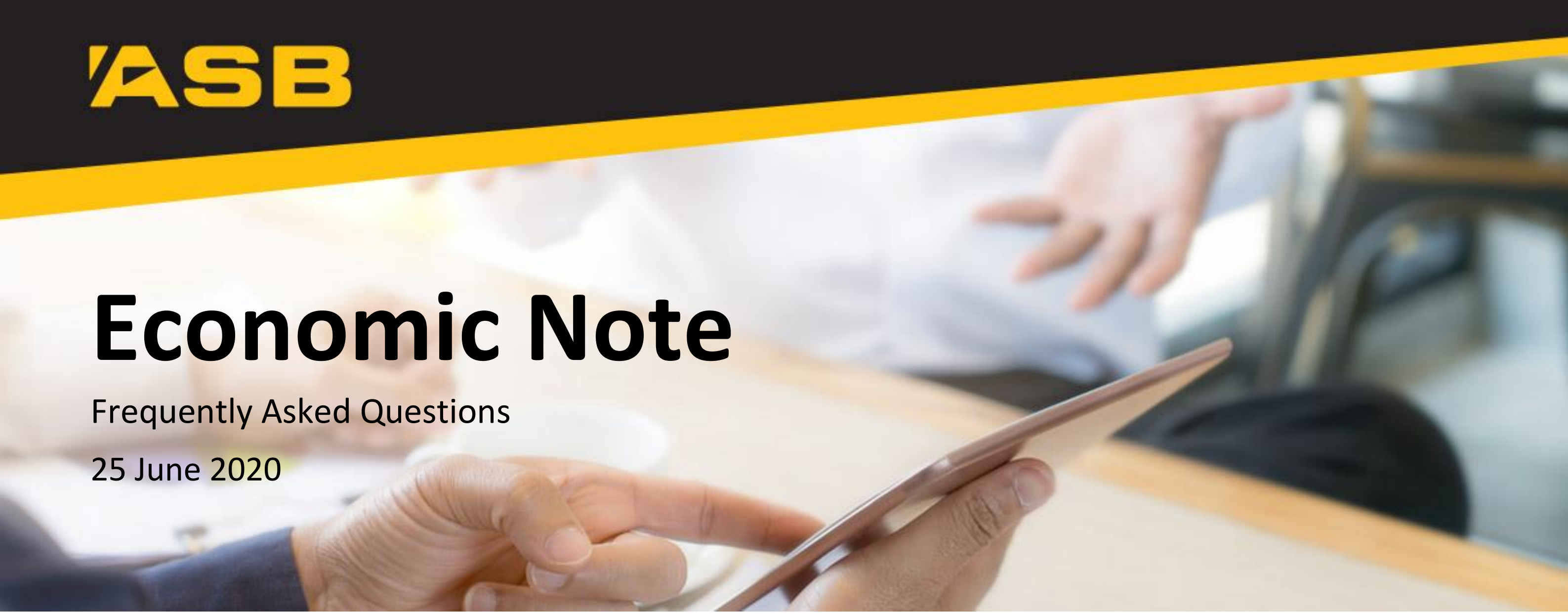

Economic Note

Frequently Asked Questions

25 June 2020

COVID Economics – Frequently Asked Questions

The deepest recession on record, a $62 billion government spend-up, faltering global trade, negative interest rates, a COVID resurgence, yo-yoing share markets…the headlines are now filled with this sort of craziness. No wonder people are asking questions!

We've put together a COVID Economics "FAQ" to address some of the more common ones we're hearing.

COVID Economics – Top 10 questions

1. How is the economy tracking? Are we really past the worst?
2. Are you worried about a second wave of COVID?
3. What's going to happen to my mortgage rate?
4. And term deposit rates?
5. What's all this about negative interest rates?
6. Are house prices really going to fall?
7. Isn't housing a great asset now that interest rates are so low?
8. Was COVID-19 a death knell for globalisation? Should we go back to being a domestically-orientated economy?
9. What's going on with quantitative easing and the government's whopping deficit? Won't all of this get us into trouble down the line?
10. My KiwiSaver balance has been all over the place. What is going on?

How is the economy tracking? Are we really past the worst?

It depends what you mean.

The worst is over for economy activity, the standard measure of which being gross domestic product. March quarter GDP growth fell 1.6% qoq. There looks to have been a double-digit decline in the June quarter. That's two consecutive quarters of negative growth, a technical recession.

But in a few days we'll be in the third quarter and the recession, technically, will be behind us. In some ways it will continue to feel like a recession but, overall, the economy seems to be regathering itself better and more rapidly than most economists and government agencies expected.

In other words, the outlook is not quite as awful as first thought. Going hard and early on COVID has paid off in this respect. Based on the latest indicators (take a look at our weekly chart pack), we've tabbed back our forecast 2020 GDP contraction to -5%, from the -7% we landed on during the height of lockdown.

