BNZ Weekly Overview

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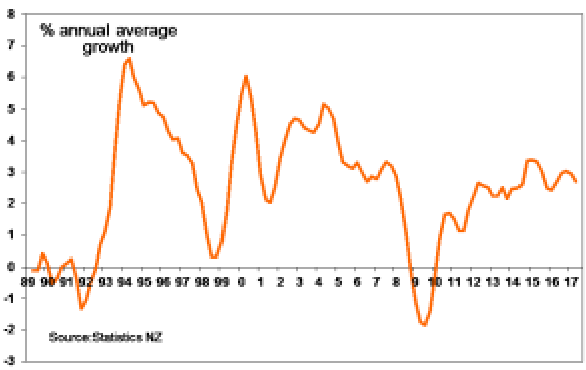
Mission Statement

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

NZ Economy Growing Strongly

Data out this morning show that our economy grew by 0.8% during the June quarter and 2.7% over the entire year to June. Average growth for the past couple of decades has been 2.7% per annum so this outcome represents an average pace of growth. Of course some of this growth simply reflects an acceleration in the population growth rate – not that such a thing matters to most businesses.



In per capita terms GDP has risen by just 0.6% in the past year from 0.7% growth a year ago, and average growth of 1.5% over the past two decades. In common with other countries New Zealand is experiencing low per capita GDP growth. This may reflect low productivity growth which may reflect the inability of statistics to capture productivity/economic growth stemming from developments in the services/technology spaces.

After Saturday

If Labour defy the latest trend in polls and win on Saturday night, what are we likely to see in the NZ economy? Here are a limited number of thoughts.

Because a new party would rule after nine years there would be uncertainty about what exactly it would do and when and what the impacts would be. This uncertainty would likely cause some small depreciation in the NZ dollar which probably would not last long – depending upon the extent to which Labour would be dependent upon the Greens' support to form a government. The greater the relative strength of the Greens likely the greater the relative decline in the NZD.

Despite plans to introduce a multitude of taxes and cancel tax cuts already legislated, Labour plan a looser fiscal policy stance than National which implies slightly faster economic growth, slightly higher inflation, slightly higher interest rates and therefore maybe eventually a slightly higher currency.

We got an example of the uncertainty effect on Wednesday when release of a poll showing National well ahead of Labour caused a half cent rise in the NZ dollar.

If this were the world before 2007 then the fiscal loosening effect could be enough to cause an immediate rise in retail interest rates. However post-2007 even fast growing economies with strong labour markets have failed to produce rising inflation. There is no reason for believing that a change in government would overwhelm the unknown factors in play suppressing inflation and cause the old paradigm to reassert itself.

So upward movements in wholesale interest rates would probably be very small and perhaps soon as lost in the wash as any currency weakness.

This probably applies even considering the fact that growth in our economy is less and less constrained by a shortage of demand factors and more and more constrained by a shortage of capacity – labour and infrastructure by and large. One of those constraints could become more binding as Labour would tighten up on immigration flows of students at less than degree levels and low skilled work visas – perhaps eventually constraining up to 30,000 immigrants per annum.

At the macro level the impact for planning horisons of most people would likely be negligible. Instead it is at the micro level that changes would be most noticeable, though picking time periods of impact is very difficult.

Reduced availability of low skilled staff in Auckland in particular will hit profits of businesses hiring such people including students studying part-time. These businesses will need to raise their wages/close down/alter what they sell and how. Perhaps more self-service kiosk-type shops.

The hospitality sector would likely be negatively affected by reduced staff availability. Investment may increase in drink-dispensing machines/robots. In fact with anyone able to go to uni. free for a year from 2018 entry-level staff availability for NZ businesses generally would get worse.

The cooling Auckland housing market will likely cool further due to some current and prospective investors backing away at the margin in anticipation of

- reduced flexibility to change rents,
- capital gains tax,
- fewer foreign buyers,
- reduced ability to lower tax burdens,
- eventually increased supply of lower versus mid and higher priced dwellings
- extended brightline test
- rental warrant of fitness-type requirements etc.

Some further stock will be freed up for young first home buyers (see below for further housing commentary).

Investors might seek out the stocks of larger home building-related companies in anticipation of the government having to arrange (potentially lucrative/subsidised) deals to make good on their promise to build lots of affordable dwellings.

