Weekly Overview

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Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

To receive the Weekly Overview each Thursday night please click here.
http://feedback.bnz.co.nz/forms/lFdYSs5FGEq4kAjP95uzTA

2014 Themes

- Interest rates will rise
- The NZD will remain highish
- The labour market will tighten, pushing employment costs up
- House prices will rise with gains spreading out of ChCh and Auckland
- Construction will boom
- World growth will improve with unprecedented uncertainty regarding monetary policies
- Business capital spending will grow
- Household spending growth will accelerate

Global Search For Yield

I go overseas at least once a year to try and gain a better perspective on what is happening in the global economy and financial flows and try to discern what such developments may imply for the New Zealand economy. And just as my two trips to Christchurch earlier this year yielded what I feel are some good insights into the likely (long) duration of this period of firm NZ growth, so too has this trip to the UK yielded a useful insight.

The world is awash with people who have decided in recent years to ease off in their spending and try to build some savings. Central banks in some locations have also sought to smooth the effects of the worst financial crisis since the 1930s by printing money, cutting interest rates to low levels, keeping such rates low, and more recently emphasising that they have no intention of removing those low rates for a long period of time.

These expressed low rate intentions from central bankers (apart from our own) are driven by two things. First there is a desire to get as much momentum as possible in economies before the monetary sugar is taken away because were recessions to return, perhaps because of ham-fisted early policy tightening, this time we might see depressionary conditions.

Second there is natural hesitancy because although we all strongly believe that consumer and business reactions to rising interest rates are different now compared with before the GFC, we don't know how different. Central bankers want more information on the new effectiveness of interest rate changes in a world where we economists now openly acknowledge that our understanding of the linkages between financial markets/flows and real economic activity are woefully inadequate.

Simple risk analysis tells central bankers they should wait as long as possible before removing their monetary sugar. What that means is ongoing loose global monetary conditions and low returns to conservative investors for an extended period of time. But investors with their growing savings are becoming increasingly unhappy with low returns on the likes of bonds and bank deposits. And their discontent is growing as they see examples of some assets which have yielded tremendous returns - such as property.

People are feeling the need to boost their returns so they are more and more actively chasing yield while for the moment clearly reassessing the sustainability of share prices following strong gains last year not commensurate with underlying economies or corporate performances. Hence the surge of both individual and managed fund demand for higher exposure to property. And the more they buy, the higher the prices go, and the simple passage of time compressing events of the past means that as each day passes investors discount more and more the falls in property prices over 2008-09.

What does this mean for little old us down in NZ where we think impacts from the rest of the world can be controlled through robust migration rules, hefty financial supervision by the Reserve Bank, the travel distance involved, and simple hiding in the corner while the big kids play?

We are a fully functioning part of the global financial and investment system. We need to be given our dependence upon imports which drives our dependence upon exports and trade agreements, and the appalling unwillingness of households to save which creates dependence upon foreign savers to finance our lovely lifestyles. We cannot shut ourselves off from global trends and those trends will affect us most likely in these ways in the next few years.

Investors will reignite the carry trade whereby they borrow in a low interest rate country and invest in a high rate country to gain extra yield while taking what they think can be a managed exchange rate risk. That means ongoing support for the NZ dollar, especially with our economic growth story going to be so good for the next three years that investors will consider the exchange rate risk inherent in the carry trade to be very low.

In addition, the global search for property is leading investors to NZ with Chinese families in particular looking for stores of value for their rising wealth away from the control of the CCP. The level of foreign buying of residential and commercial property in NZ is going to continue to rise and that will not only push property prices higher and deepen the affordability debate, it will again give additional support to the NZ dollar.

Third, there remains huge scope for shocks to the global financial system and economy. Candidates include the following.

- The lack of structural economic reform in Japan which could see that economy dive under the weight of a huge debt burden.
- The risk of outright war in the Ukraine and disruption to gas flows throughout Europe.
- The current tech-wreck in sharemarkets spreading to broader indexes and giving a negative wealth effect which could reverse the positive effect artificially created by central banks since 2010 through outrageously expansionist monetary policies.

IF I WERE A BORROWER WHAT WOULD I DO?

The Reserve Bank next week will almost certainly raise the cash rate by another 0.25% taking it to 3%. This will mean floating borrowing costs rising 0.25% as well and fixed rates tending to move higher though changes there depend substantially upon where banks are fighting for business and how offshore medium to long-term rates move. Some of those moves recently have been downward in response to investors around the world still looking for yield and the US Federal Reserve recently sounding less hawkish than expected. Across the ditch economic data including employment numbers have however fallen on the quite positive side recently and with Australian rate movements influencing our own this suggests one wants to be a bit cautious in thinking that recently reduced wholesale fixed rates in the United States and Europe could flow through to retail rate cuts here. They almost certainly will not.

This week we learnt that the annual rate of inflation in New Zealand – something which the Reserve Bank aims to influence 18 months out through official cash rate changes – fell to 1.5% in the March quarter from 1.6% during 2013 and just 0.9% a year ago. A year from now though we think the rate will be nearer 3%.

Were I borrowing now I'd fix at least three years but would prefer to fix five years.

