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TE WĀNANGA ARONUI O TĀMAKI MAKAU RAU

The Impact of Uncertainty on the New Zealand Stock Market

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Outline

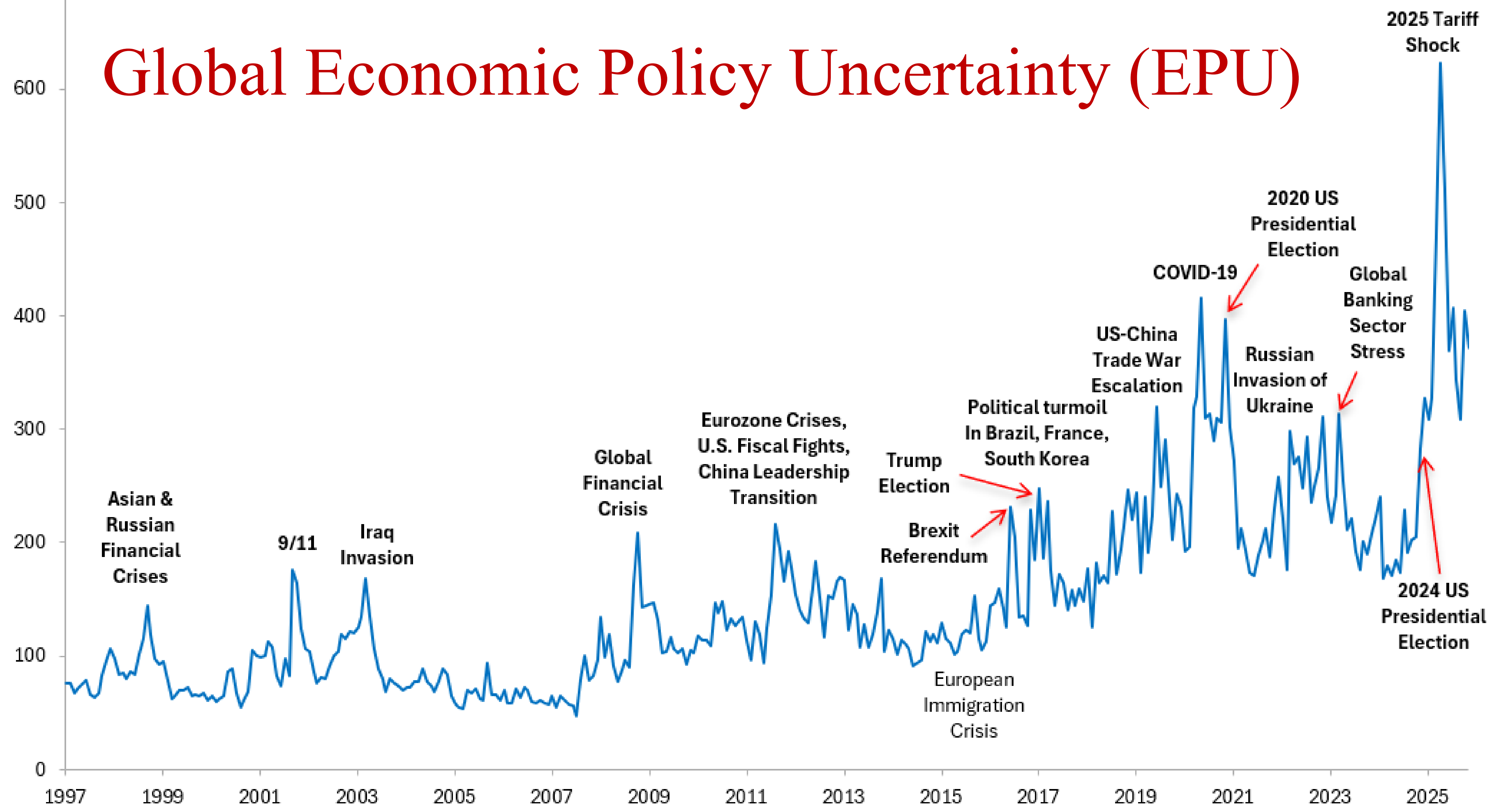
- Measuring Economic Policy Uncertainty (EPU) - Global and New Zealand
- How does EPU affect the stock market? (theoretical foundation)
- Empirical results on the impact of NZ EPU on NZX50
    - Market volatility, return correlations, and equity risk premium
- The impact of NZ EPU vs. Global EPU or US EPU
- How about Geopolitical Risk (GPR)?
- Findings summary & Practical implications

Dodd, O., Frijns, B., Vu, T. (2026). The Impact of NZ EPU on the NZ Stock Market, AUT working paper.

