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AMP CAPITAL

NEW ZEALAND INSIGHTS

September 2018

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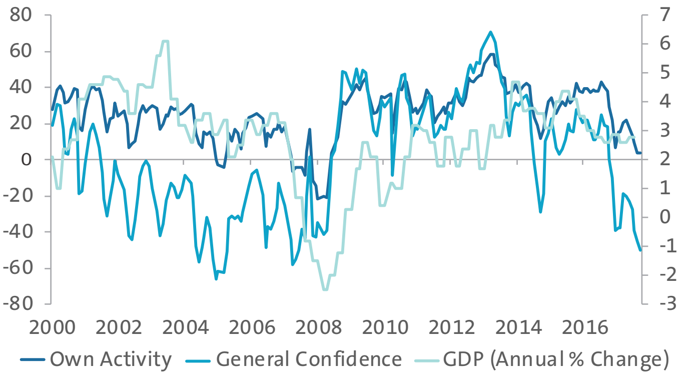
New Zealand Insights September 2018

The hardest part of the cycle

The New Zealand economy is in the more challenging phase of the economic cycle. The easier growth that comes as spare capacity is gradually absorbed has turned to the hard grind of capacity constrained growth.

Business confidence has continued to slide into darkly depressive territory, though firms' own activity outlook remains marginally positive. The blame for the lack of confidence is mostly sheeted home to the Labour-led Government. We think it is more complex than that, and at least in part reflects the fact that growth is just harder work now. This would have been the case no matter who was in Government.

Graph 1 – New Zealand business confidence



Source: ANZ Bank, Statistics NZ

Right now, there is a myriad of factors dampening the collective business psyche, including the tight labour market and resulting skills shortages, rising wages, concerns about future industrial relations settings, problems in the construction industry, mycoplasma bovis, credit availability, trade wars and renewed concerns about the outlook for China.

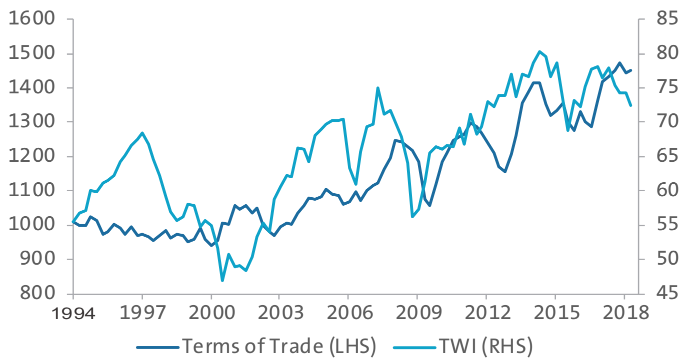
Of course, one of the key risks of weaker business confidence is the negative mood becomes more pervasive. Indeed, consumer confidence has recently nudged lower again in the September quarter to a six-year low, though still marginally positive as with businesses' own activity expectations. We think this is more a function of the impact of the more subdued housing market than anything else.

Key supports for growth

At the same time, there are key supports for growth. This includes continued strong population growth. Net migration remains high, though off its peak, slowing from a peak inflow of 72,400 in mid-2017 to 63,200 more recently. This is mostly due to rising departures (previous student arrivals who have completed their studies and are heading home), but also a slight moderation in arrivals.

The terms of trade is at near record highs, providing key support for nominal income growth. We expect the terms of trade will soften over the next few quarters reflecting softer export prices and higher oil prices, but the index is likely to remain high relative to history.

Graph 2 – New Zealand Terms of Trade and the TWI
Index



Source: Statistics New Zealand, RBNZ

While the labour market has tightened, we expect continued solid growth in labour income. The mix of that growth will change, however. Following a long period of strong employment growth and subdued wages, we now expect to see more subdued employment growth but higher wage growth.

Fiscal policy is stimulatory. The Government's Families Package was introduced on July 1st this year. This has provided extra income into households that are more likely to spend rather than save the extra income. The KiwiBuild programme will also support construction activity through 2019.

Other factors remain supportive, including stimulatory monetary conditions, even taking into account the neutral rate is now significantly lower than previously, the exchange rate has weakened significantly over the past six months and global growth is at its cyclical peak.

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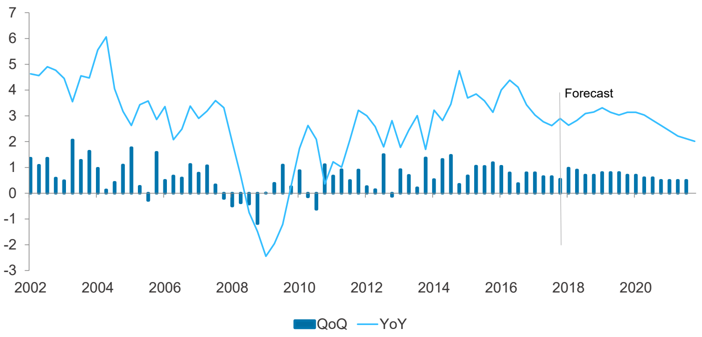
Growth isn't collapsing in a hole

Balancing those factors gives us annual GDP growth forecasts that remain largely unchanged from our last report, with 2.7% expected for calendar 2018 followed by 3.0% in 2019, and a shift lower to 2.0-2.5% in 2020.

