RESEARCH

ECONOMY WATCH

3 November 2017

Markets Too Focussed on Downside Risks

- **Slump in confidence does not portend slump in activity**
- **Though growth likely to undershoot RBNZ and Treasury assumptions**
- **Inflationary pressures are building**
- **Corporate profit margins under pressure**
- **Debt programme likely bigger than Government forecasts**

Businesses and financial markets don't like Labour-led Governments. You can make your own judgments as to why this might be so but the evidence is there for all to see. It is perhaps best revealed in the confidence indicators. Take, for example, the ANZ's Business Outlook. This survey clearly shows that businesses overstate the likely strength in activity during the reign of National-led governments and underestimate likely activity under Labour.

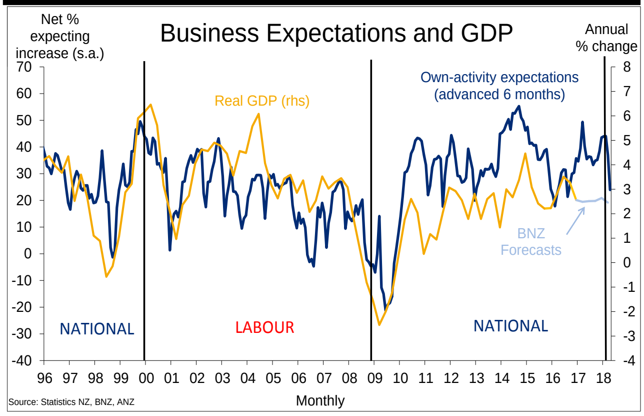
And then there's the currency. You'd be hard-pressed to conclude that it's always weaker under Labour but, equally, you can't ignore the fact that the NZD weakened considerably as the prospect of a Labour government grew.

It is perhaps not surprising that businesses feel more uncomfortable under a Labour-led regime. After all, Labour parties the world over are focused on redistributive policies which often favour the providers of labour over the owners of capital. In this regard, this Labour government is no different particularly with regard to its labour market policy concentration on raising the wages of the lowest paid.

We have thus seen business confidence drop aggressively from a net 44% (seasonally adjusted) expecting an improvement in own-activity in August to just 24% thinking likewise in October. This was the lowest level reported since February 2016. If history is anything to go by, we would expect a further sharp drop when we get the November reading.

Typically, movements in confidence are a good leading indicator of GDP and such a large drop as we are currently in the midst of would have us scurrying to slash our growth, inflation and interest rate forecasts. But, in this case, we will do nothing of the sort. Instead, we will, at least in the first instance, assume that this is the "normal" sort of reset that you would expect when a New Zealand

Helped by inventories and net exports



leadership moves from blue to red. Certainly the shift will have a negative short-term impact on investment and if the current decline developed into a more medium term trend we would reassess but, for the time being, we will remain guardedly optimistic that a combination of current economic momentum and stimulatory economic settings will see us through.

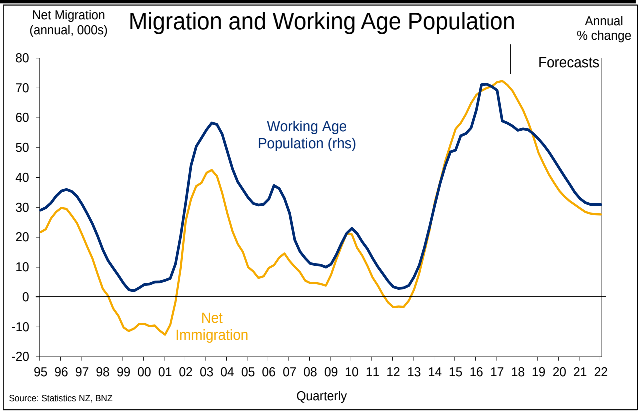
We are not convinced that financial markets understand this New Zealand idiosyncrasy. Already there are those noting the drop in confidence and using it as justification for the RBNZ leaving interest rates on hold forever. We believe this is an inappropriate way to view these shifts in confidence at this juncture.

