

# 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.

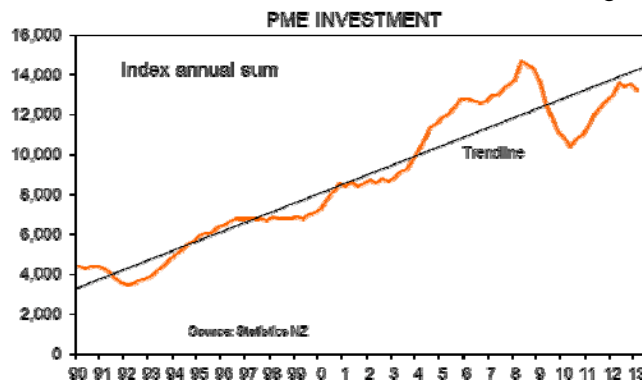
<http://feedback.bnz.co.nz/forms/IFdYSs5FGEq4kAjP95uzTA>

## Capital Spending Yet To Take-Off This Cycle

I was asked earlier this week as to whether business investment is picking up. Unfortunately in this area we lack up to date information in New Zealand and always end up making rather incomplete guesses as to the extent to which businesses are backing their positive sentiment with money being laid down for new equipment.

The official data contained in the National Accounts shows that investment in fixed assets other than residential buildings was 1.2% weaker in the March quarter than a year earlier but growth for the year to March was 3.6% compared with 5.9% growth in the year to March 2012. So there is growth but it has slowed down rather than sped up. Why?

Investment in non-residential buildings in the year to March grew 6.1% after falling 7% a year before so it is not that. Investment in transport equipment fell 1.4% after rising 2.6% so it is partly that. But mainly this slowdown arises because of a fall in the pace of PME (plant, machinery and equipment) investment to just 2.3% from 13.6% a year ago. That unfortunately is the measure we are most interested in. So we now need to try and find more up to date measures to see if this slowdown is continuing.



One indicator we look at is the value of imports of plant and machinery. In seasonally adjusted terms such imports in the six months to June were down by 6.5% from the six months to December last year. So fewer capital goods are being imported measured by value.

However, the number of commercial vehicles registered in the year to July was ahead by 29% from a year earlier and in the three months to July regos were ahead 20% from a year earlier. There is good growth underway for this partial measure. For tractors the registration growth rates were 7.5% and 12% respectively. So some growth but nothing astoundingly strong. And anyway, these data would feed into the transport equipment category above rather than PME.

The rate of growth in bank lending to the business sector still remains low. In June business debt was just 1.6% ahead of a year earlier. A year ago the growth rate was 3.8%. To the extent business capital spending

is funded by debt this suggests little is going on. However this is not a particularly good proxy measure because businesses often finance early-cycle investment from retained earnings.

All up we are left with the conclusion that as yet there is no generalised surge in business investment in plant, machinery and equipment underway. Will this happen? Our own BNZ Confidence Survey shows that a record net 59% of businesses feel confident about where the NZ economy will be in a year's time. The NZIER's Quarterly Survey of Business Opinion for the June quarter showed a net 10% of non-farm businesses planning to raise PME spending in the next 12 months. This was up from a net 8% in the March quarter and 5% in the December quarter, the strongest result since December 2006, and well above the ten year average of -1%.

The ANZ Business Outlook Survey showed a net 20% of businesses in July planning to lift their investment compared with 22% in June. This is the second best result since March 2005 and is well above the ten year average of 9%.

So the forward indicators are good. Now we wait to see whether these good intentions will in fact translate into higher capital spending levels. We are certainly not there yet and one of the key themes for our economy and most overseas since 2010 has been quite positive sentiment and intentions measures not translating into actual money being laid down as happened before the GFC. So it is an article of faith that the currently high measures will this time, finally, spur actual money of businesses being placed at risk.

