BNZ Weekly Overview

1 July 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.

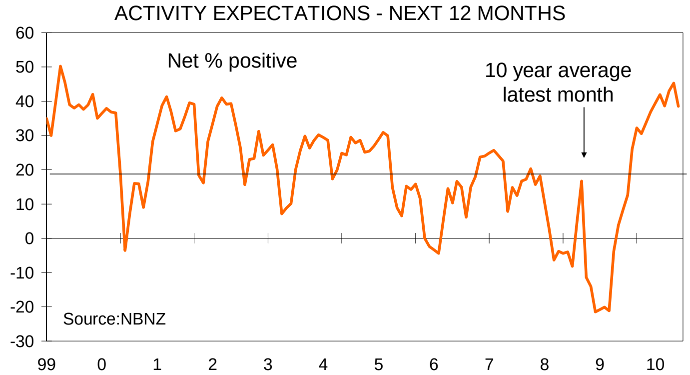
In this week's issue….

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.

Indicators Easing Off

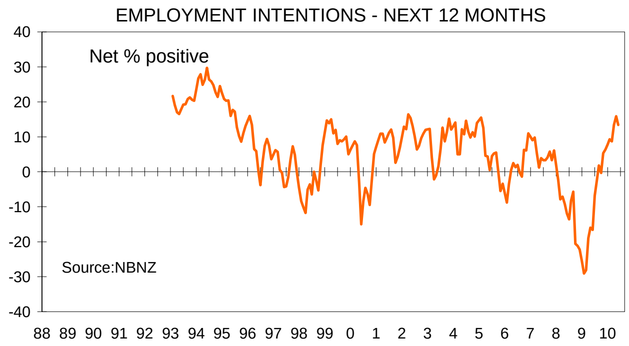
Normally, with this being the first Thursday of the month, we would run our BNZ Confidence Survey this week. However it is only three weeks since the last one so we shall wait until next week.

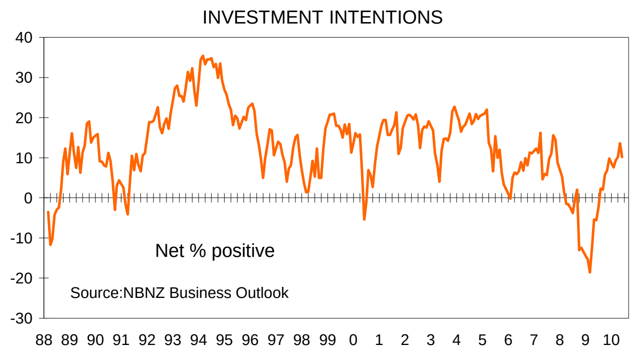
This week we have seen data released internationally adding to worries about the strength of the global recovery – with the same process underway here as well. The monthly residential and non-residential building consent numbers were weak, the credit growth numbers remain poor, and as our last survey showed, business sentiment has pulled back and this has fed through to some easing in employment and investment intentions. To whit…



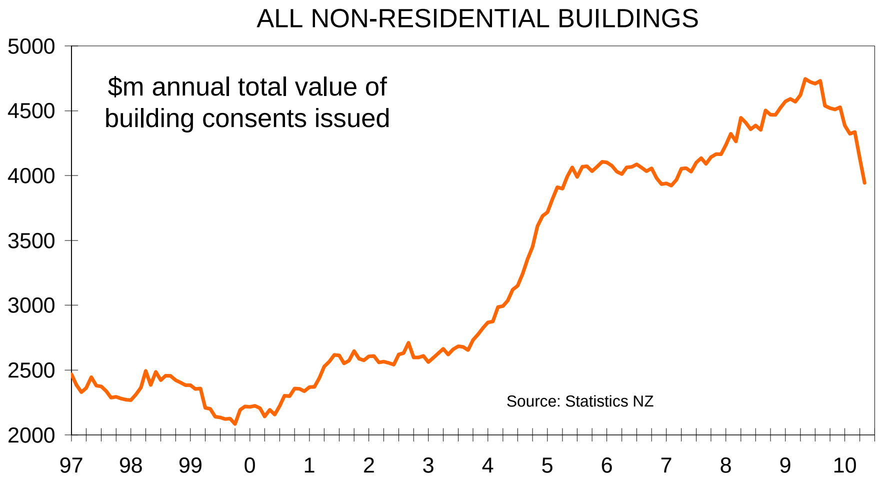
The monthly NBNZ Business Outlook survey showed that early in June a net 39% of business respondents said they expect their own levels of activity to improve over the coming year. This was down from a reading of 45% in May but still above the 19% ten year average therefore suggestive of good growth. The net 13.4% planning to hire people was also above the 2.6% ten year average. But the reading was down from 15.9% in May. So too was the investment intentions net percent at 10.2% from 13.6% in May versus a 7.9% average.

These readings remain good but like others are easing off from recent strong levels as doubts grow here and overseas regarding upturn strength. This is where we get our noted risk that the pace of NZ monetary policy tightening could turn out to be slightly slower than general expectations.

