

Input to your Strategy for Adapting to Challenges

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Thursday 11 November 2021

The Economic Outlook

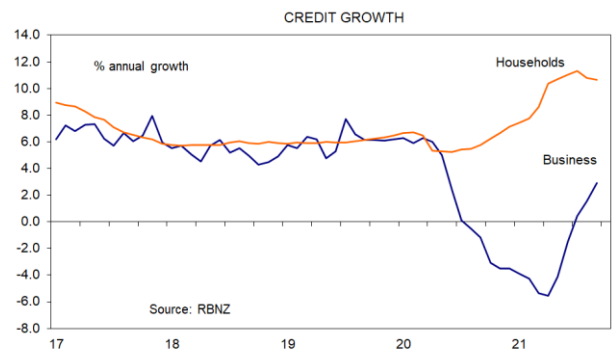
Now that mortgage rates are between 1.2% and 1.7% higher than they were 4-5 months ago, and debate is growing regarding what happens when house prices stop rising on average next year, a few people are predicting a crash.

This always happens when our economy turns. Some people (generally older males) feel gripped by a FOMO-like urge to preach doom and convince people that their years of experience means they can see a dystopia just around the corner – within two weeks in fact accordingly to one person recently delivering me their knowledge.

The pace of growth in our economy is going to slow down outside of the ups and downs associated with Auckland’s extended lockdown, and there are going to be many business failures. But there are a multitude of factors which will continue to underpin our growth in the next 2-3 years and most business collapses will be because of the usual reasons – excessive optimism driving the taking of excessive risks, inability to recognise when the ground is shifting, and inability to respond as challenges arise and change. These people will usually blame their

bank when they go under – but most of the time it is their own fault because they put themselves in a position where survival would only be possible with someone else’s money thrown into a deepening hole.

Bankers know this, and much as the Reserve Bank and others might like otherwise to happen, the next three years will involve a tightening of criteria for lending to the business sector, not a loosening in a flip-flopping away from riding a housing debt binge. That is, the divergent rates of growth in household and business debt levels recently will not now reverse.





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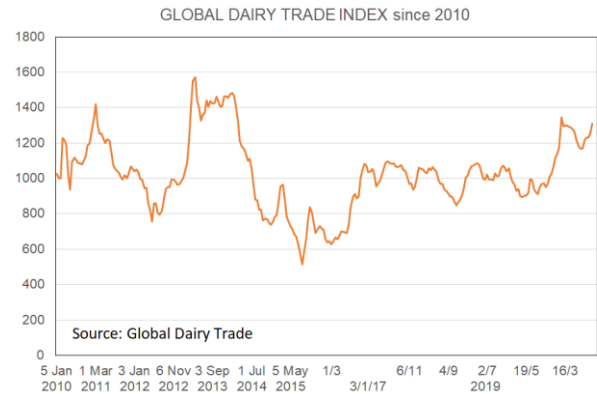


Here are some of the key factors which will underpin our pace of economic growth. If you're quick off the mark you'll already have asked yourselves before reading this far "What does this mean for interest rates if the economic outlook is good, but inflation is scarily high and the Reserve Bank needs to get it back down?" The answer is additional upside risks to interest rates. Did you fix five years at 2.99%, or three years recently below 4%? Or are you determined to keep rolling one year even when that rate heads over 5% with upside risk? If the latter – you will be tested.

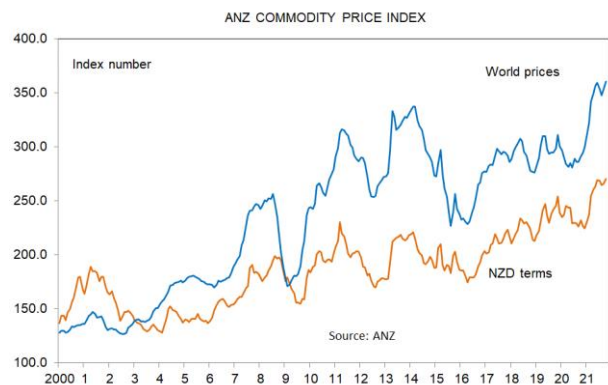
Offshore outlook

Our starting point is the outlook for world growth. There are many uncertainties surrounding Covid, and of particular concern to the 32% of our export receipts coming from China is the continuing pursuit there of an eradication strategy. This is leading to multiple lockdowns around the country causing disruptions to factory production and movement of goods and is impacting on household incomes and purchases of products containing our minimally processed commodities.

Nevertheless, dairy export prices are exceptionally strong and dairy farmers here this year may enjoy record incomes.



