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.

The Weekly Overview is written by Tony Alexander. 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 click here.
http://feedback.bnz.co.nz/forms/lFdYSs5FGEq4kAjP95uzTA

Tapering Turmoil

I'll be taking a break over the next two weeks so the next Weekly Overview will come out on August 1 and from here on there will be no issues produced during school holidays.

This week the world's attention has been firmly on the economic data coming out of the United States and the implications for monetary policy, interest rates, exchange rates, sharemarkets and so on. In a nutshell, the Friday night jobs report in the US was good so expectations have risen that the Fed. will start cutting back on their money printing come September. That anticipation of slower growth in the supply of USDs has caused the USD to rise and other currencies like the NZD to fall against it. In addition US bond yields have risen and placed upward pressure on medium to long term borrowing costs in other parts of the world which will flow through to banks raising fixed home lending rates here in New Zealand.

Sharemarkets have generally held up well though this is partly because over a week ago the heads of the British and European central banks issued statements aimed at talking down interest rates through promises to keep them low for a long time - hence the NZD's jump up against the Pound and Euro.

Given accelerating growth in New Zealand and the high probability our central bank raises interest rates before rates are officially increased in other economies relevant to us, the chances are that over 2014 – 15 the NZD will head to new highs against the Pound and Euro while edging upward also against an Aussie dollar more hit by weakness in China's economy than our own. Once rate rises start in NZ the RBNZ could move quickly given the way we expect the construction boom to raise costs, the labour market to tighten up precipitously, and the need for them to catch-up on tightening when they find tinkering with bank loan to asset value rules does not have the suppressing effect they would like in the housing market.

For your guide, in the interest rates section we take a look at how in the past two cycles interest rates rose for four years thus suggesting a 2018 peak for rates this time around.

Businesses should already have plans in place for handling the tightening labour market given that this has been one of our key messages for the past 2 – 3 years. Home buyers should already have bought the house they need given our warnings also for five years regarding the shortage of property in Auckland – the effects of which we expect to soon be felt in other parts of the country where time still exists to beat the cycle as it were.

Watch for continuing high volatility in exchange rates, be aware that the global drift for interest rates now is upward for a number of years with potential for our floating mortgage rates to reach 8.5%. House prices will rise higher given that migration flows now appear headed for boom territory thus adding to already high buying pressures and a deepening dearth of listings made worse by the low ability of house construction to rise quickly given a shortage of builders.

While attention will be naturally on Auckland – which accounts for one-third of our economy and people – and Christchurch, which accounts for around 10% of each, watch for improving commentary regarding the regions as Aucklanders shift out for better housing value and freeing of retirement funds, and as the expanding dairy sector provides growing job opportunities.

Old Folk Spending Plans

During a seminar I delivered in Nelson this week one attendee gave the opinion that movement of older people out of Auckland to other parts of the country (freeing up cash to live on) would not boost local economies much because old people don't do much spending. I noted that some information surrounding that issue might be able to be sourced from our BNZ-Nine Rewards Consumer Trends Survey. So in case the bloke who asked the question is reading this here is what the latest survey with 523 respondents shows. 55 people aged over 65 replied and they have the highest level of optimism about the economy of all age groups at a net 44% positive. See the second to last line and Column A in the table below.

Their spending intentions however are just below average at a net 5% versus 8% nationwide and the likes of 17% for 18-29 year olds. They have low intentions of buying a car, furniture and appliances, but well above average plans to travel. They appear to have enough clothing, but a gross 33% would like to work more. The survey does not tell us spending levels as such – just intentions of spending versus what the respondents consider average. Nevertheless they are interesting. http://tonyalexander.co.nz/wp-content/uploads/2013/07/BNZ-Nine-Rewards-July-2013.pdf

	Sample size	A Net Optimism	B Spend	C Car	D Furniture	E Travel	F Clothing	G Debt	H Invest	I House Prices	J % rise	K % fall	L Work	M Jobs around	N Leave NZ
18-24	42	17	17	17	33	48	90	-38	2	62	4.2	5.0	74	-48	24
25-29	48	31	17	27	56	54	85	-50	4	54	5.2	3.3	60	-25	17
30-34	55	36	-9	7	44	33	82	-67	5	51	3.9	6.3	53	-15	11
35-39	56	25	7	16	41	43	82	-52	11	70	4.8	7.5	54	-27	9
40-44	58	24	2	21	47	36	79	-71	7	53	4.3	2.8	47	-24	7
45-49	63	27	21	11	37	41	79	-43	5	63	3.3	3.8	37	-19	10
50-54	67	21	6	15	43	46	64	-55	9	69	4.9	3.8	33	-34	9
55-59	36	33	22	11	33	33	67	-56	0	58	4.3	2.9	31	-36	3
60-64	43	30	2	9	42	60	65	-37	12	53	3.8	2.9	37	-12	2
65yrs+	55	44	5	4	16	51	49	-13	2	62	4.1	1.3	33	-29	4
All	523	29	8	14	39	44	74	-49	6	60	4.3	3.9	45	-26	9

