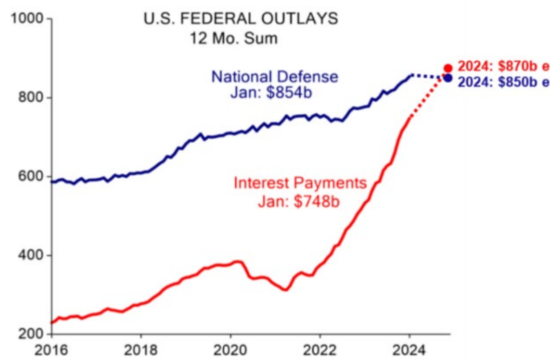
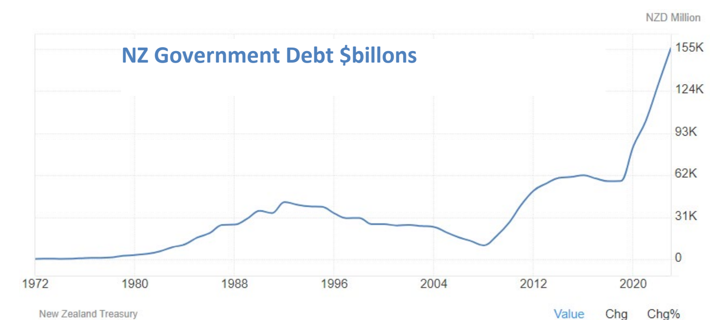
Investor Update

Despite the record fast rise in interest rates, the global economy has not yet come off the rails. It is certainly slowing but proving to be remarkably resilient to the point a 'Goldilocks' outcome is now consensus. Some commentators warn global recession is still coming and the transmission impact of higher rates is still working its way through economies. This is certainly the case but it is a sensitive timing argument. For instance, US households that are locked into 2% 30year term loans remain unimpacted (though don't want to move home and lose the benefit), NZ households that were locked into 3% 5year rates are still immune. Corporate balance sheets are also generally in good shape with many taking advantage of ultra-low interest rates during the Covid period to lock in cheap long-term financing. Meanwhile borrowers that have rolled off near free money and re-financing at today's interest costs (including Governments) are struggling. As servicing costs rise, debt levels lift as borrowers switch to interest only loans (where they can) and credit card and student loan balances also rise. Credit bureau Centrix says overall NZ loan arrears have reached a seven-year high. Higher interest rates have already been factored into liquid market valuations including fixed interest, equites and to a lesser extent property and infrastructure. Greater pain is being felt in low/no cash flow activities including property development, venture capital, private equity and private credit.



How much more economic contraction we have is a function of timing. Borrowers including Governments are now hurting as massive low cost Covid borrowings and record budget deficits are refinanced at higher rates. US interest costs will be higher than defense spending in 2025 and NZ is on track to spend more on debt interest than public health. We are now "paying the piper". So why are markets still performing and economies plugging along? It is in the expectation that rates will be cut soon by central banks as inflation recedes. Central banks are nervous. Reluctant to cut rates too early and then need to reverse policy, central banks presently prefer to be cautious. The longer they leave cuts the faster and greater the economic damage (and repair time) will be. While economies are presently holding on, another year of rates at current levels would most certainly push the world into deep recession. So, our obsession with daily inflation data will only intensify as the year progresses and each blip in inflationary components will correspond to rate cut speculation and market jitters. Central banks will also have to decide whether to doggedly pursue their inflation target ranges or allow for more leeway and patience. The politicization of rate policy will also increase this year as a record number of country elections sees the pressure come on central banks for relief and to let economies run. With such high interest costs, fiscal consolidation has also become a necessity, forcing governments to pull in spending and putting even more pressure on economies. So, are markets right? Is inflation moving down quickly enough to enable earlier rate cuts? We can only wait and see but investors do need to ensure they have sufficient defensive assets in place as this story plays out.



