Research
Economy Watch

3 June 2025

Retail outlook on a knife edge

- **Lower interest rates boost spending**
- **So too do more people**
- **But the labour market is weak**
- **Margins are under pressure**
- **And we're a long way from normality**

When economic cycles turn they invariably develop a self-fulfilling momentum that generates shifts in activity much greater than inherently conservative forecasters might contemplate. Until Master Trump arrived on the scene, we were developing growing confidence that we were at the start of a sustainable economic recovery. Now we are less certain.

For GDP growth to truly gather pace consumer spending simply has to accelerate. After all, private consumption represents almost 60% of expenditure-based GDP. The good news is that the building blocks for an upturn are still in place, so we cling to the hope that a recovery in economic activity can progress. The question is how long this can remain the case in the face of current heightened uncertainty.

With all this in mind we thought we should set out some of the key factors we are considering that will impact our views on retail spending while trying to navigate our way through currently very choppy waters.

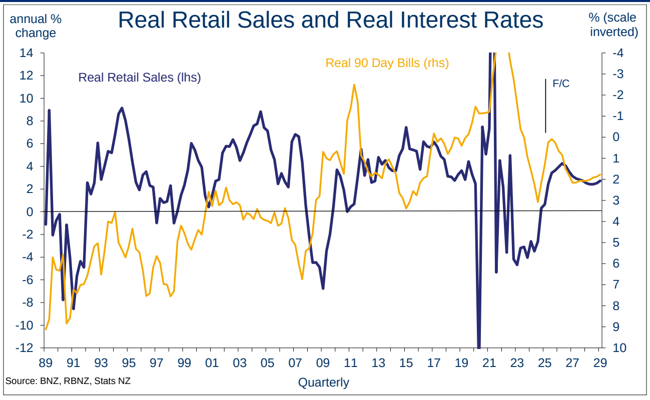
No one factor dominates at every point in time. And the positive impacts of some can be offset by negative contributions from others generating a veritable tug of war. Indeed, that's the situation we now find ourselves in.

First up, history shows us that lower interest rates are a key driver of consumer spending via numerous channels:

- Lower interest rates free up cash flow for those with mortgages who, typically, have a higher marginal propensity to consume.
- Lower rates make it easier to take on more debt for big ticket purchases.
- Lower rates support asset prices delivering a positive wealth effect.
- Lower rates encourage housing market turnover and new residential building both of which generate higher spending.
- Lower rates stimulate economic activity, generally, creating more jobs.

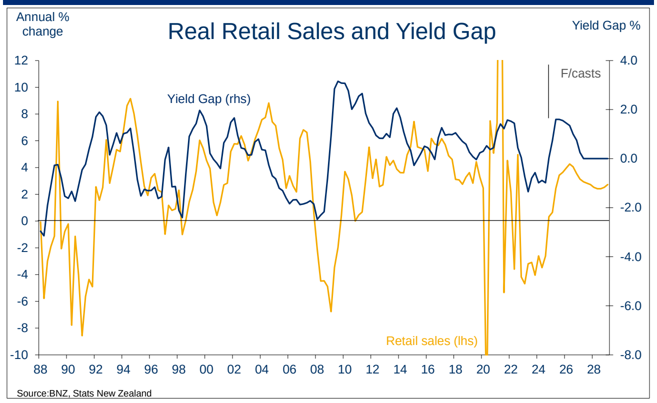
It is clear changes in the level of interest rates are correlated with retail sales. The absolute level of rates seems less relevant than the direction of travel. Already households are benefitting from falling mortgage interest rates, and with a substantial proportion of mortgages rolling over in the next twelve months, there is much greater benefit to come.

Lower rates, higher spending



Another way of looking at this dynamic is the relationship between the yield gap (90 day rates – 10 year bond rates), which is also strongly correlated.

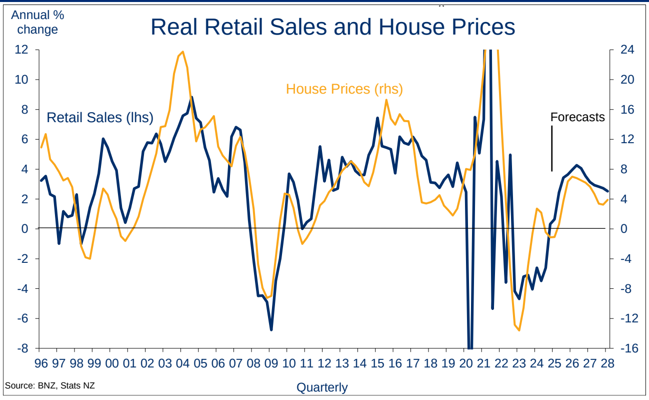
Yield curve also relevant



The impact of interest rates on the housing market can have a huge impact on retail spending. The relationship between changes in mortgage rates and house sales is strong. When people move residence they tend to buy new furniture for the new place bolstering the sale of durable items.

