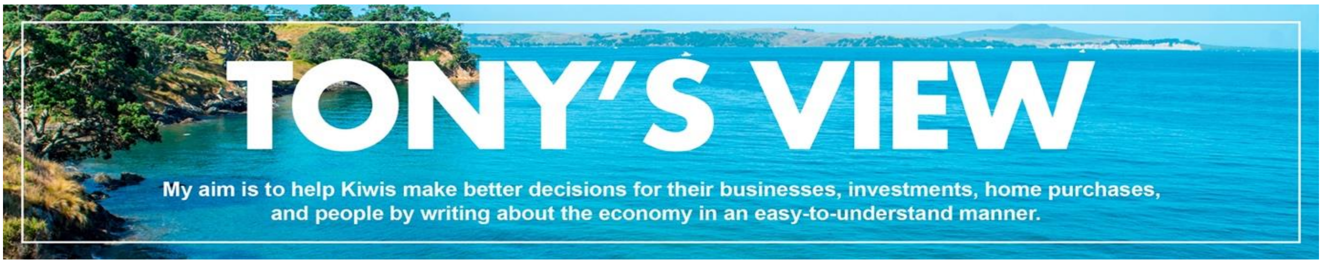

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Thursday 9 February 2023

The Economic Outlook

I've delivered a few webinars so far this year but proper in-person speaking kicks off next week and in past years I've found it useful to write an article about the broad economic outlook as part of my preparation for a year's first talk. So, here goes.

Let me start with a key point just being learnt again by people in the United States in light of the January employment numbers soaring 517,000 rather than the expected 185,000. There is a strong tendency for people and the media to over-emphasise negative factors and gravitate towards scenarios of recession and woe. Debt blowouts, price collapses or escalations and crises everywhere. We all did it in March 2020.

If you know this and have the ability to undertake balanced analysis of the factors in play you will be far more able to profit from economic trends when making your investment portfolio allocations than those who continually look for the next collapse.

But let's start by feeding the negatives to those who love swallowing them.

The downside

Jump in mortgage servicing costs

Many people this year will roll off fixed rates onto new rates perhaps 3% higher. Their need to keep servicing their mortgages will mean less household spending available for other things like fridges and carpet.

Determination to travel offshore

The borders have opened and we are determined to get overseas as much as possible regardless of the stories of travelling woe and shocking incompetence of airlines at getting baggage to their paying customers. This means reallocating money away from other things.

Pandemic binge over

We have probably finished our pandemic-driven binge on spas, home renovations, gym equipment etc. That means lower sales for retailers of these items and many of them being placed on Trademe as people seek to raise some cash.

Unemployment increase

The unemployment rate is set to rise as businesses seek to cut costs in an environment where their ability to pass on cost increases is being reduced. Mild fear of job loss will contain the willingness of some people to spend.

Household wealth reduced

House prices nationwide have fallen on average 15% from their peak in November 2021. There are probably not many people who boosted their spending quickly in response to the high level of prices compared with late-2020. But some will have and the pullback in prices now to where they were on average in January 2021 will encourage some people to feel less wealthy and reduce some of their planned spending.

House building correction

There is a multi-year decline in house construction likely to get underway this year as underlying problems weed out some builders and developers and potential buyers focus back on making a purchase from listings of existing properties.

Election uncertainty

This is an election year and traditionally many people and businesses will put off spending, hiring, and investment decisions until after the election.

Cost of living shock

Soaring prices for household goods and services mean lower volumes of such able to be purchased unless incomes also soar. Diversion of spending towards necessities like food give an extra downward push to sales of other items.

Credit crunch

The return of LVRs in February 2021, 40% deposits required for investors from May 2021, maximum 10% of bank new lending being at low deposit from November 2021, and the CCCFA changes from December 2021, have combined to produce one of the biggest household credit crunches in NZ history. Reduced access to credit means reduced household spending.

Uncertain world economy

Most of the news we receive from offshore is bad. War in Ukraine, high energy prices, increasing militarisation driven by the aggressions of authoritarian countries, strikes, predictions of recessions and so on. This flow of negative news tends to dampen consumer and business willingness to spend and take risks.

Climate change costs

The household cost of living is being increased by global efforts to reduce factors contributing to climate change. There is also wealth and income loss from weather events attributable to climate change (warmer air holding more water and producing more intense periods of inundation in a country which one Prime Minister described as "irredeemably pluvial"). Insurance premiums are also rising to reflect greater payouts while individuals and businesses are having to devote spending to damage mitigation.

