24 July 2018

bnz

Economic Expansion Maturing

- **Growth and profitability under pressure**
- **Economic drivers faltering**
- **Uncertainty hampers investment**
- **Capacity issues remain**
- **Inflation and interest rates to rise**

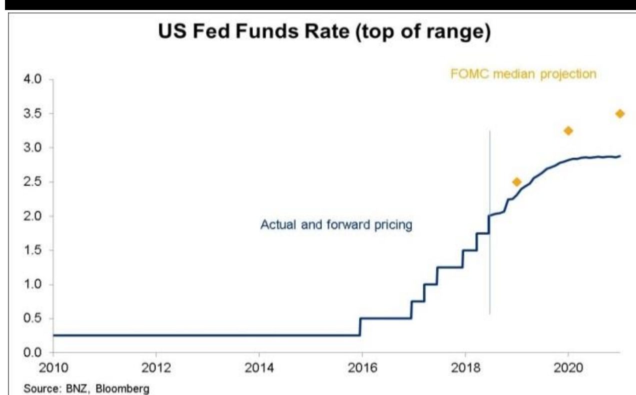
Economic cycles always come to an end. We can say that with certainty. At this stage our central projection is that the current cycle keeps on keeping on but we caution that the expansion is already very mature, cracks are developing and it increasingly feels as if a tipping point is not far away. Importantly, even if our central projection of continued growth proves accurate, the operating environment for businesses and investors alike will be more difficult to navigate.

From a global perspective, the single biggest risk facing New Zealand is not tariff wars, Brexit, increasing Chinese debt or the ongoing political machinations of Europe. All these things are of interest, and do have the potential to cause economic and financial market volatility, but they are unlikely to be cycle-stoppers. In contrast, the prospect of tightening global monetary conditions poses a real threat to both real economic activity and asset prices – the latter already looking fully (or over) valued.

In terms of tightening:

- The Federal Reserve has already raised its cash rate seven times to 2.0%, and another four rate increases are penned in.
- The Canadians have raised rates four times.
- The UK has started its tightening cycle.
- The Europeans are talking about moderating QE.
- The Japanese are moderating QE.
- The Australians have a tightening bias.

Fed Leads The Tightening Cycle



As global monetary conditions become more restrictive, world growth will inexorably slow and with it asset prices correct. No one really knows how this process will play out. But the potential for it to "go wrong" is high.

That said, these are risks rather than our central view. Our central view sees trading partner growth moderate but not collapse. We are looking at weighted trading partner growth of 3.5% per annum over the next five years compared with 3.7% for the last five. Much of this does depend, however, on an improving Australia and Eurozone offsetting the negative impacting of slower, albeit still strong, growth in China.

Trading Partner Growth Moderates

Domestically, all the things that have driven the economic expansion over the last few years are either coming to an end, or moderating in their intensity. This includes:

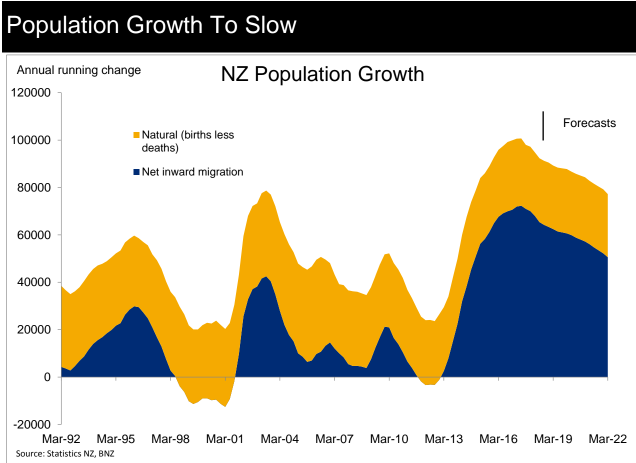
- Net migration
- The terms of trade
- Tourism growth
- Confidence
- House price inflation
- Corporate profitability
- Low interest rates and
- Employment growth

Looking at each of these factors in turn…

Net Migration

In 2016 New Zealand's population growth peaked at 2.2%. Of this 1.6% can be attributed to migration, the other 0.6% was natural population growth. We expect annual

