Weekly Overview

13 March 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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http://feedback.bnz.co.nz/forms/lFdYSs5FGEq4kAjP95uzTA

2014 Themes

- Interest rates will rise – yep, happened today.
- The NZD will remain highish – certainly is.
- The labour market will tighten, pushing employment costs up – employment intentions rising strongly.
- House prices will rise with gains spreading out of ChCh and Auckland – rising but spreading evidence muted.
- Construction will boom – evident in the consents data and on the ground.
- World growth will improve with unprecedented uncertainty regarding monetary policies – up and down views continuing on policies in most foreign countries.
- Business capital spending will grow – intentions very high but statistical evidence of a surge not yet in hand.
- Household spending growth will accelerate – card transaction data quite firm and spending per capita back at 2007 levels.

Speaking in Auckland – FX, Housing, Interest Rates, Chinese house buying

This week I gave a talk to a large group of residential property investors in Auckland and spent considerable time after the talk chatting about issues of importance to them. For many that issue was the exchange rate. While acknowledging my comment that currencies can't really be predicted the main point I put across was that although the NZ dollar is currently high by historical standards, our terms of trade are at their highest level since 1973 and have risen by 20% over the past year. That basic fundamental says the NZD will be high. The other basic fundamental is that our growth rate looks set soon to exceed 4% in a world where economies continue to struggle to get onto sustainable-looking growth paths and some, China, are generating deepening worries about the extent of their decline in average growth.

Then there is the third fundamental thing relevant to our currency being high which is what today is all about – a tightening leg of the monetary policy cycle. The Reserve Bank has lifted the official cash rate for the first time since 2010 and we expect that from 2.5% yesterday and 2.75% today the rate will be 5% come the end of 2015. Beyond that further rises cannot be ruled out given that much of the growth in our economy is coming and will come from factors not particularly sensitive to interest rate rises – Christchurch rebuilding, catch-up house construction in Auckland, infrastructure, accelerating world growth, booming net immigration, and even the dairy sector expansion to some degree.

While the popular view among analysts is that all of this is already factored into the exchange rate, the risk is that the NZD goes higher and stays high for a lot longer than people are thinking. But history shows us that our currency can be volatile, that it more often than not falls sharply rather than calmly from high levels, and that such declines are usually associated with deteriorations of sharp nature in world growth prospects.

Therefore, if you believe the world is about to suffer a shock then the NZD will decline. But barring that the risk is we stay elevated. Personally speaking, if I had Kiwi dollars which I wanted to ship into foreign currencies I would be in no hurry against the Yen as that economy looks set to disappoint a lot of people given recent poor data (only 0.7% annualised growth in the December quarter), and lack of strong proposals for structural reforms.

I would tend to sell the NZD against the British Pound at levels above 52 pence. Against the Euro I'd sit on my hands for some time as the risk is their growth disappoints this year with one reason being worries about their eastern flank – Ukraine.

I would look for spikes in the NZD against the greenback to sell near 88 given that as money printing eases in the United States the greenback will find more and more strength. Against the Aussie dollar I think we can go up a tad further but not all that much and I'd be a seller above 95 cents.

But remember, currencies do what currencies do and they often do it in response to specific events – which we can't forecast.

I did of course spend some time discussing the housing market during and after my presentation and made the broad comments that perhaps one reason Auckland house prices on average have risen 45% since the start of 2009 is that there has been an element of catch-up following the 2001-07 period when non-Auckland prices gained around 130% but Auckland prices "only" doubled. Also, in the past year two-thirds of the nationwide 3% jobs growth occurred in Auckland. Plus migration surges tend to boost Auckland more than the rest of the country, and buying by Chinese investors is, anecdotally, a lot stronger in Auckland than elsewhere.

Speaking of foreign buying, next week I shall release the results from our latest BNZ-REINZ Residential Market Survey which this month will contain updated information on dwelling sales to foreigners. This week I released our monthly BNZ Confidence Survey results which show confidence remaining at a very high net 66% optimistic and good anecdotes flowing from almost all sectors which reported.

