SALT

New Zealand Chartbook

May 2024

HFM Asian Performance Awards 2023
WINNER
Australian Equity
SALT LONG SHORT FUND

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

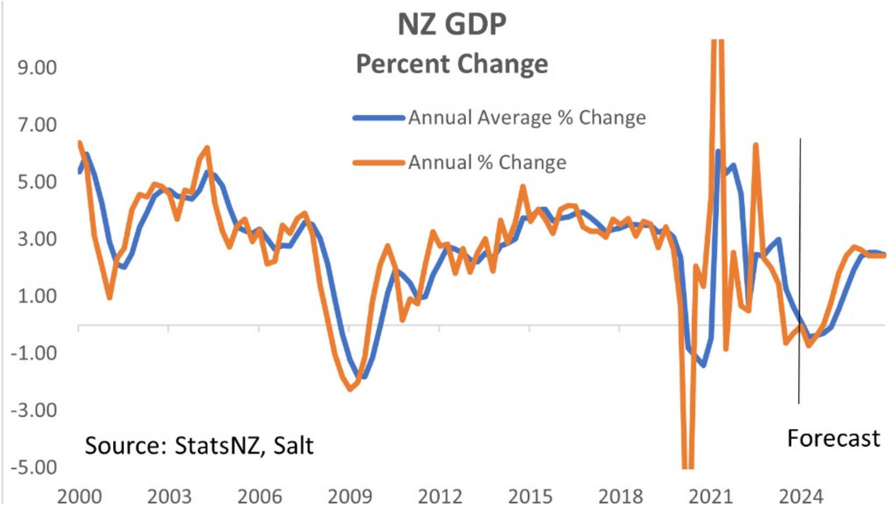
RESEARCH IP
FUND MANAGER OF THE YEAR 2022
- FINALIST -
BOUTIQUE FUND MANAGER OF THE YEAR

riaa Responsible Investment Association Australasia
Responsible Investment Leader 2022

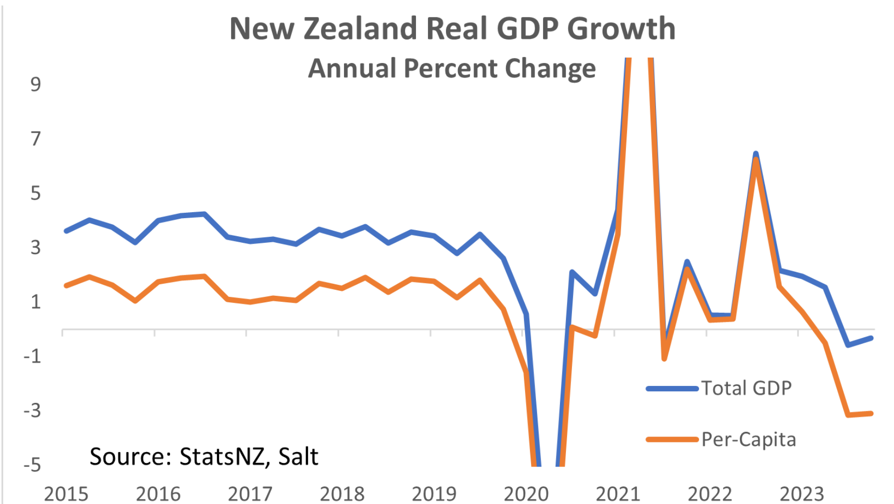
Highlights

- The New Zealand economy is struggling, having now contracted in four of the last 5 quarters.
- We expect two more negative quarters of GDP to come in the first half of this year, driven by weakness in the key interest rate sensitive sectors of the economy. Growth is likely to stabilise in the second half of the year.
- Conditions are becoming less tight in the labour market with the unemployment rate having risen from a low of 3.2% in March 2022 to 4.3% in March 2024.
- We see a further increase in the unemployment rate to above 5% and perhaps as high as 5.5% over the remainder of this year as employment conditions deteriorate further, while labour supply continues to expand via net migration.
- Headline inflation continues to moderate however the disinflation process remains unbalanced. The rate of traded goods inflation is falling faster than that of non-tradeables.
- We expect headline inflation to back inside the RBNZ's 1-3% target band by the third quarter of this year. Progress towards 2% continues through 2025.
- We remain comfortable with our view that the RBNZ will be able to begin gradual reductions in the OCR from November this year. That is based on our view that by then we will have seen further GDP and labour market reports that are weaker than the RBNZ's current expectations, allowing them to bring forward their current easing timeline.

New Zealand Economy is Struggling



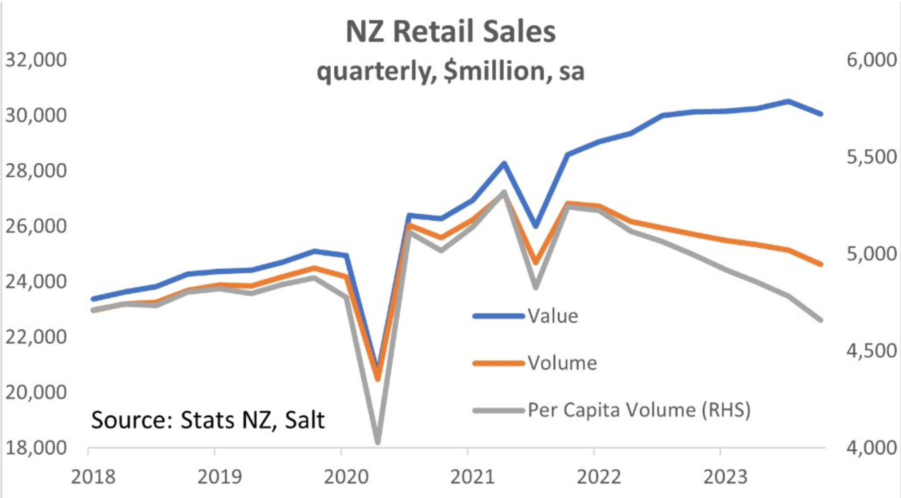
New Zealand GDP has now contracted in four of the last five quarters with annual growth of -0.3% in the year to December 2023. We think there are two more negative quarters to come in the three months to March and June, after which growth stabilises in the second half of the year. We don't see any return to meaningful growth until the start of 2025.