In fact, using the ANZ Commodity Price Index in world price terms, we can see that our overall export price level is ahead 24% from a year ago.



The IMF are predicting world growth of 4.9% over 2022 from 5.9% this year, with an easing to 3.3% in the years after 2022, which is below average growth of just over 4%. On this basis we should

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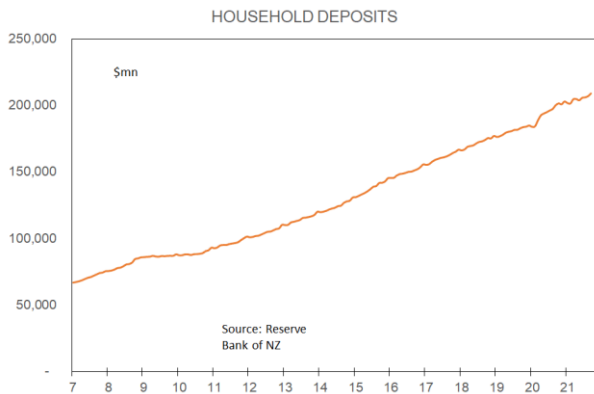


not expect continuing rises in export commodity prices much beyond current levels as China's uncertainties offset upward pressure from developing countries consuming our better quality food.

There is upside for tourism receipts once the borders open up. But how quickly the boost runs through our economy is hard to say.

Household spending

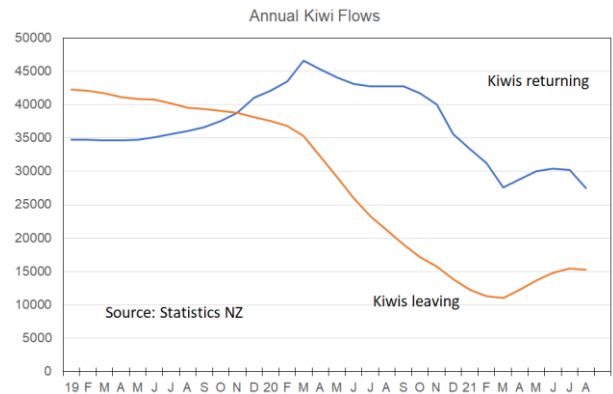
Households will in the New Year start diverting spending back towards overseas travel. However, with evidence that half of the money we would normally spend on travel in the past year and a half having been saved, there is a sizeable cash buffer to allow both travel and continued firm domestic spending levels.



There will also be spending support from recent strong jobs growth, rising job security which people are yet to truly feel, and accelerating wages growth.

Support for household spending will also come from strong growth in wealth over the past year and a half, including a near \$400bn lift in the value of the housing stock.

But there will be four factors restraining spending growth. First, a wave of people is likely to leave New Zealand not just for travel, but for work in countries desperate for labour. These include the countries we normally go to such as Australia and the UK. A turning of the flow of Kiwis in versus Kiwis out is already broadly underway.



Be aware that while the data show over 180,000 people (largely Kiwis) have gone through the MIQ



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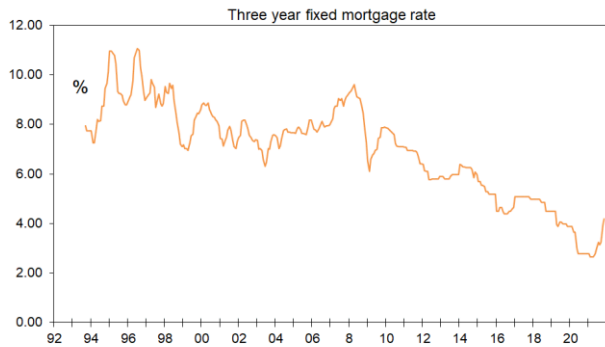
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system, many of those coming in have gone back out or were coming in anyway through normal times. Plus, of the 24,000 people this week seeking MIQ places, 42% are here already, wanting to go offshore then return.

Second, mortgage rates have risen strongly already and rises of the same magnitude recorded so far are likely to be repeated in the coming 12-15 months. This will make perhaps the biggest dent in household spending as borrowers divert funds towards debt servicing. However, there will be an offset from better returns on bank deposits which are running at high levels.



Third, the pace of average house price inflation may approach zero in the second half of next year and this change will be accompanied by expressions of concern and forecasts of falling prices which will make people wary of spending.

Fourth, the embracing of a world not dominated by Covid restrictions will see reduced spending on home renovations and the many things which we have unsustainably binged on over the past year and a half. This includes couches, cars, kayaks, and so on.