A Do you expect the economy to be in a better or worse shape in a year's time?
B In the coming month do you think you will spend more or less than usual?
C Are you thinking about buying a new car within the next 3 months?
D Are you thinking about buying new furniture and/or appliances within the next 3 months?
E Are you planning to take an overseas holiday in the coming year?
F Are you thinking about buying more clothing and accessories within the next 3 months?
G What do you think you will be doing with your debt in the next six months?
H Are you thinking about buying an investment property within the next 3 months?
I In what direction do you think house prices in your area will move in the next 12 months?
J How much do you think house prices will rise by in your area in the next 12 months?
K How much do you think house prices will fall by in your area in the next 12 months?
L Would you like to earn more money by working more hours each week?
M Are you finding jobs or extra hours of work becoming more or less readily available?
N Are you thinking about shifting overseas within the next 12 months?

The Week's Data

Sentiment Good

On Tuesday NZIER released their June Quarterly Survey of Business Opinion. This is a great collection of indicators sourced from the non-farming business sector which provides insight not just into sentiment but into capacity availability, cost pressures and pricing intentions, and employment and investment plans. The latest survey tells us that growth in our economy is accelerating and capacity pressures are growing – which means higher inflation, higher interest rates, and a higher exchange rate.

- Seasonally adjusted business confidence stayed steady from the March quarter at a net 31% optimistic.
- A net 26% of businesses say they are having difficulty sourcing skilled labour which with the unemployment rate at 6.2% is concerning as the ten year average for this reading is 21%. Difficulty in finding unskilled labour is average.
- A net 9% plan raising employment versus an average 3% and 5% last quarter.
- A net 10% plan more plant and machinery investment versus -1% average and 8% last quarter.

These latter two indicators tell us that there is only a mild acceleration in growth underway which will please the Reserve Bank. However cost pressures are nonetheless rising.

- A net 22% of businesses plan raising their selling prices from an average 29% and 13% last quarter.
- The manufacturers' and builders' capacity utilisation rate eased to 91.3% from 91.5% but this is above the average of 91%.
- A five year low 63% of businesses said that sales are their main constraint on growth from 68% last quarter. 10% now say labour and 10% capacity generally from 7% and 8% respectively last quarter.

All up some good results but indications of cost pressures rising though not enough to disturb most people's existing predictions of how inflation and monetary policy will pan out.

Retail Spending Growth Accelerating

The value of spending using debit and credit cards (not the Paymark data which are less complete than the Statistics NZ data referenced here) rose in seasonally adjusted terms by 0.6% in June for core retailing categories. This follows a 0.5% rise in May and means annualised growth during the June quarter was a healthy 5.2% compared with 4.8% in the March quarter and 4.5% in the December quarter. The pace of retail spending growth as approximated by this particular indicator therefore appears to be lifting slightly.

Annualised growth in spending on durable goods during the June quarter was a strong 10.7% from 3% growth in the March quarter, hospitality spending accelerated to 17.3% annualised from 5.1%, and apparel spending switched to 15.9% from -12.1%. Spending on consumables slowed to -3.5% from 7.3%.

Interest Rates

Rates Rising – In A Volatile Fashion The Next 3-5 Years

Wholesale rates have jumped up again this week in response to a leap in US bond yields caused by a better than expected employment report for June. Should US data in the next few weeks print on the weak side then rates will retract a bit. But if the data run is strong then rates will rise further. On the domestic front it is very unlikely that we will see anything emerge to change the prevalent view on when monetary policy tightening will start in NZ – but watch for a lot of puff and wind regarding tightening being delayed because the LVR rules might prove effective (they won't). Watch also for discussion around the weakening in the NZD against the USD perhaps bringing forward in time the RB's first OCR increase. Note in that regard however the lesson of the past two decades which is that the pass-through of a currency change into inflation is much less than it used to be and seemingly less predictable as well.

