BNZ 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.

So Many Problems Overseas

Since the start of this year share prices around the world have fallen sharply, oil prices have tumbled taking prices for other commodities with them, the Bank of Japan has introduced a negative interest rate, the European Central Bank is expected to ease again soon, and expectations of four rate rises this year from the US Federal Reserve have evaporated. Why the turnaround in sentiment?

There is no single factor accounting for the deepening heebie geebies but a gathering of many geographically dispersed things. An early trigger for the rout was the tightening of US monetary last year and uncertainty about what it would do and the risk that the Fed. might blindly continue to tighten regardless of current economic conditions. An underlying source of concern getting worse by the week now is weakness in China's economy, evidence of massive excess housing and factory capacity, worries about debt levels, and a weakening yuan pushed downward by massive capital outflows which are steadily depleting China's huge foreign currency reserves. Plus the lower the Yuan goes the cheaper Chinese products in foreign markets and the higher the risk of deflation in economies like Japan and the EU.

Japan's economy spluttered last year almost back into recession and faith in the efficacy of Prime Minister Abe's Three Arrows policy (easy fiscal and monetary policies plus deregulation) has evaporated. The Bank of Japan is engaging in unlimited money printing, businesses and aging households don't won't to borrow more money, government debt grows still, and the BoJ is now charging banks 0.1% to deposit money overnight.

Oil exporting economies are suffering badly because of the 70% fall in oil prices from 2014 levels, FX reserves are being run down, new taxes are being planned and subsidies targeted to be reined in, while unrest rises in the likes of Saudi Arabia. The Middle East is all but going up in flames in large portions and radical Islamism has taken hold in northern Africa. Prices of shares in energy sector stocks are tumbling and banks exposed to the broader energy sector are expected to take some hefty losses and hundreds of billions of dollars of planned investments in the energy sector have been scrapped. The same goes for investments in exploitation of resources of coal and iron ore. It is now also believed that sovereign funds of oil exporting countries are offsetting oil revenue losses by selling shares and thereby depressing global equity markets.

The European Union remains afflicted with rigid economies, a poor banking sector now getting slammed on sharemarkets, fiscal problems, migration digestion pains, an aggressive Russian neighbour, weak business investment, and a failing deflation fight even with a -0.3% central bank deposit rate which looks likely to be cut again. Perversely, according to some analysts any further rate cuts in Europe may tighten monetary conditions rather than loosen them as banks raise lending rates to compensate for lost margins from overnight deposits with the ECB.

This potentially self-defeating monetary policy is a bit like the theory that money printing during weak growth periods encourages rather than discourages deflation because extra money sloshing around means businesses stay open longer and keep flooding markets with their product and depressing prices.

There is also a rerating of the global tech sector going on with talk of a repeat of the dotcom crash of the late-1990s. Share prices have fallen sharply for the likes of Netflix, Yahoo, LinkedIn, Twitter, Yelp, Facebook, Amazon, Fitbit, eBay, etc.

Plus there are long-term lingering problems associated with the global financial crisis of 2008-09. Banks still need to raise more capital in Europe, hard core hard to change youth unemployment has worsened in Europe, fiscal and monetary buffers to use against any new shock are minor compared with capacity which existed in 2008, China's excess construction of just about everything as they fought the GFC from 2009 has been mentioned above, productivity growth globally has declined and wages growth has stalled in most economies, restructuring problems and strikes persist in Greece and a new crisis there could easily erupt.

And finally, following the major concerns of US monetary policy, China and oil, we now have major worries about banks overseas. On top of worries about bank losses from lending to the energy sector and emerging markets are concerns about negative central bank deposit rates hitting margins, difficulties in finding capital to meet strengthening capitalisation requirements, continuing investigations of irregularities pre- and post-GFC, and now flattening yield curves in the United States slashing profits from the traditional borrow short/lend long strategy.

In coming weeks we will see central bankers and government ministers increasingly acknowledge the risk to their economies and inflation forecasts from global woes and proposals will be mad to try and boost growth and inflation. But quick macro policy changes will not alter the new economics of the oil and wider energy sector, will not hasten China's transition to a consumption-driven economy and make debt and capacity problems disappear overnight, or compensate for the failure of European countries to open their economies up and stop ongoing reliance upon temporary stimulatory packages to boost declining trend growth rates.