Population Growth To Slow

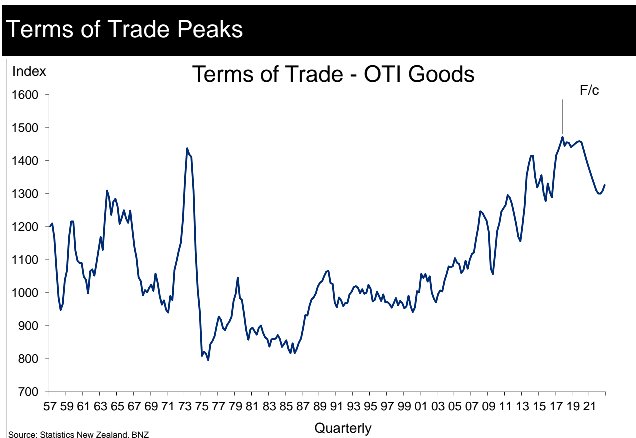


total population growth to fall to 1.5% over the medium term as net migration declines.

The Terms of Trade

New Zealand has benefitted from a spectacular rise in its terms of trade that has had a huge positive impact on New Zealanders' incomes. In the first instance this was brought about by increased commodity returns but over the last decade plummeting import prices, especially for manufactured goods, have been the biggest driver. Looking forward, we believe import prices will start to edge higher while the price of our commodities peaks – largely lead by dairy.

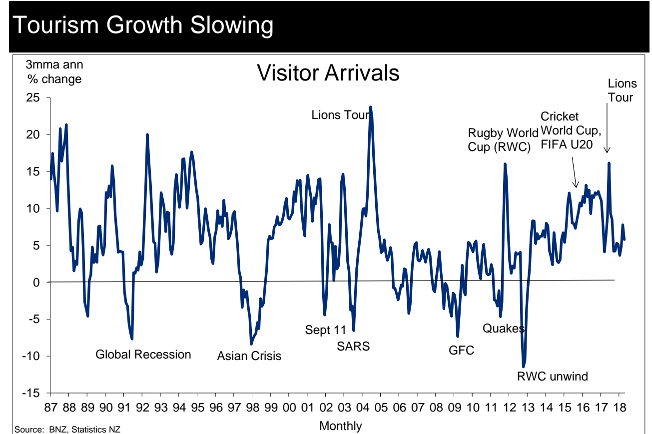
Terms of Trade Peaks



Tourism Growth

Over the last five years tourist inflows have risen almost 8.0% per annum. We think growth of around 5.0% per annum is more likely over the next five years. This is not because demand for New Zealand as a destination will fall but rather because we are capacity constrained in the sector.

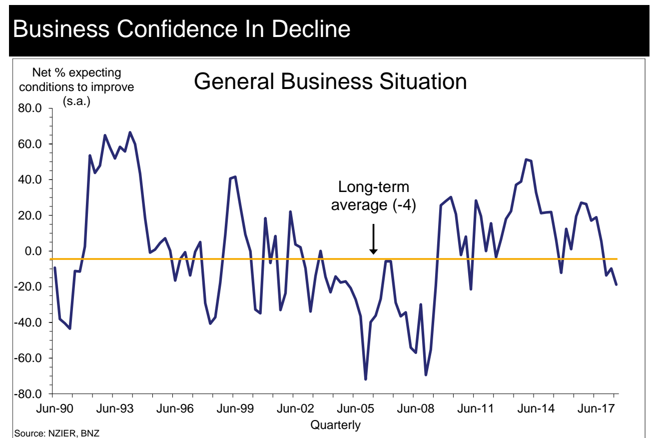
Tourism Growth Slowing



Confidence

Business confidence is under pressure. Businesses are clearly discomforted by a combination of rising input costs and changes to government policy. Indeed, the two are inter-related on many levels when one considers such things as increasing minimum wages, higher petrol costs and the future costs of greening the economy. Depending on what side of the political fence you stand on the drop in confidence might be seen as justified or not. Whatever the truth, confidence drives behaviours and we believe weaker average confidence levels will lead to weaker average investment growth. Total business investment has been expanding at a 5.4% pace over the last five years. We are forecasting just 3.4% over the next five. In order to protect the economy from further downside risk from this source it is imperative that the Government looks to stabilize falling confidence as soon as is practicable.

