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New Zealand Chartbook

January 2024

RESEARCH IP FUND MANAGER OF THE YEAR 2022 - FINALIST - BOUTIQUE FUND MANAGER OF THE YEAR

RESEARCH IP FUND MANAGER OF THE YEAR 2022 - WINNER - ALTERNATIVES FUND OF THE YEAR

Westpac Auckland Business Awards
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Finalist Excellence in Innovation 2022

riaa Responsible Investment Association Australasia
Responsible Investment Leader 2022

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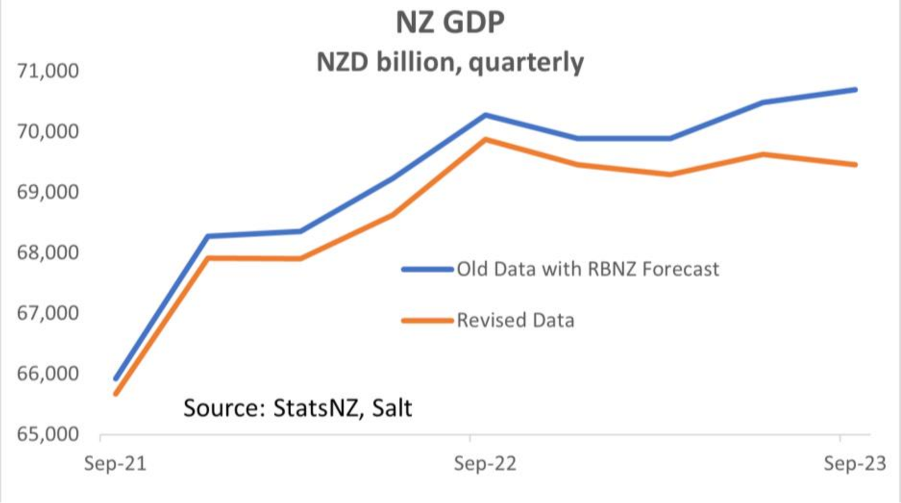
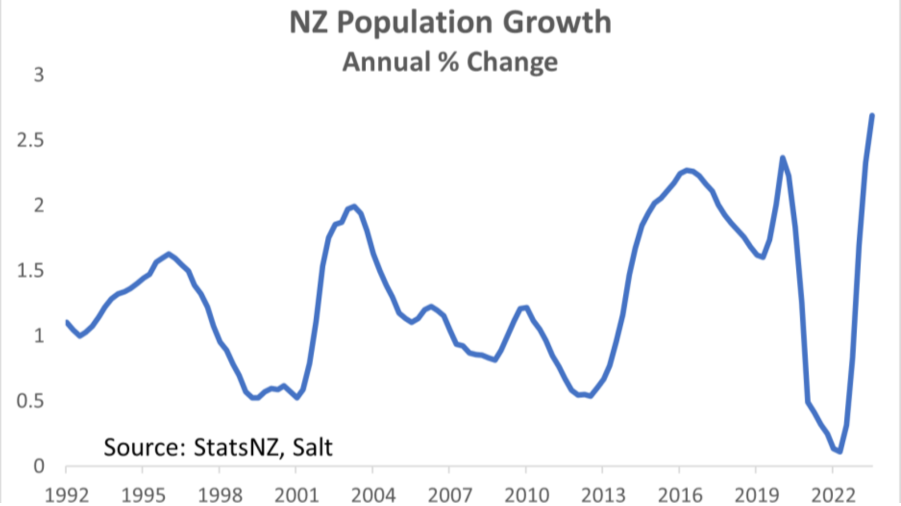
Highlights

- Ongoing pass-through of higher interest rates, slowing employment growth, weaker business investment, and softer global growth all paint a picture of broad-based weakness in activity in the period ahead.
- Migration-led population growth, which at 2.7% in the year to September is the strongest in decades, is taking the roughest edges off the recession, but not eliminating it entirely. The jury is still out on its net impact on inflation.
- Conditions in the labour market are becoming "less tight". Employment growth is slowing to zero, but continued growth in labour supply is expected to see the unemployment rate hit 5.6% this year.
- Headline inflation is surprising on the downside, but most of the surprise is in tradeables inflation, not in domestically generated inflation pressures which are the focus for the RBNZ.
- Downward GDP revisions are something of a game-changer for monetary policy, but only up to a point. While it supports our view that the RBNZ has done enough, it doesn't of itself bring forward interest rate cuts. That will require downside surprises in non-tradeable inflation.
- We believe the RBNZ has done enough tightening, but we don't expect the first cut in interest rates to come until November this year.

The Great Revision



Given the long list of negatives for the economy, we have been surprised by the resilience in some of the activity data. That was "put right" with the release of Q3 GDP data showing a contraction in activity of -0.3% q/q (RBNZ +0.3%) and downward revisions to prior data. Applying the RBNZ forecast to the old data and comparing with the new tells us the economy is 1.7% smaller than the Bank was expecting.



Population growth, largely via net migration, has provided the biggest offset to the headwinds for growth in activity. And the growth in people is meaningful. At 2.69% for the year to September 2023, that's the highest growth rate since the current data series began in 1991. Older data series (use with caution!) show this is the strongest population growth since the 1950's.

