



**ANZ INVESTMENTS 2023  
MARKET OUTLOOK**

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### THIS DOCUMENT IS INTERACTIVE

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# 2022: A CHALLENGING YEAR ACROSS THE BOARD

As we reflect on 2022 it reminds us that, throughout history, investors have always faced periods of challenge. In 2022, those challenges stemmed mostly from inflation. Amongst developed countries, many saw annual inflation hit multi-decade highs, a result of post-COVID supply-side constraints, tight labour markets pushing up wages, and as the war in Ukraine pushed global energy and food prices sharply higher.

Against this backdrop the world's central banks began hiking interest rates, and they did so at a record-setting pace. In the US, the Federal Reserve (the Fed) lifted the fed funds rate by 425 basis points (or 4.25%), while at home, the Reserve Bank of New Zealand (RBNZ) raised the Official Cash Rate (OCR) by 350 basis points (or 3.50%).

Rising interest rates meant bond investments fell (as they tend to underperform in that environment), and equities also struggled as companies faced rising costs – notably from wage bills and higher borrowing costs.

The technology sector, which had flourished for more than a decade in the low-interest-rate environment, was hit the hardest as rising bond yields pushed up the risk-free rate – meaning the valuations of these companies declined. Furthermore, investors have started revising down expectations for earnings growth for some companies given the more challenging economic environment.

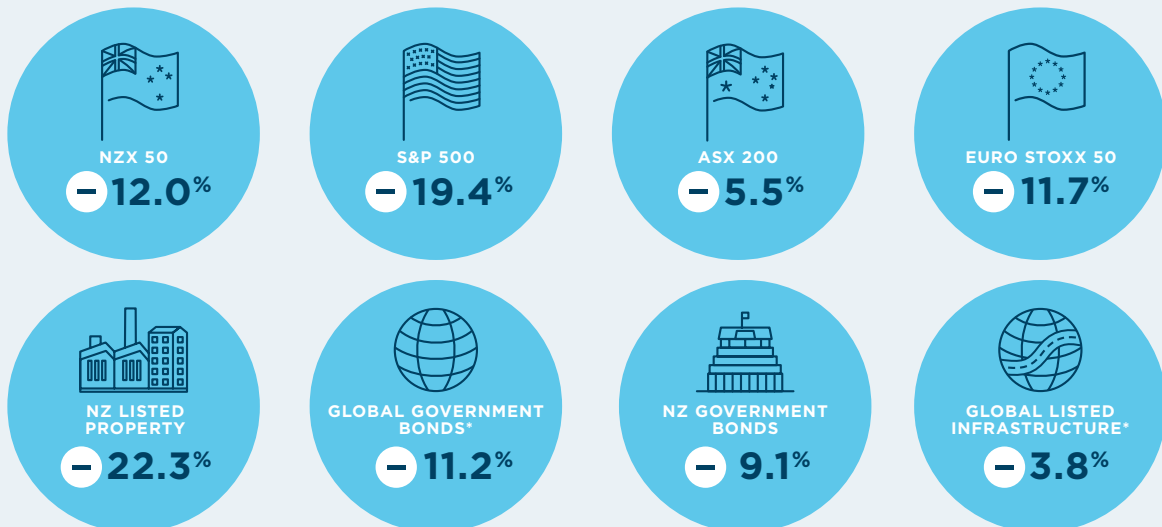
It meant that in 2022, the tech-heavy NASDAQ 100 Index fell 32.97% – its worst year since 2008, while the broader S&P 500 Index ended the year down 19.44%. Closer to home, the NZX 50 Index fell 11.97%. However, in Australia, the ASX 200 Index outperformed most global counterparts, falling just 5.45%, as its exposure to the energy and materials sectors was buoyed by a recovery in oil and other commodity prices.

For bonds, it was even more of a historic decline, with the Bloomberg Barclays Global Aggregate Index (Total Return, hedged to the New Zealand dollar) falling 11.75%, its worst performance since the inception of this index.

Nevertheless, 2022's equity market losses came after three consecutive years of double-digit gains for the S&P 500 Index – two of those being of more than 25%. And as for bonds, for more than a decade they had played an integral role in a diversified portfolio, offering investors a steady income stream and protection during times of heightened volatility.

