Weekly Overview

5 February 2014

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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

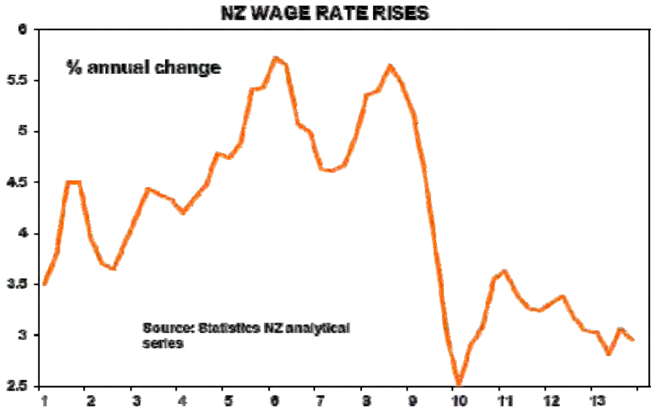
- Interest rates will rise
- The NZD will remain highish
- The labour market will tighten, pushing employment costs up.
- House prices will rise with gains spreading out of ChCh and Auckland.
- Construction will boom
- World growth will improve with unprecedented uncertainty regarding monetary policies.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

Labour Market Roars Ahead

Relevant to the third theme above we received the Household labour Force Survey this morning and the numbers were much stronger than expected. Rather than rising by just 0.5% during the December quarter job numbers soared 1.1% after jumping 1.2% in the September quarter. This very strong result means jobs growth from a year before was 3% which is the fastest pace of growth since 2006.

The unemployment rate fell as expected from 6.2% to 6% but would have fallen further were it not for the participation rate rising from 68.6% to 68.9%. This rate is now at a record level meaning that at no other time in the past has such a high proportion of the working age population been either in work or actively looking for it.

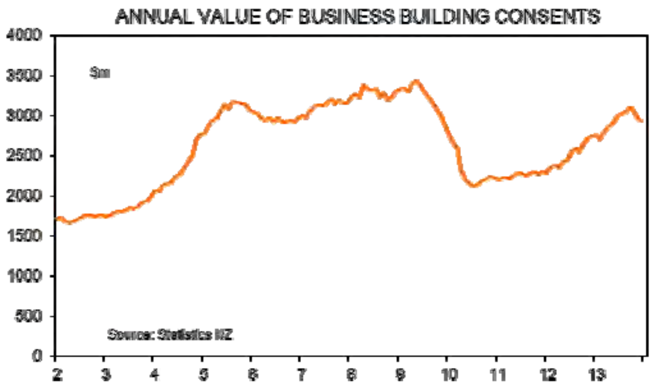
This is the sort of thing which makes one convinced that sometime very soon there will be a wages response to the hastening jobs growth. So far however that response has yet to appear. The analytical wages series compiled by Statistics New Zealand which tries to keep the mix of jobs unchanged as best as possible rose 0.7% in the December quarter after rising 0.8% in the December quarter of 2012 and 1% in the 2013 September quarter. There is as yet no acceleration in wages growth underway. But it will come, and in anticipation of this the Reserve Bank will soon be tightening monetary policy.



Also, as this is election year and as we all examine the polls to see what other people on average are thinking, the government will take heart from what seem to be the fairly obvious electoral implications of a rapidly strengthening labour market. As job security rises it seems reasonable to conclude that people's appetite for change will diminish rather than rise.

Are Businesses Backing The Upturn Yet By Investing?

There are few up to date measures of business investment available in New Zealand but one which we try to get something from is the value of imports of capital goods contained in the monthly merchandise trade release from Statistics New Zealand. In the December quarter imports of plant, machinery and equipment in seasonally adjusted terms fell by 3.9% from the September quarter and were just 4% ahead of a year earlier. That is not the sort of outcome which would lead us to say that there are solid signs of businesses buying into the upturn by boosting their capital spending.



We reach a similar conclusion when we look at the building consent numbers released last week. The value of consents for what we classify roughly as "business" buildings was 19% lower in the December quarter than a year earlier.

But are there reasons for believing that this vital element of the surge in economic activity expected for this year and next will occur? Yes. The net percent of non-farm businesses planning to boost their investment in plant and machinery rose to 18% in the December Quarterly Survey of Business Opinion from 8% in the September quarter. This was the strongest result since 1994. The net percent planning higher investment in buildings rose to 7% from 3% - the highest since 2004 though hardly a surprise considering the Christchurch rebuild.

