Handout prepared for TMM Better Business Conference, Airport Novotel, November 12 2019

NZ ECONOMY AND HOUSING MARKET

12 November 2019

Tony Alexander
Economics Speaker and Writer, tonyalexander5@outlook.com , 027 317-5474
To sign up to "Tony's View" email me.
Issues are also posted here http://www.tonyalexander.nz/publications.php

My Aim
To help Kiwis make better decisions for their businesses, investments, home purchases, and people by writing in an easy to understand manner.

Everything's Great!

If you take a look at the data, you'd conclude fairly quickly that people in New Zealand must be feeling really happy about the economy.

- The unemployment rate sits at 3.9% compared with 5.3% in Australia, and job numbers have risen by almost 400,000, or 17%, in the past five years.
- The economy has recorded positive growth for 34 quarters in a row and increased in size by 17% from 2014. Real income per capita is 16% higher than before the global financial crisis.
- The volume of retail buying we each do on average is 21% higher than pre-GFC.
- The number of dwellings being built is the highest since 1974 and 50% above the average yearly number for the past 20 years.
- Export receipts have risen about 5% in the past year.
- The terms of trade (export prices versus import prices) are only just below a record level.
- The inflation rate is only 1.5%.
- The government has completed its fifth year of surpluses.
- The current account deficit is only 3.6% the size of the economy.
- The number of people visiting New Zealand is 40% higher than five years ago.
- Mortgage interest rates are the lowest in half a century and still falling.
- The Kiwi dollar on average is 5% below its average for the past decade.

But there is little ecstasy out there. Instead we have the following.

- The ANZ Business Outlook Survey shows a net 42% of businesses are pessimistic about the economy. This is down from a net 18% positive just ahead of the late-2017 general election and the worst reading since 2008. A net 61% of farmers are pessimistic, a reading at the levels of 2006 despite export prices in NZ dollar terms rising 70%. Retailing sentiment is at GFC levels.
- A net 6% of businesses plan cutting investment versus a ten-year average net 9% usually planning to raise capital expenditure.
- Consumer confidence measured by Roy Morgan and ANZ sits at a reading of 118 which is below the 120 ten-year average.

Why the Woe?

We can consolidate the numerous factors people can cite into five broad categories plus a bunch of miscellaneous items.

1. A Slowdown Has Happened

The latest economic growth rate for NZ is 2.4% in the year to June. This is a slowdown from an average 3.5% achieved between 2014 and 2018. That earlier surge was caused by three key factors.

1. A 40% rise in tourist numbers.
2. A strong rise in residential construction.
3. A net migration boom adding 4.5% to the population (some 230,000-extra people).

In addition, oil prices fell sharply over 2014-15, interest rates fell away from 2015, export prices rose, and there was underlying growth in sectors like aged care, healthcare, and the digital economy.

But now visitor numbers have flattened out, net migration has eased to near 50,000 the past year from a peak 64,000 three years ago, businesses have become wary of the new government and almost stopped growth in capital spending, and the economy lacks capacity.

2. Labour Force Management

The old days of high unemployment and employers being able to place an ad in the newspaper and sort the wheat from the chaff from motivated, skilled applicants has gone. The availability of all types of labour has plummeted, not just in New Zealand but around the world – especially in the construction sector after the GFC led people to abandon building careers.

A net 42% of NZ businesses say they are finding it difficult to source skilled labour. This is down from the tightness of mid-2018 but well above the average reading of 30% difficulty.
A net 28% of businesses say they find it hard to get unskilled people. The average is just 8%.

What is interesting is that the gap between difficulties finding skilled and unskilled people is very small. So even the option of hiring people to train up is difficult.

But the problem of labour force management is more than just an overall volume and relatively high shortage of unskilled people situation. We are now over ten years down the track from the GFC ending. Many hard-working, loyal people have refrained from shifting jobs or asking for decent pay rises because of worries about the world economy. Now these people can see that there are plenty of opportunities. They have been burdened with repeatedly training up unmotivated lowly skilled people and apologising to customers for the poor-quality work which increasingly is occurring.

The skilled loyal people are starting to leave and this costs businesses dearly as these people are taking their “meta-knowledge” with them. This is knowledge not just of how processes work in a firm, but how things go wrong and the early signs of problems developing. Their knowledge can lead to problems being captured early. Loss of these people can mean problems escalate and businesses who are already losing money by having to redo work will see losses grow even larger.

