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.

Weeding Out – Putting the Outbreak in Context

Over the past decade, in the face of the failure of economic models to any longer give accurate insight into inflationary pressures, and with some big trend changes in key variables, I've shifted my analysis and resulting commentary. I've moved away from the traditional bank/market economist approach which involves this.

- Develop a view of the economy's prospects.
- Critically assess every new piece of information in terms of how it might change that view.
- Make outlook changes, focussed on monetary policy implications, when the data justify it trying neither to move too often or not often enough.
- Sounding credible when the forecasts prove wrong so people nod their head in the face of your failure and ask "Where do you think things go now?"

That last line was perhaps a bit cynical, but it's how I've described currency forecasting for three decades now.

What I shifted to over a decade ago was less emphasis on the numbers and much more emphasis on the following approach.

- Highlight trend changes in key factors affecting people's businesses, investments, and housing markets in particular.
- Drag people away from unrealistic interpretations of what is happening out there.
- Make people aware of blind spots they may have regarding the way things work – e.g. assuming the country remains filled with motivated, skilled unemployed people.

I think this approach has been working okay so far, so I'll stick with it until one day I'm horribly wrong – and I'll close up shop and do more chainsaw work and native bush regeneration instead.

I don't propose running through my big list of trend changes underway (I do sometimes in my presentations), but instead want to concentrate on two I have discussed many times in the past because their implication is about to get magnified. A period of "weeding out" of businesses across most sectors is upon us and the intensity of this rationalisation process is going to be increased because of the economic shock associated with the coronavirus.

The first big change of relevance here affecting businesses is loss of pricing power. In the old days when costs went up businesses could maintain margins by increasing selling prices. Consumers would pay the higher prices, sometimes rationalising that the price rises were just general inflation. Mainly however, back in the pre-internet days the cost of searching for cheaper alternatives was very high in terms of time, stress, petrol etc.

Nowadays we can all easily find alternatives online and when businesses raise their prices we will search for those alternatives in quick-time at virtually zero cost.

So, when business costs go up, maintaining margins is now much more difficult. Some businesses might have coped by trying to sell more. That is fine when the economy is growing very strongly. Now it isn't. We are chugging along near 2% and the rising tide of customers which produced more sales and covered up other growing problems is no longer going to be there.

Second, labour availability for businesses is now structurally poor. From the mid-1970s until recently businesses could generally quite comfortably find the staff they wanted from the large pool of unemployed people – perhaps people fearful because of recent layoffs and prepared to accept any terms offered to them.

But now staff are hard to find – be they skilled or unskilled. The workforce has aged and older people are going to soon start retiring in greater numbers. They will take with them not just knowledge, but the ability to train new people, and perhaps willingness to accept altered workhours which younger people with mortgages to service or high rents to pay could not tolerate.

This morning we learnt that even though jobs growth in the December quarter was only 1,000, the unemployment rate fell to 4.0% from 4.1% in the September quarter and 4.3% a year earlier. And the labour force participation rate (the proportion of the working age population either in work or actively looking for a job) fell to 70.1% from 70.6% a year ago. In fact, whereas job numbers grew 1% during 2019, the labour force available for employers to use grew only 0.7%.

Labour costs to businesses measured in terms of wages, retraining, recruitment, redoing work etc. have increased and will likely increase further. This will further compress margins because of the loss of pricing power noted above. But it will also place pressure on businesses to respond – and that is where the double whammy of weeding out comes along. The first hit is simple loss of profitability from loss of pricing power causing some businesses to close down.

The second hit is outright prolonged floundering from not being able to reset strategy either because of a failure to recognise that the ground rules of running a business have changed, or because of the thing big businesses repeatedly fail at – being able to successfully implement a strategic plan.

My worries centre around the lack of sufficient growth currently in business investment. Things have slowed down, discontent with the government is highish, and businesses are responding by still trying to hire more people while avoiding tough long-term decisions by cutting back on capital spending. This can only lead to greater vulnerability to a shortage of labour, reduced productivity growth, and reduced ability to respond to the many uncertain changes which come along.