As we look ahead to 2023, uncertainty remains high. As shown by the emergence of shocks over the last few years, such as COVID-19 or the war in Ukraine, it's hard to know what's around the corner. However, while challenges remain, there are many things to be optimistic about. Unpacking what the future holds for global investment markets, here's ANZ Investments' 2023 Market Outlook.

## AGAINST A BACKDROP OF HIGH INFLATION AND RISING INTEREST RATES, GLOBAL EQUITY AND BOND MARKETS FELL



\* Hedged to NZD.

# INFLATION TO MODERATE AND CENTRAL BANKS TO SLOW THE PACE OF RATE HIKES

...but we don't expect a shift away from inflation-taming policy.

Inflation, and how central banks navigate it, will remain key in our assessment of the outlook for equities, bonds, and the broader economy. In 2022, rates of inflation remained stubbornly high due to a combination of lingering supply-side issues, soaring energy costs, and elevated housing-related costs – namely rents and building costs.

However, it now appears that inflation in most developed countries has peaked, with many of the aforementioned drivers of inflation showing signs of easing.

Looking ahead, we expect this to continue into 2023, where headline annual inflation in the US will likely drop to somewhere in the range of 3-4% by the second half of 2023, down from the 7.1% in November 2022. Meanwhile, in New Zealand, pricing pressures appear to be a little stickier – and very reliant on global factors – but we expect a decent pullback from the current 7.2% rate of inflation.

Policy makers are also optimistic. The Fed, which prefers to look at the core personal consumption expenditures (PCE) measure of inflation, expects it to drop to 3.1% in 2023, down from 6% in October, while here the RBNZ expects the Consumer Price Index to fall to 5%.

Nonetheless, we are often asked – what could cause inflation to remain high?

The key risk would likely be a wage-price spiral. In the post-pandemic recovery, we saw a shortage of labour, which increased the bargaining power of workers, driving up wages. While we expect the labour market to loosen to some

degree, if this is not the case, there is a risk that ongoing wage pressures force businesses to raise their prices to make up for their escalating labour costs, further fueling inflation.

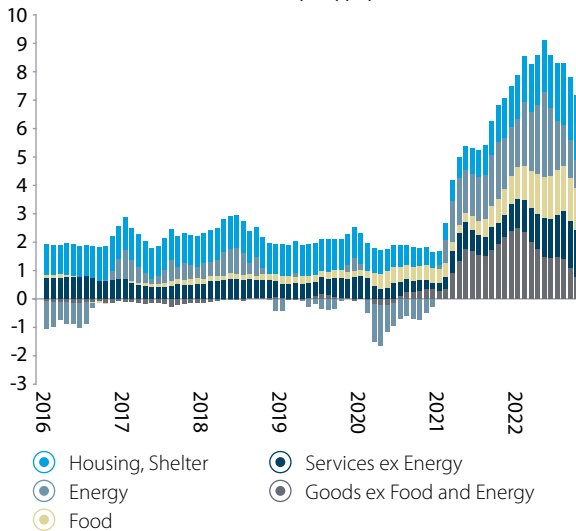
While we expect inflation rates in most developed countries to slow, we don't expect a marked shift in central bank rhetoric away from a focus on returning inflation to their target levels.

As some policymakers have noted in the past few months, an over-tightening that leads to a growth slowdown and/or an increase in unemployment, is a better trade-off than an under-tightening, where inflation would become entrenched. As witnessed in the 1970s and 1980s, entrenched inflation – particularly inflation expectations – brings more widespread and longer-lasting consequences.

Moreover, central bankers have policy levers to fight a growth and employment shock, notably monetary policy easing (a reduction in interest rates), whereas an under-tightening could lead to much higher interest rates in the medium to long term, which ultimately requires a higher economic cost to bring under control.

*“Given this, we expect central banks to continue to raise their key interest rates into restrictive territory. Last year, the focus was on inflation and central bank reactions to inflation; this year the focus will be on the impact of higher interest rates on consumers and businesses.”*

A breakdown of US inflation (CPI)(%)



Source: US Bureau of Labor Statistics.



Maaïke van Tol, Head of Asset Allocation at ANZ Investments

There is a concern that factors such as deglobalisation, ageing demographics, labour shortages, and higher costs brought about by reducing carbon emissions to limit global warming to 1.5 degrees Celsius, could result in inflation being structurally higher. If this proves to be the case, this may require a less accommodative monetary policy stance than in the decade following the Global Financial Crisis.