### Risks

Speaking of risks – there are so, so many it is difficult to know where to start and no list we make will contain all of them. For the pessimists out there or simply those people wondering if they are off-track thinking it is best to hold off a bit longer before spending, here are a few of the things we are all tossing coins about.

The Federal Reserve in the United States will soon start a “tapering” exercise involving reducing the amount of money printed each month. Anticipation of this uncertain process starting has already depressed sharemarkets, pushed US 30 year home mortgage rates up 1.25% and caused the US dollar to rise. But the pace of tapering is completely unknowable and will stop and start depending upon how US economic data develop. This factor has not only caused the changes in the US just noted but contributed to an outflow of hot capital from emerging economies raising fears of a repeat of the 1997/98 Asian Crisis in some countries. To counter outflows some emerging country central banks have raised interest rates. India is being slammed particularly badly as investors also add another decade or three onto the time period in which they feel India's economy will surge like China's. Western companies are currently quitting India in droves.

In Japan the Bank of Japan aims to double the money supply in the next two years in the hope that banks will lend (maybe, maybe not), people will borrow and spend (maybe, maybe not), and inflation will appear and rise to 2% (probably not). The Japanese government is also undertaking yet another fiscal stimulus yet at the same time plans raising its consumption tax from 5% to 10% in two steps to try and rein in a huge deficit and contain a debt to GDP ratio already near 250%. The IMF have identified the risk of debt monetisation in Japan and financial collapse as the most probable candidate for major global economic disruption in the next few years. Note also that the Japanese PM plans undertaking some deregulatory policies – but the chances are he will back off.

In Australia the Aussies have woken up to the fact that yet again they have blown the opportunities provided by a once in a lifetime resources boom with the Federal Government locking in expensive spending programmes, wasting billions, and parties in the current Federal election campaign making more (largely uncoded) spending promises while also examining new and higher taxes to fund their vote-buying gimmicks. In addition the government, employers and unions have overseen increased rigidifying of the Australian labour market and boosting of labour costs which are badly affecting the international competitiveness of Australia at a time when the United States in particular has seen its competitiveness soar. The current view is that Australia will achieve near 2% GDP growth in the coming year but that could prove too optimistic. In particular, while recent weakness in the AUD is positive for the manufacturing sector, large chunks may leave the country as Australia's cost base is deliberately increased by government actions even as the

economy struggles to adjust to the end of the resource investment boom. That may mean more than just call centres and some editorial jobs shifting across to New Zealand with any luck.

Yet at the same time the Aussie housing market is turning upward as investors anticipate some years of low bank deposit returns so seek better yielding investments elsewhere. Hence also a drifting of the AUD lower with perhaps quite a bit more to come.

In Europe the most recent data releases have surprised on the better than expected side. But this still leaves the Euro-Zone having shrunk for six quarters in a row with growth of only 0.3% in the June quarter driven largely by Germany. Government deficit and debt tracks look about as bad as they did six months and a year ago, their economies by and large remain as rigid as before, questions remain about the sustainability of the Euro, the UK will be holding a referendum on EU membership by the looks of it, and industry is shifting to the United States. For Europe it is not so much that the worst has passed as that it has been converted into another 5 – 15 years of poor economic performance which will shrink the EU's contribution to global economic activity.

In China the new leadership is showing more of a leaning toward the attitudes of Mao than had been hoped for (supremacy of the CCP etc.), a transition of the growth source from exports and fixed asset investment toward consumption is not happening, and the populace are growing increasingly discontented with pollution, unsafe food, media control etc. as more and more people shift from peasant status to worried and questioning middle-income earners. The place is heating up and that is dangerous because the CCP will likely react by seeking some nation-binding and building diversion – such as conflict with Japan, or anti-Western sentiment. They appear to be opting for both.

