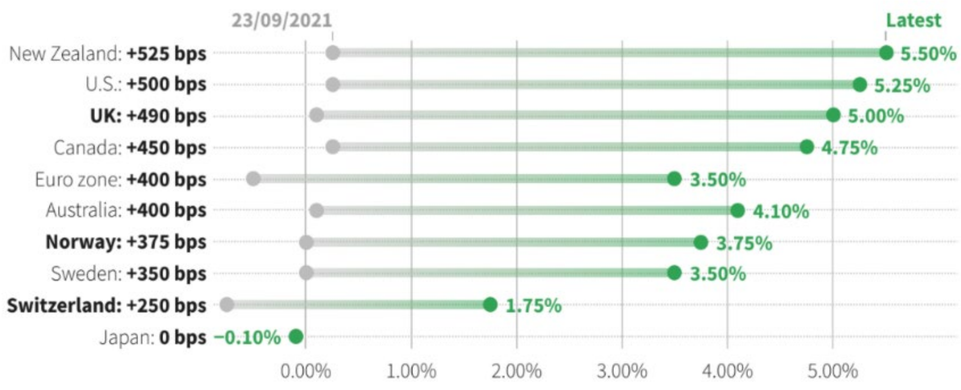
Investor Update

It feels too long since the Covid lockdowns to still call the rebalancing of the global economy "transitional" but that is what it is. Central banks and governments initially expected the transitional phase would be shortish and inflation fleeting but here we are 18months later and global supply and demand is still trying to equate. The Russian invasion of Ukraine and China locking back down did not help. Goods including materials and commodities are getting closer to equilibrium but now services are struggling to meet demand with rising costs being felt particularly in areas such as health, hospitality, travel and public services. There are recent signs labour conditions are easing but not quickly enough for many economies where wage price pressures are potentially becoming embedded. Higher interest rates are unlikely to be the answer and instead more proactive immigration policies and a focus on skilled worker education are required to address short term needs and then longer-term structural pressures.

Central banks are proving patient with wage pressures but are, none the less, keeping labour data front and centre of policy thinking. The rate of deflation this year has been roughly in line with forecasts but was expected to accelerate through the rest of the year. Labour shortages are making that projected track less likely and raising the question of how will central banks react? In April/May they generally signalled a pause in tightening after record rate increases but their language has recently become more wary with some (BOE, US Fed, RBA and ECB) contemplating additional hikes. The BOE, Norway and Switzerland all recently lifted rates again while the RBA remains on pause. Markets that had developed an expectation for rate cuts later this year are now more cautious, recalculating the risk for recession, reduced corporate earnings and higher for longer interest rates. At the same time, economies are still holding up better than expected despite much tighter credit conditions. This leads to a confusing outlook for investors. Most importantly, will central banks be prepared to let inflation now run higher than their targets in the belief it will come back into range naturally over time (the lag effect) or, do they keep tightening regardless of the potential damage caused. Even though the rising cost of living is hurting households, political pressure will more likely bear on central banks to not crush growth, preferring households to keep their jobs and have a softer end to the economic cycle than a hard landing. There will be greater clarity this coming quarter as the impact of more expensive money and tighter lending conditions works its way through business and household finances and as inflation data matures further.

The Great Interest Rate Race

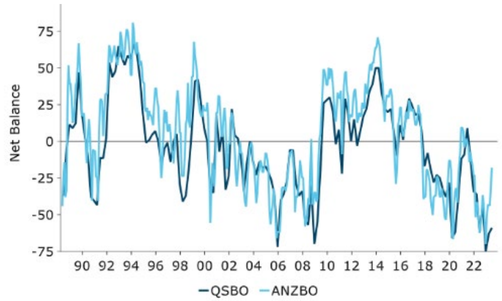


Source: Refinitiv Datastream | Reuters, June 22, 2023 | By Sumanta Sen

As investors we think the outlook is more positive than we have seen for the last year. Primarily because economies are now well advanced into a weaker part of the cycle and much higher interest rates are unlikely from here. We may not be at the peak, but we are very close and more stimulative monetary policy settings are very likely within the next 12-18 months. Markets look out this far when assessing value and have already factored in weaker economic growth and negative earnings (which may continue to positively surprise). Further support may also come from the record levels of cash that institutional investors have been sitting on during this period of uncertainty. These excess funds (though now earning higher deposit rates) will need to be deployed into broader markets at some point and while they still offer reasonable value. As markets have continued to tick up and recover this year, those institutional investors have been missing out on returns and FOMO is building.

