Treasury Trends

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Consulting the crystal ball for 2021 and beyond

While 2020 was an exceptional year, are there any learnings we can take to support businesses and the wider New Zealand and Australian economies into 2021 and beyond?

At a macro level, the strategy and implementation of fiscal stimulus was unprecedented, and while it saved many businesses, from a financial market perspective, was 2020 really that exceptional? Looking at it from an FX perspective, yes, there was above average volatility, but we have had some years when currency ranges were almost double what 2020 offered. Equity markets, and the sugar rush that was 2020, have so far continued into 2021 but how sustainable will this be?

Key Points

- New Zealand and Australia are well placed to prosper from a global economic recovery
- Uncertainty remains the biggest handbrake on business investment
- Global supply chains may continue to be congested for a considerable time
- Foreign exchange and funding markets will remain as volatile as ever

2020 – not a financial crisis

It is relevant to remind ourselves that 2020 was a year in which a pandemic created an economic crisis that fiscal stimulus managed, but it was not a financial crisis. To this end, while monetary policy was supportive, have we now reached the stage where the impact of further policy changes will be severely limited in the coming years? With these questions in mind, what do we think 2021 has in store?

Fourth YOY Trade surplus ahead

On the positive side, both New Zealand and Australia are well placed to prosper from a global economic recovery. We produce commodities that are in high demand and, as a result of this, New Zealand is on-course to record its fourth year-on-year trade surplus - although shipping logistics may have a part to play over the coming quarters. New Zealand also had a stronger bounce in Q3 GDP than initially expected, and the half year economic and fiscal update highlighted a higher tax take and lower operating expense than prior forecasts. With a strong government balance sheet, debt to GDP in New Zealand is now expected to peak at 51% in 2024, down from the earlier forecast 54%.

The Treasury also expects unemployment to peak at a moderate 6.8% in 2022. Australian metrics are forecast to be slightly better for debt to GDP and slightly worse for the unemployment rate. With these positives, there is limited risk of a sovereign downgrade.

(Continued on page 2)

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Strong NZ/AU government balance sheets

To be fair, the strong position the New Zealand economy finds itself in is due to a combination of present and past governments, so we should celebrate the fiscal austerity, strong macro-growth performance and enabling of business from the past National government (and prior to that Michael Cullen) which allowed us to enter this economic downturn with low levels of debt and a strong balance sheet. While not perfect, we should also applaud the actions of the existing New Zealand Labour government with their wage support programmes and rapid expenditure that supported both businesses and individuals when most needed thereby maintaining economic confidence.

The New Zealand and Australian government balance sheets are in a strong position compared to peers, and this will be important going forward as the respective central banks, like many other central banks globally, will eventually become limited in the effectiveness and efficiency of their individual monetary policy stimulus programmes. While the RBNZ and RBA are by no means in unique positions with inflationary pressures failing to gain momentum over the past decade, it is interesting to note the RBNZ, RBA, BoC and Federal Reserve have all evolved their mandates to incorporate full employment alongside the traditional stable finance system and inflation targeting.

Investment for growth slow

While full employment is a desirable goal that can only be fulfilled in a successful and growing economy, it should be noted that currently the main challenge for these central banks is to stimulate the flow of money, in exchange for goods and services, within their domestic economies. While there is plenty of available cash within the financial system, and the possibility of even cheaper funding in New Zealand via the RBNZ Funding for Lending Programme, the real question is why business won't leverage their balance sheet, borrow more money, and invest for growth … with the unfortunate answer being companies won't when the economic outlook remains so uncertain. Ultimately, if a company is reluctant to borrow when the OCR rate is at 0.25% or 0.10%, what will fundamentally drive it to borrow when rates are at -0.25%?

So, with strong fiscal footing and easy monetary frameworks, what does our crystal ball highlight as the positives and negatives for 2021?

