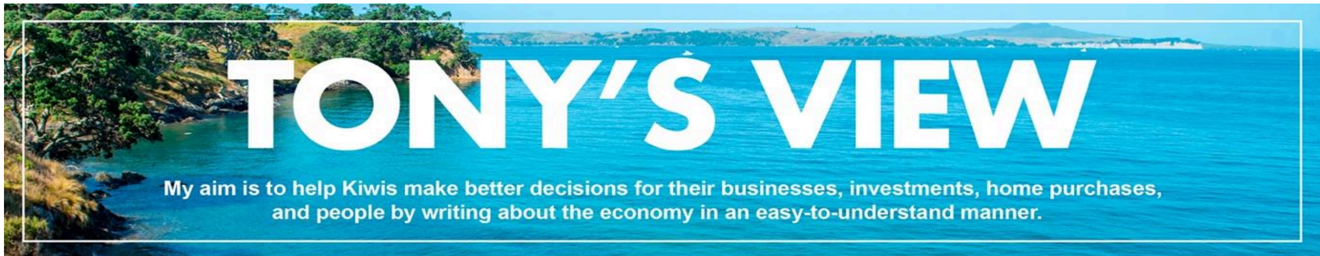

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Our Uncertain World

We always live in uncertain times and there is no long run equilibrium – even though most of us assume such a situation will one day be reached when we generate forecasts stretching beyond three years. But there is the usual level of uncertainty about the future most of us are used to incorporating into the outlooks and actions for our businesses and personal finances, and then there is the situation we have been in since 2019.

The number of factors bringing uncertainty not just about the future but about what is going on right now or has just happened is unprecedented. It started in 2019 with unexpected deflation worries bringing record low interest rates, speculation about negative bank deposit rates, and a renewed surge in prices for assets such as houses.

In 2020 we then had the global pandemic and we all proved we had no idea what would really happen. Forecasts of sharp declines in employment, GDP, house prices and construction were very wide of the mark.

Post-pandemic

Now, we are in a post-pandemic environment. And just as we had no idea what a pandemic would produce because none of us had lived through one before, now none of really has any idea what a post-pandemic environment will produce because again this is a new experience for everyone.

We can list the uniqueness of the post-pandemic economy as one reason for distrusting most forecasts and not basing one's business and investment strategies strongly on a particular set of forecasts proving correct. But there are many other uncertain factors in play and for those people who still think they can close their eyes and base their actions on what forecasters say will happen, here is an unfortunate reality check.

Unique over-stimulus

Central banks primarily, but governments also, over-stimulated their economies during the pandemic. Too much money was printed, interest rates were kept too low for too long, and spend-happy Finance Ministers injected too much extra

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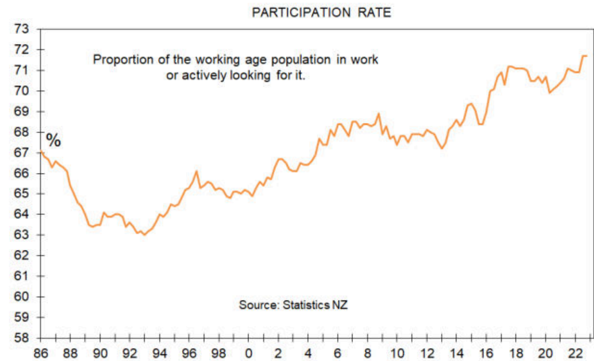
money into economies. Excess stimulus has produced shortages of labour and materials along with asset price hikes and inflation.

This is new to us, and we don't know how long it will take for these things to unwind. The economic models which large agencies like central banks run are explicitly constructed to produce forecasts when shocks like this occur. But these models are based on assumptions never tested in a real world hit by a pandemic, and the number of shocks is too large for models to produce reliable forecasts.

In other words, central banks are flying blind with regard to how the effects of excess stimulus unwind.