Economic Policy Uncertainty (EPU)

- **Economic Policy Uncertainty** (EPU) is an economic risk where the future path of government policy is unclear, raising risk premia and leading businesses and individuals to delay spending and investment until this uncertainty has been resolved (*Baker, Bloom, & Davis, 2016*).
- Policy uncertainty may refer to uncertainty about monetary or fiscal policy, the tax or regulatory regime, or uncertainty over electoral outcomes that will influence political leadership.
- **National EPU** indexes are newspaper-based measures (frequency counts of relevant articles in leading newspapers).
- **Global EPU** Index is a GDP-weighted average of national EPU indices for 18 countries.

Global Economic Policy Uncertainty (EPU)



Notes: Global EPU calculated as the GDP-weighted average of monthly EPU index values for US, Canada, Brazil, Chile, UK, Germany, Italy, Spain, France, Netherlands, Russia, India, China, South Korea, Japan, Ireland, Sweden, and Australia, using GDP data from the IMF's World Economic Outlook Database. National EPU index values are from www.PolicyUncertainty.com and Baker, Bloom and Davis (2016).

Measuring NZ EPU - The News-Based Approach

- NZ EPU Index is developed by AUT researchers – Sara Ali, Ihsan Badshah, and Prasad Hegde, following the methodology of Baker, Bloom, & Davis (2016). Available at https://www.policyuncertainty.com/.
- Methodology:
  - Textual Analysis of close to 10 million newspaper articles: the index quantifies uncertainty based on newspaper coverage of economic policy developments.
  - NZ Data Sources: NZ Herald, Fairfax, Stuff, and Interest.co.nz.
  - Scaling: The monthly count of these articles is scaled by the total number of articles in the same newspapers.
- NZ EPU allows capturing the "domestic noise" that global uncertainty indices miss.

NZ EPU – Word Combinations

Uncertainty Uncertain	Economy Economic	Cash rate Deficit Legislation Parliament RBNZ, Reserve Bank of New Zealand Regulation Tariff Tax, Taxation, Taxes War

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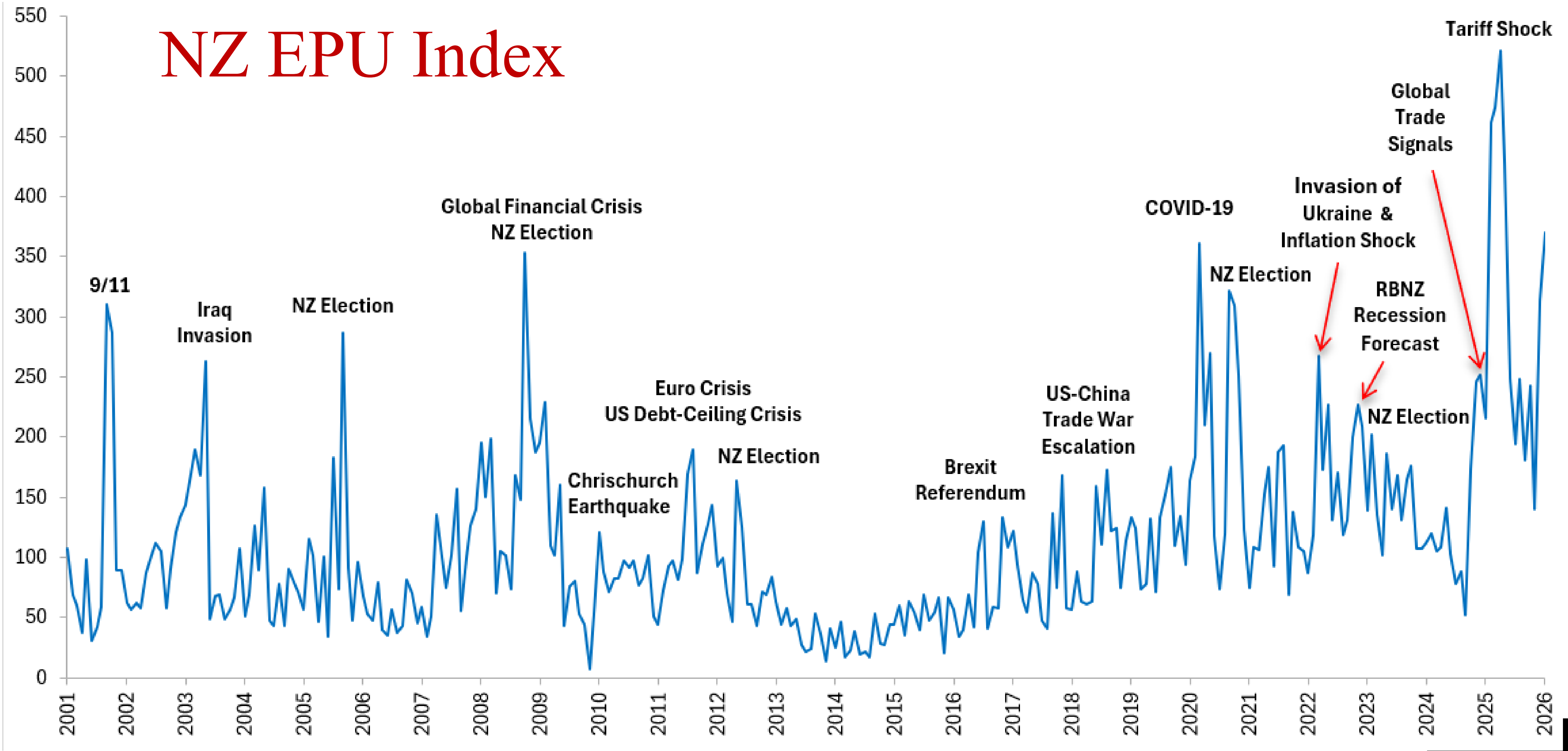
NZ EPU – Word Combinations Mentions Heatmap