The Chinese leadership are trying to get ahead of the discontent curve with what is called a “mass line” campaign aimed explicitly at strengthening the supremacy and role of the China Communist Party in China. Around the country meetings have been held warning of seven subversive Western currents working their way through Chinese society. These include such terrible things from a dictatorships point of view as

- Western constitutional democracy
- Promoting universal values of human rights
- Media independence
- Civil society
- Pro-market neo-liberalism
- ‘Nihilist’ criticisms of the Party's past (never mention Tiananmen Square – or the deaths during the Cultural Revolution, or the Great Leap Forward.)

This campaign should be taken as a reminder to all of us that our country is building up economic dependency upon a civilisation with appalling governance, a chip on its shoulder (one hundred years of humiliation), and condescending attitude toward all other civilisations – the “Barbarians”. Then again, embracing western democracy has not gone too well in Egypt. Failing to immediately put down internal dissent has resulted in a civil war in Syria which could lead to the country splitting apart.

It would seem to be a good idea if our primary producers restrained some of their enthusiasm for product demand coming out of China and actively maintained a strong presence in other markets. China has shown high willingness to use trade as a weapon when they disagree with something another country has done – such as restricting Norwegian salmon imports after Norway gave a Nobel Peace prize to a prominent dissident. And we have a tendency not to like being bullied, with a preparedness to make economic sacrifices (Americans make military ones) in order to hold fast to our values – such as being nuclear free.

Eventually there will be an issue of human values/economic conflict between New Zealand and China and the path it takes will be a lot more damaging to us than the simple little pieces of polite opprobrium directed toward little brother New Zealand following Fonterra's dirty pipe announcement.

Speaking of conflict, the Middle East is simply going up in flames as sectoral schisms of various sort assert themselves. This raises global terrorism risks and the possibility of a shock to oil prices should Israel be dragged into one of the conflicts, the US therefore get dragged in, and the Iranians therefore block the

Straits of Hormuz – or someone blocks the Suez Canal, etc. It's been a while since there was a terrorism or oil price shock to the financial markets.

Risks here in New Zealand? Earthquakes. Tainted milk products. A central bank experiment in restricting high loan to value lending which will eventually be acknowledged as not effective as a monetary policy instrument and cause a catch-up period of official cash rate rises which will send the NZD to potentially very high levels. A housing market short of stock and getting shorter in Auckland as net migration inflows soar on the back of Kiwis flocking back from across the ditch.

The world remains a very uncertain place and that means businesses and households should take great care with the amount of debt they take on and the proportion of that debt left at floating interest rates.

Here is some more useful information on Chinese social media discussion of the Fonterra tainted milk whey debacle.

<http://www.victoria.ac.nz/home/about/newspubs/news/newslatest/chinese-kiwis-defend-new-zealand-on-social-media>

### **IF I WERE A BORROWER WHAT WOULD I DO?**

Interest rates are going up with fixed rates rising ahead of floating rates as is the normal pattern. Driving forces behind fixed borrowing costs facing banks rising include improving economic data offshore (especially in the US) and some good data in New Zealand. Good data means a greater risk of inflation popping up therefore a greater risk of monetary policies tightening sooner rather than later – not that placing a time-frame on the tightenings here and overseas is a clear cut affair. As we have emphasised here for the past 3 – 4 years the range of uncertain factors feeding into growth, inflation, and monetary policy outcomes is huge. There has long been an incentive for borrowers to lock in a mix of floating and fixed interest rates and that situation is not changing. All that is different now compared with 1 – 3 years ago is that risks for interest rates have shifted decidedly from falls to rises and the yield curve is steepening.

What that means is that floating rates are holding steady because they are determined mainly by current monetary policy settings – a cash rate unchanged at 2.5% - while fixed rates are rising in anticipation of floating rates going up.

At this stage there seems little reason for believing that fixed borrowing costs are going to jump massively. The history for the United States – a key influencer of our fixed borrowing costs – has been one of periods of strong data followed quickly by bursts of weak data in the past four years. There seems little reason as yet for believing that this pattern is about to change. But volatility in our rates due to data coming out of the US is likely to increase quite a bit as the Federal Reserve soon starts trying to curb then eventually stop, then eventually reverse its extraordinary money printing operations.

