NZ Observer

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Mission Statement

To assist Kiwi SMEs in planning for their likely upcoming operating environment by discussing the economy and its implications in a language they can understand.

SUMMARY

- There are plenty of courses available for small business owners to take. But the sign-up rate is very low. How might one better encourage owners to engage with course providers? Perhaps not by emphasising the potential business growth benefits, but instead by highlighting failure and simple ways to avoid it.
- The Reserve Bank has eased monetary policy and will do so again as falling dairy prices and a still slowing Chinese economy worsen the country's economic outlook a tad – by perhaps enough to warrant undoing at least half and maybe all of last year's 1% cash rate increase. But how will the Reserve Bank offset the extra stimulus to the Auckland housing market? More lending controls look highly likely, and eventually foreign buying restrictions as well.
- The Kiwi dollar has recently traded below US 70 cents for the first time since the middle of 2010. Further depreciation is likely but a substantial drop looks off the cards as although US monetary policy looks likely to be tightened, the lesson NZ provides from 2010-11 and again from 2014-15 is that such tightening may not be sustained. Plus our economy retains good support from construction, migration, and household spending.

The Power of Loss

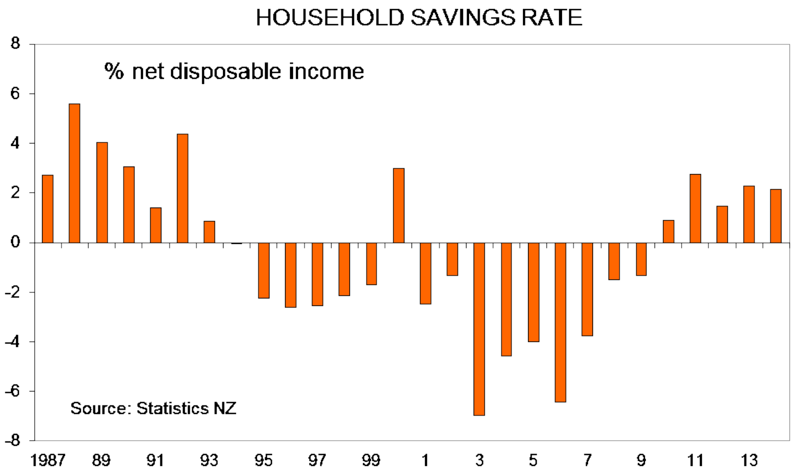
Recently I attended a gathering at which the Minister for Small Business Craig Foss invited discussion from participants in the small business sector regarding their concerns. A number of things came up ranging from concerns about compliance costs – something which increasingly irks businesses of all sizes - declining labour availability and increasing dependence upon overseas backpackers who need to be trained, then leave, and more training of new ones is then required.

There were concerns expressed about taxation, and how the language used by government and business course providers and advisors was often not that used by the owners themselves – "governance" for instance.

One strong area of focus was the way in which small businesses tended to stay small, sometimes through not having the skills needed to get bigger, lack of desire, weariness to accept outside capital and direction and so on. Related to that there was hefty discussion about the low participation by small business owners in the large and still growing number of special programmes being set up for them to learn business skills.

An example was given of almost 300 small businesses being referred to one particular course, but only four taking it up. One reason cited for this lack of participation was simple lack of time to attend a course. Another reason expressed was that businesses are not convinced of the need to develop new skills so they can take themselves from having the ability to start up a business to running it well, then to growing it.

One might think that a way to try and get higher small business participation in courses would be increased advertising of them. But consider what such advertising for the past quarter of a century has done to our personal willingness to boost savings for retirement. Nothing if the statistics are anything to go by. As Kiwis we so love borrowing money that the continuing trend decline in interest rates underway since the early 1990s has easily dominated any nods we have given to those letting us know that it would be a good idea to boost our long-term saving. In fact looking at the graph below one cannot conclude that we willingly save more. The negative savings rate only became less bad once interest rates really started going up over 2006 into 2008, and after that one could put the movement into positive territory (a miserable +2.1%) down to the shock of the Global Financial Crisis. Not TV ads.



So what might be a good way to get more small business owners to take courses? One idea is this.

As humans we are over three times more sensitive to the loss of a thing than the gain of a thing. If we make $100 we feel it is only natural we do so as we think we are reasonably clever. If we lose $100 we feel stupid and question our own competence in a sometimes deep soul-searching exercise. Hence, in the 1990s and 2000s when finance companies were attracting deposits from banks they were not saying to potential clients that they should come to them and gain an extra 2%, but warning that if they did not shift their business they would lose 2%.

