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.

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Strong Year Ahead – 2014 Could Be A Classic

Good afternoon everyone and welcome to another year discussing where the economy, interest rates, NZD, labour market, house prices etc. are going. Put simply this year is going to be strong for our economy with booming construction which will bring escalating building costs and contractors driving increasingly gaudy golden utes with mag wheels. Interest rates are going to go up in the first proper monetary policy tightening cycle in a decade. The last one started on January 29 2004. We exclude the short-lived rise in the OCR from 2.5% to 3% in June-July 2010.

Rising cash returns for investors in a global extraordinary low rate environment will push the NZD higher though with a mid-year currency high-point possible though at risk of not occurring until 2015 depending upon how rapidly US policy is tightened and how strong economic recoveries become in the UK, Australia and Europe.

House prices will rise as the Econ 101 imbalance between demand and supply at current prices continues with gains spreading out of Auckland and Christchurch and the effects of October 1's lending rule change for low deposit buyers slowly fading but remaining as a restraint. Booming net immigration will assist housing market strength but fail to alleviate tremendous strains which will appear in the labour market. Wages growth will accelerate and be a vital element in boosting productivity growth as low wage payers go out of business and people shift to more profitable positions.

There will be some hefty bouts of volatility in the currency, interest rate and equity markets associated with the extremely uncertain paths which most major economies are on. And being an election year there will be lots of journalists calling us economists up scratching their heads in wonderment when we tell them the election is barely relevant to the economy this year.

So I hope everyone has had the opportunity to enjoy summer sunshine before knuckling down to it for another year. I did – but at Broadbeach on the Gold Coast it's hard not to get lots and lots of sunshine. I understand Wellington got lashed as usual by bad weather. As schools go back the weather usually improves remember.

2014's Themes

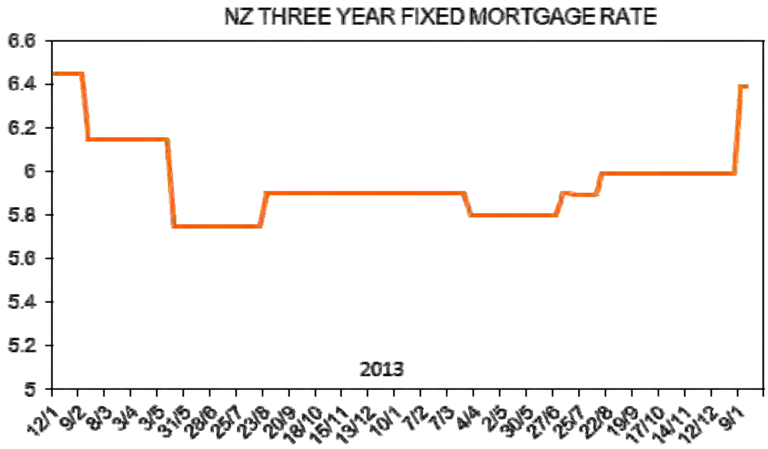
- Interest rates will rise
- The NZD will remain highish
- The labour market will tighten, pushing employment costs up.
- House prices will rise
- Construction will boom
- World growth will improve with unprecedented uncertainty regarding monetary policies.
- Business capital spending will grow
- The upturn and rising house prices will spread at uncertain speed out of Auckland and Christchurch to much of the rest of NZ.

Key offshore debates

United States – Speed of growth and how fast tapering will occur, how soon the funds rate will be lifted.
China – Impact of non-performing loans following the 2009+ credit boom, ability to switch from export and fixed asset investment as growth-driving forces toward consumption, impact of loosening controls on outward capital flows.
Australia – ability of strengthening retailing and housing to offset the resource sector investment decline plus vulnerability to China shocks.
United Kingdom – Spread of the upturn out of South-East England.
Japan – Whether the Abenomics Three Arrows growth surge was a one-off and reversion to low growth and deflation beckons.
Eurozone – The extent to which growth will be restrained by lack of banking sector reform and weak credit flows, rising radicalism, whether further ECB stimulus will be needed to combat deflation risks, German consumer spending, and developments in the increasingly moribund France.

IF I WERE A BORROWER WHAT WOULD I DO?

