BNZ Weekly Overview

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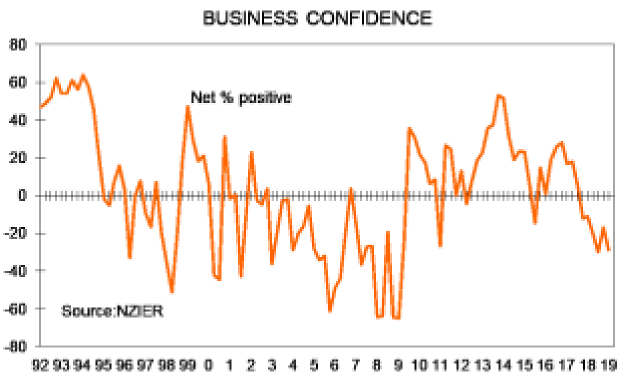
Mission Statement

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

Businesses Unhappy - Again

New Zealand is not immune from the general air of caution sweeping the global economy in recent months and we could see this in the NZIER's Quarterly Survey of Business Opinion released this Tuesday. Just before the 2017 general election which brought a centre-left party to power a net 18% of NZ businesses were confident about the economic outlook. That fell to a net 30% pessimistic by the September quarter of last year. That pessimism eased to 17% late in 2018 but over the March quarter of this year a net 29% were once again worried about the economy.



Because this deterioration coincides with reductions in sentiment readings offshore one would be hard-pressed to run the argument that it is concern about government policies such as rising minimum wages, union promotion, and higher taxes driving the new fall in sentiment. But such things would hardly help feelings in the business sector.

There is nonetheless some political/policy implication from this renewed decline in sentiment. Last year, before claiming she understood the concerns of businesses because she scooped chips in a fish shop, the Prime Minister said that weak business sentiment was "…a flashing neon sign with giant lights and fireworks going off behind it." Yeah, one hears business leaders use such language all the time at weekly meetings. No-one is excellent at every aspect of their job!

In response to the collapse in sentiment – which was at odds with the state of the economy – the PM announced creation of a business advisory council. Remember that? Guess it didn't work to assuage business concerns.

The point is this. The government is sensitive to charges that it has no understanding of how the economy works and the things which concern businesses. Witness divorced-from-reality KiwiBuild plans which unfortunately have now crumbled to dust, and Industry Training Organisation reform plans which hopefully will be somewhat adjusted.

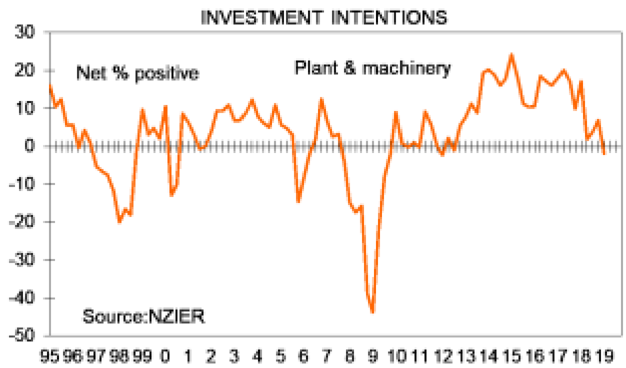
The new government has enjoyed good economic conditions so far. But now things have deteriorated to the point that the Reserve Bank is warning it may need to cut interest rates, and businesses are feeling apprehensive. Some people have noted to me that some big corporates in Auckland are doing more than the usual redundancies and restructurings. A new cost-saving focus one imagines in a time of compressed profits.

The PM said that she aims to boost business confidence. She has failed to do so and that means there is likely to be greater caution with regard to promoting policies which will have any additional deleterious impact on business sentiment. The chances of a comprehensive capital gains tax have just taken another dive.

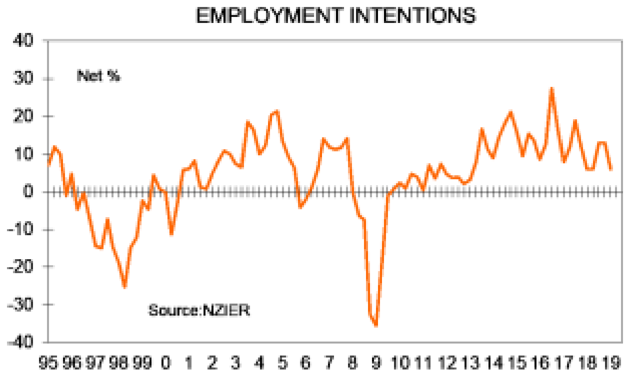
That is good from a productivity point of view. But there is a growing risk that come election year the government's finances will be in less good shape than they are at the moment. Could that prompt other tax increases in order to fund desired tax reductions for low income earners? Probably not for two reasons.