In one fell swoop the finance companies hit not only our higher psychological exposure to loss than gain, but also our deep-seated FOMO driver – Fear of Missing Out. This FOMO driver is very strong in our teenagers, and we had just reached the point in the Auckland housing cycle, by our estimation, where FOMO was becoming a strong force.

That is, inexperienced, under-capitalised people were entering the property market as investors, attending courses and evening seminars not driven by greed but by a fear of missing out on what the media keeps telling them are easy gains. If something is on the front page of the country's biggest newspaper most days of the week you are going to tend to believe it is true and want to take some action on a thing which clearly is a matter of moment to any thinking person.

So how does this relate to small business owners and their reluctance to attend courses? Simple. You don't tell them what they will gain by attending a course, but what they will lose by not attending. Consider for instance how the courses tend to be promoted

-how to grow your business
-how to handle staff disputes
-how to make the most out of a new free trade agreement
-getting your goods into Australia
-simplifying your compliance costs.

To a small business owner their thinking is likely to run along the lines of “I can grow my own business, what can go wrong? I’m not taking any crap and don’t need to be told how to manage my own people. Exporting is too tough so I’ll give that a miss. Getting stuff across the ditch is easy. I’ve got cousins there who can help. My accountant takes care of all that compliance stuff.”

Now try these taglines

-Most small businesses close within five years. How to avoid disappearing like the others.
- Five businesses sunk by poor staff management leading to disputes – how to avoid their failure.
-Each week you’re losing customers. How to avoid losing 1.4 billion of them.
-Telecom, the Warehouse and Ansett couldn’t survive in Australia. What do their failures teach us to avoid when growing there?
-Neglected compliance can wipe out your profits. How to avoid the simple mistakes.

Anyone with a decent marketing background could probably say the same thing in half the words for each of these examples. The aim is not so much to scare people into attending a course, but to let them know what bad things they can avoid by going.

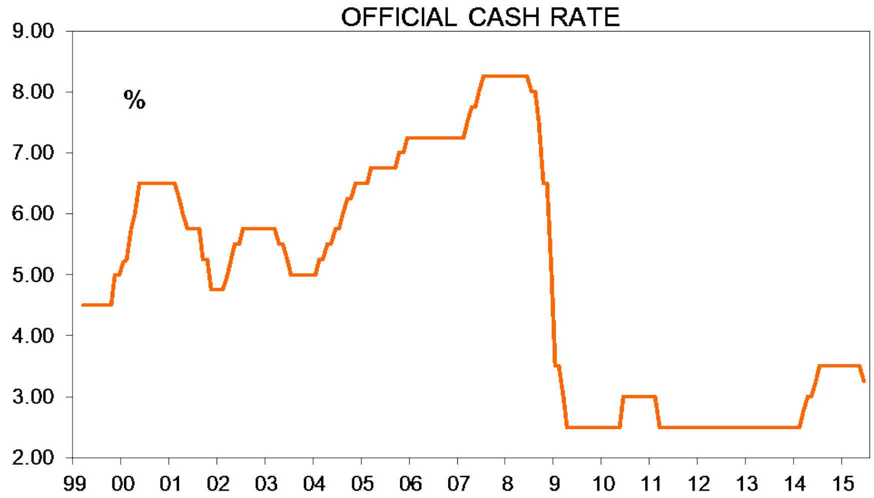
In similar vein, when I used to do a lot of tramping and receive the quarterly Federated Mountain Clubs bulletin the first thing I would do for each issue was go to the back and read the accident reports. I wanted to know what went wrong and how to avoid making the same mistake next time I was out in the bush or up a mountain. Knowledge of what could go wrong got me out into the bush more, not less. And again with a tramping analogy, when two inexperienced walkers meet on a track they will talk about the lovely waterfall over there, the beautiful birdsong somewhere else, and so on in gleeful tones. When two hardened trampers meet they’ll casually ask questions about how many in the other party, track conditions further along, latest weather forecasts, other people on the track and so on. Plus maybe then mention the scenery, and sometimes the other persons smell.

So, if you are a small business owner reading this and you’ve not signed up for one of the many courses on offer, ask yourself – what am I missing?.