Graph 3 – New Zealand GDP
% change



Source: Statistics NZ and AMP Capital

The reality is that growth has slowed. GDP growth peaked at an annual average rate of 3.9% in the year to September 2016 and has since slowed to under 3%. Let's keep that in perspective – that is at about the level at which we expect the US economy to peak this cycle. Furthermore, key fundamental supports means growth is not collapsing in a hole.

Support for that story came with the release of June quarter GDP recently showing 1.0% growth in the three-month period and 2.8% for the calendar year. Sure this included some catch-up from one-off negative factors in the March quarter, but this result included some one-off temporary weaknesses of its own, not the least of which was the temporary closure of the Marsden Point oil refinery, a contraction in activity that will bounce back boosting growth in the September quarter.

Further credence was given to the strong result by the fact that growth was broad-based, with 15 of 16 industry groups posting increases over the quarter. The only sector to contract was mining, the sector impacted by the refinery shutdown.

So a strong result, seemingly in defiance of weakness in business confidence. It was also a result that was significantly higher than the Reserve Bank of New Zealand (RBNZ) was expecting. They had 0.5% pencilled in for the quarter.

We expect growth will hold up in the near-term. On top of the bounce-back from the refinery shutdown, the September quarter will also be the first result since the introduction of the Government's Families Package on July 1st. We expect a number that will come in close to 1.0% for that quarter, broadly in line with the RBNZ's pick of 0.8%.

Can't dismiss weak business confidence

But we do not dismiss the weakness in business confidence as entirely a figment of the imagination. Looking at the June quarter GDP expenditure accounts, a noticeable weakness was evident in the business investment. That said, this series can be fairly volatile as business investment can be quite lumpy, but it is certainly an area to keep watching closely.

As we have argued repeatedly in the past, business investment is critical to the longevity of the cycle. With the labour market now tight and firms reporting skilled and unskilled labour shortages, business cycle theory tells us that firms will now switch to capital to resource growth in demand for their goods and services.

This is the part of the cycle we have not been good at in the past, and explains our woeful productivity record. That's mainly because by the time we have got to this stage in the cycle in the past, inflation has already been on the rise, and interest rates have been rising on a trajectory that makes business investment prohibitive.

Graph 4 – New Zealand productivity
Annual % change

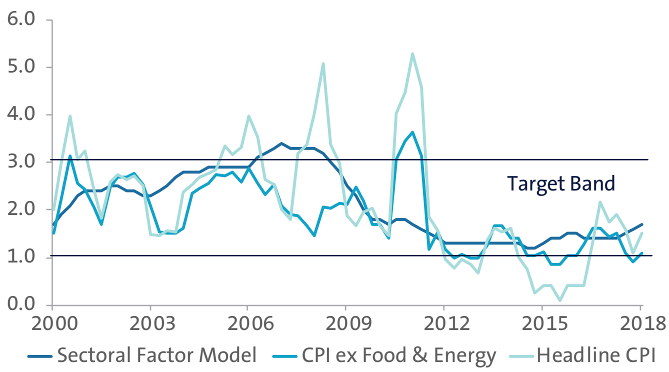
Source: Statistics NZ

The good news this time around is that interest rates are low, and look set to remain low for the foreseeable future. Conditions are right for higher investment and cyclical recovery in productivity. But this needs businesses to have the confidence to invest. Much now depends on why firms are grumpy and what they intend to do about it. Watch this space.

Inflation moving higher

If the economy is capacity constrained, we would also expect inflation to start to emerge. Indeed, inflation ticked higher in the year to June across a range of measures, including the headline rate and key indicators of core or underlying inflation.

Graph 5 – New Zealand inflation
Annual % change



Source: Statistics NZ and RBNZ

The higher headline rate is largely a function of higher petrol prices. We expect headline inflation to continue to move up as higher petrol prices continue to impact, along with higher fuel excise. The recent weakness in the New Zealand dollar will also boost inflation over the next few months.

But it's trends in core inflation that will determine the outlook for monetary policy. Here too, inflation nudged higher in June, with the RBNZ's sectoral factor model posting an annual increase of 1.7%, its highest rate since 2011.

In a capacity constrained environment, inflation can rise at the same time that growth slows. What matters to the RBNZ is not the absolute level of growth in the economy but rather the pace of growth relative to the economy's potential to grow without generating inflation. As spare capacity is absorbed, it is not inconsistent with lower growth and higher inflation at the same time.

The concern for the RBNZ is if growth slows and generates fresh spare capacity, putting renewed downward pressure on inflation.

Monetary policy outlook is uncertain

But the growth slowdown combined with the risks brought by the gloomy mood makes the monetary policy outlook uncertain. The RBNZ has recently articulated a 'balanced' view with respect to the outlook for interest rates.

