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Quarterly Survey of Business Opinion: June 2008 quarter

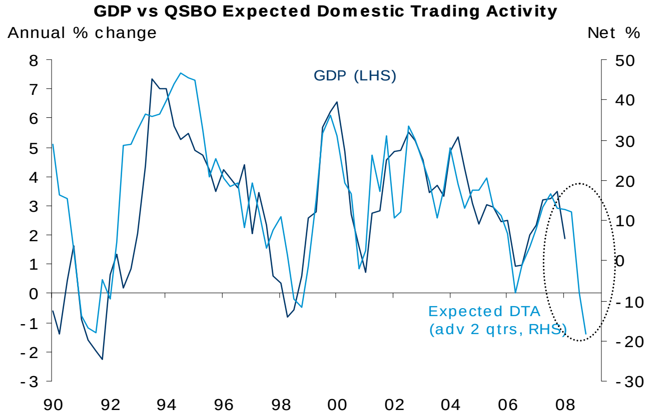
Key points

- **Broad-based weakness in activity indicators.**
- **More than just a technical recession.**
- **Despite falling demand, intense cost pressures see firms trying to put through price increases.**
- **We doubt hiking prices in a no growth environment is sustainable, but firms seem to lack any other alternative at this stage.**
- **July rate cut remains a 50-50 call.**

Assessment

As expected, today's QSBO highlighted sharply weaker growth. Headline business confidence hovered near the level recorded in the March quarter, with a seasonally adjusted net 54 percent expecting the general business situation to deteriorate in the next six months (58 percent in March). However, activity measures deteriorated sharply, with firms' experienced (past 3 months) domestic trading activity (DTA) falling to a net -18 percent, from a net -7 percent in the March quarter. DTA expectations for the next three months also tumbled, with a net -18 percent reading, down from a net -8 percent in March. This is the lowest level since March 1991 and suggests that the negative GDP quarter for Q1 was not a flash in the pan and a contraction in Q2 is also likely (if not worse than in Q1). The September quarter is also looking negative. Based on the historical relationship, the economy is on track for the deepest contraction in growth since the early 1990's.

GDP vs QSBO Expected Domestic Trading Activity



Sources: ANZ National, Statistics NZ, NZIER

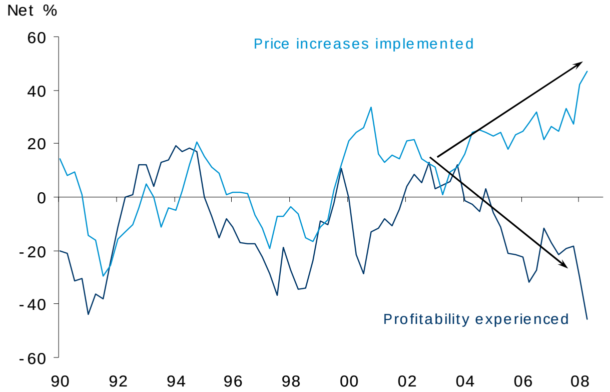
The weakness was consistent across all regions in the survey, and also across the sectors. All sectors recorded a drop in output for the past three months. Merchants (retailers) reported the biggest drop in experienced DTA. This is not surprising given the weakness seen in retail sales (barring fuel and food) of late as households' discretionary income is whittled away by rising cost of living pressures. The merchant's DTA is at a level last seen in 1991. Architects noted that their work availability in their own office for the next 12 months continues to deteriorate across all types of work, an indication that the contraction in construction activity is moving beyond housing.