The low availability of labour is blindsiding many Kiwi businesspeople who are used to being able to source employees easily and to set the rules of engagement. And an extra problem they have is that Baby Boomers are increasingly retiring and more and more employees are younger people requiring different management skills because of their different expectations. Plus, a key labour problem around the world is that the high speed of change is rendering skills obsolete at the fastest pace ever seen. The need for intensive retraining programs has grown, but businesses focussed on cost-cutting are not doing enough people retooling. And lack of investment is curtailing productivity growth on top of that caused by government regulations surrounding the likes of health and safety etc.

The answer for businesses in this environment is to stop focussing primarily on profit growth via attempted output growth. Targeting higher output in a capacity-constrained economy can be very costly. What some businesses need to do is cut output. Cut loss-making and low profit customers, locations, and product lines. Develop growth plans first by working out the quantity and quality of resources which can be employed in coming years, then figuring out what output growth that will allow.

3. Pricing Power Decimated

Between 2005 and 2007 New Zealand's labour market was very tight and one of my main messages back then, along with handling the lack of labour by cutting output, was to raise prices to both boost profit and ration output. Many companies did so quite successfully, hence rising inflation then rapidly rising interest rates.

But these days businesses in most industries have lost the ability to comfortably raise selling prices and get away with it. In the old days it cost consumers and business input buyers a lot to find alternatives to products they were buying. Shoppers had to spend time, petrol, and generate stress driving around town finding shops hopefully selling the item they had discovered cost more than they expected in their usual location.

But now, courtesy of the internet, it costs nothing to go online and search for alternatives. In fact, looking for stuff online is a recreational activity and undertaking product searching is fun. So, faced with higher than expected prices consumers now do not automatically pay. They go online and possibly also write something negative about the original retailer on social media.

The power of most businesses to raise prices has been permanently reduced by the internet. This is one key explanation for sustained low inflation around the world despite firm economic growth and resource shortages.

The solution for businesses is to focus on clients, products, and locations where they may have some pricing power, and again to drop low-profit things. Cutting costs through automation, relocation, reconfiguration is also necessary.

4. Social Licence to Operate Challenged

In August in the United States, 180 of the country's largest businesses said they are changing their primary focus away from maximising shareholder returns to acting for the benefit equally of shareholders, customers, staff, suppliers, and the community. This is a substantial change and a key driving force behind it is the increasing societal concern about businesses and their impact on society.

In the United States there are concerns about businesses creating and promoting the opioid addiction epidemic. In many countries there is disgust at high executive salaries and payment of bonuses even when companies perform poorly, as happened in banking sectors following the GFC, and Fonterra in NZ.

There are growing concerns about plastics and plastic packaging in particular. Some massive businesses are playing loose with people's personal data and privacy. Worries about climate change escalate every month. Wages growth has failed to keep pace with profit growth in most countries, and in some sectors worries about water pollution are becoming dominant. Gender diversity and inclusiveness are new large concerns.

Pressure on businesses to change the way they operate are coming from governments via regulations, millennial staff, clicktivists, and managed fund operators.

Businesses are having to spend more time mitigating the negative impacts of their activities on the society. Operators in some sectors feel disrespected and dismissed – farmers – while others – tourism operators – face an existential threat should the world take climate change seriously and cease

travelling huge distances to see smaller versions of landscapes already available to them for virtually no air travel.

In a nutshell, running a business is no longer just an issue of making something and selling it for more than it costs to produce, and around the world business operators are struggling to identify often quickly appearing areas of societal concern, and adapting to them.

5. Offshore Problems

It is true that anyone who has focussed just on offshore problems this past decade and refrained from investing, hiring people, or buying a house, has probably missed out on substantial gains and profits. Offshore worries about the likes of the Euro falling apart or Greece going bankrupt have by and large been red herrings.

But world growth is now slowing and some of the offshore factors in play do have capacity to go bad and affect us here.

- US-China trade war

Because almost everything we export from NZ is made in NZ we are not seeing the massive disruption to manufacturing globally from US businesses looking to source inputs outside of China. But we are vulnerable to any generalised movement away from multilateral trade rules and relationships, and shifts in sourcing of primary products perhaps as part of any resolved US-China trade deal.