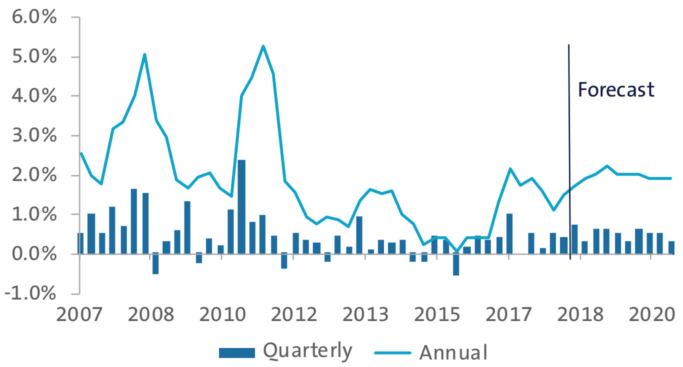
They continue to project no change in interest rates for the foreseeable future, with the Statement indicating there is an equal chance of the next move being a cut as there is of it being an increase.

In fact, in alternative scenario modelling in the August Monetary Policy Statement the RBNZ signalled they would act more aggressively with 100 basis points (1.0%) of cuts to the Official Cash Rate if growth surprised to the downside than they would if inflation surprised to the upside. That second scenario would generate 50 basis points (0.5%) of interest rate hikes.

The June quarter growth result was one nail in the coffin for near-term interest rate cuts. Our September quarter growth forecast should make it two nails. But it's not until we see data for the December quarter that we will get a real sense of underlying growth in the economy, and the true impact of weaker business confidence on the business investment and the labour market.

Graph 6 – New Zealand inflation forecasts

% change



Source: Statistics New Zealand and AMP

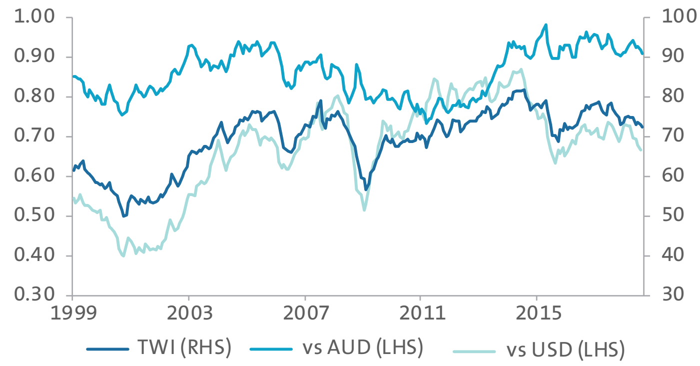
For now, we maintain the view that the Official Cash Rate is on hold until the second half of 2019, when we expect to see a series of hikes taking the OCR back to its new neutral rate of around 3.0-3.5%. But it remains the case that if the RBNZ does anything in the next six months it's more likely to be a cut than a hike.

New Zealand dollar may see further weakness

The New Zealand dollar (NZD) has been on a weakening trajectory this year, particularly as the US Federal Reserve has continued to hike interest rates, while here at home the market has started to price in the possibility of interest rate cuts.

The NZD has fallen from a strong 73 cents against the US dollar in April to a recent low of a touch over 65 cents in early September. We have been more stable against the Australian dollar as similar factors have impacted both antipodean currencies. On the trade weighted basis, the currency has slid 5% over the same period.

Graph 7 – The New Zealand dollar



Source: RBNZ

At current levels the New Zealand dollar is undervalued relative to our estimates of fair value. That said, further weakness would not surprise, especially as global monetary shifts to less stimulatory while conditions at home remain on hold.

But there are positives too that should prevent any significant weakening from here, especially relatively contained external imbalances and the still relatively high terms of trade.

> In a capacity constrained environment, inflation can rise at the same time that growth slows

New Zealand Fixed Income

September 2018 can be characterised as the quarter that New Zealand fixed income markets reset.

The reset saw the following key changes:

> New Zealand interest rates really decoupled from global and in particular US interest rates.