In addition, our monthly BNZ Confidence Survey contained a good number of comments from respondents regarding business machinery spending picking up.

- Capital equipment importer. Positive start to year. Good potential seen for 2014. Margins still very tight however.
- Starting to see more enquiries for capital equipment, and sales are up MTD & YTD.

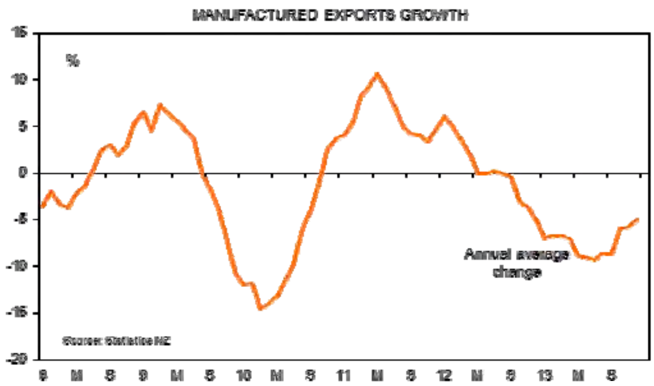
So maybe investment is on the way – companies are certainly going to need it given the way accelerating growth will soon reveal a shortage of staff.

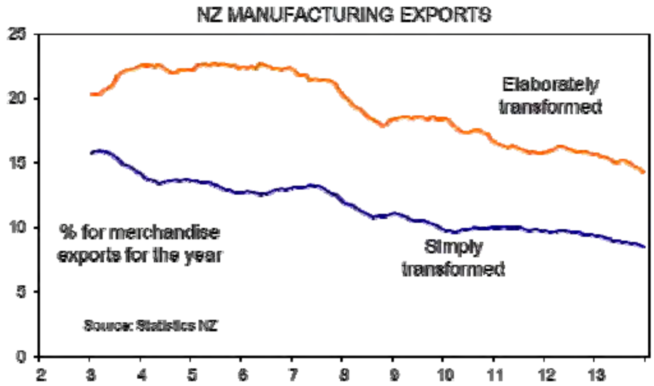
What about exports? Is this the lovely sort of upturn we would all like to see which is driven by surging exports other than simply the same old things selling for higher prices? Of course not. This upturn is a temporary thing driven largely by the domestic economy with the driving force not being investment but reconstruction of Christchurch, catch-up house building in Auckland, plus some government infrastructure spending. There is an export contribution but it is simply higher prices for milk flowing through – leading to more investment in milk production which is a source of downward pressure on New Zealand's productivity growth considering that the superior alternative would be investment in value-added products. But the incentive structure for dairy producers actively acts against that – so more milk will flow.

That aside, what do the latest trade data tell us about our export progress? The value of merchandise exports from NZ rose by 4.4% after falling 3.4% during 2012. Nothing flash there. However, the seasonally adjusted value rose by 7.6% in the December quarter and by 7.4% in the September quarter. So the second half of last year was very strong. That strength came principally from exports in the second half of the year compared with the first, seasonally adjusted, jumping 35% for dairy products, 20% for forest products, and 11% for fruit.

What about more than basic commodities? To answer that question we need to look at the Level of Processing data which were also released this week. While exports of primary products jumped about 7% seasonally adjusted in the September quarter then 10% in the December quarter, exports of manufactured goods rose 4.3% then rose 2.3%. Those results are not too bad.

For all of 2013 primary exports however while primary exports rose 7.7% manufactures fell 5%. The trend in the latter is downward though to a lesser degree in recent months.





Will this recovery persist? Probably not given that half of New Zealand's manufactured exports go to Australia and the NZD recently hit a 35 year high against the AUD near 95 cents. Plus there are these comments received in our BNZ Confidence Survey.

