

BNZ Weekly Overview

5 November 2015

ISSN 2253-3672

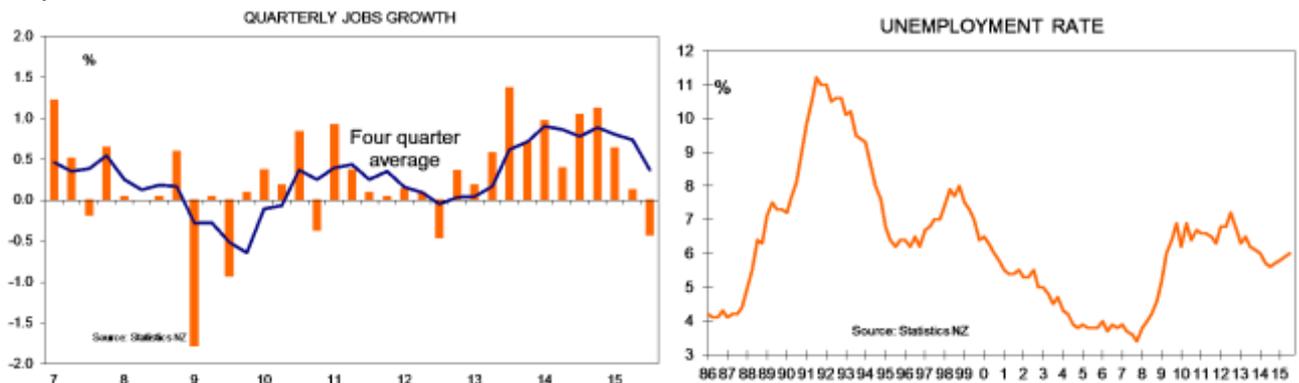
Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

Labour Market Reflects Early Year Sentiment Collapse

This morning the main gauge of how our jobs market is doing was released. The Household Labour Force Survey tells us through survey-based estimates the number of jobs created in the most recent quarter, how many people are in the workforce, how many are officially unemployed and so on. Strong jobs growth is considered a good thing by just about everyone except employers struggling to find staff, and anyone opposed to whichever political party happens to hold the reins of power at the time.

What we learnt this morning is that courtesy probably of the collapse in business sentiment earlier this year job numbers fell by 0.4% during the September quarter. This was the worst result since a 0.5% fall in the middle of 2012. Job number declines are relatively rare and we don't see this as the start of a downward trend, especially given the many comments we get from firms regarding their inability to find the staff which they want.



Labour demand is strong and this can be seen for instance in the ANZ Business Outlook Survey where year ahead employment intentions have lifted to a net 12% positive from 3% in September. The average reading is 6%. Earlier this year the reading was +23% and the decline to only 3% helps explain the jobs decline last quarter. The more recent rise suggests employment will bounce back in the current, December, quarter.

The unemployment rate moved up to 6% from 5.9% which is actually quite a small rise considering the fall in employment and strong migration-driven population growth. The country's working age population rose 0.6% in the September quarter and was ahead 2.2% from a year ago.

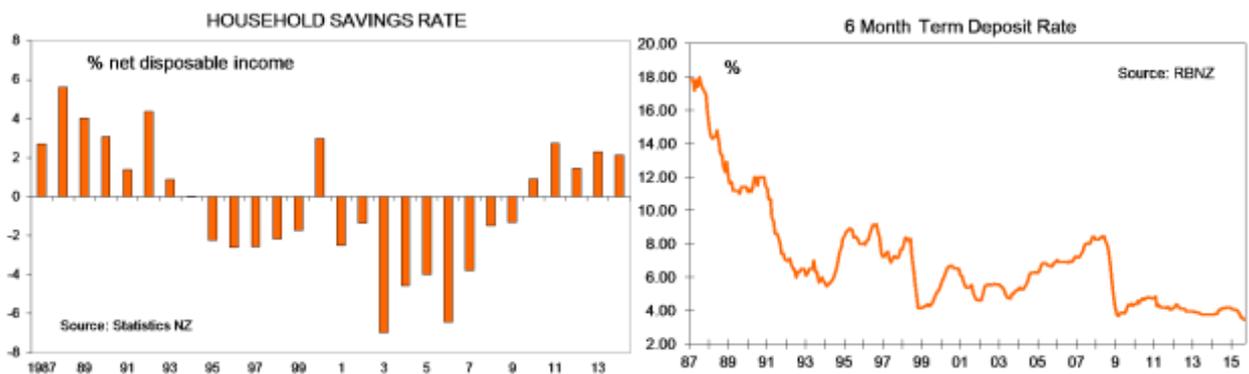
Does the weak result mean the Reserve Bank made a mistake not cutting interest rates last week and they should have injected some stimulus to the economy? The risk is certainly very strong that they are continuing their post-GFC habit of over-estimating inflation, and as noted last week personally I would have cut the OCR one last time. But the key point to be noted regarding these labour market numbers is that they are a lagging indicator of the NZ economy, not a leading indicator. They reflect what happened earlier this year and do not tell us what will happen six months from now. So our central bank will pay more attention ahead of the next rate review on December 10 to business and consumer spending measures, confidence gauges, currency changes, and inflation predictors than this week's jobs report. A rate cut come December is probable.

