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Yovich & Co. Market Update

2nd October 2022

As at 30th September	NZX 50G	All Ords	Shanghai	FTSE	Dow	NASDAQ	NZDAUD	NZDUSD	OCR
Previous Week	11434.82	6788.72	3088.37	7018.60	29590.41	10867.93	0.8797	0.5742	3.00%
Week Close	11065.71	6678.67	3024.39	6893.81	28725.51	10575.62	0.8743	0.5590	3.00%
Change	-3.23%	-1.62%	-2.07%	-1.78%	-2.92%	-2.69%	-0.61%	-2.65%	0.00%

The local market fell 3.23% last week, following the global downward trend, after stronger than expected inflation reports in Europe and the US. That brings the NZ market down 5.64% for the month of September, and 17.12% for the year to date in 2022. The US market was down 2.91% last week, ending a horrible September at 9.34% down. The US market is now back below its June lows, and 24.77% down for the year to date in 2022.

Currency markets were volatile during the week, with the NZD dropping further as risk sentiment falls. The NZD has now fallen to 0.55 against the USD. The Dow Jones Commodity Index was down slightly by 0.35%, while the price of Brent Crude oil actually increased slightly by 1.44% to US$87.90.

Interest rates increased again, with the NZ 2-year swap rate up 12bps to 4.74%, and the 5-year swap rate up 13bps to 4.55%. Interest rates in the US were flat during the week. The RBNZ meets this Wednesday, and it is widely expected that it will hike the OCR by a further 50bps to 3.50%. The market will be focused on the RBNZ's policy outlook; they have previously forecast an OCR peak of 4.10% in 2023, however the market has moved to price in an OCR peak around 4.80%, with some economists predicting 5.0%.

The construction sector has noted that the price of imported steel effectively jumped by 10% following the recent decline of the NZD alongside price rises. ANZ's Business Outlook survey lifted during September, while inflation expectations eased slightly.

The biggest movers of the week ending 30th September 2022				
Up			**Down**	
Pacific Edge	4.17%		The Warehouse	-10.43%
A2 Milk Corporation	2.17%		Fletcher Building	-6.20%
Vista Group	1.86%		Fonterra Shareholders' Fund	-6.18%

Market Spotlight – NZ Housing Sector Update

As interest rates rise, asset values tend to fall. This is true for shares just as it is true for houses. Higher interest rates affect how much debt a borrower can take on, as debt repayments are higher. It also makes housing less attractive to investors, as the rental return needs to be compared with what an investor can get if they simply invest in a bank term deposit, among other investment options. As a result, house prices have fallen in NZ as interest rates have ramped up all of a sudden.

Of course, interest rates are not the only factor that affect the housing market. Ultimately, prices are a function of supply and demand, but underneath that are several factors that either incentivise or hinder supply, and either fuel or dampen demand. Successive governments since the 90s have struggled to tame house price inflation, leading to our current position of having one of the least affordable housing markets in the world. This stifles economic productivity, as more savings are tied up just to own a house, and more capital is diverted to unproductive housing, as opposed to productive business ventures.

CoreLogic's House Price Index shows that prices in NZ fell 3.5% during the quarter to August, with Auckland and Wellington showing quarterly declines of 4.6% and 7.6% respectively. The declines have been very sharp, with the recent quarterly change being at a worse percentage than during the global financial crisis in 2008. This reflects the sharp turnaround in the direction of interest rates, being a factor that has dampened the demand side.

The other factors that are affecting demand include new rules that tighten credit availability, changes to tax rules, and lower net migration. With new laws in place, financial institutions are required to do more due diligence before approving lending. In general, owner-occupier borrowers require a 20% deposit, while investors require a 40% deposit. Also, while there are no rules yet regarding debt-to-income ratios, banks have already tightened up on their debt-serviceability tests, and the proportion of lending going to borrowers with high debt-to-income ratios is dropping. Also, net inwards migration has fallen dramatically compared to pre-covid years, which puts downward pressure on housing demand. We have seen that affecting rental growth, which in turn affects the return investors can make.

On the supply side, there has been a boom in the building industry in recent years, which has been closing the housing shortage gap. The number of new dwellings consented in the year to August was up 8.9% on the previous 12-month period.

However, while these factors have contributed to a sharp recent drop in house prices, we have started from a very high peak in December 2021, which came after a year of incredible price appreciation. In fact, while recent monthly changes have been negative, the annual change in the housing market remains positive at 5.8% in the year to August. Perhaps the most important reason why we haven't seen a larger drop in house prices is the fact that we still have a tight labour market, with still very low unemployment. This means that while borrowers are paying more of their incomes on debt repayments with higher interest rates, they are able to continue servicing their mortgages without defaulting on their loans. In fact, mortgagee sales remain very low, there is no panic selling from investors, and even despite the recent drop in values, it is estimated that there are very few new buyers with negative equity.

Where house prices go from here will depend a lot on how quickly NZ and the world can get on top of inflation. At current RBNZ forecasts, the expected increases to the official cash rate are already mostly priced into fixed mortgage rates. There are signs that inflation is peaking, with commodity prices falling, including oil prices. The falling NZD is not helping however, as imported goods become more expensive, adding to inflation pressures. The continuing tight labour market is also adding to inflation pressures, with employers still short of staff. Building activity is still high, however this is starting to slow down. We should expect further house price depreciation throughout this year, with some commentators forecasting a correction of 10%-15% over the year. This however needs to be seen in the context of an average annual price increase of 27.6% during 2021.

Investment News

Synlait Milk (SML.NZ) – Back Into Profit

Synlait are back in profit in FY22, with adjusted net profit of $34.0m, after making a loss of $28.5m in FY21. Revenue was up 21% to $1.66b, assisted by higher commodity prices, and gross profit was up 119%. Foreign exchange gains assisted the financial results this year. The company predicts that cash flows will remain robust in FY23 but softer than FY22, and costs will increase modestly.

Current Share Price: $3.55, **Consensus Target Price**: $3.98

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The Warehouse Group (WHS.NZ) – Adjusted Net Profit Down 49%

The Warehouse announced their full year results, with adjusted net profit of $85.5m, down 48.9% on FY21. Sales of $3.3b were down 3.5% on FY21. The company had a record FY21, followed by a challenging first half of FY22, however the second half of the year was an improvement on the previous corresponding period (pcp). Global supply chain issues presented a challenge to the company. A final dividend of 10.0cps was declared, taking the full-year dividend to 20.0cps, being 34% lower than FY21 dividends.

Current Share Price: $3.09, **Consensus Target Price**: $3.56

A2 Milk Company (ATM.NZ) – Share Buyback to Commence on 5th October

Further to its announcement in August, A2 Milk intends to commence its on-market share buyback programme on 5th October. The buyback may run for up to 12 months, and the company may acquire up to 37,180,621 ordinary shares, being 5% of the total shares.

Current Share Price: $6.12, **Consensus Target Price**: $6.62

Freightways (FRE.NZ) Completes Allied Express Transaction

Freightways announced in August that it had entered into a transaction with Allied Express Transport Pty Ltd to provide a significant entry point to the Australian market for Freightways' Express Package Division. The transaction has now been completed, which will grow a scale courier and express freight business in Australia.

Current Share Price: $9.80, **Consensus Target Price**: $11.84