Business Confidence In Decline

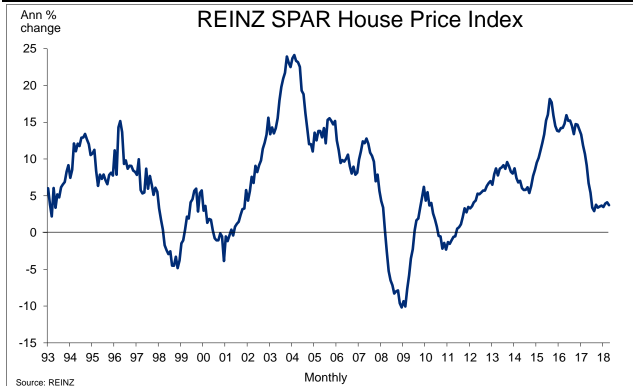


House Price Inflation

Over the last five years house prices have been appreciating around 10% per annum. A substantially reduced pace of appreciation can be expected over the next five years. We are not forecasting a major correction given that excess demand for housing is expected to persist but, equally, significant price increases look

unlikely. Accordingly, the wealth effect on consumption will be lessened in the period ahead.

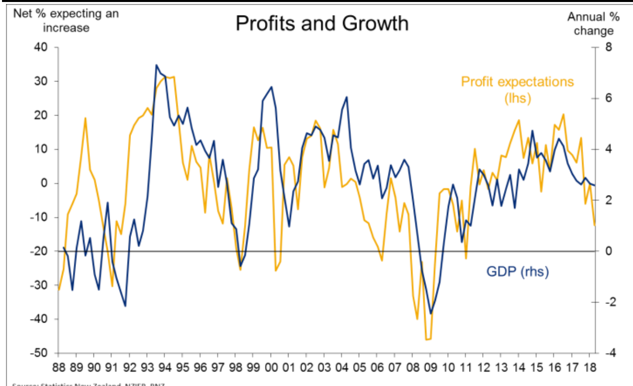
House Price Inflation Slows



Corporate profitability

Corporate profits are under pressure. Demand growth is moderating while input costs are rising. It's hard to see this changing any time soon. Clearly this environment also has negative implications for the listed sector with equity returns likely to be reduced.

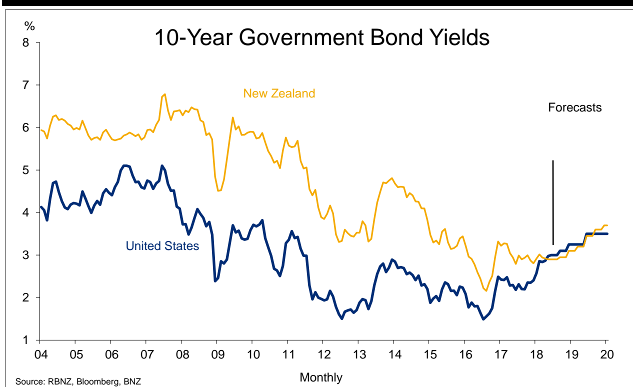
Profit Slump Worrying



Interest rates

Interest rates are, and have been, incredibly low. At best rates will not fall any further. At worst significant upward potential exists.

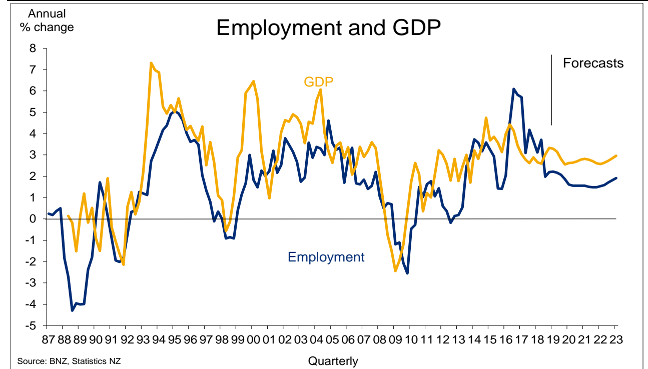
Interest Rates To Rise



Employment growth

Employment growth is likely to moderate. Rising wage costs will dent the desire to hire. But the big stumbling block to further growth will be the lack of an available supply of labour.

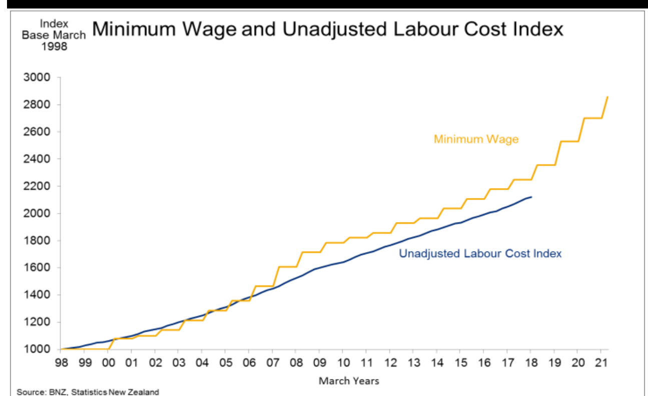
Employment Growth Slows



Over the last five years economic growth averaged 3.2% per annum. Putting all the above together, over the next five we see the pace of growth slowing to average 2.8% per annum. Moreover, we believe the risks are heavily weighted to the downside. Indeed, as the economy's potential growth rate is around the pace of expansion we are forecasting, and the economy is already operating at potential, then the possibility of an upside surprise is very limited.

