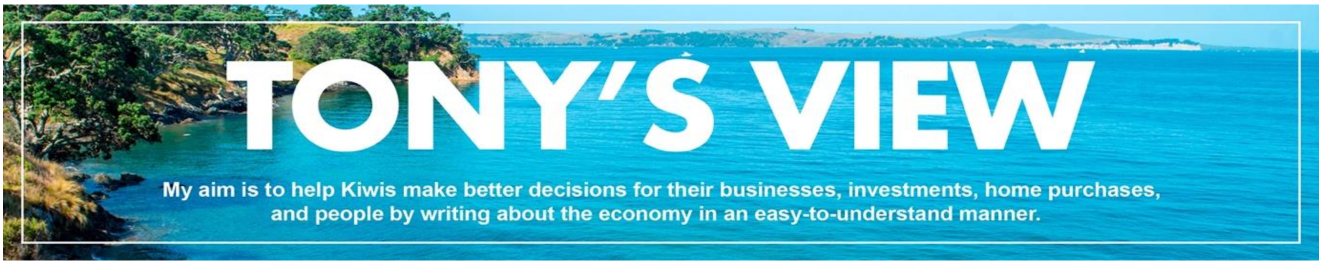


Input to your Strategy for Adapting to Challenges

Feel free to pass on to friends and clients wanting independent economic commentary

ISSN: 2703-2825

Thursday 12 May 2022

Sign up for free at www.tonyalexander.nz

Are we headed for recession?

There are a number of problems when it comes to using models for predicting where one's economy is likely to go. First, they are based on the ways in which things interacted in the past with distortions to those relationships caused by the multiple shocks which are always running through an economy.

There is very little chance that the relationships and the shocks in magnitude, timing, source, and focus, will be the same in the future.

Second, models are based on known numbers. But most of the numbers when looking forward to make predictions are not available – the things they refer to have not happened yet. So, predictions are based on guesses/estimates/gut feels for key inputs into forecasting equations. These guesses will often be wrong.

Third, past relationships between key things may simply be correlations rather than causal intertwining.

Fourth, the primary purpose of models is not for predicting what will happen in the future, but for estimating what the impact will likely be of specific assumed changes in key things. For instance, what is likely to be the impact on inflation if government spending is boosted x%? Models can tell you that. But if the answer is a boost to inflation of y% over a certain period of time that doesn't tell you what inflation will be. It just says it will be y% more than whatever it would have turned out to be without the boost in spending.

Somewhere along the track a few decades back the popular understanding of models went off track towards thinking they generate reliable forecasts rather than being simple simulation exercises.

Personally, my approach to picking where the economy is likely to go largely involves identifying all the likely positive (growth stimulating) factors and the negative (growth suppressing/reversing) factors. Throw in the starting point, make a pick, then as quickly as possible ignore whatever the number is and concentrate on the numbers which are actually of use to people.

If I say to you the economy will grow 1% rather than 3% that is useful information only because of the implications you will draw in your head for the likely impact on business sales, cost pressures, ease of finding staff, competitor pricing behaviour, cost of new premises, business valuation for potential sale, and so on.

That is why I in fact completely avoid picking where GDP growth will go and instead just concentrate on the specific areas of interest such as house prices, labour market, interest rates etc. Not the exchange rate though – that's the door through which every single piece of information about an economy in the past, the present, and the future flows. There are too many factors in play to attempt reliable predictions and I reckon I've proved my uselessness in this area enough.

So, let's have a run-through of the key things in play which will influence the pace of growth in our economy over the next couple of years and therefore impact on borrowing costs and interest rate hedging decisions, staffing etc.

And let's start with the thing which has motivated this article – my monthly Spending Plans survey.

Factors potentially driving recession

Household spending

Household spending usually accounts for about two-thirds of spending in our economy and the outlook is not positive. We have been on a spending binge during the pandemic and now do not need to keep buying as many spas, cars, electric bikes, furniture, appliances, home renovations etc.

Consumer spending is naturally set to weaken because of the binge ending. But we also have many other factors in play.

Cost of living soaring

People are having to divert spending to weekly groceries and away from other things because of higher prices for necessities.

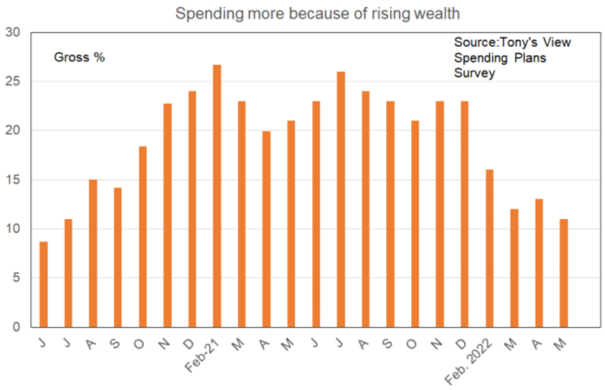
Debt servicing costs rising

This factor always gets a lot of attention because the maths generates some scary percentage changes in interest costs. The headlines concentrate on the housing impact. But the bigger impact is borrowers cutting spending on things to ensure they keep servicing their mortgage and keep the roof over their heads. That is what will happen now, and this will particularly affect the hospitality sector.

