NZ Insight: The low consumer confidence puzzle

6 July 2022

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Contact

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The low consumer confidence puzzle

Overview

- Our Consumer Confidence survey shows consumers are miserable, and do not expect things to improve. Consumer confidence is usually a timely indicator for household consumption spending (the biggest part of GDP), so understanding what's happening here is important.
- While COVID disruption is likely an important factor, we think low confidence is a genuine reflection of the challenging economic environment households are facing.
- Consumer confidence has also fallen sharply in our trading partners – despite rapidly tightening labour markets, and in some cases, record levels of labour demand. This synchronised drop in confidence has coincided with sharp increases in inflation and rising interest rates.
- What does weak confidence mean for the outlook? We think it's a symptom of a softening outlook for household spending in New Zealand. But, there are still (just) enough supports out there for household spending to not go backwards.
- The pessimism we're seeing in consumers is a key reason for our expectation that, after a fourth 50bp hike in August, the RBNZ will return to 25bp hikes, and will then pause hiking after November's MPS (with a peak OCR of 3.5%). By then, signs of slowing demand should be clear. That said, fighting inflation remains the name of the game – and the RBNZ won't stop until they're convinced they've done enough to bring inflation back to target.

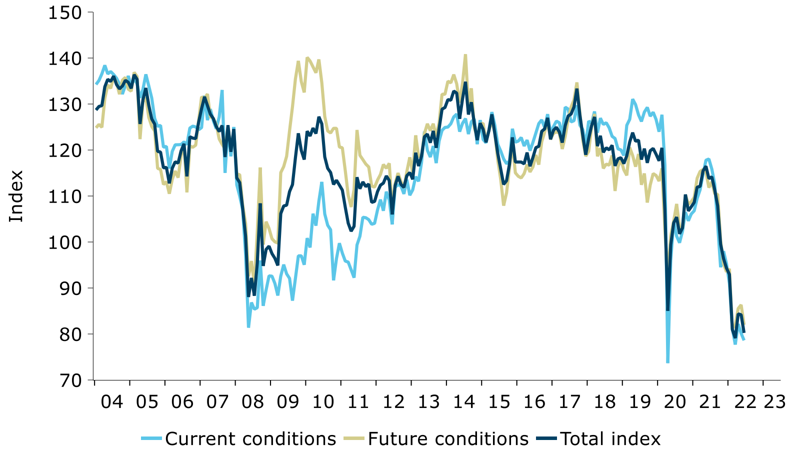
Consumer confidence is outright recessionary

While the key stresses and strains for businesses in the New Zealand economy primarily relate to an inability to keep up with strong demand, a very different story is being told by the steep deterioration in consumer sentiment in New Zealand. Barring the first lockdown in 2020, consumer confidence has never been this low since the data started in 2004. It's worse than during the depths of the Global Financial Crisis (GFC), a period characterised by massive uncertainty, rising unemployment, and a shrinking economy.

Given the strong historical correlation between consumer confidence and economic growth, it's worth digging into what's happening here. Does the fall in confidence simply reflect the ongoing impact of COVID restrictions? At the other end of the range of possibilities, is it the canary in the coalmine for an imminent recession? Or does it simply point to tough times ahead, as the RBNZ purposefully taps the economic brakes in order to rein in surging inflation? If you're a regular reader, you'll know we lean towards the latter interpretation.

The reason we aren't pinning the current fall in consumer confidence on Omicron is the fact that we have not seen any rebound in forward-looking measures. The forward-looking measures tend to be pretty glass-half-full, on the whole. After the GFC for example, we saw a rapid improvement in consumers' expectations for the future (figure 1). That makes sense – when you've just been through a massive economic shock, you'd expect things to get better (or at least, not be able to get much worse). But at the moment, consumers see no end to the tough times, with expectations for future conditions just as negative as their assessment of current conditions. Consumers report it's a terrible time to buy a major household item, and expect the economy to get worse over the next five years.

