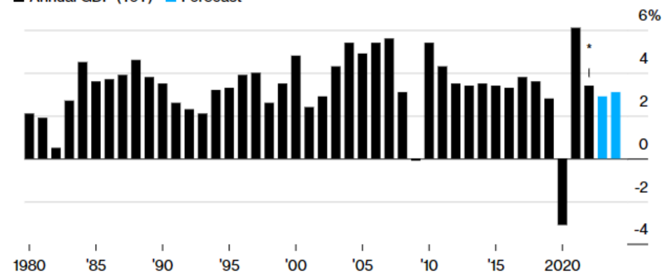
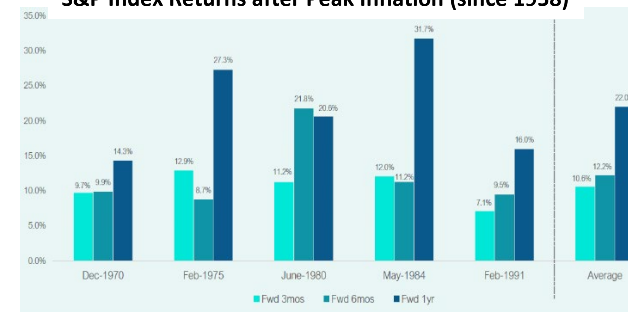
Investor Update

The global economy began the year in a position of economic resilience as trends in late 2022 were generally better than expected (NZ excluded). The IMF recently predicts world growth in 2023 at 2.8% down from 3.4% in 2022. Stronger economies are providing a challenge for inflation management as are the inflationary effects of increasingly fragmented global trade. Geo-political forces have emerged to change the shape of trade (security concerns) as much as the ongoing disruption caused by a post Covid lockdown hangover. Tighter global credit conditions, particularly on the bank of US regional banking concerns are doing some of the policy work with tougher bank lending standards disinflationary.



This global economic cycle feels very different. We now have China stimulating growth as they exit their failed Covid lockdown (adding to global inflation on demand and disinflation on supply) on the other hand we have many post lockdown countries dealing with excess demand that is proving stubborn to quell despite higher borrowing costs (see US consumer resilience charts opposite). Many economies are still running on substantial Covid period household and business savings which is delaying the impact of higher borrowing costs. Indebted households have yet to fully feel the pain using up their reserves and still confident of their employment. Meanwhile, rising deposit rates are beginning to provide new incomes for non-indebted households adding to net demand. Given already historically fast rate rises, the dilemma for central bank policy is just getting greater. Though inflation peaked in 2022 and trending lower, it is proving stickier than central banks would like. The combination of even further interest rate increases in the quarter and much tighter bank lending standards will hopefully act in concert to slow inflation but we are now seeing a clear departure in central bank policy approaches given how far rates have already been raised. Rate rises are a blunt tool to tame inflation, equivalent of taking a sledge hammer to a nail. The transmission effect to the real economy can have very long lag periods and unintended consequences. While maintaining price stability is a core responsibility, central banks are generally required to give a wider consideration to their actions. This is most often the preservation of full employment which means not putting economies into deep recession. These considerations, as well as the different inflation drivers for their economies, is now creating a diversity in central bank direction. We have some pausing (RBA, BOC, BOJ) and determined to assess the lag impact of the rate rises (which seems very sensible) versus those slowing (US Fed, BOE) and those still strongly raising (ECB, RBNZ) believing inflation to be more embedded. NZ has a particular set of conditions including a painfully stretched labour market to deal with. Different policy approaches may be justified but settings in the extremis are troubling for markets trying to look through potential recession to the start of the next cycle. This does add up to more volatility in the coming quarter even though the general direction for inflation and economic activity is down. The opposite chart shows how the US sharemarket has performed (since 1958) after peak inflation and rising an average +22% return over the next 12 months.

