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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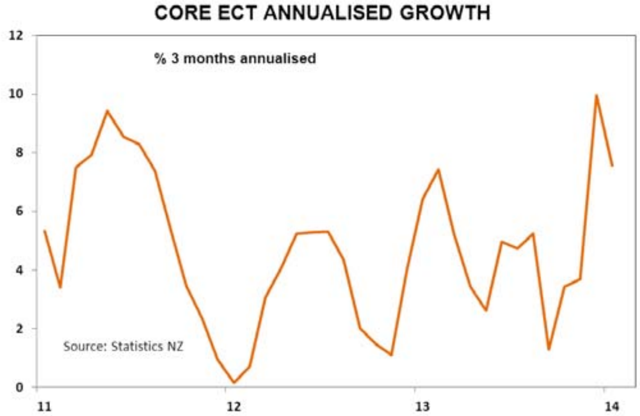
2014's Themes

- Interest rates will rise
- The NZD will remain highish
- The labour market will tighten, pushing employment costs up.
- House prices will rise with gains spreading out of ChCh and Auckland.
- Construction will boom
- World growth will improve with unprecedented uncertainty regarding monetary policies.
- Business capital spending will grow
- Household spending growth will accelerate.

No Changes

We've received almost no fresh information on the state of the NZ economy this week beyond the Electronic Card Transactions data yesterday. They show that in January core retail spending in seasonally adjusted terms fell by 0.8% after rising by the same amount in December. Smoothing over the past three months we get an annualised pace of growth of 7.6% which is quite healthy but boosted hugely by the short-lived 2.6% surge in core retail spending in October.



There is strength in retail spending but it still seems a bit volatile. The annualised pace of growth in spending on durable goods was in fact only 1.6% in the three months to January and that provides good reason for containing one's enthusiasm about surging consumer spending. Yet as this year progresses and the unemployment rate heads to 5% then below (it hit 3.5% in 2007), accelerating wages growth, more people with jobs, strong employment confidence, and rising house prices will act to offset the effects of rising interest rates and bring better conditions for the country's retailers.

Key offshore debates

United States – Growth lifting to 2.8% from 1.9% in 2013 but could interest rates jump as tapering proceeds?
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 – Construction is picking up along with manufacturing, but worries exist regarding the 2017 referendum on EU membership, and the risk of premature policy tightening by the BOE.
Japan – Tension with China is growing as Japan breaks away from its post WW2 accepted pacifist shackles to confront its traditional regional competitor. Conflict appears probable with potentially severe economic consequences.
Eurozone – growth is picking up but will it be strong enough over the cycle to seriously dent entrenched unemployment, especially of youth? If not will the resulting social deterioration foster more radicalism?

Employment in the **United States** rose by 113,000 in January which was less than the 175,000 gain commonly expected. However one positive note was that private sector employment jumped strongly while government job numbers declined and this suggests things are moving firmly in the right direction. Hence reaction in financial markets was relatively limited and the theme for the US remains one of growth improving and lots of fingers crossed that this fourth time around for a post-GFC recovery things will not again fade away or get hit by a new international crisis.

In fact that is exactly the sort of sentiment expressed by the new Fed. Chairman Janet Yellen on Tuesday night when she said that the economy is improving and tapering will continue at the pace of $10bn a month. The fact that the unemployment rate has fallen to 6.6% which is almost at the 6.5% rate previously signalled as a trigger for interest rates to start going up has not led to a sell-off in bond markets as no-one expects that past indication to be adhered to. Her comments delivered some strength to equity markets around the world as did the decision by Republican leaders in the House of Representatives to advance legislation raising the Federal debt limit. So all good so far – but risks remain surrounding the labour market.

The data highlight for **China** this week came in the form of trade numbers which showed exports in January not 3% ahead of a year earlier as had been commonly estimated but 10.6%. Imports were also ahead much more than expected with 10% growth. The data suggest both good export sector growth and good domestic economic growth sucking in imports. But there is some scepticism about the accuracy of the data given the timing ahead of the Chinese New Year when things can get quite distorted, and the way it disagrees with other indicators recently released which were on the weak side.

