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New Zealand equity outlook 2025

Interest rates to remain the biggest consideration in the coming year

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5 December 2024

2024 was still a game of two halves

From a broader economic perspective, 2024 could easily be characterised as a year of two halves. We began the year with the official cash rate (OCR) at a sustained peak of 5.5% - as high as it had been since 2008 – and with the Reserve Bank of New Zealand (RBNZ) steadfast in its approach to keeping it there to see off inflation. Indeed, as we approached mid-year, despite the market already pricing in rate cuts, RBNZ Governor Adrian Orr was still expressing the need to stay this course until late 2025. But then, with nothing having seemingly changed, something did.

July's RBNZ Monetary Policy Statement sounded a suddenly less cautionary tone, and by August we had seen the first rate cut since early 2020—albeit by just 25 basis points to 5.25%. While this timing was a surprise to the markets, given that none of the underlying economic data had changed, it was nonetheless a welcome one, stimulating a near 10% rise in the S&P/NZX50 index by the middle of November.

At 25 basis points (bps), RBNZ's first rate cut in August was not the deepest. But even the following 50 bps cut in October, while continuing a change of direction, still felt more like an easing off of the handbrake rather than a pressing down on the accelerator towards less constrained times. Which is why, even with the further 50 bps cut made in November to finish the year at a two-year low of 4.25%, we anticipate 2025 to also be a year of two halves, both for the economy and company earnings.

There are a number of headwinds still to be navigated. Yes, tradeable inflation is now back in the RBNZ's comfort zone at around 2.2%, but non-tradeable inflation—such as insurance, rent, rates and electricity—remains stubbornly high. Alongside this, unemployment is yet to peak. We have record numbers of New Zealanders leaving the country, and there remains significant concern around what might happen if the New Zealand dollar weakens further and stays low for longer. Therefore, while the RBNZ has evidently committed to a rate cut cycle, the underlying fundamentals point to caution trumping confidence for at least the first six months of 2025.

Factors to consider for 2025

As we head into 2025, we have picked three key elements that we believe will have the greatest influence over market behaviour and performance: interest rates, the strength of the New Zealand dollar and geopolitical uncertainty.

Interest rates will undoubtedly remain the biggest consideration through 2025, and are therefore due our heaviest attention. For retail investors, Term Deposits have proved to be a highly attractive proposition, riding the inflationary winds to still offer returns of around 5% (albeit before taxes). But with rates now heading toward 3%, these same

investors will begin to seek more income from higher-yielding stocks. As we have already seen, interest rate changes have been a positive for the equity market, and so we anticipate seeing more retail capital flowing through to it.

Falling interest rates should also encourage greater activity of another kind. As rates go lower, so too does the hurdle rate for M&A activity. It has been notably quiet in 2024 in this regard, but do not be surprised to see the rumour mill start up and then to see some of our NZX companies subjected to buy-out bids before too long. Notwithstanding the still-prevailing headwinds, as investors we would demand full value for any sale as we see the potential for earnings growth through the second part of the year.

If you are looking for sector winners from falling interest rates, then the obvious picks are real estate-related. Commercial Real Estate has already shown signs of stabilising values across the board. However, it has to be said that tempering this somewhat are concerns around income: from occupancy in a still-weakened economy and from the removal of depreciation on buildings.

The retirement sector is also a beneficiary of falling rates and the encouragement this gives to the residential market. With values here again heading upwards, and an ageing population looking to downsize their home and upsize their lifestyle, demand for quality retirement units will continue to increase.

And so to our dollar. Spooked by the threat of what we might loosely call "Trumponomics", the kiwi dollar risks weakening further in 2025. This is potentially good news. But it could also be bad news.

On the positive side, a weakened dollar will be welcomed by our exporters, and in particular our dairy, meat and produce sectors. It is also helpful for tourism, which as has been proved before the wilderness years of COVID, is good for the wider economy.

But on the flipside, a weaker dollar is bad for importers as it could serve to undermine the RBNZ's efforts to dampen inflationary pressures. The potential irony here though is that if US president-elect Donald Trump follows through with his threat to impose heavy tariffs on China, the cause of our weakened dollar could also provide respite as China seeks to find a solution to its sudden oversupply.

All of which leads smoothly into our third key area of interest and influence: the geopolitical maelstrom that the world has gotten itself into. The impact of Trump's threatened tariffs is just one consideration for 2025, and indeed years ahead. Conflict in the Middle East and in Ukraine will continue to jeopardise the stability of oil prices. Furthermore, should China incur the wrath of the West with its own expansionist policy, then the impact of any global sanctions on our biggest trading partner would be felt severely in New Zealand.

So what does this all mean for market followers here? It is too early to see any green shoots of recovery for cyclical companies such as those exposed to the building sector. In fact, things could still get worse before they get better, particularly if unemployment continues to track upwards, and so we should not be surprised to see further downgrades in forecast earnings.

It will take time for lower rates to flow through and so we may not see company earnings pick up until the second half of 2025. The market has, of course, partially priced in this future state. But for the meantime, the smart money will remain in the sectors that have proved themselves most resilient to the changing economic landscape: data centres, renewable energy, retirement and healthcare.

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