TONY'S VIEW

Input to your Strategy for Adapting to Challenges

Feel free to pass on to friends and clients wanting independent economic commentary

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To subscribe, email me…tonyalexander5@outlook.com
To enquire about having me in as a speaker, same address.

My Aim

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.

Covid-19 Gets Worse

The Covid-19 virus outbreak which originated in China has got worse over the past week, not better. Outbreaks have appeared in the Middle East, Italy, South Korea and Japan, and Japanese actions in quarantining the Diamond Princess show that one of the most sophisticated health systems in the world can make big mistakes. Hence rising concerns about the ability of every other country's health systems not just to cope with the volume of potential patients, but develop appropriate containment policies.

Because things are now veering toward less optimistic scenarios, anticipation of more severe economic consequences is growing. This has caused falls in bond yields, falls in share prices, mild declines in riskier currencies like the NZD and AUD, and rises in generalised safe-haven currencies like the Yen and Swiss franc. Plus, gold prices have jumped sharply.

Most concerns centre around the tourism sector and its servicing businesses. A view is developing that not only will outward visitor flows from China remain non-existent or depressed for many months, but that virus concerns will cause people everywhere to stay at home. Current expectations of a 13% decline in global travel could easily prove optimistic.

This development means NZ operators in the tourism sector can have little faith that redirection of marketing efforts to countries outside of China will result in people from those countries travelling all the way down here.

Increasingly it looks like the plateauing of our tourism sector growth will turn into a deep downturn which will directly and indirectly affect the employment of about 165,000 people servicing foreign tourists. There will be some offset from Kiwis holidaying at home.

We can anticipate layoffs in the tourism sector along with hospitality and sectors doing the likes of providing catering for airlines, food and drink to eating establishments, rental car services, campervans, Airbnb etc.

In Australia deepest worries about the foreign education sector have eased with Chinese students finding a way around entry restrictions by leaving China, staying in another country for two weeks, then continuing onto Australia. A similar development here should see the worst-case scenario for our export education sector avoided.

Until people start eating out again in China times will be tough for food and beverage suppliers from New Zealand who do not have an established relationship with a home delivery service provider in Chinese cities. Prices for many products are likely to decline, layoffs in affected sectors mainly off the farm are likely.

Concerns are increasing regarding the impact on supply chains of factories either remaining closed or operating at below normal levels in China. Hopefully this situation will ease up if China's rate of outbreak keeps falling and most of the 300 million migrant workers quickly make it back to the coastal cities. So far apparently about half of them have according to many people commenting on the situation in my quarterly survey – results out early next week.

Lack of staff coming back from New Year in China will curtail some construction projects here reliant on Chinese staff. Product flow uncertainty is likely to lead to some planned product launches being delayed a few months.

But until we can be confident that factories are back up and running, we will see problems for a number of businesses in New Zealand reliant upon imports of components, machinery, textiles, packaging materials etc. from China.

This route of downward pressure on our economy is virtually impossible to calculate but don’t be surprised if the supply of something you and I have taken for granted is suddenly an issue. It’s virtually a lottery as to which item will become in short supply and affect us first.

But there is more to the imports disruption than that. Ships are not going to be where people thought they were going to be. That means the reason you might not get your goods from countries other than China is that the ship they were coming in on was meant to start in China and progress from there. Now perhaps it is not.

Also, reduced visiting ship numbers will mean fewer coastal ships and that will mean some importers of products which land in Auckland for instance will be forced to use road and rail transport to distribute to the other main centres.

Communicating these past few days with people offshore, they have described cancellation of shows and displays in their countries as people avoid crowds. We might see the same thing here. Not yet though.

The extent of economic weakness coming this year will be accentuated by the drought and approaching election which could produce a Labour-Green government without the restraint from NZ First. (Expect NZF to push back against more Labour-Green policies pre-election in order to show their value.)

So, what do you do?

We have had recessions before, but not since the GFC of 2008-09. So newer business operators may not know what to expect if we do see our economy shrink for either the developing consensus view of one quarter, or the bad scenario of four quarters this year.

