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.

This Is What You Get

There are currently 2.8 million people in the NZ labour force versus 2.3 million at the start of 2010 when perhaps we can say that the recessionary effects of the global financial crisis were done and dusted. That means an extra 500,000 people earning incomes, probably for the first time since the last recession.

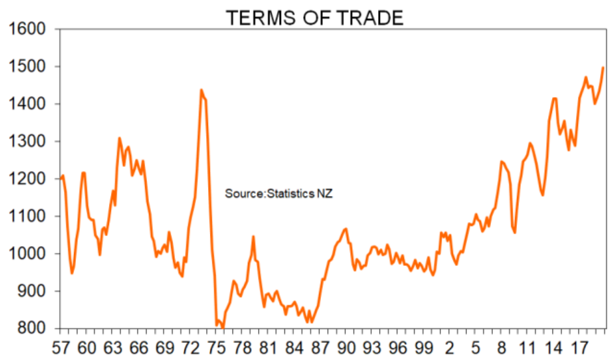
But we also had about 440,000 people aged 55 and over in the workforce back then of which all but 75% would have left the labour force. Thus, our net jobs growth of 500,000 is actually gross jobs growth of about 800,000.

That means about 29% of people currently employed in New Zealand have never seen a recession – give or take a few. (26% just counting people aged 29 and under right now.) It will be worse in Australia where there has been no recession for about 27 years.

This means there are a heck of a lot of people who don't know what usually happens when a recession comes along. There's only one problem with that sentence, and that is inclusion of the word "usually". There is nothing "usual" about this recession if that is what we are going to have and the progress of the virus suggests we might.

Usually we have a recession because of a big tightening of monetary policy and soaring NZ dollar in New Zealand to fight inflation associated with a surge in economic activity and hikes in wages and business margins. And/or there is a collapse in our export prices, and sometimes as bad luck would have it, we get hit by a drought or offshore crisis.

This time around our interest rates are the lowest any of us have ever seen. Our export prices are high and in fact the country's Terms of Trade hit a record level during the December quarter we just learned.



Our migration numbers are firm. The currency is just below its average for the past ten years. Fiscal policy is expansive.

Great list – and as I've said repeatedly in response to a summation like this of our good economic conditions over the past five years – "What could go wrong?" Covid-19 is the answer.

What we are experiencing is a unique shock, so don't expect that anyone can draw up a concrete list describing how things are going to play out over the coming year. But it is worth having a go so that the 26% - 29% of our workforce who have never seen a recession before can get at least some reasonable feel for how things go and not panic at a loss of the high job security they have been taking for granted.

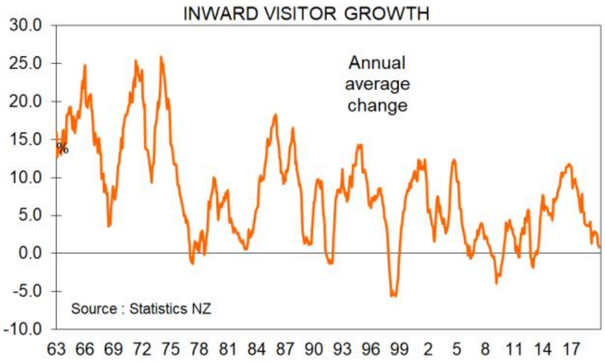
As regards the number of businesses in operation which have never seen a recession in NZ before, I'll let someone else try and calculate that. The number will be large.

So, here is this week's view on how I think things will go.

The Tourism Shock

Many sectors will be affected by temporary material shortages and temporary cessation of exports to China. Many will be affected by a general sentiment decline and rise in caution. But one sector is about to get the largest shock it has ever experienced – tourism.

Consider the following graph. It starts in 1963 and shows the annual average rate of growth in visitor numbers coming to New Zealand. Note that the worst down-turn was of about 5% magnitude during the Asian Financial Crisis of 1997/98. In the GFC the decline was only 3%. Note also that such declines are rare and the sector has grown and grown over more than the past half century. Tourism makes the same contribution to GDP now as it did back during the Asian crisis.



The current decline could easily be between 10% and 15% if not considerably more as people will not just want to avoid travel because their economies are weak. They will want to avoid being confined on a cruise ship, trapped in another country, away from home and family should infection misfortune strike loved ones, and having to potentially self-isolate upon return home.