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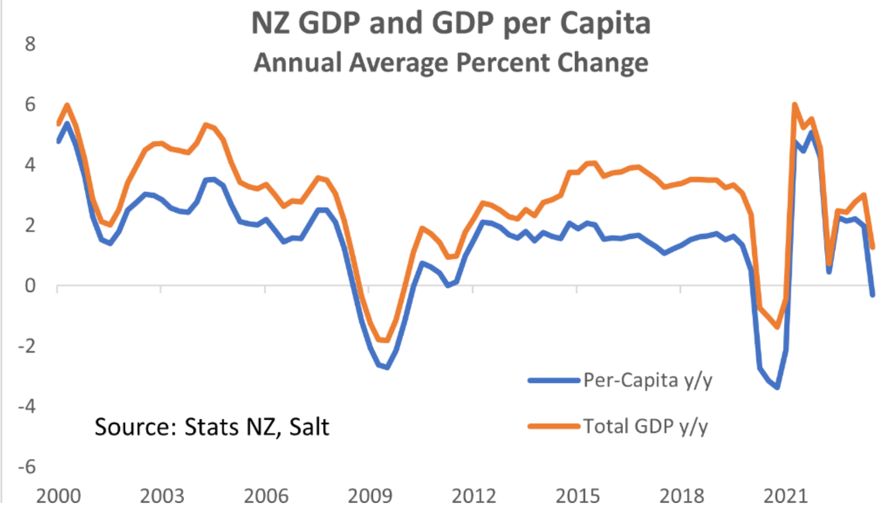
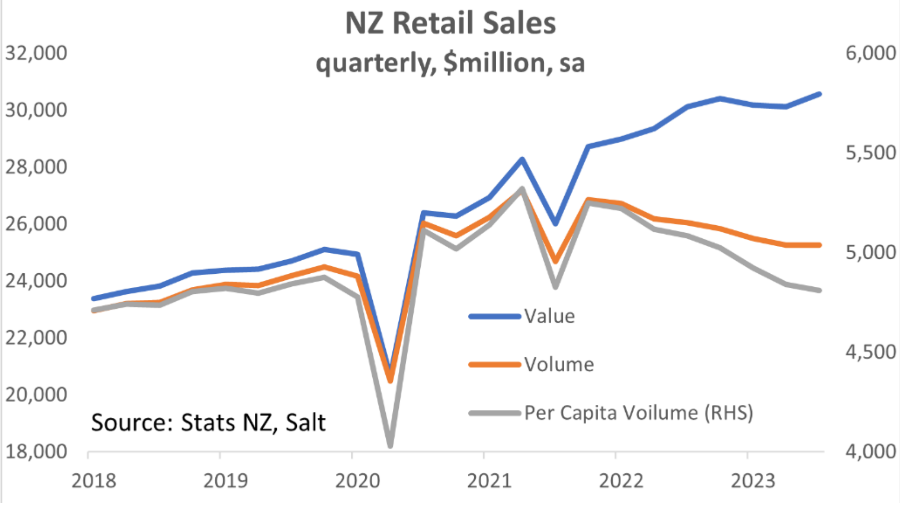
Higher interest rates and cost of living are biting



That means interpreting data with care. We use per capita data to remove the impact of population growth. We know households and businesses are feeling the bite of higher interest rates and the higher cost of living. That's supported by the annual average percent change in total GDP data showing growth of 1.3% in the year to September, but per capita GDP down -0.3%.



Retail spending has held up well in nominal (value) terms, helped by population growth and the resilient labour market. However, while the value of spending has held up, that has increasingly been absorbed by inflation. That means that while we are spending roughly the same value, we are buying less stuff (volume). Furthermore, retail sales volume per capita is down -5.5% over the last year.

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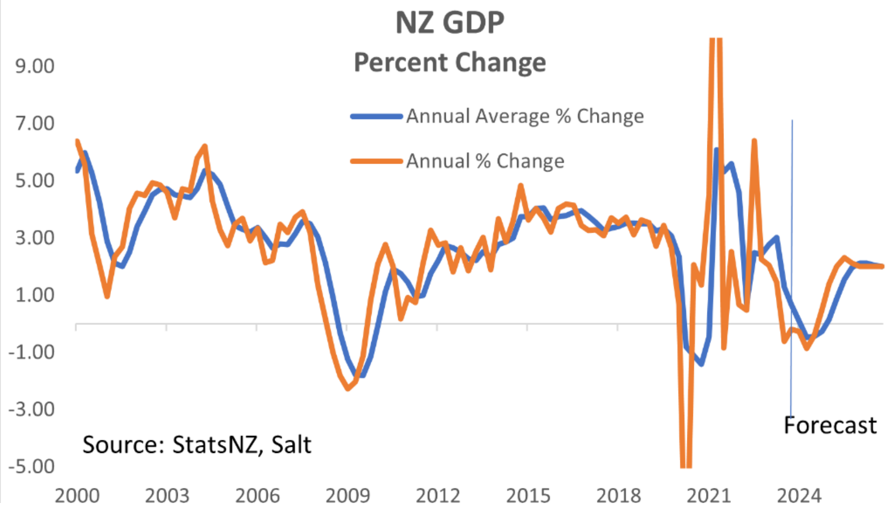
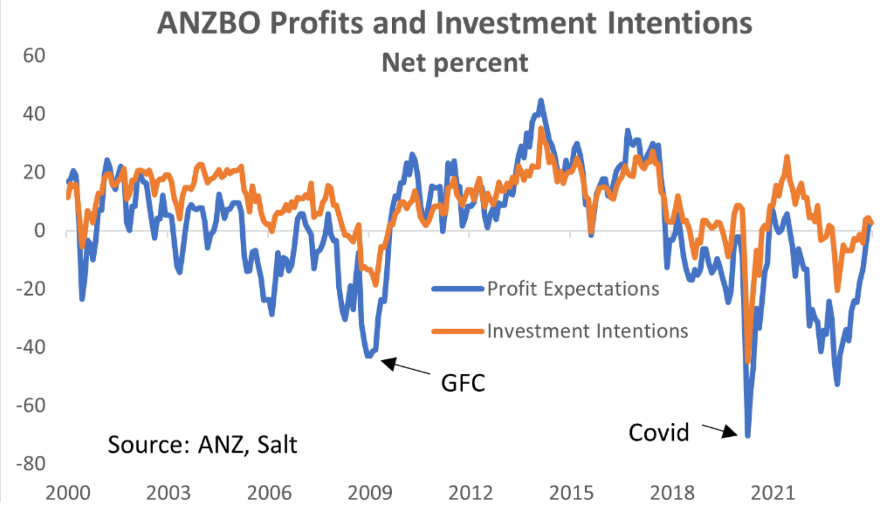
Tough times still ahead

