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.

US Election

Markets initially sold off as it became clear last night that Mr Trump would become the 45th US President. However recovery was swift as attention turned to a likely economic stimulus from higher infrastructure spending, possible absence of the previously expected tightening of US monetary policy next month, likely tax cuts, and reduced burdens upon sectors such as health and banking. The President-elect's acceptance speech used language and inclusiveness not present on the campaign trail and this heartened many who fear that as President he might behave as he did whilst campaigning these past few months.

Figuring out exactly what the incoming President's policies will be and how they will fare in their attempted passage through the Republican-controlled Congress is currently anyone's guess. It needs to be remembered that Mr Trump campaigned not just against the Democrats but also against many Republican representatives. So their goodwill toward him, while undoubtedly there because of his victory, will be tempered by his past attacks on them as members of an elite increasingly divorced from the realities facing many Americans.

For New Zealand the economic ramifications do not seem deep. The chances of TPP being signed had already largely gone out the window as our negotiators over-estimated their ability to bring the US and Japan into the arrangement without hefty compromise. Potential for eventually faster growth in the US economy from fiscal stimulus will provide export opportunities at the extreme margin.

Some migration boost may ensue to NZ, but it is important to look beyond the initial dummy-spitting by those who opposed Mr Trump and see how things settle down. There has already been some extra upward movement in US medium to long-term interest rates overnight in anticipation of larger budget deficits and higher inflation and this adds to the already growing pressure for fixed home lending rates to rise here. Big movements up are unlikely, but perhaps this time post-GFC we can have very high confidence that we have finally gone past the low point for the fixed rate cycle. I'd fix three years now.

The Kiwi dollar seems to have attracted little attention during the initial bout of flight to safe haven currencies and assets last night. We changed little against the USD but fell against a surging Yen, then rebounded against same. My personal view remains that the Kiwi dollar has support from a wide range of factors, not the least being the strong state of the economy plus the new element of recovering international dairy prices. Any weakness attributable to the uncertainty surrounding the President-elect may already have been and gone.

Lending Into Property

If a bank ever finds itself in the position of reporting a big decline in profit, a loss, need for additional capital, or need for a taxpayer bailout, the cause is invariably too much lending into the property sector. That was the case for New Zealand and Australia in the 1980s and of course for banks overseas which were caught out by the 2008-09 global financial crisis.

Lessons were learnt in Australasia following the problems of the 1980s and we had a "good" recession over 2008-09 (and a good Asian Crisis in the late-1990s) because we went into the downturn with relatively vanilla banking products, absence of a massive surge in property lending, and absence of a massive surge in property construction.

But now this lesson of needing to maintain a focus on property lending risks has been learnt by all banks and banking regulators globally. A desire to avoid bad lending mistakes and placing taxpayers again in the position of having to bailout banks has led to many regulation changes.

One example is "haircut" regimes being put in place around the world. What these entail is depositors having a portion of their funds locked up in bank capital in the event that a bank needs quick recapitalisation. This supplants funds which might otherwise have to come from taxpayers and aims to ensure a bank in trouble in the evening can open its doors the next morning. In New Zealand it is called Open Bank Resolution.
http://www.rbnz.govt.nz/regulation-and-supervision/banks/open-bank-resolution

Banks also have to put aside more capital when financing lending for investment property purchases. Banks have also tightened up their lending criteria unilaterally – without explicit instruction from the central bank. For instance lending by some NZ banks to foreigners has been curtailed.
http://www.stuff.co.nz/business/industries/80840914/Westpac-and-ANZ-stop-lending-to-foreign-property-buyers

There is also a noticeable crackdown on riskier property lending being undertaken by banks in Australia. Suburbs classified as being at greater risk of a price correction are having increased minimum deposit requirements put in place for new borrowers.
http://www.news.com.au/finance/real-estate/buying/nab-blacklists-loans-for-properties-in-risky-suburbs/news-story/23504712c5868d7a6a4c0d10d9d4d028

The major banks have ceased some lending to foreigners.
http://www.theaustralian.com.au/business/financial-services/nab-tightens-lending-to-foreign-home-buyers/news-story/a11449d7bc2e36871b01e20d3df7a5f8

This tightening of lending rules whether voluntary or imposed is happening in many countries.
The Czech republic.
http://www.radio.cz/en/section/business/central-bank-moves-to-tighten-mortgage-loans-as-real-estate-boom-sends-up-housing-prices

United Kingdom
http://www.dailymail.co.uk/property/article-3359192/Buy-let-landlords-face-tougher-rules-Treasury-set-hand-controls-Bank-England.html

United States
http://nreionline.com/lending/banks-take-step-back-construction-loans

Canada
http://business.financialpost.com/news/economy/poloz-to-keep-close-eye-on-impact-of-new-mortgage-rules

South Korea
http://www.businesstimes.com.sg/real-estate/s-koreas-property-curbs-could-temper-gdp-boost-from-construction

But in addition to regulatory rule changes and cutbacks in property lending driven by prudent risk management there is an extra constraint on bank lending running its way through the NZ banking sector. NZ banks are required to reduce their reliance upon foreign funding of NZ lending activities. Ahead of the GFC some 40% of lending on average was funded by foreigners – bank borrowing offshore, That has since declined to 29% but that still leaves the NZ banking system at risk should another GFC-like event come along and cause a seizing-up again of the international financial markets.