This is where the biggest hit to our economy is going to come from in dollar terms and also length of time given that for other sectors such as forestry, meat, and seafood, the export weakness is driven mainly by the temporary China shutdown now slowly easing. And for manufacturing and construction, the absence of imported components, while highly disruptive, will also pass within maybe a couple of months as China production ramps back up. The IMF estimate China's factories are back to operating at 60% capacity.

But tourism is a discretionary consumer purchase easily sacrificed during hard economic times and highly risky during a global contagion. It is a regionally-focussed activity here. It has been the saviour of some locations which have lost other industries over the past three decades. It provides employment for a lot of people at the lower end of the skills spectrum, and is filled with many small businesses offering services of one kind or another.

The only prospect of continuation in business for some of these operators will be if you and I take a decent domestic holiday. Driving on the roads is about to become safer with fewer foreigners out there causing accidents. Finding accommodation will be much easier. One imagines discounts will be available on a range of food providers and activities and if I were advising the tourism management bodies in tourism destinations, I would be emphasising the need for a domestically-focussed campaign. A resurrection of "Don't leave home until you've seen the country" sort of thing.

As an aside, Christchurch post-earthquake has missed out on the tourism boom from 2014. Our second biggest city will be less affected by the tourism decline than many other locations.

Financing Costs

The Reserve Bank will ease monetary policy but it will not make much difference for at least nine reasons.

1. Borrowing costs are already low.
2. Monetary policy has eased aggressively already heading into this shock.
3. The shock is concentrated in sectors affected by an offshore volume of purchase decline (tourism) and reduced mortgage and business interest rates will do nothing to lift their willingness to travel here. That includes the effect of any slight Kiwi dollar decline.
4. Increased risk aversion by lenders will result in some higher credit spreads being charged to some borrowers.
5. There is almost no evidence that cutting interest rates boosts business capital expenditure.
6. The decreased incentive to save can easily be offset by the desire to build savings in case of worse times ahead – precautionary saving.
7. Lower borrowing costs will have no impact on widespread self-isolation should that become necessary in the event of the virus spreading

within our communities as is now happening in some other countries including Iran and Italy.
8. Lower term deposit rates will discourage spending by those with assets.
9. Slashing interest rates can look like panic and sends a signal to people that they should worry. Hence the US sharemarket selloff after the 0.5% rate cut on Tuesday night.

Nonetheless, 15% of mortgage holders are on a floating mortgage rate and another 23% are within six months of their fixed rate coming up for renewal. The repricing of these $104bn worth of mortgages will free up some cash in coming months.

Investments

Share prices don't just fall, they fall to sometimes extremely different degrees and not necessarily at the same time. The same goes for eventual price recoveries. This makes for an exciting environment for share traders.

Nervous people tend to sell and this aggravates the overall proportionate decline in share prices. Skilled investors know this and when they see even average risk-tolerant investors capitulate and sell, generally they will take that as the signal for them to start buying – either building positions in oversold strong companies, or riding the eventual price recovery of what are called "high-beta" stocks. These are those which tend to rise and fall by more than the index averages.

Almost all KiwiSaver members will have no experience of recession battering their portfolio market values. The KiwiSaver scheme started in July 2007, but balances would have been minimal and for initially few people when markets crashed in 2008.

KiwiSaver members experiencing cash flow problems will try and get their money out and they won't be able to. Others, upon hearing this, will plan to reduce future contributions in order to boost precautionary/liquefiable savings for when the next recession appears. For some this will mean planning to invest in property rather than placing as much as they have been doing with KiwiSaver. Some members will take contribution holidays.

People with privately managed shareholdings – either self-managed or in managed funds – will look to liquidate some of their holdings not necessarily for fear of further declines but because they need the cash.

History repeatedly tells us that all shocks such as this end up being a blip on long-term share price graphs. But the trick is reminding yourself during the heat of the weakness that you invested in something which has a history of doing exactly what it is doing right now. Falls of 10% plus are established behaviour for sharemarkets, just as clawing the couch is established behaviour for most cats.

Retailing

Consumer confidence will fall, driven by a rise in job insecurity, layoffs concentrated in tourism and hospitality, reduced hours of work and curtailing of overtime, and apprehension about what is happening.