First, going into the 2020 general election promising tax increases would be electoral suicide. Second, there is no government campaign to sell the benefits of tax cuts for low income earners. It looks like they have pulled back from promoting a redistribution theme surrounding a capital gains tax. This is leaving handy space to slot in a shift in the KiwiBuild focus from "affordable" housing decreasingly desired by potential buyers, toward an increasingly vital need for radically more social housing.

Back to the NZIER's survey now. Not only are a net 29% of businesses now feeling pessimistic about the year ahead, a net 2% plan cutting investment in plant and machinery. This is a deterioration from a net 7% last quarter planning to boost such investment and the weakest reading since the GFC barring a brief dip late in 2011.



Employment intentions also weakened, but at a net 6% positive still sit above investment intentions and the deterioration since pre-election of 6 points is far less than the 22 point deterioration for investment intentions.



This leaves us with our worries regarding productivity growth in coming years and business profitability. Maintaining margins has become extremely difficult these days and without investment which boosts productivity it is difficult to see the current low profitability situation improving. If a wide round of company restructuring has not in fact just started then watch for something deeper in the next three years.

In the March quarter a net 21% of businesses said their profitability has declined and a net 16% expect further decline. The ten year averages for these two measures respectively are -10% and +3%.

The difficulties businesses have raising selling prices mean we cannot read all that much into the fact that capacity use remains high at 92.5% versus 91% average. And a net 50% of businesses find skilled labour hard to find versus 53% in the December quarter and 28% average while a net 33% find unskilled labour hard to source from 35% and an average 6%. If you have been using these and other capacity measures to make forecasts of inflation and interest rates post-GFC you'll have been repeatedly wrong. Pre-GFC you'd probably have been reasonably right.

And of course the financial markets are expecting that our central bank will fairly soon cut borrowing costs in response to slowing growth and low inflation outcomes, rather than raising them in response to these now not useful survey indicators of capacity pressures. C'est la vie.

For your guide, what happened last year after confidence fell to -30%? GDP growth slowed from an annualised pace of 2.8% in the first half of 2018 to 1.8% in the second half. Assuming growth near 2% p.a. going forward seems reasonable.

Housing

I received an email this week from someone seeking my opinion as to whether the Auckland housing market was on the cusp of producing rapidly falling prices. I could have repeated what I have written here before about Auckland not following Sydney and Melbourne for a whole variety of reasons – nine at last count.

But instead I looked just at Auckland specifically and noted the following points, all in the context of Auckland's market having topped out late in 2016 and for now through to maybe the 2021 stimulus from APEC and the Americas Cup at the earliest, would be relatively flat. But alongside the state of being "relatively flat" there is the other fundamental which needs attention.

Many people are jealous of others who have gained from strong house price rises in recent years and they have not. Perhaps young people largely who had the misfortune to be born in the 1980s or 1990s and have had to suffer the horrors of modern medicine, technology, and transportation.

Then there are others who have had every single one of their perennial forecasts of plummeting Auckland house prices wrong for over ten years now. They are seeking redemption and hope to see it, ready to leap out in the faces of any optimists with a bold scream of "I told you so". Give 'em a few more years and they'll be standing on the corners with signs proclaiming 'The end is nigh."

Then there are the uninformed – which is most people. That is how markets function. I consider myself informed in NZ housing markets, but ignorant cannon fodder in other markets, such as for cars, computer equipment, and clothing.

The uninformed just go with the flow and are best thought of as the crowd which extreme view holders wish to influence – and in this part of the housing cycle those extreme view holders are once again the pessimists. And they are seizing on titbits of information to lay hints that things are ugly in Auckland and about to get worse. So back to the email.

I was informed that some houses are selling for 30% below their rvs. Yep, and some will be selling above their rvs (rateable values) – same as one, two, three, four, five etc. years ago. Selectively discussing transactions is not a wise thing to do, especially when the sales below rv are reported to be occurring in the snobby areas of Auckland which have traditionally attracted people trying to get their kids into particular schools (on the basis that who you know is more important than ability or that ability is absent so contacts are all they'll ever have), the upwardly mobile from the SME sector, and wealthy foreigners.

Some foreigners have been weeded out of the market because of the ban on buying by non-residents from last October. Margins have become very tight in the business sector so many people are struggling to see an environment over the next few years where they can be confident of being able to service a large mortgage on a house in a knobby area. And finally, the rvs on many houses in such aspirational suburbs were pretty absurd anyway, having been bid up in the days of open slather.

