BNZ Weekly Overview

29 November 2018

ISSN 2463-4328

Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

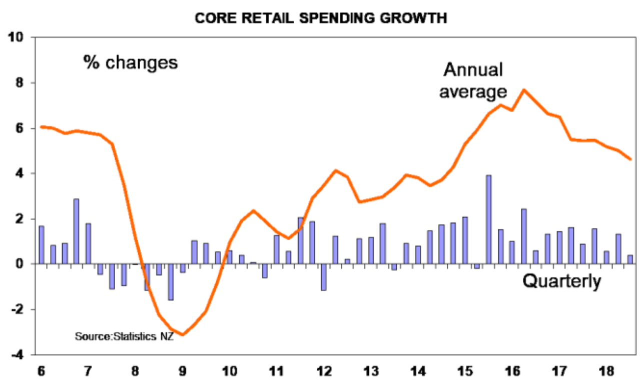
Our Economy

Retailing

This week we learnt that during the September quarter retail spending volumes rose by 0.4% from the June quarter and 3.9% from a year earlier allowing for seasonal factors and excluding the volatile fuel and automotive sectors. The 0.4% quarterly growth is on the low side as average quarterly growth for the past three years has been 1.2%.

Quarterly growth changes have been highly volatile in recent years so the slowdown from 1.3% growth in the June quarter does not necessarily mean that householders have suddenly closed their wallets. Were that the case then we would expect to see much weakness in spending on big ticket items like appliances. But spending on durable goods grew 1.5% in the quarter and 7.8% for the entire year.

Nonetheless, the peak rates of growth in retail spending ended some time back as shown in the following graph.



It seems reasonable to expect that for the next three years core retail spending volume growth will average less than the 6% achieved over the past four years. Factors accounting for the slowdown include the easing off of house price inflation, slower jobs growth, weaker business and consumer confidence, slower growth in foreign visitor numbers, and slower population growth. But there is still likely to be support from the strong labour market and slowly accelerating wages growth, still above average net migration inflows and therefore population growth, sustained low interest rates, and firm though probably not growing house construction.

Does this mean retailers can feel their individual outlook is okayish? Not really. Competition in the sector is fierce and consumers are being presented constantly with new offerings and ways of purchasing goods and services. Further chain store closures are expected and the difficulties retailers already have finding staff are likely to get worse as new higher minimum wage rules for working visas get implemented on top of the domestic minimum wage rises underway.
https://www.radionz.co.nz/news/business/376264/businesses-to-bear-cost-of-migrant-pay-increase

The challenges to councils around the country of trying to consolidate strip retailing in the face of emptying shops are likely to intensify.

Business Sadness

Today saw the release of the monthly ANZ Business Outlook Survey. This is the one which was sitting at a net positive reading of 18% in August last year but then dropped quickly when opinion polls showed Labour might win the election. Sentiment has remained depressed ever since although at -37% the reading for November just announced is better than -50% in early August.

For your guide, during the last nine years of National rule the economy grew 2.5% per annum on average, job numbers rose 1.6% on average, and this measure averaged +20%. When Labour last led for nine years, despite sentiment averaging -20% the economy averaged growth of 3.5% per annum and jobs 2.5%.

Businesses are being hit not just by uncertainty associated with the new centre-left government, but low availability of labour and increasingly squeezed margins. It is hard to see this situation changing in the next two years and the chances are that heading into the next election sentiment will still be very depressed even though GDP growth will probably be close to 2.5%+.

The Housing Market

A real estate agent last week sent me an email querying whether an expectation of a valuer friend that prices were about to fall 10% in Auckland looked reasonable. There are certainly scenarios in which such a thing could happen, but such scenarios are far less probable than those where prices sit flat to slightly rising over the next few years as we progress through the gap between periods of rapid price growth.

