BNZ Weekly Overview

1 August 2019

ISSN 2463-4328

Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

Our Economy

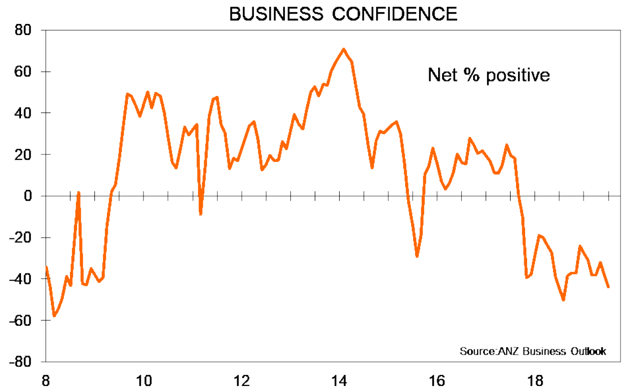
Last week not everyone could read the location labels on the three detailed housing graphs showing shifts in sales to investors over the past year. So I've reprinted them bigger in the Housing section. If you still can't read them, best upgrade your 386 to at least a 486.

The United States economy has just recorded its longest period of economic growth since data started in 1854. Their unemployment rate is near a half century low, and growth in GDP was an annualised 2.1% during the June quarter. Our own economy has been growing quite well also in recent years with positive annual average growth since early-2010. Our unemployment rate is just 4.2% and annualised GDP growth was about 2.2% in the six months to March.

We can all rabbit on about risks surrounding Brexit, the Persian Gulf, anti-China sentiment fomented by China's military, spy, and coercion network expansion, Europe's slowing growth, Trumpian America, trade battles, a retreat from multilateralism and globalisation, technology disruption and so on. But anyone who has paid attention to worries over the past decade and sat on their hands not hiring people, investing in shares or property, has missed out on capital gains and/or business growth opportunities.

But even if we put potential offshore shocks to the side, should we not be thinking about a rapid slowing in NZ growth anyway simply because we have been growing for so long and the upturn is long in the tooth? There is plenty of reason for taking a cautious approach to one's planning for the next couple of years going by what business sentiment surveys are telling us.

The ANZ's Business Outlook survey released yesterday revealed the Prime Minister is failing in her goal to improve business confidence – a bit like Phil Twyford with KiwiBuild. A net 44% of business respondents have a bad outlook for the economy. This is up from 38% in June, compares with a net 18% positive sentiment pre-election, and apart from two months last year is the worst level of feeling since three months early in 2008 when the official cash rate was above 8%.



Which is sort of the crux of the issue here. Business sentiment collapses are traditionally associated with interest rates being hiked to fight inflation. But interest rates are low and still falling because the world has changed post-GFC and firm growth plus resource shortages no longer bring the inflation bogeyman out from behind the bushes as used to happen.

Putting aside for now the still growing list of studies attempting to (as yet unsuccessfully, completely) explain the structural shift in inflation dynamics, why are businesses so dour? After all, consumer sentiment is at above average levels, exporters seem okay with the NZ dollar's level, borrowers are living the rates dream, and world growth is near average with our terms of trade only just below record highs.

The answer is that business success in the end depends upon management competence, not the state of the economy. No-one undertaking an MBA has their lecturer tell them on the first day that their company can only thrive if GDP growth is above 2%.

We economists have infiltrated your thinking these past three - four decades because we have been able to give you insight into newly worrying interest rate and exchange rate pressures, and some still spend an inordinate amount of time trying to predict interest rates and have been getting it wrong for over a decade. And we know that changes in the pace of growth through macro impacts will drive share prices on average, and valuations for commercial property.

But we are living in a very different world now from what we have all become used to one way or the other since things opened up in this economy in the mid-1980s.

Businesses now face a range of challenges which lie outside changes in the pace of economic growth. Pay less attention to our waffling about tiny changes in GDP growth prospects and focus instead on the massive changes sweeping the globe and how to handle them.