Note however that because of supply chain disruptions, some spending which we have wanted to do but could not because of stock shortages will be pushed into 2022 and 2023.

Overall, the underlying pace of household spending growth is likely to slow but remain firmly positive.

House building

The number of consents issued for the construction of new dwellings has soared by 25% over the past year to exceed 47,000. The underlying pace in recent months has been an annualised 51,000. The building sector will be exceptionally busy over 2022 through 2023 and this will strongly underpin growth in the economy.

But one key element driving surging construction is FOMO. People who cannot buy an existing property are flocking to builders to get something built. All stops are being pulled out to facilitate as much construction as possible, with politicians and planners believing that facilitating supply

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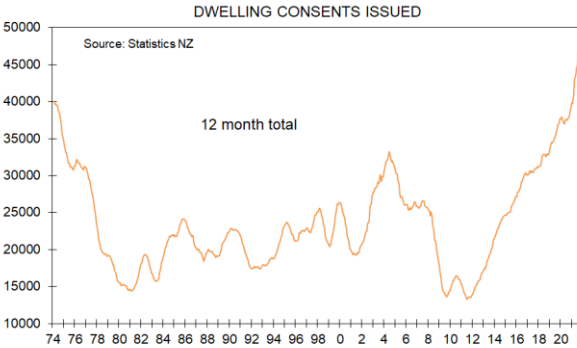
growth will lead to reduced prices. This won't happen on average.

Over 2022 FOMO will decline in the face of much higher interest rates, net migration outflows, and talk of shortages switching to ponderings of over-supply.

At the same time, banks will continue their recent pullback in the provision of finance to both developers and young people seeking to buy off the plan.

Once the boom surge starts easing off the combination of these things plus extreme shortages of labour and materials, along with soaring costs, will see an increasing number of projects cancelled. Stories will emerge of people losing deposits, completion dates and final purchase prices blowing out, finance being pulled, and builders going under.

Housing markets move in cycles for sales, prices, and construction. Booms never last and the current boom is the greatest relative to population since the 1970s.



Good developers with years of experience and good lines of funding in terms of capital and long-established financier relationships will be fine. They have seen ups and downs before, produce good product, have strong relationships with councils, and act professionally when they sell to buyers.

It is the newer operators who will feel the greatest pressures and the comments I have been making since February this year regarding challenges ahead for the home building sector are directed primarily towards these people. Your sector experiences big ups and then big downs. Booms never last. Don't be afraid of paying for some outside advice regarding your business currently and its vulnerabilities to the various factors specific to the sector. The sooner you control your debt, your cash flows, and your order book, the better placed you will be to handle the things currently dominating your time – sourcing and



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Business capital spending

With labour in short supply, businesses are likely to shift their focus towards boosting productivity and reducing dependence upon people. This suggests good growth in business capital spending. Rising interest rates will act as a small drag on this lift. More important though will be continuing uncertainty surrounding Covid globally, low ability to plan because of supply problems through into 2023 and tightening bank lending.

Banks are likely to rein in already weak growth in lending to the business sector because of concerns for business profitability and cash flows stemming from multiple sources.

One is timing of receipt of raw materials. Another is labour shortages and vulnerability to low quality output and having to redo completed work. Recruitment and retention and training costs will be rising.

Another problem is going to be vulnerability to booming sectors naturally pulling back from unsustainable growth paths and levels of activity. Included here are residential construction and all related activities (mainly from late-2022), production and distribution of durable consumer goods which Kiwis have binged on).

Banks pride themselves on acting to curtail credit availability before problems appear in sectors. There are many problems and challenges arriving across multiple business sectors and numerous studies over the decades have shown that a key deficiency of the business scene in New Zealand is inadequate management skills.

While many businesses will have improved their skills through handling the effects of the global pandemic, many will still flounder in the face of inability to invoice clients because resource shortages are preventing output completion, soaring input costs, and increasing government regulations.

A period of weeding out in the business sector is likely as we emerge from the global pandemic's depths. It will happen at the same time as banks grow more cautious and interest rates push to levels not seen in a decade.

Specific sectors

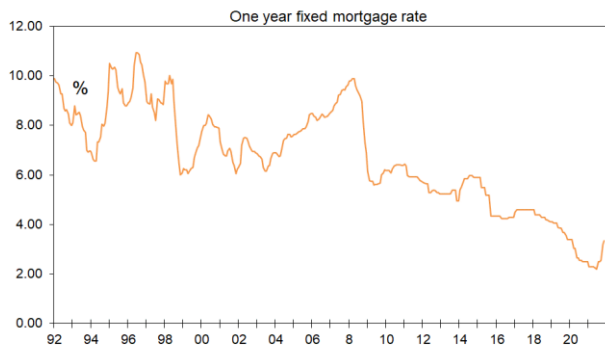
I have already specifically mentioned house building which is experienced an extreme cycle. But there are sector sectors experiencing ongoing underlying firm growth about which we economists usually say very little due to lack of familiarity and data. I will not disappoint in that regard. But here are some areas of good growth – feel free to suggest others for the next time I write such a list.