Labour shortages

New Zealand is a nation of small businesses and many of those businesses are struggling to achieve desired output levels because of shortages of staff. Profits are being crunched and that means reduced funds available to business owners to spend and invest. Also, many businesses will have to respond to the lack of staff by permanently scaling back the size and expansion plans of their business.

The upside

But there are many positive factors in play including some which lessen the intensity of some of the above negatives. Taken alongside the negatives they suggest it remains a 50:50 call as to whether the New Zealand economy has a recession this year. If we do, this will be a welcome relief for many businesses because they already cannot meet customer demand. A dropping off of such demand will make no difference to the volume of their activity, and it will allow them to secure resources (people) freed up by other businesses.

China growth surprise

Of emerging significance is this first factor. Prospects for growth in the Chinese economy this year and next are turning upward at pace. The IMF have recently lifted their forecast for growth this year from 4.4% to 5.2%.

After belatedly recognising Covid could not be eradicated the authorities let it rip through the population from early-December. The infection then recovery of some 1 billion people in six weeks has been very swift and there is a new very strong policy focus now on restoring strong growth in an economy which has been the driving force behind many other countries' economic growth for the past three decades. The potential for a new Chinese mainland economic surge bodes well for the flow of tourists to New Zealand as well as demand for the commodities forming almost all of the items we physically ship there.

The same goes for Australia and when growth in our Tasman neighbour is firm this tends to be positive for us as well.

The recent surprise announcement by the Chinese authorities that students enrolled in foreign institutions will only have this year's qualifications recognised back home if they actually study offshore rather than remotely means the return to NZ of Chinese students 1-2 semesters earlier than had been expected. That is good news for Auckland CBD in particular.

Remember what I wrote about counter-cyclical property investing and there being very few Warren Buffet-like people who can walk against the tide of people going the other way. It will be interesting to see how the Auckland inner-city

apartment market goes in the coming 1-2 years. It's due for a catch-up.

Re-shoring

Concerns about supply chain robustness are leading some businesses to bring their manufacturing operations back to New Zealand. The impact on the economy is likely to be small however. For most businesses it makes no economic sense to do so. China is an extremely attractive location to have one's goods manufactured with highly developed and efficient distribution systems.

Accrued household savings

During the pandemic households around the world built up large excess savings in bank accounts assisted by government handouts in one form or another. These savings can act as a buffer against consumer spending cutbacks for the reasons outlined above. Currently there is a lot of attention on accrued household savings in China and what use they may be put towards.

Most mortgage rates have probably peaked

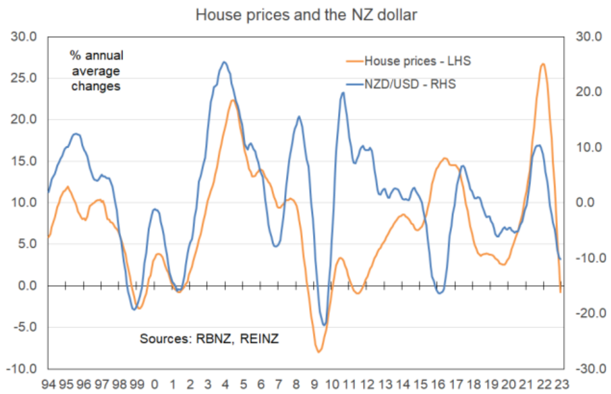
Floating mortgage rates probably have another 1% to go up as bank costs of funding floating rate lending are closely tied to the Reserve Bank's official cash rate. But only 10% of borrowers are on floating rates and they are mainly people near the end of their long-lasting mortgages.

The true story here is falling medium to long-term bank fixed rate borrowing costs as investors anticipate monetary policies here and offshore easing through 2024. The path will be decidedly rocky as illustrated by the rise in US wholesale interest rates this week following their surprisingly strong jobs report. But the drift now looks downward and eventually there will be a shift in media and household focus away from worst case scenarios and an incorrect belief that fixed rates move in concert with the OCR.

No NZD surge

We have not entered this period of economic "challenge" with a highly over-valued NZD crushing the export sector which has tended to be the case in the past. The NZ dollar is sitting near US 63 cents compared with 67 cents a year ago, 72 cents two years back, and 64 cents pre-pandemic.

If you like stuff related to stuff, look at this next graph. The orange line shows the annual average change in nationwide house prices measured on the left side. The measure is a full 12 months versus the year ago 12 months and that is why it does not yet show the 15% fall in the monthly house price index from November 2021. That means the orange line will keep going lower for a while now.



The blue line shows the annual average change in the NZD/USD exchange rate measured on the right side. I include the graph merely because it is another one on the way to showing that NZ house prices are getting into oversold territory. This tells us nothing about when house prices stop falling let alone what the next pace of increase will be over whatever period of time.

