26 September 2018

NZ Confidence Consistent With National Income Growth

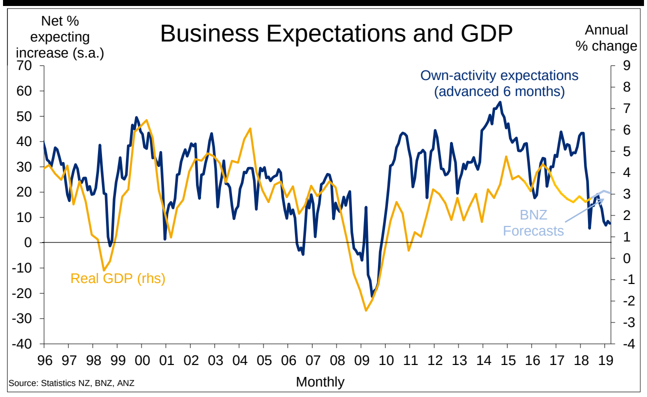
- **Confidence jump over-rated**
- **Seasonal factors at play**
- **Weakness reflects earnings not volume pressure**
- **Inflation target within close reach**
- **No smoking gun for a rate cut**

We are on record as saying that we do not believe the economy will slump in the manner that business sentiment has been suggesting. We have also said that inflationary pressures are likely to be sustained even as growth moderates. On this basis, you would have thought that we would have jumped at today's lift in business confidence and pricing intentions as a validation of our view. To an extent we do but, we have to say, that, at the same time, we are astounded by some of the exaggerated commentary suggesting that rebounding business confidence would remove concerns about the economy.

To start with, there was no rebound in sentiment. Both business confidence and own-activity indicators traditionally jump significantly between their August and September readings. That they did so again should be seen as nothing more than seasonality not a sudden surge in ebullience from the business community. At face value these indicators are still consistent with prospective GDP growth of around 1.75% - well below anything that anyone is forecasting.

Be that as it may, there were positive messages in ANZ's business survey that are worthy of note. Most importantly, going into the release increasing weight was being put on the view that New Zealand business confidence would continue falling. Instead, there was nothing in today's survey to validate that assumption.

Sentiment remains moribund

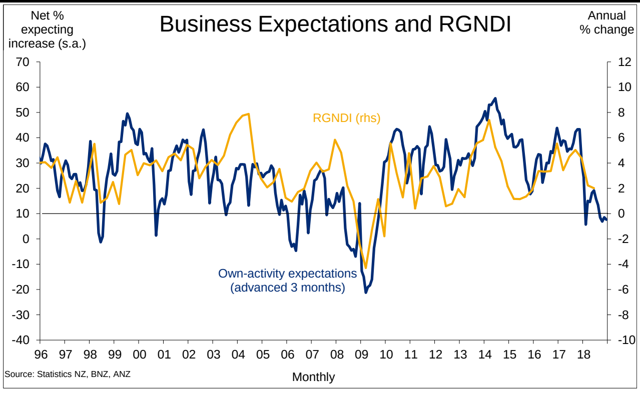


More generally, there's been a lot of confusion as to why business sentiment has plummeted while real GDP growth has been sustained at a solid level. Some are quick to label the negativity as nothing more than political uncertainty coupled with the fact that businesses typically don't like Labour governments. Others believe the confidence slump is a serious warning of an impending deterioration in New Zealand's economic prospects. There is probably an element of truth in both of these interpretations.

At its core, however, we continue to believe the weakness in business sentiment is mostly a reflection of the fact that it is getting harder to make money. This is very much revealed in the continued weakness seen in profit expectations. But corporate earnings can be adversely impacted in two ways: sales volumes can drop or the margin made on each unit of sales can fall. The former will be instantly (and almost one for one) reflected in falling GDP. The latter, however, may eventually feed through to GDP via lower hiring and investment activity, but will tend to have a lesser impact and certainly not an immediate one. This, as far as we are concerned, is the very reason why the gap between sentiment's implication for GDP and actual GDP growth has widened.

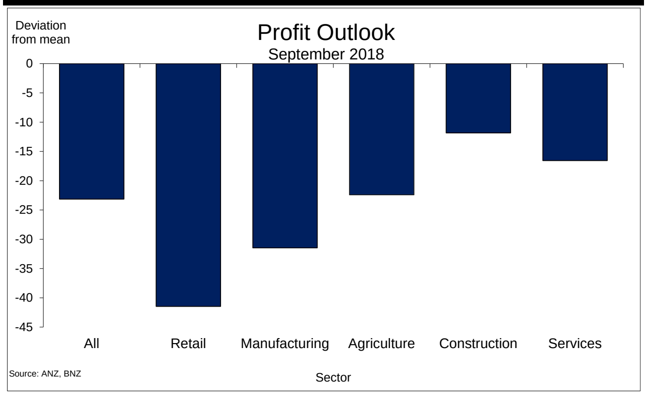
If we look, instead, at measures of national earnings rather than activity then the sentiment indicators become much more aligned with what is going on and what we expect to happen. Statistics New Zealand publishes a Real Gross National Disposable Income (RGNDI) series which includes the relative prices of our exports and imports (the Terms of Trade). If our export prices are rising more than the price of our imports then we, as a nation, are getting better off and our businesses, particularly our exporters, are the recipients of higher earnings. If the reverse holds (import price inflation is greater than export price inflation) then New Zealand and New Zealand businesses come under pressure. This is exactly what is happening at the moment and is being reflected in a drop in RNGDI growth, a likely decline in the terms of trade (think dairy prices down and oil prices up) and a squeeze on corporate margins. This is entirely consistent with what business sentiment is showing us.

Pessimism reflects earnings pressure

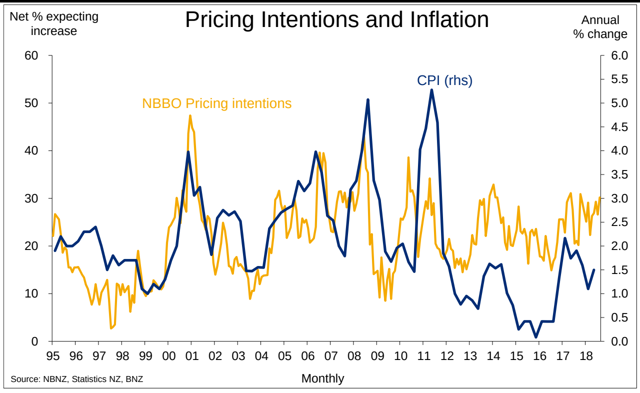


We should note that this morning's trade deficit was a reflection of the very same phenomenon with the nation's trade shortfall widening despite the strength in export volumes as the relative price of exports and imports starts to move in the "wrong" direction. Further weakness is anticipated on this front to the extent that a widening current account deficit is likely to weigh on the NZD.

Profit expectations weak



Inflationary pressures still there



But while earnings and activity might be being pressured to the downside, there was still sufficient evidence in today's business survey to suggest that inflationary pressures remain on the up. Inflation expectations actually fell to 2.12%, their lowest level since April, but pricing intentions rose to 30.2 from 26.6 and remain consistent with headline inflation rising to the mid-point of the RBNZ's target band.

It is highly unlikely that today's survey will influence tomorrow's RBNZ decision, which apart from the fine print will already be done and dusted. However, what we can say is that, while the data was a continuation of the softness seen over the last few months, it was not sufficiently negative to provide the smoking gun for an RBNZ rate cut any time soon, especially when set aside the recently higher-than-expected GDP outturn and the ongoing evidence in the pricing indicators that the Bank's 2.0% inflation target is now within grasping distance.

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