S&P Index Returns after Peak Inflation (since 1958)



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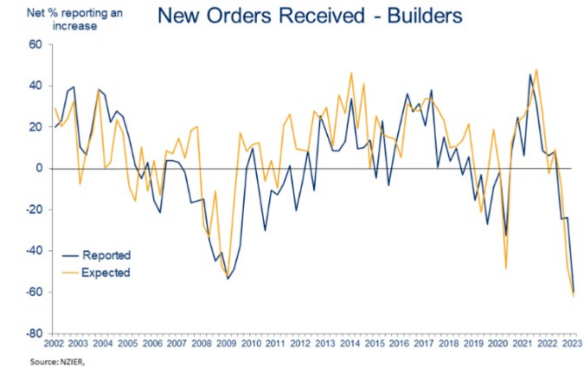
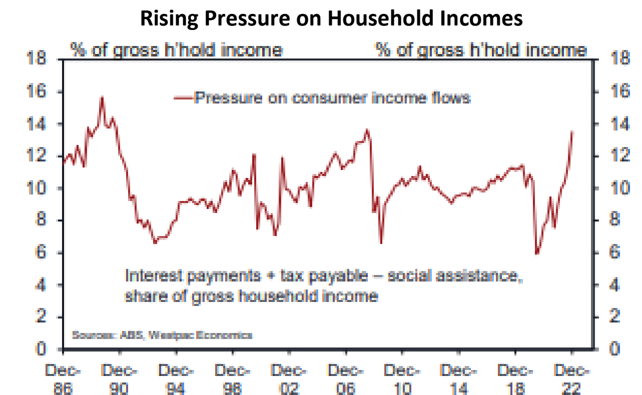
New Zealand Despite an unexpected negative GDP number in the December quarter (-0.6%) the RBNZ then surprised markets by lifting the cash rate further than expected in early April at 50bps to 5.25% (a 14 year high) and they continue to express a very hawkish tone given sticky inflation data. They are also keeping a wary eye on fiscal activity ahead of an election period while post Gabrielle re-building will strain resources. NZ had better net migration in the quarter which was also suprised and while it may be the start of improved labour conditions, the RBNZ sees it as potentially inflationary. Markets are now having to reassess a peak rate which may have upside risk from 5.5% (presently likely in May). Given the lag effect of rate rises (mortgage resets) businesses are increasingly worried what the the impact of higher interest costs and much tighter credit conditions will have on household spending. Meanwhile property prices continued falling in the period (down another 1.1% in March) making home owners feel poorer. Barfoot and Thompson recorded their lowest level of home sales since the GFC. The recent latest NZIER Quarterly Survey of Business Opinion showed a net 61% of firms expect economic conditions will deteriorate over the coming year and reporting labour constraints as the main issue. Business confidence slightly improved off very low levels in December while own business activity has generally been better than expected. The chart opposite shows the sharp fall in new orders by builders after a post Covid period of very strong construction (again impacted by very tight lending). There has been a 30% drop in monthly consent issuance since March 2022. While inflation remains so high (last 7.2%) we are not likely to see any relief from the RBNZ and there is a risk of a greater downturn in the second half of the year when we may already be in recession.



Australia Despite experiencing the same hot inflationary conditions as NZ, the Reserve Bank of Australia paused rate increases in the period (at 3.6%) being more patient to see the flow through affects of recent hikes on their economy. The RBA also remains wary of tight international funding conditions impacting local credit conditions though presently remains on course to lift rates a further and final 0.25% in May. The higher cost of money is certainly slowing domestic activity evidenced by weaker household spending. The chart opposite from Westpac shows the rising drain of increased interest costs (+24%) on household incomes. Savings rates are declining and excess savings accumulated during covid are being used up to cover higher costs adding to the stickiness of inflation. Strong net migration should assist a very tight labour market (unemployment at 50 year lows) and help to restrain wage growth. "Australia is expected to experience the biggest two-year population surge in its history, with an extra 650,000 migrants this financial year and next driving a 900,000 jump in the number of residents" (The Australian). Australia's exports are booming again on resurgent Chinese demand (including for previously banned coal, timber, wine and barley) and despite the increasing geo-political pressures arising from the AUKUS security pact and US/UK nuclear submarine deal. The Australian economy may yet avoid recession and presently on track for a softer landing than NZ with economic growth forecast to come in around 1.5% to 1.7% for 2023 though inflation targets may not be reached until 2025.