All this and other graphs I put here now and then show is that the rubber band is starting to get stretched the other way – especially in Auckland. Not in Wellington. Nothing more.

Tourism surge

We Kiwis are determined to get the flock out of our pandemic hellhole for a while. It seems everyone on the planet is thinking the same about their own pandemic prison and that means good growth in inbound visitor numbers here.

We worry about the lack of staff discouraging people from coming. But they're going to find the same virtually anywhere they go so we shouldn't beat ourselves up thinking the service failings here will especially damage us relative to other countries. We're not that special.

Foreign students

Not only will numbers of Chinese students studying here rise quickly this year but those from other countries will likely be back in good numbers.

High job security

Yes, feelings of job security will decline as the unemployment rate rises this year. But the chances we get remotely close to the 6.5% unemployment rate of 2009 are small and the predictions by Treasury and the Reserve Bank of rates above 5.5% look too pessimistic in light of the shortages of staff every business is aware of.

The holding of staff by businesses through any dearth of sales this year is likely to be the greatest ever seen outside the immediate pandemic and wage subsidy period of 2020.

TINA – businesses need to invest

This was an acronym used in the 1984-87 reform period and it stood for There Is No Alternative. (Actually, there was back then but that doesn't seem to have worked so well for North Korea.)

In black and white it goes like this. If you are in business, you will not easily find the staff you want. You are not prepared to pay the wages that need to be paid to get staff on your payrolls. You believe the good people eager to work for you for 5% more are out there. You are wrong.

Forward-looking firms will have already addressed this long running management blindspot in New Zealand and have been concentrating on boosting productivity through investment in labour-saving technology, focussing on their most profitable lines and locations etc.

Many businesses have yet to do so and as they realise the staff are not coming through the door will be dragged kicking and screaming into investing to boost productivity. Robots anyone?

Or for many, AI? I've tried ChatGPT. These next few years of accelerated flows of funds into AI will be fascinating to watch. My pick? Some of the biggest beneficiaries will be old folks and individuals generally bereft of a companion. Why go online to the WWW for contact with the world and risk chatting with a weirdo who will steal your money, make weird picture requests, and maybe worse. An AI is likely to meet many companionship needs and could be favoured by parents over a "real" online person. Monetise that. Best watch the movie "Her" however.

No fiscal austerity

The NZ Crown accounts are in exceptionally good shape and there is zero pressure from offshore credit rating agencies for the NZ government to get debt down.

Net migration turnaround

The general expectation of us in the field had been that at some point this year the net migration flows would turn a bit positive and nothing major would happen. But we have already seen the net flow turn up to the tune of almost 6,000 in the year to November 2022 and we may be on the way to a net gain equalling 0.8% of the NZ population by the end of 2023.

This means more consumers, more need for housing, and also more staff for struggling business.

There are also over 200,000 people undergoing the process of having their family working visas changed to permanent residency and while that may not much impact on consumption it will add extra buyers into the housing and small business markets.

Firm wages growth

New Zealand has a highly deregulated labour market and while the Reserve Bank may not like it, it is pleasing to see extra strong wages growth in response to the shortage of staff around the country. Average hourly ordinary time earnings have risen by 7.2% in the past year from 3.8% a year ago and 4.3% two years ago.

Since the start of the pandemic in the March quarter of 2020 the Consumers Price Index has risen by 14.4% while this wages measure has gone up by 15%. Wages growth is exceeding the cost of living increase (excluding the higher interest rates effect) but this attracts little focus in the media.

On average, people's incomes are keeping up with the rising cost of living.

We can't put numbers on the magnitude of any of these negatives and positives. But the risk here is that people have become overly pessimistic about growth in the NZ economy this year. The message to businesses is be careful before laying off staff and raise debt or capital to invest and boost productivity while dropping low profit lines and locations. To staff the message is keep pressing for higher wages.

To residential property investors the message is don't fall into the trap of trying to pick the bottom. Chances are it will have been and gone by the time you feel it is "safe" to make a purchase. For commercial property investors the message is to consider the impact on valuations of now slowly falling long-term interest rates, the growing need by businesses for more suitable (efficient) premises, and the underlying growth in demand assisted by population growth accelerating.

For house builders the message is the same as given here almost two years ago. Watch for the correction in unsustainably high construction levels and keep an eye out for projects which one may be able to take over cheaply. At this phase in the house construction cycle expansion through acquisition can trump organic growth.

If I were a borrower, what would I do?

Personally I would not fix longer than one year.

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.


TONY'S VIEW
My aim is to help Kiwis make better decisions for their businesses, investments, home purchases, and people by writing about the economy in an easy-to-understand manner.