BNZ Weekly Overview

19 August 2010

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.

In this week's issue….

The Weekly Overview is written by Tony Alexander. 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 email me at tony.alexander@bnz.co.nz with 'Subscribe" in the Subject line.

Informed Uncertainty

Remember that this is all informed guesswork at best – especially now. That is, don't for goodness sakes be running your business or personal finances on the basis of a particular set of projections (ours or others) coming true because this is still the biggest period of economic uncertainty any of us have seen on a global basis.

As noted last week, none of us know when businesses or consumers will decide the future is "safe" enough that they will walk into banks looking for extra finance. When that happens we don't know to what extent interest rate sensitivity will be different from the past. Actually if you think about those two sentences you'll realise what we are saying is that in the current very uncertain environment it is not interest rates which are the prime determinant of whether people borrow or not. That means interest rate rises being undertaken by the Reserve Bank are almost irrelevant. Almost, but not completely because rate rises do affect cash flows and as anyone who has operated a business knows it is usually dearth of cashflow which causes a business to go under, not the fact that their product or service is bad.

Also on the list of things we don't know are commodity price movements which of course influence farmer spending and investment decisions. Dairy prices have soared, pulled back, but now with grain prices heading skyward because of weather events overseas (plus a forecast plaque of locusts in Australia next week) the dynamics are changing once again. Dairy and beef animals overseas are often largely grain as opposed to grass fed and as costs rise one would expect fewer to be farmed. That volume effect will tend to underpin prices for some of our major exports at the same time however as overall demand is dented by the grain supply shock cutting into household budgets.

The exchange rate's likely course is of course is a complete unknown at any point in time so concentrate your efforts on figuring out your bottom line and net asset vulnerability to shock moves up and down then discuss with a professional the options available for hedging an appropriate part of that risk. Be especially wary of forecasting driving your hedging decisions.

Finally, be wary of falling into the trap of thinking everything is bad out there and there is little point in getting up in the morning. The number of hours worked by employees in New Zealand rose in seasonally adjusted terms by 1.3% over the March quarter this year and by another 0.6% during the June quarter. This is not a jobless recovery.

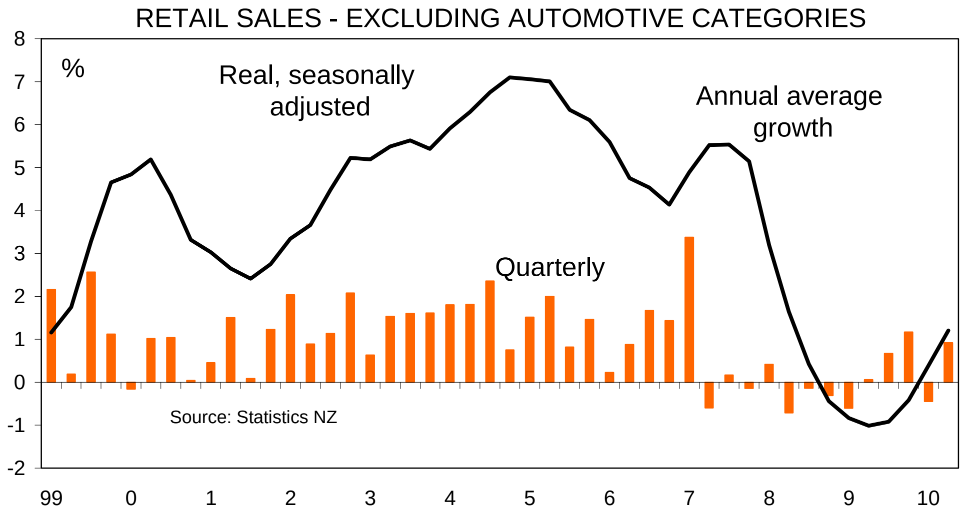
Just for your guide, when you strip away the analysis of latest data and so on, what are the main points we think people should consider as they ponder the operating environment over the next couple of years?

- We will receive both negative and positive interest rate, exchange rate, commodity price, housing market, labour market and economic growth shocks because no-one has a model which reliably tells us how the world exits a near Depression scenario. The next two years will be like the last two – all about learning stuff.
- Interest rates are highly likely to rise but the process will be very stop-start as the Reserve Bank assesses the impact of rate changes, and unpredictable fluctuations in global risk tolerance move long rates around – as has happened on the downward side over the past two weeks.
- House prices will remain underpinned by vendors not feeling much need to sell and below replacement level construction only slowly recovering. Over 2011 discussion will grow regarding construction shortages and awareness will then rise of builders going offshore. To whit….
- The labour market will tighten up quite a bit as skilled people leave for Australia. Watch for a migration tightening there which will reduce inflows from elsewhere but of course leave open entry for us Kiwis who will therefore experience a relative rise in demand from employers actively searching us out. Expect recruitment campaigns like we have seen in the past for health professionals. Wage pressures will hasten from the second half of next year and employers who have failed to implement good remuneration schemes through the weak period will find staff shooting off to better workplaces.
- The NZ dollar will remain as volatile and unpredictable as ever with heavy influence from fluctuations in global risk tolerance..
- Commodity prices are likely to remain well supported by average growth in our trading partners (good support from Australia and China), plus weather events hitting food production offshore.
- Farm land prices are likely to slowly rise as farm balance sheets rapidly improve, and investor capital seeks dairy exposure.
- The manufacturing sector will be well supported by the low NZD/AUD exchange rate plus good Aussie demand caused by their economic growth.
- The tourism sector will experience accelerating growth over 2011 over and above the obvious boost from the Rugby World Cup. The general election shortly after will have little economic impact.
- The non-residential construction sector will be weak through 2011 but improve over 2012.
- This year and next many businesses will still fall over because of cash flow constraints and an inability to tap sources of support which have been used up over the past two years – or three in the case of retail which hit a wall in the middle of 2007.
- The government will fly many kites regarding further structural reforms – such as the compulsory savings idea this week which will have the managed funds industry slobbering over their spreadsheets but will almost certainly not be imposed. The Aussie scheme came in through an Accord process with the unions involving wage restraint in exchange for employer contributions. Zero chance of that here. Based on this year's Budget however one can reasonably expect alternative reforms after the 2011 election is out of the way.