And herein lies a significant problem. The economy appears to be severely capacity constrained. This constraint is very clear in the labour market where a significant number of businesses are reporting that they can't increase output because labour is in short supply. Consistent with this, the unemployment rate at 4.4% is considered to be below the level that creates broader inflationary pressures. The future supply of labour is limited as net migration declines and tight labour markets across the globe mean the competition for labour increases. The only way for many to hold onto staff is to pay them more. Moreover, there will be significant further upward pressure on wages from the increasing minimum wage and rising wages in the state sector. In theory at least, this should, eventually, put upward pressure on selling prices (namely CPI inflation).

Wage Growth Must Rise

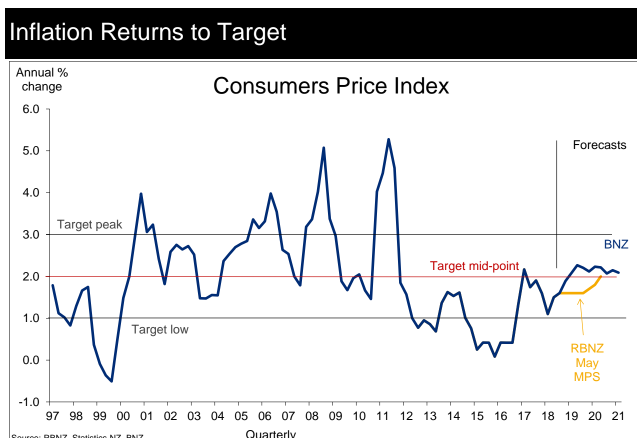


One of the ways to mitigate the inflationary impact of a tighter labour market is to substitute capital for labour but, as already discussed, the increasingly fragile state of business confidence means investment activity is likely to be postponed.

In addition to these factors, we are seeing rising inflationary pressure emanating from increased fuel prices, heightened government (local and central) excise duties, higher global inflation, and a weaker exchange rate.

Consequently, we believe headline inflation will soon move back towards the centre point of the RBNZ's target range. Average CPI inflation for the five years ended December 2017 was just 1.1%. We think it will average 2.0% over the next five year period. While there will be no great urgency for the central bank to raise interest rates, and we do not expect rates will need to be pushed aggressively higher, equally, there is little argument for keeping the cash rate at record low levels.

Inflation Returns to Target



We are forecasting the cash rate to move progressively higher, from mid next year onwards, peaking at 3.0% late 2020. While this may be an overly aggressive forecast we can say with some degree of certainty that the economic impetus driven by falling interest rates over the last decade is unlikely to be repeated and should be, at least, partially reversed.

Note that there is even more upward pressure at the longer end of yield curves as global bond yields push higher. This is particularly so for New Zealand where rates have so far failed to respond to the movement offshore and domestic securities are, effectively, pricing in long term CPI inflation of just 1.4%. Moreover, in New Zealand's case, we think there is now significant risk that bond issuance turns out to be greater than forecast as the Government succumbs to a combination of weaker-than-expected revenue growth, as GDP forecasts fall short of Treasury's expectations, and higher costs, as the electorate demands greater reward for having inserted this Government into power.

While the overall picture is one of heightened risk, in an environment where it will be harder to make a buck, one shouldn't overlook the fact that the New Zealand economy still looks well placed by international comparison.

- Relatively robust growth is still anticipated
- While the fiscal position looks like it will deteriorate the Government's net debt position will still look favourable by comparison barring any major disaster
- The balance sheets of New Zealand banks look sound
- The central bank still has plenty of room to ease in the event that it needed to
- The economy should still be underwritten by
    - Ongoing service sector export expansion
    - Population growth (albeit slower)
    - Investment in infrastructure
    - Favourability as a tourism destination
    - Solid (albeit falling) commodity prices
    - Fiscal stimulus

On balance, then, there still seems good reason for guarded optimism regarding the period ahead. However, businesses have to be prepared for a more difficult and variable operating environment as cost pressures increase and uncertainty rises.

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