- Paint Manufacturing. Forward orders look good but export concerns with appreciating NZD against AUD.
- Manufacturing. Local demand is strong, but the strong dollar is hurting exports.
- Manufacturing engineering in Dunedin - very tight market with high dollar especially to Australia killing the margin
- Electronics manufacturing... a strengthening economy has to be good overall for NZ... but the ever-strengthening $Kiwi makes survival very difficult as an exporter in this very competitive industry.
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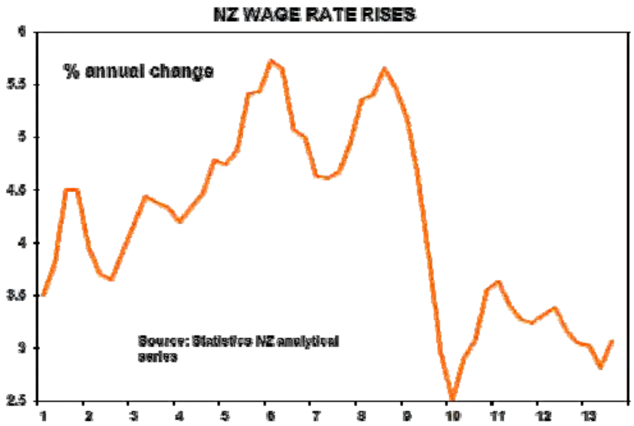
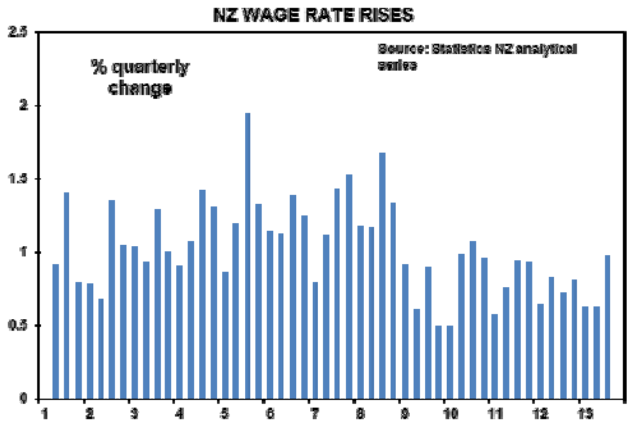
http://tonyalexander.co.nz/wp-content/uploads/2014/02/BNZ-Survey-Results-February-2014.pdf

I've included that last comment because it highlights two things beyond the high NZD hitting exports which will affect the manufacturing sector this year and next. The high NZD will also make competing against imported goods difficult. And as the labour market takes off and wages rise, as they should, some already pressed businesses will find themselves in unprofitable positions.

So far there is minimal evidence of wages growth accelerating and that is not surprising as it takes a while for a decent change in labour market strength to feed through to wage changes.





This is the only comment in our survey showing revealing wages pressure.

- Hospitality... Wage increases, but turnover static

Wages growth will soon accelerate however as firms start to compete more aggressively for staff. The more interesting phase will come when staff realise that for the first time since 2007 they are in a strong bargaining position and start demanding much more generous remuneration. In the absence of a productivity-driving surge of business investment this will naturally concern the Reserve Bank (too bad), and be one factor producing upside risk to interest rates this cycle.

Speaking of interest rate risks, this week I have spent a couple of days in Christchurch staying at the Copthorne Commodore Hotel by the airport and speaking with a number of business groups. One clear message which came through was that there is general disbelief that the reconstruction of Christchurch will be able to proceed within the timeframe which many people are planning. Costs are rising and staff availability is widely seen as becoming a huge constraint on activity.

What this means is that the period of strong (inflation-inducing) construction may last for a lot longer than generally thought. This will increase the risk both that interest rates go higher than the 4.5% OCR peak generally picked currently, and that rates stay high much longer than forecast. Hence the conclusion that borrowers should try where possible to lock some of their debt in for periods of not just three years but longer as well.

<u>Key offshore debates</u>

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 – 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. Extent to which trade may be disrupted as tensions rise with China. Financial collapse as govt. debt is huge.
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, whether entrenched long-term unemployment will fall, and developments in the increasingly moribund France.

The **United States** data releases started positively this week with fourth quarter GDP showing growth at an annualised pace of 3.2% from 4.1% in the September quarter. This is a good clip which would have been even stronger without the artificial dampening of Federal government activity. The firm growth does however reinforce the chances of tapering continuing at a steady pace in coming months and that will be problematic for emerging economies which have become used to this sugar rush to help cover up their corruption and rigid inefficient economic structures.

