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.

The New Order

Yippee. Another year above ground for most of us and what a year it looks likely to be. The new US President is in place signing so many executive orders he probably reckons he does not need to bare chest and wrestle a bear to win popular support as President Putin does. The world is moving away from the guilt-focussed victim-seeking liberal agendas of the past few decades towards individual self-interest, nationalism, liberal criticism, and a challenge to political correctness.

What does it mean for us that nationalism in particular is on the rise in the US, UK, Europe, China, Japan, Turkey, Russia, Australia etc.? Probably nothing in terms of foreign investment in New Zealand as although in theory outward flows from the United States will decrease as investors fear special tariffs being placed on goods imported into the US from foreign factories, in truth we traditionally attract little greenfields investment from offshore. Mainly we sell people our existing assets. No big economic loss there if such flows were to ease.

Some people think the change in conditions offshore will bring a flow of migrants to New Zealand. Our cultural cringe and sense of smallness make us pay attention to such theories and get a warm feeling in our tummies. But unless they are Kiwis they will have to join the queue to get in. Foreign migration to NZ is not going to be boosted unless our immigration rules are loosened. But the world is moving against free migrant flows and given that there is a general election here this year the chances are we will see some further tightening of the rules applied to people wanting to come here.

But there are one million Kiwis offshore and 4.5 million or so here and it seems reasonable to expect that being a liberal, fair-minded bunch of egalitarians we will not feel comfortable with a lot of what is happening offshore and will choose to come back here or not to leave. That means net migration flows into New Zealand are likely to remain high over the next few years and that will put pressure on government to boost infrastructure spending, speak deeper words about housing affordability (yet achieve little), and revise downwards estimates of the taxpayer burden from an aging population because of the extra workforce growth strong migration flows imply. People who migrate tend to be working. People over 65 staying in the workforce will also boost tax revenues and reduce fiscal burdens.

The high chances of fiscal stimulus in the United States through higher infrastructure and military spending along with tax cuts will boost one of the ongoing biggest sources of uncertainty for global financial markets which has been around for perhaps five years now – the speed of tightening of US monetary policy. If things do really surge in the US without a turn upward in the pace of productivity growth (which has dropped in most countries not just NZ in recent years) then higher inflation risk could produce rapid US rate rises.

These would feed through into higher interest rates here which will cause some extra slowing of the housing market. But rates are highly likely to still remain low by historical standards and with strong population growth, shortages of construction finance, shortages of materials, and shortages of skilled staff, house prices will remain well supported and almost certainly (99% chance) rise virtually everywhere around the country this year. But do be extra careful about over-reliance upon any particular set of interest rate forecasts as you contemplate the management of your interest rate risk. Predictability has been minimal since 2008 and has become ever worse. Seek advice.

Trade is where the global rise of nationalism has the most relevance for ourselves. The TPP was never going to mean all that much for our economy, it was clear months back that it was dead, and now the US has killed it off completely. No TPP-1 agreement is likely as all negotiations will have to go back to first square anyway. Instead we might look at the China-led version.

But that is where things will get extra tricky.

China has risen over the past four decades economically, politically, strategically etc. internationally with essentially no restraint. The Chinese authorities have taken advantage of the weakness of liberal Western regimes to expand legally false claims to territory in the south China Seas, copied Western technology, and increasingly in recent years made it harder for foreign businesses operating in China to expect stability in their operating environments. Speak with any exporter of infant formula there to get insight into this if you like.

Now there is pushback from the United States. How this will manifest itself is unknown. But in recent years when asked what we consider to be the greatest threat to NZ economic prospects our response has been conflict in the China Seas slamming trade and confidence. That risk has risen and along with interest rate uncertainty poses the biggest risk still going forward.

