Insightspaper

AMP CAPITAL

NEW ZEALAND INSIGHTS

June 2018

INSIGHTS
IDEAS
RESULTS

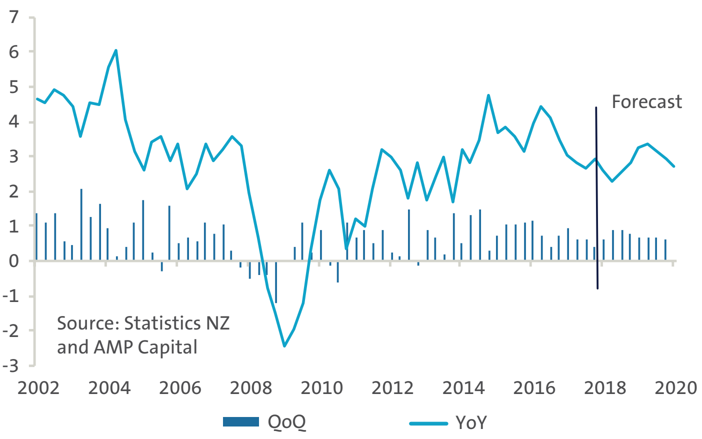
New Zealand Insights June 2018

Over the hill?

Among all the hype of synchronised global economic momentum during 2017, the New Zealand economy had already peaked and growth was moderating. The key questions for us for 2018 were how soft the first half of the year would prove to be, and how much new upward momentum would be achieved through easier fiscal settings in the second half of the year and into 2019.

With respect to the first question, growth has proven softer than expected in the early part of 2018. GDP expanded by only 0.5% in the March quarter with the annual pace of growth slowing to 2.7%, down from the heady peaks of 4.4% in the year to June 2016.

Graph 1: GDP growth



Regular readers will know we expected a soft patch in the first half of 2018. The economy is close to running at its full potential and has already maxed out capacity in the building and construction sector.

Employment growth has slowed as the labour market has closed in on full employment, and businesses are reporting increased difficulty in finding both skilled and unskilled labour. Population growth is modertaing as net migration slows, though this is proving to be only gradual.

There have been added complexities. It's only in the last few weeks that the full implications of Mycoplasma Bovis have become clearer and is taking a toll on business confidence. Confidence was already low given uncertainty about the policy direction of the new Government and the impact on activity, profitability and ease of doing business of upcoming changes to industrial relations, and faster increases in the minimum wage.

But the economy remains in fundamental good shape, even for a cycle that's getting a bit long in the tooth. The ageing rock star is thinking about a quieter period ahead by taking up a residency in Vegas. Not down and out, but maturing gracefully.

Fiscal matters

We continue to expect fiscal policy to deliver a boost to growth in the second half of the year. This was always going to be the case no matter who took the Treasury benches in the 2017 election – it was just a matter of what shape that easing took.

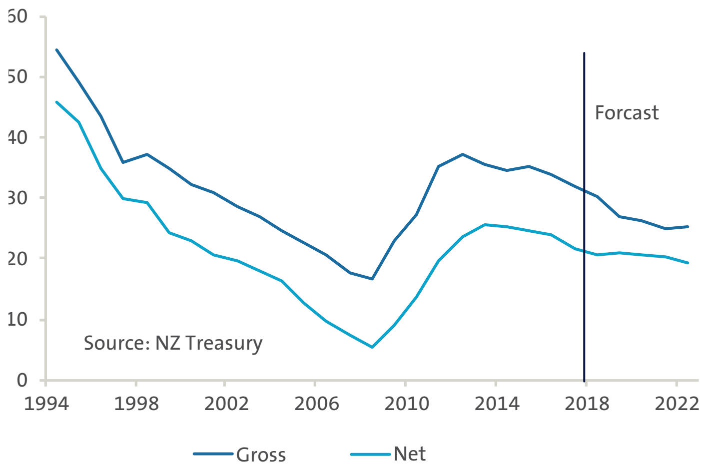
The new Labour-led Government delivered its first Budget in May, though this was not their first major fiscal event. They had already made a number of announcements in December last year, including the Families Package funded by the cancellation of the previous government's tax cuts. This comes into effect on 1 July and includes changes to the Accommodation Supplement and Working for Families tax credits.

The Government's first Budget had to pass three tests. First, it had to build on its 100-day initiatives and meet its commitment to the electorate of greater investment in the core social areas of health, housing and education. Secondly, in the interests of a happy and sustainable coalition, it had to allow its coalition partners to point to key policy victories. Finally, and by no means least, it had to prove to a still sceptical business community that it could deliver on its commitment to key Budget responsibility rules.

Finance Minister Grant Robertson has managed a good balance between the three. A strong economy helps and that is what this Government has inherited, along with a healthy set of fiscal accounts. The fact that revenue has been running ahead of forecast has allowed some extra buffer, especially as the higher revenue has been deemed sustainable.

Forecasts of rising budget surpluses and falling net debt, to below 20% of GDP in 2022, is predicated on a continuation of good economic times. GDP growth is forecast to average 3% per annum over the next five years. That's higher than our forecasts, and points to downside risks to revenue and budget surpluses, and upside risks to debt.

Graph 2: Debt to GDP



Credibility was achieved by maintaining adherence to key fiscal ratios. The most critical of those ratios is the net debt target which the Government is expecting to comfortably meet by 2022. Note, however, that debt held by Crown Entities is expected to rise from 0.5% of GDP to 2.2% by 2022. This isn't included in core Crown debt (but should be).

Nevertheless, the lower core Crown debt ratio may well see renewed questions about whether the Government is using its balance sheet effectively, and whether it should be investing more now, especially while interest rates are low.