Our current forecast is that the rate rise cycle for floating rates starts in the first half of next year, takes the official cash rate from the current 2.5% to 4.5% come late-2015 and after that it depends very much upon how Kiwis react to rising rates this particular economic cycle. History tells us that we will largely ignore the RB for a long time therefore the risk is that the cash rate rises to 5.5% and not 4.5% and that floating mortgage rates therefore reach 8.5%. Note, if you signed up for your first mortgage like I did at 18.5% or higher and struggle to take seriously the whimpers of today's young buyers regarding houses not being affordable at a rate near 5%, tell them that in the previous cycle floating rates peaked at 10.9% (2008) and the one before that 11.3% (1998). Could the next peak be in 2018?

Last cycle the RB started tightening in 2004 and rates peaked in 2008. The cycle before that they started in 1994 and rates peaked in 1998 at 11.3% (actually 11.5% 1996 but they didn't start trending down until after 1998's 11.3%. Therefore this cycle if they start in 2014 mortgages rates will most probably peak in – well, probably 2018!

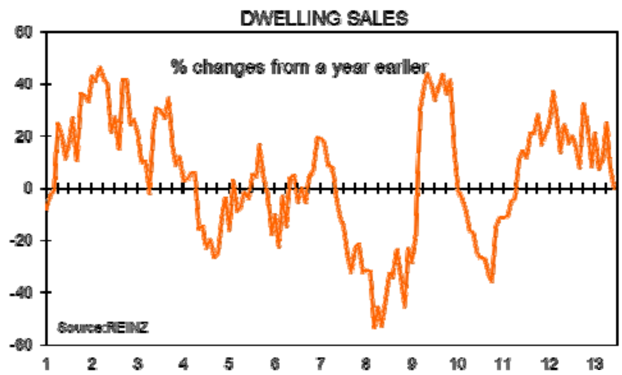
FINANCIAL MARKETS DATA

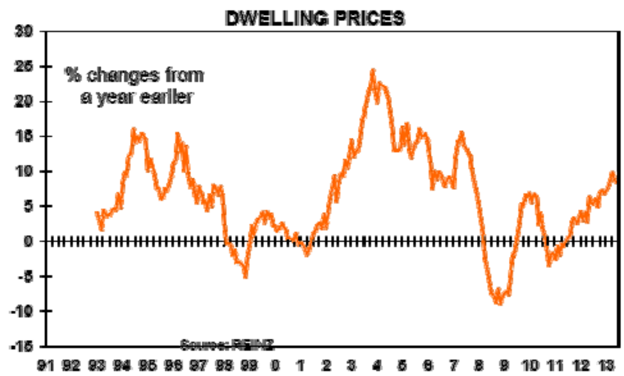
	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	2.50%	2.50	2.50	2.50	2.50	5.4
90-day bank bill	2.67%	2.67	2.66	2.67	2.76	5.7
1 year swap	2.91%	2.88	2.79	2.78	2.58	5.8
3 year swap	3.65%	3.62	3.34	3.11	2.83	6.1
5 year swap	4.13%	4.06	3.71	3.41	3.18	6.3
7 year swap	4.44%	4.35	3.99	3.69	3.52	

Housing Market Update

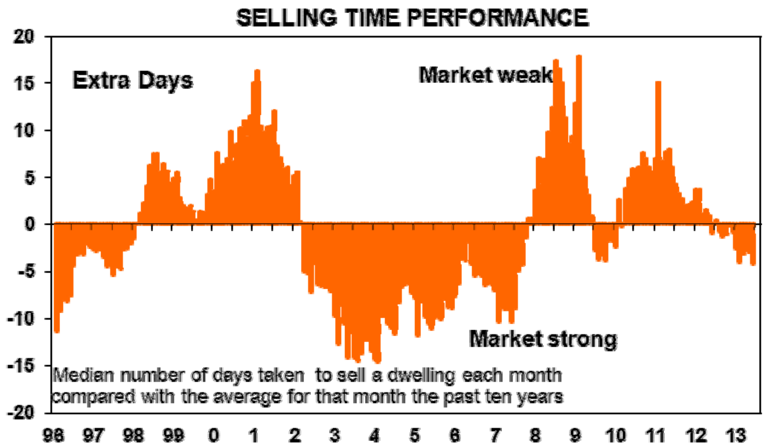
Same as usual – short supply, prices rising

The REINZ released their monthly data this week and they show that in June there were 6,135 dwellings sold around New Zealand which was exactly the same number as a year earlier – spooky. The average selling price however was ahead by 8.4% with a 3.5% gain registered during the past three months. So prices are currently rising at an annualised pace of about 14% led by Auckland with an annualised pace of 27%, Christchurch 15%, the rest of the North Island 2%, the rest of the South Island 13%, and Wellington 4%.