I have striven to highlight many of these challenges in this publication in recent years (along with pointing out the logical outcome of housing demand exceeding housing supply). My focus has shifted from simple data analysis and its implications for financial markets toward these broader issues. And whether our economy achieves average growth over the next five years of 1.5%, 2.5%, or 3.5% does not matter as much as one might think when it comes to which businesses will still be around come 2024, and which will be toast.

Here are some of the factors businesses are struggling to handle.

Pricing power for most businesses has disappeared now that technological advances mean you and I as consumers and business buyers can, at virtually zero cost, search for information online about alternative suppliers, products, and prices. Rising business costs can no longer easily be recovered through adopting a cost-plus pricing model and raising prices. Margins are tight and they are only going to get tighter and tighter.

The **speed of change** businesses face is the fastest they have ever seen and is only going to get faster across a spectrum of facets such as how consumers use their products, new outputs, competitors and distribution systems, shifts in consumer preferences, production methods, logistical channels, and so on.

Handling the speed of change and the loss of pricing ability requires a level of awareness and managerial expertise which we Kiwis with our many failed forays overseas have proved we do not by and large have. Our adherence to “number 8 wire” thinking is completely at odds with what is needed to thrive in a world of accelerating digital change, shifting partnerships and collaborations, and **surging issues such as climate change, plastics, water pollution** etc. Head in the sand thinking and pleas built on self-perceptions of special roles remain.

And it gets worse because one of the areas in which studies have shown we struggle is **staff management**. Too many of us have old ideas regarding what staff want, deserve, and should put up with. Now that the labour market is tight and employees are realising they have move power in many instances than the bosses, we are struggling to keep and attract staff. Bosses ignorant of what strikes and invasions of shopping malls are telling them are going to suffer.

As mentioned here recently this will now get worse. Unskilled labour is almost as hard to find as skilled labour. And good, long-serving, staff are leaving, taking their meta-knowledge with them.

Somewhere down the track, in all probability, access to bank finance for many businesses will become structurally worse as the Reserve Bank lifts **bank capital requirements**. NZ businesses have traditionally grown through bank funding rather than capital raising. This will become a new challenge.

The upshot is this. The state of the economy and its prospects cannot explain the appallingly high level of business pessimism. But Kiwi business cultural weaknesses can explain why we are struggling to handle the world of massive change we are now living through. And that means that unless this world of change stops – which is very, very unlikely – it is completely unreasonable to expect that smiles will return to the faces of our businesspeople any year soon in the near future.

And that is why the PM made a mistake in setting a goal of strongly lifting business sentiment ahead of the next election. It is out of her hands just as it would be out of the hands of National had they won in 2017 – though the level of pessimism would have been less as there is a downward bias to business survey results when Labour are in power.

Specifically, the economy averaged 3.5% growth per annum when Labour were in power from 1999 to 2008. The ANZ confidence measure averaged -18%. But it averaged +23% when National were in power from 2008 to 2017 and growth averaged 2.5% per annum. So businesses get worried about the economy overall when Labour rule. But as regards their own firms things are different. The net own activity expectations measure averaged +21% from 1999-08 and +31% from 2008-17. That measure is currently +5% with a 20 year average of +25%, nowhere near as bad as the confidence reading of -44%.

So what is it that businesses need to do? First, stop paying so much attention to us economists when we prattle on about GDP growth heading toward 2.3% rather than 3.1%. It really doesn't matter as much as before.

Second, target growth based upon the resources you can reasonably expect to command over the next five years. That is, don't sign up lots of new customers and then go and try and hire people to service them. The risk is you don't, or you do but their work is so poor that productivity falls and money is lost redoing work to adequate quality.

Third, stratify your markets, products, and customers according to the profit they yield you. Cut out the low profit and loss-making bits as a way to boost overall profit.

Fourth, try and get ahead of the consumer and eventually legislative curve with regard to issues of the environment, plastics, and climate change.

Fifth, while traditionally we Kiwis eschew external advise, actively seek it out. The chances are high that other people will bring insight you cannot generate yourself.