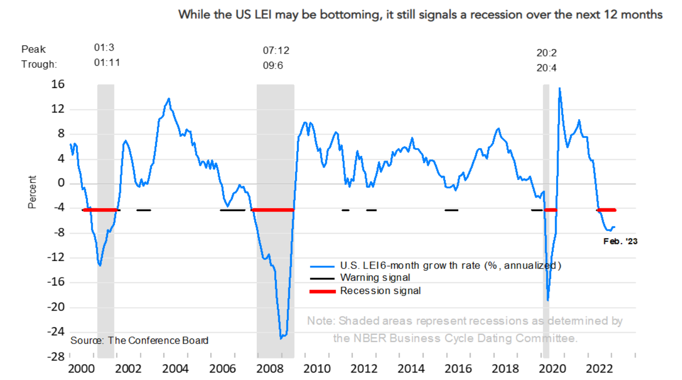
Rising Pressure on Household Incomes



US

Middle America is still spending up large. This is supported by higher wages and strong job postings while public perceptions about the strength of the labour market remains higher than it was pre-pandemic. The March Conference Board consumer confidence index rose from 103.4 to 104.2. Leading indicators (see opposite chart) are however contractionary suggesting a slowdown is still on its way and a recession likely in the second half of the year. For now, domestic consumption is supporting the economy while labour (3.5% unemployment) in the services industry particularly remains tight. Stronger net migration and boomers working for longer should assist. Manufacturing was slightly weaker while house prices have held up well surprisingly well and much better than expected given the increasingly difficult credit environment. The turmoil in the US banking sector will impact confidence and the effects are likely to linger and have further to play out. The US Fed and regulators moved quickly to prevent possible contagion risk from the collapse of Silicon Valley Bank and Signature Bank but depositors across the US banking system remain extremely wary. There will be ongoing stresses as bank lending gets tougher and liquidity dries up. This will put additional pressure on their commercial property market that unlike housing has not exited well from Covid and values are forecast to fall significantly. The Federal Reserve wary of banking system stress, has chosen to pause and delay rate hikes for now though there is a very long way to get back to target inflation (2%) levels.

US Conference Board Leading Economic Indicator – Recession?



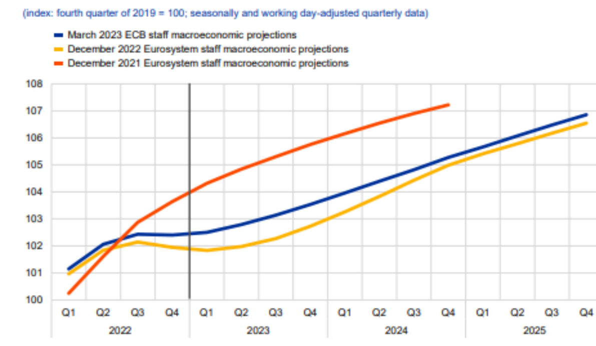
China

Following a disastrous Covid lockdown, China is back on the growth trail and trying to get their economy back up and running. This requires some major financial support for their heavily indebted construction sector. Rescue packages for developers and financiers and fast tracking of projects is underway to regain confidence in this battered but crucial industry. The China construction gauge rebounded to 65.6 from 60.2 - the highest reading since May 2012. House sales also increased in February for the first time in 20 months. Surveys showed manufacturing activity posting its biggest jump in more than a decade while non-manufacturing has also jumped with the PMI for March at +58.2 and well up from +56.3 in February. More recently, China's official composite PMI rose to +57 in March, sending a positive signal about the recovery in their domestic economic economy. The non-manufacturing component of the index jumped to +58.2 and way ahead of consensus for +55. China is now aiming for 5% GDP growth this year and seeking to create 12 million jobs. The rebound in China is underpinning better global growth prospects with improved manufacturing orders for Europe and Asia while Chinese demand for commodities is rising. On the negative, China announced an increase in defence spending to 7.2% of GDP (fastest since 2019) while the relationship between China and the US has become even more hostile. There is an increasing risk the world may partition into two or three sides. The recent visit by Xi Xing Ping to Russia exacerbated tensions while China recently began a third day of military drills around Taiwan including a simulated attack from the east (Economist). As Gideon Rachman of the Financial Times writes, if Taiwan's chip factories fell under Chinese control it would give Beijing a chokehold over the world economy. As the US has already discovered, replicating Taiwan's semiconductor industry is much harder than it sounds.

