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

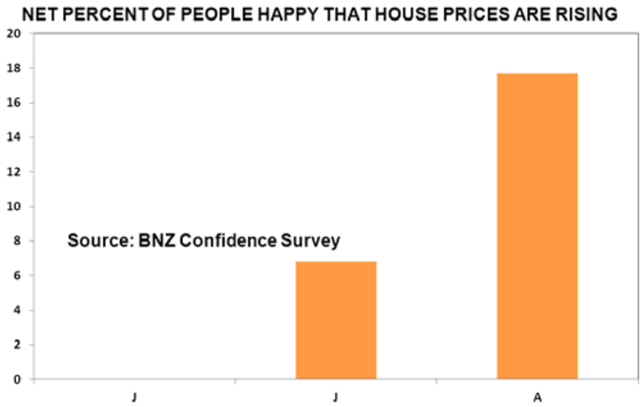
NZ Economic Prospects Are Ratcheting Upward

I'm back from holiday now having escaped not only some shocking weather just north of Wellington but also the earthquake of a week or so ago. The immediate impact of the earthquake and its aftershocks is a disruption to economic activity. But the longer term impact will be an extra spur to construction sector business. It is abundantly clear that a lot of buildings are not of a standard which would leave you wanting to be anywhere near them when the Wellington fault moves. And if that is the case for us where we know a big jolt will one day come, and Christchurch had a devastating quake when no-one even knew a fault line was there, then all of NZ needs to undergo a rigorous upgrading of commercial buildings in particular including unfortunately the removal or special strengthening of a lot of lovely facades around the country.

The local and national politicians in conjunction with commercial property owners will undoubtedly have a great number of discussions regarding what standards to apply, when, and what timetable to use for remediation or demolition. But the upshot will be extra building sector activity. That activity may not be hugely relevant to this economic cycle but it may well factor into the capital spending decisions which building companies make in the next 2-3 years as they find their work levels rising strongly because of the Christchurch rebuild and catch-up in Auckland house construction. Firms are more likely to invest and undertake extra staff training if they expect more than just a three to five year boom from the Christchurch and Auckland factors. Therefore anticipation of remedial earthquake activity will be relevant to this economic cycle and it is just another factor delivering upside risk to growth forecasts for the NZ economy over the next three or so years.

Another one of those factors is the announcement this week by Fonterra of a 50 cent lift in this season's payout. Allowing for an expected production boost the dairy sector is going to thrust an extra 1.7% into our GDP this year compared with last year. And there is increasing evidence that businesses are aware of this and other boosts to economic activity coming along.

Our monthly BNZ Confidence Survey will be released in a few days after I have gone through the industry comments provided by over 700 respondents. But the net percent of respondents expecting that the economy will be in a better shape in a year's time than it is now is a record 59% - up from 56% last month. That is strongly suggestive of the labour market soon experiencing the surge we have been anticipating for some time now. That surge will eventually lead to wage pressures and the lag there is usually 18 or so months. That wages surge will come on top of increasing contractors charges already underway plus rising materials prices and elicit a pre-emptive strike by the Reserve Bank against inflation. Note also that the survey results will show a rise in the net percent of people feeling happy that house prices are rising to 18% from 7% a month ago.



For now the RBNZ still have some time on their side afforded by the actual inflation rate being just 0.7% and the Kiwi dollar rising again after being battered about over May and June by a resurgent US dollar. I hope all those Kiwis coming back from Australia shifted their hard-earned lucre into NZDs some time ago because the way the NZD is rising against the beleaguered AUD we could soon be above 90 cents. And I also hope those many Kiwi expats in the UK looking to shift funds down to the better hemisphere took advantage of the recent decline against the pound. I still see the rate consolidating above 55 pence.