	Cash Rate	Deficit	Legislation	Parliament	RBNZ	Regulation	Senate	Tariff	Tax	War
Uncertainty & Economic	1614	871	787	999	1267	695	167	618	4529	1597
Uncertainty & Economy	1722	806	647	813	1315	523	185	523	3791	980
Uncertain & Economic	683	405	358	515	535	285	84	194	2243	754
Uncertain & Economy	652	364	271	425	473	223	113	153	1910	604

NZ EPU Index



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Data source: https://www.policyuncertainty.com/

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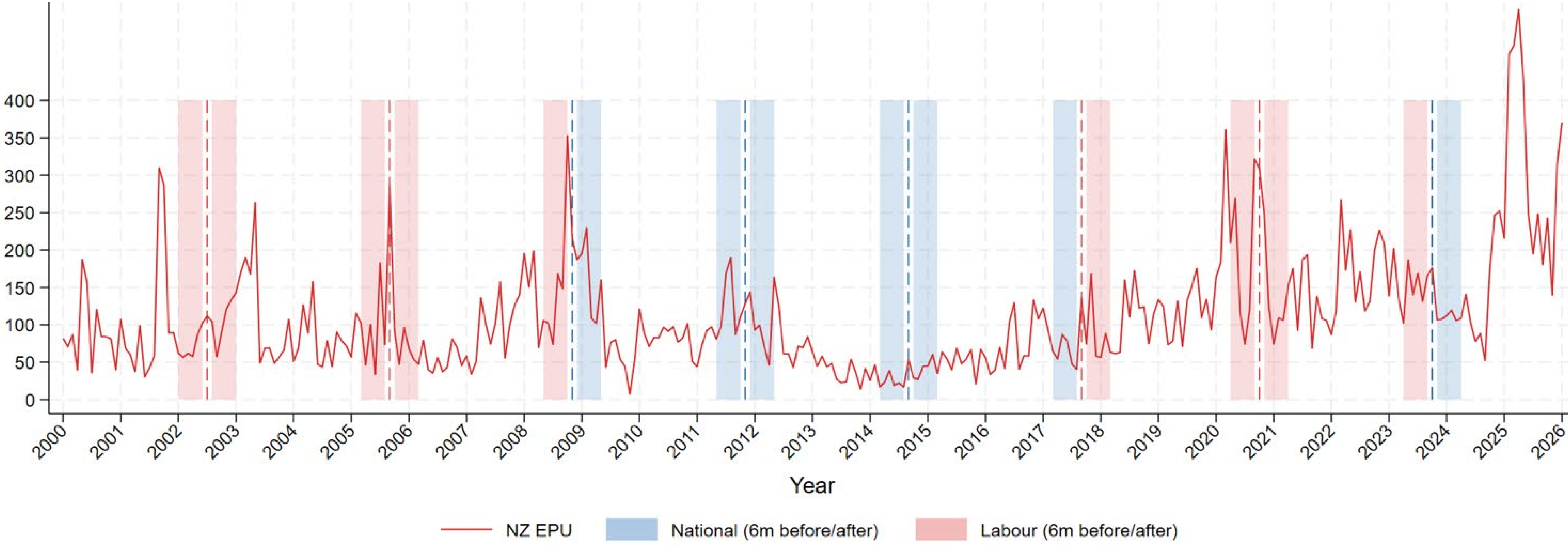
NZ EPU and NZ Elections



