2 October 2018

QSBO Highlights Rising Cost Pressures

- **Business sentiment dips further**
- **Ruffled by government policy concerns**
- **But still consistent with near-trend economic expansion**
- **Labour cost prices cited but not yet seen**
- **Inflation indicators argue for 2.0%+ CPI growth**

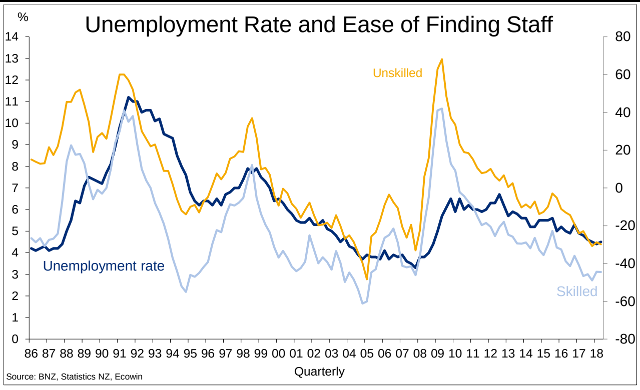
Today's Quarterly Survey of Business Opinion was a lot better than it could have been. Fears were building that business confidence may have been on an unstoppable slide ultimately resulting in much lower GDP growth, a weaker NZD and a cut in the cash rate. Instead, the data seem to suggest that the trough in business expectations might be behind us.

Don't look at the headline confidence number, which has deteriorated further, as this is not a great indicator of anything. Instead, a glance at the forward looking indicators for own activity, employment and investment reveals a picture of relative stability.

The forward-looking own activity indicator does remain weakish (falling, on a seasonally adjusted basis, to +10 from +12) but it is still consistent with economic growth running at around a 2.5% pace. This is much stronger than the ANZ survey, and even our own PMI and PSI data, have intimated. Moreover, with capacity constraints continuing to build, this pace of growth might well be close to the economy's potential growth rate.

PMTE investment intentions similarly remained weak (+4 from +2 a quarter earlier) and are consistent with investment growth tailing off rapidly. Profit expectations imply the same. But the overall picture is no weaker than what is already built into our forecasts.

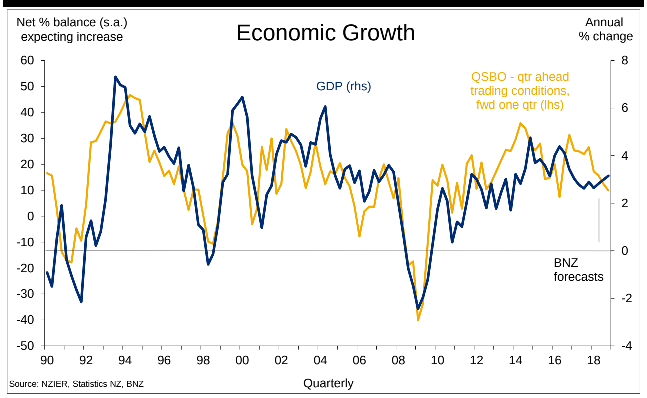
Unemployment To Fall Further



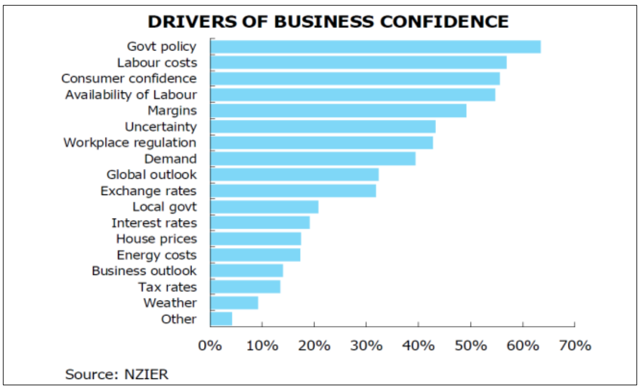
With regard to the labour market, it looks like employment growth in the September quarter might be less than we had anticipated. However, employment intentions rose to +13 from +6 (a twelve month high). This degree of intent suggests we should be revising upward our longer term employment forecasts which would, in turn, imply further downside risk to our already low unemployment rate expectations. This downside risk remains supported by the ongoing difficulty firms are reporting in finding both skilled and unskilled staff.