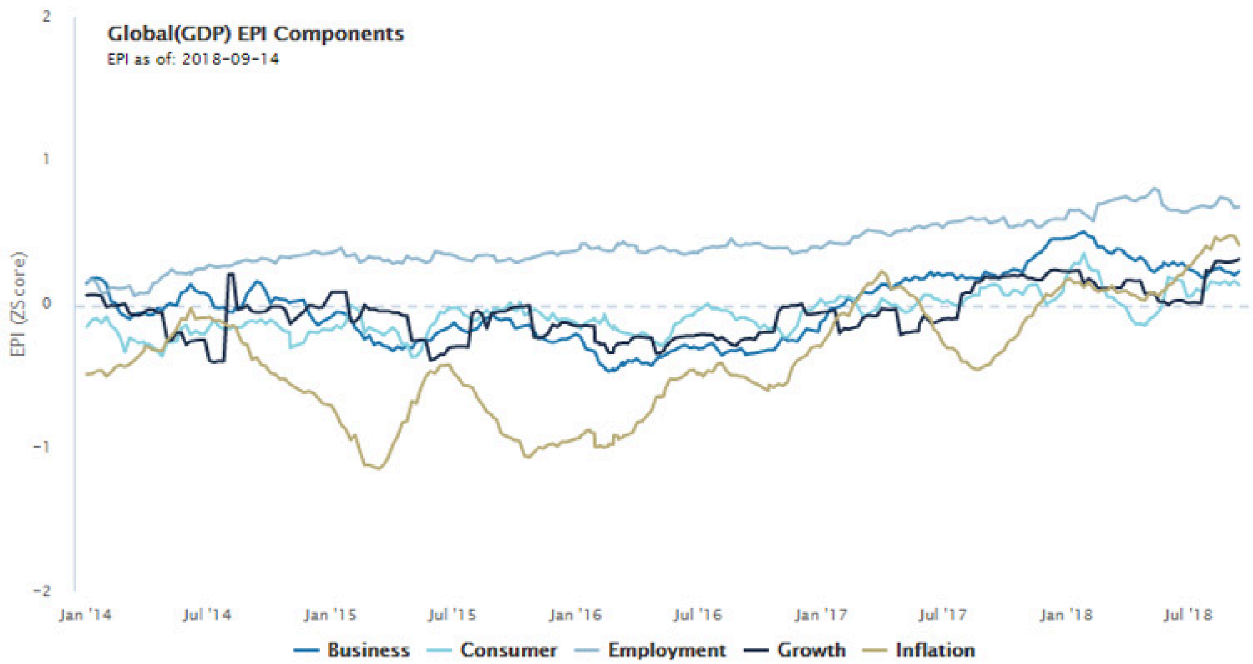
> New Zealand forward looking economic indicators (business confidence and Manufacturing PMI) continued to signal slower growth ahead, while at the same time global economic indicators look more positive.

> The Reserve Bank of New Zealand (RBNZ) and Governor Orr became more dovish – concerned about the risk of slowing growth at the same time that core inflation and inflation expectations are well contained.

Looking at the world economy, the economic data continues to be robust, albeit with some slight softening in recent weeks (refer Figure 1). This positive picture comes despite the threat of an escalation in trade tensions between the US and China and the stresses seen in emerging markets.

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

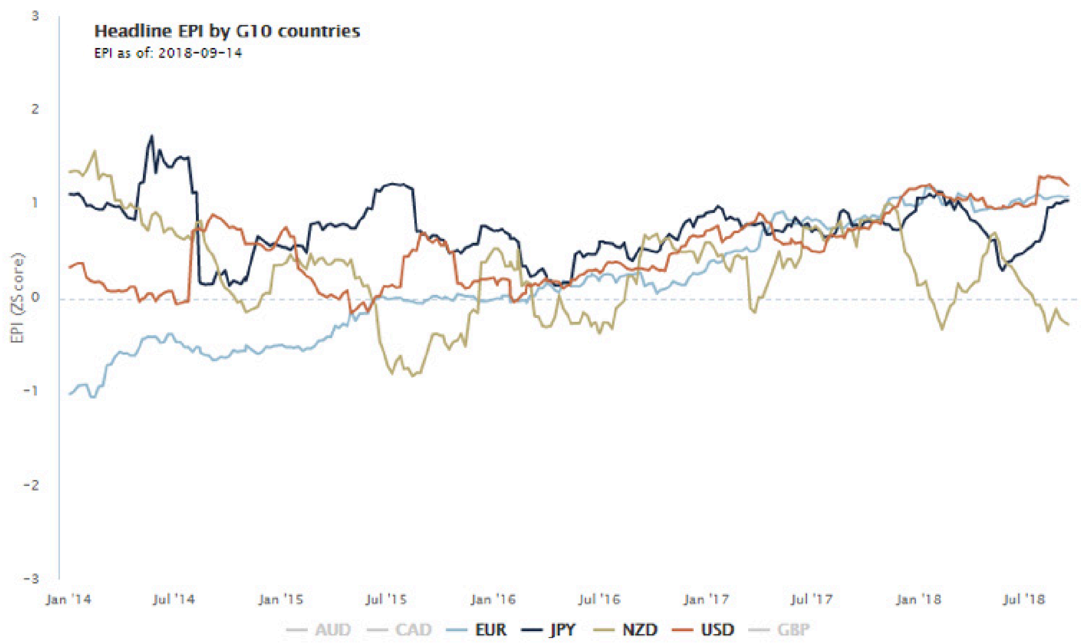


Source: AMP Capital

When looking across key global economies, it is the big developed nations/blocs (US and Europe) that are driving growth. Even Japan has rebounded with some renewed strength (refer Figure 2). The exception to this good news is the sagging fortunes in New Zealand economic data. After a brief rebound at the end of Q1 and early Q2, the economic data in New Zealand has resumed its slide.

