BNZ Weekly Overview

24 November 2016

ISSN 2463-4328

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.

Making Forecast Changes

The first trick to being a good macroeconomist is to develop a view on where you see the economy going then only alter that view at the margin as new developments occur or data show your view is off track.

The second trick is knowing when changes are large enough and data variance great enough to warrant a decent shift in one's outlook. All of us have experienced periods when we have hung onto a view for too long, and changed it too soon.

At the moment we live in a world where uncertainty about where things are going is the greatest any of us have ever seen. This is mainly because the GFC has rendered most economic models useless. Key relationships between things like GDP growth and jobs growth, jobs growth and wages growth, wages growth and inflation, interest rates and debt growth, etc. have all changed. We don't know when if ever a new steady environment will be reached and that is why one of the key points we started making here some seven years ago was that people should be very wary of developing risk management strategies heavily reliant upon a particular set of forecasts proving accurate. We retain that warning.

Looking at our situation currently we have some data developments which are a bit different from what we expected. Net migration inflows are exceeding even our optimistic forecasts outlined four years ago. Tourism sector growth is exceeding expectations. Jobs growth is well above previous forecasts, wages growth continues to surprise on the low side, retail spending growth on the high side, inflation low. Some are surprised by house price rises.

Things are all over the place but not by enough to alter our key message of the economy being strong now and for the next few years even taking into account the second reason why we might change our forecasts, real world shocks.

One of those is the recent North Canterbury earthquake, the aftershocks, and the growing list of affected buildings in Wellington.

The immediate effect is a decrease in economic activity (people can't get to work). The eventual effect however is a stimulus through rebuilding and remediation. But because the construction sector is already at capacity the rebuilding will mean less construction elsewhere (Auckland housing supply growth will be constrained yet again). Therefore the stimulatory effect on the economy will be small, but upward pressure on construction costs and overall inflation will be slightly greater than expected. Yet within the context of forecasts of inflation and interest rates having been largely wrong since 2008 this effect is lost in the wash of existing prediction uncertainty.

The other shock which everyone is guessing at is the election of Mr Trump as US President. As peace and diversity-loving non-supporters riot in the streets, attack bystanders and threaten death we are wondering what the impact will be on our exports. The TPP was already dead before the election given the statements of the candidates. It would also deliver only a small estimated benefit to NZ over a long period of time and we would not be able to notice it in any of our economic measures. And what NZ needs is not more incentives to farmers to boost production, but incentives to farmers to add value. That means not just trade deals which improve access for value added products like nutraceuticals, but a change in mindset down on the farm – a sector which is not a driver of jobs growth in New Zealand any longer.

Death of the TPP means little to our economic outlook. Of greater consequence in terms of the outlook for our economy over the next three years is the stronger USD and higher interest rates.

The USD has strengthened because of expectations of a stimulus to growth from much looser fiscal policy in the United States and greater scope for tightening monetary policy. Fine. But we have been here before post-GFC with markets getting excited about and pricing in faster US growth and higher rates. And they have been wrong every time so far. Maybe this time will be different because of the mandate given. But the risk is that markets do what markets do and that is get ahead of reality and become highly vulnerable to alterations in expectations of what is to come.

Thus at this stage we think it is premature to make any radical changes in expectations for either US growth, world growth, NZ growth, NZ interest rates, and the NZD as a result of the US election. All we can reasonably say is that at the margin the NZD will track lower against the USD than previously expected, and fixed borrowing costs will be slightly higher.

The bigger implications of the US election as with Brexit and as with the many coming elections in Europe lie in the societal and geopolitical arenas and that is outside the scope of what we discuss here. So lets stick with something we reckon we know a bit about and can present a record of giving good insight into...

Housing

There isn't much new worth adding here this week. My view on the housing market remains pretty much what was expressed in the first Weekly Overview for 2016.

"Suffice to say that the central themes discussed last year as relevant for 2016 remain unchanged – investors flocking to the regions and boosting prices there, raising the risk of the RB following behind and imposing Auckland's 30% investment purchase deposit requirement. Interest rates staying low encouraging more people to buy. Booming net immigration raising demand. Supply everywhere but Auckland particularly constrained by shortages of builders and land, land banking, and red tape."

