31 October 2018

Disconcerting Undertones

- **Business sentiment sub-par**
- **But no longer in decline**
- **Construction misery a surprise**
- **Agriculture malaise expected**
- **Inflation pressures rise further**

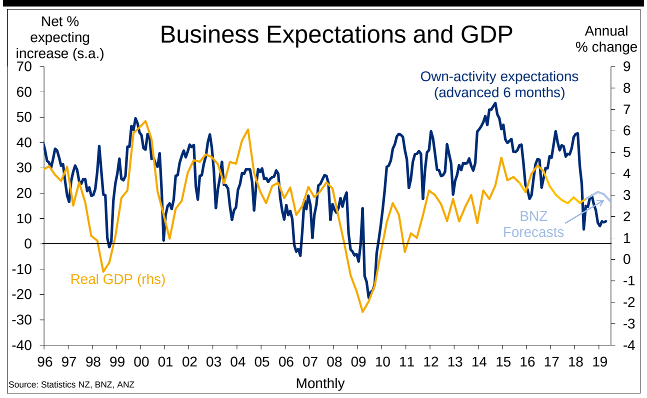
ANZ Bank Business Outlook				
Net balance - next 12 months				
(All sectors)	**October**	**September**	Change	Average
General business outlook	**-37.1**	**-38.3**	1.2	9.3
Own business	**7.4**	**7.8**	-0.4	24.3
Profits	**-15.3**	**-13.4**	-1.9	9.6
Employment	**-0.3**	**-1.3**	1.0	8.5
Investment	**-3.3**	**-9.2**	5.9	13.7
Pricing intentions	**32.2**	**30.2**	2.0	21.3
Inflation expectations	**2.22**	**2.12**	0.10	2.59
Exports	**14.2**	**18.6**	-4.4	29.8
(Own activity outlook)				
Retail	**-7.8**	**-13.3**	5.5	24.6
Manufacturing	**16.2**	**6.8**	9.4	29.0
Agriculture	**-2.3**	**13.9**	-16.2	22.8
Construction	**0.0**	**12.5**	-12.5	19.5
Services	**12.6**	**14.9**	-2.3	30.4

The good news is that the recent slump in business confidence seems to have come to an end. Moreover, any talk that the economy might soon drop into recession can be heartily dismissed by the data. But that's not to say that everything is hunky dory rather that things are not getting any worse. At face value sentiment readings are still consistent with GDP growth dropping to under 2.0%, a level that would likely result in rising unemployment and an increased probability of rate cuts.

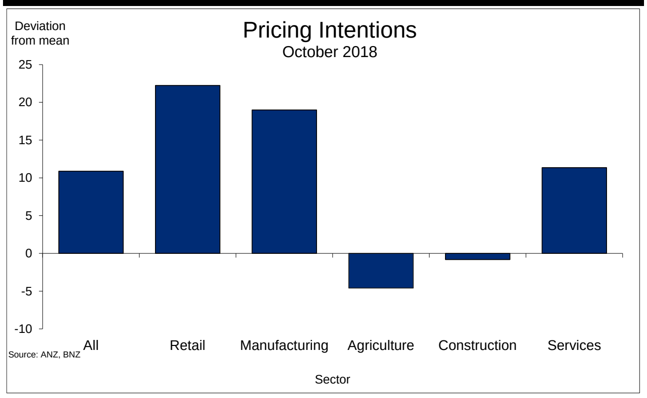
We still do not believe that this will be the case. We continue to see evidence that economic momentum can be sustained at levels which are close to the economy's potential meaning that the labour market will remain tight, price pressures elevated and the chance of a rate cut minimal. Be that as it may, there are a number of nasty undertones in today's ANZ Business Survey.

From a top down perspective, news on profitability continues to look disconcerting across the board. All sectors are reporting profit expectations that are well below sector means. Retail looks particularly ugly. We can only assume this reflects a combination of cost increases (in particular labour costs) and a backdrop of an intensely competitive market, exacerbated by the ongoing intrusion of on-line sales. That said, profit expectations in retail (and manufacturing) did at least improve on month earlier levels).