Will we respond to global changes by getting much closer to China? Probably not though our economic dependence upon them will likely grow. China is a bullying one party state with near total party control of the media and legal system, subjugation of individual rights to the desires of the party, high corruption, and a completely different attitude toward man's relationship with nature than we have. As analysts are increasingly finding when they examine the likes of Brexit and Mr Trump's victory history, values and culture matter – and they matter a lot more than economics.

There are big differences between Kiwi and Mainland Chinese CCP-driven cultures and in the event where we might have to choose sides in conflict between the United States and China, it seems fairly obvious who's ships we will position our personnel on and alongside. God forbid we reach such a point however.

But while we scratch our heads trying to understand where the world outside our shores is going, it pays to remember that here in New Zealand the pace of economic growth has been good recently and looks highly likely to remain so.

Business and consumer confidence readings are at well above average levels as are business hiring and investment intentions. Dairy prices are well off their lows (and hopefully extra income goes into off-farm investment rather than more cows). Tourism is booming with strong support from Chinese visitors. The best article I have ever seen discussing these visitors was published last weekend and is available here. Read it if you wish to better profit from the growth in this important market (assuming no war).
http://www.stuff.co.nz/business/88443782/more-chinese-visitors-abandoning-tour-buses-and-going-it-alone

Construction is also booming especially in Auckland. Watch for increased allocations of funds to infrastructure in this year's Budget due in May as strong economic growth drives strong tax revenue and surplus estimates.

World growth is also picking up. Economic data have been better than expected in recent months in the United States, China, Japan, the UK and Europe. The IMF also recently forecast a lift in world growth this year from 3.1% last year to 3.4% this year and 3.6% next year.

What could possibly go wrong? Beyond the China Seas, potential global protectionism, European nationalism and existential threat to the Eurozone and EU, and interest rate uncertainty, there are earthquakes. The experts appear to be making greater effort to make us aware that we are in a more seismically unstable period and the risks of a large shake in the bottom of the North Island/top of the South Island region have increased.

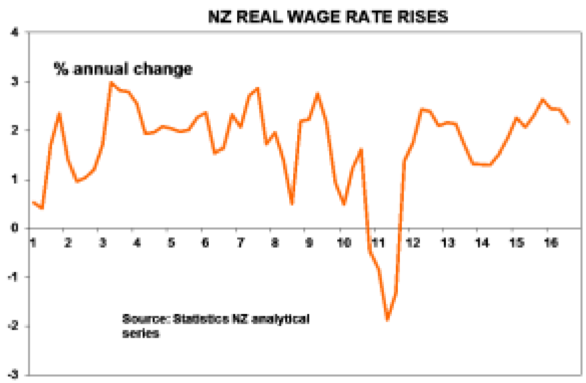
It will be interesting to see how businesses adjust their long-term plans regarding facilities and staff locations to factor in these heightened risks of work and life disruption. Some may opt for relocation up the Kapiti Coast especially as in three years time the Transmission Gully Motorway is scheduled to almost be open. Some may look not at Auckland but just south of it as transport links improve in and out of Auckland – perhaps Hamilton.

Real Wages Growth

A lot of people tell outright falsehoods about wages growth in New Zealand. Here is some clarification.

As yet there is no evidence that the uptick in jobs growth in New Zealand since 2013 has produced any acceleration in the pace of wages growth. This has led to the popular view that household incomes are being crimped and people are in a woeful state. Not so.

Since 2007 the measure of wages growth which we follow has risen by 32%. Consumer prices over that period of time have risen by about 17%. Real wages have gone up by 15%.



Using the wages data which runs to the September quarter of last year we see that with inflation then at just 0.4% real wages rose 2.2%. A year before they rose 2.3%, a year before that 1.5%.

While nominal wages growth has been low inflation has been ultra-low.

Housing

This week saw the release of the Demographia Annual Housing Affordability Survey. It ranked Auckland as the fourth least affordable city in the world for housing. Understandably this release has caused a lot of discussion amongst those concerned about the ability of young people to get their foot on the housing ladder. And much hand wringing has been with us for a number of years now with no impact on the pace of price rises.

