



**BAGRIE
ECONOMICS**

ECONOMIC UPDATE NZPPI JUNE 2018



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The global economy

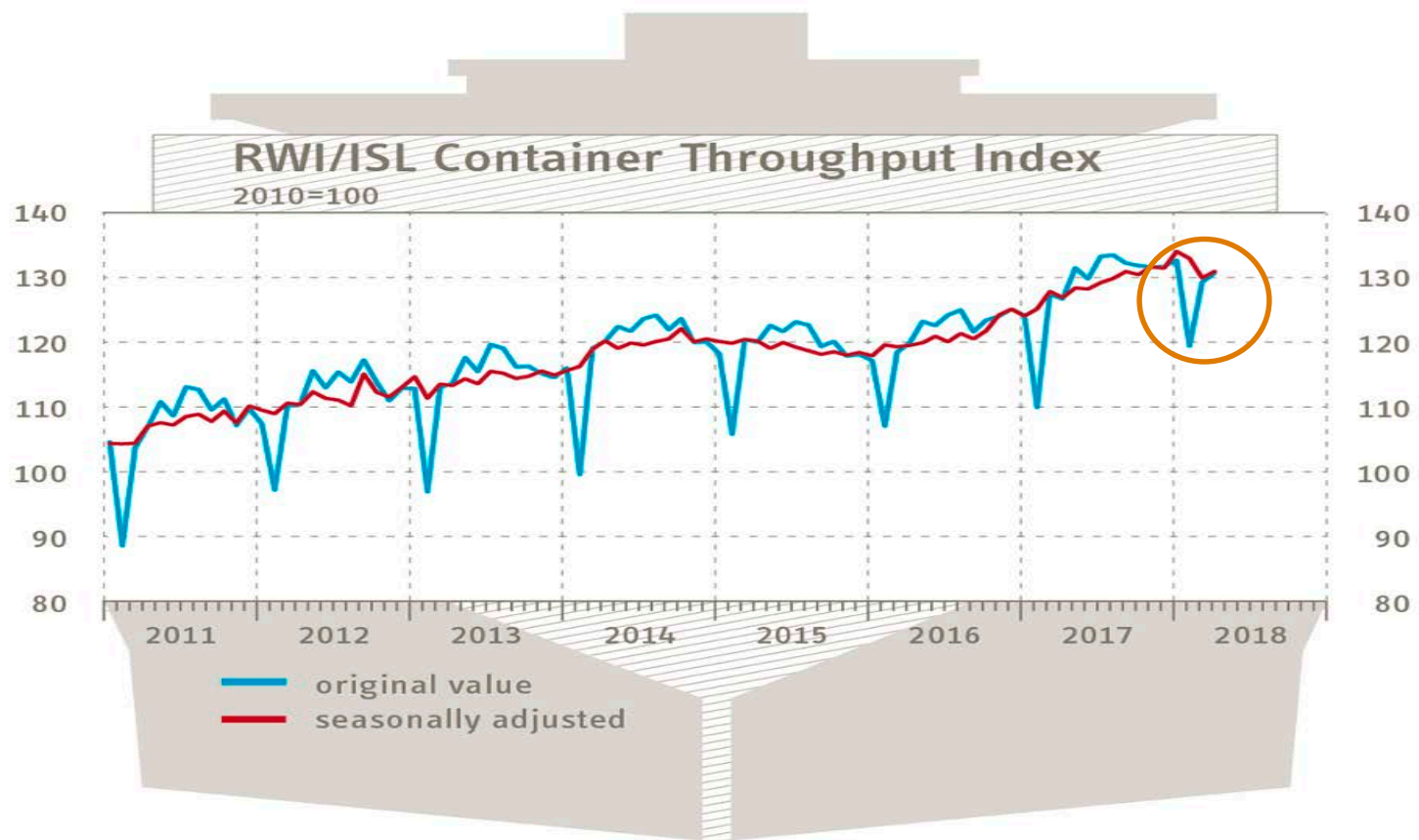
The glass is half full

- Global growth is solid
- Falling unemployment
- USA is doing well
- China
- There are good reasons the Fed is hiking
- Other leaders stepping up
- Fed hiking; ECB BOJ not
- Buoyant commodity prices