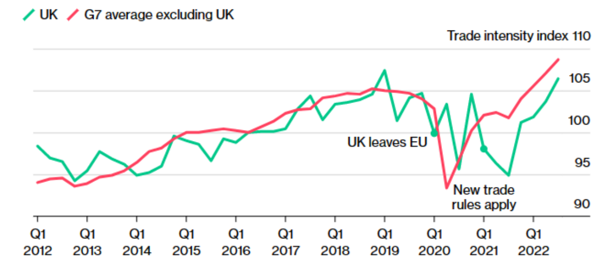
Strong Rebound
China's manufacturing PMI rose to highest since April 2012

Europe & UK

Against the odds, the Eurozone economy managed to expand in the last quarter of 2022 +0.1%. This in the face of record high inflation and continued concerns for energy supplies. A concerted effort to move energy reliance away from Russia has paid off with gas prices falling to pre-Ukraine invasion levels. This is also improving business confidence. More recently a composite PMI measure for the Eurozone (S&P Global) climbed from 50.3 in January to 52.3 in February driven by strong services demand. Manufacturing fell slightly in March to a 4 month low though orders are improving and expected to accelerate on Chinese demand. Headline inflation (driven by energy) fell in March (to 6.9%) though tight labour conditions mean services inflation is still elevated and keeping core inflation at record highs (5.7%). Despite banking system contagion concerns (Credit Suisse collapse) the ECB confidently increased rates by a well signalled 0.5% to 3% with a further 0.25% in May to 3.25% likely. President Macron invoked a special provision of France's constitution to increase the country's retirement age from 62 to 64. France spends around 14.5% of its economic output on pensions, compared with 7.5% in the U.S. and 10.4% in Germany. This invoked riots but reflects the reality of this growing financial burden.



Finland became NATO's 31st member doubling the length of NATO's border with Russia and an own goal for Putin. Reuters reported Russian oil sales to India twenty-two times higher than 2022. Energy revenues account for 42% of Russia's budget which are down -46% on a year ago). After falling in December -0.5%, the UK economy delivered a positive +0.3% growth surprise in January. The UK and EU finally agreed on a new post-Brexit trading arrangement for Northern Ireland which will create green and red lines for goods flowing into Northern Ireland. Goods that will remain in Northern Ireland will flow freely and a new "Stormont brake" will allow Northern Ireland's devolved government to pull an "emergency brake" on any new EU laws from being imposed on the province. Though still expecting inflation to fall sharply over the year, the BOE of England raised rates to +0.25% to 4.25% and expected to pause. Fiscal tightening is also underway to begin repairing public accounts. Corporate taxes will rise from 19% to 25%. Interestingly Britain is experiencing a surge in skilled migrants post Brexit as employers make use of a new migration system and the impact on trade from Brexit has not been as bad on trade feared (see chart opposite). The Australian Financial Review reported that a surprise new British 10% tax on wine will wipe out any benefit from the Australia-UK free-trade agreement.



Japan

The BoJ Tankan survey in the quarter confirmed that business conditions are mixed with a weakening in manufacturing activity but a recovery in services as domestic demand improves on still pent-up post Covid demand. Economic growth is projected to pick-up on Chinese demand and continued monetary and fiscal policy support. Being so net energy dependent, headline inflation in Japan should moderate on lower energy prices while the BOJ sits on rates.

Emerging Markets

Meanwhile the IMF forecasts that emerging economies could expand at 4% In 2023 and 3 times the pace of advanced markets as the benefit from improving growth in China and increasing consumer spending from a fast growing middle class.