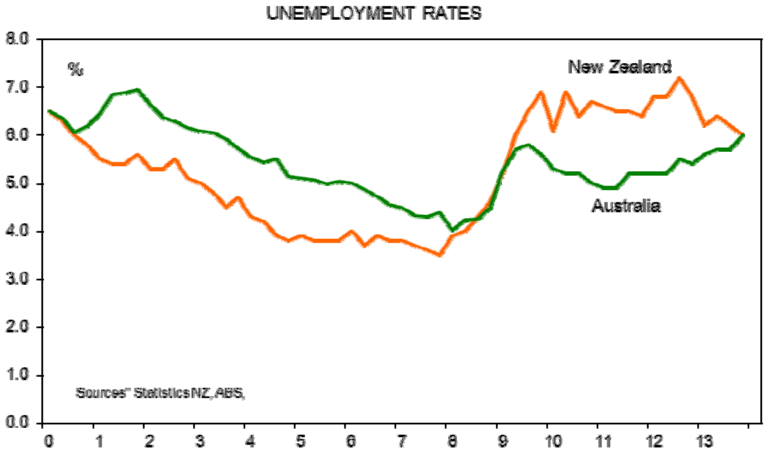
Expectations for the pace of growth in China's economy can have a substantial impact on expectations for overall world growth given that China is the world's biggest exporter and soon to become the biggest importer. Expectations can also heavily influence sharemarkets and therefore wider generalised sentiment about what people in other countries see around them. Thankfully in New Zealand, with our low savings rate, movements in the sharemarket are not a big influence on our sentiment or spending levels.

As for most other economies data have been thin on the ground in **Australia** this week. Lots of media attention was on not just the paroling of convicted drug smuggler Schappelle Corby but the announcement by Toyota that they will stop manufacturing automobiles in Australia. Their announcement follows the same decisions by Ford and Holden and means that come 2017 the car manufacturing industry in Australia will cease to exist – something which should have happened as it did in New Zealand a long, long time ago. The sector has been propped up by subsidies running into the billions of dollars for many years, with the political power wielded by the companies leading them to accede to union demands for very generous wage and non-wage benefits – which is the other big news item. The Federal Government has announced a Royal Commission into union governance and corruption.

In Australia productivity growth in recent years has slowed, corruption appears to have risen, and businesses have been finding it harder and harder to operate. While there is hefty foreign investment in the mining and now farming sector, Australia's viability as a regional, let alone global, manufacturing base has been declining for a long time. These developments were clouded by the multi-year resource sector investment and export boom encouraged by the rise of China. But now that the boom has ended and investment is winding down deficiencies are being revealed.

For us in New Zealand the relevance of this is that the NZD is likely to stay strong against the AUD for quite some time as headlines in Australia fall mainly on the negative side and as vitriol from various quarters fills the pages as lobby groups boost their activities. The nasty climate will tend to keep the attractiveness of Australia to Kiwis low this year and next, encourage Kiwis to come back here, thus helping boost overall migration flows toward the 30,000 – 35,000 net gain which we expect this year. This will help underpin our retailing and housing sectors while providing a modicum of relief for employers who will find accessing staff here increasingly difficult as the year advances.

For your guide, this afternoon the January employment report was released in Australia and it was worse than expected. Some jobs growth near 10,000 had been anticipated after a large decline in December. But numbers in fact fell by 4,000 after declining 23,000 in December. The result means that job numbers in Australia are exactly unchanged from a year earlier. The unemployment rate has now risen to 6% from 5.8% in December and 5.4% a year ago. By comparison the NZ rate has fallen to 6% from 6.8% with job numbers ahead 67,000 or 3% last year.



The Confederation of British Industry in the **United Kingdom** this week noted that their latest member survey shows rising intentions of boosting investment in R&D and new technologies, raising hopes that the so far largely consumer-led upturn will gain an extra investment leg soon. To be sustainable the upturn will need it and one can make the same comment for all other developed economies undergoing growth improvements as well.

The CBI confidence was reflected back by the Bank of England which lifted its forecast for UK GDP growth this year from 2.8% to 3.4%. But it said that the inflation situation and outlook is more benign than earlier thought and stressed that the base rate will be kept at the current 0.5% for a long period of time. This forward guidance is considered vital by the BOE and other central banks as a means of keeping rises in business borrowing costs in check as growth accelerates. For now the markets are pricing in a policy tightening in April 2015.

While everyone is hoping that the growth momentum displayed by the **Japanese** economy last year was not just a stimulus-driven flash in the pan, there is a clear risk that things do peter out. Ahead of the April 1 rise in the consumption tax there may be some unsustained rise in consumer spending, and perhaps recognising that business willingness to invest will not grow as much as hoped. In fact this week we learnt that core machinery orders (a leading indicator of actual business investment) fell by a far greater than expected 15.7% in December. Companies are forecasting another 2.9% drop for the entire March quarter.