The only thing not there was the 30% investor minimum deposit requirement imposed in Auckland spreading everywhere not at that rate but at the higher 40%.

This link will take you to the March 23 Weekly Overview where I discussed a list of points supportive of Auckland house prices presented to an audience of 700 people at a seminar in Auckland.
http://tonyalexander.co.nz/wp-content/uploads/2016/03/WO-March-23-2016.pdf

Where the housing market sits currently is that we have the same upward pressures on prices from low interest rates, high net immigration, shortages of resources, plus a whole lot of people aching to buy anything they can get a mortgage for because they feel they have missed out on something. But we also have reduced availability of credit from banks which is actually a plus and a minus for house prices. The minus is that the constraint on people buying is now credit supply, not credit cost. That has been one of our key points since the LVRs were first imposed in 2013.

The plus is that a shortage of finance means developers cannot raise funds to build properties as quickly as they would like. Supply growth is constrained.

Data, as discussed last week, show that activity has slowed along with the pace of price rises. The question is whether this slowing is a permanent thing or just a longer version of what we saw after tighter LVR rules in October 2013 and October 2015. We suspect the latter and this means we have little hesitation in suggesting to young buyers in particular with access to credit that they take advantage of the reduced number of competing buyers in the market at the moment. And keep in mind that if we are right and the market reignites then access to credit will become tighter still as first the LVR percentages get raised again, then probably after the election the Reserve Bank get their hands on a debt to income tool once permission from the Minister of Finance is granted.

Regarding the boost to housing demand from migration flows ask yourself this. Have some truly wonderful things happened recently which will encourage Kiwis to seek their fortunes offshore? In the UK with its Brexit uncertainty? In Europe with coming elections looking like they will set the scene for first the Eurozone then perhaps the EU to collapse? In Japan with near zero economic growth? In China with tightening personal and business freedoms and ad hoc introduction of new rules? In Australia with a dysfunctional parliament preventing reforms for 12 years, a deficit getting worse, potential credit rating cut, and weak labour market? In America with uncertainty surrounding the incoming President?

The answers are all no. There is a growing disincentive for Kiwis to go offshore, and an increasing incentive to remain here with the exceptionally strong labour market, talk of personal income tax cuts, and deepening and diversification of interesting sectors in our main agglomeration of Auckland.

On Tuesday we received migration numbers for October. They show that the annual net population gain from migration flows hit a record 70,300 in October from 70,000 in September, 62,500 a year ago, and an average gain of 21,252 over each of the past ten years. The boost to the economy and housing market from migration continues to grow with this past year's gain equivalent to a boost of 1.5% more people.

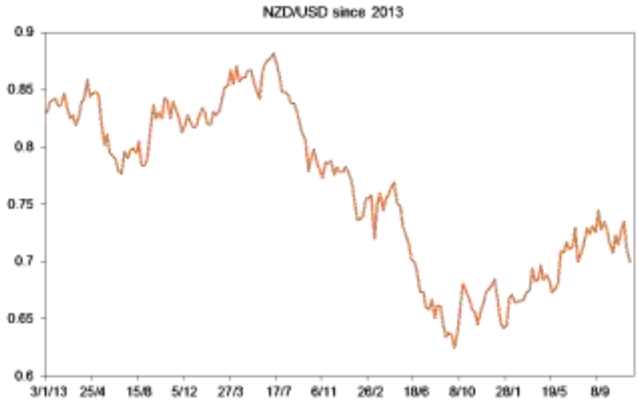
Over this year what has happened with regard to the pace of growth in new housing supply in Auckland? It has slowed down. In the three months to December 2015 dwelling consent numbers for our largest city were ahead 24% from a year earlier. In the March quarter this annual growth rate slowed to 18%. It then fell to 4% in the June quarter before recovering to 12% in the September quarter which was just over half the 22% pace of a year earlier. Dwelling supply is growing, but at a slowing pace.

For now we think the residential real estate market will remain subdued by the standards of the past year or so. But come the New Year a pickup is possible and if that happens then more LVR tightening will eventually follow. We wait to see.