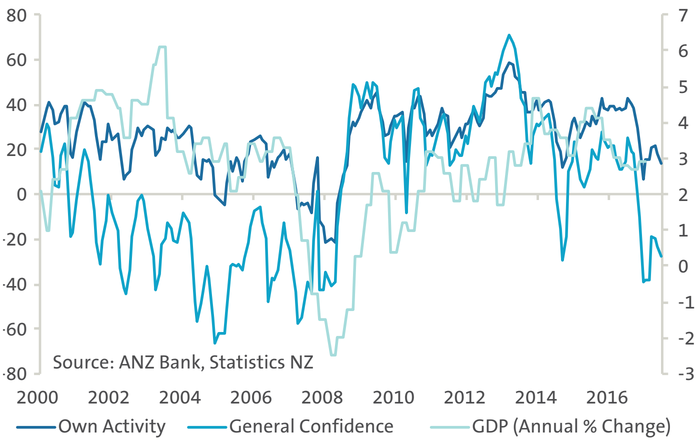
Our view on this hasn't changed. While economic times are good it's prudent to have debt falling as a percentage of GDP. The bigger the buffer that is built up in good times, the more effectively the Government can respond when the next (inevitable) downturn arrives. Add to that, the fact the economy is already capacity constrained, especially in the key construction sector. We simply can't build any more than we are currently building.

Looking further out, fiscal pressures are likely to only increase over time as structural trends such as demographic pressures become more problematic. Also, by next year a raft of working groups, including social policy, education and tax, will have reported back. And Budget 2019 will be the first to incorporate the new Living Standards Framework which we expect will come with additional calls for investment, and will have implications for fiscal policy more generally.

Business confidence still negative

One factor of continuing concern to the growth outlook is stubbornly low business confidence. That concern is only mitigated by the fact that firms are still modestly upbeat about their own prospects, which is the more critical driver of hiring and investment decisions, and economic growth generally.

Graph 3: Business confidence



The Government will be no doubt disappointed the Budget did not provide a meaningful boost to business confidence levels. There are other factors at play, most notably mycoplasma bovis but also lingering uncertainty about the Government's policy agenda especially with respect to areas that will impact on firms directly including industrial relations.

But we are concerned that the longer general confidence remains low, firms expectations of their own outlook may come down to meet it and have a more significant impact on hiring and investment decisions. In fact this is the biggest risk to the growth outlook.

Mycoplasma bovis

It's only in the last few weeks that the full extent of the implications of Mycoplasma bovis have started to emerge. This is a major factor impacting low business confidence readings.

During May the Government announced its preference for eradication of the disease. The eradication plan entails the culling of 150,000 head of cattle. From an immediate production perspective, that means higher meat production with a negative impact on dairy production.

But that's just the initial impact. The longer-term implications for farm management, productivity and profitability are all highly uncertain, but more than likely all negative. It's a stressful time for the rural community, especially in the beef and dairy sectors.

External sector in good shape

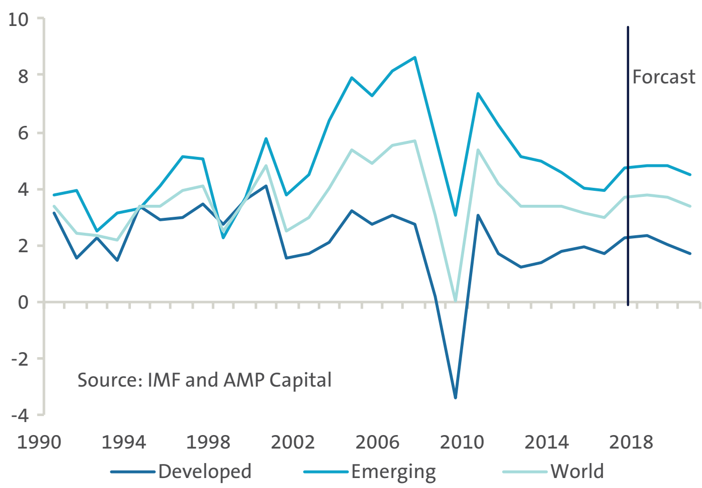
On a brighter note, New Zealand's merchandise terms of trade remain close to record high levels. In the March quarter the index was down 1.9% from the record high reached in the December 2017 quarter.

We expect some further weakness in the period ahead, mostly due to higher oil prices offset slightly by a recent firming of dairy prices as observed in recent Global Dairy Trade auctions. Further out, we expect to see some softening in key export commodity prices.

But the index is expected to remain at relatively high levels, which will continue to support strong national income and GDP growth.

Also we expect demand for our products to remain high given the strong levels of global GDP growth. Global GDP came in at 3.7% in 2017, and we expect a broadly similar outcome in 2018.

Graph 4: Global GDP



However, there is the recently increased risk of trade protectionism. We are watching the US/China trade situation with interest, as well as the US approach to the renegotiation of NAFTA.

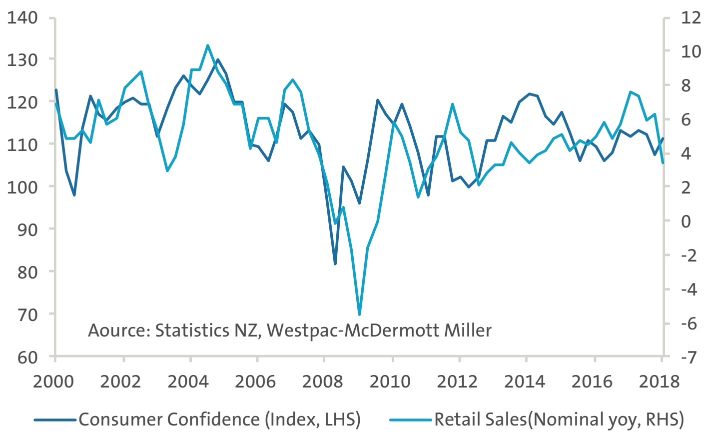
We are mostly concerned about the increasing disregard for rules of global trade. As a small open exporting country we rely on a rules-based global trading environment. The key message for New Zealand is to continue to work towards bi-lateral trade agreements that are in our best interests.

Households in fine fettle

Households are generally upbeat. Consumer confidence is off its 2014 highs but remains in positive territory.

Retail spending growth was soft in the March quarter, though that followed a bumper December quarter. The annual rate of growth of nominal retail sales has halved since last year but is still running at 3.4%. The slowdown in retail spending is also consistent with the recent slowdown in the housing market.