But few people were dwelling on the GDP numbers come Monday US time when the January ISM PMI came in much weaker than expected at 51.3 from 56.5 in December. This is the lowest reading since May and the big question is to what extent the shock result (a reading of 56 was anticipated) was due to bad weather rather than a true downward shift in the manufacturing sector's momentum. This seed of doubt thrown into the economic mix contributed to falls in sharemarkets and government bond yields around the world.

Attention is now firmly on the monthly non-farm payrolls report due out on Friday night. Last month's report was quite weak and the question is to what extent the data were biased downward by bad weather.

China's official PMI for January came in not quite as bad as feared with a decline to 50.5 from 51 rather than movement below 50 into shrinkage territory as happened for the earlier-reported HSBC PMI which captures more SMEs than the official measure. But China risks being caught up in a general movement away from emerging economies associated with the US tapering exercise.

House prices in **Australia** are rising as people take advantage of very low interest rates and seek better yields than available on term deposits and bonds – especially with worries that bond yields may rise and deliver capital losses as US tapering occurs. Additionally, maybe forecasts that the sharemarket will have a poor year after a stellar performance during 2013 are encouraging investors out of equities. Whatever, data from RP Data show that state capital house prices on average rose by 1.2% in January to sit 9.8% up from a year earlier led by Sydney 13.4%, Melbourne 11.9%, then Perth 6.9%.

This is relevant to us in New Zealand as it increases the chances that some Aussie investors will look across here for yield. It also means we can expect continuing growth in residential construction with evidence that the earlier boom in Melbourne construction has spread to Sydney and may now be spreading to Brisbane. Demand for builders appears to be increasing and this will tend to make it harder for NZ companies to source the people they need.

The **United Kingdom's** PMI for January remained in quite healthy territory at 56.7 from 57.2 in December. Being well above the 50 level the measure is boosting confidence that rising manufacturing activity will lead businesses to further the economic recovery by raising their investment spending. This manufacturing strength comes on top of strength in the housing market which saw mortgage approvals in December rise to their highest level in six years. The talk now in the UK is when the BOE will start signalling that conditions are getting strong enough to start thinking about and planning for the removal of a base rate of 0.5% set in place since March 2009 as the central bank battled to prevent a depression.

But the question for the UK is the same as will come for the US and which we are asking ourselves already in New Zealand – how sensitive are borrowers and savers now to interest rates? No-one knows and as we have noted for a half-decade now, as the removal of extraordinary monetary stimuli occurs there is essentially zero chance that all changes will occur at the optimal pace. Given the huge unknowns central banks will either raise interest rates too rapidly and choke off recoveries, or they will raise them too slowly and produce asset price bubbles and risk a lagged inflationary surge.

In **Japan** the economic data remain good but there are three reasons why good numbers are to some extent being discounted. First they could merely represent a short-lived impact from the Abenomics easing of monetary and fiscal policies. Second they could be caused by spending ahead of the planned April 1 increase in the consumption tax from 5% to 8%. Third they may be driven by one-offs effects (on profits for instance) of a sharp weakening of the Yen last year. Uncertainty about the sustainability of Japan's move away from deflation and pick-up in activity will remain for all of the first half of this year with a lot of attention on whether the Third Arrow of deregulation really exists. Probably not, especially now that the Trans-Pacific Partnership trade deal encompassing nations accounting for 40% of global GDP appears stuck in the mud of US domestic politics.

In the **Eurozone** one measure of business sentiment rose to its highest level in 30 months which sounds great – until you count back 30 months to July 2011 and ask yourself why the good sentiment back then did not lead to good growth and prevent the Eurozone economy shrinking 0.6% in 2012 then an estimated 0.4% last year. Confidence is what almost all sports fans have about their teams heading into a game – then they crash.

In fact a key thing causing worries in Europe currently is the risk of deflation and how the ECB may combat it. The Eurozone inflation rate fell to 0.7% in January rather than rising to 0.9% as had been expected.

Emerging Markets Crisis?

The GFC got kicked off by the US sub-prime crisis. After that we thought things were getting better but global sentiment and economic upturns got hit by worries about European sovereign debt and break-up of the Euro. Things have again however settled down with the US fiscal squabbles not flaring into another global disturbance as some feared. But now a new crisis with contagion risk may have started, coming out of the previously rapidly growing and much in favour by investors emerging markets.