- China Growth

The pace of growth in China has already slowed from the four-decade average of 8.1% p.a. to almost only 6%. Further slowing is likely and this means a reduced pace of growth in demand for our primary products, especially as China may use market access as a weapon against countries not kowtowing to certain demands. 29% of our export receipts come from China, (15% Australia) Chinese visitors spend about $1.6bn p.a. in NZ, and Chinese students make up about one-third of our export education sector.

- Middle East Tensions

It is hard to know what is new and what is just ongoing friction. But there is potential for disruption to oil supplies which history shows will affect our growth and world growth and sentiment.

- Sharemarkets

Prices are very high and although the scramble for yield is continuing as the global consensus settles around low interest rates for longer, there is potential for a market correction of large magnitude if enough investors decide to take risk off the table and bank multi-year capital gains at the same time.

- European Growth

Germany may be in recession, Italy possibly also. Doubts about the cohesion of the EU and Euro persist.

- Brexit

No-one knows how things will pan out and potential for disruption remains very high.

Miscellaneous Concerns

This is a non-exhaustive list of other things potentially causing concerns in the business sector and maybe amongst consumers as well.

- NZ population growth has slowed down recently courtesy of easing net migration inflows and the aging population.

- Credit availability structurally declined in and following the GFC and further decline is likely as the Reserve Bank looks set to raise minimum bank capital requirements. Banks will react by restricting lending to sectors requiring higher capital to be set aside than for low risk sectors. That is, they will reduce lending to farming and commercial property developments and favour buying of existing houses.
- The infrastructure pipeline looks fragmented. Gaps between big projects mean skilled people may shift offshore to work on other projects and firms may also relocate machinery or not invest in new equipment.
- There is not confidence that the coalition government has the ability to respond should the world economy weaken sharply. The ideological drivers of some parties and MPs is seen as blinding them to business pressures and requirements and there are growing concerns that should Labour and the Greens get re-elected, the current pressure being placed on sectors such as farming would intensify – especially if NZ First is not in the next government.
- Monetary policy easing in recent years has taken interest rates to such low levels, and money printing offshore has proven so ineffective in stimulating lending/borrowing, growth and inflation, that should a shock downturn come along, the ability of our central bank and others to effectively combat it as in the past three decades would be minimal.
- The speed of change in our personal lives, business operating environments, and maybe our societies and planet are the fastest we have ever seen. Potential for disruption to so much of what we do can easily lie just around the corner.
- Retirees and those approaching retirement face an environment of extremely low returns on low risk assets. Their logical response will be to spend less.
- New, big offshore retailers are set to enter NZ with potential severe disruption for some retailers, and some are already here. Costco Wholesale, Ikea, Chemist Warehouse.

So, Are We Munted?

No. As humans our natural tendency is to focus on the negatives. We are more attuned to threats than opportunities. Those who ignored threats in the past got eaten by the wild animals and weeded out of the gene pool. We are the descendants of the scared and cautious cowards who ran for their caves at the first hints of trouble. So, we are naturally drawn to negative headlines and peddlers of woe on the internet.

There are some strong forces suggesting that the slowing of NZ growth since the first half of 2018 will not continue in straight-line fashion to recession – unless the world economy falls over and that is not likely despite the gasps of astonishment about President Trump or the UK Prime Minister, or leaders Bolsanaro, Duterte, Putin, Erdogan, el-Sisi, Maduro, Xi, Trudeau, Kim, and so on.

1. Net migration inflows have eased from 64,000 in mid-2016. But at rates just over 50,000 there is still an extra 1% boost to our population occurring. That does not lift income per capita, but that is not relevant for businesses simply hoping for more customers.
2. Consumer confidence is below average but still in positive territory.
3. There remains underlying growth in sectors like aged care, healthcare, and the digital economy.
4. There is so much construction to be done yet a shortage of people to do the work, that activity levels in the widely defined construction sector are likely to remain firm for many years.
5. World growth is expected to recover slightly next year.
6. Monetary policies are being eased around the world, and while their effectiveness has reduced, the changes nonetheless will deliver some small stimulus.
7. The NZ dollar is below average and may decline further in the near future.
8. Our terms of trade are only just off record highs.
9. Fiscal policy is on a stimulatory setting and highly likely to be eased further before and after next year's general election.
10. The tight labour market is keeping job security firm and buffering the economy.