Graph 5: Retail spending

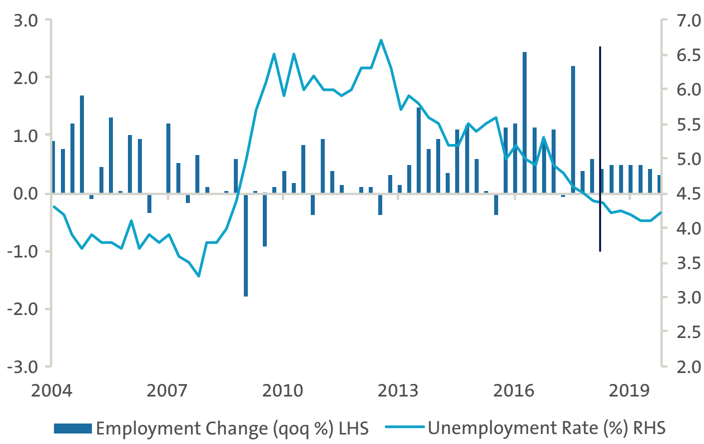


We expect the retail sector to be the major beneficiary of the Government's Families Package which comes into effect on 1 July.

Labour market continues to tighten

Employment growth has slowed in line with recent economic softness and as the unemployment rate has reached 4.4%, its lowest level since September 2008 and now at a level consistent with full employment. Firms are reporting increased difficulty in finding skilled and unskilled labour, yet that is yet to show up in any form of wage pressure, at least outside the already at-capacity construction sector.

Graph 6: Labour market



High levels of net inward migration has been a key source of labour supply in recent years. The annual net inflow peaked at over 72,000 in the middle of 2017 and has now slowed to 67,000. The slowdown is about one-third due to lower arrivals and two-thirds due to rising departures. We put that down to the improving global economic environment.

We think the net inflow continues to slow and for migration to be a reduced source of labour supply growth in the period ahead. At the same time, we find it difficult to believe the already high New Zealand participation rate can move higher.

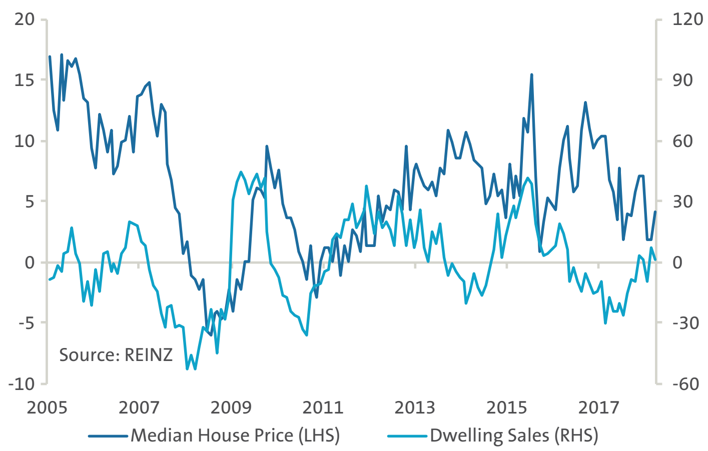
Put continued, albeit lower, labour demand together with slowing net migration and no further gains from increased participation, and the labour market seems to us the unemployment rate will continue to head lower. That will see stronger wage pressures emerge in time.

A critical factor in how the cycle plays out from here is how businesses respond to the tightening labour market. In short, now is the point in the cycle we would expect businesses to look to increased investment to resource the future growth in demand for their goods and services. That's why we are concerned about lingering low levels of confidence. Businesses won't invest if they aren't confident about the outlook.

Housing and construction

The existing market has slowed significantly since the peak of 2016. Since then activity has been more muted, though there was a renewed flurry of activity in the later part of 2017 and early in 2018.

Graph 7: House prices



There are headwinds and tailwinds for house prices in the period ahead. The headwinds include a number of policy changes including the extension of the so-called 'bright line' test to five years and the likely ban on foreign buyers of residential property. This will put downward pressure on house prices. However, that's offset by the tailwinds of strong household incomes, the healthy jobs market and still optimistic consumer confidence.

The combination of factors leaves a somewhat benign outlook for house prices, though we are swayed to the expectation of a drift lower in prices given the already high starting point, especially in Auckland.

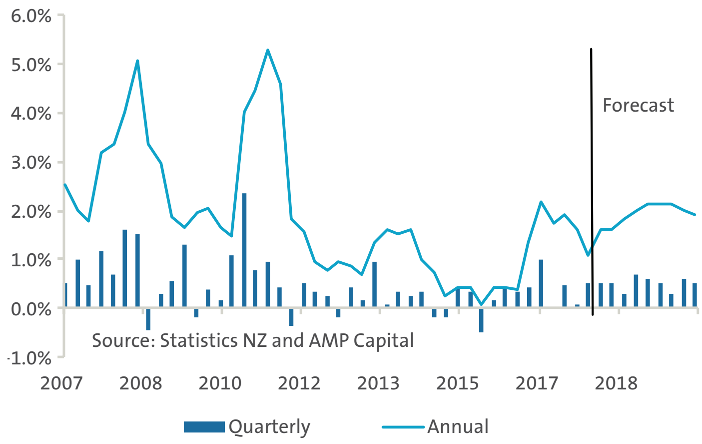
Construction has slowed as we expected, mostly due to capacity constraints, including the full gambit of regulatory factors, labour supply and project financing. If anything, labour demand has slowed recently as various projects have been delayed or cancelled.

But the reality is we are still short a vast number of houses and, while net migration has slowed, it is still adding to the shortage, particularly in Auckland. The Government's Kiwibuild programme will help fill some of the gap, though our concern about the speed with which this would get off the ground was vindicated in the Budget.

Inflation: like waiting for Godot

With wage growth missing in action, so too is core inflation. This has been a recurring theme over many years. In fact, in the March quarter the annual rate of core inflation dropped back to 1.1% from 1.6% in December, though this was mostly due to a large quarterly increase in March 2017 dropping out of the annual calculation. The next quarter to drop out is a zero for June 2017, so we expect to see core inflation back up to around 1.5% in June 2018.