Yet as pointed out not just all last year but since 2009 in terms of ourselves being less munted in New Zealand during and following the GFC, we have a highly deregulated economy will positioned to adjust itself to unpredictable shocks and a set of special growth supporting factors. These factors include high migration which is highly likely to continue as the one million Kiwis offshore compare what is happening around themselves with good stories from NZ. Hopefully people in the regions realise that with the combination of massive net migration inflows and Auckland's high house prices they have a perhaps once in a lifetime opportunity to boost populations quickly in their towns.

We have a construction boom set to last a number of years, stretched out partly by a shortage of tradespeople. We may have a dairying sector adjusting to the other 99.8% of the world's population realising rising Asian incomes means higher milk demand thus boosting their own production, but we are seeing in our farming sector what we have always seen – diversification to new profitable areas. These include not just wine which now brings in $1.5bn in FX earnings a year, but honey exports now worth what wine was worth in 2002 - $300mn – and farmers planting hillsides in manuka.

Tourism is booming as is the foreign education sector, and unlike in other countries businesses in New Zealand are willing to invest in new plant and equipment with such investment intentions at well above average levels. Auckland is becoming an international city attractive to the highly talented people needed to boost technology developments and their implementation.

The relatively good position we find ourselves in means there will remain strong support for the Kiwi dollar and exporters should give thought to boosting hedging on dips toward 60 cents every few months. Borrowers face so benign an environment it is difficult to describe. And with a cash rate of 2.5% scope exists to cut rates should the world's woes hit our shores more forcefully. House prices will keep rising in response to low debt servicing costs, strong population growth, investors searching for higher yielding assets, and shortages in some locations. Employers will continue to struggle to find the staff they want even with the net migration boom and while some may leave Auckland for lower occupancy and transport costs, others will shift there to access the staff pool and 1.5mn potential customers with a growth rate twice the rest of the country.

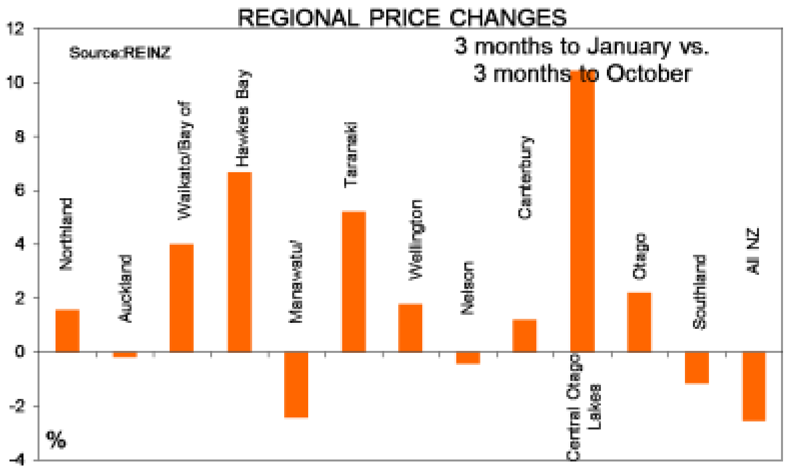
What is our biggest risk? Not the Auckland housing market having a big correction as so many people have badly predicted for many years now through lack of understanding what the market's prime drivers are. (The shortage gets worse every day.) China is our big risk, not just because we get 19% of our merchandise export receipts from there, but because everyone else we trade with has hefty exposures also to the Chinese economy.

Housing

Part of the story for the NZ housing market at the moment is Auckland stepping back as investors have been scared away by a 30% deposit requirement, IRD number and bank account rule, two year bright line test for capital gains, on top of low yields encouraging investors to look elsewhere. The withdrawal of investors for now is providing space for owner occupiers to step in but they are only arriving in limited numbers so turnover in the three months to January in Auckland was down 15.8% from a year earlier. Prices meanwhile on average have fallen by 3.8% to sit 11.5% up from a year earlier. This is a decent giveback after prices in the previous three quarters on average rose by 3.8%, 6.1%, and 8.0%.

Will this fall in Auckland prices continue? In the short-term maybe. But the fundamentals for Auckland argue in favour of prices steadying then rising again though not remotely at the 25% annual pace of mid-2015. These fundamentals centre around a booming population growing near 3% per annum but the existing housing shortage still worsening because construction is well below levels required.

In the regions things are quite different. In the three months to January turnover in Northland was ahead 48% from a year ago, Waikato/Bay of Plenty 32%, Hawkes Bay 32%, Central Otago Lakes 24%, Taranaki 21%, and Southland 18%. And prices in the past three months have risen respectively 1.6%, 4%, 6.7%, 10.4%, 5.2%, but they have fallen 1.1% in Southland. Note that these price measures, included in the following graph, are not adjusted for changes in the type of houses being sold whereas the Auckland numbers above are from adjusted data. Auckland's unadjusted three month change was a fall of just 0.2%.