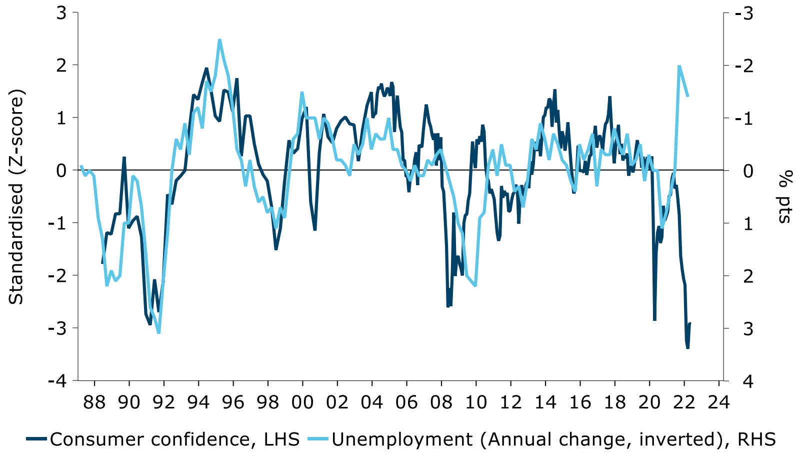
Figure 1. New Zealand consumer confidence



Source: Macrobond, ANZ Research

What makes the drop in confidence harder to digest is that at 3.2%, New Zealand currently has the lowest unemployment rate since the official data began – and a broad range of other indicators suggest the labour market is incredibly robust across the country. As figure 2 shows, over history there's been a strong negative correlation between confidence and unemployment (note the latter is inverted to more clearly show the strength of the correlation). Not surprisingly, when unemployment is falling, confidence tends to increase, and vice versa. But not in 2022. Unemployment has fallen rapidly (from what were already low levels relative to history), and yet confidence has tanked. We haven't seen this kind of disconnect before.

Figure 2. Consumer confidence and annual change in unemployment



Source: Westpac, Stats NZ, Macrobond, ANZ Research

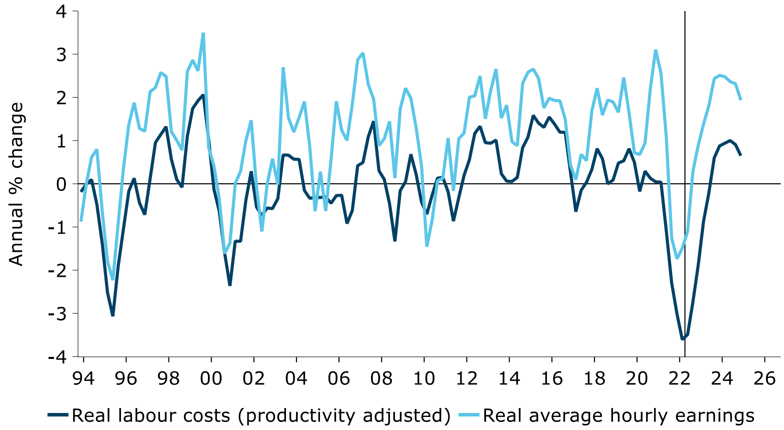
Note: The ANZ Roy-Morgan consumer confidence index, while very timely and at a monthly frequency, is only available from the end of 2003. We use the Westpac consumer confidence index prior to Q4 2003.

Of course, we haven't seen this combination of high inflation, low unemployment, and a global pandemic before either (at least, not in the past 40-ish years for which we have reliable economic data). Unemployment may be at a record low and wages may be growing faster than at any time since the GFC, but we're also going through a cost-of-living crunch. New Zealand, and many other countries, emerged from COVID in far better shape than anyone expected. But that also meant the policy response ended up being too effective at stimulating demand (especially given the supply chain havoc wrought by COVID). We're now dealing with the consequences of an overheated housing market and broader economy – inflation.

The rise in inflation has been abrupt, with annual CPI inflation rising from just 1.5% in Q1 2021, to an eye-watering 6.9% in Q1 2022. And we're forecasting inflation peaked at 7% in Q2 this year. For many Kiwi households, this will be their first exposure to high inflation during their working lives. And it's highly unpleasant. We've gone through a post-GFC decade where inflation was stubbornly below 2% (the midpoint of the RBNZ's target range of 1-3% for annual CPI inflation). That meant even the low nominal wage growth we saw after 2009 was sufficient to keep real (ie CPI-adjusted) incomes growing (although still much slower than house prices).