This week I released the latest Growing With China issue which is shifting from a monthly to a quarterly frequency. It is here. http://tonyalexander.co.nz/wp-content/uploads/2013/07/GWC-July-2013.pdf

The situation in the United States has been quite well summed up this past week by the two main measures of consumer confidence. The University of Michigan index has risen to 85.1 in July from 82.7 in June. That is a signal that consumers are probably going to up their spending and on that basis companies will boost their hiring and investment and so a positive spiral gets underway. That means an increased chance of the Federal Reserve tapering its money printing and hence strength in the US dollar and higher interest rates but uncertainty for share prices as volume of money becomes a depressing factor while anticipation of higher dividends becomes a driving force.

But the alternative consumer sentiment measure from the Conference Board fell to 80.3 from 82.1 so the opposite conclusions hold. This has by and large been the story of US data for three or four years now with the oscillation from positive to negative and back again usually spread over a few months and involving screeds of data rather than the two simple indicators discussed here in a one week period.

I point out this issue simply to highlight that considerable uncertainty remains about the strength of growth in the US economy and therefore considerable uncertainty and potentially high volatility remains possible and likely for the likes of the US dollar, long term interest rates and share prices. But at least the drift in the United States is toward improvement and that is why the debate is all about when the Fed. start their tapering and not about whether they boost money printing.

In Europe there have been some better than expected indicators released recently for the manufacturing sector and general confidence. But if you read the commentaries from European analysts you'll see that no-one yet is talking about a firm lift in economic activity coming along. Discussion is more about the fresh deterioration of late last year and this year ending and hopefully nothing fresh coming along to prevent a very slow acceleration in the pace of growth in the next few years. That is, the continent remains highly vulnerable to any ructions in China and any new debt crisis in the beleaguered southern European economies.

An Investment Observation

Often people ask me where they should invest their money. Much of the time the question comes from people with a decent quantity of assets who consciously diversify their exposure. Discussing things with them is no problem though I cannot give advice as such. The problem arises when such discussions are spread, overheard, or requested by people with limited investment experience and smallish quantities. For them the massively important aspect of spreading one's risk by diversifying across asset classes tends not to enter the frame and they are the ones who end up having their retirements devastated should the investment go wrong.

This problem of unsophisticated people not diversifying their investments probably arises because for them investing the money is a problem which they want to get rid of. For the skilled investor, possibly already with sufficient assets to retire on, decisions are based around ideas of taking advantage of opportunities in a generally relaxed manner. The unsophisticated person may see an investment which a sophisticated person has gone into and place 100% of their funds into that not realising that for the latter person the asset only represents 5% - 10% of their portfolio.

This is a key reason why there are so many restrictions on who can discuss investment matters with people, and why so many people have lost so much money in the past which they could not afford to. They were simply seeking one perceived "safe" place to put their funds so they could get on with normal life and figured that if more sophisticated people than them were putting money there it must be a great thing.

Greater priority by investors needs to be given to diversifying their asset base and achieving that requires talking not with anyone promoting a particular asset (they'll want your 100%), not just with your neighbour or life-long friend or listening to the voice on the radio and TV from the lovely man who used to read the news or host that great show years ago. Talk with an unbiased advisor.

IF I WERE A BORROWER WHAT WOULD I DO?

I look around and see that although central bankers in the US, Japan, UK, Australia, and EU are trying to signal intentions to keep interest rates low for a long time, investors are increasingly feeling that the trend for rates now is upward at completely unpredictable paces. That says to me that we have seen the lows for fixed borrowing costs this cycle so I have an incentive to move sooner rather than later if my intention is to boost the proportion of my loan with interest costs fixed.

However given the high uncertainty it pays not to place any high faith in a particular set of interest rate forecasts and definitely not to form an interest rate risk management plan predicated upon a set of forecasts proving correct. The incentive is for one to strongly focus on spreading risk by taking a mixture of floating and fixed rate terms. I'd take a serious look at locking in half my mortgage at our three year Classic fixed rate of 5.89%.

