Weekly Overview

30 January 2014

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Mission Statement

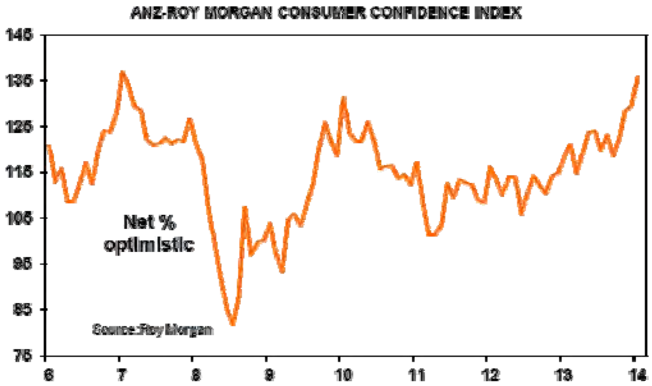
To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

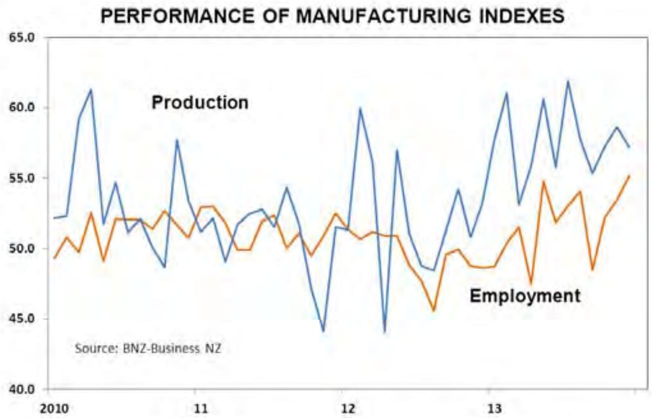
To receive the Weekly Overview each Thursday night please click here.
http://feedback.bnz.co.nz/forms/lFdYSs5FGEq4kAjP95uzTA

2014's Themes

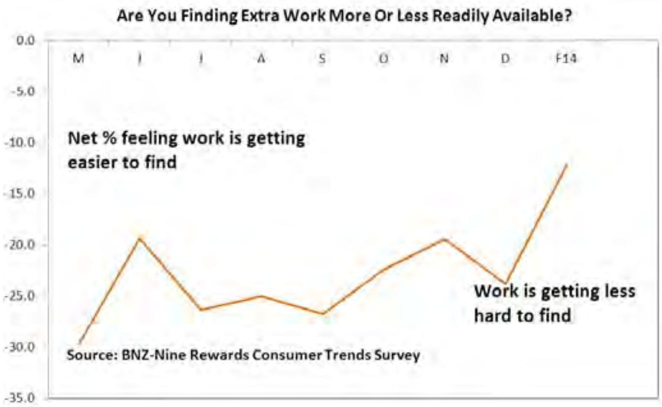
- Interest rates will rise
- The NZD will remain highish
- The labour market will tighten, pushing employment costs up.
- House prices will rise
- Construction will boom
- World growth will improve with unprecedented uncertainty regarding monetary policies.
- Business capital spending will grow
- Household spending growth will accelerate.
- The upturn and rising house prices will spread at uncertain speed out of Auckland and Christchurch to much of the rest of NZ.

So what have we learnt in the past week to challenge or reinforce our central views? No challenges that's for sure. Consumer confidence measured by a regular Roy Morgan survey rose to a seven year high in January suggesting good growth in consumer spending in the near future. The BNZ-Business NZ PMI held at a high level of 56.4 in December and the employment index jumped to a six year high of 55.2.





Our own BNZ-Nine Rewards Consumer Trends Survey released on Tuesday also supports a good outlook for retailers with a net 47% of the 549 respondents expressing optimism about the economy in a year's time. Perhaps indicating the way in which the labour market is improving only a net 12% said they are finding it hard to get jobs or extra hours compared with a net 24% two months ago. That is a good sign for the retailing and housing sectors. The Reserve Bank might be interested in the fact that a net 69% of people expect house prices to rise, up from a net 55% in our late-November survey. Full results are here http://tonyalexander.co.nz/wp-content/uploads/2014/01/BNZ-Nine-Rewards-February-2014.pdf



We also learnt this morning that dwelling consents soared by 14.6% in the December quarter, grew 47% in December from a year earlier, and rose 26% for the full year. Building boom. That boom will be assisted upward by the demand being created by booming net immigration. Courtesy of a net migration gain in December of 2,408 compared with a loss of 582 a year earlier the annual net flow now stands at +22,468 from a loss of 1,165 over 2012 and an average gain the past ten years of 9,644. This boost to population growth will assist the economy's overall growth this year and while delivering some extra staff will probably more boost inflation than suppress it.