NEWTON ROSS
PRIVATE WEALTH MANAGEMENT

ALUARIUM

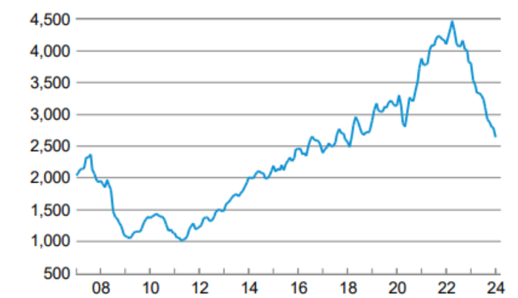
New Zealand

Our households are really feeling it now. While initially improving on the change in government, consumer confidence is once again falling. After a couple of years of record consumer price inflation, higher living costs are baked in and far more so than any wage adjustments. Indebted households have also had or are soon to face a mortgage rate reset shock. Non-performing house loans increased by over 10% in January. The combined cost pressures are telling and starting to impact consumption with a notable decline in retail spending. On the flip side, net savings households are reveling in higher interest and portfolio earnings and contributing to robust demand particularly for services. We are seeing this in better domestic tourism and the global affect from higher end inbound tourism. In 2023, near record net immigration numbers supported activity but this impulse is waning though but not so the worrying pace of kiwis leaving our shores for greener pastures. A new government has sharply improved business confidence though the honeymoon period has quickly passed and all eyes will be on the 30th May Budget. The Government needs to find the keys to the productivity box which will be challenging because after such rampant and ineffective spending over the Covid years, they will have no choice but to fiscally consolidate. How they balance their reduced spending and presumably reduced revenues (slower economy and tax cuts) will be interesting. We can certainly expect retrenchment in the public service and a greater focus on long-term infrastructure activity to address our severe deficits. They will need to be selective and effective. With our economy now in recession (last 5 quarters on a per capita basis) the next few quarters will be difficult too and may flatline to Christmas. The RBNZs tight monetary policy is certainly being rewarded with a much slower economy. Though non-tradables (domestic) inflation remains sticky and in part due to the immigration surge, we should see a rate cut by the end of the year and possibly sooner.

Figure 1. ANZ-Roy Morgan Consumer Confidence

Source: Roy Morgan, Macrobond, ANZ Research

Figure 1: Building consents for new dwellings (seasonally adjusted 3-month moving average)



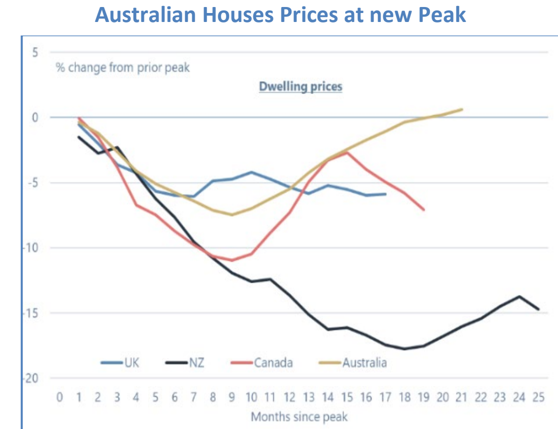
Source: Stats NZ

Australia

As is often the case things across the ditch look better than here. They are experiencing the same interest rate shocks as we are but the mood is better with recent consumer confidence improving and being driven by a stronger labour market with employment up in February. Australia's current account surplus also rebounded to $11.8bn and is now back to the same levels a year ago on better export demand (China) and strong inbound tourism. China recently removed tariffs on Australian wine as it starts a re-engagement programme with strained trading partners. Unlike our economy, Australia is still expanding and up +0.2% in the last quarter of 2023 and +1.5% for the year. Like NZ, Australia has had record net migration levels and a further 450,000 are expected this year. This will support consumption and increase labour resources but also likely to add to inflation as well. Interestingly Australia recently stopped their "golden visa" scheme for wealthy applicants running since 2012 and of which 85% came from China citing the scheme was "delivering poor economic outcomes" and replaced with more skilled-worker visas (Economist). Australian wages are up +4.2% over the year and the largest increase since 2009 with 38% of public

sector workers receiving an average increase of +4.3%. Though unemployment has risen to 4.1% and households are feeling the cost of living and higher interest rates, they remain perky with reasonable business confidence and a solid outlook for public and private investment. Much of this is targeted for infrastructure and building projects (A$948bn pipeline) which will assist offset their currently weak residential construction. Interestingly, while commercial property is under pressure (CBD offices selling at a 20% discount to peak), their housing market is strong and recently set a new high for dwellings (AFR). Unlike the NZ market which is still -15% below peak. This will further support household confidence.

