AMP Capital Investors (New Zealand) Limited

Investment insights

China-New Zealand progress and opportunities

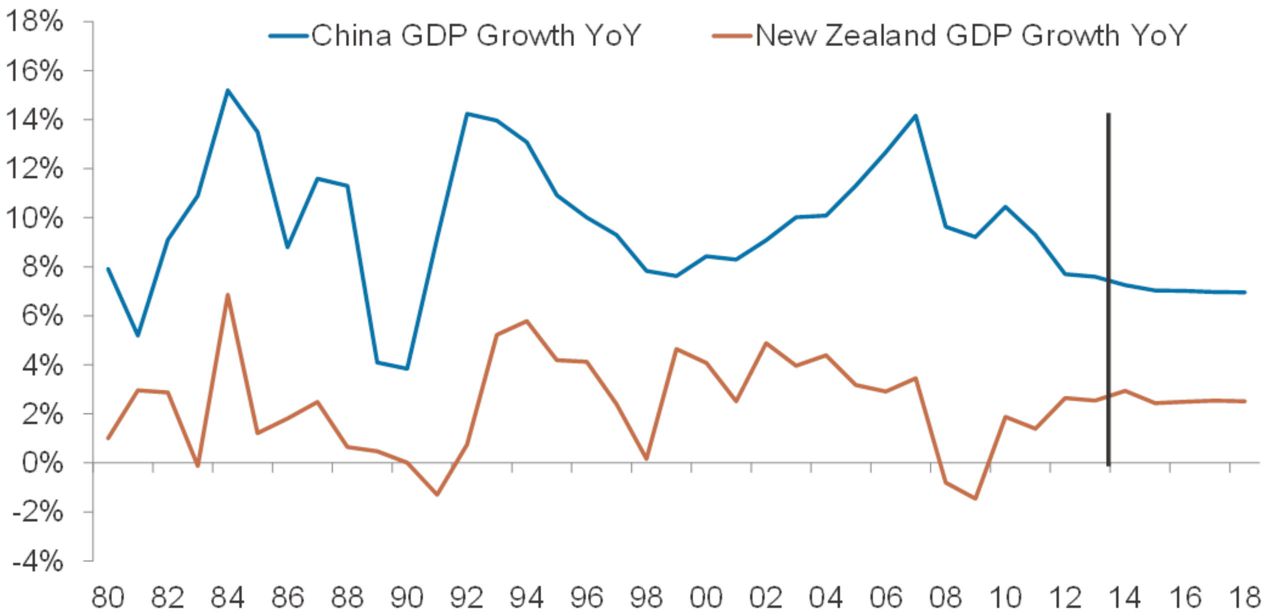
OCTOBER 2013

As China's economic and political influence in the world grows, New Zealand is right to pay attention. China offers a range of opportunities for New Zealand, and the 2008 signing of the Free Trade Agreement (FTA) was a step in the right direction. As China's economic growth begins to slow and coming up to the five year anniversary of the FTA, it is timely to look at the commercial linkages between our two countries and think about what lies ahead.

Macroeconomic overview and outlook

Most China watchers are familiar with the idea that China's economy is set to grow at a slower pace in the coming years as the authorities look to transition the drivers of economic growth to the domestic consumer, with less emphasis on exports and infrastructure/ property investment. This transition will likely see China's GDP growth reduce to around 7% from the double digit growth seen in the last decade. The point to note though is even at a slower growth rate it is still relatively strong growth both in terms of the rate and the value magnitude.