When this happens, people tend to most pull back from spending on what we call "durable" items. These are things which last a long time and which don't always need replacing straight away because they can be used in poor condition for a while. Think all types of furniture, motor vehicles, expensive electronics and home appliances. We also tend to pull back from spending on stuff viewed as big rewards for the years of hard work we've done, or simply because we reckon we deserve it. That means expensive clothing and accessories, higher-priced cars, overseas travel, expensive weekends away.

We also retreat from aspirational things which we feel would better reflect our climbing economic and perhaps social status. That means holiday homes, powerboats and shiny yachts, coastal properties, "better" suburbs darling.

If your business involves the supply of any of these things you will experience sales weakness greater than the retailing average.

People who already have such things may look to offload them either because they need to generate cashflow or cannot comfortably service the debt they rose to buy them. Ferraris go for a song when the US has a decent recession.

This means some cheap stuff will start to appear on the likes of Trademe. If you are cashed up and in a position to buy, your incentive is to bargain hard whether on an online sales platform or in an actual shop for such things. Retailers will in fact be forced to implement deeper than normal discounting.

We consumers will tend to switch to some buying of smaller items which can make us feel good right away (even if there is an after-effect). This can include alcohol for home consumption, fish and chips instead of a restaurant, nice lipstick, a nice hairdo etc. We'll buy a nice tie or shirt instead of a suit. We'll cut back on weekend drives in order to save petrol costs and look to do things closer to home.

We will tend to shift from shopping in middle to higher-end shops to a level down. Good business for the likes of Postie-Plus and such-like.

Retailing around NZ is already in a challenging state because of margin-management issues, high rents from intransigent landlords, and online competition, and there are going to be greater problems now for centres already experiencing emptying CBDs. Shops will sit empty, and if the landlords opt for generating any rent possible by leasing to tattoo parlours, vaping enterprises, etc., it could be the death knell for sustained shopping in such locations.

The owners of retail premises will encounter falling values and reduced bank credit availability. Shopping centres will tend to get less traffic, a higher proportion of which will be people just wandering around window shopping or shouting themselves a family meal in the food court as an outing.

Retailers should consider trying to reduce costs by negotiating a lower rent. A landlord is likely to prefer accepting a reduced rent rather than lose a tenant and risk both the premises sitting vacant for an extended period and later in desperation contributing to fitout costs.

We will have some spare time on our hands so will take up new crafts and buy materials online in all probability. The craft sector boomed when SARs struck. We will engage in some light home maintenance and renovation.

Construction and Manufacturing

The ANZ have calculated that about 20% of farming inputs are imported (but lots of fertilizer, supplementary feed, and big machinery which can be done without for a while). About 25% of construction sector and 28% of manufacturing sector inputs are imported. We are going to see stalling of come construction projects because of a temporary absence of essential inputs. Same for manufacturing.

This will cause some unfortunate flow-on effects to contractors dependent upon construction project continuation in particular.

Business Generally

Decreased bank willingness to lend and potential equity partners pulling back will cause many people who were planning to launch a new business to postpone or cancel their start-up. This will reduce the pace at which innovations boost our long-term rate of economic growth. But some businesses will thrive, and this quote from a Harvard Business Review article last year sums up the situation quite well.

"…recessions are a high-pressure exercise in change management, and to navigate one successfully, a company needs to be flexible and ready to adjust."

https://hbr.org/2019/05/how-to-survive-a-recession-and-thrive-afterward

Recessions challenge existing business plans and perhaps highlight that one does not have a plan at all or only an outdated one. The average business needs to treat recessions as the mother of all prompts to re-examine all assumptions about what your firm is actually doing and where it is headed. But being prepared for shocks such as this one is why the sub-title for this publication reads as follows. "Input to your Strategy for Adapting to Challenges"

As I've highlighted in talks these past few years, focus on building flexibility into hiring, leasing, product-ordering arrangements so that adjusting to a much weaker economic environment can be done in a way which preserves the most valuable thing to avoid going under – cash flow.

Your bank is very unlikely to call in your loan because your asset values have declined. But they will if your cash flow collapses. You're essentially bleeding to death as opposed to hobbling around with a broken foot. So, get cash flows under control. And as discussed elsewhere and last week, shift staff to reduced hours as opposed to laying them off if possible.

