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.

A Few Reasonable Thoughts

NZ dairy prices appear to be edging up. Our economy is well underpinned by a range of sectors including tourism, construction, export education, most primary exports. Investors globally are searching for yield and looking further and further afield. Given these factors is it reasonable to expect the NZD to fall by much if at all in the next one to three years? Not really unless you see NZ interest rates falling a lot more while rates rise appreciably overseas.

The latter looks very unlikely, the former probably not a high probability. Chances are we head soon to 75 cents then speculate about 80 and eventually the 88 peak of 2014.

Auckland's population growth is high, forecasters are revising upward their predictions for the speed of future population growth, a shortage of houses exists and continues to get worse, investors are scrambling for yield outside bonds and term deposits. Is it reasonable to expect that Auckland house prices plateau in the coming year? No. They will continue to rise but the Reserve Bank will eventually tighten credit supply controls further and they will generate something approaching a plateauing over 2018.

Central banks globally have been over-forecasting inflation since 2008. Technological developments seem to be structurally lowering average inflation rates. Is it reasonable to expect that the pace of these developments (Uber, Netflix, robotics etc.) will slow down in the near future? No. Therefore inflation stays low as do interest rates.

Our economy is growing firmly, jobs growth is so strong employers must actively search for staff offshore, government accounts are in good order, more people feel wealthy from house prices rising than feel poor. Is it reasonable to expect that there is enough discontent that there will be a groundswell of support in next year's election for people along the lines of Bernie Sanders, Donald Trump, and Mr Brexit? No – but issues like growing income and wealth disparities and homelessness do require attention.

Auckland housing is expensive and becoming more so. Is it reasonable to expect great numbers of people will desert the city for the provinces? No. This has never happened in previous cycles when Auckland prices have soared and Auckland has continued to account for a growing proportion of the population – 20% in 1961, 34% in 2013, projected at 40% in just a few years.

The provinces outside of Hamilton, Wellington, Nelson, Christchurch, Central Lakes, and perhaps Tauranga will not experience high population growth. In fact as each year goes by while the theory is that more Baby Boomers will cash up and leave Auckland, remember also those who are aging and needing close medical care. They will want to be near as much healthcare as possible.

And is it reasonable to think that because technology allows many of us to work remotely we will do so and cause a repopulation of the regions? No. Business and national growth increasingly these days comes from agglomerations of skilled, open thinking diverse people interacting with each other to quickly develop, apply, adjust, and reapply ideas in the commercial space. This is hard to do remotely and high frequency face to face contact has become an essential aspect of modern business. Hence people will keep cramming into the agglomerations/neural networks of London, Auckland etc.

And even when a person does work remotely, speaking from personal experience of a family member, they still choose to be in Auckland because of the interactions with skilled people which may deliver the big opportunity which they are seeking – in this instance in social media.

Plus, consider the furore developing over the government proposal to allow online-only schools. The idea that kids not living in the wop wops or with particular special requirements should be closeted at home and denied the vital social skills which interaction with other children in a formalised education environment can deliver is widely rejected. No widespread telecommuting there.

Dairy and Tourism

In the year to June 2016 exports of dairy products including casein brought in $12.2bn. Over the same period spending by visitors to NZ amounted to $10.3bn. Dairying is our biggest single export.

But in the year to June 2014 dairy brought in $16.8bn, last year $13.1bn, this year $12.2bn so the trend has been down. Hopefully that trend has now ended.

In the year to June 2014 tourism brought in $6.8bn, last year $8.7bn, this year $10.3bn. That trend looks like continuing according to people in the industry.

It may still be a few years before tourism (excluding the extra $3bn+ coming in from foreign students) is bigger than dairy but it probably will happen, especially as the backlash grows against what we call the negative externalities of intensive dairy farming – water quality in particular.

Stuff We Are Guessing At

Since the GFC things have changed in the world of economics and frankly we are struggling to understand what those changes are and what they imply. First, we are tending to overestimate economies' growth rates. This is because our models and pre-2007 experience tell us that with interest rates so low and so much money sloshing around the world businesses must surely be happy to invest and consumers to spend.

But businesses have grown wary of debt as have consumers by and large (which is one reason why interest rates are so low), governments have been tightening fiscal policies, workers have lost skills, industries are being disrupted by new technologies, and some chooks are coming home to roost here and there – lack of economic reforms in Japan, EU and China, excessive debt in China.

Second, we are overestimating wages growth. Labour markets have tightened up quite a bit, even in the likes of the United States. Aging populations are part of the explanation. Yet wages growth won't accelerate. We don't know why. Maybe low unionisation, maybe staff fears of being laid off as they read stories of woe around them or in other countries, maybe businesses bargaining harder to try and protect margins.