The glass is half empty

- Debt is higher than pre GFC
- Weak productivity
- Poor demographics
- Low rates have pushed investors up the risk curve
- Policy armoury is empty
- When the Fed hikes nasty things can happen
- Trump, Italy
- Protectionism, trade wars
- Geopolitical hot spots

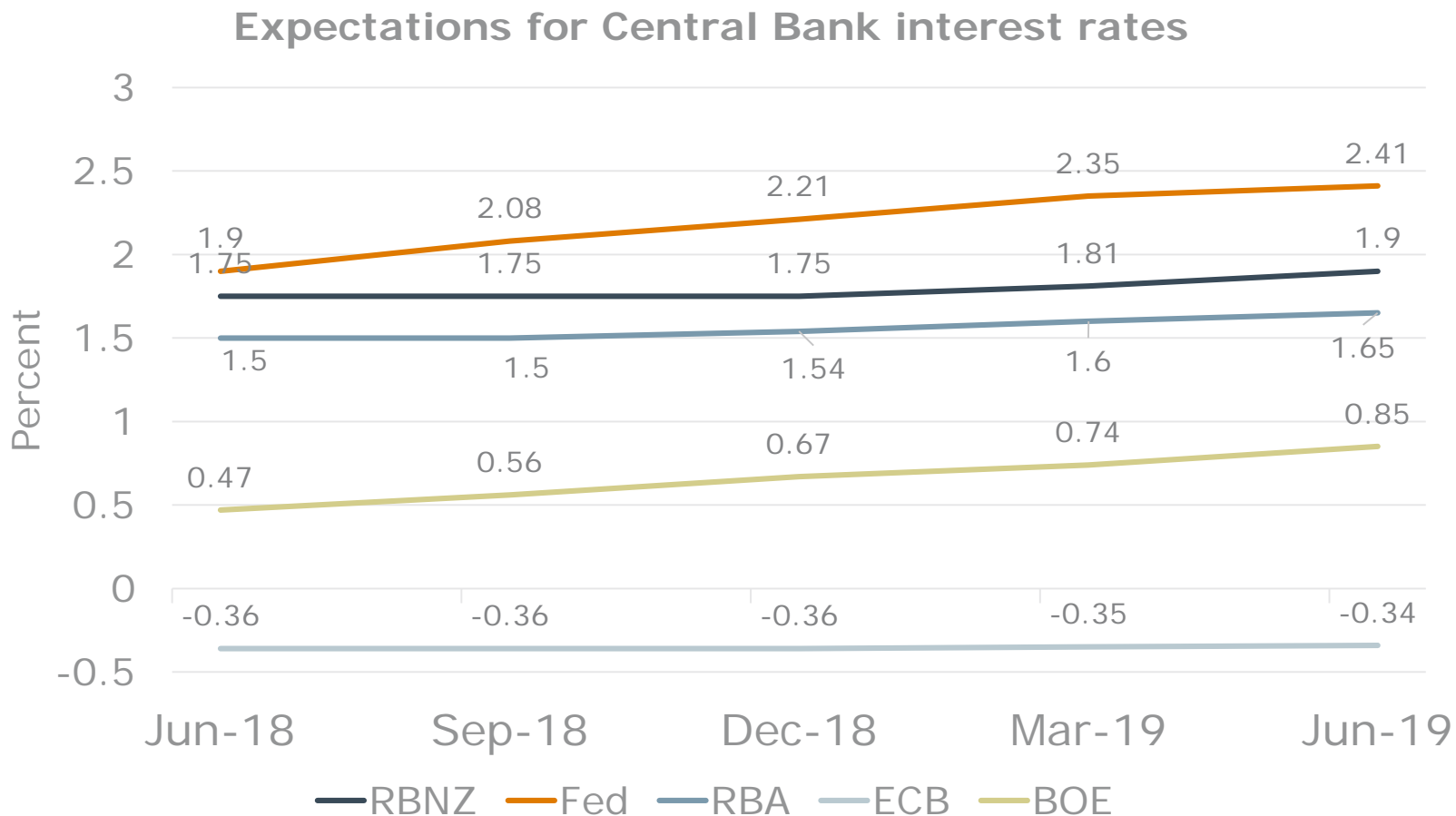
Are we seeing a turn in the trade cycle?



