11 May 2022

Recession Bells Are Tolling

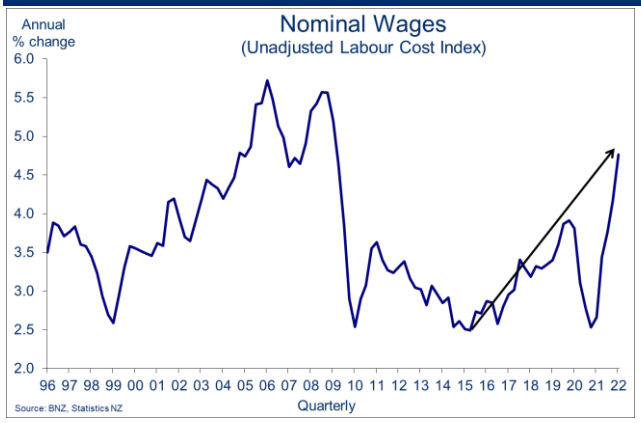
- **Synchronised global tightening portends weak outlook**
- **Big hit needed to bring unemployment and inflation to target**
- **Asset price correction already under way**
- **So much smells of 2008**
- **But pain should be moderated**

The chances of the New Zealand economy moving into recession are rising by the day. New Zealand's economic "imbalances" continue to be exposed at a time when the global economy is increasingly coming under duress. The policy measures taken to "fix" these issues are getting more and more aggressive. The chance of a soft landing is fading.

The fundamental issue we face is that the economy has suffered a series of massive supply shocks. Domestically, the biggest impact has been felt via the labour market. Those suffering with COVID and\or isolating have left businesses short-staffed and needing to employ swathes of temporary staff. This is costly and, eventually shows up in selling prices. As if this wasn't bad enough, closed borders imposed an additional constraint on the supply of labour. And don't forget labour was already in short supply pre-Covid. Consequently, not only have businesses been forced to take on more labour to cover shortages but they have also had to compete, via rising salaries, for the diminished pool of labour which remains available to draw on.

The labour market has, thus, provided a major general inflationary pulse for the economy. But labour supply constraints have not been limited to New Zealand. Many of the same issues are being faced across the planet meaning the cost of imported goods is also rising.

Wages jump

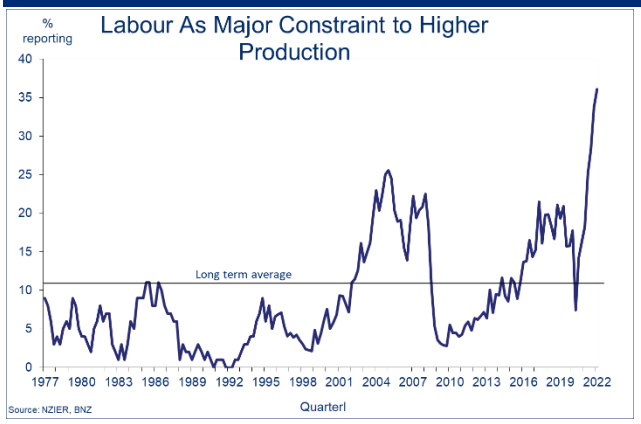


And, in New Zealand's case, the freezing of international supply chains has further reduced the capacity of the economy to produce goods and inflated prices as an auction market for goods in short supply develops.

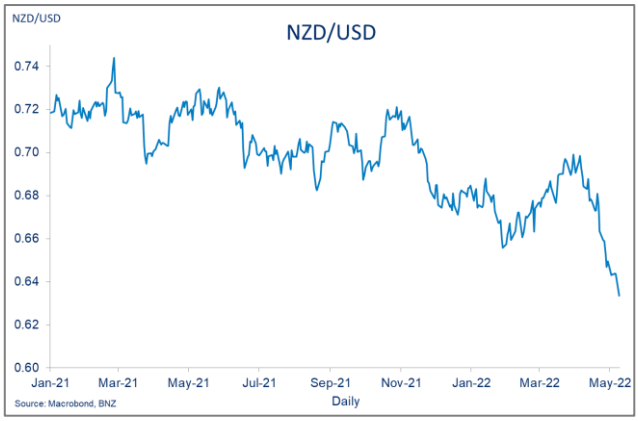
As if all this wasn't terrible enough: the Russians decided to invade Ukraine, and the Chinese decided to impose one of the most severe lockdowns seen on the planet. The former added to supply chain issues and resulted in massive upward pressure on energy prices, food, fertiliser and some base metals costs, amongst other things. The later simply dropped demand further.

