Sporadic

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Implications of Unforecastability

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I make between 100 and 150 presentations around the country and occasionally overseas each year (in October I will be speaking at numerous functions in London then Hong Kong and Tokyo), and occasionally speak at a conference and sit in on the preceding session. Ahead of speaking at a conference three weeks ago in Tauranga I listened to a speaker invite the audience to make sure they know exactly what it is they are selling to their customers.

Applying the question to myself the answer is I sell two things.

-Better understanding of what is currently happening in the New Zealand and international economies and why.
-Insight into whether it might be a good idea to make some tweaks in one's operational and/or strategic plans to allow for things developing which may not match earlier expectations.

What I am not selling is actual forecasts of where things are going to go. That is because forecasts are too often wrong. That is especially so in the post-GFC world where most forecasts are proving off track. Apart from most of us picking the 1% rise in the official cash rate last year, interest rate forecasts have almost all been wrong since 2008. Seven years of failure. Worldwide.

All those companies and investors buying into the concept of Peak Oil and oil prices holding above US$100 or $90 a barrel from here on out have wasted billions of dollars of investment in oil extraction from expensive sites, and even investment in expensive alternative energy sources. Bought a house in Invercargill anticipating a boom associated with oil extraction from the Great South Basin? Forget the boom, just enjoy the location, visit Stewart Island and Bluff, and relax in your affordable home reading a book outside beyond 10.00pm on summer nights.

In Australia tens of billions of dollars of investments planned on the basis of iron ore and coal prices holding up are being cancelled now that prices have plummeted. On our West Coast (the real one, not the beautiful Waitakeres in Auckland which I visited last weekend) the collapse in coal prices has had a profoundly negative economic impact.

Anyone buying dairy assets on the basis of Fonterra's payout forecasts proving correct will have noted that two years in a row of starting with a payout forecast of $7 have finished with outcomes sharply different - $8.40 then $4.40. None of us can accurately predict the season's earnings for our single biggest export.

Anyone selling US bonds in the middle of last year in expectation of the imminent ending of money printing by the Federal Reserve causing bond yields to soar will have lost money because the yields instead fell!

And where are all those people now who predicted Auckland house prices would collapse? Probably still renting, watching home ownership move out of their reach, with their partner asking 'Are you really sure house prices will fall? Really sure? Still?"

And back on interest rates, amidst expectations of accelerating NZ growth and rising inflation our central bank took its official cash rate up from 2.5% in 2010 to 3%. Come early-2011 they cut it back to 2.5% in response to weak data and the second Canterbury earthquake. Last year they raised the rate 1% to 3.5%, now they are again cutting it and the whole 1% increase could very well be wiped out.

The European Central Bank did a similar thing in 2011 by raising their cash rate from 1.75% to 2.25%. It now sits at just 0.3%. The Reserve Bank of Australia raised their rate from 3% in 2010 to 4.75%. It is now only 2%.

There are many more examples. The point is this – a broader extrapolation of what I wrote over five years ago thankfully in the context of interest rates, and for a couple of decades with regards to exchange rates. You cannot base your business growth and risk management strategies strongly upon a particular set of forecasts proving accurate. You need to explicitly note unpredictability and build two key things into your business.

-Resilience. The ability to withstand and quickly respond to unexpected changes.
-Customer centrality. Use surveys, loyalty programmes, big data, whatever to get as close to your customers as possible in order to make sure you are actually delivering what they want, know right away when you are off track, and can understand quickly when the broad market has changed.

On that last point, if you are waiting for regular data releases from the likes of Statistics NZ, and analysis of such by us economists to tell you what is happening in your customer base, you'll be out of business soon. It is not just that the data lags are as long, the coverage as patchy, and the data as inaccurate as they have always been, the key change is that in a world of big data you should know well before I possibly can what is happening in your market. In today's world I need to know what you know already in order to speak about how our economy is faring.

But that is an important issue I will come back to another time. For this Sporadic I want to place in front of you some understanding as to why our forecasts are proving really really wrong. Hopefully if you gain understanding you will take the next steps of
reinforcing your own intelligence gathering systems, perhaps partnering with a firm which can do that for you, and building resilience into your plans.

