

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.

Interest Rates and Dairying

You will have noticed that not all banks have passed on last week's 0.25% cut in the official cash rate and of those that have not all have passed it on completely. Why is this? There are two reasons. The first is that banks on average in New Zealand get about 25% - 30% of the money they lend and have already lent out to Kiwi businesses and households from foreign savers. This is because we Kiwis prefer to spend now rather than later, we save little, and as a result we live off the willingness of people overseas to continue to fund our overspending.

That willingness has declined recently amidst a wave of investor withdrawal from holding bank assets associated with worries about European bank exposure to the retrenching energy sector. We have been caught in the backwash of this wave of concern and as the 25%+ portion of money we have lent out comes up for renewal it is costing us near a 2% margin above the equivalent NZ rate as opposed to a 1% margin a year or so ago. During the depths of the GFC this credit spread as we call it was about 3% and before the GFC it was only 0.2%. Consider that change from 0.2% credit spread pre-GFC to 1% - 2% after and you will see why the old relationship between things like the official cash rate, bank bill yields, swap rates, and eventual retail lending rates has changed substantially since 2008.

Because our funding costs have been rising there have recently been increases in bank retail lending rates facing householders and businesses in Australia and New Zealand without an increase in the official cash rates. In fact the Reserve Bank specifically referred to the rising credit spreads as one of the reasons they surprised 80% of the market and cut their cash rate last week to 2.25%. They were seeking to offset the impact of rate rises already underway.

Not all banks have the same proportion of their funding derived from offshore. Some small banks with small lending books but large local depositor bases don't fund offshore at all. Thus for them funding costs have not risen as much as for those that do. They are in a position to cut their floating rates 0.25% with minimal margin impact.

The other reason for banks not all passing on all the 0.25% cash rate decrease is simple competition. Mortgages are fairly vanilla products but competition comes in more than the form of price. Distribution channels are important and some banks will be investing in such areas rather than trying to win more business from their same structure by just cutting rates.

What about the calls in some quarters for banks to be forced to pass on the rate cuts because we are not doing what some interpret as the Reserve Bank's wishes with a threat of violence to achieve that aim? No need for such dictatorial practices loved by former Prime Minister Rob Muldoon or Jake the mus. If the RBNZ truly wants floating interest rates to fall 0.25% and that is not happening then they can simply cut the cash rate again.

Prior to the 2007 crash we saw this the other way around. The Reserve Bank were trying to slow growth in the economy and reduce inflation by raising the cash rate. But fixed rates remained low so the expected impact on inflation of raising floating mortgage rates was not working. Therefore they did the only thing they could do and raised the cash rate even more. The rate eventually hit 8.25% in 2007 and helped push the NZ economy into recession before we took a hit from the GFC which doubled the length of that recession.

Dairying

On another issue, media are scouring the countryside seeking dairy farmers upset at their banks during this time of stress. Memories run deep of the farming sector rout in the 1980s when farmers were hit by the combined effects of a high exchange rate, high interest rates, and removal of subsidies which had encouraged over-investment and over-production.

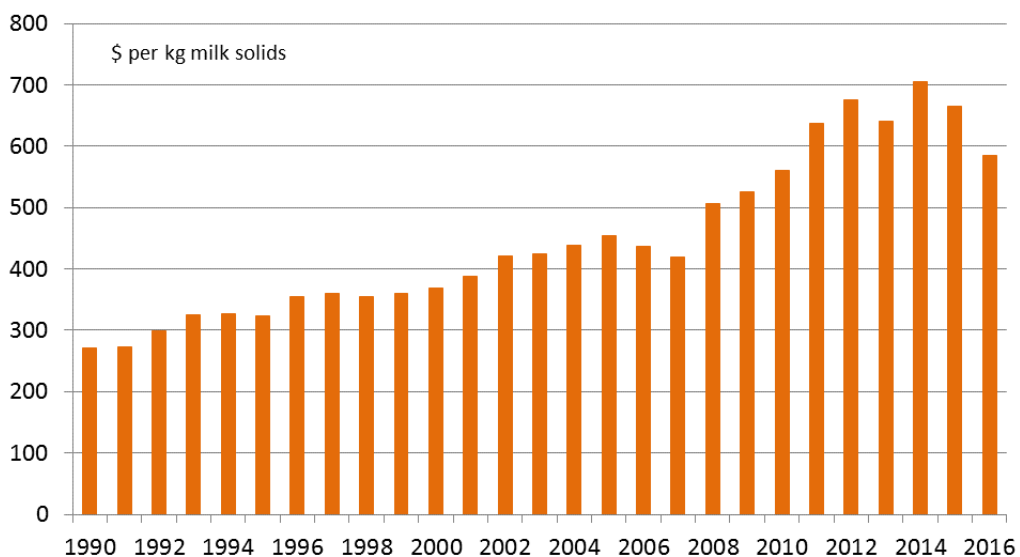
But the memories of those times and other periods run deep amongst bankers as well and since then practices related to handling businesses in trouble across all sectors, not just farming, have vastly changed. The monitoring by banks of client accounts and financial positions is far deeper and more frequent than ever before as most borrowers and accountants could attest, with one aim being to allow the early identification of problems and to work with the borrower to develop plans for handling issues as soon as possible. There is no desire simply to let the rot set in then force a sale of the business somewhere down the track.