In the last few weeks of last year we warned about a round of fixed housing interest rate rises being imminent because of rising funding costs. That has come to pass. If you want to fix for three years now it will cost you 6.39% compared with 5.99% at the start of December. Fixing five years now costs 7.2% compared with 6.99%. In June these rates were 5.8% and 6.2% respectively, thus showing again the way in which fixed rates rise ahead of moves in floating rates as they are driven to a large degree by expectations as to where floating (wholesale) rates will go.



The common expectation is that the floating mortgage rates will start rising in March when the Reserve Bank probably undertake their first increase in the official cash rate this cycle. Considerable uncertainty surrounds the speed with which policy will be tightened. But given the way in which we think the labour market could rapidly tighten up and threaten inflation the greater risk is of rapid rather than slow rate rises.

Speaking of inflation, this Tuesday the December quarter inflation numbers were released and they were above expectations with a 0.1% rise in the CPI for the quarter rather than a 0.2% fall which was commonly expected and predicted by the Reserve Bank. The annual rate rose to 1.6% rather than holding steady at 1.4%. For now inflation is well away from threatening 3% but that will change and perhaps this result was a hint of the upside risks we believe face interest rates this year.

Relevant to inflation and interest rate prospects is the availability of spare resources in the economy to handle growth. The best gauge we get of that comes from the NZIER's Quarterly Survey of Business Opinion. The latest release of a couple of weeks ago showed very high business sentiment and resource availability not yet a hugely pressing issue for businesses.

The capacity utilisation rate eased to 90.2% from 91% and a ten year average of 90.8%. The net percent of businesses saying they are finding skilled labour hard to find held steady at a net 30% from 29% in the September quarter. But this is above the ten year average of 21%. For unskilled workers a net 10% are having sourcing difficulties compared with 5% the previous quarter and an average of 0%. We expect the levels of difficulty in sourcing labour to soar this year and next.

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	4.9
90-day bank bill	2.96%	2.94	2.78	2.70	2.67	5.2
1 year swap	3.52%	3.45	3.36	3.05	2.77	5.3
3 year swap	4.19%	4.24	4.22	3.92	3.03	5.5
5 year swap	4.62%	4.71	4.73	4.41	3.33	5.7
7 year swap	4.93%	5.02	5.06	4.72	3.63	5.8

So were I a borrower what would I do? The floating rate is currently 5.74% but will probably be near 6.25% before mid-year and near 7% come the end of the year. The current three year fixed rate is 6.39% and the five year rate is 7.2%. I would fix three years.

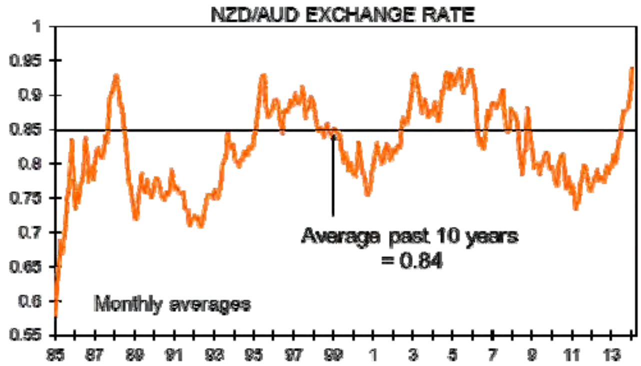
NZD High Against AUD

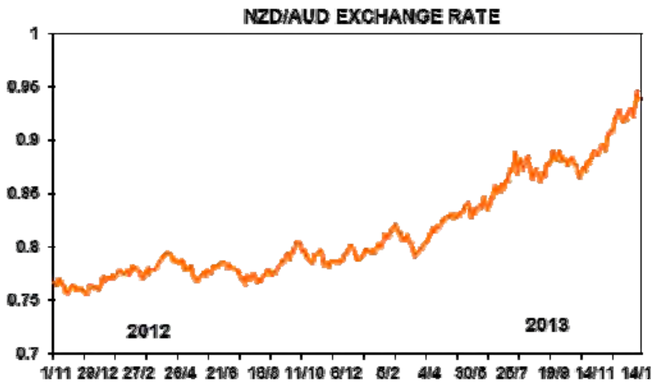
The Aussie dollar has been pushed down against the US dollar from $1.05 in April last year to near 89 cents recently in response to the weakening of the resource investment sector, a lacklustre labour market, cuts in the cash rate, and concern about slowing growth and shock risks in China. Just last week the employment report in Australia for December was much weaker than expected with job numbers falling over 20,000 rather than rising 10,000 as anticipated. Annual jobs growth for 2013 of 0.5% was the weakest since 1992.