Housing

Last week I invited you to give thought to the impact of increasing life expectancy on demand for investment property. Basically the longer people expect to live the greater their ability to recover from a financial shock and the longer the payoff from investing in an asset which produces both growth and capital gain. This aspect of increasing life expectancy is probably still in its infancy but will attract more discussion in coming years. Something which has been with us and having a strengthening impact for over a quarter of a century however is the message to get ready for retirement.

Consider the first baby boomers born in 1946. In 1976 they were 30 and focussing on getting through oil crises, come 1986 they were 40 and getting toward peak career earning periods. But with share prices crashing in 1987 along with the property market, and governments shifting their fiscal policy planning focus from the year ahead and the electoral cycle to a ten year period at least, we started to see discussion of the cost of providing pensions for the retiring baby boomers.

Very quickly from the early-1990s the message started to go out in official government campaigns and advertising by financial service providers that people needed to save money and prepare for their retirement. So maybe they did, although the savings data do not show this. Check out this graph of the NZ household savings rate.



So did newly fearful baby boomers start jumping into shares having seen their dreams of early retirement through share clubs of the 1980s collapse in the 1987 crash? Definitely not. Did they start ramping up cash in term deposits? No. In 1991-92 there was a huge structural adjustment in the average level of interest rates in New Zealand as inflation settled down near 2% following some painful years of the Reserve Bank getting price rises under control. Those people seeking fixed returns flocked to finance companies and we all know how that ended up terribly for so many of them.

Lets just put it in black and white here. The clever and/or lucky ones started building up their wealth through investing in housing. They have done extremely well by ignoring anyone talking about overvalued markets, low yields, brain drain and so on.

So now to the present day where we still have the message that people need to prepare for their retirement, but it is less shrill, more professionally argued, and either not a focus for young people trying to save a home deposit, or those already with a house figure Kiwisaver will take care of things for them. Plus we have seen any party advocating raising the retirement age or cutting national superannuation getting slammed in the polls. Labour hold their annual conference in Palmerston North this weekend and on the agenda apparently will be dropping their policy of raising the retirement age following criticism from leader Andrew Little that it contributed to their losing last year's election.

The conclusion of people and the position of the Prime Minister and Finance Minister is that taxpayer funded super will be kept in place with approximately the same arrangements as now. The scare stories probably no longer work, especially as young and middle aged people see reports of surveys showing how very happy old people are, and how they get happier as they get older! That is not the message given from the early-

1990s when the image was painted of a decrepit dystopia for all those who failed to save up money in managed funds to supplement their pension.

So what does this all mean for the housing market in the next few years?

- The increasing appreciation of how happy old people are according to surveys,
- the high sustainability of the current national superannuation system according to our two most senior cabinet ministers, and
- the growing belief that Kiwisaver will take care of any extra retirement expenses,

mean the incentive to save for retirement has diminished. But offsetting this is

- the expectation of a lengthening period being spent in retirement reliant upon non-labour income,
- adjustment to the very slow capital accumulation generated by investment in simple savings products, and
- hopefully awareness that big financial crises come along near once a decade

The need exists for preparation for funding one's retirement through a diversified asset portfolio containing more growth assets heading into the traditional retirement age of 65 than was the case previously. This argues in favour both of property and managed funds. Housing investors should be careful not to become overly weighted toward property. Those favouring shares should be careful not to underestimate the cash flow benefits of continuing rental income when equity prices fall 30% - 40% as they do every now and then.