Consumers Bought More Stuff

During the June quarter retail spending after removing the effects of price changes and seasonal factors grew by a better than expected 1.3%. But we like to look at a subsidiary measure which accounts for about 75% of total spending and excludes automotive categories. This less volatile "core" measure grew by 0.9% in the June quarter after falling 0.5% in the March quarter, rising 1.2% in the December quarter, and rising 0.7% in the September quarter.

The first point to make therefore is that the latest result is a good one. The second point is that this core measure can still be quite volatile and one should treat it with some caution. Third, that caution appears to be well justified when we consider that on average the prices of core items fell 0.5% over the three month period. That means there was a lot of discounting by retailers. In fact in each of the most recent four quarters average prices have decreased 0.4% whereas they rose 0.9% in the previous four quarters on average.



As an aside, with inflation at 1.8% and unusual discounting by retailers one can see that a return to better consumer spending will cause a cessation of this downward price impact on overall inflation and easily start pushing inflation toward the 3% target band upper limit. Hence rising interest rates!

But back to the spending, it was possibly driven by discounting and therefore when we economists look at that we tend to think maybe that means this upturn will not continue. Maybe you and I just brought forward in time the spending we were going to do later this year just to take advantage of a cheap deal.

To get an even better feel for what we think consumers are doing we can then look at an even more disaggregated measure of spending on what we call “durables”. These are things we tend to buy if we think our future income potential is okay. Sales of durables rose by a firm 2.6% in the quarter after rising only 0.2% in the March quarter. That sounds good. But average prices of these durable goods fell 2.4%. So we are still left with thinking discounting explains the volume strength.

It would be nice to say that we will get a clearer picture in coming months. But as we warned three months ago we won’t. The increase in GST to 15% on October 1 will cause a lift in retail spending ahead of that date – but we don’t know by how much. And after October 1 the change will produce a fall in spending. But we won’t know by how much.

That means that for the rest of the year we are largely going to be flying in the dark with regard to figuring out how firmly household spending is growing – as if there were not enough uncertainty around already!

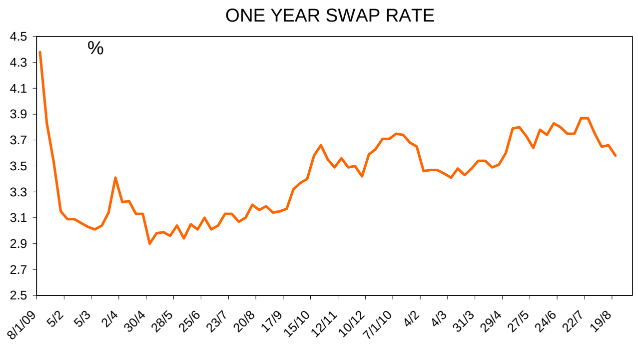
INTEREST RATES

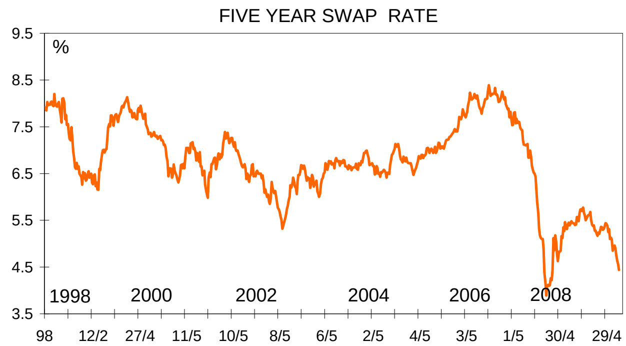
The world has been going through a process in recent weeks of pushing out expectations for when central banks in major economies will be able to start raising their interest rates. That change has placed some surprisingly strong downward pressure on medium to long term interest rates (fixed rates). That downward pressure has also appeared from our own shores with an increasing chance the RBNZ will not raise the cash rate every 6 weeks over the coming year and a half. That is, they are guaranteed to pause sometime in the near future to see how things are looking.

These changes in global monetary policy expectations have caused the likes of the one year swap rate here in NZ to fall to 3.58% from 3.66% last week and 3.87% four weeks ago. But that’s nothing. The three year swap rate has fallen to 4.11% from 4.2% last week and 4.54% four weeks ago. And the five year rate has fallen to 4.44% from 4.56% last week and 4.90% four weeks ago.

Looking ahead we think a lot of the change in monetary policy expectations has now been factored into the curve and scope for further declines looks fairly limited. The curve is quite vulnerable therefore to three things. First, a switch back in global expectations toward hopes of early policy tightenings if economic data surprise on the upside. Second, a risk that with the gap between floating and fixed rates now so much less than in recent months we will see a move by borrowers to fixed. Third, if business credit demand improves in the near future the resulting increase in demand for quite attractive fixed rates could elicit a quick market pricing response.

At this stage we still expect another rise in the official cash to come on September 16.





