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

Forget Worrying About Rising Interest Rates

Fresh data relevant to NZ's economy have been thin on the ground this week and the only real point of interest has been around the Reserve Bank's review of the 1.75% cash rate on Wednesday afternoon.

As had been universally expected the rate was left unchanged. But some pundits might have been surprised by the change in wording regarding the potential next direction of change for the cash rate.

Back at the previous review on February 13 the RB Governor wrote "The direction of our next OCR move could be up or down."

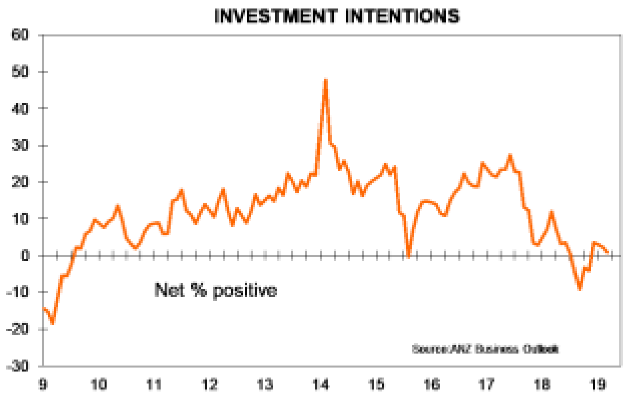
This time however the wording was dovish. "Given the weaker global economic outlook and reduced momentum in domestic spending, the more likely direction of our next OCR move is down."

This adoption of an easing bias represents a change from statements printed since May last year noting as much of a chance of rates going down as up. This change in tone back then by the RB away from simply saying that monetary policy would react to whatever came along came well ahead of other central banks recognising over our summer that their tightening hints were no longer warranted.

The pace of growth in many major economies has slowed over the second part of 2018 into 2019 and risks continue to lie downward. But it is not just offshore risks which have prompted the RB to adopt an easing bias. They have also expressed a mild concern about domestic growth "…low business sentiment continues to weigh on domestic spending."

This is in line with our concern expressed about businesses reacting to their low confidence more by cutting their spending than their hiring. In the December quarter the economy and job numbers were both 2.3% up from a year earlier. But business investment was virtually unchanged. Businesses have eased off committing to productivity and capacity-enhancing capital items.

In fact the just-released ANZ Business Outlook Survey this afternoon revealed a fall in business investment intentions to only a net 1% positive from 2% last month and an average of 16% for the past ten years. Business confidence slipped to a net -38% from -30% in February – the worst result since September and well down from -24% in November.



A pullback in business investment is bad for long-term growth in labour productivity in the NZ economy and therefore bad for the ability of businesses to be able to maintain margins as their costs go up. Already a net 14% of businesses expect their profits to go down – almost as bad as the net 17% feeling this way in the middle of last year.

But back to monetary policy. For borrowers this new world we live in is something completely different from what we experienced from the 1970s until 2007. For so long our worries centred around high inflation either in place or at risk of coming should monetary policy be too lax. The need to take precautions against the risk of borrowing costs soaring and being volatile helped spur the growth of financial products and bank dealing rooms. Now the need for such products is low. There seems hardly to be any good reason even for locking in borrowing costs for a long period of time because everyone who has done so since 2009 has been caught out.

Yet again we have seen forecasts and warnings about rising inflation and rising interest rates prove wrong. That makes over a decade now of bad interest rate forecasting – not just here but in every other country as well apart from the United States for perhaps a three year period which ended just a few weeks back.

Inflation globally has settled structurally lower, interest rates have settled structurally lower. Yields on assets like commercial and residential property, shares and even businesses have settled structurally lower.

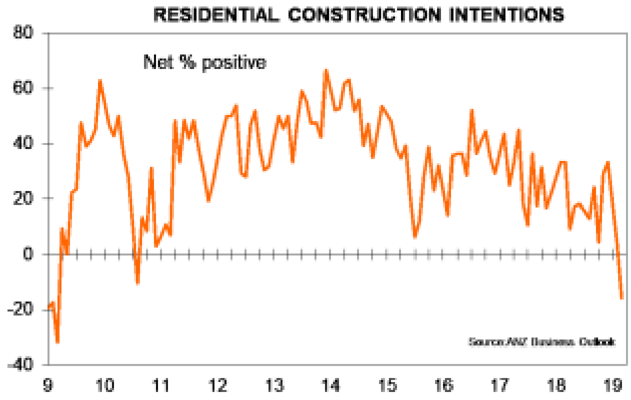
Will inflation ever return? Maybe if everyone gets complacent and governments start taking power away from their central banks.

And complacency does have a tendency to come back. Consider the loose bank lending standards for home buyers in Australia post-GFC despite the lessons of pre-GFC America etc.

For now however borrowers can enjoy continued very low interest rates – and that is a key reason why house prices will remain high. The alternative return to investors of placing their funds – whether borrowed or not – elsewhere is now very low. They might as well continue to hold onto their properties. And after all, it's not as if the proposed capital gains tax regime would provide an incentive to sell one's property asset and invest in shares or a business!

Housing

The monthly ANZ Business Outlook Survey released this afternoon showed a collapse in residential construction expectations of builders. A net 16% expect to see work go lower as opposed to a net 4% in February thinking things would be improving. This latest reading is well below the ten year average of a net 37% positive and the worst reading since the start of 2009 – in fact exactly ten years ago.