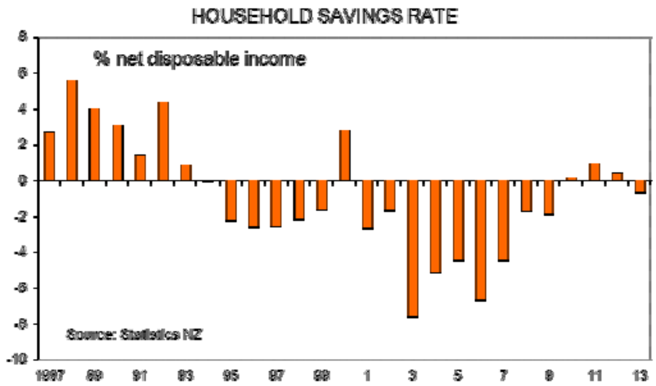
We have seen leaders of the main political parties start their election campaigning with promises which will raise questions as to where the money will come from to pay for them, and will the deficit blow-out again should growth fall away? In fact a key thing to watch for will be assumptions about future growth which increasingly get based upon the coming strong growth environment continuing for a long time. Like the museum which wrongly counted as visitors those people simply popping in to use the can, patronage and growth assumptions have a tendency to become massively divorced from the underlying reality.

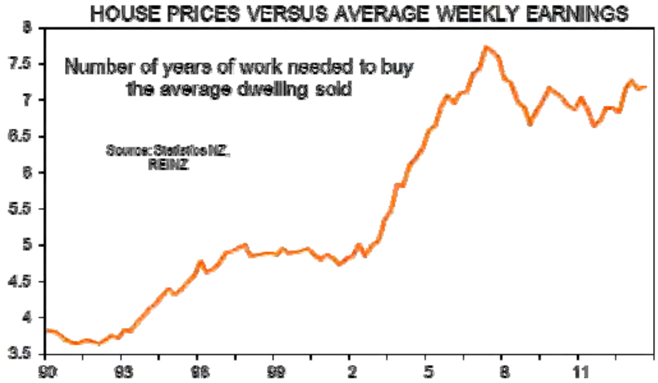
We are forecasting that the NZ economy will grow 3.9% this year following estimated growth of 2.7% last year. But we won't be able to sustain that sort of growth rate for long given that businesses are already reporting above average difficulties finding the people they want, business investment in capacity and productivity-enhancing systems and machinery has been low in recent years, and both construction and dairying booms inevitably and always fade. Or crash. So by all means enjoy the ride up, but take care not to be caught by the many cowboys and over-optimistic small business operators who will get weeded out on the other side.

Looking over the period beyond the next 2 – 3 years it pays to remember that growth for the coming decade or two in New Zealand is not going to average what it did between 1992 and 2007 when GDP on average rose 3.5% per annum. Why?

- In the 15 years leading to 2011 the labour force grew 29%. Growth of just 11% is expected for the next 15 years.
- Between 1992 and 2007 the unemployment rate fell from 11.4% to 3.5%. It won't now fall from 6.2% to -1.7%.
- Inflation settled at low levels from 1992 and so did interest rates. People took advantage of newly low rates to radically boost debt thus delivering an unsustainable pace of growth in retailing and house prices.
- Our vulnerability to shocks is now greater than back then given lack of dry powder for the Reserve Bank (low official cash rate).
- The payoff from the reforms of the 1980s and early-1990s ended a long, long time ago. No-one these days is proposing communally acceptable additional reforms.
- Global credit conditions and the free-spending caused by them are never (hopefully) going back to the looseness of the 1980s through to late-2000s.
- NZ's household savings rate went from 4.4% in 1992 to -6.7% come 2006. It has "recovered" to -0.6% but a decline to -10% or so is very unlikely.

