WHEN WORDS BECOME ACTIONS

THE BOTTOM LINE

- **Business sentiment deteriorated in the June quarter to the lowest level since 2011.** Changes to and uncertainty about the policy environment are making businesses apprehensive. At the same time, businesses are grappling with uncertainty about demand, credit constraints and capacity pressures. Cost escalation is impacting profitability.

- **Importantly, pessimism is affecting firm decision making.** Expectations of activity are more positive than headline business confidence suggests, but softened in the June quarter. Firms no longer expect profitability to improve from here. Investment intentions softened, while hiring intentions were flat. Today’s data point to continued softening in GDP growth through this year. How businesses respond to the challenges they are reporting will have important implications for the economic outlook from here. It is fair to say that downside risks have increased.

KEY RESULTS

- **Business sentiment deteriorated in the June quarter,** according to NZIER’s Quarterly Survey of Business Opinion. Headline business confidence deteriorated 9%pts, with a net 19% (sa) feeling pessimistic in Q2. This is the lowest level since March 2011. The drop in confidence was widespread across regions, with Taranaki, Otago and Blenheim particularly downbeat. Businesses are also downbeat across a broad range of sectors, particularly in retail (with sentiment at its lowest level since 2009). In retail, sales have softened and costs have increased sharply, contributing to a sharp drop in profitability.

- **Headline business confidence points to lingering pessimism amongst businesses, consistent with our ANZ Business Outlook Survey and anecdotes from our discussions with businesses.** Changes to and uncertainty about the policy environment are making businesses apprehensive. At the same time, businesses are grappling with uncertainty about demand, credit constraints and capacity pressures. Cost escalation is impacting profitability.

- **The economy is experiencing a softer patch.** Experienced domestic trading activity is more positive than headline business confidence, but softened in the June quarter. Net 7% of firms reported an increase in their own activity (versus 15% in Q1). Looking forward, a net 13% of firms expect their own activity to pick up in Q3, down from 16% in the previous survey. Overall, this is consistent with a softer pace of GDP growth through the second half of the year. Experienced trading activity was last at this level in March 2013.

- **Profitability deteriorated considerably.** Net 16% of firms experienced deterioration in profitability in the quarter (compared with 7% in Q1), with net 12% expecting further declines (from 0%). Cost pressure is contributing to reduced profitability, with squeezed margins putting pressure on businesses to increase their prices. And with businesses no longer expecting a rebound in profits, caution appears to be passing through into decision making.
• **Experienced costs picked up for a net 36% of firms (up 5%pts).** This is expected to continue in the next three months with net 41% of firms expected cost pressures to increase further (up 6%pts). **Firms expect to pass these cost increases on,** with net 29% of firms expecting to increase prices (up 8%pts) and net 25% increasing prices over the past quarter (up 9%pts). We expect that firms will be looking to increase prices cautiously, given the challenges they are facing.

• **Pessimism is affecting investment intentions.** Net 4% of businesses intend to reduce investment in buildings (a deterioration of 3%pts), while intentions to increase investment in plant and machinery deteriorated from net 17% to 2%. **One bright spot is hiring.** Hiring intentions were flat at net 6% of firms expecting to increase headcount, while net 14% increased employment over the past quarter (up 5%pts), boosted by services hiring. Hiring expectations are consistent with continued employment growth, but at a softer pace than in 2017.

• **A key question regarding the outlook is how businesses will respond in this environment.** Our expectation is that GDP growth will remain supported by low interest rates, fiscal spending, and supportive conditions for our exports. But given the challenges they are reporting, will firms be willing to invest? Will they remain cautious about hiring or look to improve productivity? And will they be willing to increase prices in response to rising costs? We expect that margin squeeze will provide the catalyst needed for inflation to increase, even if it is gradual. But the outlook is uncertain and it is fair to say that downside risks have increased.

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**Figure 1: GDP vs QSBO expected domestic trading activity**

**Figure 2: CPI vs pricing intentions**

Source: ANZ, NZIER, Statistics NZ
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