RWI/ISL computations based on data provided by 88 ports. April 2018: flash estimate.

Shipping volumes off peaks and airfreight traffic is flat

The world biggest economy now has higher interest rates than most



Focus on key emerging markets

Fed raises
interest rates



USD firms



Pressure on emerging
market currencies



Capital flight, dollar value of
debt increases. Inflation rises



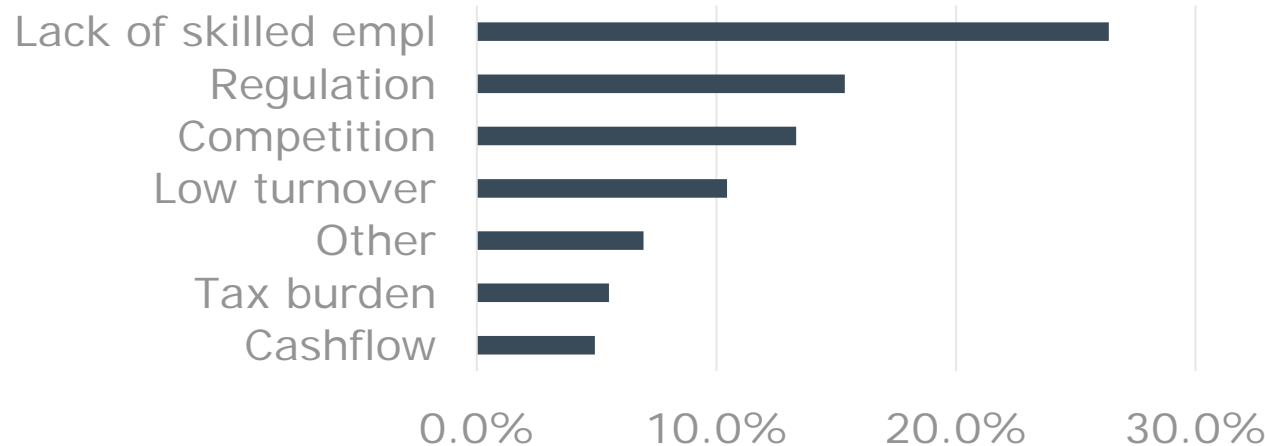
Central bank raises interest
rates to defend currency