Interest rates will fall. But they are already very low so the alleviating cash flow impact will be minor. The NZ dollar will decline. But the extent of decline will this time around be mitigated by a perception (not there yet, but maybe coming) that New Zealand is at lowish risk of a large virus outbreak because of our isolation. (Apparently NZ, Iceland, and Australia are rated as best able to isolate themselves from a global pandemic.)

The recent uptick in people leaving their job for better pay elsewhere will stall. Staff will value security and history tells us that people will accept reduced hours of work rather than accept pay rate cuts which might be locked in. And employers would do best to remember the recent and still continuing labour shortages which suggest retaining staff should be a priority now in labour force management if possible. For some businesses the killer blow may not be the coming period of weakness, but inability to re-staff when the upturn eventually comes along.

Your debtors will delay paying their bills and you’ll be looking to do the same for your creditors. You’ll cut orders for inputs and orders to yourself will decline. Responding to cash flow problems affecting predominantly businesses in the tourism, hospitality, and education sectors, business finance firms are shifting some client loans to interest-only. This is good, but recognising that lending institutions will be expecting some losses as a result of the sector-specific and generalised business sector weakness that the outbreak is bringing, all borrowers should anticipate a tightening-up of credit availability.

Hard hit will be distributors and producers of durable goods – things which last a long time and which we can usually put off buying, with little impact on our lifestyles, until things get better. Cars, couches.

We will cut back on discretionary purchases – extra goodies at the petrol station for instance. Business will cut their marketing and advertising budgets. But we will increase purchases of little things which might make us feel good. I recall last recession some focus on the concept of a “lipstick index” measuring increased purchasing of lipstick in tougher times.

History tells us that when the business sector is scared and when they are financially suffering business owners cut back on aspirational purchases. That means boats, holiday homes, coastal property, and upgrading to higher-priced property.

If the virus reaches New Zealand, we will do like people in affected countries are already doing – we’ll stay away from crowded locations – stadiums for concerts and sports events, crowded trains and buses, restaurants, airplanes, casinos, children’s entertainment facilities and possibly early childcare. We’ll use our cars instead and sign up once again to Sky whilst adding some of the newer online services like Disney etc. Some businesses will pull back from advertising because they don’t want to stimulate sales they may not be able to meet because of supply interruptions from offshore.

At some stage we may panic-buy supplies in case we need to isolate ourselves in our houses or apartments. If you do that and something breaks down in your residence, it will stay broke until your isolation ends.

If you break your leg, you'll dread going to the hospital to get fixed up because of the infection risk.

The government will look to boost spending in areas where immediate delivery can occur, and as discussed with regard to logging gangs, will look to get people shifted to other jobs involving similar skills. But there are big, big limits on how big this transference exercise can be as we are talking about people in the private sector – not public servants. And relocating to another part of the country is a big ask.

When considering how to handle this coming period of uncertain weakness, remember the insulating factors noted here last week. And realise that an upturn will eventually come along which will for some period produce above average growth – eventually. Don't think that this is the end of the world. Instead give thought to what farmers do when they receive a shock from something like having all their cattle killed to contain M.bovis, or being unable to grow peas in the Wairarapa to kill off a bug, or their prices collapse, or drought, or flooding, or market closures, or strikes at the meat works or on the wharves (in the old days), and so on.

Hardly any farmers quit the business. They hold onto staff as best as possible because of ongoing shortages of people – good people in particular. Good employers will build reputation of long-term benefit. Bad ones who follow their old method of handling a shock by laying off as many people as possible and they will structurally reduce their ability to find people when the crisis ends.

Farmers slash expenses, delay all but vital capital spending, put expansion/redevelopment plans on hold, don't take a decent holiday, pull kids from more expensive schools, and they have learnt to talk with their banks right from the start.

This is a big change which has occurred over the past two decades and which the banks have been forthright in promoting. A banker will be far more receptive to an early warning of cash flow or debt ratio issues than presentation of horrible numbers already in play. I would hope that right now anyone in the tourism sector being affected by the absence of Chinese visitors and coming decline in visitors from everywhere else will already be having conversations with their financier. Call them now if you have not already done so.

