Investment Update – July 2021

NZ Economic Conditions

The New Zealand economy has navigated the disruption of the Covid 19 outbreak successfully to date. Policy and market responses to Covid induced disruption have created a set of circumstances that could not have been envisaged in the immediate aftermath of the initial outbreak.

Household disposable income grew by 2.8% in the year to March 2021 with most of the growth occurring in the March 2021 quarter. Gross employment earnings on an accrual basis for May 2021 were $12.5 billion versus $11.4 billion in May 2020. Interest payments as a percentage of household income fell to 5.9% in the year to March 21 as opposed to 6.9% in the year to March 2020.

Unemployment has fallen to 4.7 percent; the participation rate remains high at 70.4% and firms' hiring intentions are strong. Demand for labour is exceeding supply in certain market segments. The introduction of additional skilled workers to the economy via immigration on a permanent and temporary basis remains highly constrained. Wage pressures are embryonic, but some wage and salary inflation appears inevitable if the current employment conditions persist.

The government accounts also reflect the positive movements in employment statistics. April 2021 PAYE deductions were up 12% on April 2020 and 31% better than April 2019 accepting that April 2020 was at the peak of Covid induced uncertainty.

Business activity is also buoyant. The ANZ Business Own Activity indicator was at 29.1 in June, the highest since the 2017 election. This outcome is consistent with GDP growth of 3%. As a corollary to the supply constraints and buoyant conditions, business intentions to increase prices have risen to 85.6%, a record high. Farmers are also experiencing a favourable price outlook. Fonterra's indicative milk price outlook ranges between $7.25 and $8.25/kgMS. Meat and fibre prices have lifted, and log prices have increased 25% year on year.

Despite the government's measures to restrain prices house values have continued to be elevated. For the year ending May, national median house prices are up 32%. Massey University's affordability report indicates house prices increased 5.1% in the February to May quarter and the national house to income ratio has risen to 12.4 times. CoreLogic suggests that whilst prices are still increasing (+1.8% in June) the rate of increase is slowing. Concurrent with the continuing price strength the volume of houses available for purchased has declined.

The ultimate expression of these economic indicators is GDP growth. Statistics New Zealand reported New Zealand GDP up 1.6% for the March quarter with the economy worth $325 billion in current prices. Services, which represent about two thirds of the economy, made the largest contribution to the outcome despite the absence of an external tourist sector. Although the March quarter showed great improvement the annual result which includes 2020 lockdowns was a fall in GDP of 2.3%. The quarterly result is in stark contrast to the Reserve Bank of New Zealand (RBNZ) forecast for the period which was for a fall of 0.6%.

Impact on NZ Interest Rates

The March quarter GDP was a major surprise and challenges the assumptions on which the RBNZ has made its economic forecasts. The RBNZ had already introduced an increase in the Official Cash Rate (OCR) for mid to late 2022. The inflation implications arising from the economic data and the GDP outcome is leading to a re-evaluation of the timing and extent of future OCR increases. The fixed interest market pricing now suggests that the OCR could be increased as soon as late 2021 and the ANZ economists have shifted their base forecast to February 2022. Linked to this changed expectation of the timing of an OCR increase is the implication that the RBNZ will seek to tame any incipient inflation sooner. As a result, the inflation assumption embedded in long-term interest rates has reduced and the yield curve flattened, and longer-term interest rates fell.

The fixed income markets were able to record a positive month. The S&P/NZX NZ Government Bond index was marginally positive for the month at plus 0.09% and the S&P/NZX Investment Grade corporate bond index returned 0.28% for the month. Where the intertest rate curve ultimately settles in terms of the prevailing level of interest rates and its shape will depend on the level to which inflation rises and its persistence. If inflation remains at current levels, then fixed income investors will see erosion of real purchasing power which is unlikely to be a sustainable outcome.

NZ Share Market Performance

The S&P/NZX 50 Gross index had a much better outcome for June rising 2.7%. In terms of overall contribution to the positive index outcome the larger capitalisation companies Fisher & Paykel Healthcare and A2 Milk together with Spark contributed the most to the index. Both FPH and A2 have experienced a bounce back from previously depressed levels. The capitalisation of these companies (FPH constitutes approximately 14% of the index) dominates the weighted outcome.

