BNZ Weekly Overview

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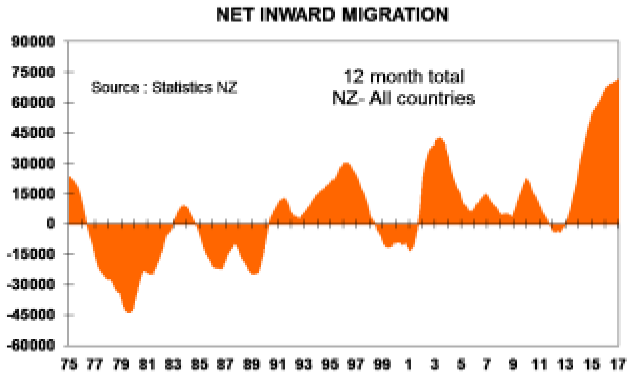
Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

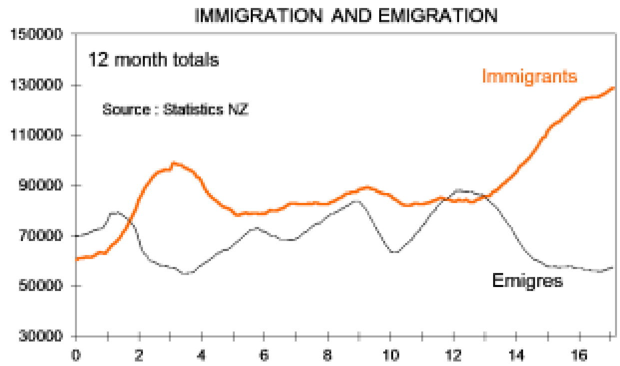
Migration Boom Continues

-More consumer spending, housing demand, upward pressure on rents and dwelling prices, more infrastructure pressure, but businesses still struggle to get staff.

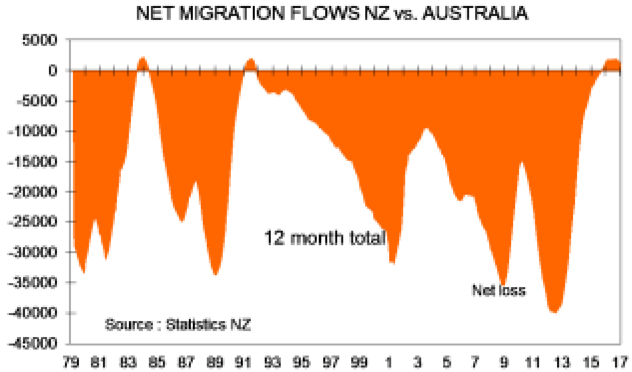
There was a net gain to New Zealand's population from permanent and long-term migration flows of 71,333 people in the year to February. This was up from 67,391 a year ago and a loss of 4,068 five years ago. This record net inflow reflects a jump in people coming into our increasingly polluted paradise to 129,000 from 84,000 five years back, and a fall in the numbers leaving to 57,000 from 88,000.



The gross inflow rise of 45,000 people is made up of 8,000 more students, 19,000 more work visas, 4,000 more residence visas, 2,000 more long-term visitors, and 12,000 more Kiwis and Aussies. So the actual migration surge of foreigners is about 23,000 or 31% of the total net migration turnaround from five years back of 75,000 people.



The biggest change in flows is across the Tasman which has gone from -39,000 to +1,027. This latest annual gain is down from a multi-decade peak of 1,958 in the year to September.



The net flow of people across the Tasman may have peaked, but the chances of a rapid move into large net outflows again are not very high. The relative state of the NZ and Australian labour markets has a big influence on Tasman flows and what we see currently and for the near future is strong labour demand in New Zealand but weak demand in Australia.

The Australian economy is growing at about 2% with support from construction, tourism and retailing plus higher volumes of exports. But the end of the period of massive development of the minerals sector has produced high unemployment in Western Australia and parts of Queensland. The closing down of the car assembly industry has led to weakness in the Victorian and South Australian economy.

Business sentiment in those two states has been depressed by failure of the electricity systems. At the Federal level politics is a mess with frequent leadership changes in the past decade and inability of the government to get legislation through Parliament.

