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

In one of the talks I gave last week someone asked what my biggest worry is regarding the New Zealand economy. My reply was I'd worry most if unexpected circumstances were to arise to produce a fall in Fonterra's payout to below $5 per kilogram of milk solids over the next couple of seasons. Why?

Partly because the sector is so heavily indebted after a couple of decades of strong growth with our central bank warning of the dangers of that debt since pre-GFC days. Partly because farmers are being hit with new requirements to mitigate the polluting impact of their activities on air and water. Partly because many farmers adopted high input production strategies when payouts were high and some still need to adjust back to largely grass-based feeding. Many already have.

Partly because the sector has an unfortunate slowly deteriorating public image with the most recent images on TV being of cows walking and calving in deep mud in winter cropping paddocks. Campaigns by dairy representative bodies to try and improve the sector's image through advertising and farm days are a good idea. But they get wiped out with a single image of a muddy calf.

Partly because the sector is struggling to get staff and that struggle will get worse as the labour market tightens further, the cultural link of New Zealand with our farming heritage declines further (under pressure from the focus on farming's polluting aspects), and as the range of other opportunities facing young people widens even more.

Partly also because credit availability to the sector has tightened up after some years of strong debt growth. And further tightening is likely when the Reserve Bank requires lenders to hold higher levels of capital.

Partly also because two parties in the coalition government have little affinity with the sector and should they get voted back in at next year's general election it is likely there will be new anti-pollution imposts on dairying. Maybe NZ First will not be there to restrain them.

Partly also because of the failures of Westland Milk and the history which New Zealand businesses have of expanding overseas and losing hundreds of millions of dollars.

Partly also because of the way in which farmers have pressed Fonterra management to maximise milk payouts to help service debt and debt-driven land purchases, rather than retain a good quantity of earnings each year to reduce debt and boost capital. Milk volume growth has been uncontrolled. Neither that approach or the legal requirement to accept whatever new milk comes forth looks like changing. So, these fundamental flaws at the centre of the cooperative's being mean it would be a long stretch to expect the entity will do anything other than depend upon debt-driven growth in its next attempted expansion/development/value-added phase once the current turbulence settles down in a few years.

Partly because the sector is hugely dependent upon exports to totalitarian China and it, like the USA, uses trade as a weapon to get other countries to do what it wants, or not do what it doesn't want. When we one day push back against the bullying to come (remember ANZUS and nuclear-powered ships) our biggest exporters to China will pay the greatest price.

Partly because in any year the sector is vulnerable to a surge in production or exports offshore.

Partly because little new capital is now going into the sector and selling a dairy farm has become very difficult. Land prices are falling. Data are thin on the ground, but price declines seem fairly muted so far. So far, in that practically no forced sales are yet occurring.

Dairying is a vitally important part of our economy and without it most of us would be a lot poorer. But the sector has failed to live up to its potential and the ideas of many of following the example set by Tatua have collapsed in the winter mud, weighed down by a burden of debt. The share price is down over 50% from its 2013 peak at a time when the NZX50 has risen around 125%.

The structure of the sector is not optimal, there are no simple, quick fixes, and the sector, like tourism, is highly vulnerable to an event or series of events directly attributable to climate change which make average consumers radically change their habits – in this instance cutting air travel (which our foreign tourism sector is almost 100% dependent on) and cutting consumption of red meat and dairy products.

It would not be surprising if at some point credit rating agencies were to look through the good state of the government's finances and issue a country downgrade warning on the basis of this export sector vulnerability.

Is the outlook overwhelmingly bad? No. A rising world population needs feeding. Risky, yes. But outside the scenario of a global consumer boycott of red meat and dairy products to try and mitigate the inundation affects of global warming, it looks more like a matter of changes in production practices and debt levels being needed on the ground here in NZ, and a lot of accelerated research into effects mitigation.