Third, we are overestimating inflation. This is a biggie. Central banks and private sector forecasters have near consistently since 2008 made inflation forecasts which have turned out to be too high. Initially we blamed growth rates not meeting expectations. But while that excuse has some relevance in low growth economies like the US, Japan and Europe, that does not apply here in NZ.

Our inflation could be tracking unusually low because of imported deflation (the opposite of the imported inflation of the 1970s when inflation first became a problem). Low wages growth is relevant. Technology is also a factor with you and I easily able to challenge any retailer raising prices by showing them a cheaper product on our smart phone. New technologies are appearing cutting production costs and slaughtering old operators – Uber hitting taxis, Netflix and YouTube hitting the increase-prices-every-year-and-charge for-anything-people-actually-want tv model. Guess which NZ company looks like this decade's Telecom, and which sports will be first to realise the implications for their common appeal of high payment needed for life viewing. If like me you like veging out watching muscled blokes slamming into each other there is plenty of near-live stuff available on YouTube.

Increasingly we are of the view that low inflation is here to stay, and increasingly we wonder at the pointlessness of cutting interest rates to try to boost growth to boost inflation when no-one's model ever said that with growth as strong as it is now inflation would be so low. The models don't work.

And we question why inflation from 1% - 3% is so great. Frankly, in an age when employers seem very reluctant to give wage rises to those not striking for it or running corporations, a falling cost of living is fantastic. The danger however accrues at the macro level as discussed here in the August 11 issue.

Falling prices risk turning a recession into a very deep downturn as business debt ratios rapidly worsen (falling sales, falling prices, fixed debt), same for governments, and consumers buying durable goods cut spending further awaiting price declines.

This waiting for price declines is not something we do for electronics. We know these things will get cheaper. But we like new cell phones and slimmer tvs. Not so for household furnishings, cars etc. where mainly we are just replacing what we already have because stuff is looking worn out and decrepit.

Low inflation and maybe deflation are not necessarily problems when economies are growing. The problem is when the inevitable recession comes along.

Thus we can expect central banks to keep trying to restore a buffer of inflation close to 2%. Good luck. The world sits potentially upon the cusp of revolutionary technological changes which will radically reduce prices for more than just our taxi rides and tv shows.

Fourth, exchange rates. Just joking. Our forecasting there is no worse than it has always been. Toss a coin.

Housing

I gave a talk to a conference in Queenstown this week and one of the attendees asked this question. “Putting issues of supply and demand to the side, what will happen when house prices fall sharply?” There is so much wrong with the question it is hard to know where to begin.

First is the assumption that because something rises in price in a manner which most people do not understand that means there must be a big price correction downward. Mainly though is the opening statement that we should put aside what is happening with demand and supply when considering where the price of something will go. That is just silly given that it is the interaction of these two things which determines the price of something freely traded like houses, socks, cars and spaghetti.

In my experience most people do not understand why NZ house prices have risen so much – and I would include most economists in that group given that they have been incorrectly forecasting house price movements for three decades in some instances. It all comes back to what everything in economics ultimately comes back to - supply and demand and the recommendation from my Professor that when unsure simply sit down and draw the two curves and play around with them to get an understanding of what has happened, is happening, and is likely to happen.

And when it comes to Auckland something substantial is not just happening now it is about to happen in a manner only a very select grouping of people are cognisant of at the moment.

Demographers are revising upward their projections of Auckland’s population growth. The official Statistics NZ revision to sub-national population projections will come out in early 2017. Watch for that.

NZ Dollar

The Kiwi dollar traded for a while above US 73 cents this week so it is coming close to its average level for the past decade of 74.3 cents. The NZD remains as ever very well supported by an economy with better recent performance and immediate prospects than most others, better government finances, better flexibility, and better trade linkages. While further interest rate falls will constrain the NZ dollar, it is probably only if US monetary policy gets quickly tightened in the coming year that the NZD will slide much against the greenback.

Chances are that the NZD rises rather than falls, especially in light of the mild improving trend in dairy prices which today led Fonterra to lift their projected payout for this season from $4.25 to $4.75.

Regarding the NZD’s currently high levels against the British Pound above 55 pence and Aussie dollar near 96 cents – further appreciation is possible but watch for excessive greed in the short-term. These rates are good for shipping funds offshore if that is one’s need in the coming year and it might be a good idea to manage one’s risk by undertaking part of that transaction now rather than waiting for further gains.

If I Were A Borrower What Would I Do?

Nothing new. We expect the official cash rate to be cut another 0.25% in November and February so it will end up at 1.5%. After that – who knows? We expect no further cuts but all interest rate forecasts around the world have been blown out of the water since 2007. So as we have been advising for seven years now, don't develop an interest rate risk management strategy highly dependent upon a particular set of interest rate forecasts coming true.

Were I borrowing at the moment I would fix two or three years with about 25% of my debt floating.

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/

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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