Corruption comes across as a far greater problem at all levels of government than in New Zealand, there are friction points around free speech, Islamism and terrorism, union tactics, high house prices, long commuting times, expensive childcare, rising bank mortgage rates, and an investment property boom which seems set to any day bring a set of new lending restrictions amidst worries about a house price correction.

In Australia jobs growth has been only 0.8% in the past year compared with over 4% in New Zealand. Full-time employment has fallen by 0.3% whereas it has risen about 5% in New Zealand. Since the middle of 2009 NZ employment has risen by 19% with full-time job numbers up 22% and part-time 10%. In contrast in Australia since 2009 employment has lifted just 12% with full-time job numbers up 9% and part-time employment up 18%.

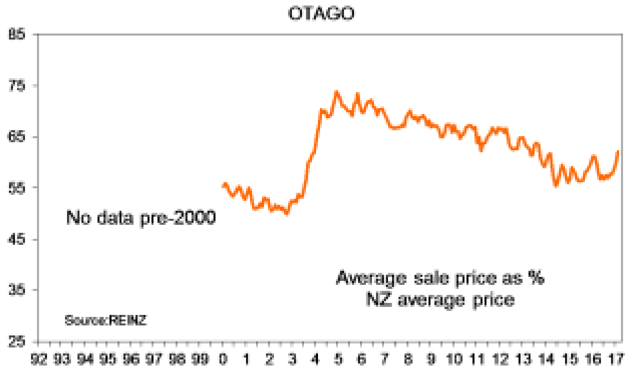
Or put another way. 88% of net jobs growth in New Zealand since 2009 has been full-time. In Australia this was only 54%.

In New Zealand there is an abundance of employment opportunities to the point where business demand for migrant workers has soared. In the past year 43,000 work visas were issued compared with 39,000 a year ago and 31,000 three years ago.

The chances are high that with some strong driving forces for our economy such as booming construction, tourism, and a wide range of smaller sectors, Kiwis will continue to opt to work here rather than shift offshore, especially to Australia. Many more of the one million Kiwis living offshore will come back, and ongoing labour shortages mean importation of foreign workers is likely to also stay high – though one or two people may have something to say about that in coalition negotiations after the September 23 general election.

Strong net migration inflows for NZ look like continuing. This will help underpin the pace of economic growth – in Auckland in particular. This will tend to place more pressure on infrastructure and necessitate additional spending in that area. With a housing shortage and weaker than needed dwelling supply growth, house prices are set to remain well supported with a small upside bias in our main centres. This upward bias will be accentuated by people switching their houses from renting to local tenants toward hosting tourists through the likes of Airbnb. The only hope of a downward rents correction for tenants appears to be a collapse in tourism.

Last week I forgot to include the graph showing Otago's house prices versus the NZ average so here it is now. This series excludes central Otago.



If I Were A Borrower What Would I Do?

Budget for rising interest rates. In 2008 interest rates plunged in New Zealand as our economy went into recession (partly because floating mortgage rates hit almost 11% early in the year) and then the GFC struck. The cash rate was cut quickly from 8.25% to 2.5%. Floating rates fell from near 11% to below 6% by late-2009. Three year fixed rates went from 9.6% to 6.1% in ten months.

Since then rates have bounced up (then down) in response to strengthening economic growth leading to expectations of higher inflation and tighter monetary policy. But after raising their cash rate 0.5% in 2010 the Reserve Bank had to cut it by the same 0.5% in 2011. And the 1% rise to 3.5% over 2014 was more than reversed between June 2015 and November last year with 1.75% worth of cuts taking the rate to 1.75%.

Most people who have a mortgage at the moment have either taken out that mortgage in this nine year period of low interest rates and repeatedly incorrect forecasts of sustained rate rises, or they refixed old mortgages at the new lower rates.

This warning is not being delivered to that latter group. You remember much higher interest rates and many times you will have warned new borrowers about higher rates of the past possibly coming along again. Instead this is a warning to the new borrowers who have taken on a high level of debt without any personal experience of interest rate hikes.