We will also talk further in our September report about Artificial Intelligence (AI) providing the next global productivity revolution. A recent McKinsey's paper estimated AI could add the equivalent of $2.6 to $4.4 trillion p.a. to the global economy and 0.6% p.a. labour productivity growth over the next 20 years. For example, they say banks could generate an additional $200-$340 billion p.a. from increased productivity and a 25% improvement to profits for pharmaceutical companies and medical product firms from faster drug development.

NZIER Business Confidence Survey - ANZ

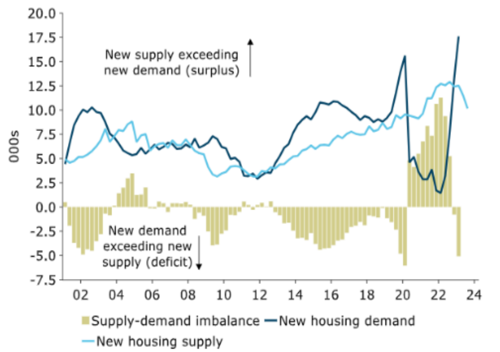


Source: NZIER, Macrobond, ANZ Research

New Zealand

Our economy entered a technical recession in the period. We had two consecutive quarters of slightly negative GDP growth which was not surprising given much tighter credit conditions, declining home prices and the extreme and adverse weather events. Mortgage and consumer credit data shows some borrowers are starting to fall behind on payments. Businesses in the recent NZIER quarterly survey are reporting a broad weakening in demand though labour constraints are easing as migration surges. The survey is showing a slight improvement in confidence from record low levels (as shown opposite) though 58% of businesses remain pessimistic (better than 75% in 2022). Corelogic has national house prices down -10.6% over 1 year and -12.5% over 1 year in Auckland. Home consents are -11% on the year but there are early signs the market may stabilizing as auction clearance rates improving. The Government accounts are worse than forecast with an operating deficit of $6.1bn now expected and $2.1bn worse than recent Treasury forecasts. Net public debt is also $5.1bn higher at $73.3bn. Tax revenues are down on weaker business activity. On the positive side, consumer confidence is recently less negative and we are having a surprise influx of migrants which should assist our stretched labour market, add to net demand and possibly home demand. The government recently announced an extension to our working visa schemes which was welcomed by a desperate hospitality industry as tourism rebuilds. Ahead there are substantial cyclone repairs to be undertaken and a renewed government focus on critical infrastructure spending. Our softer economic position and declining inflation means our OCR rate may have peaked at 5.5%. The deflation will accelerate in the second half of the year as we move through the price spikes in fresh food and as supply constraints ease further and airfare prices fall. Of course, we have a General Election looming along with the associated policy angst which will impact decision making and particularly business investment. We expect trading partner demand to remain firm for exports and tourism to further build so the growth outlook for the rest of the year looks flat but not dire.

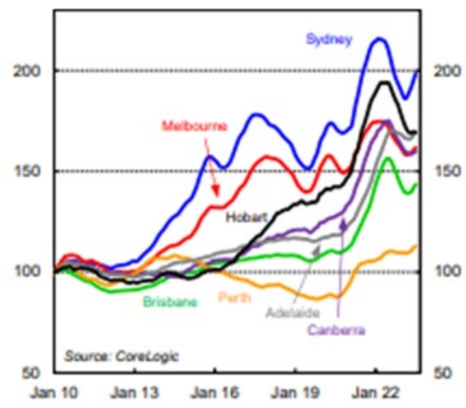
Strong Migration Growth to Lift Housing Demand