What do investors do? If you are a risk-taker then have fun trying to pick asset price movements which could be violent for stocks in the most affected sectors. But most of us aren't risk-lovers, and the best thing we can do is simply ride it out. "This too will pass." Long-term trends will reassert themselves, and asset prices will receive some support from lower interest rates. If you are checking your Kiwisaver balance daily and fretting about the decline then you really don't understand the product. It's not in the next week that you're going to be spending it. Maybe that is why housing investment is so popular.

All up, for now things are heading in the wrong direction for the Covid-19 outbreak. Start exercising caution in your spending and planning how you will make alterations to get your business through the possibly-coming period of weakness of unknowable duration. Rather than laying off staff place them on reduced hours. Take the opportunity perhaps to catch-up on maintenance.

In fact, take the opportunity of this shock to accelerate your handling of the "weeding out" period I've been writing about for some time. I've been expecting this period of rationalising in and of businesses in response to staff shortages, loss of pricing ability and therefore ability to comfortably manage margins, adjustment to new pressures surrounding the likes of climate change and use of plastics, and structural reduction in credit availability.

The virus outbreak provides an opportunity to perhaps make some big decisions with easier explanations to affected parties than might otherwise have been the case. And the outbreak from China reinforces the point many of us have been making in recent years that New Zealand has become dependent upon the Chinese export market. While our natural tendency as commodity producers is to whore ourselves to whoever has the highest offer, it would be wise to diversify. In the case of our primary sector that means the rest of Asia and if possible, back to the UK and EU.

Are we going to ban visitors from Italy and South Korea now that the virus outbreak seems

entrenched in those countries? Are you going to avoid eating at Italian and Korean restaurants? To get a feel for the answer you might want to peruse the paper I wrote in 2013 looking at how the West views China different to other countries.
https://www.yumpu.com/en/document/view/51725125/sources-of-western-apprehension-about-china-tony-alexander

Ending of the Bank Super-cycle

I calculated these numbers on Monday to illustrate what I mean when talking about a banking super-cycle ending. These are the rates of growth in lending to the private sector in New Zealand over the ten-year periods ending in 1999, 2009, and 2019

1999	138%
2009	151%
2019	58%

Those days of high credit growth ended with the GFC. But more restraint is now guaranteed. Banks not only are going to redirect lending away from risky sectors toward less risky ones because they have to raise their capital levels over the next seven years starting in July. They also are not able to raise term deposits at the same rate as they are lending money out. The ANZ did an excellent paper on this two weeks ago showing the gap opening since early-2018 between these two variables. The upshot is likely to be reduced bank willingness to lend generally.

Now let's throw in strong feedback from my most recent survey showing bad delays faced by mortgage brokers trying to get decisions from banks – hinting at worsening staff shortages.

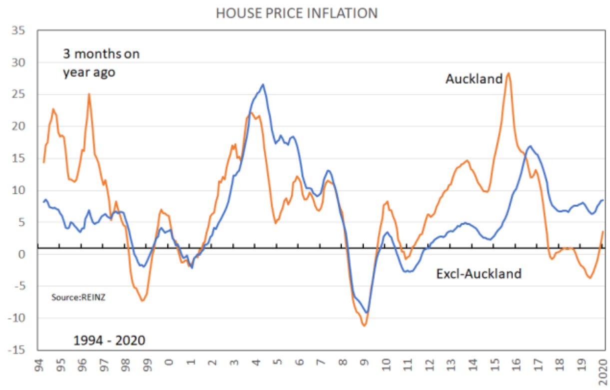
For future expansion you'll need to focus more on retained earnings and new equity. Debt will not be as readily available – but it will still be there.

The low growth in our private sector debt since the GFC means there is little threat here or overseas (low debt growth there too) from Covid-19. The world's banking sector is in good shape to handle customer problems.

Housing Market

No new data which I pay attention to were released this week so let's take a look at a longer than usual list of reasons why house prices around New Zealand entered a new upward phase from the middle of 2019. And it is useful to note something interesting about the upturn – it is happening in both Auckland and outside Auckland on average.