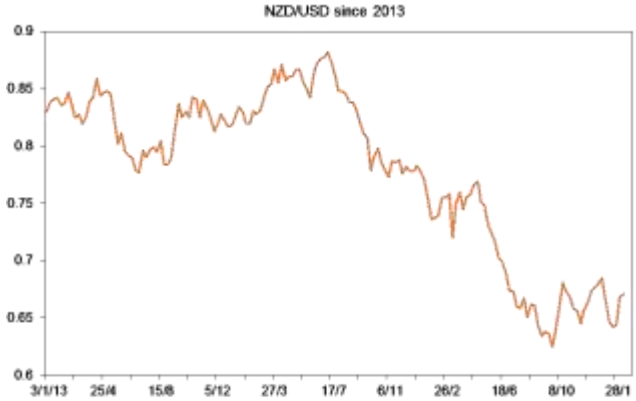
This regional strength is likely to continue all year given the low interest rate environment and the Reserve Bank may feel it necessary to slow things down with a 30% deposit requirement though that is a 50:50 call at this stage.

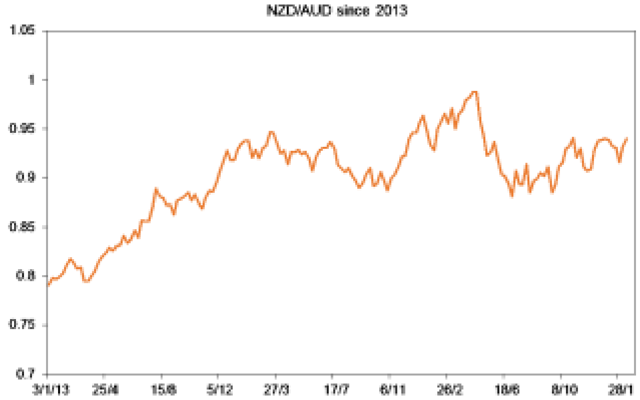
NZ Dollar

The NZ dollar this afternoon was trading near US67 cents from 66.8 one week ago and 64.4 two weeks ago. Similar movement has been made upward against the Australian dollar to 94 cents, lesser gains against the Euro and Pound, and no gain against the Yen. This latter development reflects the Yen rising in spite of the cut in the Bank of Japan's deposit rate to -0.1% a fortnight ago because the bout of nervousness gripping investors around the world has led to buying of the Yen as a save haven.

And yet, in the past when such nervousness appeared the NZD would invariably suffer as well. That is not happening now. The NZD is holding up and in fact even stronger than it was before the most recent 7.4% fall in global dairy prices. Why the disconnect? Because New Zealand stands out very well as a good performer at a time when the rest of the world has so, so many problems.

Our fiscal accounts are good, non-dairy exports are strong, construction is booming, migration is stellar, and our cash rate of 2.5% is well above rates elsewhere. This then goes to illustrate our key currency point – the NZD is well supported and it is not reasonable to expect that any bouts of weakness will prove long-lived.





You will find current spot rates here. http://www.xe.com/currency/nzd-new-zealand-dollar

If I Were A Borrower What Would I Do?

Wholesale interest rates have fallen over the past week spurred downward by the cutting of Japan's deposit rate to -0.1% and fall of Japanese ten year government bond yields below 0% for the first time ever, new falls in oil prices assisted by the International Energy Agency lifting its estimate of excess production, more declines in share prices centred around tech, energy, and banking stocks, and growing worries that the world economy is in for a decent downturn.

The one year swap rate here in NZ has fallen to near 2.60% from 2.65% last week and 2.75% one month ago, and the five year rate to near 2.86% from 2.93% and 3.16% respectively. Does this mean bank fixed lending rates are going to fall sharply? Not as much as you might think because one of the things happening offshore is that as investors worry about everything around them they are increasingly worried about the profitability of banks in Europe. This has led to a general shying away from funding banks in general around the world meaning we NZ and Australian banks are having to pay more to get our offshore funding.

We raise funds in foreign currencies at foreign market interest rates and swap that money back into NZ dollars with the cost of the swap to remove exchange rate risk effectively raising the interest rates we pay to NZ levels from foreign levels. So no, we do not raise cheap money offshore to lend for big margins in NZ. The only way you can do that is to not hedge away the risk of exchange rate movements and that would be a very stupid thing to do in stable times let alone the increasingly unpredictable risky environment we live in nowadays.

For Noting

Nada.

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
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