	Headline business confidence		Domestic trading activity – next 3 mths		CUBO	Avg selling price – next 3 mths
	actual	s.a.	actual	s.a	actual	actual
Q2 2006	-44	-36	-1	3	0.9136	36
Q3 2006	-19	-21	10	8	0.9230	28
Q4 2006	3	-9	15	13	0.9171	28
Q1 2007	-15	-9	16	17	0.9182	40
Q2 2007	-37	-28	9	13	0.9156	35
Q3 2007	-27	-29	15	13	0.9134	34
Q4 2007	-26	-39	14	12	0.9204	35
Q1 2008	-64	-58	-10	-8	0.9262	45
Q2 2008	**-64**	**-54**	**-23**	**-18**	**0.9237**	**49**

However, the weakness in activity is against the backdrop of intense cost pressures. The number of firms reporting increasing costs rose to a net 71 percent in June (from a net 62 percent in March) to be at the highest level since December 1986. It is not hard to think of where these costs pressures are originating from, with fuel, wages and electricity prices likely to sit near the top of the list.

Not surprisingly, bottom lines and profitability are under extreme pressure. The combination of sharply weaker growth, but increased cost pressures poses a nasty mix for corporate earnings. A net 46 percent of firms reported falling profits for the past three months, which is up from a net 30 percent in the March quarter. Expectations for the future look little better, with a net 40 percent expecting falling profits for the next three months. The moves seen in the equity market of late, with the NZX 50 close to 30 percent below its peak, is certainly consistent with this weak earnings outlook. In addition, cashflows are not being helped by the rise in overdue debtors, especially for builders who report a sharp rise in expected difficulties collecting payments (from a net 30 percent in March to a net 41 percent in June). The level is comparable to levels in the late 1990s.

Profitability and Price Increases Experienced



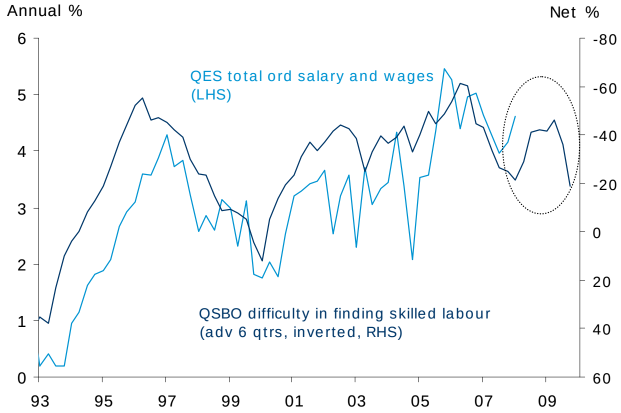
Sources: ANZ National, NZIER

Pricing intentions move higher, suggesting some firms have little choice but try to pass cost increases on. With firms facing such erosion in profits – and we note manufacturers have reported declining profits for 18 consecutive quarters – firms are resorting to putting up their prices. A net 49 percent of firms intend on increasing their prices within the next three months. This is up from a net 45 percent in March and is the highest level since March 1987. This suggests that near-term CPI inflation could exceed 5 percent and will certainly be disconcerting for the RBNZ. Yet, we doubt that in an environment where activity is going backwards, those price increases will be sustainable. However, it seems that firms are having no choice but to try it on for now.

Businesses continue to flag a tightening of the belt. A net 3 percent of firms stated they reduced staff levels over the past three months. This compares with a net 4 percent in March that actually increased staffing levels. Further weak employment growth looks likely, with a net 6 percent of firms expecting to reduce staff levels over the next three months. In terms of the composition, only the services sector reported increasing staff levels over the past three months, although all sectors are expecting to lower staff levels in the near future. Merchants (retailers) are the most pessimistic on the labour front, with a net 22 percent expecting to decrease staff in the next three months.

Resource pressure in the labour market is easing, albeit of a high base. As a result of fewer firms looking to hire, the gauges for difficulty in finding labour have improved (i.e. labour is less difficult to find). Skilled staff is still difficult to find, but less so compared to March (a net 19 percent of firms in June compared to a net 36 percent in March). Unskilled staff on the other hand, is getting easier to find with this gauge rising to the highest level since September 1999. This suggests that wage inflation may be close to peaking – something that the RBNZ has expressed concern about recently. Investment intentions remained largely unchanged from the March quarter, with a net 18 percent and 17 percent of firms expecting to reduce investment in buildings and plant and machinery respectively.