We also believe investors are making the wrong judgment calls around:

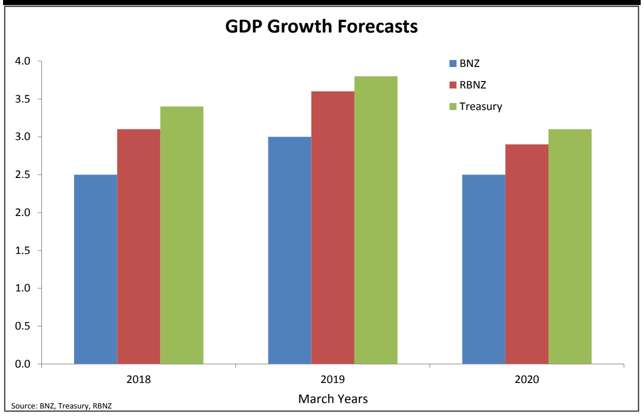
- expectations that the incoming government will change the Reserve Bank Act; and
- that it will slash net immigration.

Many believe changes to the Reserve Bank Act and/or Policy Targets Agreement will mean interest rates will be lower than would otherwise be the case. This is largely due to the fact that an employment target – of sorts – will be included alongside the Reserve Bank's inflation target. Yet there is no evidence to support the conclusion that the Bank would be more dovish under that arrangement. Indeed, from an economic sustainability perspective, the tightening labour market, as evidenced by yesterday's

Migration Eases



Growth Expectations Compared



labour market report, is probably of more concern than are any immediate inflationary pressures.

As for migration . . . yes, it looks very likely that net migration will fall faster than we had built into our forecasts. In part this will be due to Labour's differing migration focus but, actually, recent data have been showing that net migration was coming under pressure of its own accord in part because Kiwis are resuming their offshore pursuits as the rest of the world looks increasingly economically attractive.

Most importantly, you need to look at the impact of migration flows in a supply context not just a demand context. Many see lower migration leading to lower growth, lower inflation, and lower interest rates in the same manner that declining business confidence might. But what we have learnt from the recent migration cycle is that the supply impact outweighed the demand impact on inflation. It was this that initially caught forecasters out as the migration-demand-driven pick up didn't generate the inflation that was anticipated. If the relationship is maintained when net migration falls then it would be reasonable to assume that if the supply side impacts again dominate (via the labour market) then inflation will be higher, not lower, than would otherwise have been the case. It doesn't seem to us that the market is willing to contemplate this scenario.

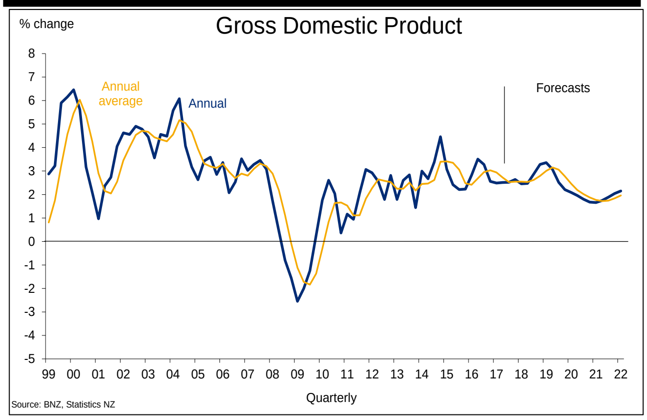
More generally, we have had a go at recasting our forecasts based on the information that we currently have on likely new policies. This should be considered as work in progress and our forecasts will evolve as we get more detail.