Australian Houses Prices at new Peak

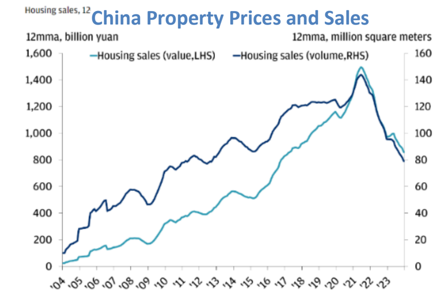


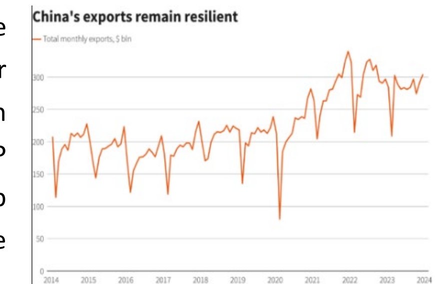
US

The US economy continues to perform and turned in a +3.2% annualized growth rate in the last quarter of 2023 and +2.1% for the year. It is on track for +2% growth this year. Impressively, manufacturing activity jumped in March exceeding all economist estimates and the first expansion since 2022. Despite its resilient economic performance and increase activity index, the US consumer is starting to slow and now providing some headwinds for their economy. At the same time inflation is proving tricky to read moving higher in the quarter (see chart opposite) then reversing post quarter end and lower at +0.26% versus expected +0.4%. The US Federal Reserve kept rates on hold in the period and reiterated its view for at least 3 rate cuts this year and possibly as early as June. The US unemployment rate moved higher (+3.9%) in easing labour market conditions. Interestingly (and unlike NZ) productivity has also accelerated sharply up +2.6% year on year. This acceleration was due to an increase in hours worked and large positive labour supply. But no one is sure how much productivity contribution has actually come from 'off the books' undocumented illegals. AI driven productivity gains will become more pronounced this year in the US and expected to improve company earnings. The chart opposite shows the Conference Board's Leading Economic Indicator as rising off negative levels that historically would mark recession. Economists now place the probability of a recession over the next 12 months at 40% vs 65% in June 2023 so, a 'soft landing' is now consensus. Ahead, the US faces the uncertainty of the US general election on 5th November which will weigh on consumer and business confidence. A Trump victory would probably see a continuation of large budget deficits, increasing tariffs (higher import prices & tradeables inflation) and a tough focus on immigration. Trade, diplomatic and foreign affairs policy settings would all dramatically change as the focus would move squarely back to a "better America."

China

Despite their weak property sector, falling share markets and foreign capital outflows, Chinese industrial production was actually strong at +7% year on year and overall investment ok at +4.2% in the quarter. This is despite the continued fall in property investment (-9% year on year). Chinese industrial profit surged +10.2% in the first two months of the year having contracted -2.3% in 2023. GDP finished the final quarter of 2023 at +5.2% year and up +1% from the prior quarter due to strong industrial but also services activity. Retail sales were +7.4%. China activity is improving though still weaker than target, authorities announced a further stimulus package of $150bn. They also moved to shore-up their financial system most exposed to property development through a consolidation of some regional banks and the PBOC cut the reserve requirement for banks as well. The property sector continues to drag on the economy with further declines in house prices and now falling for the 7th consecutive month. After the recent "Two Sessions" Conference in March, the National People's Congress confirmed Xi's continued leadership and paved the way for more Party control over government and private sector activity. Xi wants to be more directive on investment to ensure the right focus on technology and science development and for better financial system control. The Conference reduced the 2024 GDP growth target to +5% while also announcing a +7.2% increase in defence spending. Chinese exports continue to hold up well in the face of ongoing deglobalisation and a move by many western economies to insulate themselves from a reliance on Chinese production. Apple manufacturing is a specific case in point where 95% of their iphones are made in China. Many exports are simply shifting to proxy export countries such as Vietnam and Cambodia. They are also aggressively pricing EVs for export and again raising trading alarm bells in the west. As an interesting aside, China installed more solar panels in 2023 than any nation has built in total (Bloomberg). The Chinese share of US Treasuries has also reduced from 14% in June 2011 to less than 3%.