Post-GFC Behavioural Changes
You and I, businesses and governments are more sensitive to prices and debt levels than before the GFC. This affects our willingness to alter how much we spend in response to changes in interest rates, exchange rates, personal incomes, lump sum receipts etc. These are really important coefficients in economic models developed over modern times of the 1980s – 2000s. Our altered behaviour is probably still altering and we do not have enough data to produce accurate, model-generated forecasts of where things like investment, consumption, growth, wages, inflation, interest rates, etc. will go. It may take a generation for things to settle down.

China
As discussed on and off for three years now, the more we are reliant upon China as a destination for our primary sector exports like dairy, forestry, meat, fish etc., the greater will be the volatility in primary producer incomes, investment, spending, regional economies, and eventually the overall economy. This arises because China tends to have some very large inventory cycles. Everyone buys at once because others are buying, everyone stops stocking up at the same time because others have stopped stocking up. Hence big cycles for iron ore, coal, wool, forest products and of course milk powder. But on top of that, in the case of milk powder at least, no-one seems to know what level stocks are actually at! If you have income in any way dependent upon primary sector exports (rural contracting, rural financial services etc.) you face higher volatility than before and you should adjust for that by lowering your debt to income limits, diversifying across primary sectors, showing a preference for fixed supply contracts…

And just to top it off, volatility from China is enhanced by lack of knowledge regarding how China's transition from export and investment-led to consumption-led growth will go (badly so far), how financial liberalisation and capital flows will affect Chinese asset markets and economic growth rates (witness the current official panic regarding the Shanghai sharemarket boom and bust), and what China's growth rate and labour market strength really are. The data are rubbish.

Booming Global Liquidity
The Global Financial Crisis showed us all in the field of economics that we do not well enough understand the links between financial sector expansion and real economic activity. Ahead of the GFC and helping to cause it was a surge in private sector generated credit. Since then we have seen a surge in public sector generated credit as central banks have injected trillions of dollars into their and the world's financial systems to first ensure liquidity and then boost asset prices, hopefully lower interest rates, hopefully spur investment, hopefully avoid deflation, and hopefully give economic growth enough momentum that things can return to normal.

No country has reached that new normal point yet. In the United States money printing has stopped but the key question being asked is whether things are now "normal" enough to allow the Federal Reserve to raise interest rates and not have the economy turn down again. After all, that is exactly what has happened twice in New Zealand. Based on our experience you'd give perhaps a 50% chance to Fed rate rises in the coming year being followed quickly by rate cuts from late-2016.

The likes of the IMF, Bank for International Settlements and our own Reserve Bank have all recently expressed concern about financial stability stemming from the world being awash in capital and no-one knowing quite where it will pop up the disappear again. It is interesting to note in the context of this capital looking for a home that back in 2001 5% of managed fund assets were in non-core classes like residential property, hedge funds, commodities etc. Now that proportion is 25%.

Disruptive Technologies
New technology has completely changed the economics of the oil industry forever. The combining of 3D ground imaging, fracking, and horizontal drilling has allowed exploitation of shale oil reserves previously not accessible. The outcome is a structural adjustment downward in oil prices, plus a sharp lift in the speed of future oil supply response to any rise in prices. Companies are still drilling shale wells yet capping them right away. When oil prices rise they will uncap them and run down their in the ground inventory. Compare that with years and billions of dollars needed to develop traditional large oil fields.

Uber has disrupted taxis services, Netflix television, Airbnb accommodation and so on.

More disruptive technologies will appear and render unprofitable existing service delivery models and maybe even other basic dirty industries like oil extraction.

Shocks
Yes it seems true that there are more shocks occurring these days such as terrorist attacks, diseases, debt mountain collapses, and so on. But the bigger issue from here on may be shocks combined with a radical reduction in the ability of authorities to mitigate their impact. Interest rates are already low if not zero, or in the case of the ECB deposit rate, negative 0.2%. Government annual deficits are less than over 2008-11 but debt levels are higher. Ability to absorb shocks with deficit spending is reduced.