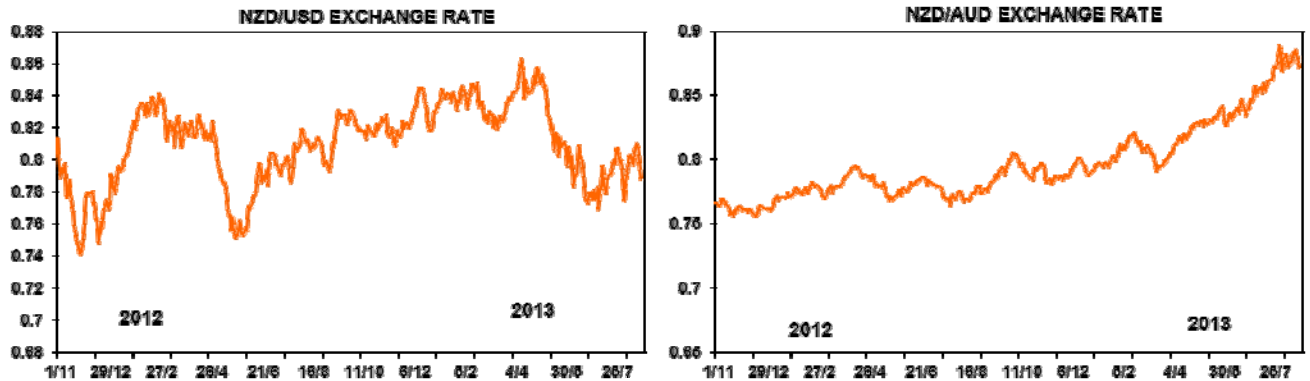
For your guide, those borrowers with a lot of experience and much nouse started locking in their debt at long term fixed interest rates quite early this year when the likes of the five year swap rate was 1% lower than it is now. Plus it pays to note that a round of increases in fixed housing rates is currently going through the markets. We have just lifted our two year rate to 5.95% from 5.65%, the five year to 6.9% from 6.6% (6.2% a couple of months ago), and the seven year fixed housing rate to 7.45% from 7.09% (6.99% two months ago). The three year rate remains steady for the moment at 5.99% having been raised a couple of weeks ago from 5.89% and 5.8% two months ago. Good luck if you are planning to go through this cycle on floating rates. Last cycle they peaked at 10.9%, the one before that 11.3%. Best pick this cycle? 8.5% with massive uncertainty. History shows a strong tendency for us forecasters to under-estimate cyclical interest rate peaks and the longevity of tightening monetary policy cycles.

**FINANCIAL MARKETS DATA**

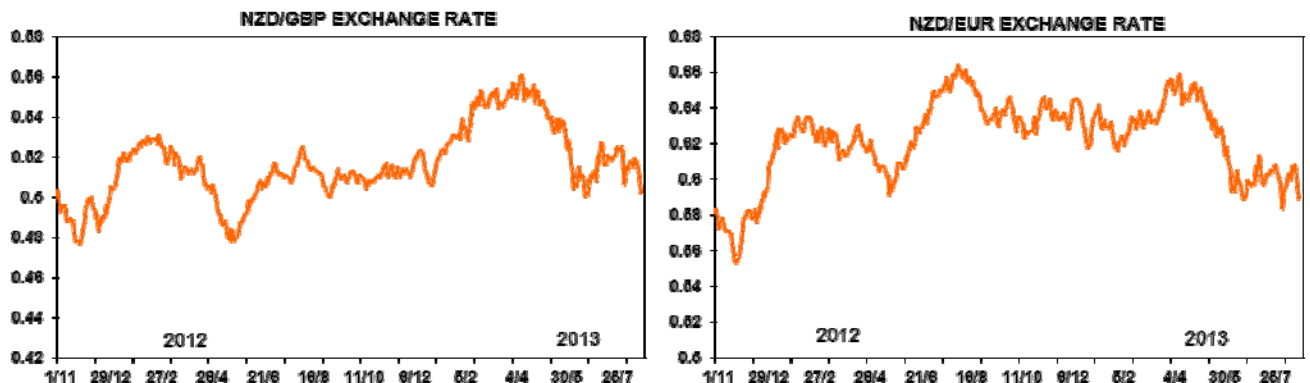
	<b>This week</b>	<b>Week ago</b>	<b>4 wks ago</b>	<b>3 months ago</b>	<b>Yr ago</b>	<b>10 yr average</b>
Official Cash Rate	2.50%	2.50	2.50	2.50	2.50	5.4
90-day bank bill	2.67%	2.67	2.66	2.67	2.76	5.7
1 year swap	2.96%	3.01	2.95	2.75	2.69	5.8
3 year swap	3.91%	3.89	3.75	3.18	2.92	6.1
5 year swap	4.42%	4.35	4.22	3.51	3.28	6.3
7 year swap	4.74%	4.65	4.50	3.77	3.61	