Tight labour market

In New Zealand businesses have traditionally based their plans on the assumption that labour will be available when they want to hire new people. Operators are used to an environment of good labour availability. But that labour is now not available and the aging and retiring population means even less labour proportionate to the population will be available in the future. That proportion, known as the labour force participation rate, is already at a record high. It is not accurate to say that young and/or old people have newly deserted the labour force as a result of the pandemic.

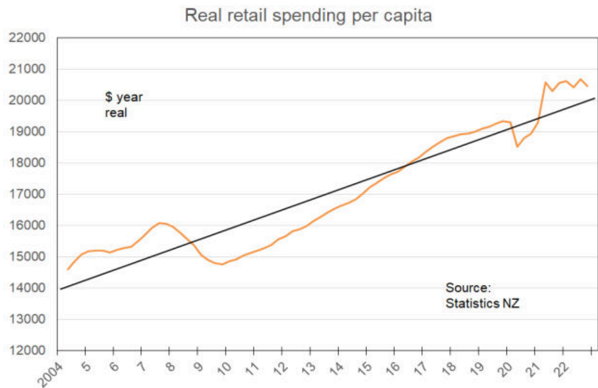


We know businesses need to adjust to the ongoing shortage of labour by boosting productivity and diverting labour resources away from low-profit activities to high-profit ones. But we have no idea how rapidly this transition towards an explicit productivity-driven growth model will take. That is, for now we remain in an environment of insufficient capital expenditure and insufficient restructuring.

At some stage the restructuring will come, and the initial impact will be negative and disruptive. We don't know when though.

We also don't know what impact ongoing high job security will have on people's willingness to keep spending despite high mortgage rates. Retail spending should have been well crunched by now by falling house prices, high interest rates, and the

soaring cost of living. But all that has happened is the volume of retail spending per capita has flattened, as seen in this following graph.



Building boom reversing

In 2011 the annual number of consents issued for new dwellings to be built fell to the lowest number since the 1960s (therefore a lot lower as a population percentage) of 13,500. The number just under a year ago hit 51,000 and now the total is 48,000 – potentially headed towards 30,000. The 20-year average is 28,000 so the 30,000 could be generous. We simply don't know.

There are shortages of dwellings in some parts of New Zealand – though calculating shortages is impossible as it all depends on what you think is a desirable average number of occupants per household. "Should" Auckland look like Nelson, Christchurch, the West Coast, or Auckland of 1991?

Talk of shortages has encouraged a belief that building dwellings will yield good returns for anyone no matter how inexperienced they are. Unfortunately, many inexperienced, under-capitalised, over-optimistic people have become property developers. They have paid too much for land, made excessive assumptions about the willingness of banks to finance them, the generosity and timeliness of councils working with them, the availability and cost of staff and materials, the ability of buyers to get bank finance at time of settlement, and final selling prices.

There is a weeding out process in the construction sector underway and it could easily run for the next 2-3 years. The only saving graces may be

1. the surprising surge in net migration inflows boosting housing demand,
2. the presence of Homes & Communities as a buyer for badly needed social housing purposes,
3. falling interest rates through 2024-25, and
4. the fact that a smaller than usual proportion of consents have translated into actual construction these past two years because of capacity constraints.

None of us picked that consent numbers would exceed 50,000. So, there is no reason for

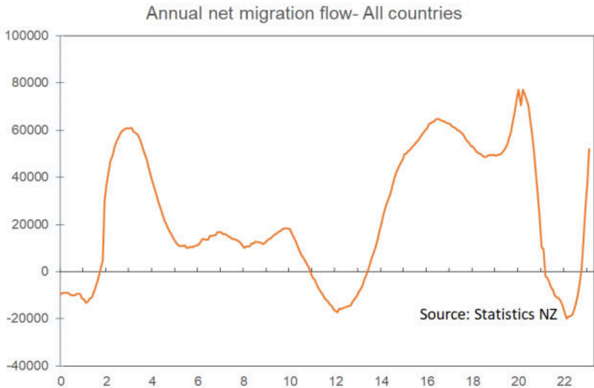
believing that a miracle has now occurred, and we can accurately predict what the low-point in the cycle will now be.

