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BNZ 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.

Weekly Overview Back

I'm restarting the Weekly Overview after on January 22 this year putting it into abeyance for an undefined period. Will it be the same as before? The average length will be less than in the past and in the email I circulate for distributing each edition you will be left in no doubt as to whether I think it is worth your while taking a few minutes to read it, or whether it is just filler.

Lets start with a reminder that as the only NZ economist to correctly call the direction of the Auckland housing market these past six years, I'm going to continue to write a lot about housing. It feels good to get something right in a world where most other forecasts are wrong. To recap, as previously pointed out in Sporadic, apart from most of us correctly predicting the 1% rise in the official cash rate last year, almost all interest rate forecasts since 2008 have been wrong. They are likely to remain askew for a number of years – just ask US economists as they change their predicted timing and magnitude of rate rises in the US, and explain why ending of US money printing and rising expectations of US rate tightening have caused their bond yields to fall rather than rise. These are weird times we live in, very weird.

And don't forget the hundreds of billions of dollars of investments in the oil sector now wasted and/or being canned as a result of the structural decline in oil prices. TV crews in Alaska will probably be heading back to the lower 48 now that gold prices have settled a lot lower than anticipated. And of course there are plenty of Kiwis staying in NZ and coming home from Oz (not all of them deported) now that the Australian commodity super-cycle has come to an abrupt end and probably won't reappear for another generation. The cycle may return just in time for your young babies to head across the ditch to build a nest egg so they can buy a house back in New Zealand in the 2030s. But they shouldn't count on easy home affordability given many factors discussed these past few years, and one I have chosen to re-emphasise in the Housing section below.

London 2015

Last week I got back from a couple of weeks in London with a quick stopover in Hong Kong on the way back. While in London I gave presentations at numerous functions including human resource companies recruiting people to work in NZ, NZ Trade and Enterprise and KEA, and groups of Kiwis with common business interests of which there are quite a few. Truth be told I'll whore my services to whoever wants to know about the NZ economy when I head up north.

Keeping it short and sweet, my main observation for London is that it is booming. There are cranes everywhere, the trains are packed, financial sector hiring appears strong, foreign visitors are everywhere, and there is a strong positive buzz to the place. I did not get across to the Continent this time around but speaking with people and reading material am prepared to say I see no reason for changing my generally pessimistic view on the long-term growth prospects for Europe. Economies are rigid, unemployment and welfare dependency are entrenched, politicians are cowered and voters are favouring extremes, and the place just seems to be scrambling without purpose to figure out what to do with an expanding Russia to the east, a growing wave of people heading up to Europe from the south, and poor economic structures.

It is little wonder that the UK is very assertively seeking close relations with China, whilst the EU is belatedly picking up on the Asian growth and our links with it by pursuing a free trade agreement (non-agricultural one suspects) with New Zealand and Australia.

Kiwis in London remain as interested as ever in three key things back in NZ. The exchange rate, Auckland house prices, and the strength of the labour market. My messages in these areas were that NZ's economic prospects look acceptable so barring the usual ups and downs of global risk aversion lowering and raising high beta currencies like the NZD they should not expect to see the sort of weakness in the NZD which they fantasise about. I outlined factors which have accounted for Auckland house prices rising and how the pace of rises will slow but not stop, and how investors are shifting as predicted to buying in the regions. And I noted that there is a solidity to the NZ labour market you don't find in other countries, courtesy of its deregulated nature encouraging businesses to hire and hire full-time rather than casual, the structural change in Auckland to becoming a proper big city rather than just the big Wanganui which some people outside Auckland in NZ stuck in a '60s time warp still incorrectly think it is, and of course the strong growth in the construction sector.

I spoke at recruitment/migration expos in London and Manchester and in the latter received the most interesting questions during my time over there. One person asked if there were many earthquakes in New Zealand. I said that there are not anywhere near as many as Japan, but that any part of the country is vulnerable to a decent shake, and areas for which no fault lines have been detected should not be considered safe – just ask Cantabrians. I should have spent some time outlining the building standards which have earthquake preparedness in mind and how they have been strengthened recently.

Another person in Manchester asked if Wellington was really windy. I struggled to contain the intensity with which I wanted to blurt out it blows a...holes and simply said yes it is, it really is, though mainly in spring. Potential migrants asked about areas of strength in the labour market, and at that point I concentrated on the solidity of growth in New Zealand in a wide range of sectors as compared with Australia which is suffering from the commodity super cycle ending, rigidities built up over 23 years without a recession, and how Aussies were less well-placed to take advantage of the shift in where growth is coming from in China than New Zealand is.

For NZ employers contemplating tapping the UK market for staff – I think your peak period of ease for doing so has been and gone this decade. You would do better building up relationships with Kiwis who might be thinking about returning.