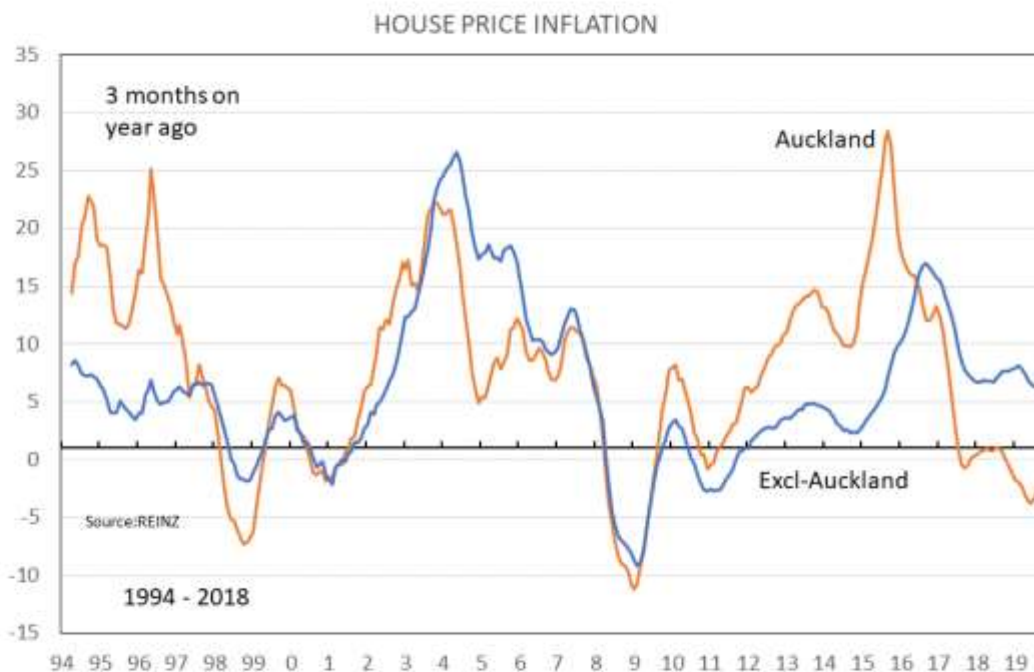
It seems reasonable to keep expecting that outside of unpredictable shocks, our economy will continue to record growth rates near 2% - 2.5% over the next 3-5 years, that inflation and interest rates will remain low, and that wages growth will be mild.

However, in some sense it does not matter all that much for many businesses just how fast our economy grows in the near future. That is because their problems are not solely related to not being able to find customers to service, but to shortages of resources, rising compliance costs, rising rents, and shrinking margins.

In some sectors such as construction, retailing, and farming, we are seeing businesses fail in spite of strong sectoral fundamentals. This tendency for the most indebted, disorganised, and optimistic to be weeded out is likely to spread to virtually every other sector in the economy over the next three years. A period of weeding out is upon us – and that weeding out may become quite severe if the world economy turns down sharply and/or our commodity export prices collapse.

Housing

Between 2011 and 2016 Auckland house prices doubled on average. Since the middle of 2014 prices on average in the regions outside of Auckland have gone up by 56%. Why have prices surged so much? It is certainly not because there has been a huge lending splurge from the banks. Over the past five years the level of household debt has risen by 39%. This is not much above growth in the nominal size of our economy of 27%.



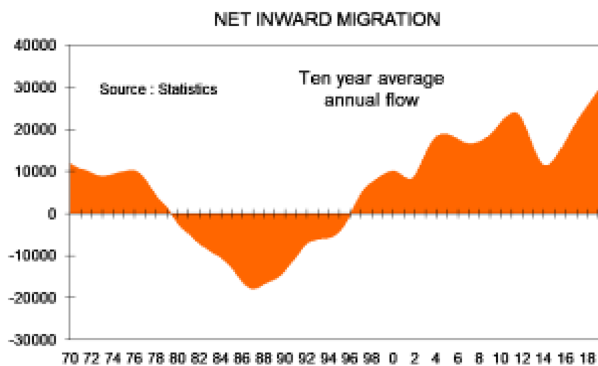
In the previous five years ending in 2014 housing debt grew by just 18%. In the five years to 2019 debt grew 70% and in the five years to 2004 68%. It was pre-GFC (Global Financial Crisis) that debt surged, not since then.