In a nutshell it means we need to fund ourselves more from local depositors and if we can't raise those deposits then we can't lend out as much as we might like to. The need to raise term deposits explains why the cut in the official cash rate in early-August led to only minor cuts in mortgage rates and increases in some deposit rates.

The lower interest rates go the greater the imbalance between growth in the amount which people want to borrow and growth in the amount which people want to place on deposit. The Reserve Bank knows this problem exists and that is partly why there remains little sense any longer in cutting interest rates further. The cuts can't stimulate growth and drive inflation because they can no longer stimulate credit demand. This, plus the fact that our economy is already booming, means that this week's cash rate cut to 1.75% is almost certainly the last for this period unless the world economy tanks.

The upshot of the global tightening by regulatory authorities and banks of financing property purchases and property construction by developers is a safer global banking system and slower growth in house construction. In the NZ context it means as we highlighted some weeks back, ironically at the time when Auckland's Unitary Plan will eventually allow far greater housing density, lack of finance means growth in house supply will remain slow. Hence prices rise further. Hence the Reserve Bank eventually tightens lending controls again. Catch-22.

Housing

This week I thought it might be useful to offer an alternative angle on the housing market which few people will have given thought to. (I wrote this a day before the government announced a $300mn boost to provision of emergency housing and my advice to anyone involved in the sector is get cracking and put the funds to use because once house prices flatten your political capital will disappear.)

Take yourself back to 2005-07. There were growing worries about homeless people in Auckland and many stories about people living in camping grounds, sleep outs, garages and so on.

Over 2008-09 this situation got a lot worse as people lost their jobs, dwelling construction in Auckland fell to new lower levels, yet the population kept growing. The NZ population grew by 1.2% in 2006, 0.9% in 2007, 0.8% in 2008, 1.2% in 2009, then 1% in 2010.

But the focus on this issue disappeared even as more people got into worse housing situations. A study by the University of Otago using census data found 28,649 people to be homeless in 2001, 33,295 in 2006, and 41,705 in 2013.

http://www.stuff.co.nz/national/80719962/One-in-100-Kiwis-homeless-new-study-shows-numbers-quickly-rising

Why a loss of focus on this issue from 2008?

One reason will have been the media and general focus on overall economic weakness rather than conditions in just one (important) aspect of people's lives. The other and major reason however is likely to be that most people adopted an incorrect expectation that house prices would collapse, and then when they didn't embraced the view that they would not rise, then when they did they focussed again on forecasts that they would fall back. We had quite a different view but that is not the point of these comments.

People stopped worrying that they were missing out on capital gains and stopped worrying that they might not be able to eventually buy the sort of house they wanted or their kids would want. People who were not homeless or living in bad circumstances stopped worrying about the aspect of the property market which most interested them – making sure they did not miss out should prices keep rising. No FOMO, no price panic, no homeless focus.

The only reason we have seen a renewed and long overdue focus from policy makers on the plight of the homeless etc. is that the average person has the property market at the front of their mind. What does this mean?

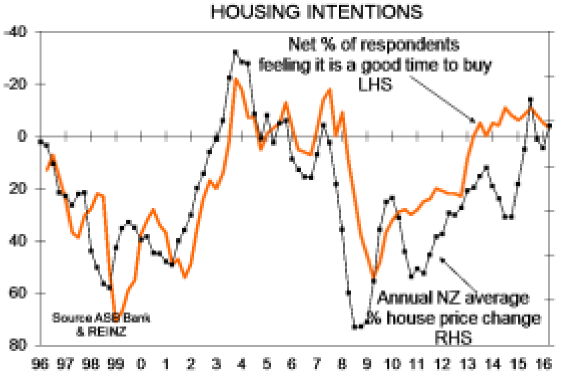
It means first that about five years of forming and implementing policies to attack housing deprivation issues from 2008 – 2012 was lost because average people not suffering housing deprivation had no worries about rapid price rises. It means that once prices flatten out again and reporters find examples of price declines in some towns and some suburbs of Auckland (whether sustained over a year or just statistical variations) the focus on housing deprivation will once again disappear.

If you are in the business of trying to address housing deprivation issues then you will only have the ears of politicians and the media for as long as house prices rise and are expected to rise further. Your clock is ticking. You've perhaps got a couple of years left at most to be on the front pages.

There was some media excitement yesterday following release of the quarterly ASB Housing Intentions Survey. A net 26% of people said that they feel it is a bad time to buy a house. Does this mean prices are about to fall? No.

This measure tends to change after the pace of house price inflation has changed. More people think it is a good time to buy as prices fall, more people think it is a bad time to buy as prices rise. The series has no predictive ability unfortunately.

