insightpaper

AMP CAPITAL

NEW ZEALAND INSIGHTS

March 2019

INSIGHTS
IDEAS
RESULTS

New Zealand Insights March 2019

GDP growth – headwinds and tailwinds

New Zealand's GDP growth has shifted down a gear and the peak in the economic cycle is now well behind us. From a peak of over 4% growth in 2016, growth has now settled at a level of around 2.5%.

Growth in the second half of 2018 was disappointing, even given that revised level of where we think the economy is performing. This reflects a number of economic headwinds, including a moderation in global growth, and slower population growth that will flow through into a moderation in consumption growth and help alleviate demand and supply imbalances in the housing market. Rising capacity constraints will also continue to have a moderating influence on growth in activity.

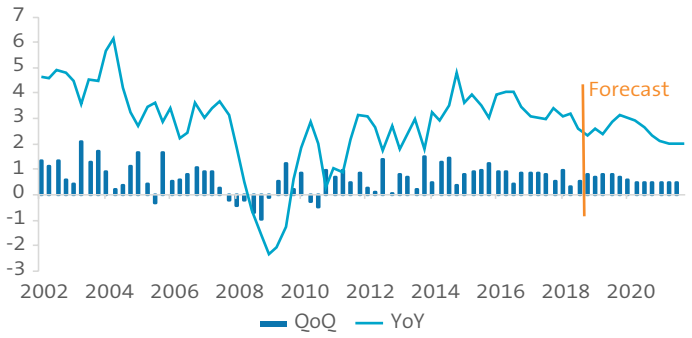
But there are tailwinds too, largely on the back of fiscal stimulus and strong growth in labour income, albeit a different mix in the sense that we expect employment growth to slow and wage pressure to build. Indeed, wage growth is already being supported by public sector pay settlements and scheduled increases in the minimum wage. At the same time, monetary policy also remains highly stimulatory.

Confidence levels are soft though not problematic, assuming you can look through the pessimistic level of general confidence and focus instead on the low but still mildly optimistic level of confidence firms still have with respect to the outlook for their own business. That said, after a few months of improvement, business confidence retreated in early 2019, as has consumer confidence. We put this more recent softness down to the pending release, at the time of surveying, of the report from the Tax Working Group and speculation on its likely support for a Capital Gains Tax.

Balancing all those factors out, we see annual average growth of 2.7% in 2019, not significantly different from the 2.8% achieved in 2018. We see growth of 2.6% in 2020.

Chart 1: New Zealand GDP

% change

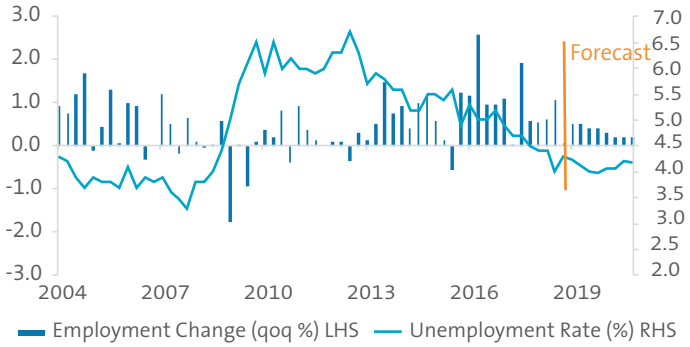


Source: Statistics NZ and AMP Capital

Labour market tightening

Recent labour market data has been volatile over the past two quarters, with the unemployment rate falling sharply in the September quarter of last year, only to reverse most of that decline in the December quarter. Looking through the noise, the trend decline in the unemployment rate is intact and the labour market is undeniably tight, with the unemployment rate at 4.3% at the end of 2018.

Chart 2: New Zealand labour market



Source: AMP Capital

But this is yet to manifest into a meaningful lift in wage pressure. The private sector Labour Cost Index (LCI) is running at around a 2% annual pace. Given this measure of wage inflation is more akin to a measure of unit labour costs, the rate of change in the LCI is broadly consistent with underlying inflation of around 2%, bang on the mid-point of the Reserve Bank of New Zealand's (RBNZ's) target band.

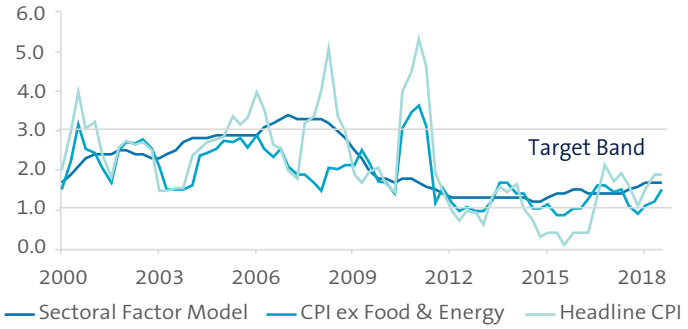
We will continue to watch the labour market closely. With GDP growth having shifted down a level, the economy is now growing at a rate that is undeniably closer to the economy's potential growth rate. What impact that now has on the unemployment rate and wage growth will be a key determinant of the next move in interest rates.

Our sense is the unemployment rate has a bit further to fall, which will exacerbate existing skills shortages and put further upward pressure on wage growth, especially given the steady rise in the minimum wage which is in turn putting pressure on business margins.