Down But Not In Descent



Profit Outlook Poor



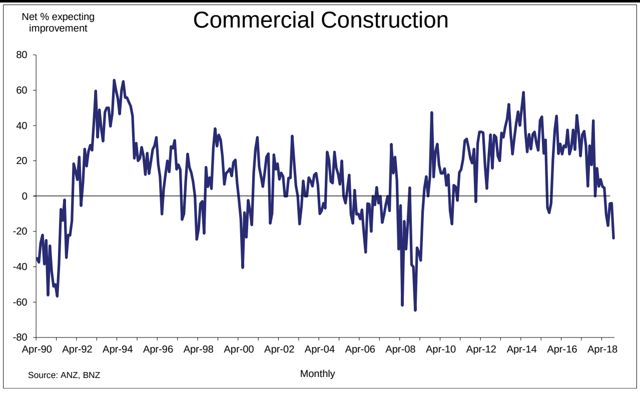
The biggest inter-month slump in profit expectations came for the agriculture and construction sectors. We can only assume that agriculture is getting beaten up by concerns over the growing possibility of a drought, a weakening dairy payout and the approach of substantial environmental cost imposts in addition to cost pressures elsewhere. Whatever the reason, the fact that a net 53.5% of those in the sector are negative about future profits is very worrying but probably not surprising.

What is surprising is the downward trend in just about everything associated with the construction sector. Profits are falling, the own-activity indicator is trending towards levels approaching the post-GFC period, employment intentions are weak and even pricing intentions are softening. In addition, residential construction expectations are on a downward trend and commercial expectations are downright negative. Our GDP growth forecasts are quite dependent on the construction sector continuing to expand, albeit at a moderating pace. Today's data build on trends that suggest this might be unlikely. Accordingly, we will have to keep a very close eye on this component of our forecasts with a view to a possible downgrade.

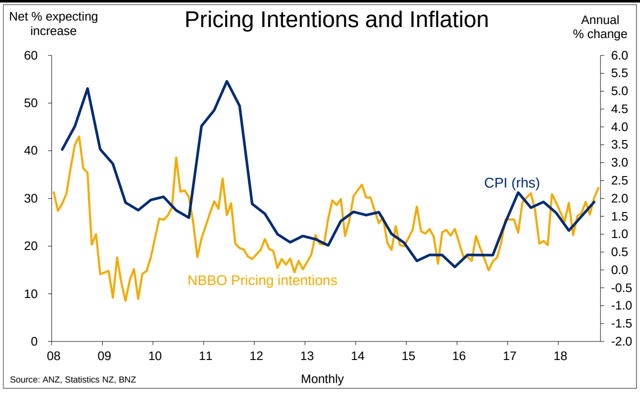
We'd have thought much of the negativity in the sector would be attributable to the frustrations around capacity constraints. We still think this is the case but have to concede that this assumption is inconsistent with declining selling price expectations.

While construction sector price intentions might be declining the same can't be said about the remainder of the economy. In aggregate a net 32.2% of respondents to the survey said they intended raising prices. This is consistent with annual CPI inflation pushing through 2.0%.

Construction Expectations Weakening



Higher Inflation Foretold



It was also the highest reading since February 2014 when intentions temporarily jumped to 32.2%. Prior to that you have to go back to September 2008 to get a higher reading. Importantly, retail pricing intentions jumped to 49.0% and are well above average.

Putting all this together there was enough in today's data to support our view that the New Zealand economy will hang together despite the headwinds that it is facing. But there is gathering evidence that those headwinds are blowing relatively strongly and, in some cases, from unexpected directions. This will leave us pondering the prospect that the wheels might fall off, particularly were we to be hit by either some form of external shock or a very dry summer. Nonetheless, now is not the time for the RBNZ to react to those risks by cutting interest rates, particularly at a time when pricing data suggest a diametrically opposite course of action.

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