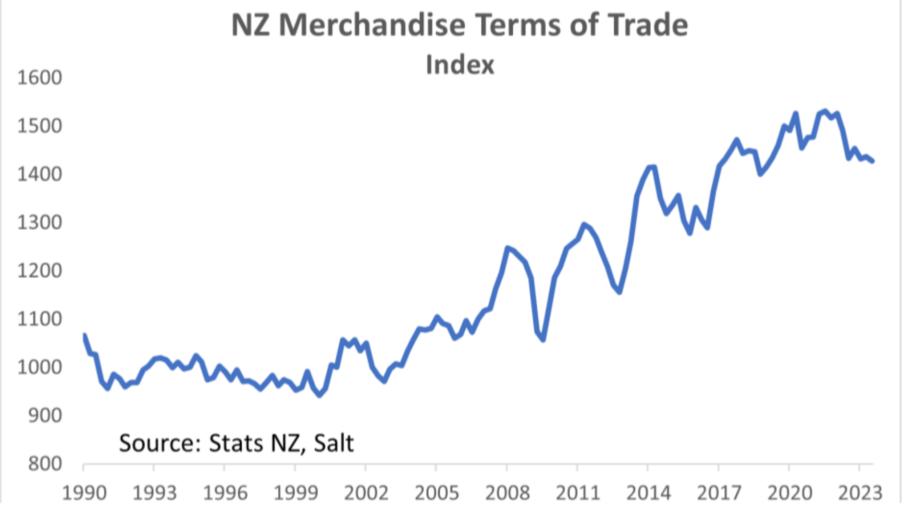


Ongoing pass-through of higher interest rates, slowing employment growth, weaker business investment, and softer global growth all paint a picture of broad-based weakness in activity in the period ahead. Population growth is taking the roughest edges off the recession, but not eliminating it entirely. We expect negative GDP growth in each of the next 3 quarters to be reported, out to Q2 2024.

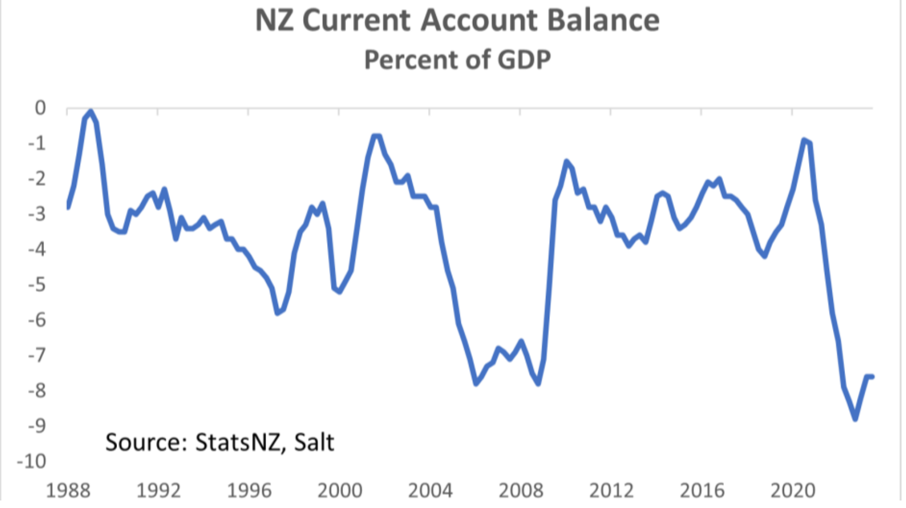


Business confidence has surged in recent months according to the ANZ Business Outlook Survey. The election outcome (there is a well-known political bias in this survey) and increasing belief that interest rates have peaked are most likely factors. We also think it reflects that the recession has not proven as deep as feared. Profit expectations and investment intentions have improved but are not yet positive.

Vulnerabilities in the external sector

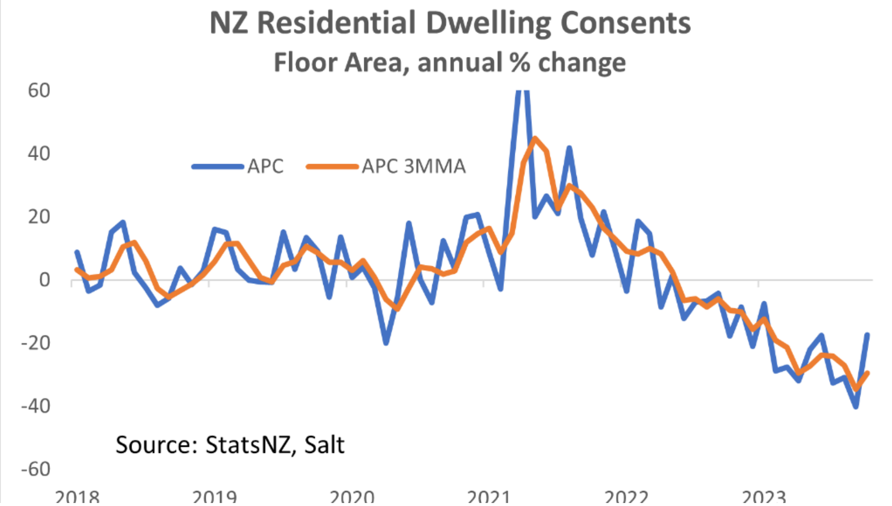


The terms of trade declined again in Q3, though there may be a modest recovery in the months ahead as some commodity prices have already started to recover (dairy). Lamb drove exports prices lower over the quarter while import prices were down mostly on the back of lower imported petrol prices. The RBNZ will be keeping a close eye of ex-petrol import prices as it continues to assess the inflation outlook.