I've written all of these things previously. The new element in play, coming along at exactly the same time as our growth rate has slowed to 2%, the interest rates buffer has near evaporated, and margin pressures have become intense, is China's latest food market virus.

Calculations of the economic cost of the outbreak are yielding greater and greater numbers as the virus spreads and actions are taken to contain it. Predictions are growing of sustained sharemarket weakness, declines in commodity prices, vastly reduced global tourism, cutbacks in confidence and investment etc. Basically, uncertainty is high and growing so people are veering toward the more negative scenarios now.

The chances are not high that severe economic pain lies ahead in a macroeconomic sense. But downside risks mean that NZ businesses are likely to further restrict their capital spending – thus boosting further their dependence upon labour input and reducing further any productivity growth. Loss of sales for some directly exposed to sales to China and Chinese visitors will affect many others. Pressures to restructure will grow. Bill payment times will stretch out and cash flows become more troublesome.

The upshot will be some acceleration in my anticipated pace of inefficient, unresponsive businesses being weeded out across most NZ business sectors over the next 3-5 years.

If you are in business the sorts of things you need to be thinking about include how much more you might be reliant on labour now than in the past and how to reduce that dependency and therefore vulnerability to further labour market tightening. Whether cutting output or output growth might be a better route to maintaining or growing profits than trying to get bigger and bigger – at least until the big decision is made to undertake a lot more capital expenditure.

If you are an investor then the key thing to remember is this. We've seen viruses before, we've seen shocks before. At the time they are scary, buyers back off, some people sell, cash flows to defensive stocks. Eventually the effects pass. Stock prices recover. We all end up saying that we should have bought so and so stock back when things looked bad. Within a short time, the graphs showing share index movements reveal the fall in prices to be just a blip increasingly lost in the data flow.

What we don't know is whether we'll be in the frame of bemoaning lost buying opportunities in a few days, weeks, months, or over a year from now.

In a nutshell, is there anything which makes me as an economist say in response to the current shock, that this time it's different? No. This will pass, but because we are far more exposed to China's economy than before the impact will be deeper than from SARs in 2003. Newspaper media seem to be doing a good job bringing us insights into various businesses and sectors affected by the virus so far.

Use the shock as impetus to look deeply into your business and how it runs, develop new, perhaps more flexible, strategies, and make some perhaps tough decisions you've been putting off.

At this point I was going to take a run-through of some recent data such as ANZ's consumer confidence measure (which was good), and lending growth data, which was strong for housing. But what happens in times like these is this. We conclude that the data are out of date. We expect things like sentiment measures to decline, retail sales gauges to weaken and so on.

Data end up being broken into four time-related portions.

1. Pre-shock not entirely relevant.
2. Shock-affected largely overly negative.
3. Post-shock upwardly biased for growth numbers as catch-up spending and activity occurs.
4. A return to normal.

Been there, done that many times already. For your guide, when the excrement hit the fan at the end of 2008 and the ball started rolling to a new Great Depression around the world, we economists could have jumped on the bandwagon preaching woe. Some did. Some non-economists made ridiculous panic-driven predictions of collapsing house prices in New Zealand. But most of us didn't. We warned of big risks but concentrated on insulating factors like plunging interest rates and a much weaker NZD and fuel prices.

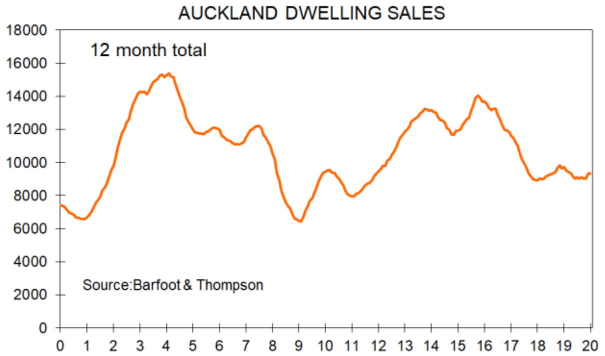
At some point in either late-2009 or early-2010 I received a letter from the then Reserve Bank Governor. It basically said (in professional terms) thanks for not scaring the chooks. This is another one of those times though of far lesser magnitude, and I still see no reason to run around frightening people – even though the worst is almost certainly yet to come.