Figure 2: Economic Pressure Index (EPI) for selected countries at headline level

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

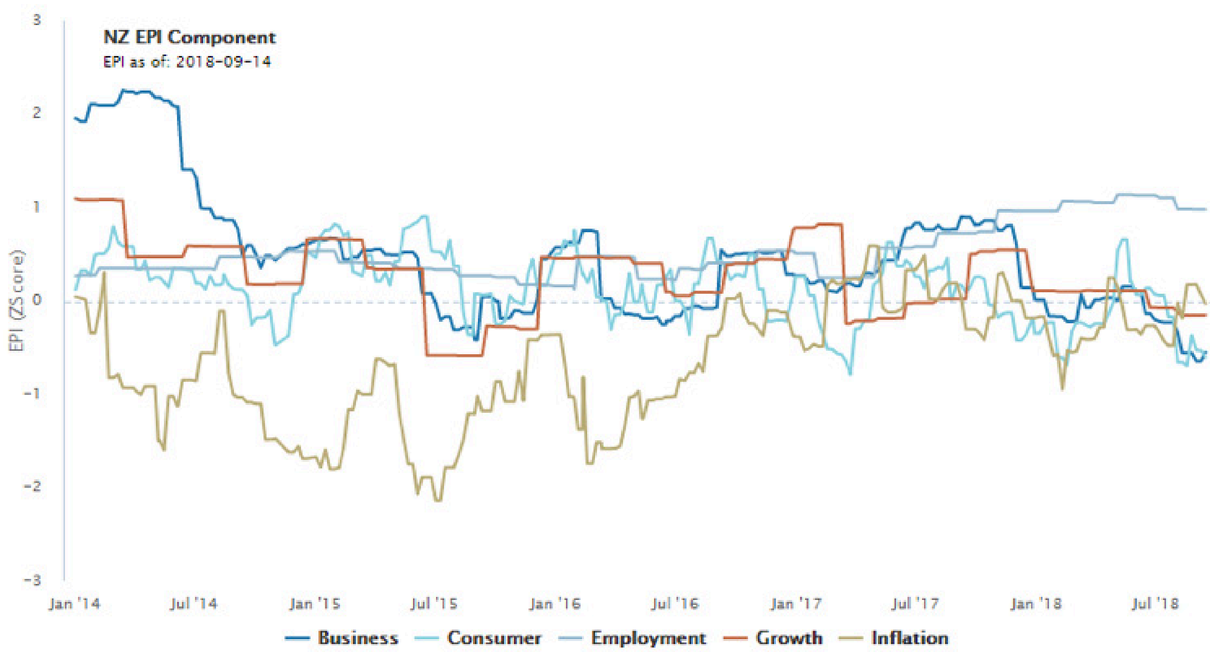


Source: AMP Capital

Looking at the sectors within the New Zealand economy, it is the business and consumer that are the focus of weakness (refer Figure 3). While weakness in business and consumer measures do not necessarily translate into slowing growth and employment, there is certainly increased risks that the slowing growth scenario will eventuate.

