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.

Dairying – When Too Pessimistic?

One of the comments I have made in talks for many years and here in the Weekly Overview every now and then is that while we can all take a usually well reasoned and reasonable view on where demand for a commodity will go, we are all hopeless at forecasting supply. That means we cannot forecast commodity prices.

In the dairying context this manifests itself currently as many people saying that in spite of the current low level of prices the long term outlook for demand for dairy products is good. In the NZ Herald yesterday for instance..."Demand from China is expected to increase by 30% over the next ten years, and some analysts have picked a 40% to 45% increase in world demand over the same period." We are invited to believe that things will soon get a lot better. But where are the supply forecasts? And where are the cost of production comparisons between alternative suppliers?

Demand probably will rise, but that gives little insight into price let alone profit forecasts unless you also forecast both supply growth and cost changes, both of which have surprised Kiwi farmers on the upper side the past two years.

This week an emailer referred me to some material just put out by the European Commission. They estimate that global milk production this year will rise by 3.5 million tonnes and note that in February milk production in Ireland was up 37% from a year earlier.

Last week the Chief Executive of Westland Milk came back from a trip offshore and made comments along the lines that European milk production will be higher and its international promotion will be more aggressive than anticipated. And "We were expecting European processors and farmers to be already feeling some economic pain that might cause them to reduce production, but this is not the situation for most."
https://www.agriland.ie/farming-news/new-zealand-co-op-expects-two-seasons-low-milk-prices/

On this basis they anticipate two more seasons of weak prices after the current season – meaning four years of weak returns. What will happen if milk solid payouts stay below average breakeven levels for two more seasons as European production takes some time to react to lower prices, and currently rising stockpiles of dairy output eventually get run down?

- Dairy farmers will shift away from bringing in supplementary feed and revert to pasture grazing. Already well underway.
- Cow numbers will fall bringing potentially much more price weakness for cows than we have seen so far where prices have gone from around $2,200 a head to $1,700. In previous, lesser, downturns some herds have sold for $400 a head. This is the way in which sharemilkers see their net asset position most badly affected.
- Demand for water irrigation will fall, calling into question the viability of some proposed schemes.
- Our rivers will thankfully get cleaner as cow numbers and fertilizer application decline.
- Incomes for companies servicing the dairying sector will fall sharply, bringing weakness initially in dairying regions but spreading to the city-based operations of these servicing companies.

- Land prices will fall, perhaps by up 40% though variation will be huge. Given that in contrast to the United States where 80% of dairy returns accrue as dividends, 80% of NZ dairy farm returns accrue as capital gains, this will cause some substantial losses for many investors. Price falls for regions will depend substantially upon what the next most valuable use is for that land.

For your guide, the US Department of Agriculture recently projected that dairy prices won't start rising until 2019.
http://www.ers.usda.gov/publications/oce-usda-agricultural-projections/oce-2016-1.aspx

Thankfully average prices rose 2.1% at the Global Dairy Trade auction two nights ago. But the volumes being placed at those auctions have been deliberately reduced over the past year so they may not provide as good a guide to how things are faring on an individual contract basis behind the scenes as was the case previously. Nonetheless a rise is a rise so that is good. And it pays to remember one of the key fundamentals for any asset able to be quickly repriced – like currencies, shares etc. Just as prices can overshoot on the topside they can also overshoot on the downside. At some point pessimism about NZ dairying will be well overblown. The trouble is that we never really know when that point is reached until we are well past it. Given the paucity of dairy farm ownership changes so far, we are probably not there yet.

Saving For Retirement – or The Misfortune of Not Being Run Over By a Bus

For quarter of a century now governments in New Zealand have officially been encouraging us householders to save. Sometimes national interest of a reduced foreign debt has been cited, sometimes the vulnerability of the banking sector to the changing whims of offshore savers regarding whether they want to keep lending money to NZ banks. Mainly though it has been on the basis of scare stories regarding national superannuation being unsustainable and the inevitability of it being cut and the retirement age raised.

It is not inevitable that it be cut given that voters shy away from parties promising to make reductions, and even though the logic of rising life expectancy says the age of eligibility should go up, voters probably won't go for it.

Saving is good from a precautionary point of view in terms of being prepared for something going wrong, and if one assumes that super will still be paid at the current rate from 65 down the track – an assumption which seems reasonable given the politics involved, not the fiscal reality – then saving is a good idea for covering health costs.

Two-thirds of the fiscal impact of an aging population comes from higher health costs and as anyone who has been sick or injured knows it is not always the case that the generally well respected NZ public health system is able to provide the services required in a timely manner. So saving for health costs in retirement is probably a good idea.

I mention this as partial counter to the argument in some quarters that there is no point in saving for retirement because when you are old you will be sick and unable to enjoy life anyway. By this argument better enjoyment from a whole of life point of view can be gained by spending the money when young and able to fully benefit in a recreation sense rather than having it sitting doing nothing when old – or worse – being taken by a government as offset to unaffordable superannuation costs. This logic is sound. But spending up large on the assumption of ill health and good public health provision leaves a person highly vulnerable to the very unfortunate situation that they retire and remain healthy for many years but with not much money to do anything! What a disaster.