One motivation for people currently getting worried about prices falling sharply outside the CBD (where apartment prices have and will show greater volatility than inner and outer suburbs) is stories about prices falling in Australia. Over the past year average prices across Australia have fallen by 3.5%. Sydney is off 7.4%, Melbourne 4.7%, Perth 3.3% and Darwin 2.9%. In contrast Brisbane is ahead 0.4%, Adelaide 1.8%, and Hobart 9.7%. These data come from Corelogic.
https://www.corelogic.com.au/housing-update

Will we follow Australia? Probably not because there are some special factors behind declines across the Tasman. The most important of these is that banks in Australia have engaged in irresponsible lending over the past few years, signing people up to mortgages they could not really afford and facilitating hefty purchasing by investors using interest-only financing. Since early-2017 the interest-only lending has been well reined in and more recently banks have been tightening their lending conditions in response to wider concerns expressed by the regulator – the Australian Prudential Regulatory Authority – and of course the Royal Commission.

Early next year when the final report from the Commission gets released there are likely to be new restrictions placed upon bank mortgage lending and in anticipation of that banks are cutting lending now.

History and the personal behaviour of probably every single one of us tells us that when we are discovered doing something wrong we often overreact and too radically change our behaviour – especially if there is an element of reducing an accumulation of something.

In New Zealand, thankfully, the most irresponsible bank lending occurred during the initial period of financial deregulation in the 1980s and then such activity shifted to the finance companies which grew strongly from the mid-1990s. As pointed out here during the GFC, we did not go into that event with banks having undertaken lending in New Zealand as had been happening overseas. Hence the focus we have placed upon the true GFC-style threat to our banking sector which was excessive reliance upon offshore short-term financing rather than bad lending.

The upshot is this. While we have seen some tightening of bank lending conditions in New Zealand in recent times and some tendril of what happens in Australia is probably still to thread its way here, we are not seeing or going to see the same credit crunch that is happening across there.

That is the first point of difference. A second is that we have not seen the same rush of Chinese money into New Zealand as was happening in Australia. That offshore buying helped drive prices and construction higher. But Chinese people for some time now have been struggling to get their funds off their mainland. And with the pace of growth in China's economy slowing, authoritarian human rights abusing surveillance rule deepening, further tightening on outflows is likely. A weaker Chinese currency spurred by outflows would only further raise the ire of President Trump and virtually guarantee not just movement from 10% to 25% tariffs on over US$200bn worth of Chinese imports come January 1, but tariffs to be applied to the greater remainder after that.

The withdrawal of Chinese new money inflows has hit the two big Aussie capitals hard.

Here in New Zealand there is now a ban on foreign buying. But data from Statistics NZ show the extent of such buying has been much lower than people were thinking. Plus given the fact that much financing involving some communities such as Chinese and Indian occurs outside mainstream institutions it is not hard to imagine that family/business facilitated means will be found to get around the official restrictions anyway.

Third, in Australia a few years ago some clever people figured out that people who managed their compulsory superannuation savings for themselves (self-managed superannuation funds) could use them to gear into property. So many did. But now all major banks have ceased lending to SMSFs for such purposes so that is a previous source of demand no longer there. We do not have such a dynamic in New Zealand.

Fourth, even in the absence of any change in the Reserve Bank of Australia's cash rate banks across the Tasman have been raising their mortgage lending rates. The opposite has been happening here.

Fifth, in Australia's major cities there looks to be a temporary oversupply of apartments. Coupled with cutbacks in bank lending to developers this is leading to a decline in such construction and buildings which were going to be put up containing apartments are now being redesigned as office space.

Here in New Zealand outside a few regional locations of sustained low long-term population growth (shrinkage in some places) you would struggle to find excess inventories of properties.

Sixth, while foreign buyers can still purchase new properties in Australia they face much higher State level stamp duties and land taxes. Even Kiwis buying new or existing houses will pay purchase taxes now totalling near 8% of the purchase price in most states, and an annual tax on the land component of perhaps 3% above a threshold level set lower than for the locals.

We do not have states in NZ so do not have one of their key funding sources of stamp duties and land taxes.