FINANCIAL MARKETS DATA	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	2.75%	2.75	2.75	2.50	2.50	4.9
90-day bank bill	3.28%	3.21	3.10	2.94	2.66	5.2
1 year swap	3.74%	3.72	3.64	3.44	2.77	5.3
3 year swap	4.35%	4.40	4.37	4.18	3.10	5.5
5 year swap	4.65%	4.70	4.66	4.69	3.40	5.7
7 year swap	4.86%	4.89	4.86	5.00	3.68	5.8

NZD Eases

It goes up, it goes down. You can't forecast which direction will prevail but you can sometimes make the effort to stand back and acknowledge that a currency looks unusually high or unusually low in the context of your understanding of the factors which move it. Doing that you can then make a decision about selling or buying it, or making arrangements to do such if you see a risk that in the near future the currency gets weirdly high or low. That is where building a good relationship with a currency specialist is useful. They may not have much better insight than you or I regarding what the next week's, month's or year's move will be. But they will have a better feel than you for whether an exchange rate is looking stretched toward one end of its spectrum or the other.

In that regard can we stand back from whatever up or down news appeared during the week and conclude that the NZD is looking stretched one way or the other? Frankly no. Although the NZD is high by the standards of the past decade against all currencies we keep an eye on, that high level is easily justified by our relative strength against other economies in areas like our strong terms of trade, good government accounts, good economic structure, projected Chinese demand for our exports, and GDP growth this year and next.

More than that, now that NZ monetary policy is being tightened while central banks offshore remain fearful of doing so because their economies are munted in a variety of ways, the chances are that the NZD goes higher. Unless that is world risk aversion surges because of war in Europe for instance or between japan and China. In that case the NZD would fall away.

This past week the NZD has edged slightly lower on the back of the weakness and volatility in national sharemarkets, a further 2.6% fall in average dairy prices at the fortnightly Global Dairy Trade auction last night, and this morning's slightly lower than expected March quarter inflation outcome.

Exchange Rates	This Week	Week ago	4 wks ago	3 Mths ago	Yr ago	10 yr Average
NZD/USD	0.859	0.871	0.853	0.834	0.838	0.726
NZD/AUD	0.918	0.928	0.946	0.935	0.814	0.839
NZD/JPY	87.8	88.8	86.3	87.2	81.4	72
NZD/GBP	0.514	0.519	0.512	0.509	0.548	0.423
NZD/EUR	0.622	0.629	0.613	0.613	0.642	0.545
NZDCNY	5.34	5.40	5.25	5.04	5.18	5.1
USD/JPY	102.21	101.95	101.17	104.56	97.14	99.3
GBP/USD	1.67	1.68	1.67	1.64	1.53	1.72
EUR/USD	1.38	1.38	1.39	1.36	1.31	1.33
AUD/USD	0.94	0.94	0.90	0.89	1.03	0.87
USD/RMB	6.221	6.2	6.1499	6.0462	6.1869	7.15

For more detailed FX analysis including the 'BNZ Markets Outlook", "BNZ Strategist" "BNZ Commodities Wrap" and lots more go here. https://research.bnz.co.nz/Research/NewZealand/Pages/NZpublications.aspx

Housing Market Update

Additional analysis and commentary are available fortnightly in the NZ Property Press and monthly in the NZ Property Investor magazine.

No Logic in Regional LVR Policies

I think it is time that a certain very un-PC truth was told about the impact of the Reserve Bank's loan to value rules which became effective at the start of October last year. They were not driven by specific concern about the Auckland housing market and there is nothing inequitable about regional housing markets suffering because of the rules.

I state this because the RB did not primarily introduce the rules in order to stem house price inflation whether that be from Auckland, Christchurch, Ashburton or Riverton. If prices rise more slowly or even fall then they consider that to be a simple positive externality - something additional but not targeted.

What the RB are aiming to do is limit the exposure of bank balance sheets and therefore the overall economy in the event of a shock which causes house prices to fall precipitously and cause borrowers to face negative equity. Think of that shock as being a foot and mouth outbreak.

In the event of such a thing house prices will fall everywhere as the economy shrinks by some huge amount. There is little reason for believing that Auckland house prices will fall more than prices elsewhere. In fact if one looks at house price changes between late-2007 and the nationwide average bottom early in 2009 the biggest declines were recorded in Southland, 12%, Central Otago 10%, nelson 8%, Canterbury 7%, Otago 6%, Waikato and Northland 5%, and then Auckland 4%.

If lots of people have borrowed with 90% debt in Napier then lots will have negative equity should prices fall 20%. If lots have borrowed with 90% debt in Auckland and prices fall 20% then again lots of people will be in negative equity positions.

The fact that so many people are bemoaning the large impact which the LVR rules have had in the regions tells us that there are lots of people, proportionately speaking, who buy houses with low deposits outside of Auckland and Christchurch.

There is no moral superiority in the argument that regionally-based young buyers are either disproportionally affected by the rules or affected when they should not be. They are just as much (in proportion to population probably) a part of the negative equity bank capital base risk that the Reserve Bank is trying to mitigate as the young buyers in our two largest cities.

Arguments for regional implementation of the LVR rules therefore do not hold water. In fact, given that the only shock likely to cause a huge decline in NZ house prices is something like foot and mouth disease, the chances are that the regions would suffer far greater house price declines and negative equity positions than Auckland in particular.

Arguments against the LVR rules need to be couched in terms other than alleged but unproven disproportionate regional impacts. A better angle is as we have been highlighting the disproportionate impact on first home buyers compared with foreigners and investors all around the country. In that regard again the regions fare better than Auckland given the lesser influence of now newly-favoured foreign buyers in those non-Auckland markets which traditionally attract less interest from people offshore.

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