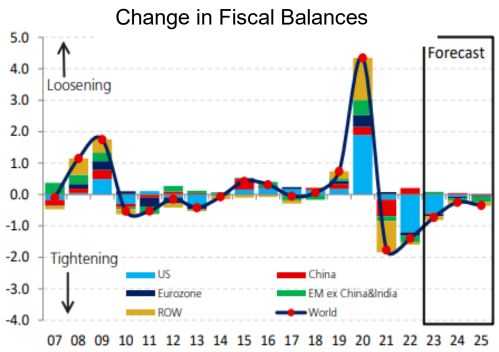
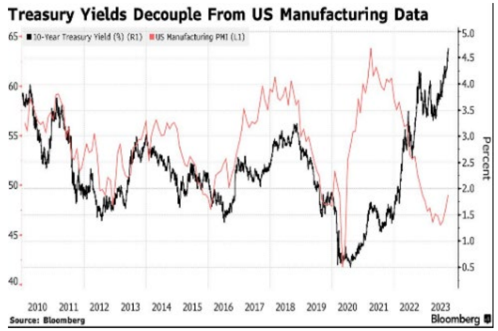
Investor Update

More questions were raised than answered during the September quarter. There was a general expectation economic data would reveal more and assist central bank policy discussion. Instead, we got conflicting data that showed resilient or at least improving economic activity in most economies, re-igniting inflationary pressures and central bank statements showing they are wedged firmly between the competing priorities of price stability versus employment (growth). The goldilocks' soft landing scenario is presently looking tougher. So far, post Covid, households have been on a tear. Spending Covid savings and re-engaging firstly with buying goods and then services. The subsequent inflationary pressures have been immense. This momentum has underpinned US activity particularly, but most developed economies. Demand was largely driven by easing fiscal policies funded through public borrowing and now record government debt levels. This stimulus is fading as government accounts come under increasing scrutiny (credit downgrades) and sharply higher interest costs bite into operating budgets.

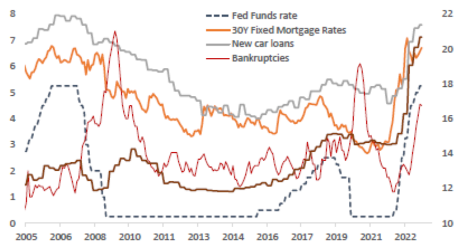


Governments everywhere are under real pressure to get deficits under control. So fiscal stimulus is withdrawing (see opposite top chart on tightening). Are we on the edge of a much sharper slowdown? Or are we just experiencing a de-synchronized environment due to the post pandemic effect where yields are not connecting to real world activity (see the US treasury yield decoupling graph opposite).



Historically, it would be fair to recognise that the very sharp increase in the cost of capital should be at best disruptive and at worst destructive for overpriced and overleveraged assets. While liquid markets have been assessing this risk (bond and equity market falls), more illiquid markets such as commercial property and infrastructures remain exposed to significant revaluation risk. Central banks are keeping a close eye on exposed (especially regional US) banks. There has been some recent commentary comparing the environment to pre GFC conditions though important differences remain (structural global financial system stability being one) making this not likely but markets are recently pessimistic for a deeper global recession.

Figure 4: Interest rates across products have surged, and corporate bankruptcies are ticking up



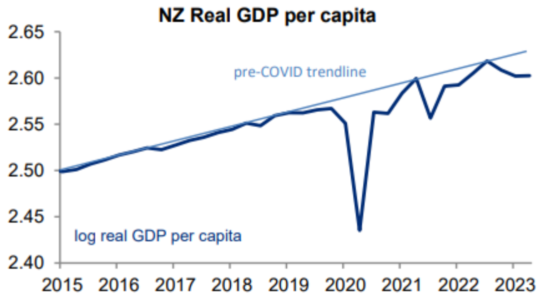
Source: J.P. Morgan, Bloomberg Finance L.P., Federal Reserve.

Very recent data suggests the impact higher interest rates are now starting to bite. This is showing up in rising delinquencies across consumer credit channels (see US car loan and bankruptcies opposite). Around 5.4% of mortgage borrowers in NZ have reverted to interest only repayments and around 18% of Australian mortgaged households have reached 'high repayment burden' status. Global consumer demand is waning and showing up in lower services PMIs with the final S&P Global services index easing from 50.5 to 50.1 in September and close to contractionary. This is still not yet translating into weaker employment (recent US job openings surprisingly higher) but hiring intentions are slowing.