**NZD Down Near 2 Cents**

The key theme offshore this past week has been increased expectations of Fed. tapering starting soon as a result of some better than expected US jobs market data. First time unemployment insurance (jobless) claims fell to their lowest weekly level since September 2007 well before the GFC got rolling. The US core inflation rate also crept up in July to 1.7% which is close to the 2% level it is believed the Fed. wants inflation to stay near before it contemplates tightening monetary policy.



If tapering starts soon that means fewer USDs sloshing around than previously thought and that means less money to sell the USD, buy shares, and invest in bonds. Hence the US sharemarket has weakened, bond yields have risen, and the USD has generally gone up. The NZD has naturally fallen against a stronger USD. But we have also faced downward pressure in response to a slight pushing out of market expectations for when the RBNZ starts raising the official cash rate. That pushing out stems from this week's announcement regarding maximum high loan to value ratio lending being more stringent than expected. The RB is intending that the LVR rules do some of the early work of monetary policy and thus spare exporters some of the pain of a rising currency.



Unfortunately the RBNZ's hopes are unlikely to be realised given the magnitude of pressures in the housing market, the many ways first home buyers can get around LVR rules, and the way interest rate expectations are soon likely to change toward anticipation of a more rapid rate tightening cycle once things do kick off than would otherwise have been the case.

## BNZ WEEKLY OVERVIEW

Offshore the Aussies remain focussed on the Federal election campaign with some very divergent forecasts for where the AUD is headed but generally caution about its prospects given slowing growth in China. The AUD is considered to be a proxy for a broad China play therefore when China economic data look better than expected, as they did a week ago, the AUD goes up. If things go negative again in China then the AUD will decline.

Speaking of China, there was another slight modicum of downward pressure on the NZD this week from tainted milk stories – one involving Westland Milk and the other the revelation of another previously unreported Fonterra incident back in May.

<b>Exchange Rates</b>	<b>This Week</b>	<b>Week ago</b>	<b>4 wks ago</b>	<b>3 Mths ago</b>	<b>Yr ago</b>	<b>10 yr average</b>
NZD/USD	0.784	0.805	0.7916	0.816	0.81	0.67
NZD/AUD	0.872	0.88	0.861	0.832	0.773	0.85
NZD/JPY	77	78.9	79.54	83.7	64.2	69.6
NZD/GBP	0.502	0.519	0.5184	0.539	0.513	0.388
NZD/EUR	0.587	0.607	0.6022	0.633	0.65	0.52
NZDCNY	4.83	4.93	4.86	5.01	5.15	4.99
USD/JPY	97.72	98.01	100.48	102.57	79.26	105.7
GBP/USD	1.57	1.55	1.53	1.51	1.58	1.72
EUR/USD	1.34	1.33	1.31	1.29	1.25	1.28
AUD/USD	0.90	0.91	0.92	0.98	1.05	0.788
USD/RMB	6.124	6.1195	6.137569	6.1371	6.3572	7.56

