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 US Growth Stimulus

To what extent will the furore over executive orders being signed by President Trump and language he uses spill over into actual impacts on the area we are interested in – the NZ economy? Its not an easy question to answer for at least two reasons.

First, the analysis of most people will be impeded by the media-assisted distaste they feel, or the support they hide for President Trump (49% of Americans support the migrant bans http://www.reuters.com/article/us-usa-trump-immigration-poll-exclusive-idUSKBN15F2MG 57% want reduced legal immigration, 49% of Brits support his state visit).

And for your guide, ahead of the election 57% disapproved of President Obama's moves on gun control, 56% disapproved of Obamacare, 61% opposed taking more refugees, and 62% opposed the President's policies toward ISIS.

Emotions will rule and these people respectively will have a very negative or a very positive view on economic impacts. This is the same dynamic we use to help explain why so many people have got their housing market analysis wrong this past decade. They have been driven by the emotion they feel over declining home affordability for first home buyers and the stretching away of jafaland from the rest of the country. Actual analysis never really got done of fundamentals like demographic changes and supply growth.

So, if you are going to analyse what the new leader of the "free" world is doing first you have to kick as many of your emotions to the side as possible. Good luck Spock.

Second, it is simply not possible yet to take a reasonable view on the effect which the new President's policies will have. Consider building the proposed wall along the border with Mexico. It will cost by the looks of it between $10bn and $32bn. That is a fiscal stimulus, but paying for it with anything other than a larger deficit will be a fiscal drag – and even a larger deficit will drag on growth because of the implied need for higher taxes down the track and the extra upward pressure on interest rates. If payment comes via a special tariff on imports from Mexico this will increase the cost of living for American families while hitting profits for American companies which ship goods for inclusion in the goods which come back across the border.

And we don't know what the timeframe will be for a wall anyway.

Building the two oil pipelines which have now been freed up for construction will boost economic activity but legal issues make timetables unclear.

President Trump plans making changes which will free up exploitation of an estimated $50tn worth of energy reserves in the United States. We don't know when this will happen, how quickly businesses will boost exploration and exploitation, and to what extent the already recovering expenditure on shale oil and gas exploration will cloud the eventual stimulus to the energy sector.

He also plans undertaking $1tn of spending on US infrastructure over the next ten years. Again, we don't know when such spending will kick in or where it will be focussed and how it will be financed.

He plans ripping up the agreement on climate change targets agreed in Paris. But we don't know again when and how this will impact the bottom lines and spending plans of US businesses.

He plans to aggressively grow the US military. A well oiled industrial machine already sits ready to start designing then pumping out extra equipment so this could be an easy stimulus to undertake with quick impact. But we don't know when this will start happening.

He plans cutting the average tax rate on US business profits from 35% to 15%. This has capacity to boost business investment (which has been lacking post-GFC) and accelerate the average pace of growth in wages. A clear positive but we don't yet know when. Same for planned unspecified tax cuts for individuals.

Tariffs to discourage US businesses from outsourcing are planned. But it seems fairly clear that US businesses are aware of this threat and chances are few will now plan to shift US production offshore. Instead they will reshuffle production for the US market so it stays in the US and service other markets not by exporting from the US but by investing in factories offshore for supplying offshore markets. Such changes will retard productivity growth and therefore the long-term pace of economic growth.

The cancellation of TPP means a lot in the geopolitical space and reduces the previously planned increase in the ability of US companies to sue foreign governments to stop legislative changes which would disadvantage them. So in some respects that is an own goal. But TPP was never a game changer economically for anyone. The big uncertainty revolves around what planned bilateral trade deals will look like and whether countries will feel they can reasonably enter into one with a country led by someone who says each agreement will have a 30 day opt-out clause for the US if anything upsets them. Statements like that start to make even China look like a reliable trading partner for infant formula producers. Global trade liberalisation might go backward and that will retard global growth in the long-term though probably be cheered by the left.

The executive order instructing Federal agencies to not do anything advancing Obamacare has little immediate economic impact and when the new government gets around to ripping up the recently introduced system there will be little effect on the economy. The impact will concentrate on individual health insurance businesses and people who won't be able again to access healthcare. Thank goodness for our "socialist" system considered so frightening to many Americans.

A Federal employee hiring freeze has been put in place. That will have only a minor negative impact as Federal employee numbers have essentially not changed for a couple of decades or so.

NAFTA is to be renegotiated. Complete uncertainty surrounds that but it probably won't be the death knell to Mexico's economy that people naturally think because there is little evidence it has actually boosted Mexican incomes.

Two Federal regulations are to be cut for every new one to be put in place. The economic impact will almost certainly be zero and any low level bureaucrat should be able to draw up lists of hundreds of little regulations they can rip away with minimal impact when new meaningful ones get introduced.

Overall, putting aside the disgust some people feel about so much of what the new US President is doing and saying, and about those he has surrounded himself with, we can boil his campaign promises and executive orders to date down to this economically speaking.