Emerging economies have entered into a potentially bad economic patch following a strong five years of growth and rising incomes assisted by low Western interest rates, money printing in the United States, investor flight from developed countries, and all the hype surrounding BRICs and hangers-on. Most of these economies have failed to use the period of strong growth to drive through economic reforms which would boost productivity and allow their economies to handle the inevitable shocks which all economies eventually face.

What is happening currently is that the US tapering exercise is not just reducing the flow of excess funds to these countries but also causing investors to sell up as they anticipate other investors selling up as tapering eventually ends and US interest rates start rising. Related to that the improving economic conditions in the developed economies at long last following the GFC are discouraging investors from seeking less traditional investments. Now throw in the structural slowing of growth in China and the way it is revealing problems in the financial sector, the switch in China's growth (slowly) from investment to consumption causing a reduction in demand for hard commodities, plus political turmoil in some countries and you get a potential rout.

Economies affected include Argentina (high inflation, capital controls), Turkey (Islamisation, falling EU membership chances, rising nationalism, fights on borders, large current account deficit, high inflation), Indonesia (poor infrastructure, flooding, high inflation, exposure to slowing China), South Africa (high inflation, high current account deficit, lack of poverty reduction following the end of Apartheid, high unemployment, growing political discord), Russia (corruption, falling energy revenues, high inflation), Brazil (high inflation, exposure to Argentina), India (poor infrastructure, rampant corruption, entrenched poverty and discrimination, socialist leanings, high inflation.

Some economies have attempted to stem sharp declines in their currency (which will boost inflation and raise domestic angst which is already high in some countries such as Argentina) by raising interest rates. Movers so far include Turkey, India, South Africa. But history shows that if investors think other investors think other investors are scared then everyone will try to head out of the exit at once and currencies can collapse. The ability of a country in that case to fund itself may dry up, and as happened during the Asian Crisis, provision of emerging deficit funding may become necessary from the IMF.

We are not at that point yet. But the situation is developing rapidly and will bear close watching in coming weeks, especially should some shock arise such as a particularly poor set of trade or inflation numbers for one of the relevant economies.

IF I WERE A BORROWER WHAT WOULD I DO?

After leaving the cash rate unchanged as largely, though not universally, expected last week the common expectation now is for the start of the removal of extraordinarily low rates to start on March 13 with a 0.25% rise. The general consensus is that the neutral level for the official cash rate is about 4.25% and we expect that level to be reached by the middle of 2015 with a peak of 4.5% just after that – which is where you should be cautious. The chances that a monetary policy tightening cycle will end with the cash rate peaking just 0.25% above neutral are on the low side. History tells us that rates can spend a considerable period of time above normal.

That is one reason why I personally would fix three years rather than for a two year period currently. Fixing two years now would see one's rate mature near the start of 2016 and the risk is that at that time there will be scary stories of cash rates rising much higher than the 4.5% we have pencilled in then. Such talk will create a bit of panic and could encourage some inexperienced borrowers to then lock in long-term fixed rates they would not currently touch with a barge-pole.

How rapidly can the cash rate and therefore floating mortgage rates rise? The last time a tightening cycle started in January 2004 the rate got hiked 1.5% within ten months. We are forecasting a 1.25% rise over 12 months. Last cycle the extent of the rate rise was 3.25% (from 5% to 8.25%). This time we are currently forecasting a 2% rise from 2.5% to 4.5%.

A number of people have enquired as to what the future holds for **investors**. As a reminder, I do not write from the investors point of view because whereas most borrowers are the same all investors are unique and stock standard replies cannot suffice across their wide range of circumstances. All I will say is that as the official cash rate goes up, bank bill yields will go up, floating mortgage rates will go up, and term deposit rates will go up as banks seek cheaper funds than relying on the increasingly pricy bill market. As a general rule for those who invest in term deposits there is an incentive to take short terms as monetary policy gets tightened but a time will come when locking in a long-term rate is optimal. That point is a long way off given the risk that this tightening cycle goes on for a lot longer than currently commonly thought. Why? Because it is hard to imagine the Reserve Bank easing until the Christchurch rebuild is waning and the RB don't expect activity to peak until 2017.

But I have spent two days in Christchurch this week and there is a strong view that the rebuild will go on for a lot longer than people are thinking given the planning difficulties involved and the expected shortages of people in particular.