History tells us that our farming sector has always changed at the margin, and Country Calendar regularly shows us ways in which farmers are changing what they do and how they do it – though few dairy farmers are likely to pursue the option of bee-keeping which features so regularly on that programme. As for tree growing, that excites few farmers and is not an optimal use for the largely flat paddocks which make up the bulk of current dairying land. But up north there is a change toward horticultural products.

It's a question of how much time dairy farmers will have to change. The sector is perhaps quite a few years off being able to acceptably handle the next shock years when they inevitably arrive. Were low payouts to come now (and although risks are there as world growth ebbs, there is as yet no firm prospect of anything below $6 coming along), the negative official cash rate scenario would fully come into play.

And it all goes to show that dairying's problems have nothing to do with financing costs or the exchange rate, which at US64.5 cents currently sits ten cents below the ten-year average and near three cents below the 20-year average. If any farmer thinks their problems will disappear if the currency falls, interest rates fall, more visas are issued for farm workers, city folk show them more respect, the marketers find better markets overseas, climate change gets ignored, National win the next general election, or the unemployed are required to work the land, then their future will be grim.

So ultimately what we need to do is this – add dairying to our growing list of sectors which are struggling despite high levels of customer demand. That list now comprises retailing, construction, as well as dairying. Over the next couple of years this list will grow and in fact virtually every sector of our economy is going to experience a rise in liquidations, bad debts, write-offs and general restructuring. You don't need a big negative like sky-high interest rates, commodity price shock, global recession, or NZ dollar at US 85 cents to experience a prolonged period of business "weeding out".

- Our economy is no longer growing at the average of 3.5% per annum seen from 2014-18. We're closer to 2% and probably still slowing if we extrapolate business survey results.
- Both skilled and unskilled staff are very hard to find and good long-serving people are starting to shift employer in order to get the wage rise they know they deserve but which bosses who have taken them for granted post-GFC won't give.
- Bank debt is less readily available. In fact, the debt surge ended in 2008.
- Disruption is happening across many sectors.
- NZ businesses have failed to sufficiently invest in recent years to handle change.
- Some elements of the government may not be anti-business as such, but they lack any historical or cultural awareness of the multitude of challenges which business people face. They won't help.
- Some of our biggest businesses have done extremely poorly in recent years. If they with their highly paid experts and carpet bag leaders fail, what truly is the situation for our less visible SMEs?

Perhaps growing concerns about the multitude of factors hitting the business sector outside of the pace of customer base growth explains the bulk of the very high levels of business pessimism in regular surveys.

As an aside, and to help explain why we economists are not forecasting recession in spite of appallingly high business pessimism, consider the following. In the ANZ Business Outlook survey the headline confidence measure is about 40% below its 20-year average. But the Own Activity measure is about 20% below average, the employment intentions measure is 13% down, and the investment intentions measure is 12% off its long-term average.

The availability of credit to the business sector is likely to tighten up in coming years – on top of the tightening to come when the Reserve Bank forces through higher capital requirements. And the tightening as low term deposit rates cause savers to search for returns elsewhere, depleting banks of valuable domestic retail liquidity funding. It's bad timing in that regard for the economy, and perhaps the RB's recognition of the damage they are about to inflict these coming few years helps explain why they undertook a panicked slashing of the OCR last week.

The next few years will be rougher than the past five.

- Make sure you have your expenses under control,
- focus on your highest yielding customers and offload those of low yield,
- cut debt levels before you get told to,
- reduce as quickly as possible your dependence upon exports to China,
- cut use of plastics,
- accept climate change and both signal your virtue on it and take concrete mitigation measures,
- invest in labour-saving measures,
- budget for higher wage costs, and
- focus a lot more on new products and innovations rather than expanding the old range into new markets you might not be able to service anyway because of resource constraints.

Basically, tighten up your ship. Rougher waters are approaching – hence our central bank's panic.