Falling house prices

Central banks cut interest rates during the GFC and the pandemic for many reasons, one being to try and push asset prices higher in the hope that feeling wealthier would encourage some people to spend more. This happened and now the reverse is to occur.

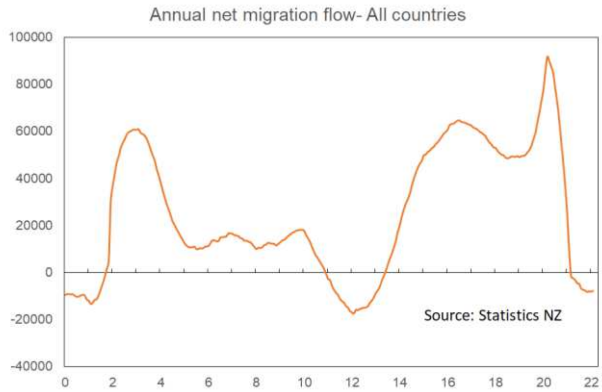
House prices are falling and expected to keep doing so. Share prices are also down and may weaker further (I've no idea and even if I did it would make zero difference to management of my long term focussed share portfolio. I'd maintain the same contributions, keep the same Growth orientation, and check the balance maybe once a month at most still).



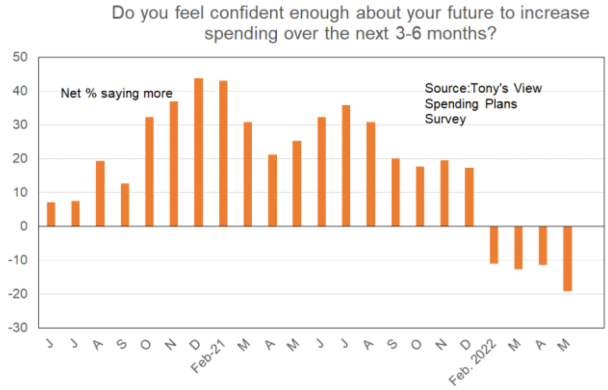
Migration losses

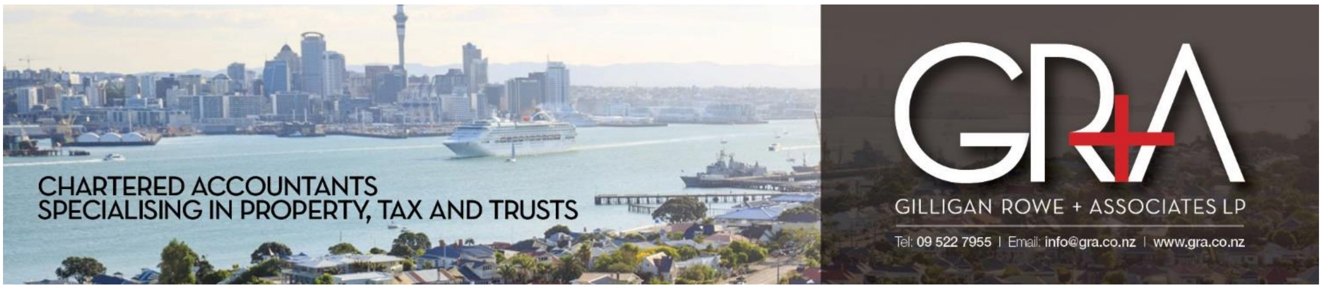
I have long had the view that the one million Kiwis offshore will not flock back to our shores simply because our first year of covid control was excellent. I have also warned that opening of the borders will see many young Kiwis go offshore, principally for work. This is now happening and will generate economic weakness here in three traditional ways.

First, slower population growth naturally will dampen aggregate economic growth. Second, discussion of the brain drain will negatively impact on consumer and business sentiment, again curbing willingness to spend. Third, coming at the heights of a house building boom many people will join the dots or falling demand versus soaring supply (new builds and listings) and naturally curb their building plans.



My latest Spending Plans survey shows a record net 20% of respondents saying they will cut back their spending, with especially large weakness in plans for eating out and buying furniture, cars, and technology.





Business pessimism

The monthly ANZ Business Outlook Survey tells us that a net 42% of businesses have a negative outlook for the economy and only a net 8% expect their activity levels to improve in the next 12 months. This latter measure is well below the ten-year average of 26% and down from 22% six months ago.