"…the companies that emerged from the crisis in the strongest shape relied less on layoffs to cut costs and leaned more on operational improvements."

But when cutting costs, be careful not to sacrifice long-term positioning.

"Although it's wise to contain costs, failing to support brands or examine core customers' changing needs can jeopardize performance over the long term."

https://hbr.org/2009/04/how-to-market-in-a-downturn-2

Your customers are going to be looking around for cost-saving and more effective solutions during their tough times. So are the customers of your competitors. Make sure your brand is presented in positive manner so you are front of mind for all in your market.

This second Harvard Business Review article (you get free access only to 3 a month) gives insight into how to segment your customers and might interest some businesses.

Examine the potential for digital transformation of your business. If output is below what you had before some ongoing expenses will be less and perhaps that frees up some cash for investing in a digital modernisation and rearrangement of your business. The HBR study noted that investment in IT and hiring of IT skills tended to go up during recessions as companies pursued this strategic imperative aimed not just at boosting productivity but flexibility also. This type of investment (better if done pre-recession) can lift understanding of exactly what parts of your business are most affected and what changes may yield optimal results.

Take the opportunity of this accelerated weeding out environment to run through all your expenses. Have you ever bothered negotiating with electricity suppliers for a better rate? Are input suppliers willing to accept a discount or suggest a cheaper alternative? Have subscriptions for magazines and online services blown out? Switch from big company bashes aimed at high achievers and senior management, to all and sundry with something simple such as Friday fish and chips or a regional outing for families.

Ensure communication with staff worried about their income is prioritised and if they are to be asked to make some sort of sacrifice make sure you make one also else productivity could collapse through resentment.

Use this shock environment to undertake the review and revamp of what you do which I've been advocating for some time in response to pressures much discussed here in the past…

-margin squeeze through reduced ability to raise prices
-competition squeeze from online and other new competition
-staff shortages and rising training and hiring costs
-new social pressure surrounding the likes of use of plastics and contribution to climate change.

Go through all your data to identify which locations, customers, and products may be losing you money. In this environment you may no longer be able to afford yourself the luxury of saying you're prepared to keep carrying the cost because of an anticipated long-term payoff.

Shift focus if possible to the highest yielding products, locations, and clients and ensure they are well serviced and feel valued during these tougher times.

Education and Training

Because some NZ universities have shifted their focus from research and servicing New Zealanders to maximising foreign student residence-seeking numbers, their business models in the short-term and potentially longer are cracked.

We have seen strident pushback from some universities, calls for public health risks to be lifted in order to boost student revenue, publicising of hiring freezes, and stories about students never returning. The universities are showing you what not to do in response to tough times. Contrast their shrill calls for special treatment with the mature attitude displayed by leaders in the tourism sector. Be careful placing threatening pressure on politicians claiming your case is special. You're Kiwis, you're no more special than anyone else on these shores.

In times of recession many people will either choose the time to undertake education they had been planning – most probably in a polytech – or simply seek to boost their hiring credentials. Also, availability of teachers may temporarily improve. Bargaining power of current employees in sectors such as early childcare will diminish as (largely) females seeking extra household income seek to enter the profession perhaps earlier than they had been planning after having their own children (according to my wife who has a PhD in this field). Home-based childcare (formal or under the radar) will increase as a family income boosting method.

Current Education Ministry plans to try and bring in more early childcare workers from overseas will look even less politically palatable. In fact, a generalised sentiment will grow that the government will need to pull back on issuance of work visas to foreigners – something about which it is virtually guaranteed NZ First will campaign on (and receive substantial support for) heading into September's general election.

Some families will pull their children from private schools. This happens all the time when family businesses struggle in normal times, it is just that the numbers will be greater than average.

I've written enough for now. Don't panic.

1. Protect cash flows
2. Talk with you bank – now.
3. Avoid layoffs if possible.
4. Switch capex from big physical things toward IT.
5. Maintain branding advertising.
6. Review everything because this is the trigger for the weeding out period I've been predicting.

Housing Market

It is a near impossible task to try and accurately balance the various factors affecting our housing market as a result of the virus outbreak, alongside the usual uncertain factors. But the chances are the various things in play will balance each other off and leave the market still with rising prices – in the cities. For the regions I would suggest the boom is over.

