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.

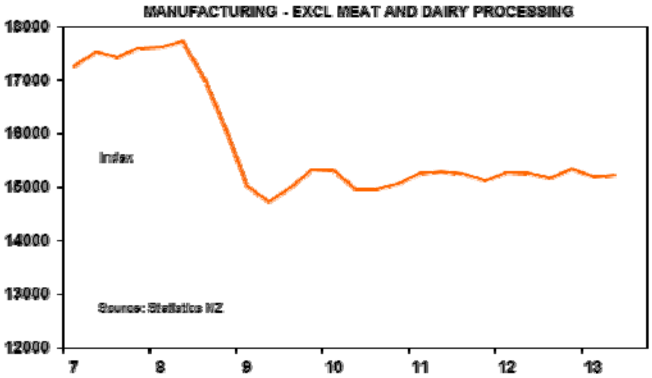
The Weekly Overview is written by Tony Alexander. The views expressed are my own and do not purport to represent the views of the BNZ. To receive the Weekly Overview each Thursday night please click here. http://feedback.bnz.co.nz/forms/lFdYSs5FGEq4kAjP95uzTA

Manufacturing Great – But Not Our Fortė

Note that there will be no Weekly Overview next week as I shall be off tramping

Early this week we learnt that during the June quarter total manufacturing activity in New Zealand after adjusting for price changes and seasonal effects fell by 3.4% after shrinking 0.9% during the March quarter. That meant production was down 0.6% from a year earlier and 7.1% from the pre-recession output level in the December quarter of 2008.

But in New Zealand one needs to account for the fact that about one-third of manufacturing activity involves the processing of primary products, mainly meat and dairy. If we exclude those two sectors which were badly affected by drought earlier this year then we find that core manufacturing output rose 0.1% in the June quarter but that this followed a 0.9% fall in the March quarter and still left output down from a year earlier by 0.3%. Core output was also a large 13.5% down from December quarter 2007. The graph below basically sums up the state of the true manufacturing sector in NZ – flat-lining since the middle of 2009 with zero trend growth underway.



Every now and then people get quite excited with the idea that we can all work closely together, shed negative thoughts, and create a large and vibrant high value-added manufacturing sector in New Zealand which embodies our massive inventiveness and have-a-go attitude and will see our vulnerability to primary sector fluctuations substantially reduced as we dance hand and hand into the setting sun. Some manufacturing lobbyists take this excitement as one of their many launching pads to argue for sectoral subsidies, maybe protection from imports, exchange rate controls – basic Muldoonism they remember so lovingly.

But New Zealand will never have an economy driven by high value manufacturing for a variety of reasons. One is that all manufacturing activities are relocatable and those which embody high technology especially so. There are companies continually surveying the world looking for manufacturing technologies and operations which they can purchase and slot into large operations they have high familiarity with. And much as a Kiwi/Aussie etc. may say they would like to keep the business in their home country, once the millions in offer documents start piling up the temptation to sell and start up something new gets to be too great.

Another reason is that although we Kiwis are good at inventing things we are not good at taking those inventions and making billions of dollars from them. We prefer to keep inventing interesting things rather than setting up large companies – though obviously there have been exceptions to this of which we are justifiably proud.

A third reason is that New Zealand's competitive advantage is in the primary sector – farming in its various pastoral, horticultural and aquatic forms. Our export dependence upon the primary sector now appears to be bigger than it was four decades ago, and it is those primary products which customers offshore desperately want from us – not our manufactured goods by and large even though some of them are world-leading for the moment.

New Zealand will always have a high value-added manufacturing sector, but it will never be a primary driver of our economy. That role has always been performed by our primary sector and probably it always will be. That is why trade agreements giving access for our primary products offshore are very important, why border controls preventing the entry of pests and diseases are vital, and why we should all watch Country Calendar on TV.

