Weekly Overview

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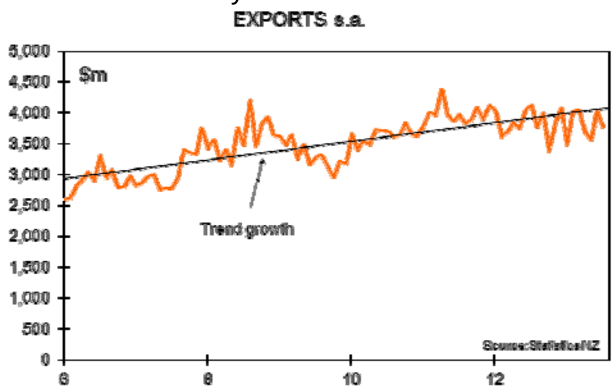
Mission Statement

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

Export Receipts Falling

Last week we examined the question of whether business capital spending is yet rising as growth in the economy accelerates and the answer was no. But we also noted that with investment intentions rising such investment would surely appear soon. This week the monthly merchandise trade data told us that in the three months to July the value of imports of plant and machinery was ahead 13.5% from the three months to April and but down 3.9% from a year earlier. The trend in this rough proxy for capital spending appears to be upward which is good news. But we have been in this situation many times before – as the graph below shows. Therefore one cannot yet conclude that business investment is truly on the rise.



Something definitely not rising is merchandise export receipts. In seasonally adjusted terms export revenue fell by 5.9% in July, 3.3% in the three months to July, and 3.2% for the entire year to July. We are not experiencing at all an export-led upturn in the NZ economy. This is a domestically driven lift which will cause a fresh deterioration in the current account deficit which will lead to worries about a credit downgrading and lots of forecasts that the NZ dollar is about to fall sharply. It won't however because essentially all forecasts since 1985 made on the basis of the current account deficit have been wrong. The Kiwi dollar corrects downward and stays down when conditions are newly poor in the world economy and investors take money back to their home asset markets and away from peripheral destinations.

Fonterra

Fonterra announced on Tuesday that their new estimate for this year's final payout will be 30 cents higher than the one made just a few weeks ago at $7.80. This adds another half a billion dollars into the economy and means that compared with last season and allowing for production rising GDP will receive a boost of about 2%. This is a large number and when we throw in the construction upturns in Christchurch and Auckland plus extra investment in the dairying sector which will be spurred by the higher income we get an outlook for NZ growth which is streets ahead of most of the rest of the planet.

The implications for our currency are fairly obvious as are the implications for monetary policy and the extra incentive provided to borrowers to shift away from multi-generational low floating mortgage rates into medium to long term fixed rates for some part of their mortgage. Pity about the completely unnecessary panic and reputational damage to the cooperative and the country caused by the false positive botulism test.

Syria

It looks likely that some Western powers including the United States, Britain and France may punish the current Syrian government for its use of chemical weapons. A lift in conflict in the Middle East increases the chances of disruptions to oil flows out of the region and that is why oil prices have risen this week. Prices will rise and fall as opinions about the depth of the conflict, its longevity, the involvement of outside powers, and its spread wax and wane. This volatility in oil prices will correlate with volatility in global investor risk tolerance meaning that our currency will go down and up as worries about Syria and the wider Middle East go up and down. This will generate volatility in petrol prices but probably won't shock our economy as such unless things really hit the fan and oil prices soar while world growth forecasts get slashed. For now this is just another one of the many sources of volatility we have taken pains to emphasise here in the past few years. There is no stability and the level of debt and the way you manage it should reflect this fact.

Labour Shortages

This past week I have come across an unusually high number of people in Wellington noting that their companies are struggling to find builders and electricians. One of the key points I have been emphasising for the past two and a half years has been that when the NZ economy gets going the labour market is likely to tighten up very, very rapidly. That appears to be happening even though at 6.4% the June quarter unemployment rate was well above the ten year average of 4.6%.

In fact as previously noted, in the NZIER's Quarterly Survey of Business Opinion for the June quarter a net 26% of businesses said that they are finding it hard to get skilled labour. The ten year average is 21% so even with above average unemployment sourcing skilled labour is worse than average. This cuts to the heart of the issue regarding a lot of the people making themselves available for work not having what employers are looking for.

