Sporadic

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tony.alexander@bnz.co.nz

Some Perspective

Sporadic 18

I've held off writing about the recent turbulence in the Chinese sharemarket and associated big falls in other markets until things settled down a bit – which they have to a slight degree for now. Compared with four weeks ago just before attention turned to the little-watched Chinese market, the Shanghai share index has fallen by 19% though it is almost 40% down from its June peak. The Dow Jones Industrials Index in the United States has fallen by 9% though is 13% off its peak in May. Compared with a year earlier the Shanghai index is up 40% and the US index down by 6%.

The fall in Chinese share prices including a 1.2% decline yesterday has brought forth much talk of a crash, China's economy heading into recession, everyone who talked positively about exporting to China in recent years getting their comeuppance, and the NZ government having messed up by letting exporters sell to such a wobbly country.

Here are some points to clarify things in no particular order of importance. Hopefully they will leave you better informed than the bulk of people appear to be currently.

When the Shanghai market boomed 110%, we rose just 7%.

1. When the Shanghai share index rose by 110% between November 2014 and June this year no-one wrote in our media or media anywhere else that China was clearly booming and we would soon be growing at a 5% pace. The Chinese market's rise attracted little attention outside China, and it happened when the Chinese economy was slowing down. There is minimal connection between the Chinese sharemarket and the Chinese economy. The rise was simply driven by a combination of people shifting funds away from failing housing markets following revelations of over-supply and new investment restrictions along with falling house prices. Plus the authorities encouraged people to invest, then to borrow and invest, in shares. Very little Chinese household wealth is held in shares.

2. Our own sharemarket rose by only 7% during the period when the Shanghai index gained 110%. We are not much correlated.

3. Many in the West have been waiting for the Chinese economic boom to collapse since 1978. Thus there is glee in many quarters about falling share prices and the panicked moves by officials to try and stem rises, now including arresting people who predict price weakness. This coverage has helped prompt acceptance that China's good days are over. But all such views have been wrong for three and a half decades now.

4. Much as many have over-emphasised weakness in the Chinese economy, the country nonetheless does have many problems. The biggest one is that with rising costs, excess production, and over-investment, China's economy can no longer rely upon growth coming mainly from exports, manufacturing, and fixed asset construction. Eventually growth will be 65% (rather than the current <40%) driven by household consumption. But householders continue to save earnings and although retail spending is rising over 10% a year this is not fast enough to take up the slack left by other sectors weakening.

China is stuck in an interim period between growth drivers and one cannot know how long it will last. The problem is made worse by weakness in house prices caused by excess construction, plummeting property development sapping revenue flows to local governments and making worse their high debt burdens, and high debts owed by developers exposing China's banking system to potentially large losses.

However, while five cuts in interest rates have yet to have much impact, there is still near 4.5% worth of rate cuts which can be made if the Chinese economy slows precipitously. Fiscal coffers in Beijing also remain good, and as Japan has shown, when your debt is largely internally financed you can keep building more and more concrete and steel things to underpin growth for a great number of years. The difference with Japan is that China has massive household consumption growth to eventually come. Japan does not.