On the negative side for all markets we have reduced consumer confidence, reduced employment and job security, and probably a tightening of bank lending conditions. On the positive side we have reduced interest rates, continued firm net immigration which might get a boost, and the risk of a stalling and potential easing of house construction because of a shortage of some materials. This last factor may be of great relevance to some tradespeople unable to do jobs because of the absence of some inputs. But the Chinese factories appear to be reopening and shipping will eventually get restored so any interruption to the completed house supply line will hopefully be relatively short-lived. Two – four months maybe.

Why do I have a more negative view on the regions than Auckland, then Wellington, then Christchurch? Because the regions are being hit by drought, a decline in international tourism, and weak times in forestry in particular.

What's going to happen is something I've been warning about these past three years. Some regions will find themselves in the position of having a building boom exceeding underlying growth in the population base. And with unemployment going up, while some people may think in terms of staying or going to the regions for better housing affordability, more will look to seek their fortunes in the big labour markets in New Zealand. Those opportunities lie in the cities and not so much in the regions.

Which parts of the country are most vulnerable? Those most reliant on international tourism. That means Rotorua, but far less so Taupo. Queensland but less so Wanaka. Taranaki not really because they have been off the beaten track for foreign tourists anyway. Same for Hawkes Bay. West Coast of the South Island? The loss of strength in an industry which has been seen as the saviour of the region will hit hard, especially coming on top of negative weather events. Canterbury – well it has missed the tourism boom from 2014 because of the earthquake causing a lack of facilities including hotels and a city centre. So, Christchurch will actually be less affected by the tourism recession than the other major centres.

Otago outside Queenstown – Dunedin basically – will feel it because tourism and eco-tourism in particular has been a growing activity. Southland will also feel it – thus delivering even more bargaining power to Rio Tinto over electricity transmission costs. Good timing for them in that regard.

Do I think house prices on average will fall in some regions? It is possible in some. But a key thing to remember is this. All the parties listed below will be worried about the state of the economy as the year progresses. All of them will know the limitations on monetary policy with interest rates starting the downturn already so low (especially after the Reserve Bank's ill-advised 0.5% rate cut last year). All of them will know the limitations on fiscal policy and short-term stimulus measures as well. Taskforce Green-type projects do not lead to sustained growth.

All of them will want house prices to go up so people will feel less worried about their wealth. They are the banks, Government, Treasury, and the Reserve Bank. None of these relevant parties is going to come out and say that it would be really good for our economy if household wealth were to receive a boost from rising house prices. But they are likely to pull back from negative comments and perhaps ease up on policy proposals which might generate some weakness.

The biggest relevance may be for the Reserve Bank's prudential housing policy.

In the space of just a few weeks the chances of an additional easing of LVR regulations have come back on the table. If things continue to get bad in the next few weeks the Reserve Bank won't wait until the May Financial Stability Report to announce an easing in minimum deposit requirements. Will they defer the demand for banks to build capital bases over the next seven years? Probably not given the timeframes involved.

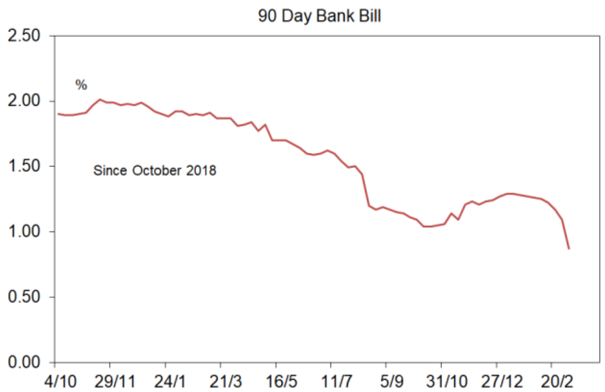
I could write a lot more on housing this week. But I'm still a bit zombified after last week's effort to process over 450 responses to my quarterly survey. (That's what I get for telling people to pull their finger out. Serves me right.) And I've been busy with the speaking season kicking off solidly this week.