## Housing Market Update

### LVR Rule Changes To Hasten Price Appreciation Outside Auckland

The Reserve Bank Governor on Tuesday announced that from October 1 banks will be restricted to having no more than 10% of the value of their new home mortgage lending at loan to value ratios above 80% with a few exceptions such as people switching an existing mortgage to another house. This 10% is slightly lower than the 12% which had been expected and will lead to less finance being made available for first home buyers and investors who cannot extract guarantees from others, equity participation etc. It will logically lead to the 10% being made available only to those prepared to pay a premium for it perhaps in the form of a higher interest rate, higher fees, more security etc.

The question is whether this will have the impact which the Reserve Bank wants – namely restraining the rise in house prices. Almost certainly not. Prices are rising in response to catch-up buying from investors and first home buyers running into a worsening supply situation that will not change much this cycle given accelerating population growth courtesy of a migration boom (see below), plus an aging population placing even more pressure on the housing stock. In fact credit growth is not particularly strong. Household debt at the end of June was only 5.1% ahead of a year earlier. Growth is averaging almost 0.5% seasonally adjusted a month or 6% annualised so little real acceleration in lending growth is underway. Attacking lending growth as the RB is doing will therefore have little housing market impact.

Eventually the Reserve Bank will be forced into a period of catch-up increases in interest rates which will likely scare the beejebers out of those who have not yet seen our central bank in full action. Before then some buyers will shift their attention out of Auckland to other, cheaper, parts of the country where their deposit will go further so the RB move will accelerate the spreading of Auckland and Christchurch house price gains to the rest of New Zealand. The spread of ultra-fast broadband will encourage this population spread also to some degree. Frankly that sounds like a positive thing though some parts of the country have a lot to do in order to build their image as a suitable place to live.

Media have started to discuss retirement options a bit for Baby Boomers.

<http://www.stuff.co.nz/dominion-post/news/9048645/Small-rural-towns-hit-mark-for-retirees>

Watch for calculations soon of how much a typical aged Aucklander could free up by selling their house in Auckland.

During the week I gave a talk on China to an audience in Blenheim and of course spoke about the perceived impact of Chinese buyers in the Auckland housing market and the way regions such as Marlborough should be actively positioning themselves to attract people leaving Auckland because house prices are high. These include young people wanting to pursue their increasingly difficult to achieve dream of home ownership not wanting to sacrifice themselves to a life-time of debt they might only realistically pay off with their Kiwisaver funds when they turn 65. In addition with an aging population plenty of retired Aucklanders will realise they can sell their million dollar-plus house and buy something a lot cheaper elsewhere in New Zealand and free up many hundreds of thousands of dollars in cash. That cash would come in useful for flying to visit grandchildren or paying to fly them to visit you.

Regions like Marlborough should be actively marketing their positives in Auckland media with attractions including the beautiful Marlborough Sounds, lots of vineyards, gorgeous weather, lots of interesting coastline south of Blenheim, a fantastic drive on SH 6 to the West Coast and onward, handiness to Nelson, lovely coloured fountain at night-time, nice walks along the river, and one day the cessation of earthquakes. The salt works are also great to visit and I hope the old Cob Cottage is holding together.

Or retiring housing-rich Aucklanders might consider another alternative. Selling in Auckland, buying or renting a house elsewhere in a part of the country which they like and which perhaps holds significance for them, and buying an apartment on the Gold Coast or Sunshine Coast to take advantage of the fantastic weather over there and the great beaches. Then one might spend just over six months in NZ and the rest of the year across the ditch with I understand superannuation eligibility rules restricting one to being overseas less than six months each year. Someone please correct me if that is wrong.