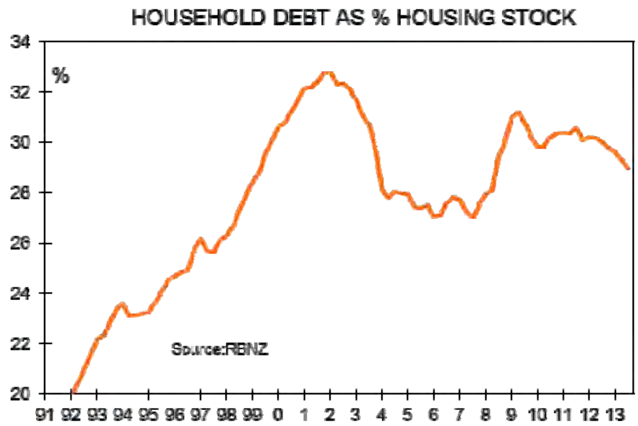
For Auckland the key housing fundamental is a shortage of property which will not be substantially alleviated for many, many years given a shortage of sections and approaching dearth of builders. This shortage will tend to support prices but gains this year on average are likely to be less than last year due to the obvious effects of the minimum deposit rules introduced in October last year and rising financing costs.

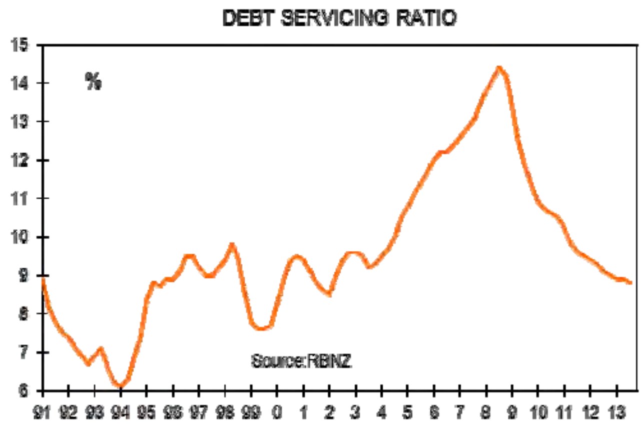
With regard to those rising mortgage interest rates there is a very important point to note. No-one really knows how sensitive householders here or overseas now are to rising interest rates. We in NZ are right at the front of what will be the most uncertain period of monetary policy tightening the world has ever seen – and that uncertainty will persist for many years. So be prepared for a stop-start sort of tightening cycle over the next two – three years as the Reserve Bank and the rest of us look at every scrap of information to try and gauge the effects of the tightening.

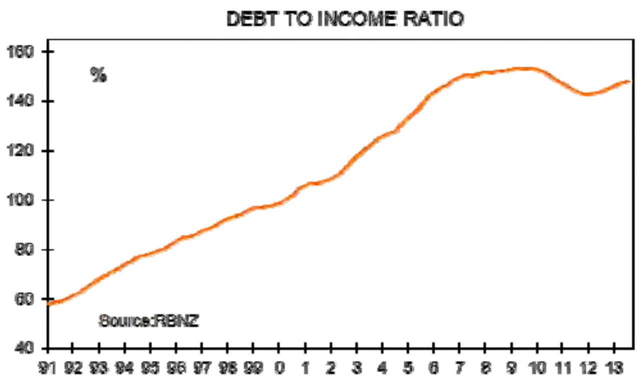
One word of caution – we could see a repeat of the 2004 – 07 scenario whereby floating rates jump up but the impact of those rate rises is muted by people moving into fixed rates. Fixed rates never rise as much as floating rates and their movements are heavily tied into what is happening with monetary policies and expected to happen with monetary policies in other countries – mainly the United States. Central bankers overseas are going out of their way to send strong messages to their relevant markets that they have no intention of raising interest rates for a long period of time. They don't want to risk forestalling nascent upturns in business investment in particular as that investment recovery has been a key element missing in improvements in economies since 2009. As offshore rates remain low rises in our fixed rates will be restrained.