Auckland Housing

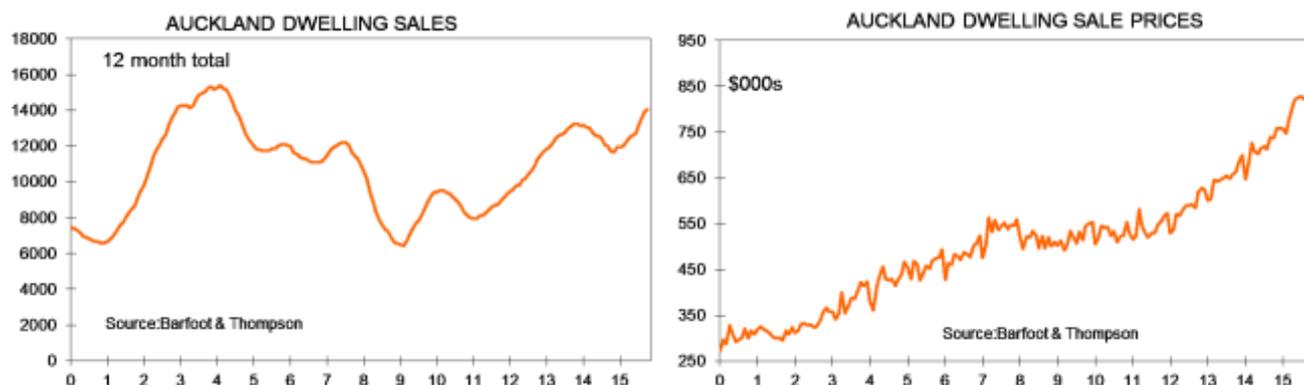
Just a quick comment here regarding why there is such high demand from young people to live as close as possible to the city centre which is where many people work – increasingly so as Auckland becomes more of a centre for agglomeration-driven innovation. Commuting in Auckland is difficult and if you are reliant upon trains to get around you face a problem. Sometimes it feels like you could walk faster to your destination than stay on the train.

Three months ago I took the train from Britomart to New Lynn some 12 km away. It took half an hour at very slow speed. This week I took the train in the other direction. It took 40 minutes with the train waiting for a few minutes first at Newmarket then just outside the Britomart tunnel. That is an average speed of 18kph. New York's average speed I understand is about 29kph, London's Underground 33kph, Tokyo 36, Sydney 43.

Getting to New Lynn from the CBD two hours before heading back in the train I took a taxi. It took just over ten minutes and cost \$40. Taking the train saved me \$36 but cost me an extra 50 minutes in total door to door. I can see why people seem to still prefer commuting in their cars and why avoiding commuting may spur an eventual extra lift in demand for city apartments.

Regarding housing data, this week the monthly Barfoot and Thompson Auckland numbers were released. They show that in October sales were ahead 14% from October 2014 but this followed over 40% gains in September, August and July. We need to be careful however with these annual comparisons because last year activity cooled off ahead of the general election on September 20 then took off afterward with confirmation of a returned National government rather than victory to Labour and a range of promised new taxes.

In seasonally adjusted terms sales fell 20% in October so there may have been some buying ahead of rule changes from October 1. It will take a few months for the data to settle down and allow us a better picture of the underlying level and rate of growth in sales but it would be surprising not to have things generally quietening down given the measures introduced specifically to achieve that.



The average sales price edged up to \$840,000 in October from September to be 14% ahead of a year ago and up 0.9% in the three months to October from the three months to July. Three months ago this rate of price gain was 6.3%, six months ago 2.4%, and nine months ago 3.9%. So price growth has slowed down after accelerating late last year.

Dwelling Supply

Demand for housing is rising around New Zealand as populations grow, especially in Auckland, and old houses need replacing. How is new supply going? On average in each of the past 20 years consents have been issued for the construction of 22,500 houses. The total in the year to September was 26,200 so new supply is growing at a pace almost 17% above average. This is good news and given the efforts being made in Auckland to speed up house construction this number is likely to rise further, though there will be downward pressure from the ending of the residential construction boom in Christchurch.

