

## Economic Commentary

16<sup>th</sup> July 2024

The June quarter was generally up and down, with portfolios bouncing around with inflation and interest rate expectations as new economic data has been released. Further progress is being made in the fight against inflation, but in NZ this is taking a toll as the economy is looking bleak. The environment is certainly challenging for many mortgage holders and business owners. The NZ government budget was much as expected, with adjustments to tax thresholds being the main announcement. From an investment perspective, the US markets continue to be the bright spot with strong overall performance, although this is being driven by a relatively small group of technology companies.

Markets now expecting rate cuts in both the US and NZ before the end of the year, with 2 cuts priced into wholesale interest rates in both countries by the end of the year.

Share markets	Performance – NZD	
	3m	12m
NZX 50 (NZ)	-3.2%	-1.7%
ASX 200 (Aus)	-0.6%	13.1%
S&P 500 (USA)	2.4%	25.2%

  

Interest Rates	10-yr Govt Bonds	
	Jun 24	12m ago
NZ	4.67%	4.54%
US	4.34%	3.82%

After some unexpectedly high inflation figures in the first quarter of the year, inflation has now resumed its gradual decline but at a slower pace than hoped. The latest numbers from the US indicate that over the last 12-months consumer prices increased by 3%, which is now approaching the long-term target range. While the US releases CPI inflation figures monthly, Stats NZ only release our figures on a quarterly basis, and we await the June figures. The Reserve Bank (RBNZ) expects these to come in at around 3.6%, although most economists are picking closer to 3.3%. In their recent monetary policy statement, the RBNZ was certainly much less “hawkish” than previously, which has led the wholesale interest rate markets to expect the first OCR cut before the end of the year. This is a big change from just a few months ago, when it was looking much more likely that rates would be on hold until 2025. Even though the timing is still uncertain, what does seem clear is that interest rates have peaked, and the next move will be down. So, as we have been mentioning for some time, locking in some good rates on fixed interest holdings over a longer period will prove to be a positive for portfolios as rates fall over the next couple of years.

The new government’s first NZ Budget generally produced few surprises. The most discussed aspect was the “tax cuts”, as the media and politicians like to refer to them. In fact, what was announced was 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

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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.

Although there are certainly political tensions in NZ, they at least are relatively less dramatic than what is occurring in other parts of the world. The UK has just seen a landslide victory for the Labour party after 14 years of successive Conservative governments. French elections are ongoing, and the outcome remains uncertain, but there has been an increase in support for right-wing parties (as there has been in general throughout Europe). The most significant global election taking place this year is in the US in November. We are quite often asked as to the implications of the US political environment on markets and portfolios. The election cycle usually causes some short-term volatility in markets, and the effects are uneven depending on the policies of the candidates. The political influence on markets is driven mostly driven by fiscal policy (spending intentions and the impact on government debt) and foreign policies. Ultimately, however, the path of inflation and interest rates over the coming few years will be a more important influence on the performance of markets. Of course, as recent days and the attempted assassination of former President Trump have shown, there can always be “black swan” events which come out of the blue and throw all predictions out the window!

In this environment, we continue to manage portfolios cautiously, with a slightly underweight position to shares and correspondingly a small overweight to fixed interest. However, we do have some optimism that the economic cycle may be approaching a bottom and interest rate cuts will lead to improving conditions in time. The quality fixed interest holdings that we have added over the last couple of years will underpin returns going forward. Whilst short-term deposits have offered good rates at present, there is significant reinvestment risk in adopting an exclusively short-term strategy given the likely future path of interest rates, and it is for this reason that we have introduced longer-term holdings and a greater spread of maturities.

**“Money grows on the tree of persistence” - Japanese proverb**

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