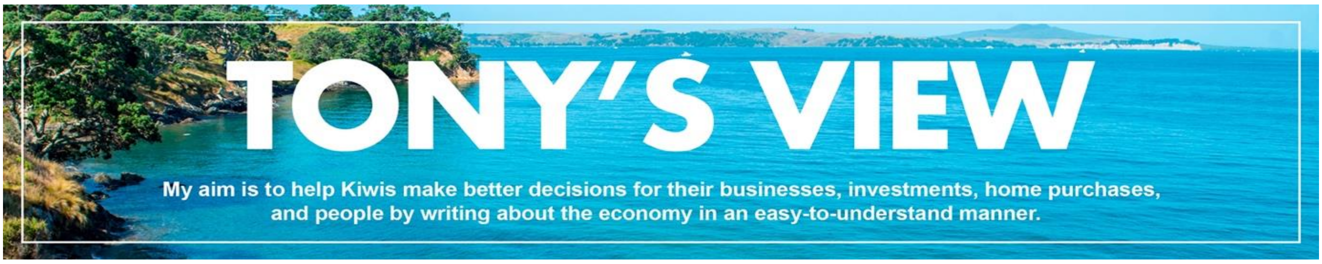


Input to your Strategy for Adapting to Challenges

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

ISSN: 2703-2825

23 May 2024

Sign up for free at www.tonyalexander.nz

Monetary policy unchanged

Yesterday the Reserve Bank reviewed its official cash rate which was last changed when it rose to 5.5% exactly a year ago. As was universally expected they made no alteration and gave no hint of a change in their thinking that the first cut won't come until about the middle of next year.

As discussed here for some time, while the chances are very high that the first cut will come before mid-2025 and in my view probably before the end of the year, the Reserve Bank faces no incentive to hint at such as yet.

The lesson out of Australia and the United States is that after pulling inflation back from rates well above 5% the final leg of getting it cemented near the common target globally of 2% is proving very difficult.

At the start of this year the common expectations were three cuts in Australia and six in the US before the end of 2024. Now the markets are factoring in one across the ditch at best and 1-2 in the US.

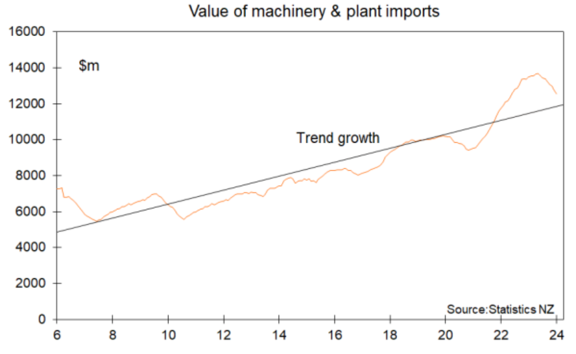
Each week brings fresh data which causes fluctuations in optimism regarding the track for offshore inflation. But the underlying theme remains one of the financial markets tending to be more aggressive in their pricing of an easing than central banks are comfortable with.

A key consideration here in New Zealand is that the data in hand do not yet support a view that business pricing plans have been crushed in response to household spending being crunched.

At the moment businesses still feel that the best way to handle cost increases is to raise selling prices. This has worked well in the past three years but has been the end-cause of inflation for a while sitting over 7% and still currently being 4%.

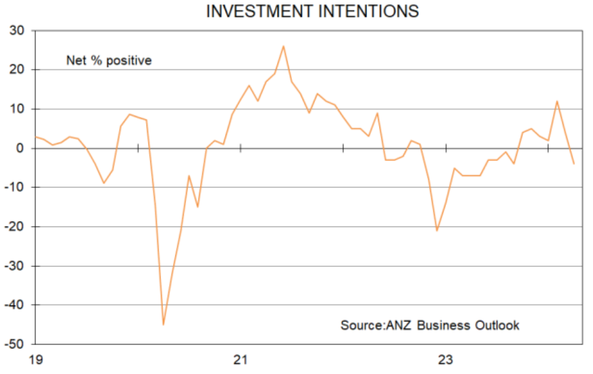
The Reserve Bank needs evidence that businesses are shelving price-rise plans and focussing instead on cutting costs, tolerating lower margins, or boosting productivity. Raising output per person with higher capital expenditure is not traditionally a route embraced by many when sentiment is as poor as it is now and getting worse.

In fact the value of imports of capital goods was down 14% in the March quarter from a year earlier. That piece of data is about as good as it gets with regard to getting a feel for the path of business investment in New Zealand outside of the quarterly GDP numbers. We can look at investment intentions data from the ANZ Business Outlook Survey to get a monthly feel for how things are tracking.



But given the small size of our economy it is best not to pay too much attention to monthly measures and instead average over two or three months to see what may really be happening underneath.

