial and overconstructed residential markets (China). Resilient areas include industrial (logistics), healthcare and retirement sectors.

Annual % Change – ANZ Residential Property Forecast

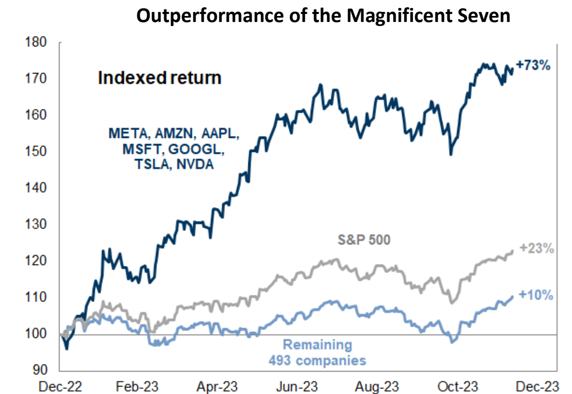


In NZ we are seeing similar patterns though with strong net immigration and declining house construction rates we remain significantly underhoused with rising rents also a feature. As the costs for construction deflate and interest rates decline, activity is expected to pick up and existing home demand and sales should improve. Unfavourable tax settings are also expected to be unwound (interest cost deductibility and shorter

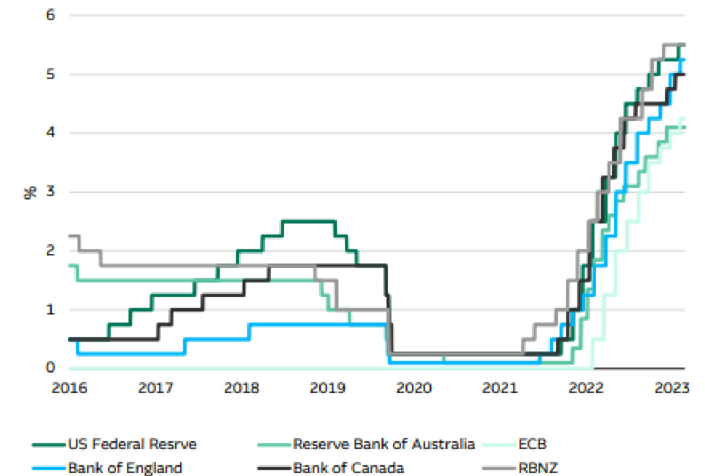
bright-line periods) encouraging capital back into the sector. Bank forecasts for residential property are for flatter prices in 2024 but better sales and prices on lower interest rates as we move out to 2025.

International

Accelerating disinflation, relatively robust economies (few in contraction) and the outlook for easier monetary conditions supported global share markets through 2023 though not without volatility. The MSCI All Country Index finished the year +21.4% and +22.1% in NZD terms and according to Harbour the fourth highest annual return this century. Much of this return was concentrated in the US, Japanese and European markets. The US market return was dominated by their top tech companies that continued with impressive growth after a very tough 2022. These dominant companies including Tesla, Alphabet (Google), Microsoft, Meta (Facebook), Apple, Amazon and Nvidia delivered a return of +73% for the year. When removing these companies from the wider S&P500 index, the index return falls from +23% for the year to +10% showing the dominance of these companies. 72% of the companies in the wider index underperformed in 2023. From a valuation perspective the same is true with the top 'magnificent 7' tech companies trading at 33.6x earnings and the wider market at 20x earnings and when stripping out the tech giants the market valuation is closer to 15x earnings. This suggests that the wider markets still offer relatively good value and with improving corporate profits expected this year should continue to underpin a wider improvement in market values. It is interesting to note that the magnificent 7 are expected to post a +40% increase in aggregate earnings in 2023 compared with a -2.6% decline for the rest of the market. Elsewhere, Europe and especially the UK remain attractive for further improvement as they work through more difficult economic conditions in the first half of 2024. Despite being relatively undervalued the Chinese market continued to disappoint in 2023 and down -11.2% as regulatory/political interference and capital controls continue to drive out foreign investment.



Fixed Interest Following record official interest rate rises over 2022/23, central banks have paused hiking as inflation retreats as quickly as it rose. Though not back to target levels in many countries, markets are pricing in earlier interest rates cuts than officials are suggesting. There is an expectation that cash rates will be cut as much as -1.3% in the US this year and a similar amount in Europe, UK and Canada. Stickier inflation issues in NZ (wages and services) mean we may need to wait longer for cuts though recently weaker than expected economic activity may see the RBNZ act in 2024 rather than in 2025.



The prospects for lower interest rates saw a strong rise in NZ bond values for the year, up +5.4% after a +7.3% increase in the December quarter. Bond yields have retreated significantly with the NZ 10year Government Bond falling from 5.6% in October to 4.3% at the end of the year and US Government Bonds finishing with yields down at 3.9% from over 5% in October (prices for existing bonds rise when interest rates fall). The Bloomberg Global Aggregate index finished up +6.6% over the year. With lower cash rates coming, investors also moved into bonds to lock in higher yields for longer. This flow is expected to continue and provide support for fixed interest markets. Against this buying support there is a wall of new issuance from indebted governments coming this year as they raise fresh funds to cover increased interest rate payment costs and fund fiscal deficits. Some US$2.1 trillion of additional issues are expected from the US, UK, Eurozone and Japanese governments alone. This may provide headwinds for markets as investors worry about debt sustainability and credit ratings (NZ being no exception).