This was a huge issue from 2003 – 2007 especially when the unemployment rate fell to 3.5%. We said back then that for many businesses a change in operating model was required. The traditional goal of growing revenue as much as possible is not necessarily optimal in a resource-constrained environment when one must pay high labour search costs, training costs, and eventually wages. For some firms it was better then to sell less and cut marginal input costs and that is likely to be the case again soon.

IF I WERE A BORROWER WHAT WOULD I DO?

I would expect to see borrowing costs oscillating upward because of growth accelerating in the NZ economy and ending of US money printing soon. But I would also not expect to be able to reasonably predict the path of rate rises because of massive uncertainty surrounding developments offshore. (Does one hasten to fix because of Fonterra's payout news or hold off because of food safety problems and the deepening Middle East crisis?) In this sort of environment my strong incentive is to move a portion of my mortgage onto fixed interest rates as my debt servicing ability could handle with the incentive being to move sooner rather than later – significantly simply to mitigate risk.

I would initially think about placing some of my mortgage at a three year fixed rate and some at five years while keeping maybe one-third floating. But it pays to note that fixed home lending rates have risen recently with the likes of our three year rate for instance now sitting at 5.99% from 5.8% a couple of months ago and the five year rate at 6.9% from 6.2% two months ago.

Making the jump from either floating or a discounted 12 – 18 month fixed rate to a proper fixed rate (three years and beyond) now costs more than it used to. Taking that into account my preference now would be to take a mixture of floating, 18 month fixed, and three year fixed. The cost of fixing five years at 6.9% is just too distant from the short-term rates. Fixing only a maximum of three years will however leave me vulnerable to whatever the Reserve Bank has to do with interest rates this cycle with history suggesting that rates may be near their peak in three years.

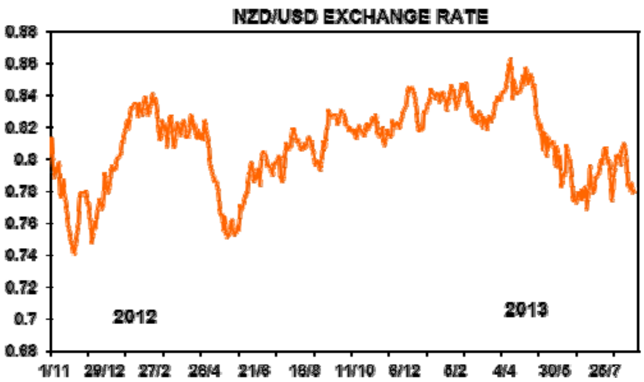
This week there was some early upward pressure on wholesale interest rates but that reversed as investors sold equities and bought government bonds because of concerns about the developing situation in Syria.

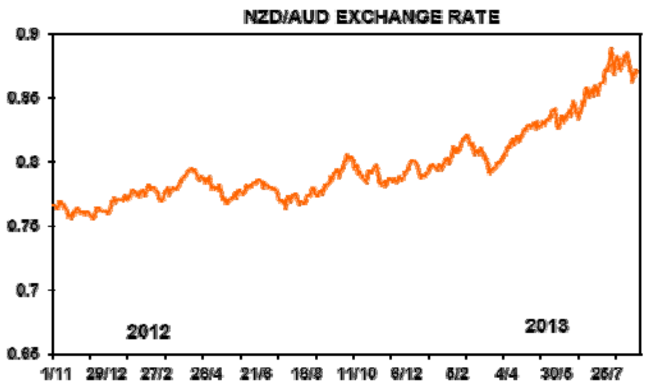
FINANCIAL MARKETS DATA

	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	2.93%	2.96	2.95	2.80	2.67	5.8
3 year swap	3.87%	3.91	3.74	3.29	2.90	6.1
5 year swap	4.39%	4.42	4.21	3.64	3.22	6.3
7 year swap	4.71%	4.74	4.48	3.92	3.54	

NZD Nothing Major

The NZD is basically unchanged against all currencies this past week except the greenback where we have shed almost half a cent. That fall comes about as the USD has been bought up by investors seeking a perceived safe haven ahead of anticipated military strikes against Syria as punishment for the regime's use of chemical weapons.