For your guide, based on our official cash rate forecasts floating mortgage rates will be close to the current three year fixed rate of 6.35% within three months and reach the current five year rate of 7.2% about one year from now.

Just for the heck of it, here are some graphs showing that household debt as a proportion of the value of New Zealand's housing stock is not all that stretched, that the debt servicing ratio is currently very low, but that debt compared with income is high.







Also, if buying of real estate by Chinese is your area of interest, here are some links to articles noting rising Chinese property buying with the third one noting that NZ is the fastest growing destination for buying according to the Juwai.com portal for selling property to Chinese buyers.

According to a Juwai press release last month the top five destinations for Chinese buying real estate are USA, Australia, UK, Canada, Germany.
http://list.juwai.com/news/2014/02/chinese-outward-investment-soars-how-to-profit

Here is an article noting increased targeting of China by real estate vendors.
http://www.opp-connect.com/28/02/2014/china-and-us-to-top-cross-border-property-investment/

This one notes that New Zealand is the fastest growing destination for Chinese home buyers.
http://www.opp-connect.com/13/12/2013/us-is-top-for-chinese-home-buyers-in-2013/

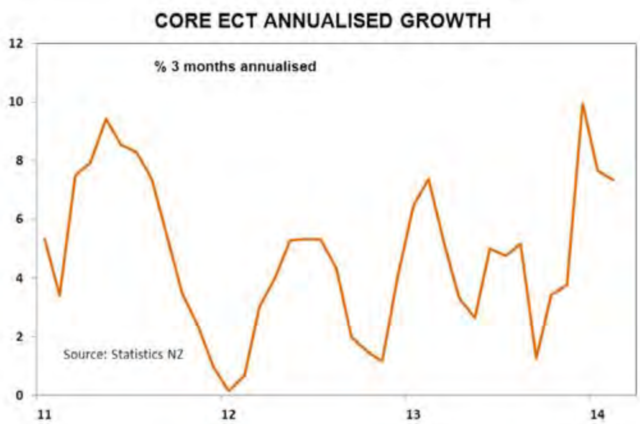
Some discussion of the Australian context.
http://www.watoday.com.au/comment/cashedup-chinese-are-pricing-the-young-out-of-the-property-market-20140309-34f9k.html

Two weeks ago the Reserve Bank of Australia Governor noted the role which Asian investors are playing in pushing up house prices in certain inner city suburbs often associated with schooling.
"in particular parts of our cities, the role of foreign investors is quite prominent indeed"
http://www.news.com.au/finance/real-estate/rba-chief-warns-foreign-buyers-drive-up-prices/story-fncq3era-1226848427262

National Party policy is to leave foreign property buying rules for New Zealand unchanged (having passed legislation last year giving the Reserve Bank the power to impose minimum deposit rules which have shut out our first home buyers). The mix explicitly biases NZ house sales to foreigners. Labour Party policy is to adopt Australia's rules of restricting foreign buying to newly built property only. Labour would also seek to build 10,000 state houses a year (probably unachievable), impose a capital gains tax, and negotiate (presumably with the RBNZ) an interim exemption to the LVR rules for first home buyers.

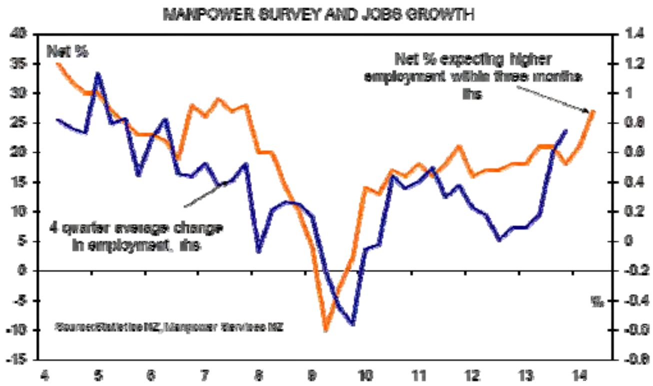
Upward Trend in Household Spending

Core retail spending in seasonally adjusted terms using debit and credit cards recovered by 1.1% in February after falling 0.7% in January to give annualised growth for the past three months of a healthy 7.3% from 3.8% three months ago and 5.2% six months ago. Spending growth is very volatile from month to month but the trend rate appears to be ticking up. That would be consistent with what you would expect from the currently very high levels of consumer confidence and strongly rising employment.