In fact it may pay to try and get your head around this. The Reserve Bank will raise interest rates to try and buy time for growth in labour and capital inputs plus productivity gains to catch up with growth in aggregate demand in the economy. Buying time means spinning expected growth out over a longer period of time. In the case especially of the necessary rebuild of Christchurch, the necessary building of previously not built houses in Auckland, the beefing up of capacity in its many forms in the dairy sector, and improving the country's infrastructure plus earthquake ratings for buildings, this means flattening the growth over more years rather than causing the construction to never happen.

The Reserve Bank's policy tightening will explicitly extend the period of capacity-pushing growth in the economy and not kill it off until the next cycle comes along. Form a picture in your head of the top being lopped off of an ice-cream and placed beside the capped confection to produce a nice long sundae-dish type thing. This creation as opposed to the normal policy tightening effect of using a blower to get rid of the top of the ice cream onto the next table (cycle) means the interest rate cycle will not look the same as a normal cycle will. It is highly likely to be extended. That is why borrowers need to think in terms of getting interest rate protection through 2016, 2017, and even 2018. That is also why exporters should be careful about forecasts of the NZD falling away anytime (year) soon.

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%	2.96	2.78	2.70	2.67	5.2
1 year swap	3.54%	3.53	3.45	3.09	2.81	5.3
3 year swap	4.24%	4.18	4.24	3.97	3.14	5.5
5 year swap	4.65%	4.61	4.71	4.47	3.45	5.7
7 year swap	4.93%	4.90	5.02	4.79	3.76	5.8

NZD Unchanged

The NZD has ended this week unchanged against the USD from a week ago near 82 cents though spent some time below 81 cents as worries about emerging economies caused some movement away from the more risky/volatile currencies. But we have fallen against the AUD courtesy of the AUD bouncing upward.

The Aussie dollar has risen against the greenback by two cents this past week largely in response to comments yesterday from the RBA following their first board meeting for the year. The RBA Governor removed any reference to the potential need for lower interest rates by saying "…the most prudent course is likely to be a period of stability in interest rates." He also failed to repeat previous comments regarding the AUD being "uncomfortably high".

There is a strengthening view that the Bank of England will raise interest rates well ahead of the Federal Reserve and ECB, with the markets looking at a rise perhaps early next year compared with additional easing coming in Europe and the Fed. holding off until 2016. That is leading to some flows of funds into British Pounds which help to explain why the NZD is very slowly losing ground against Sterling.

Exchange Rates	This Week	Week ago	4 wks ago	3 Mths ago	Yr ago	10 yr Average
NZD/USD	0.82	0.82	0.8276	0.828	0.843	0.726
NZD/AUD	0.921	0.938	0.9239	0.871	0.808	0.839
NZD/JPY	83.3	83.7	86.77	81.6	77.9	72
NZD/GBP	0.502	0.495	0.5046	0.518	0.535	0.423
NZD/EUR	0.606	0.6	0.6089	0.612	0.624	0.545
NZDCNY	4.97	4.97	5.01	5.05	5.25	5.1
USD/JPY	101.59	102.07	104.85	98.55	92.41	99.3
GBP/USD	1.63	1.66	1.64	1.60	1.58	1.72
EUR/USD	1.35	1.37	1.36	1.35	1.35	1.33
AUD/USD	0.89	0.87	0.90	0.95	1.04	0.87
USD/RMB	6.0613	6.0549	6.051112	6.098	6.2327	7.15

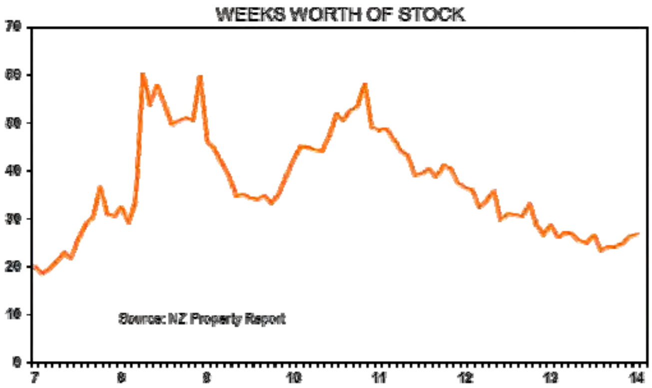
For more detailed FX analysis including the ‘BNZ Markets Outlook”, “BNZ Strategist” “BNZ Commodities Wrap” and lots more go here. https://research.bnz.co.nz/Research/NewZealand/Pages/NZpublications.aspx