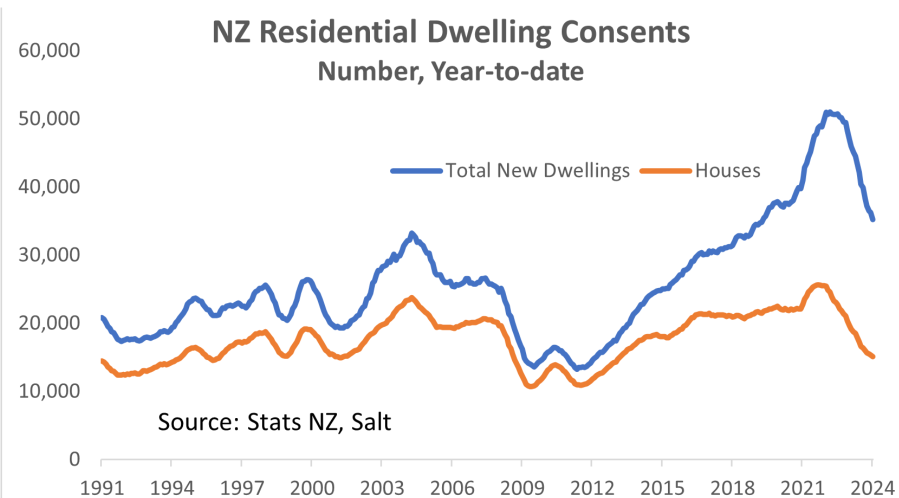
The recession would have been significantly deeper had it not been for the very strong recent population growth. Strong net inward migration saw NZ's population grow by 2.8% in the year to December. Adjusting December year total GDP growth for population growth, GDP contracted -3.1% on a per capita basis. If you want to argue the toss about whether we are in an actual recession, a per capita recession is undeniable.

SALT

Weakness in interest rate sensitive sectors



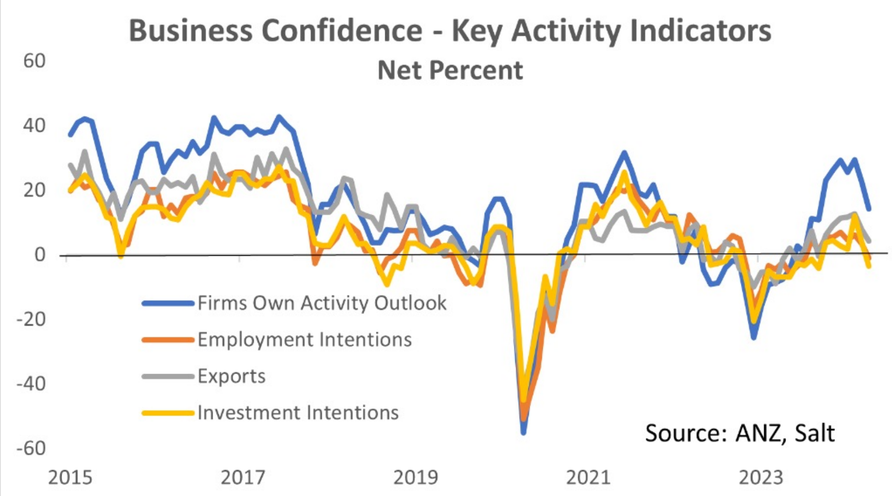
Its tough going in the retail sector. Retail spending is being hit by weakness in the labour market, and less disposable income due to interest rate increases. On the plus side, wage growth has been strong, as has population growth. In calendar 2023, the volume (inflation adjusted) of sales were down -4.1%. Adjusting further for population growth and the annual rate of per capita sales volumes are down -6.7%



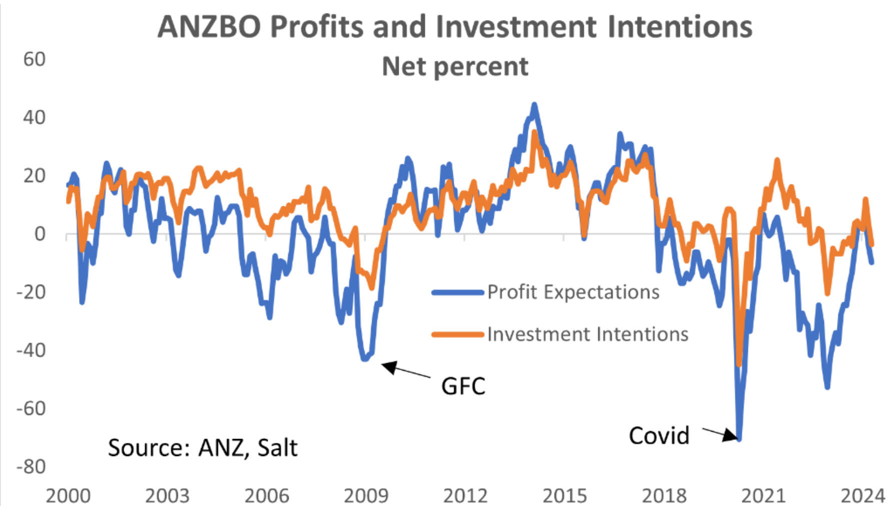
Residential construction has also been hit hard by falling house prices and higher interest rates. The strong population growth is playing out via higher costs of rentals. We don't expect to see any significant pick up in construction activity until interest rates start to fall, making that a story for 2025.