Borrowing Costs

In Sporadic 9 issued on June 3 we looked at developments since the start of the year and concluded that the outlook for the New Zealand economy had got worse, substantially because of the continuing decline in global dairy prices and ongoing slowdown in China. The Reserve Bank looks to have done the same analysis, looked at the 0.1% inflation rate, and concluded that some and perhaps all of the 1% increase applied to the official cash rate between March and July of last year warrants being removed.
http://tonyalexander.co.nz/wp-content/uploads/2015/06/Sporadic-9-June-3-2015.pdf

Therefore, for the second time following a post-GFC tightening they have embarked on a process of unwinding what they just did. The first time was in March 2011 when following some weak economic data and the second Canterbury earthquake they cut the cash rate from 3% back to the 2.5% the rate was taken to in early-2009. It had been lifted to 3% in mid-2010. On June 11 last week the RB cut the 3.5% cash rate to 3.25% and we expect a further cut to 3% at the next review on July 23. Cuts after that will, as the RB have noted, be dependent upon data.



The reduction in mortgage rates underway and yet to come will clearly stimulate housing markets around the country (not really affected within 18 months by cow prices or milk returns outside of main dairying regions), not just from an affordability point of view for owner-occupiers, but as investors facing yet more years of low bank term deposit rates throw the towel in and seek higher yielding assets, especially as they look to living many years in retirement and needing cash flows.

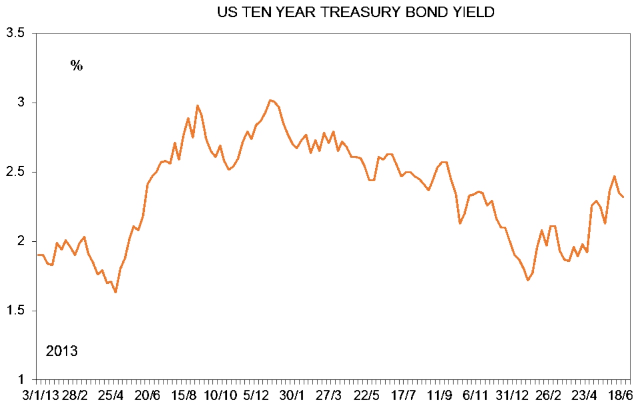
So how will the RB handle the extra upward pressure on Auckland house prices? Almost certainly there will be extra macroprudential tightening applied. That is, they will eventually require banks to hold more capital for investment property loans, thus causing those interest rates to sit higher than rates for owner-occupied lending. Maybe rates go back to where they sat two weeks ago. The effect will be minimal. The government may join in by extending the two year brightline test for automatically applying capital gains tax to any investment property bought and sold within two years – perhaps first to five years, then later ten. If not under this government then probably the next one. That won't scare many people one suspects beyond a handful of skilled tax-evading flickers.

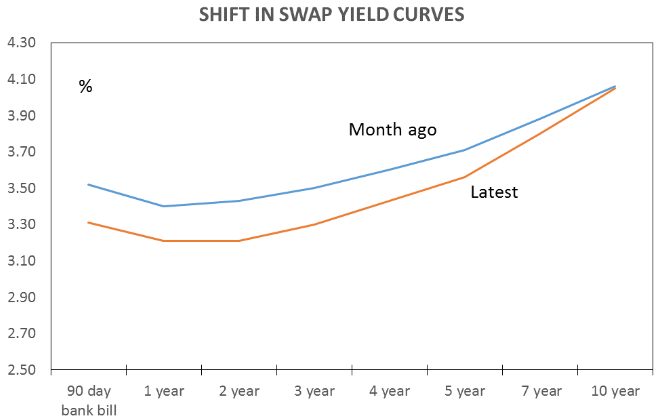
Full implementation of a regime restricting foreign buyers along the lines of Australia's rules will eventually come, but probably not this cycle.

It is not highly likely that restrictions on lending exceeding a multiple of borrowers' income will be introduced. These take the form of limiting the amount people can borrow to, say, four times joint income. This would radically limit access to home ownership in Auckland to young people and those on low incomes while having very little impact on investors and doing nothing for supply beyond perhaps spurring construction of low priced apartments. Lifting the investment property deposit requirement from 30% to 50% or higher is quite possible.

