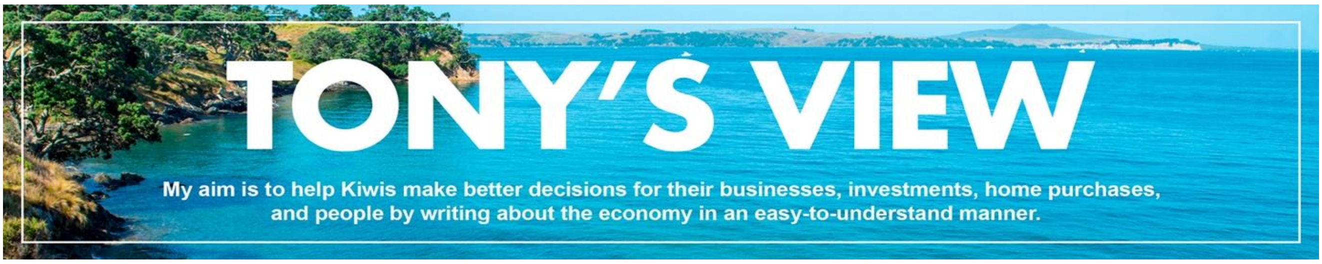

Input to your Strategy for Adapting to Challenges

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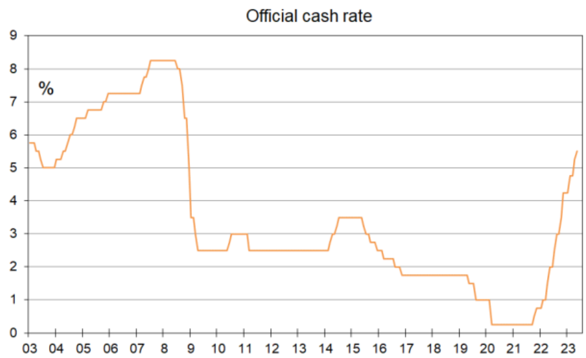
Recession coin toss

Ever since the Reserve Bank predicted that our economy would enter recession this year, I've had the view that such an outcome is a 50:50 call. Absence of a recession is hardly the same thing as good growth which is useful for covering up business mistakes simply as more customers come through the door. But predicting a recession did serve a useful purpose for the Reserve Bank.

In essence, a central bank has two key weapons which it can deploy to suppress consumer inflation. The first everyone knows about – raising interest rates. This weapon has been very effectively used with the official cash rate being taken from the record low of 0.25% in October 2021 to 5.5% now. That is a 5.25% rise over a period of just under nineteen months.

In the previous monetary policy tightening cycle from 2004 to 2007 it took three and a half years for the OCR to rise from 5% to 8.25% - a gain of just 3.25%.

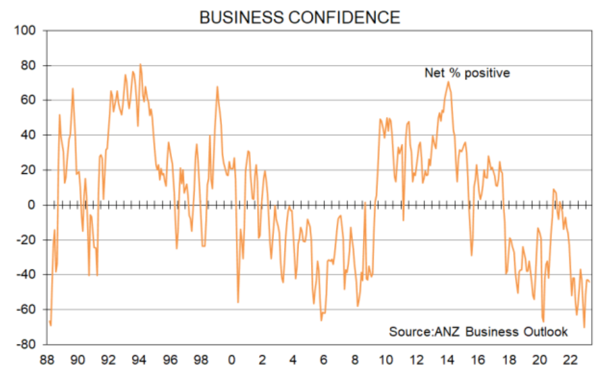


The Reserve Bank learned something from that period – that they had tightened monetary policy too slowly. In fact, as they tightened, they seemed at pains sometimes to stress that things were okay and painful rate levels would not be needed. They eventually admitted after the Global Financial Crisis that they should have moved more swiftly – as a number of us were telling them at the time.

Back then they did not employ the second main monetary policy weapon for affecting overall inflation – strong words. This time around the Reserve Bank deployed such words on November 23 last year when they raised the OCR by a record 0.75% in one go and warned that a recession lay ahead.

Since the pandemic we seem to trigger easily when presented with words like shortage or recession and the various surveys of business and consumer sentiment taken after the November tightening show a large impact from their words.