SALT

Business confidence reality check

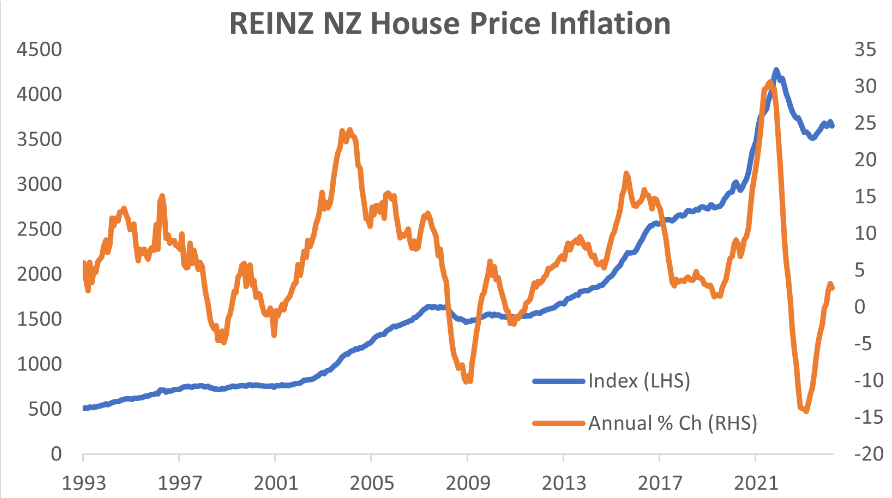


We have been surprised by the recent strength in business confidence, putting it mostly down to the change of government. More recent readings have taken a turn for the worse, reflecting an economy that is still struggling. We expect confidence to continue to soften over the next few months as trading conditions remain tough going, even with strong population growth taking the rough edges off the recession.

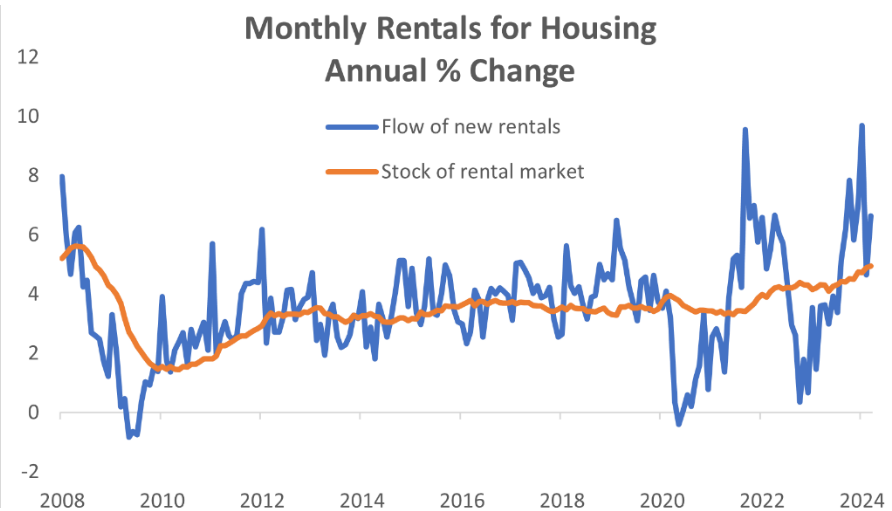


As the economy has deteriorated, interest rates have remained high and cost pressures have eased only slightly, firms profit expectations have also slipped back in the most recent survey. Investment and employment intentions slipped back into negative territory in April.

Housing market stabilising, but no strong rebound



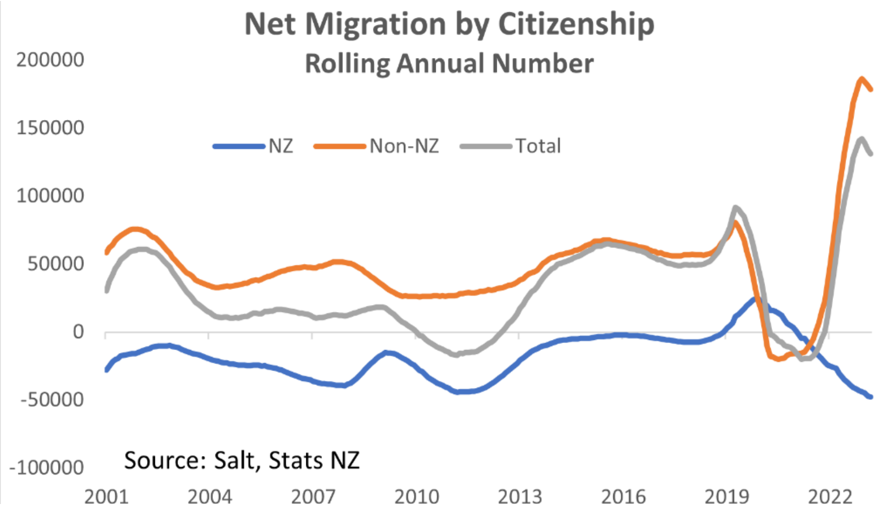
The price of existing homes is going nowhere fast. That's despite 2.8% population growth in the year to December 2023. The number of listings is up but is rising faster than sales, so inventory is increasing. That dynamic is preventing price pressure coming back into the market. We think there will be greater confidence from buyers once interest rates start to fall.



