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.

Low Inflation Locked In

The theme when it comes to inflation post-GFC is that surprises lie almost all of the time on the low side. That is, expectations of high or rising inflation have almost always been dashed in every economy for the past eight years. We saw an example in the United States on Friday night for monthly inflation which was accompanied by weaker than expected data on things like retail sales, and comments from the Federal Reserve Chair suggesting that having raised rates 1% they might not be far off the new “neutral” level.

The main example of relevance for ourselves is the June quarter Consumers Price Index released this week which saw the annual rate of inflation fall to 1.7% from 2.2% in the March quarter.

Three months ago when many people were trying to imply inflation was getting riskily high by noting the non-tradeables rate had climbed to 2.5%, we instead invited people to look at a measure commonly attracting attention in the United States. This is inflation excluding changes in food and energy costs. That index rose by only 1.6% in the year to March from 1.0% a year earlier. Now it has fallen to 1.4%.

Core inflation by this measure is only just above the 1% floor of the 1% - 3% band targeted by the central bank. And core inflation measured by stripping out the top 10% and bottom 10% of price movers is just 1.8% from 2.2% three months ago.

Our central bank still has time left on its hands before needing to make any changes in the official cash rate and this has been the case for quite some time. Having said that, one can easily be excused for thinking in recent years that tightening was needed because the measures which we economists traditionally look at to get a gauge on whether inflation pressures are building have been flashing for some time.

The rate of capacity utilisation is above average. Businesses are less and less constrained by a shortage of customers and more and more by a shortage of staff.

Yet here is where the inflation link between strong growth, capacity constraints, and inflation has broken down. Strong jobs growth is not leading to accelerating wages growth and we can only guess as to why. And therein lies the core problem. Because we do not know why wages growth has not accelerated we cannot be entirely confident that the absence of this source of inflation is permanent. It could reappear any time and it would be great for people’s incomes and a more efficient allocation of staff resources in the economy if the pace of wages growth were to double.

But equally, unless someone can come along and tell us with confidence that such an acceleration is to soon appear, there is little justification for expecting a precautionary strike against inflation from a central bank which has had its nose bloodied two times already since 2010 by tightening too soon and having to reverse increases in the official cash rate.

The upshot of all this is that borrowers are probably not going to face much of an increase in interest rates for a number of years. That means that investors will continue to seek assets other than term deposits and bonds for many more years. That means there will continue to be good demand for residential property from investors for many years. That means rising prices. That means no easing by the Reserve Bank of its LVR requirements for many years. It also means the Reserve Bank is going to keep putting in place the markers needed to get another tool for influencing the housing market, a debt to income restriction on mortgage sizes. That means that for property buyers the incentive is to move sooner rather than later – which is nothing different from what we have been saying regarding the housing market since the middle of 2009.

Saving for Retirement

Some things you are just not supposed to say. In New Zealand the list of these things (if one were able to compile it) would be one of the longest in the world possibly. We are just too pc. One of these things is to suggest anything other than that people should live in fear of retiring with limited resources and should maximise their retirement savings from as early an age as possible.

New Zealand is a country with lots of small towns from which young people are leaving, offering in the long-term some low purchase price or rental options for those people who will in two or four decades time find themselves retiring without owning a paid-off house and with little in the way of saving.

But that is not the point I wish to make here. Instead it is to emphasise the rising longevity of people and the ever-increasing proportion of retirement age people choosing to remain active in the workforce.

Back in 1998 only 5.8% of people aged 65 and over were still working at least one hour a week. That percentage is now almost 24%. We are healthier these days when we reach 65 than before and will be even healthier in the future. This does not mean that the time during which we need to depend solely upon savings and superannuation will be less going forward than before – though it does produce the glaringly obvious conclusion that the retirement age needs to be lifted to perhaps 70 or higher to help contain the fiscal impact of a universal benefit set at 65% of the average wage being paid to anyone with the good fortune to hit 65. (Remember if you are in this boat that you have to go and apply for the benefit when you hit 65, you won't automatically find it in your bank account.)