According to Aussie Home Loans the long-term average proportion of dwelling sales which go to first home buyers across the ditch is 20%. In our March BNZ-REINZ Residential Market Survey we asked agents what proportion of their sales went to first home buyers and the answer from 355 responses was 24%. We repeated the question in our May survey and got a result of 23% from 549 responses.

But whereas the Aussie long-term average is 20% the current proportion is apparently a record low of about 14% as investors push out first home buyers. Interest rates are low in Australia and falling so investors are looking for better returns in property. Ditto for New Zealand one suspects as investors enter the market and first home buyers depart – in despair. The Reserve Bank's planned actions are already leading banks to tighten up on high loan to value ratio lending and this might account for our survey a couple of weeks ago finding that a net 18% of agents this month are noticing more first-home buyers in the market. This is down from 28% in July and is a record low.

Here is something interesting. One reason that home affordability has deteriorated so much in New Zealand in spite of much lower interest rates these days than at any other time since the 1960s is that new houses are far larger than they used to be. Plus construction standards and consent costs along with section prices are a lot higher. But while house sizes have increased here in NZ, in the UK they have declined. Typical new dwellings in the UK are now half the size they were 80 years ago apparently and that makes them the smallest in western Europe.

We had our own version of this in the Auckland inner city apartment market a few years ago as developers put up buildings to house largely Asian students used to cramped accommodation. With LVR rules tightening up in a market already short of property for entry-level buyers we are likely to soon see the Auckland apartment market reviving again with demand from buyers for lesser-priced properties which are near where they want to be. The alternative for many will be either forgoing home ownership this cycle, buying further away from the city centre, or shifting elsewhere in the country.

Speaking of buying this cycle. For the past four years first home buyers have been asking me whether it would be better for them to hold off buying until prices fall and they can get something cheaper. My answer now is the same as it was back then. The longer you hold off the higher prices will go. Those holding off since the end of 2008 because they believed silly forecasts that house prices would collapse 40% are now facing average Auckland house prices instead near 40% higher than they were back then. Given the appalling track record of the doom-sayers in getting their price decline forecasts correct is it any wonder that there is such a stack of first home buyers and investors wanting to purchase now rather than wait for better conditions further down the track.

And migration data out yesterday show more and more buyers arriving every day looking for property. In the year to July the net migration gain for New Zealand was 10,569 people. This was up from 7,907 one month earlier (that is a very quick turnaround), a net loss of 3,799 people a year ago, and an average net gain for the past decade of 10,520 per annum. In other words we have now officially entered above average net migration gain territory. Where may this end?

If we annualise the last three months' seasonally adjusted figures we get a gain of near 24,000. That is boom territory and will clearly add to housing pressure. The key driver behind the migration change is Kiwis not going to Australia and more coming back. For instance in July last year 4,337 people left for Australia. In July this year the flow was only 2,624. The monthly inflow to NZ from Australia has risen from 1,145 in July last year to 1,503 this year.

The net annual migration change for all countries of 14,368 is three-quarters due to a 10,674 reduction in the net loss to Australia from 39,849 to 29,175.

Nevertheless, can we this early in the housing cycle take a pick for when it may shift once again from a seller's to a buyer's market where the buyers will be able to pick and choose from a good range of houses on offer, even though the prices may not correct downward by all that much if at all? The answer is not really as there are too many unknowns. Best guess? 2017-18.

**Key Forecasts**

Dec. year		2011	2012	2013	2014	2015
GDP	annual average chg	1.4	2.7%	2.5 – 3.0	3.0 – 3.5	2.0 – 3.0
CPI	on year ago	1.8	0.9	0.5 – 1.5	1.5 – 2.0	2.5 – 3.0
Official Cash rate	end year	2.5	2.5	2.5	3.5 – 4.25	3.5 – 4.5
Employment	on year ago	1.6	-1.3	2.5 – 3.5	2.0 – 2.5	1.0 – 2.0
Unemployment Rate	end year	6.3	6.8	5.5 – 6.5	5.0 – 6.0	5.0 – 6.0

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