# THE CHANCE OF A RECESSION IN THE US IS GROWING

...however, a deep recession is unlikely.

Looking back to 2021, global growth in most developed countries flourished, as the post-COVID reopening and pent-up demand saw GDP figures surpass expectations. However, in 2022, as central banks began to raise interest rates, we started to see growth rates slow as concerns about the level of economic activity in a rising interest rate environment began to set in.

This year, in the US, following 425 basis points (or 4.25%) of interest rate hikes by the Fed, we expect the cumulative effects of policy tightening to weigh on the country's pace of growth, which could tip the world's largest economy into a mild recession.

As economies ebb and flow, several characteristics are consistent in each economic slowdown. Some feature early in the cycle, and some later on. When we look at the US economy, there are indications that some of these factors are already at play.

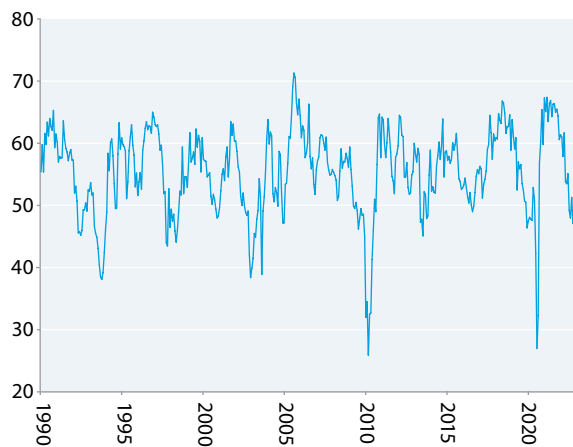
Beginning with housing, much like most other Western countries, US house prices surged in 2020 and 2021, driven by record-low interest rates and demand for more space as remote working took off. However, as the Fed began its tightening cycle, mortgage rates in the US increased at a rapid pace. The average US 30-year mortgage rate more than doubled, from below 3% in mid-2021 to above 7% in the final quarter of 2022. Eventually, and somewhat inevitably, this saw house price growth slow, then fall. According to the S&P CoreLogic Case Shiller House Price Index, US house prices have declined each month from their June 2021 peak.

We are also starting to see a slowdown in new orders in the manufacturing sector – which tends to be indicative of an economic slowdown. According to the Institute of Supply Management, the new orders component of its December survey was 45.2. A reading below 50 indicates a contraction and it's the fourth consecutive monthly reading below this level, and is down from a high of 61.7 in February 2022.

If this trend continues, we can expect slower orders and higher wage and interest costs to pressure company earnings. Some companies have provided cautious guidance during the last reporting season, and analysts have started to revise expectations for a small fall in earnings growth in the next quarter, while still expecting growth over 2023. However, if the operating environment continues to worsen, we can expect a larger fall in earnings growth.

Finally, we can look at the labour market. To date, this has been one of the pillars that has held the US economy together. Despite rising prices hitting consumers in the pocket, the tight labour market and strong wage growth has meant that consumers have been able to absorb their additional costs. However, while the labour market remains strong (the unemployment rate is still near record-low levels and wage growth is still rising, albeit at a slower pace), we are starting to see signs of a potential crack; large technology companies have started laying off workers, while others have put hiring freezes in place.

**US ISM Manufacturing New Orders**



Source: Institute for Supply Management.

“We believe a recession in the US will be shallow. During the pandemic there was a solid accumulation of household wealth; asset prices rose, wages increased, the social safety net improved, and stay-at-home measures saw spending slow. Against this backdrop, we believe the chance of a deep recession is low.”



*Armand Grewal, Senior Investment Strategist at ANZ Investments*

# HOUSING DEBT, COST OF LIVING, AND A GENERAL ELECTION

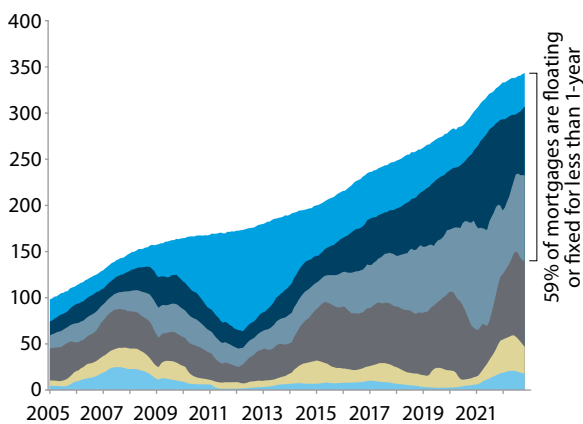
## A busy and challenging year ahead for New Zealand.