China to continue to grow faster than New Zealand

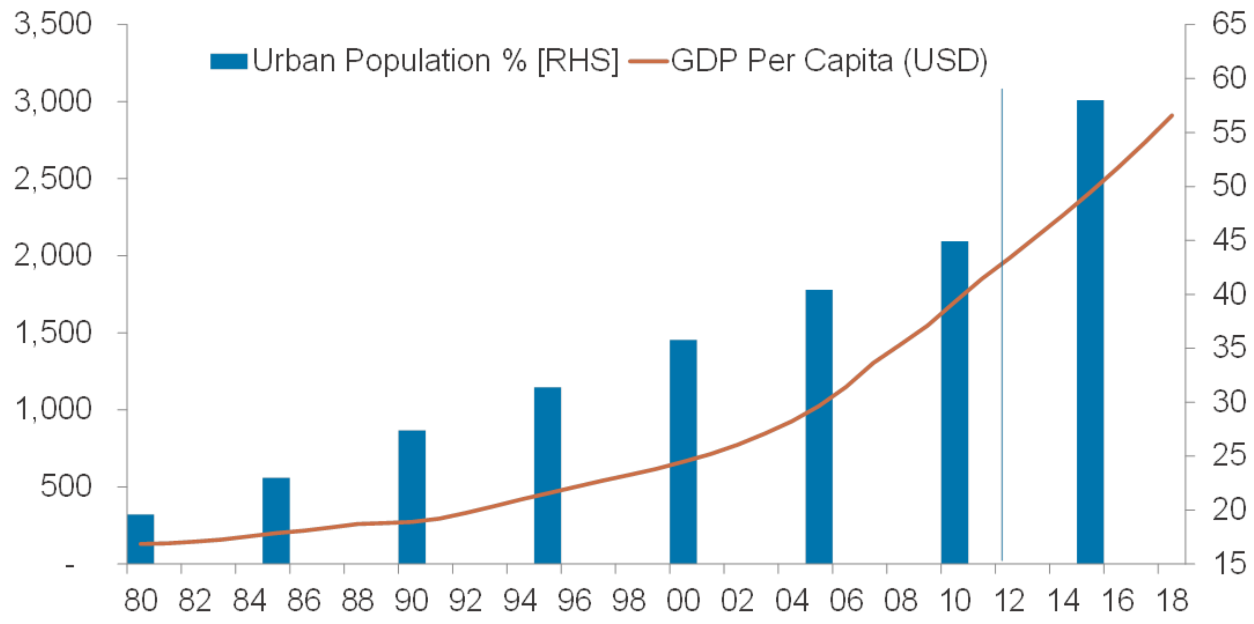


Source: IMF, AMP Capital

Along with transitioning to a more domestic consumer-driven economy, there is a push to lift urbanisation rates further (forecast to rise from 53% in 2012 to 70% by 2030) in an effort to lift the incomes and productivity of the remaining rural

population. This will add further impetus to a growing consumer market in China whose rising incomes will see a lift in demand for many of the things New Zealand is known for, such as agricultural exports and tourism.