The pace of US economic growth over the next few years but not necessarily this year will receive a boost from higher spending on infrastructure and the military, frightened companies holding off outsourcing, building the wall, extra energy sector investment, and lower taxes for businesses and households.

But this spending will lift the rate of inflation and likely hasten the speed with which the Federal Reserve raises interest rates whilst also boosting long term rates to an extra degree because of bigger Federal budget deficits.

Can these effects be reasonably encapsulated and analysed in economic models? No. It is not just that we don't know the magnitude of changes or their timing, we also haven't had economic models which work properly since the Global Financial Crisis.

So that brings us to another impact of the new President and his policies – heightened uncertainty. This uncertainty will manifest itself as extra volatility in financial asset prices such as for gold, currencies, shares, etc. You should explicitly factor this into the risk profiles you adopt with your investments, interest rate and currency risk management facilities.

Regarding currencies, in theory one would expect faster US growth and higher interest rates to boost the USD – not so fast. The incoming Treasury Secretary has already tried talking the USD down, the head of the newly created

National Trade Council has accused Germany of using an undervalued Euro to boost exports, and the President has accused Japan and China of playing with their money markets.

The new US President is a mercantilist – like China. That means he will use whatever means are available or creatable to boost exports of US businesses while making it hard for foreign businesses to get their goods and services into the United States. One element of this is higher tariffs, another is lobbying/threatening US firms who produce goods offshore for US consumption (cars and drugs so far), another is unbalanced trade deals, another is tax favours for US exporters, another is new non-tariff barriers on imports (China are experts in this area, Europeans too), and another element is currency manipulation. Note that mercantilism emphasises reducing economic dependency upon other nations, so boosting exports is less important than restricting imports, the stage which China has probably reached.

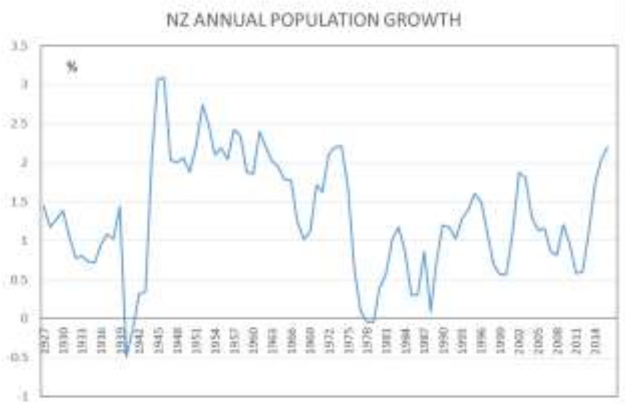
Chances are the new administration will seek a weaker USD and not allow the greenback to rise as the economic growth outlook improves. Watch for how this will eventually manifest itself as a fight with the Federal Reserve much further down the track.

So, chances are the NZD faces downward pressure from a global trading system getting decreasingly free, yet upward pressure from our good growth sectors (tourism, construction, recovering dairy plus net immigration) and perhaps a weaker greenback. Overall, the NZD will probably rise.

NZ interest rates have already risen partly because of higher current and predicted interest rate tracks in the United States. Further upside looms though the pace is unlikely to be rapid.

Our net immigration boost is likely to remain high for the next four years as those of us here stay here and the one million of us Kiwis offshore feel more inclined to return. This will reflect not just the distaste of some for the new America and uncertainty about the impact of Brexit, but the excrement storm about to flush through Europe as countries undertake elections starting with the Netherlands in mid-March. The chances of nationalistic parties with anti-Euro and anti-Muslim agendas gaining greater power are very very high.

For your guide, courtesy of the migration boom New Zealand's population is growing at its fastest pace since 1974 at just over 2% per annum. Note the upward trend in the pace of growth since the late-1970s. This reflects the upward trend in average migration flows. As noted previously, in the ten years ending 1986 New Zealand experienced an average net annual migration flow of -17,000. In the ten years to 1996 that turned to a gain of 3,000, then a gain of 11,000 to 2006, and now a gain of 22,000 in the ten years ending in 2016. Hence infrastructure pressures, hence housing availability and pricing pressures, hence calls for increased numbers of police, healthcare workers etc. and strengthening state focus on delivering services more efficiently and in a more targeted manner using new technologies.



Speaking of Kiwis staying here and coming home – a key attraction is the exceptionally strong labour market. During the December quarter job numbers rose by 0.8% after rising 1.3% in the September quarter. Growth from a year ago was probably somewhere approaching 4.5% when we note the June quarter rise of 2.4% was largely caused by some classification changes.

Despite 0.8% quarterly jobs growth the unemployment rate rose from 4.9% to 5.2%. Why? Because people are so confident of finding a job they are actively looking for work and being counted therefore as unemployed rather than sitting back in despondency. This is very good and such a massive contrast to the situation offshore.