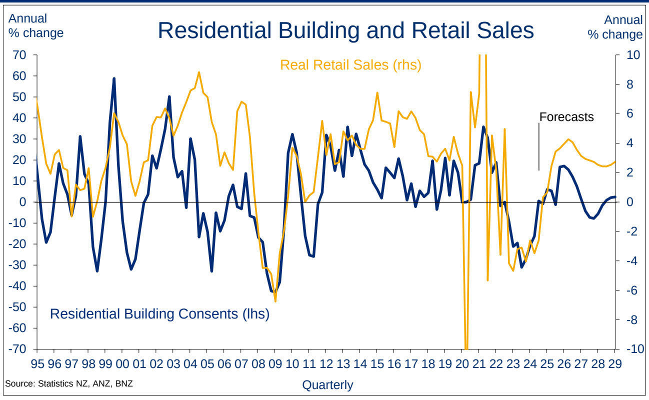
Additionally, rising sales are associated with rising house prices. The wealth effect of this, in combination with the increased turnover can have a dramatic impact on retail sales. There is no doubt in our minds that the apparent turning point for house sales has had a marked impact on initially stopping house prices from falling and, more recently, seeing house prices beginning to edge higher.

House price turn very important



Not surprisingly, when housing markets tighten residential construction usually finds some strength, which again bolsters spending on durables' items.

Residential construction matters

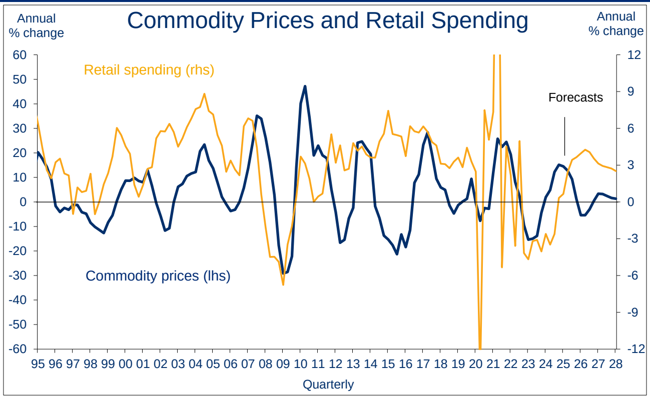


Be that as it may, residential dwelling approvals are currently very weak, and we struggle to see much momentum developing any time soon especially given the supply of houses currently available for sale and the high relative cost of construction.

In summary, we do believe developments in the broader housing market are, and will continue to, provide some support to retail spending in the year(s) ahead.

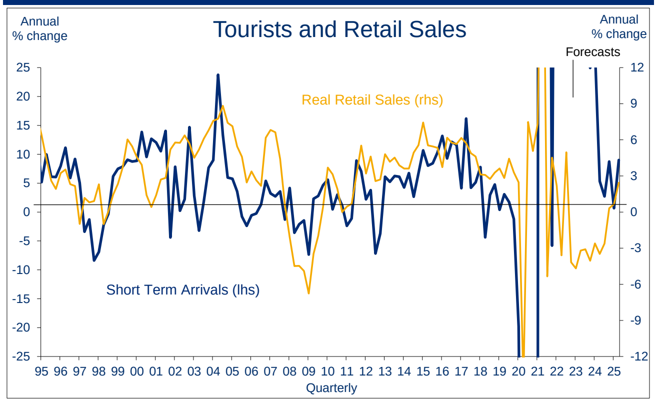
Clearly income is a strong driver of retail spending. Income takes many forms with wages and salaries being the most obvious. Another important source of income, however, is that earnt by the primary sector. This is strongly driven by commodity prices. With New Zealand commodity prices currently soaring, the impact of this is most definitely being felt in rural New Zealand. And it is no coincidence that retail spending growth in the South Island is stronger than in the more urbanised North Island.

Commodity prices support the south



The other supporter of the South and, of New Zealand more generally, is the tourism sector. The pickup in short term visitors, albeit modest and tenuous, has provided a fillip to retail spending. For the record, this spending should appear in the exports of services, rather than in private consumption when it enters the national accounts.