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

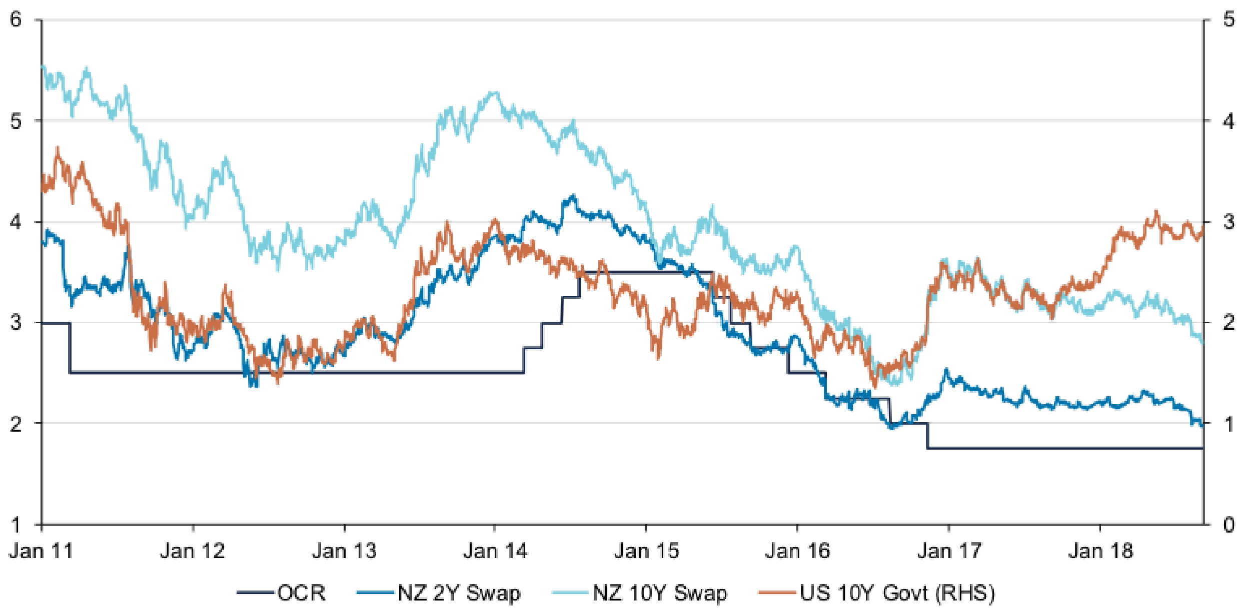


Source: AMP Capital

The falls in business confidence has certainly captured the attention of the RBNZ. At the most recent Monetary Policy Statement, released in August, the RBNZ pushed out the timing of any tightening in monetary policy to the end of 2020 (previously the end of 2019). The RBNZ also outlined a scenario where they could reduce the Official Cash Rate below the current 1.75% should growth slow below current expectations in the period ahead. New Governor Adrian Orr appears to want to adjust monetary policy well ahead of any potential deterioration in the economy. The risk of rate cuts cannot be underestimated as the RBNZ seems comfortable for inflation at or above the mid-point of their 1-3% target band should the economy warrant further monetary stimulus to boost economic activity.

The net impact of the change in tone from the RBNZ and the weaker New Zealand data flow has seen New Zealand rates decouple completely from US rates (see Figure 4 below).

Figure 4: New Zealand swap and OCR and US 10 year government yields (RHS); %



Source: AMP Capital, Bloomberg

We now think that the OCR will be on hold for an extended period, potentially beyond the RBNZ's 2020 timeframe. The risk of a global slowdown in late 2019 or early 2020 cannot be discounted as the drivers for expansion abate. In particular, global economies become more capacity constrained, and central banks remove monetary stimulus in a world with elevated debt levels. The US Federal Reserve in particular must plot a delicate path of controlling building inflation pressures without over tightening monetary policy and triggering a slowdown or even worse a recession in the US economy. Any global slowdown will reduce the requirement for the RBNZ to start hiking the policy rates in 2-3 years' time.

What does that reset mean for our fixed income portfolios?

We now favour:

> more overall interest rate sensitivity in portfolios as the prospect for higher overall New Zealand yields becomes more distant. We now sit close to benchmark duration;

> more short and mid maturity interest rate exposure as the RBNZ will be on hold for an extended period;

> less longer maturity exposure as long-term interest rates will not be immune to higher global and in particular US yields. However, the scope for much curve steepening will be limited, with the RBNZ on hold and investors looking to get additional yield by extending the maturity of their exposures;

> more exposure to interest rate swaps and very high grade bonds to boost the portfolio yield in an environment that credit spreads remain tight but swap spreads remain wide.

We also maintain our exposure to inflation linked bonds as they remain cheap, in an environment of shrinking excess capacity in New Zealand and where the RBNZ appears to favour easier monetary policy to boost economic activity and support a rise in New Zealand inflation.

New Zealand Equities

The historic New Zealand bull market has continued apace, with returns from the S&P/NZX50 Gross Index in the quarter to end-August coming in at a powerful 7.6%. This came in the face of offshore equity headwinds, slowing New Zealand business confidence and a mediocre result season which saw earnings downgrades exceed upgrades. The only positive driver has been a moderate decline in bond yields, but the equity market multiple expansion has been far greater than warranted by this factor.

Chart 1: S&P/NZX 50 Index - PE Valuation

Source: FNZC

This chart looks at the one year forward price earnings (PE) ratio for the New Zealand market and rolls it forward every month. Remarkably, the PE has doubled to 26.6x from the low point of 13.3x in January 2012 when the great bull market began. An investor is now paying $26.60 for every $1 of earnings. This is truly uncharted territory as the vertical scale has been extended with alarming regularity.

Record PE multiples could perhaps be justified if earnings were booming, but this is not the case. Earnings forecasts had risen steadily for the last five years but they appear to have peaked out in April, which is in line with a sharp slowdown at that time in surveyed business confidence and firms' expectations about their own future profitability.

