

Input to your Strategy for Adapting to Challenges

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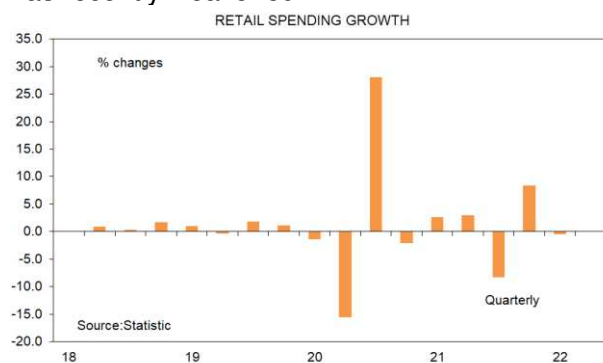
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Thursday 26 May 2022

Retail trade trends

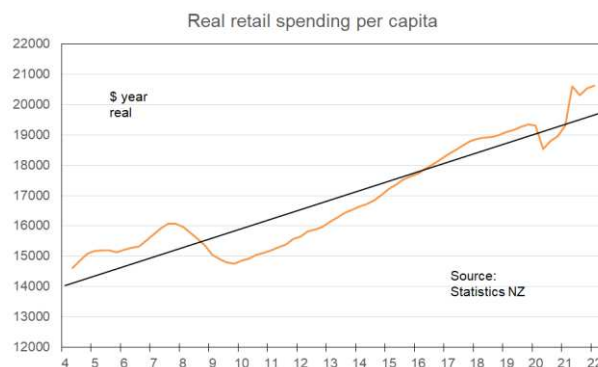
On Tuesday Statistics NZ released March quarter data on retail spending around New Zealand. I haven't taken a look at the data for a while because of the many disturbances from the pandemic. Those disturbances remain in place for these latest numbers and therefore we cannot really say anything too definitive with regard to sectoral trends.

But for what it is worth, here is what the numbers do indicate. First, note this first graph showing extreme changes in quarterly rates of retail spending growth over the past two years. The March quarter change in retail spending adjusted for inflation is a small decline of 0.5%. Spending has recently weakened.



I'm not going to bother citing annual changes because of the Covid distortions.

The level of spending per capita however still remains well above long-term trends. That encourages me to adopt a negative bias towards predictions of how strong our spending will be over the next couple of years. Adopting a forecast of caution is made relatively easy when we consider factors such as rising interest rates, falling asset prices, net outward migration flows, and a pullback from a two-year pandemic spending binge on some items.





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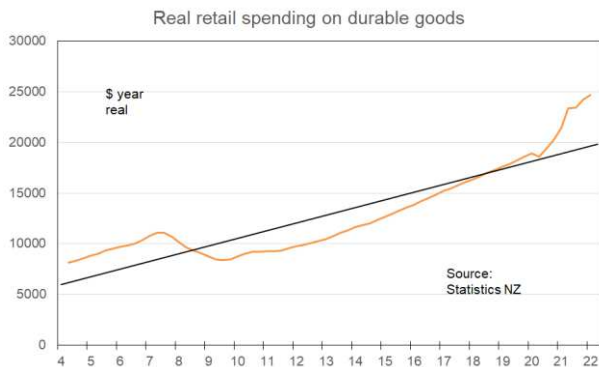
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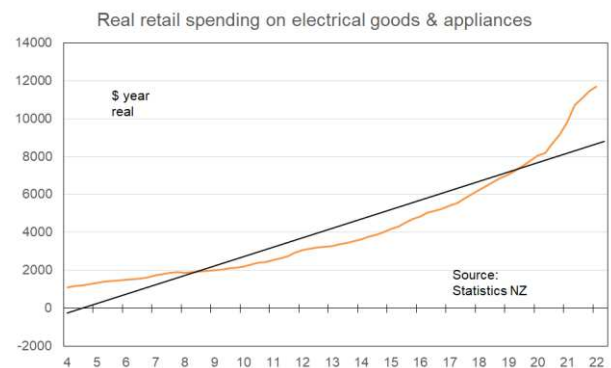
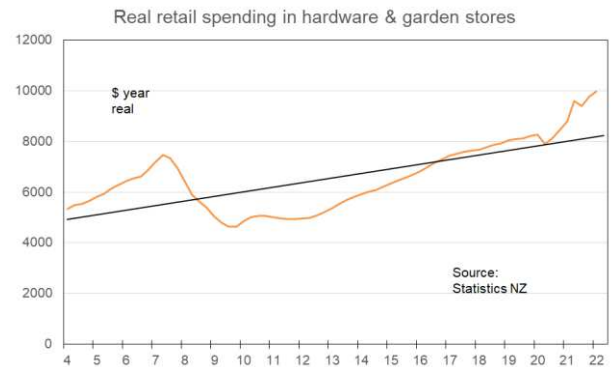
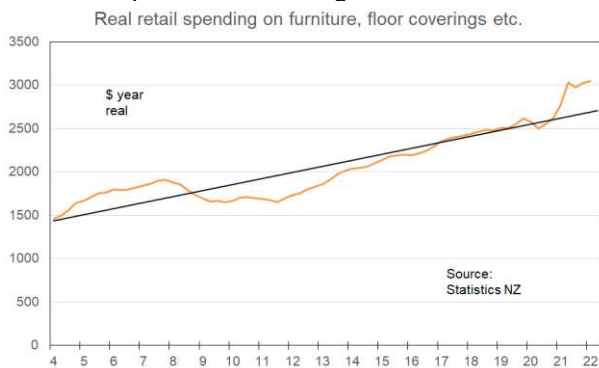
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Here are some graphs showing the extent to which we have unusually splurged on some things. They are the ones most at risk of sales weakness through into 2024. Durable goods are things which last a long time and which we can usually go without or without replacing for a while if we are nervous about anything. Nerves are high now – hence weakness for durables goods spending lies ahead.