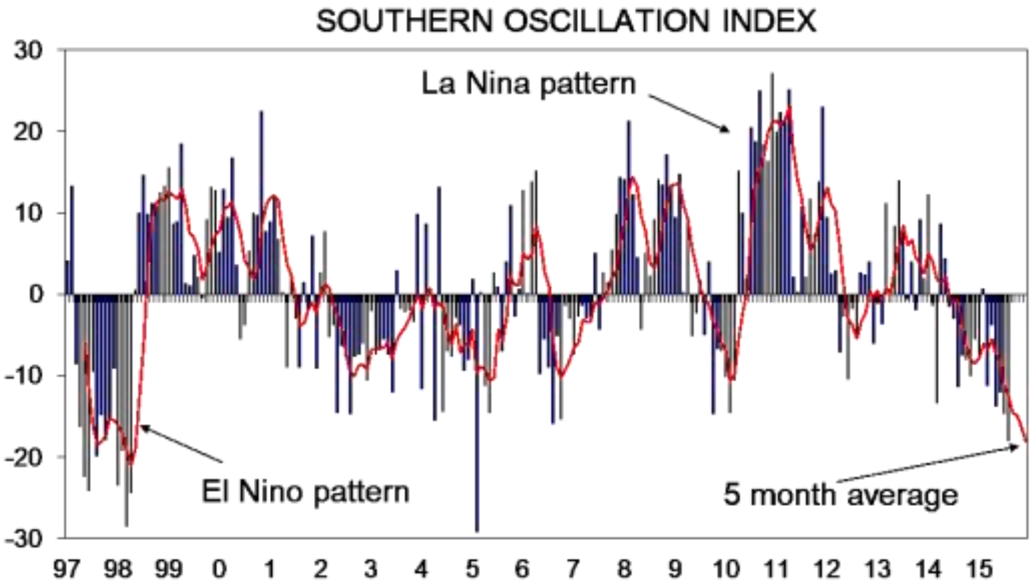
China's cheap labour/internal migration/infrastructure boom has ended and the economy will undergo adjustment issues for some time. This will place a cap on growth in Asia more widely, Australia, and here. But the size of China's market will continue to grow and rising middle incomes particularly leave still valid the prevalent commentary in recent years regarding rising demand for safe food of good quality and other such goods and services including tourism.

5. New Zealand is a commodity exporter and we sell our largely unprocessed products to the highest bidder. China has been that bidder in recent years. To have expected dairy and other farmers to have accepted lower incomes since 2009 in order to altruistically spread NZ Inc. export risks over a wider base in the interests of supporting the entire community is ridiculous.

6. As highlighted in Sporadic 16 released on July 30, while weakness in dairying is highly negative for our economy, plenty of other sectors are doing well. Our BNZ Confidence Survey released yesterday http://tonyalexander.co.nz/wp-content/uploads/2015/09/BNZ-Survey-Results-September-2015.pdf revealed plenty of non-dairy exporters reporting higher sales following the recent fall in the NZ dollar.

E.G.
"A very busy first five months of the financial year, and international sales greatly assisted by falling NZD.
Some growth in Flexible Packaging with drop in NZD...
NZ$ depreciation has helped; at these exchange rates we secure more global (offshore) work than we can cope with.
Also exchange rate is favourable and some competitors have dropped the work rights so we are flavour of the month in some markets.
...tight in NZ but lots of opportunities off shore helped by exchange rate
Weaker exchange rate having a very positive impact."
And so on.

Recession for NZ resulting from dairy and China weakness is still a low probability scenario – though one would be foolish to rule it out given the developing El Nino weather pattern and much uncertainty still surrounding the Chinese economy.