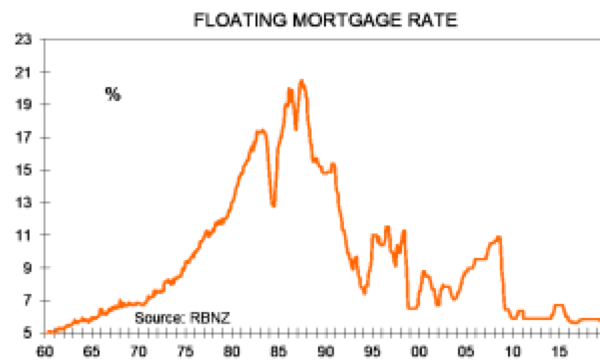
The surge in house prices reflects a large number of factors altering, some over a very extended period of time.

Two income families from the 1970s.
A structural rise in credit availability from 1985.
Tougher building standards, fees etc.
Foreign buyers.
Structural falls in interest rates 1992, post-GFC.
Bigger houses being built now vs. the past.
3-decade message to invest for retirement.
Population shifts to cities.

Older couples divorcing.
Airbnb

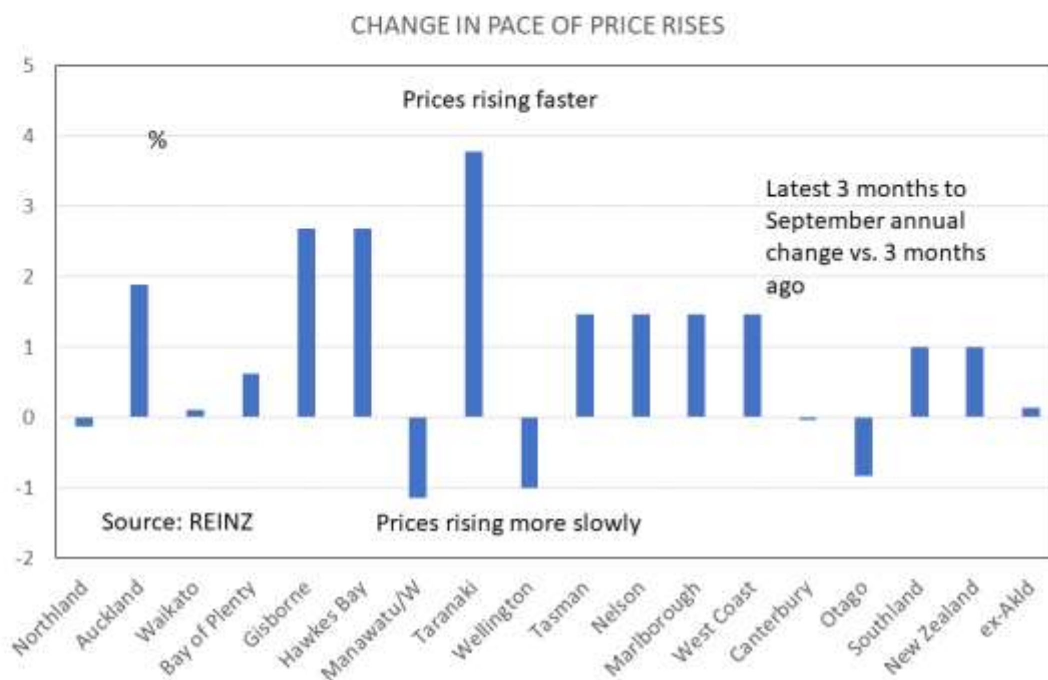
Net migration flows shifting.
Land supply constraints





The most recent surge we can attribute substantially to under-building of houses in Auckland ahead of the GFC, the structural decline in interest rates, a surge in net migration inflows from 2012, and buyers catching up after delaying purchasing for various reasons from 2007 – 2011. FOMO – fear of missing out – also kicked in strongly once Auckland got rolling.

The most recent data released by REINZ on October 15 tell us that listings remain in relatively short supply, that turnover is showing signs of slight improvement in Auckland, and that prices now appear to be rising anew in Auckland while continuing their firm gains in most other locations. I produce graphs and commentary around regularly released data in my weekly publication "Tony's View" available for free from www.tonyalexander.nz and by emailing me asking to subscribe at tonyalexander5@outlook.com



So, what lies ahead? Is it reasonable for instance to think that our markets will undertake a recovery such as that which is happening in some of Australia's state capitals? I discussed this issue in my October 17 Tony's View, but in summary, we did not follow Australia's 10% - 15% house price falls for reasons such as these which gave special downward impetus to Australia's markets.