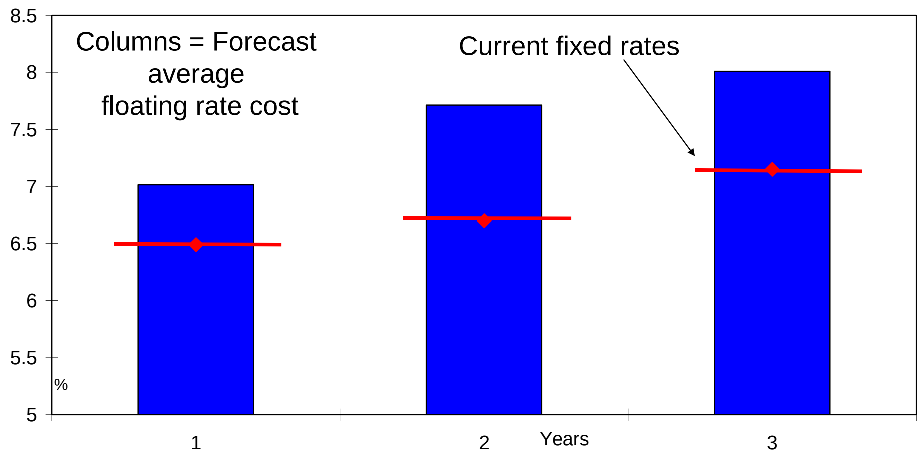
Key Forecasts

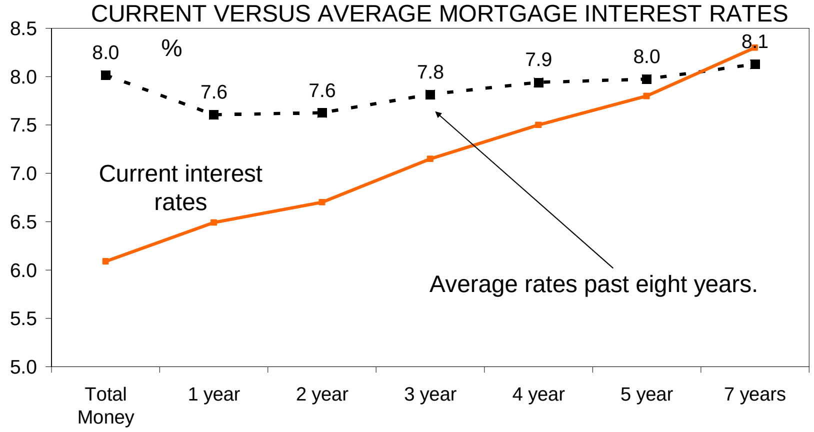
- Tightening through to mid-2012.

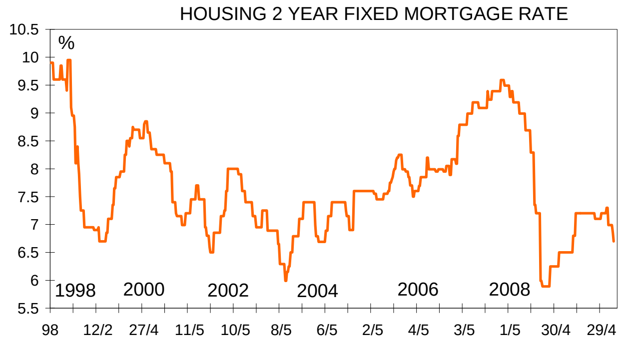
FINANCIAL MARKETS DATA	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	3.00%	2.75	2.50	2.50	2.50	5.9
90-day bank bill	3.26%	3.32	3.26	2.95	2.73	6.2
1 year swap	3.58%	3.65	3.87	3.51	3.17	6.3
5 year swap	4.44%	4.56	4.90	5.31	5.41	6.6
180-day term depo	4.10%*	4.10	4.80	4.90	3.15	6.0
Five year term depo	6.50%	6.75	6.75	6.75	6.00	6.5
* 150 days = 5%						

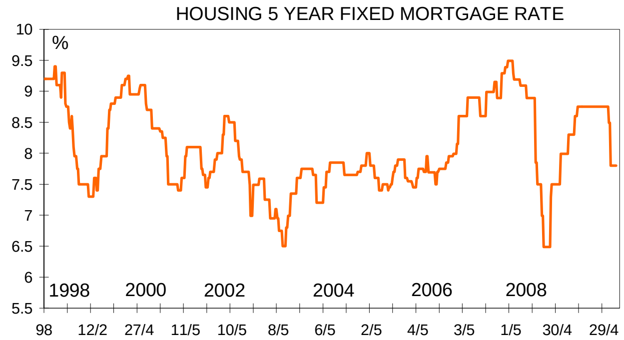
If I Were a Borrower What Would I Do?

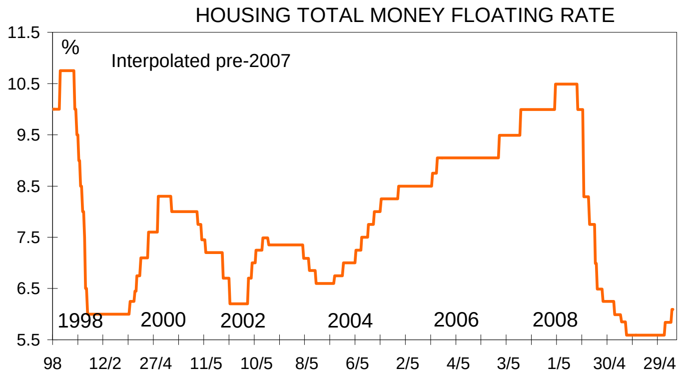
I can float at 6.09% with that rate rising over the coming 1-2 years, or fix two years currently at 6.7% or three years at 7.15%. The cut this week in the two year rate from 6.85% is enough to make me opt for that rate as I expect the floating rate to hit almost 6.7% after two more rate rises.





