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

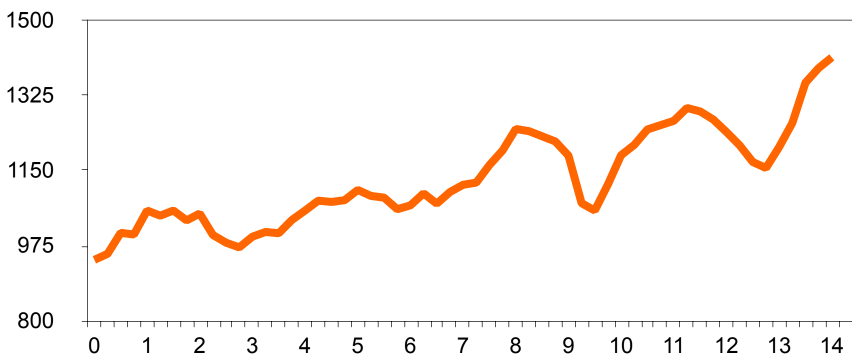
Domestic Activity Picking Up

We've received a few new pieces of economic data this week so let's take a run-through and see if they alter the odds of whether the Reserve Bank will raise the cash rate another 0.25% next week and perhaps six weeks after that.

First.y we saw average dairy prices fall another 4.2% at the fortnightly Global Dairy Trade auction. This makes for eight auctions in a row of declining prices largely on the back of rising supplies of product offshore and not so much because of any great easing in demand. Fonterra have already responded to recently lower prices by cutting their payout for the season just ended from $8.75 per kilogram of milk solids to $8.40, and predicted a $7.0 payout for this season.

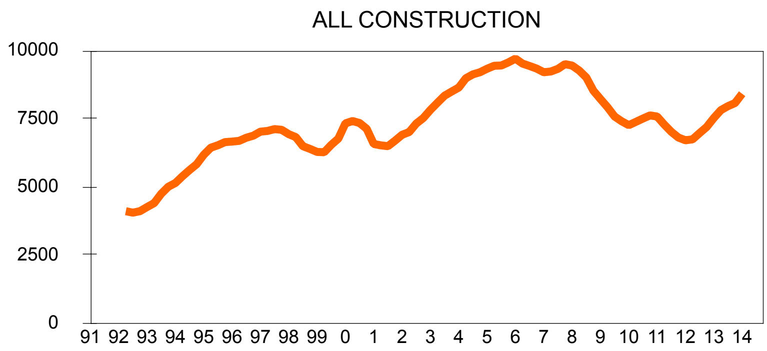
It is unsurprising that prices have eased given that the surge upward last year was so huge and was guaranteed to elicit a supply response. But the steady way in which prices have been falling is a point of concern worth keeping an eye on. I shall get a good feel for how farmers are viewing things next week during three days of chats with many people at National Farm Fieldays.

The falls in dairy prices have yet to be captured in our terms of trade which we learnt this week rose by another 1.8% during the March quarter to sit 17.3% ahead of a year earlier and just 1.7% below the all-time



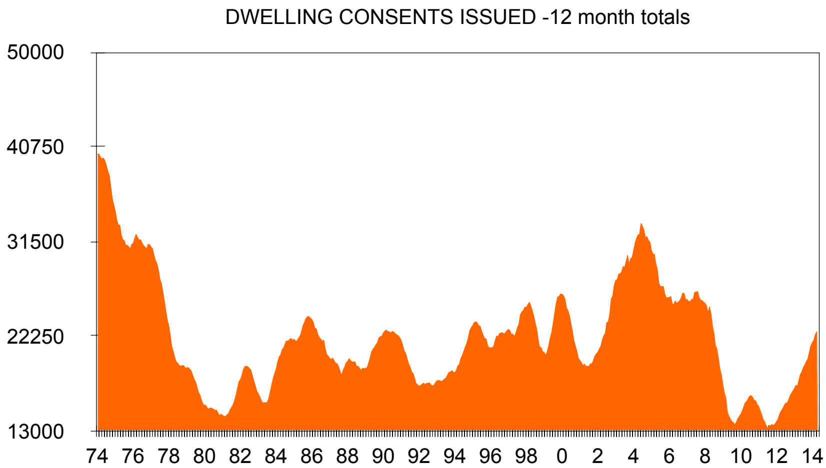
high recorded in the early-1970s. The high levels for our export prices compared with our import prices help explain why the Kiwi dollar is so high but also why it has eased slightly recently as more up to date commodity price gauges have fallen.

