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.

To receive the Weekly Overview each Thursday night please sign up at www.tonyalexander.co.nz

2014 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

Farm Fieldays 2014

This is the second week of June so once again, as for all bar one of the previous ten years, I am at National Farm Fieldays for three days in the BNZ tent speaking two times a day and the rest of the time between about 8.30am and 3.30pm having numerous chats with farmers. Wednesday was dry most of the day though power was out for the whole site early in the morning due to the storm which swept down from further north. Numbers of attendees were noticeably down due one suspects to the weather. Thursday was busier though much wetter and I suspect Friday, tomorrow, will be when all those who avoided today and yesterday because of weather worries and the need to check their properties and stock will show up.

Here are some of the things I have picked up at this year's Fieldays.

- Just as people were saying in the first year I was here, 2004, the price of land is high and it is hard for a young person to get into farming with the goal of owning a farm. No change there though the difficulties are now that much greater with land prices so much higher.
- It is hard to get school leavers to think about a career in farming. One person with some expertise in the area noted that what is tending to happen is that foreigners are being brought in to do the basic tasks such as placing the cups on cows in the milking shed. But while such people may find themselves well up the career ladder into management positions after a few years they will have difficulty raising funds to purchase their own operation. Instead what is tending to happen is that Kiwis who have been following other careers decide they want to be their own boss so move into the dairy sector, gain skills on the management side in particular, then after a couple of years seek to raise finance for their own operation.
- There is some good underlying awareness of rising dairy output overseas and especially the risk of a lift in exported production in the United States. There are worries about China seeking to reduce it's dependency upon NZ milk by finding supplies from elsewhere, and worries about our rising dependency upon the Chinese market.
- Given the labour pay rates which were quoted to me it is clear that with the construction sector rising strongly in Auckland and Christchurch farmers are going to struggle to get the staff which they want. Such potential staff will in many instances it appears be better off taking a building job than being a farm labourer. Hence the rising dependence upon imported labour noted above. Some farmers still seem to erroneously think that Kiwi youth owe some cultural debt to farming and should be more actively encouraged to accept the low initial pay rates and get stuck into the sector.

- Most dairy farmers were expecting a drop in the payout this season and the $7.00 announced recently by Fonterra was actually better than expected. The break-even point for most is between $5.50 and $6.00.
- Farmers don't come to Fieldays just to look at big tractors, V8 powered chainsaws and oogle irrigation machinery. They are also intensely interested in innovations which can boost productivity. For many it is a question of perhaps having a couple of hundred grand they wish to spend and trying to figure out the best place to put it, rather than just buying more machinery for the sake of it.
- There is a lot of institutional money circling, looking for exposure to the agricultural sector. But it is hard to find.
- One wants to exercise caution with regard to becoming an equity partner in a dairying venture along with a bunch of other city slickers. There is not the structure in farming for managing such investments as there is in commercial property for instance.

Overall people seemed to be in good heart and although farmers would like the NZD to be lower there was not really all that much moaning about it. As with other sectors they seem to have become used to our currency sitting at high levels, hence few expect the Reserve Bank's continued warnings about the over-valued NZD and it's expected decline actually leading to any big movement or intervention to actively get it lower.

IF I WERE A BORROWER WHAT WOULD I DO?

This morning the Reserve Bank met market expectations by raising it's official cash rate 0.25% to 3.25%. The rate rise follows two earlier ones and means that 0.75% worth of monetary policy tightening has been undertaken. Actually it would be more accurate to say that 0.75% worth of undoing extraordinarily easy monetary policy put in place to fight a global depression scenario has now been undertaken.

It pays sometimes to remember that no sane person out there before 2008 ever thought that we would see monetary policy eased so much in New Zealand that mortgage interest rates would go back to levels not seen since the 1960s. Certainly not myself having taken out my first mortgage in 1987 at 18.5% and feeling very chuffed when the rate fell to 15%. I like telling that story to young people who have no knowledge of where interest rates used to be in New Zealand. It scares them a bit, but realistically there is little chance of rates ever going back to that level - just as there was little chance of 1960s rates coming back again!

The fact that depression-fighting interest rates are no longer needed here can easily be seen in the plethora of data releases showing our economy not just growing, and not just growing firmly, but entering a period of growth which exceeds that which can be comfortably handled given the stocks and rates of growth in our various resources such as buildings, machinery and people.

For instance, during the March quarter the quantity of building work undertaken around the country was ahead by 16% from the December quarter. The annual rate of growth in the volume of core retail spending was almost 4% in the year to March. Employment grew by 3.7% or 83,000 over the year to March. GDP grew by 0.9% in the December quarter, 1.2% during the September quarter, and we expect data to be released soon showing growth of close to 1.2% during the March quarter.