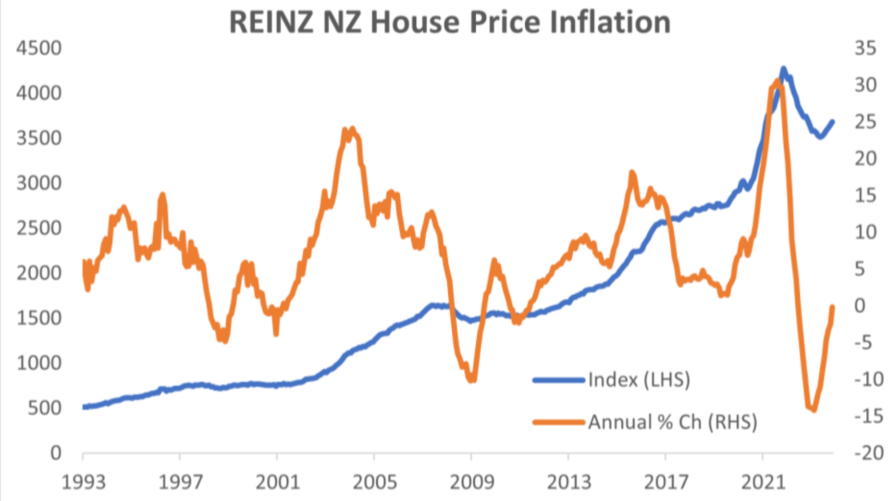


The current account deficit remained stable at -7.6% of GDP in Q3. We still expect a further modest improvement in the quarters ahead, but we expect it to remain well entrenched in unsustainable territory. This leaves us vulnerable to shocks and ensures the rating agencies will be keeping a close eye on this and fiscal policy.

Housing market stabilising, but no strong rebound



The decline in residential construction activity appears to be bottoming out. The negatives of rapidly rising interest rates, falling house prices and closed borders are now being replaced by rapidly rising net migration, stabilising house prices and at least the perception, if not the reality, that interest rates have peaked. Still, total residential floor area permitted is down around 24% on year ago levels.



Falls in house prices are also leveling off. Stronger population growth via net migration, the likely peak in mortgage interest rates and perhaps the fear of missing out on a bargain by new home buyers has led to a halt to the rapid price falls. However, we don't believe that conditions are in place for a rapid recovery in prices - we're expecting more of a bounce along the bottom.

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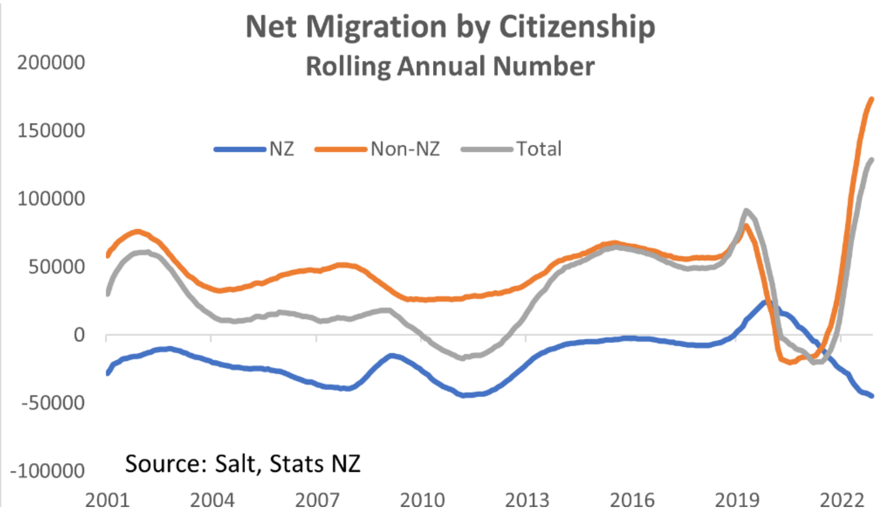
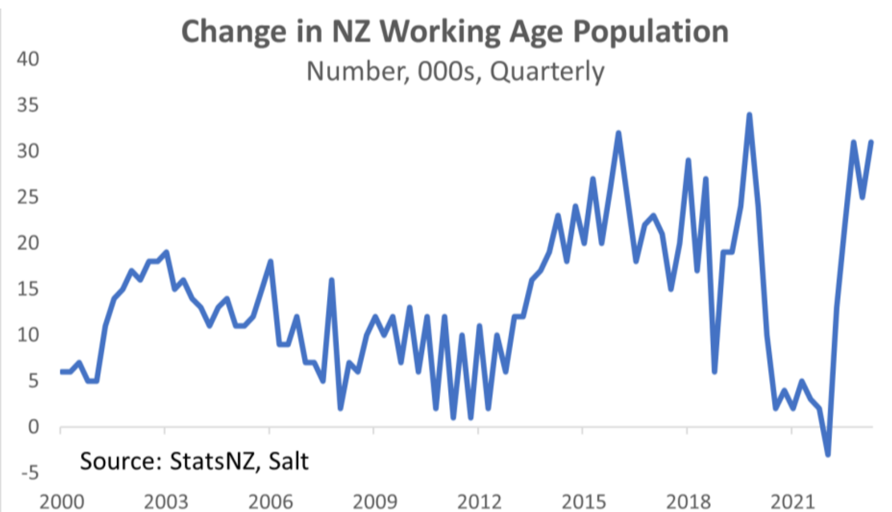
(Still) close to a peak in net migration