So I don't treat stories of sales well below rv in the likes of Remuera as indicative of Auckland overall. As a side issue, when the economy weakens aspirational buying shrinks for all but the wisely cashed up. That hits the poncy suburbs hardest along with holiday home locations – such homes perhaps having to be sold off to shore up business finances.

In fact, thinking about it now, as bank lending standards tighten because of rising capital requirements in coming years, high business debt levels partly used to fund lifestyle purchases will be restricted. And dairy farmers – some have coastal holiday homes. Maybe they will need to sell for the same reason and because of the extra pressure which will have to come from banks for farmers to reduce debt levels if the proposed new capital requirements are brought in.

Second, there are stories of rapidly falling sales and prices easing in the inner city apartment market. Inner city apartment markets tend to be much more volatile than other markets in a city, and in Auckland's case there is a special role which has been played by the educational institutions. Studying in NZ is no longer the near guaranteed route to residency that it was, and with a crackdown on fraud out of India also underway the numbers of students coming through have declined.

That means that perhaps instead of three students in a bedroom there are two, or the luxury of one. Less cynically, it means less demand for inner city apartments. Prices and sales have retreated and they will likely retreat further. But again, I do not recommend people blindly extrapolate such a development to the wider Auckland market.

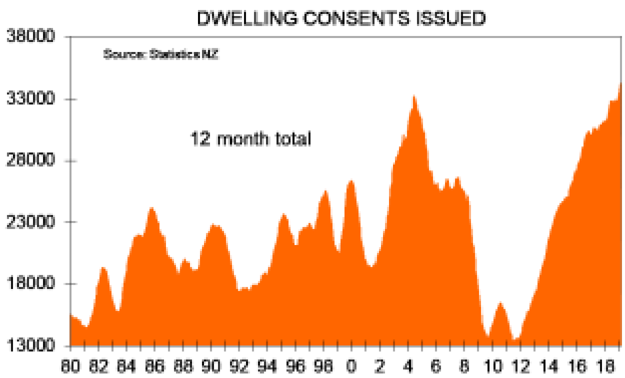
And then there are the broad macroeconomic fundamentals. Net migration is holding up very well and could even be improving again. A slowing Aussie economy will help that. Interest rates are falling, not rising. The labour market remains extremely tight. The economy's pace of growth may have slowed but it still sits near 2.0% nationwide. Credit availability is less than what it was, but not by all that much as yet. There is growth in Auckland housing supply. But the shortage persists and lack of people in the construction trades will mean many consents currently being issued will not be acted on. (See below.)

So I simply read the extra little focus on some negative data points in Auckland at the moment as consistent with a market which is flat. It will now and then go down a bit, now and then go up a bit.

And it is not in Auckland that the most interesting housing developments have occurred over the past two years but in the regions, and that will remain the case through this year. We expect to see the regions slowly flatten out as we advance through 2019 into 2020.

After that the next interesting thing will be Auckland rising again. That might happen in 2021 but it feels too soon and people risk placing too much emphasis on the economic stimulus from a really big international meeting and boat races.

Regarding housing supply growth, dwelling consent numbers issued in the three months to February were ahead by 23% from a year ago with Auckland ahead 44% and the rest of NZ 10%. Is housing supply therefore booming? No for two reasons.

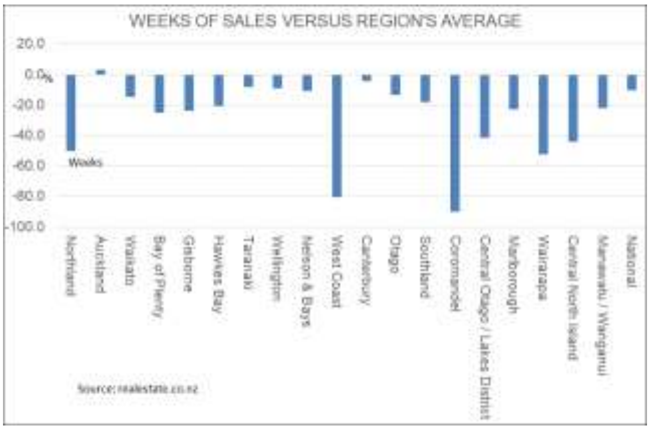


First, it is certainly strong with annual consents at 34,300 now compared with the previous peak of 33,000 in 2004. But since then the country's population has grown by about 20% with Auckland up 34% and the rest of NZ 17%.