These factors tell us that it would be unreasonable to extrapolate the Aussie house price correction to our shores. But can we nonetheless generate a big price fall scenario here anyway? Not really. None of the things we would expect to see some combination of are in operation to radically force prices lower. To whit…

Interest rates are flat to falling and tighter monetary policy could still be a very long way off. In fact as noted last week world growth forecasts are being revised lower and there are risks associated with many things like Brexit, the US-China trade war, problems in emerging markets, the Italian budget and so on. NZ core inflation is still only 1.2% and although wage costs facing businesses are rising the ability of employers to pass on higher costs into higher selling prices is these days very weak. This means we fully expect to see a lot more businesses run into profit problems over the coming year.
House supply is rising but the shortage of tradespeople means further growth may not occur. Construction costs continue to rise and rise. Migration flows are easing only slowly. And bank lending rules imposed by the Reserve Bank are of course easing.

Loan To Value Ratio Changes

Earlier this year we opined that the slowing housing market would likely encourage the Reserve Bank to ease LVR rules again as happened effective from January 1. That has come to pass. In the Financial Stability Report released yesterday morning the RB noted the slowing in mortgage lending growth and house price inflation. In response they have cut the minimum deposit requirement for investors from 35% to 30% having cut it from 40% a year ago. And banks may now have up to 20% of their lending to owner occupiers at less than 20% deposit. This had been 15% from the earlier 10% percentage of volume limit.
https://www.rbnz.govt.nz/news/2018/11/reserve-bank-to-ease-loan-to-value-ratio-restrictions

Will these changes spur the housing market anew? Not really. The cycle does what the cycle does and the cycle in Auckland peaked out two years ago and is in its flat section for perhaps 3 – 4 more years regardless of RB actions. The rest of NZ will eventually follow.

But the changes are important in that as with all the factors we have already listed above they will help underpin average NZ house prices.

HUDA

One or two people may have got excited this week upon hearing news that the government will merge Housing NZ and KiwiBuild to create the Housing and Urban Development Authority which will aim to radically speed up bureaucratic processes to get housing developments off the drawing board more quickly. Start date is "by 2020". Council rules will apparently be overridden when necessary and public input may be limited to only the very early days of any development.

That looks like a recipe for a legal quagmire the first time someone's view in a pleasant area looks like being negatively affected. So much for all the effort which went into Auckland's Unitary Plan. At some stage the bigger issue of limitations on the Auckland Council's ability to determine city outcomes separate from central government control will need to be addressed.

Will HUDA alter the housing supply picture enough to alter house price dynamics? No. There is no change to the quantity of available builders, electricians, council inspectors, quantity surveyors, plumbers etc.

In a capacity-constrained economy it is only measures which improve capacity that have the ability to alter volume outcome upward.

Prefabs

But what about speeding up construction of housing through prefabricated construction techniques? Sounds great in theory with cost savings as discussed in the following article. https://www.stuff.co.nz/business/industries/108918754/prefab-industry-piles-in-to-help-with-kiwibuild

But are we talking quality KiwiBuild houses or will production, by the time it happens, be redirected to where we think the government will have no choice other than to eventually direct its construction efforts – toward social housing and away from "affordable" for upwardly mobile young couples. The waiting list for state housing is soaring and worse is set to come as rents rise further because of rising owner costs and reduced rental supplies. The supply curve moves up and to the left. Worse is to come also for "less desirable" tenants which landlords will soon be more actively discriminating against given soon to arrive greater difficulties in getting problem people out.

In Ireland where a housing shortage exists prefabrication is being concentrated on social housing. https://www.independent.ie/business/personal-finance/property-mortgages/fasttrack-flats-wont-be-finished-until-late-next-year-37569214.html

At some stage the KiwiBuild programme will morph into a state house building programme.

Your Strategy

-Thing to consider in your next annual strategy session.

Climate Change

Let's start this section with the biggest one of all environmentally but not economically-speaking over the long-term – climate change. A major report was released in the United States this week – the National Climate Assessment - summarising the conclusions of studies into the effects of climate change in the United States. Released every four years since the 1980s this edition looks explicitly at the impact so far in the US of climate change. One key focus is on the increase in extreme weather events which are damaging infrastructure, ecosystems, the economy and social systems. Looking ahead there are expected to be more and more impacts from rising temperatures, rising sea levels, and extreme events.

