Insightspaper

AMP CAPITAL

NEW ZEALAND INSIGHTS

June 2017

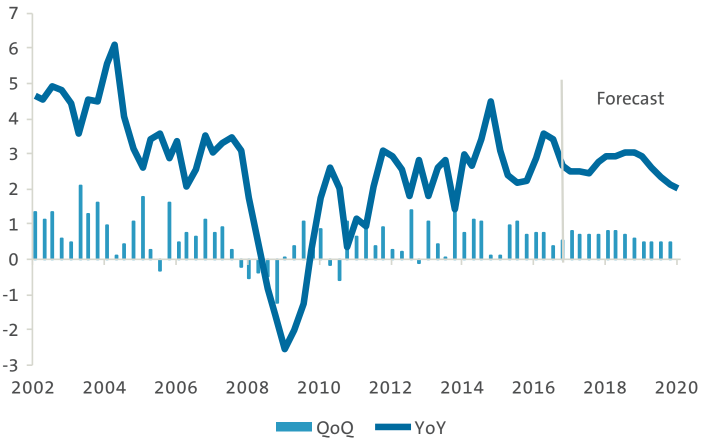
INSIGHTS
IDEAS
RESULTS

New Zealand Insights June 2017

The New Zealand economy has come through a relatively subdued six months. A series of one-off negatives impacting the final quarter of 2016 (dairy production) and the first quarter of 2017 (transport and construction) conspired to deliver below trend growth of 0.9% over the six months to March.

Two consecutive quarters of low growth begs the question of where to from here? We're inclined to accept the series of one-offs at face value and assume a modest rebound over the next few months to around the 0.7% per quarter we think underlying growth is running at. Note this delivers lower growth than both the Reserve Bank of New Zealand (RBNZ) and The Treasury are forecasting.

Figure 1: GDP % change



Source: Statistics NZ and AMP Capital

Furthermore, growth is going through somewhat of a compositional change. There are known capacity constraints in both the tourism and construction sectors that will limit the ability of both of these sectors to deliver contributions towards ever higher growth. At the same time, however, we expect growth in consumer activity to remain solid as population growth remains strong and as labour income continues to rise.

We are also seeing the early signs of a much needed uptick in business investment and fiscal policy is about to turn modestly stimulatory over the period ahead. Finally, we have seen solid gains in the terms of trade over the last two quarters

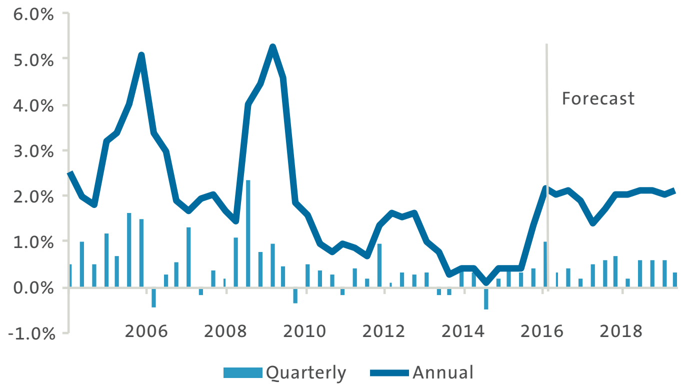
We now see annual average GDP growth of 2.6% this year, rising to 3.0% in 2018 on the back of a return to trend plus a bit of fiscal stimulus, before moving lower again to 2.5% in 2019.

We expect growth in consumer activity to remain solid as population growth remains strong and as labour income continues to rise

Core inflation still benign

Headline inflation has spiked higher over the last two quarters to be at 2.2%, comfortably back in the top half of the 1-3% target band. That's largely thanks to a bigger than expected increase in the March quarter which saw the Consumers Price Index (CPI) rise 1.0% over the three month period thanks to some "one-offs", including the impact of poor weather on fresh produce prices.

Figure 2: Inflation % change



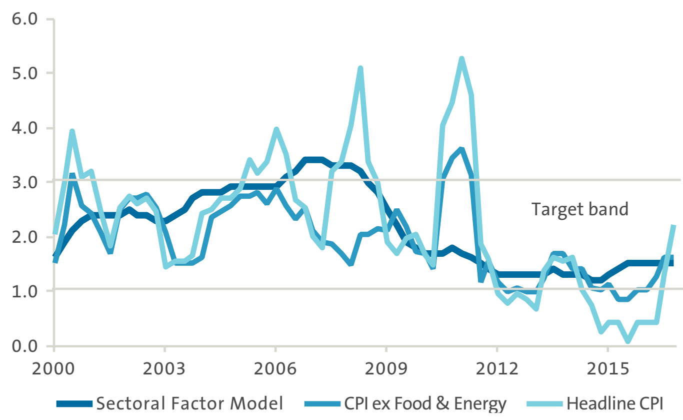
Source: Statistics NZ and AMP Capital

This is good news for the RBNZ as one of the chief worries for them in recent times has been that low inflation would become entrenched via its impact on inflation expectations. But with headline inflation now higher, inflation expectations have also turned back up quite nicely. One risk diminished.