Inflation still boringly benign

Right now inflation is looking boringly benign. As growth has run ahead of potential, spare capacity has been absorbed, wages growth has moved up and business margins have tightened. However, key measures of core inflation have nudged only gradually higher and remain below the mid-point of the Reserve Bank of New Zealand's 1-3% target band.

Chart 3: New Zealand inflation
Annual % change



Source: AMP Capital

The complicating factor in the inflation outlook right now is that GDP growth is clearly past the peak in the cycle and has just had a period of sub-par growth in the second half of last year.

A key point to keep in mind is that slower growth by itself is not sufficient reason for the RBNZ to cut interest rates. What matters for the Bank is where the economy is performing relative to its potential and the extent to which spare capacity is being absorbed or created. If part of the reason for lower growth is constrained capacity, which we think is the case in New Zealand right now, it's possible to see lower growth AND higher inflation at the same time.

We continue to expect GDP growth to strengthen in the early part of this year, but not to the extent we expected in earlier forecasts and there are downside risks from the clearly softer global economic outlook.

OCR cuts more likely?

The RBNZ has already signalled via its alternative scenario modelling that it will be more responsive to downside risks to inflation than it will be to upside risks.

Even so, the RBNZ surprised us with its dovish turn in its March OCR review. We sheet this directly home to the the global economic outlook, and in particular to the recent dovish shift from a number of global central banks and the implications for the New Zealand dollar if the RBNZ did not follow suit.

The RBNZ will be doing its normal forecasting round prior to the next full Monetary Policy Statement. It seems likely the RBNZ will lower its forecasts for growth and inflation and there will be plenty of global and domestic news to absorb over the next six weeks. That leaves us thinking that while the probability of a rate cut just went demonstrably up, its not in the can yet.

Gas in the (fiscal) tank

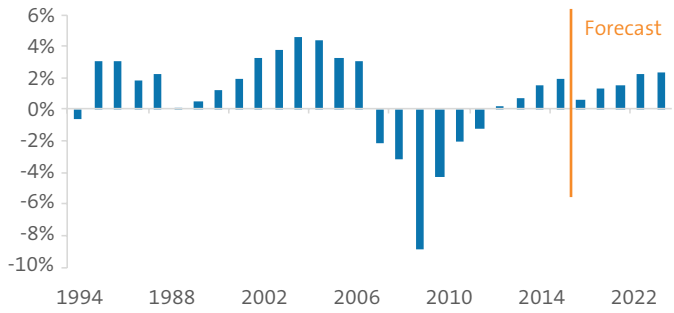
One thing that has concerned us (and markets) about the slowdown in global growth that became evident over the latter part of 2018 was the lack of any ability to meaningfully adjust policy settings should further stimulus be required.

In the US, for example, while the Federal Reserve has made the most progress of any central bank to normalise monetary policy, there is only limited room to cut interest rates to any meaningful extent. Furthermore, fiscal policy is also constrained by the fact that the US budget deficit is already deteriorating at the same time growth is peaking.

In Europe, the European Central Bank has only just stopped printing money and key policy rates are still negative. Even in China, the ability to respond with monetary and fiscal policy is not as great as it was.

In New Zealand, we are fortunate that while monetary policy is constrained by the extent to which it could adjust to any downside shock to growth and inflation, we have ample room to move on fiscal policy.

Chart 4: Fiscal balance
Operating balance excluding gains and losses



Source: NZ Treasury

Indeed, the forecast outlook of solid rising fiscal surpluses has not gone unnoticed by the rating agencies. Standard and Poor's recently upgraded New Zealand's credit rating from AA- stable to AA- positive.

External accounts in good shape

New Zealand's current account deficit came in at 3.7% of GDP at the end of 2018. The deficit has been on a deteriorating trajectory over the past two years, reflecting higher oil and lower dairy prices that has contributed to a worsening in our trade balance.

That said, our external position remains in relatively good shape by historical New Zealand standards. Putting aside the recent deterioration, our terms of trade are still at a relatively high level. In fact, the recent strengthening in dairy prices, combined with a stabilisation in oil prices, points to a near-term recovery in the terms of trade and a stabilisation of the deterioration in the current account balance.

Chart 5: NZ net international investment position
% of GDP

Source: Statistics NZ

Our International Investment Position (IIP) has been improving as a percentage of GDP given the relatively low level of our current account deficit. However, we did see a deterioration at the end of 2018 given the weakness we saw in global markets as the year came to a close. The IIP fell from -53.6% in September 2018 to -57.0% of GDP in December.

The recovery in the global asset market in the first few weeks of 2019 should see much of this deterioration reverse in the March quarter. Furthermore, given the continued contained nature of our current account position, the trend improvement in our IIP should remain intact.

Exchange rate

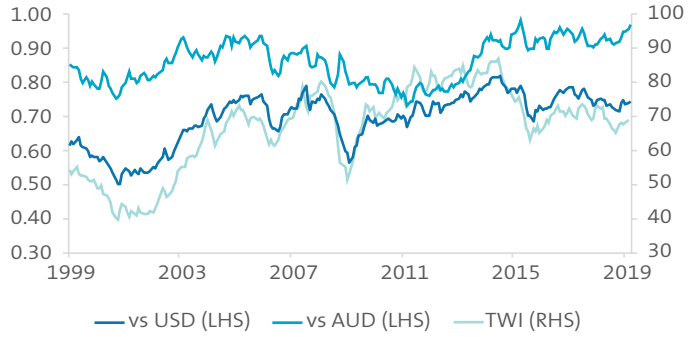
The outlook for the NZ dollar (NZD) versus the US dollar (USD) has become, if anything, less complicated over the last few weeks. The Kiwi is sitting at around our estimate of fair value, suggesting no clear pressures in either direction from here.