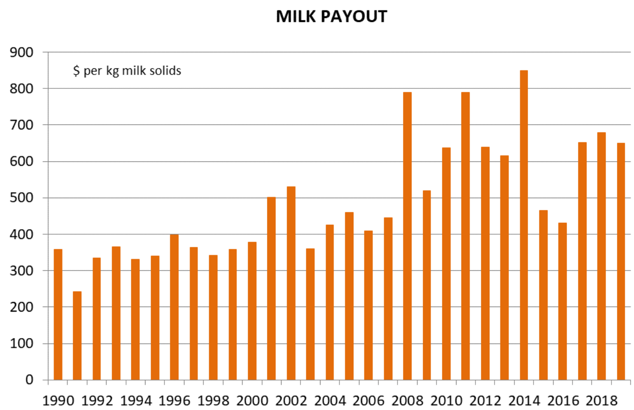
Sixth, plan to invest to reduce dependence upon labour, enhance flexibility to handle unpredicted changes which are certain to come along, introduce latest technologies, and boost collection and interpretation of data relevant to your business market.

Seventh, seek out firms to partner or collaborate with.

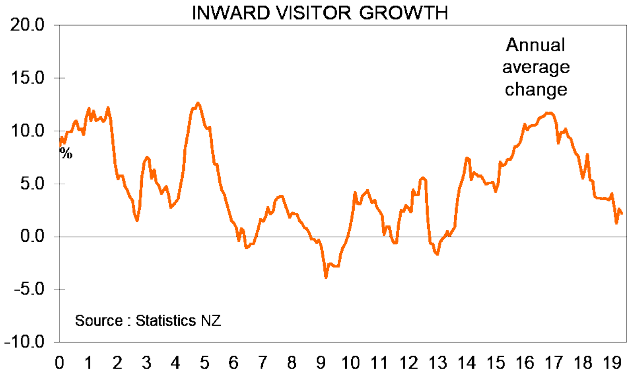
Eighth, don't put off doing these things. Schedule a one day strategy session in the coming three months.

And finally, think about the conditions which have driven your sentiment to such poor levels now while the economy is still doing okay. Now imagine how you would be left if a shock downturn were in fact to come along.

Not convinced yet? Think about the dairy sector. They have (hopefully) passed peak cow, and pressures are growing from a wide range of sources. All going well the sector will slowly reduce debt levels, land prices will fall gradually (so far 4% - 12% though hard to read given few farm sales), production will shift back to low input systems, and pollution issues will be steadily addressed. Now imagine what would happen in the sector, given all their pressures, if overseas milk supply were to boom at the same time as slowing global and Chinese growth cut demand, and the payout fell back below $5 as happened over 2014/15 and 2015/16.

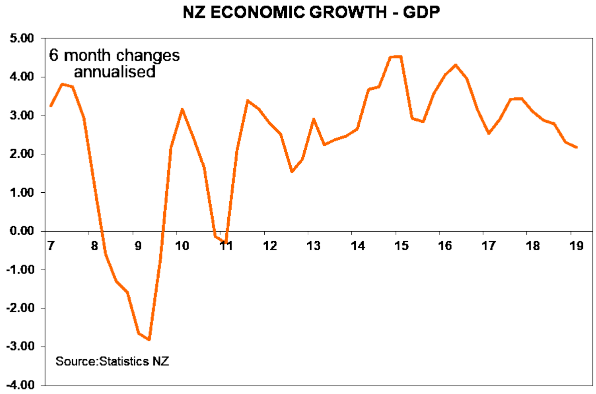


Which brings me to a useful point to finish on. Growth in our economy has slowed and immediate prospects look acceptable but not stellar. The adjustments occurring in the dairy sector, our second biggest export, are feeding into downstream businesses dependent upon the dairy sector. The foreign tourism sector has flattened out following a boom. Construction has boomed but may be near a peak given resource shortages. Businesses will likely newly curtail capital spending more than they already have given their high pessimism.