Housing Market

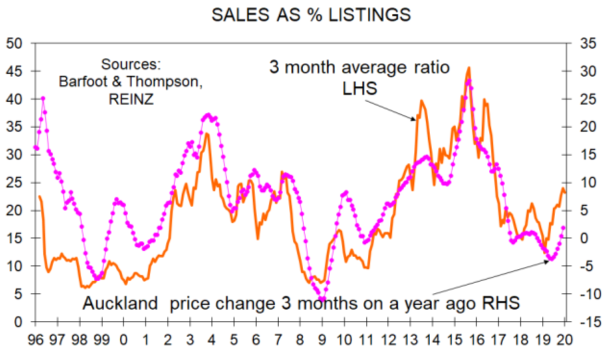
See the Barfoot & Thompson survey supplement included in this week's email distribution of Tony's View and available on my basic web page http://www.tonyalexander.nz/publications.php

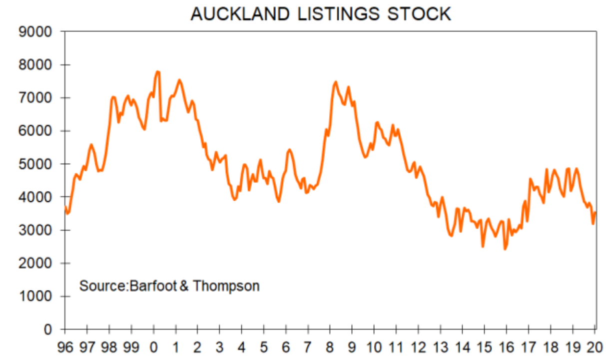
The new survey reveals that more and more people are showing up at Open Homes and auctions, prices are rising, and FOMO appears evident. Interestingly, lots more first home buyers are seen as active in the market but not investors in net terms. Overall, a net 24% of the 367 largely Auckland-based respondents feel that the city is in a seller's market.

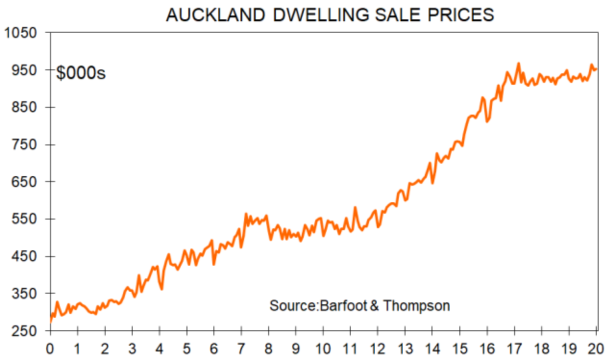
Yesterday we also received Barfoot & Thompson's monthly sales data. Sales pulled back after a December boom but on average have improved slightly recently.



However, listings are in short supply and one of my favourite graphs tells us that this means more upward pressure on prices. The orange line shows a three-month average of the ratio of sales to listings. It rises when sales go up but listings don't respond. These rises tend to be followed very quickly by an acceleration in the pace of price gains, shown as the pink dotted line.







However, while I think Auckland prices on average will rise 10% - 15% this year, there will be a check on the magnitude of price gains from increasing supply. The number of consents issued for construction of dwellings in Auckland over calendar 2019 added up to a record 15,154 – a 17.8% rise from a year earlier.

The message here to real estate agents struggling for listings is what I wrote over three years ago – you need to have some good relationships with developers to secure rights to sell their new stock as sales of new dwellings have become a much larger portion of total sales now.