For us, perhaps the key finding from this survey is the confirmation that the negativity in business sentiment is not being driven primarily by expectations of weakening demand. Rather it is a combination of rising input costs,

Growth Down But Not Out



Labour Costs Feature



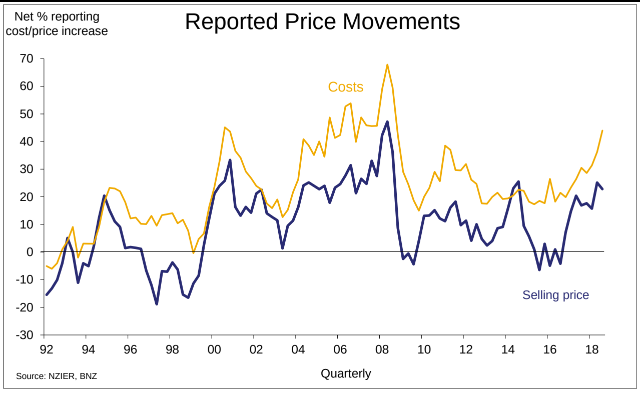
and frustration with both government policy and the inability to find staff, that is putting confidence under pressure. This being the case, one would expect business sentiment to be a less effective indicator of activity than might have been the case in the past.

This quarter NZIER asked businesses a specific question on what was driving their confidence levels. Top of the list was government policy. The second highest reported concern was labour costs. This fits very strongly with the anecdotal evidence that we are receiving. The question thus must be, that if almost 60% of businesses are reporting labour cost issues, why is it that so little wage inflation is being reported in the official data? Will it just appear with a lag (our assumption) or is there something wrong with the way wage growth is being measured?

Whatever the case, we believe wage escalation will ultimately put upward pressure on unit labour costs and, eventually, consumer price inflation. This stands as the main premise behind why we think talk of a rate cut is premature. Slowing growth only results in lower interest rates if it leads to a weakening labour market and lower inflation. While there is substantial evidence of the lower growth story, there is no evidence (at this stage) that the unemployment rate might push above the NAIRU in the foreseeable future or that inflation will languish well below 2.0% for a further extended period of time.

Indeed, from an inflationary perspective, the QSBO not only reported ongoing tightness in the labour market but it also showed that net 44% of businesses reported that

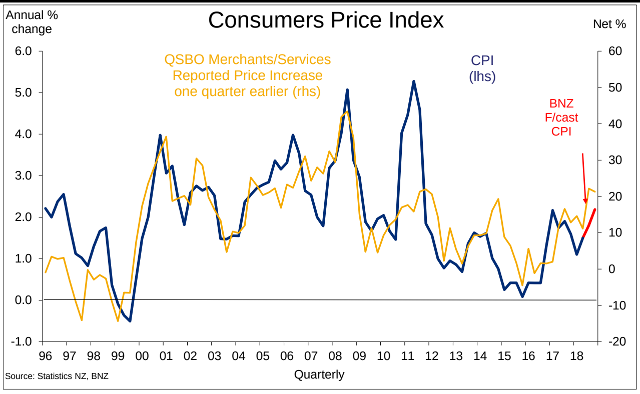
Costs Soaring



costs rose in the quarter. This was the highest reading since September 2008. Businesses cannot accept falling margins forever. Moreover, a net 28% of businesses say that they will be raising selling prices. While this is no different to the readings of the last two years, it is still, nonetheless, consistent with annual CPI inflation headed into the top half of the RBNZ's target band.

We also put together a proxy CPI indicator which is just a combined merchants and services selling price index. This too supports our view that annual CPI inflation will get to 2.0% faster than the RBNZ suggested when it put its last MPS together. Last but not least, the ongoing tightness in CUBO (NZIER's capacity utilization indicator) provides further support for this view.

CPI Inflation Approaches 2.0%



When all is done and dusted, then, we maintain our view that the RBNZ will not be lowering interest rates any time soon. We would not go so far as suggesting they will be tightening either but feel that the possibility of such should not be discounted.

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