Previously I have listed higher levels of business capital spending as a supporting factor for the economy in the next few years. I will return to such a view, but for now with rising pessimism about the world economy and deepening resource and pricing issues, it does not seem reasonable to anticipate good business spending growth in the near future.

In fact, in the ANZ's April survey only a net 3% of businesses said they plan boosting capex in the coming year. This is the lowest reading since late-2020 and well below the average of 13%.

Growing risk of world recession

The Russian invasion of Ukraine has thrown energy and food markets into turmoil, leading to downward revisions to world growth predictions. There is deepening concern about the impact on European growth of the accelerating switch away from using Russian energy sources. Central banks are rapidly raising interest rates away from record low levels explicitly aiming to slow down the pace of growth in their economies.

In China the blind adherence to a failed covid management policy (made necessary by inadequate Chinese-produced vaccines, low vaccination, and expiry of effectiveness of such anyway) means worsening supply chain interruptions. There are more upward pricing pressures to come which will keep central banks nervous but potentially have a greater impact on business and consumer confidence which will actually limit the need for extra interest rate rises.

Fonterra have just revised downward their payout projection for this year in response to price falls at the fortnightly dairy auction. With Chinese consumers increasingly not eating out the prospects for our food commodity prices are looking less and less good.

Labour shortages

If you don't have the flour and the sugar, you can't make a cake. Many businesses in New Zealand continue to strive for a level of output they are not going to be able to achieve or maintain because the ingredients they need are not there. Lobbying a Labour government to let more migrants in who will push rents and house prices higher simply to boost business profits is not going to work.

The priority for a Labour government is not business profits but staff incomes and those incomes will not benefit in a couple of parliamentary terms from more working visas. The government is focussing on training people up, raising their productivity, while improving the country's infrastructure.

There is no growth strategy from the current government, but there is one aimed at improving the lives of working Kiwis (and the beneficiaries for whom a booming labour market is of not much help it seems).

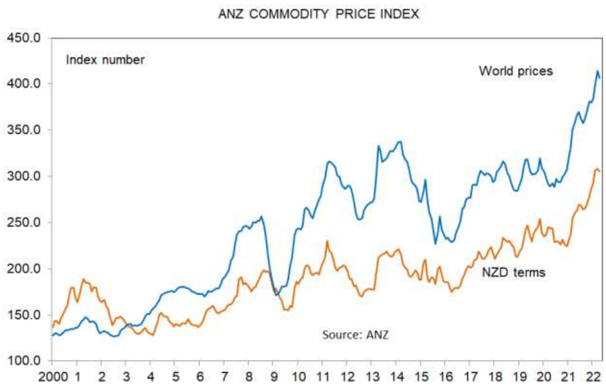
Businesses have always had to cut their cloth to suit market demand. Now they need to do the same to suit resource supply. For some that will mean they are not viable. For most it will mean curbing growth plans. For some it will mean cutting output. For all it means trying to raise productivity.

Factors combating recession

Since the last time I ran this positive and negative list exercise the outlook has deteriorated, and recession risk has increased. But that does not mean recession is guaranteed. Here are growth supporting factors in play.

High export prices

Prices for our exported commodities are now generally falling. But they remain quite high and that will work to keep primary producer profits up at a time of rapidly rising input costs (fuel, machinery, feed, labour, etc.)



Easing fiscal policy

We have a Labour government in power going backward in the polls but facing positive surprises on the monthly fiscal numbers. They are getting zero pressure from credit rating agencies and fund managers to accelerate debt reduction plans and the Finance Minister has just pushed out the projected timing of a return to surplus despite this year's fiscal numbers running $4bn better than Treasury projected just six months ago.

The debt target has just been radically raised from a range of 15% - 25% to 50% of GDP. A substantial fiscal stimulus could lie just around the corner and if the polls remain bad for labour early next year, we could see them open the spigots as they have done each previous time when faced with losing since the 1980s. Tigers don't change their stripes and fiscal laxity looks certain.

This will tend to underpin growth in the economy – and if the focus is on infrastructure who can argue against a splurge?

High job security

To get a true rout in house prices you need unwilling sellers having to act because they have lost or fear losing their jobs. That is not and probably will not happen this housing and consumer spending cycle because of widespread shortages of staff across all sectors except residential real estate.

There has been essentially no jobs growth in New Zealand over the past six months. But this reflects lack of supply, not a lack of demand.

International visitor inflows rising

The near unanimous view is that the return of foreign tourists will be a slow burn upward. The Aussies will visit for sure, especially soon to ski. But the rest of the world is likely to be slow in coming all this way down here and the Chinese market will be absent until some time after the current covid management strategy over there is changed.

Nevertheless, as each month goes by for the next three or so years foreign visitors will provide more stimulus to the economy.