QSBO difficulty in finding labour and wages



Sources: ANZ National, NZIER, Statistics NZ

Firms are increasingly identifying demand as a major factor limiting expansion. In the June quarter, 59 percent of firms identified that sales were the major limiting factor, while 34 percent pointed to supply-side factors (18 percent labour, 7 percent capacity, 7 percent finance and 2 percent materials). This compares with 49 percent stating sales as the major limiting factor in the March survey. We expect this theme to continue as the economy slows, although we will be closely watching those highlighting the availability of finance given the turn in the credit cycle.

Capacity pressures remain elevated. Capacity utilisation (as measured by the CUBO) fell only marginally in the June survey to 92.4, from the record high 92.6 in March. Looking at the split, the fall was largely due to less capacity from builders, while manufacturers' capacity was largely unchanged. The former is not surprising given the weakness seen in the housing market and anecdotes we are hearing on the construction front. However, the latter is somewhat of a surprise. Perhaps the sharp fall seen in the NZD/AUD – which is an important currency for the majority of NZ manufacturers – has enabled some firms to increase production. However, the level as well as the recent trend in the capacity utilisation measure doesn't quite sit with the activity gauges. The CUBO looks puzzling to us given what has been happening to other activity indicators, particularly when past and expected overtime work has declined quite sharply.

Implications

Today's survey results pose a nasty cocktail of weak growth but high inflation for the RBNZ. It suggests the economy is slowing more rapidly than the RBNZ forecast in June, but with higher near-term inflation. Weak economic growth will give the RBNZ confidence that medium-term inflation pressure will recede, as will evidence to suggest that the labour market is turning, particularly with difficulty in finding labour improving sharply. At the margin we believe today's report strengthens the case for moving in July. In saying this we are placing particular weight on the readings from skill shortages as an indicator of pending wage pressure. However, a July cut still remains a 50-50 call, with a lot dependent on next week's Q2 CPI result, particularly the composition of non-tradable inflation. Moreover, stratospheric oil prices – while a one off that should technically be looked through – will continue to have a material say, particularly with the headline inflation rate set to breach 5 percent.

	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Decade Average
Business Confidence	-37 *(-28 s.a.)*	-27 *(-29 s.a.)*	-26 *(-39 s.a.)*	-64 *(-58 s.a.)*	**-64** *(-54 s.a.)*	-16 *(-16 s.a.)*
Domestic trading activity – past 3 months	8 *(12 s.a.)*	0 *(2 s.a.)*	10 *(6 s.a.)*	-7 *(-7 s.a.)*	**-22** *(-18 s.a.)*	9 *(9 s.a.)*
Domestic trading activity – next 3 months	9 *(13 s.a.)*	15 *(13 s.a)*	14 *(12 s.a)*	-10 *(-8 s.a)*	**-23** *(-18 s.a)*	13 *(13 s.a.)*
Capacity Utilisation (CUBO)	0.9156	0.9134	0.9204	0.9262	**0.9237**	0.9065
Average selling price – past 3 months	25	33	28	42	**47**	17
Average selling price – next 3 months	35	34	35	45	**49**	24
Costs – past 3 months	46	46	45	59	**68**	31
Costs – next 3 months	48	44	49	62	**71**	30
Difficulty finding labour – skilled	-42	-41	-46	-36	**-19**	-34
Difficulty finding labour – unskilled	-26	-19	-33	-22	**6**	-11
Investment intentions – Buildings	-5	-6	-8	-18	**-18**	-9
Investment intentions – Plant & Machinery	3	3	-3	-15	**-17**	1
Employment intentions – past 3 months	2	5	4	4	**-3**	1
Employment intentions – next 3 months	11	12	14	0	**-6**	4

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