- Average house prices went from 3.8 times average annual earnings in the early-1990s to a peak of 7.7 times
- In 2007 and 7.2 times more recently. A move to ten times is very unlikely.



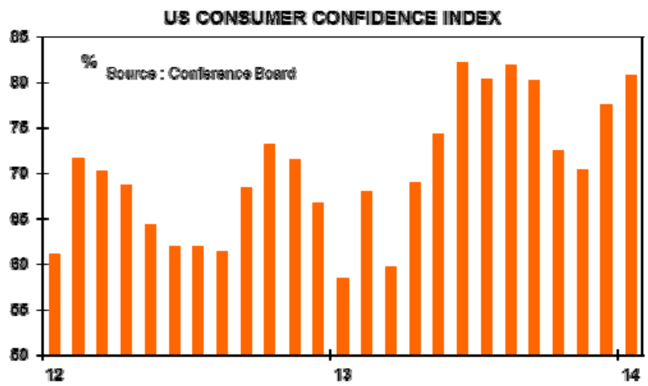


Therefore, much as the next one, and two and maybe even three years will look strong (be careful about over-optimism for 2016), average NZ GDP growth from here on out is likely to be around 2% rather than the previous 3.5%.

Key offshore debates

United States – Growth lifting but could interest rates jump as tapering proceeds?.
China – Impact of non-performing loans following the 2009+ credit boom, ability to switch from export and fixed asset investment as growth-driving forces toward consumption, impact of loosening controls on outward capital flows.
Australia – ability of strengthening retailing and housing to offset the resource sector investment decline plus vulnerability to China shocks.
United Kingdom – Spread of the upturn out of South-East England.
Japan – Whether the Abenomics Three Arrows growth surge was a one-off and reversion to low growth and deflation beckons. Extent to which trade may be disrupted as tensions rise with China.
Eurozone – The extent to which growth will be restrained by lack of banking sector reform and weak credit flows, rising radicalism, whether further ECB stimulus will be needed to combat deflation risks, German consumer spending, whether entrenched long-term unemployment will fall, and developments in the increasingly moribund France.

In the **United States** a bout of the heeby geebies went through markets this week associated with worries about financial turmoil in emerging economies. The data were neither here nor there, simply suggesting as usual that an upturn is underway but there remains reason for some caution. For instance, on the positive side the Conference Board consumer sentiment measure rose to a higher than expected 80.7 in January from 77.5 in December.

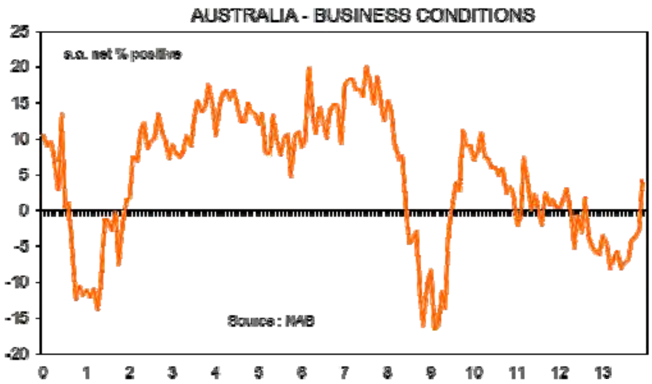


But orders placed for durable goods fell 4.3% and the core measure excluding aircraft and the defence sector declined 1.3%. So this is not a straight-line recovery. But it is strong enough for the Federal Reserve to pull back on its money printing with an announcement last night that the monthly stimulus will be cut to $65bn after being cut from the original $85bn to $75bn late last year. This tapering exercise will have a major influence on markets this year.

In **China** growth doubts grew on Thursday following the weaker than expected flash PMI reading from the HSBC survey. The January index was 49.6 which was below December's 50.5 and the commonly expected 50.3. The result is the weakest since 47.7 in July and raises the question of whether GDP growth which slowed to 7.5% in the June quarter of last year then improved to 7.7% in the December quarter might once again be slowing.

This is not as strongly relevant for the NZ economy as it is for Australia's given the Aussie export dependence upon iron ore and coal shipped to China. But it does reinforce upside risks for the NZD/AUD exchange rate which will hurt NZ exports to our second biggest export destination.