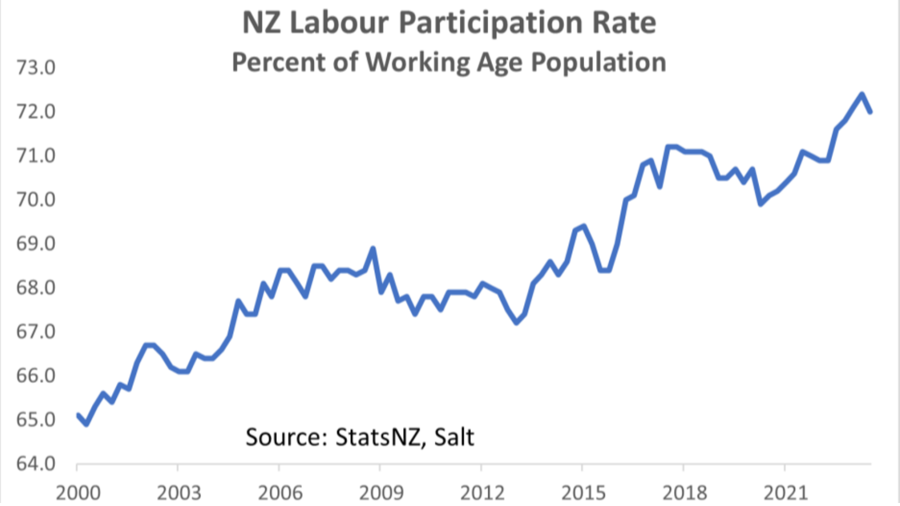


Net migration has continued to surge, well beyond our expectations. The net inflow of people stood at over 128,000 in the year to October. This accounts for the bulk of population growth over the past year. Monthly data has started to moderate but is still running higher than a year ago, so the annual total continues to climb. We think we are close to a peak, but we said that last quarter!

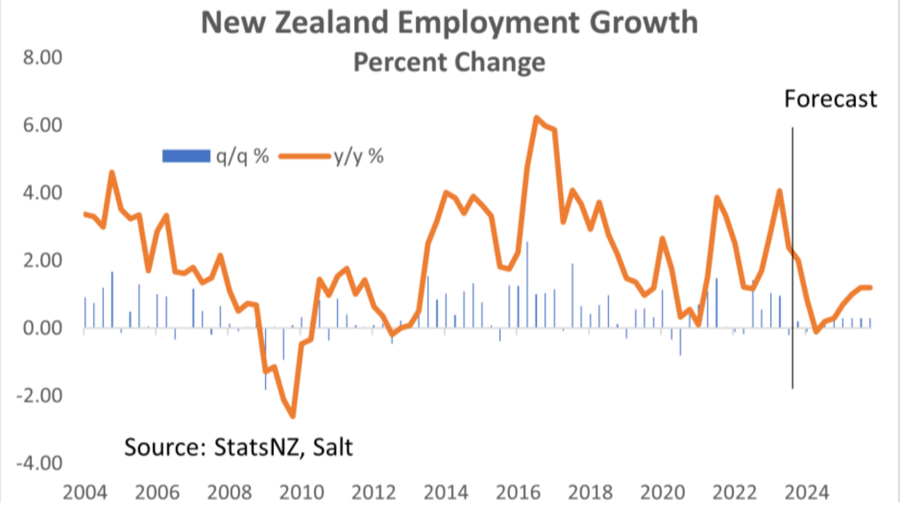


The significant inflow of people has seen a significant boost to labour market supply with 122,000 people added to the working age population over the last five quarters. That of course followed a period of closed borders where labour supply dried up completely, leading to labour shortages and strong wage growth. Those pressures are now easing.

Strong employment growth now moderating



At the same time as the working age population has been growing rapidly, a growing proportion of people have become active members of the labour market by being in work or actively seeking work (the participation rate). A high PR is a sign of a well-functioning labour market but could also be a sign of financial stress in households and/or that young people have chosen to go into work rather than study.



Employment surged as Covid restriction eased and borders reopened. We think most of that pent up demand has now run its course with labour demand now facing into weaker activity across the economy. We think employment growth essentially flat-lines through most of 2024, hitting zero on an annual percent change basis around mid-year. A worse outcome will be avoided by firms trying to hold onto skilled labour where they can.

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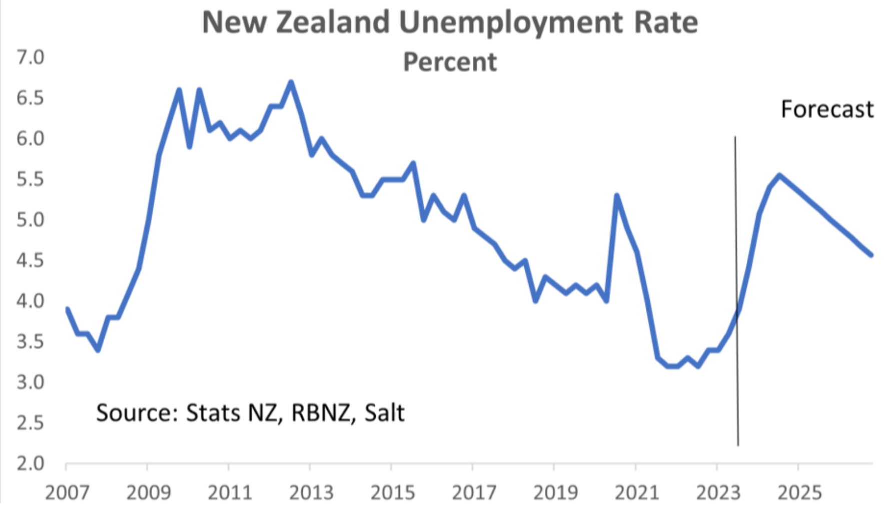
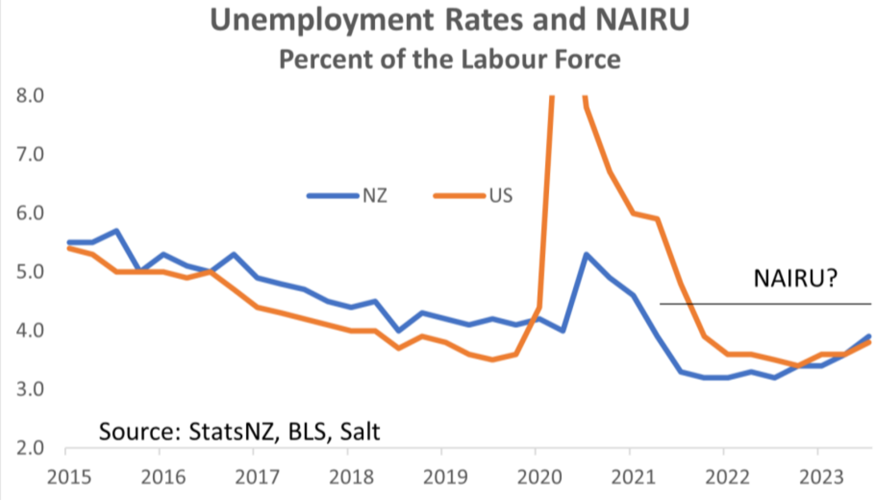
Unemployment set to rise further