The contradictory nature of the data we are seeing suggests we are close to the cusp. It will either be poor economic data that will allow an easier central bank response (market supportive) or persistent inflation (and potentially stagflation) and resilient demand which locks in higher rates and for longer leading to a hard landing in 2024. The coming months will be critical in determining the trajectory of the global economy. Continued vigilance in managing inflation, efforts to enhance supply chain resilience, and diplomatic solutions to geopolitical conflicts are all essential for stability and growth. Additionally, the pursuit of digital innovation and sustainability offers opportunities for economic transformation and long-term prosperity.

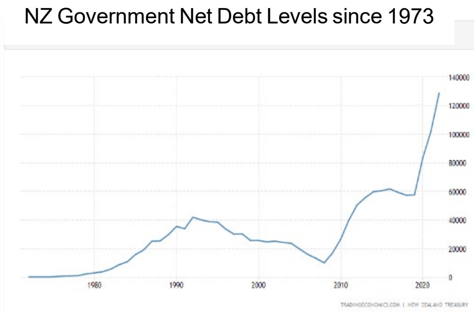
New Zealand

At the time of writing the general election (14th October) has not completed but looking like a conservative coalition government outcome. Regardless of who is in power, they will be dealing with a difficult fiscal position with significant downside risks to financial forecasts that have been built on optimistic assumptions for growth and tax revenues. Our finances have been trashed over the last few years with record debt and debt servicing costs rising. Meanwhile our GDP and productivity per capita keep falling. A return to budget surplus by 2026/27 is also unlikely without some significant spending cuts or revenue raises. After keeping our doors firmly closed for years, strong net migration is now flooding NZ (likely a net inflow of around 90,000 migrants this year) in an apparent sharp policy (panic) reversal. Net outward migration of Kiwis however continues with September having the largest outflow of Kiwis since 2001. The net migrant inflow is improving labour capacity and recent data shows employers are less pessimistic about the labour market which has been a key business constraint (and highly inflationary).



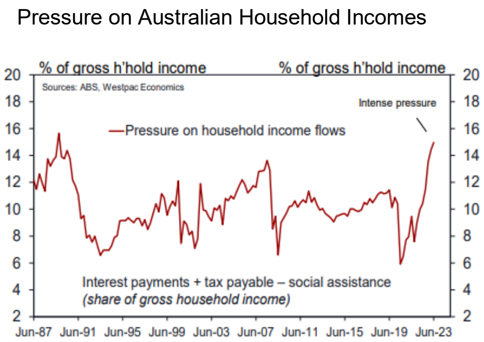
Source: BNZ, Bloomberg

The mood of the economy remains gloomy with the recent NZIER (QSBO) showing 53% expect economic conditions and own trading to worsen as rising input costs continue to impact. Interestingly, the bulk of businesses are now passing on costs completing the inflation cycle. A better than expected Q2 GDP growth rate of +0.9% (1.8% yoy) however lifted us out of certain near term recession. Elsewhere farmers are doing it tough with cuts to farmgate milk forecasts ($7.15kg). A Federated Farmers survey showed confidence at record lows with 81% of farmers assessing conditions as bad). Building consent issuance continues to fall (42,000 homes consented) down -17% on last year. The downturn in consents follows the sharp rise in interest rates and building costs. Falling house prices and less buyers means developers remain cautious on new projects. Weighted mortgage rates have now risen to circa 5.4% which is still 2% below the current 2 year mortgage rate so higher household debt servicing costs are still on the way as more mortgages reset. Household confidence is also low and reflected in lower retail spending despite more migrants, full employment and wage rises. Our biggest trading partner (China) is having growth issues and may impact on exports. With this soft backdrop the RBNZ kept rates on hold at the October meeting. On the positive side, mortgage issuance is rising, heavy traffic increasing, residential property sales improving, export commodity prices recently lifting, employment full and of course summer is on the way!