Valuation measures for shares, exchange rates, houses etc. give no insight into where the price of the relevant asset is going to go. If someone says their analysis shows an exchange rate to be over-valued by 20% we are invited to accept the view that from here on the currency will fall. But before getting 20% over-valued it was 5% above trend and did not fall. Then 10% and did not fall. Then 15% and did not fall. Perhaps the only reason it is over-valued 20% is because it is on its way to being over-valued by 80%.

No forecast insight is delivered by long-term valuation measures and the rise in Auckland house prices in recent years in spite of much moaning about the city's unaffordability ranking shows these numerous measures of how high prices are should not be considered by buyers as giving any guide to where prices are set to go. Anyone who has treated them that way has missed out on getting their foot on the housing equity ladder and perhaps you should have a word with the analysts advising you to hold off buying since 2008 and ask them why they got things so wrong.

Potential buyers need to look at the fundamentals, not the valuation measures and the simple fundamentals for Auckland which we have highlighted for eight years now are as follow.

House construction fell below levels required by population growth in the mid-2000s. That under-construction got much worse post-GFC when house building around New Zealand fell to levels of the 1960s. Even though construction is now rising it still is failing to keep up with population growth.

Migration flows added about 42,000 people to Auckland's population last year. With an average household occupancy rate of three people per house that migration surge necessitated construction of 14,000 more houses. At best 9,000 were built. Auckland's housing shortage continues to grow.

There is more one could write here – but that will come in the next few weeks.

NZ Dollar

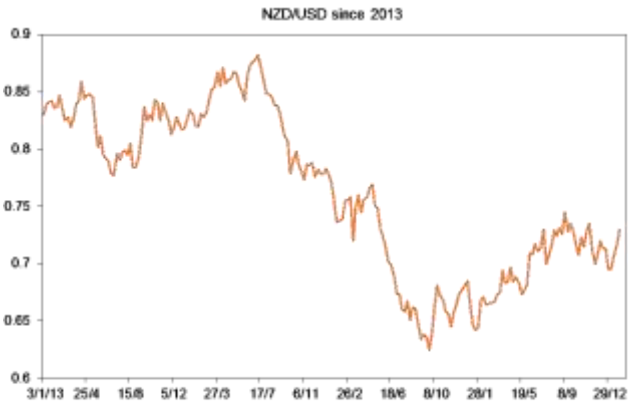
The international environment is very uncertain with the election of Mr Trump, Brexit, rising Chinese debt and tensions sure to escalate in the South China Sea, questions about the survival of the Eurozone, European Union and NATO, tightening US monetary policy, Greek debt problems on the cusp of surfacing again, rising nationalism throughout Europe, and poor economic policy reform progress in Australia.

A lot of people will interpret the relevance of this for New Zealand through the lens of the old adage that if America sneezes we get a cold. But anyone taking that approach and acting on it since the very mediocre recovery in world economic activity under way from 2009 has missed out not just on soaring NZ house prices but a firmly growing NZ economy and sharemarket. We have done alright while the rest of the world has wallowed – and that is the way things are likely to continue over the next few years.

We enter 2017 with well above average readings of consumer and business confidence, employment and investment intentions, dairy prices well off their lows, booming tourism, booming construction, population growth near twice the long-term average, a current account deficit only 2.9% of GDP, and lots of political and fiscal stability.