To cap things off, more recently, the New Zealand dollar has fallen sharply pushing up tradables goods prices even further.

Labour constrains production



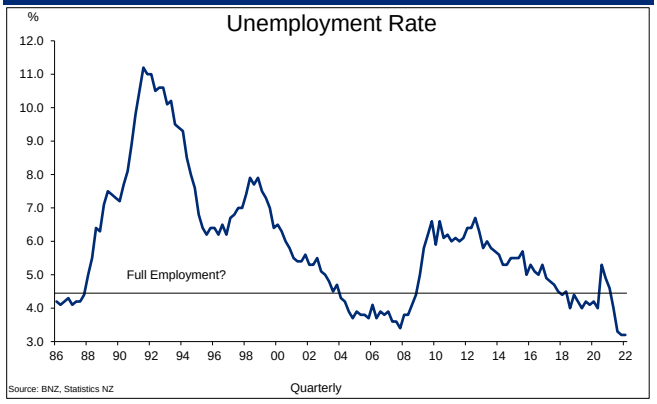
NZD in decline



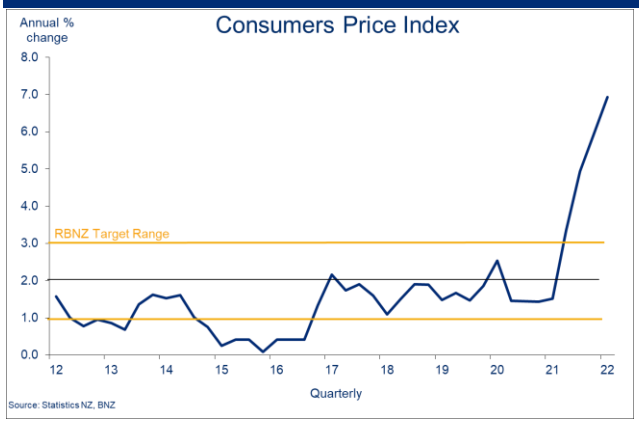
And, yet while supply was poleaxed, a combination of government support, ultra-low interest rates, effective Covid containment policy and the remarkably resilient New Zealander kept demand far loftier than any of us ever imagined.

The result of all this is that demand is exceeding supply, the unemployment rate has plummeted to levels that are seen as being well and truly inconsistent with maximum sustainable employment and CPI inflation has climbed to thirty-year highs.

Not maximum sustainable employment



Not acceptable inflation



There is only one way that this "disequilibrium" can be solved. A process will have to be found that equilibrates supply with demand.

It is difficult to see a quick resolution to supply side constraints. The Government can help at the margin with appropriate labour market settings to encourage folk into the work force and provide flexibility for employers and businesses alike. It can also do its bit to facilitate the hiring of offshore labour where and when deemed appropriate. The "right" Covid settings can also help ease some pressure points.

This is all well and good but it's hard to see how any of this can dent the excess demand for labour sufficiently to put the labour market back into balance.

This means the RBNZ is faced with doing the majority of the heavy lifting. But with inflation and the unemployment rate so far from their respective targets, and supply unlikely to lift markedly in the near term, the only available option is to crush demand to meet the new levels of supply.

From the RBNZ's perspective, this means getting CPI inflation down from an expected annual peak of around 7.0% in the June quarter of 2022 back to near 2.0% and seeing the unemployment rate rise from its current low of 3.2% to something of the order of 4.5%. Realistically there are only three ways that this can play out:

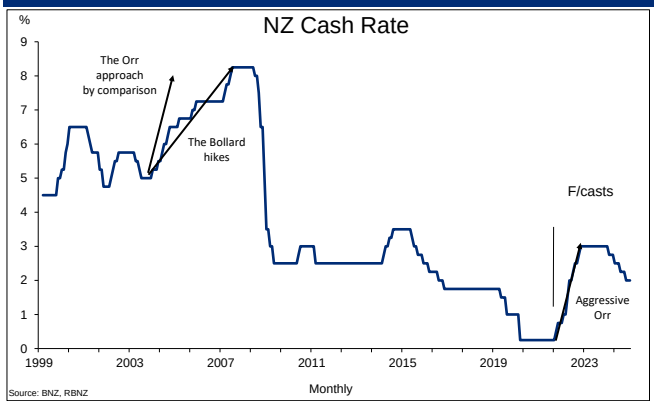
- There is a sudden positive supply response both domestically and internationally;
- The economy goes through a relatively protracted period of low growth;
- The economy goes into recession.

We accept that supply conditions will start to improve. Already, fewer people are isolating because of Covid, border controls are being reduced and global supply chains are starting to ease. But there is a very long way to go.