Now, consumers are on the back foot. Even though wage growth has been much stronger in recent quarters, inflation is stronger still. That's seen real wage growth turn negative, eroding households' real spending power (figure 3). While we do expect wages to begin to catch up with inflation before too long, until that happens, it's a serious shock for households.

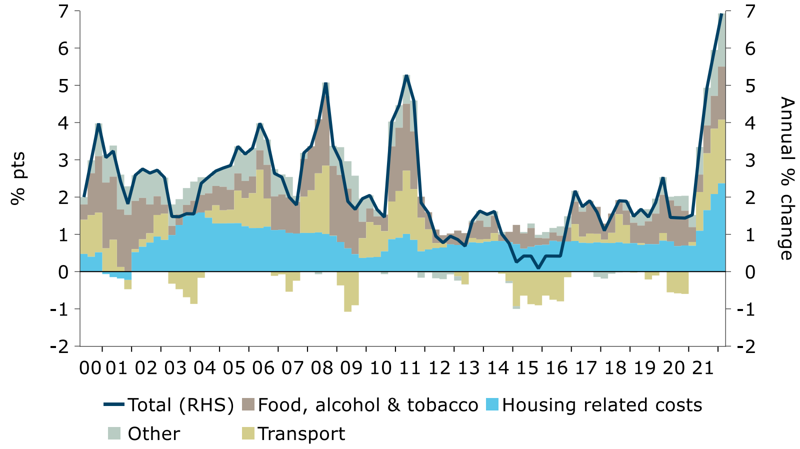
Figure 3. Real wage growth



Source: Stats NZ, Macrobond, ANZ Research
Note: CPI has been adjusted to remove the impact of 2010's GST increase.

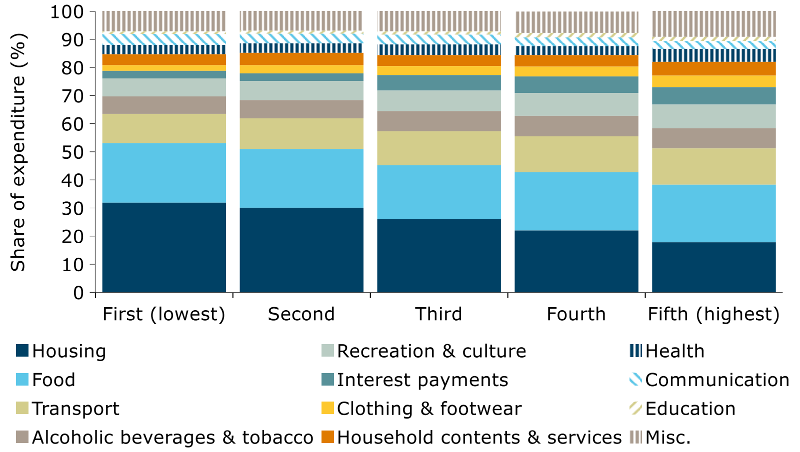
What makes the inflation pain worse is where we're seeing the biggest price rises. Most things are going up in price, but the bulk of the increase has been concentrated in essential parts of the CPI basket: housing, food, and transport (figure 4). With the tragic events in Ukraine adding further pressure to oil and food prices, the squeeze on essentials has only gotten worse over 2022. For lower-income households, this inflation is particularly hard to cope with. Food, transport, and housing are a significantly larger share of the consumption basket for lower-income households (figure 5). And it's likely that for the very lowest earning households, that cost of living pressure is even more acute than shown in figures 4 and 5. Higher earners aren't immune either, with these three essential categories making up over 50% of the expenditure basket even for the top 20% of households by income. Inflation is hard on everyone – but it hurts the poor the most.

Figure 4. Contributions to CPI inflation



Source: Stats NZ, Macrobond, ANZ Research

Figure 5. Consumption baskets by income quintile



Source: Stats NZ, Macrobond, ANZ Research

Note: Income quintiles in the Household Living-cost Price Index are based off data from the Household Economic Survey, using equivalised median annual household disposable income. See this Stats NZ report for further details on the Household Living-cost Price Index (HLPI).