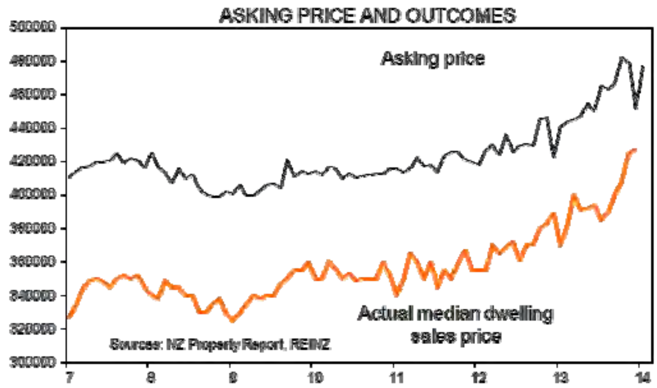
Housing Market Update

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

Nothing Much

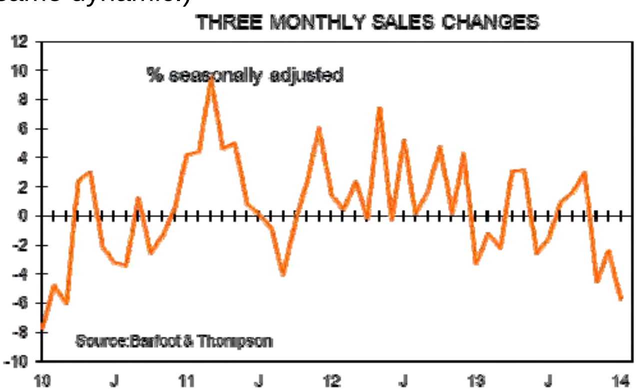
Data from the website www.realestate.co.nz this week show that the number of fresh listings in January rose by a healthy 15.4% seasonally adjusted from December. But as this followed falls of 10.6% in November then 9.5% in December one cannot conclude that vendors are rushing to get their properties on the market. In fact for the three months to January listings fell 6.7% in seasonally adjusted terms from the three months to October and the end month stock of listings was down by 6.3% from a year earlier. Comments submitted in our first BNZ Confidence Survey for 2014 show that real estate agents are still finding listings to be in short supply in many parts of the country.

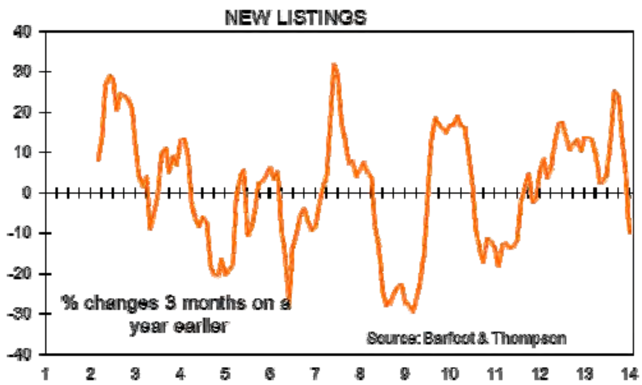




Based on sales data for the three months ending in December (no January turnover data are in hand yet) the number of week’s worth of stock stood at 26.8 a month ago from 26.3 two months ago. There is a mild upward trend in this measure but that could be because sales were depressed by the LVR rules imposed from October 1 and as the shock of those rule changes is overcome we expect sales once again to climb and relative stock availability to once again worsen.

Barfoot and Thompson released their January data for Auckland activity today. During the month they sold 854 dwellings which was roughly a rise from December in seasonally adjusted terms of about 5%. This is quite a positive result considering that chatting with a number of real estate agents in Christchurch this week the comment was made that many had longer than usual breaks over Summer. (Different city but maybe the same dynamic.)





The number of new listings received by Barfoot and Thompson during the month was down by 14.7% from a year earlier at 1,228. This is the weakest annual rate of change since December 2012 and before that April

2011. The stock of listings at the end of January stood at 3,371. This was a 10.4% decline from a year earlier.

The average sales price for January was $647,000 from $700,000 in December but this measure can go all over the place. In the three months to January the average sales price rose by 3.1% after climbing 1% in the three months to October and 3% in the three months to July.

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