Urban population and incomes are rising



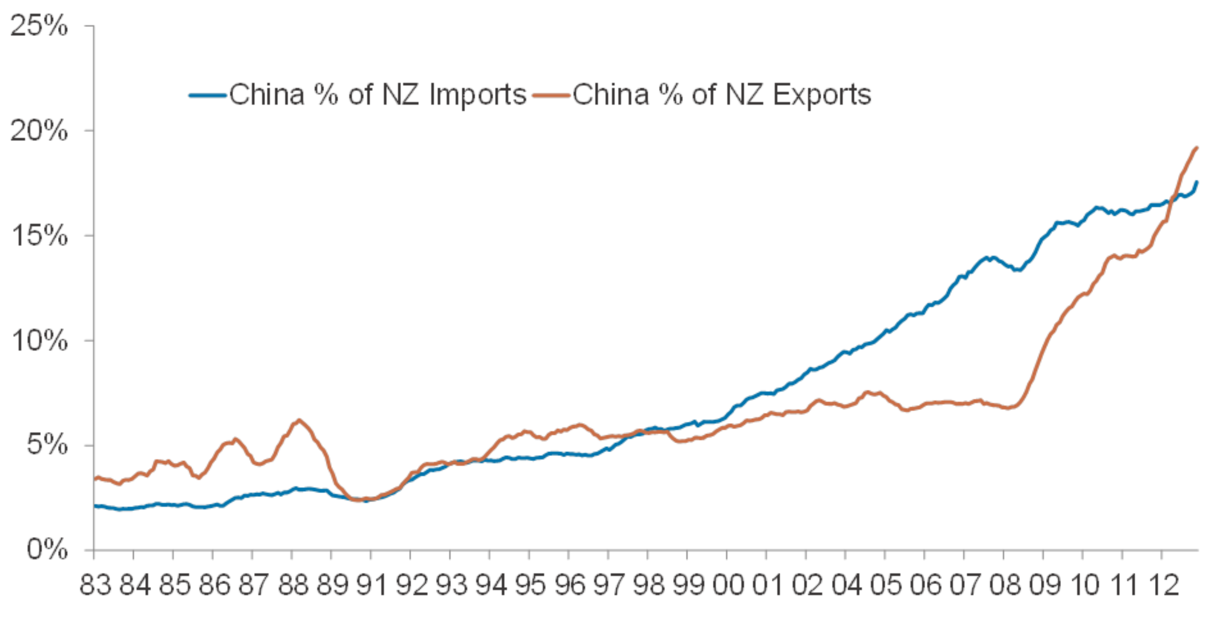
Source: IMF, World Bank, AMP Capital

While the outlook for China is a slowing of growth, the push for economic rebalancing presents opportunities for New Zealand. Indeed, if China is able to make a successful transition to this lower and more sustainable consumer-driven growth pattern it could actually mean greater positive economic impact for New Zealand despite the slower growth pace.

China-New Zealand trade: a progress check

New Zealand's exports to China have been steadily increasing, growing to about 20% of all exports with dairy a key driver. Indeed New Zealand Treasury estimates the contribution of China-driven dairy exports at around 2% of GDP since 2008. Premium food exports are a good angle to take as it plays on our competitive advantage and acknowledges that we