In contrast to the case that a collapse in Greece now would (will) do far less damage than if it had happened in 2010, a new Lehman Brothers Bank collapse could cause more because of this lack of fiscal and monetary buffers. Money printing would attempt to fill the gap along with unwinding of the many macroprudential controls central banks are putting in to do a job previously they used interest rate rises for.

The upshot of these many factors affecting the economic environment in which we operate is as noted above.
Predictability has declined sharply. You must not tie your business strongly into one particular scenario. You need to embrace flexibility, boost customer information flows, establish an innovation chain and network, and challenge the traditional Kiwi characteristics which we may have been able to survive with in the past but which if they persist will confine us to mediocrity and a volatile primary and tourism sector-dominated economy over the coming century.

For insight into those restraining characteristics see Sporadic 5 on NZ Business Culture. http://tonyalexander.co.nz/wp-content/uploads/2015/04/Sporadic-5-April-23-2015.pdf

The Past Week

Nothing much positive is there?

- The ANZ Business Outlook Survey showed a decline in business confidence to a net 2.3% negative – the lowest reading since March 2011. Employment intentions are at a net 15%, a two year low, investment intentions 12%, similar but with both measures still above ten year averages.
- Greece has defaulted, and no-one knows what happens next.
- China's main sharemarket has fallen 25% the past two weeks and things are so bad interest rates have been cut for the fourth time in about seven months.
- Russia has extended its ban on importing Western food including dairy by another 6 months.
- Westpac's employment gauge fell to a two year low and wage expectations to a six year low.
- Dairy prices fell another 5.9% to sit 34% below early-March and the lowest since 2009.

Hence – NZD lower still, interest rates to be cut further, sentiment gauges to decrease more.

If I Were A Borrower What Would I Do?

I cannot give you a forecast of where interest rates will be in a year's time that I would be willing to back to the hilt. I simply maintain the position spelled out in my NZ Observer issued on February 24. To whit…

"Currently the drift in rates is downward, assisted strongly by banks trying to boost market share. Were I borrowing at the moment I would hold off for another round of cuts in fixed rates. If someone offered me a four or five year rate at 5.5% I would take it today. A three year rate at 5% would win my business right away also."

Currently the BNZ three year rate is 5.29% and the five year rate 5.75%, compared with 5.59% and 5.79% in February. The three year swap rate which forms the base of our funding cost was back then 3.73% and the five year swap rate 3.79%. Those rates are now 3.23% and 3.5% respectively – drops of 0.5% and 0.29% respectively. To date bank competition for mortgages has concentrated in the one to two year terms. Hence as the one and two year swap rates have fallen from 3.63% and 3.64% in February to 3.14% and 3.15% (0.49% falls) the same term fixed mortgage rates have declined 0.7% and 0.4% to 5.19% and 4.99%.

I personally would remain willing to take a punt that with China looking worse, Greece imploding, NZ consumer, employment, and business sentiment measures worsening, and dairying having a downward correction, the rates I seek will eventually be reached. So as in February I remain waiting for slightly lower three and five year fixed rates before I jump.

But were I not prepared to wait – and admittedly in the past my behaviour has been more conservative than this as a borrower - I would lock in the bulk of my debt at 4.99%.

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11. How much are we slowing? http://tonyalexander.co.nz/wp-content/uploads/2015/06/Sporadic-11-June-25-2015.pdf
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9. A Shift in the Wind – NZ Growth To Slow. http://tonyalexander.co.nz/wp-content/uploads/2015/06/Sporadic-9-June-3-2015.pdf
8. Eight Records Driving Auckland House Prices. http://tonyalexander.co.nz/wp-content/uploads/2015/05/Sporadic-8-May-12-2015.pdf
7. Auckland Housing Shortage Again. http://tonyalexander.co.nz/wp-content/uploads/2015/05/Sporadic-7-May-5-2015.pdf
6. Auckland Housing Shortage is how big? http://tonyalexander.co.nz/wp-content/uploads/2015/04/Sporadic-6-April-29-2015.pdf

Sporadic 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. It is a supplement to the monthly NZ Observer. Please sign up at www.tonyalexander.co.nz
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