That said, we expect headline inflation to move lower again in 12-months when the outsized March result drops out of the annual calculation. Indeed, our forecast headline CPI increase for the year to March 2018 is 1.4%.

But monetary policy is all about the trend in underlying or "core" inflation. There are a large number of measures of core inflation. The two that matter most to the RBNZ are the CPI-excluding food and energy, and the outputs from their own sectoral factor model. Both measures show core inflation stuck at around 1.5%, well short of the mid-point of the target band.

Figure 3: Inflation annual % change



Source: Statistics NZ and RBNZ

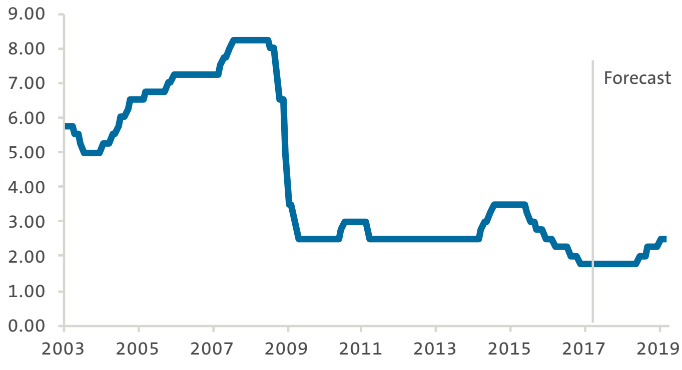
Monetary policy on hold until...?

The upshot is conditions are not yet in place for the RBNZ to be concerned about a sustained rise in core inflation. Indeed, wage inflation remains subdued with the Labour Cost Index, if anything, trending down recently.

For that reason, we had no problem with the RBNZ's May Monetary Policy Statement. Many interpreted it as erroneously dovish. We took a more pragmatic attitude in that the message was right for the time.

That said, there is, at least in our view, an internal inconsistency in the RBNZ's projections. It seems to us that if the RBNZ is going to be right on its bullish growth forecasts, it would not be able to wait until 2019 before tightening. Similarly, if the Bank is right and ends up not tightening until 2019, it will be because it got the growth outlook wrong.

Figure 4: Official Cash Rate



Source: RBNZ and AMP Capital

So where does that leave the monetary policy outlook? Well the easy bit is that interest rates are at the lows for the cycle, but for how long remains highly uncertain. We still have May 2018 penciled in for a first hike, but the recent weakness in growth has us thinking it is more likely to be later than earlier.

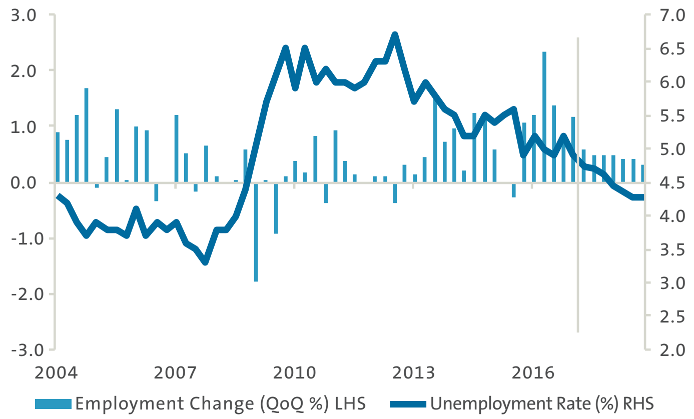
Watch the labour market

The lack of wage inflation in recent years explains a large part of the persistently weak domestic inflationary pressures and it's the labour market that remains key to the outlook for core inflation.

Right now, wages remain subdued despite strong economic growth fueling strong growth in employment. That's because we have seen strong growth in the supply of labour at the same time. A combination of net migration inflows and a record high in the labour participation rate has seen 330,000 people enter the labour force over that last five years.

With that strength in the growth of the labour force, the unemployment rate has been relatively slow to fall despite strong jobs growth. From a peak of 6.7% in September 2012, the unemployment rate had fallen to 4.9% by March 2017. We expect the unemployment rate to continue to drift lower as labour demand remains solid, but for no significant economy-wide wage inflation to emerge until the unemployment rate moves closer to 4%.

Figure 5: Labour market



Source: Statistics NZ and AMP Capital

Productivity and business investment

New Zealand's low labour productivity growth rate has been in the news again following the recent country report from the Organisation for Economic Co-operation and Development (OECD).

We think about productivity from both structural and cyclical perspectives. Let's do the easy bit first. Labour productivity growth rates have been low in many developed economies since the Great Recession. At least part of this is cyclical. The recession saw sharp increases in unemployment rates. As economies recovered, labour was plentiful and relatively cheap given wages were subdued, so firms resourced the growth in demand for their goods and services with labour. That keeps labour productivity suppressed.