This result calls into question not so much the recent improvements in retail spending and housing which are expected to continue, but the prevalent assumption that there will be no further easing of monetary policy by the RBA. The Aussie central bank has cut its cash rate from 4.75% in October 2011 to 2.5% as of August last year and another cut remains possible though not highly probable in light of yesterday's inflation report. The Aussie CPI rose by a higher than expected 0.8% in the December quarter giving an annual inflation rate of 2.6% from 2.2% a quarter earlier.

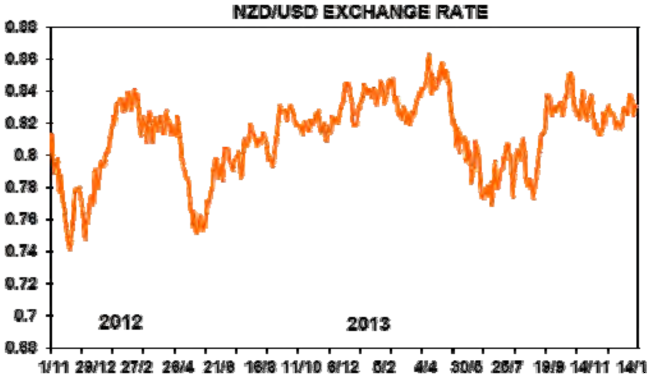
But while downside risks bedevil the Aussie economy and currency the opposite situation applies in NZ with construction set to soar, the labour market tighten sharply, and interest rates soon to rise. No wonder then that the NZD/AUD cross rate has risen from 76 cents in April last year to seven year high close to 95 cents this week.

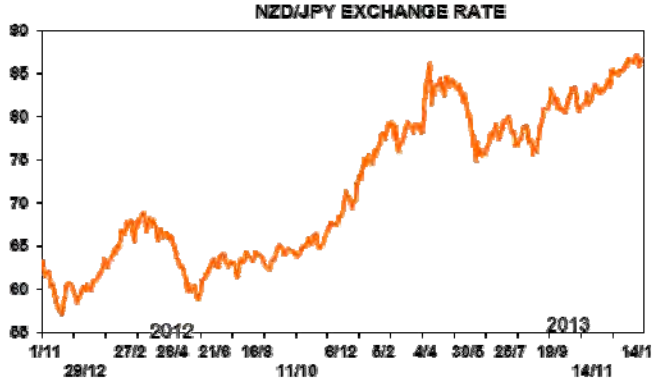
From these levels further appreciation of the NZD is possible. But history tells us that this is about as high as the NZD goes against the AUD. Plenty of people will start talking about parity should we see one more surge upward but perhaps the smarter players will stand back, look at the graph, and start reweighting toward the AUD while being prepared to get it wrong for a few months before the correction eventually comes along.





As for the NZ dollar on its lonesome against the greenback what have been the developments since early-December? We sit near 83 cents which is basically where we were then. Nothing has changed with regard to the NZ story. For the United States however there were fresh doubts sown regarding the risk of rapid tapering of money printing following the weaker than expected December employment numbers released a couple of weeks ago. Jobs growth was just 74,000 rather than the 200,000 expected. But before Christmas fourth quarter GDP growth reported at 4.1% was much stronger than expected so expectations for the pace of both economic growth this year and the pace of tapering have not really changed.