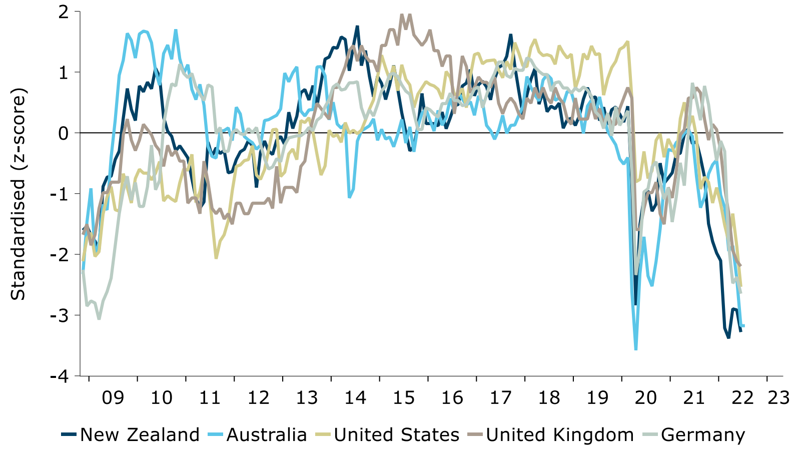
While high inflation is certainly one key reason for low confidence, it has accomplices. In particular, asset prices have taken a beating as central banks hike interest rates to tame inflation. The S&P 500, for example, is down nearly 20% since the start of this year. And house prices, most Kiwis' biggest asset, have fallen 5.5% from their November peak – with further falls expected over 2022.

Then there's COVID, and more specifically Omicron. When discussing the fall in confidence in the May MPS, the RBNZ noted that "The spread of COVID-19 throughout New Zealand… has likely contributed to lower consumer confidence". And while that's undoubtedly true, we don't think it captures the full picture. The stubbornly low 'future conditions' part of the consumer confidence survey and the fact that confidence has remained weak despite COVID restrictions easing both suggest that low confidence reflects a genuinely difficult time for consumers. Inflation is eating into their real earnings, while they watch their assets fall in value, and the mortgage bill rise.

It's not just New Zealand

Looking at the global picture helps to put New Zealand's consumer confidence readings into perspective. In recent months there's been a synchronised deterioration in confidence in advanced economies (figure 6). You can't pin that on Omicron disruption in New Zealand.

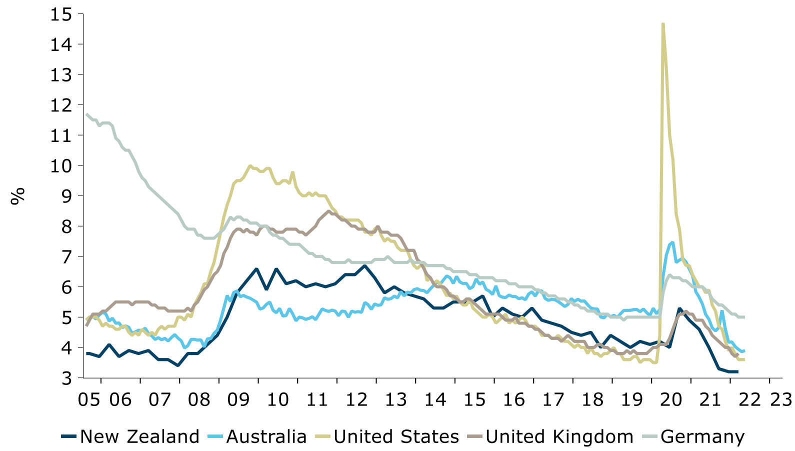
Figure 6. Global consumer confidence indices (standardised)



Source: University of Michigan, GfK, DG ECFIN, Macrobond, ANZ Research

And just as we see here, global labour markets have recovered incredibly quickly from the COVID shock; far quicker than during the GFC (figure 7). Australian job vacancies have never been higher, and in the US there are nearly two job openings for every unemployed person – an unprecedented level of labour market tightness. Wage growth has either accelerated, or is expected to take off, across most of our major trading partners. Job security could hardly be better, at least in the short term. And yet, consumers are still miserable.