And we haven't even mentioned the commonly discussed global risks of

- trade wars,
- competitive currency depreciations,
- newly ineffective monetary policy safety nets,
- Brexit,
- the growing pushback against China's military, spying and coercion expansionism,
- increasing liberal opposition activity in Russia,
- demonstrations in Hong Kong,
- issues in the Persian Gulf, Kashmir, Ukraine, Venezuela and potentially Argentina, plus
- highly-priced sharemarkets overdue for a decadal correction.

Older Folk Seeking Higher Returns

Speaking of shares, if you are an older person looking for higher yielding assets because the low returns on term deposits do not cut the mustard any longer – get professional advice before you potentially switch into equities. Think first in terms of capital preservation, and then returns. And if you swerve away from equities as a result of discussions with experts, friends, and family, be careful about jumping anew into property. The bulk of the property price adjustments in response to the multitude of long-term structural changes outlined in this publication repeatedly since 2011 have occurred.

And be aware that further legislation will come which strengthens the position of tenants over landlords and imposes costs on property owners. Think especially of what will happen to local authority rates as councils start spending money to mitigate the effects of rising sea levels and stronger weather events. Councils only have one big source of income. Property owners.

Possibly for some people it might be worth investigating a reverse mortgage, though few banks offer them. I've learnt that the rule of thumb used is you can borrow up to your age less 45 as a % of your property's value, with an 8% interest rate applied.

Also, see if your council offers a deferred rates scheme. By all means, have a look at some of the higher interest earning options out there. But be aware of the extra risk you will be taking on. If someone is offering to pay you 6% - 8% then they are lending the money out well into double digits. And the only people who will be paying such high rates to borrow funds will be those the banks won't touch as risks of failure are too high. Remember the poorly run finance company sector ahead of the GFC.

And be aware of the advertising tricks used by high interest rate financiers. They invariably show a happy retired couple enjoying the outdoors in some way.

Peer to peer lending platforms? By all means have a look. But be aware of the higher risks involved and this very key aspect. The sector has yet to go through a credit cycle. That is, it has yet to be hit by a recession. So, we don't really know what sort of losses will arise when economic conditions turn sour.

A thought regarding the NZ dollar

The Reserve Bank have undertaken a panicked 0.5% cutting of the official cash rate. They have been scared by newly falling business and consumer sentiment readings, growing turbulence offshore, and inflation which refuses to consolidate near 2%. Given the new committee structure and some personalities involved, how long before we see attempts to jawbone the Kiwi dollar lower, perhaps supported by direct currency intervention? And, would the RB really like house prices to take off again in the hope that this would spur inflation? If and when they probably ease LVR rules again late this year the verbiage surrounding the announcement will be interesting to read.

Housing

The REINZ released their nationwide monthly data this week and I only look at their well compiled House Price Indices to get a feel for what is happening with house prices around the country. For NZ as a whole in the three months to July average house prices were 1.6% ahead of a year ago with Auckland down 3.4% and the rest of NZ ahead 6.3%.

Four years ago, in the three months ending July 2015, Auckland house prices were ahead 25.3% from a year earlier and the rest of NZ was ahead 5.5%.

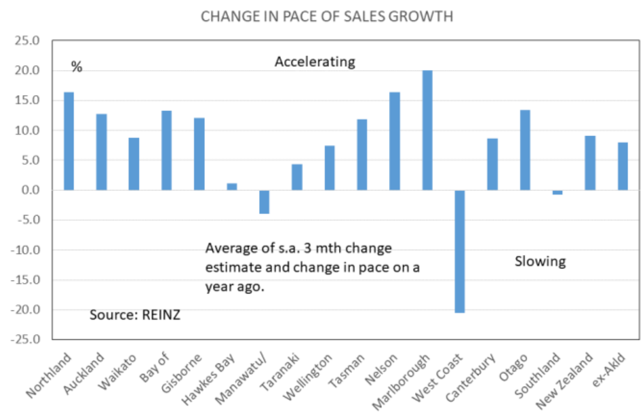
The following table shows the latest change from a year ago with the change in the three months to April versus a year back also presented.