Furthermore, with the RBNZ on hold and the US Federal Reserve (the Fed) now also on hold, monetary policy seems unlikely to deliver a clear direction anytime soon. That said, our view is that the RBNZ is unlikely to cut interest rates, and that we are not prepared at this stage to believe the Fed has done with rate hikes.

The outcome of the trade dispute between the US and China will have implications for the US dollar. Given our expectation of a positive outcome, both monetary policy and trade dispute outcomes suggest upside is more likely for the USD and therefore downside for the NZD versus the USD.

The NZD has strengthened against the Australian dollar over the early months of 2019 with the cross rate now stronger than fair value. That has been the result of expectations the RBA may cut interest rates and the relatively strong performance of New Zealand commodity prices (dairy). Relative monetary policy expectations will continue to be the key determinant of this cross rate in the weeks and months ahead.

Chart 6: New Zealand dollar



Source: RBNZ

The outlook for the NZ dollar versus the US dollar has become, if anything, less complicated over the last few weeks. The Kiwi is sitting at around our estimate of fair value, suggesting no clear pressures in either direction from here.

New Zealand Fixed Income

A deteriorating global growth backdrop has seen a number of central banks move to a more dovish policy stance in the first quarter of 2019, triggering widespread falls in global bond yields, including here in New Zealand.

Key themes include:

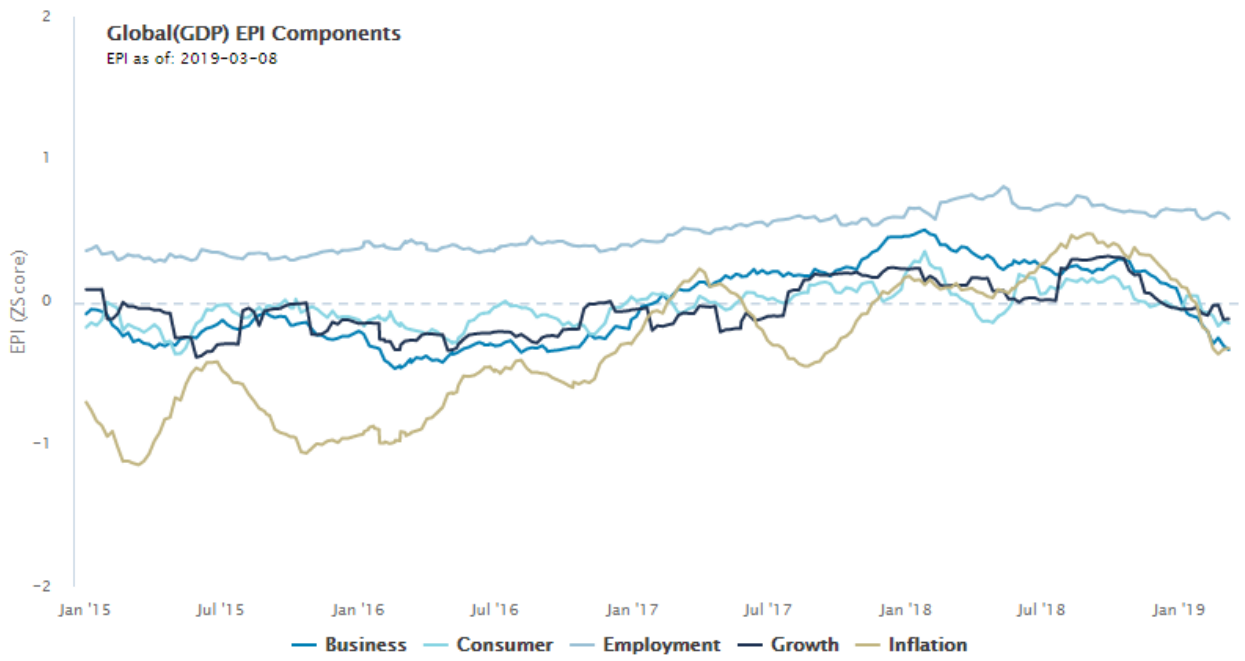
- A weaker global economic backdrop (particularly in Europe and China) led the US Federal Reserve to pause its tightening cycle, while the European Central Bank (ECB) also moved to a more dovish policy stance. In New Zealand the Reserve Bank of New Zealand (RBNZ) also signalled potential rate cuts primarily due to the weaker global outlook.
- These moves supported a synchronised fall in global bond yields, which are now expected to remain "lower for longer".
- The economic outlook in Australia has also deteriorated rapidly in recent quarters, with the Reserve Bank of Australia (RBA) now widely tipped to cut rates later in the year.
- New Zealand was not immune to the global downdraft, with domestic yields falling to record lows across the curve by the end of March. The fall in domestic yields was exacerbated late in March when the RBNZ signalled that "the more likely direction of our next OCR move is down".

Downside risks to global growth

Turning first to the world economy, the economic data has deteriorated sharply since late 2018 (refer Figure 1). This was triggered by a spike in equity market volatility, an escalation in trade tensions between the US and China, and a marked slowdown in both Europe and China. Global manufacturing (and the wider business sector) has been most severely impacted, while the consumer and inflation components of our EPIs have also turned down.