Pressure on
economy

Theme 1: Strong economic policy settings for NZ

Major problems facing firms



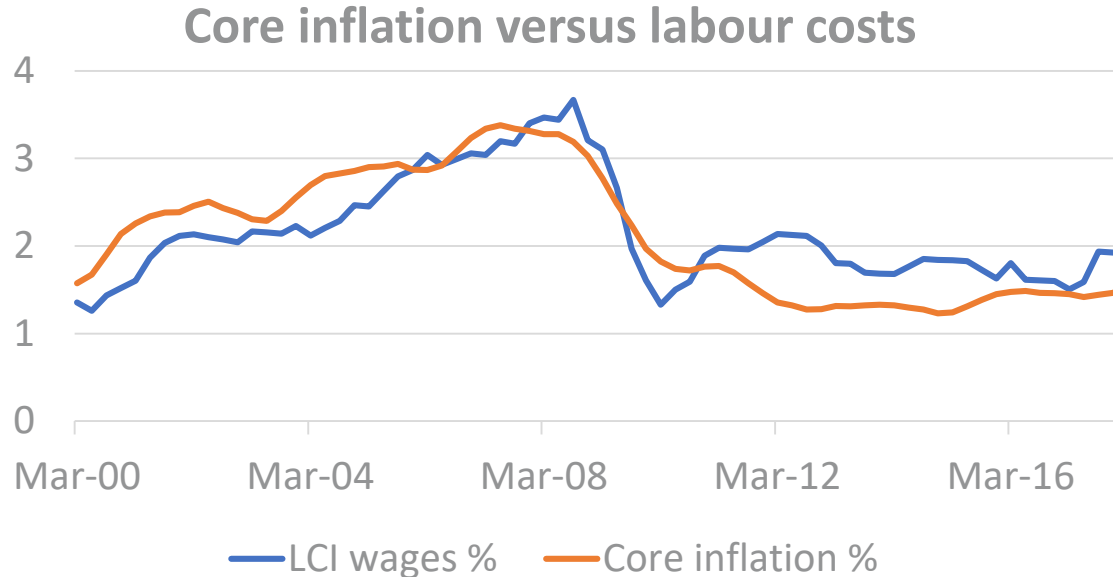
- **At full unemployment and better external accounts**
- **Being at capacity is a good thing** but brings challenges
- **Low inflation, political centrality & policy manoeuvrability**
- **Strong fiscal position and currency that will adjust**
- **1# rank for ease of doing business**
- **13# most competitive nation**
- **Key issues: productivity, housing affordability, inequality, environment, sustainability**

Theme 2: Traffic lights – as many reds as green

	Signal	Comment
Global scene	Red	Fed is hiking and the world has a lot of debt
Inflation	Green	Green for now but risks moving to amber
Household debt	Red	High but stable
Corporate debt	Green	Corporate balance sheets are strong
Dairy debt	Red	Debt now an issue given "peak" cow
Asset valuations	Yellow	Expensive
Productivity	Red	Weak
Financial stability	Yellow	Improving
External accounts	Yellow	Improving but external debt is still high
Shadow banking sector activity	Green	We don't have a shadow anymore
House building excesses	Green	Still a shortage of supply
Credit growth	Green	Reined in at the top of the cycle
House prices	Yellow	Slowing, notably in Auckland
Household sector	Yellow	Negative savings rate an issue

We are late cycle but don't have a smorgasbord of red lights. We do have warning signs though

Theme 3: Can inflation remain low?



- **Still deflationary suppressants from technology**
- **Economy is growing modestly**; housing weakening
- **But**
 - **We are at full employment**; labour costs to rise
 - **The policy prescription is inflationary**
 - **Social justice capitalism brings financial costs**
 - **NZD easing**

Theme 4: A shift to a cash-flow investment mindset is underway

- For asset classes we have:
 - Stretched valuations
 - Tighter credit conditions
 - Growth in a mature stage of the cycle
 - Social conscience of society being pricked
 - Foreign investment restrictions
 - Basing in interest rates and a turn in the liquidity cycle
- **Housing** – removal of negative gearing, restrictions on foreign buyers, capital gains tax, shift in landlord-tenant relationship to the former, costs (insulation etc) etc
- **Dairy returns typically 10%**; cash 4-6%, capital 5-6%
- **Dairy**; peak cow, intensification, conversion and production
- **Dairy** - new environmental taxes (water, nitrogen, carbon). Fresh water regulations

Theme 5: The transition for the NZ economy

Old drivers

- Migration (slowing)
- Tourism (capacity?)
- Housing (flattening)
- Construction (peaked)
- Financial conditions (largely low rates)

New drivers

- Still some old drivers but new:
 - Fiscal policy
 - Commodity prices strong
 - The new economy?
 - Wages
 - Lower NZD (tourism boost)

The challenges

Uncertainty

Getting productivity up

Will the public sector crowd out the private sector?

Will regulation tighten financial conditions?