Graph 8: CPI



A number of factors are expected to see higher headline inflation in the quarters ahead. Higher petrol prices (due to both oil prices and taxes) and the recent weakness in the New Zealand dollar will add to imported inflation.

But the Reserve Bank of New Zealand (RBNZ) is concerned about trends in core inflation and here we expect to see inflationary pressures build also over time. As mentioned above, we expect wage pressure to build over time as the labour market continues to tighten. This will be given further impetus by the scheduled increases in the minimum wage. Offsetting that to some extent will be the intensive competitive pressure in the retail sector.Also, we remain optimistic about the prospects of the New Zealand economy to achieve a cyclical improvement in productivity in the late part of this cycle, though that remains reliant on business investment not being delayed or cancelled because of low business confidence. Higher productivity will subdue future increases in unit labour costs.

We still expect the RBNZ to tighten monetary policy, but not until mid-next year. That's broadly consistent with the Reserve Bank's latest Monetary Policy Statement, the first under the new Governor Adrian Orr.

There was a dovish tilt to the Statement with the line "The direction of our next move is equally balanced, up or down". That said, a cut seems unlikely and the interest rate projections themselves continue to flag the next move as a hike. While a cut seems unlikely, the Bank is obviously ready and willing to respond a change in the outlook for inflation, through lower-than-expected actual out-turns or a change to the growth outlook.

In the meantime, the central outlook remains for above trend growth in the period ahead, a continued absorption of spare capacity, and an eventual move to withdraw monetary stimulus, though that appears at least a year away.

New Zealand dollar

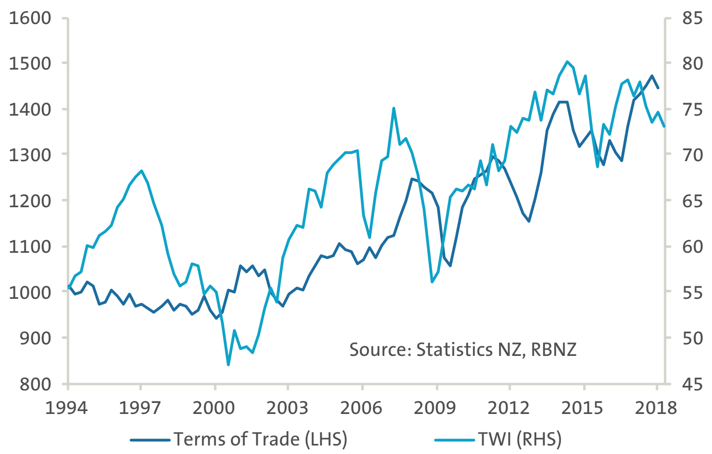
The New Zealand dollar (NZD) has weakened in recent months. This is in part due to the renewed strength in the US dollar (USD), but is not the only factor.

Monetary policy divergence has played a key role as the interest rate differential between the US and New Zealand has closed up. Indeed, following the latest hike by the US Federal Reserve (the Fed), the key US monetary policy rate is now higher than New Zealand's Official Cash Rate.

That divergence will increase over the next year as the Federal Open Market Committee continues to raise the Fed funds rate while the RBNZ remains on hold. That will put further downward pressure on the NZD.

However, there are also key fundamental supports for the New Zealand dollar, not the least of which is the terms of trade. So while we may see further downside in the NZD in the months ahead, any significant downside will be limited by the terms of trade.

Graph 9: NZD and Terms of Trade



Solid growth ahead, but not without risks

Following a subdued patch in early 2018, we expect a fiscally-induced pick-up in GDP from mid-year. We are forecasting growth of 2.7% this calendar year, rising to 3.2% in 2019. The cycle then turns down further into 2020 as the fiscal stimulus runs its course. We see GDP growth of 2.5% in 2020.

Those projections are not without risks, primarily that low business confidence becomes entrenched into firms' expectations of their own activity. That will be negative for business investment, hiring and overall GDP growth.

And while the global economic environment is positive, the global political environment is become less friendly towards rules-based trading environment. We must take every opportunity to facilitate new trade agreements. Friends are important.

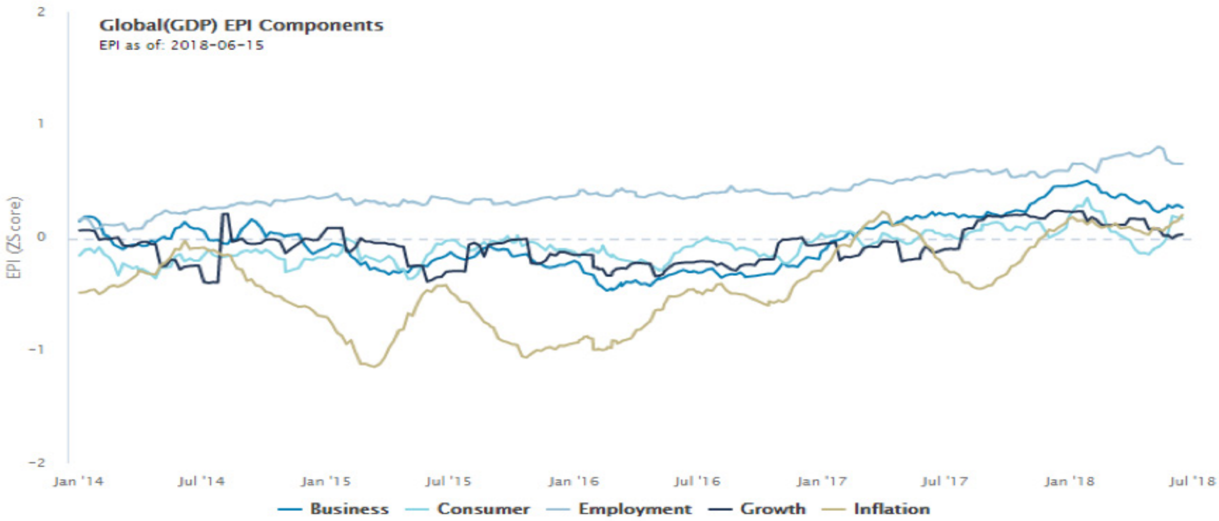
NZ Fixed Income

Introduction

Since the end of Q1 2018, and into Q2 2018, global economic activity softened on the back of weaker consumer and business activity. Some of the decline was driven by poor weather and some as data retraced a little from overly positive levels. However, over the last month that weakness appears to have abated, and economic activity and inflation have resumed their upward trajectory (refer Graph 1).