Its like the people who say there is little point spending a lot of money on education etc. because you might be run over by a bus tomorrow. They run the risk of the disaster of not being run over.

As long as the mortgage is paid off by retirement things probably won't be bad except for the adjustment from spending up large from one's wage or salary income to living off super at a rate of $296 a week per person if living with someone else, $385 a week living alone.

Housing

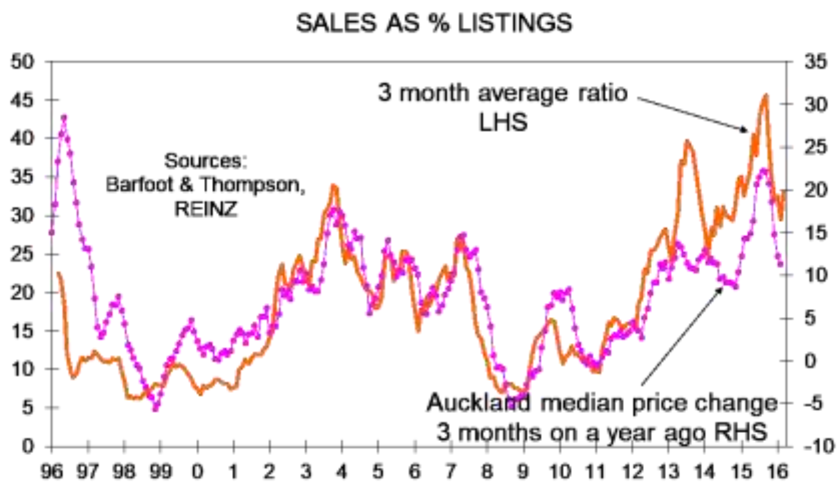
Here are our main housing themes

- Auckland's market has ended a pause and is now going up again underpinned by a worsening shortage of property.
- Regional markets are well underpinned by investor demand and that is propelling more construction which in some smaller lifestyle-like centres will eventually lead to excess supply.
- Falling interest rates will encourage more investors to seek property assets while having little impact on already outbid young buyers. A new wave of out bidders is coming.
- Construction costs will keep rising with the latest extra costs coming from better health and safety regulations.
- The Reserve Bank will soon again warn about housing and get closer to using non-interest rate controls in the regions – e.g. a 30% investor minimum deposit requirement.

This week we learnt that in Auckland Barfoot and Thompson real estate agency sold 1,341 dwellings which was a 16% fall from a year earlier but firm 15% seasonally adjusted rebound from February. However this monthly rebound followed a 20% fall in February and if we look at the entire March quarter we see sales were down 11% on a year ago and flat seasonally adjusted. Thus we might lean toward saying that a period of weakening sales since the start of October could have ended.

The average sales price jumped to $867,000 in March from $822,000 in February but this measure always jumps a large amount at this time of year as the nature of stock being sold shifts a tad toward houses from apartments. Compared with a year ago in the March quarter average sales prices were ahead by 9.6%, but down around 3% from the December quarter. It is however normal for this three month price change to be quite weak compared with earlier months so we would not advise extrapolating out the 3% fall to an annualised decline of 12%. Lets assume for the moment that prices have flattened. One cannot say either that they are trending down or that retracement since October has definitely ended.

Stock remains in short supply, which generally means prices risk rising further. The number of new listings received in March was 6.2% fewer than a year earlier and at the end of the month the stock of listings was down 7.6% from a year ago.



NZ Dollar

If the NZD were going to drop lower on the back of dairy prices falling away it not only would have done it by now it probably already has done so given that the USD rate near 68 cents is 20 cents lower than the rate almost two years ago. First point. Second point, the commodity price link exists on the basis that reduced export receipts mean reduced demand for the NZD (to be converted from other currencies). But the NZ current account deficit is sitting at only 3.1% of GDP which is below the average for the past two decades of 4.1% of GDP.

On this basis, if anything, the NZD should be above average (if you believe trade flows are the main currency determinant, which they are not). So what are the 20 year averages and where do we sit now?

	20 Year Average	Current Rate	Difference
USD	66	68	2 cents above average
AUD	85	90	5 cents above average
JPY	70	75	5 yen above average
GBP	0.40	0.48	8 pence above average
EUR	0.54	0.60	6 centime above average
TWI	69	72	3 thingies above average

The NZD is above average, by about 4.5% on a trade weighted basis. That is not much considering the below average current account, and considering

-interest rates still above levels offshore
-the good state of our economy compared with economies offshore,
-the stable political situation in NZ compared with the crumbling European project, approaching potential Brexit in UK, frightening presidential contest in the United States, potential early election in Australia, and failing key economic policy for the Japanese Prime Minister.