Looking at the graph we can see that hitting 7% - 9% annualised growth is not a recipe for a sustained period of strong activity a-lah 2011. But things certainly are adding up for this year being better than last for retailers on average – though finding the average retailer could be a challenge.

Speaking of employment and a strong labour market, the quarterly Manpower Employment Outlook Survey of 650 employers showed a net 27% of employers planning to hire more staff in the next three months. This is the strongest result since the end of 2007 (watch that – the fact that the economy went into recession right after that suggests caution is required in interpreting these and similar results). The following graph plots the employment intentions measures as the orange line then quarterly employment growth smoothed over four quarters as the blue line. There is no short-term correlation (seen by examining quarterly employment changes which are not illustrated here as the graph is too messy). But the trends match up.



And confirming other sources showing that the services sector is picking up and that this period of growth in the economy is not simply construction driven, a high net 37% of employers in the fire, real estate and insurance sector plan hiring extra people, a net 31% in services plan doing so, and a net 19% in retail and wholesale trade plan taking on more people.

Key offshore debates

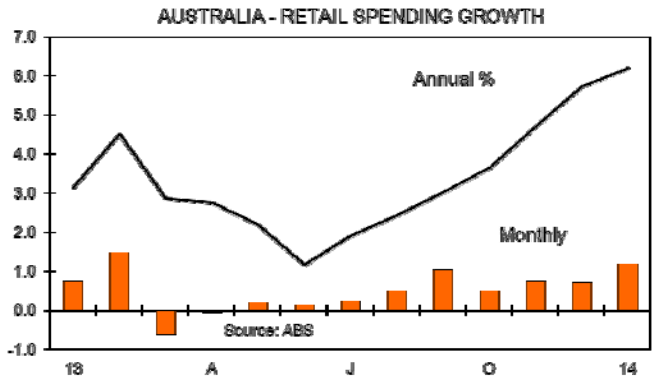
United States – Growth lifting to 2.8% from 1.9% in 2013 but could interest rates jump as tapering proceeds?
China – Impact of non-performing loans following the 2009+ credit boom, ability to switch from export and fixed asset investment as growth-driving forces toward consumption, impact of loosening 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?

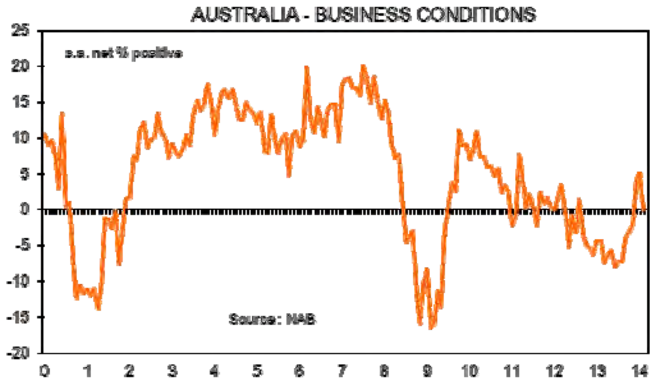
The monthly employment report in the **United States** showed slightly stronger than expected jobs growth in February with a gain of 175,000 from 129,000 in January and 84,000 in December. Growth has averaged 215,000 each month since the start of 2013 therefore the most recent string of results is relatively weak. Hence doubts persist 0 for the fourth year in a row – regarding the underlying strength of upturn in the US economy. Hence uncertainty remains regarding the pace with which the Federal Reserve will remove their monetary stimulus.

For now the view is that money printing will decline at the pace of about $10bn a month from the current rate of $65bn following two bouts of monthly reductions from $85bn.

