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Yovich & Co. Market Update

3rd July 2022

As at 1st July	NZX 50G	All Ords	Shanghai	FTSE	Dow	NASDAQ	NZDAUD	NZDUSD	OCR
Previous Week	10813.92	6762.38	3349.75	7208.81	31500.68	11607.62	0.9096	0.6327	2.00%
Week Close	10753.16	6720.43	3387.64	7168.65	31097.26	11127.84	0.9109	0.6132	2.00%
Change	-0.56%	-0.62%	1.13%	-0.56%	-1.28%	-4.13%	0.15%	-3.09%	0.00%

The NZ and Australian markets were relatively uneventful last week, down 0.56% and 0.62% respectively, while the US was down 2.2%, dragged down by the NASDAQ which was down 4.13%.

With the first half of the calendar year completed, the NZ market is down 16.6% this year to 30th June, and 20.3% below the peak in January 2021. By comparison, the US market is down 20.6% in the year to 30th June, and 21.4% below the peak in January 2022.

Recession concerns globally led to falling interest rates, as investors pare back their expectations for global growth. The US 10-year Treasury rate was down 9bps to 2.99%, while the 2-year Treasury rate was down 10bps to 2.92%. In NZ, rates fell more, with the 10-year swap rate falling 15bps to 4.11%, while the 2-year swap rate fell 18bps to 4.06%.

With a risk-off sentiment and a strong USD, the NZD fell to 0.6132 against the USD.

New Zealand has agreed to a free trade deal with the European Union, which will reportedly help grow exports by $1.8b a year by 2035.

The biggest movers of the week ending 1st July 2022				
Up			**Down**	
Air New Zealand	8.33%		Pushpay Holdings	-7.63%
SkyCity Entertainment Group	6.55%		Ebos Group	-5.26%
Skellerup	4.84%		Oceania Healthcare	-5.21%

Market Spotlight – Australian Banks

We have been discussing recently the rising interest rate environment, with the RBNZ and other central banks all pushing up their respective cash rates to fight inflation, leading to increased bank lending and deposit rates. Generally speaking, higher interest rates are good news for banks, and there are two reasons for this:

1. Higher net interest margin: Banks make their money by being the intermediary between depositors and borrowers, with the main source of income being the margin between what they pay depositors and what they charge borrowers. As rates increase, that margin also generally widens.
2. Bank prospects reflect the prospects of the economy: When the economy is strong, there is more activity from households and businesses borrowing money. Generally speaking, central banks tend to raise interest rates only when the economy is strong, because that is when jobs are plentiful, spending is high, and inflation starts to rise.

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The chart below tracks the share prices of the four major Australian banks from a common base, over the last five years.

Key: ANZ, CBA, NAB, Westpac.

You can see the effect of the beginning of the Covid-related lockdowns in the first quarter of 2020, with share prices dropping sharply, only to recover as the economy both in Australia and in NZ was robust with support from government subsidies and loose monetary policy from central banks.

From the beginning of 2022, the banks' share prices have risen in line with central bank rate hikes, and expectations of further rate hikes. However, just recently there has been a correction.

Why have we seen a correction in share prices?
While rising rates are a positive for banks, raising interest rates too aggressively can result in an economic recession, which would negatively impact lending. As mentioned, bank prospects reflect the prospects of the broader economy. While generally we see rate rises in a strong economy due to rising demand, this rate rise cycle is being driven more from lower supply. The market is becoming concerned about the potential for the aggressive rate hikes to result in recession, leading not only to less lending, but also higher loan default rates. Hence the correction in bank share prices.

What is the outlook for loan repayments?
Research from Jarden Securities estimates that:

- 30% of total mortgages are currently on fixed rates.
- Over $500bn in fixed-rate loans is expiring by the end of 2023, going from low rates c. 2.5% to c.5.0% in Australia, before rates are estimated to drop again in the second half of 2023.
- This will translate to annual interest payments increasing c.80% from $60bn to over $100bn by mid-2023.
- This increase in annual interest payments will affect those highly indebted borrowers more. It is expected that 20% of borrowers will see a >40% increase in repayments, while borrowers with a debt-to-income ratio over 6 will see their repayment rise to c.50% of income.
- These borrowers will likely have to cut back discretionary spending.
- However, in aggregate, households have significant buffers, with large increases in deposits over the Covid period, increased mortgage prepayments, and interest rate serviceability buffers applied at loan origination.
- With unemployment in Australia expected to increase only modestly to 4.25%, as long as unemployment remains relatively low (below 6%), the risk of mortgage defaults should be contained.

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In summary, while higher rates will mean higher interest payments by borrowers, the impact on loan losses will be modest based on low unemployment. However, increased interest payments will impact on discretionary spending in the economy, affecting the broader prospects of the economy. This is, after all, the point of the cash rate hikes from the Reserve Bank of Australia, to reduce demand in the economy.

What can we expect for the economy?
In Australia as well as in NZ, the effect of higher mortgage costs as a percentage of household income will have the effect of lowering overall discretionary income, especially among those households with a large amount of debt compared to income. Lower consumption in the economy will be particularly felt in the sectors sensitive to housing, i.e. construction, retail, tourism/hospitality.

Investment Portfolio View
The banking sector is an integral component of any well-diversified investment portfolio. Exposure to this sector provides an above-average dividend yield and long-term growth of earnings and dividends.
The table below shows some key information for the top four Australian banks (AUD).

Bank	Current Price	Consensus Target Price	Forecast Dividend Yield	Forward P/E Ratio	3-Year EPS CAGR	3-Year DPS CAGR
ANZ Bank (ANZ)	$22.13	$27.67	6.50%	10.5	-3.5%	-3.9%
Commonwealth Bank of Australia (CBA)	$91.00	$92.59	4.20%	17.2	-2.3%	-6.7%
National Bank of Australia (NAB)	$27.74	$31.79	5.28%	13.3	-6.6%	-13.8%
Westpac Bank (WBC)	$19.54	$24.67	6.25%	12.9	-8.1%	-14.4%

CAGR = Compounded Average Growth Rate

Investment News

Investore Property (IPL.NZ) Announces Share Buyback

Investore Property has announced that it will undertake a share buyback programme of up to 5% of Investore's shares on issue over the next 12 months, as the Board believes that using some debt to buy back shares at the current share price is a good use of funds.
Current Share Price: $1.61, **Consensus Target Price**: $1.72

Property For Industry (PFI.NZ) to Pause Share Buyback Programme

PFI announced on 25th May that it would undertake an on-market share buyback programme. To date, the company has bought approximately 2.9% of shares, at an average price of $2.4114. The programme is currently paused, as PFI has entered a blackout period in relation to its 2022 interim results.
Current Share Price: $2.42, **Consensus Target Price**: $2.49

SkyCity Entertainment (SKC.NZ) – Independent Review of SkyCity Adelaide

South Australia's Liquor and Gambling regulator is commissioning an independent review of casino operations in South Australia, including SkyCity Adelaide. Inquiries to date have highlighted significant failings on the part of Crown Resorts as operators of Crown Casinos.
Current Share Price: $2.93, **Consensus Target Price**: $3.38