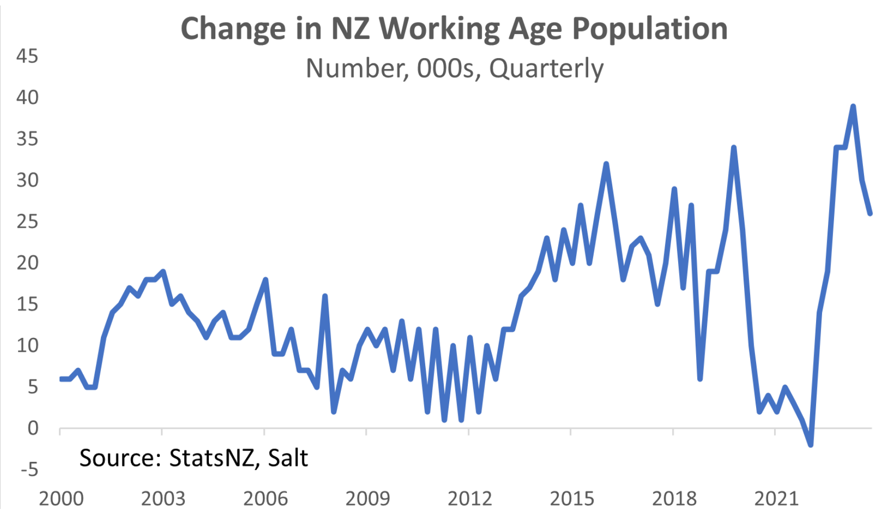
With residential construction in the doldrums at the same time we are seeing very strong population growth via net inward migration, there must be a release valve somewhere. That role is currently being played by the rental market where rentals are rising sharply again for new renters (the flow) which is contributing to an accelerating increase in rents for the market as a whole (the stock).

SALT

Likely past the peak in net migration



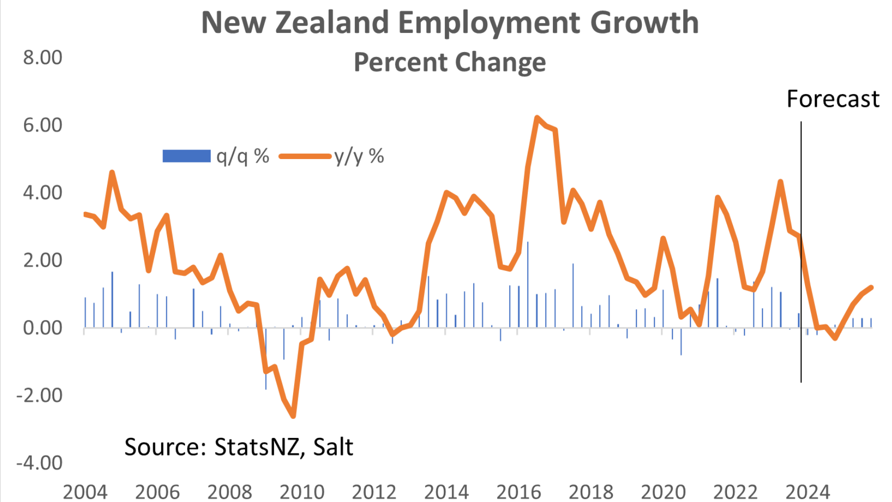
After peaking at 142k in November 2023, the annual total of net inward migration is down to 130k in February 2024. That still a massive number for a country the size of NZ, with all its associated pressures on housing and broader infrastructure. We expect the annual rolling total continues to fall over the remainder of the year, particularly as the labour market continues to soften, offering less opportunity for work.



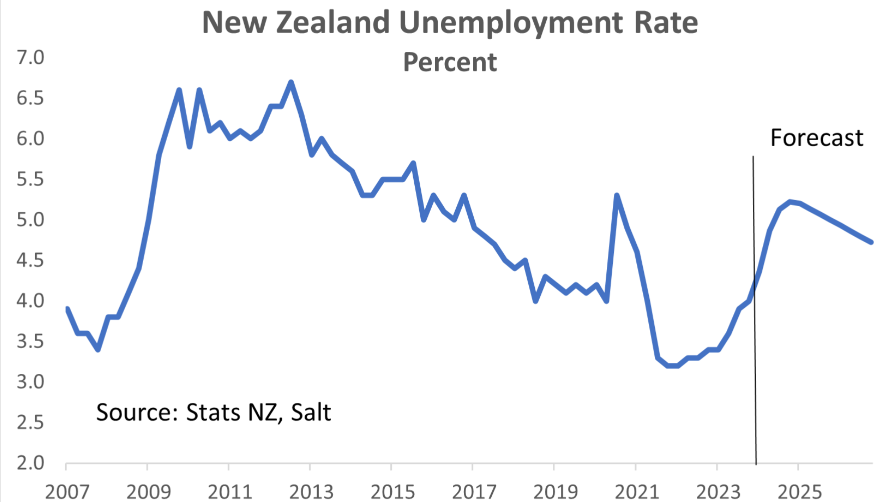
The significant net inflow of people has seen a significant boost to labour market supply with 196,000 people added to the working age population over the last year-and-a-half. That of course followed a period of closed borders where labour supply dried up completely, leading to labour shortages and strong wage growth. Those pressures are now easing.