The economic cost of capping some sectors

The transition 2# - more secular and big picture

Old key drivers

- Dairy
- Non renewables
- Rapid credit accumulation
- House prices (wealth effect on spending)
- Land prices (wealth effect on spending)

New drivers

?

The old model contributed to income inequality, placed pressure on the environment and has contributed to a housing affordability crisis. It also left the economy unbalanced.

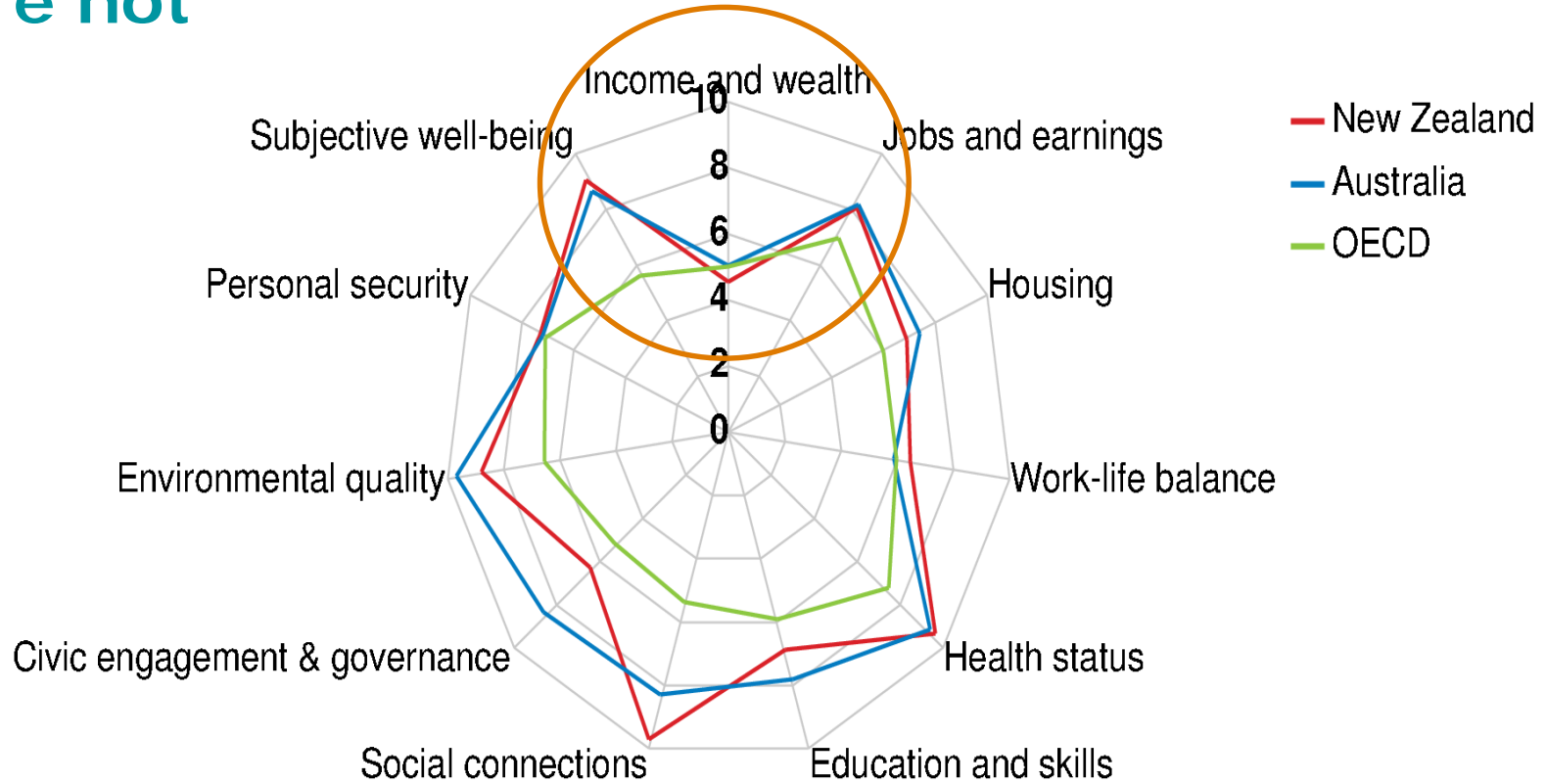
We don't know what the new model is yet

Uncertainty matters!