There has been little impact on the NZD from developments in China this week apart from some early unsustained weakness against the AUD which was lifted for a while against the USD by better than expected data on the Chinese economy. The HSBC early PMI estimate for August moved above the 50-level for the first time in four months thus signalling some growth.

China is one of the BRIC economies which have performed extremely well in recent years, especially following the global financial crisis. That recent good performance partly came from low interest rates and a flood of capital looking for a home as the US Federal Reserve and other developed country central banks flooded their financial systems with money. Now however investor attention is turning away from thinking about where to place all that extra liquidity to shifting it back from emerging economies in anticipation of the Fed's tapering exercise which could start as early as next month.

As funds flow out of emerging economies their currencies are falling, inflation rates are rising, funding for business growth is worsening, and interest rates are being increased to stem currency routs. Growth prospects for emerging economies have changed quickly and questions are now being asked about their vulnerability to a new financial shock and whether they could repeat the 1997/98 Asian Crisis when rapid capital outflows caused currency collapses. The generally accepted answer is that a repeat of that crisis is unlikely given that few businesses have borrowed unhedged in cheap foreign currencies. But as growth slows we could be in for a new source of volatility in financial markets along the lines of the emerging economy debt crises we have seen every decade or so in recent times – Mexican debt crisis, Argentinian, Russian etc. In fear of such an outcome the IMF have already started to try and calm investor nerves by saying it stands ready to provide financial support if needed.

How is this relevant to us? Our main direct export exposure is to China and after that to Australia because of the latter's exposure to China and Indonesia. But the important financial link is that we are seen as a peripheral, volatile currency and that means should worries deepen about Russia, Mexico, Indonesia, China, Brazil, India, South Africa, Thailand, Turkey etc. the NZD will be sold off as investors take their money back home.

Strong support for our currency from the high demand for our primary sector exports is one thing. But in the event of a financial shock such a fundamental counts for little.

So… do you buy the NZD because our export prices are strong, our growth is headed to 4+% and our central bank will be raising interest rates years before other Western central banks do? Or do you sell it because weaknesses in our food quality regimes are showing up and being actively exploited by our competitors http://www.theage.com.au/business/opportunity-to-milk-fonterra-fallout-20130818-2s52a.html And because risks of a bout of the global heeby geebies are rising? Good luck.

Exchange Rates	**This Week**	**Week ago**	**4 wks ago**	**3 Mths ago**	**Yr ago**	**10 yr average**
NZD/USD	0.784	0.788	0.807	0.81	0.804	0.67
NZD/AUD	0.873	0.872	0.872	0.84	0.774	0.85
NZD/JPY	76.6	77	79.2	82.7	63.1	69.6
NZD/GBP	0.505	0.502	0.525	0.538	0.508	0.388
NZD/EUR	0.589	0.587	0.608	0.629	0.64	0.52
NZDCNY	4.80	4.83	4.95	4.96	5.11	4.99
USD/JPY	97.70	97.72	98.14	102.10	78.48	105.7
GBP/USD	1.55	1.57	1.54	1.51	1.58	1.72
EUR/USD	1.33	1.34	1.33	1.29	1.26	1.28
AUD/USD	0.90	0.90	0.93	0.96	1.04	0.788
USD/RMB	6.1198	6.124	6.1316	6.1218	6.3515	7.56

Housing Market Update

Non-Bank Lenders in Australia

One of the things we expect to see happen as a result of the Reserve Bank applying quantitative lending restrictions on registered banks is the same sort of thing that happened the last time the RB tried to influence the economy by controlling credit volumes – growth in non-bank lenders. This is happening in Australia it seems though not because of credit controls.