The ECB President this week downplayed the risks of deflation in the **Eurozone** but admitted to economic risks while giving no hint that he may have to do what many in the markets expect and ease monetary policy again. Given that the cash rate is already near zero at 0.25% scope for a simple traditional policy easing is minimal and instead some quantitative efforts may be needed. There is the weapon of signalling that rates will stay low for a long period of time which is what the RBA employed last week and the BOE this week. But such signalling has proved a source of confusion and frustration for the Federal Reserve and Bank of England with unemployment rates to which they had tied promises of rate steadiness falling a lot faster than they had expected.

In May elections for the European Parliament will be held and there is a high chance that far right parties opposed to immigration and the Euro if not the EU itself will do well. This has potential to cause some substantial disturbances in European financial markets as national governments will be unable to ignore any voter swing to the far right, even though turnout is likely to be a very low percentage of eligible voters. The pressing issues of immigration, failure of many migrants to integrate into existing communities, and perceived loss of jobs in already high unemployment areas to migrants are some factors which lie behind the vote in a Swiss referendum this week to place controls on EU migrant numbers within three year's time.

Switzerland is not a member of the EU but it has signed up to the freedom of movement protocol and the turn against such a rule by Swiss voters may embolden far-right parties and sentiments in the EU proper.

IF I WERE A BORROWER WHAT WOULD I DO?

Although the US employment report on Friday was a tad weaker than expected this has not placed much downward pressure on long-term interest rates around the world. Tapering of US money printing is expected to continue which has the capacity to push up long term yields. But there are persistent worries in various quarters regarding low inflation and the risk of deflation in the Eurozone in particular which will tend to cap expectations of central banks raising interest rates for quite some time. No-one is putting a serious time-frame on when the ECB may raise rates, the Bank of England is not expected to start the rate normalisation process until perhaps April next year, and 2016 is picked as the year for the Federal Reserve to possibly move. The Bank of Japan is seen keeping its 0.1% cash rate low for a lot longer, and across the ditch although the common expectation is that the next rate change will be an increase there are huge doubts that it will come this year.

All up the upward pressure on medium to long-term interest rates here in New Zealand for the initial part of this year looks like coming from our own shores and our own monetary policy tightening cycle. Shocks however (up or down) are more likely to come from offshore than domestically. In that regard we have received no information in the past week to alter our view that the first 0.25% rise in the official cash rate will come on March 13 and that by the end of the year the rate will be at 3.75% or thereabouts from 2.5% at the moment.

Keep in mind as you look at forecasts for how quickly rates will rise, how high they will get, and how long they stay up, that every single one of us is guessing as to how much more sensitive people are to interest rates this cycle compared with those in the past. We don't know. One can make a strong argument that with a whole lot of people now used to five years of low interest rates their sensitivity and eventually outright indignation (then anger) will make OCR changes a very powerful tool for the RB. But last week I argued here that the response of the construction sector to rising interest rates will be a lot less this cycle than in the past because the nature of the construction work being done is not overwhelmingly cyclical.

That is, Christchurch will be rebuilt and the restraint on the speed of the rebuild will not be the cost of financing but the availability of other resources. Auckland is short of houses and both central and local governments are determined to build more – but again the restraint on the speed of this building catch-up will not be financing costs but resource availability. The same goes for the infrastructure projects being pushed through. One can also run an argument that with milk looking like gold the restraint on development in the dairy sector will also not be financing costs but resource availability again.

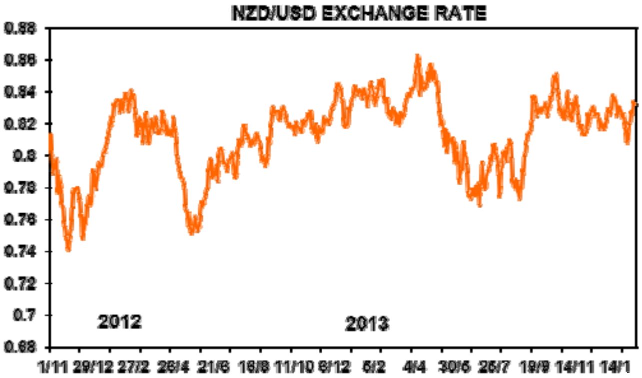
So take care in your assumptions about what interest rates will do over the next five years. I feel there is upside risk further out though see little reason for pushing any aggressive line that this year rate rises will be much different from our forecast 1.25%.