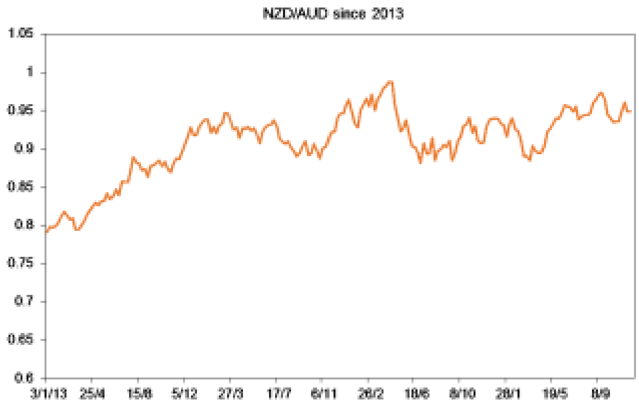
NZ Dollar

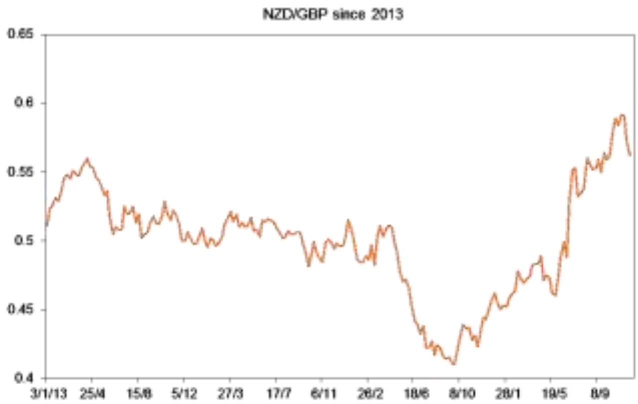
The Kiwi dollar has remained low this week against a USD still buoyed by a rise in expectations that two weeks from now monetary policy will be tightened in the US, and by expectations of stronger growth as fiscal policy gets eased by the incoming President.

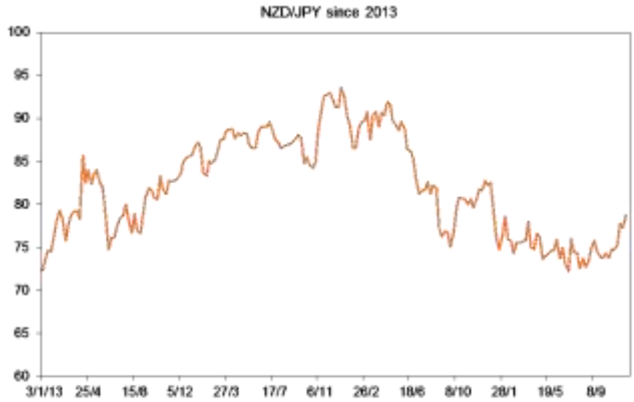
The NZD this afternoon was trading near US 70 cents from 71 cents last week and 73.5 cents two weeks ago.

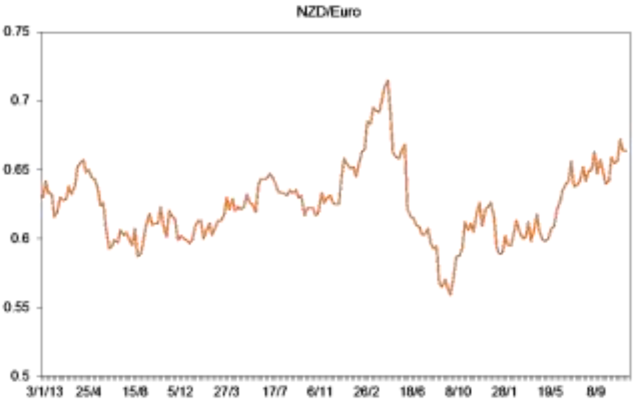


But against the Aussie dollar we are unchanged near 75 cents, against the Japanese Yen up near 79 from 77 last week, down one penny against the British pound to near 56.2 pence, and unchanged against the Euro at 66.4. So this is a story of a firm USD rather than a weak USD.