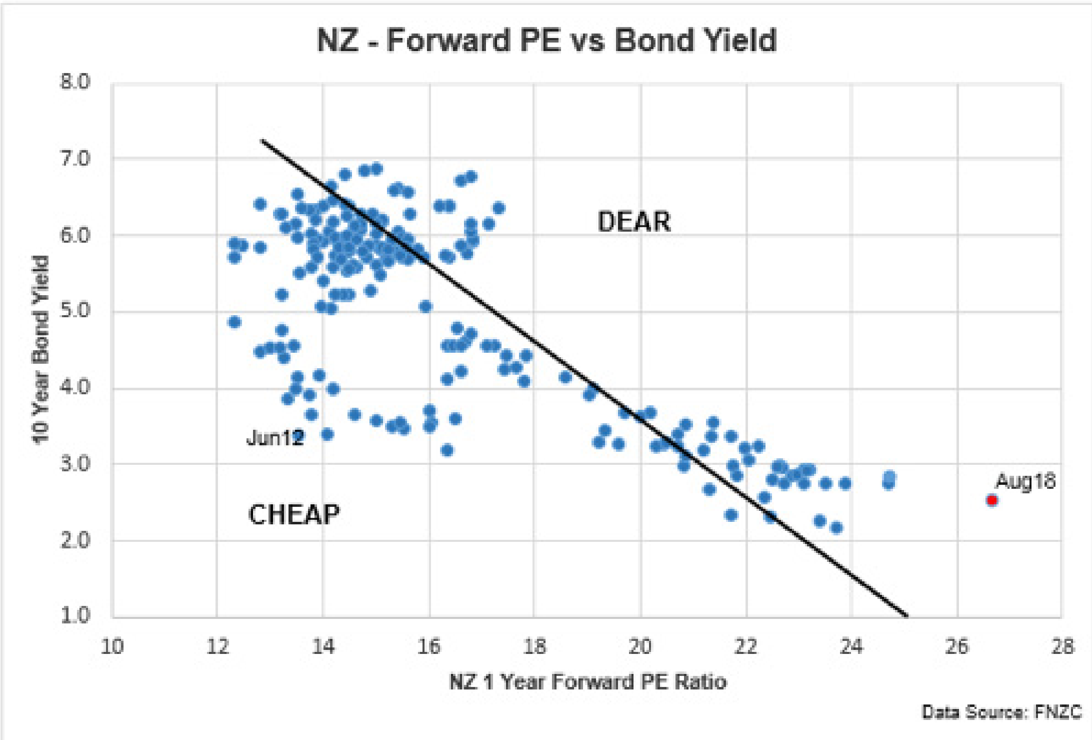
Australia has been similar. A fascinating piece by JP Morgan strategists in Australia delved into what they saw as a "P/E'xplosion, being all price and no earnings". Pulling the S&P/ASX 300 apart into five PE quintiles, they showed how the top quintile of most expensive stocks rose by an average 9.6% in August despite its EPS forecast falling by an average -3.9%. This combination drove a PE multiple expansion of a massive 4.2 points. At the same time, the bottom two PE quintiles (ie the 40% of cheapest stocks) saw virtually no multiple expansion. The rich became richer.

This analysis provides a possible explanation (albeit not a reason) for what is happening in New Zealand. It may be that global passive and quant inflows are swamping our small market. During August, the top 10 stocks in New Zealand rose by 6.8%, but the S&P/NZX50 Gross Index excluding these stocks advanced by a far lesser 1.2%. This performance by the largest stocks has driven a clear valuation divergence between them and everything else, with FNZC data showing a staggering 9 PE point difference between the average market PE forecast for June 2019 (25.1x) and the median PE (16.0x).

We have been cautious for some time that an overheating US economy would place pressure on their bond yields and this would ripple around the world. This view has proven only half-right. US bond yields are indeed rising but the transmission mechanism has been a sharp depreciation in the New Zealand dollar (NZD) rather than higher New Zealand bond yields. Indeed, New Zealand 10 year yields rallied from 2.75% to 2.54% over the quarter to August as the new Reserve Bank of New Zealand (RBNZ) Governor appears to have taken a slightly more dovish tilt.

The chart below shows that while falling bond yields are helpful for New Zealand equities, they have run far beyond what can be justified and are setting new records in the gap to fair value.