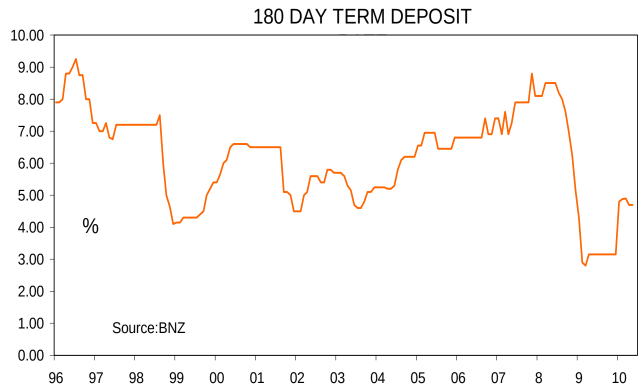


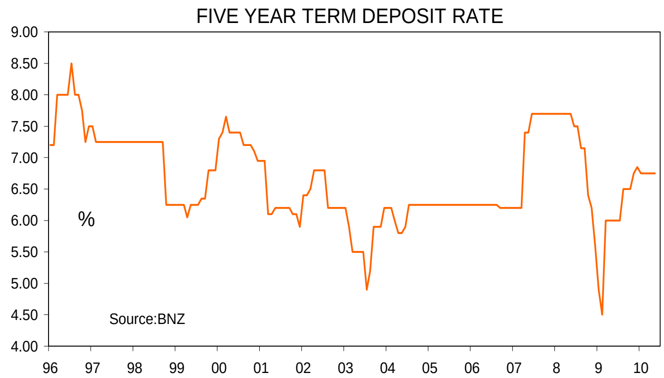




If I Were a Term Deposit Investor What Would I Do?

Nothing new. I would have most short term but some toward five years to improve the average yield.



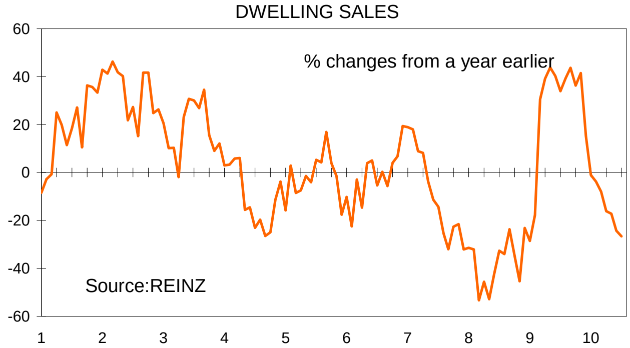


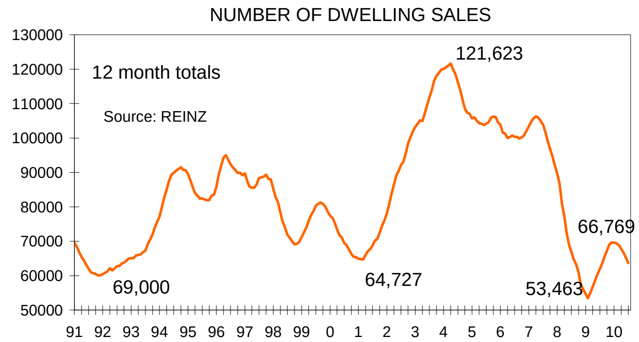
HOUSING MARKET UPDATE

Housing Market Flat

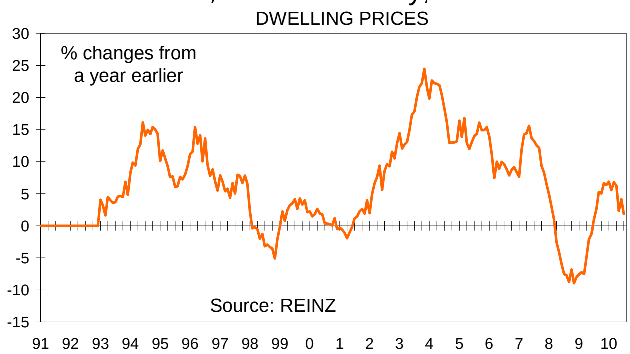
The REINZ released their monthly data last week and there was nothing in there justifying a change in our market commentary or view. Activity is flat, buyers know they can pick and choose, sellers won't discount to get a sale, places are sitting on the market longer than usual but not appallingly so, and prices are essentially flat.

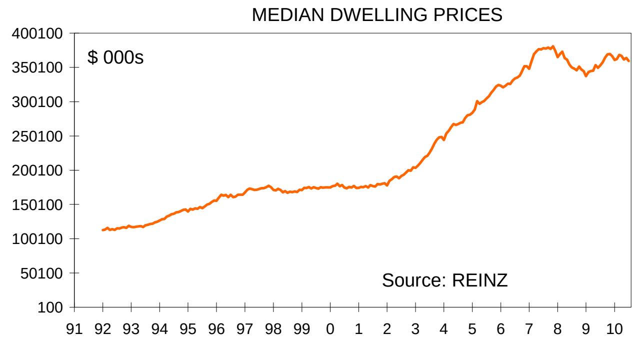
In July there were only 4,411 dwellings sold around the country. This is the lowest July turnover on record and down 27% from a year ago. Turnover for the year to July was ahead 2.8% from the previous year at 63,701 units.