But, and it's a big "but", the worst is not over for the labour market. Nor, we suspect, the housing market. They're

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both important components of the economy, and where the recession rubber hits the road for many.

To date, the labour market has held up pretty well thanks to the Government's wage subsidy tiding firms over to the other side of lockdown. Based on the latest Jobseeker figures we estimate the unemployment rate is currently a little over 6%. But as the wage subsidy rolls off, firms are going to face some tough choices. We believe the peak in the unemployment rate has effectively been 'postponed' by the wage subsidy to the second half of the year. Formally we forecast a peak of 7.7% in Q4. This slackening in the jobs market means wage growth, which had finally started to lift pre-COVID, is set to fall sharply to levels around 1% yoy, about as low as it gets.

Are you worried about a second wave of COVID?

Of course. We're already seeing COVID flare ups in some parts of the world and authorities in some of those areas have reinstituted localised lock-downs.

The road back to global economic normality was never going to be a smooth one. And the sporadic COVID outbreaks we've seen simply reinforce our view that there will be frequent set-backs. Until a vaccine presents itself, these sorts of flare-ups can be expected to continue to occur. Business confidence, retail spending, and firms' investment and hiring plans will take a knock each time, slowing or temporarily stalling the economic recovery.

Importantly though, we don't think that the second waves we're seeing will snuff out the global recovery entirely. That is, another health crisis will not necessarily produce another economic crisis. Policy makers appear reluctant to return to full nation-wide lockdowns, for fear of the intolerable economic consequences. It's more likely that we see other measures, like localised lockdowns, used to manage outbreaks.

What's going to happen to my mortgage rate?

Economists talk about the Reserve Bank of New Zealand's (RBNZ) adjustments to the Official Cash Rate (OCR), but the RBNZ's ultimate focus is influencing retail rates within the economy. That means mortgages, and business loans. The RBNZ has been very clear that, following its interest rate adjustments and bond purchases earlier in the year, it wants to see retail rates in the economy lower. Since the start of the year mortgage rates have fallen by between 0.34% (for the six-month rate), through to 1.1% for the four- and five-year rate. The cheapest rate at the time of writing is the 18-month special of 2.65%.

The world is quite different to what we imagined six months ago. And in that vein, we must acknowledge there is more than the usual amount of uncertainty about the outlook. When it comes to mortgages, our core scenario is that we have an extended period (years rather than months) of extremely low mortgage rates, with rates only around 1% or so higher in five years' time than they are today.

Could rates get even lower? Absolutely. The economy may yet need more stimulus to pull itself out of the COVID-19 hole, and the RBNZ still has a range of tools it can use to put downward pressure on lending and term deposit rates. However, we don't think fixed-term mortgage rates would fall by much compared to how far they have fallen already. That is, we think the largest falls in mortgage rates are behind us. It's also expensive to wait – floating mortgage rates are significantly higher than all the fixed-term rates, so you need to do some careful calculations if you think it's worth trying to time the right moment to fix if you think it isn't now.

Could rates get higher? Now that rates have unexpectedly fallen to record lows, it's worth pointing out they can unexpectedly go up too. We think it is prudent for borrowers carrying debt for longer than the next couple of years to budget on mortgage interest rates being higher than they are now. Our forecast of modest rate increases over the next five years is discussed later in the report. If the economy recovers quicker than we currently expect, we'd likely see mortgage rates to start lifting earlier and/or faster than our current forecasts.

And term deposit rates?

Term deposit (TD) rates are low, and the risk is they have further to fall.

For the most popular TD rates – short terms up to 1 year – a key influence is what the RBNZ does with the OCR. Our expectation is that the OCR will stay at its current record low of 0.25% until early 2024. There remains a risk it is cut further, if the economic recovery from COVID-19 starts to disappoint.

Along with the setting of the OCR, another driver of term deposit rates are bank funding requirements given TDs are now the dominant form of bank funding. Banks are now relatively well-funded so the incentive to offer attractive TD rates at certain maturities is likely to fade. Even without an OCR adjustment, lower retail rates are possible if things go the way they have in Australia. The Reserve Bank of Australia has a cash rate setting of 0.25%, the same as the RBNZ. Aussie banks pay under 1% for all term deposit rates now (see here). Mortgages are lower there too, you can get a 2.29% two-year rate for example. That's the direction things can go in New Zealand too, but it will be a balancing act between term deposit rates and mortgage rates across all the banks, as well as the actions of the RBNZ over the year ahead that determines how much lower things can go.

So, the bad news for savers is that term deposit rates are expected to stay low and risk dipping further from today's levels. However, this time the returns at least won't be eroded by strongly rising consumer prices, as has been the case sometimes in the past. That is, inflation-adjusted returns from TDs (so-called "real" returns) are not as bad as low nominal rates would suggest.