	3 months vs a year ago	**3 mths to April vs year ago**
Northland	4.9	2.6
Auckland	-3.4	-3.1
Waikato	4.2	5.8
Bay of Plenty	6.1	7.7
Gisborne	9.9	12.0
Hawkes Bay	9.9	12.0
Manawatu/W	17.2	17.6
Taranaki	6.2	6.8
Wellington	6.6	9.9
Tasman*	6.6	7.0
Nelson*	6.6	7.0
Marlborough*	6.6	7.0
West Coast*	6.6	7.0
Canterbury	1.6	1.3
Otago	8.7	9.3
Southland	17.9	15.2
New Zealand	**1.6**	**2.3**
ex-Akld	6.3	7.3

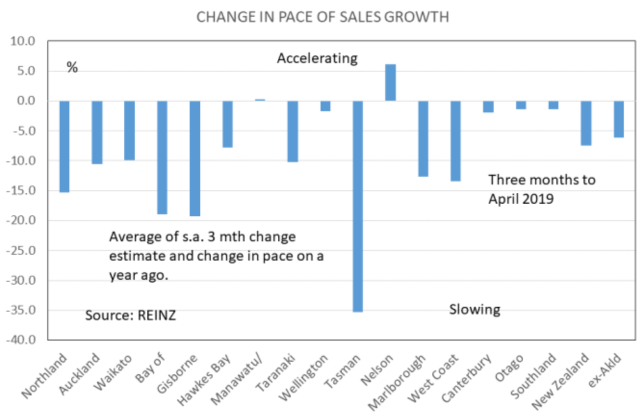
* One index covers all four regions.

Note that the pace of price growth is slowing in most parts of the country apart from Northland, Canterbury, and Southland.

With regard to sales, things are turning out to be better this year than I thought would be the case, supported no doubt by the unexpectedly low levels of interest rates, confirmation of no CGT, and still good though easing net migration inflows. Total annual sales have started to creep back up again. The graph below shows that in almost all regions sales are now improving.



Compare these latest results with our estimated sales pace changes for data in the three months to April. The turnaround is widespread.



Given the reasonable outlook for NZ growth maybe we can have a flat to slightly positive outlook now for real estate turnover in the coming year.

If I Were A Borrower What Would I Do?

Downside risks prevail for global growth, international and domestic inflation, and therefore average interest rates. Can we predict the pace at which interest rates will decline further? Every one of us economists has proved we can't these past 11 extraordinary years. So do not develop a borrowing strategy based upon what anyone says interest rates will do over the coming year or so.

The chances certainly favour rates being lower in a year than they are now. What about in two years? Maybe, maybe not. So perhaps the optimal way to consider your strategy is from this basis. None of us seriously believe that inflation is going to suddenly reappear in the next few years and produce soaring interest rates to please the hearts of Baby Boomers facing achingly low term deposit rates. Therefore, it is hard to argue in favour of fixing for longer than a three-year term.

Countering that argument however is the American situation whereby people usually fix their rate for three decades and refix lower (legislation gives them that right) when rates fall away. But here in NZ if you fix for any term you do not have a legal right to march into your bank and refix at newly lower rates on offer at zero break cost should they appear. So, we tend not to fix long term – except when monetary policy is tight and short fixed rates are well above long-term fixed rates. And that is exactly the time you should not touch long-term fixed rates with a bargepole. And that behaviour tells us that when people choose their fixed rate term it is not on the basis of what they think will happen with interest rates but simply on the basis of affordability.

We Kiwis tend to fix in the 1 – 3-year period. The BNZ rates for these terms are 3.69%, 3.75%, and 3.99% respectively. Personally, were I buying a property currently and taking out a mortgage I'd veer toward the one-year rate for two reasons. First it is the lowest. Second, the chances are greater of rates being lower in a year's time than higher given the newly deteriorating track for the world economy and the easing bias of our central bank.

Good luck. Just remember, no economist will be putting their interest rate forecasting record over the past 11 years on their CV.

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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