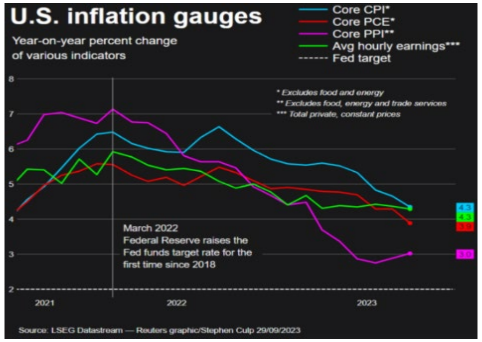
Australia

Australia has experienced a massive jump in net migration and above most forecasts. Net migration this year will be over 475,000 and another 375,000 in 2024 expected. Westpac esimate net migration will be 125,000 higher than pre Covid expectations. This migration is supporting what is otherwise a slowing economy with annualised growth at 2.1% (June quarter) and expected to come at 1.2% for 2023. Post Covid consumers have underpinned economic growth for the last 3 years along with public spending while net exports have been flatish (though improving) and housing detracting. The consumer is coming under increasing pressure (see chart opposite househld income flows) with net negative savings and higher debt servicing costs impacting discretionary spending. This will get worse as mortgage rates resetand unemployment expected to rise as companies cut costs in this weaker environment. The RBA kept rates on hold recognising growth is very weak and inflation heading in the right direction. A rate cut is also possible this year while tax cuts coming in 2024 will also be supportive. After very strong trade results in 2021 and 2022, terms of trade have fallen this year (-7.9%) on lower commodity prices while key trading partner China's slowing economic activity remains a worry. Weaker trading conditions are impacting company profits and the softer demand outlook means cost cutting is coming and business investment dropping. This will drag on the economy though infrastructure spending to date remains strong and supportive. Overall, growth will be positive this year and likely to accelerate slowly in 2024 before tracking higher again.



US

It is amazing how resilent the US economy has been. US final GDP data for Q2 came in at +2.1%. Their economy has been principally bouyed by a determined consumer working their way through covid savings but also on better business investment and on continuing US fiscal support (and despite their record public debt levels). The September services ISM index is still expansionary though pulling back to 53.6 frm 54.5 prior period. Even manufacturing data though still slightly contractionary improved with the ISM index surprisingly rising to 49 from 47.6. Factory orders are up (1.2%) and employment still strong. House prices were firmer though higher mortgage rates are starting to impact on household confidence wth the Conference Board consumer confidence index easing from 114 in July to 106.1 in August. 30 year mortgage rates are now at 23 year highs (7.9%) and this is driving a multi-decade low in mortgage applications which is not a good indicator home sales. Inflation is also trending down with all US inflation gauges (opposite) moving in the right direction but still not fast enough for the US Fed. Core inflation (PCE) excluding food and energy is running at a 2.2% annualised rate and not far from the Fed target and the lowest since 2020. Higher headline inflation, stronger than expected economic activity and tight employment conditions saw renewed hawkish language from the US Fed. Their suggestion rates need to be higher than longer led to a sharp jump in bond yields and caused other markets to also fall in the period. The prospects for rate cuts are now well into 2024. Markets were also wary of the increasing friction in Congress on Government debt and deteriorating budget deficits. A costly shutdown of federal agencies was only averted in the final hours before deadline and adding further to rating agency concerns on the high level of additional bond issuance required for funding. The outlook for US growth is slower but not tip into recession given their momentum.

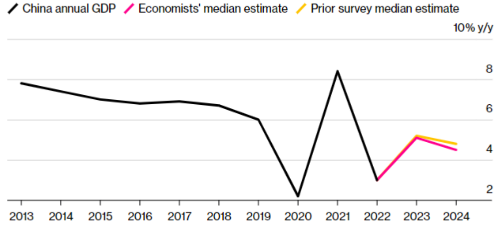


China

The Chinese economy is presently a shambles and risking sliding back to 4% GDP growth levels, far below their 5.5% target. They face a myriad of challenges exacerbated by their Covid lockdown period. At a structural level, China is trying to transition to a high value technology and education based economy build on strong domestic demand. This pivot is working for them as they invest aggressively in chip manufacture, computing, AI, EVs, robotics and transport as well as military equipment. They are quickly dominating many areas of modern economy development which is worrying the west.