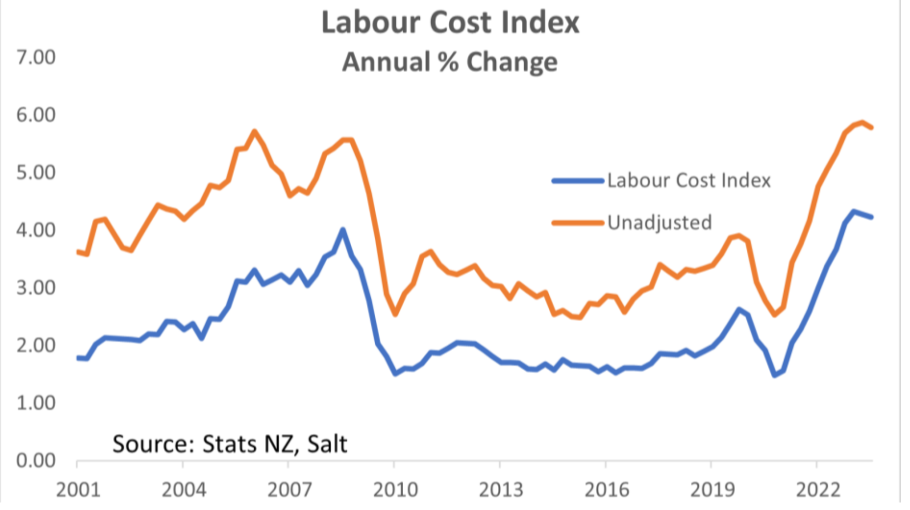


At 3.9% in September 2023, the unemployment rate is well off its low of 3.2% a year earlier. We expect the unemployment rate to move to 5.6% by September this year. That's higher than our previous forecasts, not because we think employment will be worse, but rather because of the stronger than expected net migration flows and the higher working age population.

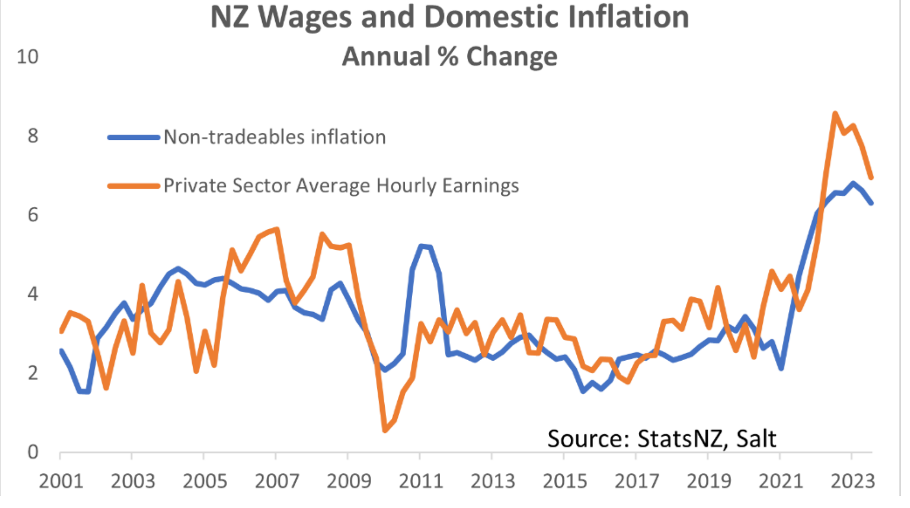


The concept of the Non-Accelerating Inflation Rate of Unemployment (NAIRU) is an important one for central banks. NAIRU is the unemployment rate at which the economy is considered to be at its natural rate of unemployment, and any deviation from this rate is believed to lead to changes in the inflation rate. In both NZ and the US, NAIRU is thought to be around 4.5%.

Wage growth has likely peaked



As the unemployment rate has slowly lifted from its lows, wage inflation appears to have peaked, but is not yet showing any meaningful moderation. The annual rate of increase in the Labour Cost Index, a measure of wage inflation that adjusts for the quality of work done, stood at 4.2% in the September quarter. That's a long way from the 2% that would make it consistent with the RBNZ's inflation target.



Likewise nominal wage growth has also peaked. After hitting 8.6% (annual percent change) high in September last year, this measure has since fallen to 6.95%. Again, that is a long way from the 3% (allowing a generous 1% for productivity growth) that would give the RBNZ comfort and confidence that inflation was heading back to 2% on a sustained basis.