Our central forecast, currently, is that New Zealand's growth stalls completely in 2023. The danger is that the wheels well and truly fall off.

Kick-starting the softening, the RBNZ has already begun what we expect to be an extensive tightening cycle. The New Zealand cash rate has so far been hiked by 125 basis points taking it from 0.25% to 1.50%. But we are less than half way through the process. We are expecting a further 50 point increase at the May 25 Monetary Policy Statement followed by a series of rate increases until such time that the cash rate reaches somewhere between 3.00% and 3.50%. This will represent the steepest increase in the cash rate since the Reserve Bank began inflation targeting, and its magnitude will come close to matching the Bollard era tightening cycle which ultimately ended in the 2008/2009 recession, albeit that it wasn't just interest rates that generated that recession.

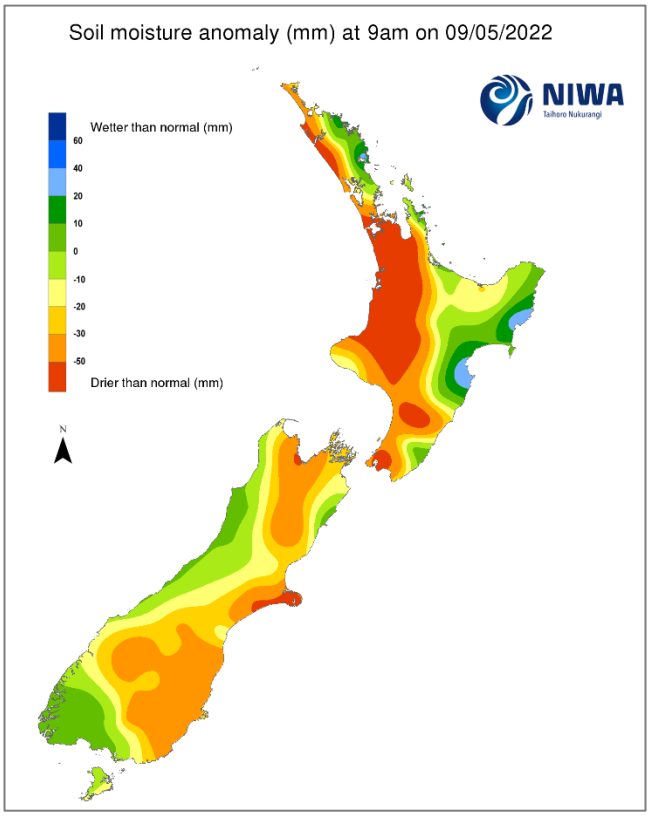
Aggressive tightening



Many associate the 2008/09 recession with the GFC (Global Financial Crisis) but, actually, NZ was headed well into its downturn before the term GFC had passed anyone's lips. In the words of the RBNZ: "The international financial crisis actually played little role in the early part of New Zealand's economic recession. Rather it was drought, falling house prices and high petrol prices that dragged New Zealand GDP growth negative over the first three quarters of 2008". And, of course, the hike in interest rates!

There's not much talk of drought at the moment but, the truth is, much of the country is being impacted by severe water shortages. And, ironically, some of the country that is not in shortfall is being hampered by too much water, such as Gisborne and parts of the Hawkes Bay. In general, there is strong evidence that agriculture production has been adversely impacted by weather conditions and there is a growing fear there is more bad news to come especially given the possibility of La Nina hanging around for a while longer.

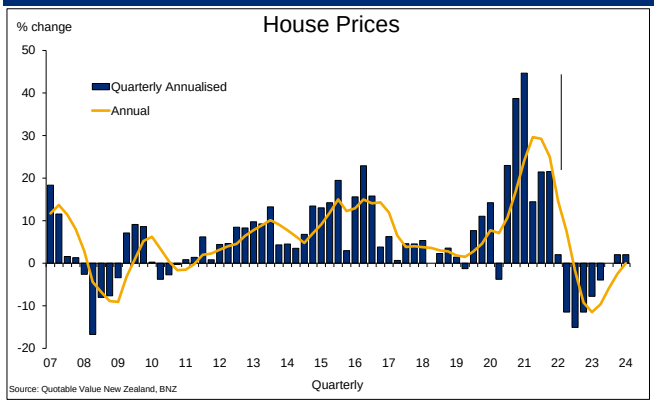
Weather not being kind



What we do have, though, is falling houses prices. And that is most definitely going to get worse. The REINZ's Stratified House Price Index is already down 4.2% from its peak. And the consensus view is that prices will eventually correct between 10 and 15%. The risk is that they go even further than this. In 2008 the peak to trough house price decline was 10.9%.