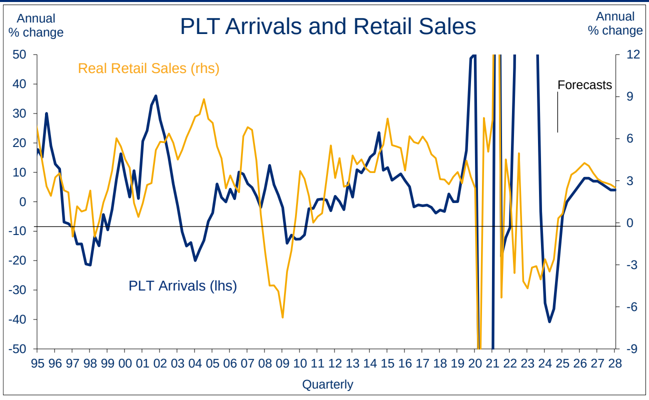
Tourists do their bit



Not surprisingly, the more people there are in the country the higher spending will be. Tourism plays its part as does general population growth. The latter had been under significant downward pressure when closed borders prevented migration inflows and then, more recently, border opening resulted in pent up demand being revealed for the traditional Kiwi OE. The OE outflows were then exacerbated by the relative outperformance of the Australian economy.

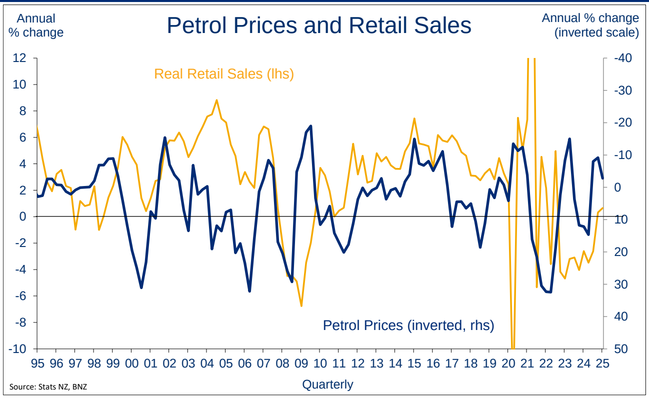
Net migration is now turning the corner, albeit slowly. This will be retail positive. In particular, there is a decent correlation between permanent and long term arrivals (PLT) and real retail sales.

Migration turns the corner



Another factor giving spending a nudge is the current weakness in global oil prices. Petrol is a relatively price inelastic good. So when prices rise/fall consumers' effective disposable income (to spend on other goods and services) falls/rises.

Petrol relief

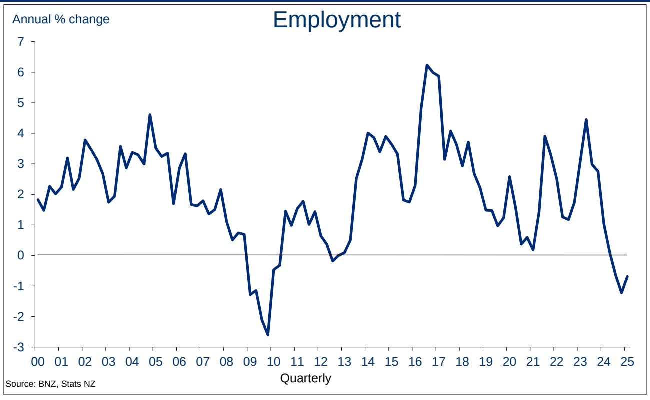


On the flip side, we have no doubt increases in local authority rates and insurance costs are having a significant negative impact on the disposable incomes of home owners whose interest rate cash flow relief is being gobbled up by these other non-avoidable factors.

To get sustained spending growth it is imperative that real disposable incomes begin to rise. We've already noted the boost to such from farm earnings, but wider income growth is also necessary. Eventually, this may be forthcoming but any general expansion in the compensation of employees is currently suppressed.

Most importantly, employment is still broadly contracting. 3,000 people entered the ranks of the employed in the March quarter but this followed a 36,000 loss over the previous twelve months. Any material growth in the June quarter looks increasingly unlikely, especially following the release of the soft April employment indicators. And, even with our relatively optimistic forecasts, we wouldn't expect employment levels to return to their previous peak until early next year. The balance of risk is that it takes even longer.

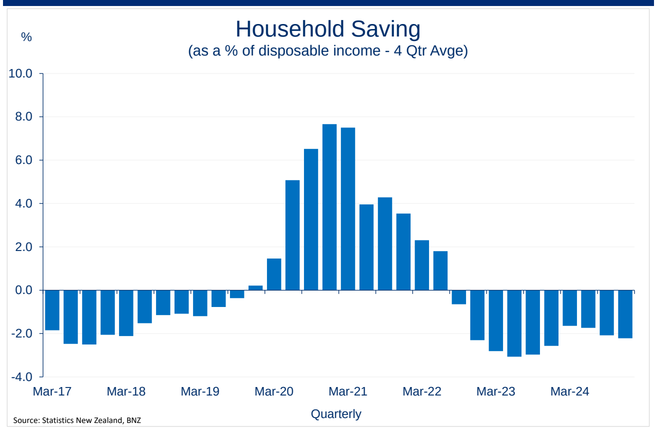
Employment negative



Real average weekly earnings are still rising, albeit at a moderating rate, but not sufficiently to keep aggregate income growth positive. It will take a sustained pickup in economic growth to see meaningful income growth return.