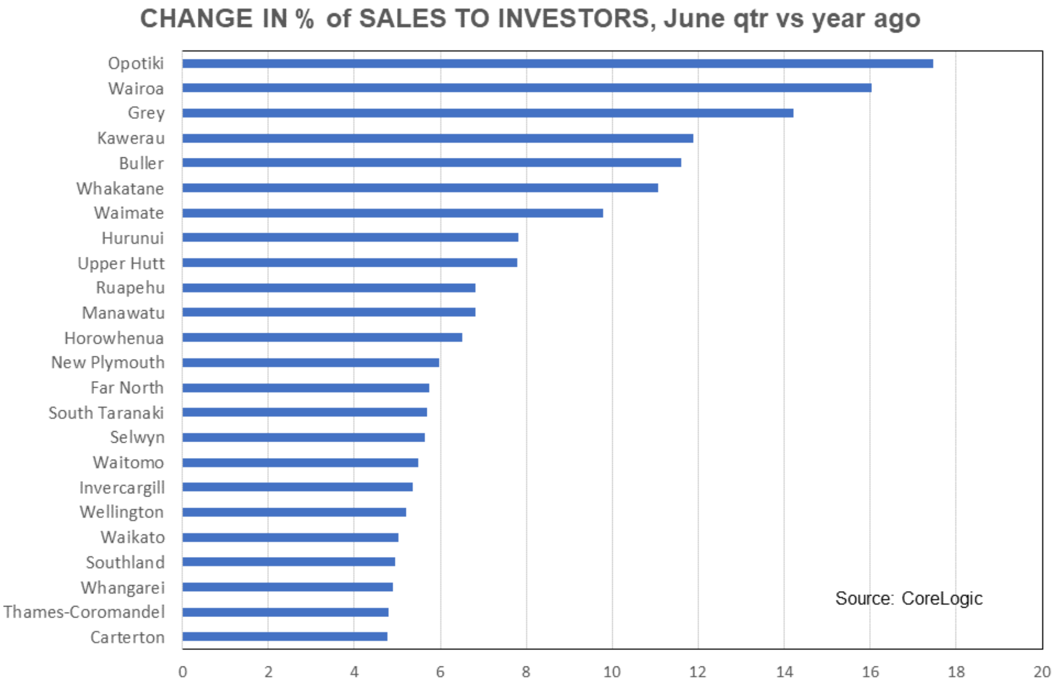


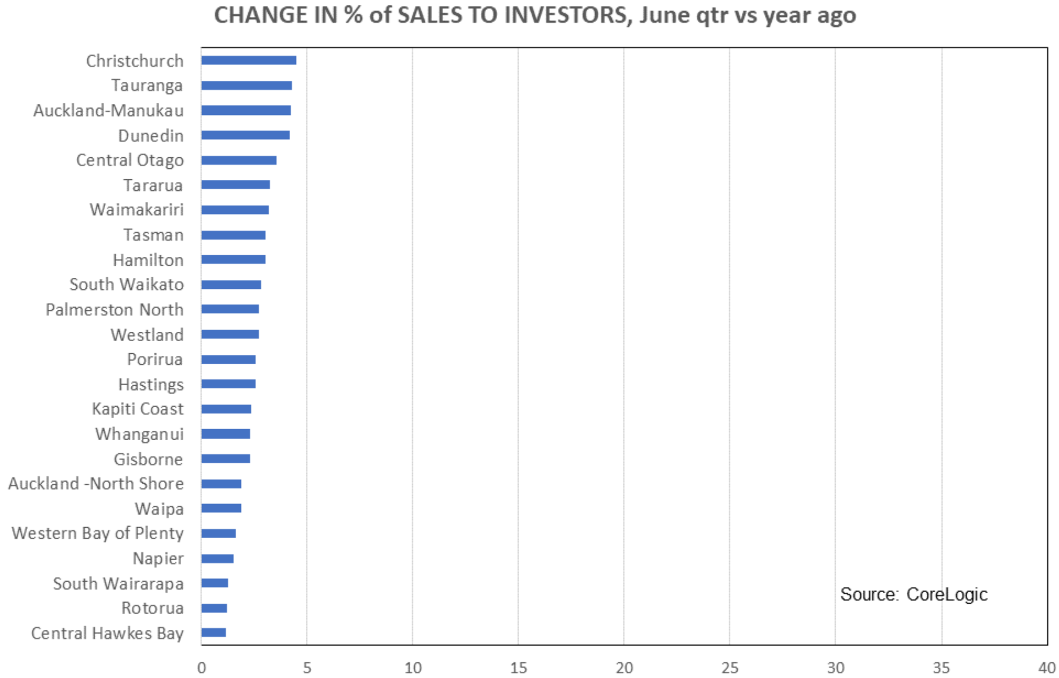
Consumer spending growth may remain above average, but it has slowed down, perhaps in response to slower jobs growth driven partly by a lack of more people to enter the workforce. Older people, seeing returns on their savings diminish, will likely be cutting spending. Net migration inflows have come off their peaks though remain firm.