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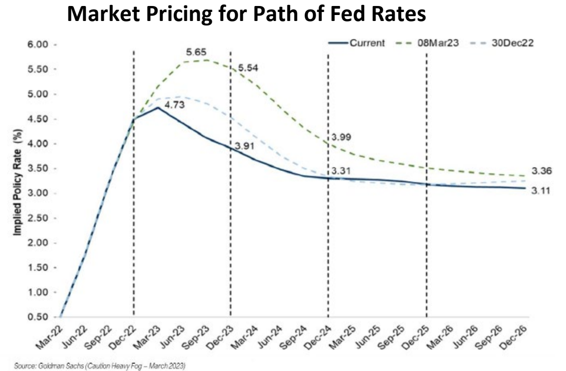
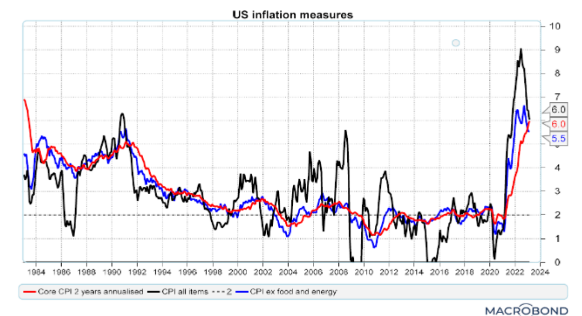
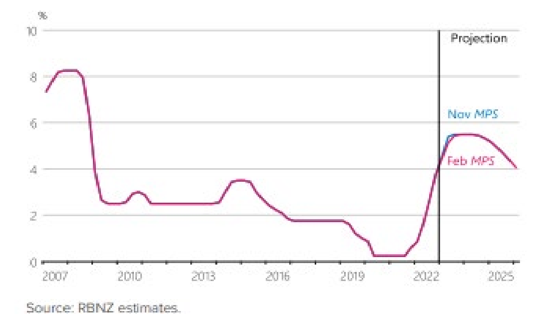
MARKETS The recent US regional and small bank fears have led to tighter credit conditions not only in the US but also Europe with contagion risk still prevalent. Central banks, regulators and government responses have been swift so far and reassuring to markets. Tighter lending standards are also disinflationary. How much monetary policy work has been done by this squeeze is hard to gauge but at Powell's recent press conference his wording changed from "ongoing increases in the target range will be appropriate" to "additional rate tightening might be needed". His softening of forward guidance is a signal that the Fed sees itself as having less work to do than it previously thought. Market pricing for Fed policy rates has also pulled back swiftly from early March with a peak level at the current 4.75% rate and nearly 1% lower than thought in March. Have we got there? Though the Fed expects headline inflation to retreat quickly from here, core inflation is going to be stickier and possibly structurally higher than a 2% target (3-4%?). De-globalisation, aging demographics, tight labour, retiring boomers, onshoring key industries, geo-political stresses mean higher core inflation could be the new norm. How policy makers potentially assimilate this will be key. For now, 2% remains the target but increasingly central banks are pushing out the period to achieve this from 2024 to 2025 and beyond.





Cash The RBNZ has stayed firmly on task to get inflation back to its 1%-3% target raising rates a surprising 0.5% (market 0.25%) to 5.25% early April and a 14 year high. This marks their 11th consecutive rise. They seem to prefer to go hard and early rather than pause to assess effects. Citing very tight labour markets, cyclone re-building spending and cheaper offshore wholesale bank funding they have left the door open further rises. The February RBNZ MPS peak rate of 5.5% now looks redundant and 5.75% more likely and reached in 2 further 0.25% rises (next one in May). There are growing concerns this will all be too aggressive and deliver a deeper downturn in the second half of the year and then requiring faster reversal rate cuts. Stronger net migration along with the recent Government announcement it will open the border for all health workers' residencies could begin to shift the dial on some labour stresses. The RBNZ will see any strong net migration as inflationary. Household incomes are now beginning to be hit by higher interest rate servicing though most of the impact will not arrive until later this year. Meanwhile the RBA has paused at 3.6% wanting time to assess the impact of their rate increases so far.



Fixed Interest The volatility in global interest rates markets in the quarter was at levels not seen since the GFC driven by the US regional bank concerns (SVB & Signature Bank collapse). Yield curves remained inverted in the period with longer yields coming down on better inflation and slower economic growth data. The signals for recession remain in place and the US 10 year government bond yield fell to 9 month lows over the period (to 3.43%). The chart opposite for the NZ interest rate swap curve shows yields fell across the maturity curve in the quarter with the green line reflecting pricing 3 months ago and recent pricing shown by the blue line.