Chart 2: NZ - Forward PE vs Bond Yield



Source: FNZC

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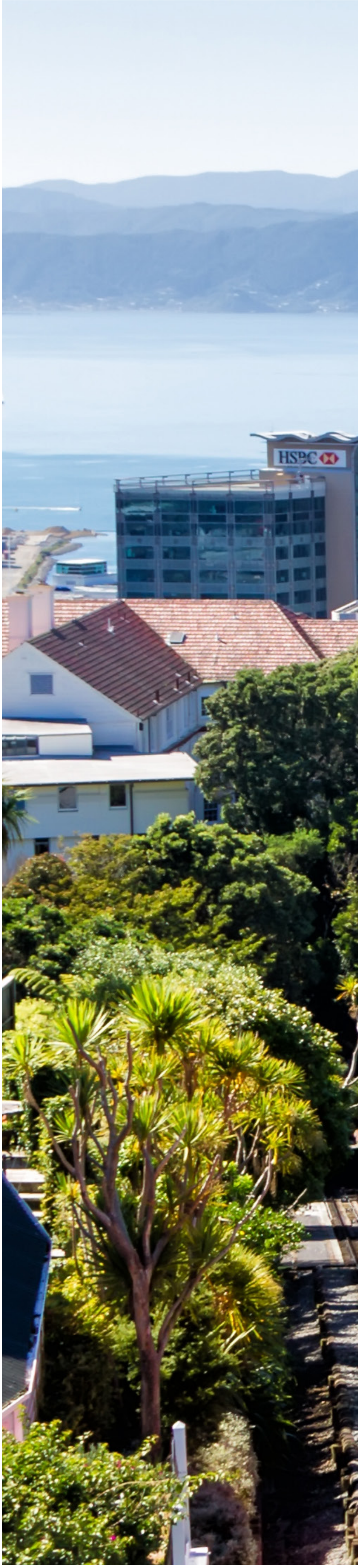
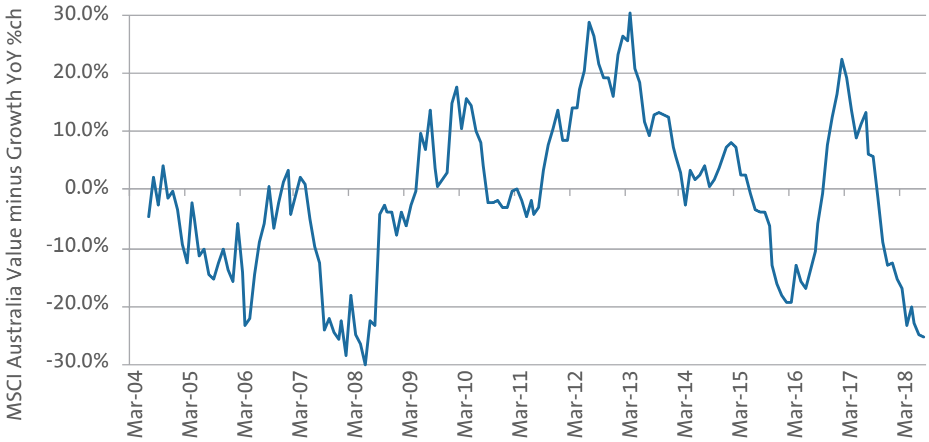


Accompanying the extraordinary performance of expensive large cap companies, we have seen 'growth' sharply outperform 'value' as a style. It is hard to do this style analysis in a small market like New Zealand which is dominated by single company developments, but the chart below looks at the annual performance of 'growth' versus 'value' in Australia.

Chart 3: MSCI Australia - Annual Value minus Growth Performance



Source: MSCI

This shows that 'value' has lagged 'growth' by around 25% over the last year. However, historically extreme levels of outperformance such as this have tended to be followed by sharp snapbacks.

While the New Zealand market has continued on its merry way, we are something of an outlier versus most global peers. Merrill Lynch research calculates that global equities ex US technology stocks fell by 6.2% in the calendar year to end-August. Fed tightening amid gradually emerging US inflationary pressures have seen higher interest rates drive US dollar (USD) appreciation and exact a heavy toll on many emerging markets. Year-to-date lowlights include Turkey -20% (-50% in USD), China's Shanghai Composite -18% and Hong Kong -7%.

New Zealand and Australia appear to have acted as safe havens, although our currencies have been far from immune. The weakening of the NZD into the mid $0.60 region has been a key theme for the Manager, with holdings in companies such as A2 Milk, Sanford, Scales and NZ Refining being obvious plays. Fisher & Paykel Healthcare is also a key large cap beneficiary and this positive tailwind has seen our positioning be more circumspect than otherwise given its extraordinary valuation.

While the New Zealand market rose by 4.4% in the month of August, the actual reporting season was something of a mixed bag. Revenues were largely in line but cost pressures from petrol prices, wages and the weaker NZD saw modest overall operating profit misses, with bottom line profits benefiting slightly from lower interest costs. UBS analysis points to year-ahead earnings downgrades in the order of 2%. Given well documented weakness in business confidence surveys, our expectation is for further downgrades over the next few months, with only NZD sensitive companies being immune. For example, a net -17% of firms in the monthly ANZ Bank Business Confidence survey expect their profits to fall over the next year versus outcomes of generally between 20% to 30% from 2013-2017.

The decoupling of the remarkable New Zealand market performance from its far more sombre earnings drivers and from fundamental valuation benchmarks makes calling its path from here very challenging. Recent quarters have seen momentum trump every other driver, but the further this extends the more cautious we become. It appears that sizeable passive and quantitative funds flows are swamping everything else for now. Just one example came on 11 September. Global markets were largely flat and there was little news in New Zealand but a large inflow into the US-listed iShares NZ fund drove a clamour for New Zealand stocks and an advance of 2.0% seemingly out of nowhere. One day, when this money wants to depart for the next country that is flavour of the month, we suspect it will have join a very long queue that is desperately trying to leave through a very small exit door.

To conclude, the New Zealand market has continued to perform far beyond our expectations. Valuations are extremely extended, earnings drivers are weakening and global monetary settings are changing from quantitative easing to quantitative tightening. The Manager has positioned cautiously given these factors. While remaining fully invested, we are focusing on those areas of remaining opportunity such as mid-cap companies that have been left out of the passive money avalanche and in those companies that will benefit from a weaker NZD as our economy slows and the RBNZ's monetary settings remain dovish relative to a hawkish US Fed.

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INSIGHTS
IDEAS
RESULTS