- Post-GFC in Australia substantial irresponsible lending with poor repayment ability assessment was undertaken and about three years ago the Reserve Bank of Australia tightened rules on

lending to investors to prevent this. In NZ we did not have the same loosening of lending criteria for investors post-GFC.

- In Australia about 60% of dwellings built are apartments and this market can be highly volatile. In New Zealand only some 12% are apartments.
- More Chinese were active in Australia's markets than New Zealand's. So, when rules were tightened in China to more heavily restrict capital outflows some five years ago the impact was greater in Australia than here.
- In Australia people started using their Self-Managed Superannuation Funds to gear into property. Banks stopped lending for this purpose a couple of years back, taking away a source of demand.
- States in Australia over the past two years have introduced and raised taxes on foreign buyers and owners of residential property.
- Australia generally has an over-supply of dwellings whereas in NZ we have shortages.

Australia's markets fell away but ours did not. Now, in the space of just four months the question people ask me has shifted from whether we will follow Australia down to whether we will follow them strongly up. We will not for the following reasons specific to Australia.

- Interest rates have been cut three times so far this year.
- Rules on bank lending to investors have been eased.
- A big court case against Westpac alleging improper calculation of debt servicing ability was thrown out.
- Investors are catching up on buying after pulling back.
- A fresh wave of owner-occupier buyers has entered the market sensing that there is an opportunity to pick up something well-priced following 10%+ falls in properties.
- Hefty publicity is being given to the recent surge in prices with elements of FOMO likely to now be in play once again.

Nonetheless, can we reasonably feel that the worst for Auckland (prices down 3.5%) is over, and that the regions may retain more strength than earlier thought? Yes.

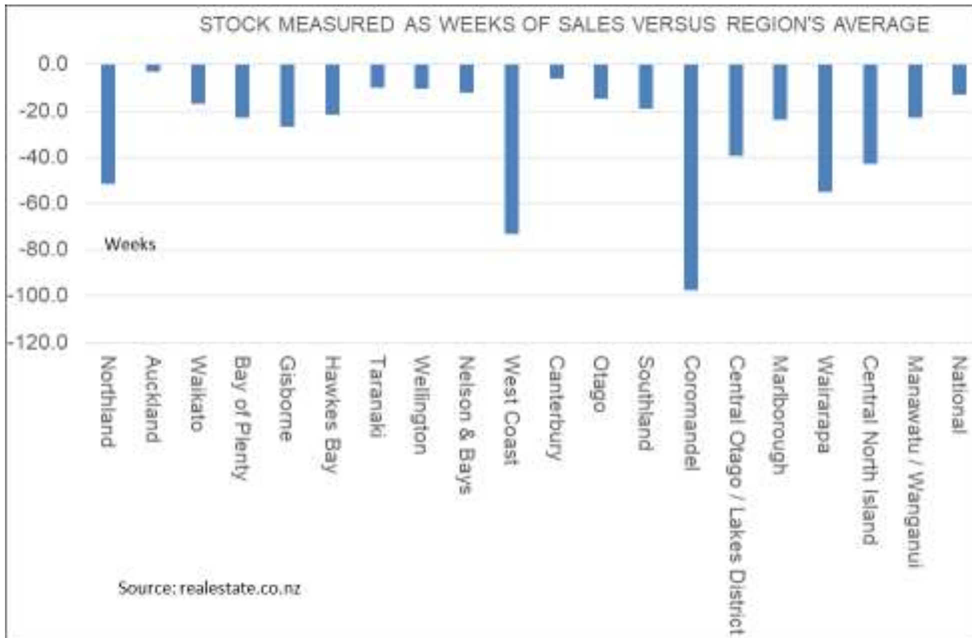
There is extra support for housing now coming from investors partly reacting to the confirmation of no capital gains tax. But I give that factor only a small weighting. Instead, the new decline in term deposit rates and expectations of further declines is encouraging investors who were thinking of selling to hold onto their properties. And others who may have felt no desire to purchase property in the near future are also searching for yield and perhaps choosing to place their funds into a property investment of some sort.

