BNZ Weekly Overview

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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

Not Munted

While the summer holidays are supposed to be a happy time, often we can end up paying a lot of attention to negative things – especially as our New Year's resolutions die in a fog of fags, booze and biscuits binged on couches usually within two to three weeks.

These past few weeks have brought plenty of things for people to worry about in the economic sphere if they want to – with basically all of them located offshore. That in itself should serve as a warning. Since the end of the Global Financial Crisis all warnings of a fresh new downturn sourced from the likes of a series of Greek crises, China slowing, US money printing and so on have been wrong. Anyone who has kept their business, job seeking, or investment powder dry (unused) because of worries about many things offshore will have missed out on a fantastic period of growth in NZ in recent years.

Our economy and job numbers have grown by 15% over the past four years, share prices have soared, and so too have house prices.

Let's have a look at some of the bad things happening offshore – things which almost all share one very strong feature. No-one truly has the foggiest idea of the magnitude and duration of negativity of each of them.

Let's start with Brexit. An unholy mess seems not to come close to describing the situation. There is a chance that come March 29 the UK will leave the EU with no new agreement in place – a hard exit. It is feared that this will bring chaos to trade flows and money movement and that this will throw the UK into recession. Sounds about right although all forecasts of recession immediately following the decision to quit the EU almost two years ago proved wrong.

Downside risks to UK growth exist but we don't really know if a hard exit will occur or whether the end-March deadline will be shifted. The event is however ample reason to be cautious about growth in the UK economy even though some recent labour market indicators have been quite strong.

The Federal government shutdown continues in the United States and there is no sign of the gap between President Trump and the new Democrat-controlled House of Representatives closing at all. Negative economic effects from the shutdown are starting to appear and no-one knows how much longer the situation will continue. Downside risks to growth once more prevail.

China has just recorded its slowest annual pace of economic growth in three decades at 6.6% - not that any reliability can be placed in the numbers as they do not match up with other indicators of growth which suggest a pace closer to 3%. Growth has likely been over-stated by the official numbers for many years which means all the worrying ratios of various debt measures to GDP which we have been seeing this past year are probably much higher in reality. Hence one reason why Chinese citizens want to get their funds anywhere else on the planet.

High debt and the still developing trade battle with the United States coupled with a shrinking working age population and signs of popular discontent with the state of the economy within China suggest downside risks to growth this year. However, the authorities have recently eased both monetary and fiscal policies and every single forecast of a major China decline in the past four decades has been wrong. It would seem a very long shot to expect an economic crunch as such in China this year, especially as plotting the course of the trade dispute with the US is impossible. But weakening growth with impacts on economies highly dependent upon sales to China is on the cards. Hence worries about the likes of Germany for instance.

In Australia there are worries regarding the deepening drought, exports to a slowing China, falling house prices, a credit squeeze with more to come, slowing house construction, and a possible Federal election come May.

After 27 years without a recession could this year produce one? The chances do not seem all that high especially now that share prices have recovered and expectations of monetary policy tightening by the Reserve Bank of Australia have declined. That also is what has happened in the UK, EU, Canada and US these past few months.

Reflecting these downside risks to growth and the concrete evidence of weakness in some key economies like Germany, the IMF this week made a further cut to their forecast pace of world growth over 2019. A year ago they expected growth of 3.9%. In October they cut that prediction to 3.7%. Now it is 3.5%. Their 2020 pick is 3.6%. https://blogs.imf.org/2019/01/21/a-weakening-global-expansion-amid-growing-risks/

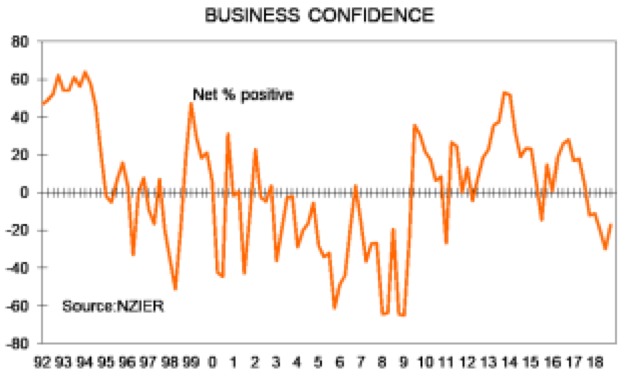
Is there manifestation of rising world growth risks in measures directly relevant to ourselves? Has the NZ dollar fallen away anew amidst a global bout of risk aversion? Six months ago the NZD was buying US 68 cents. It buys the same now. We could get 77 Yen then but only 74 now. But we are up slightly against the Euro and British Pound. No, FX markets have not become convinced enough of an export-sapping decline in world growth.

