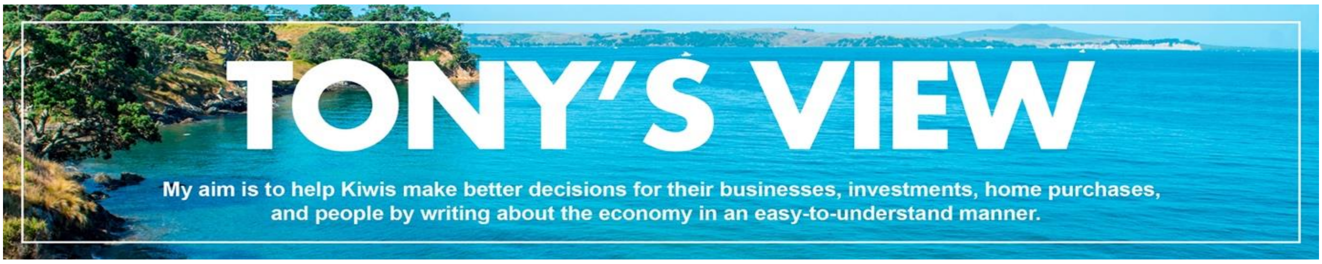


Input to your Strategy for Adapting to Challenges
Feel free to pass on to friends and clients wanting independent economic commentary

ISSN: 2703-2825
31 October 2024
Sign up for free at www.tonyalexander.nz

The cyclical recovery in inflation

In 2022 I started to deliver a warning that come 2024 there would be a period of weeding out of businesses across all sectors of the economy. This would come about in response to

- weakness in consumer buying over an extended period,
- tight monetary policy,
- exposure to businesses and ventures artificially and unsustainably boosted by the pandemic excess stimulus period, and
- simple catching up generally on delayed restructuring.

One might think on the basis of the recent surge in business sentiment that this weeding out must surely be about over now that interest rates are falling.

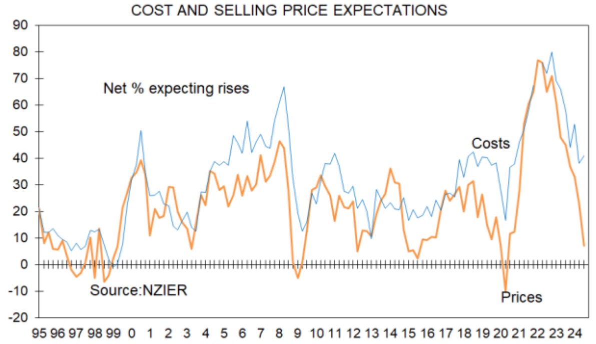
But no. There are a lot more business closures to come and if you are in operation at the moment you need to keep an especial eye on your exposure to business clients who are becoming tardy in paying their bills.

It is not just that there is enhanced downward pressure on cash flows from the IRD catching up on tax bills and using up of extra savings which might have been built up during the pandemic loose credit/handout period. There is also some unique severe margin pressure in place.

We can get a feel for this by looking at some specific results from the NZIER's Quarterly

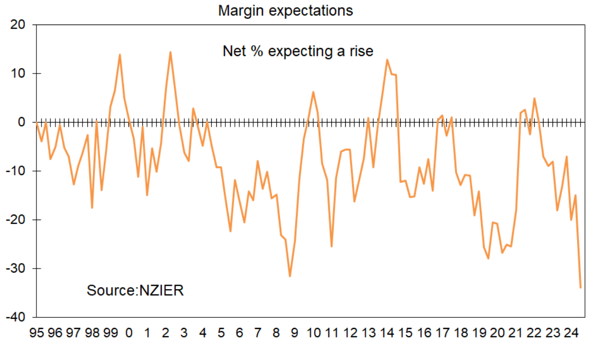
Survey of Business Opinion. From their survey NZIER calculate the net proportion of businesses who expect their costs to go up in the coming quarter and the net percent who expect their selling prices to rise. I like to compare the two to get a rough gauge of the degree of margin pressure on place.

This first graph starts in 1995 and shows as the orange line the net percent of businesses planning to raise their prices. The blue line covers costs. Note that cost expectations are usually above price expectations.



On average since 1995 a net 31% of businesses have said they expect their costs to rise and a net 23% have said they plan raising their prices. The latest readings are 41% and 7%.

That is, cost expectations are above average, and price expectations are well below average. The difference is 34 points. This next graph plots this difference from 1995.



The margin contraction expectation is at a record low. Actually, if I extend the analysis back to 1970, we find only one other time period with a greater result. That was -36% in 1976.

Businesses are expecting to experience their worst margin compression broadly speaking since 1976. This is what I was referring to many months back when I was speaking and writing about the four boxes of monetary policy. Here is a reminder.

Box 1 is interest rates rising and box 4 is inflation falling. Everyone understands that relationship. Box 2 is household spending being crunched because of rising interest rates and that means eventual success in box 4.

But monetary policy is all about box 3. In this third box businesses find they cannot increase their selling prices to recoup still rising costs because their customer base has been crunched in box 3 and price rises simply cannot occur.

Businesses are currently still experiencing rising costs. But we are at the part of the monetary policy cycle 18-24 months after the true tightening of November 2022 in which the biggest gains from that tight policy are achieved. This margin crunch is enough to encourage the Reserve Bank to ease monetary policy at a good clip because they know substantial business failure and hopefully productivity-enhancing restructuring is now set to occur.