Export education sector returning

This also may be a slow burn with little change this year but some foreign students returning from the start of 2023. The impact will mainly be noticed in Auckland. But the flow of students there may be put at risk by the city's growing reputation as a dirty, dishevelled, empty shop-ridden crime-infested cesspool. So much for the America's Cup-related sprucing up.

As the early-2000s taught us, image counts for a great deal in the export education sector. That image for Auckland CBD is not conducive to foreign students, Chinese ones in particular, returning any time soon.

Strong house building

Consent numbers are at record levels and all efforts are being made to expand and accelerate infrastructure development and upgrading to support construction.

Having said that, the greatest shocks occur in sectors and assets where growth and upside are near universally accepted as natural, desirable, and inevitable. Such is the case for house construction.

A correction in activity levels lies ahead. But it probably won't generate actual falling levels of building activity until some unpredictable time next year, and the pullback from the peak will be cushioned by ongoing capacity shortages blunting the peak this year into 2023 and spreading orders out over time.

Specific sectors

Some sectors of the economy are on long-term upward paths and as noted back in January, here are some of them.

Space
Gaming
Green energy
Medtech
Creative arts
IT Aged care
Healthcare

Implications

But let's say we do go into recession later this year. What does that actually mean for the things we are interested in?

Will unemployment soar? No. Demand well exceeds supply.

Will more businesses fail? Yes, but fewer than "normal" because the reduction in customer demand for many will largely mean better ability to deliver on time with desired quality of service rather than the current environment of rationing output.

Will house prices fall? They are anyway and any recession effect will be almost lost in the wash of the pullback from unsustainably high levels of late-2021.

Will migration flows alter? Yes. More Kiwis will feel inclined to shift to Australia. Therefore, there will be some extra downward pressure on house prices and consumer spending levels.

Will the NZ dollar decline? It already is and if we have a recession the chances are major economies offshore will also look troubled. This will therefore limit downward pressure on the NZD. A lot will come down to the subsequent timing of interest rate changes and how soon the Reserve Bank is expected to switch to easing monetary policy.

That is, recession will increase the chances that the official cash rate gets eased from early-2024 rather than late that year.

Note that recession would also raise the chances of LVR rules being eased early for home lending.

Recession would encourage the government towards additional easing of fiscal policy and energise the already growing debate about tax cuts.

If I were a borrower, what would I do?

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.

Rates consolidate

This week's Tony's View is already long enough so I'll keep the interest rates section short. With sharemarkets falling this week worries about world growth have caused wholesale interest rates to fall slightly. The track for rates here however remains upward and the next review of the NZ official cash rate on May 25 is likely to produce a 0.5% rise to 2.0%. My pick remains for a peak of 3% based on the restraint the RB wants already being well underway.

My outlook implies maybe another 0.5% upside for 2-5 year fixed mortgage rates and about 1% for the one year rate, and I expect rates to be easing from some point in 2024.

My current expectation for the one-year fixed mortgage rate in May each year is shown in the first column of the table below. I focus on that rate because there are many people who have fixed one-year repeatedly since 2009 and the strategy has worked very well.

The second column shows what the one-year rate will average over the next 2-, 3-, 4-, and 5-year periods. The last column shows the current

best 2 – 5-year fixed rates charged by the lenders I track.

	Forecast 1 year rate	Rolling average rates	Current fixed	
2022	4.49		4.49	1 yr
2023	5.25	4.87	5.19	2 yr
2024	5.00	4.91	5.39	3 yr
2025	4.25	4.75	5.55	4 yr
2026	4.00	4.60	5.79	5 yr

If these forecasts prove correct (I'd give that a 10% probability), rolling one-year fixed will deliver an average rate for the next two years of 4.87%, three years 4.91%, four years 4.75%, and five years 4.60%.

If I were a borrower, what would I do?

Personally, I wouldn't fix longer than two years and if I were more brave than I am I would revert to the optimal strategy from 2009 up until mid-2020 which was to blindly roll one year every year.

To see the interest rates currently charged by major lenders go to www.mortgages.co.nz

Tview Premium contains more interest rates discussion and graphs than included in Tony's View.

Links to publications

Tony's View Spending Plans Survey

Spending Plans Survey

Tony's View Business Survey

Business Survey

Tony's Thoughts Vlog

NZHL HOME LOANS | INSURANCE

REINZ & Tony Alexander Real Estate Survey

REINZ REAL ESTATE INSTITUTE OF NEW ZEALAND

Oneroof weekly column

OneRoof

[Handling high interest rates](#)

[Handling staff shortages](#)

[Handling high cost of living](#)

mortgages.co.nz & Tony Alexander Mortgage Advisors Survey

mortgages.co.nz

Tony Alexander Regional Property Report

first mortgage trust

Crockers & Tony Alexander Investor Insights

Crockers PEOPLE & PROPERTY

[Investing Insights](#)

Sharesies