

Sporadic

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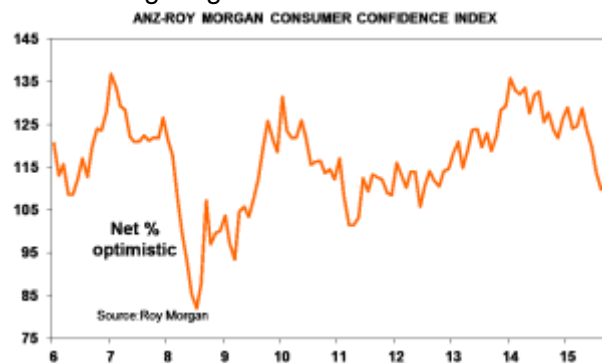
A Summarised Outlook and Situation Report

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I give regular briefings on the economic situation to BNZ staff and in my latest briefing this week these are some of the things I invited people to be aware of.

Our economy continues to grow with improvement of 3% in the year to June but the pace of growth has slowed down from an average of 0.8% in the September and December quarters of 2014 to just 0.3% in the March and June quarters of this year. Given that agricultural production did an unsustainable recovery in output during the most recent quarter, and considering the strong 1.9% growth in population in the past year, one can reasonably say that underlying per capita growth has just about stalled recently.

This near stalling would gel with indicators such as falling business and consumer confidence. Sentiment of consumers is now below average with the monthly ANZ Roy Morgan measure at 111 in September which is below the ten year average of 117 however not horribly so and the reading was an improvement from August's four year low of 109.8. That tells us that people are not feeling exuberant but they are not indicating that they will be closing their wallets in the near future. Retailers can have expectations of a reasonable Christmas spending period but no strong surge.



Why has growth slowed down and why do we see the annual pace slipping below 2% next year? There are the pluses which we have highlighted here many times of the lower NZ dollar and reversal of monetary policy tightening, along with good performances in most non-dairy export sectors, strong construction and the boost from above average population growth. However the story for 2015 is mainly one of negatives appearing and that is what we should be paying most attention to for the remainder of this year.

So lets run through some of the things occupying the minds of many people currently, starting with the United States. Growth in the US is okay with good growth in employment in particular with full-time job numbers regaining their pre-GFC peak (we are ahead 6%). But there is no evidence of an acceleration in the pace of wages growth, the sharemarket is well off its peaks with some obvious continuing wobbles and worries about high valuations, businesses remain reluctant to invest, and the rising US dollar is sapping some export sector strength.

Encapsulating the more cautious mood regarding the US economy was the Federal Reserve last week which decided not to raise interest rates for the first time since 2006. Specifically the Fed. cited worries about the Chinese economy.

China is failing to make the desired transition from growth being driven by exports, investment, and house building to private consumption. In fact there seems little hope of this happening in the near future with worries about falling house prices amidst estimates of potentially 22 million empty apartments, huge sharemarket wobbles and weakness, and absence of welfare, education, and health reforms which would encourage people to reduce their high savings rates.

It has become commonly accepted now that China's growth numbers are works of fiction and estimates go as low as just above 3.5% for growth rather than the reported 7%. Recession in China in the near future is unlikely. But the monthly numbers continue to get worse and it is likely that after five cuts in interest rates since late last year, extra infrastructure spending, and easing of housing sector constraints that there will be further stimulus measures announced. Risks for now however lie on the downside and more attention is on China's immediate growth prospects than prospects for any other country.

That includes Japan where growth numbers are also coming in weaker than expected, inflation is falling away again and analysts openly talk of money printing failing and the third arrow of Prime Minister Abe's economic policy – deregulation – not being big enough. Perhaps the Brace Blossoms' rugby performance this week shows what the Japanese economy might be able to achieve if it opened itself to the presence of more foreigners.

In our second biggest export destination of Australia growth is commonly seen chugging along above 2% with good growth in non-mining sector investment offsetting the ending of mining investment associated with the commodity super cycle which has now ended and probably won't return for a generation. Dwelling construction is strong in Australia and businesses might have gained some hope that economic reform will be undertaken following the change in leadership of the governing party. However the new leadership's ability to get legislation through the Senate may be as poor as the previous top team so the chances of Australia boosting productivity, cutting its relatively high labour costs, and boosting output in the near future still do not seem all that high. (This is highly relevant for our migration flows – discussed below.)