Later in the cycle the unemployment rate is lower, skilled labour becomes more difficult to find and more expensive as wages rise. Firms then turn to capital for growth, especially while interest rates are still low. It's during this part of the cycle that productivity starts to improve.

Figure 6: Productivity annual % change

Source: Statistics NZ

The turning point is when the economy reaches full employment. The United States is there now which is why we are looking for a pick-up in business investment now to prolong the cycle and prevent the need for more aggressive interest rate increases. The good news from the lower-than-expected first quarter growth rate in the US was that one of the strongest contributions to growth came from business equipment spending.

New Zealand is getting closer to this point and, in similar fashion to the United States, the pleasant surprise from our weaker-than-expected first quarter of 2017 growth was also strength in business investment. The early signs are good for a cyclical improvement in productivity.

But (I sense you all thinking), this hasn't happened in the past. You are correct. I put that down to the high cost of capital (high interest rates) that have prevented a shift to capital expenditure. Remember during the last cycle the Official Cash Rate (OCR) peaked at 8.25%. This time it's different. While the OCR won't stay at 1.75%, we expect a far more muted interest rate cycle this time.

There are of course structural factors at play. The OECD picks out one of the ones that matters most – education. The challenge there is that's not just about what happens in school. There are two parts to education – teaching AND learning. Good policy can improve teaching, but learning is harder to influence.

And as long-time readers will know, we are not big fans of R&D tax credits. A more targeted approach through the likes of Callaghan Innovation provides a better return on investment for the tax payer.

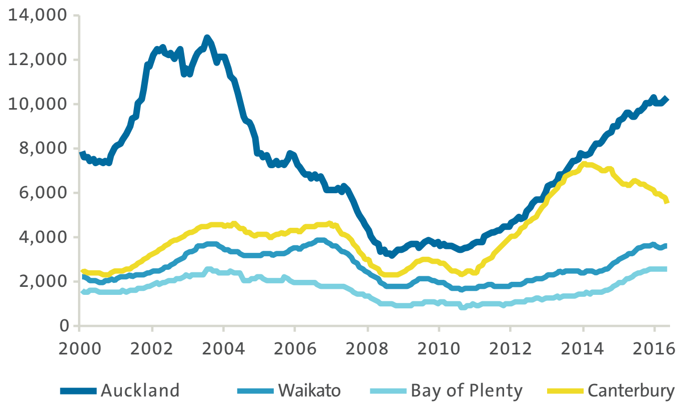
Housing market: existing market softer, new construction to remain at high levels

The housing market certainly has a softer feel to it. Prices are moderating, especially in the white hot market of Auckland and the surrounding regions of Waikato and Bay of Plenty. At the same time, house sales are down around 20% on year ago levels.

Three factors are at play here. Firstly last year's tightening in loan-to-value restrictions has had some impact. However, we think the more significant factor has been the recent rise in mortgage lending rates which has sapped some of the energy out of the market as mortgage holders and potential home buyers factor higher mortgage costs into their decision making. Thirdly, as news spreads that the market is softening, some of the urgency is removed from home-buyers as they are more prepared to sit back and wait and see what happens.

In terms of new housing, we expect construction activity to remain strong, particularly in the top-half of the North Island. There is still a shortage of housing, particularly in Auckland, and net migration inflows have yet to establish the much anticipated downward trend.

Figure 7: Building consents number, year-to-date



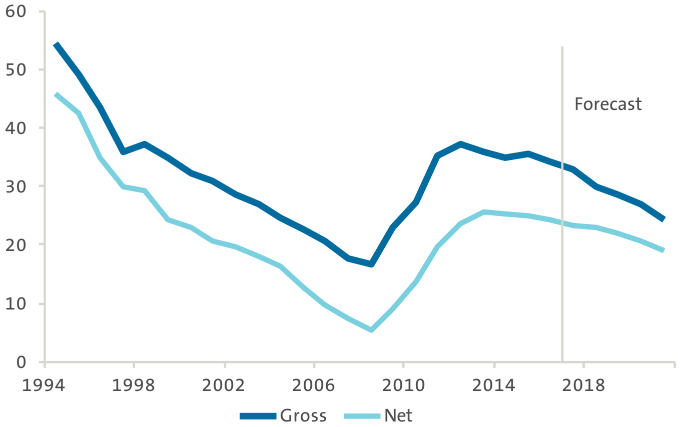
Source: Statistics NZ

The Budget, fiscal policy and the election...

The National-led Government has worked hard to get into a strong fiscal position. They have had to manage a full range of economic, seismic and meteorological disasters, all of which have had significant fiscal impact. Through a mixture of strong economic growth and fiscal restraint, the Government has got the books back in order while at the same time investing heavily in infrastructure to support the growing population and economy.

Even now, with the books back in order and an outlook of solid growth underpinning rising budget surpluses and falling debt, there was still an element of restraint in the Budget. That is typified by the new debt target of 10-15% of GDP.