Economists Trim China Forecasts

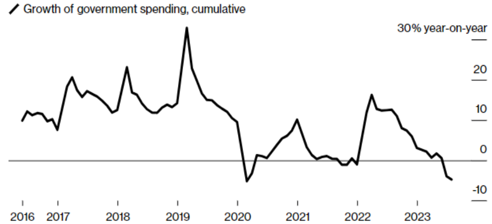
Outlook darkens as data for second-largest economy flashes warning signs



Source: Bloomberg survey

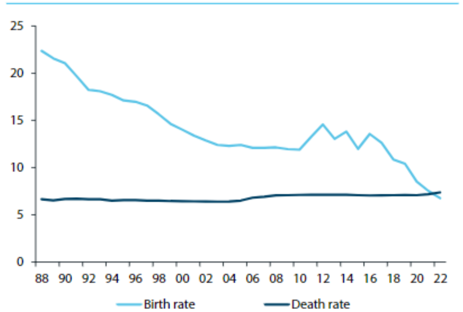
China's Government Has Reduced Spending This Year

Growth of on-budget spending has turned negative



Source: China Ministry of Finance; Bloomberg
Note: Data covers China's two main budgets, the general budget and capital spending, or "funds" budget

CHINA DEMOGRAPHICS



On the other hand, China's traditional growth engines of residential and commercial property, infrastructure investment and manufactured exports are struggling. A prolonged property slump, falling exports and weaker domestic consumption (households are feeling poorer and unemployment rising) are hurting. Replacing external demand with stronger domestic demand may take a generation or two to achieve but geo-political pressures are driving faster de-coupling with the west while demographics are a significant headwind. Highly educated young workers also cannot find a career path in present China let alone any work at all. They have stopped publishing their youth unemployment figures which last came at a very high 24%.

While Beijing prioritizes long term growth transition, they have been prepared to let their embattled residential property construction industry wallow. This is creating significant internal (not external nor systemic yet) financial stress. Apart from the fact that property buyers cannot take possession of their incomplete homes (a major source of social pressure) developers are spectacularly failing and lenders (particularly non-bank and local government off balance sheet lending) are facing significant losses. Central government wants to see this de-leveraging need to balance that against debt defaults and a potential failure for their $60 trillion financial system. Certainly, confidence has been hit and this alone might be enough to completely stall their economy.

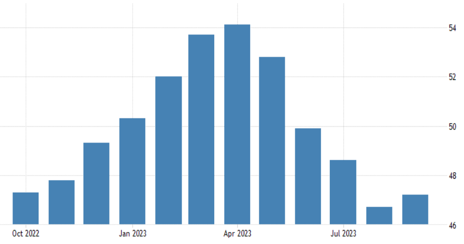
The People's Bank of China recently did a surprise cut to interest rates so some state directed assistance is now starting to appear. As an aside, Rodney Jones from Wigram Capital (a NZ based China expert) estimates Chinese excess house construction to be 70m units at $10 trillion which could take 10 years to absorb. So, they face a real risk of "Japanification" while foreign direct investment has also collapsed and fallen to a 25 year low (Bloomberg) being 94% less last quarter than the same time in 2021.

US Commerce Secretary Gina Raimondo said that US companies tell her China is becoming increasingly "un-investable" because of growing risks to doing business in the world's second-biggest economy (AFR). The world needs strong Chinese economic growth until India and the new Asian economies can pick up the slack down the track. Decreasing Chinese demand would be significant headwind for commodity exporting countries including New Zealand.

Europe & UK

Europe is still expected to deliver growth this year of just under 1% but its economy is in a fragile state. Activity was softer in the quarter on weaker foreign demand (China) for German exports (in particular) while domestic demand is also becoming subdued as higher interest rates and tighter credit conditions impacts on consumer spending and business investment. While manufacturing has been particularly weak this year the services sector has been strong but now it is easing too. Eurozone PMIs (see composite activity index opposite) fell to a 33-month low of 47.0. A slower economy has not translated to the labour market yet with EU area unemployment at 6.4% and just off the EU record low in 2021. Easing growth and lower energy prices saw Eurozone inflation fall to 4.3% from 5.2% in the quarter and the slowest in 2 years. The ECB tightened rates a 10th time up to 4% in September but is now mindful of weaker activity noting this is likely the last rate rise. After rising in June, UK economic growth unexpectedly fell in August with composite PMIs falling from 50.8 to a contractionary 47.9 level in August. This is a steep decline and led to the BOE pausing on rate rises for the first time in nearly 2 years at 5.25%.

