BNZ Weekly Overview

16 October 2014

ISSN 2253-3672

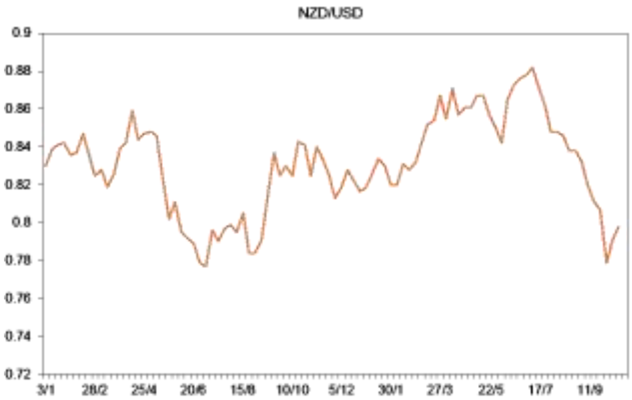
Mission Statement

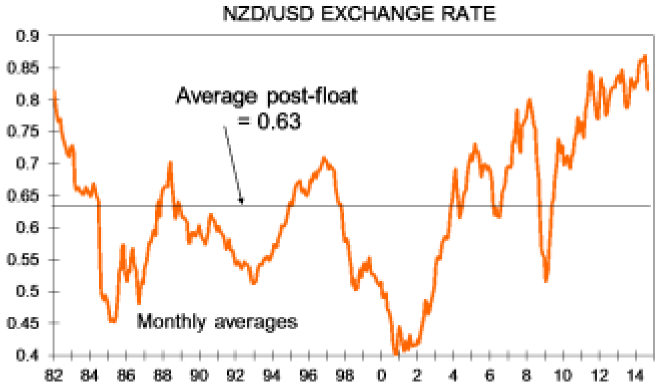
To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

NZD Headed Where?

Welcome back everyone. I've spent a couple of hot weeks on the Gold Coast and by the sounds of it you had to endure some fairly windy conditions in NZ while on a day to day basis those interested in currency movements were blasted with up and down factors raising hopes then dashing them regarding where our currency might be headed.

At the moment the Kiwi dollar is trading against the greenback near 79.8 cents compared with 81 cents the last time I sent out a Weekly Overview on September 25, 84 cents at the start of September, and over 88 cents back in July. On October 6 a low of 77.5 cents was reached. Why the decline?





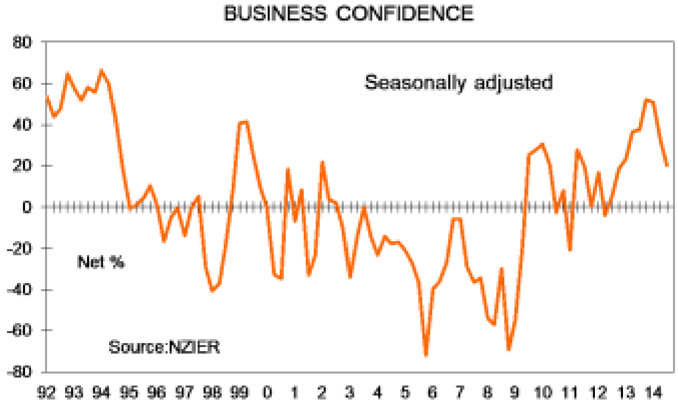
One recent factor was the strong comments from the RB Governor regarding the desirability of the currency falling from an unsustainable and unjustifiable level. He was referring to the way in which the NZD had held up so well in spite of a near halving of international dairy prices and some deterioration in the global economic outlook.

That global outlook has in fact continued to deteriorate with the IMF cutting their forecasts for world growth, analysts cutting their forecasts for commodity prices, and investors starting to adopt less risky positions because of many uncertain factors such as Ebola, slowing Chinese growth, increasingly bad economic data out of Europe and Germany in particular, war in the Middle East and the ongoing insurrection in Ukraine. Just last night core retail spending in the US was revealed as falling 0.1% in September whereas a rise of 0.4% had been anticipated. With that sort of result the chances of the Federal Reserve tightening monetary policy next year are plummeting – hence some big interest rate falls discussed below which are good news for NZ borrowers.

Economic prospects facing our exporters have dimmed and that means a lower NZD due to lowered risk tolerance and reduced prospects for export growth.