Housing

I could do a big summary of housing market situations here, but instead lets start with a question a lot of people have probably not asked themselves. If you can figure out and understand the answer then you'll have a better grasp of one of the reasons why people are investing more and more in property and why the risk of the sort of sharp market correction which our central bank and Finance Minister keep warning about is a lot lower than you and they think.

Check out this link to an article discussing the issue of increasing human lifespan with the possibility that the first person to live to be 1,000 years old may already have been born. Usually this is however discussed in more realistic terms as the first person to live to be 150 having already been born.

http://www.dailymail.co.uk/health/article-3285537/Has-person-ll-live-1-000-born-s-experts-believe-new-book-professor-reveals-s-good-news-rest-us.html

What do you do if you think this will be you? You'll adjust your thinking about things from short-term payoff to long-term benefits, and re-evaluate the risk of doing certain things because of the impediment cost stretching over many more years than you might envisage if you were going to die aged 70 for instance. You'll think about one day completely changing career from carpenter to brain surgeon, from psychiatrist to cafe owner. You'll think about receiving regular income from a job for a longer period of time. This is the first angle relevant to investing in housing.

The longer you envisage working (choosing to work at that) the greater you will rate your ability to recover from a financial shock such as your share portfolio losing 50%, or your house price falling 40%. You will be reasonably confident that you can weather the storm as compared with expecting to die at 80 and losing

labour income from aged 60 or 65. You'll be more willing to invest in growth assets such as equities and housing.

The other housing angle in this is that you will almost certainly be thinking in terms of spending many decades in voluntary and eventually involuntary retirement. You'll be thinking about investing in assets which will yield you income and capital growth over a long period of time – again property and shares as opposed to cash and fixed interest.

You'll positively salivate at the thought that if you had a portfolio of five or so investment properties you could spend decades relaxing and enjoying the planet whilst others supply your income.

There is a small version of this happening right now. Life expectancy is rising as advances are made in medical treatments and illness prevention strategies become more widely embraced and enhanced. Your grandparents may have died in the 70s or early 80s, your parents maybe in their 80s. You will be thinking about reaching the end in your 90s. Longer life expectations will be encouraging people to invest in property, especially as they are bombarded with predictions of a rising world population and more people living in cities.

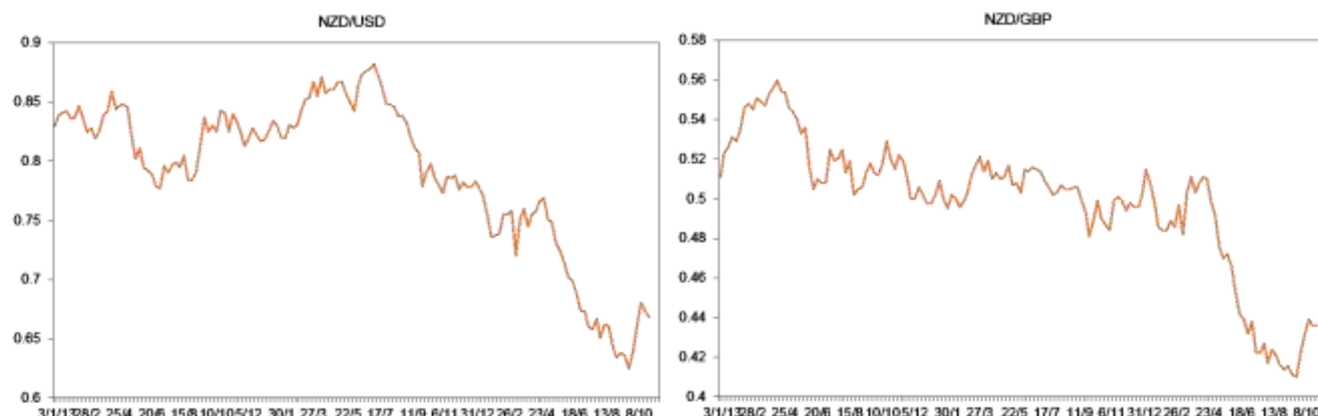
Rising life expectancy is one factor helping to drive investment in property, helping to push prices higher, and keeping in check the risk of a severe price correction. In the event of a correction, because people will year by year anticipate working for longer, they will less and less feel the need to crystallize a loss to stop it getting bigger and this will reduce the number of sellers each cycle from here on out.

Just a quick comment regarding the widespread anecdotal evidence we have been receiving for up to three months now regarding fewer people attending Open Homes and a lower proportion of properties selling successfully at auctions. Some people are seeing evidence of prices falling. This is not likely to be the start of a downward trend. Instead it is likely to be asking price cuts by over-optimistic sellers who had been essentially taking the proverbial by holding out for an unrealistic price in the hope that some mug would feel panicked enough to pay through the nose so they avoided missing out.