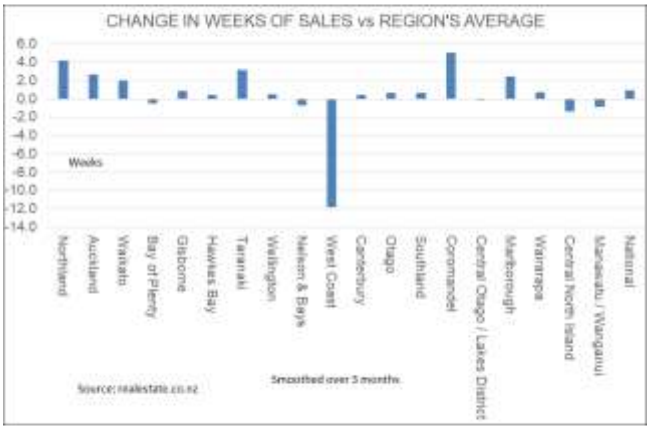
Second, there is no labour supply boom. Some of the consents will not be acted on for a variety of reasons, a key one of which will be weak presales. Buyers see no need to hurry and can take their time, hoping for investor selling delivering them a possible bargain. Also construction costs keep rising and it is highly likely that the seemingly poor level of commercial risk management in the construction sector will see some more biggish operators close up shop in the coming year.

Listings

This week we received monthly data on listings from realestate.co.nz. We are using these numbers to get a feel as to whether the sales strength in the regions is starting to ease off. We measure that by comparing weeks' worth of stock versus average for each region. If stock measured in weeks of sales is below average we conclude that activity is strong. That is what this first graph shows for every location except Auckland.



No surprises there. But we want to see if strength is starting to fade for a region so we compare the latest result with three months ago to get the following graph.



It tells us that the degree of strength is fading in almost all regions but not by all that much. Our expectation is that as the year progresses all regions will place above the zero line in the second graph and eventually, in 2020 probably, all will have sales activity measured in weeks' worth of stock above the zero line in the first graph.

So far, conditions around the country bar Auckland remain strong but minor easing in strength is underway apart from in the Bay of Plenty, Central North Island, and Manawatu/Wanganui.

A Family Compound

A thought occurred to me while finishing this week's Overview off on Thursday afternoon. I've been reading an increasing number of articles in the likes of the Wall Street Journal, Financial Times, and Economist magazine discussing the widespread nature of poor housing affordability in cities around the developed world, and the policies which are largely failing to alter things. Common points identified as causes include low land availability, infrastructure costs, development rules, consent processing times and so on.

I read about the struggles of young people trying to buy a house, and of older people with now highly priced large houses. Up to two decades ago people would give me their opinion that retiring baby boomers selling houses would cause big price declines. Not only was that view wrong, the older folk have bought extra properties to help finance retirements governments repeatedly told them would be austere unless they built their own investment portfolios.

Will these retiring boomers now sell? Not in great numbers as all they read about is falling interest rates and diminishing returns on bank term deposits. More than that, they are reading about struggling younger people, and perhaps are starting to think explicitly about how they can help their offspring or grandkids using their property(s).

Then it struck me. The farming sector has been going through this scenario for far longer – poor farm affordability for young farmers. The youngsters can either buy what effectively is an affordable yet basically over-sized lifestyle block of uneconomic size, or wait and build up equity for the end-game of farm ownership.

City young folk may need to take the same approach. Build up equity over a long time period, then pursue ownership of a home delivering the benefits they seek and need – location, size etc. And the best way they can build up equity beyond maximising income is through minimising current housing expenses – by staying at home or moving in with a parent or grandparent with a decent sized house for as long as possible.

For some older folk this may be unpalatable – fair enough. But many will see a route toward spending good time with grandkids and "making up" for the stuff ups they did with their kids when they were little. They will remain connected – which ads in newspapers for retirement villages this week are telling us are vital for living a healthy old age.

And here's something to consider. Younger folk these days are quiet – real quiet. No loud stereos – they've never seen one. Happy to embrace headphone technology. Happy to share because they are not the 1970s – 1980s generation which knew hardship, pain of high unemployment and dog eat dog individual fight to get ahead, and they are happy to pay maybe $70 a head board versus $600 - $1,000+ a week rent on their own place.

If you are older and reading this, ask yourself this question. Is the best option for you and your family opening up your house to help your offspring? A family compound rather than just a valuable place you can feel chuffed about buying for $79,000 in 1979 and now worth $1.9mn. You're "clever". That's old news. Now for the sharing.

Your Strategy

-Things to consider in your next annual strategy session.

Nothing this week.

If I Were A Borrower What Would I Do?