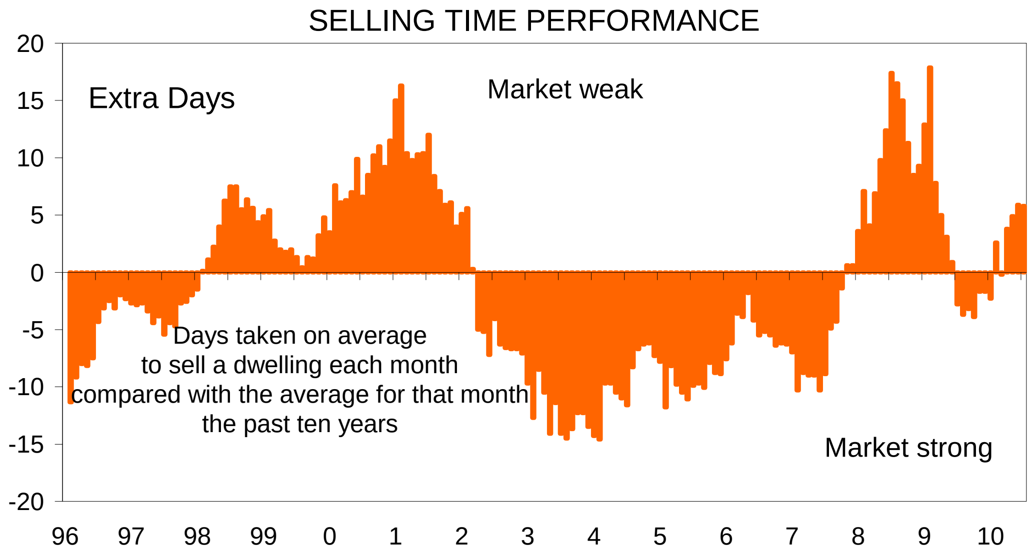
If turnover was low because buyers could not find the properties they want as someone else had already snapped them up then prices would be rising. If turnover was low because no-one really wanted to buy then prices would be falling. But while the average median price (index measure) fell 1.2% in July this followed a 0.6% rise in June, 1.4% fall in May, small 0.3% fall in April, but collective 2% rise over February and March.



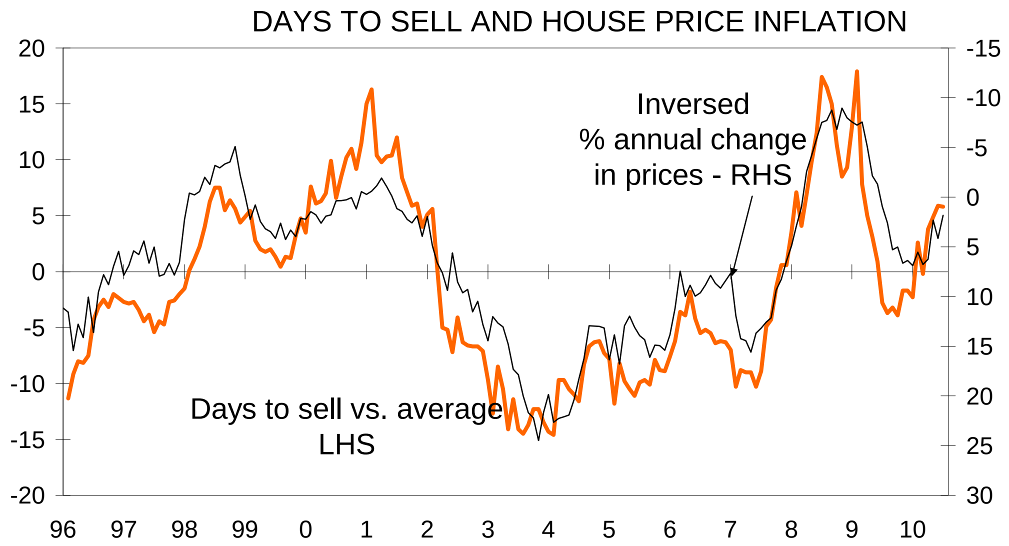


On average over the past three months prices have edged down 1.1% after being flat in the three months to April and ahead 0.6% in the three months to January. We read that as flat with a small downward bias which in the whole scheme of things is a very good result. Unemployment remains above average, the net migration flow is turning downward sharply, and investors have lost the tax deductibility of depreciation.

In the month it took on average 45 days to sell a dwelling compared with 37 days a year ago. More importantly though sales in the month took 5.8 days longer than average for July versus 5.9 days in June, 4.9 days in May all the way back to about even in March. Properties are sitting on the market for longer, but as the following graph shows things are well away from 2008 levels.



It is worth keeping an eye on this measure however because it is quite well correlated with the annual rate of change in house prices, which currently stands at 2.8%.



All up things are weak with prices near static. Nothing new there.

One final point. Just be aware that there is a downward bias to house sales data reported by REINZ at the moment because an uncertain proportion of those who used to report now are not doing so either because they don't have to or because free stuff they got in exchange for reporting is no longer available. We believe the downward bias is small but don't really know by how much. Note however that it will only be the turnover number that is affected not average sale price or days to sell.

Old Folk Will Stay Put

This comment I am just whacking in here to refer people to as the issue comes up in future years. There is a long-running assumption that as the population ages old folk will want to downsize their accommodation and shift into a nice modern low maintenance house or flat. I recall analysing the price difference between such places and average existing houses during a day spent in Westport 10-15 years ago waiting to fly back home after tramping further north. There was no price gain for pensioners in selling and then buying.

The issue however in these sort of things is what is the assumption one is making in the first place? It is that old folk will want to move. The truth however appears to be that they do not. A report referenced on page 9 of the August 18 "The Australian" newspaper this week shows that while 88% of people over 55 are living in houses bigger than they need, more than 90% believe their home is the right size for them. The same percentage want to stay in their home even as they increasingly need in-home care services. The report was put out by the Australian Housing and Urban Research Institute.