Figure 8: Crown debt % of GDP



Source: NZ Treasury

We think that's the right strategy for now. The economy is performing well, the output gap is closed, and the RBNZ's next move will be to raise interest rates, though not until next year. Furthermore, the Government is already investing heavily in infrastructure and the construction sector is probably the most constrained in the economy already. There will come a time for the Government to use its balance sheet to support the economy, but that's not now.

It also depends on what you use debt for. It needs to be something that doesn't just support growth in the near-term, but rather increases the capacity of the economy to grow sustainably.

As we write, its only three months to the General Election. The National-led government will be relying on the benefits of the strong economy, low unemployment, low interest rates and, while nominal wage growth has been subdued, strong real wage growth by virtue of low inflation, to secure a fourth term occupying the Treasury benches.

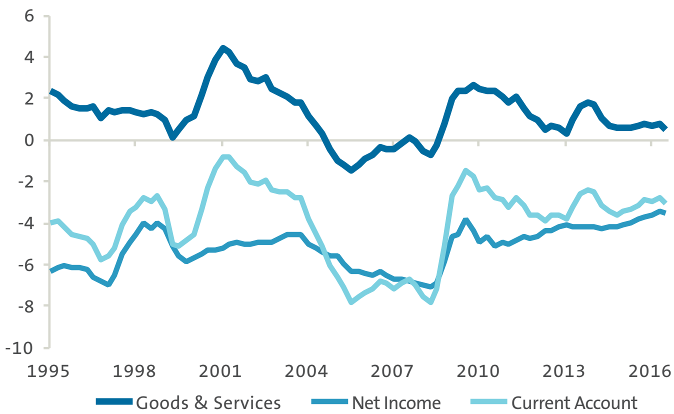
But the National-led Government appears vulnerable on housing, particularly the availability of affordable housing. The not-unrelated issue of immigration, an issue of heightened global anxiety, is likely to be to the fore during the election campaign also.

The good news is that both the main political parties that are likely to form the nucleus of the next Government support the foundations of New Zealand's macro-economic stability. Regardless of outcome, we expect little change in the framework of monetary policy. One of the first jobs for the incoming Government will be the appointment of a New Reserve Bank Governor along with a renegotiation of the Policy Targets Agreement. Nor do we anticipate any reduced commitment to prudent fiscal management, though the detail of fiscal policy settings may look different under different governments.

External sector still looking OK

One of the other post-Great Recession surprises has been the (relative) strength of our external position, especially in the light of the rapid deterioration in dairy prices over 2014 and 2015. New Zealand's current account position has remained well behaved and while it slipped to a deficit of 3.0% of GDP in the year to March, similar periods of strong growth have coincided with significantly worse deficit positions.

Figure 9: Current account balance, year to date: percent of GDP

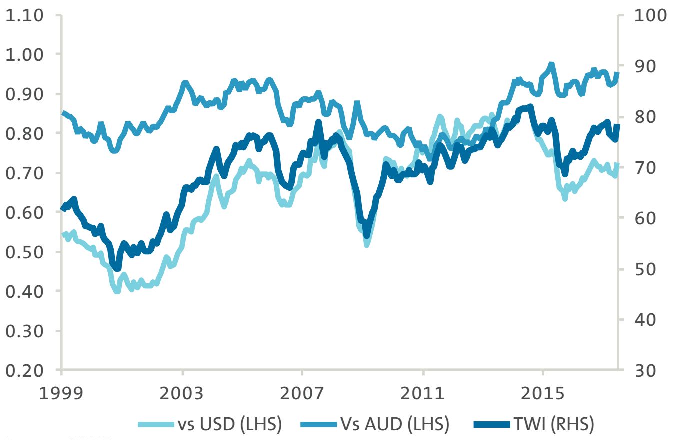


Source: Statistics NZ

New Zealand dollar

There are a number of forces impacting the New Zealand dollar (NZD) at the moment. Kiwi was trending down nicely towards fair value USD 68 cents in recent weeks, only for that trend to be reversed more recently by fresh weakness in the US dollar as expectations around future US Federal Reserve tightening wavered.