In **Australia** 2013 ended and this year started with strong data on housing and retailing but very weak employment numbers. So quite mixed but a higher than expected inflation number last week almost completely ruling out any further cut in the RBA's currently 2.5% official cash rate. This week there were some strong numbers in the form of the NAB business confidence measure rising to a three year high of 4.2 from -2.9 in December. The Trading Conditions measure leapt to 12.5 from 1.9 – a four year high. Perhaps reflecting the effects of the AUD's decline the export expectations index rose to 0.6 from -0.2, a two and a half year high.



In the **United Kingdom** conditions have improved quite a bit in the past six months and the Bank of England has pulled back from a previously stated policy of not raising interest rates until the unemployment rate dips below 7%. The rate has in fact fallen to 7.1% from 7.8% six months ago but it is clear that underlying economic strength and inflationary pressures and the need to ensure the upturn is not nipped in the bud require that this method of trying to convince the markets that interest rates will stay low for a long time is no longer appropriate. Instead the BOE Governor has said that rates will remain "well below historical norms" in the medium term.

This is similar to the phraseology which is being used in the United States where the unemployment rate has also fallen earlier than expected and too soon for the central bankers to want markets aggressively pricing in imminent cash rate rises. Data released last night shows the UK economy grew by 0.7% in the December quarter of 2013 to record full year growth of an acceptable 1.9%. growth approaching 3% is commonly forecast for this year.

In **Japan** there was a shock during the week in the form of the monthly trade deficit coming in much larger than expected. In a world where investors are shifting funds away from economies with deep structural problems such as large deficits there are worries about confidence in the economy and the effect this may have leading into a planned rise in the consumption tax from 5% to 8% on April 1. But realistically the level of Japan's trade deficit is not a true concern when set alongside the question of whether growth will be sustained this year after an initial surge on the back of much looser fiscal and monetary policies last year.

In the **Eurozone** although some recent sentiment indicators for Germany have been better than expected deep worries persist regarding the potential for deflation now that inflation is just 0.8%, some economies are clearly still struggling, France is stuck in a hole of their own making, and credit flows are still impeded. The ECB President Mr Draghi speaking in Davos ruled out further quantitative easing but did speak in terms of examining how the ECB may buy packages of business loans from banks – allowing the banks to create liquidity by securitising them.

This hint of money injections might seem positive for growth but it would only be implemented if economic conditions deteriorate further and this version of money printing would act to depress the Euro.

IF I WERE A BORROWER WHAT WOULD I DO?

Wholesale borrowing costs have edged very slightly lower this week in response to rate falls offshore caused by deepening worries about the weakness in emerging markets. Signs of this weakness and causes for concern include the weak Chinese manufacturing data for January, a fall in the Turkish lira to a record low, the biggest fall in the Argentinian peso since 2002, and rising tensions in some countries such as the Ukraine, Turkey, Thailand etc. Fears of capital flooding out of emerging markets due to US tapering have also driven fears and will probably continue to do so for some time.

This is ironic. It means that US tapering (reduced monthly money printing) is pushing bond yields both up and down. They go up because less money sloshing around means less demand for bonds (and equities). But yields get pushed down because worries about a hit to world growth and financial flows from crisis in emerging markets cause investors to seek out government bonds in low debt countries like the US, plus reduce their inflation and world growth forecasts. Note though that in both cases equity markets suffer.

Nevertheless, the track for interest rates in new Zealand this year is upward and were I a borrower I would opt to fix most of my debt for three years at 6.39%.

The Reserve Bank told us again this morning that interest rates are going up. While meeting our expectations by leaving the official cash rate unchanged at 2.5% they noted the strong economy and improving world outlook bringing inflation risks and said "…there is a need to return interest rates to more normal levels. The Bank expects to start this process soon."

Our view is that the first rate rise will come on March 13 and the cash rate will end the year at 3.75%, and end 2015 near 4.5%. It has a risk of going higher than that given the competition which has broken out between political parties to ease fiscal policy, the shortage of resources in our economy, and our poor productivity growth record. I would fix. Now.