It's worth thinking hard about the timeframe to invest for because the increase in return you can get for making a longer time commitment can make a difference. For example, the current return on a six-month term deposit is 0.75% higher than the three-month rate (1.65% vs. 0.90% for deposits over $5k). There are sometimes higher rates for a particular term. So it's worth checking the whole table of rates and checking if there are any "specials" on offer. Higher returns are possible through longer-term investments and also diversification into different assets with different risk profiles. But you need to be sure those investments suit your needs. Talking to a financial advisor could help.

What's all this about negative interest rates?

Some commentators have speculated that NZ could soon join some offshore countries in having a negative central bank policy rate. It can't be ruled out of course, but our view is that there are more effective monetary easing tools the Bank can use before going down that route. Indeed, the offshore experience with negative rates has been decidedly mixed. The benefits have been questionable, and some of the side effects – which can include a *reduced* flow of bank credit – have been undesirable.

Regardless, the important thing to note is that even if interbank interest rates went mildly negative, retail interest rates would very likely remain positive. So, sorry, your bank is not about to pay you to borrow from them.

The only time a *retail* interest rate has been offered with a negative interest rate, that we are aware of, is in Denmark. But even then the 'negative' rate was largely technical in nature, with a borrower there still likely to end up paying more back to the bank than they borrowed once other factors were taken into account.

Are house prices really going to fall?

They already are. Our view has been that March 2020 was the peak for house prices this cycle and so far this has proved to be the case. The May REINZ house price index showed national house prices down about 1.2% from March. Auckland prices are 1.7% below March levels, and Otago is unsurprisingly underperforming at 3.3% below March levels. Admittedly, some regions like Canterbury, Bay of Plenty, and Taranaki have yet to experience outright price falls.

From here, we're continuing to call a 6% peak-to-trough decline in nationwide house prices. Our sense is that this is at the optimistic end of the spectrum, with many other forecasters calling for double-digit declines. We remain happy to occupy this less negative ground.

Recent data and anecdote from the sector have been much less negative than would be associated with a full-blown property market 'crash'. Volumes and activity are well down on the March highs, as you would expect. But downward pressure on prices is being limited by the fact the market went into the COVID crisis with a full head of full steam and with a clear imbalance of supply relative to demand. This supply shortage still appears to be in place with vendors, as yet, not being pressured to list en-masse. As discussed in our recent housing note, government and mortgage rate support will also help to cushion the market.

Still, we think those sounding the all-clear on house prices are being a tad hasty. The big test for the housing market was always going to be the back half of 2020. It is now winter, the quietest period for the market, and over the next six months the winter winds of rising unemployment, reduced job security, slowing population growth, and slowing household income growth are going to blow a little harder.

Uncertainty around the upcoming general election and a wobbly global economy won't exactly help confidence in the market either. Housing confidence fell in the three months to April, we'd expect another fall when the next survey is released in August.

Isn't housing a great asset now that interest rates are so low?

We need to think about the outlook for the asset price and the asset's yield. As outlined above, house prices are likely to remain under downward pressure for the rest of this year but will probably perform better in 2021. The economy will be recovering, net inward migration may (slowly) resume, and mortgage rates will stay around rock-bottom levels.

Residential housing rental yields are currently 3-5% depending on where you are in the country. Our latest housing note outlined our expectations for national rental inflation to fall slightly, perhaps to around 1%, now that the prior shortage of supply has quickly flipped into a state of balance, or even excess demand in some places.

Mashing the above together suggests a total housing return that is negative this year, but recovers to around 5% or so next year. This isn't bad in the context of term deposit rates that are likely to remain sub 2% for some time, although it's worth noting property is a higher-risk asset class.

Was COVID-19 a death knell for globalisation? Should we go back to being a domestically-orientated economy?

No, and no.

There's been a temptation in some quarters to point the finger at highly interconnected global supply chains and more general international trade connectiveness as features of globalisation that have been exposed by the COVID-19 pandemic. The implication is that NZ should refocus inward and re-shore industries that we currently rely on overseas imports for, thus protecting ourselves should another global trade shock hit us in future.

This is not the time to go back to the bad old days. As a small, open economy we would argue that our prospects for a return to economic health are best served by continuing to plug into the global economy. Finding high-value niches to export into, looking for opportunities to streamline supply chains, pursuing fairer trade access, and importing products and services for which it doesn't make sense for us to compete in due to scale, resources, market distance or other factors.

Indeed, the patchy global economy and subdued global trade are some of, if not *the,* key factors restraining NZ's economic recovery. The sooner the global economy properly re-opens, the sooner the NZ economy can return to health.

What's going on with quantitative easing and the Government's whopping deficit? Won't all of this get us into trouble down the line?