Frankly, the NZD looks undervalued. Hence a repeat of our comment made here for many months now. Exporters might be advised to boost hedging on the occasional bouts of weakness in the NZD because compared with the rest of the world we look really, really good. Who wouldn't want some of that to rub off on the rest of the world by appointing Helen Clark as UN head?

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?

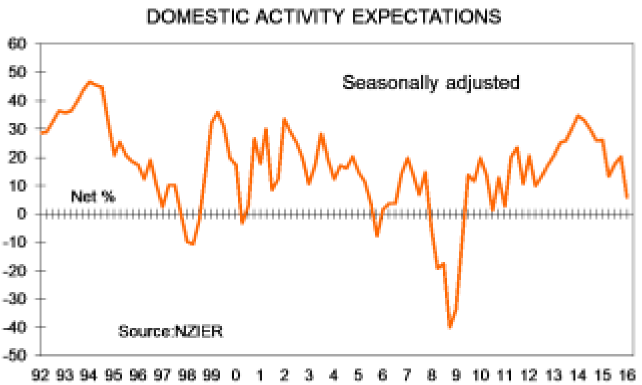
Nothing much new to report here. The Reserve Bank is expected to cut the official cash rate again, taking it to 2% either on April 28 or more probably June 9. If I were borrowing at the moment I would have around 20% floating and the rest probably fixed for 2 years at 4.39%.

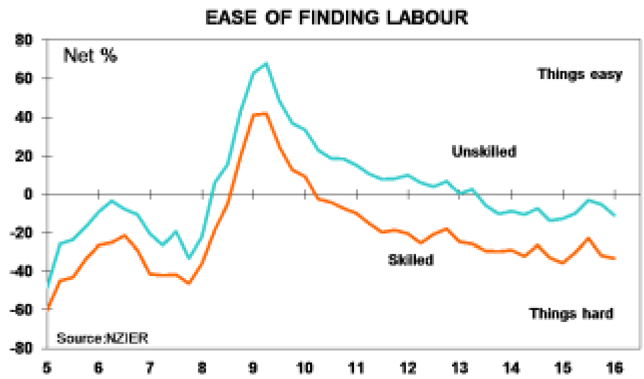
If I Were An Investor ...I'd see a BNZ Private Banker
The text at this link explains why I do not include a section discussing what I would do if I were an investor.
http://tonyalexander.co.nz/regular-publications/bnz-weekly-overview/if-i-were-an-investor/

For Noting

The NZIER this week released their long running Quarterly Survey of Business Opinion. It dates quickly but when released gives us quite a good up to date feel for what is happening in the economy. What this release tells us is unsurprisingly that businesses have become more cautious about how strong the economy will be in the near future.

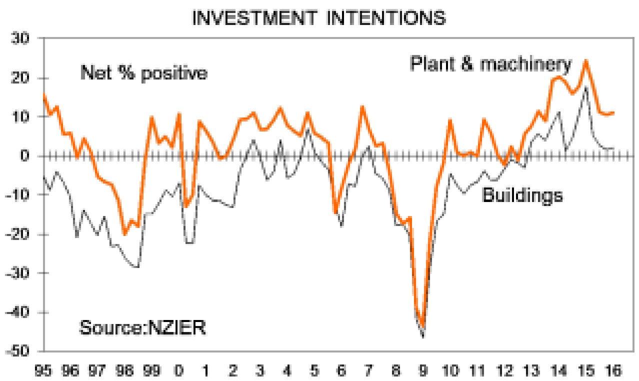
Only a net 2% expect economic conditions to improve, down from a net 15% in the previous three months but above the long term average of a net 4% pessimistic. Only a net 6% expect their domestic activity levels to improve which is below the 10% average, down from 20% the previous quarter, and the weakest result since early-2011.

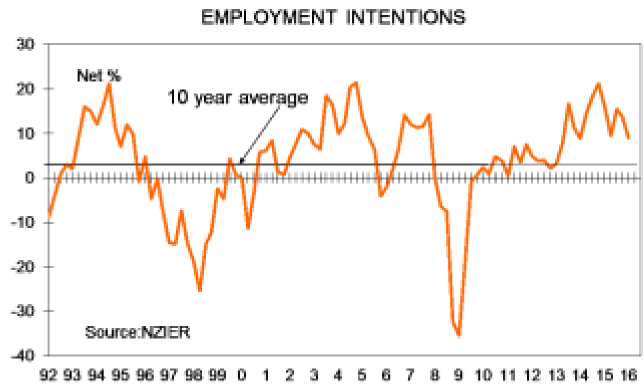




Nonetheless, a net 9% plan hiring more staff, down from 14% the previous quarter but above the 2% long term average. And why not given that a net 33% of businesses say they are having trouble finding skilled staff and a net 11% say they are having difficulty getting unskilled people.

A net 11% of businesses plan boosting capital spending, up from 10% in the December quarter and above the 2% average.





So we can say that businesses are feeling downbeat, but they nonetheless still plan to hire people and invest. That is good for jobs growth and economic growth overall.

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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