Graph 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

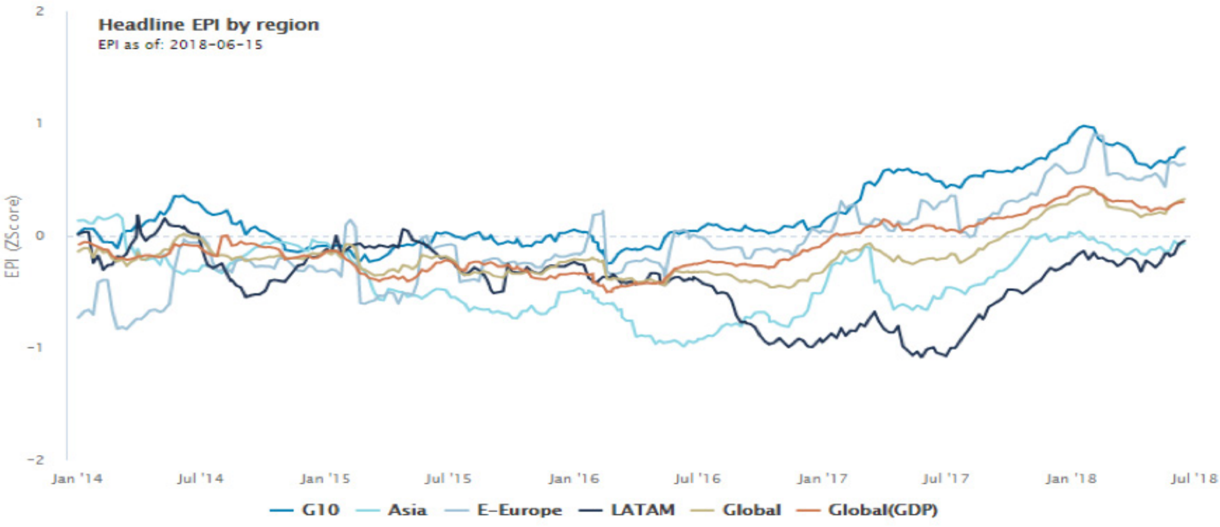


Source: AMP Capital

Looking across the regions, the same rebound in economic data can be seen (refer Graph 2). In fact, the synchronous movement across regions that we have mentioned in previous Insights remains intact.

Graph 2: Economic Pressure Index (EPI) across regions 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

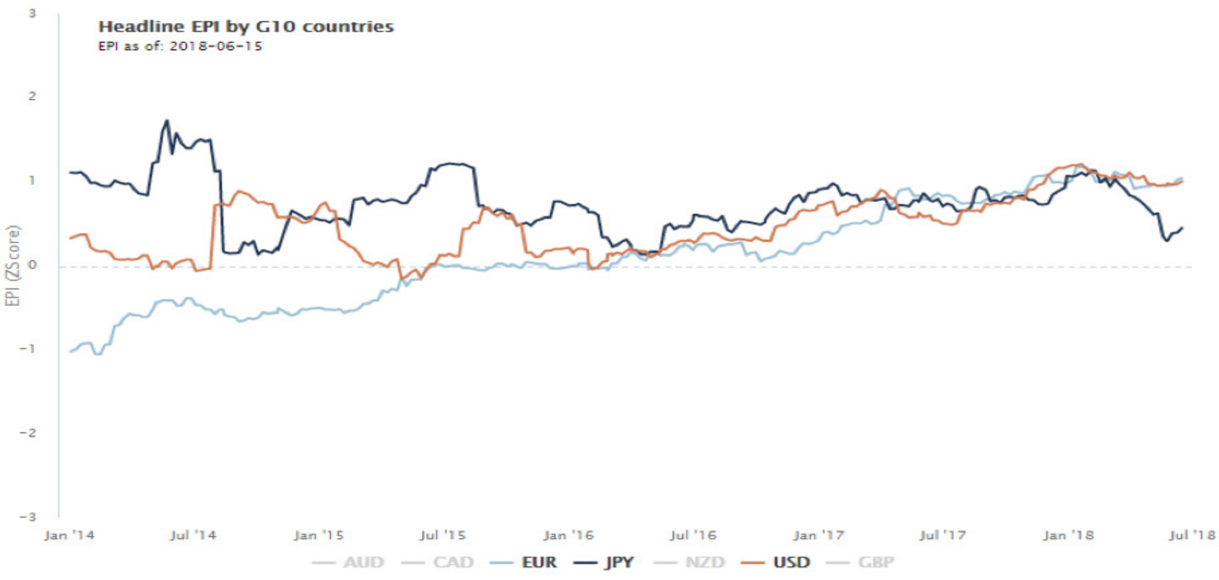


Source: AMP Capital

The key drivers for the improving data in the G10 and at the global level continue to be the US and Europe, with the Japanese economy being the notable outlier among the large developed economies (refer Graph 3). However, even the Japanese data has stabilised over the last week or so.