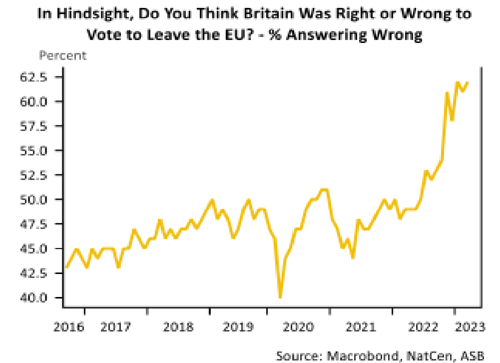


Europe & UK

It has been a tough grind for the Eurozone as industrial and manufacturing activity contracted through 2023 and it is not yet finding its feet. Fortunately, services demand underpinned by the lowest unemployment rate since the Euro started (6.4%) has provided sufficient momentum to keep overall growth expanding albeit at a very low rate. While their economy remains weak, there are some green shoots appearing. Germany's Business Climate index in March brought it to a 9-month high and recent orders have lifted for beleaguered German manufacturers. Recent ECB surveys point to a slow recovery over the year though consolidating government spending will be restrictive. Inflation continues to edge down to +2.4% in March, from +2.6% in February with most components declining (food, goods, energy, services) and wages growth also starting to moderate. Upside risks to inflation include geopolitical tensions. Since mid-November global shipping costs have increased and as much as 250% on some of the China-to-Europe routes due to the Red Sea

disruption. The ECB remains in wait and watch mode for further deflation but they are closer to their 2% target though also acknowledging the risks that broader financial conditions are restrictive.   Rate cuts should come later in the year. As an aside, NATO's European members need to find an extra €56bn a year to meet the alliance's defence spending target (FT).

Across the channel, the UK economy has been spluttering along and like NZ, entered recession at the end of 2023 with broad based falls across household spending, business and housing investment. Retail sales have been particularly weak as household income comes under pressure from higher debt servicing costs and withdrawal of Covid fiscal support. Meanwhile house prices have also been weaker and undermining confidence and household savings are rising. Inflation fell to +3.4% from 4% and the lowest since 2021 though the BOE remains on hold at 5.25%. Recent business surveys are more positive with own activity increasing though GDP is expected to remain flat over 2024. Against the weaker economic backdrop, the UK's tax burden will rise to an estimated 37.1%of GDP by 2029 and the highest level since 1948 while the non-domiciled tax status rules will also be abolished (capital flight coming?). It has been 3 years since Brexit with estimates of a corresponding 22%-27% reduction in trade. The survey opposite shows that more than 60% of public respondents think it was wrong to leave the EU. Interestingly the UK recently publicly blamed China for two malicious cyber campaigns that targeted Britain's elections watchdog and parliamentarians. UKs BAE Systems recently increased production of 155mm artillery shells under a contract with the UK Ministry of Defence that will see it raise its production capacity eight-fold.



Japan

Japan is flirting with recession. The Government downgraded its outlook for the economy in February as weak consumer spending dragged on activity and industrial output has also stalled. The Yen fell to its lowest level against the US dollar since 1990 supporting export competitiveness but raising import inflation. Resurgent inbound tourism has also benefited from the low Yen. In the quarter Japan lost its spot as the world's largest economy and falling behind Germany. Japan continues to be beset by weak consumer demand and poor demographics. More than a third of the over 70's still work. Until inflation comes down sufficiently (from 3.1%) or wages increase, demand is likely to stall and continue to decline (contracting last 2 quarters). Despite a flat economy the sharemarket rise strongly in the period +20% year to date and finally back above its 1989 highs. Over the same 35 years the S&P500 index is up 15x. The BOJ lifted interest rates back to 0% from -0.1% as it seeks normalise rates. How far they can lift rates and not be overly restrictive will difficult particularly with public debt at 245% of GDP, higher interest rate costs would be unsustainable.