Figure 1: Economic Pressure Index (EPI) for globe across different economic sectors

EPI>0 indicate stronger data compared to previous 10 years; EPI<0 indicates weaker data compared to previous 10 years; z-score



Source: AMP Capital

Global central banks take a dovish turn

In response to the heightened financial market volatility and growing downside risks to the global economy, the Fed surprised by pausing its tightening cycle in late January. It also signalled a slowing in its balance sheet reduction plans, a key factor driving the earlier withdrawal of global liquidity and ensuing market volatility. This dovish turn from the Fed helped underpin risk sentiment, boosting equity and credit markets and limiting the impact of downside risks to the global economy.

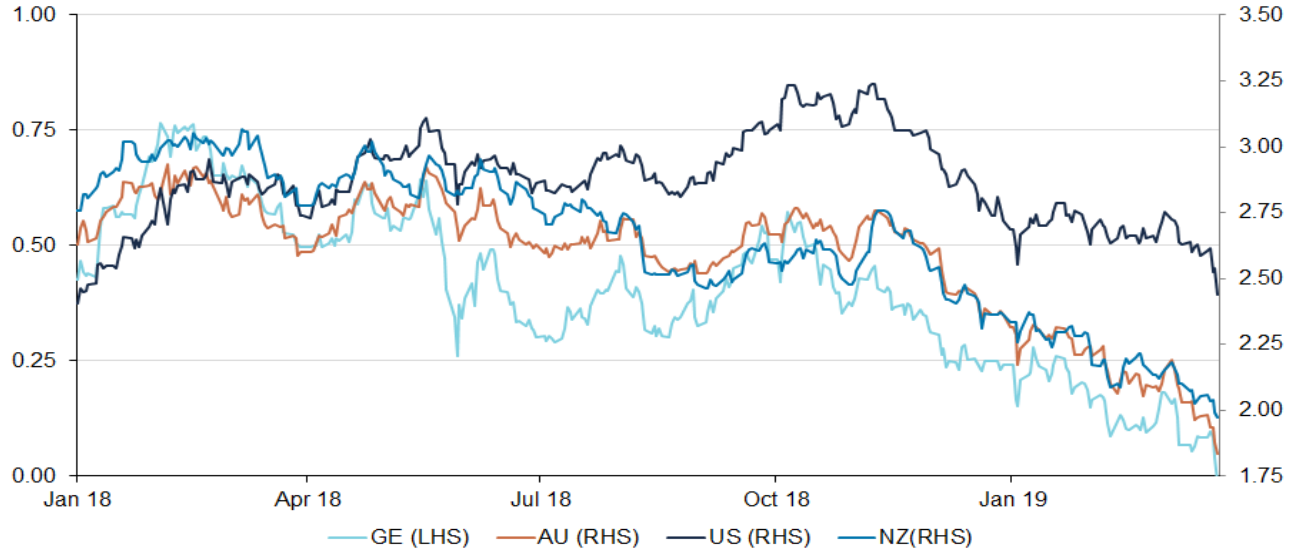
The European growth outlook also deteriorated rapidly in late 2018, with pronounced weakness in the Italian economy and German auto sector, alongside Brexit-related event risk. In response, the ECB slashed its growth forecasts, re-implemented term loans to the banking sector and pushed out the timing of potential rate hikes. China's central bank also moved to stimulate its domestic economy in the March quarter by announcing further stimulus plans, including increased government spending, lowering taxes, cutting official interest rates and reducing Reserve Ratio Requirements.

Global bond yields "lower for longer"

By late March, there were tentative signs of 'green shoots' emerging in a number of major economies following stimulus efforts. However, global central banks have made it clear they will be "patient" with respect to any future policy tightening – a sign that risk assets are likely to remain underpinned for much of 2019 while global bond yields are expected to remain "lower for longer".

By the end of March, US 10 yr bond yields had fallen to their lowest level in more than a year, German bond yields had fallen below zero for the first time in 2½ years, while New Zealand and Australian 10 yr bond yields fell to record lows late in the quarter. Global yield curve flattening was also a common theme over the quarter.