Australia

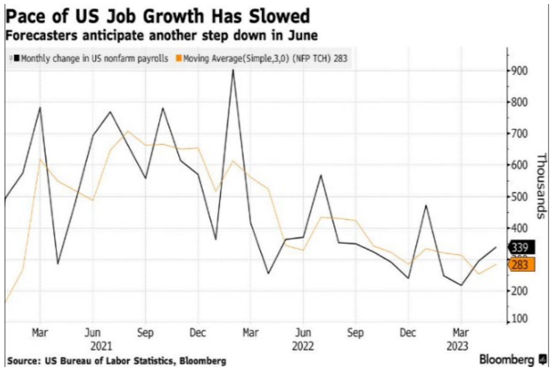
With its tightest labour market in 50 years, the RBA remains concerned wage pressures are still building leaving core inflation at higher and stickier levels than preferred. Down from +6.8% in April but still +5.6% year on year in May. The RBA lifted rates 0.1% to 4.1% in June and recently paused but signalling additional rises may be in order. The market is pricing in another 0.35% in rate rises by September. The RBA has been generally patient to see the lag effect on rises. Higher mortgage rates are impacting consumer spending and households have run down significant Covid savings. Substantial planned infrastructure spending, still solid business investment and booming exports (current account surplus of $12.3bn) continue to support their economy. There has also been a recent turn up in house prices (Sydney +6.7% from January lows - Corelogic) which will assist consumer sentiment and building approvals are running ahead of forecasts. Westpac has the Australian economy at +1.4% this year after +3.7% in 2022 and only +0.5% for 2024 as business investment then slows on weaker demand. They also expect unemployment to rise from 3.5% to 5.3% in 2024 which should ease wage inflation. Australia may have a technical recession in the second half of this year (currently a 50% chance) but a deeper recession still appears unlikely. Australia took a net 387,000 in new migrants in 2022 with their population growing 500,000 and up to 26.3m. This is the fastest growth since 2008 and will be supportive of demand and help ease very tight labour conditions. Australia is expected to surpass the United Arab Emirates to become the top country to attract inflows of high-net-worth individuals. (AFR).

Australian Home Prices Turning



US

The US economy remains a headscratcher. Their first quarter revised growth rate came in at 2% and up from 1.3%. Nonfarm payrolls increased by 209k in June, the smallest gain in 2 years and below expectations of 220k. Wage inflation however remains persistent at +4.4% year on year showing labour market conditions remain tight. The June University of Michigan consumer sentiment index rose from 59.2 to 64.4 in June (survey: 63.9). Durable goods orders are up while the Conference Board consumer confidence index rose from 102.5 to 109.7 in June. The US economy is performing above expectations due to robust services demand and households spending and despite much higher mortgage servicing costs. The average 30-year fixed-rate mortgage rate has increased to 6.75% from just under 3% in June 2021. Despite higher interest costs, new home construction increased 21.7% in May and house prices also risen. The increase by number of housing units was the most in more than three decades (Reuters). On the flip side, manufacturing weakened in June with the ISM manufacturing gauge falling to its lowest level since May 2020. Regional activity gauges are however quite divergent and showing manufacturing remains strong for some areas. At the same time, inflation though blipping up slightly in June is coming down at 4.6% year on year and the lowest since April 2021. Inflation expectations (opposite) are also coming down to 3.8% in June and the lowest since April 2021. The US has an economy with clear signs inflation is cooling though labour conditions remain tight (3.6% unemployment rate) and activity is weakening slightly. This confusing picture has Fed Reserve head Jerome Powell suggesting another 2 rate hikes maybe required this year. That could take the present cash rate of 5.25% to 5.75% and some commentators are saying 6%. The re-homing of many critical security industries (such as silicon CHIP

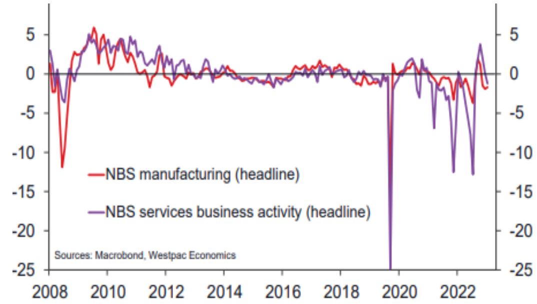


and battery making) will also support activity while the Biden government continues with significant fiscal stimulus following the resolution of the budget debt ceiling. After the recent regional banking stability concerns, the Fed Reserve annual stress test showed that large US banks (those with over $100b in assets) have enough capital to weather a severe economic slump. Despite this comfort the US yield curve remains just as much inverted and still signalling recession.

