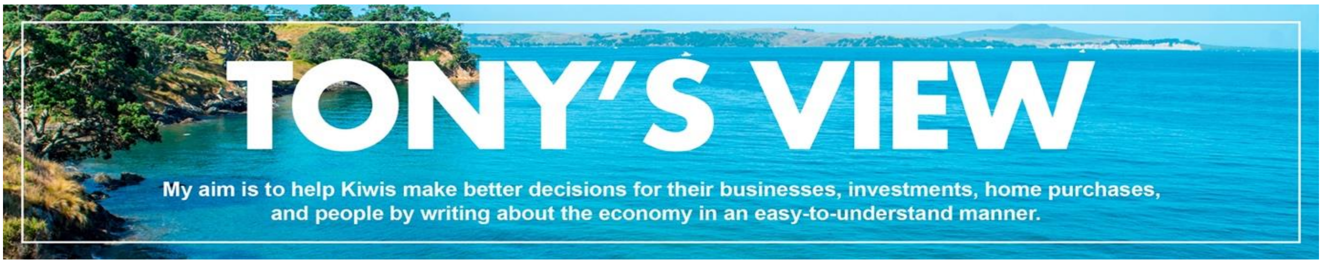

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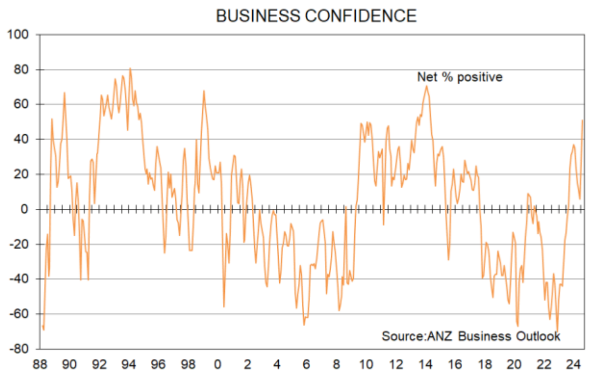
A reality check

Oh dear. A few people got a bit scared by my writing last week with the emphasis on factors which will restrain the strength of our recovery through 2024-26 and long-term rates of growth in productivity, GDP, and incomes. Yet within one hour of sending the report out the astute amongst you will hopefully have seen why I felt such a reality check to be necessary.

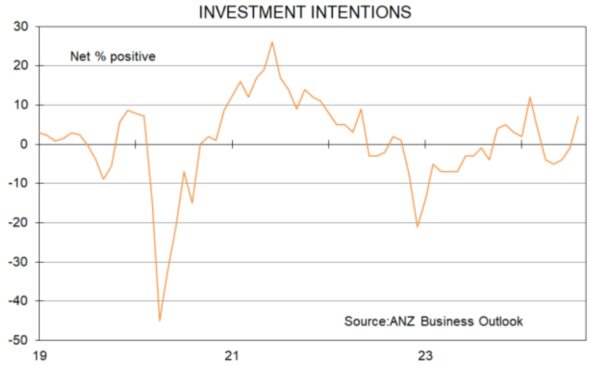
ANZ released the results of their monthly Business Outlook Survey. This gauge of business feelings and plans has been around for a few decades and delivers very useful information on where things seem to be headed. But sometimes the various gauges can look a tad divorced from reality and a dose of scepticism is often required, same as is the case for my own monthly surveys.

Consider the headline result from their survey. Whereas two months ago a net 6% of businesses said that they had a positive outlook for the economy, now a very high net 51% say that.