The relevance here is that as our population ages average occupancy per house will continue to decline as it has for quite some time now and that decline may even accelerate from next year. That implies that the number of houses needed to be built each year to meet normal accommodation requirements will drift up from next year.

Now throw in builders leaving for the green fields, eager employers and high pay rates in Queensland and Western Australia, rising construction costs courtesy of China's domestic upgrading over the next few decades, and one easily gets extra underlying house support. Not short term of course but over the medium to long term.

All that means is yet another warning not to blindly base your house price expectations on measures of fair value based upon the structure of our economy and society over the past few decades. Structures change over time. Bigger houses on average, more inside toilets, more bathrooms all up, better insulation, stronger walls, and so on.

Are You Seeing Something We Are Not?

If so, email us at tony.alexander@bnz.co.nz with Housing Comment in the Subject line and let us know.

Key Forecasts

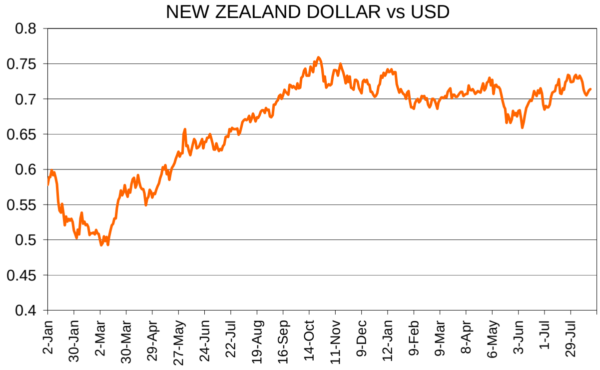
- Dwelling consent numbers to recover now with potentially good activity from late-2010.
- House prices edging higher after tax change effects wend their way through.

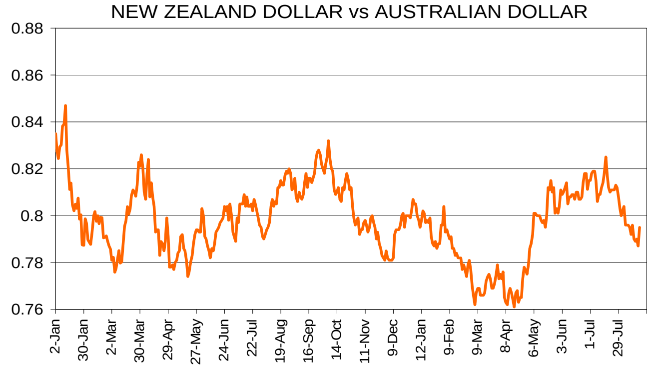
Exchange Rates & Foreign Economies

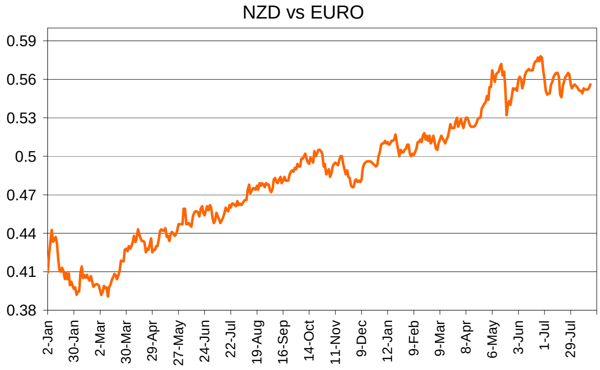
Exchange Rates	This Week	Week Ago	4 wks ago	3 mths ago	Yr ago	Consensus Frcsts yr ago*	10 yr average
NZD/USD	0.714	0.713	0.708	0.689	0.674	0.610	0.592
NZD/AUD	0.795	0.796	0.817	0.800	0.815	0.770	0.856
NZD/JPY	61.00	60.60	61.20	63.30	63.8	61.366	66.8
NZD/GBP	0.458	0.454	0.463	0.482	0.407	0.380	0.345
NZD/EUR	0.556	0.553	0.548	0.566	0.477	0.445	0.51
USD/JPY	85.43	84.99	86.44	91.87	94.659	100.600	113.9
USD/GBP	1.559	1.570	1.529	1.429	1.656	1.607	1.709
USD/EUR	1.284	1.289	1.292	1.217	1.413	1.372	1.156
AUD/USD	0.898	0.896	0.867	0.861	0.827	0.792	0.69

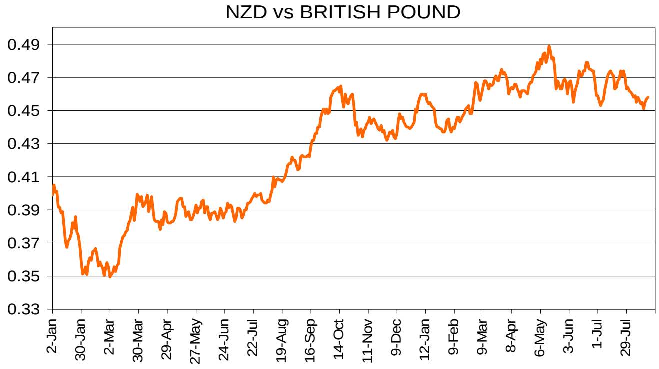
Kiwi Unchanged From Last Week

A week ago the NZD was buying US71.3 cents and this week it is at practically the same level. It fell to 70.5 early in the week on a small rise in risk aversion associated with some weaker than expected US data, then recovered as investors returned to growth and risky assets with good demand for European government bonds at auctions, good European economic growth numbers, and a rise in US consumer confidence.