Euro Area Composite PMI – Trading Economics



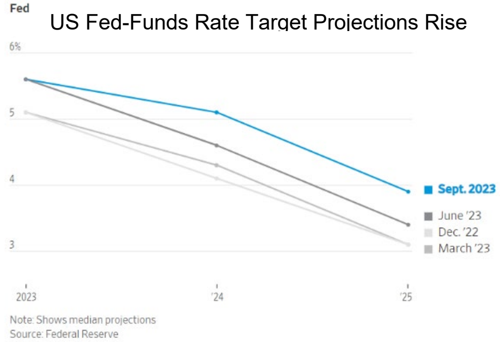
Given the weaker global economic backdrop, tighter monetary policy, slowing consumer demand, slower construction activity and falling home prices economic activity is expected to slow further over remainder of this year and the UK economy may enter 2024 in recession and finish 2023 with slight growth of 0.4%. Inflation is coming down at (headline at 6.7%) but remains elevated compared with the Eurozone and US. Wage pressures have not helped but more recently seem to be slowing.

UK Manufacturing, Construction and Services

Japan

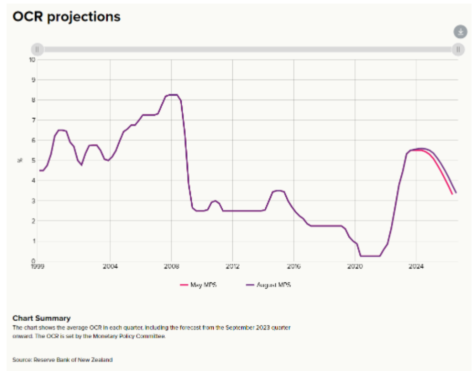
After a very strong start to the year the Japanese economy, so reliant on exports slowed markedly in the quarter feeling the effects of weaker world growth and especially Chinese demand though wider Asian demand has been resilient. The BOJ, unlike elsewhere has retained ultra easy monetary settings as inflation (though slightly above target levels at 2.5%) allows the BOJ to focus on growth. Their inflation has been driven by higher commodity prices but not extended to wage inflation which the BOJ ironically wants to see to underpin elusive sustainable domestic demand. This means interest rates will stay lower for longer even though the rest of the world is hiking. Japan's aging demographics and weak domestic demand make their monetary policy management particularly challenging.

MARKETS



Central banks are just not getting the capitulation they are seeking. Headline inflation spikes due to sharp energy price rises has been confusing the picture of lower trending core inflation. Wage pressures continue to highlight tight labour conditions in most economies (not China and Japan for different reasons) while food prices remain elevated and commodities prices again rising. Resilient economies to date have been shrugging off tighter credit conditions though more recently cracks are starting to appear and may widen quickly. It feels like we are at a nexus and central banks right on the cusp of either overtightening or under cooking things. The sharp rise in bond yields in the quarter reflects not only central bank uncertainty but also the insatiable supply of government debt requiring market absorption.

Cash



Globally cash rate rises were generally paused during the quarter though the talk got surprisingly tougher and took markets unawares. Indications now are a preparedness for at least one additional rate rise before year end but also consensus that would be the top. The peak may however be retained for longer with an extension in dot plots and our own RBNZ extending its OCR projection as well (blue line opposite in August vs red in May). The ECB, BOE, BOJ and RBA are pausing on softening growth data driven by credit costs weakening domestic demand, residential construction and home prices. The Fed has regained a hawkishness stance while the PBOC have finally moved to ease conditions and provide some support (confidence) in their beleaguered property market.
With NZ term deposit rates now around 5.9% to 6% investors are becoming more hesitant to take on market risk. It is important to remember that real rates of return after tax are still negative while the roll over risk for longer dated term deposits is high (see projected OCR opposite) and may lead to disappointment on rollover. Furthermore, longer dated term deposits offer little liquidity.

Fixed Interest

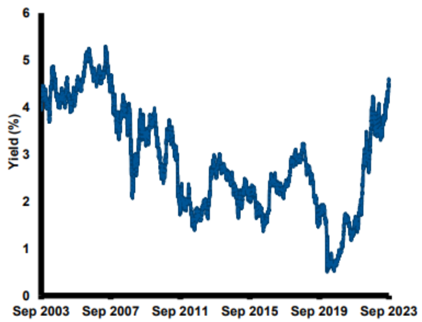
Global interest rate rose sharply driven by a fundamental repricing of the Fed narrative of 'higher for longer' rates. The US 10-year Treasury yield rose to 4.8% and the highest level since 2007. The US 2-year Treasury yields lifted to 5.15. So, the interest rate curve has become less inverted in the period as the risks for US recession receded The US had a credit downgrade from Fitch Ratings in August from AAA to A+ and the recent near US Government funding shut down also impacted investor confidence. Adding pressure to US bond yields is rising concern that their escalating federal budget deficit will create a greater supply of bonds than the market can meet. Credit spreads however are still well contained and supporting a soft landing outlook. NZ bonds followed suit with yields rising to near 5.6% and the highest since 2011. Fixed interest yields for clients are now closer to 6% and provide better protection than term deposits to interest rate rollover risk, better diversification protection and the opportunity for capital gains when central banks finally begin to cut rates. Though likely presently elevated we expect long dated bond yields are now closer to their 'new normal' and that the post GFC era of free money has passed.