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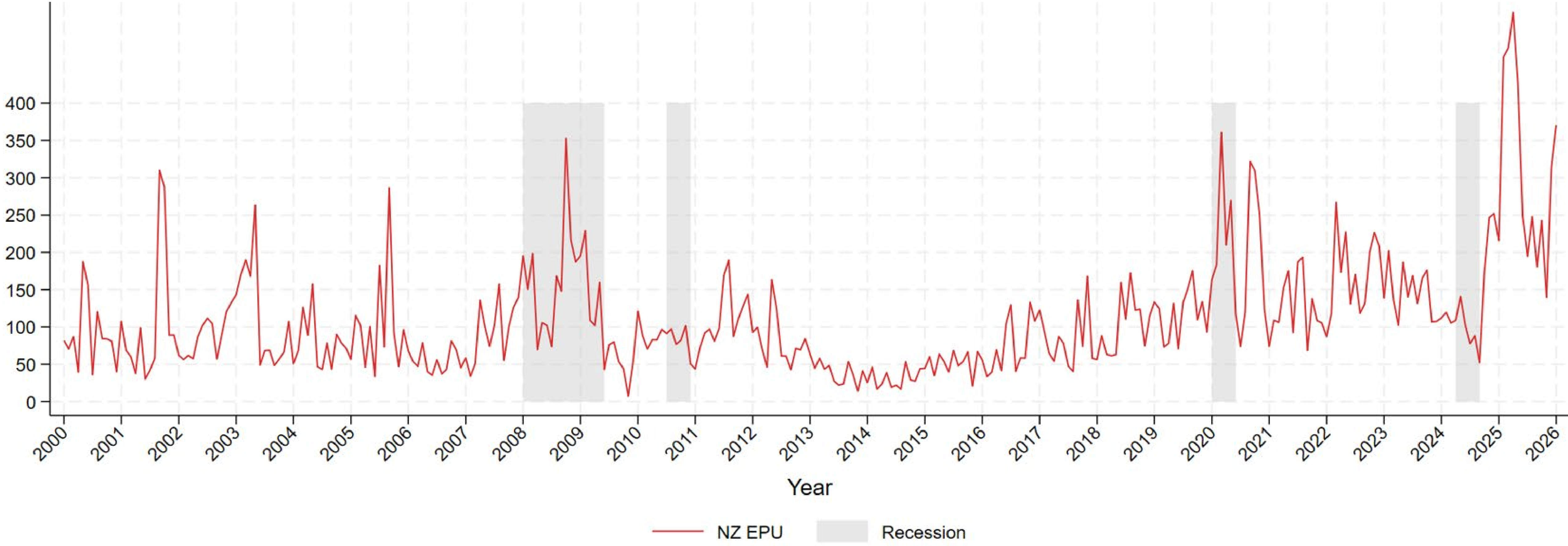
NZ EPU and NZ Elections

- We observe:
  - an increase in NZ EPU in the 3-month period before NZ Elections
  - a decrease in NZ EPU in the 3-month period after the Elections
  - an increase in NZ EPU after the Elections when there is a party change
- However, due to the short time series sample used in the analysis, we can not conclude that the observed patterns are statistically significant.

The Expected Impact of EPU on Stock Market

- Pastor & Veronesi (2013) developed a general equilibrium model of government policy choice in which stock prices respond to political news.
- Predictions of the model:
  - Policy uncertainty introduces a **systematic risk**. Investors cannot diversify away the risk of a major policy shift.
  - Policy uncertainty rises in **weak economic conditions**.
  - News about policy changes triggers stock price adjustments, leading to an increase in **stock market volatility** and stock **correlations** (systematic risk outweighs idiosyncratic differences), especially when the economy is weak.
  - Political uncertainty commands a **risk premium**. Investors demand higher returns to hold stocks when policy is unclear. The required equity risk premium is greater in weaker economic conditions.