Figure 10: New Zealand

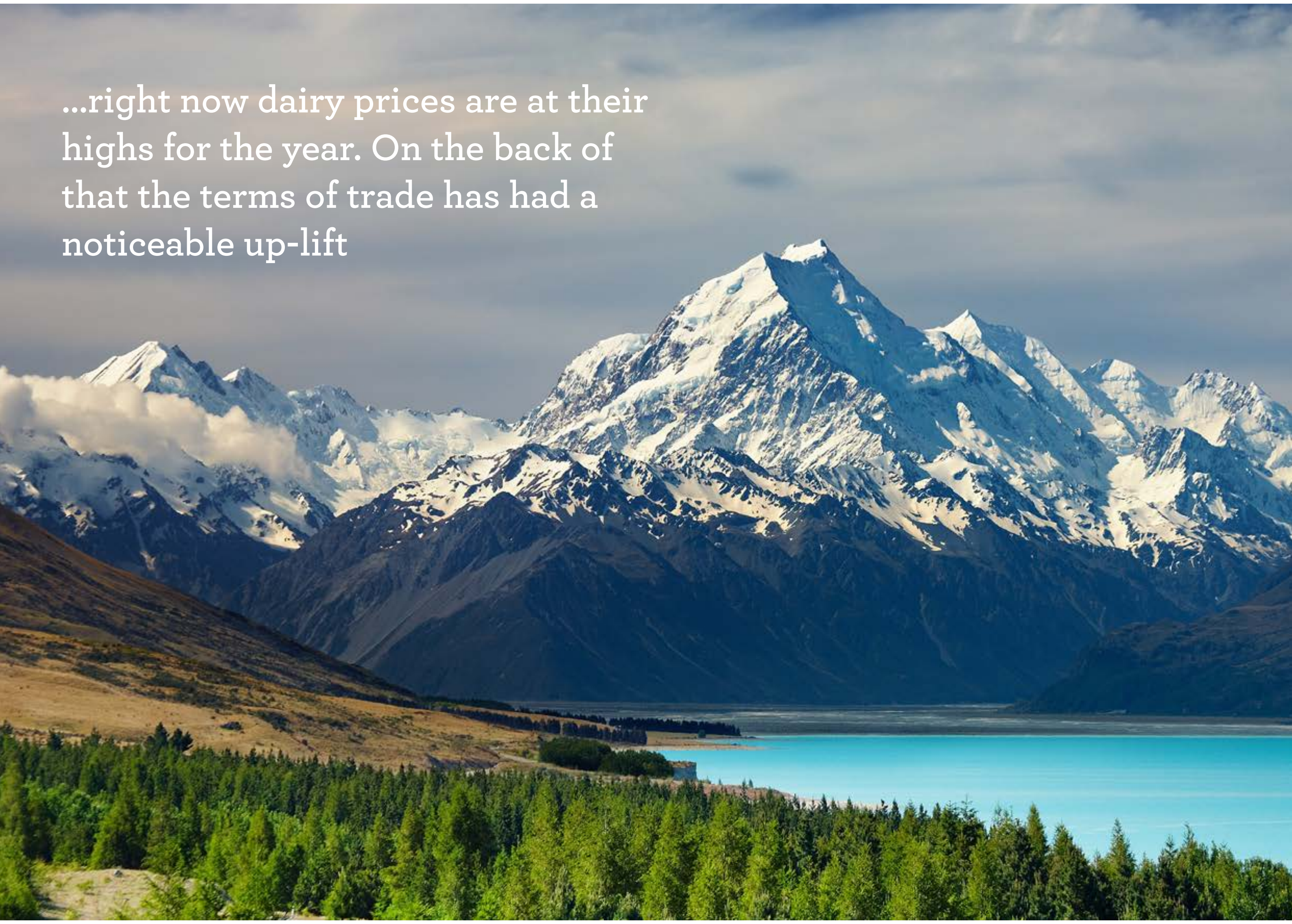


Source: RBNZ

There are other factors as play. First and foremost, the New Zealand economy remains a standout performer. On the other side of the equation, there are new questions about the strength of the US economy, the UK is dealing with Brexit and fresh political uncertainty, and much of the recent news out of Australia hasn't been that flash. And the May Budget had the Government releasing a set of accounts that showed the Crown in good fiscal shape and must be the fiscal-envy of the developed world.

Also, soft commodities are currently outperforming hard commodities. Dairy prices have had a nice run recently and while we question the sustainability of the recent lift in prices, right now dairy prices are at their highs for the year. On the back of that, the terms of trade has had a noticeable up-lift.

Looking ahead, we see some renewed softness as the US Federal Reserve pushes on with intentions to continue to hike interest rates. Indeed, assuming another hike in the Fed Funds rate this year, the short-term interest rate gap closes up to less than 50 basis points. We expect that would lead to the NZD retesting fair-value of US 68 cents.



NZ Fixed Income

Introduction

Before updating our views for fixed income markets for the coming period, it is worthwhile recapping developments over the last three months.

RBNZ – Our call for the RBNZ to be on hold for an extended period was spot on with the RBNZ repeating the message that they remain staunchly on hold with both upside and downside risks. We see no reason to change this view and don't see any change to the OCR until the second part of 2018. New Zealand short end yields will continue to be well contained in the short-term.

Global rates – We expected global yields to gradually move higher over 2017. However, what we have seen is yields slowly drift lower. The key drivers behind the lower rates is a combination of: disappointment regarding the progress of the policy programme from President Trump; some softening in economic data, particularly versus elevated expectations (see Figure 11); speculative short positioning being trimmed; and falls in commodity prices.

In addition, the European Central Bank (ECB) is only moving very slowly towards announcing some tightening in monetary policy. Two of these were risk factors that we had identified, namely Trump and the headwinds caused by large speculative short positions. Moves in global rates mainly influence longer maturity yields in New Zealand. So falls in global rates lead to falls in New Zealand longer-term rates, flattening the New Zealand yield curve. However, despite recent falls in global yields, we still expect global yields to gradually move higher over the rest of 2017.

