PERSONAL INVESTMENT CENTRE
FINANCIAL PLANNERS AND INVESTMENT ADVISERS

Economic Commentary

18th April 2024

The first quarter of the year has been solid, with portfolios continuing to rise and adding to the gains from the last couple of months of 2023. This has been despite the latest data suggesting that inflation is going to be a stubborn enemy to defeat. Wholesale interest rates have risen since January, which has intensified over the last couple of weeks. It is now increasingly likely that interest rates will remain at current levels for a longer period of time. This is going to prove challenging for many in the short-term, particularly in NZ as the economy appears to be slowing rapidly. From an investment perspective, the overall trend of a declining interest rate environment over the next 12-18 months is still intact, albeit with less certainty around the timing of rate reductions.

Share markets	**Performance – NZD**	
	3m	**12m**
NZX 50 (NZ)	2.8%	1.9%
ASX 200 (Aus)	6.4%	16.7%
S&P 500 (USA)	16.8%	35.9%
Shanghai (China)	6.4%	-4.8%
Euro 50 (Euro)	16.6%	25.8%

Interest Rates	**10-yr Govt Bonds**	
	Mar 24	12m ago
NZ	4.54%	4.20%
US	4.20%	3.47%

There has been a consistent run of economic data released in NZ, the US, and globally since the beginning of the year which suggests that inflation is persisting at higher levels than many had expected. In NZ, the latest Consumer Price Index (CPI) figures for the March quarter showed an annual rate of inflation of 4.0% and a quarterly number of 0.6%. While this continues on a downward path (falling from 4.7% for the year to the end of December), it was above the projections of the Reserve Bank. The devil is also in the detail. Non-tradeable inflation, which is the part which reflects NZ domestically driven pricing, is still at 5.8% for the 12-months and well above both expectations and the long-term target. Unfortunately, it is the unavoidable costs which are biting the hardest for most people. Whilst the increase in food prices has flattened out (although not fallen!) rents, insurance, and council rates are pushing ever higher. It remains highly unlikely that the Reserve Bank will look to increase the Official Cash Rate again, but it is now looking equally unlikely that they will make any cuts until next year. This means that mortgage rates may remain around current levels for some time yet. Most borrowers have now rolled off previous fixed terms which were locked in at the lows of a couple of years ago, and the significant increase in mortgage payments is seriously hurting disposable income. Retail sales and spending on hospitality (restaurants, bars etc) is declining on a per-capital basis. This reduced demand means that the NZ economy is now in recession, with two quarters of negative growth. It is likely to be a tough year for many with unemployment set to rise.

While NZ is suffering the twin difficulties of stubborn inflation and recession, the US economy is still powering ahead with growth of 3.2% in 2023. While the US has seen the same level of increases in interest rates, the economy is seemingly resistant to the typical slowdown that this brings. Employment remains strong, retail spending is solid, and the overall picture remains healthy. It really is something of a mystery as to how and why the US economy is holding up so well. A couple of years ago the expectation was that a recession would be seen in the middle of 2023, but this never eventuated. However, the strong economy is making it difficult to bring inflation down to target levels. Expectations now are for the US Federal Reserve to start to reduce rates later in the year, which has been progressively pushed back from March. Again, it would not surprise us if the first rate cut doesn't eventuate until the first quarter of 2025.

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Given the stubbornness of inflation and the likelihood of rates remaining as they are for a longer period, it will also not surprise us if we see a pull back in markets over the next couple of months. Already we have seen some weakness in April. The strong run since the beginning of November has been somewhat overdone, in our view, on an overly optimistic view that rates will come back more quickly than we thought was ever likely. However, we also believe that the longer-term trend of a gradual decline in inflation back to the target of around 2%-3% remains intact overall. This will lead to declines in interest rates at some point over the next 12 to 18 months. The uncertainty is around timing, which is something that nobody can predict. The NZ Reserve Bank is in an unenvious position. Their core mandate is to keep inflation low and stable around the midpoint target of 2.5% over the medium term. However, with the NZ economy clearly starting to suffer, pressure will mount to relieve some pain by starting to bring rates back down. If they do so before inflation is truly under control and it rears its head again, this would be a significant problem.

Much of the improvement in the equity (share) parts of portfolios over the last five months have been from the international side, and especially from US markets. These are now looking a little stretched, particularly given the strength of the inflation numbers. If we do see something of a pullback over the next month or two, this may be an opportunity to dollar-cost average in on the belief that the long-term trend is still in play. However, we would take this carefully. There are still geopolitical issues at the forefront in the Middle East and Russia which warrant caution. We continue to believe that fixed interest is attractive and will look to lock in good rates over a spread of maturities, but certainly some for longer periods. Although medium and long-term rates are lower than short-term ones, this reflects the expectation that rates will fall over the coming year or two. For example, if the 12-month rate is 6% and the two-year rate is 5.50%, this means that the 12-month rate in a year's time would need to be below 5% for the two-year term to provide a better average return over the period than two successive one-year terms. We take these calculations into consideration in our recommendations.

"Inflation is taxation without legislation" – Milton Friedman