That which tends to happen when your economy grows strongly is the rate of inflation eventually rises. This happens as people naturally react to diminishing availability of resources by bidding prices up. Houses are in short supply in Christchurch and Auckland so their prices are rising firmly. In response to the shortages of houses the construction of dwellings is rising strongly. That is placing hefty demands upon supplies of building materials and builders. So their prices are rising. Demand for commercial office and factory space is rising so rents are going up. Businesses will find it difficult to grow their outputs as resource shortages get more problematic. To ration their output they will start raising their selling prices and THAT is where you really start to see inflation getting away from you - increased business pricing power.

Thus our central bank for now is raising interest rates to take away the depression-fighting stimulus. Then at some stage next year these rate rises will instead become aimed at suppressing resource-sapping growth. When that happens the language of the Reserve Bank used during their six weekly official cash rate reviews will shift from merely warning about rising house prices (boring) to warning businesses about their pricing actions.

And just for the record because of a very silly question put to me by a reporter this week, official cash rate changes made today do not immediately have an impact on inflation. It takes about a year and a half for actions taken now to have an impact on price-setting behaviour and the overall rate of inflation.

As noted here for the past three weeks or so, were I borrowing for a home at the moment I would take advantage of the recent declines in fixed interest rates to lock in either a three year rate at 6.25% or at a four year rate at 6.59%. But I am an investor (yippee) and have locked in a six month term deposit rate recently anticipating rolling onto higher rates in 6, 12, and 18 months from now. Then maybe in a year and a half I will lock in for a longer term. But it pays to remember that there is HUGE uncertainty surrounding where interest rates will go in all countries in this post-GFC environment. So be careful about making any borrowing or investing decisions which are based heavily upon any particular set of interest rate forecasts.

	OCR	90 day bb	1 year swap	2 year	3 year	4 year	5 year	7 year
This week	3.25	3.5	3.8	4.06	4.28	4.43	4.53	4.73
Last week	3.00	3.46	3.71	4	4.19	4.33	4.45	4.64
4 weeks ago	3.00	3.42	3.75	4.06	4.27	4.41	4.52	4.68
3 months ago	2.75	3.2	3.57	4.02	4.28	4.47	4.63	4.89
1 year ago	2.50	2.66	2.79	3.06	3.34	3.54	3.71	3.99

NZD Bounces Back

The NZD has risen over two cents against the greenback in the past week and one and a half cents against the Aussie dollar. This movement up partly reflects a rise in investor willingness to buy risky assets like our currency following the good US job numbers on Friday night. But over one cent of the rise happened today when the Reserve Bank kept in place the forecast interest rates track which it published three months ago. That dashed the expectations of those erroneously reading the degree of hawkishness in our new central bank Governor and anticipating that the series of rate rises would cease for a few months as from today. The markets are now back to the position we have held all along that there will be a series of four rate rises and then there will be a pause. This rise in interest rate expectations lifted the NZD.

In Europe, as had been widely expected, the European Central Bank last Thursday night cut their rate paid to banks for depositing funds overnight to -0.1% in the hope that this would encourage banks to lend money. Clearly they don't have much faith in this unusual move as they also cut the rate for lending funds to banks from 0.25% to 0.15% whilst making available a €400bn line of credit to banks for lending to businesses.

In theory the changes mean a lower Euro. But in practice the markets know that they have the ECB by the short and curlies and that just as the Federal Reserve in the United States has been trying to protect the US economy from cleansing shocks since the 1990s under Mr Greenspan, now the ECB President has placed himself firmly on the hook of responsibility for keeping Europe growing. But whereas Mr Greenspan created the conditions for the Global Financial Crisis, Mr Draghi, as President of the ECB, is mainly having his negative impact by keeping pressure off the politicians to suffer the electoral opprobrium from their cuddled masses of implementing reforms needed to once again make Europe a competitive place to do business.

Europe is a mess. Were it not a negative overnight deposit rate at the ECB would not be necessary. And with inflation now just 0.5% it is no wonder that bond yields in Europe have fallen to record lows for some previously frowned on debtor countries. The risk of sustained deflation in Europe is not yet high. But the risk is there and that means upward pressure on long term borrowing costs in New Zealand could be quite limited all through this year into 2016.

Yet with NZ monetary policy tightening and investors increasingly looking for yield, the NZD still looks like a currency which is going to be well supported for the remainder of this year through well into 2015.

Up until about three or four years ago when I was able to access the data for free I used to present an annual analysis of the accuracy of currency forecasting for Kiwi economists surveyed by the Consensus Forecasts people. What I showed was that we economists not only sucked completely at picking the extent of change in the NZD/USD exchange rate one year ahead of time, we could not even pick the direction. In fact I showed that you would have a higher success rate, probabilistically-speaking, simply tossing a coin as to whether the NZD went higher or lower rather than going on what we said.

I mention this because on page D4 of this week's Sunday Star Times an article notes research recently conducted by Pathfinder Asset Management which shows the median year ahead forecast to be out on average by 9%. Some more information on forecast accuracy would have been useful rather than just this percentage. But the upshot is that you are a fool if you base your currency hedging strategy on a set of forecasts for where the NZD will be in a year's time. You would do best instead to use a currency advisor to help you work out your exposure to currency movements then develop an appropriate hedging strategy.