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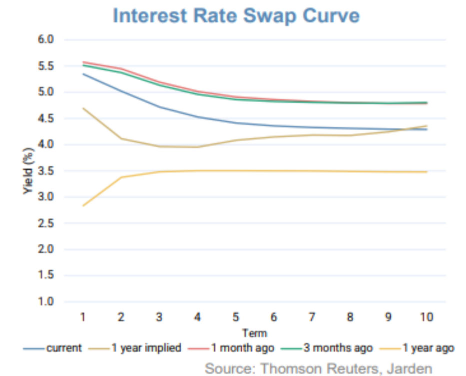
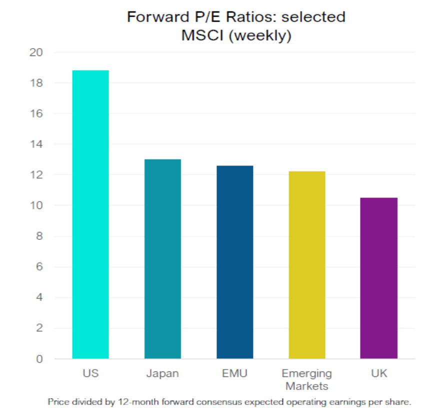
This shift in rates was more pronounced for mid to longer term maturities again reflecting the outlook for recession. The move in bond yields lower over the period provided good returns for portfolios. At present levels bond yields have become much more attractive for investors and offering the opportunity to earn better income but also the potential for capital gains should the economy slow too quickly. Bonds also provide better portfolio diversification protection at these levels. We moved a portion of portfolio holdings from shorter dated bond maturities to market length maturities to lock in better yields.



Source: Thomson Reuters, Jarden

Equities

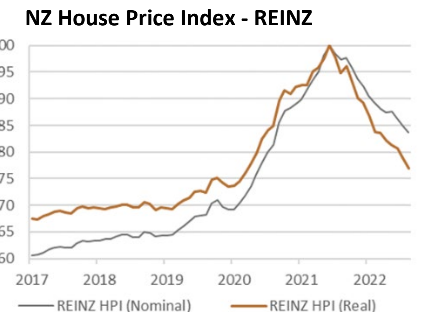
Global sharemarkets rose in the quarter and some very strongly. The US Nasdaq index rose +20% on recovering tech stock prices that were so heavily impacted in 2023. Markets does expect company earnings to slow as the year progresses towards probable recession. However, company results in the period were better than expected. S&P500 dividends were up +8% y/y and average margins though lower still well above long term averages (11% vs 8%). Of course, some of this is inflation. Corporate results in NZ were also steady and ahead of expectations on a revenue basis with a greater number of beats than misses. Underlying earnings also surprised positively. Companies have been passing on rising costs to consumers where they can. The forward 12 month pricing for various market P/Es is shown in the graph opposite factoring in lower earnings and discounted for recession. US market P/Es are around historical long term averages but well below 2021 levels while other markets offer better relative value particularly Europe. If history is a guide, peaks in US inflation (when the Fed pauses) have typically coincided with the bottom for their market. S&P forward returns at three, six and 12 months following inflation peaks since 1958 were positive, with median returns of +10%, +12% and +22% respectively.



Price divided by 12-month forward consensus expected operating earnings per share.

Property

NZ house prices continued their fall over the quarter and now down -16% to -19% from their peak (depending on sources) in November 2021. Prices are still only back to 2020 levels! Sales have also plummeted. While better net migration and weakening may provide some medium term support, a wall of completed supply is coming to market over the next 6 months and interest rate costs will soar for households. House prices are also under pressure globally with Australian dwelling prices down -9% from peak and Sydney -15% though recently strong net migration in that market will help. The same price drops are repeated through Europe though homes in the US have held up surprisingly well. Commercial property also continues to retreat as higher interest rates impact valuations though industrial property has performed relatively better.



Commodities

Accelerating Chinese demand is once again supporting commodities across the board with industrial metals, met coal, lumber and food especially beef stronger over the quarter while milk prices have languished a little on strong offshore production. Shipping costs have recently bottomed and risen on increased Chinese container use while recently higher energy prices will also provide some headwinds for our exporters. The outlook for commodities is flat to positive on slowing global but rising Chinese activity.