Figure 11: US Economic Surprise Indices (ESI)

US economic data has swung from surprising on upside (>0) to surprising on the downside (<0) over the last few months

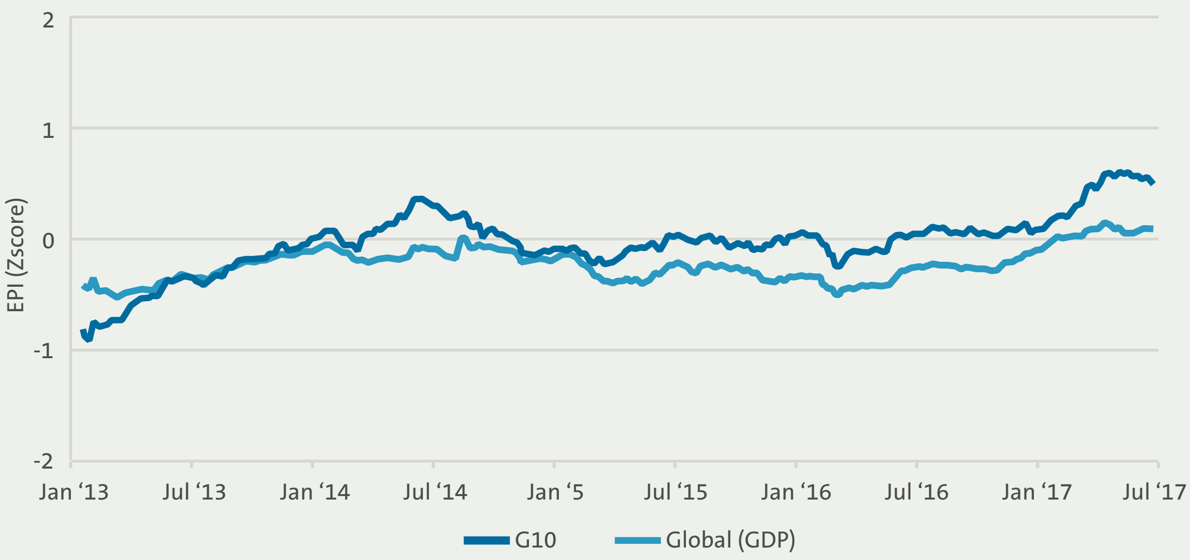
Source: AMP Capital

The falls in the US economic surprises is approaching the lows. Some stability, or rebound, in this measure could see US interest rates move higher.

Outlook – global

Despite the fall in economic surprises shown above, overall global and developed market economic data continues to hold up well. This can be seen in the economic pressure indices (EPIs) in Figure 12 below. (Note a positive reading indicates stronger economic data and a negative reading weaker economic data.)

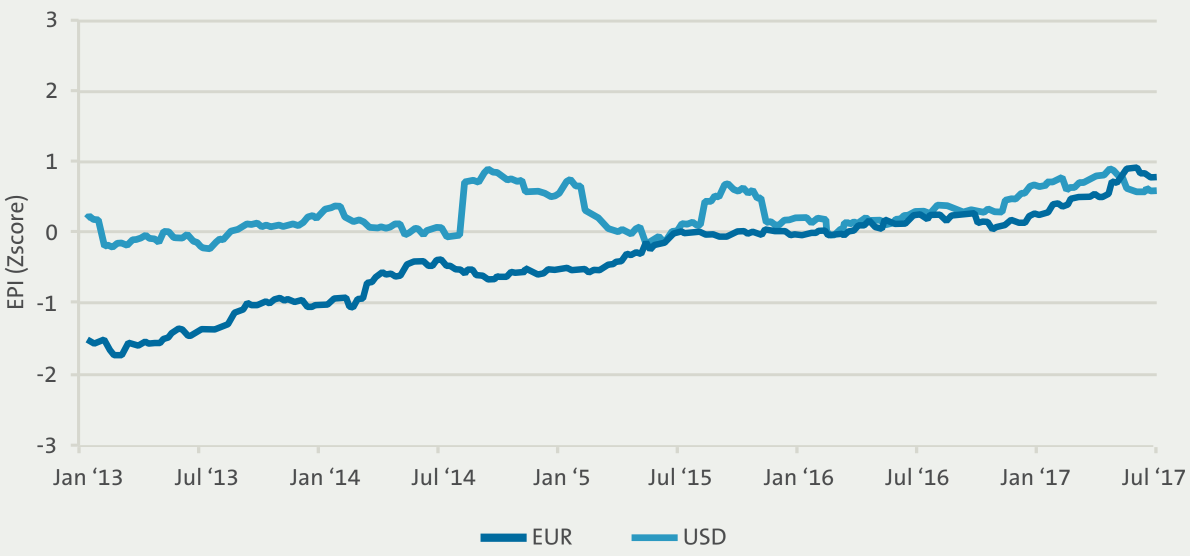
Figure 12: Global and developed market (G10) Economic Pressure Indices (EPIs)



Source: AMP Capital

What is significant has been Europe joining the positive economic party (refer Figure 13). This broader based level of expansion is a healthy development and should see excess capacity being removed from the global economy, eventually leading to higher inflation and higher yields.