In Auckland consents totalled 8,700 in the past year which is 15% above the 20 year average and rising at an annual growth rate of near 22%. This is good, but if we were to allow for growth in Auckland's population in the past 20 years then we may only be at the growth-adjusted average still. The housing shortage in Auckland is not yet improving and that bespeaks of good support for prices going forward though with a rate of appreciation lower than in the past year given buyers backing off in response to recent regulatory changes.

NZ Dollar

The weaker than expected employment numbers released yesterday morning plus the 7.4% fall in average dairy prices at the latest auction caused the Kiwi dollar to lose around one cent US. But apart from that blip one can continue to say that our currency is still going through a firm risk-on phase. As noted last week this involves investors around the world feeling others feel they feel others feel that things are okay so it is safe to buy high beta assets like commodities, equities and far flung currencies.

At some stage this risk-loving phase will pass and a bout of the heebie-jeebies will cause our currency to weaken again. I have no idea when that will happen. For now the NZD still seems well supported. Watch for the US non-farm payrolls report on Friday night which could cause a change in expectations of monetary policy tightening in the United States and thus alter USD support.

If I Were A Borrower What Would I Do?

I gave a presentation to a large group of people interested in the residential property market in Auckland last week and the usual question came up regarding interest rates. Specifically many people were quite fixated on if and when the next cut in the official cash rate would come because they want to lock in at least a two year fixed rate at the lowest level possible.

That makes sense from a cost minimisation point of view. But if you are one of these people and you are sitting there floating waiting for the low point in the cycle let me offer some thoughts for you to ruminate on.

First, we economists have proved since 2007 that we cannot accurately forecast low and high points in short-term interest rate “cycles”. Too many times we have decided that a low point has been reached, advocated fixing as long as possible, only to see interest rates either keep falling or to rise as expected but then go to newly low levels. Be careful about relying too much on what we think the Reserve Bank will do in the next few months. It is where the focus of so many economists lies and what we talk about more than any other thing. But talking and fixation do not translate into accuracy.

Second, even if people like me were really really confident about the low point in the rates cycle you may not want to lock most of your mortgage into one fixed term. Predictability of many things has plummeted since 2007 and you should consider allowing for that by keeping some of your debt floating and the rest at a couple or even three fixed rate terms.

Third, if picking the bottom is the thing you are fixated on, try this perspective. No sane person ever said until recently that we should expect NZ borrowing costs to fall back to levels of the 1960s. For borrowers these interest rates are astoundingly low and for those of us who have borrowed in the past we have the benefit of perspective which new borrowers do not have and which means when we fix a rate slightly above the low point we don't lose any sleep. That is because we remember paying 18.5% in September 1987, or even higher. To us there is little meaningful difference between 4% and 4.5% beyond bragging rights. Its a complete gimme!

For younger borrowers maybe one-quarter of a percent makes a big difference. Can I politely suggest that if the viability of your purchase is highly dependent upon whether you lock in at 4% versus 4.5% that you probably should not be buying the house in the first place. There is a risk that when your two year rate matures borrowing costs will be higher than they are now. If you couldn't service a rate of 6% then don't buy. Personally I don't think costs will be 6% in two years. But then again I did not pick these amazingly low rates a year ago – especially in the context of all of us expecting higher rates on the back of further rises in the official cash rate from 3.5% and tightening monetary policy in the United States pushing fixed rates upward.

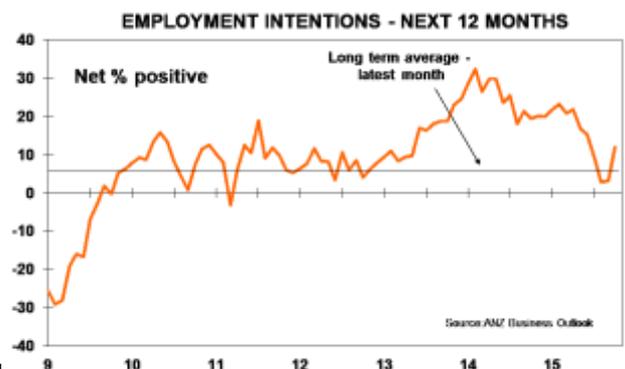
For Noting

Pessimism Evaporates

Between March and August this year when international dairy prices were falling rapidly, one or two journalists and Opposition MPs started predicting that the economy was heading into recession. But such predictions never really gained momentum because of two factors. One, the stimulus to growth coming from many other things including the lower NZD and easing monetary policy plus non-dairy exporters doing well and a construction boom. Two, the high probability that the collapse in dairy prices would get overdone and there would be a price recovery.