But with the NZ dollar settling below 90 cents for now many NZ exporters can have a reasonable expectation of good sales of goods and services across the ditch in the coming year.

In Europe forecasts have actually been raised ever so slightly recently by the likes of the OECD. But still growth of only near 1.5% is expected and the opportunity afforded to governments by the sense of crisis surrounding the GFC to introduce deep economic reforms has been blown. The financial sector remains bogged down with insufficient levels of bank capital, banks retreating to focussing on their home countries, labour markets remain rigid, debt levels are still high and rising, and as is the case with most other parts of the planet the ability of the Eurozone to cushion the economy in the event of a shock – such as a Chinese recession – is minimal. Interest rates are already near zero and money printing since early this year has failed to drive growth or even inflation upward. There is now open speculation that the European Central Bank may extend money printing beyond the current planned end-date of September 2016.

Russia and Brazil are sinking into deeper recessions as the effects of corruption and plummeting energy export receipts wash their way through their economies. India is okay.

The world economy is growing at a slightly below average pace with downside risks which the IMF and World Bank are likely to highlight next month when they update their economic outlooks. We should keep an eye on developments offshore, and as noted, in China in particular.

On a positive note dairy prices on the Global Dairy Trade auction site have improved 48% in the past three auctions – which just goes to show that we cannot actually use the auction results in any strong way to gauge what the payout is likely to be for the season. There is too much volatility. But at least for the moment it is now looking like this season will have a marginally higher payout than last season. Dairying will nonetheless remain a drag on the economy this coming year through 2016.

Another drag, almost, is construction in Christchurch. The reconstruction period took longer to get started than we all thought, but it seems to have peaked earlier than we were all thinking. An over-supply of houses appears to have developed with part of that being a price mismatch between what earthquake-displaced people can afford and the new houses which have been built.

Up until recently we thought rising commercial building would more than offset the residential construction decline which is now underway and likely to persist for maybe three years. But the feedback coming out of the

commercial sector is that construction costs are so high and so many businesses have either got comfortable outside the CBD or have already signed up to new premises in the inner ring outside the CBD that they are unwilling to pay the prices developers need in order to go ahead and get their projects rising from the earth. And with the infrastructure rebuild over 75% done probably the best we can expect is a plateau in Christchurch construction activity in the coming year. The risk however is that the city becomes a negative contributor to GDP – which is not a bad thing necessarily, it is just happening sooner than most of us were expecting, by around two years.

Four Points On Housing

In the housing market the four interesting things I have been pointing out in seminars are these.

Buyers Purchasing Out of Auckland

First, buyers are in a rush to secure property outside of Auckland, attracted by better yields, lower prices, absence of six years of big price hikes, and underneath all that a view that there is a catch-up in prices due in many places. I agree. History tells us this flow will stay strong for the coming year (assisted by low interest rates), that it will lead to a rise in house building outside of Auckland, and that in smaller locations some late-cycle buyers will be badly caught out. But that is something for perhaps a couple of years from now. For the moment the excitement in the housing market has shifted outside of Auckland.

Offshore Chinese Backing Off

The second interesting housing market development is a plethora of anecdotes – and nothing more than anecdotes – of Chinese offshore buyers pulling back from the Auckland market. None are running scared and no-one has any stories of properties being sold. But some deals have been walked away from and the buyers are seeing too many little roadblocks being put in their way. None by themselves are deal killers - but the gestalt is becoming compelling.

- NZ IRD and foreign tax identifiers required from October 1
- Two year capital gains tax bright line test
- Consultation underway on a withholding tax from perhaps July next year
- 30% minimum investment property deposit (not relevant for many buyers who have cash).

Note that it is not just offshore Chinese backing away from Auckland at the moment. Inexperienced, under-capitalised people who were entering the housing market from early this year feeling that they had to buy any old piece of crap to avoid missing out on “easy” money have also backed away - thank goodness. The figures do not show this yet, but they probably will before the end of the year.