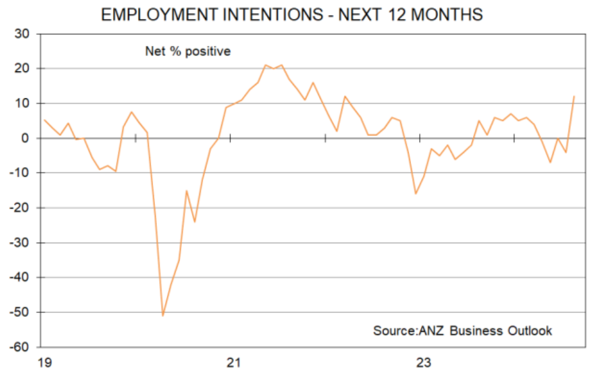
As the following graph starting in 1988 shows, this is an unusually high reading. Are we really in the same economic environment as on those previous occasions of high confidence? I don't think so. People may have let the prospect of interest rate relief go to their heads.



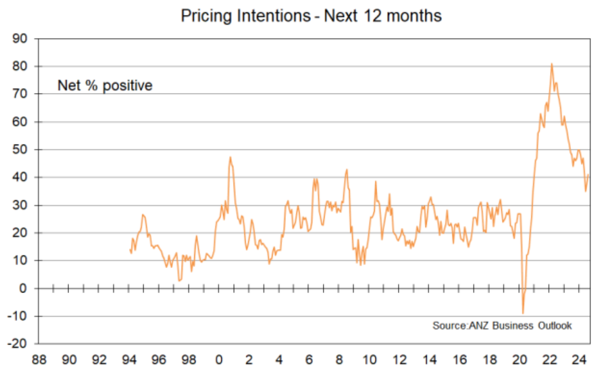
Consider also the net proportion of businesses expecting to be busier in a year's time. This has jumped to 37% from 16% last month. I think this reading is more realistic because technically the absence of deep interest rate restraint will bring economic growth. But I'm not convinced this reading will stay at these above 23% average levels for long.



A net 12% of businesses now say they will boost staff numbers in the next 12 months. That seems too optimistic. Investment intentions at a net 7% positive seem more realistic.



What mainly concerns me however about the survey is the pricing intentions measure. It has gone up to a net 41% of businesses planning to raise their prices in the next 12 months from 38% last month and 35% two months ago.



This is concerning and is the reason why I took some time a few weeks ago to describe the four boxes of monetary policy effectiveness. To recap, the first box is interest rates going up in order to get inflation down in the fourth box. Everyone understands that relationship. Most people also understand the second box. This shows consumer spending being crunched because of higher interest rates and we know this will lead to inflation falling in box four.

Most people however don't understand box three. In box two not a single one of us consumers set the prices of the 649 items which go into the basket of goods and services making up the consumers price index.

Prices are set offshore for 40% of items and the rest in box three where businesses set their selling prices. Inflation only goes down if businesses stop passing on cost increases.

That is, when the costs of operating one's business go up businesses will simply adopt a cost-plus pricing policy if demand is strong enough and pass the cost increases through into higher selling prices.

What the Reserve Bank wants is business realising that consumer spending has been so badly crunched they cannot pass on cost increases and must instead seek to maintain their margins by boosting productivity and cutting expenses.

That is what this year is all about and is a key reason why the economy has looked so bad. Businesses are finally shifting away from cost-plus pricing.

I noted after the Reserve Bank cut their cash rate early in August that they were gambling on the lagged effect of crunched consumer spending already underway to cause businesses to continue their switch away from cost-plus pricing.

But the fact that the net proportion of businesses planning to raise their prices has risen from 35% to 41% is concerning. The average reading consistent with 2.3% average inflation and 2.7% average GDP growth since the early-1990s has been 25%.

But with just 0.2% growth this measure needs to go well below 25%. It is not and that is where my main concern about the coming year or two lies.

It is not guaranteed that the Reserve Bank will cut interest rates as much or as fast as the financial markets are pricing in. It is not guaranteed that the degree of economic stimulus which businesses are expecting to flow from easing monetary policy will occur.