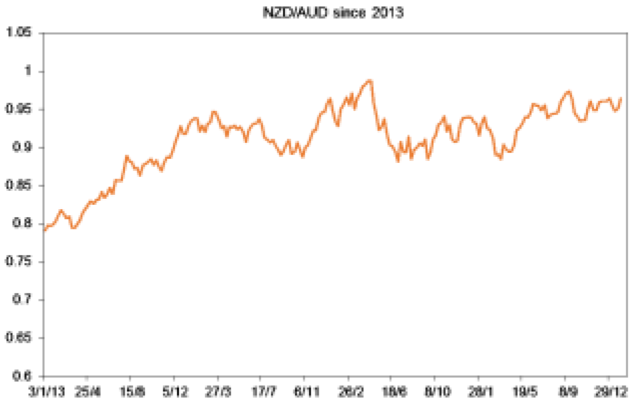
While we should fully expect lots of currency fluctuations as a result of the approach taken by President Trump to any issue, (keep 'em guessing, bluster, challenge facts as lies, claim conspiracies, make personal attacks, deliver over-the-top praise when people get on board, never look weak, never lose, confuse with outlandish claims) underlying support for the NZ dollar looks strong.

It is unsurprising that since dipping to US 69 cents on January 4 the NZD has rebounded to now sit near 73 cents. A boost of about half a cent came this morning when the December quarter increase in the Consumers Price Index came in at 0.4% rather than the more commonly expected 0.2%. Annual inflation is now 1.3% whereas the Reserve Bank's most recent estimate for calendar 2016 was 1.1%. The chances of monetary policy tightening over the 2017-18 period have risen – hence a firmer NZD.

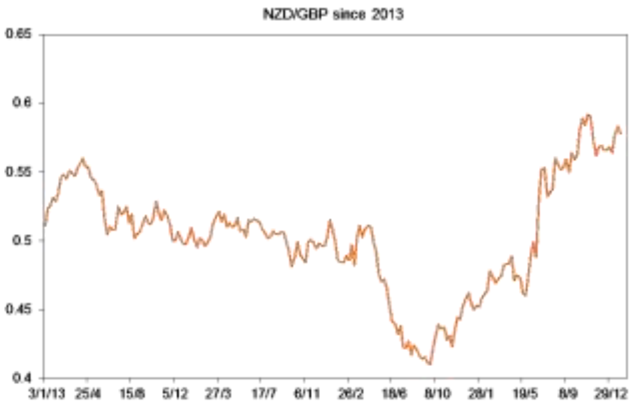


Chances are we will rise from here, especially as this week the new US Treasury Secretary tried jawboning the greenback lower. Mr Trump's cancellation of US participation in TPP had essentially no sustained NZD impact as the move was expected and the deal anyway would have had minimal economic impact on NZ estimated at best to add up to $2.7bn over a decade. Meh.

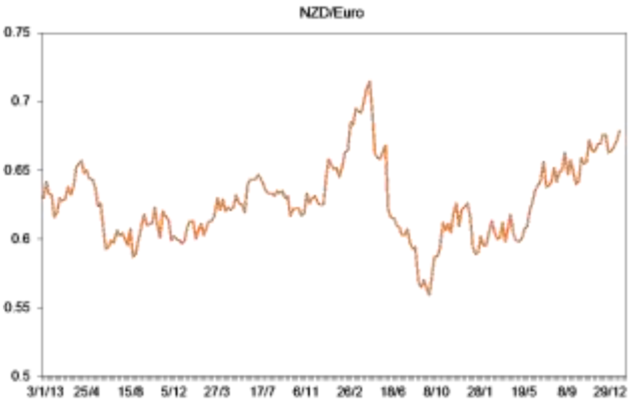
Against an Aussie dollar struggling against a very uncertain political and policy environment there is a good chance we reach parity this year. This is especially so as we expect the RBA to cut their cash rate from 1.5% to 1.0%. We now sit near 96.4 cents from 96 cents five weeks back.