Speaking of figures, some showing the surge in housing activity since early this year are contained in lending data. The annual pace of growth in total household debt has accelerated to 6% in July from 4.8% in January. This is the fastest pace of debt growth since late-2008.

Migration is Huge

Third, given that population growth is an obvious factor influencing housing markets the fact that net migration inflows continue to go through the roof is supportive of markets all around New Zealand, though more so in Auckland which garners around 60% of the net flow. Data released on Monday show that the country's annual net gain has risen to 60,300 in August from 59,600 in July and 43,500 a year ago. In seasonally adjusted terms the net monthly gain appears close to plateauing, suggesting the peak annual flow may end up very near 65,000 or a 1.4% population boost. In fact since flows turned positive in mid-2012 the population boost adds up to a total of 2.6%.

For your interest, here is a table showing the net migration flow for each region since August 2012.

| | 2012 Population | Net migration Flow 2012-15 | Net Flow as % Population |
|-------------------|----------------------------|---------------------------------------|-------------------------------------|
| Northland | 163500 | -52 | 0.0 |
| Auckland | 1476500 | 54,768 | 3.7 |
| Waikato | 421500 | 2,369 | 0.6 |
| Bay of Plenty | 278800 | 1,148 | 0.4 |
| Gisborne | 47000 | -328 | -0.7 |
| Hawke's Bay | 157500 | -232 | -0.1 |
| Taranaki | 112700 | 777 | 0.7 |
| Manawatu-Wanganui | 231200 | 818 | 0.4 |
| Wellington | 485100 | 2,385 | 0.5 |
| Tasman | 48600 | -41 | -0.1 |
| Nelson | 48200 | 642 | 1.3 |
| Marlborough | 44600 | 248 | 0.6 |
| West Coast | 33100 | 69 | 0.2 |
| Canterbury | 556000 | 15,938 | 2.9 |
| Otago | 207400 | 2,910 | 1.4 |
| Southland | 95900 | 1,054 | 1.1 |
| NZ | 4408100 | 116,621 | 2.6 |

Back to the record net national migration gain of over 60,000 - here is the question to be answered. How fast will the turnaround in flows be? Given that economic expectations offshore are deteriorating, and that in Australia especially there is no sign that growth is about to take off, it does not seem reasonable at this stage to expect that the easing of the net migration gain will be sudden. Migration flows are likely to remain a stimulatory factor for our economy over the next two to three years. This will support the housing market in particular and suppress wage rises yet again while keeping the unemployment rate elevated while jobs growth likely remains firm.

Back To The Fifties

The fourth housing factor needing to be highlighted, which has huge relevance outside of housing, is the continued deterioration in expectations that borrowing costs are going to go up to any appreciable degree in the near future. In the United States last week the Federal Reserve expressed concern about the Chinese economy and decided not to start raising their 0.25% funds rate. The European Central Bank has openly opined about extending money printing because inflation shows no sign of approaching 2%. Our own central bank not only cut the cash rate another 0.25% two weeks ago, they also sounded more dovish regarding future growth, inflation, and the interest rates track than the markets had been expecting. A range of central banks are likely to ease their monetary policies in coming months.

Given that high inflation tends to beget high inflation expectations it seems reasonable to expect that low inflation globally will beget low inflation expectations – and falling ones at that in many parts of the world. Low inflation is starting to get locked in, especially as businesses say they are getting less pricing power as consumers use modern technology to search for better prices when buying something.

The chances are strong that just as all forecasts of a decent sustained hike in interest rates anywhere on the planet these past eight years have been wrong, so too will similar forecasts for the next one to three years. Frankly it seems best to stop thinking in terms of interest rates rising but not quite getting to levels of the 2000s, and instead think in terms of the post-WW2 period through to the early-1970s. Floating mortgage rates averaged less than 4% in the late-1940s. They crept slowly higher and two decades later were just over 6.5%.

NZ floating rates are likely to reach an average near 5.75% within two months. Fixed interest rates in many cases will be over 1% lower than that. Welcome to the fifties – but without the milk bars and winkle-pickers.