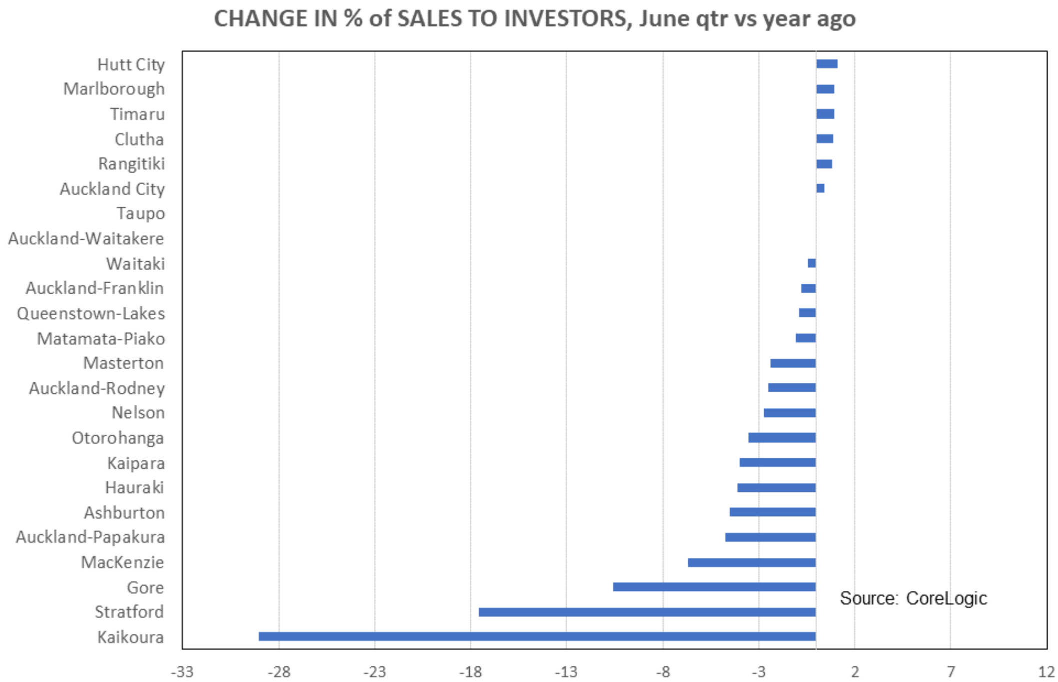
There are no king hits to the economy. But we have settled into a slower growth phase near 2% after a stellar period of growth averaging 3.5% annualised from mid-2014 to early-2018.



Housing







If I Were A Borrower What Would I Do?

Next Wednesday the Reserve Bank will announce the outcome of their review of the 1.50% official cash rate and release their latest set of economic forecasts. The chances are that they will caution about a slowing of NZ's pace of economic growth in response to slowing international growth, trade risks offshore, Brexit-related risks, flattening tourism growth, and some slowing domestic growth drivers.

Chances are good then that at a minimum they will retain a bias toward easing monetary policy and might cut the cash rate. What impact will a cut have?

For borrowers it will lead to some downward pressure on interest rates. But the lower interest rates go the less direct the pass-through of OCR cuts to lending rates. There are a number of reasons for this. One is that banks need to maintain high levels of funding from retail deposits for regulatory requirements including those related to liquidity. We savers are of course rate sensitive, and there is already evidence that with term deposit rates going so low more and more people are not prepared to sacrifice flexibility for minimal yield gain and are simply chasing whichever bank has the best on-call or short-term deposit rates.