One example of a durable good is furniture.



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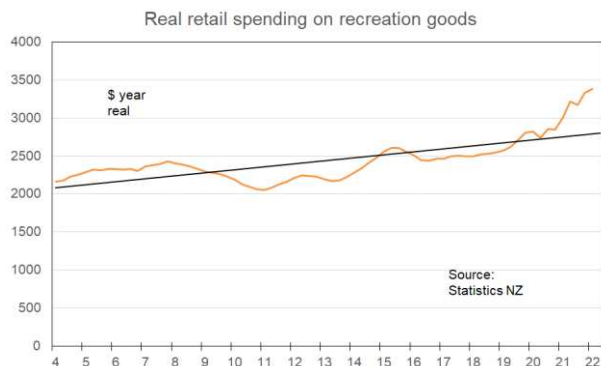
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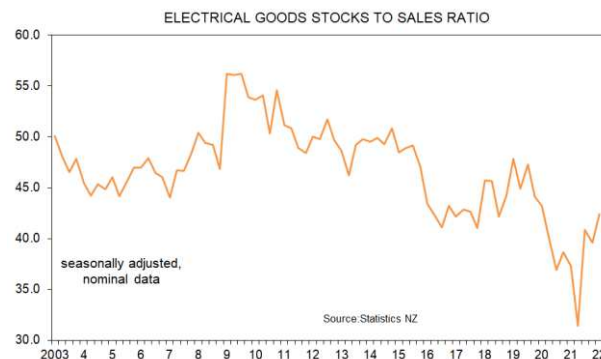
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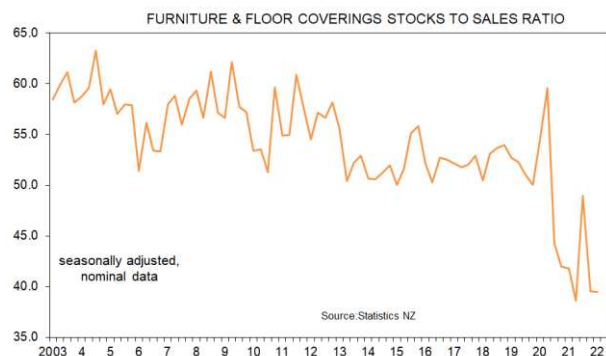
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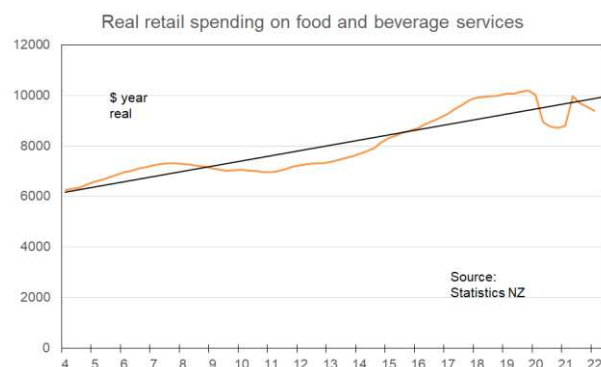
In normal times one would be quite concerned about retailers of durable goods holding excess stocks and having to deeply discount prices to move stock. But stock levels are low because of the disruptions to supply chains which are continuing.