can't ever supply all of China's food needs. But it puts a lot of emphasis on maintaining brand and reputation – something that is hard to build and easily lost.

China has become a key trading partner



Source: Statistics NZ, AMP Capital

*rolling 12 month average

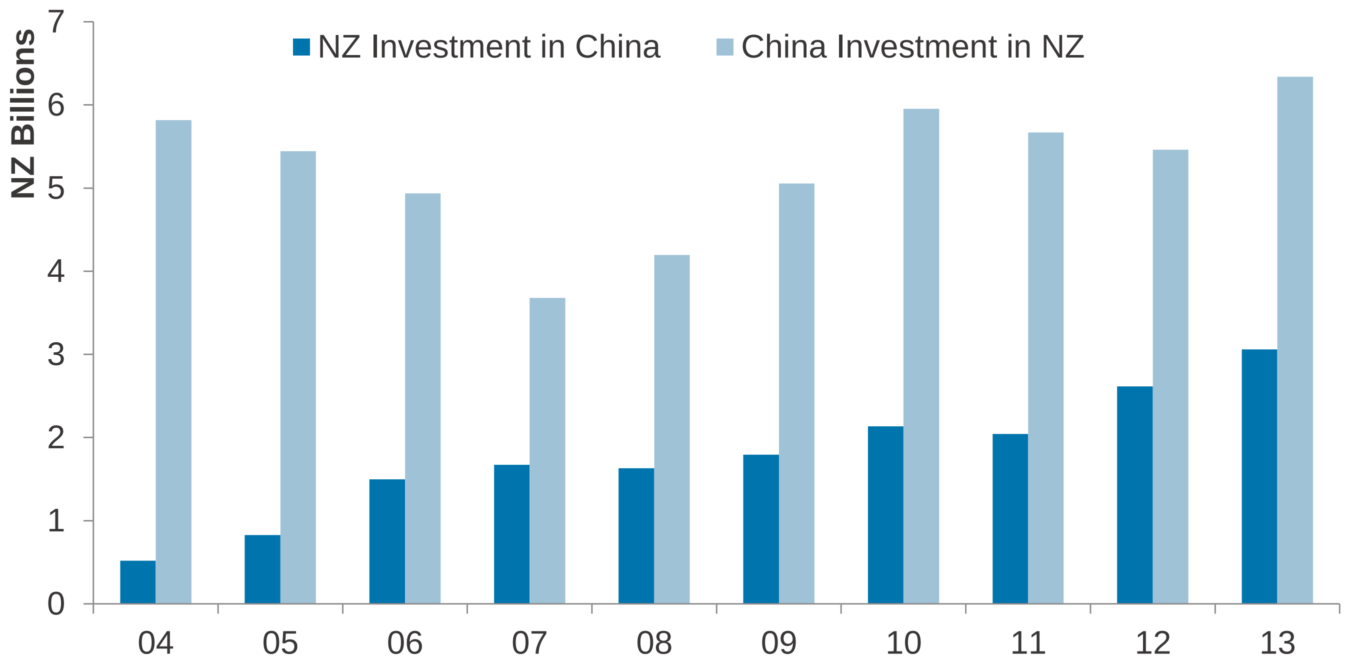
That's why tourism and service exports are a logical complement and are of increasing economic importance to New Zealand. We are fortunate that as the Chinese have become wealthier and more keenly aware of the world, they see New Zealand's relative safety and natural beauty as an attractive place to visit. With China's outbound tourism expected to grow to 100 million in 2015, this is worth paying attention to. Education is another aspect which New Zealand has gained from, directly through fees and indirectly from broader spending and even cultural links.