The graph's orange line shows the net percent of people feeling that it is a good time to buy a house, measured on the left side axis in reverse order. Flipping the left axis upside down makes for a tidy graph showing how the feelings measure and price change measure drift together – but with the annual pace of house price inflation changing first. In fact it is even more stark than that because the annual pace of change reflects what has happened in the past year whereas the feelings gage is a spot result. So the lag between prices changing then feelings changing is actually longer than the graph suggests.



Thus, personally speaking, even though people are saying very strongly that they think this is not a good time to buy a house, that is simply because prices have risen so much.

NZ Dollar

The Kiwi dollar has not sold off aggressively in the face of a surge in global uncertainty regarding a Trump Presidency. Our strength has been retained even as share prices temporarily fell sharply and the Yen and Swiss Franc jumped up. Why?

It comes back to the point which we have strongly stressed here in the past year. Our economy is in very good shape and has good prospects at a time when people are very uncertain about growth prospects elsewhere. To restate my personal view, the chances are that the Kiwi dollar is headed up, not down. This is especially so in light of the recovery in dairy prices and a soaring tourism sector – our two biggest export earners.

Additionally, while a rise in the US funds rate next month of 0.25% remains probable, chances of another cut to NZ rates following this morning's 0.25% reduction to 1.75% are slim. We expect no reduction from these levels.

Thus market expectations for the extent of the closing of the interest rate differential between NZ and US interest rates have now changed slightly at the margin and that favours the Kiwi dollar going higher.

I remain an NZD bull.

For the record, last week the NZD was buying US 72.8 cents. Now the rate is just over 73 cents We remain near 95 Aussie cents.

If I Were A Borrower What Would I Do?

A few weeks back our sniffing of the wind led me to write here that if I were a borrower I'd change from fixing one-third floating and two thirds two years fixed to one-third floating, one-third two years fixed and one-third three years fixed. This change was driven by signs of rising funding costs offshore and an anticipated ending of the recent period of official cash rate reductions from the Reserve Bank.

This week the RB cut their cash rate to a record low of 1.75% from 2% but signalled that further cuts are unlikely. We agree. We have also seen in recent weeks a general drifting up of rates offshore and reduced expectations of further rate cuts in the likes of the UK.

And a couple of days ago we lifted our three year fixed rate from 4.49% to 4.59%. The rate is still extremely low by the standards most borrowers have become used to over the past one to three decades and it is unlikely to dent the housing sector. However, it may have exactly the opposite effect and provide the spark for the new surge up in housing turnover which we have been anticipating.

With people slowly shifting their interest rate expectations to flat/rising from flat/falling and a few scary stories from media commentators likely to appear, potential buyers of houses will feel that they should hurry their purchase before interest rates rise further. And before new LVR rules come in. And before a debt to income regime is imposed. And before the Asian buyers watching each other at auctions re-enter the market in force. And before the Chinese authorities change rules to allow individuals to take more cash off the mainland.

This effect of getting in before rate rises coupled with

- plenty of very strong NZ economic data recently,
- upward revisions being made to NZ population growth forecasts,
- government accounts getting in good enough shape for tax cuts to become

- more probable somewhere down the track, and
- rising awareness that lack of funding for property developers will limit dwelling supply growth

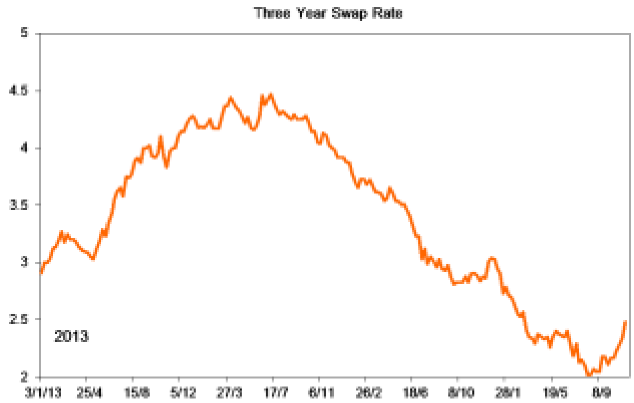
means more buyers are likely to be back in the market soon.

Just to clarify, although fixed home loan lending rates are now rising, there is nothing in play which suggests to us that big rises approaching 1% lie just ahead. We simply don't know. In this post-GFC world all forecasts of sustained interest rate rises globally have been wrong. And while the high pace of growth in our economy would have us talking about fixing five to seven years pre-GFC that is not the case now because none of us any longer has a model which gives reasonable insight into where inflation is heading. All forecasts post-GFC have proved to be too high.

So panic mode by borrowers is not required. But more attention to choosing a mixture of fixed rates on the basis of managing risk (unknowns) is.

Were I borrowing at the moment I would now have one-third floating and two-thirds fixed three years to give insulation against the risk that US inflation gets bumped up by tariff hikes and that this lifts long-term funding costs a decent whack. If I did not value having the ability to make early repayments without penalties then I would fix entirely for three years – before rates go higher.

The three year swap rate has risen this past week from 2.35% to 2.48%. A month ago it was 2.17%.



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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