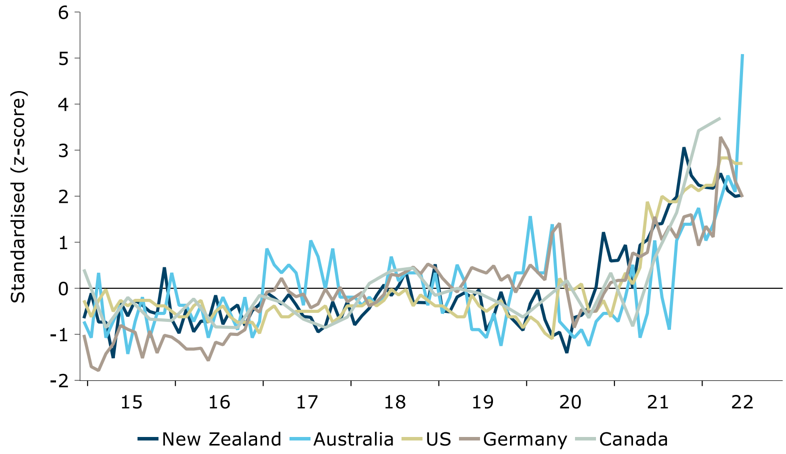
Figure 7. Global unemployment rates



Source: National sources, Macrobond, ANZ Research

Again, it's clear that inflation is weighing on consumers' minds. Just as we've seen a significant fall in consumer sentiment, we've seen a big increase in consumers' inflation expectations. In New Zealand, consumers have historically not had a good handle on actual CPI inflation – with the inflation expectations measure in our survey usually ranging between three and four percent (versus sub-2% actual inflation). However, consumers are well aware of inflation now (indeed, they win the real-time forecasting prize for 2021), and they expect it to continue (figure 8). A low unemployment rate is good, but when interest rates are surging and the cost of living is rising quickly, it's easy to see why consumers are feeling blue.

Figure 8. Global consumer inflation expectations (standardized)

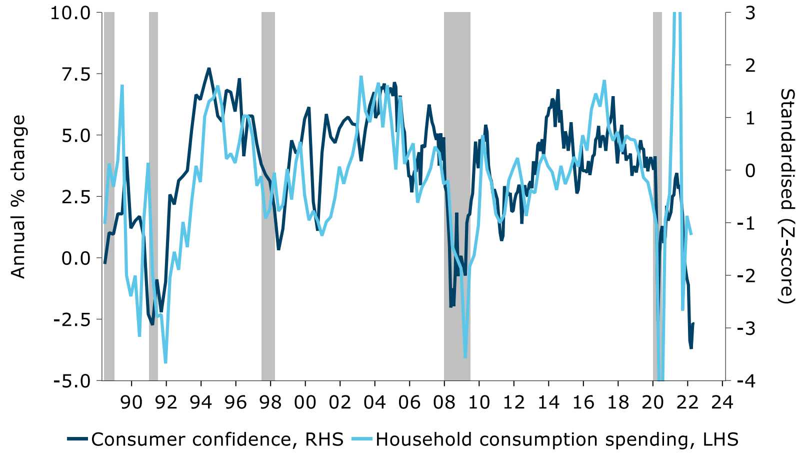


Source: ANZ, University of Michigan, Eurostat, BoC, Macrobond, ANZ Research

What does this mean for the outlook?

So consumers are feeling rubbish – and it's not just COVID. Newspapers lately are full of one tale of woe after another about our malaise on all fronts. But what does this mean for the economic outlook? Historically, there's been a very strong correlation between household consumption spending and consumer confidence. Obviously correlation does not necessarily mean causation, but consumer confidence has often been a warning sign that the economy is about to deteriorate. Taking this historical correlation literally, one might expect household spending to fall rapidly over 2022 (figure 9).