NZ EPU and Economic Recession



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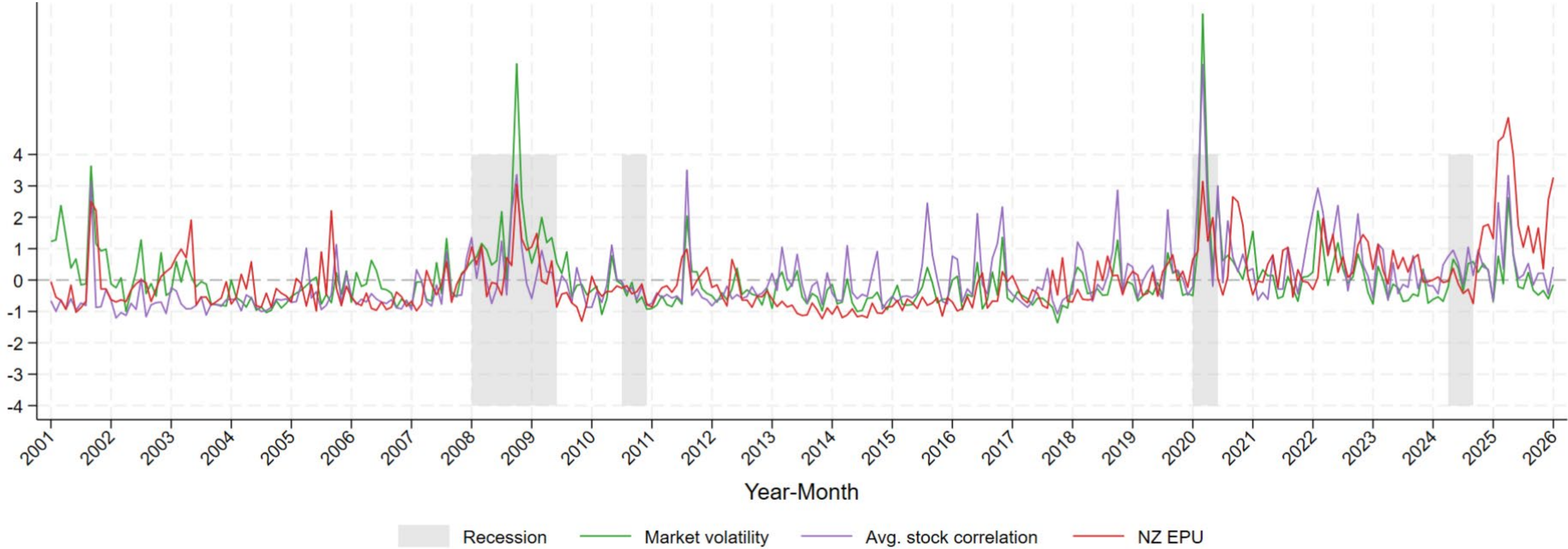
NZ EPU and Economic Conditions

- NZ EPU is significantly higher during NZ economic recessions.
- Higher NZ EPU is also negatively associated with NZ consumer confidence, economic growth, and industrial production growth.

NZ EPU and NZX50 Volatility and Stock Correlations



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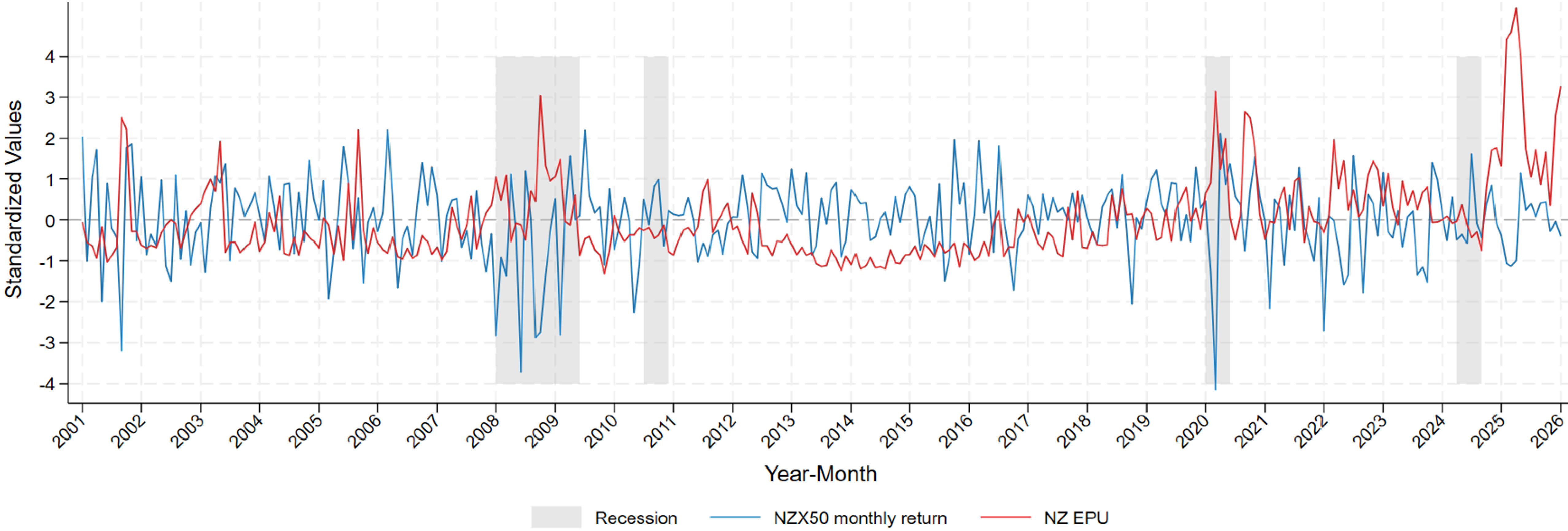
NZ EPU, NZX50 Volatility & Stock Correlations

- NZ stocks are significantly more volatile and more correlated when there is more policy uncertainty (high NZ EPU).
- The positive association between NZ EPU and NZX50 volatility is stronger in weaker economic conditions. High NZ EPU is associated with a greater increase in market volatility and stock correlations during:
  - economic recessions,
  - periods of low business confidence,
  - periods of low industrial production growth.