There is a lot of detail in the 1600 pages and even the summary is a bit hard to digest. But media outlets have done some reasonable work deciphering the report and a simple Google search allows us to see that climate change effects are already apparent and affecting business performance. Worse is set to come. https://nca2018.globalchange.gov/

Last night saw the release of the United Nations' Environment Programme noting global CO_2 emissions rising for the first time in four years and outlining the extremely low probability that emissions will be reined in. The planet is going to get hotter and hotter, weather more extreme, periods of rainfall more intense (warmer air holds more water for release), damage to infrastructure more widespread and intense, inundation events worse etc. https://news.un.org/en/story/2018/11/1026691

On the same topic, representatives from 200 nations will meet in Poland next month to discuss ways of reducing the speed of climate change. They may not fail to come up with ways, but there will almost certainly be failure to implement measures in an increasingly nationalistic world where the growing spread of authoritarian-type leaders will strongly place national interest above global concerns. Plus, much as citizens may be aware of the climate change debate, many see no effects seemingly relevant to them, and many view the issue as yet another smokescreen behind which lie attacks on capitalism and free will.

Sea levels will rise along with water acidity. The planet will get warmer though some locations colder as key wind patterns around the Arctic shift. Weather will become more extreme.
http://cop24.gov.pl/

For specific insight into expected effects of climate change in NZ you can look through the Ministry for the Environment Report. They drill down to the regional level.
http://www.mfe.govt.nz/climate-change/likely-impacts-of-climate-change

https://www.newshub.co.nz/home/new-zealand/2018/03/where-climate-change-will-hit-nz-hardest-revealed-in-new-interactive-map.html

For your guide the pace of rise in sea levels around NZ has doubled over the past 25 years to 3mm – 4mm each year. But some parts of NZ are rising and some falling for tectonic reasons. So coastal erosion will be worse in some places and less if not absent in others. This article provides some insight.
https://www.nzherald.co.nz/nz/news/article.cfm?c_id=1&objectid=11753386

In your business' next strategic planning session it would be a good idea to think about how climate change will affect the location you work from, your lines of product distribution and input receipt, your customer bases and your growth areas. Maybe there will be no clear effects. Maybe there will be opportunities. Consider change in insurance premiums and insurance availability for locations vulnerable to inundation. Farmers can consider the implications of rising temperatures for the shifting southern boundary of crop tolerance and spread of pests and disease endemic to warmer temperature bands. We like to holiday in warm places. Will we need a trip to the GC to enjoy heat in 10 years' time?

Note that the US report referenced above estimates that come 2090 US GDP will be 4% lower than would otherwise be the case if global temperatures rise over 4 degrees centigrade. The big impact is more on massive species extinctions, disproportionate impact on poor, low lying, and hotter countries, and coastlines. But be aware that as time goes by, the planet heats, targets are not met, and disquiet rises, the risk grows that governments will feel forced to implement very rapid change. Thus a new "event" risk will grow each year in particular for NZ farmers and all vehicle users.

Just to finish on a positive note, the inevitable collapse in cryptocurrency prices along with the reputations of those who spruiked them is good for the environment. When prices were high the benefits from mining Bitcoin were good. But the collapse in prices from near US$20,000 to near $4k now is discouraging mining activity which used more electricity than the likes of NZ, Switzerland and Portugal were using per annum. It was costing more to mine one Bitcoin than the average US household used in two years. Ernst and Young estimate 10% of last year's ICO cash raised was stolen, 70% of crypto issuing firms have not yet developed an actual product, and 30% of those cryptos are now worthless. Tulips anyone?

If I Were A Borrower What Would I Do?