Figure 9. Consumer confidence and real household consumption spending



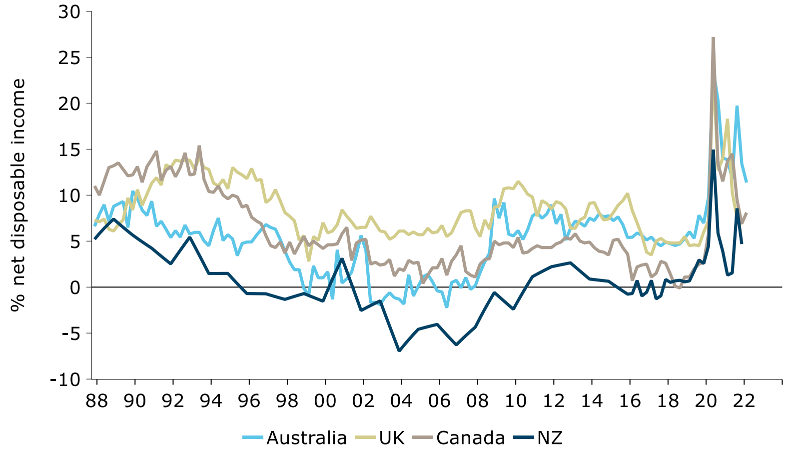
Source: Westpac, Stats NZ, Macrobond, ANZ Research

Note: The ANZ Roy-Morgan consumer confidence index, while very timely and at a monthly frequency, is only available from the end of 2003. We use the Westpac consumer confidence index prior to Q4 2003. The grey bars indicate recessions in New Zealand.

But that's not our forecast – or the Reserve Bank's for that matter. And there are a few key reasons. As we've already noted, this drop in consumer confidence is likely a result of the surging cost of living and the monetary policy tightening it has triggered. But we expect wage growth will catch up. So while consumers are likely to pull back on spending, rising wages should still provide a solid baseline. We do expect a significant slowdown in household consumption spending growth, but not an outright fall in spending levels (although we wouldn't rule that out as a possibility, particularly if the correction in the housing market were to accelerate).

One key difference between now and the pre-COVID decade is the level of savings that households have accumulated. Prior to COVID, New Zealand had a very low (often negative) household savings rate. But since 2020, Kiwi households have had a significantly higher savings rate – and households in other countries even more so (figure 10). Australia in particular has seen a massive buildup of pandemic savings – and we expect that will provide a fairly sizeable offset as the RBA hikes rates across the ditch. In New Zealand, our accumulated savings should help as well, although it's a smaller buffer than in some other countries, and interest rates have risen faster here. But every little bit helps.

Figure 10. Household savings rates

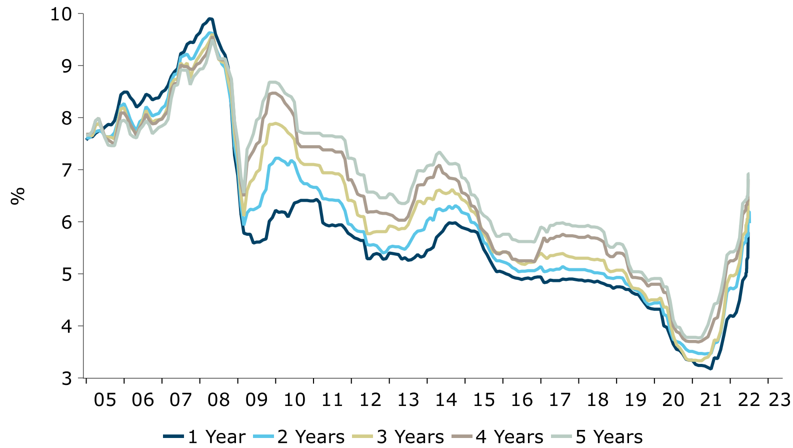


Source: ABS, Stats NZ, ONS, StatCan, Macrobond, ANZ Research

Note: New Zealand only has quarterly (experimental) savings data back to 2016. Prior to this, we use the annual data.

