Harbour Outlook

January 2024 Investment Outlook

December Review

The US Federal Reserve (“Fed”) performed an unexpectedly “dovish” pivot at its December meeting and markets now anticipate a "soft landing" where inflation returns to 2% without the Fed having to inflict severe economic damage, opening the gates for a flood of cash into equity markets. The so-called “Fed pivot” saw capital markets quickly focus on when and by how much the Fed and other central banks would cut interest rates. After a lower-than-expected core inflation reading, institutional and retail investor money came off the sidelines from money market funds into equity markets on expectations that the currently high yields offered in money market funds would fall early in the first quarter of 2024. This flood of capital contributed to a broadening in sector performance with all ACWI sectors apart from energy positive for the month.

Locally, the New Zealand share market delivered a solid return over the December month supported by the fall in government bond yields over the month. The market saw the negative impact of earnings downgrades during the period from consumer cyclical companies offset by lower bond yields and a flurry of merger and acquisition (M&A) proposals that highlighted valuation anomalies. The best performing New Zealand sectors for the month were information technology (+16.5%), consumer staples (+8.2%), and real estate (+7.3%). The worst performing sector over the month was energy (-2.5%), driven by a block sell-down of shares at a discount.

The "soft landing" view is not unique to the US with economists expecting a version of that to occur for much of the world next year. A lot needs to go right for economies to stick the soft landing. Since the 1960's, for example, central bank tightening of more than 400bps is almost always followed by recession, though the starting point for policy rates this time was particularly low. Tight labour markets are generating wage growth that is keeping services inflation too high for comfort. Forward labour market indicators suggest wage pressures should continue to ease, but if they don't, central banks may have to resume tightening cycles or keep rates higher for longer than markets currently assume. Ongoing consumption growth is another risk to the soft-landing narrative, particularly in the US, and may require central banks to further tighten financial conditions to reduce demand.

The New Zealand economy is in much worse shape than previously thought and tight monetary policy appears to be working. Q3 GDP data showed the economy unexpectedly contracted 0.3% in the quarter and negative historical revisions meant the economy is 1.8% smaller than the Reserve Bank of New Zealand (RBNZ) had assumed in its most recent November MPS. The big signal here is that monetary policy is working better than previously assumed and, despite the large influx of migrants, activity is not holding up particularly well. On a per capita basis, it's awful, with GDP down more than 3% over the past year. All else equal, these data should lower the RBNZ's OCR forecast when we see it next. However, we still have inflation and labour market data before the RBNZ meets next at the end of February.

Market Outlook

Bond and equity markets have been trading in a highly correlated fashion over the last several months in both directions and, on some metrics, they've been around their most correlated in decades. Anyone who has looked at the history of these two markets will know this tight relationship probably won't last forever as such correlations are unusual.

Over the past two years, investor interest has been focussed on how to navigate a "hawkish", rate increase biased, central bank policy. A more balanced monetary policy setting with official rates not being increased rapidly, and company earnings expectations finding a base locally provides a more constructive framework for local share market returns. The local New Zealand and Australian share markets are starting to offer a useful alternative for income-focussed investors after the sharp drop in long-term government bond yields over the last few months.

Our economic base case remains for an orderly slowing in global economic activity (resilient but including potential technical recessions), rather than deep recession. If the next step lower in inflation proves stickier and inflation rates remain above central bank targets, then the move in bond yields may have overshot near term. In contrast, recession risks may be being underappreciated by equity investors. We would not be surprised to see bond yields oscillate around current levels reflecting economic data points and expect equity market volatility will increase as bond markets land on how far and how fast interest rates need to fall – just as the ride up in interest rates was volatile for share markets so too will be the ride down in interest rates. We still think more RBNZ rate cuts can be priced for this year, and the market-implied trough for the OCR is too high at 3.5%, but the recent decline in interest rates has delivered market pricing that better reflects the balance of risks, in our view.