PERSONAL INVESTMENT CENTRE
FINANCIAL PLANNERS AND INVESTMENT ADVISERS

Economic Commentary

15th August 2024

Share markets	Performance – NZD	
	3m	**12m**
NZX 50 (NZ)	3.7%	2.9%
ASX 200 (Aus)	6.2%	14.4%
S&P 500 (USA)	9.3%	27.8%

Interest Rates	10-yr Govt Bonds	
	Jul 24	12m ago
NZ	4.40%	4.73%
US	4.10%	3.97%

Another eventful quarter has resulted in generally solid results for the three months to the end of July. Wholesale interest rates have continued to decline as inflation figures move closer to long-run targets of around 2%, and this has buoyed markets. From the middle of July, we have started to see a gradually rotation in sharemarkets with investors beginning to move from an overconcentration in US technology companies to a broader view. Since the beginning of August there have been dramatic developments with a sharp market decline followed by an equally quick bounce back, and the NZ Reserve Bank somewhat unexpectedly cutting the Official Cash Rate. For those with a passion for investment and economics, it has been a fascinating period!

After some unexpectedly high inflation figures in the first quarter of the year, inflation has resumed its gradual decline and is continuing to move toward target ranges of around 2% per annum. The latest numbers from the US indicate that over the 12-months to the end of July, consumer prices increased by 2.9%, which was the lowest rate since March 2021. While the US releases CPI inflation figures monthly, Stats NZ only release our figures on a quarterly basis. Inflation in NZ was 3.3% for the year to the end of June, and there is general expectation that it will move into the Reserve Bank target band of 1%-3% when the figures for the September quarter are released in October. Overall, this is good news, and markets have reacted well. Sharemarkets continued an upward trend through the last 3 months, and wholesale interest rates declined quite significantly. Unlike retail rates offered by banks for savings and term deposits, the wholesale interest rate market moves rapidly in response to new economic data, particularly around inflation. As wholesale rates have fallen, the value of bonds and fixed interest funds in portfolios have increased, producing good returns.

A couple of developments at the end of July and beginning of August threw markets into a bit of a tailspin. Data on new jobs is released in the US on a regular basis, and these numbers for July showed a rise of only 114,00, compared to expectations for the month of around 160,000. Along with some other data, markets took this as a sign that the US economy is slowing and perhaps moving toward recession. This was coupled with developments in Japan. For the last 30 years the level of inflation in Japan has been virtually nil, due to a combination of factors including an aged demographic and relatively smaller worker-aged population. This has meant that interest rates have been also effectively zero. With interest rates much higher in the US and other countries, institutional investors have been taking advantage of what is known as a “carry trade”. This involves borrowing in Japanese Yen at a low interest rate, converting to USD (or similar), and investing the proceeds at higher interest rates. Because interest rates in Japan have been low compared to the US, the Yen has been weak. However, with inflation picking up, the Bank of Japan recently increased their cash rate slightly. This caused the Yen to increase in value, and the carry trade began to unwind. The effect of these two developments led to a massive fall of 12.4% in the Nikkei (Japanese sharemarket) on 5th August, the most in a single day since 1987. The effect spread with other markets also falling sharply. In our view, the reaction was massively out of proportion to the underlying causes, and we wonder if computer

trading was a major factor. These "algorithms" tend to follow the herd, making movements more extreme. In any case, markets bounced back very quickly, with the Nikkei back up 10% the following day and most recovering to now be back to similar levels as previously.

The NZ Reserve Bank (RBNZ) surprised most economists (and ourselves) by reducing the Official Cash Rate (OCR) from 5.50% to 5.25% at their meeting on 14th August. This is the first cut since rates started to increase in late 2021. The surprise was due primarily to the significant change in direction. At their meeting in May, the RBNZ actually indicated that there could be a further increase in rates this year, and that the first cut wouldn't happen until mid-2025. Although the NZ economy has slowed up further since then, this is largely in line with what the RBNZ expected in their May report. It seems that somewhere between then and now, the RBNZ committee have had a bit of a rethink! We expected a hold but with an indication that a cut will happen prior to the end of the year. Ultimately, we don't disagree with the cut and from a portfolio perspective it is welcome. But such a change in direction undermines the credibility of the Reserve Bank, which should be about stability and transparency in decision-making. The new projections are for the OCR to come back to a neutral position of 3% over the next three years. If so, that would likely bring 12-month term deposits to perhaps 3.5% – 4% over that time. The news media is already breathlessly anticipating the housing market to jump and the economy to transform overnight. In reality (to which the media seems to only bear a passing resemblance), changes in monetary policy take time to flow through.

The government's "tax cuts", as the media and politicians like to refer to them, took effect at the end of July. In fact, these represent a relatively modest adjustment to the income thresholds at which the different tax rates kick in. This last occurred in October 2010. What we have seen since is underlying increases in the proportion of income tax paid by individuals as general inflation has pushed taxpayers into higher tax brackets (known as "fiscal creep"). In the year ended June 2011, a person on the median full-time wage/salary earned $48,024 and paid $7,427 in income tax. This is an average tax rate across their income of 15.5%. For the year ended June 2023, the median income for the same person was $73,417 and they paid $15,418 in income tax, or 20.6% of their income in tax. Of course, the increase in earnings was mostly due to inflation, so the growth in actual purchasing power of the taxpayer was relatively minor. What we have essentially seen is an increase in taxation by stealth. Under the government's changes to the brackets, a taxpayer earning $73,417 will pay $14,246 in tax, or 19.4% of their income, still well above the 2011 level. Of course, the question of whether these changes to the brackets are affordable or desirable in the current economic climate is a different question altogether! However, it would be nice to see some transparency around the debate.

Portfolios are well positioned with strong fixed interest holdings offsetting the decline in rates. In shares, the funds we employ are very well diversified and have lower exposure to US shares and the technology sector than global benchmarks. We remain comfortable with our settings in this ever-changing environment.

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