While interest rates are still low relative to, say, 2007, the speed of those interest rate hikes still represents a challenge for Kiwi households. The RBNZ has been ahead of many other central banks in lifting interest rates – and we're now about a year out from when mortgages hit their 2021 trough (figure 11). Many households will be rolling into mortgage rates that are twice what they locked in last year. That's going to be a significant drag on discretionary spending over the next year or two as households roll over to new (higher) mortgage rates. Outright falls in house prices are also likely to weigh on spending through wealth and confidence effects – as well as via a drop in construction sector activity (something we discuss at length in our latest Property Focus).

Figure 11. Standard mortgage rates

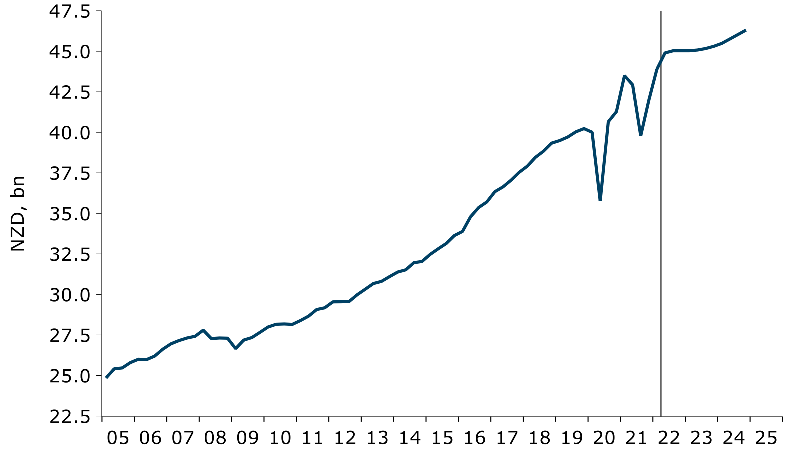


Source: RBNZ, ANZ, ASB, Westpac, BNZ, Macrobond, ANZ Research

Note: The RBNZ's mortgage rate data is only released monthly, so for the most recent observations, we use the average mortgage rates across the 'big four' banks.

When we bring it all together, there are clearly headwinds to consumer spending and demand over the next year or two. Consumers are miserable and don't expect things to get better, inflation is hurting, interest rates are rising, and asset prices are falling. But at the same time, the labour market has never been tighter, and household balance sheets have made it through COVID in pretty good shape. So while we expect consumption growth to slow to a crawl from the second half of this year (figure 12), we don't think spending will fall to the recessionary levels implied by the level of consumer pessimism.

Figure 12. Real household consumption expenditure forecast



Source: Stats NZ, Macrobond, ANZ Research

This softening in demand from consumers is one key reason why we think the RBNZ will return to more normal 25bp hikes after the August MPS, and only lift the OCR to 3.5%. We think they'll be surprised by just how quickly demand starts to ease as the impact of OCR hikes flows through the economy – and weaker consumer confidence is just one symptom of monetary policy working. We're forecasting two more 50bp hikes in July and August, and 25s in October and November, bringing the OCR to 3.5%. But beyond that, a seriously stretched consumer and a construction sector that's likely to be in decline over 2023 should give the RBNZ the confidence that they've broken the back of inflation, and can give growth a chance.

That said, uncertainty could hardly be higher. Inflation is still the name of the game. And while it is our expectation that evidence of softening demand will emerge over the second half of this year, the RBNZ can't afford to give inflation any room to breathe. Any upside surprises on inflation and the labour market are therefore likely to go straight into a higher OCR path. We think inflation peaked at 7% in Q2 (which is also the RBNZ's forecast). But with geopolitical tensions continuing to rumble and global food prices surging, risks are to the upside. Central banks will not risk losing their inflation targeting credibility – so don't expect the RBNZ to spare the economy if they don't see evidence of inflation falling.

And as part of that inflation battle, in the absence of a miracle recovery on the supply side (eg a huge surge in technological advancement and/or labour from abroad), the RBNZ need weaker consumption spending. So in fact, the question is not, "to what extent will lower consumer confidence translate into lower spending?" so much as it is "how high will the OCR need to go to bring about the weakness in consumer spending that the RBNZ believes it needs to see?" Retailers face tougher times ahead, regardless.

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