The fundamentals still strongly support prices going higher though, as we have noted for some time now, rising at a slowing pace now that the Reserve Bank has knocked many of the uninformed, undercapitalised people driven by FOMO out of the market. Chinese buyers have also backed off as they see a lengthening series of small roadblocks put in their way, consider wealth lost through China's sharemarket rout, and struggle to get funds out of China amidst a new crackdown on capital outflows by the authorities.

NZ Dollar

If you've got money offshore which you are wanting back in NZ in the next few months or you're an exporter, you'll be scratching your head a bit trying to understand why in the past five weeks the NZD has risen over 4 cents against the USD to now sit near 67 cents, three British pence to near 44, and over four cents against the Aussie dollar to near 94 cents. The NZD's gains break a pattern of oscillating declines broadly underway since May last year when our currency was buying 88 US cents.



There are a number of reasons for the NZD strength. Firstly we have seen strong gains in our international dairy prices so that they now sit "only" 52% down from peak levels of early-2013 rather than 63% back in August. Second, indicators of consumer and business confidence have improved. Third, the world is going through what we call a "risk-on" period. This is a phase when investors feel not too bad about where the world economy is going, are not worried about official efforts being made to restrain growth, and shift some of their assets toward traditionally riskier investments such as shares and peripheral/commodity currencies like the NZD and AUD. Hence the record level for the S&P/NZX50 above 6,000 for instance – over an 8% rise from levels of early-September.

It is impossible to predict how long a risk-on or risk-off phase will last so we cannot reliably indicate when the NZD will head back to US 63 cents or below AUD90 again. But at some stage analysts will once again expect an imminent tightening of monetary policy in the United States, forecasts will return of a rising USD, worries will grow about the impact of higher interest rates on share prices, and investors will shift toward more conservative asset mixes. For now the mild upward pressure could be waning as the US sharemarket has rallied quite a bit in recent weeks and profit-taking could very easily soon set in.

But it is worth repeating the warning we have been delivering to exporters for all this period of a declining currency from the middle of last year. Fundamentally the NZ economy is in good short-term shape with stimulus from construction, non-dairy exporters, strong services sector growth, and absolutely booming migration flows. It is not reasonable to expect the Kiwi dollar to fall completely out of bed.

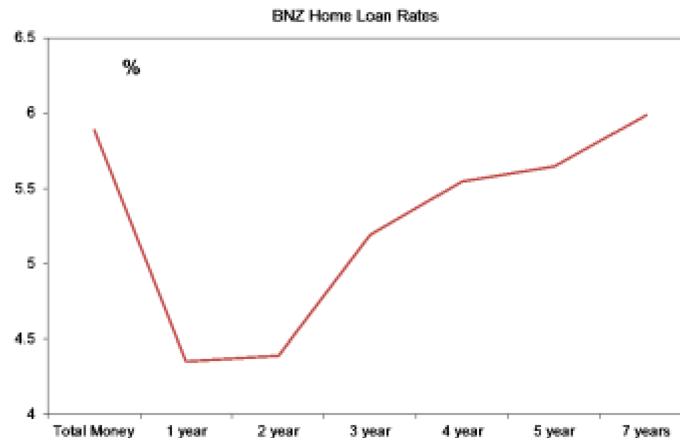
If I were A Borrower What Would I Do?

Compared with the previous three reviews of the official cash rate there were few people this time around expecting a rate cut from the Reserve Bank. Expectations of a cut have been falling in recent weeks in response to a pullback in worries about how much the NZ economy is slowing. Spending using debit and credit cards has picked up to an 8.2% annualised growth rate recently. Consumer and business sentiment measures have improved (though the latter remain low), and most significantly international dairy prices have recovered strongly. But one could not rule out a cut because of the disinflationary effects of the Kiwi dollar's rise in the past few months weakening RB expectations/hopes of an import pricing feed-through into higher consumer inflation, slowing wages growth, some cooling in the Auckland housing market, and actual inflation sitting at only 0.4%.

Personally I thought at a pinch that the RB this morning would complete the job of removing the 1% official cash rate rise last year, but they left the rate unchanged at 2.75% while noting "...some further reduction in the OCR seems likely." So maybe on December 10 there will be another, probably final, cut.

Given that the no change decision met market expectations there was little impact on wholesale interest rates. The main rate of relevance to floating interest rates, the 90-day bank bill yield, remained near 2.88% having been 3.5% in May and 3.7% a year ago. Of relevance to funding costs for fixed rate loans, the two year swap rate is near 2.8% from 3.5% in May and almost 4% a year ago. The 1.2% fall in this rate in the

past year explains the fall in the two year fixed home lending rate from 5.75% in October last year to 4.69% just over a month ago, and the intensity of competition for mortgage business explains the subsequent decline in this rate to a record low of 4.39%.