NZ EPU and Stock Returns



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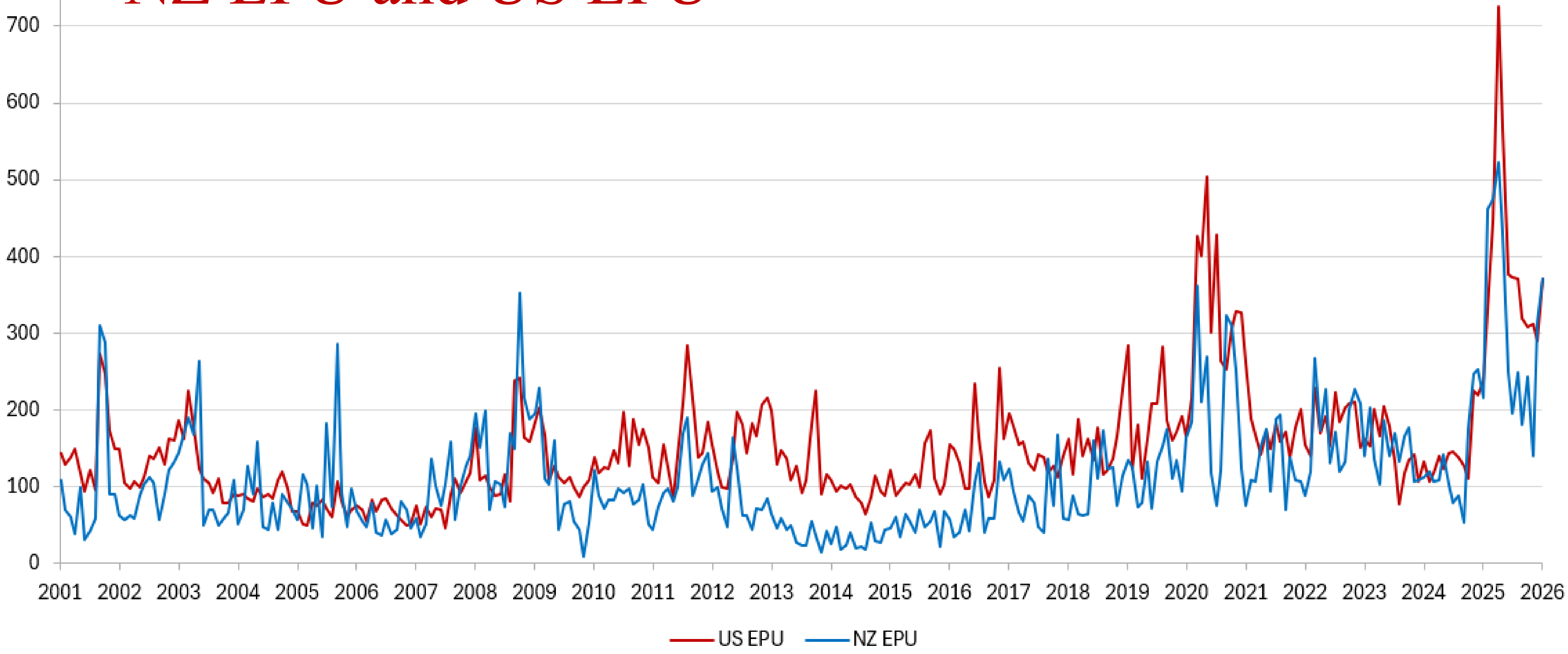
NZ EPU and Equity Risk Premium

- Investors expect compensation for the policy uncertainty risk, requiring a higher expected future return. A **higher expected return** leads to an immediate decline in stock prices.
- High NZ EPU is associated with significant **negative contemporaneous returns**. The negative impact of high NZ EPU on contemporaneous returns is amplified by weak economic conditions (economic recessions).
- Regarding future returns, it takes **from 6 months to 1 year** from the period of high NZ EPU and economic recession for returns to turn positive (to realise **equity risk premium**).