Election year

Traditionally in New Zealand we use an approaching general election as an excuse to put off making decisions about home purchases, hiring, firing, capital spending, business relocations, strategy changes, personal investments, and so on. The effect tends not to be large. But currently in the business community there is a very high level of concern about and distrust of the Labour government. The risk of Labour holding the reins of government after this year's election is likely to have a greater than usual dampening effect on business and hiring decisions the closer we get to election day.

Migration boom

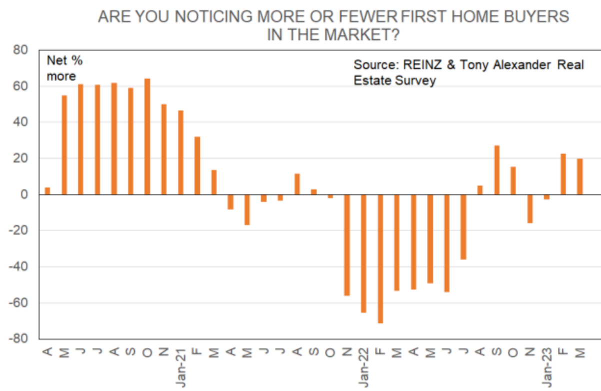
No-one expected that in the year to February the net migration gain would be 52,000 as compared with a loss of 20,000 a year ago. The surge in inflows has taken us all by surprise to the extent that discussion over the past few days related to better ability for Kiwis in Australia to gain citizenship has centred around a population-sapping brain drain. Very little focus has been on the already soaring net inflows which may be bringing some improvement in business ability to find staff.



But the quick acceleration in population growth is also set to place some sudden new pressures in the housing market. These pressures on first rental accommodation and then ownership will be exacerbated by the shift of some accommodation away from long-term renting towards foreign students and the newly booming inflow of foreign tourists.

Once interest rates are seen to be falling with high confidence, the large queue of buyers waiting for the cyclical bottom in house prices will step forward and the shift in housing market dynamics could be rapid and large.

We cannot know when this will happen and what the magnitude of the shifts in key things like sales and prices will be. But if I were a young person looking to make my first house purchase, I know what I'd be doing right now. Many already are with my monthly surveys of real estate agents and mortgage brokers both showing first home buyers back in the market.



Cost of living shock

Average consumer prices have risen 6.7% in the past year and 17% since the end of 2019. The soaring of living expenses is something very new to a great number of people and the extent to which this will affect overall spending, investments, house buying etc. can only be guessed at. It has been over three decades since the last period of rapid cost of living growth (high inflation) and structural changes in the economy and our behaviour since the end of the 1990s means a lack of data on how consumers react to high inflation in the 2020s.

Long-term

There is also a group of unique factors less large in the short-term than the ones above, but of potentially huge relevance in the long-term. Here are a few.

Climate change

Inflation rates are being boosted by the costs of damage caused by weather events attributable to climate change, pricing changes to reflect new risks (insurance etc.), and expenses related to adjusting to climate change such as relocating and strengthening infrastructure. We don't really know the extent to which we are frogs in slowly heating water.

De-internationalisation

China has not democratised as many Westerners hoped from the opening up of 1978, and its activities in other countries and military expansion have in the past two years led to a wholesale reassessment of the threat it poses – especially in light of China's support for Russia's invasion of Ukraine. Countries are shifting production out of China and attempting to deny China access to crucial technologies. The amount of manufacturing reshoring from China back to New Zealand is likely to be very small. But we face costs associated with adherence to Western values and pushback against China, including the risk of loss of export access. China accounts for one-third of New Zealand goods exports receipts so vulnerability is high.