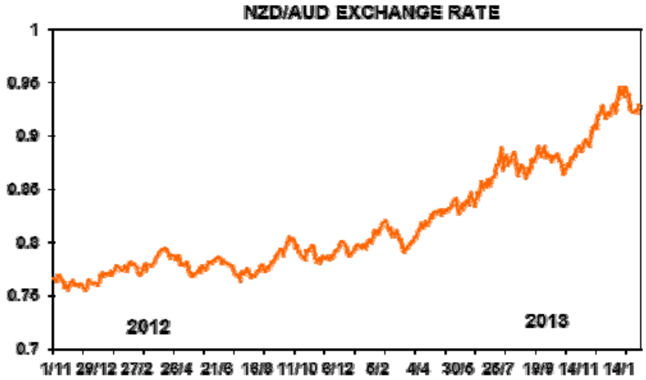
This week rates have barely moved, as shown in the table below.

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	2.95%	2.95	2.89	2.70	2.70	5.2
1 year swap	3.53%	3.54	3.44	3.12	2.86	5.3
3 year swap	4.25%	4.24	4.18	4.00	3.20	5.5
5 year swap	4.66%	4.65	4.69	4.53	3.52	5.7
7 year swap	4.95%	4.93	5.00	4.86	3.83	5.8

NZD Range-Trading

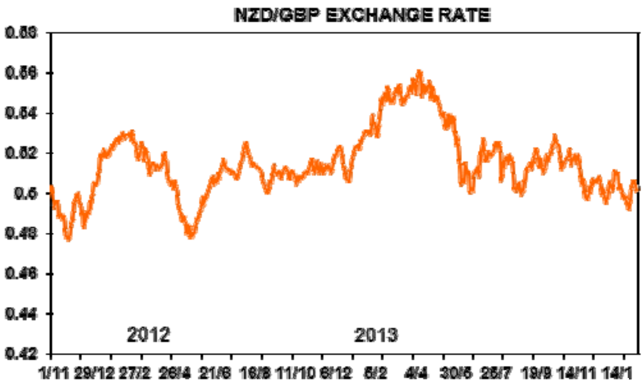
The Kiwi dollar has risen one cent against the greenback from a week ago to sit just over 83 cents which as the first graph shows is well within the trading range in place since September last year. The gain came about initially in response to a rebound in the Aussie dollar and recovery in world sharemarkets/decline in global risk aversion.

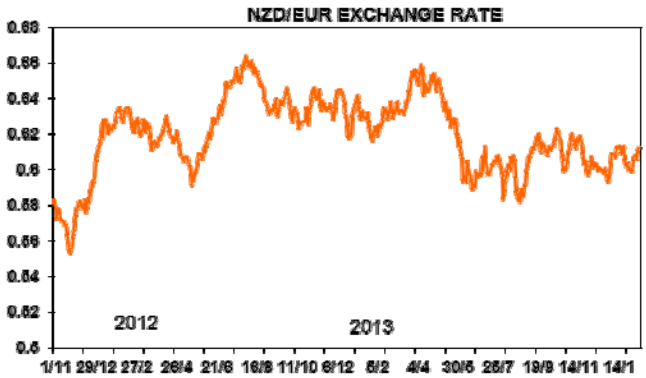




The AUD got a boost last week when the RBA withdrew its earlier expression of concern about the high currency, and received another small boost this week as global risk aversion eased slightly following some progress on the US debt ceiling problem, and a good number for business sentiment measured in the NAB's monthly business survey. Yet underlying all this prices for iron ore have been continuing to edge lower and the AUD, like the Aussie economy, remains vulnerable to downside shifts in sentiment regarding the Chinese economy. In fact the AUD is more closely tied to China sentiment than the NZD so if China's outlook worsens the NZD will probably regain some recently lost ground against the Aussie dollar.