As noted many times before here, these failures, closures, restructurings etc. will extend across all sectors and your vulnerability may not be your business but the ones you sell to. These developments explain why we economists are forecasting rising unemployment even as the economy's growth rate slowly improves through 2025.

But these developments also bring the best acquisition, market expansion, staff hiring opportunities for those businesses who can weather the weeding out storm – probably because they anticipated it.

There is an important thing to note with regard to the issue I raised last week of when cyclical upward pressures on inflation return. The NZIER data tell us inflation for the near future is beaten. But consider what we learnt from the consumer price index release a few weeks back.

Inflation has fallen to 2.2% but this is substantially because we are importing deflation. The tradeables goods index has fallen by 1.6% in the past year. But the non-tradeables index which reflects domestic pressures referenced here still increased by a very high 4.9%.

The NZIER survey says we can be confident that the 4.9% rate will fall away fairly well over the coming 2-3 quarters. That is good for monetary policy.

But it is unreasonable to expect that tradeables deflation will continue. This measure will be back in positive territory next year and that will be associated with still rising costs for businesses bringing things in from overseas.

For me what this suggests as a risk is the following. Businesses will still be facing cost pressures in a year's time, but perhaps from a slightly altered source. They will be wanting to rebuild their crunched margins. They will only be able to do this if household spending (box 2) is firm.

Thus my concern is that once retailers report that they are experiencing good sales growth, inflation could reappear quite quickly. That is where my focus lies rather than the near term outlook which is all downward for inflation and interest rates.

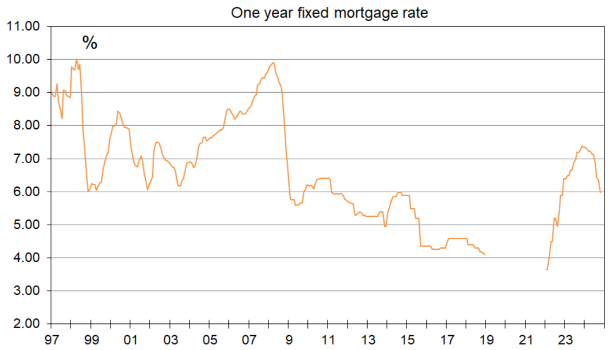
Watch out for the return of inflation and interest rate worries along with some new tightening in labour market conditions come the start of 2026 and especially through that year as the growth upturn truly gains some reasonable strength.

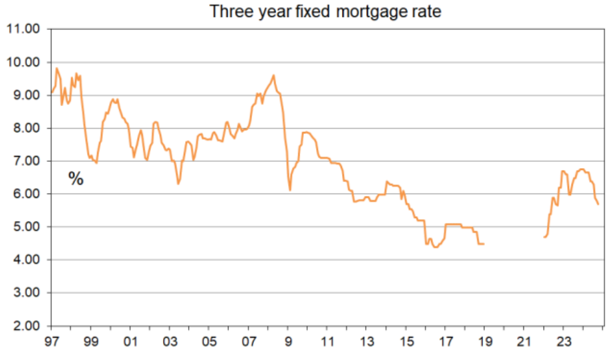
The interest rate implications of my concerns are reasonably clear. The cyclical lows for medium to long-term rates will come a lot earlier than we may all be thinking. More importantly, the time to fix 3-5+ years may arrive early though that depends upon when monetary policy expectations switch back to the upside.

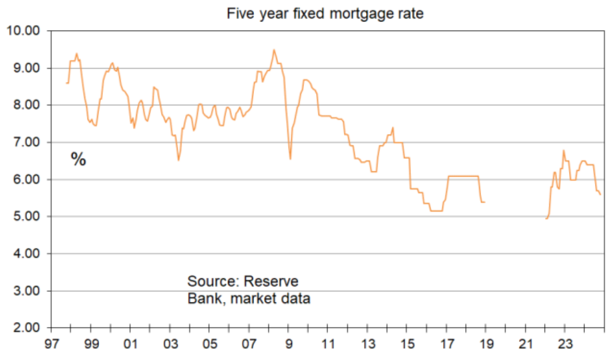
If I were a borrower, what would I do?

This week we've not received any fresh news of enough importance to cause any decent changes in market expectations for where NZ inflation and monetary policy are headed. Wholesale rates are largely where they were a week ago and I've written quite a bit in this section in recent weeks so won't this week.

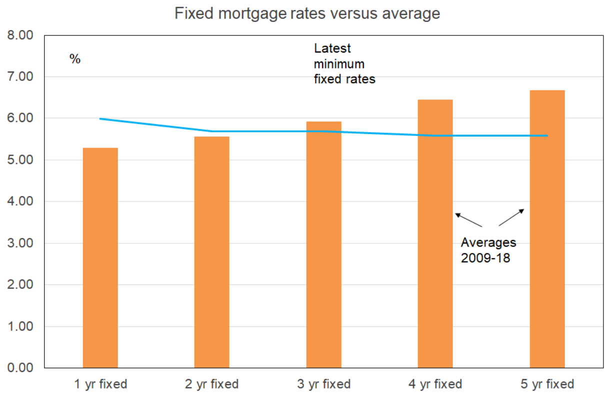
These three graphs show levels of the one, three, and five year fixed mortgage rates over the past few years excluding the 2019-21 period when rates were absurdly low because of worries about deflation and then the effects of the pandemic.







This graph shows how current rates compare with averages from 2009-19.



If I were borrowing at the moment, I would be happy to fix for just six months in anticipation of switching to a longer rate at some point from mid-2025 onwards.

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

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.