China

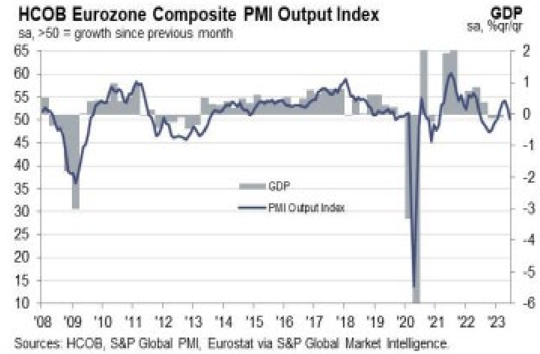
After coming out of lockdown strongly, Chinese growth appears to haves stalled during Q2 as consumer spending declined, housing start slowed, property sales fell and prices dropped. Households are feeling less wealthy and confident. The Caxin/S&P Global services index eased to 53.9 in June from 57.1 in May. Manufacturing activity was also lower for a third straight month in June though only slightly down (opposite) on average with firms retaining workers and business investment remaining steady. The government continues its push for greater infrastructure investment and activity in higher income industries (critical technology focus). It is also campaigning (again) to attract and improve foreign investment conditions as it tries to build deeper capital markets outside of real estate. Despite the slower outlook (5% vs 5.5%) stimulus has been limited to date to a cut in two benchmark lending rates while officials are still working on stabilizing and repairing their heavily indebted property development market. With inflation recently much weaker there remains room for stimulus to be applied. Xi continues to invest heavily in militarization and advancing China's belt and road initiatives. After tense relations with the west and specifically the US, Treasurer Janet Yellen is in China (at the time of writing) seeking to reduce the strain. Meanwhile the US and China continue to implement escalating technology bans and tariffs especially around computer chip and battery manufacturing.

Chinese Manufacturing Flat - Westpac

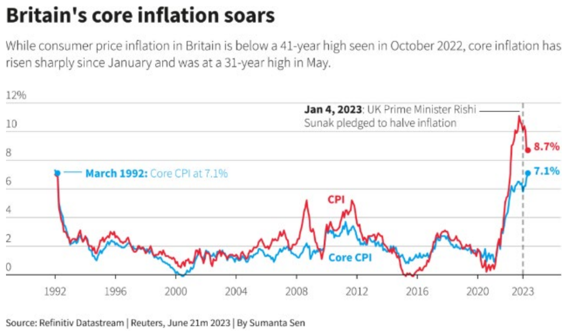


Europe & UK

European activity is at best mixed. Strong services demand has generally offset falling factory orders as global demand weakens. French strikes and protests have impacted services demand though recently stronger manufacturing data has surprised in France, Spain and Germany (vehicles) while Italy remains very weak. German business confidence is also lower while Rhine water levels continue to slow freight movement. The PMI for the 20 nations sharing the Euro was 50.3 in June from 52.8 in May and well below consensus forecast of 52.5. Inflation is also mixed across the region re-accelerating in Germany (6.8% annualised) and much slower in Spain (1.9% annualised). The disparity shows the challenge the ECB has though at its recent Forum it reaffirmed that further tightening will be required.



Across the channel, the UK economy is facing its own set of challenges**.** UK manufacturing contracted further in June 46.2 from May 47.1 while services activity is also starting to slow (though remains positive). Inflation is also very sticky at 8.7% and the fastest for any major advanced economy. Core inflation increased to 7.1% in June. The BOE looks likely to have no choice but continuing to raise rates at least another 0.5% to 5.5% and various forecasts have a terminal rate of 6%. Like NZ, the UK has a fixed rate mortgage market meaning the transmission of higher rates into mortgage repayments is taking time (the lag effect). Households are not yet affected by greater servicing costs and being fully employed continue to spend and drive services inflation (7.3%). Consumer confidence will be affected though by the further slump in house prices. Growth is set to slow and the UK enter recession in the second half of the year. UK government debt levels have now passed that of GDP for the first time in 62 years (FT).



Japan

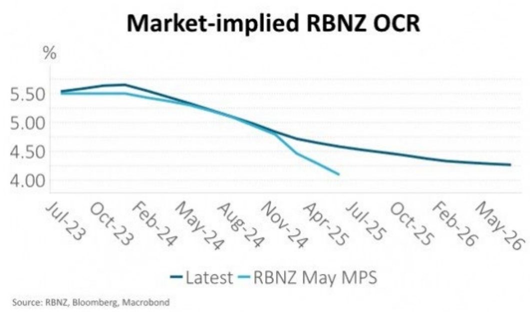
During the first quarter Japan recorded a robust +2.7% (annualised) growth rate that was much higher than expected and reflecting the improving business mood of the country. Falling raw material costs and the removal of pandemic curbs lifted factory output and consumption. The recent Tankan survey shows companies expect to increase investment. Inflation by global standards is low at 3.2% in May but still extreme for Japan and at a 40 year high. Recent inflation data is slower but not likely to retreat to target 2% levels for some time. Unlike other central banks, the BOJ retains a stimulative -0.1% cash rate and a weak yen is importing cost inflation. Growth is expected to come in at 1.1% for 2023. During the quarter Japan's Nikkei index surpassed 33,000 for first time since 1990.