Banks need term funding. So OCR cuts won't get fully passed on into term deposit rate cuts. That means the cost of funds does not fall 0.25% each time the OCR is cut and the extent of the decline shrinks the lower that interest rates go.

Banks also get a proportion of their funds from zero-interest accounts – NBIs = not bearing interest. When interest rates are high these accounts are very valuable but form only a small proportion of the total funding cost. When interest rates are low they can form a progressively rising proportion of total funding cost and this mutes the percentage pass-through of OCR cuts through into lending rates.

Banks are also facing ever-rising regulatory and compliance costs as our central bank progressively takes a more hands-on approach to bank regulation. Plus, come November, banks will find out how much extra capital they will need to raise over what time period. Capital is not free and holding more raises the overall cost of funds.

Nevertheless, come Wednesday, if the RB cuts the OCR from 1.5% to 1.25%, we will see retail interest rates edge down a bit. But no-one seriously believes that there will be much impact on either the pace of growth in the economy or inflation. Credit demand has shifted structurally lower following the GFC, and I cannot recall anyone in the past three or more years approaching me at any function complaining that their borrowing costs are too high. One person has complained about the near 8% mortgage rate used for making calculations surrounding debt-servicing ability – but that is it.

The big constraints for businesses and their growth are labour force management, handling the speed of change and the digital revolution, regulatory imposts from increasingly meddling governments, environmental issues, and so on. Not financing costs.

Similarly for home buyers and owners, mortgage interest rates are not the issue. Finding an affordable house often is. And people seem to have picked up on the realisation that lower interest rates this past quarter of a century have been factored into higher house prices.

So will lower mortgage rates drive the housing market up again? I think some demand will be spurred as people look anew at yields and the fact they are rising in some important parts of the country. But I don't think the impact will amount to much.

What about other assets? This is where debate is raging offshore. Sharemarkets are already at high levels. Are they over-valued, will they fall sharply, have they become more vulnerable to shocks? We don't know, and history shows us that we cannot pick such things.

All one can say is that low risk investors who are concerned about the returns they are now getting on assets like term deposits need to realise that the bulk of asset price adjustments to structurally lower interest rates have already occurred. If they shift into higher risk assets they chose not to go into before they might get better yields. But they will introduce asset value risk which was not there to any meaningful degree with bank deposits or government bonds.

These people have to simply accept that unless they take more risks – which they avoided in the past – they will receive lower returns. Perhaps better options to compensate for lost income are undertaking part-time work, renting out space on Airbnb, plus cutting back on café visits, reducing offshore holidays – you know – the list of things I wrote here a couple of years back regarding what young people could do in order to cut spending and improve ability to get a house. Anyone back then who bought a ?>"@% house would have done quite well wouldn't they when the government's chief science advisor subsequently came out and said the meth-testing regime was rubbish and decontamination was not needed in all but the most extreme instances. Instant capital gain.

Perhaps disappointed savers need to look at things this way. Bank term deposit rates used to be high because inflation was often high and threatening. But the period of bad inflation from 1973 to 2007 was an aberration in human history.

Now we are back to the old low inflation centuries and so interest rates are back to their old low levels. Its just a pity for the older folk who paid mortgage rates over 20% when they were borrowing but are now getting deposit rates near 3% when they are depositing.

Maybe you could lend funds to your kids or grandkids for a tax free return near current headline deposit rates. Just get everything drawn up legal and airtight and be prepared to sue them if they polish the chips on their shoulder and a decade from now reckon you should gift them the loan rather than get the funds back.

The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The views expressed are my own and do not purport to represent the views of the BNZ. **This edition has been solely moderated by Tony Alexander**. To receive the Weekly Overview each Thursday night please sign up here. http://feedback.bnz.co.nz/forms/lFdYSs5FGEq4kAjP95uzTA
To change your address or unsubscribe please click the link at the bottom of your email. Tony.alexander@bnz.co.nz