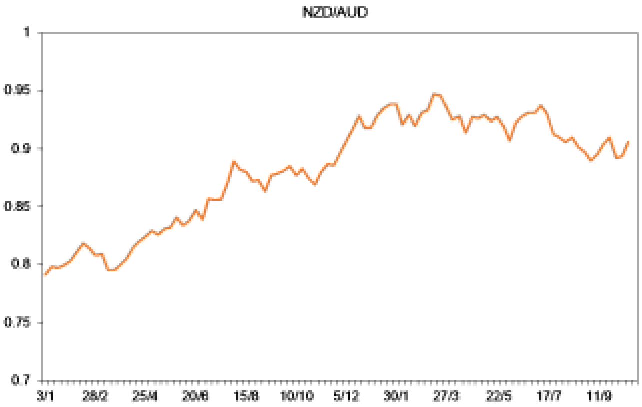
The NZD has also faced downward pressure from the Reserve Bank revealing that it sold a greater than expected $541mn of NZD during August. Plus we have seen further support for the argument that NZ economic growth is slowing in the form of decreased sentiment and intentions readings in the NZIER's very useful Quarterly Survey of Business Opinion, and weak debt and credit card spending data for September.

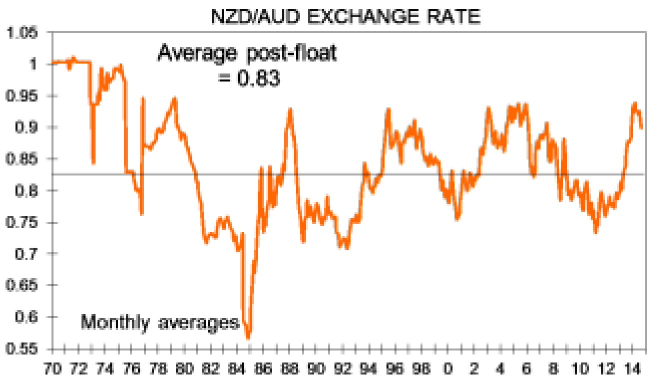
The weak data and decreased export growth prospects mean the chances are slowly falling for a further rise in our official cash rate in March next year. Some forecasters suggest the next move may not come until 2016. That is possible but not at this stage all that likely.



These factors help explain why the NZD has fallen. But we have to remember also that there are factors holding our currency up. Foremost amongst these is the fact that our economy is in far better shape than most others, increasingly so in fact when compared with Europe which appears headed back into recession (a 40% chance according to the IMF), Japan (25% chance) and Australia, not so much the UK and United States.

Our finances are in good shape even though it is looking like the timing for a fiscal surplus could be pushed out a year. Our current account deficit is low, we are a net importer of energy and energy prices are falling with oil prices down 27% in recent weeks, and more foreign investment money may be diverted our way from Australia as they increasingly look likely to tighten up on foreign buying of residential property. Developments in Hong Kong suggest investors who might have looked to purchase there could also be headed our way.





Meantime net migration inflows into NZ are booming and still headed higher. This will tend to underpin the pace of economic growth and the Auckland housing market in particular – thus placing some extra upward pressure on monetary policy. These factors also argue against the Reserve Bank seriously contemplating the removal of loan to value rules in the near future, even though data from Corelogic now show clearly that the drop in purchasing by young people and rise in purchasing by investors which we predicted over a year ago has in fact happened.

We also have got the general election out of the way with a pro-business government well entrenched, surveys again are showing us to be one of the least corrupt countries in the world, and while we rise up world rankings for various economic measures Australia is going down.

What does all this mean then for the NZ dollar? It is reasonable to expect that as the global economy once again deteriorates rising risk aversion will cause our currency to fall further. However given the support for our growth from domestic factors centred around construction, our relative attractiveness, and the inevitable ending of the Chinese dairy destocking period, it does not seem reasonable at this stage to expect the NZD to fall below 70 cents. In fact maybe some of that sentiment helps explain why the NZD jumped over a cent last night following weak data in the United States. The USD got sold from what may have been excessively long positions and we benefitted from that with a tiny bit of help also perhaps from average dairy prices rising 1.4% at the Global Dairy Trade auction.

	This Week	Week Ago	4 Weeks Ago	3 Months Ago	Year Ago
NZD/USD	0.798	0.791	0.811	0.872	0.843
NZD/AUD	0.906	0.894	0.904	0.93	0.883
NZD/JPY	84.6	85.5	88.1	88.6	83.3
NZD/GBP	0.499	0.489	0.499	0.509	0.529
NZD/EUR	0.622	0.622	0.63	0.644	0.623
NZD/CNY	4.89	4.86	4.98	5.41	5.14
USD/JPY	106.02	108.09	108.63	101.61	98.81
GBP/USD	1.60	1.62	1.63	1.71	1.59
USD/EUR	1.28	1.27	1.29	1.35	1.35
AUD/USD	0.88	0.88	0.90	0.94	0.95
USD/CNY	6.1216	6.139	6.143	6.204	6.1002

But then again anything is possible. I do not fall into the camp of those who believe that exchange rates can be reasonably predicted, especially not post-GFC where the strength of economic relationships has changed, so many disappointments continue to appear overseas, and no-one can stick their hand up and claim forecasting success on anything approaching a consistent basis.

The times we are living through continue to be very uncertain. None of us can reasonably claim to know what is going to happen and what the impact will be of any of the factors on this following list.