Assuming that the RB have faith in their housing measures and if we see dairy prices falling further, then the full 1% increase in the cash rate could be gone by the end of the year though at this stage we thing just 0.5% worth of cuts is likely. Does this mean borrowers should simply float their debt and eschew fixing? Not necessarily. There are two key points to note as you consider your interest rate risk management strategy.

First, it is highly likely that monetary policy in the United States will be tightened before the end of the year. This will apply upward pressure on NZ fixed interest rates. In fact, with US tightening expectations lifting over the past 2 – 3 weeks we have seen the highly-watched ten year US government bond yield rise from 2.13% three weeks ago to near 2.35% now. And while the cash rate cut in NZ has helped push the NZ one year swap rate down to 3.21% from 3.4% and the three year rate from 3.5% to 3.3%, the five year rate has fallen only from 3.65% to 3.56%.





The yield curve is steepening and there is more to come. Thus within a few months the cost of moving from floating to fixed rates may become prohibitive for most people and the fixed rates from about the three year term will likely be higher than they are now.

Thus, if you are looking to fix beyond three years it may pay to do it sooner rather than later.

Second, if you place high credence in what we have just written about where floating and fixed rates might go over the remainder of this year then you are forgetting what I started writing five and a half years ago. This was and is that a person would be foolish to base their interest rate risk management decisions strongly upon a particular set of interest rate forecasts proving accurate. Essentially everyone has got their rate forecast wrong since 2007. The GFC has not just thrown traditional relationships between key economic variables into disarray as we humans have altered our behaviour, it has also produced an unprecedented surge in global liquidity about which central banks can only guess as to the ongoing effects. Predictability of financial variables went out the window a long time ago.

Therefore you must not place faith in anyone's interest rate forecasts (or exchange rates for that matter). Instead you should explicitly recognise that the world has changed, forecastability has plummeted, and you need to adopt a risk management strategy which reflects this. You start by figuring out your bottom line vulnerability to rate changes then decide how much of that volatility risk to hedge away with fixed interest rates, or more sophisticated products for business borrowers. If you feel you could easily handle a 2% movement in rates in any direction then you might choose to stay floating or fix just 25% of your debt. If 1% could be handled but not 2% then maybe you fix half your debt and do it at a mix of terms from say one year to five years.

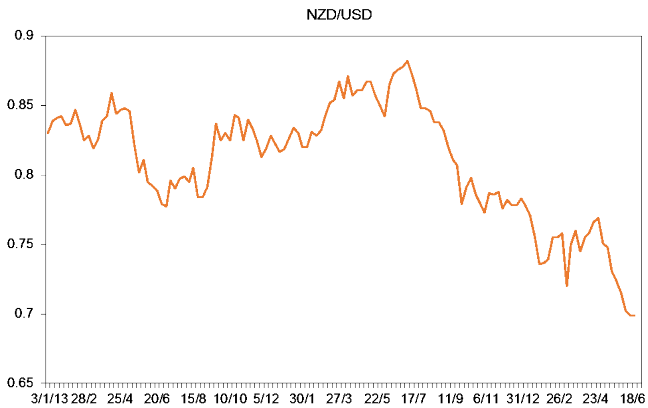
If you could not handle a 1% rate change then your incentive is to fix perhaps up to 80% of your debt – again at a range of terms.

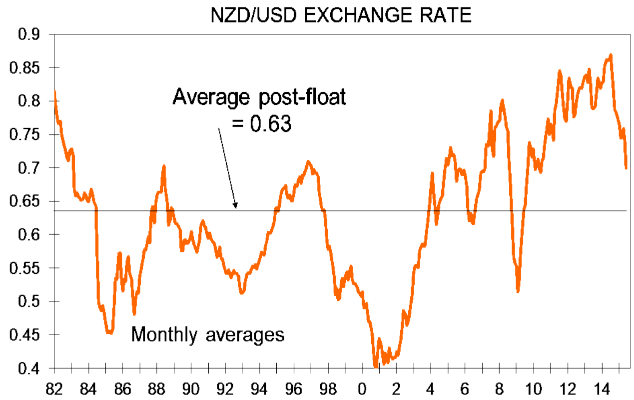
Good luck and remember to count your blessings that as a modern borrower you are paying the lowest rates since the 1960s, as opposed to those of us who took out our first mortgages in the late-1980s at 18.5% and up to 23% for some unfortunately people. The offset for you however is that if you are borrowing to buy a house then the house price is a lot higher compared with incomes because affordability has been boosted by lower borrowing costs. The market has factored that cost reduction into house prices, with an extra boost from higher incomes due to more joint family incomes. The big winners from the lower interest rate environment are not home buyers but businesspeople. As always, before you decide, independent financial advice is always good to get.