SALT

Slack in the labour market increasing

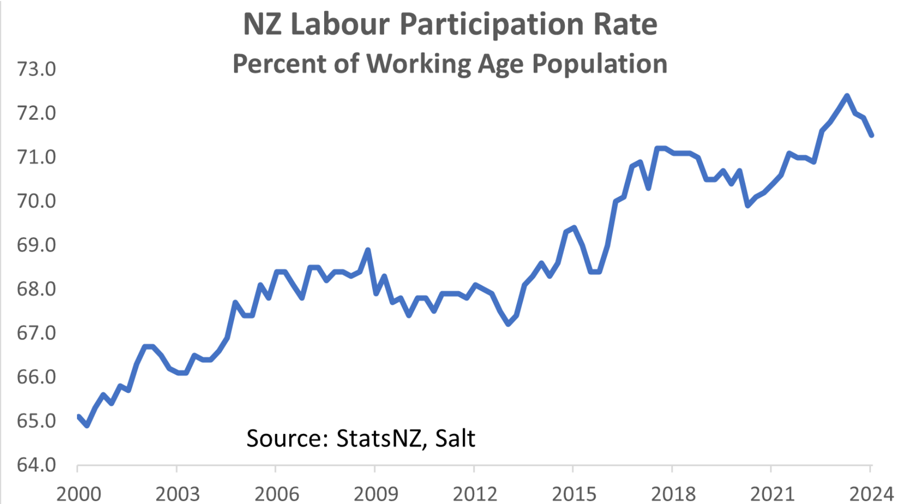


While net migration is now moderating, it is only happening slowly. At the same time, falling demand, lower profitability and business confidence that is on the wane again means that new migrants are entering the country into a more subdued employment environment. Employment contracted -0.2% in Q1 2024 and that's before recent public sector job cuts have been captured in the survey.

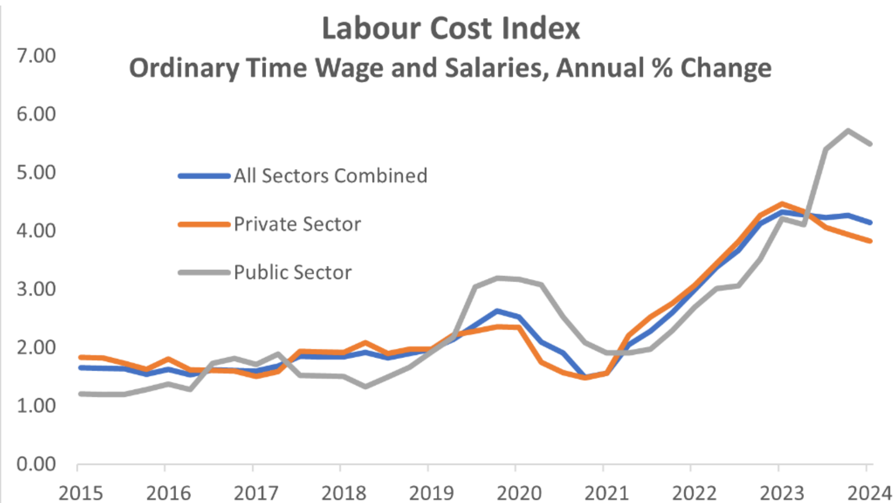


The upward trajectory in the unemployment rate is now firmly entrenched. The combination of weak employment conditions plus still strong growth in the working age population saw the unemployment rate rise from 4.0% in Q4 2023 to 4.3% in Q1 2024. We expect the unemployment rate will be over 5% by the end of the year, perhaps as high as 5.5%.

Wage pressures easing, but only gradually

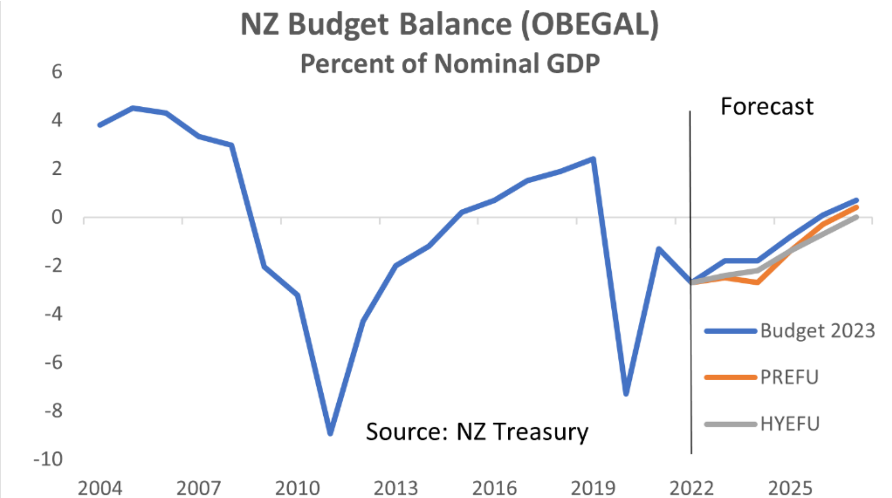


The rise in the unemployment rate would have been even greater in Q1 2024 had it not been for a sharp fall in the participation rate (the proportion of the working age population either in work or actively seeking work). This fell from 71.9% in Q4 2023 to 71.5% in Q1 2024. This could be due to discouraged workers who have given up looking for work or more people opting to study.

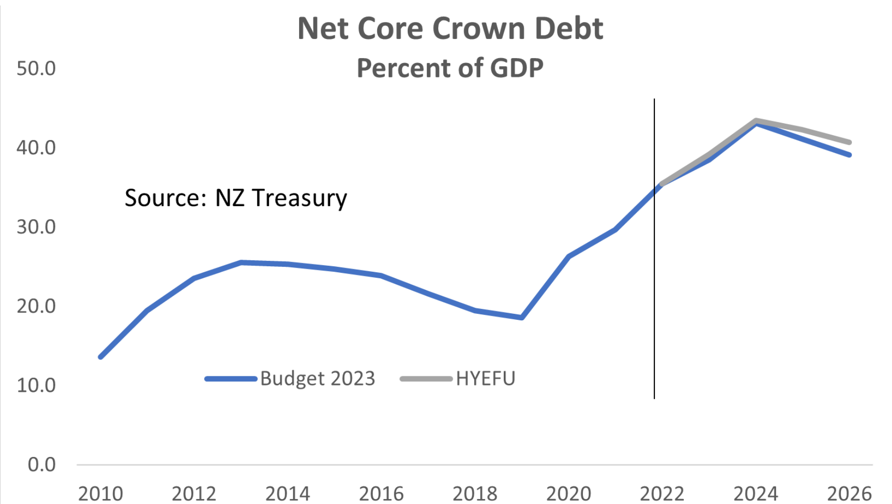


As slack has increased in the labour market, wage inflation has eased, albeit gradually. The Labour Cost Index (LCI) is a quality adjusted measure of wage inflation, not to be confused with nominal wages. The private sector LCI peaked at 4.5% y/y in Q1 2023 and has since fallen to 3.8% in Q1 2024. The RBNZ is most interested in private sector wages as that is the sector over which they have most influence. They will want to see this back towards 2%.