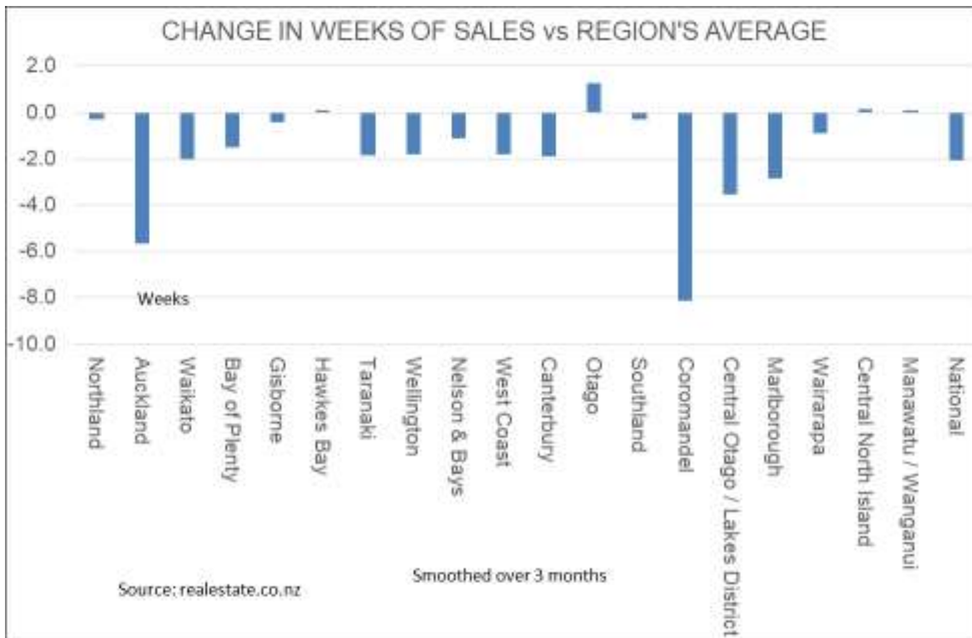
Factors supporting our housing market going forward then amount to these.

- Net migration inflows are holding up well near 50,000 per annum, and given slowing world growth it seems reasonable to expect that our population growth rate will remain supported from this source for many more years.
- Interest rates are low and going lower.
- The economy looks likely to continue to comfortably support a strong labour market. Good job security and rising job numbers are supportive of housing.
- There is little prospect that the centre-left government will look for new ways to penalise landlords. However, introduction of ring-fencing of losses and higher rental property standards may encourage some investors to sell.
- Housing supply is rising but limitations on the availability of labour suggest a construction boom is not going to happen.

Having said that, the rise in house supply is likely to constrain feelings of FOMO in Auckland. And for that reason, while it now seems reasonable to expect price gains close to and even above 5% for each of the next three years, it would be optimistic to anticipate gains approaching and exceeding 10% per annum. I am not willing to say that Auckland is starting a new cyclical upturn.

But the turnaround in Auckland is shown most clearly in the following three graphs using data from realestate.co.nz The first show listing stock levels measured in terms of weeks of sales. The second shows how these measures have changed from three months ago. Note the Auckland turnaround which is shown most clearly in the third graph.





In the regions low interest rates are comfortably extending a period of catch-up price gains which I had expected to be near complete by now. But to anticipate a fresh price surge when there are some specific factors hitting the pace of growth in regional economies – a dairying "downturn" driven by environmental concerns, and near cessation of growth in tourist numbers – would be unrealistic.

Now and then I produce other graphs for each region showing how prices compare with long-term averages and they appear in Tony's View.

Implications

Businesses

It's only going to get harder to run one's business. Consider running a one-day Strategic Planning session and give thought to the following.