NZ EPU and US EPU



Data source: https://www.policyuncertainty.com/

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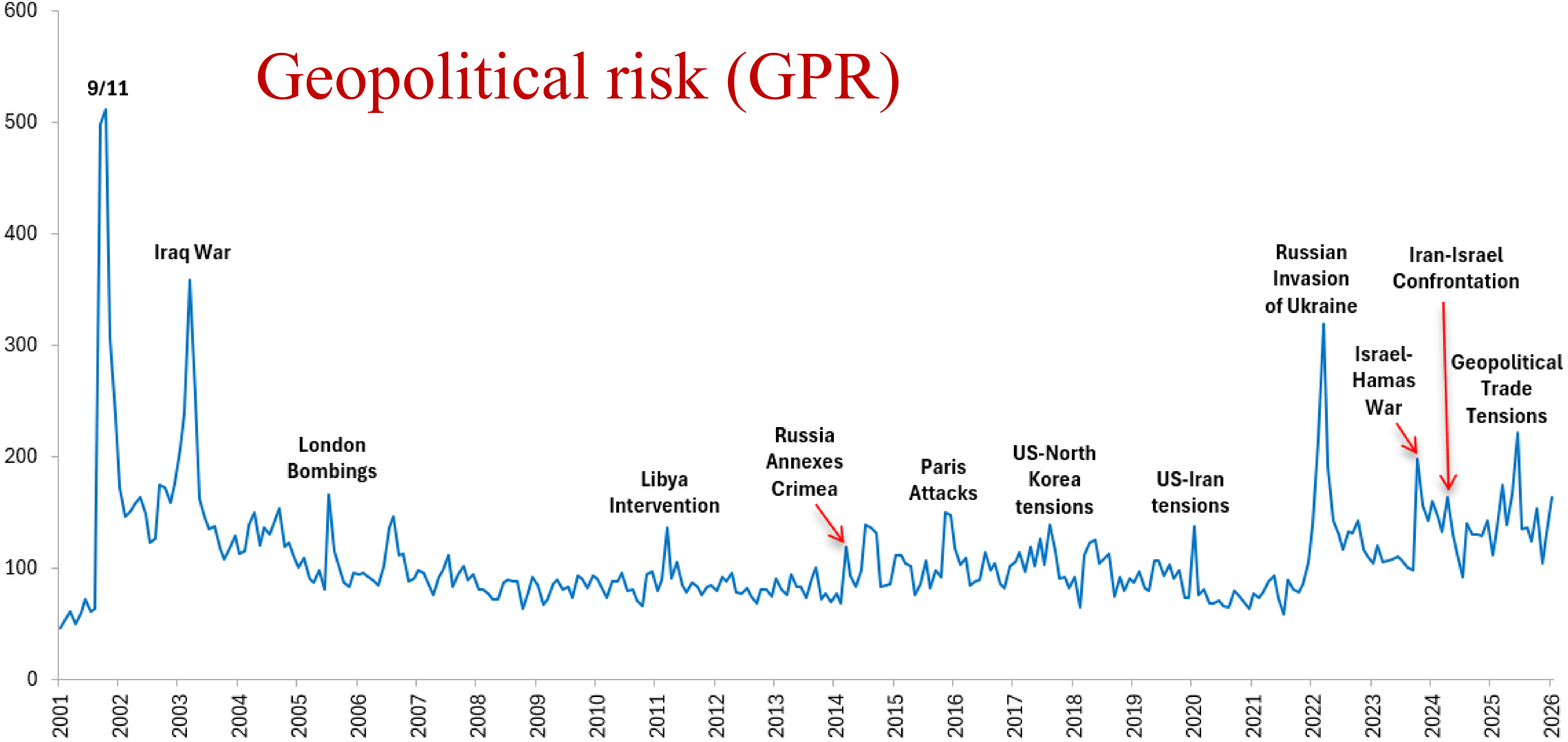
NZ EPU vs. Global or US EPU

- NZ EPU co-moves significantly with Global EPU.
- Among national EPU indices, the US EPU has the greatest impact on NZ EPU, followed by Australia and China EPUs.
- The impact of NZ EPU on the NZ stock prices remains significant after we account for the impact of US EPU or Global EPU. NZ EPU contains price-sensitive information specific to NZ.