Chinese tourists represent a growing opportunity

Source: Statistics NZ, AMP Capital

But if there's one area that we really haven't taken full advantage of, and the one that also seems to bring the most controversy, it's investment. Direct investment from China into New Zealand has gradually lifted through the years but still only accounts for about 2% of all foreign investment into New Zealand. Going the other way, the numbers are equally uninspiring. And it's arguably this New Zealand investment into China which we should be focusing on.

New Zealand needs to invest more



Source: Statistics NZ, AMP Capital

Some of the key drivers of direct investment returns include market share, market size and growth of the market – China definitely ticks the box on the latter two. Indeed, New Zealand ought to be thinking hard about investment opportunities in China given their economy is set to grow faster than ours, or any of the other developed markets for that matter.

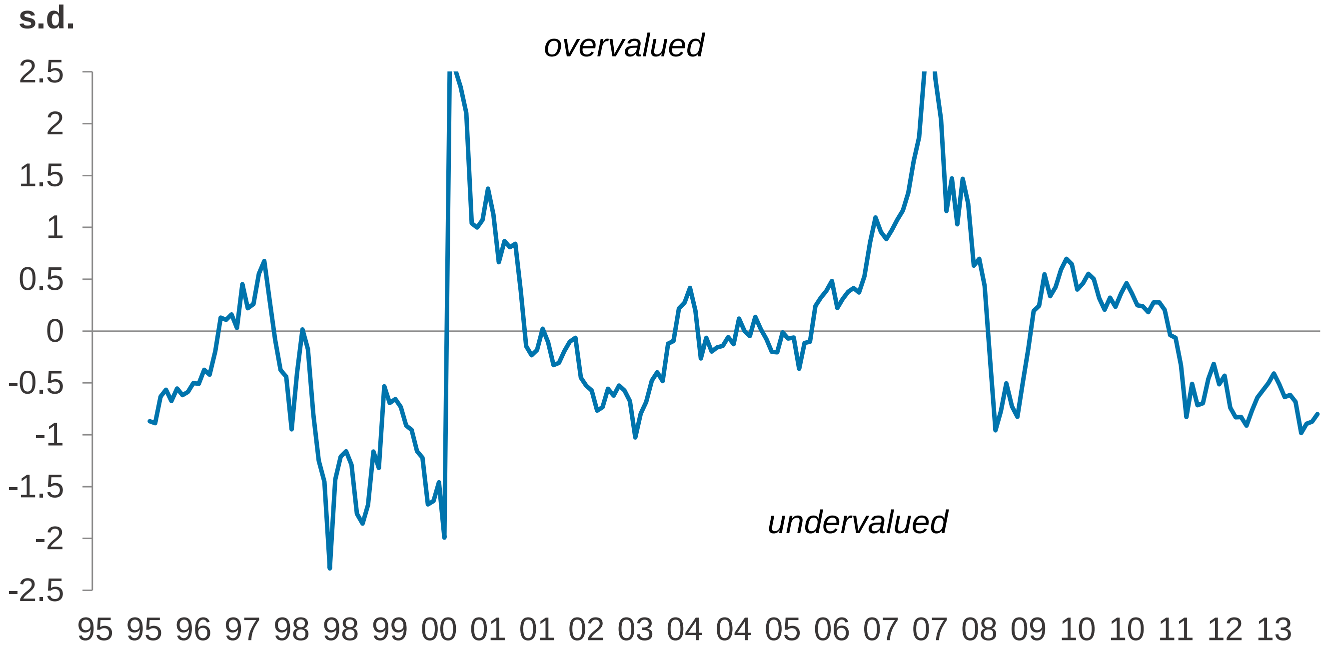
Further, investing in China helps overcome some of the difficulties of being geographically isolated and the lack of scale here. While there are certainly pitfalls in investing in emerging markets, the FTA takes on relevance here in that it looks to level the playing field for cross border investment between our two countries.