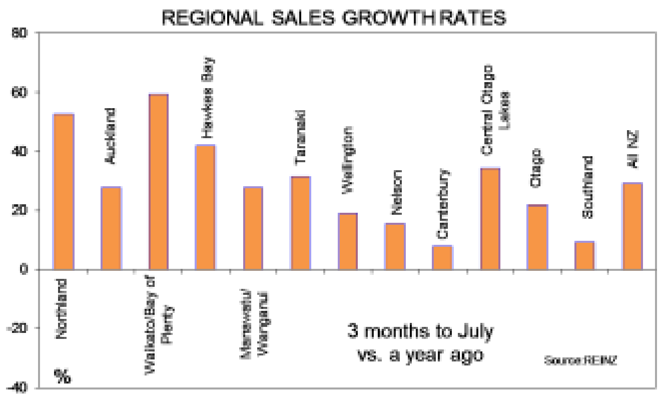


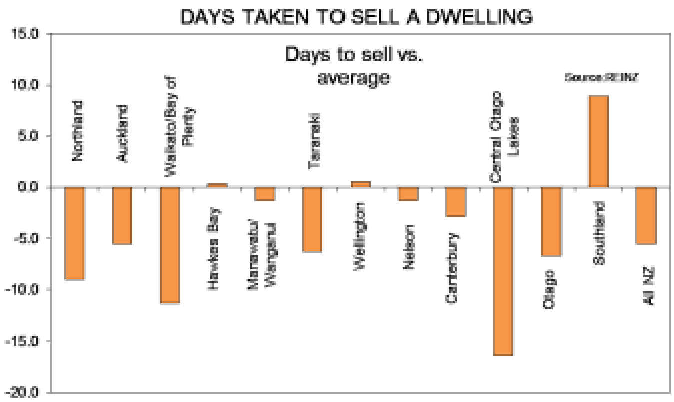
7. On a couple of other issues, China is not the sole source of downward pressure on our dairy export prices, which even after the 10.9% rise in last night's limited supply auction still sit 32% down from early-March levels and 58% below their peak.

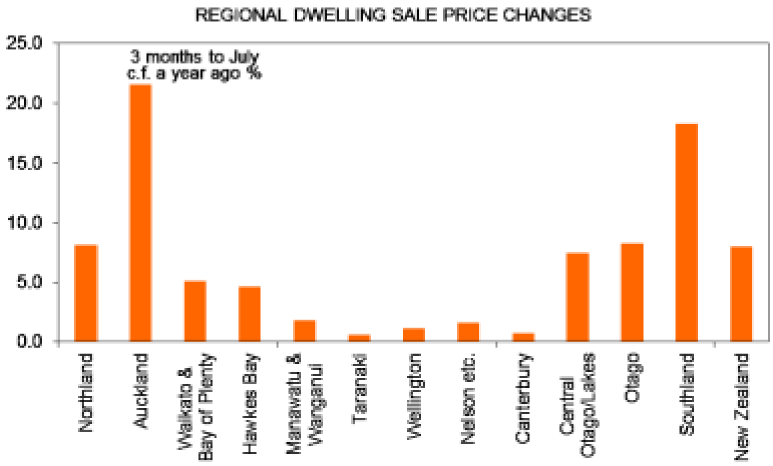
The long list includes these factors.

- Higher production to come from Europe as a result of production caps ending in April.
- Higher production to come from the United States because of cheaper oil causing lower prices for biofuels causing lower demand for biofuel inputs causing lower input costs for beef and milk feedlots.
- Higher production in any country in the world able to run cows because we are not the only ones clever enough to see the rising demand coming from China's increasingly wealthy families.
- Falling demand from OPEC countries hit by weak oil prices.
- Rising production in New Zealand (though falling this season) and the never-ending focus on bulk milk production, drying and bagging rather than adding value.
- Russia's ban on imports of Western food products (though we are excluded).
- High dairy stocks in China – though no-one seems to know how high.

8. The other issue I wish to mention is the growing volume of evidence regarding housing strength shifting away from Auckland to the regions – all of them it seems except Christchurch which is now over-supplied with houses and facing weaker than expected CBD construction.