MARKETS

Markets continue to work through the direction for interest rate policy settings. After a dreadful 2022, markets have rallied and recovered some ground on the prospects of deflation, interest rate pauses and then cuts. The timeframe for these is slipping back further than Q4 now with sticky and in some cases resurgent inflation appearing. Despite the record rise in interest rates some economies are just refusing to lie down. The lag impact of rate rises to real world effects is one thing, but consumption is proving to be far more resilient and labour markets remain stubbornly tight. Good economic news is presently not good news for markets, which want to see economic capitulation that can prompt easier interest rates settings. There are some recessionary signs ahead, even if mild and technical at this stage but wage inflation remains the key. We need to see a reduction in wage pressures before markets can move much higher. It is important to note that much of the global share market recovery this year has been very narrow and in large technology stocks and in the US. Broader markets also rose but only modestly and have significant valuation room to yet recover. Bond markets have an inverted yield curve set for recession which will steepen as central banks finally move into cutting mode. This offers the opportunity for investors to extend their bond maturities and lock in rates for longer. Bonds at these higher yields should now provide structurally better contributions to portfolios including greater income generation but also much improved diversification benefits. It will be interesting to see how the deteriorating NZ government accounts may impact bond pricing locally.

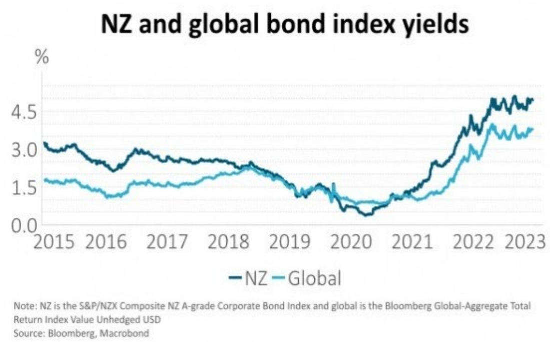
Cash

Cash rates look to move a little higher from here. At least, that is how central banks are telling it as they became more hawkish over the quarter on surprisingly strong economic and inflation data. The RBNZ OCR track (see opposite) has moved higher for longer and this policy extension is being reflected around the world with central banks talking about a further 0.25% to 0.5% hike in rates being needed. Some central banks have already raised again while others pause and wait for more data. If we aren't there yet, then we are certainly close to peak rates. It is notable the transmission effect of rate rises is not straight forward in fixed rate lending markets like NZ and the UK whereas the impact is more immediate in countries like Australia where household debt servicing costs are skyrocketing. It will be a fine balancing act for the RBNZ to manage this lag without tipping the economy further into recession.



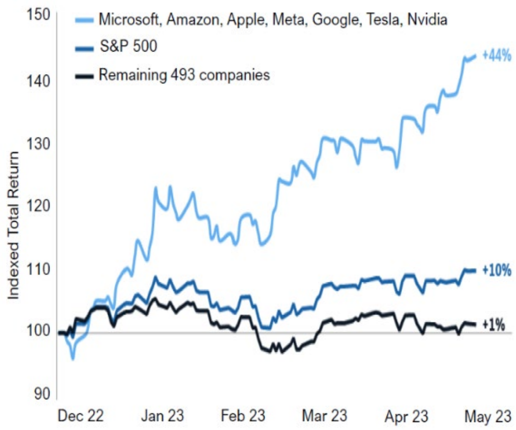
Fixed Interest

Cash and bond yields are now running between 5-6% and providing much higher income. Yields are also above the long-term neutral rate (the level where it is not restrictive nor too accommodating for the economy). Bond prices that rallied hard in the first quarter were flat to slightly down in the second quarter as markets firstly focused on global banking system risk (contagion risk from the US) and then worried further about new spurts of inflation. 10-year government yields moved back up to 3 month high levels providing a potential entry opportunity for investors that believe yields must be at or close to their cyclical highs. While long dated bonds may still be too volatile, shorter dated bonds are also providing high yields with less risk and will be an attractive and more liquid alternative to term deposits for many investors.