One Partial Measure of Consumer Spending Rising Well

For an economy to get rolling with good speed you fairly much need to have strong growth in consumer spending because that accounts for about 65% of economic activity in a modern economy. We are starting to get more indications that this is happening. This week the monthly Electronic Card Transactions release from Statistics NZ showed that spending using debit and credit cards rose in seasonally adjusted terms by 1.2% in August if one strips out the volatile automotive and non-retailing components.

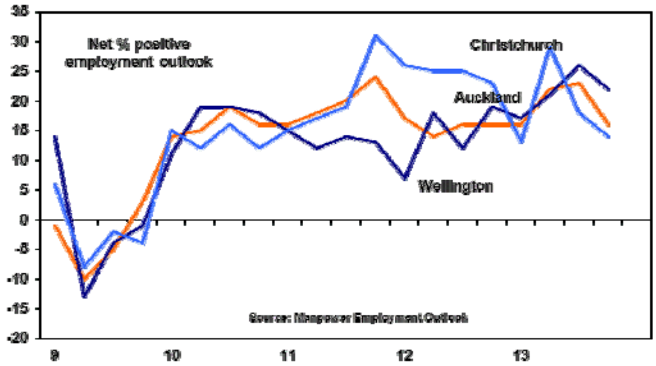
This core measure has in fact risen at an annualised pace of 5.2% in the past three months following annualised growth of 2.7% in the three months to May, 7.3% before that, and 4.1% a year ago. The trend is upward and reinforcing the positive import of the trend is the fact that spending on durable goods is growing strongly - ahead at an annualised pace of 6.8% in the past three months from 4.8% three months earlier and 5.1% a year ago. The latest growth rate is positive not extreme by any means and you should be careful when reading newspaper reports of the changes as they focus almost exclusively on just the latest month which is dangerous in our tiny little economy.

Labour Market Not Soaring Yet

Changes in the labour market habitually lag changes in the overall economy as businesses tend to wait until they are certain that an upturn is happened before committing to the often expensive process of searching for, hiring, training, and slotting in new employees. This may be especially the case this cycle given that on so many occasions over the past four years hopes of an upturn have proved misplaced. One indicator of this caution is contained in the quarterly Manpower survey of employment intentions.

Their survey of 641 NZ employers has found a decline in the net percent expecting to boost staff numbers, seasonally adjusted, to 17% from 22% in the previous quarter. This is the weakest result since expectations for the September quarter last year. Declines were recorded for all three locations reported – Auckland to 16% from 23%, Wellington to 22% from 26%, and Christchurch to 14% from 18%.

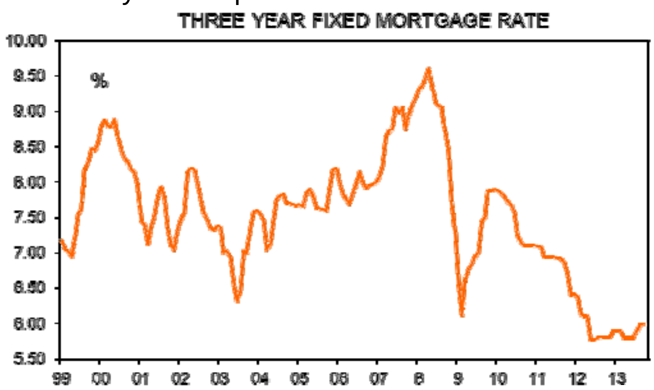
These results run counter to those in other surveys such as from the ANZ and NZIER showing rising employment intentions and serve to remind us that caution is a dominant element in this recovery. But the slowness of the labour market response to improving economic fundamentals buys businesses a bit more time to start figuring out how they will find staff once the labour market truly gets humming.