Fiscal ratios continue deterioration



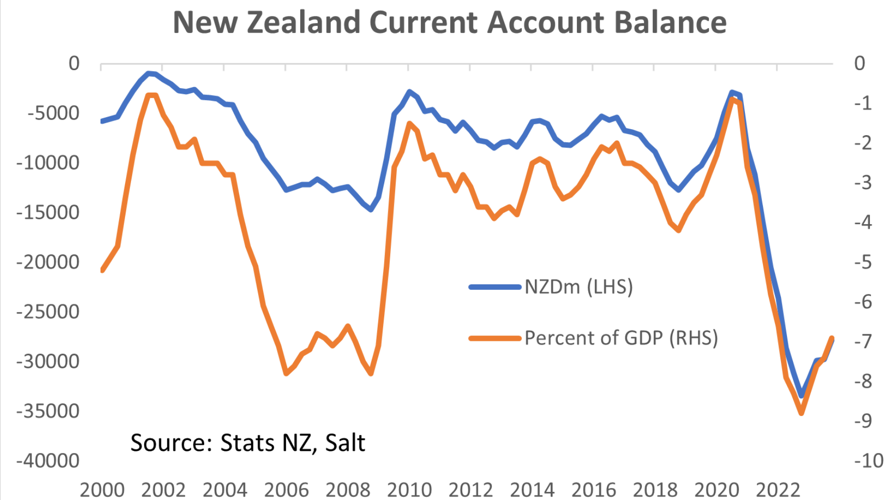
The 2024 Budget Policy Statement indicated the fiscal situation continues to deteriorate. The Government remains committed to income tax relief in Budget 2024. We will have to wait for the Budget for details. Our guess remains that the timing will remain on track, but the quantum remains open for debate (and headroom). The fiscal situation remains incredibly tight and tough choices are having to be made.



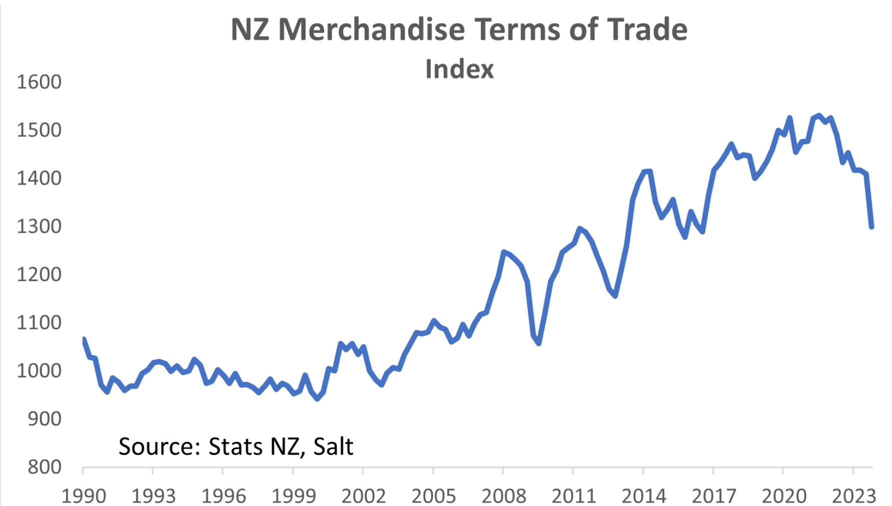
The Government has set a goal of reducing net core Crown debt to below 40% of GDP, close to the peak level expected in the HYEFU. Once that has been achieved, that ratio will be kept to a range of 20-40% of GDP. OBEGAL balances will be managed in a way that is consistent with the debt objective. Increased debt issuance in the order of $10-15 billion appears likely to be announced at Budget time.

SALT

Vulnerabilities in the external sector



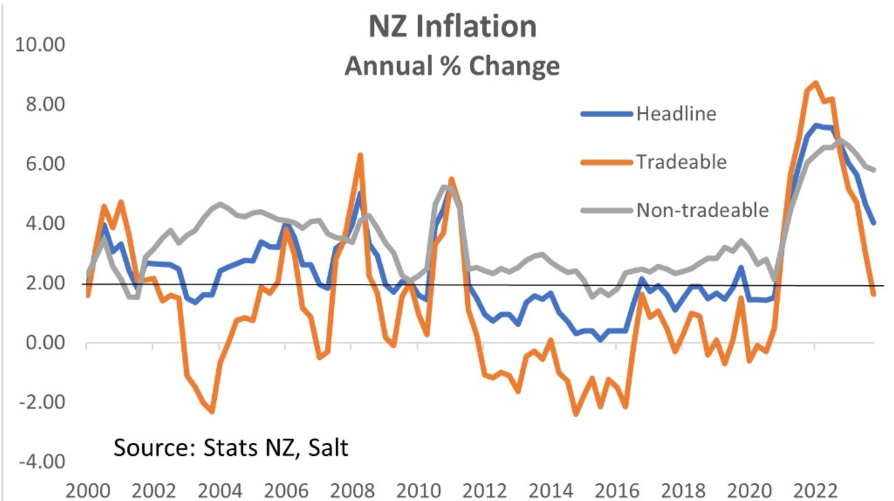
December quarter Balance of Payments data shows the NZ economy remains seriously out of balance. The deficit improved from a revised -7.4% of GDP to -6.9% of GDP. Still too big a deficit and still unsustainable but heading in the right direction. The risk is the improvement stalls at a level that still has the rating agencies attention.