There was some bad news out of **China** this weekend in the form of monthly export numbers. Rather than showing export receipts coming in 5% ahead of a year earlier in February they were revealed to be down in fact by a whopping 18.1%. One can quibble about the accuracy of month on year ago comparisons around New Year. But the graph here shows the trend rate of growth in China's exports has been falling since the middle of 2010. This calls into question the CCP's ability to deliver 7.5% GDP growth this year and perhaps helps explain why the PBOC allowed the Yuan to weaken recently, and why credit conditions may be loosened again very shortly. Such weapons tend to be pursued in economies where political appetite for true economic reforms is weak as it is in China these days – and Japan it seems still.

In **Australia** there is support for growth coming from rising house construction, strong retail spending, and even firm export growth as iron ore exports in particular grow – though prices have just fallen sharply because of worries about China's speed of growth and financial sector. Retail sales rose by a stronger than expected 1.2% in January to be 6.2% stronger than January 2013. This is the strongest annual rate of growth since mid-2009.





But businesses have become a tad less optimistic over the month with the NAB Business Survey of over 600 firms showing a fall in the current conditions index to 0% (neutral) from 5.1% in January. The employment measure worryingly fell away to -5.6% from 0.3%. The recovery in the Australian economy is looking relatively jobless at this stage.

In addition yesterday we learned of a decline in consumer sentiment in the monthly Westpac/Melbourne Institute survey to 99.5 in March from 100.2 in February and 110.3 back in November. Rising unemployment is affecting consumer confidence.

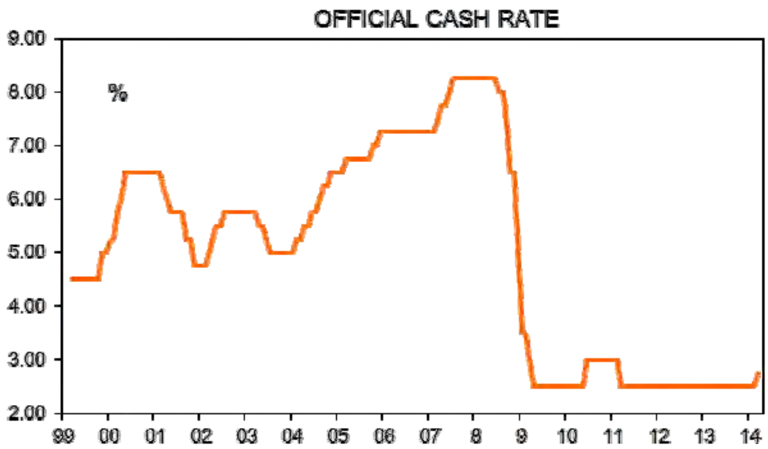
In the **United Kingdom** many economic indicators recently have been on the positive side but the government continues to impose tight fiscal policy with more to come. Spending cuts look like being announced in the budget due in a couple of weeks with a fresh £20bn deterioration in the government's accounts revealed this week. The business sector meanwhile is applying pressure for some relaxation of visa rules to try and fill worsening skills gaps in the labour market. However with recent data showing migration inflows running well above the government's target the chances of that seem low. Nevertheless, the improving UK economy, skills shortages, and upturn in construction in particular suggest scope for attracting British builders to New Zealand may not be as great as previously thought.

In **Japan** there was another revision – downward – to estimated GDP growth during the December quarter. We now see that growth was a truly miserable 0.17% compared with the first estimate of 0.3% and September quarter growth of 0.24%. June quarter growth was 1.0%, March quarter 1.1%, and full year growth was just 1.5%. The result has raised deep concerns that after an acceleration in the March quarter as consumers and businesses make purchases to beat a rise in the sales tax to 8% from 5% on April 1, economic activity will contract during the June quarter.

Confidence amongst small business operators has in fact taken a step down in Japan with the Economy watchers measure falling to 53 in February from 54.7 in January and 55.7 in December. The trend has flattened out in positive territory however.

IF I WERE A BORROWER WHAT WOULD I DO?