- Can't compare business confidence in 2000 with 2018; the RBNZ hiked 200 bps in six months in 2000
- There are some worrying aspects to weakness in confidence in 2018
- Some basic drivers of investment
 - **Growth** (the accelerator channel)
 - **Tobins Q** (market value of assets versus replacement – you invest when the former is rising faster than the latter)
 - **Uncertainty** (time value option of waiting)

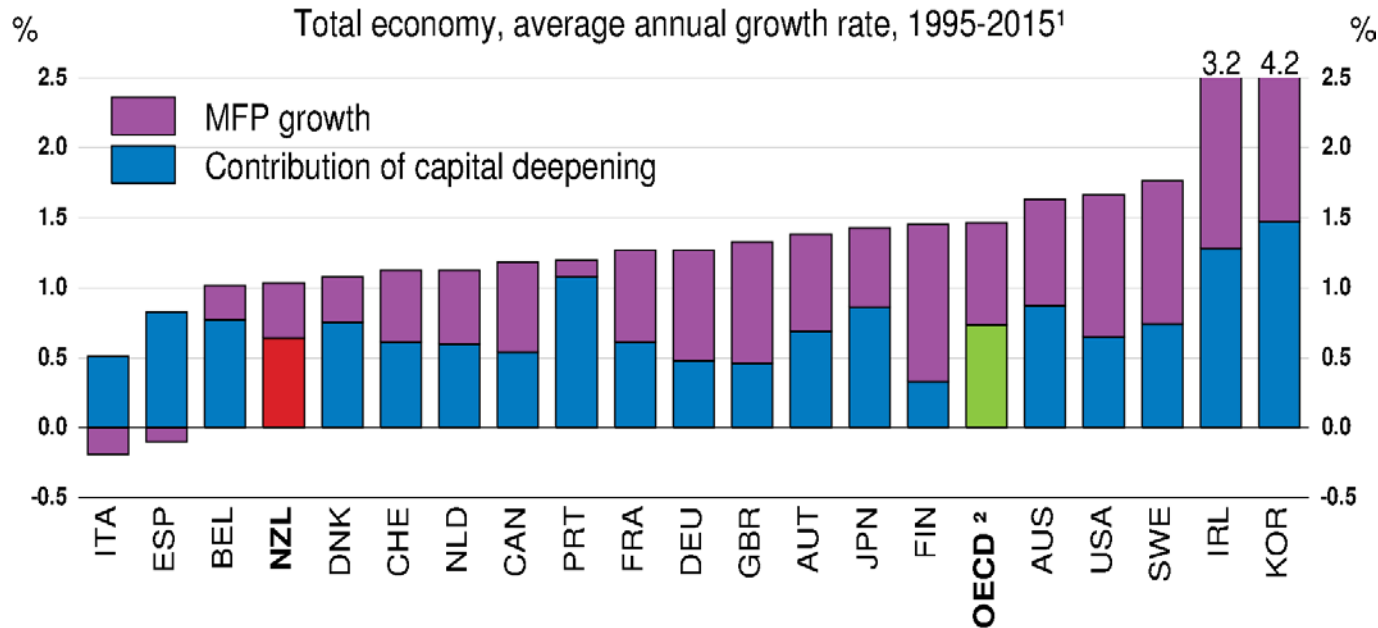
Growth is steady – we are late cycle, asset price inflation is cooling while costs are still rising, and uncertainty is high

Theme 6: Well-being above average, incomes are not



Few disagree with the need to address some social deficits in NZ. They are linked to economic performance and cohesion. The concern is that not enough attention is being paid to productivity