Graph 3: Economic Pressure Index (EPI) for selected countries at headline level

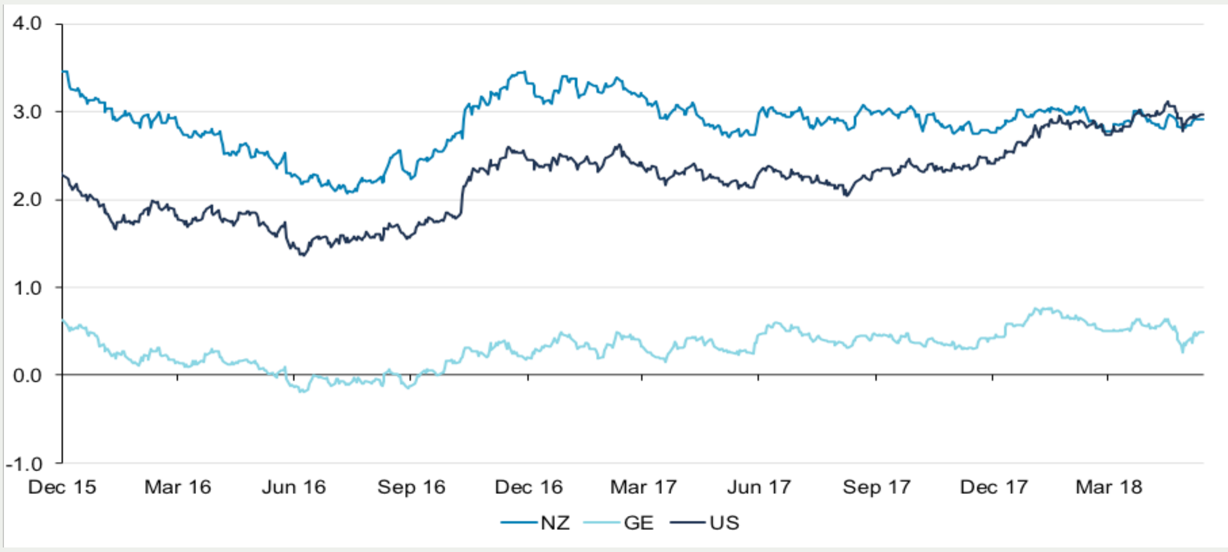
EPI>0 indicate stronger data compared to previous 10 years; EPI<0 indicates weaker data compared to previous 10 years; z-score



Source: AMP Capital

The strength in the economic data is underpinning the tightening in monetary policy rates in the US and the approaching slow retreat from QE in Europe. The pick-up in inflation along with tightening policy rates is underpinning the rise in long-term yields in the US and Germany. The latter has been buffeted recently by the flare up in Italian politics and the associated risks to the Eurozone, but is still showing an upward trend. Graph 4 shows the 10 year yield for US, Europe and New Zealand.

Graph 4: 10 year government bond yields across selected economies; %



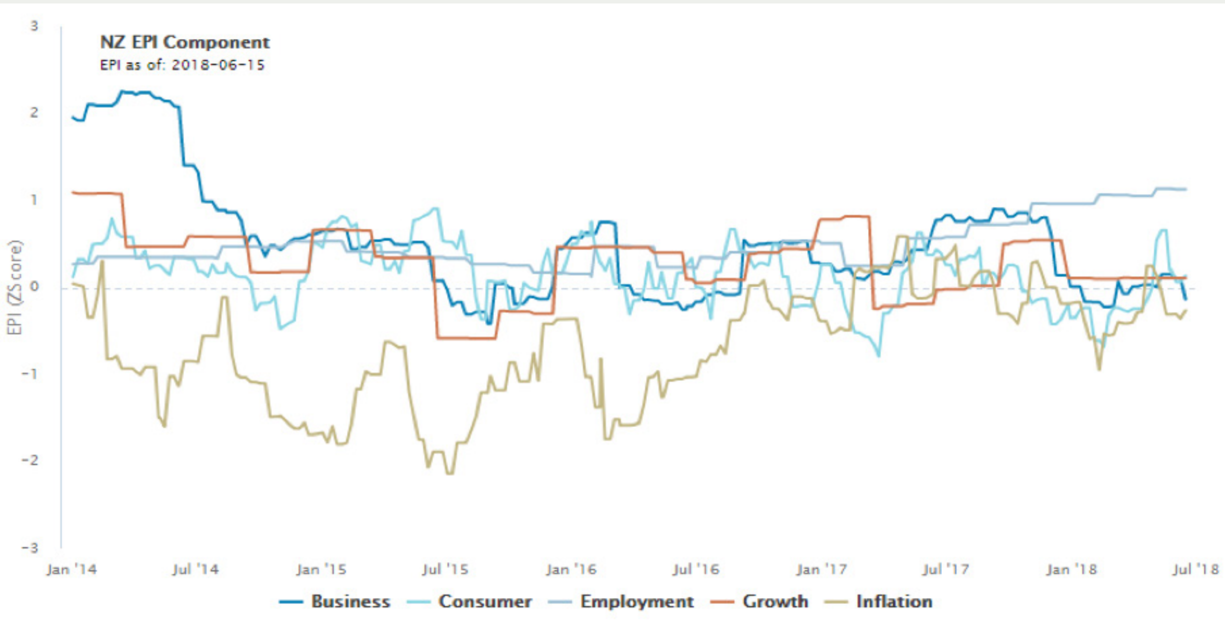
Source: AMP Capital, Bloomberg

The disappointing aspect has been the lack of movement in New Zealand yields when compared to what US (and to a lesser extent German) rates have done. Why the lack of movement in New Zealand long term interest rates? There are two key reasons.

The first is that the New Zealand economy continues to be suffering from some post-election blues. This can be seen in the EPI for New Zealand in Graph 5. In particular, the business and consumer data after a small rebound in May 2018 has softened again in response to some policy uncertainty, such as the new Government setting up a number of panels to review areas such as tax and labour laws. Business confidence was also unsettled by the decision to halt new oil and gas exploration without consultation.

Graph 5: 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 second is that New Zealand monetary policy remains on hold. At the May Monetary Policy announcement, the new Reserve Bank of New Zealand (RBNZ) Governor Adrian Orr also confirmed that policy rates would remain on hold for an extended period, as we had expected. The RBNZ focused on core inflation, which remains well contained and below the mid-point of the 1-3% inflation target.

The new policy targets agreement (PTA) signed between the Government and the new Governor requires monetary policy to be directed at achieving price stability over the medium-term, as well as a new objective of supporting maximum sustainable employment.

Looking ahead, we feel headline inflation is likely to be biased higher in New Zealand. The pick-up in headline inflation is driven by:

> higher commodity prices

> a weaker New Zealand dollar

> a rise in petrol tariffs

> rising wages (spilling over to broader price pressures)

> rising international prices (as global excess capacity continues to be eroded).