- Infrastructure
- Healthcare
- Aged care
- Green energy
- Space
- Medtech
- Biotechnology
- Storage & distribution facilities

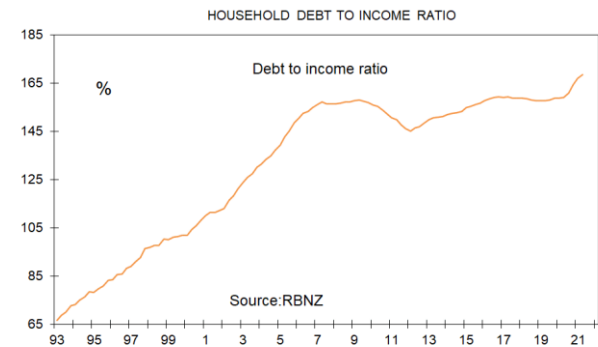
If I were a borrower, what would I do?

Nothing I write here or anywhere else in this publication is intended to be personal advice. You should discuss your financing options with a professional.

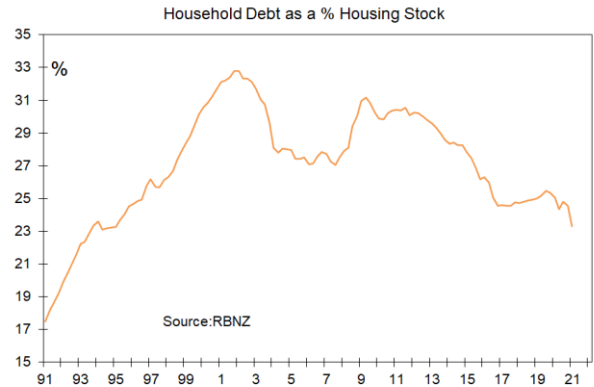
Back in 2007 when one-year mortgage rates were pushing towards 10%, the ratio of household debt to household disposable income was about 157%. That was the ratio just before Covid struck, and now it sits at 169%.



The debt burden is only slightly greater than pre-GFC.



The recent debt binge has been assisted by surging house prices which have caused the ratio of debt to the value of the housing stock to fall to a 26-year low of just over 23% from 25% pre-Covid and 28% pre-GFC.



It is politically correct to say that the NZ household debt burden is huge, that we are irresponsible managers of our finances, that we are in hock to the rest of the world, and that we exist in a house of cards which could collapse at any stage.

All people holding such a collapse view have been wrong on every occasion over the past four decades and there is no justification for believing the emergence from a global pandemic and restrictions on our economy and society will now precipitate such a collapse. Butterflies flutter about and feed when released from their cocoon. They don't curl up in a ball and crash to the ground.

From an interest rates point of view this simply means that there is a lot more tolerance to rising borrowing costs than people have convinced themselves.

Borrowers should prepare for interest rates rising to levels they have not seen for many years, or in the case of those who have taken on a mortgage for the first time in the past six years, have never seen before.

My expectation for the one-year rate in October each year is shown in the first column of the table below. I focus on that rate because there are many people who have fixed one-year repeatedly since 2009 and the strategy has worked very well.

The second column shows what the one-year rate will average over the next 2-, 3-, 4-, and 5-year periods. The last column shows the current minimum 2 – 5-year fixed rates charged by the lenders I track.

	Forecast 1 year rate	Rolling average rates	Current fixed	
2021	3.45		3.45	1 yr
2022	4.5	3.98	3.99	2 yr
2023	5.25	4.40	4.39	3 yr
2024	4.65	4.46	4.59	4 yr
2025	4.25	4.42	4.75	5 yr

If these forecasts prove correct (I'd give that a 10% probability), rolling one-year fixed will deliver an average rate for the next two years of 3.98%, three years 4.40%, four years 4.46%, and five years 4.42%.

The last column shows what the current minimum fixed rates are for those time periods.

Given that there is a rate premium one should be prepared for rate certainty, rolling one-year fixed will deliver a cost higher than one could get by fixing at the moment – if the forecasts are right.

If I were a borrower, what would I do?

Personally, I would fix three years.



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