- How to keep up to date with the increasingly rapid speed of change in consumer preferences and shopping methods, distribution chain changes, products from competitors and so on. Extra investment may be needed in real-time data services showing sales and marketplace changes. Extra attendance at conferences may be needed. Collaboration with researchers etc.
- Skills are becoming harder to source and become obsolete more quickly. Consider how to retain and retrain staff, and how to train up new people quickly. Consider the remuneration and work flexibility desired by new workforce entrants and older people wanting or needing to stay in the workforce but not prepared to wok as much as in the past.
- Look at Statistics New Zealand sub-national population projections to get a feel for where customer base growth may be strong and where weak. This can guide decisions on locating facilities and targeting markets. Consider the strong growth in cities and how that is where the future workforce will come from – not the countryside which is increasingly reliant on migrants to fill farm jobs.
- How to reduce use of plastics and cut greenhouse gas emissions. How can you prove environmental sustainability to your customers?
- Interest rates look set to remain low. Do you need to pay for specialised interest rate risk management advice?
- Banks are likely to have to hold more capital in coming years and willingness to lend to businesses generally will decline, especially for agricultural operators and commercial property developers. Before planning to grow consider not just what labour resource you can command

going forward, but what level of bank funding will be available. You will likely need to shift toward financing growth through new capital and retained earnings.

- You might be fine, but your vulnerability could be to your product and service suppliers. Their work chain interruptions may cost you dearly in failing to meet your customer requirements and expectations. Maybe consider higher inventories and back-up service providers.
- Margin management has become permanently more difficult. Raise prices where you can, but cut back reliance on low-yielding goods and services, customers and locations.
- Be aware of special political risks which come from selling into China and bias output plans toward other markets.
- The population is aging yet at the same time more migrants are coming in. How are these trends relevant for your products and customer base, and for staffing?
- How vulnerable are your premises to increased inundation risk from global warming in terms not just of physical impacts but asset repricing and insurance availability?

Investors Generally

There has been a structural downward shift in global and local inflation in recent years along with the strength of the linkages between the pace of economic growth, relative shortages of resources, and the resulting upward pressure on prices. This has produced a structural downward shift in the average level of interest rates whether measured by government bond yields, central bank lending and deposit rates, mortgage rates, corporate bond rates etc.

Because of reduced returns on low-risk interest rate products investors have sought other investments. This has pushed up the prices of assets like property and equities and structurally reduced their yields as well.

For investors, the permanent lowering of interest rates has permanently lowered returns on all products. Thus, the starting point for anyone contemplating their investments going forward has to be an explicit acknowledgement that one cannot achieve the same nominal or real returns as in the past – unless one takes on more risk.

And that is the kicker to be wary of. Higher returns have almost always required higher risks. But history shows us that our individual ability to understand the nature, extent, and driving forces behind the higher risks we take on is often much too low. Partly this is explained by the fact that for most of us investing is a stressful activity and our brains want that stress taken away. So, we tend to too quickly latch onto investment products which offer the good returns we want and maybe feel we deserve, without taking the time to properly understand the risks to returns along the way and the capital value and tradability of our investments and how these things can change.

If investors can become aware of this human tendency to skip over the details then greater effort can be out into understanding something before investing in it. And that can mean greater understanding of what is happening if and when returns fall for a while, and that in turn can reduce not just the stress at such times but the risk of panicked selling. This panicked selling is again something driven by our brains trying to avoid stress.

We tend to over-extrapolate the most recent things we see. So, if an asset falls in price our natural inclination is to believe that it will fall in price further. Our focus then shifts away from the long-term plans and expectations we had when we made the investment toward avoiding what we now believe will be further losses. We will crystallise our loss to date in order to avoid future losses.

People like Warren Buffett and skilled fund managers know we think and act like this and they become contrarian buyers – picking up cheapening assets in times of panicked selling because the long-term fundamentals underpinning them may not have changed at all.

So, as investors contemplate what to do with their funds now that low risk returns on assets like bank deposits are so low, and that share prices and many property prices have already structurally adjusted

much higher, they first need to understand their own psychological weaknesses and behaviours regarding investment decisions. Do that and then assess the range of assets on offer in more dispassionate manner.

This publication is written by Tony Alexander, independent economist. You can contact me via LinkedIn or email tonyalexander5@outlook.com, ph. 027 317-5474

This publication has been provided for general information only. Although every effort has been made to ensure this publication is accurate the contents should not be relied upon or used as a basis for entering into any products described in this publication. To the extent that any information or recommendations in this publication constitute financial advice, they do not take into account any person's particular financial situation or goals. We strongly recommend readers seek independent legal/financial advice prior to acting in relation to any of the matters discussed in this publication. No person involved in this publication accepts any liability for any loss or damage whatsoever which may directly or indirectly result from any advice, opinion, information, representation or omission, whether negligent or otherwise, contained in this publication.