Theme 7: Productivity growth is poor

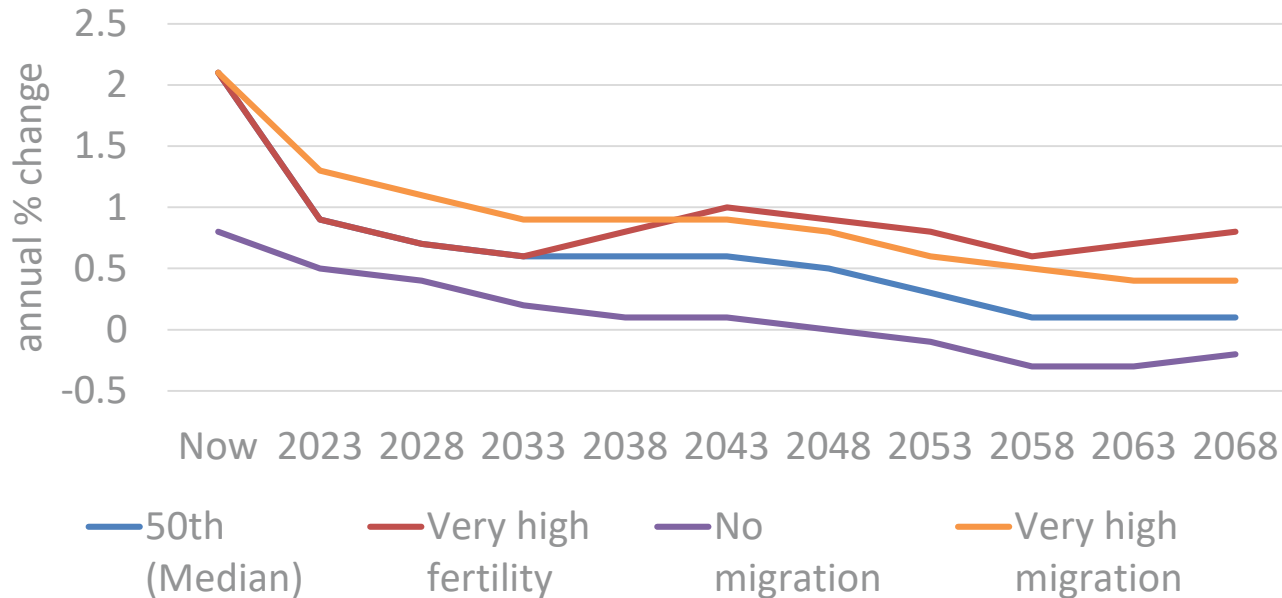


- Low levels of foreign direct investment
- Little agglomeration economics; unaffordability in Auckland
- Low expenditure on R&D and few large scalable cities
- Lack of competitive pressures in some sectors
- Low non-residential investment per capita
- High skill mis-matches which lowers productivity

Source: OECD (2017), Productivity database; OECD (2017), Economic Policy Reforms: Going for Growth 2017.,

Theme 8: Demographics are better than most

Labour Force Projections



- Labour force growth to slow but not contract
- Levers that can be pulled but there is no free lunch
- Migration has usurped fertility as the driver of population
- High fertility assumes 2.5; currently 1.81 (has dropped)
- Asian fertility rate now above Europeans
- High migration cycle assumes 30k! We are at 68k

Theme 9: Budget economic development spend

- Total spend **\$2.763 billion** over five years (incl 17/18)
- R&D tax credit **\$1 billion** but you need to spend \$100k
- Provincial growth fund projects **\$383m**
- **\$714m** for increasing aid
- APEC **\$100m**, America's Cup **\$100m**

Some "interesting" economic development initiatives

- \$27 for tax compliance activity
- Money for MBIE and Corrections to comply with the Holidays Act 2003
- Increasing the number of labour inspectors
- Drug smuggling networks – strategic disruption (\$54m)
- Money for MFAT (\$150m)
- My favourite: \$8m to improve superannuation portability to the some Pacific Islands