For the Kiwi dollar to track downward at a more solid pace however requires more than just easing export prices. Easing domestic inflationary pressures are needed and that looks fairly unlikely given the acceleration in some domestic growth measures. In particular we found out yesterday that the seasonally adjusted volume of building work undertaken around New Zealand during the March quarter was ahead by 16% from the December quarter.



This is a stronger than expected pace of growth which just highlights the way in which construction is driving our economy upward. This construction surge comes largely from the rebuilding in Christchurch and catch-up house construction in Auckland, but with contributions also from earthquake strengthening, water-tightness remediation, and general upgrading perhaps spurred on by the many television programmes about doing up houses.

We also learnt this past week that the number of consents issued for the construction of new dwellings rose in seasonally adjusted terms by 1.5% in May and for the past year consent numbers were 8% above their ten year average with full year growth of 26%. Interestingly however, apartment consents have risen by 74% over the past year and house consents 21%.



The annual pace of growth in lending to the business sector slowed to 2.6% in April from 3.3% in March and lending growth to the household sector slowed to 5.4% from 5.6%. This latter easing came about as seasonally adjusted growth in household lending eased to just 0.3% in the month from 0.4% in each of the previous three months and 0.5% in each of the five months before that. So lending growth to households has slowed down, undoubtedly influenced by the credit controls put in place last October.

What do these various pieces of data tell us? Export growth is slowing, domestic growth is picking up, debt growth is muted. So some sectoral shift in the growth driver is underway but there is little obvious reason for reaching any new conclusions regarding labour market tightness or inflationary pressures. So monetary policy looks still on course to be tightened further, with the probability of such perhaps increased slightly recently by the easing in the NZ dollar.

IF I WERE A BORROWER WHAT WOULD I DO?

I wrote a lot in this section last week, noting how recent falls in long term wholesale borrowing costs in the United States have fed through into NZ long term funding costs. That has prompted banks to shift some of their point of competitive focus away from the short term fixed rates to medium to long term ones. The result is falls in those rates great enough that were I borrowing now I would hop out of floating and either fix for three years at 6.25% or four years at 6.59%. After all, next week we expect the RBNZ to raise the cash rate another 0.25% and that will take floating rates to near 6.5%.

Basically, unless you believe that the world is set for a new economic plunge or we are about to have a foot and mouth outbreak, fixing three years and beyond now appears optimal.

	OCR	90 day bb	1 year swap	2 year	3 year	4 year	5 year	7 year
This week	3.00	3.46	3.71	4	4.19	4.33	4.45	4.64
Last week	3.00	3.42	3.69	3.98	4.16	4.32	4.4	4.62
4 weeks ago	3.00	3.35	3.7	3.99	4.22	4.37	4.49	4.68
3 months ago	2.50	3.2	3.55	3.9	4.17	4.37	4.54	4.81
1 year ago	2.50	2.66	2.78	3.02	3.23	3.41	3.57	3.85

NZD Eases Slightly

The NZD has shed ground against all other major currencies this week in response to some easing in dairy prices, a generalised bout of weakness as happens in asset markets every now and then for no big reasons, and slightly riding the coat-tails of a marginally weaker Aussie dollar.

The AUD is suffering slightly in response to falls in iron ore prices and plummeting sentiment following the black budget of a few weeks ago. Economists across the ditch are pulling back on their expected timing for interest rates rising. The result is that with NZ interest rates going up the differential will be more in favour of the NZD possibly for longer. This does not add up to the NZD heading to parity against the Aussie dollar given some of the downward pressure on our currency from the likes of easing dairy prices. But it does reinforce our view of the NZD remaining at highish levels for a long period of time.

Shocks which could push the NZD sharply lower remain a possibility, with one worsening candidate being military action in Asia now that China has ditched it's pretence to having a "peaceful rise" and bullying smaller nations on waters to the east and south, very, very south, of China. The language from America regarding China's actions is toughening up, and the Japanese, a race who historically have refused to kow tow to the Chinese, are slowly moving away from their pacifist constitution in logical response to China's aggression. Japan is taking a wider role in broader Asian regional security.