Hence my comments last week regarding one aspect of this period of weakness in the economy not being a particularly firm inventory cycle downward movement. This will help mitigate the extent of weakness in the NZ economy – to the extent that local manufacturing of durable items remains in New Zealand.



Now, contrast those patterns above with these.



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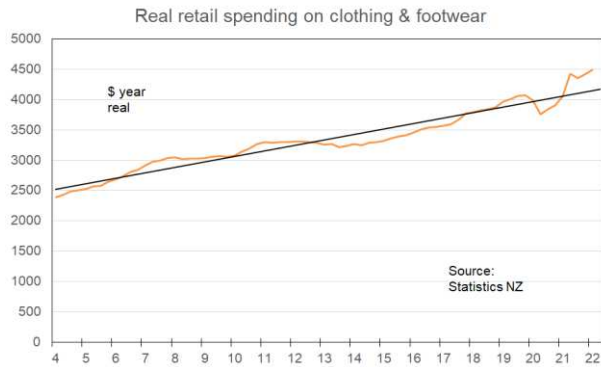
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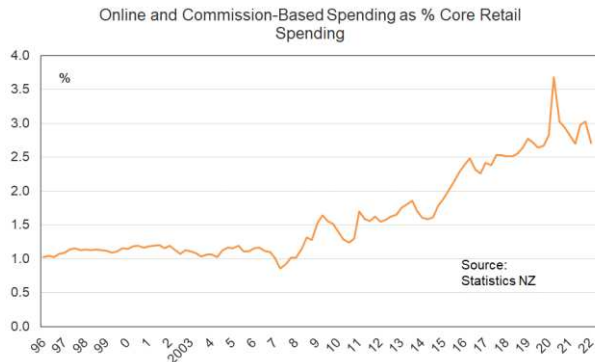
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spending they are aiming at is that by households. Add in the high increase in our cost of living, falling house prices, falling share prices, war in Europe, lockdowns in China, and an eventual 25 a litre increase in petrol prices, and some of the issues retailers have attracting staff will soon become redundant.

There has been a flattening out of the proportion of retail sales being done online. The shift towards buying over the computer appears to have stalled for now.



The path ahead looks particularly challenging for the retail sector. The Reserve Bank has explicitly stated it is running the risk of over-crunching the economy to suppress inflation and the area of



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.

Monetary policy crunch

The Reserve Bank met market expectations yesterday by raising the official cash rate 0.5% to 2.0%. But there was a surprise in the release in the form of their predicted peak in the cash rate increasing from 3.4% mid-2024 to 3.9% mid-2023. They plan to raise their cash rate and apply extra downward pressure on activity in the economy, labour, and housing markets faster than pencilled in three months ago and to a greater degree.



The Reserve Bank made some strong statements regarding the need to get inflation set firmly back towards the 1% - 3% target range.

“...monetary conditions need to act as a constraint on demand until there is a better match with New Zealand’s productive capacity. A larger and earlier increase in the OCR reduces the risk of inflation becoming persistent

The level of global economic activity is generating rising inflation pressures

On balance, a broad range of indicators highlight that productive capacity constraints and ongoing inflation pressures remain prevalent. Employment remains above its maximum sustainable level, with labour shortages now the major constraint on

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production. The Reserve Bank’s core inflation measures are above 3 percent.”

The Reserve Bank firmly acknowledged the slowing world growth environment and headwinds generally facing the New Zealand economy. But they have concentrated on the lack of capacity in our economy to handle the levels of demand which are still out there and that appears to have been a key motivator of their decision to adopt a far more hawkish monetary policy stance.