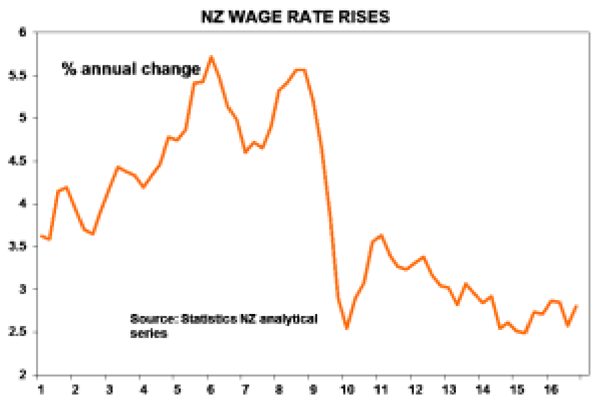
Consider the United States. Their unemployment rate is 4.7%. Is their labour market stronger than ours? No. Their participation rate – the proportion of the working age population in work or actively looking for it – is only 62.7%. Australia's is 64.7%. Ours reached a massive 70.5% in the December quarter from 70.1% in the September quarter and 67.7% when the labour market was at its post-GFC weakest in mid-2009.

Since mid-2009 job numbers in New Zealand have risen by 401,000. 355,000 of them are full-time – again a sign of a very robust labour market.

And here is another sign. The employment rate (the proportion of working age people who have a job) rose to a record 66.9% in the December quarter from 66.2% back before the last recession got going in 2008. And in a sign of how people are aging differently these days, the employment rate for people aged 65 and over held steady at 23.6% in the December quarter compared with only 5.8% back in 1998.

New Zealand is easily soaking up the effects of the net migration boom. Is this yet driving wages growth? No.

The measure which we follow, the Labour Cost Index analytical series put together by Statistics NZ, rose 1.0% in the December quarter from 0.6% in the September quarter and 0.7% a year ago. The annual pace of rise has therefore risen to 2.8% from 2.6% last quarter and 2.7% a year ago. But statistically speaking this is minor and we cannot yet really say that wages growth is accelerating.



One final comment for this week, the scientists who radically advanced the Doomsday Clock last week have got it wrong. Trump and his cohorts are accused of being too close to Russia. Yet Russia is the only other country with a nuclear arsenal big enough to assist in delivering global apocalypse. The chances of nuclear winter taking care of all our global warming problems (technically possible via dust blocking the sun for three years) appear to have gone down, not up.

If I Were A Borrower What Would I Do?

If you are interested in what the Reserve Bank is going to do with monetary policy it is almost certain (for readers of the WO) that you are thinking about what it means for mortgage rates. Some people will come from the angle of what it means for deposit rates. A handful will be interested in implied pressures on the exchange rate upward and downward.

We usually look at this from the borrower's point of view and doing so delivers something quite important which needs to be understood. Currently there is growing speculation that the Reserve Bank will raise the official cash rate this year because of slightly higher than expected inflation, an improving outlook for growth, increasing evidence of capacity constraints, and rising inflation expectations. These changes in policy expectations are driven by the view that the Reserve Bank will need to slow the pace of economic growth by causing mortgage lending rates to rise.

But here is the thing. They already have. As highlighted here last week the three year fixed mortgage rate we charge has risen by 0.6% since the start of November. The two year rate 0.5%, and the one year rate 0.2%. Floating mortgage rates have gone up 0.15%.

Actually, this week we boosted our one year rate another 0.1% to 4.59%, the four year rate another 0.2% to 4.89%, and the five year rate another 0.3% to 6.09%.

In effect monetary policy has already been tightened. Especially as the NZ dollar is tracking higher than the Reserve Bank built into their currency assumptions and 10% above the ten year average. And then there is more. Credit availability has declined.

In a post-GFC era we banks operating in New Zealand need to decrease our dependence upon the savings of foreigners which can dry up when global financial markets hit turbulence. That means we need to fund much more of our lending in New Zealand from New Zealanders. But we Kiwis don't like saving.

In the year to March 2016 the household savings rate was -2.2%. A year before that it was -1.5%. Thankfully the government is into it's third year of running a surplus and business profitability seems generally good while business investment is not growing strongly. But we banks are struggling to get the funds we need from Kiwis. Hence you might have noticed in recent months some easing off in the intensity of competition between banks for lending for house purchasers – and developers of course who are one of the riskiest groups to lend to.

Throw in the official Reserve Bank tightening of rules on bank lending and you get an environment where the main thing monetary policy aims to change – the cost and availability of mortgage finance – has tightened quite a bit in the past year with the official cash rate falling from 2.5% to 1.75%.

In fact, for your guide, our current floating mortgage rate is 5.79% whilst the cash rate is 1.75%. Just before the cash rate was cut from 2.5% in March last year the floating rate was also 5.79%. Of actual relevance, the 90-day bank bill yield has declined in the same period from 2.6% to 2.0%. Our margins haven't soared 0.6%. Other funding costs have risen.

While it is highly likely that we will see the official cash rate moving up in the next two years, it would be wrong to think that it is going to get hiked anytime soon. Our view for now remains that cash rate rises will start sometime in the first half of 2018 with the cash rate ending that year at 2.5%, then ending 2019 at 3.5%.

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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