Equities

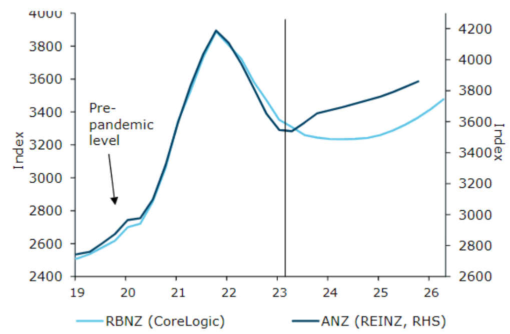
Share markets have had a decent run this year but looking into the data shows the recovery has been driven by a smaller number of sectors and companies. Stellar returns in IT and consumer discretionary companies delivered nearly 70% of the return for global share markets year to date (MSCI AWCI). The chart opposite shows the return from the 7 top performing technology companies over the period to end of May versus the total return from the S&P500 and then the remaining 493 companies. The broader Dow Jones Index is up +3.8% year to date while our market is +3.6% and Australia +2.3% in local terms. So, while the S&P500 index might look expensive to its 10-year averages most of the companies in it are still trading well below their historical PE averages. Company earnings have also been much better than expected so far this year. They are certainly down in many markets but much less negative than feared by analysts. Q1 earnings for the S&P 500 declined YOY by -2.1% against expectation of a -6.7% decline. Institutional investors that had been defensively positioned for equities going into 2023 started to succumb in Q2 as markets moved higher than expected. This led to many short market positions being unwound and greater cash flows coming back into sharemarkets. From here investors will be very focused on company earnings results particularly as we move into a more difficult recessionary period for most economies and tougher trading conditions. Markets have already priced in a slowdown but should company earnings be materially negative to expectations (say -8%) then we may see a short term dip before rebounding on easier cash rate prospects and better economic prospects ahead. Both the number of companies reporting positive EPS surprises and the magnitude of these surprises are above their 10-year averages. As an aside, Apple's market value exceeded $3 trillion for the first time in the quarter. For context, NZ's GDP is US$250b.



Property

At the end of May the ANZ revised up their house price forecasts predicting the floor had been reached and publishing their track opposite for pricing and being more optimistic than the RBNZ. Auction clearance rates have recently improved and sales are also better. CoreLogic data shows property prices continued their decline in June however falling -1.2% nationwide (-10.6% over 1 year) and -3% in Auckland (-12.5% over 1 year). The REINZ index is down -18% nationally from the November 2021 price peak, although it is still up +5.4% over the past five years. Building consents are down from -26% compared with the very high levels in April 2022. Home completions in Auckland are now running at record levels with more than 14,700 homes built in the last 12 months (interest.co.nz). With much higher mortgage costs, the near term outlook for residential property remains challenging though we have had surprisingly strong net migration which should provide some support. Overseas residential property markets are also mixed with the Australian and US markets recently turning up while European, UK and Chinese markets are weaker. Commercial property values remain under significant pressure given higher vacancy and interest rates post Covid.

NZ Home Price Forecasts – RBNZ, REINZ, ANZ

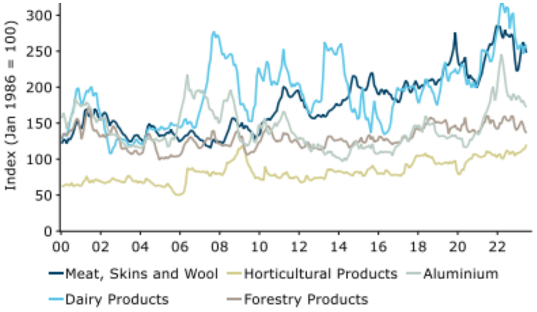


Source: RBNZ, REINZ, ANZ Research

Commodities

Global commodity prices continued to fall in the quarter with the Bloomberg Commodity Index down -13.7% year to date led by lower energy prices. Precious metals, agriculture and rare earth metals are slightly higher over the period. NZ export commodity prices have not been immune from the global run-down with the ANZ Commodity Price Index -11% over 12 months and lumber prices down around -22% over this period. Weaker Chinese demand has also affected meat and dairy prices. Horticultural prices have fared better though production is down from adverse weather which is hurting growers. Shipping costs are still easing from record high levels as the demand for global goods continues to normalise post covid and now reduce further on weaker economic conditions.

ANZ Commodity Price Index – Sub Indices



Source: Macrobond, ANZ Research