What about our export prices? The ANZ Commodity Price Index in world price terms has fallen for the past seven months to register a decline from May of 10%. Yes, reducing global optimism is starting to affect our export prices.

What about tourist flows? These can take some time to change but it is interesting that in the three months to October visitor numbers were ahead only 4.1% on a year earlier whereas growth for the past five years has averaged 7.3%. A slight slowing in growth has occurred but the fact that inward visitor numbers rose by a seasonally adjusted 2.4% (9.6% annualised) in the three months to October makes us reluctant to say a downward trend in tourist growth is underway.

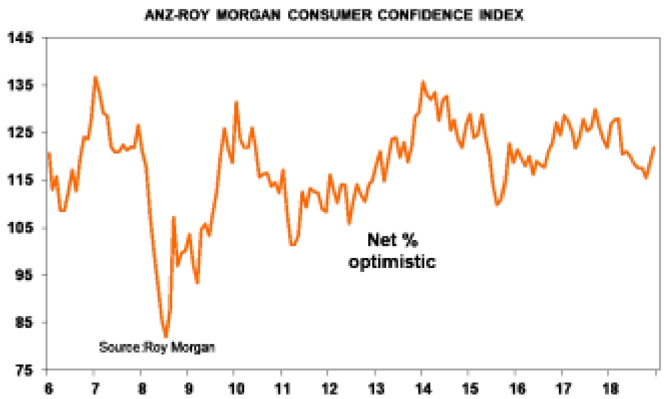
What about sentiment? Are Kiwi businesspeople getting increasingly worried about developments offshore? Maybe they are, but any effect is being swamped by a pullback from deep unwarranted pessimism earlier in the year associated with the change in government.

The NZIER Quarterly Survey of Opinion showed recently that in the December quarter a net 17% of businesses were pessimistic about the economy. This sounds bad. But it is better than net readings of -30% in the September quarter and -20% in the June quarter.



The net percent of businesses planning to hire people held steady at 13% which was up from 6% mid-year. And this takes us to the big offset to slight downward pressure on growth starting to come from easing export prices. Courtesy partly of a very strong labour market NZ consumers are in reasonable heart.

The Westpac McDermott Miller consumer sentiment reading has improved in the December quarter to a reading of 109 from 104 the previous quarter and ten year average of 111. Not stellar, but about average and getting better. The ANZ Roy Morgan measure similarly has improved to 122 in December from 119 in November, a low of 115 in October, and a ten year average of 119.



Regarding the state of the labour market. The NZIER's QSBO has revealed a rise in the net percent of businesses having difficulty finding skilled labour to 53% from 44%. This is the strongest reading since 2005. A net 35% from 29% find it hard to get unskilled labour. Also the highest since 2005. Anecdotes of labour hiring difficulties abound.

Prospects for continued reasonable growth in consumer spending look good – though many retailers will still struggle as the competitive environment continues to change apace. Prospects for business investment also look good with a net 7% of businesses in the QSBO planning to boost investment in plant, machinery and equipment. The ten year average is 9% but the reading is up from only 2% in the June quarter.

With help from still low levels of borrowing costs our economy is probably again going to record growth in the 2.5% to 3.0% or so range this year. Nothing spectacular but nothing bad either. The risks however lie more on the downside than the upside courtesy of the growing evidence of a slowdown in world growth.

Housing

I wanted to start the year with a reminder of the long-term factors influencing the housing market in New Zealand, but will do that run-through next week. This week let's start with Australia – not falling house prices caused by excess construction and a credit crunch, but an example of what governments and those promoting quick housing developments through special powers need to be wary of – bad construction.

Already in New Zealand, despite our pride in being "hands-on" jacks of all trades with good enough technical competence, we have proved incompetent when it comes to building houses which don't leak. In Australia they seem to have escaped this problem. But they have made excessive use of fire-promoting exterior wall claddings on multi-storey buildings, poor Chinese steel, and there is a new concern sweeping the country.