I stress this partly because of a conversation I had with someone at Fieldays earlier today. The person said that they would like to borrow money to fund their farm expansion in Danish kroner so they could get a lower interest rate. I pointed out that while such a transaction was certainly possible it is not the sort of thing we banks promote, largely because we do not have confidence that the borrower fully, heck even partially, understands the huge currency risk which they are taking and how it could threaten not only their cash flow but their total business.

One only gets a lower offshore interest rate if one leaves the debt unhedged. That means one takes the risk that the NZD might plummet. This would not just push up debt servicing costs in NZD terms, but would also worsen the company debt to equity ratio as the debt would rise in NZD terms. The person countered by noting that surely the NZD is not going to fall strongly because I had just a few minutes before run through a list of reasons as to why I think our currency will remain elevated for a long time. That is when I pointed out that I personally don't believe I can accurately forecast the NZD.

The customer could also have pointed out that if the NZD falls sharply then that would boost NZD receipts from their farm exports. But my counter to that would have been that the NZD tends to fall largely when our export sector is getting slammed with falling demand and falling prices because of a sharp deterioration in the world economy.

So as our central bank raises interest rates and you, as an exporter, think about borrowing in a foreign currency, don't. It is pot luck as to whether the deal will work out for you and why would you punt your farm and the mental health of yourself and yours on you getting your own personal exchange rate forecast right.

	NZD vs. USD	AUD	JPY	GBP	EUR
This week	0.865	0.922	88.3	0.515	0.639
Last week	0.842	0.907	86.5	0.503	0.619
4 weeks ago	0.867	0.924	88.2	0.517	0.632
3 months ago	0.852	0.947	87.5	0.512	0.613
1 year ago	0.792	0.838	74.8	0.505	0.593

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

Warning - Chances Are This Will Shock Some Of You

There is talk that the Reserve Bank could consider putting extra credit controls in place in order to try and stem inflation sourced from the housing market. The new restrictions could take the form of limiting how much someone could borrow to a multiple of their household income. In this way people would not be able to borrow as much as they can now therefore upward pressure on prices would be less than would otherwise be the case. If the restrictions were harsh enough house prices could even be pushed lower, though that is not highly likely given that the overwhelming impact of credit restrictions will be felt by the group of people who have already been shut out of the market to a big degree by the maximum loan to value rules - young first home buyers.

Is this something about which we in the lower, middle, and upper middle classes, and those silly enough to self-identify in New Zealand as in the upper classes, will feel greatly worried about? Heck no. We have already bought lots of investment properties over the past few years and keep hearing stories about how rents are lower than they should be. We are wary of raising our rents because to do so to a large degree would make us look like pricks - be "up ourselves" in the Kiwi vernacular - and that is something one has to assiduously avoid in this country.

But if it becomes even harder for young people to buy a house then they will have to rent for longer, so it will start to become more socially acceptable to raise rents. So we will, and while we will tut tut about how difficult it is for a young person to buy a property these days our incomes will rise and we will, yet again, feel happy that we ignored the many doomsters and kept buying properties the past two decades.

And just in case you are starting to feel insulted by these comments, it gets worse. You see the bulk of us with money and owning houses probably live in a reasonable one already. The last thing we want is more houses and noisy people living closer to us. After all, if we are here in New Zealand by choice we are here for lifestyle rather than income, and a key part of that lifestyle is not living cheek by jowl with other folk if at all possible.

So again, we will tut tut about how hard it is for young people to buy a house and how difficult it is to get a resource consent, a building consent, find a builder, get council inspectors out, manage contractors and so on. But we will not as a rule strongly support measures which either increase the pace at which houses can be built, decrease the cost of doing so, or allow more houses to be squeezed into any given area. Unless maybe that area is a CBD in which we think the developers can go for it because after all, while the CBDs have more restaurants that years ago, they do look less and less like the New Zealand ethnicity mix we remember from our early days, so who cares what number and size of apartments get crammed in there.

In New Zealand it is politically correct to express concern about the high level of house prices. But the next time you have a discussion with someone on the subject, dig, dig, and dig and the chances are you will both end up admitting that you have done well out of property and question why would you want extra supply putting your rental income and accrued capital gains at risk.

Sorry young folk, but much as you may feel the future belongs to you and your smartphone tapping ways, for now the wealth and the power belongs to us - the Baby Boomers. And you my dears form part of our retirement packages. So don't expect any of the radical suggestions which I have thrown into this section of the Weekly Overview every now and then for solving the housing affordability crisis to actually gain traction.

I wrote this article on Friday then on Sunday saw this headline in the Sunday Star Times "Rich People Blocking Housing Growth". Labour, the Maori and United Parties prevented a government bill passing recently which would have reformed parts of the Resource Management Act and made it easier for new houses to be built.

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