Some people might be getting a tad excited at the moment about potential cuts in interest rates because rapidly falling fuel prices will push inflation lower than the Reserve Bank was thinking. The falls in prices have been driven by a number of factors. One is the comment by President Trump that he does not believe Saudi Arabia's leader ordered the death of Mr Khashoggi. This opinion in the face of possibly contrary evidence is expected to elicit a favour from Saudi Arabia in the form of keeping output up in order to maintain low prices. Second, as noted last week, world growth forecasts are being cut at the moment and that means less growth in oil demand.

Third, the US is allowing Iran to continue exporting oil to more countries than previously expected.

Fourth there is the factor we've highlighted in presentations numerous times in recent years. The combination of 3D ground imaging, horizontal drilling, and fracking technology has forever changed the dynamics of the oil industry. Fracking wells can be quickly and easily sunk and if prices fall they are left capped. Then when prices rise they can be uncapped by the many smallish companies which own them.

The technologies have led to surging oil production in the United States to the point where it is now the world's biggest oil producer on the way to becoming a net oil exporter come 2023 according to the International Energy Agency. The breakeven price for West Texas frackers is only $30 courtesy of strong efficiency gains made when oil prices plummeted over 2014.

The technologies also mean that there is an inventory of oil sitting in the ground able to be flowed onto world markets at the turn of a wrench when prices rise enough. A supply response to high prices has now become very fast whereas in the past a supply response required either a political decision by OPEC members or years of development and expenditure of billions of dollars to develop a new oil field.

So oil prices as measured by the benchmark Brent crude measure have now fallen from the US$86 peak to around US$60 and we have seen prices fall away at the pump in NZ.

Yes, the falling prices will push our inflation rate lower. But just as we noted when prices were rising that the Reserve Bank would look through the price rises, so too will they look through the price declines. Only if a sustained change leads to sustained changes in business selling prices which risk sustained changes in wage costs will our central bank react. These days such transmission mechanisms are far less formulaic than before. No-one talks any longer about a wage-price spiral.

The upshot is that it is best to focus on core inflation when looking at what our inflation rate is doing. The measure excluding food and energy prices rose just 1.2% in the year to September while headline inflation is running at 1.9%.

No rate cut by the Reserve Bank is imminent. But then again, no rate rise is on the immediate cards either. We have the same view as the markets roughly have that monetary policy will be tightened in the second half of next year. Given the persistent tendency of inflation forecasts to be too high since 2009 the risk is that this rate rise timing gets pushed out yet again. In fact, just two weeks ago we saw pullbacks in market expectations of monetary policy tightening in Australia and the Eurozone, and this week expectations are declining for how much the US Federal Reserve will raise rates over 2019.

Just last night the Federal Reserve Chairman made comments indicating he feels upside to rates from current levels is more limited than he thought in October. Hence the large sharemarket rally last night and weakness in the US dollar as markets factor in less interest rates support than thought. Hence extra strength in the Kiwi dollar – a currency well supported by good commodity prices, good underlying growth drivers, good fiscal numbers, and absence of special factors affecting many other places around the world. No Brexit. No slowing EU with Italian fiscal recalcitrance. No slowing US growth in housing, manufacturing and business investment with Federal budget uncertainty and political instability. No increasing authoritarianism and capital controls as in China. No negative GDP growth as in Japan. No housing credit crunch and plummeting iron ore prices as in Australia.

Inflation worries are coming off the boil – again, again, again.

For borrowers the news is good, especially given the competition between banks to attract home buyers in a flattish market.

For investors the news is bad. Term deposit rates at levels near 5% for terms less than one year still look to be many years off. There is some competition at the moment at and just below the one year term with rates near 3.5% which will likely prove attractive to some frustrated savers. Were these the bad old days the low levels of bank term depo rates would have generally older money holders in search of conservative assets flocking to finance companies. Remember how they used to proudly say they managed their risk by diversifying across three or more finance companies?

These days the Reserve Bank properly supervises these institutions and their appetite for funds is much more constrained than before. But there are alternatives out there nonetheless which can allow a conservative investor to boost their yield slightly.

To change your address or unsubscribe please click the link at the bottom of your email. Tony.alexander@bnz.co.nz