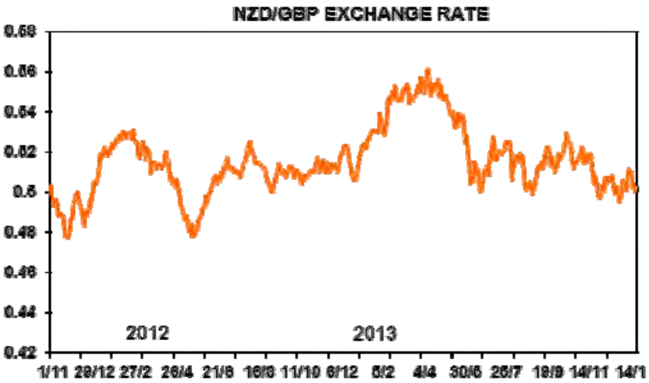
Exchange Rates	**This Week**	**Week ago**	**4 wks ago**	**3 Mths ago**	**Yr ago**	**10 yr Average**
NZD/USD	0.83	0.834	0.8209	0.851	0.84	0.826
NZD/AUD	0.938	0.935	0.9198	0.877	0.797	0.939
NZD/JPY	86.7	87.2	85.38	83.5	74.6	86
NZD/GBP	0.5	0.509	0.5025	0.524	0.53	0.503
NZD/EUR	0.613	0.613	0.6005	0.617	0.63	0.609
NZDCNY	5.02	5.04	4.98	5.19	5.22	5.00
USD/JPY	104.46	104.56	104.01	98.12	88.81	104.12
GBP/USD	1.66	1.64	1.63	1.62	1.58	1.64
EUR/USD	1.35	1.36	1.37	1.38	1.33	1.36
AUD/USD	0.88	0.89	0.89	0.97	1.05	0.88
USD/RMB	6.0515	6.0462	6.071385	6.0933	6.2181	6.0528

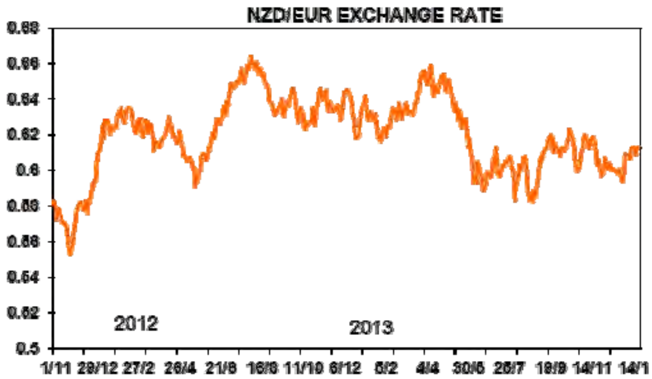
Fluctuations in actual and expected tapering will affect the USD and therefore the NZD/USD exchange rate this year so those affected by this rate should not expect the near stability of the three cent range in place since late-September to continue.

Personally speaking I find it difficult to pick where the rate will be at the end of the year. This is not just because of uncertainty surrounding US tapering but because some big obvious up and down factors are working against each other. Pushing the NZD lower will be the US tapering pushing the USD up. But pushing the NZD up will be strong growth approaching 4%, commodity prices supported by structurally growing demand for protein in China and world growth improving to 3.7% this year from 3% last year according to the IMF. In addition, and this could be the biggie which pushes the NZD higher, monetary policy in NZ will be tightened this year and begin to offer cash returns to investors not seen for a number of years. The carry trade may come back into play.

It is an election year with the outcome less certain than for the last two elections and lots of uncertainty regarding what policies may be contained in a coalition agreement should National win, and what imposts will be placed upon high income earners, taxpayers, and businesses should Labour win. But history tells us that NZ general elections are not driving forces for the economy or financial asset prices so although there will be plenty of commentary, solid impacts will be few in the short-term.

For the British Pound there is some underlying support from improving GDP growth, falling unemployment, and a rapidly rising housing market in particular all set to promote increasing discussion then expectations of monetary policy tightening. This will limit NZD appreciation against the Pound this year and levels above 51 pence let alone 52 look good for selling NZDs for GBPs. But does this mean those long-suffering Kiwis and Brits living in NZ and the UK with Pounds they want to shift will see low rates near 45 pence in the near future? Probably not. The NZD will be a globally well supported currency this year.





There will be less speculation of Eurozone monetary policy tightening and in fact lots of talk about further quantitative easing because of deflation worries. So there is greater potential for the NZD to rise against the EUR this year than the GBP.

As for the Yen, (graph on previous page) further NZD appreciation there looks probable as money printing in Japan is likely to continue in earnest.