That is, in the six months to July Auckland house prices fell by 0.4% while they rose 1.7% elsewhere. Since then Auckland prices have gone up by 4.6% and the rest of the country 6.8%. It looks like our biggest city accounting for 45% worth of the housing stock in the country, is back in sync with the rest of New Zealand. If so, this represents a reversion to the pattern which was broadly in place before the most recent cycle where Auckland soared from 2012 but the rest of the country on average did not kick off until 2014-15. But it was never a one – to – one match in the past and won't be in the future so don't get too hung up on trying to match house price inflation rates across the country.



So, why have prices risen strongly since the middle of 2019?

1. Falls in interest rates from the middle of last year.
2. Confirmation of no capital gains tax.
3. Some foreign buyers (apparently) finding ways around the foreign buyer ban, using Kiwi residents.
4. Absence of a talked-about big decline in net migration inflows.
5. A strong recovery in business and consumer confidence levels.
6. Worsening listings shortages.
7. Transport infrastructure problems reminding people of the value of close-in living.

8. KiwiBuild all but completely canned.
9. Some FOMO (35% of agents seeing this in Auckland in my Barfoot & Thompson quarterly survey).
10. Faster wages growth.

For your guide, SARs struck in 2003. The death rate was about 10% versus probably well less than 1% for Covid-19. Spread of SARs was however much, much less than this latest virus from China. NZ average house prices that year rose 23% assisted by a migration boom and small 0.75% decline in interest rates. But … foreign visitor numbers still grew 3% that year.

Considering our housing market in the context of Covid-19. The positive is low interest rates continuing for longer with cuts possible. Migration numbers might improve slightly as Kiwis stay at home and a few offshore return. Sharemarket wobbles will encourage some investors to look slightly more favourably at housing. But consumer confidence will ease off. The labour market will soften a bit – and that gets to the interesting aspect of this event.

Consider the sector most affected – foreign tourism, followed by primary production and forestry particularly. These things are regionally-based more than city-based. Same goes for drought. At the margin the virus will encourage some movement of people back to where job opportunities are the greatest and that is our cities.

Rotorua and its environs may be greatest hit. Queenstown will also be affected but less so.

Interest Rates – Will They Rise or Fall?

The chances of borrowing costs falling in New Zealand have increased sharply this week amidst deepening concerns about the economic impact of the Covid-19 virus from China. Outbreaks have appeared in the Middle East, Japan, South Korea, and Italy and at a minimum analysts are now expecting bad times for the global tourism industry over the next few months if not all of the year if containment does not occur before the end of March.

Early data releases are revealing some of the virus impacts with Chinese car sales down 92% in the first half of February from a year earlier, and a measure of services sector sentiment falling firmly to a 76-month low in the United States.

These worries have pushed the yield on the benchmark US ten-year government bond yield down to a record low near 1.3% from 1.56% last week and 1.8% at the start of the year. Financial markets in the US are now expecting the Federal Reserve to cut its funds rate two times this year with another cut considered likely for 2021.

The chances of easier monetary policy here have increased but the Reserve Bank, having unwisely panicked last year and given away 0.5% worth of its rate buffer in August, will be hesitant to move. The deepest impact of the virus outbreak is being felt in forestry, tourism, and increasingly hospitality. Lower interest rates will do virtually nothing to help their situations.

CHOOSING YOUR FIXED MORTGAGE RATE TERM

Minimum rates are again unchanged this week.

When fixing a mortgage rate term most people take whichever rate is the lowest. So, each week I shall calculate what rates would have to be in the future to make this option better than some alternatives. Note, there are far, far more alternatives than calculated here. And always remember, it is worth paying a premium for rate certainty over a longer period of time. It's also worth using a broker to get the best deal. Broker use is far higher in Australia than New Zealand but we will probably catch up.

Current minimum fixed rates across the main banks. *

1 year	3.39%
2 years	3.55%
3 years	3.89%
4 years	3.99%
5 years	4.09%

I can fix 1 year at 3.39%.