The two are notionally distinct, but related.

The Reserve Bank started quantitative easing (QE) in March, after reaching the limits of conventional monetary policy stimulus – that is, setting the Official Cash Rate as low as feasible at 0.25%. QE involves purchasing government bonds on a large scale to flood the economy with cash, and directly lower wholesale interest rates. To date, the policy has been relatively successful in restoring calm to government bond markets and keeping interest rates much lower than otherwise. Indeed, this 'stimulus' is finding its way to main street in the form of recent cuts to retail mortgage rates and term deposit rates.

There are risks to QE. Exceptionally low interest rates can cause a rip higher in inflation, although to some degree this is exactly what the RBNZ is after. There are also financial stability risks but, again, pushing cash into higher risk asset classes is really what super easy monetary policy is about. Finally, the RBNZ will have to extricate itself from its large holding of government bonds at some point. This has occasionally proved tricky for offshore central banks in the past. But we're comfortable this risk can be managed, particularly given some of the lessons evident from, for example, the US Federal Reserve's experiences shortly after the global financial crisis.

At the same time as the RBNZ has been ramping up its purchases of government bonds, the NZ Government has been selling a record amount as it borrows to pay for its costly COVID-19 support programmes. The RBNZ's primary intention in buying bonds is not to support the government's funding task, but it is certainly a big help. The Government would have much more difficulty finding a home for all its bonds were it not for the RBNZ. Indeed, until recently, the RBNZ has been buying all of the bonds the government has been issuing, and then some.

What of this huge run-up in government debt? The 2020 Budget projects net debt to nearly triple from 19% of GDP in June 2019 to around 55% of GDP by mid-2023. Some of this debt-funded spend-up was simply a matter of getting cash out the door as fast as possible, for example the wage subsidy put in place as we went into lockdown. But as the pressure comes off, the government should be running a ruler over new spending plans. The economy will need plenty of stimulus for some time to come, but it's about the quality of new spending as much as the quantity.

Should we be concerned about this magnitude of government debt?

The ratings agencies haven't sounded particularly alarmed to date. No doubt this partly relates to the fact a 60% net debt/GDP ratio still compares favourably to where many offshore economies were at even *before* COVID struck – for example the US at 94%, the UK at 74%, and Japan at 153% (Australia is lower at just 17%).

Key in our assessment is the ability to service the debt, and the willingness of the private sector to provide funding as the RBNZ gradually steps back in future. Helpful in the case of the former is very low interest rates. Indeed, the government forecasts debt servicing costs to remain at 'just' 1.2% of GDP even as debt peaks in 2023 – the same as was incurred over 2018/19. We're also comfortable offshore investors will continue to buy NZ bonds – last week's heavily over-subscribed $7b bond syndication was a case in point.

My KiwiSaver balance has been all over the place. What is going on?

The investment story that has been impacting KiwiSaver and other investments over the past year or so has two distinctive parts - the positive investment environment that prevailed over 2019 and into early 2020, then a volatile and rapidly changing period since February as the COVID-19 pandemic gripped the globe. 2019 was a great year for many investments. In NZ, we saw the local sharemarket set record highs and gain over 30% over the course of the year. Offshore markets also set record highs and recorded very strong gains over 2019.

In the space of a few months everything changed in the world because of COVID-19. By late March sharemarkets had plunged by 30% or more from the record highs set only a month earlier. People's KiwiSaver balances were down by varying amounts, largely depending on how much exposure a particular fund had to plunging sharemarkets. However, strong responses from central banks and governments around the world since late March are having the desired effect on businesses and economies. Confidence in these actions have helped sharemarkets recover significantly since late March. KiwiSaver balances have recovered significantly too.

Over the year ahead we expect to see more volatility. The COVID pandemic is completely unprecedented in its impact on economies and markets. Anticipating the likely recovery path is extremely difficult and thus investor sentiment will remain fragile and sensitive to abrupt changes in the outlook. Uncertainty and volatility like this is uncomfortable but it's important to remember that investing is for the long term. As we've seen in the past, investment markets and the economy will recover, but this takes time. The key thing right now is to focus on the long-term and make sure you're invested in the right fund. There are various tools around to help with this, such as Sorted and the Help Me Choose tool for the ASB KiwiSaver scheme.

Financial market volatility shouldn't put you off saving. A major sharemarket dip endured in late December 2018 was followed by an extremely strong year in 2019. The drop in March 2020 was very large, but the subsequent recovery over April and May has also been strong. In a similar vein, the strong recovery in markets and investment balances since March this year highlights the importance of sticking with well thought out long-term strategies, rather than chopping and changing in an attempt to time the market. How you react to the associated impact on your investment's value can help you understand your tolerance for taking risks, and ability to ride out periods of volatility in financial markets.

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