There has been such a recovery though it pays to remember that prices are still half of what they were at the peak of two and a half years ago. The recovery however coupled with the absence of the business and consumer spending collapse some chicken litters seeking a change in government prophesied has produced lifts in measures of consumer and business sentiment.

The most recent of these was the monthly ANZ Business Outlook survey released on Friday which showed that in early-October a net 11% of surveyed businesses were optimistic about where the economy would be in a year's time. One month earlier this



reading was a net 19% pessimistic and in August it was 29% pessimistic. So sentiment has bounced up quite well and it now sits at the average reading for October seen in the past ten years. If you had no other numbers to go on you would say that implies economic growth in the coming year of 2.5%.

There were improvements also in the various subsidiary measures which we like to look at. The net proportion of businesses planning to hire people jumped up to 12% from 3% in September. This is still down from 23% in February but well above the average reading this past decade of 6%. So good jobs growth remains in prospect and that is the sort of thing which leads us economists to say consumer spending growth prospects look reasonable and that wages pressure will eventually develop.

We also saw in the survey a net 12% of businesses saying they plan to raise their capital spending levels. This was up from 7% in September but again was below the February reading of 22% and above the average October reading of 9%. So this is the sort of thing which makes us feel good about growth being sustained in the medium to long term. Business investment tends to raise productivity as new technologies are embraced and perhaps capacity is expanded.

All up, the survey validates the story we have been running since early this year of there being plenty of factors to support growth in our economy beyond just dairying.

Your Mortgage Risk Has Shifted

Before financial deregulation of 1984-85 the risk associated with having a mortgage was getting one in the first place. Credit was rationed so you had to have a good relationship with your bank built up through having a good savings record stretching over a number of years. Deregulation changed that, credit availability boomed, but previously steadyish interest rates went on a grand roller coaster ride.

We are now heading back to the pre-1984 environment. Your interest rate risk is much lower than at any period since 1984. The world is facing deflationary rather than inflationary pressures. Central banks remain largely worried about their economies' growth prospects so they are keeping interest rates low and fear the unknown impact post-GFC of raising rates.

But while they keep rates low risks in asset markets are growing. They want to reduce these risks but can't use interest rates to do it. So they are experimenting with credit controls. They are returning to the pre-1984 era where your ability to access funds to do what you want is being tightened up. In New Zealand so far we have the loan to value ratio rules introduced in October 2013. We have the 30% minimum deposit for buying an Auckland investment property introduced last month.

This is just the start. If the Reserve Bank wants to slow not just the Auckland market but newly surging regional markets (they will let those markets have their head for a while), then they will tighten again – but not via interest rates.

Your challenge as a borrower going forward is shifting from managing your interest rate risk to getting the credit you want when you want it. So my question to you is this – how much effort are you putting into your relationship with your bank? At the moment we are trying our best to lend as much as possible to you. But in coming years our discrimination between borrowers will grow. Get ready.

The Weekly Overview 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. To receive the Weekly Overview each Thursday night 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

This publication has been provided for general information only. Although every effort has been made to ensure this publication is accurate the contents should not be relied upon or used as a basis for entering into any products described in this publication. To the extent that any information or recommendations in this publication constitute financial advice, they do not take into account any person's particular financial situation or goals. Bank of New Zealand strongly recommends readers seek independent legal/financial advice prior to acting in relation to any of the matters discussed in this publication. Neither Bank of New Zealand nor any person involved in this publication accepts any liability for any loss or damage whatsoever may directly or indirectly result from any advice, opinion, information, representation or omission, whether negligent or otherwise, contained in this publication.