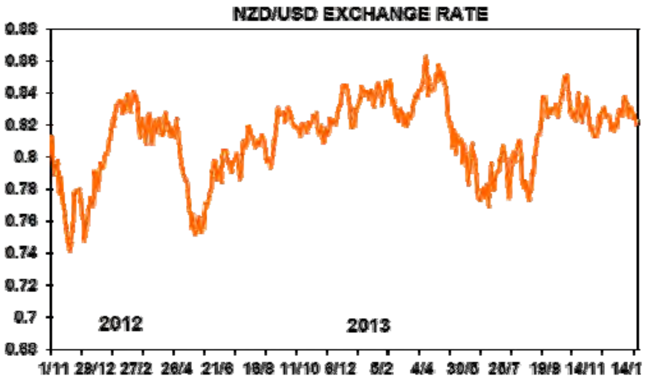
FINANCIAL MARKETS DATA

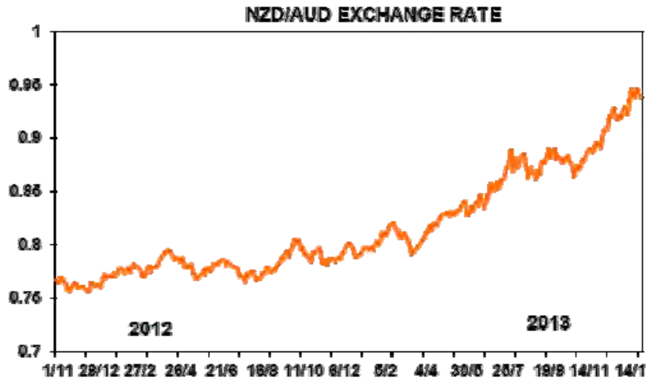
	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	2.50%	2.50	2.50	2.50	2.50	4.9
90-day bank bill	2.95%	2.96	2.78	2.70	2.67	5.2
1 year swap	3.53%	3.52	3.52	3.02	2.81	5.3
3 year swap	4.18%	4.19	4.28	3.83	3.13	5.5
5 year swap	4.61%	4.62	4.79	4.32	3.43	5.7
7 year swap	4.90%	4.93	5.09	4.63	3.74	5.8

NZD Generally Down

The Kiwi dollar has finished the week unchanged against the Aussie dollar just below 94 cents, but shed one cent against the greenback and small amounts on the other crosses. Weakness has mainly been driven by the continuing weakness in emerging markets and a wave of risk aversion sweeping the planet.

There is growing potential for high volatility in exchange rates as worries deepen about economic and social conditions in emerging markets. The theme this year for world growth is generally one of the developed world improving and emerging parts undergoing adjustments. But into this mess we are seeing rising tensions in some countries plus the US tapering exercise causing a flow of capital away from emerging country assets. This has assisted substantial weakness in the Argentinian peso and Turkish lira. There is a flight to quality underway.

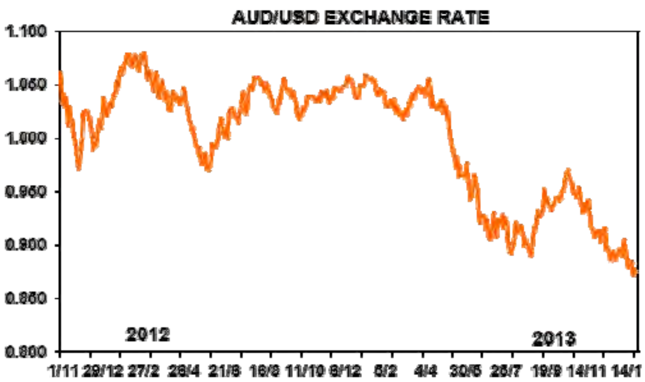


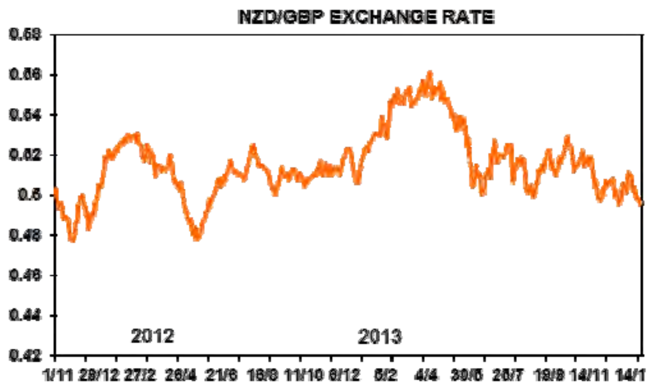


History tells us that such flights ebb and flow with sometimes large movements as bouts of profit-taking kick in and rumours swirl. In all of this generally one would expect the NZD to weaken as we are a peripheral currency. But this time around our economy has one of the most solid underpinnings on the planet and interest rates are set to rise – though the RB will give thought to the deteriorating situation in emerging countries as they contemplate policy tightening.