Figure 13: European and US Economic Pressure Indices (EPIs)



Source: AMP Capital

With this backdrop we still favour higher global yields which will have a flow on to longer-term rates in New Zealand pushing them higher.

Outlook – New Zealand

With the long end of the New Zealand rates market driven by offshore factors, the key focus in determining where short maturity yields will move continues to be dictated by the actions of the RBNZ. In their May Monetary Policy Statement the RBNZ reiterated their 'on-hold' message, indicating that they see no move in policy rates until very late in 2019.

We see the New Zealand economy continuing to perform well, driven in large part by population growth and the strong rebound in commodity prices. However, with inflation pressures remaining subdued, we think the RBNZ will remain on the sidelines ,with policy rates on hold until well into 2018 – a little earlier than the RBNZ is forecasting.

We see New Zealand short maturity interest rates continuing to trade around their recent lows, with little scope for them to move higher in the short-term. However, there is also little room for them to continue to fall, therefore we are becoming more cautious on interest rate exposure in short maturities. Markets will pre-empt any tightening in policy by the RBNZ which could see a quick adjustment higher in rates at some point.

Summary

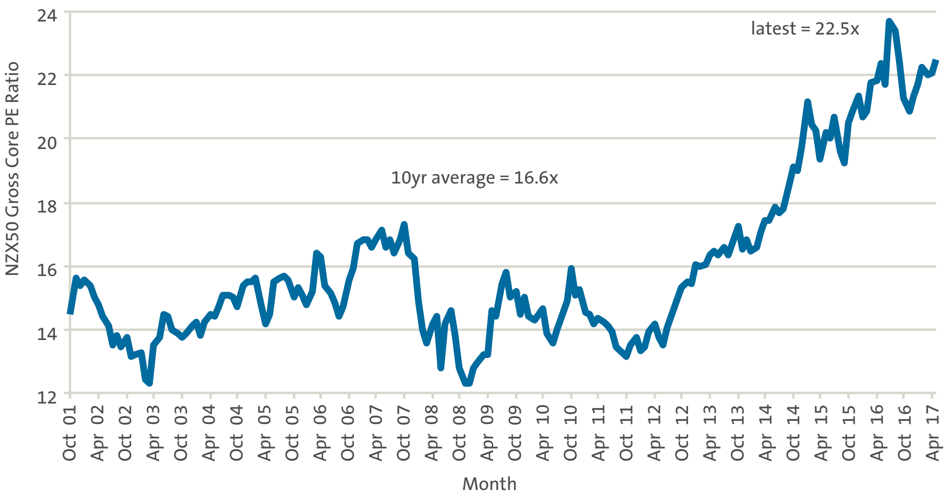
For the moment we retain a neutral view on interest rates. However, we expect both short and long-term rates to move higher toward the end of 2017 – the short-end in anticipation of a tighter policy stance from the RBNZ, and the long end reflecting higher yields globally as global inflation pressures return.

New Zealand Equities

The New Zealand equity market has risen by 9% so far in 2017, and if sustained for the rest of the year, this would mark a sixth consecutive year of positive returns. One needs to return to the dark days of 2008 to find a double-digit negative outcome. Since the end of 2011, the New Zealand equity market has now delivered a staggering 128% total return. Remarkably, every month so far in 2017 has been positive. What is driving this and can it continue?

Since the March issue of New Zealand Insights, the one year forward price earnings (PE) for the New Zealand market has lifted slightly from 22.2x to 22.5x. Critically, however, the New Zealand 10-year bond yield has fallen from 3.24% to 2.79% over the same time period, thanks to a surprisingly sanguine RBNZ Monetary Policy Statement. Relative to bond yields, our market remains extremely expensive but it is at least no worse than it was three months ago.

Figure 14: NZX 50 - PE valuation



Source: FNZC

We are witnessing a 'Goldilocks' period, where the economic porridge is not too hot and it is not too cold. The temperature is just right and that is leaving the big bad bear hiding in the deep dark woods for now.

For the last several years New Zealand has experienced a period of economic growth which has been just strong enough to drive reasonable earnings growth but not so strong that it has sparked inflation and higher bond yields, which would be a major headwind for equities. This has combined with a global carry trade/quest for yield which has seen New Zealand's high dividend yielding (but high pay-out) companies bid up aggressively to much higher multiples of earnings than ever before.

In asking whether this continues, we need to consider the ingredients in the Goldilocks story. The first is whether New Zealand economic growth continues at just the right rate to drive earnings growth, without sparking tighter monetary conditions. Secondly, we have to consider the current global Goldilocks where the risks appear finely balanced between the emergence of inflation pressures in the US, the risks of a deflationary bust in China and what happens when quantitative easing-infinity ends around the world. Right now, all of these factors are in perfect balance for equities as they remain merely potential threats which are yet to materialise.