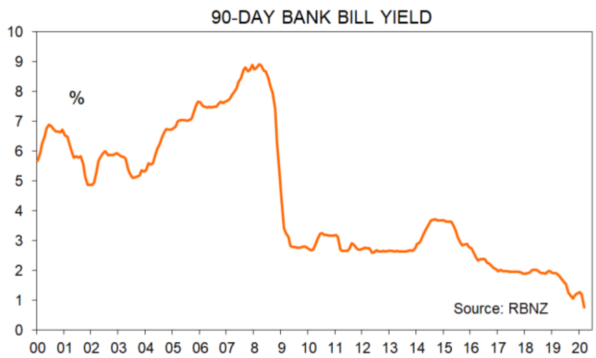
Very briefly – the monthly Auckland sales data from Barfoot & Thompson shows sales in February 43% higher than a year ago, prices unchanged from last year, stocks of listings down 21%, but new listings up – however only by 5%. Nothing major there in the context of trying to figure out the virus impact.

Interest Rates – Will They Rise or Fall?

They are going to fall. The Reserve Bank of Australia has cut its official cash rate from 0.75% to 0.5%. The Federal Reserve in the US has done an out of cycle 0.5% cut to a 1% - 1.25% range. The Bank of Canada has cut 0.5% to 1.25%. Other central banks will follow and our central bank will likely cut 0.25% on March 25.

Wholesale borrowing costs facing banks, corporate borrowers and the government have already fallen substantially. The 90-day bank bill yield is now near a record low of 0.80% from 1.2% a fortnight back and 1.3% at the start of the year. The two-year swap rate has fallen to near 0.65% from 1.15% two weeks back and 1.3% at the start of the year.





Margins on fixed rate lending discussed below have blown out so some fixed mortgage interest rate cuts are going to come very soon. For borrowers – great. For investors – sucks, unless you've already reacted to low term deposit rates by purchasing some other assets such as property or equities. Sure, share prices have fallen, but indices are still well ahead of a year ago and investors will have achieved a better yield than placing funds on term deposit a year back for perhaps 3%.

The NZX50 for instance is now back where it was in early-December. A retreat to levels of three months ago in a market not driven by debt-funded stock purchases has virtually zero perceived wealth spending implications.

CHOOSING YOUR FIXED MORTGAGE RATE TERM

Banks have made no cuts to their fixed mortgage rates this week – but they will come. Still, here is the usual analysis and I look forward to making some changes once cuts are announced.

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. *

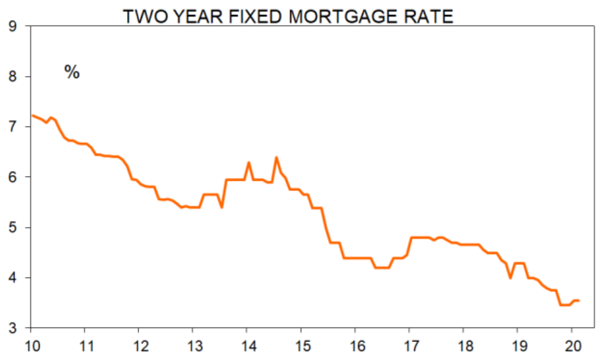
1 year	3.39%
2 years	3.55%
3 years	3.89%
4 years	3.99%
5 years	4.09%

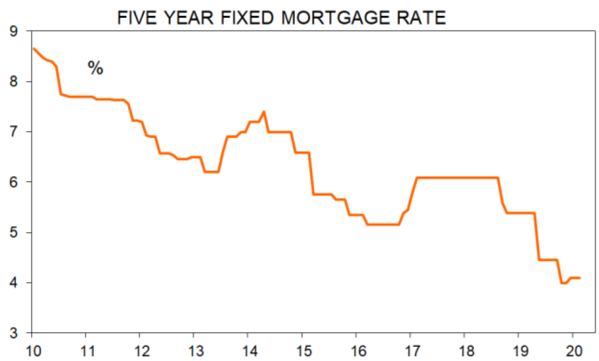
I can fix 1 year at 3.39%.

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%.

Falling wholesale borrowing costs facing banks mean fixed rate cuts are highly likely. If I were borrowing at the moment, I'd personally hold off fixing at all until those rate cuts come. While banks could cut rates now, as discussed just below, they might wait for two things. One is actual monetary policy easing from our Reserve Bank and they don't review their 1.0% cash rate until March 25. The Reserve Bank might cut before then but that risks – yet again – making them look like panicky parrots. So, I reckon they'll wait until March 25. The second factor is that the banks will want to see if they'll be placed under as much pressure to fully pass on a 0.25% rate cut as just happened in Australia. There, the Federal Treasurer called up all heads of the major banks and by the sounds of it threatened to raise the bank level applied to their profits if they didn't fully pass on 0.25% to their floating rates.