If I were borrowing at the moment I would take the two year rate because it is so very, very low compared with past rates, it gives more rate stability than simply fixing one year, it is much lower than rates for longer terms, and fixed rates may only decline a small amount more from current levels if the RB cuts the official cash rate again.

For Noting

Tall Poppy Syndrome

Back in 2011 I wrote a series of papers looking at impediments to growth of the NZ economy and concluded that the biggest impediment may be our business culture which includes the Tall Poppy syndrome. In case you would like a neat little summary of some of our practices related to cutting down Tall Poppies click on the two links below which take you to a couple of videos on YouTube made by Jordan Giesige – a North American making monthly reports about his time in our country. He discusses the Tall Poppy syndrome and references material which I produced in 2011, based upon the work of Tony Smale. Enjoy.

https://www.youtube.com/watch?v=7IqH9hxIcag
https://www.youtube.com/watch?v=ccw1rxjfrD4

Consumer Goods Imports Booming?

One might look at the Merchandise Trade data for September released this week and conclude that in spite of consumer sentiment slipping to below average levels from July consumer spending growth had boomed. The value of imports of consumer goods in the September quarter was 20% higher than a year earlier. And the annualised pace of growth in core retail spending measured in the Electronic Card Transactions data lifted to 8.2% in the three months to September from only 1.1% growth in the June quarter. However the NZD in August last year was buying near US 85 cents, 50 pence, and 87 Yen compared with rates near 68 cents, 44 pence, and 81 Yen respectively now. The lower NZD has simply boosted the landed cost of both consumer and capital goods – the latter being ahead in the September quarter by 17% from a year before.

So, much as we believe there is solidity to consumer spending growth in New Zealand assisted by the removal of rising interest rate expectations, presence of a firm labour market, and booming net immigration, things are not really booming. In fact the sharp rise in the value of consumer goods imports says to us that with consumers more price sensitive than before retailers are in for some major margin contraction in the coming year which will tend to weed out a few more operators and challenge prices of listed operators.

Financial Instability

Central banks continue their policy of cutting interest rates and keeping them very low in order to try and foster stronger growth. Such efforts along with money printing have yielded generally poor results and in spite of that speculation is rising of extra money printing by the Bank of Japan and European Central Bank, and further delays in the initial tightening of monetary policy in the United States with rates rising less over the "cycle" than previously anticipated. (Post-GFC cycles are dead.)

Liquidity conditions remain easy, highly liquid, and more and more money is seeking assets yielding something, anything. The Bank for Internal Settlements and IMF have both expressed concerns that if we had poor understanding of links between the financial sector and real economic activity leading into the GFC, our understanding now may be even worse yet the quantities of funds involved far greater.

Prudential regulators are trying their best to prepare their economies for the next financial shock – one of which seems to come along every ten years or so. This preparation takes the form of deepening regulation of financial institutions including higher capital requirements. Given the global liquidity bath does not look like ending for many years the risks are that the regulators move toward more measures aimed explicitly at stamping out the fires they see springing up as cashed up investors target assets – like housing for instance.

Thus one should not lightly dismiss the NZ Treasury recommendation made in a paper sent to the Reserve Bank discussing the loan to value ratio rules where Treasury suggest debt to income rules. The RB have made enough comments regarding problems they are encountering and working through in seeing if such rules could be introduced to make one conclude that their introduction is highly likely if strong house price rises in Auckland continue.
https://www.interest.co.nz/property/78314/treasury-expresses-enthusiasm-debt-income-ratios-paper-reserve-bank-sees-them

If such rules come in what will they look like? Something along the lines of mortgage debt not being able to exceed perhaps 4.5 times income for a household. The restriction may apply to a geographic area, perhaps exclude first home buyers. Though that latter exclusion may not achieve the improvement in financial stability the central bank would like as first home buyers generally purchase at quite high debt to income ratios. The following article discusses the June 2014 rules introduced by the Bank of England.
http://www.independent.co.uk/money/mortgages/bank-of-england-s-new-mortgage-rules-aimed-at-controlling-household-debt-9566519.html

The message here is this. If interest rates can't go up as economies grow because technology, excess capacity, and behavioural changes keep inflation well in check, then other means need to be found to keep liquidity growth under control and limit the risk of deep financial shocks which could cause depressions. The period of experimentation by central banks aimed at finding effective prudential tools suitable for the coming decades has only just started. Borrowing costs to you and I will stay low for decades. But credit availability is on the cusp of becoming far, far more difficult these next ten years. How to cope with this as a borrow? Talk with your grandparents about how they got a mortgage before 1985.

The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The views expressed are my own and do not purport to represent the views of the BNZ. To receive the Weekly Overview each Thursday night please sign up at www.tonyalexander.co.nz
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