Long-term investors have probably already locked up land just outside the Auckland urban boundary which Labour might free up. The policy change will reduce the relative price of land just inside the boundary.

Investment by farmers in emission-reducing and water-cleaning technologies and farming methods/locations will likely grow more rapidly than would otherwise be the case though this would be a slow development rather than necessarily a repricing immediately of affected farmland.

Accountants will be busier as property investors seek advice on how to change their arrangements to minimise the impact of planned property market changes.

And if National retain power? As with Labour their house building plans are likely to be frustrated by a shortage of builders. Property investors may breathe a sigh of relief. But such investors should realise that the structural shift in home occupancy in New Zealand toward a higher proportion of people renting means inevitably legislation will change to give greater power to tenants.

Farmers may also breathe a sigh of relief. But again the writing is on the wall with regard to eventual ending of the subsidy they receive through exclusion from the emissions trading scheme, free water at source, and inadequate pricing of negative externalities.

A National win would likely bring a small rise in the NZ dollar and perhaps minor decline in wholesale interest rates. But as with the scenario of a Labour win, such movements would quickly be lost in the wash of normal volatility and other larger factors in play.

Housing

One of our stronger messages in recent months has been aimed at first home buyers. It is that many investors have become overstretched and want to sell. That plus the cycle simply petering out with assistance from banks tightening lending criteria means opportunities are opening up. Young buyers should be less willing to be talked into offering higher prices by agents who can no longer back up their claim that lots of other buyers are circling around – and we saw evidence of that on Sunday night on The Block.

This link contains data showing the total value of the four homes sold at auction when compared with their reserves. The "profits" from 2012 – 2016 were $232k, $299k, $445k, $633k, and $981k. On Sunday night they totalled only $65k.
http://www.nzherald.co.nz/entertainment/news/article.cfm?c_id=1501119&objectid=11923426

The market in Auckland has cooled. At auctions clearance rates are down, bidders are few, the frenzy is dead, attendees say “meh” when encouraged to lift their bids.

The Block outcome is one of the many little things which will continue to soak into market sentiment over the coming year, giving a slight downward bias to prices on average. Mainly the effect will be to encourage some potential buyers to remain on the sidelines, give up thoughts of upshifting, and perhaps opt to do up their existing house or place funds on deposit in the bank.

And this is the environment where young first home buyers need to forget all about prices trending upward, forget about unwritten calculations of how much they might “make” on paper in a year or three, and instead focus on their desire for a family home and outright take advantage of scared investors fearful of making losses.

Now is the time to throw in some low bids, remembering that although banks are tightening up their lending criteria, priority is being given to first home buyers.

How long might this window of opportunity of
-reduced competition from other bidders and
-increased willingness to negotiate by vendors last?

We don’t know. Chances are the “excitement” won’t return to Auckland’s residential property market for 3 – 5 years. It will return because no matter which major party wins the election the housing fundamentals in Auckland won’t change. Demand growth exceeds supply growth.

But before we get to the upward leg again sentiment will deteriorate further from current levels. Stories will start to be swapped of some price discounting going unreported – and eventually the journalists will find those stories.

Here for instance is one of those angles which relates to the ability of investors to get a mortgage when it comes to paying up for the soon to be constructed apartment which they bought off the plan with a deposit one or two years ago.

https://www.stuff.co.nz/business/96888627/overenthusiastic-investment-by-unsophisticated-people

http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11922859

https://www.stuff.co.nz/business/96090203/wouldbe-purchasers-may-have-to-walk-away-from-apartments

This “settlement risk” is quite different from the long-term demand/supply dynamic which this article discusses in terms of only a limited supply of new apartments being completed in the next year.

https://www.stuff.co.nz/business/property/96370104/only-a-years-supply-of-apartments-left-in-auckland

But it is the very fact that a supply surge is coming forward which heightens the settlement risk for the coming 6 – 12 months. Nothing like we have seen in the past regarding the Auckland apartment market is likely to happen. But there is a digestion problem which may be coming and that will also provide some buying opportunities for young buyers. Big price declines are not likely as the apartments coming forward have mainly been sold by all accounts to owner occupiers (older ones) and not investors.

If I Were A Borrower What Would I Do?