NZ Dollar

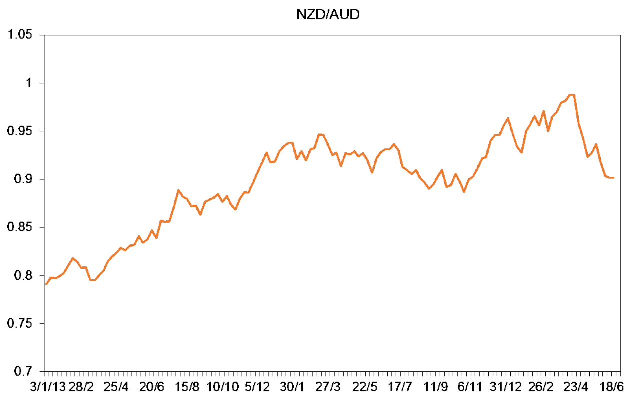
The deterioration in outlook for the NZ economy and easing of monetary policy have caused the NZD to take a step downward over the past month. The NZD has declined by three cents against the greenback to sit below 70 cents from 78 cents at the start of the year. Against the Australian dollar we have fallen to near 89 cents from 94 cents a month ago and 96 cents in early-January. Against the British pound we have fallen to near 44 pence from 47 pence four weeks ago and 42 pence in January. Against the Japanese Yen we are near 85 from 89 a month ago and 93 in January, and against the Euro 61 centime from 66 and 66.

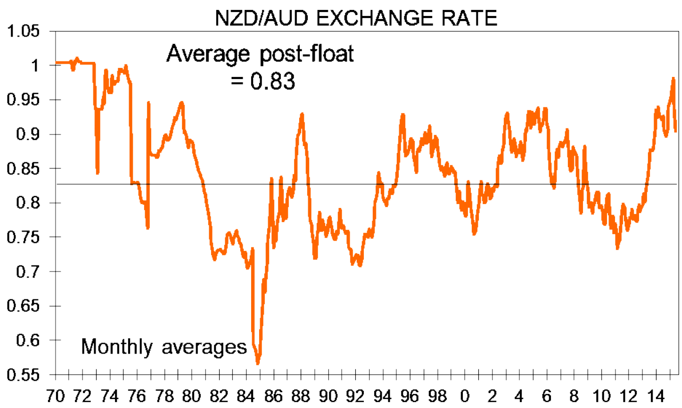
The first graph in each of the following pairs starts in 2013.



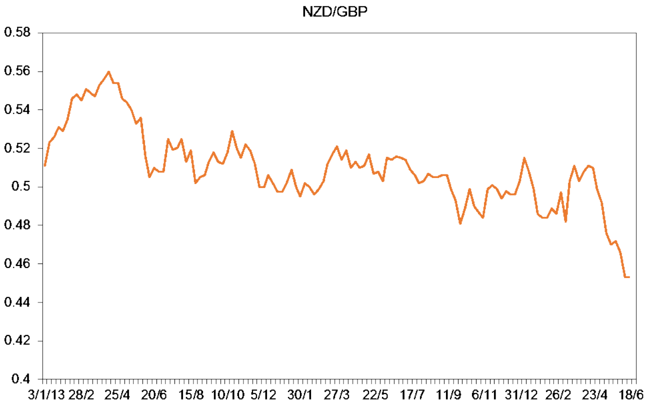


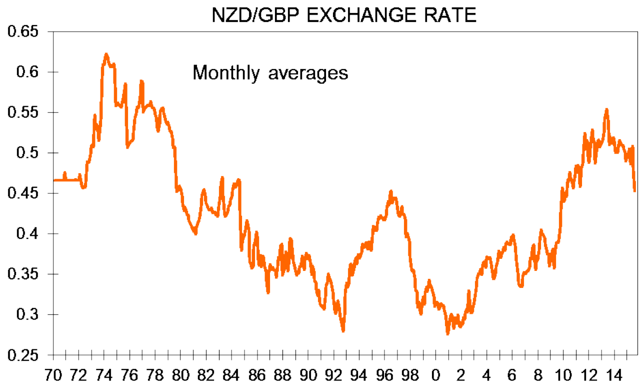
We expect (for what it is worth) that the NZD will drift lower over the next two years as the economy comes off the boil. But history and common sense tell us and hopefully you that it is impossible to reasonably forecast the path downward which our currency will take and that there will be some periods of substantial correction back upward which importers might want to wait around for before they buy into predictions of a fall to US60 cents this year.