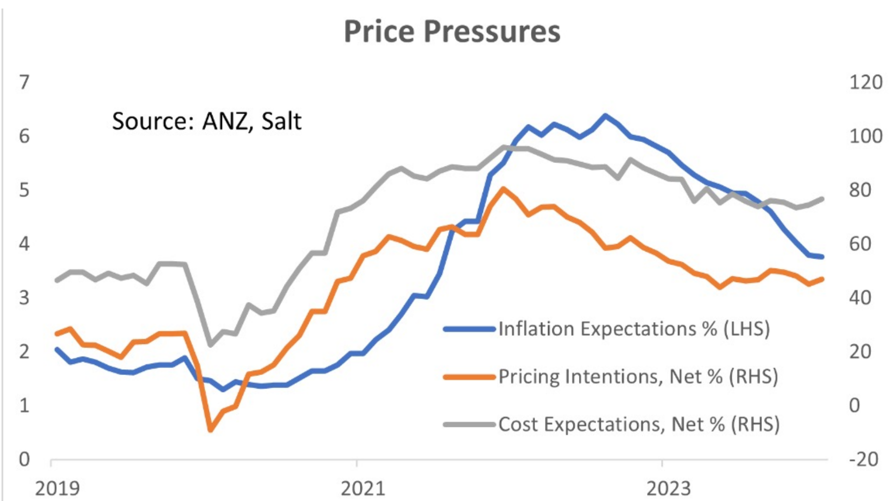
New Zealand's terms of trade took a -7.8% hit in the final three months of 2023. The index suffered the double whammy of a fall in export prices (dairy) and a rise in import prices (petroleum).

SALT

Inflation falling but domestic inflation pressures still sticky

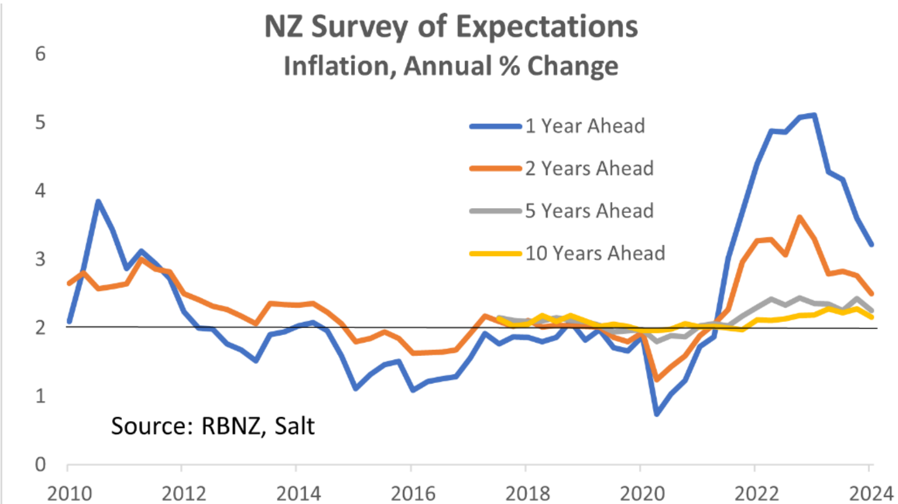


Headline inflation continues to ease, coming in at 4.0% y/y in Q1 2024, good progress on the peak of 7.3% in June 2022. However, the disinflation process is proving to be unbalanced with tradeable (imported) inflation at 1.6% y/y in Q1 and non-tradeable (domestic) at 5.8% y/y. The RBNZ will want to see further progress on domestic inflation before they are confident of a sustained return to 2%.

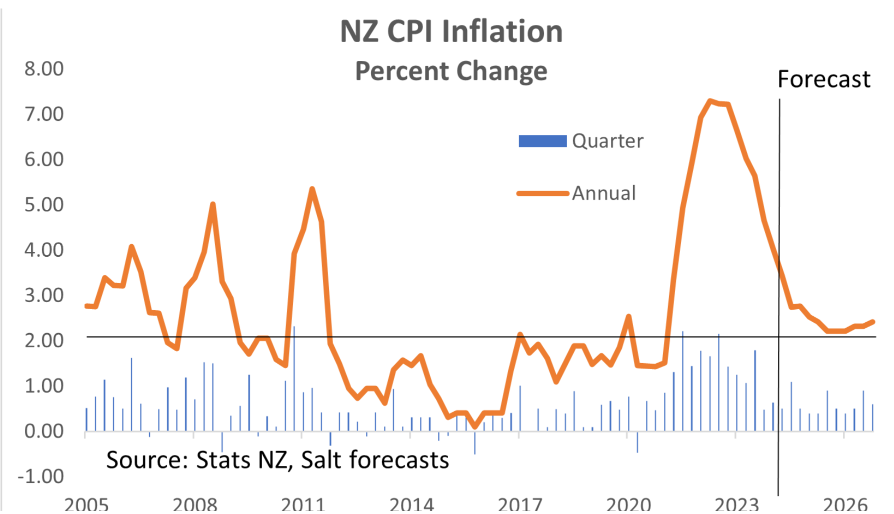


The slow progress on domestic inflation is consistent with other inflation indicators. We have already mentioned the only gradual progress being made on private sector wage inflation, while price and cost indicators in the ANZ Business Outlook are also only improving gradually. And the only slight drop in business sector inflation expectations to 3.76% was only observable at the second decimal point.