Inflation remains low in New Zealand and the general consensus is that although the Reserve Bank forecasts no cash rate change until late-2019, the chances are they will instead start raising rates in just under a year’s time. There is considerable uncertainty about the timing of rate rises, the speed with which rates go up, and what level they will peak at. This uncertainty largely reflects global uncertainty about new relationships between things like labour market pressures, wages growth and inflation, productivity growth, inflation expectations and so on.

In addition, on two previous occasions since slashing rates over 2008-09 the Reserve Bank has initiated a rate rise cycle – only to quickly reverse course and slash rates again when inflation failed to materialise as expected. This happened over 2010-11 when the cash rate was raised from 2.5% to 3% then cut back to 2.5%. It happened over 2014-16 when the rate was raised from 2.5% to 3.5% then cut to 1.75%. Twice bitten, thrice shy.

Now we have a new source of uncertainty – the unwinding of the Federal Reserve’s three bouts of money printing which started in 2008. The Fed.

has announced plans to slowly start shrinking its near $4.2tn asset base including $3.6tn of mortgage and Treasury securities purchased in order to push interest rates lower and ensure ample liquidity to try and get growth going again following the global financial crisis. In 2013 when there were indications that some unwinding might start there was a quick reaction via bond yields jumping and funds quickly flowing out of emerging markets in anticipation of a much higher US dollar. The unwinding never happened.

This time around the climate appears far calmer and the Fed. have made it clear that the process will be a gradual one. It will initially comprise nothing more than allowing purchased bonds to mature at a rate of $10bn a month starting next month, rising eventually to $50bn a month.

The way this will affect funds in the marketplace is that as either the US Treasury or mortgage-buying organisations sell new bonds to replace funds used to pay out the old ones held by the Fed. the private sector individuals and investment companies buying these new bonds will see their cash leave the system. They will either run down bank balances or sell/fail to purchase some other assets.

Because the money printing operations are estimated by the Fed. to have lowered bond yields by about 1% the reversal will presumably have the opposite effect. But the common view appears to be that the selling might only take the Fed's portfolio to $3tn come 2021 so a potential 0.5% rise in bond yields will be barely noticed over this period of time – especially when the Fed. indicate plans for three funds rate rises next year and over 2019.

What this means for us here in NZ is this. Coupled with the recent tightening of monetary policy in Canada with more expected, comments from the Bank of England indicating a greater probability of tightening, same from the European Central Bank, and rising expectations of policy tightening in Australia, the drift for NZ wholesale interest rates is likely now to be upward.

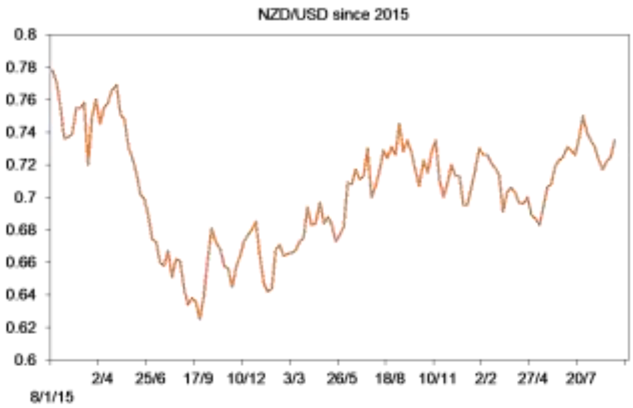
Can we reasonably pick the speed of rises? No. That is the lesson of the post-GFC period on top of the normal uncertainty naturally associated with every rate rise cycle.

Note that although the outbreak of war on the Korean peninsula would cause some potentially large reductions in interest rates around the world this is something which central banks would react to It is not something they can actually factor into their policy setting plans.

If I were borrowing currently what would I feel inclined to do? We have just taken our two year fixed home loan rate up to 4.75% from the 4.69% rate it sat at for three weeks. If I anticipated potentially receiving some spare cash I would have perhaps 10% of my mortgage at the floating rate. I would look to lock in a mixture of fixed rates for one, two and three years for the rest. The three year rate is 5.09% and the four year rate is 5.89%. Paying 0.8% a year for just one extra year of rate security feels a bit too expensive.