In my own Spending Plans Survey for instance the net proportion of consumers saying they planned spending more over the coming 3-6 months went from -28% to -43%. The ANZ Business Outlook sentiment measure went from -43% to -50% then a record -70%.



Ahead of last week's cash rate review some sentiment measures had improved as evidence on the ground has been that economic conditions are not necessarily recessionary.

In fact, in the Budget Treasury removed their forecast of recession. The Reserve Bank still have one in their prediction for this calendar year, but it is tiny. We might in fact already have recorded a recession because the March quarter retail trade numbers showing a 1.4% fall in the volume of spending were unusually weak. Then again, it is meaningless to consider an economy as having been in recession when job numbers grow 1.3% as they did over the December 2022 and March 2023 quarters.

Looking ahead, what are the factors generating downward pressure on the country's rate of economic growth and what are the upwardly pressing factors?

Downward growth pressures

Cost of living spike

The average household cost of living has risen by 17% since the start of 2020 and about 6.7% in the past year – or 7.7% if we include interest rates which can go strongly up and down each year and are best left out. People are having to devote time and effort to trying to boost their incomes through wage negotiations, side gigs, and shifting jobs, while refocussing after-tax income on the essentials plus the things denied to us during the pandemic – travel and eating out.

Higher interest rates

As mentioned above, the pace of interest rate rises has been very swift. A large part of the impact of rate rises has yet to be felt as about half fixed rate mortgages come up for renewal this year and people generally will roll from around 3.5% towards 6.5%. It is likely that the growth-suppressing impact of these rate rises to come is a key reason behind the Reserve Bank saying enough monetary restraint is now in play.

Business margin compression

Many small and medium-sized businesses face higher costs but an inability to pass those extra costs into their selling prices. They have to devote extra time to staff management, recruitment, training, and getting by without sufficient people. An outcome will be mental stress and reduced spending on aspirational purchases such as motor vehicles, lifestyle blocks, and holiday homes.

Another outcome is that businesses are cutting spending on plant, machinery, equipment, systems etc. in order to improve cash flows in the short-term. The traditional route to doing so of laying off staff is not easily available now because if staff are made redundant, they may prove impossible to replace when conditions improve.

Binge over

During 2020 and 2021 we sharply grew our spending on durable consumer items like spas and cars, home renovations and couches. Now, having done spending we might otherwise have undertaken this year or next, a "hole" exists in sales of many of these items for a short period of time.

Overseas travel

We have chosen to prioritise offshore travel having had this activity denied to us during the pandemic. This leaves less money available for other areas of spending.

Housing wealth

Our house prices on average have fallen by almost 18% since the peak of November 2021. Lower wealth tends to lead to lower household spending though this effect is often over-rated on the way up and the way down.

Labour shortages

Staff simply are not available in many locations and for many industries. This means output cannot grow as much as would otherwise be the case. That translates through not to a recession but slower growth alongside higher inflation and higher interest rates which themselves restrain growth also.

House building correction

House construction around the country has soared this past decade with a belief – false – that shortages exist everywhere. In the regions there is a high risk of over-building especially as some people move back to the cities or offshore while the flood of migrants concentrate in the cities as they always have done. In the cities there is an emerging backlash against the often ugly, poorly positioned townhouse complexes which have sprung up. It seems that every strong house construction surge in New Zealand in recent years produces some very poor outcomes.

Off the plan sales have plunged for developers and banks have withdrawn finance for many projects in the face of failures by the many inexperienced, under-capitalised, over-optimistic people who have entered the development and construction sectors in recent years.

General election

In an election year we have a tendency to place some of our spending and investment decisions on hold.

Credit crunch

Bank willingness to lend is slowly improving, helped by changes in LVRs and the Credit Contracts and Consumer Finance Act. But it is still more difficult generally to get credit now than in earlier years. This is great for the ability of the New Zealand banking system and therefore economy to handle shocks. But it does restrain growth.

Upward growth pressures

Tourism

The borders are open and just as we Kiwis are determined to travel offshore, so too are foreigners determined to travel here. International tourism is a net positive booster to NZ growth.

Migration boom

Simple population growth tends to boost economic growth in total – though not per capita. There has been a net migration gain in the past year of 65,400 people – the second highest annual total ever after the surge early in the pandemic. This represents a 1.3% boost to our population (record inflows are also occurring in Australia and the UK) and will therefore potentially add over 1% to GDP.