This result feeds into our view that we could be at peak residential construction levels very soon. Perhaps the collapse in sentiment can be attributed to the same factor likely to be underpinning the downward shift in virtually all other measures in this month's ANZ survey – the capital gains tax proposals. These proposals will disincentivise business investment, reduce long-term returns on farming, and discourage construction of lettable properties. Relatively speaking all that is incentivised is spending more money on own's own house – not a property for someone else to live in.

Your Strategy

-Things to consider in your next annual strategy session.

Just one thought for this week briefly mentioned above. Given this new world of low and steady interest rates, do you really need the level of interest rate risk management and advice you have paid for these past three decades since financial deregulation in New Zealand? Possibly not. In a world where you are struggling to maintain your margins and set to face even greater struggles going forward (the minimum wage rate rises to $17.70 an hour in a few days) maybe there is an area you can cut your costs.

If I Were A Borrower What Would I Do?

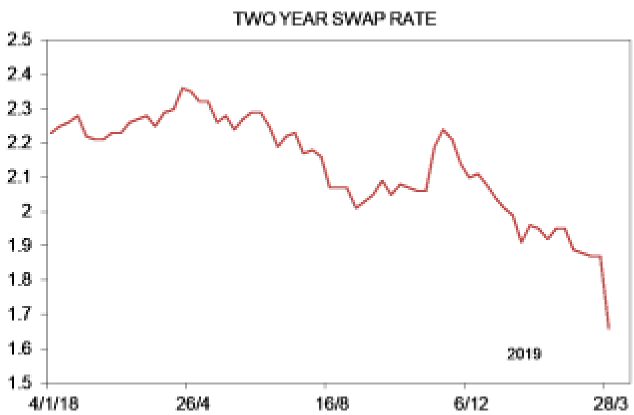
The main news for ourselves this week was the Reserve Bank adopting an easing bias. But there was equally significant news from offshore.

We saw the release of weaker than expected data on the manufacturing sectors in the United States and Germany. Bond yields in the US have fallen away anew and there is now a negative gap between the three month treasury bill and ten year US government bond yields. This change to an inverse yield curve by this measure has occurred ahead of every US recession in recent decades and the development has scared markets around the world.

At this stage it seems a bold call to predict recession in the US, especially as inversion was not followed by recession in 1965 and 1998. Nonetheless markets have become cautious and this suggests that monetary policy tightening anywhere on the planet is a long way off.

In response to the US ten year government bond yield falling to near 2.40% from 2.63% last week and 3.2% in November our local yields have fallen. The NZ ten year government bond yield now sits at a record low. A 1.85% annual return for letting your funds sit with the NZ government for ten years looks pretty unattractive – especially when you consider that you will pay tax on that return, then need to deduct inflation to see what has happened to the purchasing power of your capital. You'll be going backwards.

The bank two year swap rate has now fallen to 1.66% from 1.87% last week and 2.24% in the middle of November.



As regards what I would do if I happened to be borrowing again at the moment. Over the past few weeks I have written two things. First, that I would not be in any hurry to lock in a fixed rate because it looked to me like rates would be falling. I'm happy to stick with that comment not just because of the Reserve Bank's easing warning but because competition has picked up between banks and with residential real estate activity likely to slow further this competition can only become more intense.

And here's another reason why that competition will intensify. Many people have printed scary stories about mortgage rates rising because banks will in the next five years have to substantially boost their capital level as buffer against the next time the world goes into financial meltdown.

But what these writers have failed to appreciate is that because NZ banks won't be given all the capital from their Aussie parents that will be needed they will need to take actions which reduce their need for such extra capital in the first place. That will mean cutting back on lending to sectors for which they have to have a lot of capital as backup than other simpler, low risk sectors. Guess which sector is the latter, the one which hardly ever delivers us any losses – housing.

As a result of the likely new capital rules banks are going to bias their lending toward housing (higher house prices anyone?). And what sectors are going to find getting money from a bank more expensive and harder? Agriculture and dairying in particular – a sector which has been on a debt binge for a couple of decades, one result of which is a rising proportion of our dairy assets having to be sold offshore and to China in particular. You don't need to sign up to China's Belt and Road infrastructure scheme to get so indebted you have to flog off your assets to buyers from – China! The other sector likely to suffer is property development. That means slower growth in housing supply with the extent dependent upon how construction labour availability changes in the next few years.

Throw in extra downward pressure on term deposit rates because of the coming new capital rules and the new monetary policy easing bias and you really have to be living in la la land to believe that introducing a capital gains tax on residential investment property will have any substantial sustained impact on housing affordability.

So would I keep holding off a bit longer for an even lower bank fixed rate? Probably yes.

The second point I've been making in recent weeks has been that I would struggle to justify fixing for longer than three years given the low inflation and low interest rates outlook. I would definitely still hold that view and that is another reason why the current burst of competition which has pushed two year fixed rates below 4% is unlikely to be the last. That term plus one year and maybe six months is where the mortgage rates battle in NZ is going to be fought for a long, long time.

If I had to fix now I'd probably lock in for two years – same approach noted here for maybe over half a decade now.

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
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