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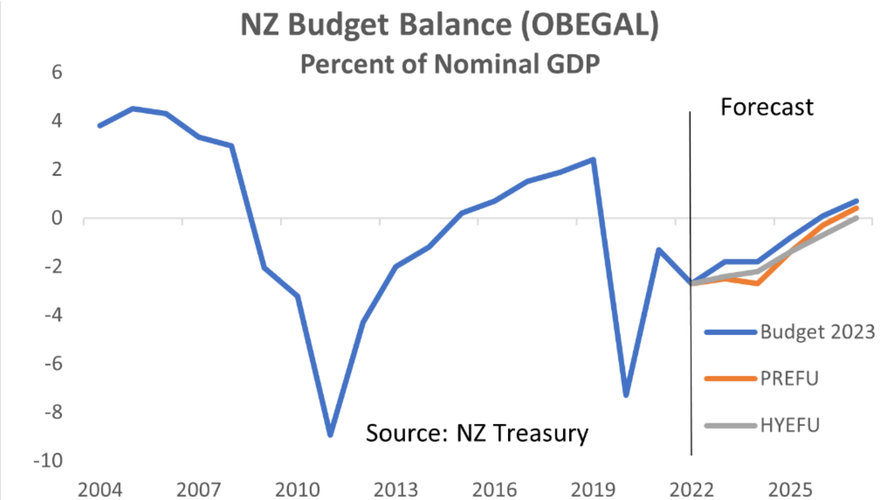
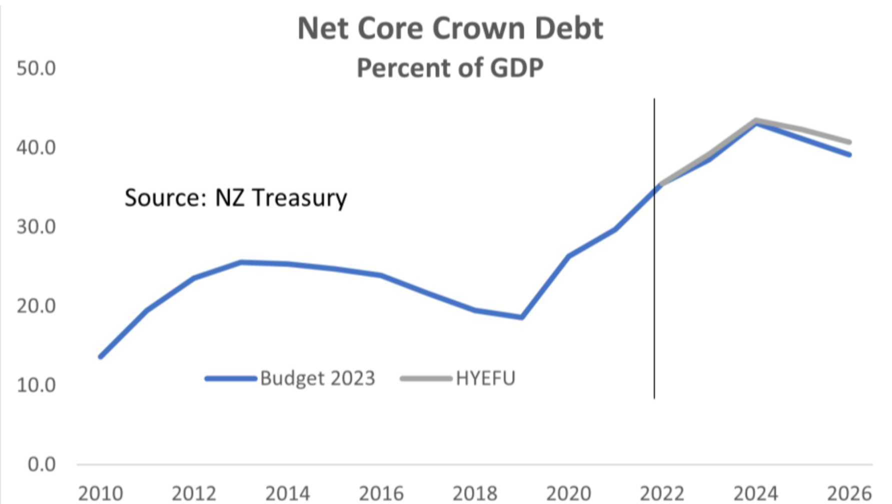
Fiscal ratios show further deterioration

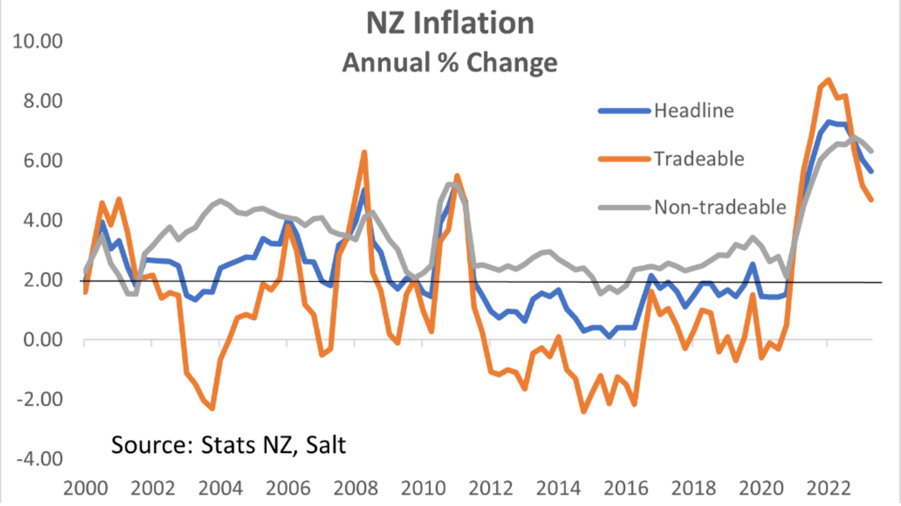


At the time of the Budget in May, we said we thought the fiscal outlook was built on overly optimistic assumptions. Since then, every update has seen a deterioration in the key fiscal ratios. The HYEFU was finalised before the new Government was formed so doesn't include any new decisions, but neither does it incorporate the significantly weaker economic environment detailed in the Q3 GDP release.

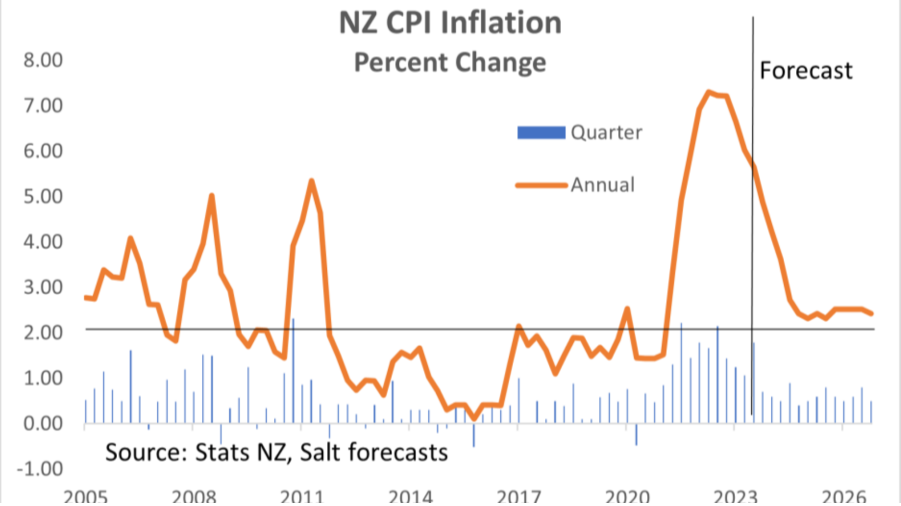


The fiscal deterioration saw a further $7.0 billion added to the bond program out to FY 2026. Again, this does not take any of the new Government's policy initiatives into account. The higher debt program adds to our concerns about the markets ability to absorb the new supply. However, we need to wait until Budget 2024 before making any assessment of the new Government's fiscal strategy.