We are also worried about what is happening to household savings. National accounts data suggest consumers are funding their current spending out of saving and the significant pool of savings that was built up during "the COVID era" is being running down rapidly. In the two years ended December 2021 households accumulated $22.2 bn of savings. By the end of 2024 this had been reduced by $16.0 bn. While the absolute numbers should be treated with caution, the direction of travel is clear and important. In particular, the trend is probably not sustainable. At the very least the run down in savings that has occurred is unlikely to be repeated so will be a headwind to future spending.

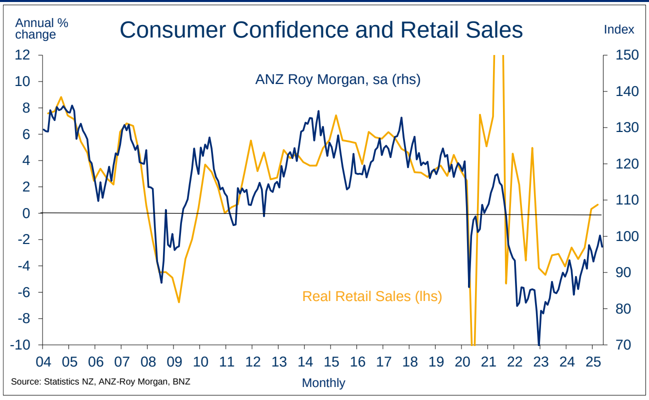
Household savings depleted



The other headwind to spending is the lack of confidence that prevails in the household sector. Confidence is trending higher but the level remains very low. Miserable people do not spend. As things stand the pace of spending is far higher than confidence would suggest should be the case. If history is to be repeated, confidence readings need to get up to around the 110 level to be consistent with the sort of expenditure growth we are currently forecasting.

This is well above both the latest Westpac McDermott Miller 89.2 reading and ANZ's 92.9.

Misery reigns



So where does this all leave us?

First up, we have been surprised by the strength in retail spending over the six months ended March 2025. Real sales over this period rose 1.8%, much faster than the average pace. Yet it certainly doesn't feel like conditions are better than normal.

But perhaps the increase shouldn't be a surprise as it might simply reflect the fact that an increased number of people in New Zealand, coupled with lower fuel prices and surging commodity incomes gave the total a nudge.

But is this momentum sustainable? We fear not. For the time being we are still forecasting a decent lift in retail sales, 2.5% for calendar 2025 and 4.0% the year after. This translates into a 1.5% and 2.9% increase, respectively, in the private consumption component of the National Accounts. But we concede that we are very nervous about this. There is a real danger that the current global turmoil results in lower New Zealand growth and employment. Indeed, uncertainty itself will reduce business confidence in hiring (and investing). Further fiscal tightening won't help either.

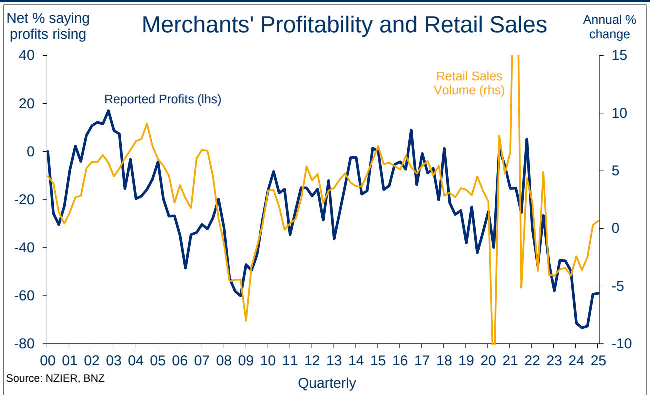
The current forecast increase in retail spending also needs to be put in context. Even if our potentially optimistic forecasts come to fruition, it means it will be 2027 before core retail sales return to their 2021 peak. That is a very long retail recession. Additionally, at no point in the forecast horizon do sales threaten to approach the trend that was in place pre-COVID. These factors help explain why retailers continue to struggle even though spending appears to be on the up.

To cap things off, the uptick in profit indicators is severely lagging the increase in sales volumes.

Retailers continue to face into rising cost and margin pressures meaning that reported profitability is disappointing.

While expectations are that the broader environment is improving there is still a long way to go before anything like normality is reached. The retail sector still has a long struggle ahead of it.

Retail profits still under pressure



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