Figure 2: 10 year government bond yields across selected economies
%



Source: AMP Capital, Bloomberg

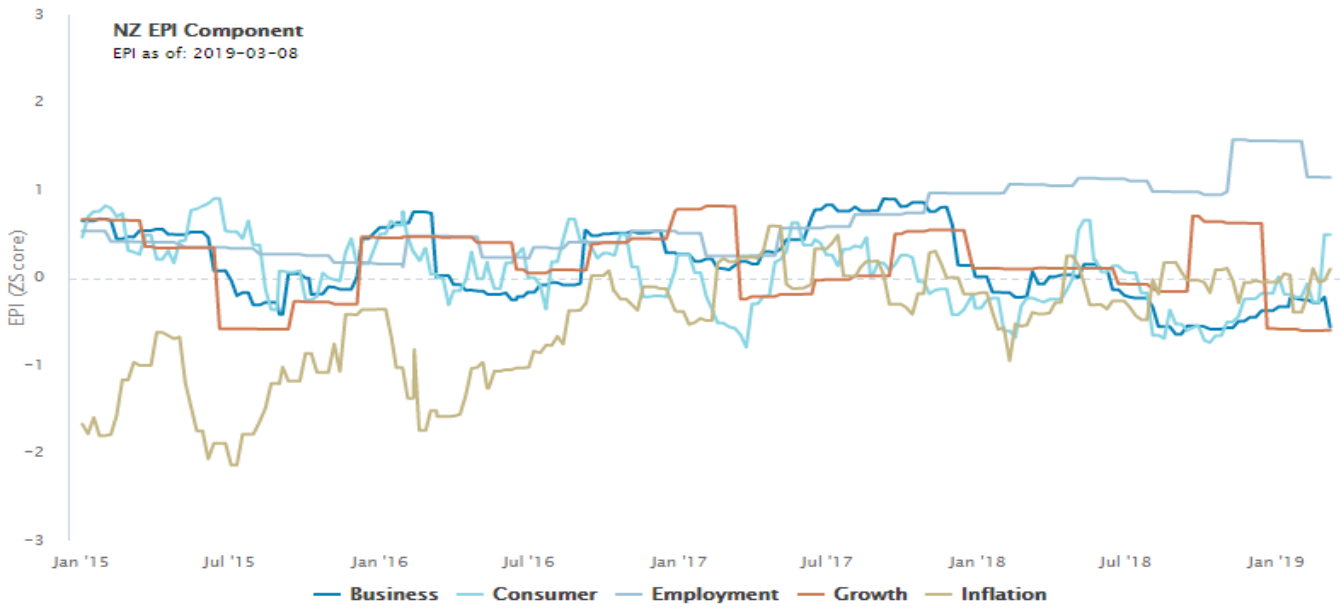
Antipodean bond yields not immune to the weaker global backdrop - RBNZ to cut rates?

In light of historic correlations, what's happening across the Tasman is also key to the outlook for New Zealand interest rates. In the March quarter we saw a deterioration in the Australian economic outlook in response to a weaker housing market, with house prices falling sharply in Sydney and Melbourne, residential construction slowing sharply, and consumer spending starting to slow due to perceived wealth effects.

Our Australian colleagues expect the RBA to lower its economic growth forecasts in May, with 50 basis points (bps) of rate cuts forecast by year-end. This view is now becoming more consensus and has contributed to the fall in Australian bond yields in recent months.

The New Zealand economy had proven relatively resilient in light of downside risks afflicting Australia and the wider global economy, albeit GDP growth did slow in the second half of 2018 as signalled by our New Zealand EPIs. Looking at the sectors within the New Zealand economy (refer Figure 3), the business sector continues to grapple with the challenges posed by capacity constraints and regulatory change, while consumer measures have recovered at the margin after a weak patch in late 2018. Employment growth remains solid, albeit is yet to show up in a more generalised lift in wage or inflation pressures.

Figure 3: Economic Pressure Index (EPI) for New Zealand across different economic sectors
EPI>0 indicate stronger data compared to previous 10 years; EPI<0 indicates weaker data compared to previous 10 years; z-score



Source: AMP Capital

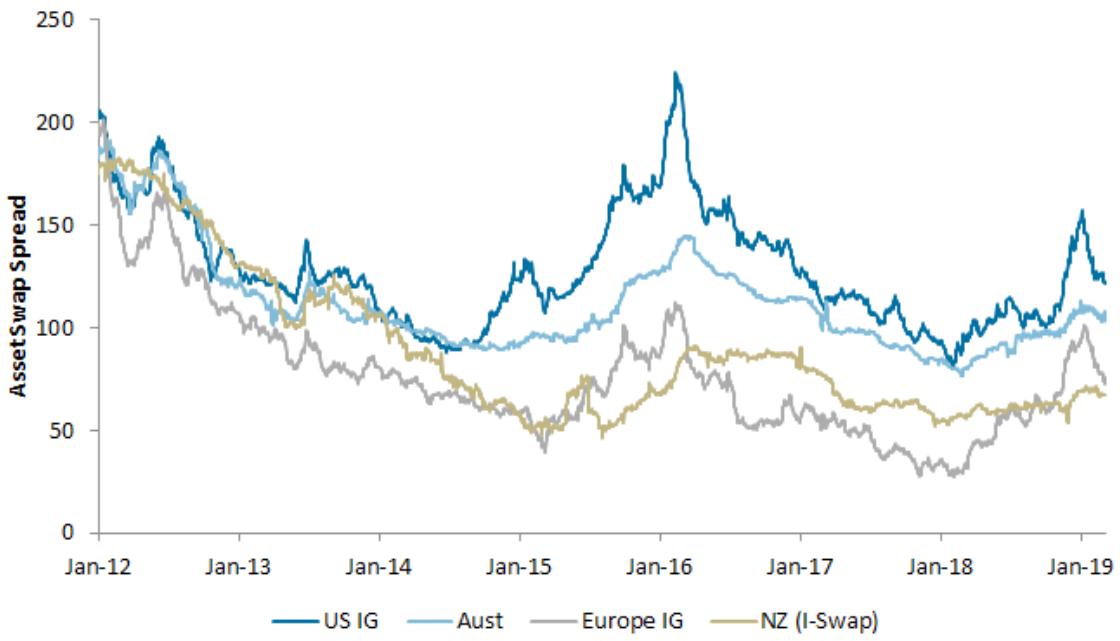
The RBNZ surprised markets at its OCR review in late March by signalling that "the next move in the OCR was more likely to be down" due to the "weaker global economic outlook and reduced momentum in domestic spending".