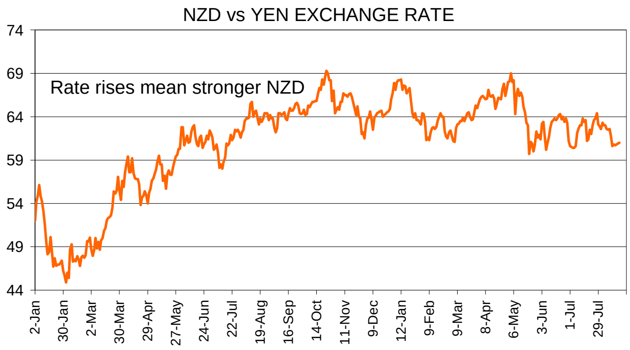


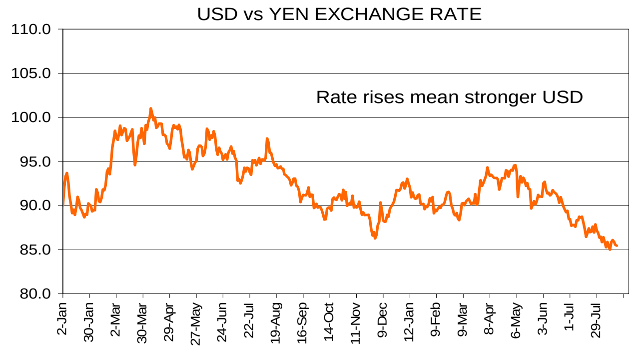


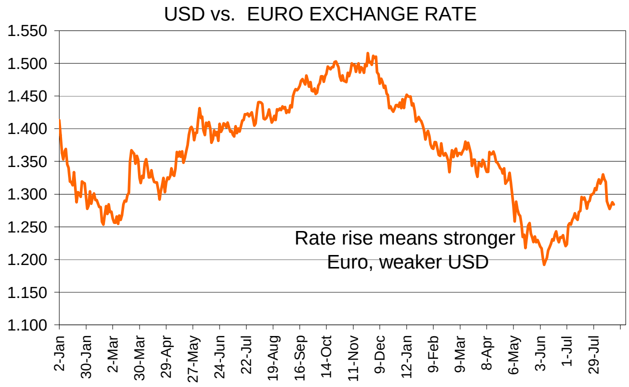


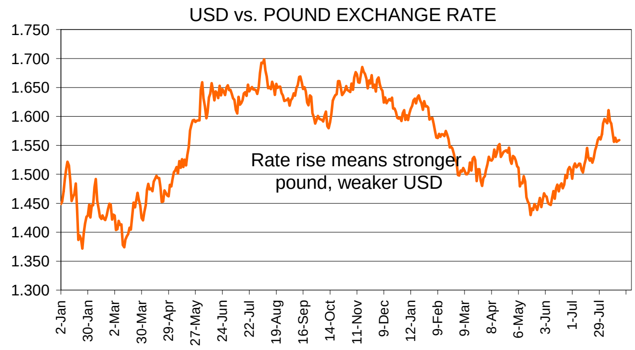


Basically nothing new and startling happened during the week to alter broad views about what is happening in major economies overseas. That means the greenback has ended little changed from a week ago against the Yen even though for a while there were worries about Japanese official intervention to lower the Yen. It did not happen. The USD has also ended practically unmoved against the Euro, while against the Pound it has weakened to near $1.56 from $1.57 – meaning that actually the Pound has strengthened a bit. That occurred because Bank of England minutes overnight were more hawkish than expected.



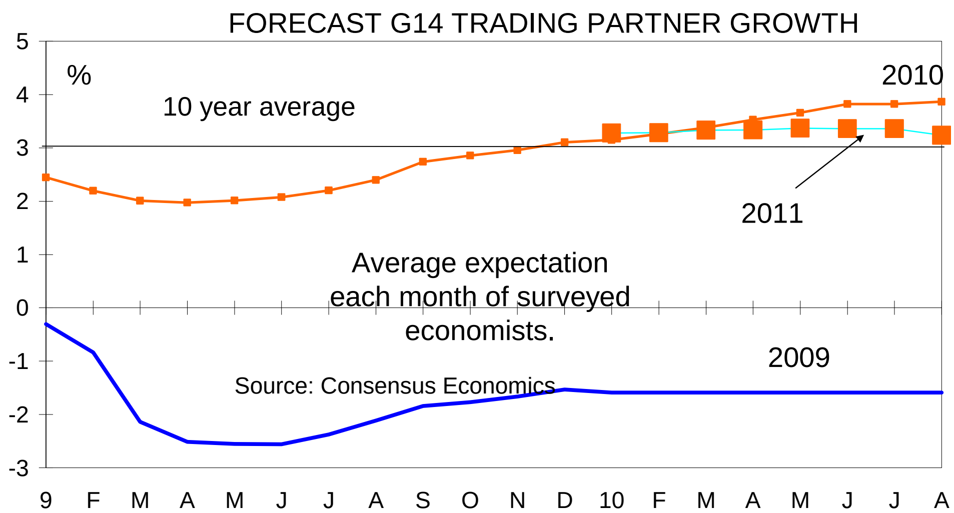






On average New Zealand's top 14 export destinations grow just over 3% per annum. After growing about 2% over 2008 they were forecast on average according to the monthly Consensus Economics survey to shrink 0.3% over 2009. That was in the January 2009 survey. In June 2009 the expectation was shrinkage of 2.5%. The shrinkage ended up at 1.6%. Yuk but it could have been horribly worse. This outcome is the blue line in the graph below.

The forecast in January 2010 for growth this year was 3.1%. That forecast now stands at about 3.9% and is shown as the orange line with little round dots in the graph. The expectation for 2011 started at 3.3% in January and is still about that. In fact in the August survey the expectation was 3.23% compared with 3.36% two months earlier. There has been only a small decline in 2011 growth expectations even taking into account some of the recent worries.