That said, doing business in China shouldn't be taken lightly. Cultural differences, business norms, regulations and intellectual property protection are among the issues that need to be considered, not to mention the language differences! This is one area where we should be looking to leverage off the growing domestic population of Chinese that are here for work and education. These linkages could prove more valuable than the short-term lift in spending.

The other component of foreign investment

But it's not just direct investment – you don't necessarily need to go to China and build a factory or open up a chain of stores. Portfolio investment offers a means for most people to gain access to the Chinese market. Similarly, the key drivers of equity portfolio returns are economic growth and stock market valuations. At this point in the market cycle valuations are cheap relative to history and growth appears to be on a cyclical uptick.

Chinese share market cheap relative to history

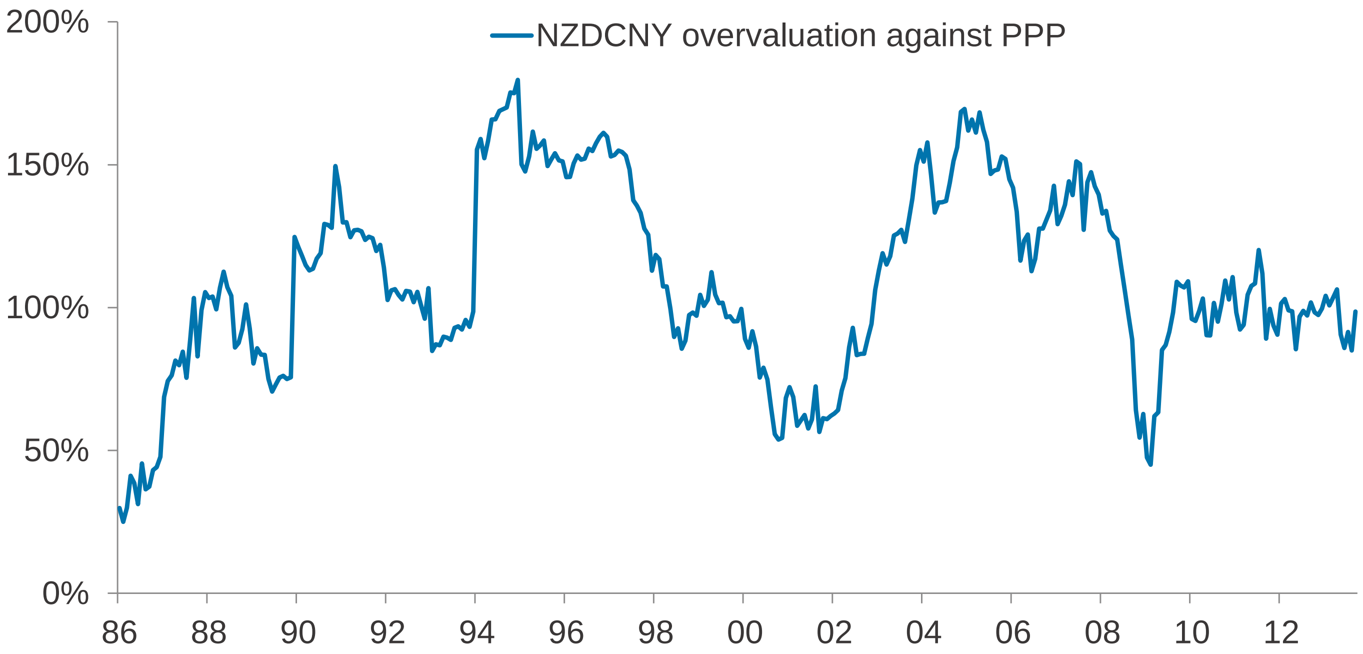


Source: Bloomberg, AMP Capital

The exchange rate outlook

The New Zealand dollar (NZD) remains elevated against most of the major currencies, and the Chinese Yuan (CNY) is no exception. Indeed, the NZDCNY exchange rate trades well above the purchasing power parity (PPP) implied exchange rate. With a much better current account position and higher interest rates, the longer term outlook is likely for an appreciating CNY and depreciating NZD.

NZD overvalued against the CNY



Source: Bloomberg, IMF, AMP Capital

Going back to the investment topic, this sort of trend would provide a tail wind for unhedged investors. It would also lift the competitiveness of our exports to China and likely drive strong growth in Chinese demand for tourism, education and other services in New Zealand.

China's drive on wide ranging economic reforms, including capital account liberalisation, will likely include a push to promote the rise of the Chinese Yuan (Renminbi) as a key global currency. This will mean moving towards full convertibility and away from the fixed exchange rate of the past. Such a move may see the NZDCNY become less driven by the NZDUSD rate, and possibly even converge toward the PPP implied exchange rate.

Summary

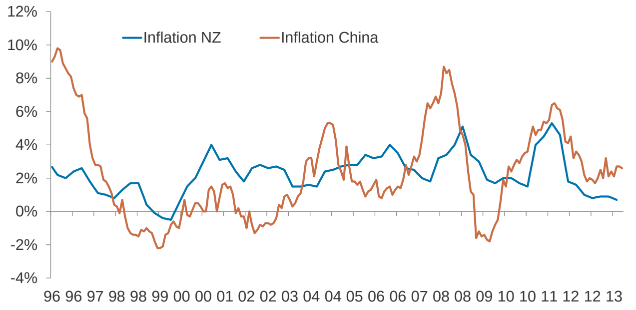
As China looks to rebalance its economy to a lower but more sustainable growth model, including embarking on a range of structural economic reforms, New Zealand is set to benefit. While progress has been made in lifting exports and tourism, New Zealand could still do more particularly when it comes to investing in China. For direct investment and portfolio investment in China there are a number of tailwinds which makes these opportunities well worth thinking about.

Callum Thomas

Research Analyst

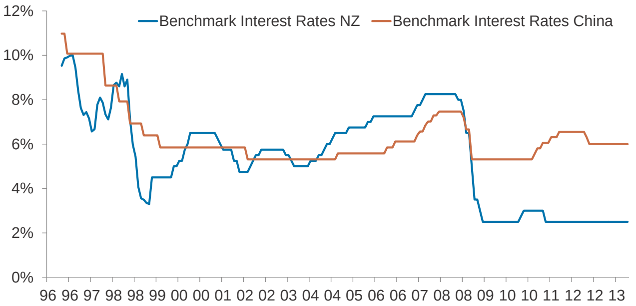
Statistical Appendix: China v New Zealand