Will there be forced ownership changes of dairy farms? Yes there will and there even was when the payout was \$8.40. But it is often not the financier doing any forcing but rather mates, accountants, farm advisors, equity partners and family members reaching the unfortunate conclusion that the extent to which outflows exceed inflows cannot be offset through attracting new capital. Same as in every other sector. In fact the even more unfortunate realisation eventually arrives that the operation's growth in recent years should probably have been funded with capital rather than bank debt and the decision to use debt rather than get others to share the profits was not optimal. This scenario of decline through choosing to use debt rather than extra capital or choosing to self-fund growth at a slower pace is the same as in every other industry such as house building, forestry contracting, computer servicing, electronics retailing, women's clothing retailing and so on.

The dairy sector has been seen by many here and overseas to be a highly profitable one with huge growth potential based around rising demand from Asian countries. No-one probably ever seriously tried to convince anyone that their crystal ball made them certain about what prices would be in coming years, and some of us well over a decade ago proved we cannot forecast the payout. But now we have proof not a single person can predict dairy prices – and the same goes for oil, coal, iron ore and so on.

To get a feel for why the dairy sector boomed recently consider the impact on people's willingness to gear up and expand based upon what happened with prices. In the graph below we show the five year average Fonterra payout from 1990. Note the steady rise over time which accelerated after the global financial crisis assisted by rising demand from China. The latest projected payout of \$3.90 is just two-thirds exactly of the five year average.

MILK PAYOUT - 5 Year average



Assumptions always have to be made about what revenue from a business will be thus payouts have to be assumed and as it turns out those assumptions were too high. Why? Only partly because demand has surprised on the weak side from China since just under a year ago. Mainly it is because of the factor we have highlighted increasingly in recent years.

All of us can take a reasoned and probably reasonable view on where the demand for a commodity will go. But we seem all equally appalling at picking what will happen with supply. We have a tendency to assume few other people have seen the demand growth fundamentals we have. And when industry participants start to realise that their supply growth assumptions are proving too low, that is when a rapid price change can occur and that is what has mainly happened in the oil and dairying sector.

Three years ago most of us simply under-estimated by how much production would rise in the likes of the European Union and United States. Now the altered supply assumptions have been factored in and price expectations have been slashed. This is hitting our previously rapidly expanding dairy sector hard for a number of reasons.

First, the pace of expansion has naturally meant higher dairy farm expansion and set-up costs than would be the case if recent production system growth had been spread over a longer period of time. Debt levels have grown rapidly to fund this accelerated burst of growth. That is what debt does – it allows an acceleration in growth. But it comes at a cost of heightened exposure to shocks.

Second, related to this, farmers have been reluctant to fund their growth with capital even though all operators would know someone who in the past had to sell their farm to another farmer because they could not service their debt. Kiwi businesspeople suffer from an unwillingness to use outside capital to fund their growth because it leads to some loss of control over all decisions and sharing of the gains. There has been a preference in farming for rapid growth to be funded by debt rather than equity.

Third, any expanding agricultural sector naturally moves into less productive land so marginal production costs tend to be higher than for existing operators.

Fourth, there appears to be a problem for the dairy industry understanding the difference between marginal cost and average cost and this has led to the adoption of production-boosting supplementary feedout systems which either reduce profits or fail to boost them for 90% of operators according to a study released last year. Every extra pint of milk produced these past few years has gone into the production of low value milk powder sold in big bags to bulk buyers. No extra milk has been needed to produce more value-added products. This is a key failing of the cooperative system.