We had a false start in 2010 when the cash rate went from 2.5% to 3% but was then cut back to 2.5% in March 2011. But this time around we expect a full-blown tightening leg for the monetary policy cycle starting with this morning's rise to 2.75% and finishing with a rate of at least 5% come the end of 2015. A higher peak is more likely than one lower than this.
http://www.rbnz.govt.nz/monetary_policy/monetary_policy_statement/2014/5655077.html



When will rates peak? We think 2016 but the risk is beyond that. In fact this morning the Reserve Bank included an interest rate track showing rates higher early in 2017 than late in 2016. They are explicitly allowing for the tightening leg of the policy cycle running for at least three years. You should too. Remember the view expressed here some weeks ago that you should be thinking of our economy over the next few years as having a growth, employment, inflation, interest rate, and exchange rate profile more like Ayers Rock (extended flat top) rather than the sine wave we all tend to have as a default picture.

As stated many times over the past month and a bit, were I a borrower at the moment I would be shifting more of my debt onto a three year fixed interest rate and trying also to find a decent rate in the four or five year area. I would watch how much debt I take on and would do what we older people love to tell younger people when they talk about debt (and moan quite a bit in the next five years) – sacrifice a lot of things and seek extra income in the first few years in order to get the mortgage down as quickly as possible.

FINANCIAL MARKETS DATA

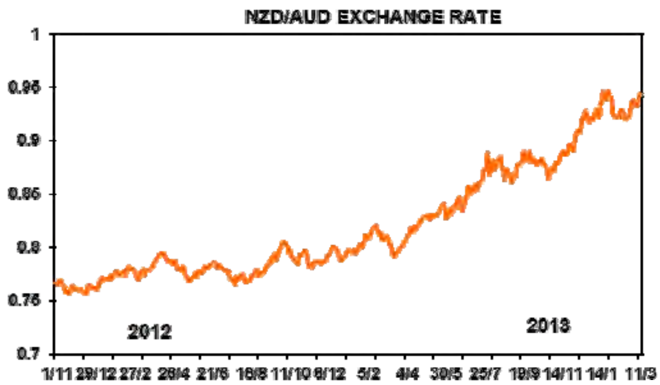
	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	2.50%	2.50	2.50	2.50	2.50	4.9
90-day bank bill	3.06%	2.98	2.89	2.70	2.70	5.2
1 year swap	3.57%	3.55	3.53	3.27	2.78	5.3
3 year swap	4.28%	4.17	4.25	4.14	3.20	5.5
5 year swap	4.63%	4.54	4.66	4.65	3.57	5.7
7 year swap	4.89%	4.81	4.95	4.98	3.89	5.8

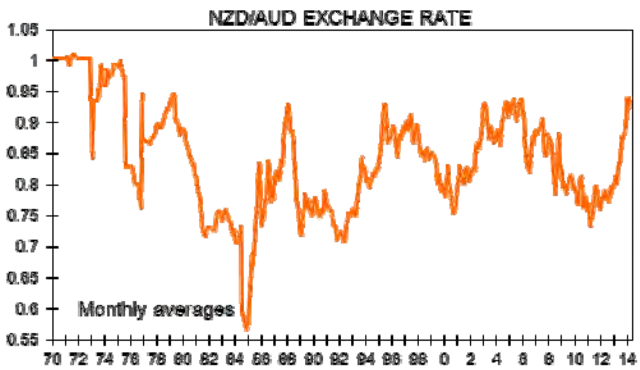
NZD Boosted

This morning's 0.25% cash rate rise from the Reserve Bank met expectations. However they included in their updated forecasts a more rapid pace for increases in interest rates than they indicated three months ago, and at the end of their published rate track in the March quarter of 2017 still had rates going up. So while the words from the RB Governor were not overly hawkish the interest rate projections were higher than expected. Thus the Kiwi dollar has received an extra boost upward today on top of rises recorded earlier in the week for a variety of reasons.

We sit this afternoon above US 85 cents and near 95 Aussie cents.