The message here is that exporters, importers and those with FX exposures should be careful with their open positions this year as there are some big forces in play on both sides of the exchange rate equation.

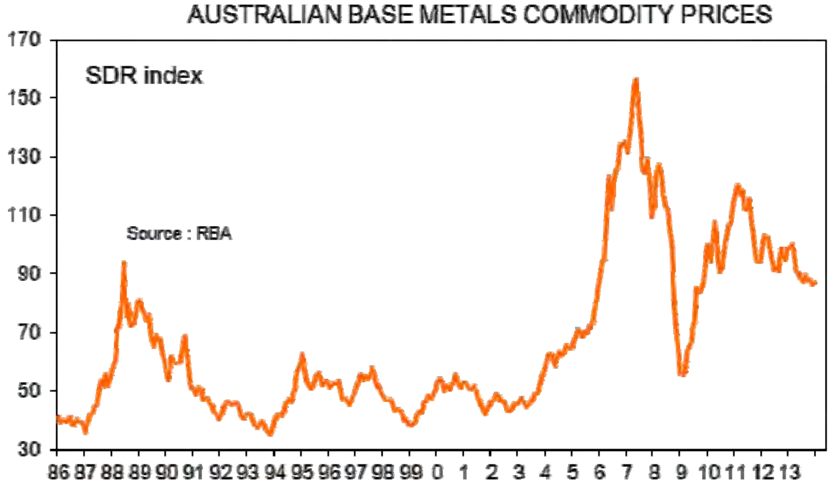
Exchange Rates	**This Week**	**Week ago**	**4 wks ago**	**3 Mths ago**	**Yr ago**	**10 yr Average**
NZD/USD	0.82	0.83	0.8164	0.825	0.837	0.726
NZD/AUD	0.938	0.938	0.921	0.87	0.8	0.839
NZD/JPY	83.7	86.7	85.88	81	75.9	72
NZD/GBP	0.495	0.5	0.4953	0.514	0.531	0.423
NZD/EUR	0.6	0.613	0.5935	0.6	0.62	0.545
NZDCNY	4.97	5.02	4.95	5.02	5.21	5.1
USD/JPY	102.07	104.46	105.19	98.18	90.68	99.3
GBP/USD	1.66	1.66	1.65	1.61	1.58	1.72
EUR/USD	1.37	1.35	1.38	1.38	1.35	1.33
AUD/USD	0.87	0.88	0.89	0.95	1.05	0.87
USD/RMB	6.0549	6.0515	6.068594	6.0906	6.2264	7.15





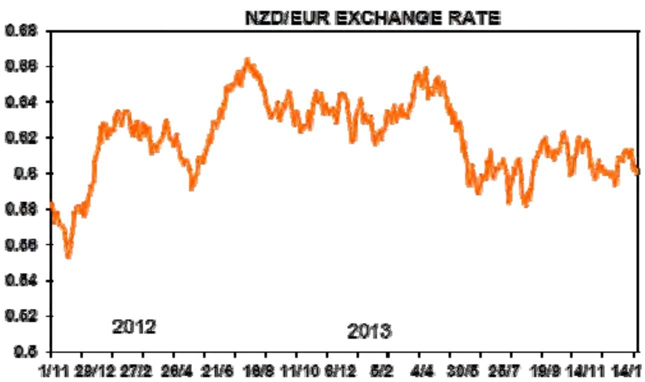
A year ago the NZD was buying just under US 84 cents compared with near 82.5 now while the AUD in contrast was near $1.05 but has plummeted to near 87 cents. The sharp jump therefore in the NZD/AUD exchange rate from 80 cents to over 94 cents now reflects not a rise in the NZD but a decline in the AUD. Why has the Aussie dollar fallen so much?