Equities The sharp lift in bond yields negatively impacted on most asset classes including shares and the global MSCI All Country World Index fell in the quarter**.** Energy was one of the few positive sectors of the market while consumer discretionary and technology stocks were the worst hit. Company earnings in the period were better than expected. US Q2 earnings beats were strong across the board and coming in above expectations with 80% of companies above forecast. Year on year earnings growth was negative at -3.8% but turned to positive +2% when excluding energy stocks over the year. Australian companies also delivered robust earnings numbers in August illustrating the underlying strength of their economy while NZ company results for Q2 were also generally positive.

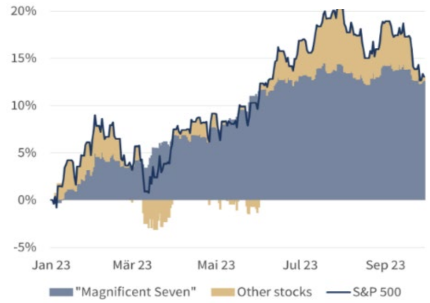
From here earnings are likely to soften on weaker domestic demand and markets are pricing for this. From a valuation perspective sharemarkets are generally at average or slightly above average levels based on 12 month forward P/Es. The S&P500 is back to 17.5x (long term 15.6x average) but valuations for this bellwether market are tricky given so much of the S&P 500 index and its performance has been dominated by the "Magnificent 7" mega technology stocks…Alphabet, Apple, Amazon, Microsoft, Nvidia and Tesla. The graph opposite shows the index is barely positive for the year when those companies are stripped out of the returns.

Highest levels since pre-GFC

U.S. 10-year treasury yield: Sep 03 – Sep 23



S&P 500 Return Contribution YTD

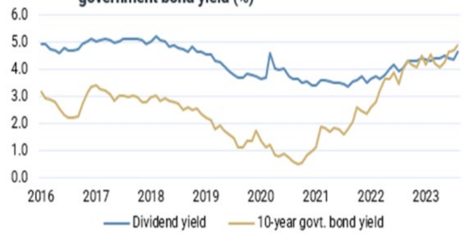


Source: Bloomberg, Rothschild & Co., 01/01/2023 – 29/09/2023

Note: "Magnificent Seven" refers to Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla

Property Many commentators are calling a bottom in the NZ housing market. ANZ said, "the house price cycle has convincingly turned a corner and our forecast is for prices to rise a further 3% this year". Residential sales are improving and auction clearance rates up to around 45% on increasing supply. Building consents however continue to fall (-17% from last year). With slowing supply and strong net migration numbers, house prices may well be turning up. Banks have also become more accommodative recently with rising mortgage applications though servicing costs are clearly restrictive. Lower building consent numbers are not a great health indicator for our construction sector. CBRE reported that the sales of commercial, industrial, and retail property in NZ declined -25% YoY during the first half of the year to $1.27bn, with only 59 sales in the major cities and mostly to private investors. Industrial properties made up around 30% of sales as did development site opportunities. Retail made up 21% and office sales 11%. High borrowing costs are continuing to directly impact valuations with institutions potentially finding better value offshore. Property dividend yields are now also competing directly with bond yields which are now higher (see chart opposite from Jarden). CBD office vacancy rates in Sydney and Melbourne rose to their highest level since 1996 (AFR). With the exception of the US, house prices remain under pressure in most markets.

New Zealand property forward dividend yield and government bond yield (%)



Source: Bloomberg, Jarden

Commodities

After a few tough months commodities prices improved slightly in September with oil +28% in the quarter on tighter global supply and industrial metals also lifting (iron ore up on lower China stockpiles). During the period ANZ cut its farmgate milk payout forecast for the new 2023/24 season to $7.15/kg. At that level most dairy operations are losing money.

Dairy prices were slightly stronger in September while broader food prices were also better. Chinese demand remains key for our exports and their weaker domestic activity and demand suggests our commodity prices may come under further pressure through the rest of 2023. A weaker NZD/USD has however been assisting.