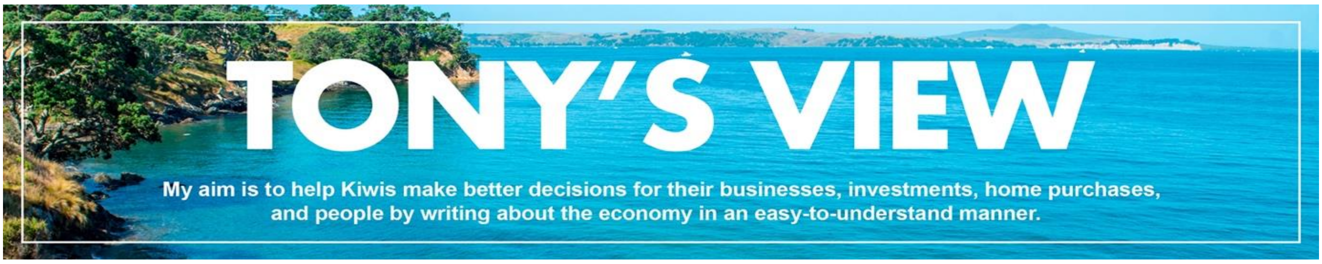

Input to your Strategy for Adapting to Challenges

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The Growth Outlook

Spring is upon us or almost here depending on the starting date you use, and improvements in the temperature can often lead to generally improved sentiment which may lead to a slightly improved economy. The links are a bit tenuous and too often people get focussed on specific factors thinking they will hugely determine where things are headed.

The job of us economists is to acknowledge special factors and seasonal influences, but concentrate on the broader underlying trends to gauge generally what lies ahead and what people should consider as they make their plans. We have to my mind decidedly proven over the past 15 years that we cannot reasonably predict changes in the pace of economic growth, inflation, interest rates, or of course exchange rates. Best add oil prices, minerals prices, dairy payouts beyond one season, and to a great extent house prices.

We know we can't do these things – but people nonetheless keep asking for forecasts even right after we describe the way things in the past turned out vastly different from what we anticipated.

It all comes down to reasonable risk management and the ability for all parties down the track to be able to say that at the time such and such a thing was the reasonable action to take in light of what we knew at the time and where things looked like they were headed.

So, keeping that caveat in mind, when we look towards where the economy is headed there will be some people who might be getting excited about things based on the weather getting better. Most however will continue to wallow in the dominant negative factors for all the rest of this year towards the middle of 2023.

Identifying the negative factors is never hard. We humans have a natural tendency to focus on the negatives and the media play them back to us. Keeping on eye on the positive factors is generally more difficult.

Here then are a couple of lists. The first list is of most but not all of the negatives which will impede the pace of economic growth over the next couple of years. Or, to put it another way, will make life running a business difficult and returns on investments potentially weak and volatile.

Interest rates

Fixed mortgage rates rose 3% - 3.5% in ten months compared with rises of less than that over 4.5 years last tightening cycle. Even though rates have decreased 0.2% - 0.4% since June, most people rolling off an old rate now will potentially be paying an interest rate near double what they were on previously.

Weather/climate change

We are having to withstand some fairly bad weather in many parts of the country and increasingly give thought to what climate change means at the personal level. For myself it means installing a new culvert to handle heavier rain events and allow for blockage of the old one from potential slips caused by new overflows from my road which the council shows no interest in addressing.

House construction correction

There won't be a fundamental over-supply of property in New Zealand, but talk of such is one factor which has caused potential buyers of new-builds to back off. Stories of failed projects and demands for higher payments abound. Pre-sales have become much harder to achieve and although there won't be a crash there is a good chance that the volume of house building has already peaked and will now ease off for the next three or so years.

Recession in UK and Europe

Russia is using gas supply as a weapon against European countries and the soaring cost of energy is hitting household budgets and crimping business profits and ability to produce. The artificial energy crisis risks throwing Europe and the UK into recession for the latter part of this year into 2023, especially as interest rates are rising at the same time – not so much to slow growth as to make sure no-one expects high inflation to continue.

Falling housing wealth

Average NZ house prices have fallen 10.8% from their November 2021 peak and maybe will decline another 5% or so. Pure guesswork frankly. As people see the paper value of their housing assets decline they are likely to cut back spending.

Offshore travel

We are choosing to allocate more money to getting out of our oppressive low income country for a while and that means less money available for spending on other things.

Cost of living surge

We are having to allocate more money to paying the weekly shopping bill and that is also causing spending to be cut in other areas.

Binge over

During the pandemic we binged on many large consumer items. Now, having got our new spas installed, we don't need any more for a few decades. Sales of the likes of furniture and appliances will pull back now from an unsustainable one-off surge.

Supply chain disruptions

Business profits and ability to plan are being hit badly by continuing disruptions to the supply of materials, especially from China where currently over 60 cities are locked down to fight Covid-19.

Labour shortages

Businesses are cutting output and having to replan future growth because of the low unemployment rate and high absenteeism.

Brain drain to Australia

At least once a generation many young Kiwis go to Australia to make money. The draw to do so currently may be the greatest we have ever seen given the extreme shortages of labour across the Tasman and strong growth in many sectors.

Rising global military tensions

Rising uncertainty about military action offshore will naturally act to discourage some business investment while injecting caution amongst consumers.