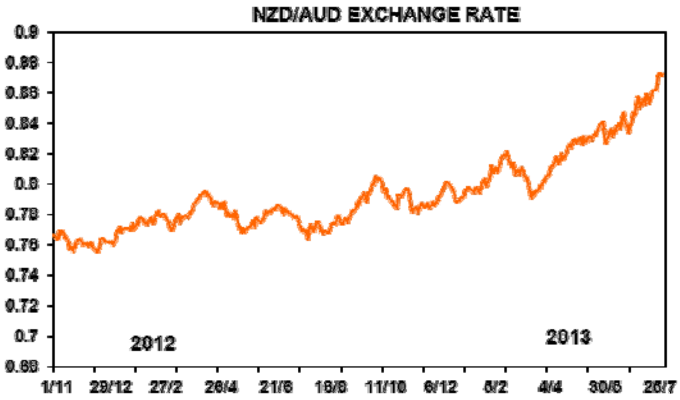
FINANCIAL MARKETS DATA

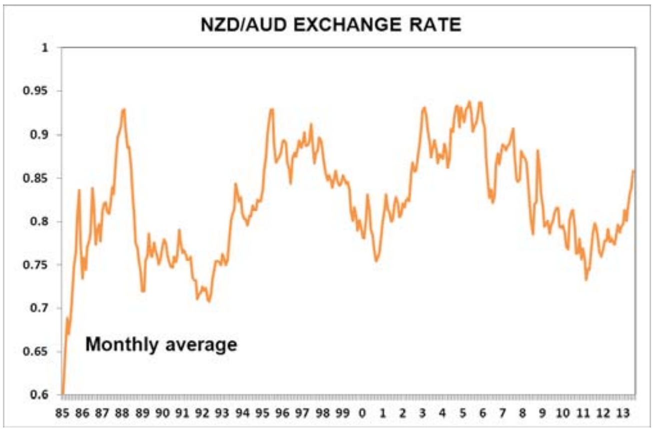
	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	2.50%	2.50	2.50	2.50	2.50	5.4
90-day bank bill	2.67%	2.67	2.66	2.67	2.76	5.7
1 year swap	2.95%	2.95	2.88	2.75	2.73	5.8
3 year swap	3.75%	3.75	3.62	3.05	3.00	6.1
5 year swap	4.22%	4.22	4.06	3.33	3.28	6.3
7 year swap	4.49%	4.50	4.35	3.59	3.55	

NZD Soaring Against The AUD

Fonterra this week raised their forecast payout for this dairying season by a higher than expected 50 cents to $7.50 a kilogram of milk solids. Last season's payout was $5.80 therefore allowing for a 6% production boost we get an extra $3.6bn cash injection into the economy this year. Compare that with what is happening across the ditch where primary sector income projections are being cut, economic growth projections are being reduced, and the RBA this week responded to such with a strong hint that monetary policy will be eased again.

It is this divergence between the drifts for the NZ and Australian economies which helps explain why the cross rate has risen to a five year high near 88 cents from ten cents less than that about a year ago. Where will this end? The starting point for answering such a question has to be an examination of where the NZD/AUD exchange rate has historically moved. That is shown in the second graph here.





The NZD historically has tended to bottom out against the AUD around the 75 cent mark and peak around 94. On that basis one would say we have six more cents to go, especially as NZ monetary policy is highly likely to be tightened well ahead of any move in Australia, and because our export mix is currently in favour while Australia's is out of favour.

But for the past few years we have all been talking in terms of the usual range for the NZD/AUD rate maybe shifting down five cents. But wait again. I recall how we all used to bemoan the country's dependence upon the pastoral sector and how the long term trend for our currency against everything would be downward.

What this tells us is what I have tried sometimes in vain to point out in this publication over the past 13 or so years – we've not really got much idea at all when we try to predict where exchange rates will go. So what does someone in the position say of wanting to get some funds into Australia do? Personally I have I am starting to move some funds across with zero expectation that I can pick when and at what level the rate will peak. Best guess? Above 90 cents but maybe not for long. My theory is that the Aussies are simply in a bit of a blue funk which will pass though interest rates there could stay low for a long time. The trigger for ta better assessment of Australia's prospects? An upward reassessment of China's growth prospects. When will that happen? Completely impossible to say.