Falling house prices constrain household spending via the wealth effect. Spending on big ticket and discretionary items normally take the biggest hit. This at a time when increased spending by New Zealanders offshore will also constrain domestic spending.

House prices going down

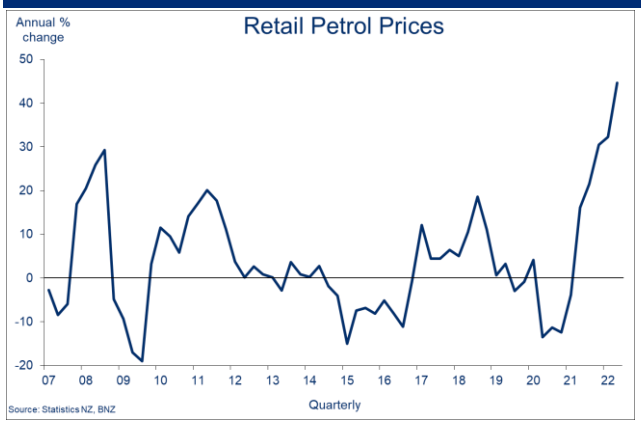


Of course, it's not just house prices that are under pressure, equities are in retreat too. The NZX50 has now declined a cumulative 19.0% from its peak.

Equities under pressure

And then there's petrol prices. So far pump petrol prices have risen 45% over the last twelve months. Without the government's excise tax cut the increase would be more like 55%. Back in 2008 the peak in petrol price inflation was around 30% (although prices had risen by a similar amount two years prior).

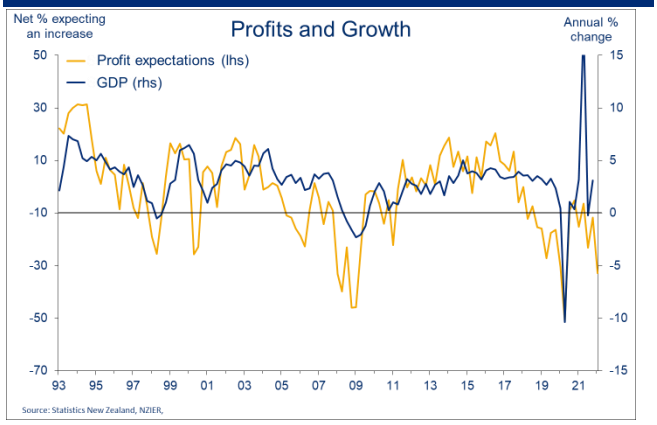
Petrol goes bonkers



So it's all looking strangely familiar!

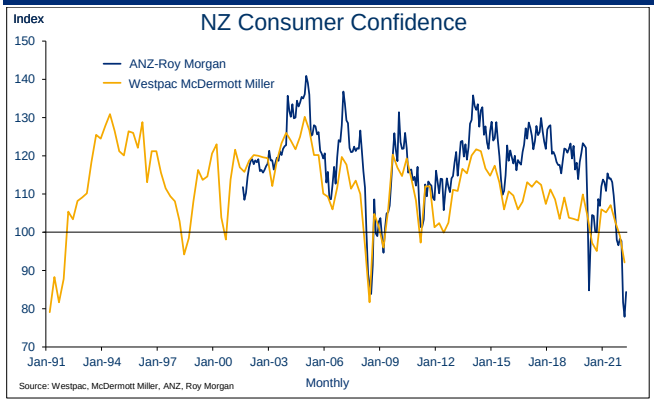
Also familiar is the role the corporate sector plays in driving economic outcomes. One of the most useful indicators of this is corporate profit expectations. According to the NZIER, a net 33% of QSBO survey respondents say they expect profits to fall. When profits are falling businesses cut investment spending and consider reducing staff. Current profit expectations are currently very much consistent with an impending recession. And guess what? In March 2008 the QSBO profit reading was exactly the same number.

Profit fall disconcerting



To cap off the domestic data, consumer confidence has plummeted and is now consistent with an economy going backwards.