As we had anticipated pre-election our major conclusions are:

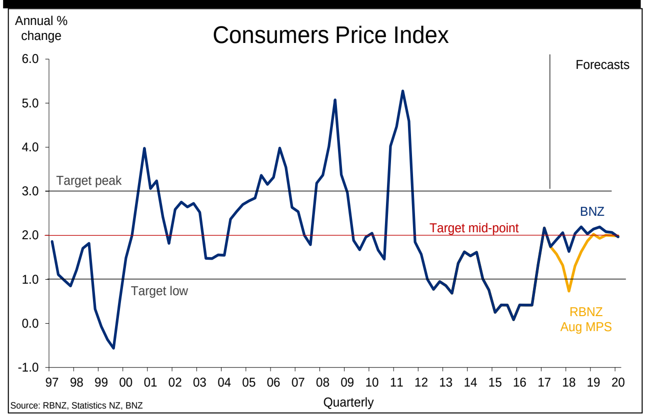
- our growth expectations are largely unchanged though its composition may change;
- inflation is modestly higher;
- government debt will be higher;
- there will be some initial pressure on corporate margins as inputs costs rise.

We are forecasting the economy to expand 2.8% in each of calendar 2018 and calendar 2019. In aggregate this is unchanged from our previous forecast. However, we acknowledge that the pattern of private consumption is changed to the extent that: net migration is expected to be lower; the tax cuts have gone; and changes to Working for Families and other benefit payments are delayed to July 1 from April 1. And while migration and the overall tax/benefit package will reduce the total level of private

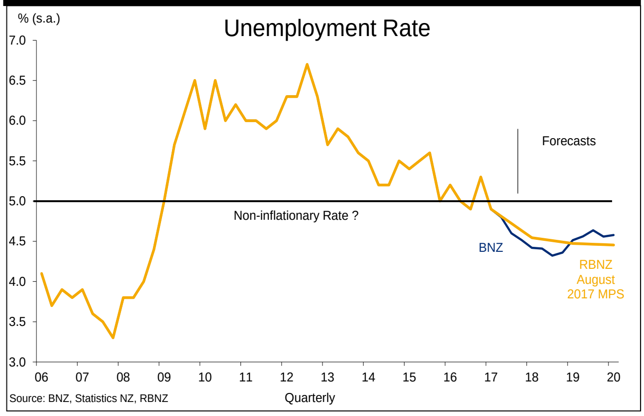
NZ Keeps on Keeping On



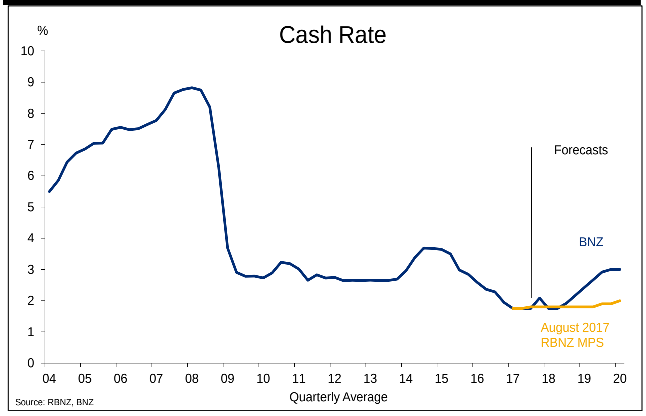
Inflation At Target



Unemployment Slumps



Rates Headed Higher



consumption, the impact of this will probably be offset by higher minimum wages and the more redistributive nature of Labour's policies which will see effective transfers from those with a lower propensity to consume to those with a higher propensity to consume.

Our investment profile has similarly remained broadly unchanged in aggregate. Short term, business investment is hit by uncertainty but resumes normal transmission thereafter albeit with some downside risk. There is some upside risk to housing investment, assuming that the government is able to build the houses that it wants to build, though the increased risk on this front is largely offset by downside from lower population growth. In effect this becomes a switch from household to government investment – a switch that may well be repeated in other areas of capital formation.