While we continue to forecast GDP growth at close to potential in 2019 (2.5-3.0%), we are cognisant that domestic risks have gradually shifted to the downside in recent months with the threat of Capital Gains Tax denting business confidence and investment intentions. Proposed bank capital changes add to the case for OCR cuts over the medium term. RBNZ Governor Orr has expressed a clear desire to run monetary policy looser than his predecessor and appears willing to provide a further boost to the economy in an effort to restore inflation to the 2% mid-point of its target band.

In our view, OCR cuts now appear more likely than not, albeit the timing is very much dependent on the domestic and global data flow and whether the RBA follows through on market pricing for rate cuts in Australia.

Global credit benefiting from low yields

Figure 4: Credit spreads in New Zealand, US, Europe and Australia
bps



Source: AMP Capital

Global credit spreads responded positively to the reduction in financial market volatility following the Fed's decision to pause its tightening cycle. As Figure 4 demonstrates, this has especially been the case in US and Europe credit markets where spreads widened sharply in late 2018 in response to equity market weakness.

Locally, credit spread movements have been fairly benign in the past year, although the market has seen some name-specific widening for lower-rated credits. The current environment of low bond yields should remain supportive of high-grade credit amid solid technical drivers (large maturities and KiwiSaver inflows), although more rigorous analysis is required for lower grade credit given the late-cycle nature of the New Zealand economy.

Outlook for NZ Fixed Income

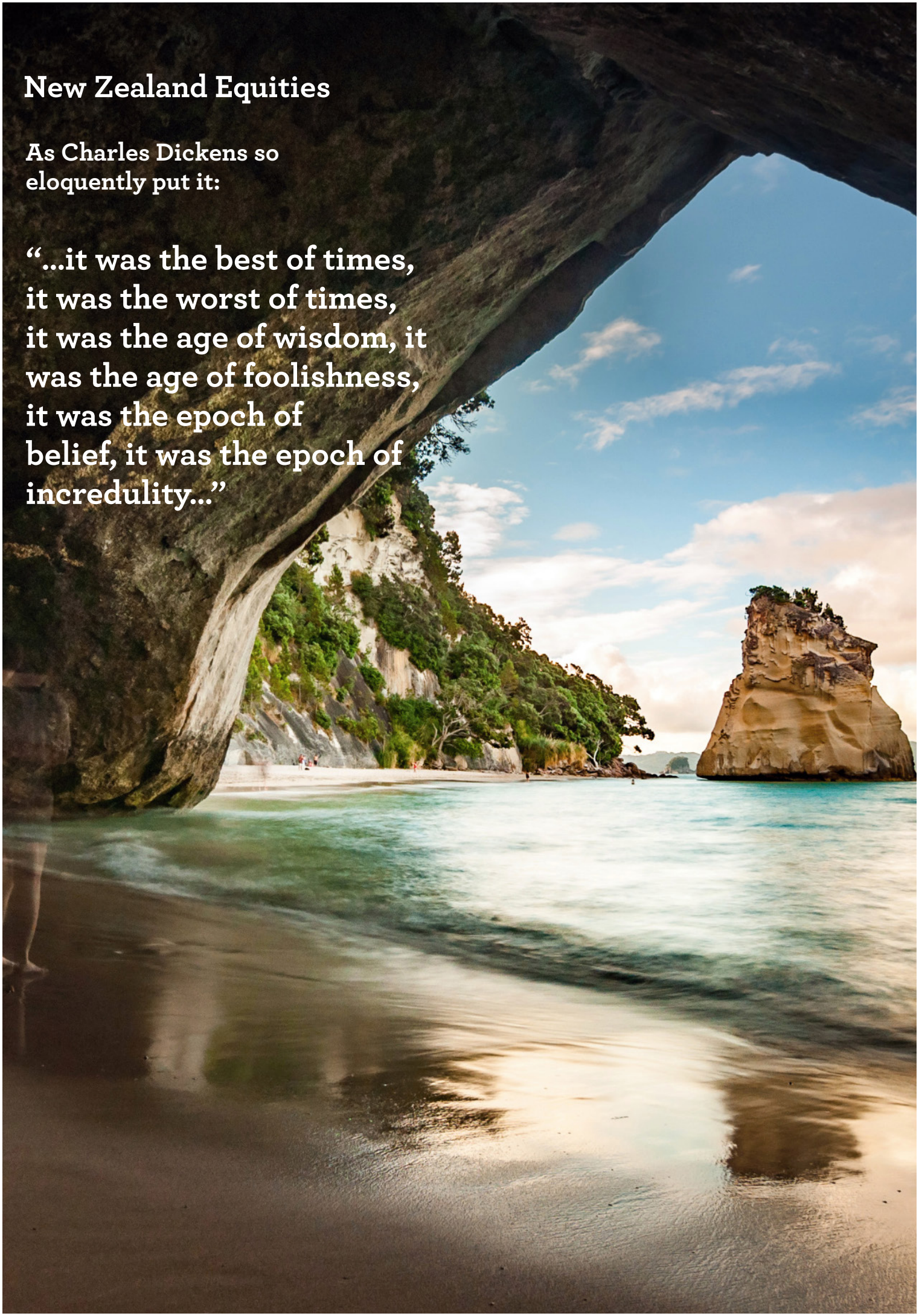
What does the weaker global backdrop, a pause from the Fed, potential rate cuts in New Zealand and Australia, and "lower for longer" bond yields mean for domestic fixed income portfolios?