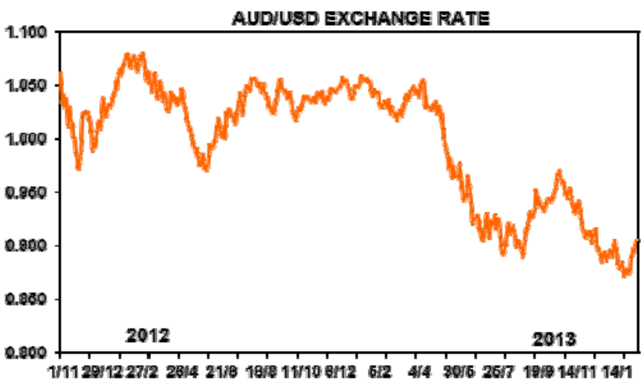
In fact I retain my view that supporting factors for the NZD are immense and set to strengthen this year. Our interest rates will rise a long, long time before rates in other developed economies, our economy is looking good from a GDP growth point of view, our terms of trade are at their highest level since 1973, and dairy prices continue to edge up. This is a recipe for strong currency support, so don't be surprised if we see 95 Aussie cents again and US85 cents also. In fact this afternoon we jumped to almost 93 Aussie cents following the weaker than expected Australian jobs data.

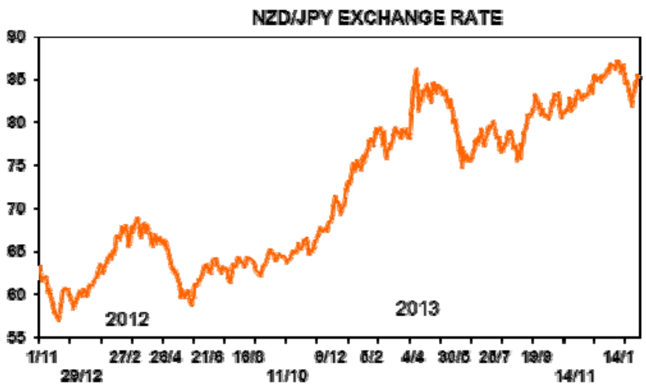




Gains of the NZD against the British Pound will be harder to make given the improving UK economy and what are likely to be rising expectations of tightening monetary policy there. Against the Euro the NZD looks likely to strengthen given the still very muted outlook for the Eurozone, deepening political concerns, and pressure on the ECB to ease monetary policy again to combat the risk of deflation. One ECB board member in fact overnight spoke in favour of negative interest rates on bank deposits with the ECB. Such rates would act as an incentive to banks to try and load their customers up with debt rather than have the funds sitting with the ECB costing money.

Exchange Rates	**This Week**	**Week ago**	**4 wks ago**	**3 Mths ago**	**Yr ago**	**10 yr Average**
NZD/USD	0.831	0.82	0.8294	0.822	0.842	0.726
NZD/AUD	0.929	0.921	0.9219	0.884	0.816	0.839
NZD/JPY	85.1	83.3	86.32	81.9	78.7	72
NZD/GBP	0.5	0.502	0.5033	0.517	0.537	0.423
NZD/EUR	0.611	0.606	0.6067	0.612	0.625	0.545
NZDCNY	5.04	4.97	5.02	5.01	5.25	5.1
USD/JPY	102.41	101.59	104.08	99.64	93.47	99.3
GBP/USD	1.66	1.63	1.65	1.59	1.57	1.72
EUR/USD	1.36	1.35	1.37	1.34	1.35	1.33
AUD/USD	0.89	0.89	0.90	0.93	1.03	0.87
USD/RMB	6.0627	6.0613	6.052206	6.0916	6.2323	7.15





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.

First BNZ-REINZ Residential Market Survey For 2014

On Monday we will release the results of our first survey of licensed real estate agents for 2014. Quick analysis done earlier today shows that most measures are improving after being shocked lower by the loan to value rules introduced on October 1 last year. Here is what we have written up so far.

"In December we asked agents to estimate the proportion of their sales going to first home buyers. The outcome was 15.3% which was well down from 23.3% in May last year and 23.6% in March. We repeated that question this month and got an outcome of 16.2%. So perhaps there is a slight recovery happening in first buyer activity. We shall monitor this.

This month we also reintroduced the question regarding the proportion of agents' sales going to investors whether they be local or offshore. Agents estimate 19.4% of their sales are to investors. In May last year that outcome was 19.1% and in March 18.5%. Thus we have some further evidence that the hit to activity as a result of the loan to value rules being introduced from October 1 is being taken by first home buyers and not investors. …, this month a net 20.5% of agents say that they are seeing more investors in the market whereas a net 39.7% say they are seeing fewer first home buyers.

Given these developments one can make the reasonable assumption that the home ownership rate in new Zealand will continue its decline. Census results released last week show an ownership rate of 64.8% in March last year from 66.9% in the 2006 census. Put another way, back in 2006 33.1% of people did not own the house which they live in but now 35.2% are in that state. The Reserve Bank's credit controls are working to reduce New Zealand's home ownership rate."

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