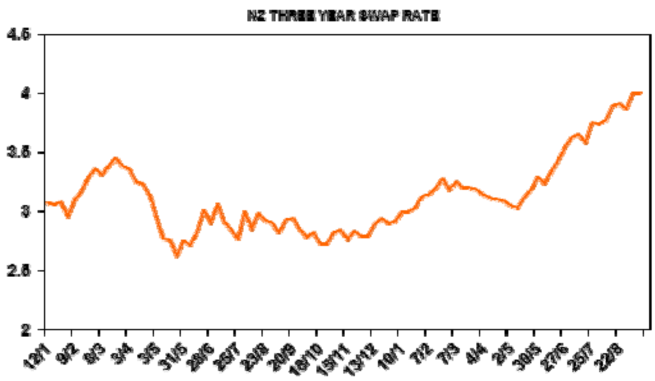


IF I WERE A BORROWER WHAT WOULD I DO?

One of the key points which I highlight here when discussing NZ interest rates is that while changes in the Reserve Bank's official cash rate are the main influence on floating borrowing costs, as one moves further out along the yield curve movements in rates overseas become more and more important. This is because in a world of large and sometimes rapid international capital flows investors are always comparing yields on similar securities between countries and if yields rise in one country this can place upward pressure on yields elsewhere as investors shift funds into the higher yielding instrument. (Note though that this is highly dependent upon why yields rise. If it is a surge in worries about the particular economy then the opposite movement in rates can happen elsewhere.)

You will undoubtedly have noticed that bank fixed mortgage rates have been increasing recently. This first graph shows our three year fixed rate since 1999. It is at extremely low levels by historical standards but is starting to rise. The rises are being driven by bank funding costs going up with one basic proxy for that being the three year swap rate. It's movements since the start of last year are shown in the second graph.





One factor pushing up this and other swap rates is expectations that our central bank will start tightening monetary policy (raising the official cash rate from 2.5%) within the year. The big factor however has been rising interest rates in the United States. One common measure of this is the ten year US government bond yield. That yield late last week rose for a while to near 3% compared with 2.6% a month ago, and 1.7% just five months ago in April.

So if we want to forecast where bank fixed lending mortgage rate are going we need to forecast not just how NZ monetary policy expectations will alter but how US bond yields will change also. In that regard we believe the NZ economy is developing a good head of steam which will see financial markets in coming months bringing forward in time and magnitude their expectations for rises in the OCR. Plus some (not all) data are coming in on the better than expected side not just in the United States but also in the likes of the UK and to a lesser extent Europe.

It all adds up to fixed mortgage rates rising from here on out but with massive uncertainty about the pace and the peak because there is also massive uncertainty regarding the strength and durability of economic recoveries occurring overseas.

The incentive for borrowers is to shift some of their mortgage interest rate exposure from floating to fixed interest rates – keeping in mind that terms of two years and less don't really give you any protection against what will happen over the interest rate cycle. True fixing is three years and beyond. Good luck.

For the record, the Reserve Bank met expectations this morning by leaving the cash rate unchanged at 2.5% but their comments were more hawkish than expected and they brought forward in time their expected first tightening to near June from near September – so interest rates rose a tad in the wholesale markets.

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	3.02%	3.01	3.01	2.79	2.67	5.8
3 year swap	4.00%	4.00	3.89	3.34	2.93	6.1
5 year swap	4.55%	4.58	4.35	3.71	3.24	6.3
7 year swap	4.88%	4.90	4.65	3.99	3.55	

Many Factors Drive The NZD Up

The NZD is a high yielding peripheral commodity currency with above average volatility acting as a part proxy for Chinese assets given our large and growing dependence upon China's economy. Thus if views about China get better the NZD goes up. If they get worse the NZD goes down. If the world looks like a less safe place the NZD goes down. If investors feel comfortable with what they see on the global stage then they buy far flung assets and the NZD goes up. If they worry about the world economy the NZD goes down. If they see increasing growth signs then the NZD goes up. If commodity prices rise the NZD goes up. If they fall it goes down.

There is a little bit more to it than these driving forces, but they are the big ones. Looking through the list of these factors what do we see.