*Minimum 20% deposit, owner occupiers, 6 largest lenders.
Compounding is minor so is ignored.

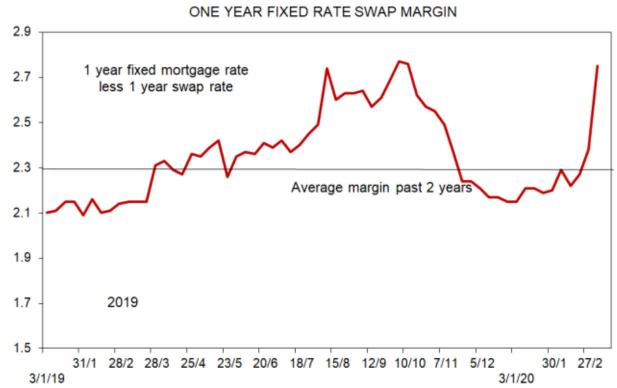


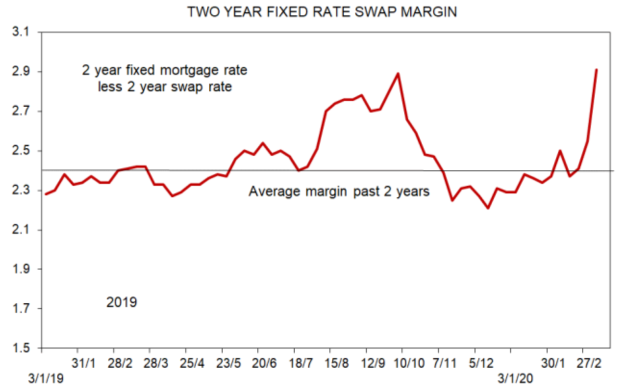


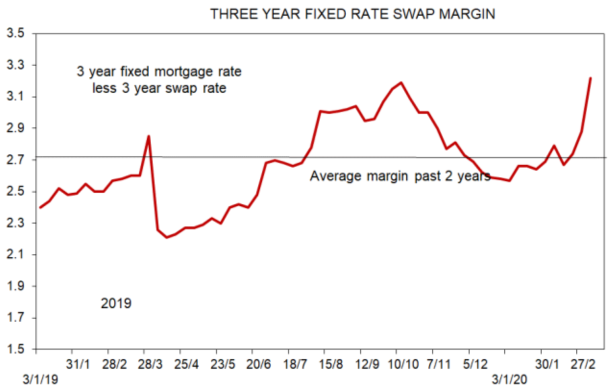
IS A FIXED RATE CHANGE IMMINENT?

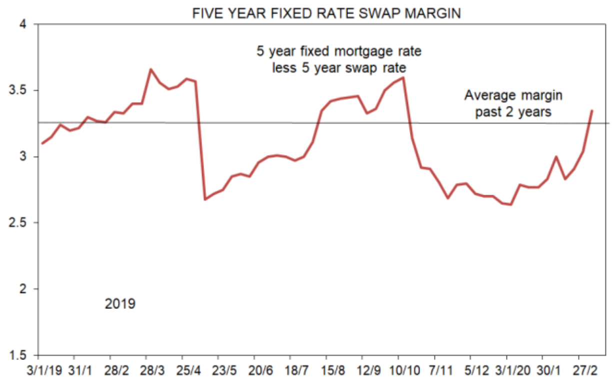
Swap rates have collapsed over the past week as positive news of 60% of Chinese factories reopening has been swamped by virus outbreaks in other countries. Central banks have cut official cash rates in the US, Canada, and Australia. More will follow, including on March 25 if not possibly earlier, our own Reserve Bank. Fixed mortgage interest rate margins have now blown out. Rate cuts are just a matter of time.

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

This publication is written by Tony Alexander, independent economist. You can contact me via LinkedIn or email tonyalexander5@outlook.com

DETAILED GRAPHS ENLARGED