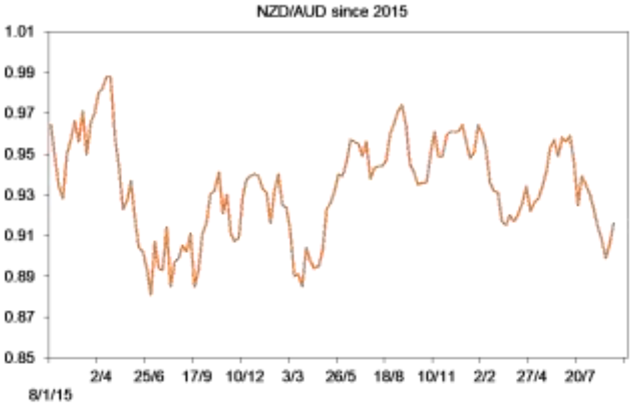
NZ Dollar

The last time we wrote about the Kiwi dollar three weeks ago we highlighted the upward trend in New Zealand's terms of trade since the 1990s as implying trend appreciation in our currency. But we noted that for the moment the NZD appeared to be going through a weak patch. In fact back then it was trading near US 71.7 cents but within a week was at 72.3 cents and now it sits near 73.5. This is still lower than 75 cents at the end of July but toward the top end of the range it has been trading in since the middle of last year.



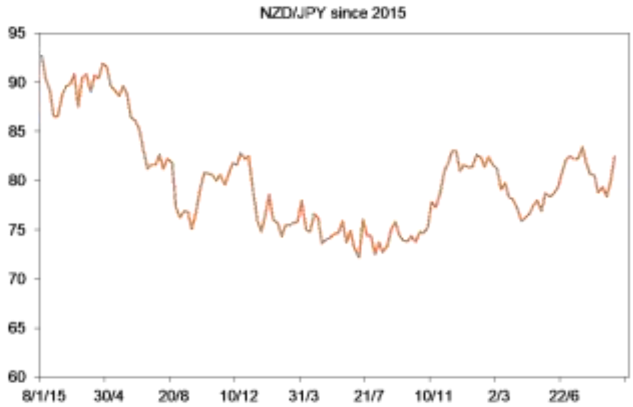
In other words – in the past three weeks nothing of interest at all has arisen in the rate of exchange between the NZ and US dollars.

Of greater interest in the past year has been the NZD's peaks against the Aussie dollar above 96 cents in September, January, and July. But now we are trading near 91.6 cents courtesy of the Aussie dollar rising on the back of a recovery in minerals prices, some good data on the Australian economy, and recently growing anticipation of a tightening of Australian monetary policy. Once again hopes of a parity party have disappeared.

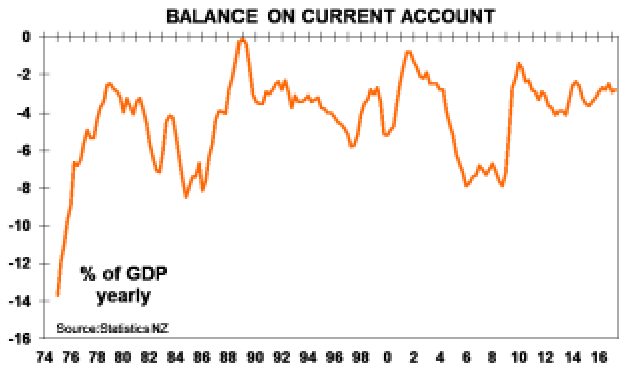


Against the British pound the NZD is currently trading near 54.5 pence from over 57 pence late in July. The NZD's decline mainly reflects the pound being boosted by data showing better than expected UK growth bringing rising expectations of tightening monetary policy.

And the same reasoning lies behind the NZD declining against the Euro from 64 centimes in late-July to near 61.8 now. The NZD has also weakened against the Japanese yen to near 82.5 from 83.5 in late-July.



Short-term direction in the NZD may be influenced by this weekend's general election – especially with regard to whether or not the night delivers a clear cut result. Outside of that, while tightening monetary policies offshore will apply some downward pressure to the NZD, other fundamentals remain strongly supportive. For instance our current account deficit remains below the 20 year average of 4% of GDP at just 2.8%.



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
To change your address or unsubscribe please click the link at the bottom of your email. Tony.alexander@bnz.co.nz