The average number of days taken to sell a dwelling fell to 34 in June from 35 in May which was 4.2 days faster than average compared with 2.9 days faster than average in May. This is the strongest result since September 2007 but still not as strong as from 2002 – 2007 on average.



In a nutshell the housing market is rising with accelerating turnover but a shortage of listings accentuating a rise in prices.

Radical "Solutions" Would Not Be Supported

A couple of weeks ago I listed questions asked by a journalist in China plus my responses, and noted that I could not find a webpage describing the results of an interest.co.nz survey of people's preferences from the eight measures I suggested could be imposed if we were serious about getting house prices down. Someone kindly found the link and sent it through. Note that I don't actually support such measures – a point some journalists did not quite pick up on. The list merely illustrates the extremes which I feel we would need to go to if as a society we wanted to radically improve home affordability. The fact that the solutions are so extreme is intended to illustrate why I believe strongly that house prices will continue to rise.

http://www.interest.co.nz/opinion/65123/our-latest-opinion-poll-indicates-ban-offshore-based-house-buyers-would-have-support-w

In addition I include the question in my BNZ Confidence Survey regarding whether people are Happy or Unhappy about house prices rising to show that there is probably very little support generally for the eight radical options as most people do not think rising house prices are a problem. 642 people responded in the late-June survey. More than enough for statistical validity.

%	June	May
Happy	36%	29%
Indifferent	35	42
Unhappy	29	29
Net % Happy	**7**	**0**

The Effectiveness of Minimum Deposit Rules

Here is a quote from the Wall Street Journal Asia of July 10, page 13, in an article entitled "Mortgage Rules Fail To Halt Rising Prices"

"Last October, it (The Bank of Israel) set the minimum down-payment at 30% for most home buyers, and at 50% for investment properties…Israeli home prices rose 3.2% in the four months ended in March…The lending restrictions can't overcome the forces of supply and demand: Israel's population is growing at a much faster rate than new homes are being built, so home prices just keep climbing… "Evidently the measures we have imposed have not been strong enough to reduce the demand for housing sufficiently to stop prices rising," the former central banker Mr Fischer concedes."

If I Were A Borrower What Would I Do?

Fixed housing rates are set to rise and it is just a matter of which bank wants to move ahead of the rest. For borrowers looking to manage their interest rate risk in this continuing lowly-predictable post-GFC environment the cost of doing so is going up. The incentive for those taking a risk management approach rather than thinking we economists can deliver them a strategy which will minimise their costs should our forecasts prove correct (and they have been wrong for four years), is to fix sooner rather than later. Note that if you think taking out an 18 month or even two year term is fixing and giving you some certainty through the interest rate cycle – you're dreaming. Three years and beyond is true risk management. Anything shorter is largely opportunistic grabbing of a low rate simply because it is less than the floating rate.

Personally, having really sat down and given it thought this week, were I truly borrowing at the moment I would have half at the five year fixed rate of 6.35%, one quarter fixed 3 years at 5.9%, 15% fixed at one year for 5.25%, and 10% floating at 5.74%.

If you are in a position where you recognise the risk management benefits of this structure but can't do it and instead take one of the low short-term fixed rates out there because otherwise you could not afford your house – then don't borrow the money in the first place. You could well be forced to sell when rates rise 3% even though your equity will be greater because you won't be able to afford the cash outflows – especially if at the moment you are a couple, both working, but plan having one partner quit within three years to raise children. Work out your cash flows assuming an 8.5% mortgage rate come 2016 and see how you would be left.

Offshore

It's all about the tapering

News of the week was the **United States** employment report released on Friday night. Non-farm job numbers rose by 195,000 in June whereas a rise of 165,000 had been expected. Results for the previous two months were also revised upward 70,000 in total. The outcome means that jobs growth has averaged 202,000 a month so far this year compared with 183,000 last year and this feeds into a picture of an improving US economy – especially as there is some downward bias to the jobs growth data at the moment caused by government sector layoffs.

The data mean that there is now a greater chance of the Federal Reserve starting their money printing tapering exercise this year – with September now the favoured month. In response to altered expectations of US money supply growth we have this week seen a jump upward in the USD and US bond yields also spiking skyward.