Having said that not all of the worries would have been captured at the time of the latest survey therefore there is a risk the forecast dips slightly next month. But the key point to note is that the world economy is not forecast to have a double dip recession and something about average is likely. But before one gets all warm and cuddly about that it pays to remember what we noted above regarding the 2009 expectation going from

-0.3% in January 2009 to -2.5% in June, then -1.5% come the end of the year. These forecasts can change quite a bit. The 2009 average forecast was even 3.5% at the start of 2008 and still 2.5% in early September 2008 just before the Lehman's collapse.

For more detailed commentaries from BNZ and the NAB group on foreign currencies, commodities, etc click on the following link.
https://research.bnz.co.nz/Research/Pages/default.aspx

*Sourced from Consensus Economics. http://www.consensuseconomics.com/

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ECONOMIC DATA

All %		Latest qtr only	Previous qtr only	Latest year	Year ago	2 Yrs ago
Inflation	RBNZ target is 1% - 3% on average	0.3%	0.4	1.8	1.9	4.0
GDP growth	Average past 10 years = 2.6%	+0.6	0.9	-0.4	-1.4	2.8
Unemployment rate	Average past 10 years = 4.7%	6.8	6.0	......	5.9	4.0
Jobs growth	Average past 10 years = 2.0%	-0.3	1.0	0.0	-0.9	0.8
Current a/c deficit	Average past 10 years = 5.9% of GDP	2.4	2.9	......	7.9	7.8
Terms of Trade		5.8	-1.6	-8.2	1.8	8.8
Wages Growth	Stats NZ analytical series	0.4	0.8	2.7	5.4	5.0
Retail Sales ex-auto	Average past 9 years = 3.9%.	1.3	0.7	1.3	-0.6	2.8
House Prices	REINZ Stratified Index	0.7	-1.2	5.1	-5.0	-1.9
Net migration gain	Av. gain past 10 years = 13,900	+16,504	20,973yr	......	12,515	4,735
Tourism – an. av grth	10 year average growth = 3.2%. Stats NZ	3.8	4.2	3.8	-2.8	0.9
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 3%. Colmar survey	46	36	57	3	-34
Business activity exps	10 year average = 19%. NBNZ	32	39	39	13	-8
Household debt	10 year average growth = 10.3%. RBNZ	2.5	2.7	2.7	2.6	9.4
Dwelling sales	10 year average growth = 2.5%. REINZ	-24.2	-17.2	15.2	40.3	-42.4
Floating Mort. Rate	(TotalMoney) 10 year average = 7.9%*	5.84	5.59	5.99	5.99	10.49
3 yr fixed hsg rate	10 year average = 7.8%	7.30	7.75	7.95	6.99	9.09

ECONOMIC FORECASTS

Forecasts at July 29 2010	**March Years**					**December Years**				
	2009	2010	2011	2012	2013	2008	2009	2010	2011	2012
GDP - annual average % change										
Private Consumption	-1.1	0.6	2.7	2	1.4	-0.3	-0.5	2.7	2.1	1.6
Government Consumption	4.2	1.4	2.7	1.4	0.9	4.8	1.6	3	1.4	1
Investment	-7.2	-9.5	4.5	5	3.3	-3.6	-12	2.2	5.9	2.9
GNE	-1.5	-3.2	5.2	2.3	1.7	0.4	-5	4.9	2.7	1.7
Exports	-3.4	2.9	2.4	6.4	2.4	-1.4	0	2.8	5.8	3.2
Imports	-4.7	-9.6	9.1	3.3	2.6	1.9	-14.9	9.5	3.6	2.9
GDP	-1.5	-0.4	3.2	3.2	1.6	-0.2	-1.6	2.8	3.4	1.7
Inflation – Consumers Price Index	3	2	4.5	2.8	2.6	3.4	2	4.3	2.7	2.6
Employment	0.7	-0.1	2.4	2.3	0.9	1	-2.4	2.6	2.9	0.8
Unemployment Rate %	5.1	6	5.7	4.9	5	4.6	7.1	6	4.9	5
Wages	5.1	1.6	2	3.6	3.4	5	3.1	1	3.2	3.5
EXCHANGE RATE ASSUMPTIONS										
NZD/USD	0.53	0.7	0.72	0.66	0.61	0.56	0.72	0.73	0.68	0.62
USD/JPY	98	91	99	105	105	91	90	97	103	105
EUR/USD	1.31	1.36	1.21	1.25	1.24	1.34	1.46	1.2	1.24	1.28
NZD/AUD	0.8	0.77	0.83	0.84	0.84	0.83	0.79	0.82	0.83	0.83
NZD/GBP	0.37	0.47	0.47	0.4	0.38	0.37	0.44	0.49	0.42	0.38
NZD/EUR	0.41	0.52	0.6	0.53	0.49	0.41	0.49	0.61	0.54	0.48
NZD/YEN	51.8	63.7	71.3	69.3	64.1	50.9	64.2	70.8	69.5	65.1
TWI	53.8	65.1	69.9	65.3	61.6	55.1	64.7	70.5	66.3	61.6
Official Cash Rate	3	2.5	4	5.5	5.25	5	2.5	3.75	5.25	5.5
90 Day Bank Bill Rate	3.24	2.67	4.15	5.65	5.4	5.23	2.78	3.95	5.57	5.65
10 year Govt. Bond	4.77	5.86	6.3	7	7.5	4.88	6.02	5.9	6.8	7.5

All actual data excluding interest & exchange rates sourced from Statistics NZ.

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*extrapolated back in time as TotalMoney started in 2007