We cannot know when our economy may be affected by our altering relations with China, but this risk appears likely to grow over time and produce greater efforts to seek other markets the cost of which will be reduced returns to New Zealand exporters.

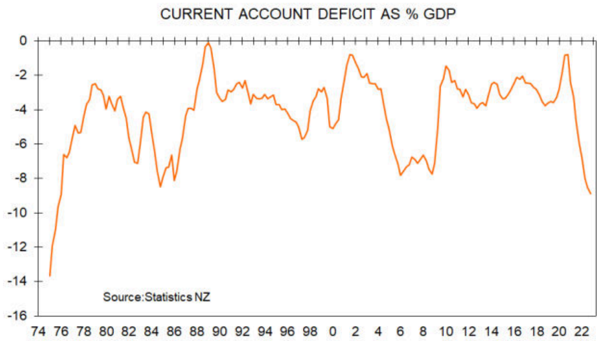
Artificial intelligence

Y2K never happened, self-driving cars are on the back-burner, and personal jetpacks just don't exist. We often over-hype new technologies and events. But AI is being seen as a potential revolution in the way many businesses are run with impacts on employment etc. which we cannot know. AI is currently quite dumb – but how far away are we from the next step to true intelligence and not recitation from rote learning, and then Skynet?

Large current account deficit

New Zealand's gap between what we make on our exports and receive in offshore investments versus what we pay for imports and pay to offshore owners of assets here including debt is at almost a half-century high equivalent to 8.9% of Gross Domestic Product (GDP). In the past, deficits of smaller magnitude have generated a great focus on the views of credit rating agencies, direction and extent of movement in the Kiwi dollar, and the impact on government policies and interest rates. Currently there is no debate on any of these things. Will such debate arise? Will credit rating agencies issue a warning? We don't know.

Probably not. But we can never predict when the financial markets will decide some underlying structural issue becomes a matter of moment. That is why even the most detailed models can't work in financial markets. We can't pick when our attitudes towards something change. Just ask your partner – have they really got over that excessively long glance given to that person on the other side of the pool last summer?



Interest rate falls over

This heading refers to the three decade period from the early-1990s when inflation surprised on the low side and interest rates around the world trended down through up and down legs of monetary policy cycles. The trend lows were reached during the extraordinary circumstances of the global pandemic.

Interest rate falls over the years have given an upward bias to rates of capital gain for assets like shares, residential and commercial property, etc. Now that bias has ended. We do not know what the new averages for interest rates will be. We do not know whether the trend now after cyclical policy tightening will be flat after some minor easing, or upward.

All we can perhaps safely say is that average asset returns are likely to be less in the next three decades than the last three.

In case you missed it

On Friday I released the results of my monthly Business Insights Survey alongside Mint Design digital marketers. You can find a pdf copy here.
Mint-Business-Insights_April23.pdf (mintdesign.co.nz)

Business concerns are strongest about the economic outlook and interest rates, but are relatively sanguine about the currency, cyber threats, and climate change. Higher spending is targeted mainly towards strategy development, staff remuneration, and staff training. Spending cutbacks are planned not just for inventory levels as was the sole case last month, but now plant and machinery as well. Over eight pages you can read the comments which respondents volunteered about their sector. I always gain useful information from these coalface observations.

On Monday I also released my latest Regional Property Insights report prepared for First Mortgage Trust and available here.
Cover.cdr (fmt.co.nz)

This month I look at where dwelling consent numbers are shifting in each region.

If I were a borrower, what would I do?

This week wholesale interest rates have fallen away in response to lower rates offshore and all bar the one year rate are now below levels before the Reserve Bank raised its cash rate 0.5%. Some banks look to have been premature in raising their two year fixed mortgage rates and it would not be surprising to see a reversal soon. If I were borrowing, I'd only fix one year personally as rates look to have peaked and attention is on the cusp of turning in the markets towards when rates fall and how fast.

I discuss rates a lot more in Tview Premium with lots of useful graphs to help your decision-making process.

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.

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