The US economy is the world's largest and its financial markets the deepest with the biggest impact on other markets. Thus a rising US sharemarket generally pressures other markets upward, and rising US bond yields generally push up yields elsewhere – which is what is happening around the world now. This jump in yields is going to give the spendthrift European governments an early indication of the cost to them of easing back on fiscal austerity. That easing off in tax rises and spending cuts means European government debt levels will be higher in a couple of years' time than would otherwise be the case. That means vulnerability of budget accounts to higher debt servicing costs will be greater and that is what is happening now.

As bond yields rise deficit projections for European governments will worsen and a new debate about when to reimpose fiscal austerity will start up – either pushed by governments themselves or forced upon them by traditional buyers of bonds who will be sitting on losses and wary or purchasing more European government debt.

The ECB President and new BOE Governor have sought to delay that debate by delivering statements just over a week ago bemoaning the rise in EU and UK bond yields as not reflecting what is happening in the EU and UK economies. But their cries of "unfair" will count for little given that the US influence on global investors' decisions is, frankly, paramount. If better returns can be earned on US bonds then that is where investors will go and if UK and EU governments want to fund their deficits and refinance maturing debt they will need to pay more.

In **Australia** the unemployment rate has continued its climb from 5% about a year ago to 5.7% in June from 5.6% in May. Job numbers grew 10,300 in the month but this was less than expected and the chances are now strong that the RBA will again cut interest rates early in August.

Exchange Rates

Exchange Rates	This Week	Week ago	4 wks ago	3 Mths ago	Yr ago	10 yr average
NZD/USD	0.796	0.777	0.79	0.859	0.795	0.67
NZD/AUD	0.856	0.857	0.835	0.815	0.779	0.85
NZD/JPY	78.3	77.5	77.9	85.7	63	69.6
NZD/GBP	0.525	0.508	0.507	0.56	0.512	0.388
NZD/EUR	0.606	0.597	0.596	0.657	0.646	0.52
NZDCNY	4.88	4.76	4.85	5.32	5.06	4.99
USD/JPY	98.37	99.74	98.61	99.77	79.25	105.7
GBP/USD	1.52	1.53	1.56	1.53	1.55	1.72
EUR/USD	1.31	1.30	1.33	1.31	1.23	1.28
AUD/USD	0.93	0.91	0.95	1.05	1.02	0.788
USD/RMB	6.1345	6.1305	6.1332	6.1939	6.368	7.56

Volatility the new norm

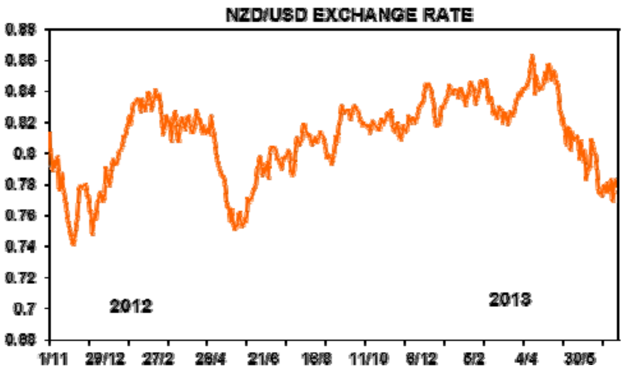
This week the NZ dollar, like other currencies, has experienced a firm degree of volatility occasioned by fluctuations in expectations for Fed. tapering plus comments out of Europe and underlying uncertainty about China’s growth rate in the near future. It traded below 77 cents for a while but this evening is near 79.5 having sat just over 78 cents at the start of the day.

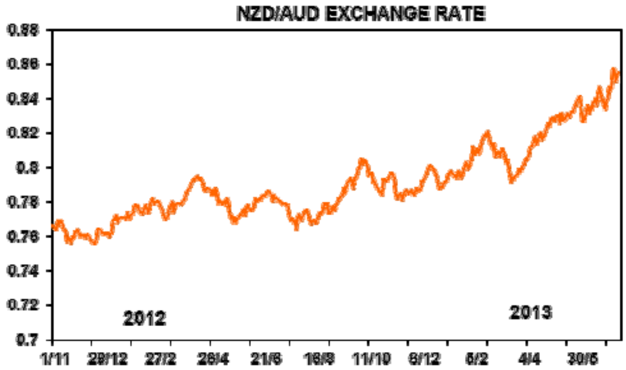
The NZD’s rise against the British Pound of almost two pence over the week (last Thursday night really) reflects comments from the new Bank of England Governor which were more dovish than expected. He indicated an intention to keep interest rates low for longer than had been factored into UK interest rates, the Pound, and the UK sharemarket. His statement came in a very rare one-off press release driven undoubtedly by a desire of the new Governor to separate UK rates from interest rates which are rising in the United States on expectations of tapering soon. In fact the European central Bank President did the same thing last Thursday night and hence a fall in the Euro against which we have risen. His comments were reinforced by one of the ECB members later noting that one could not rule out fresh money printing from the ECB.