Interest rates have peaked

We are unlikely to see much of a decline in interest rates this year. But as people pull back from their fears of higher interest rates, they will start to advance their purchase and investment plans. Until interest rates have been falling for perhaps a year this impact will likely be small.

NZ dollar is low

Unlike previous periods of tight monetary policy this one in NZ has not been associated with a soaring exchange rate which crushes the exporting sector. This time around interest rates have also soared overseas and that has kept the NZD subdued. In fact, with NZ rates now having peaked while further rises may occur offshore, some NZD weakness is likely and already our currency has fallen two cents against the US dollar since the May 23 monetary policy announcement.

High job security

People feel a high degree of certainty that they will keep their job or, if laid off, will find another one quickly. This is important because it means consumers will continue to consider purchases of large items including houses whereas in a normal downturn with soaring unemployment such plans would be widely shelved.

Savings

Around the world households built up savings during the pandemic through not being able to travel yet having their incomes assisted by their government one way or another. These savings have been acting as a buffer for spending as interest rates have gone up.

Higher interest rates

Only one-third of households in New Zealand have mortgages. It pays to remember that one-third of people live in rental accommodation and do not have mortgage debt to service. Research has shown that rents do not tend to rise when interest rates rise or fall when interest rates fall. Renters are minimally affected by tight monetary policy via the interest rate route.

Of the two-thirds of householders who own their house only half have a mortgage. Many of those with a mortgage owe only small amounts.

For people with savings the impact of rising interest rates is positive as their income rises and some of that may be spent.

Rebuilding

Activity related to reconstruction after recent bad weather events will add to the pace of economic growth.

Easing fiscal policy

In this year's Budget the government has implemented changes which will boost the economy's growth rate 1.7% this coming financial year. This positive fiscal impulse will add to growth and employment while also keeping interest rates higher than would otherwise be the case.

In case you missed it

Yesterday I released results from my latest quarterly survey of investors sponsored by Sharesies. The main results include the following.

- Interest in purchasing shares has firmed despite recent ructions offshore associated
- with the US banking sector and Federal debt.
- Worries about the high level of interest rates have become the major concern.

- Intentions to put money in a savings account reaches a record high.

[Investing Insights with Tony Alexander: Has inflation peaked?—Sharesies New Zealand]

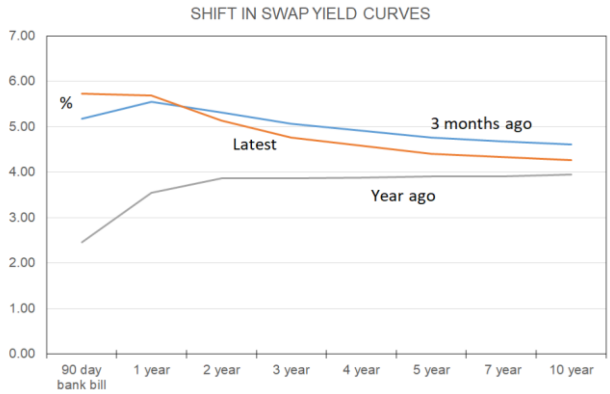
If I were a borrower, what would I do?

I have a suspicion that we are not going to see much change in commentary about New Zealand interest rates for a great number of months. The Reserve Bank have made it clear that they don't feel they will need to take the official cash rate above the current 5.5%. But they are unlikely to contemplate an easing earlier than their late-2024 predicted time unless we get some unusually weak data on inflation.

We will of course see the usual ups and downs in NZ wholesale interest rates in response to developments in the United States and to a lesser extent Australia. But big changes seem unlikely until perhaps quite late this year.

This week the 90-day bank bill yield which heavily influences floating interest rates ended near 5.72% from 5.75% last week. The one-year rate at which banks borrow in the wholesale markets to lend fixed for one year ended near 5.68% this week from 5.72% last week, 5.7% a month back, and 5.55% at the start of March.

The three year swap rate ended near 4.76% from 4.82% last week and 5.05% three months back.



If I were borrowing atm I'd fix one year but would be tempted to 18 or 24 months if they cut me a deal.

I discuss rates a lot more in Tview Premium with lots of useful graphs to help your decision-making process.

Nothing I write here or anywhere else in this publication is intended to be personal advice. You should discuss your financing options with a professional.