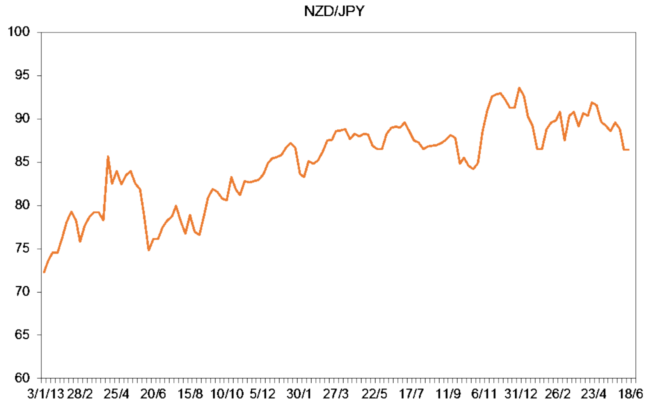


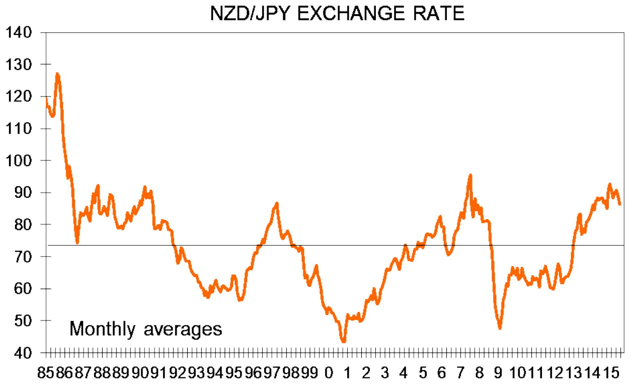
Why? Because while there will be upward pressure on the USD from US monetary policy tightening, there was also supposed to be upward pressure on US bond yields when money printing ended in October but that has yet to happen. Predictability of financial variables is low and it is possible that the markets have already factored higher US interest rates into USD pricing. After all, since September year the greenback has gained 13% against the Japanese Yen, 12% against the Euro, and 5% against the British pound.



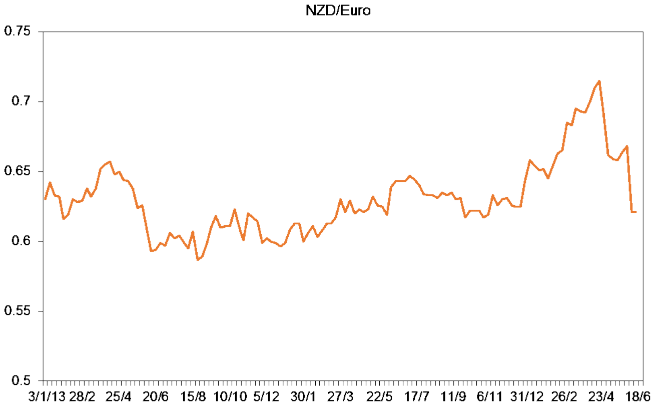


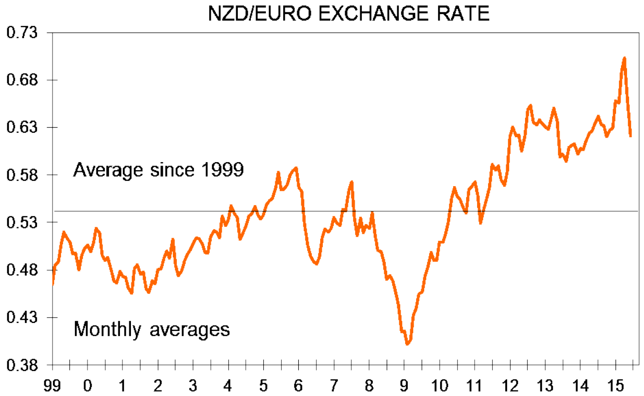
But perhaps more significantly, weakness of the NZD against the USD over the second half of this year will be restricted by the still good growth in our economy coming from construction and household spending, and the likelihood that by year's-end the multifront easing of economic policies in China will have led to improved outcomes and bring support for China-dependent currencies like the NZD and Australian dollar.