Given that 24% of New Zealand's export receipts come from China, any conflict affecting trade routes in the China seas and willingness of Chinese consumers to buy Western primary products (trade is a weapon the Chinese are wont to use) would see our currency and economy hit. The probability of this happening is not yet high. But it is moving away from low at a pace which is probably surprising quite a few people. NZ newspapers have provided some good commentary on the deteriorating situation in the various China seas, but for decent analysis try having a look at "The Australian" newspaper and the AFR where a more broad analysis than simply the relevance of Chinese to milk and house prices is considered.

Continuing with the theme of NZ interest rate prospects looking different from Australia and giving extra support to the NZD, note what is going on in the United States and Europe. The US economy shrank at an annualised pace of 1% during the March quarter. The bad winter is clearly the cause of that, but the risk is that the outcome hides some underlying economic weakness which will keep the Federal Reserve quite cautious in the monetary policy signals which they send. In Europe worries about deflation have deepened, especially following a worrying unemployment increase in Germany.

In fact it is highly likely that tonight the European Central Bank will cut it's overnight interest rate below zero in an attempt to lift business and consumer confidence and to encourage banks to boost lending. It won't work. The act of taking such a radical move tells all European consumers and businesses that things are bad and they are right to worry as none of the many policies implemented by the ECB since 2008 have worked to generate sustained growth. In addition European banks are under-capitalised, they know it, they need to raise capital, and one way to ease that burden is to restrict the lending asset base.

As noted many times here in recent years, Europe faces many deeply entrenched problems which will take a long, long time to solve if they get solved at all. France looks more and more like a lost cause, European unity is fraying in the face of societies being pressured by high unemployment yet ongoing inflows of low skilled migrants and refugees from poor countries, and Europe's obvious weakness has emboldened Russia's military adventurism.

To repeat, we look like paradise compared with Europe and that will tend to keep the NZD well supported against both the Euro and the British Pound. But as this happens note our rising vulnerability to Asian developments. Also, keep an eye on talk about El Nino. Drought is definitely not good for the NZ economy.

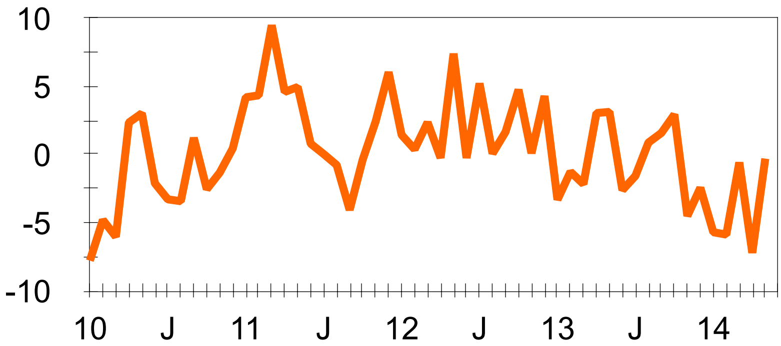
	NZD vs. USD	AUD	JPY	GBP	EUR
This week	0.842	0.907	86.5	0.503	0.619
Last week	0.85	0.92	86.5	0.508	0.625
4 weeks ago	0.867	0.929	88.3	0.511	0.623
3 months ago	0.842	0.933	86.2	0.503	0.613
1 year ago	0.795	0.834	78.9	0.516	0.608

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

Auckland Market Flattening Ended or Starting?

Barfoot and Thompson this morning reported that they sold 15% fewer dwellings in May in Auckland than a year earlier, but in rough seasonally adjusted terms sales have been flat over the past three months after



falling 6% three months ago and 5% six months ago. A period of falling activity appears to have ended for now. The graph above shows three month s.a. Changes in sales numbers.

During the month they received 1,318 new listings which was the same as a year ago but weaker than April and March results which were ahead of levels a year earlier. So we have absence of evidence of any surge in listings continuing. Total listings at the end of the month stood at 3,498 which was ahead 15% from a year earlier. Thus there are a few more houses around for potential buyers to choose from. And with some buyers out of action because of the LVR rules do we see a prices impact? Not really

The average sales price in the past three months was 10.5% ahead of a year earlier. Three months ago that pace of change was 10.7% and three months before that 9.4%. Were prices really being affected by the LVR rules we would expect this measure of change to be tracking off. It is not.