We continue to favour:

> A slightly long duration position. Despite New Zealand yields trading at record lows, OCR cuts now appear more likely than not in 2019. A "lower for longer" yield environment also favours investors' extending the maturity of their exposures, thereby benefiting from additional yield and roll down the curve. However, we are wary that the global backdrop may improve in the second half of 2019, and with valuations currently stretched, we will be closely monitoring markets for any sign of a turn in long-end yields.

> A higher exposure to selected high-grade bonds to boost portfolio yield, in a low-yield environment where swap spreads have widened and credit spreads have repriced slightly wider.

> We also maintain our exposure to inflation linked bonds as they remain cheap in an environment of shrinking excess capacity and where the RBNZ appears to favour easier monetary policy to boost economic activity and support a lift in inflation. Potential for a reduction in supply in the year ahead would also support returns.



New Zealand Equities

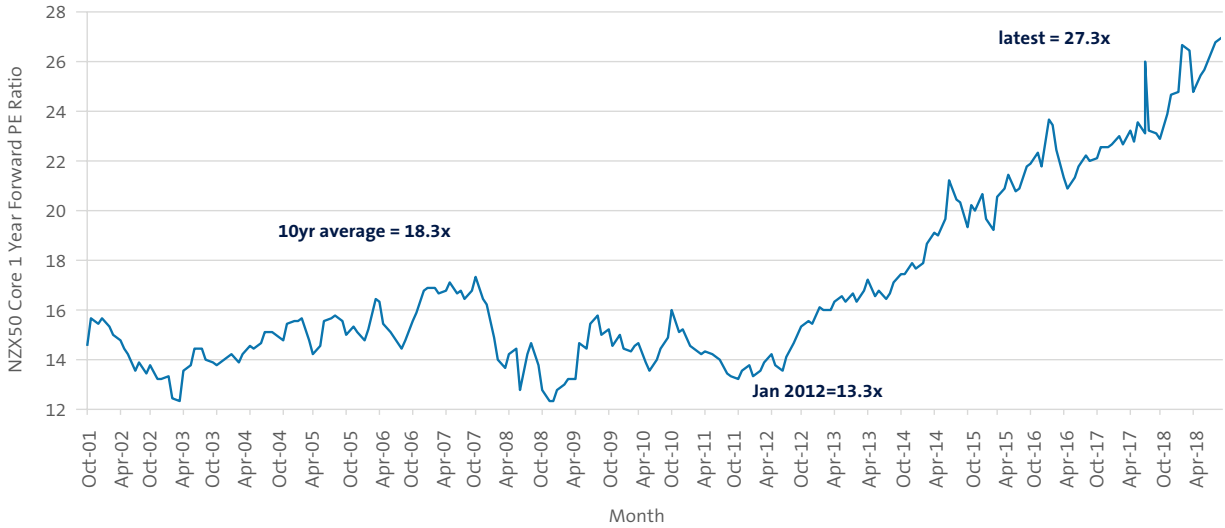
As Charles Dickens so eloquently put it:

"...it was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity..."

We will go with the incredulity. After experiencing a sharp retracement back in October (-6.4%), the S&P/NZX 50 Gross Index has fully recovered and sailed serenely onwards to set ever-higher levels. This culminated with a 3.8% advance in February, despite a rather ordinary earnings season. This means we have a case of déjà vu all over again when it comes to the valuation of the New Zealand equity market.

As shown below, the forecast one year forward price to earnings (PE) ratio shook off its tiny stumble in late 2018 and has reached new heights of 27.3x in mid-March as this piece is being written.