Interest Rates

Next Wednesday the Reserve Bank will release their latest Monetary Policy Statement and review the official cash rate which has sat at 1% since they panicked and cut it 0.5% in August last year. They last reviewed the cash rate in November, left it unchanged and wrote

"Interest rates will need to remain at low levels for a prolonged period… We will add further monetary stimulus if needed."

Is it likely that they think new stimulus is needed? Not yet. Data released since early-November have shown accelerating house price growth and lending, higher business confidence and recovered employment and to a lesser extent investment intentions, good retail spending growth, high commodity prices, improved consumer sentiment, and confirmation of a fiscal stimulus. But net migration inflows have been revised downward slightly, drought conditions have appeared in some parts of New Zealand, and the tourism sector – our biggest export earner – is set for a deepening hit from the effects of China's viral outbreak.

The Reserve Bank are highly likely to warn that they will cut the cash rate if necessary, but that at this stage it is too soon to do so.

Nonetheless, because of the deepening global growth worries associated substantially with slowing Chinese growth and falling orders to foreign exporters to China, wholesale interest rates have fallen slightly here and overseas.

The United States benchmark 10-year government bond yield has declined to 1.6% from 1.8% at the start of the year and 1.77% two weeks ago. The three-year swap rate here in NZ has fallen to 1.1% from 1.32% at the start of the year and 1.25% two weeks back.

For borrowers the outlook remains for many years of low interest rates. For conservative investors who tend to bias toward fixed interest products like government bonds, corporate bonds, finance company debentures, and term deposits – sucks to be us. Makes housing look good.

And just to repeat what I wrote a couple of weeks ago. In hindsight the 0.5% cut in the official cash rate by the Reserve Bank last August was a mistake. They gave away 0.5 percentage points worth of emergency stimulus which could have been usefully applied if needed in the very near future in response to an identified need as opposed to supposition that low business sentiment back then would substantially affect the pace of economic growth.

The previous time they cut the rate by 0.5% was in 2011 after the Christchurch earthquake, and before that, excluding the GFC, in 2001 following the September 2001 terrorist attacks in the United States. Last year did not contain a shock approaching those events.

CHOOSING YOUR FIXED MORTGAGE RATE TERM

Minimum rates are unchanged, but prospects for where fixed rates sit in the next 1-2 years have altered. So, the commentary below is new 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%.

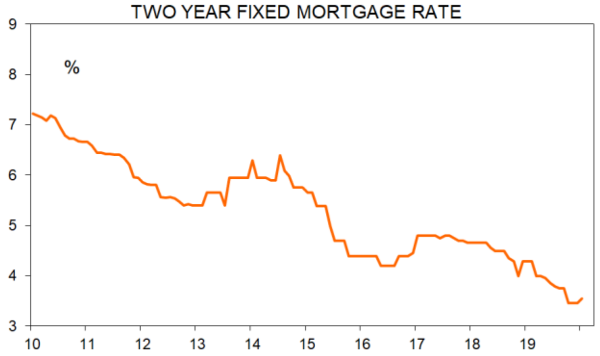
Is this better than fixing 2 years?	Yes, if in 1 year the 1-year rate is below 3.71%.
Is this better than fixing 3 years?	Yes, if in 1 year the 2-year rate is below 4.14%.
Is this better than fixing 4 years?	Yes, if in 1 year the 3-year rate is below 4.19%
Is this better than fixing 5 years?	Yes, if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

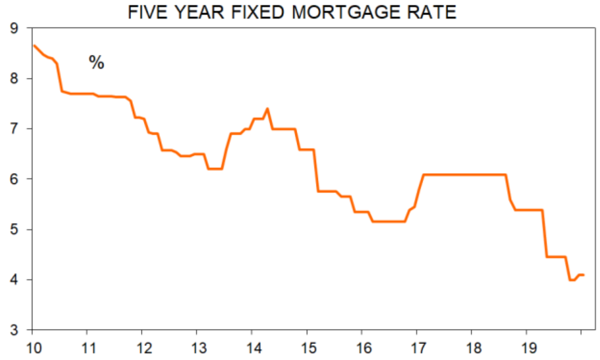
We need to acknowledge the risk that the coronavirus outbreak has an extended impact on travel flows and therefore tourism-sourced economic growth in NZ. Add in a weaker Chinese economy, lower fuel prices, reduced confidence, and interrupted global supply chains and inflationary risks have now shifted downward. 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%? No. 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.