New Zealand's economy proved resilient in 2022 thanks to the high level of monetary and fiscal stimulus offered during the post-COVID recovery. However, it has not been immune to the high levels of inflation seen elsewhere, driven in part by rising wages, and imported inflation, which was exacerbated as the New Zealand currency fell.

In response to the inflation concerns the RBNZ tightened policy well into restrictive territory, and more interest rate hikes are on the cards in 2023. It expects the OCR to reach 5.5% in 2023.

Although we believe the OCR may not reach that level, we expect the cumulative tightening already seen to pass through to the economy via a lag – which will be most notably felt in the housing market, with flow on impacts to discretionary spending and the employment sector, as businesses struggle with elevated borrowing costs.

### Residential mortgages by fixed term (\$NZbn)



- Fixed 3yrs+
- Fixed 2yr to <3yr
- Fixed 1yr to <2yr
- Fixed 6mths to <1yr
- Fixed <6mths
- Floating

Higher interest rates are likely to have a more sizeable impact on housing in New Zealand than in overseas markets, with many households still to roll off super-low mortgage rates. As of 30 November 2022, 59% of mortgages are floating or have fixed terms of less than one-year.

Source: ANZ Research.

Residential property has already had it tough, with nationwide house prices down 11% from their November 2021 peak. In its latest Monetary Policy Statement (MPS), the central bank predicts house prices to fall by 20% from peak to trough, meaning we're only part way through their decline.

Meanwhile, the headwinds consumers and businesses are facing are showing up in consumer and business confidence surveys, with headline numbers hovering near multi-decade lows.

Given all this, we believe the New Zealand economy will face challenges in 2023. While growth in the third quarter of 2022 was stronger than expected at 2.0%, about 20% of GDP is related to construction, rental and real estate services, so a severe slowdown in the housing market is likely to be felt by the broader economy. In light of this and along with weak consumer confidence and a tightening of the purse strings, we can expect New Zealand to enter a recession in the second half of the year.

It's not all negative though. A recovery in tourism should help, especially over the summer. However, the biggest challenge for the sector (and for the broader economy) is the availability of workers. The labour market is tight as it is, and immigration settings are restrictive at best – despite the easing in restrictions for some sectors announced by the Government late in 2022.

Finally, the general election will likely add further uncertainty to New Zealand's financial markets later in the year. The Labour Party has been in government for two terms, but support for the party has recently dropped to its lowest levels since 2017 when Jacinda Ardern took over its leadership. The 2023 election will focus attention on the cost of living and spending – which itself is fueling inflation. Immigration is also likely to feature, given that a shortage of workers is contributing to some of the economic challenges the country is currently facing. And with both major parties looking even in the polling at the moment, the minor parties may, once again, play a role in deciding who will be in government.

"While the New Zealand economy is expected to slow down more severely than its peers, the make-up of the market should be supportive of its outlook. Due to a preponderance of defensive utilities and internationally-orientated businesses, a more potent driver of market returns could well be movements in long dated bond yields. This is because bond yields form a key component of the rate at which future earnings are discounted by investors. All things being equal, lower rates equate to higher equity valuations. As long dated bond yields typically fall when an economy is weak, this may offer some protection for investors."



Max Lesser, Fund Manager, New Zealand Equities at ANZ Investments

# RESPONSIBLE INVESTING

## Fund managers demonstrating stewardship for the assets they invest in will be an area of focus in 2023.

2022 was another year during which we saw significant changes take place within the responsible investment landscape. The developments have been swift; from the introduction of mandatory climate reporting in New Zealand (the first country in the world to do so), to the invasion of Ukraine and the global shock waves it has caused.

At the 2022 United Nations Climate Change Conference (also known as COP 27), we saw a breakthrough with the agreement to provide “loss and damage” funding for vulnerable countries that have been hit by climate disasters.

Meanwhile, in the US, some states announced contentious views towards the incorporation of environmental, social and governance (ESG) metrics in investment decisions. President Biden also signed into law the Inflation Reduction Act (IRA), introducing a US\$396bn package of climate investments that are estimated to cut US greenhouse gas emission by 40%, by 2030.