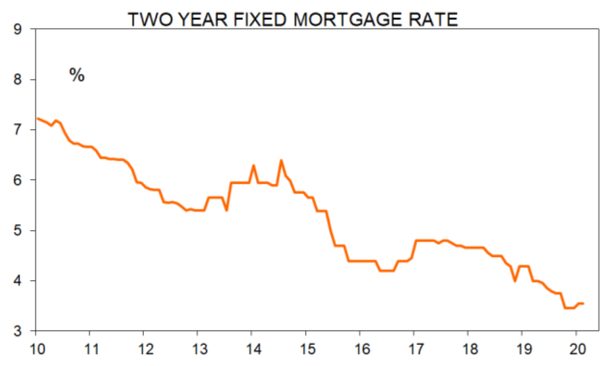
Is this better than fixing 2 years?	Yes, if in 1 year the 1-year rate is below 3.71%.
Is this better than fixing 3 years?	Yes, if in 1 year the 2-year rate is below 4.14%.
Is this better than fixing 4 years?	Yes, if in 1 year the 3-year rate is below 4.19%
Is this better than fixing 5 years?	Yes, if in 1 year the 4-year rate is below 4.27%.

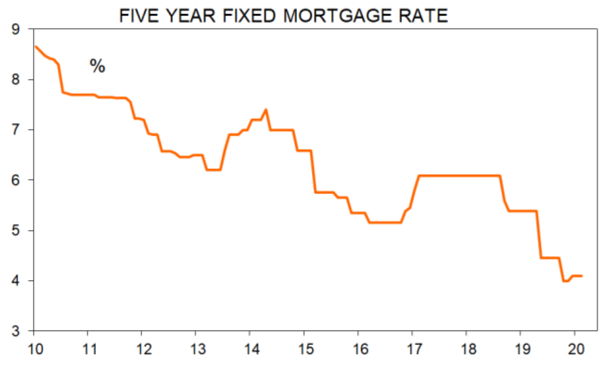
Given virus risks the chances are not high that in one year the one-year fixed rate will be above 3.71%. Therefore, if I am only choosing between fixing two years or rolling over a one-year fixed I now find myself preferring to fix just the one year. This is a change from previously preferring the 3.55% two-year rate.

What about if my inclination is toward fixing three years? Is it worth paying 3.89% the coming year rather than 3.39%? Not for me. Do I think that a year from now the two-year rate (to complete a three-year period) will be above 4.14% versus the current 3.55%? No.

All up, personally speaking, I feel the cost of rate security contained in the fixed mortgage rates for two years and beyond is currently too high when considering downside risks to growth, inflation, and monetary policies from the coronavirus outbreak. Much as it pains me to say so as a conservative borrower who likes rate certainty, I'd probably fix one year at the moment if I were taking out a new mortgage or rolling off an existing rate.

*Minimum 20% deposit, owner occupiers.
Compounding is minor so is ignored.