Against the Pound the NZD's rise has been assisted by comments from the Bank of England Deputy Governor that any further rise in the currency would be unhelpful in terms of rebalancing growth. Our rise against the Yen has been assisted by weaker than expected data on December quarter growth and reduced economic sentiment. Against the Aussie dollar the NZD's rise to the highest level since July 1975 (I was alive then, were you?) has been assisted by worries about the Chinese economy, falling iron ore prices, and weak sentiment data.





Exchange Rates	**This Week**	**Week ago**	**4 wks ago**	**3 Mths ago**	**Yr ago**	**10 yr Average**
NZD/USD	0.852	0.842	0.831	0.825	0.825	0.726
NZD/AUD	0.947	0.933	0.929	0.921	0.799	0.839
NZD/JPY	87.5	86.2	85.1	85.1	79.2	72
NZD/GBP	0.512	0.503	0.5	0.505	0.554	0.423
NZD/EUR	0.613	0.613	0.611	0.6	0.633	0.545
NZDCNY	5.24	5.16	5.04	5.01	5.13	5.1
USD/JPY	102.70	102.38	102.41	103.15	96.00	99.3
GBP/USD	1.66	1.67	1.66	1.63	1.49	1.72
EUR/USD	1.39	1.37	1.36	1.38	1.30	1.33
AUD/USD	0.90	0.90	0.89	0.90	1.03	0.87
USD/RMB	6.1456	6.1286	6.0627	6.0714	6.2163	7.15

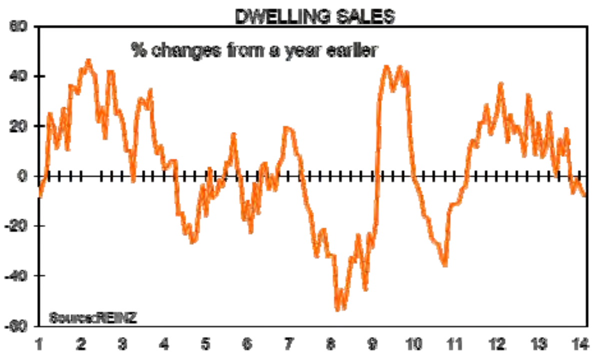
For more detailed FX analysis including the 'BNZ Markets Outlook", "BNZ Strategist" "BNZ Commodities Wrap" and lots more go here. https://research.bnz.co.nz/Research/NewZealand/Pages/NZpublications.aspx

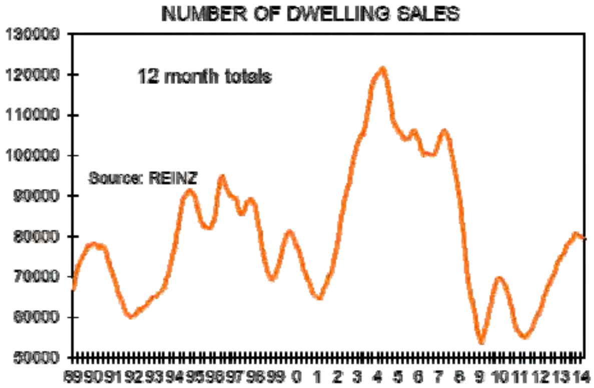
Housing Market Update

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

Housing Market Mildly Cooler – But Not Necessarily

The REINZ released their February data this week and the numbers show that during the month sales were 7.6% down from a year earlier at 6,125. Seasonally adjusted monthly rates of change in dwelling sales have been negative since October with a near 5% fall recorded in February as first home buyers continue to stay away following the Reserve Bank thumping them and our society with the loan to value rules.