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Data source: Caldara, D. & Iacoviello, M. (2022). Measuring Geopolitical Risk. *American Economic Review*, 112(4), 1194-1225. https://www.matteoiacoviello.com/gpr.htm

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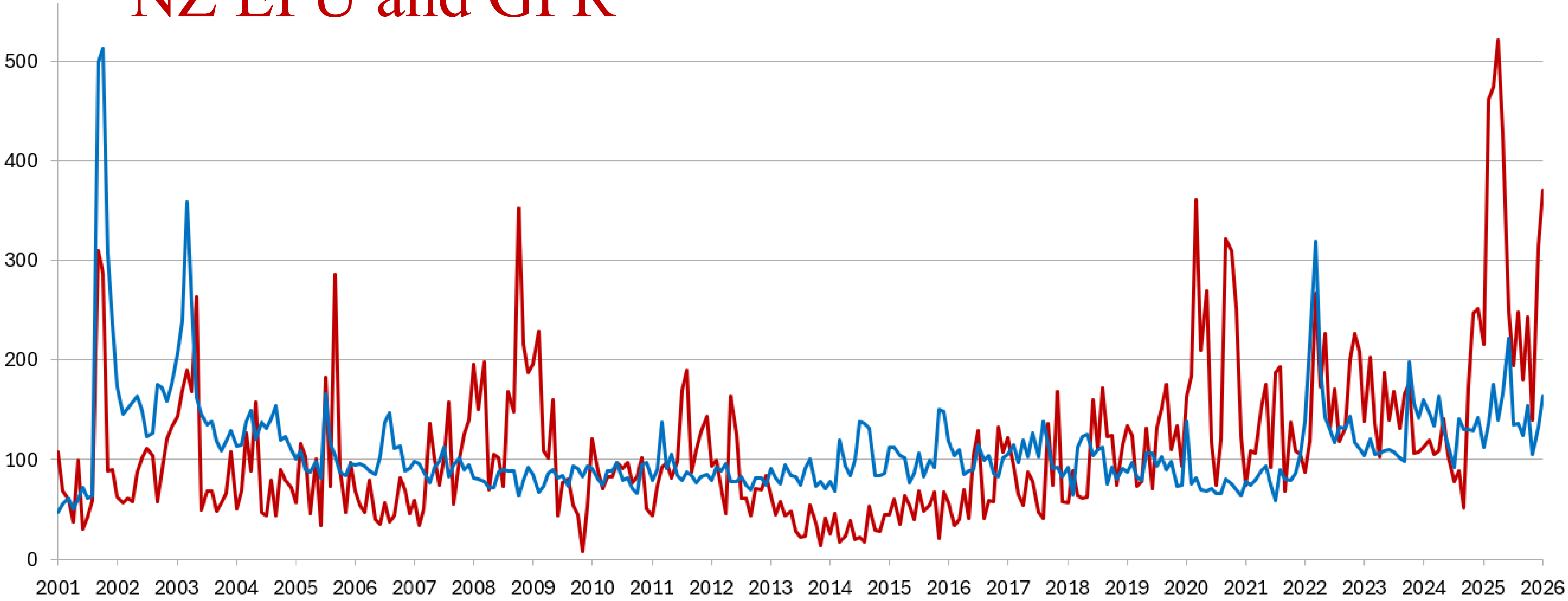
NZ EPU and GPR



Data sources: https://www.policyuncertainty.com/
https://www.matteoiacoviello.com/gpr.htm

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NZ EPU vs. GPR

- NZ EPU is significantly positively associated with Global Geopolitical Risk (GPR). Global Geopolitical Risk events contribute to policy uncertainty in NZ because geopolitical and economic risks are interconnected (geopolitical tensions can lead to policy changes, and vice versa, policy changes can lead to geopolitical tensions).
- Regarding the impact of GPR on the NZ stock market, after we account for the impact of NZ EPU, the impact of GPR on stock market volatility, correlations, and equity risk premium is insignificant.

Findings Summary

- While global factors like US EPU and Geopolitical Risk (GPR) influence the NZ economy and markets, local policy uncertainty remains a significant, independent driver of the NZ stock prices.
  - High NZ EPU significantly increases both market volatility and average stock correlations, creating a ‘double hit’ for investors, as systematic risk spikes and correlations increase exactly when diversification benefits are most needed.
  - NZ EPU is a priced risk. High NZ EPU commands a significant equity risk premium and is associated with immediate stock price declines.
  - The negative impact of NZ EPU is amplified during economic recessions and periods of low business or consumer confidence.

Practical Implications: Navigating NZ Policy Uncertainty

- Investors
  - Recognise that ‘local policy noise’ is systematic risk and account for the loss of diversification during election or policy-shift cycles in their portfolio allocations.
  - Prepare for immediate stock price declines following EPU spikes. Historically, it takes from 6 to 12 months for the risk premium to be realised.
- Companies
  - Anticipate a higher cost of capital during periods of high EPU, especially when broader economic indicators are weak.
- Regulators
  - Clear, predictable policy communication is a direct tool for maintaining financial stability and reducing unnecessary market volatility.

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