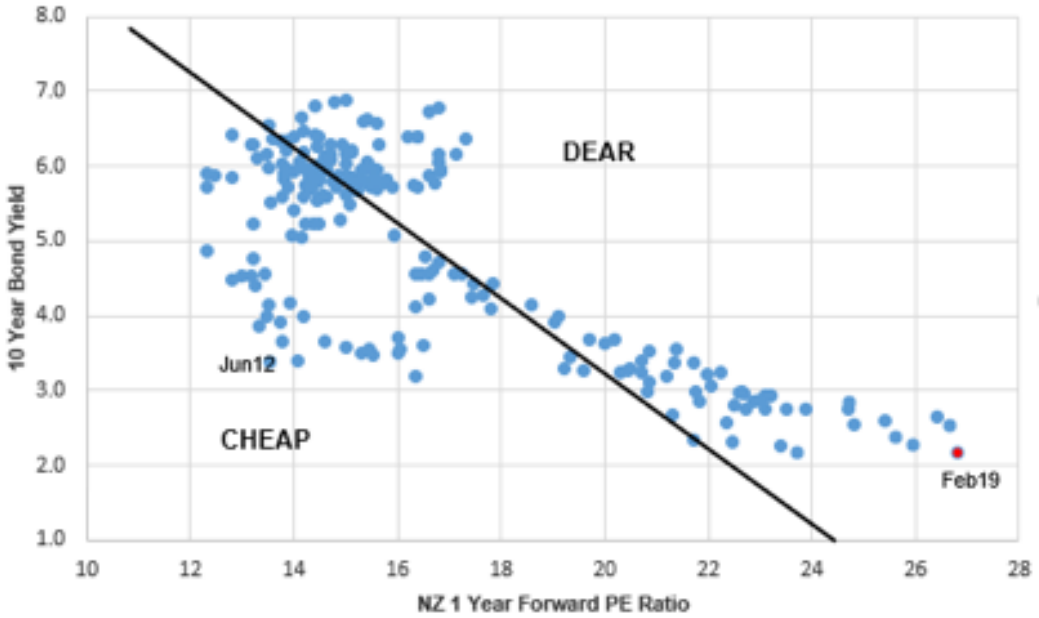
S&P/NZX 50 - PE valuation



Source: FNZC

The sharp expansion can be partially explained by falling bond yields, with 10 year yields falling from 2.59% at end-November to just 2.17% at end-February. This strikes us as a remarkably low level given that New Zealand core inflation sits at 1.9%, and indicates how investors have been forced up the risk curve in the quest for ever scarcer yield. However, even at these remarkably low bond yields, the analysis of the Manager suggests that New Zealand equities remain firmly overvalued.

NZ - forward PE vs bond yield



Source: FNZC

Each dot in this scatter-plot represents a month and shows the one-year forward PE ratio versus the 10 year bond yield. As one would expect, a lower bond yield is strongly related to a higher PE. However, at the end of February the market was 21% above the fair value suggested by this very strong relationship. This is shown by the distance from the fair value line.

Making matters worse, it is not as if the economy and earnings are booming. Year-ahead earnings forecasts for the market are still 6% below their highs reached back in April 2018. Normally this earnings forecast grows steadily over time due to inflation and as companies reinvest for growth, but earnings downgrades have more than offset this. Recent business confidence readings do not point to a revival – investors are not paying up for stronger earnings, they are simply overpaying.

That said, the market is rarely valued 'fairly'. We had a paradigm of over-valuation pre-GFC which lasted for some time but ended rather painfully. Similarly, the market was far too cheap back in 2011 and 2012 and this ended quickly thanks to quantitative easing. Today's period of over-valuation has been the case for a couple of years now and it too will end quickly when it does end. The crystal ball does not extend to when or why, but the key will be recognising the trigger when it arrives.

A fascinating aspect of the Australian and New Zealand markets during the December quarter meltdown and the sharp snapback since then has been the divergence between which types of stocks have performed and which haven't. JP Morgan strategists term this a "P'Explosion". They divided the Australian market into quintiles based on valuation. Staggeringly, the 20% of most expensive stocks have seen their PE multiples expand by 18.7 PE points over the last year, while the three cheapest quintiles have been largely moribund. In other words, the most expensive companies have become nosebleed expensive and everyone else has been left behind. This brings back memories of 1999.

New Zealand has experienced the same phenomenon, with the one-year forward PE being 27.3x versus the median of 15.6x. This tells us that there are plenty of attractive valuations still on offer, it's just that they tend to be in smaller and mid cap companies. Possible reasons are the role of passive funds and the black-box quant funds that are becoming ever more important relative to traditional active funds, ultra-low interest rates favouring mega-multiple growth companies and ultra-expensive defensives, and slowing economies raising earnings risks for many other companies that do not neatly fit into those baskets.

The outcomes of the result season dominated the relative performance of New Zealand equities over the quarter to end-February. It was a mixed bag, with positive and negative earnings surprises evenly balanced, although this had to be read in the context of earnings that had already been downgraded consistently for months.

The stand-out positive result came from a2 Milk, whose excellent execution continued, with strong volumes and margins also surprising to the upside. As a group, the gentailers delivered strong results, driven by higher wholesale electricity prices due to gas supply disruptions and a relatively dry summer. After several years of negative operational surprises, Contact Energy stood out with both cost efficiencies and strong hydro and thermal generation availability.

Negative surprises tended to come from companies with cyclical exposures. Auckland Airport's passenger growth outlook softened (not that it affected the share price), Air New Zealand warned just prior to reporting season on lower forward bookings, and Fletcher Building began to see the impact of a slowdown in Australia and stronger competition in some New Zealand segments. In addition, Ports of Tauranga saw weaker underlying container volumes, with this being a trend across all New Zealand ports, and the retirement village companies noted both construction cost pressures and a slight slowdown in sales activity.

To conclude, the New Zealand market recovered from the sharp sell-off in October and rose inexorably to reach new highs. Earnings forecasts have actually been sliding consistently since April 2018, but sharply lower bond yields have supported considerable multiple expansion. This expansion has been concentrated in the largest companies, which are trading at hitherto unseen levels, while their smaller to mid cap peers are trading at more normal levels of valuation in the historical context. This disparity, combined with cheap funding costs, has seen a lift in takeover activity and we expect this will continue in 2019. Given current valuation levels, far lower returns should be expected in New Zealand equities than have been experienced in recent years.

A fascinating aspect of the Australian and New Zealand markets during the December quarter meltdown and the sharp snapback since then has been the divergence between which types of stocks have performed and which haven't. JP Morgan strategists term this a "P'Explosion".

CONTACT DETAILS

If you would like to know more about how AMP Capital can help you, please visit **www.ampcapital.com**

CONTRIBUTORS

Bevan Graham
NZ Managing Director & Chief Economist

Carrick Lucas
Fixed Income Analyst

Matt Goodson
Director, Salt Funds Management

INSIGHTS
IDEAS
RESULTS