Consumer confidence plummets



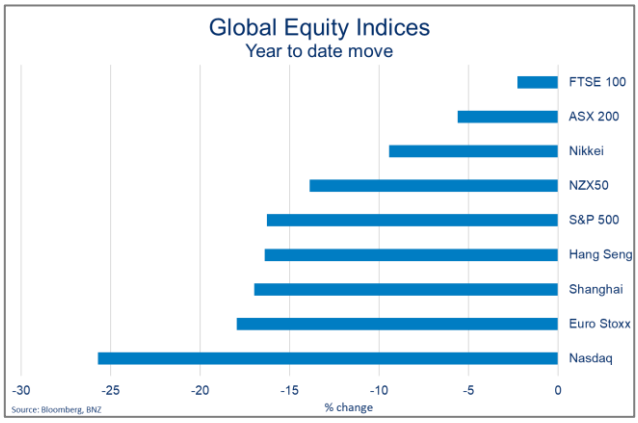
Some of the above factors are being directly impacted by developments offshore. Alas, more generally, the offshore situation will also continue to weigh heavily on New Zealand. Broadly speaking: offshore demand growth is likely to start softening; international supply shocks will remain prevalent; and rising offshore interest rates will influence New Zealand rates.

The specific regional issues are obvious. The Russia/Ukraine situation will have implications for many years to come. Chinese demand will be suppressed for some time, whether or not Covid restrictions are maintained in their current form.

What will be less obvious to some is that most of the developed world is now in the midst of what appears to be a synchronised tightening cycle. When this happens it inevitably leads to a contemporaneous slowing of the economic cycle. The consensus view is that global growth is, indeed, moderating and that that it will ease further. When any slowdown does become synchronised, we tend to underestimate the feedback loops that occur between trading partners, which usually means growth ends up being lower than anticipated. New Zealand is highly leveraged to global growth so this will weigh on our future prospects and, in particular, has negative implications for our commodity prices. This may well already be showing up in the declines being seen in the Global Dairy Trade auctions.

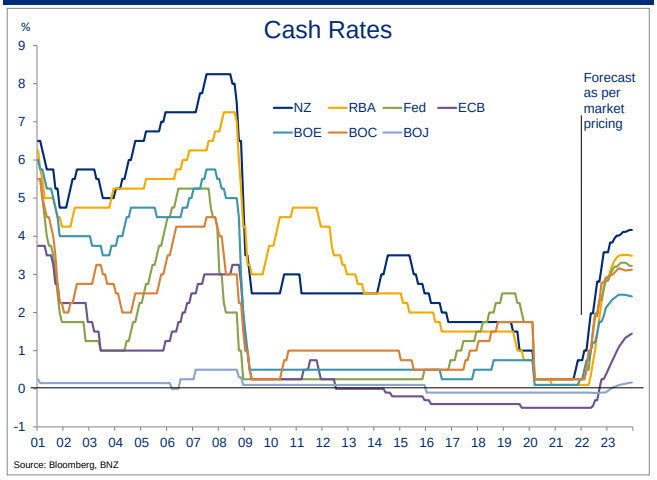
In terms of synchronicity asset markets are already correcting. Both equity and bond prices are in retreat.

Global equities in retreat



The last time we had a move in international rates similar to what markets now suggest was, again, 2008.

Cash rates headed much higher



So, whichever way you look at it, the planets are aligning in such a way that a recession seems difficult to avoid.

We should note, that when we talk the possibility of recession, we are referring to some time in 2023 when the

full impact of rate increases and falling asset prices hits home. In stark contrast, we are expecting strong expansion in GDP in the second and third quarters of this year (following a flat Q1) as the emergence from the tightest of the Omicron settings boosts the economy. Yesterday's 7.0% surge in electronic card transactions for the month of April is symptomatic of this resurgence in activity.

And when/if the recession does eventually arrive, we are quick to point out that there are a number of factors, this time around, that should moderate the pain that might be felt. In short:

- There is such a strong excess demand for labour in New Zealand currently that the first stage in any economic softening will simply ameliorate the excesses rather than drive the unemployment rate higher.
- Hopefully, an increased supply of offshore labour, albeit modest, will mean that some of the increase in the unemployment rate is more to do with an inability to absorb supply rather than wholesale layoffs.
- The peak in the unemployment rate should be lower than in previous recessions.
- The government's coffers are in decent nick so extra fiscal spending can come to the rescue if things begin to look dire.
- While there will be fallout from falling house prices, such declines will help make housing more affordable.
- The banking sector is well capitalised so the risk of a financial meltdown is very low.
- New Zealand will benefit from a pick up in tourism as international travel accelerates.
- The emergence from all that Covid-19 has thrown at us will provide some tail wind to the economy.

There is, of course, the chance a recession does not eventuate but we think, given the way the world is evolving, households and businesses would do best adopting a prepare for the worst, hope for the best strategy. Whatever the outcome, we can say with some certainty that growth can only be moderate at best. If demand constraints don't put a cap on the expansion then supply constraints definitely will.

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