In looking at the first question, the New Zealand economy appears very solid. There is always a tremendous amount of noise in the plethora of economic statistics but we have found the long-standing ANZ Business Outlook survey to give an excellent lead on economic growth 9-12 months in the future. In May, firms' own activity outlook remained rock-solid at a reading of 38.3, suggesting solid Goldilocks-like levels of GDP growth will persist for some time yet.

Absent a left-field macro shock, we do see a couple of risk factors that could affect this. The most obvious one is that cracks are beginning to appear in the housing edifice in both New Zealand and Australia. Quotable Value data for Auckland suggests prices rose

just 0.1% in the May quarter, while depending on data source, the number of listings is up 50% versus sales that are down 10-20% on last year. A bid-offer spread has opened up. These moves are tiny in the context of the surge in recent years but their interaction with leverage could become interesting.

When one looks at the outstanding stock of mortgage debt across Australasia, a sizeable 39% of mortgages are interest-only. It is not just investors maximising their tax wedge, around 25% of all owner-occupier loans fall into this category. Worse, these loans grew most rapidly in 2015 and 2016. The hit to the consumer from a step-change up in mortgage repayments could be most interesting.

Banks only comprise 3% of the New Zealand equity market but the risks from higher than normal valuation multiples being applied to earnings that encompass cyclically low bad debt levels bear watching. This is far more of a factor for the Australian market.

More importantly, retirement villages are 7% of the New Zealand equity market and have had a halcyon few years thanks to booming house prices and sales. The impact from any future house price deflation on occupation contract resale profits is obviously negative, but we are also focused on balance sheet risk. When housing turnover slumps, it will be interesting to see if retirement inventory builds up and how the operators can fund such inventory if it does. It was this factor that saw the sector heavily punished in the aftermath of the Global Financial Crisis (GFC), although it has obviously taken off since then thanks to the housing boom. The manager is underweight this sector.

A major theme for the manager through 2016 was wariness on house prices but bullishness on housing volumes. This played out with exceptional performance from the likes of Fletcher Building (+44%). Interestingly, this has turned turtle in 2017 with three of the main players on New Zealand housing and infrastructure volumes all being disappointing performers (Fletcher Building -27%, Metro Performance Glass -31%, and Methven -17%).

A latent domestic risk factor that has attracted scarcely any attention to date is that New Zealand will be holding an election in September. We do not intend to predict the outcome but would observe that an unclear result could generate uncertainty for quite some time while coalition negotiations occur. Barring a National landslide, the policies of Labour and New Zealand First point to far lower immigration inflows, which would remove a key pillar of both the housing boom and New Zealand's GDP growth (which has been far less impressive on a per capita basis).

Moving to the global backdrop, a feature of equity markets globally in 2017 has been the vicious rotation into the 'Trump reflation trade' and then a gradual ebbing in recent months. Earlier expectations of higher wage inflation and bond yields have taken a step backwards, with implied inflation expectations from US inflation indexed bonds falling from 2.0% to 1.7% over May. Bond-proxy equities have thence rallied and this has been a most helpful tail-wind to New Zealand.

Our view is that the inflation bogey-man is coming but he isn't quite here yet. In the jargon, the Phillips Curve (which trades off inflation versus unemployment) is not dead, it is just more non-linear than it used to be post the scars of the GFC, the decline of unions, weak productivity growth and changes in labour-force composition. As evidence, US states such as Maine and New Hampshire where unemployment is 3% are seeing wage inflation of 4-5%.

This may seem a little esoteric but it really matters for the New Zealand equity market, with its huge weighting to bond-proxy type companies who offer high dividend yields but little growth. What happens to the infamous 'carry trade' if free money disappears when the Fed tightens 3-4 more times, US quantitative easing (QE) is reversed, stronger European numbers see an eventual tapering of their QE, and record low unemployment in Japan sees a reconsideration of their policies? The key counter-risk to all this is that extraordinary leverage ratios in China become less sustainable as their economy slows and a sharp deflationary risk-off episode ensues.

The crystal ball is murky but what is clear is that we are investing in unusual times and it will pay to be vigilant for the winds of change, whether they be sooner or later.

To conclude, little has changed since we last wrote in March. The New Zealand equity market remains historically expensive but Goldilocks is alive and well both domestically and globally. Ownership of New Zealand equities from yield-seeking offshore investors continues to climb to new highs but there is a very small door through which to exit in the event that something fundamental changes. The manager's focus remains on finding companies that stack up well on a bottom-up valuation basis and whose earnings outlook appears relatively solid in the face of potential challenges. Notwithstanding the occasional exception at the large cap end of the market, we are increasingly finding these opportunities in the mid cap space which has been rather left behind.

...while depending on data source, the number of listings is up 50% versus sales that are down 10-20% on last year.

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

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