Does it pay to save for your retirement from as early an age as possible? Not really. You have more time on your side than before because you can work for longer. There are far greater priorities including enjoying yourself doing things which become more and more difficult the older you get, and getting a foot on the property ladder. Owning a home does have an investment aspect because it makes a big difference retiring with a paid-off house versus renting. But when making a first home purchase one's focus should really be on establishing a base for a family rather than trying to keep up with the Jones's and their stories of rising paper wealth from having bought something a few years earlier.

Personally I do not support compulsory superannuation and it is instructive to look across the Tasman where retirement saving is compulsory. Australia has a higher ratio of household debt to income than New Zealand – near 190% versus 165% - as people have sought to offset some of their savings by borrowing when young. It makes sense to do this in Australia because the pension payment there is abated for income levels and assets. Entering retirement with debt means the savings accessible at 65 can be used to repay the debt, reduce the net assets, and boost the superannuation payment.

Actually there was a piece of work done recently showing that the net of abatement income for someone entering retirement with $400,000 saved was the same as net income (including returns from assets) of someone who had $1,000,000 in retirement savings. All the savings between the two figures get completely abated away from the poor saver.

Am I arguing against joining Kiwisaver? Definitely not because it is a good way to build savings in order to help eventually finance a home purchase. And because it can improve retirement lifestyle for those who make it that far. But beyond using it as a vehicle for saving to buy one's first house it is inflexible if other priorities come along. So perhaps it would be wise when raising retirement savings not to put everything into one's Kiwisaver fund and instead allocate some saving into a fund able to be exited from easily if necessary.

If I Were A Borrower What Would I Do?

Relax. The period from the 1970s to 2007 of high inflation, strong links between growth and inflation, and paranoia about inflation taking off again looks to have been an historical aberration. We are not going back to high rates of the past and our central bank is potentially a long way off raising interest rates. They have noted that the chances of them in fact cutting rates again match the chances that the next move will be an increase.

But – financing costs are relative and for anyone borrowing for a mortgage since 2009 the interest rate level considered to be painful is much lower than those of us who were borrowing from the

mid-1980s until 2007. When pain needs to be applied by our central bank it may involve average floating mortgage rates only of 8% rather than the old 11%.

In fact in practice, because by the time the Reserve Bank needs to tighten it may have not just an LVR rule which it can lift to 100% deposit, and a debt to income regime, the burden which falls upon interest rates in fighting inflation will be a lot less. Floating rates may peak only from 7% - 7.5%. Restrictive measures when tightening comes will fall on new borrowers rather than existing ones.

But that is where caution is needed before borrowers start thinking they cannot go wrong. When the Reserve Bank raises interest rates it is aiming not so much at housing, but at inflation overall. If they raise borrowing costs only a little then the cash flow restraint on the economy is only small. The incentive to save rather than buy is only small. The deflationary upward lift in the currency will only be small.

Only if housing is considered to be the main driver of inflation will interest rate rises be minimal. In the alternative scenario of inflation being a generalised reflection of limited resource availability the need for high interest rates will be more than minor.

That is why borrowers should not get too cocky when it comes to structuring their interest rate exposure. Sitting entirely on very short-term fixed rates of less than a year involves an element of danger. Borrowers should not be averse to locking in some of their debt for three years or longer.

In fact one possible future scenario involves small rate rises and prudential tightening hitting housing hard, but capacity pressures keeping overall inflation risks high. In that case the RB may need to ease off on LVRs and DTIs whilst pushing interest rates up further.

If I were borrowing at the moment I would by now have just about given up on the hope I expressed here a month or so back regarding falls in wholesale borrowing costs providing some scope for small cuts in fixed lending rates in the near future. I would probably minimise the proportion of my loan at a floating rate because the cost at 5.9% is simply too far above the short-term floating rates. I would fix most of my mortgage for two years at 4.79% but have equal (smaller) proportions at the one year and three year rates of 4.59% and 5.09% respectively. I would then slash spending on non-essentials - you know the list – and make early repayments of my floating rate portion and then when the one year rate matures have another dollop of floating rate I could make early repayments on without having to pay a fee.