Insulating/growth boosting factors

Now, here is a list of factors which will either boost the pace of growth or at least provide some insulation against the dampening effects of the negatives

Food exports

There is a food crisis offshore caused by climate change and Russia's invasion of Ukraine. New Zealand, like Australia, is a food producer. Higher food prices may hit household budgets, but there will be a boost to our export receipts and encouragement to farmers to plant more to take advantage of the sometimes high food prices.

NZ dollar

The NZ currency is trading at below average levels. We did not go into this current period of challenge with a high exchange rate as has often happened in the past when interest rates have been increased. Rate rises this time are happening offshore as well and New Zealand does not stick out as offering a likely ongoing interest rate premium to investors.

Infrastructure spending

There is decades worth of activity needed to catch our infrastructure up to the demands of our population and to prepare for the future.

Election year spending

The latest data show that the government's fiscal deficit for 2021/22 is running some $5bn less than Treasury predicted in December. With the political opinion polls showing an increasing chance of Labour losing next year's general election, we can anticipate they will do what Labour governments have done in the past when facing a loss. They will open up the spending spigots in the May Budget.

Backlog of house building

The decline in house building from current levels will be slowed by the fact that there is a large backlog of work ordered but not yet able to be started or completed because of resource shortages.

Job security

The most unique feature of this period of economic challenge is the low unemployment rate of 3.3% and the still positive levels of business hiring intentions despite their high pessimism about the economy over the coming year. High job security for wage and salary earners has very important implications. It means many people remain interested in buying property and will emerge to place orders for new houses or bid for existing ones once things look better some months from now. Good job security will also limit the extent to which spending is cut back along with the incentive to shift to Australia for work.

Absence of mass layoffs

Businesses are aggressively short of staff and there are likely to be very few mass layoffs akin to what we have seen in previous periods of challenge. The two recent announcements have concerned a skifield hit by no snow for a while, and a tertiary institution affected by the absence of foreign students and domestic students going to work instead of studying.

Foreign tourists

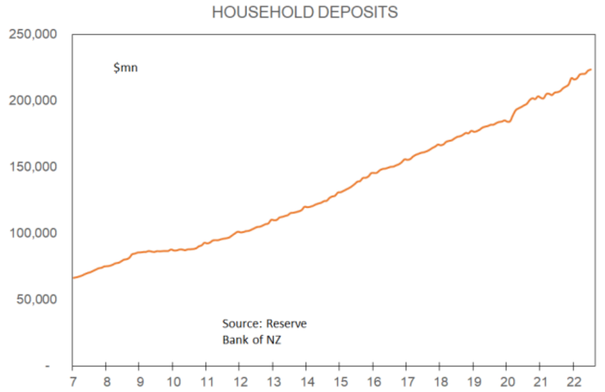
The number of foreign visitors to New Zealand is likely to be good this summer, even though flows will be constrained by weak economic conditions in source countries, lack of airline capacity, and word of mouth warnings about the impact on one's experience of the lack of staff.

Foreign students

The number of foreign students in New Zealand is once again rising with good flows expected in 2023. But it will likely take a number of years for numbers to return to where they were – same as for inbound tourism.

Household bank deposits

The level of funds in household bank accounts is some $38bn or 21% more than just before the pandemic. There is a good buffer for levels of household spending.



Growing sectors

Some sectors in the economy are experiencing ongoing long-term growth. A few include aged care, healthcare, space, games development, horticulture, green energy.

The negative factors currently and immediately prospectively in play dominate the positive factors and that means below average growth in our economy. But recession is not highly likely given some of the unique characteristics of this period of volatility and challenge including the strong labour market.

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 up just a little

It's been another week of volatility in wholesale interest rates around the world. Key causes of the likes of the US ten year bond yield rising to 3.26% from 3.12% last week and 2.8% four weeks ago include a stronger than expected number for the services sector in the United States. Expectations have climbed once again that the Federal Reserve will soon implement another 0.75% rise in its funds rate.

Also pushing rates higher was the expectation in the United Kingdom of a substantial fiscal package aimed at insulating households and businesses from the worst effects of soaring gas prices caused by Russia cutting flows to Europe.

The general view globally has shifted to inflation in the very near future maybe not being as bad as previously thought, but inflation proving somewhat more persistent further out. This view could easily flip right back the other way next week and in fact some of the pessimism eased off a bit last night.

The impact here in recent weeks has been for the markets to lift their expectation for where out cash rate will peak from 4% to just over 4.25%. The markets have also shifted firmly away from pricing an easing of NZ monetary policy before the end of 2023 to just before the end of 2024.

The one year swap rate at which banks here borrow in the wholesale markets to lend to homeowners at a fixed rate for one year has ended this week little changed from last week's 4.18%. But this is up from 3.8% four weeks ago. The three year swap rate is little changed near 4.26% from 3.6% four weeks ago.

Margins on bank fixed rate loans are now well below averages for the past two years and there is only minor scope for any further rate cuts currently following the reductions which were made early in August. As for the coming year, any rate falls will be fairly minor for the fixed rates though they are likely.

Floating mortgage rates however will go higher because the cost to banks of funding them is closely related to where the official cash rate sits at the time of lending. The cash rate of 3% currently is set to be increased to 4% probably before the end of the year. After that we shall all just have to wait and see what happens with inflation, wages, inflation expectations, and capacity pressures in the economy.

If I were a borrower, what would I do?

I would have most of my mortgage fixed for just one year and maybe a little bit at two years – though having said that in earlier years when I did have a mortgage I never once opted for more than one fixed term. Many do, however.

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