Speaking of which, across the Tasman the Australian Reserve Bank Governor recently made some downbeat comments about the state of the Australian economy and left open the prospect that there could be additional easing of monetary policy. If this happens then the pace of the NZD's decline against the AUD will be reduced.





With regard to the Yen and Euro a strong influence for the coming year will remain money printing by both respective central banks which will tend to depress their currencies. The same does not apply to the British pound where monetary policy will be expected to be tightened ahead of any move in Europe, thus tending to give the pound some support. However there will likely be volatility associated with the debate about EU membership and lack of consensus on whether exit would harm or benefit the UK economy.

Housing

It is near universally accepted that there is a property shortage in Auckland and that is what is principally pushing up prices. We noted this shortage and other very strong factors driving prices in Sporadic 8.
http://tonyalexander.co.nz/wp-content/uploads/2015/05/Sporadic-8-May-12-2015.pdf

It is not possible to reach agreement on the size of the shortage for a number of reasons. One is that in strict economic terms a shortage only exists if prices have not risen by enough to bring forward extra supply, cut demand, and therefore establish a new equilibrium. There is no ongoing shortage, just disequilibrium. Auckland prices are still rising therefore disequilibrium persists. One's calculation of the shortage will vary depending upon how much prices have risen or are expected to rise.

Second, it depends upon what you consider "normal" to be. Is it when Auckland has the same household occupancy rate as the rest of the country (in which case the shortage would be near 75,000)? Is it the number of houses needed to drop the average price to that of the rest of the country? Or is it when Auckland's occupancy rate is back where it was at some point in the past? Change that time and you change the shortage calculation.

What if we only go back to 2006 for each region, not just Auckland, and work out the change in population from 2006 to 2015. We can then take the household occupancy rate for that region in 2006 (number of people in each house on average), assume that people would like the rate to stay the same, and calculate how many extra houses were therefore needed from 2006 to 2015.

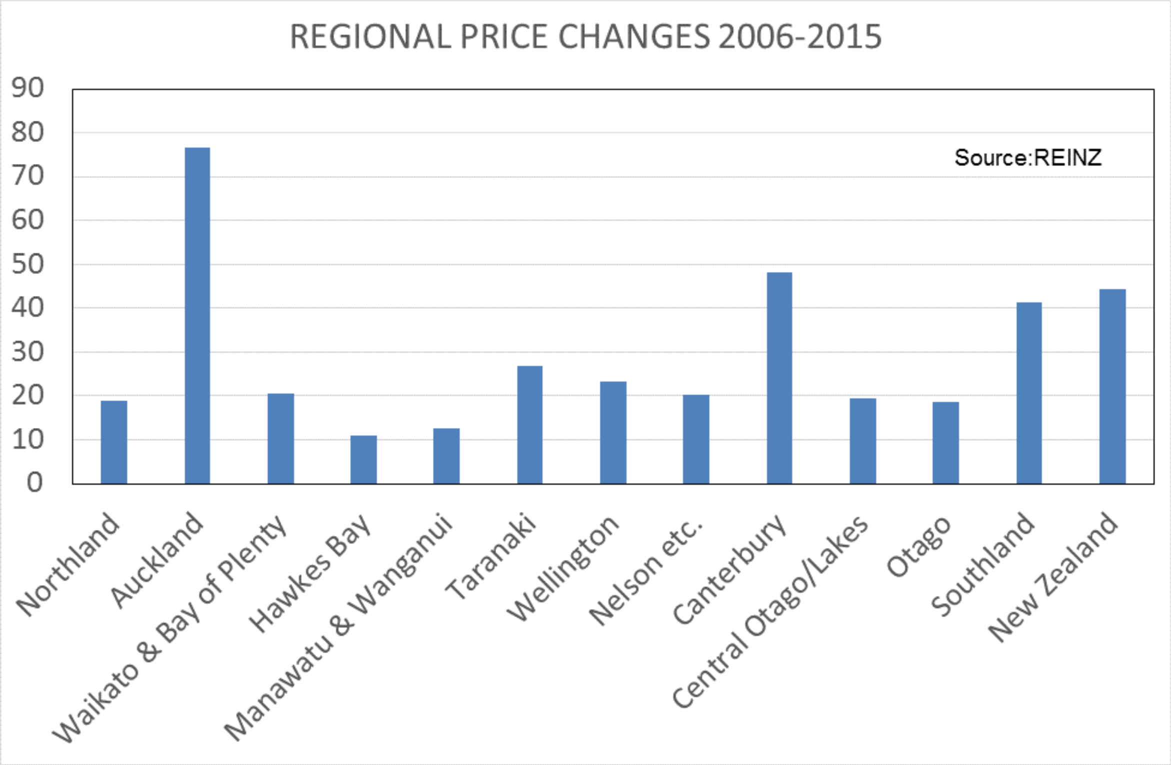
We can then compare this with the number of consents issued for new dwellings to be built, cutting that number however by 20% to allow for construction of holiday homes, replacements for existing dwellings, and consents which end up not being acted on. Running through these exercises we get the table below.