+Improving sentiment regarding growth in developed economies and in particular the US and UK. NZD up.
+Improving NZ data leading to some rises in forecasts of NZ growth and probably soon some bringing forward for expectations of NZ monetary policy tightening. Actually, this morning's OCR review contained a more bullish assessment from the RB than expected and that caused the NZD to rise by half a cent. NZD up.
+Fewer bad thoughts regarding China's economy following some better than expected data. Exports in August were 7.2% ahead of a year earlier, the pace of growth in industrial production lifted to 10.4% in August from 9.7% in July, and for retail sales to 13.4% from 13.2%. NZD up.
-Worries about a worsened conflict in Syria – opps, no, that was the position until Tuesday. Then the change in the focus of talk toward putting Syria's stockpiles of chemical weapons under supervision ready for destruction caused a sharp reduction in expectations of US military involvement hence oil prices fell and investors embraced risk as seen in the US sharemarket rising firmly. So the Syria factor this week has changed from a depressing influence on the NZD to not being so, meaning the NZD recovered earlier lost ground.

The general thrust is one of upward pressure on the NZD though it is quite hard to translate this into believable forecasts for all the cross rates. After all, the IMF have just had to back down from views on the world economy which they circulated back in April with a scaling back of their talk about emerging countries leading the world economy forward, but lifting of growth expectations for the Western world and Japan.

Plus, although the US economy is improving it is not a straight-line march to strong growth. On Friday night the monthly non-farm payroll report was a disappointment. Job numbers rose by 169,000 in August which was less than the 180,000 gain commonly expected. Perhaps more importantly the July increase previously reported at 162,000 was revised down by 58,000 and the June rise of 188,000 was revised down by 16,000. The unemployment rate however fell to 7.3% from 7.4%. The unemployment rate however fell to 7.3% from 7.4%.

You would think then that on the basis of these weak data the NZ dollar would fall because of the slight reduction in prospects for global growth and commodity prices. But instead the NZD jumped a cent. Why? Because the biggest thing influencing many asset markets currently is waxing and waning expectations for when and at what speed the US Federal Reserve will pull back from printing US$85bn a month to support the US economy and push asset prices higher.

When US data are strong expectations rise that the so-called **tapering** exercise will commence soon and proceed rapidly. That means fewer USDs sloshing around looking for a home therefore less selling of the USD therefore a stronger USD and weakness in other currencies like the NZD. But Friday night's weak jobs report suggests the Fed. will need to take great care about how rapidly it pulls back on printing money and that means more USDs looking for a home than thought and therefore more weakness in the greenback. Hence we rose against it. The complete opposite could happen in the coming week, or not.

Note the jump in the NZD against the AUD this week. That reflects the slightly more hawkish than expected comments from the RBNZ this morning versus weak jobs data in Australia this afternoon where employment fell 11,000 in August and the unemployment rate rose to 5.8% from 5.7%. Guess what that will do to NZ migration flows with Australia.

Exchange Rates	**This Week**	**Week ago**	**4 wks ago**	**3 Mths ago**	**Yr ago**	**10 yr average**
NZD/USD	0.813	0.791	0.803	0.79	0.819	0.67
NZD/AUD	0.877	0.863	0.872	0.834	0.783	0.85
NZD/JPY	80.9	78.8	77.3	76.2	63.7	69.6
NZD/GBP	0.513	0.506	0.518	0.505	0.509	0.388
NZD/EUR	0.61	0.599	0.603	0.594	0.636	0.52
NZDCNY	4.97	4.84	4.92	4.85	5.19	4.99
USD/JPY	99.51	99.62	96.26	96.46	77.78	105.7
GBP/USD	1.58	1.56	1.55	1.56	1.61	1.72
EUR/USD	1.33	1.32	1.33	1.33	1.29	1.28
AUD/USD	0.93	0.92	0.92	0.95	1.05	0.788
USD/RMB	6.119	6.119	6.122	6.1335	6.3363	7.56

Housing Market Update

Nothing meaningfully new this week.

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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