Positive risks

- Liquidity has spared the global economy from the very worst of the pandemic due to an abundance of cheap and easy money within the financial system, but money will always search out the best possible yield and this means, as far as equity markets and house prices are concerned, we may expect a continuation of what we have observed over the past six months. For central bank governors and Finance Ministers alike, this is a tricky problem. The psychology of markets dictates companies and individuals are financially more expansive when they feel their asset base has grown in value, and to a large extent this has been reflected in New Zealand's (and Australia's) recovery post the first lockdown.

  Against this though, escalating asset prices tend to create bubbles and as we all know … bubbles can burst at the most inopportune of times. This becomes the regulatory fine line … of easing expectations to slow price acceleration, while retaining the confidence of markets that a damaging 'pop' is not imminent. Furthermore, what if the 'everything rally' is shown to not actually be built on substance? It remains difficult to believe the severe pandemic could ultimately be a sustainable net positive on economies and markets, as current pricing and sentiment suggests.

- Innovation, tech, new ways of working, and productive efficiencies were once the domain of entrepreneurs and public think tanks, but nationwide lockdowns taught us we can innovate, evolve, and accelerate when needed. To some extent, the lockdowns have fast-tracked five years of projected work-place innovation within the space of six months, with the added benefit that productivity does not seem to have been adversely impacted. But still to be fully determined is how the contours of remote technology and social distancing will impact upon the services and 'face-to-face' industries longer-term.

- Keynesian economics actually work. Developed by the British economist John Maynard Keynes during the 1930s in an attempt to understand the Great Depression, Keynes's theory was that the best government response to a recession was to spend more and stimulate activity. This is what most developed economies did during the pandemic and the opposite of the austerity measures undertaken by the governments of the 1930s. While 'economic theory 101' may be out the window, future textbooks will refer to the great 'wage subsidies' and 'JobKeeper payments' of 2020. Longer-term however, the risks of ongoing debt burdens will need to be navigated.

- The Finance Minister and the RBNZ Governor acted swiftly and decisively at the height of the pandemic to support the economy. Exactly what was needed and what we got. While there has been the odd tiff since, the positive news is that the authorities are largely aligned … just don't try to talk the NZD down please, Mr Orr! The New Zealand and Australian exporting sectors may

(Continued on page 3)

be less than fully enthused, but the cold hard facts are these … our economies have been able to manage the COVID-19 pandemic well, our economies and government balance sheets are the envy of many in the developed world, and the USD has been in a cyclical weakening cycle. The NZD is merely a reflection of these facts and remember, in 2011 the NZD/USD rallied to 0.8800, and the AUD/USD to1.1100, so it's not out of the question these exchange rates could rally further.

- The Housing and Equity markets. With KiwiSaver giving most New Zealanders their first real exposure to equities (and with Australian super schemes in place for much longer), those that are fortunate enough to own a house are feeling a little, okay, 10%+ richer. Ultimately, there is a general perception that, *"it could have been a lot worse,"* and it certainly could have been! Admittedly, there is still a degree of caution, but all-up, most New Zealanders and Australians still have a job and are feeling a little better from a household balance sheet perspective. In New Zealand there is a rise of the suburbs compared to the 'CBD' as remote working is more achievable, spreading real estate and lifestyle benefits, and perhaps reducing inner city congestion and pollution. However, there may be ongoing ramifications such as reduced demand for city retail stores, and reduced returns for commercial property owners and city service providers.
- Will the New Zealand housing market froth/bubble continue, burst, or something in between? The NZ context is typically not for a bust. It is also not in the RBNZ's and the Finance Minister's interests to go too hard in reversing their stimulus measures, as any compromise in economic activity and consumer spending will exponentially slow our economic recovery. While we will always debate the affordability of the domestic housing market, any over-regulation of the housing market or mortgage books of the local banks will ultimately impact local confidence. A lack of distressed selling in the marketplace also suggests there is little prospect of forced price declines.