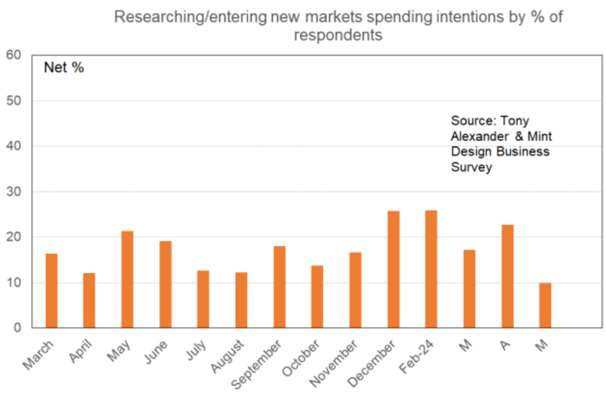
In that regard over the past three months a net 4% of businesses have said they plan raising their investment over the coming year. This is below the three decade average of 11% but up from 3% three months ago and zero six months ago. Does this mean businesses are responding to cost pressures with extra investment? No.



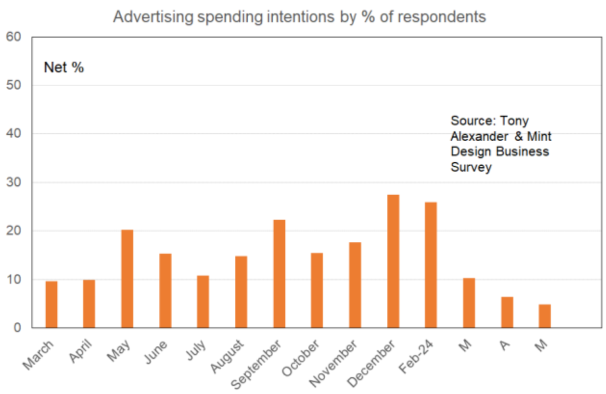
There has been an upward bias to business survey results since just before last year's general election when it became apparent that there would be a change in government. Strip that bias away and there is no evidence of a productivity through investment drive by businesses to handle shrinking margins.

Instead we are seeing a deepening focus on cutting costs. This manifests itself in some of the results seen in the most recent Business Survey which I run each month with sponsorship from Mint Design. First, note the very recent fresh decline in revenue expectations for the year ahead. Like a great number of other monthly indicators this gauge began worsening in February.

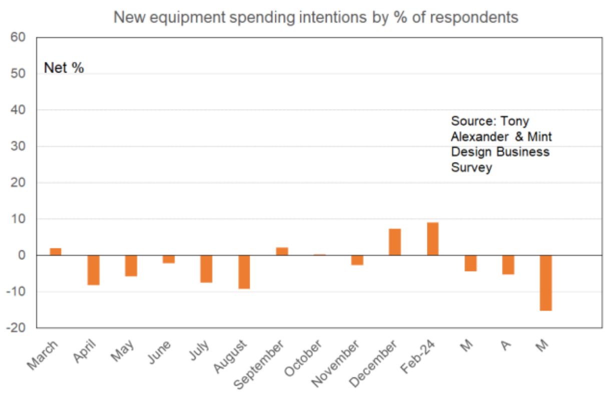
There is a downward trend in spending on research about entering new markets.



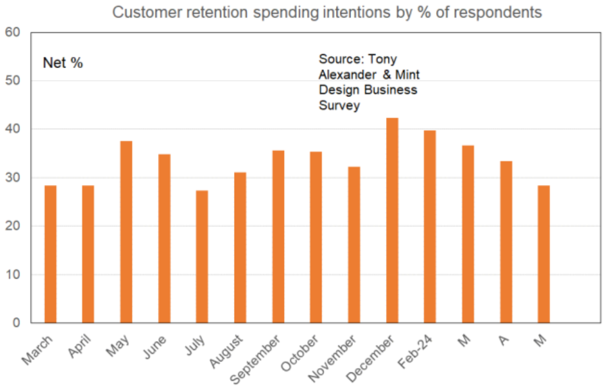
Businesses are cutting back on advertising with only a net 5% in my latest survey saying they will spend more in this area. Three months ago the reading was 26% and the trend is clearly down in the graph below.



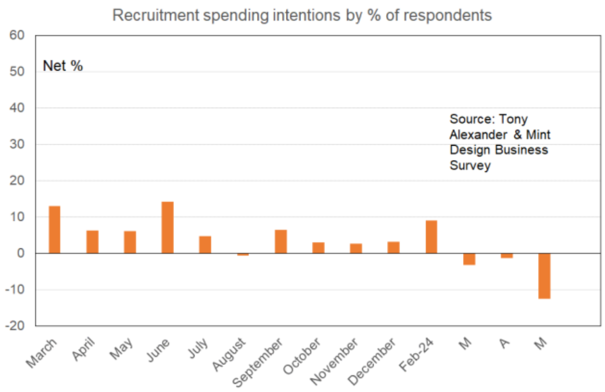
Spending plans for new equipment are negative.