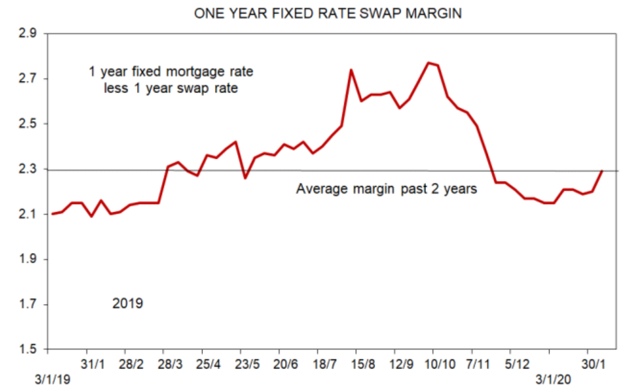


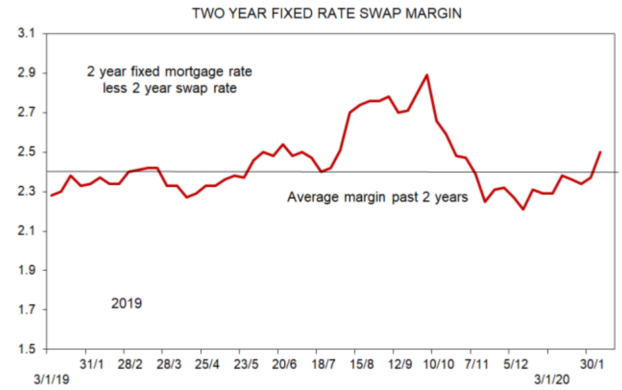


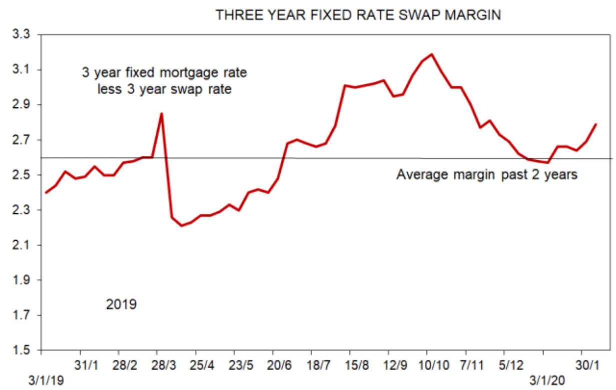
IS A FIXED RATE CHANGE IMMINENT?

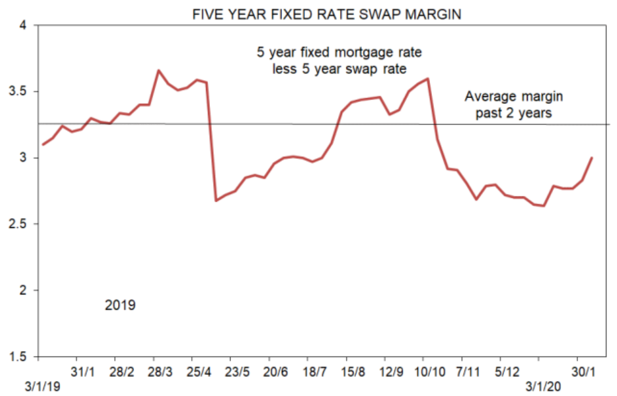
Bank mortgage margins have been moving upward since the very start of the year. Over that time the 3-year swap rate has fallen 0.2%, 5-year 0.3%. Odds increasingly favour rate cuts soon.

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.

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DETAILED GRAPHS ENLARGED

None this week.