We have just gone through a period of major change with the popular expectations of interest rates moving upward dashed in the face of weaker than expected economic data from most parts of the world and yet again lower than anticipated rates of inflation. Our central bank has introduced an expectation that the next time they change monetary policy it is more likely to be an easing than a tightening.

For borrowers this is good news and it is impossible at this stage to see at what point in time one should be worried about interest rates going up. One day this will happen – but so far that time period has evaded all parts of the planet bar the United States since 2008. That makes eleven years now of generally falling interest rates.

For conservative savers the news is bad and in simple economic terms the low level of interest rates provides people with an incentive to spend rather than build up financial assets. That of course is the intention of an easing in monetary policy – to get people to spend. In the NZ context do we need that yet?

There is no solid evidence of the labour market easing off and we continue to see stories every week of shortages of labour across a wide range of sectors. This week we have received strong warnings about soaring costs for hiring an electrician as a result of expectations of a worsening shortage. And we are seeing an increasing media focus on the need for many more people to enter the (generally low paying) hospitality sector in order to handle upcoming large events and an anticipated rise in inward visitor numbers from the current 3.8 million to around 5 million by 2025.

Of course all these rosy tourism projections are a bit like forecasts for the past 20 years of ever rising dairy production. But for that sector there is a pushback in response to rising awareness of and concerns about water pollution and global warming. It is likely to be the latter concern which eventually starts to generate some pressure on the global travel industry and our incoming numbers in particular given the long distances which people have to travel and the huge quantities of carbon dioxide they are responsible for emitting in order to get here.

Just as we have seen campaigns in Europe to get people to eat locally produced food we should anticipate that eventually there will be campaigns to get people to holiday locally as well. If I were devising such a campaign I guess I would try to get people to focus on the beautiful landscapes in New Zealand and how you can find exactly the same thing if not better far closer to one's home in Europe, America etc.

But such campaigns are probably still some way in the future – unless we continue to get increasingly hot and extended summers around the world and more evidence of rapid global warming. The risk for both dairying and tourism is that the world reaches a tipping point where society demands action be taken and chooses to do so voluntarily ahead of legislative changes – as we saw happen with plastic bags.

Speaking of which, just as the David Attenborough-narrated series Blue Planet II helped inspire the backlash against single-use plastic bags, could the April 5 Netflix release of the 8 episode "Our Planet" accelerate concerns about our impact on the natural world?

Back to interest rates, if our central bank does cut interest rates, it will be because they are worried about inflation staying too far below 2%. They will want to stimulate growth. But the links between strong growth and inflation have radically altered post-GFC and the risk is that all they achieve is minimal actual impact on inflation but extra pressure on asset prices as investor seek returns.

Have we reached the point where central banks wanting to target inflation need a weapon other than changes in borrowing costs to achieve their goals? It would have to be something which does not principally work through the growth-capacity pressure – pricing link. And the need for it is going to grow as the uselessness of cutting interest rates in the next five years runs against the extra credit tightening to come from banks reacting to higher capital requirements by tightening lending standards.

It's almost as if inflation targeting has to shift away from an organisation which has gained more weapons but lost its power. Or, the emphasis on inflation targeting in place since the 1980s is becoming a big waste of time because inflation doesn't budge much anyway.

If I were borrowing at the moment I'd be on the scrounge for a discounted two year rate and I'd bargain hard. Bankers will be concerned about modelled sales levels because we are seeing falling real estate sales numbers. Soon the regions will be cooling and that might see annual sales fall to the 65,000 we opined about 18 or so months back. Annual dwelling sales bottomed at 73,300 in March 2018 from 88,000 a year earlier. They then rose to 76,400 in November and now sit at 75,300 and falling. Maybe 65,000 will be reached by the end of this year, one year later than we were thinking.

Anyone Interested In Sponsoring?

Tony Tinworth of Taupo-nui-a-Tia College has asked if I'd be willing to help promote a secondary schools team heading off to St Petersburg later this year and looking for sponsorship. Happy to help.

"There will be a New Zealand Secondary Schools team participating in the second International Economics Olympiad to be held in St Petersburg 23 July to 2 August 2019. http://www.nzeo.co.nz/

Last year's team was organised last minute, and there was no chance to organise any sponsorship or assistance for participants.

I was hoping that you could mention the event, and if any readers were in a position to help out, with team sponsorship or airpoints, they could contact us.

In return we could do some promotion and/or talk about our experiences.

We were reasonably successful last year, with 2 individual gold, one silver and one bronze from our team of 5.

Please contact me if you can help, or have any ideas of who might be able to.

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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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