Relatively Similar rates of inflation recently



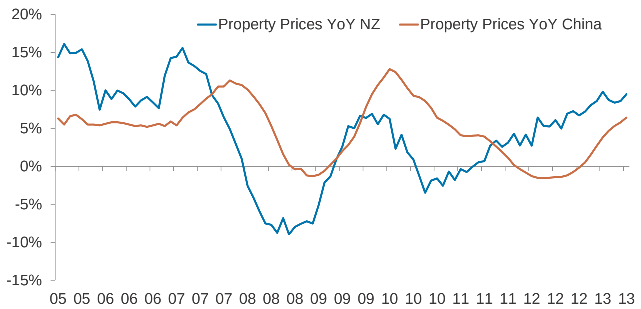
Source: Statistics NZ, NBS, AMP Capital

New Zealand benchmark rate well below china's



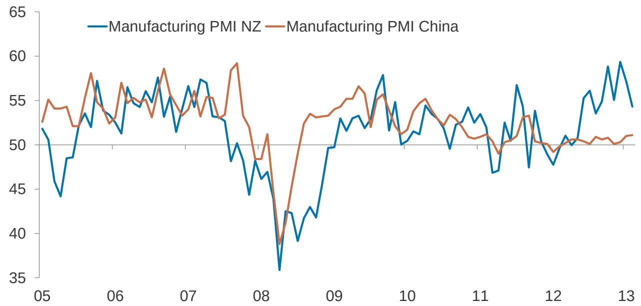
Source: RBNZ, Bloomberg, AMP Capital

Property price growth traces a similar path



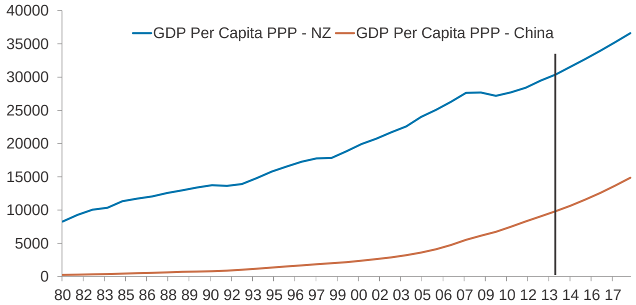
Source: REINZ, NBS, AMP Capital

PMIs show diverging short-term prospects



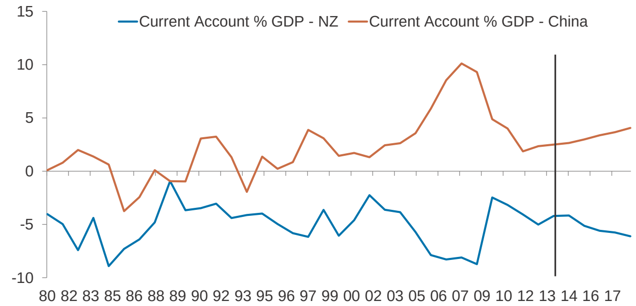
Source: Business NZ, NBS, AMP Capital

China gradually playing catch-up on incomes



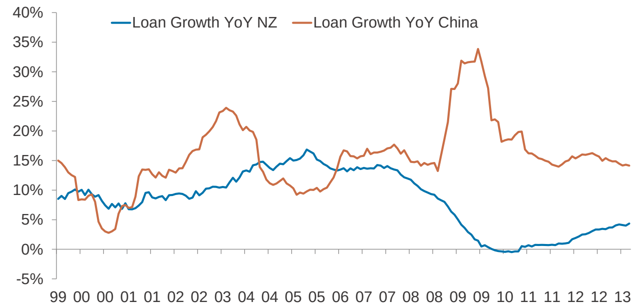
Source: IMF, AMP Capital

China saves and exports more than New Zealand



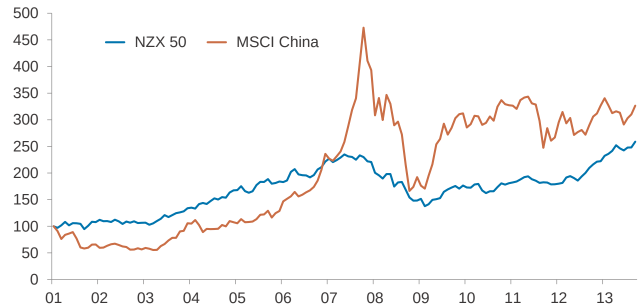
Source: IMF, AMP Capital

Credit growth took a different direction post-GFC



Source: RBNZ, Bloomberg, AMP Capital

Longer term trend clear, but NZX stronger recently



Source: Bloomberg, AMP Capital