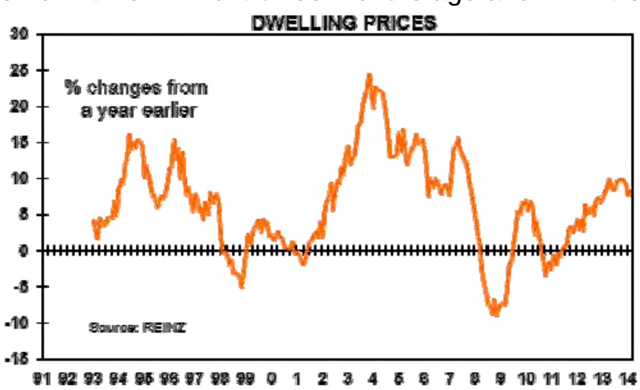


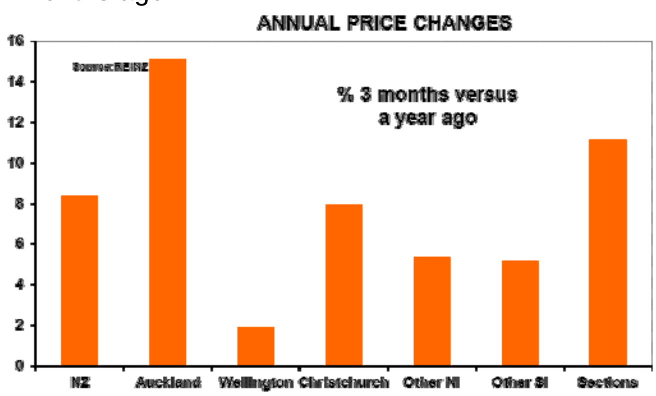


With regard to prices an LVR impact is apparent. The stratified median dwelling sales price index in February rose by 2.1% after falling 2.4% which reminds us that monthly measures really shouldn't receive much attention. Smoothing over three months we see that nationwide house sale prices have fallen by 0.5% after rising 1.2% three months ago and 2.1% six months ago. Auckland prices have declined by 0.7% in the past three months, Wellington 0.9%, while in Christchurch prices have risen by 2.1%, the rest of the North island 1.7%, and the remainder of the South Island 1.2%.

But before one concludes that prices are on a downward track it pays to note this this three monthly measure also can be quite volatile and in Auckland for instance prices fell 0.7% in the three months to February last year, 0.4% in the three months to March 2012, and 1.5% in the three months to February 2011.

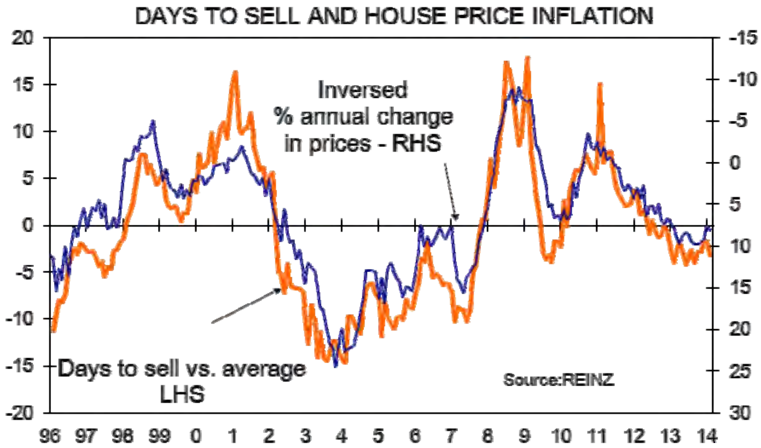
In other words – there is a seasonal element in play here. One gets a better picture by looking at annual rates of change and doing that we see nationwide prices in the three months to February up by 8.4% from a year ago versus 9.7% growth three months ago and 8.8% six months ago. For Auckland the annual change is 15.1% from 14.9% three months ago and 17.2% six months ago.





We conclude that prices are still rising and the LVR impact is mainly confined to a hit to turnover. However…

On average in February it took 41 days to sell a dwelling which was 3.2 days faster than average compared with 1.7 days faster in January and December and four days in September. The speed of turnover was initially impacted by the LVR rules but that speed has just accelerated to be even faster than average. Given the correlation between days to sell versus average and price rises this failure of turnover speed to keep easing off as happened from October to January implies that the slowing in the underlying pace of growth in house prices may not amount to all that much. More interesting now will be the impact of interest rate rises.



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