Exchange Rates	**This Week**	**Week ago**	**4 wks ago**	**3 Mths ago**	**Yr ago**	**10 yr average**
NZD/USD	0.799	0.7973	0.775	0.857	0.806	0.67
NZD/AUD	0.889	0.8712	0.847	0.828	0.769	0.85
NZD/JPY	78.2	79.97	76.9	83.5	63.2	69.6
NZD/GBP	0.525	0.5205	0.51	0.552	0.516	0.388
NZD/EUR	0.6	0.6042	0.596	0.651	0.657	0.52
NZDCNY	4.90	4.89	4.76	5.28	5.13	4.99
USD/JPY	97.87	100.30	99.23	97.43	78.41	105.7
GBP/USD	1.52	1.53	1.52	1.55	1.56	1.72
EUR/USD	1.33	1.32	1.30	1.32	1.23	1.28
AUD/USD	0.90	0.92	0.91	1.04	1.05	0.788
USD/RMB	6.1289	6.135583	6.1375	6.1658	6.3628	7.56

Housing Market Update

It Gets Worse and Worse For First Home Buyers

It would be great to be able to write here that things are moving in favour of first home buyers and those on low incomes – but that is not the case.

First, the Reserve Bank last week issued a marginally more hawkish policy statement than expected and expectations have risen of monetary policy tightening in the coming year. That has placed extra upward pressure on bank fixed funding costs and will eventually push bank fixed lending rates higher – though nothing major appears to loom in the very near future. Floating rates are likely to start rising early next year.

Second, the Labour Party have adopted my preferred policy of cutting and pasting Australia's rules regarding foreign buying of houses into New Zealand and that means foreigners have an incentive to move sooner rather than later in making their purchase.

Third, the Reserve Bank is to start tinkering with quantitative lending controls on bank lending to those with low deposits – first home buyers largely. Such buyers will need to pay more for their money now.

Fourth, the migration numbers are going off like a rocket. The net annual migration gain has risen to 7,907 from 6,242 in May and a loss of 3,191 a year ago. But more importantly, annualising the last three months we get a current pace of net migration near 23,000. Fewer people are leaving NZ, more are coming in, population growth is therefore accelerating, and that means more demand for housing.

Fifth, plenty of investors run with the rule that migration is the key driver of house price changes therefore as awareness of the migration surge rises investor demand for property will grow.

Sixth, there are no easy solutions to the housing supply shortage and this was emphasised during the week with some (very welcome) comments by the new Chief Executive of Fletcher Building Mark Adamson. He said after discovering that his company makes only 300 houses a year that he wants plans drawn up by Christmas for expanding that output to thousands concentrated in affordable housing, low-rise apartments, and multi-family dwellings. But he noted factory producing such houses would be a couple of years off.

Seventh, given that we are largely talking about the housing market in Auckland when we speak of shortages, one can't help but think that the situation will get worse in the near future as a few Wellingtonians think of shifting further away from where the country's earthquakes are centred.

It adds up to continued rises in Auckland house prices with gains slowly spreading out to the rest of the country. Note that there will be some offset to the boost in housing demand from rising net immigration as the turnaround is coming mainly from Australia and many of the people returning or not going there will have building skills one suspects. Housing supply is improving but activity is still at below average levels.

In the June quarter the number of dwelling consents issued was 34% ahead of a year ago led by Auckland with a 53% rise then Canterbury 39%. All the rest of the country had growth of 23%. For the year to June total consent issuance was 18,731 from 15,447 a year ago but this is below the ten year average of 21,820 and at 5,291 the Auckland region total has a long way to go to reach the desired 13,000.

Affordability Intractability

A month and a half ago I produced a list of eight things which I reckoned would need to be done if we were deeply serious as a society about greatly boosting home affordability. I produced the list not because I advocate the factors there, I don't, but instead to show that correcting the house price situation requires such extreme measures that they will not be taken – hence house prices keep rising. Unfortunately a few reporters skim read the list and decided that I was supporting such changes and some people with vested interests in maintaining the status quo have got upset. I guess they forgot their reading comprehension lessons from school days. But such is the risk one takes in writing or saying anything accessible to the media. It's a hard life. Cue the violins.

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

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Some things are best kept private