Low interest rates are supportive of debt-funded asset purchases. Property. Equities are supported not by low purchase funding costs but the search for yield outside of fixed interest and call rate products. Notice the double positive whammy then for housing – yield search, purchase cost.

Miscellaneous

NZ Dollar

Risks for the moment lie on the downside, associated with weakish dairy prices, El Nino risk, US interest rates likely to rise next year, NZ GDP growth slowing. But speaking with people who have travelled in offshore business and investment circles recently it is clear that NZ is viewed as a nice, safe, reasonably yielding part of the world to place one's funds and gain some primary product exposure to long-term growth associated with improving Chinese and Asia consumer buying. The Kiwi dollar is unlikely to drop substantially below current levels. Personally speaking below US 60 cents looks attractive, as does below 87 Aussie cents, 39 British Pence.

Oil

As global growth forecasts and predictions for Chinese growth in particular get scaled back, oil prices have been falling anew. It is true that US shale oil production is likely to back off quite a bit in the coming year as capital supply dries up. But ready-to-tap inventory in the ground looks strong, Iran's oil is likely to hit world markets in the coming year, and OPEC cohesion seems minimal. No-one talks about Peak Oil any longer, new huge gas fields seem to appear every few months, Japan is slowly restarting nuclear electricity production, and ever so slowly solar energy collection becomes more efficient.

Energy costs look like remaining low for many years. Hence the coal industry faces continued bleak times, the energy exploration and development sector faces many weak years, and you and I slowly will think about doing the opposite of what so many other people are doing and we will buy bigger cars (SUVs) rather than those little ones that seem to be populating our roads like midges.

Dead Wood

The world is awash with liquidity. That means lots and lots of people, managed funds, companies, are looking for places to store their cash and hopefully earn a reasonable return. Were New Zealand's capital markets more sophisticated than they are we could be attracting huge quantities of funds into our country to back our many ventures – rather than just a handful of large one-offs. Somewhere out there a managed fund is willing to back your Angora bunny farm.

Taking this angle when discussing the world awash with cash sounds positive. But there is another angle. When finding investors globally was harder, and the cost of funding ongoing losses higher, businesses would get weeded out at a faster pace. Now, the dead wood clings on for longer. It is taking longer for businesses with bad ideas/management/products etc. to be capitalistically weeded out and their assets freed up for others to use.

Global productivity and therefore income growth is slowing down. This will exacerbate worries about the absence of income growth for individuals and households in many countries, retard even further the growth prospects and opportunities for reform in Europe particularly, and reduce the speed with which the growing divide between rich and poor can be narrowed as gains from growth are distributed further down the income ladder.

Consider the New Zealand case. NZ business profits are being squeezed with rising import costs but inability to pass on such rises, plus wages rising faster than 0.4% inflation. Eventually the economy will be ready for another bout of business cleanout. Previously high interest rates might be the trigger, but not now. So companies past their use-by date will hang around a lot longer, sapping growth and raising debt risks.

Unpredictability

This is a theme I have discussed strongly in recent months. In fact five and a half years ago I noted that a person would be foolish to develop an interest rate risk management strategy reliant heavily upon any particular set of interest rate forecasts proving correct. Post-GFC the world has changed and old relationships between key economic variables like interest rates and consumer spending, employment growth and wage rises, money supply and inflation no longer hold. The economic forecasting models run by central banks, private firms etc. are no longer accurate. Throw in the effects of unpredictable technological disruption (oil, music, taxis etc.), changing fashions, the guessed-at effects of aging populations, geopolitical shocks, and weather events and you have a world where relying strongly upon forecasts is dangerous.

Businesses need to place priority on identifying trends not highly at risk of disruption and error (e.g. rising demand for safe, quality food from Asia), get close to customers to identify changes and new competition as soon as possible, stress innovation in production processes, and build flexibility in costs and practices while building resilience to the changes we have no hope of predicting.

If I Were A Borrower What Would I Do?

Banks are competing strongly with discounted short-term fixed rates so that is where I would look.

Sporadic Library

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