Fifth, dairy farmers want maximum payout and do not support retention of capital by their cooperative to move rapidly up the value-added chain to get to where the best dairy sector returns lie – off the farm. In fact milk suppliers have made it clear they also won't accept moving up the chain if funded by outside capital. Their growth focus is almost solely physically on the farm which surrounds them and that focus remains today the same as it has always been – maximising production. This is like a factory contracting out consultants to sell their toasters but reinvesting all earnings in producing more and more of the same toasters from more and more factories rather than investing in high priced heavily branded toasters which give nutritional advice, display updates on bread shape and colour as toasting occurs, and can untoast bread should one leave it in too long.

Land prices are falling as a result of the dairy downturn and they will keep falling for the coming year, but getting data on the extent of changes in farmland prices is notoriously difficult as no two pieces of ground are the same. But prices start from high levels and as we have highlighted for a few years now, the world is awash with money looking for a home. That money is increasingly willing to accept low yields, and that money is increasingly looking further afield and in the case of many Asian investors is seeking exposure to the agribusiness sector to benefit from rising food consumption sophistication in Asia. Thus falls in land prices are likely to be limited this time around as there are many willing buyers and that will help mitigate the pace of farm ownership changes.

In fact, while all the media attention is on farmers who have overexpanded in recent years and raised their production costs, there are plenty of old hands who have taken on board the message that debt is dangerous and constrained their growth. Some of them, now sitting on good cash reserves, will be willing purchasers of some of the farms which will come on the market. But only if the land is good. The properties which have been developed on marginal land in recent years may find very few buyers and they will suffer the greatest price declines as they revert to running sheep and beef or manuka for honey production. Golden gold, as opposed to white gold or the original black gold.

Does the dairy downturn need addressing with government legislation preventing banks from foreclosing in extremis? No, and were that to happen the long-term impact on the farming sector would be quite radical. Deprived of the backstop of protecting bank capital through having the ability to force a change in farm ownership to bring in extra capital banks would not be able to lend as much into the sector as has been the case and where lending would occur the cost would be higher to reflect the loss of that protective backstop. The farming sector would end up less indebted which would probably be a good thing, but immediate growth would cease as credit would have to be actively reduced across all dairy and non-dairy sectors to reflect the change in riskiness of farm lending.

Does the weakness in dairying justify a debt-funded infrastructure spending boom to boost economic growth as some commentators have suggested? No. The construction sector is already booming and does not have capacity to handle a swathe of new Think Big projects, and most non-dairy exporters are doing well – especially tourism operators and education providers. Plus any spending surge means more debt and as so many countries have shown us there are high dangers for governments in running high debt levels – absence of ability to insulate an economy when true big shocks come along, and diversion of revenue toward debt servicing rather than other projects. Plus, as we have been at pains to point out for so long now, while dairying may be weak other sectors are going gangbusters and it is factually incorrect to claim as some commentators are that everyone is suffering in New Zealand.

Even as it cut the cash rate last week the Reserve Bank predicted growth in each of the coming two years of over 3%. That is hardly an environment requiring a new splurge in government debt and probably dubious rushed construction projects.

Will there be dairy sector pain for many in the coming two or three years? Yes there will and that includes the non-dairying farms which have traditionally produced feed for dairy farms and are now switching to running their own stock, and companies which service and supply the sector, whether or not their payment terms are being stretched out to a three months.

But when can we expect prices to improve? Given that no-one has displayed an ability to accurately forecast prices for dairy products, oil, coal, and interest rates even there is no basis for believing any forecast of prices rising back to average levels in any given time period. Just look at Tuesday night's Global Dairy Trade auction which produced a 2.9% fall in the average indicator whereas all expectations ahead of the auction had been for a small price rise. Forget forecasting the next five years. We can't forecast ahead 12 hours.

But if you really do need a forecast then I suggest this exercise. You will need to do it yourself as I have not made a payout forecast since getting one wrong many years ago and won't restart now. Go to the graph on page 2 showing the five year average payout from 1990. Pick up a ruler and draw a trend line through the tops of the bars running from 1990 to 2007. See where that ruler hits the scale at the far right. That is what the trend suggests is a reasonable expectation for the current average payout, and if you extend the time scale a tad to the right you can generate an estimate of the average payout for the coming five years ending in 2021. (Hint, draw a vertical line down from where the text ends on the far right in the line just above the graph to get a 2021 vertical end point.) Looks only just above the current much-cited average break-even payout doesn't it?