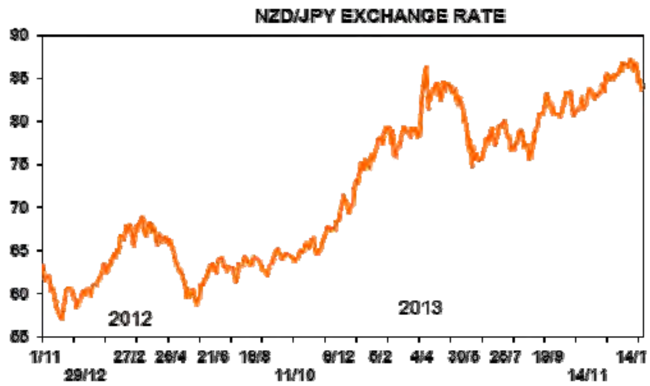
One reason is that export commodity prices have declined sharply. The SDR-denominated index of Aussie base metal export prices has fallen 12% from a year ago and 28% from levels seen early in 2011. The RBA in the past year has cut the Australian cash rate from 3% to 2.5% whereas the NZ rate has been constant at 2.5% since March 2011. Australia's economy has been hit by the ending of a massive resource sector investment boom and the unemployment rate is rising. In contrast NZ is embarking just now on one of its biggest construction booms with the terms of trade at their highest level since 1973.



The AUD has also been depressed by slowing growth in China and worries about problems of debt etc. This affects Australia more than us as the near 35% of Australia's export receipts which derive from China are made up largely of iron ore and coal. Our over 20% of receipts from China however consist largely of soft commodities and particularly dairy for which demand is less influenced by GDP growth than structurally rising middle incomes and demand for safe, quality sources of protein.

Here is the link to a chat I had with Marcus Lush this week regarding the NZD/AUD exchange rate.
http://www.radiolive.co.nz/AUDIO-Dollar-for-dollar-parity-between-the-Kiwi-and-the-Ozzie-unlikely/tabid/506/articleID/40218/Default.aspx





The way in which debate about the NZD/AUD has shifted to speculation about parity is yet another example of how you can't forecast exchange rates. For the past three or four years we along with most others have talked in terms of a structural fall in the NZD/AUD exchange rate from the traditional range of 75 – 94 cents with an average of 83 cents to something closer to 70 – 90 with an average between 75 and 80. Now all of that has gone out the window.

Why do exchange rate forecasts fail? One reason is that the exchange rate is the door through which every piece of information relevant to an economy goes through. Most of that information we cannot predict.

Another reason is that much as one may spend a lot of time trying to develop models which explain changes in variables such as interest rates and exchange rates in the past, even the most successful models will be rendered useless by unpredictable changes in the structure of economies and the structural relationships between variables.

Consider for instance how models could be adjusted for the change in consumer, business, government, and bank attitudes toward debt since 2008. We have no measure of how such attitudes have changes, and few if any models contain any measure of such attitudes anyway! Or try to factor in the rise in China and other emerging economies, the extent to which their poor structures and political systems will impede their growth in the future, and what that means for demand for our exports, Australia's, and so on.

Another factor making exchange rates impossible to forecast is that the most basic theories which should strongly in theory explain rate changes simply do not work. The interest rate parity theory for instance says that exchange rates will adjust over time to reflect interest rate differentials and wipe out the advantage to be gained by staying in a high interest rate currency over the long-term. The failure of the NZD to fall in a sustained manner since it's 1985 float in spite of above average interest rates shows this theory does not work. Neither does the theory regarding exchange rates adjusting to trade imbalances.

Worse than that, even when there appear to be clear factors which drive exchange rates, you cannot predict which one the markets will choose to focus on when. For instance just this week the markets have decided that current account deficits matter because of the risk of capital flight associated with concerns about China's pace of growth and US tapering. There is no way of predicting when such concerns will ease and traders switch to focussing instead on interest rate differentials, or growth differentials, or political risks, or trade flows, or security tensions…

The upshot of this discussion is simply that we repeat the warning delivered here for a great number of years now. You cannot run your company and make decisions regarding when or when not to make an FX transaction largely on the basis of an exchange rate forecast. You instead need to focus strongly on the ability of your bottom line to suffer a hit should you get it wrong, your ability to react calmly rather than run around in panic should things look like they are moving against you, your ability to naturally hedge and the risk that these hedges could disappear overnight should your import source country or export destination have to switch from one part of the world to another.