NZ Dollar

Regular readers will be aware that my personal view is that the NZD is going to remain quite strong over the next few years, supported by a variety of factors. These include

-high terms of trade which very soon will hit a record level above the previous peak in 1973.

-Good economic growth from 2.5% - 3.5% for the next few years, underpinned by things like a structural shift in net migration flows, tourism, a primary sector supported by growing world demand for quality products which won't kill their children, construction which will avoid a boom/bust cycle because of capacity restraints, plus the usual catch-alls of technology, digital things, green sector which we all talk positively about but have little idea regarding growth because of measurability problems and complete lack of predictive models.

-Political stability at a time of major uncertainties in many other countries.

-Good fiscal accounts, again at a time of ongoing problems elsewhere.

Those who are forecasting a falling NZ dollar may acknowledge these things, but they are placing a heavy weighting upon the US dollar rising sharply because of tightening US monetary policy. The problem here however is that their zeal for a firm greenback tends to replicate the older stories about the USD collapsing as a global store of value and medium of exchange because of the rising Euro, Yen, and Yuan.

Few people any longer believe those currencies will supplant the USD anytime soon if ever given the many problems in their respective economies and societies. But hopes for a rising greenback have been dashed repeatedly in the past eight or so years as expectations of tightening US monetary policy have proved premature time and

time again. And it looks increasingly like such a thing is again underway.

The US Federal Reserve have responded to firmish US growth and a lift in the pace of average earnings growth and inflation by raising their funds rate 1.0% in four moves starting in December 2015, and are now looking at how to slowly disengage from heavy Fed ownership of US Treasury bonds.

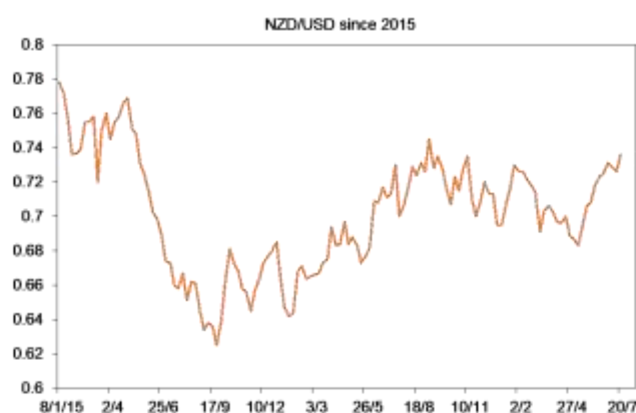
The question is the pace of further tightening and the view that such tightening will continue apace has been seriously called into question recently in light of some poor economic data in the United States, inflation not rising as much as expected, and now some less than hawkish comments from the Federal Reserve Chair acknowledging this situation.

Late last week Ms Yellen said that the funds rate is close to neutral and “There is, for example, uncertainty about when – and how much – inflation will respond to tightening resource utilisation.”

Currencies by and large are as predictable these days as things like dairy payouts, prices for coal iron ore and copper, and a person would be foolish to make any forecast in a strong manner. In a post-GFC world economic relationships have changed, especially the key link between high jobs growth and accelerating wages growth. Those of you who have been looking at forecasts of key things like currencies and interest rates for the past three or so decades need to realise that we economists no longer have economic models which give the same (error-prone) forecasts with as much accuracy as was the case pre-GFC.

Personally, I spend less and less time trying to predict what is going to happen, and more and more time explaining to people what appears to be going on in the economy and what seem to be reasonable views to have on where things will go for planning purposes.

And when it comes to the NZD my reasonable view on the NZD is that it stays firm with upside risk because of the list of factors above. And even though we have fallen this week to just under 93 Aussie cents, history suggests that we will eventually ride the coat-tails of the AUD upward further against the greenback to soon surpass US 74 cents and 95 cents Aussie. Then again the opposite could happen. Good luck.



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/

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