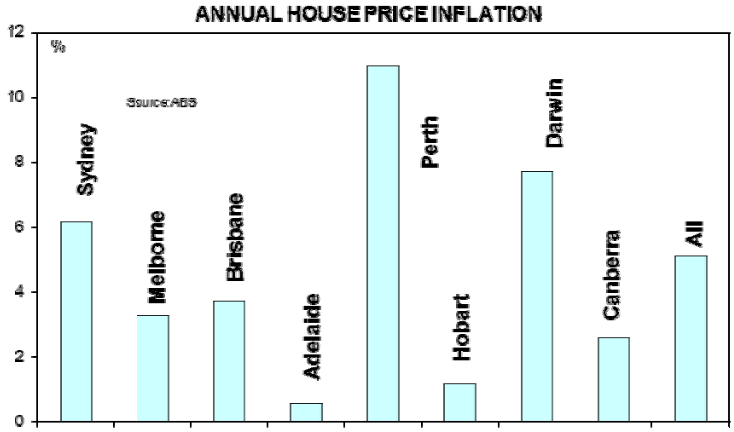
The RBA this month cut its cash rate another 0.25% so it has now fallen from 4.75% to 2.5% with hints of another rate cut to come. With lending growth to the business sector constrained by the muted economy lenders are targeting the housing sector where an upturn is underway in many parts of the country excluding Western Australia where the end of the resource sector investment boom is leading to rising unemployment.

Credit unions are discounting rates to protect their largely home lending-based books from the extra competition coming from banks with some deep interest rate cuts. One credit union has cut its three year fixed rate to 4.79% and this is the first time three year rates have been below 5% since at least 1990. The credit unions are protecting their patch.

So can we expect rate discounting by non-bank mortgage providers such as credit unions here in NZ? Of course not. The opposite dynamic is in play. NZ banks are unable to aggressively chase home buyers or at least the highly geared ones. Those people will be forced to delay their purchase and wait in a queue to get high loan to value ratio funding using criteria each bank will decide upon which could change over time. Or they can seek funding elsewhere. It is natural to expect that as demand for mortgage financing from non-bank lenders rises the interest rates charged by these lenders, as well as maybe the rates for high LVR borrowers using banks, will rise.

The effect when authorities put quantity restrictions in place in a deregulated environment without price controls is that prices adjust. Will they adjust upward for high LVR borrowers enough to scare them out of the marketplace altogether? Probably not. But some will delay their house purchase. Unfortunately for them by the time they save enough of a deposit not only will average house prices be higher but so will interest rates. That means that even if the deposit requirement gets met more and more will get weeded out by the debt servicing restrictions.

Continuing with the Australian housing market theme, weekly auction results coming out of Sydney show what might be record clearance rates as people are flooding into houses as investments because returns in banks are now too low for many. Prices are rising. There is no official Australia-wide house price measure, but one for the six state capitals plus two territories was 5.1% higher in the June quarter than a year ago with Sydney up 6.1%, Brisbane 3.7%, and Perth 11%. But things are changing on the ground with weakness in W.A. likely to see the Perth result quite different a year from now but bigger increases in Sydney and Brisbane.



Construction of houses in Australia is starting to move upward with the seasonally adjusted number of house consents issued in the June quarter ahead 9% on a year earlier.

Apartments

One thing we have long been expecting to see happen as a result of the rise in house prices in Auckland, shortage of supply, catch-up scramble of buying by young people, and new minimum deposit rules is a resurgence in the Auckland inner city apartment market. There are signs that this may be happening.
http://www.stuff.co.nz/business/9083183/Another-apartment-boom-looms

How can this benefit young buyers? First the location will suit many who are dreaming if they think they can afford to buy a property close to where they have been renting near the city centre. Second, the apartment sizes, while bigger than the old Asian student-targeted shoeboxes, will be much smaller than a standard house and thus cheaper. Third, and this is where it gets most interesting of all, there is a high chance that developers will have finance already arranged for buyers. That means buyers without a 20% deposit will be a target market for developers.

This early in the cycle all will look good and investors who are looking for better returns than what they can get from term deposit rates will feel safe as they fund some of the developers. But watch out for when the ball gets rolling and the usual dodgy lot appear offering not just fantastic financing deals for property buyers – young people and investors – but great projected returns from the other group of investors placing money in a contributory mortgage-like company associated with the developer.

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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