It stems from the Christmas Eve evacuation of over 300 people from 38 storey 392 apartment Opal Tower in Sydney after people heard banging noises and cracks were identified. Parts of the building have moved, some people could not open their apartment doors until they were forced open.

Olympic Park where the building has been constructed is part of a declared state-significant development site meaning councils are excluded from approvals which instead are handled by a government department. Sound familiar?

Australia actually has an appalling record on work quality when it comes to big Federally-driven schemes such as the broadband rollout, subsidised installation of housing insulation, and funded construction of new school facilities.

Apparently the expert engineers agree that the building is now safe and people can move back in. But value for unit owners has been decimated and repairs will prevent reoccupation of some units for perhaps four months.

Here in NZ the government's aim in creating the new housing body HUDA is to speed up construction. But care will need to be taken especially with regard to the quality of construction of KiwiBuild homes. All it will take is a report that hasty construction seems to have led to the compromising of quality in just one of these new homes for a potential permanent stain to go on all such dwellings – even though they will be geographically widely distributed and built by many different companies.

The bigger issues for KiwiBuild however are still likely going to be failure to meet construction targets due largely to lack of sufficient resources in the building industry, the wrong dwellings being built in some areas, and inability to do anything to help the growing number of people on very low incomes for whom affordability is not the issue but simple availability of anything bar emergency shelter.

The chances are good that before the end of the current government's term KiwiBuild will morph away from construction of affordable dwellings toward provision of social housing.

That switch has not yet been hinted at or talked about in any way by the Housing Minister. But he had to come clean this week while the Prime Minister was offshore (thus avoiding condemnation and derision by association) that KiwiBuild targets won't initially be met. Instead of 1,000 dwellings being built by July he now thinks 300 is more likely. Developers apparently still prefer the higher profits able to be earned by building bigger dwellings on the expensive land they must buy rather than more smaller dwellings.

On top of that the KiwiBuild homes are not being snapped up even by people who win ballots for them and more are coming onto the open market for anyone including investors to buy.

Just quickly because I'm itching to get stuck back into the big picture for housing. Auckland dwelling consent growth has been flat for almost six months. Over the past four years Auckland employment has grown by 21% versus 13% for the rest of NZ. Auckland may have annual consent numbers at 2004 peaks near 13,000. But with 34% population growth since then such a comparison is silly. You'd need 17,300 consents now to say supply growth is the same.

Auckland's housing cycle is in its hiatus. But underneath flatness I will discuss next week the demand fundamentals continue to grow.

Your Strategy

-Things to consider in your next annual strategy session.

I'm going to start this section for 2019 with the big theme repeatedly hammered last year – labour availability. There are shortages of people in many if not must job sectors in New Zealand now – and also in many other developed economies we might normally look toward to snap up a few people. Don't think you can easily recruit the people you need offshore – especially on NZ level wages.

In particular there are shortages of people in the building trades worldwide. Ireland is even trying to recruit people from offshore! To quote a Financial Times article from January 7…"We've been bringing Irish people back from Canada, Australia, and the Middle East but that pipeline has now dried up. So we are going outside the EU, looking at relevant candidates in South Africa, the Philippines, New Zealand, and Malaysia."

Whatever assumption you have made regarding the availability of people to staff your construction-related company, to supply contractors for your construction job etc., change it. There are not enough young people entering the construction sector worldwide, and the list of construction sites upon which people in NZ can choose to work or not continues to grow.

Not only has the annual number of dwelling consents issued around New Zealand risen by 5.3% in the past year, the value of consents being issued for non-residential buildings has recently been growing strongly.

We know what happens when good high quality people with a strong work ethic are not available. Mistakes happen and corners get cut. Consider doubling whatever your inspection regime is for something which you are getting built. Allow more than the usual 10% for cost overruns on your project. And allow for the consenting then construction periods stretching out for longer than you may have been thinking.

Think also of the possibility that more building companies will go under this year and how your contract may or may not protect you.

And if you are a property developer, cast your mind back one to two years ago when banks tightened up on their willingness to lend into your sector because of the need to reverse growing pressures to borrow offshore. Those particular pressures have eased off considerably, partly because of the strong pullback in investor demand for property purchase finance.