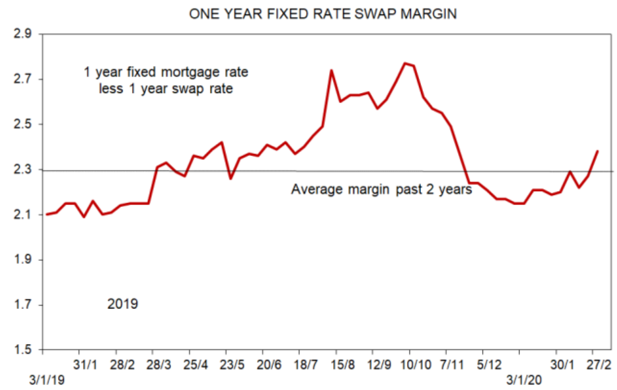


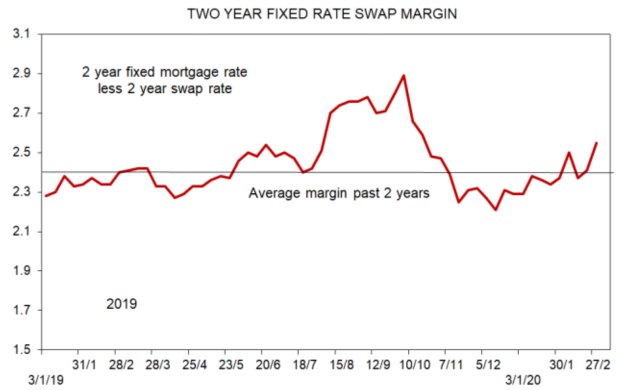


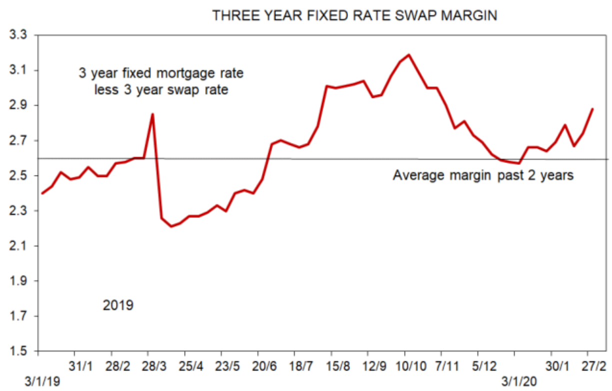
IS A FIXED RATE CHANGE IMMINENT?

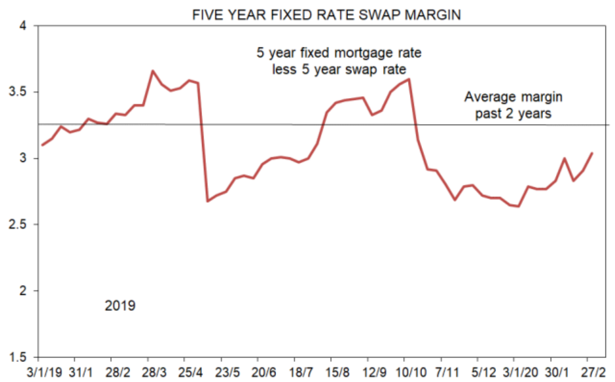
Virus worries have caused a decline in bank borrowing costs and fixed rate lending margins have widened anew. BUT. My quarterly survey of Tview readers reveals banks are very short-staffed in mortgage application areas and processing times are causing big problems for mortgage brokers. Banks will be reluctant to follow the example of the ANZ in Australia which has just slashed some key mortgage rates because problems handling the volume of extra business would risk reputational damage. Rate discounting now could over-load staff too much – yes, Health and Safety concerns can influence interest rates. Also, by standards of the past two years as yet margins are not grossly out of line for the 1-3-year terms.

You can form your own opinion as to whether banks might be about to raise or lower their fixed rates by looking at the following graphs. They compare published fixed rates with the most frequently changing component of the total cost of funds – the swap rate. Note that there are other funding costs which will not be captured here, but they change infrequently. But be warned. There is no real forecasting insight delivered by a thing (equity, exchange rate etc.) moving further from some concept of fair value or average. If a thing is 10% above trend, it might simply be on its way to being 40% above trend. For good bank rate comparisons access www.interest.co.nz









Are You Seeing Something I'm Not?

Don't be afraid to flick me an email at tonyalexander5@outlook.com if you reckon I'm missing something happening in the economy, or you've got experience or insight into some of the developments underway which you'd like to share.

Online - It's A Family Thing

For your guide, in my family it is not just myself communicating and informing people principally online and working from home.

CHILD FORUM

My wife Dr Sarah Alexander manages the network of early education and care services around the country (www.ChildForum.com) and the website for parent ratings and reviews of children's services (www.myece.org.nz).

WL

My daughter Lilia Alexander (finalist in the Youth category for Wellingtonian of the Year 2019) owns and runs Social Media based Wellington – LIVE (160,000 followers) https://www.facebook.com/WellingtonLIVENZ/ *"…the largest go-to social media-based updates and news platform for the Wellington region…"* Wellington – LIVE offers advertising options for local events and businesses. Email: info@wellington.live

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DETAILED GRAPHS ENLARGED