- Possible recession again in Europe.
- Possible failure of the Three Arrows policy in Japan
- End-game for the protests in Hong Kong.
- War in Ukraine.
- War in the Middle East involving ISIS.
- Extent of the housing-induced slowing in Chinese growth
- Ebola

Last night shows analysts also can make big errors forecasting monthly consumer spending data in the United States, and expectations have been well off the mark for export and industrial production data in Germany. These are very uncertain times and people should be extra careful about risky positions with regards to currencies, equities, even business revenue forecasts.

The sharp increase in uncertain elements which will affect the environment in which you operate your business and run your family finances serves as a very useful reminder that we should all try our best to be prepared in some degree for things going wrong again. Some investors are already doing that by selling shares, cutting inventories of their dairy products in China, switching currency exposures toward traditional safe havens. More generally one should where possible build up not just long-term retirement savings, but also what we economists call “precautionary” savings. Money put aside in case some unexpected bills come along or one suffers a sharp reduction in income. This can be hard to do for many people especially as it means explicitly delaying the purchase of major items and sacrificing current consumption of things such as travel, going to cafes and restaurants, buying the latest technology.

Preparing for rough times also means trying to get debt down as quickly as possible through means such as fortnightly rather than monthly mortgage repayments, keeping repayments up when interest rates might fall, and thinking twice before taking on debt in the first place.

This is not a steady as she goes world in which we live any longer, and we haven't even truly seen markets and sentiment levels factor in the true danger out there – the thing which we have been highlighting since the middle of 2009. Back then central bank and government actions successfully prevented the world going into a new Great Depression. But recovery since then has been weaker than needed and dry powder not used then by central banks and governments has been used. Now nothing is left to handle a new shock should one come along.

That is, interest rates are already near zero in the UK, Europe, Japan and the United States. If a bad thing happens rates can't be cut to reduce debtor cash outflows. Money can be printed. But Europe and Japan are showing us that this does not work when banking sectors have problems and people don't want to borrow the money while banks don't want to lend it.

Governments are already wary of running larger deficits for longer and one of the deepest fears out there is that one day Japanese savers wake up to the impossible fiscal position which their government is in and demand compensation through higher interest rates on their bonds, thus collapsing the economy.
Sorry to spoil your mood as the weather improves and we head into summer but seriously – we should not fool ourselves into thinking that just because our economy is going to be underpinned and we are going to get lower unemployment through putting back up stuff that fell down and building things now which should have been built years ago (Christchurch and Auckland) that everything is okay. It is not. Get your debt down and put some cash away for rainy days. We are in relatively good shape. But much of the rest of the world looks like the proverbial.

If I Were A Borrower What Would I Do?

The worsened outlook for world growth has led to investors pushing back out their expected timings for monetary policies to be tightened in the United States, United Kingdom, and here in New Zealand. The falls in long-term borrowing costs facing banks have led to some reductions in fixed lending rates. In the short-term there may be some further cuts, so as mentioned a few weeks back, were I a borrower, I would feel that time is on my side and I would keep an eye out for whoever is offering a flexible yet reasonably discounted fixed rate for a period near three years. I would keep only a small amount of my mortgage floating given that our floating rate is currently 6.74% whereas the one through three year fixed rates are 5.89%, 5.75%, and 6.19% respectively. I would wait a bit to see how the latest falls in wholesale borrowing costs feed through. To whit...

The US ten year government bond yield three weeks ago was 2.57%. Now it is 2.13% and last night briefly fell to 1.88% as panic swept the markets. The NZ year three swap rate which is one of the factors forming the basis for determining our three year lending rates has fallen to 4.14% from 4.26% three weeks ago. Three months ago it was 4.5%.

	This week	**Week ago**	**4 wks ago**	**3 mths ago**	**Year ago**
Official Cash Rate	3.50	3.50	3.50	3.25	2.50
90-day bank bill	3.72	3.75	3.75	3.64	2.72
1 year swap	3.85	3.88	3.88	3.94	3.11
2 year swap	4.02	4.10	4.10	4.19	3.65
3 year swap	4.14	4.23	4.23	4.39	4.10
4 year swap	4.21	4.32	4.32	4.55	4.41
5 year swap	4.27	4.37	4.37	4.66	4.64
7 year swap	4.36	4.47	4.47	4.77	4.95
10 year swap	4.45	4.56	4.56	4.91	5.20

Just briefly, have I altered my view on the housing market as a result of the new deterioration in global growth prospects? Not at all. The shortage persists in Christchurch and Auckland but not in the regions. Net migration inflows will probably get boosted even further by the new bad developments (where do you want to sit out a global Ebola outbreak? A city overseas or isolated NZ?) Alternative investments such as shares appear more risky. Borrowing costs are falling anew. I expect house prices to continue rising in our two biggest cities which hold almost half our national population.

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