

Economic Note

Quarterly Survey of Business Opinion

15 January 2019

Weak profitability casts shadow on outlook

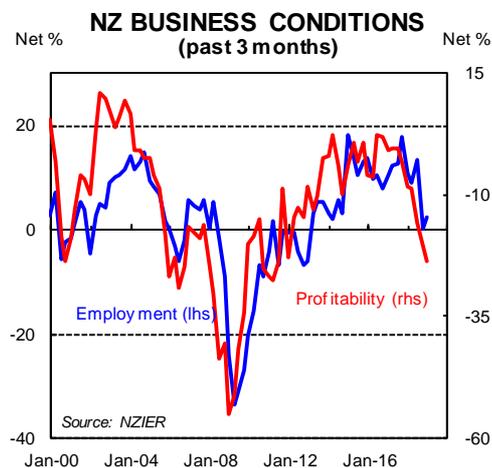
- NZIER QSBO survey suggests economic activity remained relatively soft in Q4.
- Businesses share our optimism and core view that economic growth will pick up from early 2019.
- However, profitability continues to deteriorate as cost pressures rise and if this continues weak profitability presents a risk that growth and inflation will be weaker than we are currently expect.

KEY INDICATORS	Dec-18	Sep-18	Jun-18
Business Confidence (seasonally adjusted)	-18.5	-28.2	-21.3
Own Activity (expected, s.a.)	17.3	10.6	12.8
Number Employed (Past 3 Months, s.a.)	2.4	0.1	13.6
Investment Intentions (plant)	6.7	4.3	1.5
Selling Prices (Past 3 Months, s.a.)	20.5	23.1	23.5

INFLATION INDICATORS	Dec-18	Sep-18	Jun-18
Capacity Utilisation (%)	92.8	93.2	92.8
Costs (Past 3 Months, s.a.)	47.6	42.5	36.3
Costs (Next 3 Months, s.a.)	39.5	40.5	40.0
Selling Prices (Past 3 Months, s.a.)	20.5	23.1	23.5
Selling Prices (Next 3 Months, s.a.)	20.5	29.9	29.1

Summary & implications

The NZIER Q4 Quarterly Survey of Business Opinion showed that Q4 activity remained reasonably soft, largely as expected. Our view is that economic activity and business confidence will recover from early 2019. While forward-looking responses from the QSBO shared this optimism, some of the underlying detail casts some shadow of doubt. In particular, **deteriorating profitability and a reported reluctance to raise prices presents some risk that economic momentum may remain sluggish in early 2019.** In our economic outlook, we assume an economy supported by growing demand, growing employment and accelerating inflation. However, if costs continue to grow but firms are unable to recoup margins, then inflation and employment may be weaker than we currently expect. This is a downside risk to the outlook the RBNZ will also remain very wary of over the coming year.



Activity still subdued in Q4

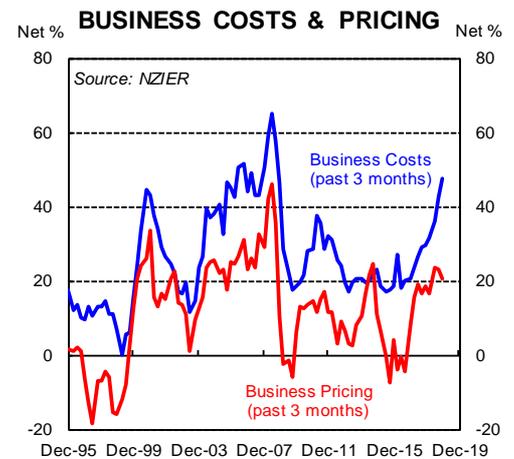
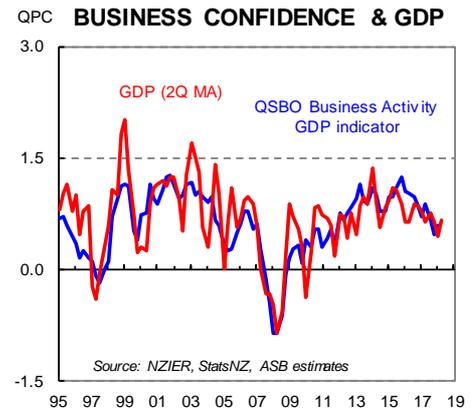
The NZIER Quarterly Survey of Business Opinion showed some very slight improvement in Q4. Moreover, the result was broadly consistent with our forecast of modest Q4 GDP growth (approx. 0.5% qoq), following weak growth of just 0.3% qoq in Q3. The key measure we focus on is experienced domestic trading activity over the past three months (i.e. over Q4), which marginally improved from zero to +4. The QSBO indicates that firms were still relatively quiet over Q4. Activity growth was very low, profitability deteriorated and new employment growth remained subdued (net 2% of firms increased the number employed, compared to an average of net +14% over the past 5 years).

Forward looking indicators improve

While Q4 activity remained weak, forward-looking expectations for Q1 improved, suggesting firms share our optimism that economic momentum will start to improve in early 2019. Own activity expectations for the next three months (i.e Q1 2019) lifted to +17 from +10 and the highest level since Q3 2017 (i.e. prior to the general election). The combination of lower petrol prices and reduced policy uncertainty (as the Government beds down key policy details) are likely to be the main factors behind improved business sentiment. Meanwhile, employment and investment intentions also picked up, although remain at relatively low levels.

But cost pressures are still chewing into profits

In saying this, some details remain soft and present risk that economic activity will remain sluggish in early 2019. In particular, we remain concerned that profitability continued to deteriorate in Q4 and profitability expectations remain pessimistic. While the proportion of firms that reported an increase in costs over Q4 increased, the proportion who increased their selling prices in Q4 and expect to raise their prices in Q1 2019 both dipped (see table on page 1). Indeed, pricing intentions actually fell in this quarter's QSBO (to net 21% from net 30%) despite the increase in cost pressures, suggesting some firms had hoped to raise prices back in Q3, but no longer think they are able to. The pattern of increased cost pressure but a muted response in selling prices was shared across the sector breakdown provided by the QSBO. Which raises a very important question: why are firms not increasing prices to recoup margin? And in the face of deteriorating profitability, how will firms respond, if they cannot recoup margins through prices? For example, there has traditionally been a reasonably close relationship between profitability and employment (see chart on front page). Our medium-term economic forecasts assume inflation begins to accelerate and employment continues to grow, but the Q4 QSBO flags some risk that this may not happen, if profitability does not improve.



GROWTH INDICATORS	Dec-18	Sep-18	Jun-18
Business Confidence (seasonally adjusted)	-18.5	-28.2	-21.3
Own Activity (expected, s.a.)	17.3	10.6	12.8
Investment Intentions (building)	-4.8	-5.1	-4.6
Investment Intentions (plant)	6.7	4.3	1.5
Profitability (past 3 Months)	-23.6	-20.5	-15.7
Profitability (next 3 Months)	-12.3	-11.2	-10.5

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