And closer to home, in September 2022, New Zealand joined the likes of the UK, Singapore, Japan and Australia by introducing ‘The Aotearoa New Zealand Stewardship Code’. We believe it’s a significant development in relation to investor stewardship in New Zealand.

### A strong foundation for stewardship in Aotearoa

ANZ Investments is proud to support The Aotearoa New Zealand Stewardship Code and be a Founding Signatory. The Code provides a framework for achieving the three interconnected goals of effective stewardship:

- to create and preserve long-term value for current and future generations
- to ensure the efficient management of capital whilst considering the best interests of clients and beneficiaries, and
- to contribute towards achieving sustainable outcomes for our environment, society, and economy.

There is strong alignment with ANZ Investments’ existing practices and approach, given the importance we already place on stewardship as part of our responsible investment framework. The Code outlines nine principles and provides a solid foundation for good practice in responsible investment in New Zealand.

### Active ownership through engagement and voting

One of key elements of stewardship is engagement. In 2022, ANZ Investments took big strides towards providing greater transparency of how we’ve engaged with companies, and where we’ve made progress towards desired outcomes. Find out more about some of the engagements we’ve undertaken in our inaugural [Stewardship Update](#).

Engagement is an iterative process that can take time. We will publish a summary of our engagement activity every six months to continue to demonstrate our progress in this area.

As New Zealand’s largest fund manager, we vote on particular issues relating to the companies we invest in. It’s one way to ‘have our say’ on the future direction of the company. It can be on matters such as electing directors to a company’s Board, executive pay and company disclosures. Each year, our portfolio managers, as well as the external fund managers we have chosen to work with, vote on thousands of different matters across the many companies our funds invest in – and we do this on behalf of our investors. In 2022, we:

- Voted on more than 6,000 unique proposals. Of these, over 400 were against management.
- Voted on proposals at over 200 meetings in the US, where a majority of the companies we invest in are based.

Another of the actions we took in 2022 was to make our proxy voting records publically available. You can view these records from over the last 12 months on the [ANZ website](#).

Stewardship is an important way for us to work with our investee companies to encourage responsible business practices and achieve better long-term outcomes for our clients. We look forward to continuing to support the Stewardship Code in New Zealand, and providing our clients with more examples of positive outcomes in this space.

“We think stewardship is key to great outcomes for our clients. It allows us to engage with the companies that we invest in with the aim of shaping their behaviour, and ensuring that our approaches to environmental, social and governance issues are aligned over the long term.”



*Helen Skinner, Head of Responsible Investing at ANZ Investments*

# THE FUTURE REMAINS UNCERTAIN – BUT OUR INVESTMENT THESIS REMAINS THE SAME

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Although many of the challenges that financial markets faced in 2022 will continue into 2023, there are reasons to be optimistic.

To begin with, following a year of declines, equity market valuations have fallen back to more attractive levels. While some investments have struggled in the challenging environment, others have held up reasonably well, meaning there has been great dispersion between the underlying performances of companies, sectors and geographic regions.

This means that, as an active manager, there are opportunities for us to invest in quality companies at attractive prices. Meanwhile, in fixed interest markets, with bond yields at near-decade highs and with the majority of central bank tightening seemingly behind us, bonds too offer a more attractive outlook than they have for many years.

As we look at the headwinds investors faced in 2022, some appear to be improving. Inflation in many developed nations appears to have peaked, and central banks look to be nearing the end of their hiking cycle – although a bias towards taming inflation will remain.

In saying all this, concerns around the fragility of society remain, with the war in Ukraine a humanitarian catastrophe. Meanwhile in China, rare protests against the authoritarian zero-COVID policy has forced the Chinese Communist Party to capitulate and reopen the economy, with a new wave of cases posing another risk to growth. Adding to geopolitical tensions is the division between the West, China and Russia, and whether this escalates further over the coming year.

Closer to home, we have a lot more to be optimistic about. As an economy, we have an abundance of low-carbon energy and healthier government finances than many. As a society, we have strong democratic principles which should help us to navigate the rising global social fragility.

As we wrap all this up, one thing that will not change is our approach to investing. We aim to invest in high-quality companies with robust balance sheets, while taking into consideration ESG risks and opportunities. We believe by doing this, with strong investment governance, we put our investors in the best place to be rewarded in the long term.





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