Smaller companies Synlait, Arvida and Vista Group had larger positive individual share price movements at +21.3%, +11.1% and +10.1% respectively. S&P/NZX 50 Gross index companies experiencing the largest absolute falls in the month were Air New Zealand (-7.2%) and Port of Tauranga (-6.1%). Air New Zealand provided an update and although its cash burn has diminished a dilutive capital raising is still in prospect. A number of corporate transactions occurred during the month. Prominent was Mercury NZ's acquisition of Trustpower's retail operations for $441 million and Precinct Properties $250 million capital raising to acquire further property and pay down debt. Westpac also announced that it will not proceed with a demerger of its New Zealand bank from the Australian parent.

Australia Continues to Prosper

Australian economic indicators reflect those of New Zealand and are even stronger in some respects on an annual basis. Australian unemployment fell 0.4% in May to 5.1%. Mining salaries continue to grow with specialised miners commanding A$400,000 per year. Demand for labour is spreading from Western Australia to the East Coast as infrastructure projects gain momentum. House price growth in Australia has also been strong with national house price growth of 13.5% for the year to June. Australia's trade surplus for May was A$9.8 billion. In the first quarter Australia recorded a current account surplus of A$18.3 billion. These outcomes were achieved despite the trade conflict with China and constraints on international service flows. Reported Australian GDP growth for the first quarter was plus 1.8% beating expectations for a 1.5% increase. On an annual basis Australian GDP is up 1.1%. As a result, the Australian economy is now larger than prior to the Covid epidemic. The National Australia Bank business survey has business conditions at plus 37, a record high. Like New Zealand, inflation expectations are rising and have increased from 3.5% to 4.4% in June. The market is increasingly doubting the RBA can hold its stated policy position of no interest rate hikes until 2024.

The Australian share market continued to appreciate with the ASX 200 up 2.3% in the month in local terms and up 27.8% for the year. The Australian real estate index performed even better with the property sector up 4.8% in June. The best performing sector in Australia was information technology lifting 13.4%. Afterpay saw a resurgence in its share price and Altium (PCB design software) received an A$5 billion takeover offer which was rejected. Financials provided a negative return of - 0.2%. Gold miners were also poor performers as gold retraced on moderating global inflation expectations.

Global Shares Gain

The MSCI Global Shares Index advanced 1.4% in the month with information technology (plus 6.9%) again the leading sector. The pullback in global interest rates shifted investment flows back to “growth' equities which outperformed the “value” thematic in the month. Financials were down 3.4% and materials (metals, concrete, paper etc) were down 4.1%. US economic data remains strong. House prices are also increasing in North America with five US cities having the largest annual increase on record. US employment statistics continue to trend positive. The US Federal Reserve has modified its headline inflation estimate to 3.4%, a full percentage point ahead of its March projection. They also reintroduced their dot plot summary which now projects interest rates increasing in 2023, a year ahead of prior estimates.

Summary

Economic conditions continue to present investors with fresh challenges of interpretation and extrapolation. The continuing appropriateness of central bank policy is being questioned. Potential exists for inflation to be less transitory than currently assumed which could require a more severe policy response from central banks. If this scenario transpired, then economic actors may be unprepared. If inflation persists and central banks allow inflation rates to run at higher levels for longer, then businesses will be unequally impacted. Alternatively, if inflation fades and the Covid reflation trade remains dominant then the outlook for markets is sanguine. However, if a setback to the recovery trade occurs from another Covid mutation or black swan event then a flight back to fixed income is feasible. Portfolio tilting towards shares and recovery sectors continues to be preferred but with core risk capital allocations being maintained.

Key Market movements over June 2021

	1 Month	3 Months	1 Year	3 Years p.a.	5 Years p.a.
S&P/NZX 50 Index	2.7%	0.7%	10.5%	12.2%	12.9%
S&P/ASX 200 Accumulation Index (NZD)	3.3%	6.8%	28.3%	9.0%	11.7%
MSCI ACWI Index (NZD)	5.7%	7.8%	29.1%	13.9%	15.7%
S&P/NZX 90 Day bank bill Total Return	0.0%	0.1%	0.3%	1.2%	1.5%