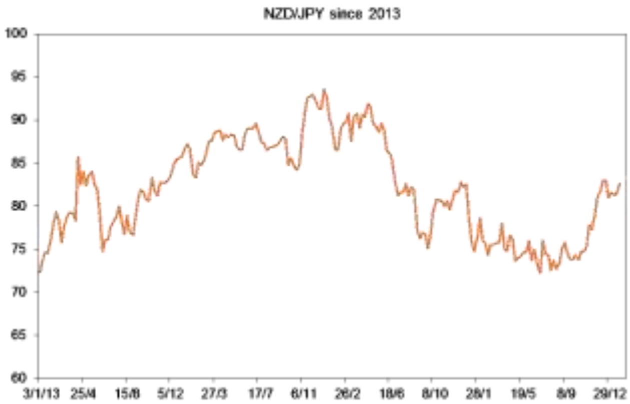


Against a British Pound affected by high uncertainty surrounding Brexit (so far not the economic death knell Remain campaigners predicted), and monetary policy the NZD could hit 60 pence from 57.8 pence this afternoon. The rate five weeks ago was 56.6 pence.



Against a Euro likely to be hit with more speculation of it falling apart this year we are likely to rise. And against a Yen affected by rising tensions in the China Seas and an underlying poor pace of economic growth we also risk rising somewhat.





So, if I were an exporter, I would look to take advantage of the occasional wave which comes along to push the NZD lower (optimism about Trumpian America for instance) to get extra hedging locked in.

However..........
If President Trump pursues an isolationist trade policy (TPP already dead, NAFTA to be renegotiated) then other countries might follow suit in the sort of beggar-thy-neighbour policy framework which made the Great Depression of the 1930s so much worse. The global rules-based trading system could weaken. In that case we could easily see the resurrection of barriers to the importation of NZ primary products in the United States and Europe. In that case the NZD would fall. A lot.

For your guide policies are being directed toward vastly greater food production in a number of countries including the United States and Australia. Plus each year progress is made on synthesised milk and meat. Look what nylon did for wool demand.

If I Were A Borrower What Would I Do?

Last year we saw rising bank funding costs and higher US bond yields following victory for Mr Trump. This prompted a rise in NZ home mortgage lending rates. That process has continued over the holidays and we now sit with our own BNZ rates at the following levels.

	Now	**Nov.**	**Jan. '16**
Floating	5.79	5.64	5.79
Fixed			
One year	4.49	4.29	4.35
Two years	4.79	4.29	4.39
Three years	5.09	4.49	4.49
Four years	5.69	4.99	5.25
Five years	5.79	5.15	5.35
Seven years	6.15	5.55	5.75

These rises have been greater than expected because Mr Trump's victory was not expected and because in major economies the pace of economic growth recently has proved slightly better than expected – China, EU, UK, US, and even Japan.

Will this pace of rises continue? You cannot rule it out because we simply don't know to what extent policy changes by President Trump will boost US growth and inflation and the pace of tightening of US monetary policy. This is a new source of global uncertainty for the financial markets and something which people should take into account when considering their management of interest rate risk.

In a nutshell it has become more risky to sit with the bulk of your mortgage floating and/or fixed for only one or two years. In mid-May I shifted my comment regarding what I would do if I were a borrower to having a mix of floating and two years fixed to having a mix of floating plus two and three year fixed. Immediately following the US election I shifted to a preference for one-third floating and all the rest fixed three years. So how about now with the three year rate 0.5% higher than November 10? Back then the extra cost of fixing five years rather than three was 0.66%. Now it is 0.70%. I still find that too much of a jump.

If I were borrowing at the moment I would have one-quarter to one-third floating and the rest fixed three years at 5.09%. If you are conservative then you might jump to five years at 5.79%.

Regarding the state of things in the wholesale interest rate markets. The ease with which we can analyse published wholesale rate changes and make comments regarding the impact on retail interest rates has collapsed. Behind the scenes there is far greater relevance now of the extra margins banks must pay to raise funds, especially offshore given that lending within New Zealand cannot be matched by borrowing within New Zealand.

The lack of domestic saving in NZ explains why the availability of finance for property developers has declined. In the bad old days of the 1980s we would simply have funded their demands by raising funds offshore. But in a world where central banks now devote far more of their attention to financial system management and the risk settings of banks that option is not prudently available.

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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