Basically, be very wary of running open FX positions and seek advice from the experts regarding what mix of hedging products best suits your business, your temperament, and your level of intelligence. Good luck this year.

One final thing. The NZD budged only slightly downward on news of a male Queensland fruit fly being discovered in Whangarei last week. Imagine how far the NZD would have fallen had the finding instead been of a sheep infected with foot and mouth disease. The chances are that one day this will happen, and if you were to be sitting on an open position waiting for the NZD to rise a bit further before closing it out, you could be wiped out by a 30 cent plunge.

For more detailed FX analysis including the 'BNZ Markets Outlook", "BNZ Strategist" "BNZ Commodities Wrap" and lots more go here. https://research.bnz.co.nz/Research/NewZealand/Pages/NZpublications.aspx

Housing Market Update

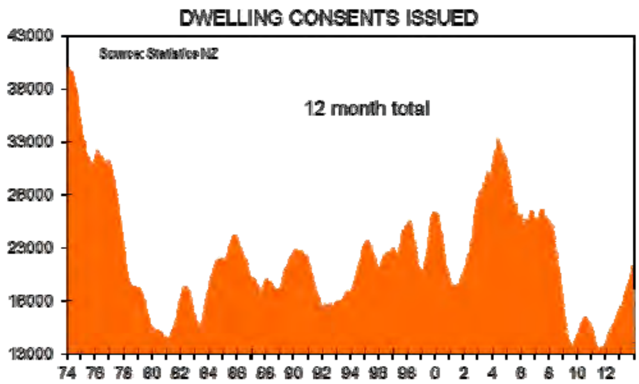
Additional analysis and commentary are available fortnightly in the NZ Property Press and monthly in the NZ Property Investor magazine.

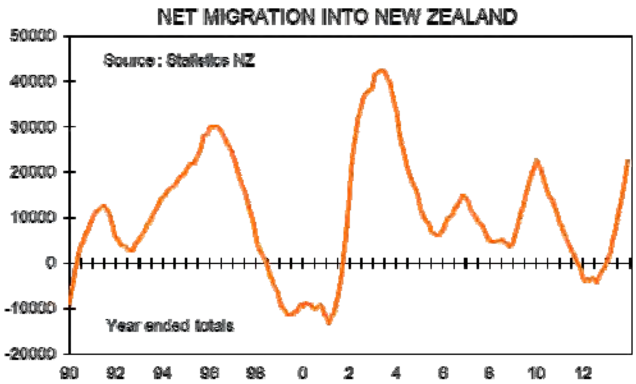
Nothing Much New

We have received few interesting new data on the state of the NZ housing market this week apart from the indicators included in our monthly BNZ-Nine Rewards Consumer Trends Survey. As noted above the survey has revealed a sharp move up in the net percent of people expecting house prices to rise in their area in the coming year to 69% from 55% two months ago.

This morning the monthly dwelling consent data were released and they showed a strong seasonally adjusted rise in December of 7.6% which followed a November rise of 12.5%. In the December quarter consent numbers rose by a strong 14.6% to be32% ahead of a year ago. The annual total now stands at 21,300 which represents a gain of 26% from 16,929 over 2012 and is a level almost exactly equal to the average for the past ten years.

Dwelling supply is thus rising, which is good for helping to offset some of the price pressure coming from strong demand. However rising construction in the context of some staff shortages will bring rising inflation and eventually higher interest rates and upward currency pressure.





And at the same time that supply is rising so too is demand. Net migration inflows are going through the roof courtesy of a big fall in the number of Kiwis flitting across the ditch to 39,154 in 2013 from 53,676 during 2012. The numbers coming this way have also moved, rising to 19,529 from 14,880. The net loss has shrunk to 19,625 from 38,796. This shift of 19,171 accounts for the bulk of the shift in the total net migration flow for NZ from a loss of 1,165 during 2012 to a gain of 22,468 over 2013.

Continuing with the exercise we have been running for many months now of simply annualising the seasonally adjusted flows for the most recent three month period we get annual net gains currently running at an annual pace near 34,000. Let's call 30,000+ the likely end number this calendar year. If so then that will be the biggest net gain since 2003. Will we reach the May 2003 peak of 42,541? Probably not given that this current surge is being driven by fewer people leaving our shores than coming in, and the cycle with Australia always turns. By late this year we think momentum for the Australian economy will look a lot better.

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