Beside each region we show estimated population growth since 2006, then the shortfall in the number of houses. These are rough estimates only based on some big assumptions. But what they show gels with what we have discussed here many times before.

	2006-15 Popn growth	**Dwelling Shortage**	**Shortage as % housing stock**
Northland	14560	-629	-0.9
Auckland	181520	24351	4.8
Waikato	41360	-1583	-0.9
Bay of Plenty	19000	-1810	-1.5
Gisborne	1320	-451	-2.5
Hawkes Bay	7660	-1087	-1.7
Taranaki	8380	-145	-0.3
Manawatu-Wanganui	3240	-3622	-3.6
Wellington	28040	-733	-0.4
Tasman	3840	-452	-2.1
Nelson	5440	338	1.7
Marlborough	1500	-1355	-6.1
West Coast	1220	-817	-4.9
Canterbury	42500	-12315	-5.2
Otago	12680	-2956	-3.1
Southland	3760	-693	-1.6
NZ	**376020**	**-992**	**-0.1**

Allowing for the assumptions and inaccuracies, there is a clear shortage of houses in Auckland and a smaller relative shortage in Nelson (which internal migration of an aging population may make worse). Everywhere else construction since 2006 has more than matched population growth needs. Hence one clear reason why Auckland house price gains have outpaced the regions, and a hint that Nelson may be due for a catch-up. For Canterbury we think interpretation of the estimated over-supply of 12,315 is problematic because of the effects of the earthquake.

How have prices in fact moved on a regional basis between 2006 and 2015? Auckland prices have risen 77%, Canterbury 48% and Southland 41%. Thus one cannot conclude, on the basis of the Southland result, that our calculated shortages are in all instances key house price drivers. Other factors go into the mix and simple price estimation models based on limited numbers of variables fail. This is especially so if the variable one focusses on is rents. Those making conclusions about the sustainability of house price rises based upon rents not rising as much as prices have so far been wrong in Auckland, and were wrong in the cycle during the 2000s and the cycle in the 1990s for most parts of the country.



One of the developments we have long been forecasting is that price rises would eventually spread out of Auckland, principally as investors would do what they have done in the past and seek better yields around the country. There has been anecdotal evidence of this all year and more and more analysts are seeing it in data released by the likes of the REINZ and Core Logic/QVNZ.

Lower interest rates will assist regional housing markets along with Auckland. But for some regions the reduction in dairy incomes will be a strong restraint, while in Auckland it will take some time before we can truly gauge the impact of the upcoming toughening up on conditions attached to investment property purchases.

Key Forecasts

Calendar Years	2013	2014	2015	2016	2017
GDP % an. av cng	2.3	3.3	2.3	2.1	2.0
Inflation Qtr on yr ago %	1.6	0.8	0.6	2.3	2.3
Employment Growth " "	2.9	3.5	2.4	1.5	0.9
Unemployment Rate Year end	6.1	5.8	6.0	6.4	6.5
NZD/USD	0.82	0.78	0.68	0.66	0.67
NZD/AUD	0.92	0.94	0.92	0.88	0.85
NZD/GBP	0.50	0.50	0.47	0.46	0.46
NZD/EUR	0.60	0.63	0.66	0.62	0.61
NZD/JPY	89.1	92.6	85.0	83.8	82.4
90-day bank bill rate	2.7	3.7	3.2	3.2	4.15

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