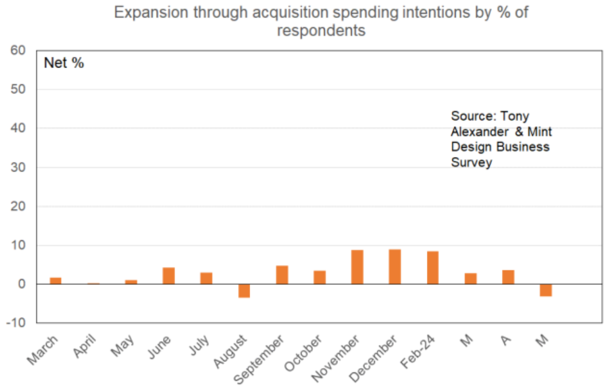
Even spending to retain existing customers is looking less firm though still net positive.



Recruitment spending plans have shifted firmly negative.

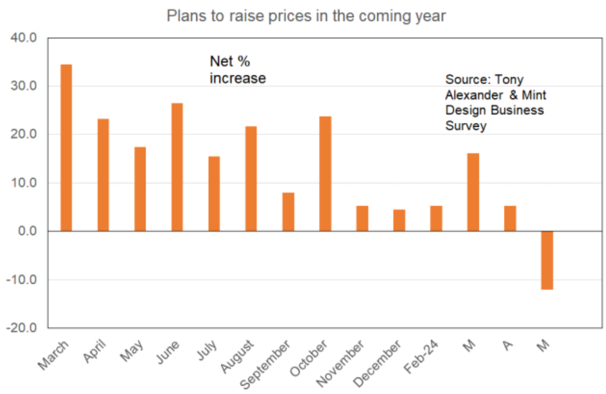


Thoughts of acquisition have also turned net negative.

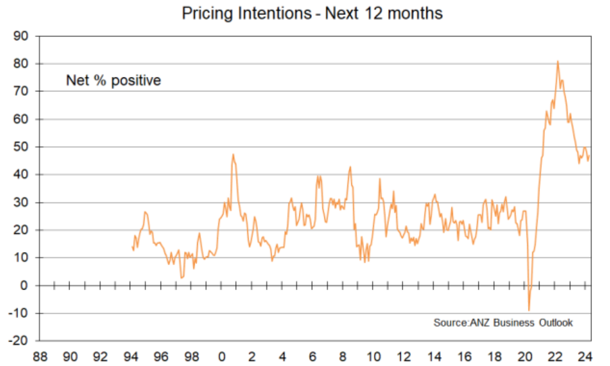


However, there is a glimmer of hope for inflation and therefore interest rates when we step back from business efforts to cut costs and look explicitly at their pricing plans.

A net 12% of businesses have just reported that they plan not raising their selling prices in the coming year. This is the least inflationary result since this version of my survey started a year ago and by itself won't be enough to convince the Reserve Bank to issue a pleasant statement.



Instead they will look at what is happening with the ANZ's long-running business pricing intentions measure and look for a solid downward trend in that reading. There is no such trend as yet. Note the initial strong fall in pricing plans in the graph below from 2022 but the stalling from a year ago in this decline.



As noted above. I expect a cut to the official cash rate late this year followed by other quick cuts, so the rate is 4.5% come the end of March. But given that almost all interest rate forecasts around the world have been wrong since 2007, who knows what I'll forecast next week? For borrowers it pays to remember that acknowledging this uncertainty is important. You need to seriously focus on spreading your interest rate reset risk across time rather than gambling on one particular fixed period proving optimal.

Also, don't forget how over 95% of you took the money and ran over 2020-21 by fixing one year at 2.29% rather than five years at 2.99%. I still get great satisfaction from the rare person I run into at conferences or via email who tells me how relaxed they are currently because they opted for the ridiculously low long-term fixed rate back then.

In case you missed it

Nothing new this week.

If I were a borrower, what would I do?

The OCR was left unchanged at 5.5% as expected. But the Reserve Bank said domestic inflation from sources like rising council rates, insurance, and rents is proving stronger than anticipated. They discussed raising the cash rate but instead lifted slightly their projections of it for the next three years which is more an exercise in signalling their still hawkish stance rather than an explicit warning that more tightening lies ahead.

Wholesale interest rates edged up following the cash rate review but probably not by enough to risk banks increasing fixed mortgage rates from current levels.

If I were borrowing at the moment, I would take a mix of 6 and 12 month fixed rates and expect to make a similar decision in 6-12 months time.

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.