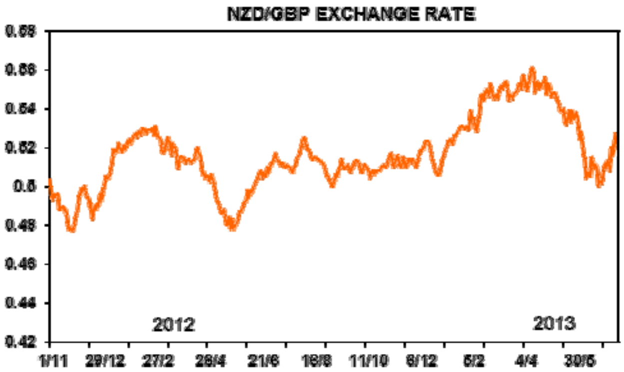
The GBP was also pushed lower by some much weaker than anticipated manufacturing data released Tuesday night. Output fell 0.8% in May rather than rising the expected 0.4%. This is important because recently commentary has been circulating noting an apparent recovery in the UK manufacturing sector after falling to 10% of GDP from 18% in the late-1990s.

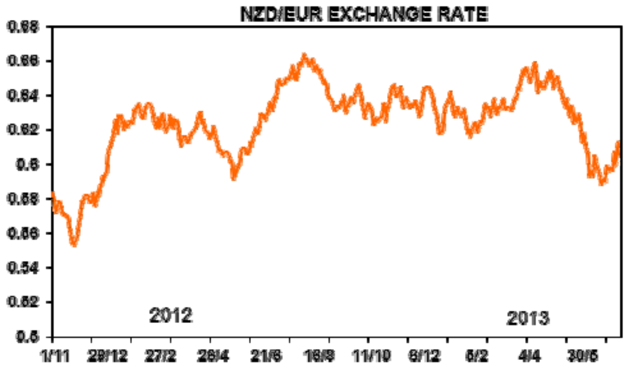
Against the Japanese Yen we have ended little changed from a week ago and the same applies for the Aussie dollar though the risk there is that we trend higher toward 90 cents.

Although high volatility is going to continue, it pays to remember that the fundamentals supportive of the NZD are very strong. We have good commodity prices which are expected to continue. The government accounts are in good order and producing positive surprises. GDP growth is accelerating. The NZD rises when the RBNZ tightens monetary policy and that tightening has not even started yet and could run for longer than people are currently generally assuming. Plus conditions are still fraught overseas and tightening policy in other major economies may be years off. Good luck.









Key Forecasts

Dec. year		**2011**	**2012**	**2013**	**2014**
GDP	annual average chg	1.4	2.5%	2.5 – 3.0	3.5 – 4.0
CPI	on year ago	1.8	0.9	0.5 – 1.5	2.0 – 2.5
Official Cash rate	end year	2.5	2.5	2.5 – 2.75	2.75 – 4.25
Employment	on year ago	1.6	n/a	2.0 – 3.0	2.0 – 2.5
Unemployment Rate	end year	6.3	6.8	5.0 – 6.0	5.0 – 5.5

The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The publication is sent to 28,000 subscribers each week and is one of a stable of regular releases which include the

- monthly Growing With China publication, http://tonyalexander.co.nz/topics/china/
- monthly Brain Gain NZ publication http://tonyalexander.co.nz/topics/brain-gain-nz/
- monthly BNZ Confidence Survey, http://tonyalexander.co.nz/topics/surveys/bnz-confidence-survey/
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- Monthly column for the NZ Property Investor magazine, http://www.propertyinvestor.co.nz/
- Most of these publications plus research into impediments to NZ's economic growth are available on his website. www.tonyalexander.co.nz

Tony Alexander has been Chief Economist at the BNZ since 1994 and apart from publications and advising management spends considerable time on the road around New Zealand making presentations and speaking with the media. He travels to the UK and Europe twice a year to assess economic conditions and present at numerous functions, has five children, tramps, and his partner Dr Sarah Farquhar runs the early childhood education network www.childforum.com

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