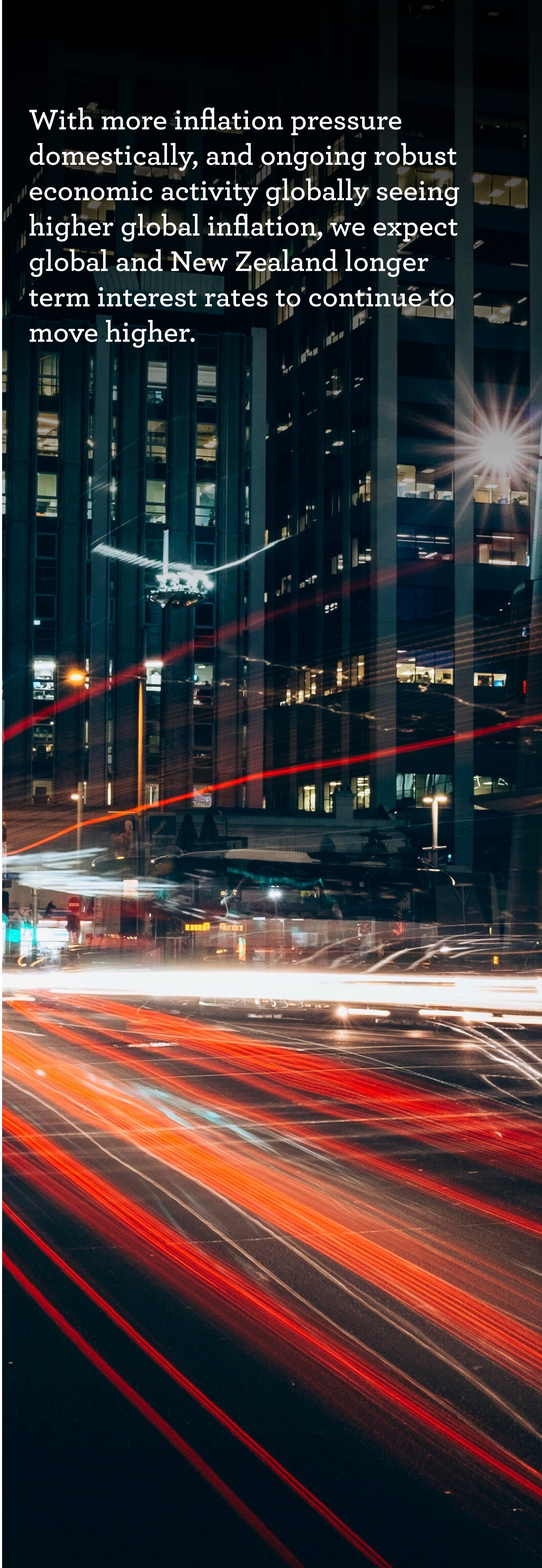
In addition, we are going to see weak historical quarterly inflation prints fall out of the calculation of annual inflation when we get the Q2 2018 inflation release in July 2018. However, we don't see the RBNZ responding until there is a sustained move higher in core inflation measures.

In fact, the RBNZ may be faced with softer economic growth (compared to the last few years) at the same time as there could be a pick-up in headline inflation. With the additional requirement in the PTA around maximum sustainable employment, this could see the RBNZ at the margin tighten more slowly than they would have previously in reaction to the pick-up in inflation. The RBNZ also appear to be hinting that they may like to see headline inflation spend some time above the mid-point (2%) of their target band.

With more inflation pressure domestically, and ongoing robust economic activity globally seeing higher global inflation, we expect global and New Zealand longer term interest rates to continue to move higher.

Summary

We continue to run less interest rate sensitivity in the portfolio to protect from our expectation that yields are likely to move higher, driven by both global and New Zealand factors. We are also biased to have overweight exposure to shorter maturity yields relative to longer maturity yields, given our view that the RBNZ will keep monetary policy on hold for an extended period despite an expected rise in headline inflation.



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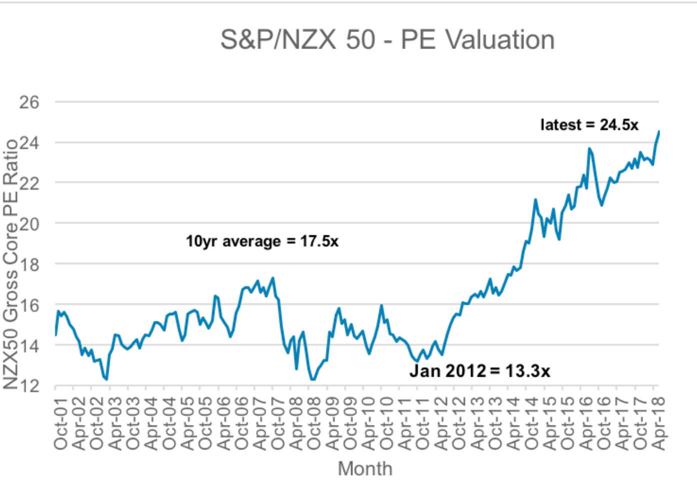
New Zealand Equities

In our New Zealand equity market write-up three months ago, we suggested that the sharp sell-off and volatility experienced during February in equity markets around the world marked a definitive end to the era of 'goldilocks', where growth had been just strong enough to support company earnings but not so strong that rising bond yields have spoilt the party. Looking at the New Zealand equity market, we argued that a mixed 'earnings season' for New Zealand companies with December balance-dates had been papered over by the extreme strength of a2 Milk. Tentative signs were also emerging of the local economy slowing and leading to a choppier earnings outlook.

In the three months since then, we have seen further evidence of the New Zealand economy slowing. Company earnings forecasts have begun to come under a degree of pressure, yet the S&P/NZX 50 Gross Index has surged by 7.7% quarter-to-date as this commentary is being written. The pesky picadores have begun to cast their lances into the side of the bull, but all he can see for now is a big red cape and he is charging.

We estimate (using First NZ Capital data) that the one year forward price earnings (PE) multiple for the New Zealand market reached a new record level of 24.5x in mid-June. The chart below puts this in context and shows that when the great bull market began back in January 2012, the forward PE ratio was only 13.3x, and the Manager has fond but increasingly distant memories of being bullish.