Negative risks

- COVID-19 vaccines may not work as effectively or be rolled out as efficiently as hoped. While there is much optimism built up within financial and equity market expectations for a rapid rebound in global economic growth, prosperity, and company earnings, any failure of the vaccine response to achieve expected benefits within the anticipated time frames may result in optimistic financial market pricing reversing. The ensuing 'risk-off' environment would include weaker equity markets, and weaker NZD and AUD currency values. Local factors in terms of timing may also be at play as differentiators here; contrast the *"no hurry"* approach in New Zealand with the "brought forward" approach in Australia in response to vaccine roll-out timing.
- An enormous amount of debt on government balance sheets has also been 'passed on' to the Central Banks (including the RBNZ and the RBA) through Quantitative Easing/Large Scale Asset Purchase programmes. Can the massive government debt required to fund the emergency fiscal stimulus responses actually be repaid? Does it ever need to be repaid? If not, then what are the implications for both financial and credit markets, and society in general, in terms of perpetual debt remaining on balance sheets indefinitely? It may also be difficult to increase interest rates due to a lack of serviceability and affordability with vastly increased debt loads.
- With the increasing 'urbanisation' of prior natural habitats, and the underlying ecosystems to house and feed the world's population, the prospect and probability of further pandemics similar to COVID-19 occurring in future years must be elevated. How will scientific development and societies respond with re-occurrences of new viruses? Furthermore, what are the implications for economies and financial markets to absorb these impacts in our now saturated and constrained times?
- Regarding China, how sustainable can the commodity/infrastructure stimulus support be? Offshore repatriation of funds brought back to China assisted the response of China Inc. following the COVID-19 outbreak, but local government debt remains elevated (even if obscured within financing vehicles). Conversely, many of these financing and stability concerns have been apparent for the last 15 or more years without any meaningful adverse impact on macro-economic activity.
- What is the future outlook for the US/Australia versus China trade wars? Despite the less overtly confrontational approach of incoming US President Joe Biden, it is unlikely that previous measures and tariffs will be fully reversed. Chinese trade and political tensions have also widened beyond the US and Australia to include the UK, and potentially the EU and perhaps even New Zealand as well. There is a risk that ongoing trade disputes restrict export-led recoveries in many economies when these are most needed.
- Re-invigoration of manufacturing and durable retail goods sectors impacted by 'the great nesting' and replacement of services spending has already occurred. However, what may be the impact of constraints in some professional services (such as quantity surveying) and other industries impacted by reduced foreign workers; there may also be further delays to the timing of already lengthy domestic infrastructure project pipelines.

(Continued on page 4)

- Global supply chains, shipping line capacity and port operations may continue to be congested for a considerable time, leading to less efficient transmission of global trade potentially at a higher cost. Rising inflation pressures may also lead to steepening yield curves by pushing long-term rates higher, while the reluctance of central bankers to lift cash rates will anchor short-term rates. US Fiscal stimulus/bond issuance may also be supporting upward movement in long-term interest rates.
- There remains the prospect that International tourism and travel will take longer to return to 'normal' than currently projected with delays until effective vaccines have been comprehensively and successfully rolled out. In New Zealand, the strong domestic travel during our winter limited the impact of international tourism, although this imbalance will inevitably impact in time. The upcoming peak summer season, with prospective international visitors unable to arrive in New Zealand (and Australia), will be the test. Renewed and ongoing COVID-19 outbreaks overseas may further delay meaningful travel bubbles.
- While largely unopposed, the New Zealand government has been far from transformational. The impact of inequality on the housing crisis after years of undersupply has now met increased 'nesting' as speculative demand worsens. Labour, and potentially goods and raw materials supply shortages due to shipping constraints, may also lead to further deterioration in domestic housing imbalances owing to resource shortages.
- Up until now there has been limited rising unemployment in New Zealand and Australia, owing to proactive and large-scale fiscal and monetary policy stimulus which has complemented the largely successful 2020 lockdowns. Although the respective low government debt starting positions have helped, fiscal stimulus will be unable to continue indefinitely at the same pace as it did during 2020. A significant rise in unemployment over the coming year(s) would be a constraint to consumer spending which has been a pillar of support for the domestic economy to date.

Ultimately, the only guarantee for 2021 is that the financial markets will remain as volatile as ever with considerable movements likely across the foreign exchange and funding markets; with these having considerable influence on treasury planning.

Happy hunting in 2021 and remember, your friendly Treasury advisor is only a phone call away!

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