Where to from here? The fundamentals of strong growth and rising commodity prices are supportive of a higher NZD. The only bugbear is the extent to which the USD unilaterally rises and the risk there is that the markets over-estimate the stimulus to US growth from the presidential election outcome and the greenback soon gives back some of its gains and we head back to 72 cents.

If I Were A Borrower What Would I Do?

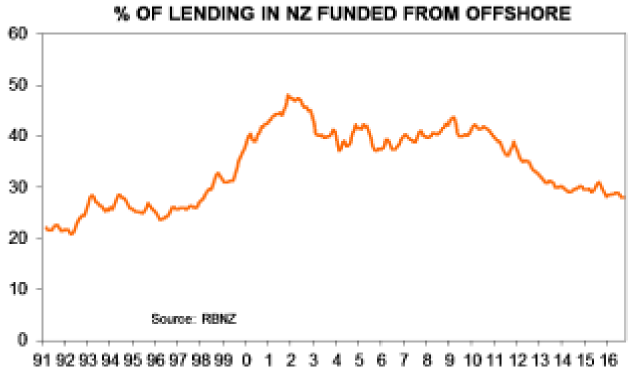
As we warned would happen last week, fixed home lending rates have just gone up in response to a rise in funding costs partly associated with the election of Mr Trump in the US raising medium to long term interest rates globally. Our three year fixed rate remains at the 4.59% rate it was raised to three weeks ago, but the two year rate has risen 0.1% to 4.39%, the four year rate 0.21% to 5.2%, the five year rate 0.24% to 5.39%, and the seven year rate (which hardly anyone touches) 0.34% to 5.89%.

Unless rates radically change offshore these changes may be the last for a while even though the US Federal Reserve is likely to raise its funds rate 0.25% next month. This change is almost entirely factored into current rates.

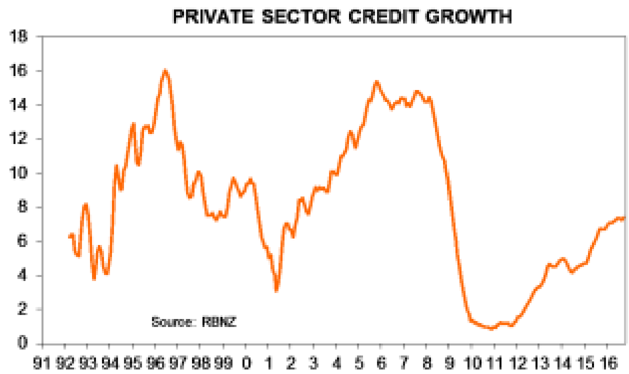
If I were borrowing at the moment I would be happy to fix most of my mortgage for three years leaving a portion floating to allow for early repayments without penalty.

For your guide, we have just raised the interest rate on our BNZ two year term deposit rate to 4%. Why? Because we need to fund more of the lending we do in New Zealand from New Zealanders. The key vulnerability of the NZ banking sector is not bad lending (took care of that in the 1984-87 period) but the lack of savings by Kiwis forcing us to borrow from foreigners.

The following graph shows the proportion of lending to NZ residents financed by non-residents. This proportion rose steadily over the period from 1998 to 2002 peaking at around 48%. It was just over 40% going into the GFC and now it is near 28% - back where we were in about 1998.



But the ratio needs to go lower and that is problematic in the current environment where the pace of growth in lending within New Zealand has picked up. Private sector credit growth was 7.4% in the September quarter from a year ago which was the strongest pace since early-2009.



We need to fund more of our lending from Kiwis, but low interest rates courtesy of low rates globally and our central bank slashing the official cash rate have driven an increase in credit demand and decrease in the desire of people to save. Hence what we are seeing now is increasing restrictions being placed on lending (focussed for now on the property development sector) and rising retail deposit rates.

The risk is this environment is that banks not only tighten lending to developers but also home buyers in advance of a further tightening being imposed by the Reserve Bank. The problem for home buyers is not just finding a place they can afford to buy, but getting finance. The cost of the finance is not an issue for the vast majority.

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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