We note that our growth forecasts were already well below those of the central bank and Treasury. If we are right, the RBNZ will have to decide whether this is disinflationary (via the demand channel) or inflationary via the supply channel. For the record, the RBNZ's August MPS published GDP track was 3.1% for the year ended March 2018; followed by 3.6% in 2019 and 2.9% in 2020. Our equivalents are 2.5%, 3.0% and 2.5%. Treasury has assumed 3.4%, 3.8% and 3.1% over the same period. If we are correct then there is clearly downside risk to government revenues which will be problematic for the government's expenditure plans.

Our growth forecasts might be unchanged but our inflation forecasts are definitely higher such that we have annual CPI now quickly moving to 2.0% and staying there or thereabouts for the foreseeable future.

We should note that some of the revision is due to the sharp drop we have witnessed in the New Zealand Dollar. This will flow through directly into the CPI over the next eighteen months but will also have lasting indirect impacts to the extent that higher inflation feeds through into higher inflation expectations which, in turn, impacts future inflation.

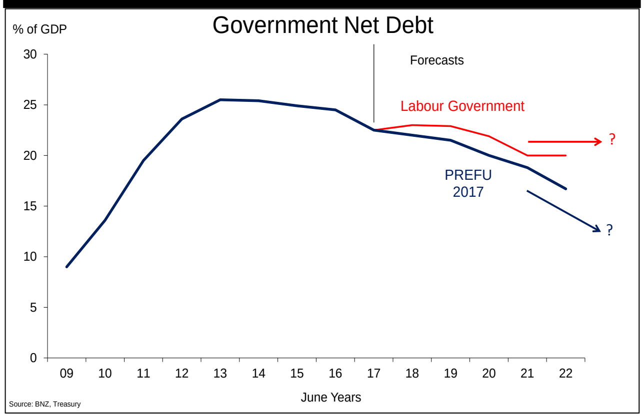
Additionally, we have lowered our unemployment rate forecasts in part due to yesterday's labour market data. This results in upward pressure on labour costs especially when coupled with reduced future labour supply.

But there are also specific policies that will be introduced that will have some impact on future inflation:

- the 26% increase in the minimum wage should push overall labour costs higher;
- increased house building will increase building costs in a capacity constrained industry;

Minimum Wage Impacts

More Debt



- tighter rental property rules will edge rents higher;
- the 10c/l petrol tax for Auckland equates to around a 3c/l average increase across the country which will feed directly into the CPI.

There will be CPI offsets, nonetheless. Free tertiary education will have a big impact. There will be some impact of the provision of free health care for all those under 14 (currently 13) and the annual free doctor's visit for the elderly. There will no doubt also be further super gold card benefits.

Putting all this together, we still see higher inflation despite our below-consensus growth expectations.

We have not changed our interest rate views largely because we already have a RBNZ tightening track that is miles ahead of the RBNZ's stated view and modestly ahead of market. But we are feeling increasingly comfortable with our expectation that the first rate hike is August 2018 followed by a further hike in November.

We also continue to believe that longer dated yields are headed higher and sooner than the cash rate as: expectations for a hike increase; inflationary pressures rise; global interest rates push higher; and the government issues an increasing amount of debt.

For the time being, we will run with Labour's stated bond tender programme which is, over the next four years, $7bn higher than National's forecasts. But we caution that Labour will struggle to keep within the spending framework that it has allowed itself and its revenue is likely to be threatened by economic growth weaker than the Pre-Election Fiscal Update presumed. Accordingly, a bond tender programme substantially higher than suggested appears likely to us. Our broader currency views are also unchanged as we maintain that offshore developments and New Zealand's relative growth prognosis will dominate. Nonetheless, we have had to moderate our currency track to accommodate a lower starting point.

In summary then, we are very strongly of the view that the New Zealand economy will keep on keeping on post the change in government but we cannot stress enough that market participants must be more wary of the inflationary pressures that are developing than the negative confidence impact on activity.

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