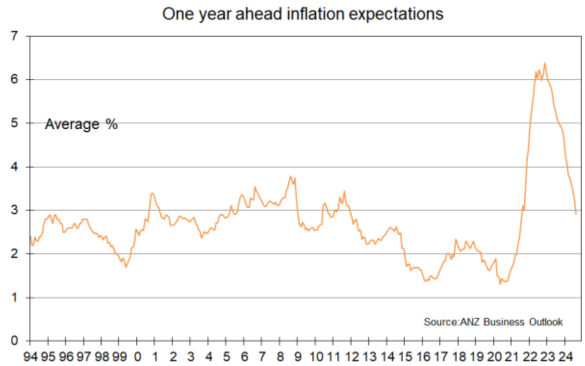
If businesses continue to raise their selling prices now that they have felt the foot coming off their box three necks, then inflation will not fall as the Reserve Bank have newly predicted.

We cannot rule out the worst case scenario. Monetary policy tightens again in 2025 or rate cuts stall in the first half of next year because inflation is failing to decline as expected.

My focus on business pricing intentions remains as strong now as has been the case for a long time and with those intentions rising, I find myself less optimistic about monetary policy easing.

What then are the implications for businesses, homeowners and investors? Be cautious. Don't be afraid to lock in a portion of your interest rate risk for a longer term than your gut may be telling you at the moment.

Should one turn newly negative? No. The rise in pricing intentions may be a last gasp blip. After all, the average year-ahead inflation rate picked by businesses has fallen to 2.92% from 3.2% last month and 4.28% at the start of the year. This is a very good development.



But we are still above inflation expectations which prevailed from 2012 through into 2020.

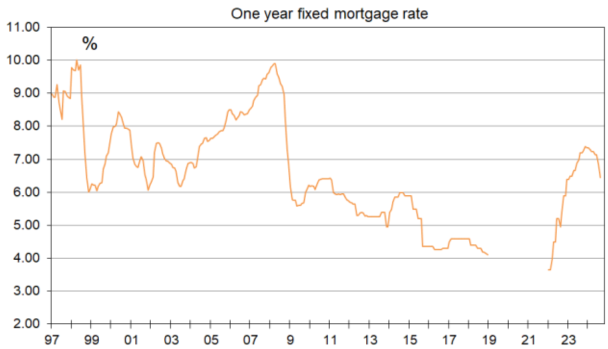
There is still a lot of water to go under the inflation and monetary policy bridges so do not base your decisions strongly on a particular set of optimistic interest rate predictions coming true.

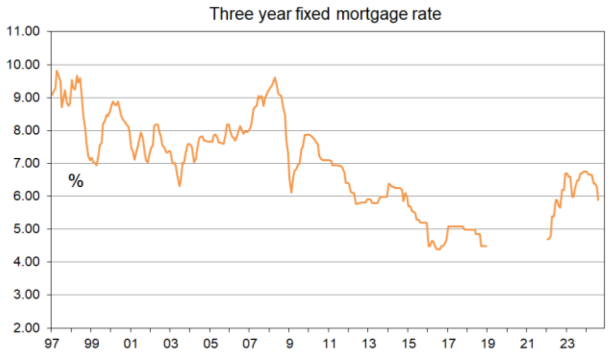
If I were a borrower, what would I do?

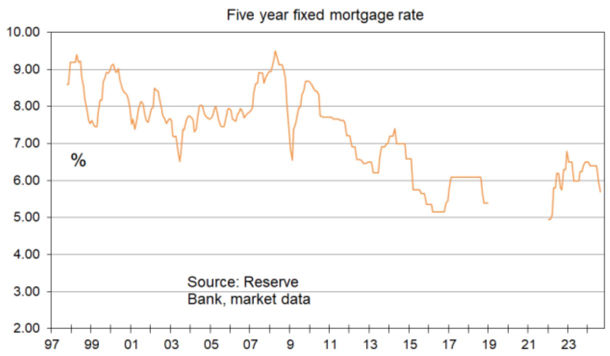
Wholesale interest rates declined slightly this week assisted by some weaker than expected data in the United States causing marginally lower rates there.

No news meaningfully changing the general outlook for falling interest rates in New Zealand was received this week – so I'm not going to write anything else.

If I were borrowing at the moment I'd probably still just fix for six months. But keep an eye out for bank specials being offered but not advertised for the 18-month term.







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.