For more detailed FX analysis including the ‘BNZ Markets Outlook”, “BNZ Strategist” “BNZ Commodities Wrap” and lots more go here. https://research.bnz.co.nz/Research/NewZealand/Pages/NZpublications.aspx

Housing Market Update

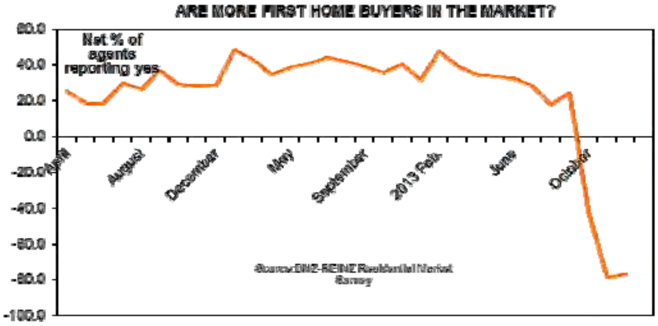
Additional analysis and commentary are available fortnightly in the NZ Property Press and monthly in the NZ Property Investor magazine.

How Long-Lasting Will The LVR Impact Be?

Quite a few indicators for the housing market have been released in the past few weeks but whatever one concludes from them there is the big caveat that we are not sure how long lasting the depressing effects of the October 1 rule changes for low deposit buying will be. We have a suspicion that a shock factor has artificially depressed market activity and many buyers will return to the market this year. But we have no data or experience which allows us to reasonably say when that will happen and at what intensity. So one must simply be cautious regarding data on housing recently released and perhaps to be released over the next two or three months as well.

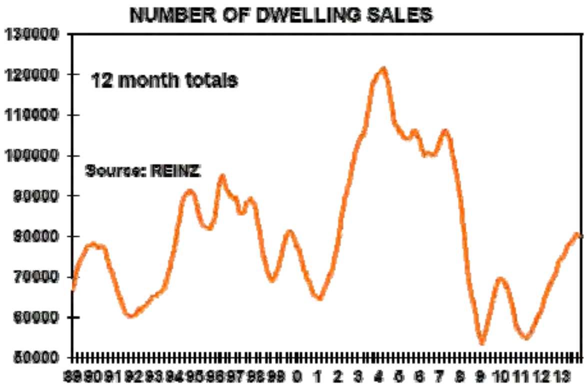
For the record though what we have is the following.

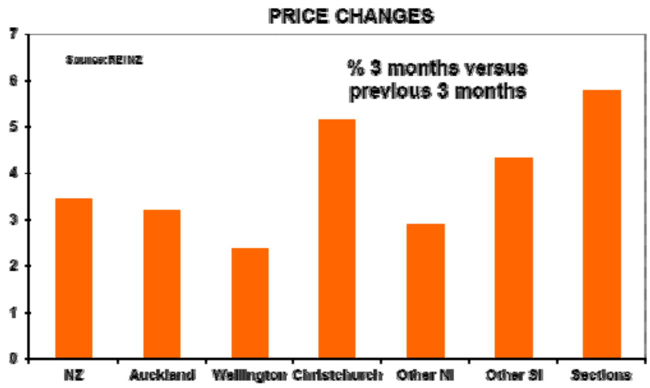
First, our monthly BNZ-REINZ Residential Market Survey last released on December 16 showed that a net 77% of licensed real estate agents were seeing fewer first home buyers but a net 6% were still seeing more investors. A net 13% saw prices as still rising but this was down from a net 41% two months earlier. A net 16% said it was a buyer’s market compared with a net 30% saying it was a seller’s market three months earlier.



So the impact of the LVR rules is obvious. It has taken first home buyers out of the market and slowed price appreciation.

The REINZ monthly data released on Monday showed sales in December were down 1% from a year ago after registering rises averaging 13% each month from January to September. Seasonally adjusted sales have fallen near 10% in the past three months. Activity growth has not just stalled it has gone backward for now. Will it go up again? The first following graph shows the 12 month running number of dwelling sales. The recent peak of 80,677 in October was weak by historic standards. A boom in turnover has not occurred, therefore a retracement from boom is not in hand. Further activity growth is likely this year.





On average in December the median dwelling sales price after adjusting for changes in the mix of properties sold (stratified) fell by 1%. But this followed rises of 1.2% in November, 1.6% in October, 0.8% in September, and 2.1% in August. So one could not conclude either that prices are falling or that price rises have in fact stopped. One needs more data before saying that.

You have to laugh about the way the media report developments in the housing market. One TV station had headlines regarding Auckland house prices falling in the month with the conclusion that perhaps the period of rising prices was over. Actually, while prices fell on average 3.4% in December they had risen by 9.3% in the previous six months. Also monthly changes should be ignored as they can go all over the place.

More in coming weeks.

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