JMI Wealth

Economic & Investment Market Review

June 2021

NZ Budget Implications

The New Zealand Government's budget for the coming year was revealed last month. The budget was of greater importance to investors this year as it was the first budget in which the Labour Party was able to implement its policies unencumbered by the competing demands of coalition partners. Despite the impact of COVID 19 over 2020 the government coffers were in better shape than feared. Taxation inflows have been higher than expected as the economy proved more resilient and actual government spending has been lower than planned as the government has struggled to implement initiatives such as construction of infrastructure. The Crown Settlement Account held $42 billion (a record level). The primary focus of the budget was 'social issues' which will result "*in the biggest lift in benefit payments in more than a generation*". In addition to benefit increases additional spending was provided for vaccine rollout, health, and housing acceleration. Although government spending will be increased, and net core crown debt is expected to peak at 48% of GDP in 2023 the ratio of government debt to GDP remains much lower than other countries. Broad fiscal strategy remains unchanged and proposed additional spending will provide further stimulus as it is likely that the additional benefit monies will be consumed. Other initiatives such as an unemployment insurance scheme similar to Accident Compensation which could cost between $450 million and $5 billion remain embryonic. The efficacy of the budget is dependent on the veracity of underlying assumptions and some variance is evident between the Treasury assumptions and those subsequently adopted by the Reserve Bank. Ultimate effects will take several years to emerge. Notably prior to budget the government has also introduced a curbing of salary increases for public servants which if implemented will offset some of the consumption stimulus arising from increasing benefits.

For fixed interest markets the budget's projections had mixed implications. Gross bond issuance over the next few years has been reduced however short-term issuance is higher than market expectation. The government will introduce a new 30-year bond in the second half of 2021. This may create pressure on longer term interest rates.

RBNZ Monetary Policy Statement

The RBNZ also issued its most recent monetary policy statement in late May. The RBNZ left its various direct monetary policy tools e.g. the OCR unchanged. However, the MPS was significant in that the RBNZ acknowledged the possibility of official interest rates increasing during 2022 with an explicit projection for the OCR to increase by 0.25 percent in June/September 2022. This projection is earlier than previously forecast. The RBNZ adopts differing assumptions in relation to inputs such as unemployment levels and house prices compared with those of Treasury. Potentially the lift in the OCR places New Zealand at the forefront of countries contemplating a rise in rates indicating that New Zealand's economic cycle is not as synchronised with other economies as it has been.

KiwiSaver Changes

The government will also implement changes in respect of the Kiwisaver scheme which may have flow on implications for investors. The number of default providers has been reduced and members in default conservative schemes making no election will be switched to balanced portfolios. The sums involved are not inconsequential and over $3 billion in funds could be shifted if existing default scheme members make no election. A shift to balanced portfolios could result in net buying of New Zealand equities of around $400 million and a greater value of international shares.

New Zealand Share Market

A group of New Zealand listed companies reported in May. Fisher & Paykel Healthcare is New Zealand's largest listed company. The company reported record revenue, up 56% and profitability, up 82%. Despite the record results the share price in the immediate aftermath has declined as the company failed to meet high market expectations. A2 Milk which was at one time the second largest company by capitalisation continued its fall from favour. In early May the company's trading update confirmed a further fall in earnings and a significant stock write-off. Also in the dairy sector Fonterra announced a review of its capital structure which may see the organisation withdraw from publicly traded equity markets. In contrast Mainfreight which has become a global logistics provider continued to thrive. Revenue grew by $448 million and net profit increased to $188 million up 27%. Fletcher Building provided a positive market update guiding investors expectation to the top end of its previously advised EBIT range and announced a $300 million on-market share buyback.

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Although there has been some strong performance from individual companies the New Zealand market index has been driven down by the weaker share price performance of A2 Milk and Fisher & Paykel Healthcare. As a result, index performance is out of step with other countries particularly Australia. Other equity markets have experienced modest positive returns whereas New Zealand is negative for the year to date.

International Trends

The United States share market continues to strengthen as vaccination rates increase, the Federal Reserve maintains monetary easing and fiscal measures gain momentum. The US budget proposes US$6 trillion of additional spending and projects budget deficits of approximately US$1.4 trillion per year until 2027. Although the deficit spending is large as a proportion of GDP, the ratio falls to 24% from 32% in 2021 and is modest compared with most countries.

International trade tensions continue and if anything, conflict between China and Australia has ratcheted up in recent months. China has introduced an 80% tariff on Australian barley and Australia is now taking World Trade Organisation action against the PRC. Iron ore is the main traded commodity between the two countries and in respect of this commodity Australia appears to hold the upper hand with price per tonne bid up to over US$200/tonne. BHP, Rio Tinto and Fortescue have been the main beneficiaries of this squeeze and it will take several years for China to source ore elsewhere at competitive prices. The Australian mining companies should be able to provide very healthy dividend yields even if the underlying iron ore price falls back over the next few years.

China remains a strong driver of economic growth even though its economy is refocussing from external export led growth to internal consumption as the main driver of economic activity. Chinese public companies may be attractively priced relative to other bourses but have their own set of issues. China's regulatory authorities are increasingly exercising their power in respect to technology companies use of market power similar to trends in North America and Europe. A considerable challenge for China in maintaining its economic momentum is demographics. Although the population of 1.4 billion is 4 times that of the USA the working age population shrank by 5 million in the last decade. Nevertheless, Chinese citizens have 241 trillion yuan of investable assets which will continue to be a global driver of financial wealth. As China experiments with innovation such as digital currency it is likely to be a leader in some technology fields. Given the importance of China as a trading partner and investor it will be challenging for New Zealand to navigate a path between it and New Zealand's other primary trading partner Australia.

Conclusion

The extent of inflation and the degree of persistence remains a key issue for investors given its impact on interest rates, subsequent individual company trading performance and market valuation. Markets are yet to reach a position of conviction on this issue. Prudent portfolio positioning needs to account for a range of outcomes. Although interest rates may lift in response to inflation the magnitude in absolute terms may be small. Fixed income still plays a role in capital preservation particularly during crisis events. Should the inflation impulse prove transitory then the worst effects of rising rates may be behind us. If, however rates lift more rapidly and to higher levels than currently priced by the market then fixed income outcomes could be disappointing. In order to mitigate against this a shorter fixed income duration continues to be appropriate.

Opportunity still exists in shares in an inflationary environment. Companies with pricing power should be capable of defending margins. Accompanying inflation should be reflation associated with opening economies and excess savings. These circumstances should be beneficial to cyclical companies. To an extent profitable growth companies' valuations have already reset for a higher rate environment and real growth will continue to boost value. Therefore, a balanced allocation between growth and value shares appears appropriate. A balance between share exposure and cash/fixed interest also continues to be relevant.