Forces are building toward higher interest rates – nothing like the rates of the past, but higher than you may have budgeted for. If you are taking out a mortgage at the moment assume your floating rate in two years time will be 2% higher than it is now. Run a scenario whereby the rate is 3% higher just in case inflation finally surprises us all on the high side.

Regarding fixed rates, they will probably rise another 0.5% this year then go higher as monetary policy starts to get tightened from probably towards the middle of next year.

Why will rates rise? Inflation has risen from 0.4% to 1.3% and will soon sit close to 2% and perhaps a tad above that rate. Banks are facing rising costs which they will seek to recover from boosting lending rates. These costs include having to hold extra capital to make the banking system more resilient to shocks, higher staff and systems compliance costs, higher offshore borrowing costs as US monetary policy gets tightened, and higher domestic funding costs as banks try to boost and hold onto term deposits.

In fact just last week our floating mortgage rate was raised from 4.79% to 4.9% without any change in the official cash rate and with the yield on 90-day bank bills falling to 1.96% from 2.2% in October. At 4.9% the floating rate is unchanged from September 2015 (4.89%) when the official cash rate was 1% higher at 2.75% and 90-day bank bills were yielding 2.9%.

The old relationships between the official cash rate, wholesale interest rates and retail interest rates have broken down. That is why you nowadays see far fewer explicit forecasts of where economists like myself think mortgage rates are going to go. Not only do we need to undertake the usual analysis and pick where the cash rate and bill yields will go, we need to take a stab at predicting where other funding costs will also go. We have no proven ability to do that.

Therefore, as we have been warning for years now, don't blindly use a set of interest rate forecasts to determine what you think is the optimal mix of floating and fixed rates for minimising your borrowing costs. The forecasts will be wrong – we just don't know by how much and frankly going by experience of the past nine years, even in what direction the error will be.

The failure of our economic models is only one reason we will fail to accurately predict interest rates going forward. The other, new, reason is the arrival of quantitative restrictions on bank lending.

LVRs are one method by which lending is being restricted. Others will come, and as strongly highlighted here recently we are already seeing sharp cutbacks in lending to newer property developers and expect cutbacks in lending to larger companies able to raise funds offshore. In fact some bankers are already restricted to lending pools at the SME level, rationing limited lending amounts per month. (Welcome to the '70s)

The cutbacks in credit availability act like a tightening of monetary policy one would expect in response to rising inflation. They will slow the pace of New Zealand's economic growth. If we could calculate by how much they will slow growth then we could take that amount out of our calculations of how much the official cash rate will need to be raised to slow the pace of GDP growth. But we have not the slightest idea.

So to repeat, the upshot is this. For seven years now in this section of the Weekly Overview I have warned that a person would be an idiot to rely strongly upon a particular set of interest rate forecasts coming true when deciding their interest rate risk management strategy. Now you would need to be even sillier than that.

So what do you do? You don't try and structure your loans so they get you through the period of high rates and you can refix at the bottom. We cannot predict when rates will peak or at what level, and definitely cannot pick when the next lows in rates will come.

I personally would have about 25% of my mortgage at a floating rate and the rest fixed three years. Why not fix four or five years? These rates of 5.89% and 6.09% are well above the three year 5.09% rate. I feel I would be paying too much for a hedge against higher rates in the future considering that all forecasts of rate hikes the past nine years have been wrong.

But this choice also reflects my personal behaviour regarding mortgages taken on since 1987. That behaviour revolves around getting the principal down as rapidly as possible as a means of not just boosting wealth but managing interest rate risk and minimising interest rate costs. You'll probably have more success doing that as a means of hedging against future rate rises than trying to pick where interest rates will go.

Why not fix one year at 4.59%? If I did it would be just to replace the floating rate portion of my loan. But that would involve sacrificing the ability to make early repayments and as far as I know one cannot offset deposits against one's mortgage if the rate is fixed whereas you can offset deposits against floating rate debt.

For the record, the Reserve Bank left their official cash rate unchanged at 1.75% this morning and gave no indication that they have changed their view on the economy or inflationary pressures from the last review early in February. We still expect no rate rise until near the middle of next year.

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. **This edition has been solely moderated by Tony Alexander**. To receive the Weekly Overview each Thursday night please sign up at www.tonyalexander.co.nz
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