Not out of the woods on inflation

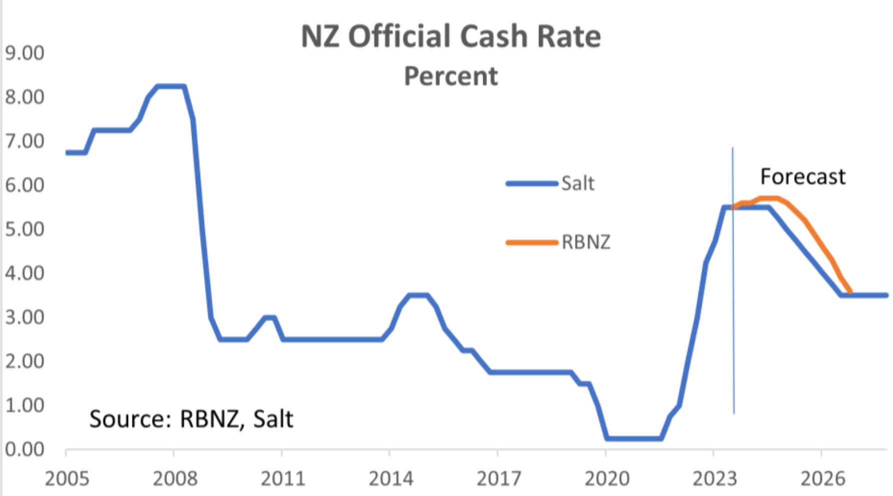


Headline inflation came in below expectations in the September quarter with the annual rate falling to 5.6%. However, it's important to note most of the downside surprise came in the tradeable component. Non-tradeable, or domestic inflation, came in close to expectations. The downside surprise thus had little implications for monetary policy.

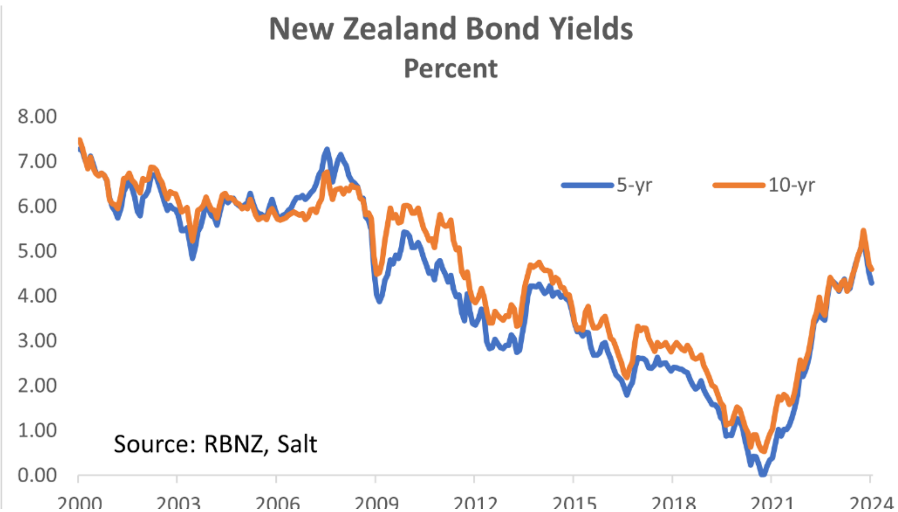


We expect annual inflation to move lower over the course of this year with headline inflation back inside the RBNZ's 1-3% target band by the end of the year. Regard any downside surprise with caution as it is most likely to come from the tradeable component. Non-tradeable inflation is expected to remain sticky, problematic, and thus the key reason any expectations of early interest rate cuts are likely to be disappointed.

OCR has peaked

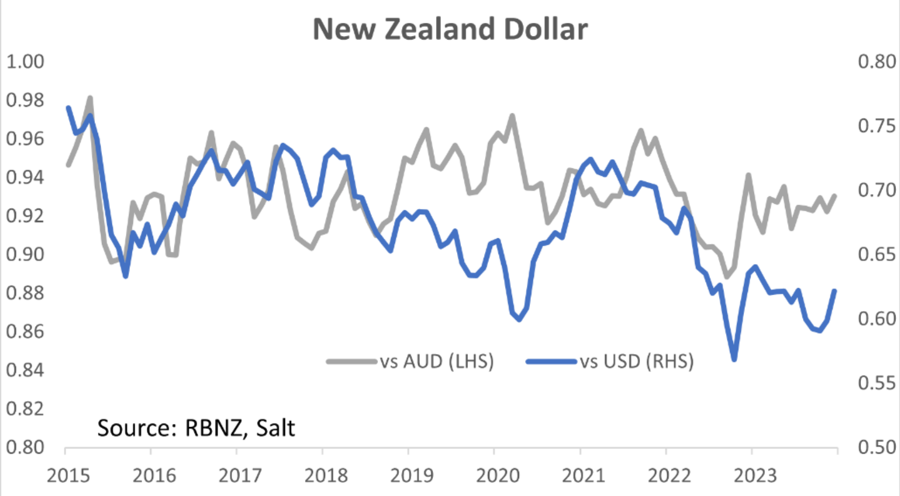


The GDP revisions were something of a gamechanger but only in the sense it supports our contention that the OCR has peaked. It tells us little about when to expect interest rate cuts. Given our expectation of still sticky domestic inflation pressures, we remain happy with our long-held view of a first OCR cut in November 2024. Anything earlier than that requires downside surprises in non-tradeable inflation.



Bond yields globally peaked in October and staged a meaningful rally into the end of the year as inflation came in below expectations, particularly in the US and Europe. In NZ that sentiment was helped by the weak Q3 GDP data. In 2024, yields will be choppy as expectations of both timing and quantum of interest rate cuts are constantly reassessed. However, the bottom line is that we are now in a higher interest rate environment.

NZ Dollar



As is usual, we look to the US to explain moves in the NZD/USD. The Fed's dovish December statement saw the USD take a hit, benefitting the NZD (amongst others). US monetary policy outcomes will be a key driver of the NZD this year. Concerns about the Chinese economy are having a greater impact on the AUD than the NZD.

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