The new “least regrets” policy

The Reserve Bank have explicitly stated that they are adopting a new policy of “least regrets”. Back at the start of the pandemic they adopted such a policy on the downside. They decided to take the risk of leaving interest rates too low for too long and over-stimulating inflationary pressures. They considered it best to take that risk than to not ease enough and regret deepening the downturn in the economy.

Now they are doing the opposite. They prefer to take the risk that they will unnecessarily crunch the economy as it is better to do that than risk inflation becoming entrenched at higher levels.

It is impossible to forecast such a shift or implementation of a least regrets policy involving an explicit bias. So, I don’t feel too bad about shifting my predicted peak for the official cash rate up from 3.0% to 3.5%. That is the level most other economists sit out and it should be noted

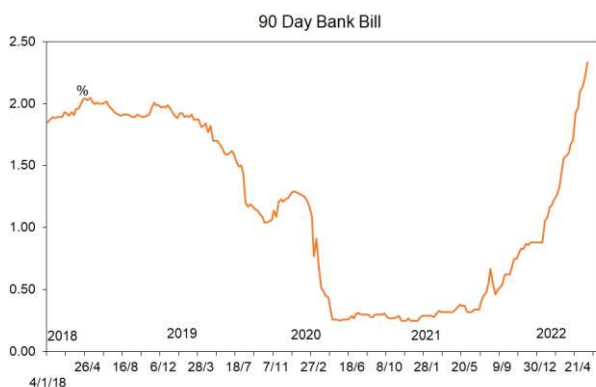
that they are tending to stay there in spite of the hawkish Reserve Bank statement.

That is because they, like me, see a good chance that the economy will weaken more than the RB thinks and so they won't need to take the cash rate as high as the 3.9% they have pencilled in.



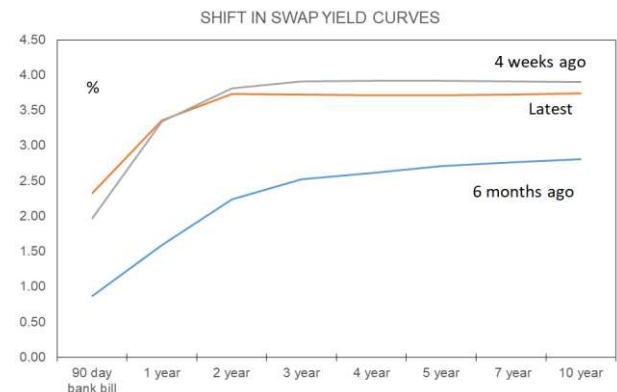
In fact, assisted by a growing view that the determination of the US Federal Reserve to raise rates rapidly will cause weak growth which quickly suppresses underlying inflation, long-term interest rates have declined this week.

The rate changes here are that the 90-day bank bill yield has increased to around 2.3% from 2.2% last week. Steady rises each week are likely from here given an expectation the Reserve Bank will raise the OCR 0.5% in July and then again in August.



The two year swap rate at which banks borrow to lend fixed has risen to 3.73% from 3.58% last week which takes it back exactly to where it was a fortnight ago.

The five year swap rate however has ended the week unchanged at 3.71% and the yield curve is now totally flat from two years onward.



This flattening of the curve reflects a growing view that the Reserve Bank will crunch the economy enough that the timing for when interest rates start falling again is going to be sooner than previously thought. Now, the fun begins as fixed mortgage rates start adjusting to reflect this curve shape and before the end of this year the mortgage curve probably goes inverse with the one-year rate sitting higher potentially than the 3-5 year rates.

From here I see scope for the likes of 3-5 year fixed mortgage rates to rise another 0.5%+, 1%+ for the one and two year rates, and 1.5% maybe for floating rates.

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	5.75	5.12	5.19	2 yr
2024	5.00	5.08	5.39	3 yr
2025	4.25	4.87	5.55	4 yr
2026	4.00	4.70	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 5.12%, three years 5.08%, four years 4.87%, and five years 4.70%.

If I were a borrower, what would I do?

No change. I would still fix two years at the longest. I see scope for mortgage rates to start coming down towards the end of 2023, first half of 2024.

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

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