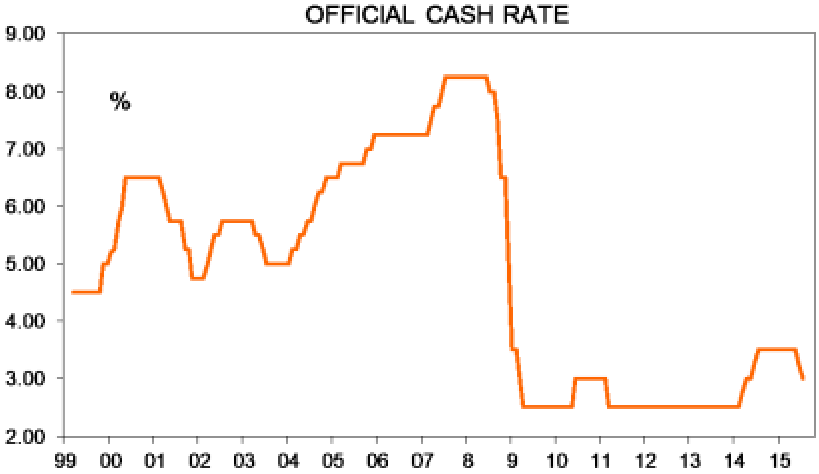


(Does anyone else think the regional price change graph above has an interesting shape?)

Note not just the 30% deposit requirement for Auckland investment property purchases from November 1 plus the requirement for all foreign buyers to supply an IRD number and the imposition of capital gains tax for all investment properties sold within two years of purchase. Two days ago IRD invited submissions on their plan to introduce in July next year a withholding tax on all sales of property by foreigners at the lesser of 10% of the purchase price or 33% of the profit. Plus annual Auckland dwelling consent numbers have now reached a ten year high of 8,530 and every fortnight seems to bring announcements regarding more land being freed up.

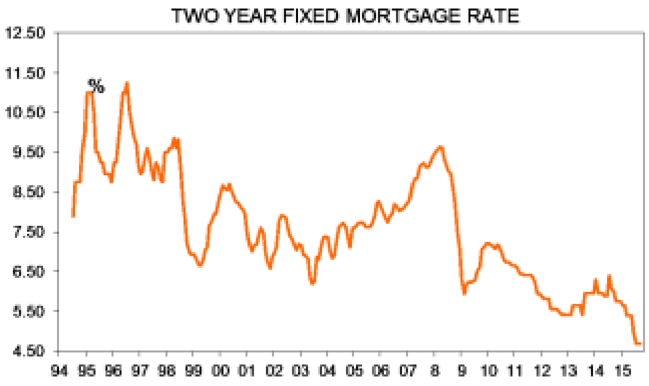
The Auckland shortage will persist for many, many years. But the period of easy gains has ended now and for the next two years prices will rise at a less stellar rate than the 20% or so achieved in the past year.

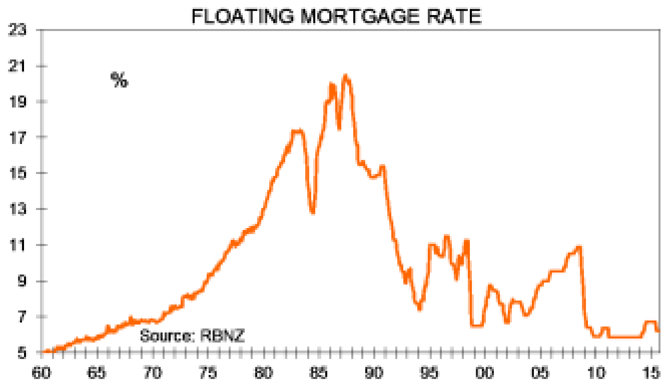
9. Expect to see the Reserve Bank add further fuel to the nationwide housing market with a 0.25% official cash rate cut on September 10, then another one in late-October. If they cut beyond that it will be because things largely international will be turning out worse than we are currently expecting. But watch for additional delaying of the planned easing of LVR rules outside Auckland. The RB are probably right now wishing they never mentioned the regional easing back in May.



If I Were A Borrower What Would I Do?

Our central bank is unlikely to raise interest rates for quite some time which suggests floating is good. But floating rates sit above short-term fixed rates so my best option would be to fix in the one to three year area. Personally I like our two year rate at 4.69% though would ask to see if I could get the three year rate below 5% which I have noted as desirable since February.





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Sporadic is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The views expressed are my own and do not purport to represent the views of the BNZ. Please sign up at www.tonyalexander.co.nz
To change your address or unsubscribe please click the link at the bottom of your email. Tony.alexander@bnz.co.nz