Inflation back in the target range this year



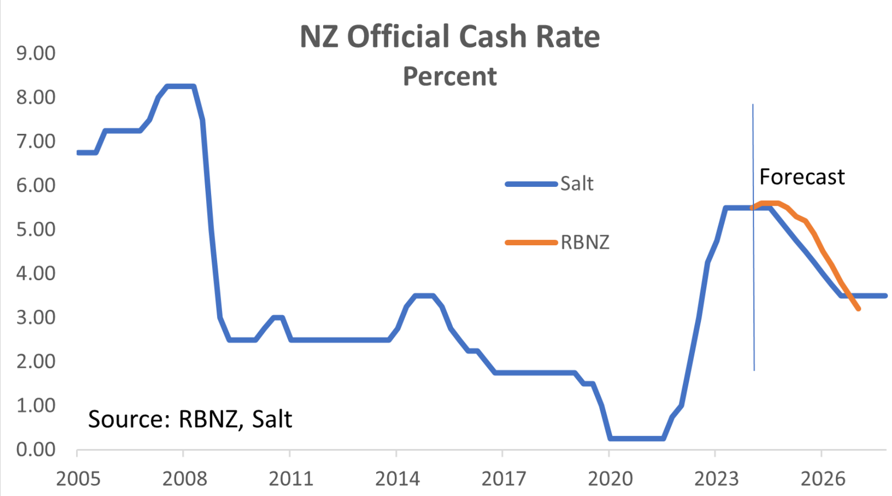
We expect the RBNZ will be happy with the path of inflation expectations in its own survey. Near-term (1-2 years ahead) expectations are continuing to fall with current inflation. At the same time longer-term (5-10 years ahead) expectations, the ones that really matter, are above 2%, but only by a fraction. Nothing to worry about too much here.



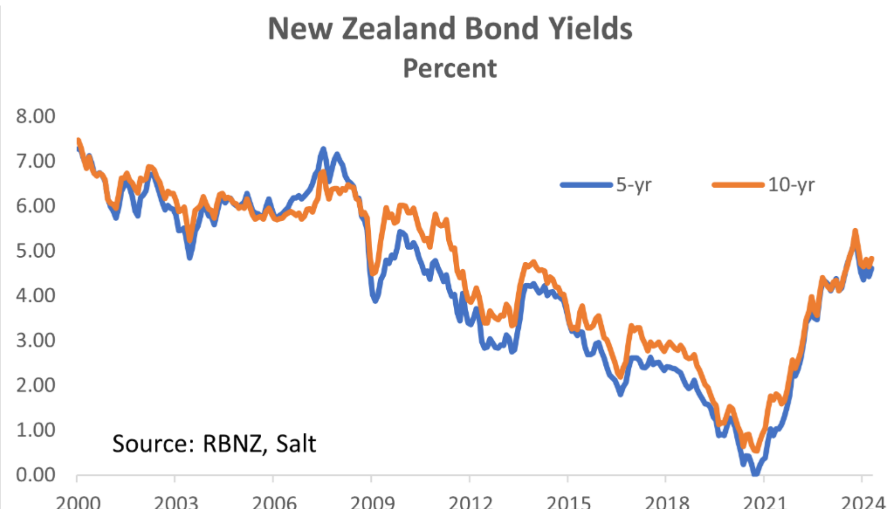
We expect headline inflation to be back inside the 1-3% target band by Q3 of this year. Further progress towards 2% is expected to be made through 2025. We expect this profile to enable the RBNZ to begin easing monetary conditions gradually in November this year.

SALT

Gradual OCR cuts from November



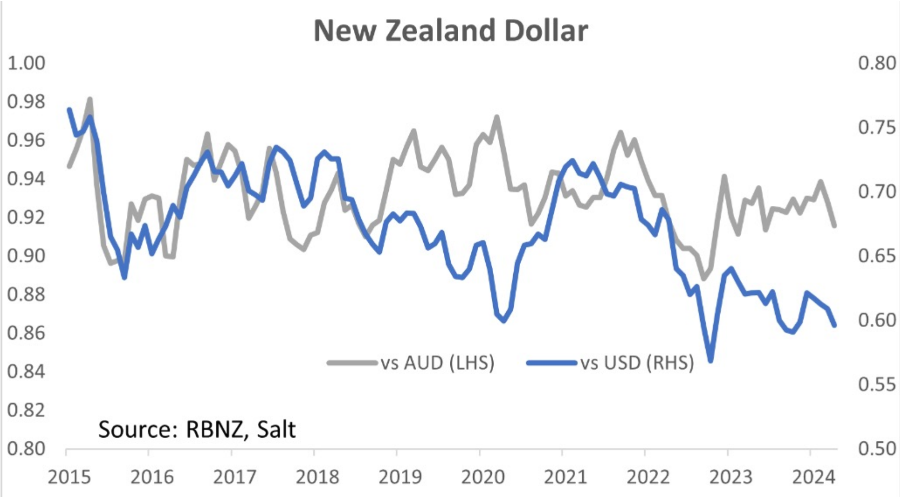
We remain comfortable with our view that the RBNZ will be able to begin gradual reductions in the OCR from November this year, earlier than the RBNZ's projected mid-2025. That is based on our (and their) view that inflation will be inside the 1-3% band in Q3 this year, and our view that by then we will have seen further GDP and labour market reports that are weaker than the RBNZ's current forecasts.



Global forces have been the primary factor behind higher New Zealand bond yields, as expectations of rate cuts have been both reduced and pushed out. It's at the short end of the bond curve where the ever-changing view of the outlook for domestic monetary policy has played out, even including a brief flirtation with the idea of an interest rate increase. Thankfully sense prevailed.

SALT

NZ Dollar



Our expectations of a firmer NZD/USD continue to be pushed out alongside the timing of US interest rate cuts. NZD/USD will just have to stay undervalued for longer. Relative economic performance continues to point to a weaker NZD/AUD.

Disclaimer