Housing

Lets get right to the basics of the Auckland housing market.

1. There are signs that Chinese buyers are returning. If true then extra demand lies ahead, one day to be added to by buyers from India.
2. Interest rates have just been cut, further cuts lie ahead, the pool of savers needing to boost yield through assets other than bank deposits has grown again and will grow further.
3. There remains a big stack of young people wanting to buy property, some catching up on buying they have delayed since 2007.
4. Ney migration inflows are not only high and expected to stay high, they are still growing and 60% of the net flow goes to Auckland.
5. The number of dwelling consents being issued in Auckland is running at about half the number needed just to stabilise the shortage at current levels.

The Auckland housing market has been in pause mode since about October last year. We can see this in the Days to Sell measure which went from 3.5 days faster than average in September, 4.2 days in August and 5.1 days in July to only 0.9 days in October, 0.4 days slower than average in November, 0.4 days faster in December and only 0.1 days faster than average in January. I'll tell you February's outcome further along.

The stratified median dwelling sales price rose 2.6% in August and 3.3% in September, then fell 4% in October, was flat in November, then fell 2.3% in December and again in January. I will tell you February's result below.

The Auckland market has paused since October and that was when the requirement for all buyers to have an IRD number came into play along with the two year bright line test for capital gains tax. And from November 1 all investors needed at least a 30% deposit.

But now look at the February numbers. The Days to Sell measure in Auckland for February was 3.7 days faster than average. Back at September's level. The median stratified dwelling sales price jumped 5.5%.

The upshot? There are growing signs that after pausing for four months the Auckland market is sparking back into life with new assistance now from the latest easing of monetary policy and indications of more to come. Will the return of Auckland strength be at the expense of the rest of the country's surge? No. Its a nationwide phenomena now.

NZ Dollar

The Kiwi dollar was edging lower this week until the Federal Reserve adopted a more dovish than expected tone last night whilst leaving their funds rate target unchanged. We end against the USD just over 67 cents compared with just under last week. Nothing interesting to note in other words. More interesting is the NZD's continuing weakness against the Aussie dollar. The AUD was lifted a couple of weeks ago by anticipation of some further improvement in minerals prices stemming from China's stepped up efforts to boost growth focussing on infrastructure. The NZD is near where it was last Thursday against the AUD at about 89 cents. Personally speaking it feels like a good level to shift some funds back to NZ from Australia.

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?

The surprise move by the Reserve Bank last week to cut the OCR to 2.25% provides us with an opportunity to remind everyone of a key point we have been making with regard to interest rates for six years now. You are foolish to make your interest rate risk management decisions highly dependent upon a particular set of interest rate forecasts proving accurate. As noted here so many times before, our ability to forecast interest

rates has gone out the window post-GFC because apart from correctly picking the 1% rise in the cash rate over 2014 we and everyone else have gotten essentially nothing right – since late-2007 in fact.

We cannot pick the low point in interest rates this cycle. There is in fact no identifiable cycle in place. Monetary policies globally are in uncharted territory, inflation forecasts are repeatedly too high yet the world is awash with printed money looking for a home which pre-GFC would have sparked a massive inflation surge. Post-GFC households and businesses are reluctant to boost their debt levels - dairy farmers being the exception.

Were I borrowing at the moment maybe to buy another disused bar in Auckland (see The Listener, February 29) I would have one-third floating to allow repayment flexibility and offsetting against credit funds, and the rest fixed for two years at 4.39%.

If I Were An Investor ...I'd see a BNZ Private Banker

The text at this link explains why I do not include a section discussing what I would do if I were an investor.

<http://tonyalexander.co.nz/regular-publications/bnz-weekly-overview/if-i-were-an-investor/>

For Noting

- Current account deficit at just 3.1% of GDP = very low and one reason for NZD strength.
- Probable Trump candidacy for Republicans in the US. Impact on NZ. No-one knows. Not even him.
- Brexit? Increasingly probable. Source of weakness for both the British pound and Euro, upside for other currencies, huge uncertainties and deeper questions about the future of the European Union.
- Wellington house prices – lots more upside to come. Big catch-up with Auckland.
- GDP up 0.9% in the December quarter after 0.9% in the September quarter bringing calendar year growth of 2.5% forecast to rise above 3% soon. The economy is in a strong state with many sectors offsetting weakness in dairying – just as we have been saying for all the past year and will do so for all this year.

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

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