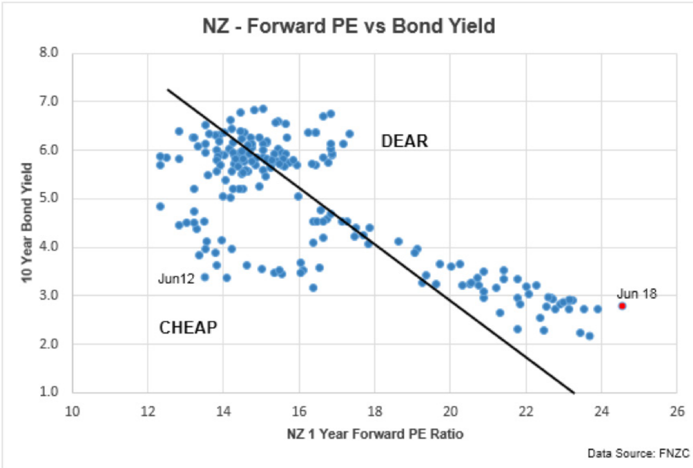
Since then, the New Zealand index has delivered a 173% return (from 3274 to 8958), while earnings have only risen by 52%. Dividends account for some of the gap but the great bulk is investors' willingness to pay a much higher price for every dollar's worth of earnings. Multiples have soared.



A remarkable aspect of the surge since March is that earnings have not been particularly strong. According to UBS research, a full two-thirds of their New Zealand coverage universe has experienced consensus earnings downgrades for financial year 2018 (FY18) over the last year, yet FY19 forecasts have barely been downgraded despite gathering economic clouds.

We track the monthly ANZ Business Outlook survey as a timely update on the New Zealand economy, and the end-May release was soft. Firms' own activity outlook fell from 17.8 to 13.6, which is far below the 30 to 60 range of the last few years and points to sub-2% GDP growth. Firms' profit expectations fell from -0.9 to -8.5. We need to go back to mid-2009 to find previous negative readings. This measure has a reasonable linkage with NZX listed company earnings and it had been running at 20 to 30 through most of the last two years. The bull has been running but earnings forecasts have clear risks to the downside.

Another possible explanation for the surging equity market would be if bond yields had fallen sharply. There is indeed a strong relationship between the forward PE multiple and the 10 year bond yield as shown below. The chart shows how the latest reading for the market is at a record distance from the fair value line – low bond yields do not explain this bull market, it is expensive on every metric. Even worse, New Zealand 10 year yields have risen from 2.75% to 2.98% so far in June.



Interestingly, both domestically and globally, the bull market has been driven by an increasingly narrow group of companies. Valuation appears to be of little consequence relative to the 'story' and the perceived long-term opportunity.

According to Citigroup research, the MSCI Australia Growth Index is on a 20.5x PE versus the Value Index on 11.9x, with the size of this divergence last being seen in early 2000 and late 2007. Citigroup also shows that the proportion of stocks with a PE over 25x now exceeds 2007 and is approaching the Nasdaq bubble era. These stocks are concentrated in the healthcare, IT and China-leveraged food segments, with medium-term earnings per share (EPS) forecasts for these companies having risen despite their current earnings outcomes being mixed.

The concentration of the strength in New Zealand equities is shown how in the calendar year-to mid-June. The S&P/NZX 10 Gross Index is 9.7%, the S&P/NZX 50 Index is 6.7%, but the S&P/NZX Mid Cap Gross Index is only 3.3%. A select number of large companies have strongly outperformed.

The New Zealand market is a little small for meaningful analysis by sector, but similar themes to Australia are evident. As an example, Fisher & Paykel Healthcare reported a somewhat soft result for its March-end period as the product cycle for its sleep apnoea masks has become dated. Earnings downgrades in the order of 3-5% resulted across the market, but the share price has since risen by over 10% and it is now on a forward PE multiple of 39x and an aggressive prices/sales multiple for such a large company of nearly 8x.

The recent juggernaut a2 Milk also experienced something of a roller-coaster ride as it delivered a less bullish revenue update than expected in mid-May but benefited from its inclusion in the crucial MSCI Index. The share price traded in a 35% range during May – remarkable volatility when one considers that this is currently New Zealand's largest listed company. The momentum investors driving the bull market surge would not appear to be the most steadfast in the face of earnings blips.

The remainder of results season was largely in-line with expectations. Mainfreight reported a generally solid set of numbers across its geographies, and the market appeared relaxed with a sizeable lift in future capex to sustain its growth path. Results from Sanford and Z Energy were largely as expected, although the latter company carries the burden of a regulatory review of fuel margins.

Heartland Bank reported an 11% lift in third quarter profit, but the share price struggled due to the potential impact of the slower economy on their loan book and the impact of weaker Australian housing on their reverse mortgage business. The Turners result was as expected, which came as a relief given sustained share price weakness.

Property companies generally reported solid results, with increasing evidence of rental growth in the industrial and office segments and further valuation cap rate contraction as market evidence of rising prices mounts. Both elements appear to be late cycle in the view of the Manager. Ryman reported underlying earnings growth of 14% in line with guidance, but we would note that this non-GAAP (generally accepted accounting practice) number has considerable definitional leeway. Disappointing unit sales numbers were offset by sizeable valuation uplifts, which were interesting in the context of housing markets that are clearly slowing.

To conclude, the reporting season for March balance-date companies delivered no major positives or negatives, but it was startling to see sharp outperformance by large cap companies such as Fisher & Paykel Healthcare, when it was one of a small number to disappoint. This illustrates the strength of current global investment trends which are seeing factors such as 'price momentum' sharply outperform others such as 'valuation' and 'yield'. This has been particularly evident in the small New Zealand market, which in New Zealand dollar terms has actually been the world's strongest in the calendar year to mid-June.

Conversely, New Zealand's business activity and profit outlook is weakening. Bond yields are at the top-end of a sideways range, with further risk as sizeable global monetary accommodation is removed by the Federal Reserve and perhaps the European Central Bank. This is not an environment which would normally be expected to lend itself to record valuation multiples, and the Manager has cautiously positioned the New Zealand equity holdings to benefit when the factors driving this market stage their inevitable reversal.

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