But what you need to think about now is the Reserve Bank of NZ's plan to have NZ registered banks aggressively boost their capital levels over the next five years by between 20% and 60%. The increases will account for about 70% of expected profits over the adjustment period. https://www.rbnz.govt.nz/news/2018/12/reserve-bank-proposes-that-bank-owners-bear-greater-share-of-financial-systems-risk

Having spent some considerable time over the summer break reading Aussie newspapers it is clear that concern about the impact on Australian banks' ability to maintain dividends in the face of requirements to boost capital levels of their NZ subsidiaries has grown rapidly. Australian-owned banks account for 88% of banking assets in NZ.

Rather than stump up all of the extra capital the Aussie banks might instruct their NZ subsidiaries to cut back on riskier lending for which above average capital ratios need to be maintained. Guess which sectors have high risk weightings because failure and non-payment of debt is greater than average? There are a few but the relevant one here is property development.

If you are a property developer I would suggest refreshing the advice delivered here a couple of years ago regarding how you go about planning your project. Do not go in the order of buying the land, drawing up the plans, getting the resource and building consents, then securing the finance. Get information on finance out in the open first up and see what funds will be available on what terms over what periods of time for drawdown and payback.

Note that if the plans for higher capital to handle the Reserve Bank's theorised one in 200 year event go ahead, the changes will occur over a number of years. At this stage the RB is just seeking consultation with banks. I have no knowledge of any plans to actually restrict credit anew as yet.

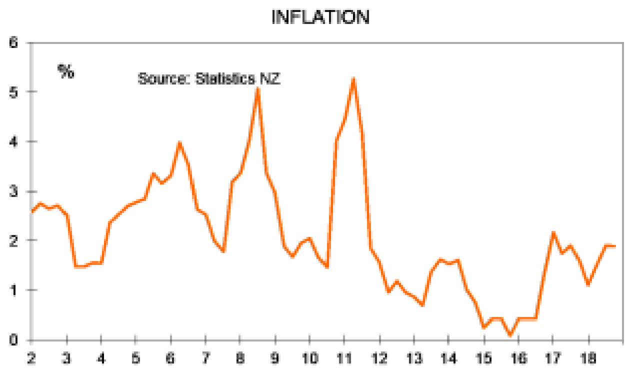
If I Were A Borrower What Would I Do?

I continue not to have concerns about interest rates rising. Consider the ten year US government bond yield. It sits currently near 2.75%. That is down from over 3.2% in November which was up from 2.8% in July. The rise reflected expectations of rising inflation from strong US growth and Fed. tightening. The easing since reflects worries about growth slowing with those worries for a while manifesting themselves as sharp falls in share prices – now substantially reversed.

It is interesting that recovering share prices have not sent bond yields back up again. That is largely because senior Fed. people have become worried about economic weakness and potentially tightening monetary policy too far. So they have made soothing noises regarding the pace of future rate rises.

This has placed downward pressure on medium-to long term interest rates here in New Zealand with assistance also from reduced policy tightening expectations in other countries. The three year swap rate now sits near 1.95% from 2.35% two months ago.

But before we start thinking that a new downward trend in interest rates is underway it pays to note that inflation in New Zealand is very slowly creeping upward. Yesterday we learnt that although the headline rate of inflation stayed steady at 1.9% in calendar 2018 from the year to September, the underlying measure excluding food and energy rose to 1.5% from 1.2%. The low was 0.9% in the year to March 2018.



The 1.5% rate is still below the midpoint of the 1-3% target range for the headline measure and the Reserve Bank have been at pains to stress that they cannot rule out cutting interest rates if the circumstances warrant it. And given that world growth risks are more definitely shifting to the downside it would be off track to suggest this small rise in underlying inflation will make them back away from that rate cut warning when they next review their official cash rate on February 13.

Overall the chances remain good that borrowers will continue to face a benign interest rates environment for a few more years yet.

If I happened to be borrowing again at the moment I would personally feel inclined to look most favourably at the two and three year fixed rates of 4.29% and 4.49% respectively. Four years at 5.19% rising to five years at 5.39% and seven years at 5.95% would not attract me. The one year rate at 4.10% is nice and low. But I've never considered a term of just one year as offering much certainty at all. I'd not have a huge amount sitting at the floating rate of 5.9% - just enough to allow for early repayment of some debt should I happen to find some forgotten notes under the mattress.

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