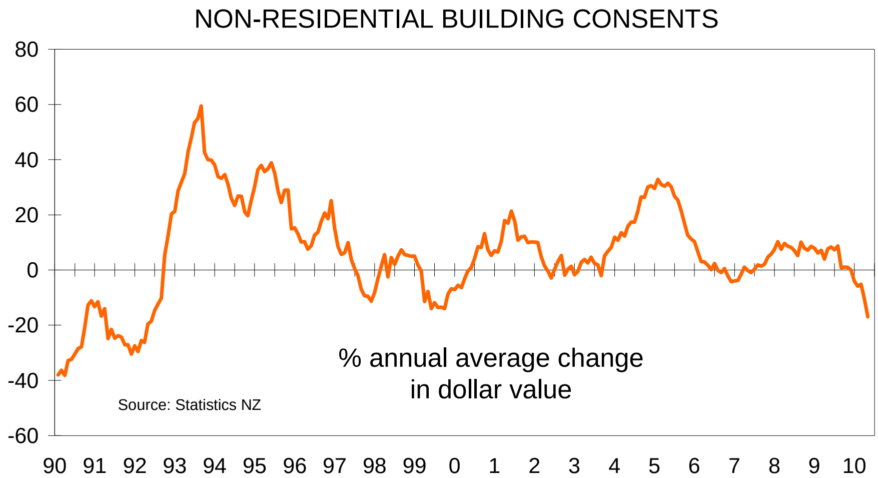




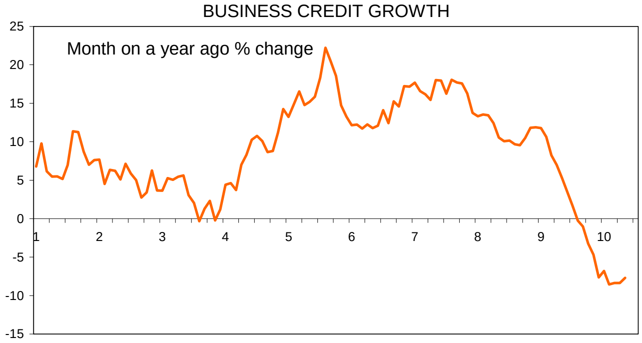
Nothing too much positive is happening with regard to the outlook for the non-residential (excluding infrastructure) construction sector. In May the value of consents issued for the construction of non-residential buildings was down 40% from a year ago, the change for the quarter was 29% from a year ago and the decline for the entire year to May was 17%. At $3.9bn worth of consents the value is the smallest since early 2007 – so not too horrible in the medium-term scheme of things. But the rapid decline is reflective of an apparent high unwillingness of businesses to expand premises coming on top of what is a normal lagged weak state for this sector following a recession.

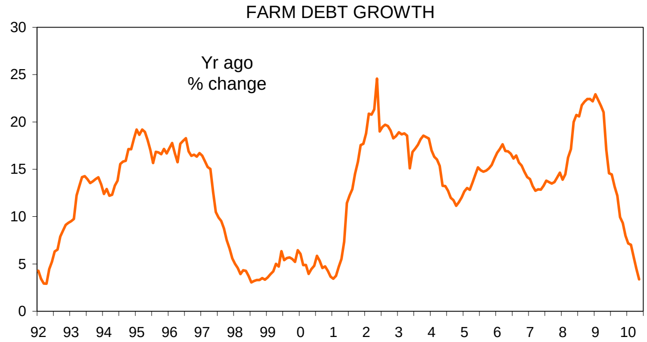


Given the caution we continue to find in the business sector with regard to debt-funding developments we think it will not be until well into next year that this sector starts to show some reasonable strength.



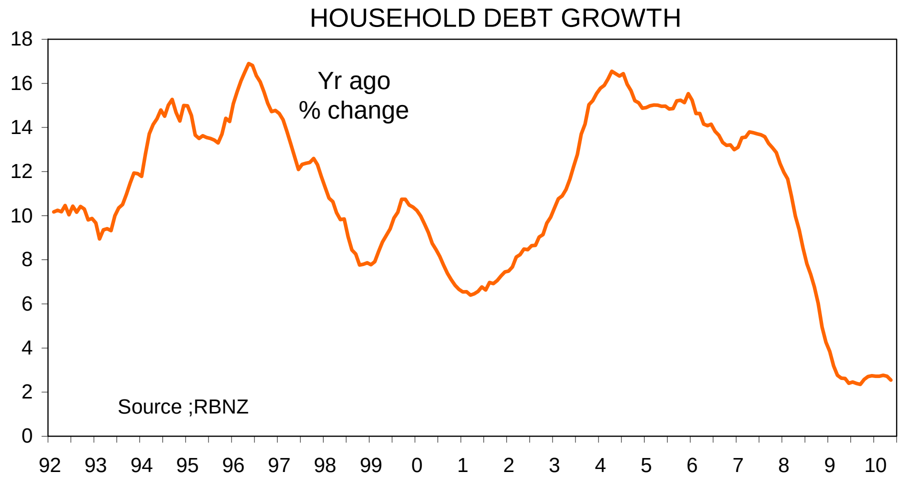
Speaking of caution, the monthly credit aggregates released by the Reserve Bank this week show that in May the level of business (urban) debt was down by 7.7% from a year ago. At $73,019mn the debt aggregate was up slightly from $72,845 in April, but this is not a sign of things improving. If we exclude this time last year when debt was plunging as borrowing (and in some quarters lending) dried up because of the global financial crisis, we find that in May 2008 business debt grew $815m, 2007 $1,846mn, 2006 $317mn, 2005 $514m, 2004 $285mn, and 2003 -$235mn. One has to go back to a period when businesses were showing a very high reluctance to borrow in spite of recovering growth since 2000 to find a worse month of May.





The growth therefore of $174mn is not to be taken as a sign that businesses are starting to borrow more. It merely suggests at a stretch we might be getting near to the end of a period when businesses have been aggressively paying down debt. But anecdotal evidence would suggest we are not actually at that end point yet.

What about farming? For that sector we find debt at the end of May stood at $47,072mn which was $10mn down from April whereas in May 2008 the change (upward) was $1,667mn, 2007 $628mn, 2006 $566mn, 2005 $493mn, and 2003 $278mn. The result for this year's May is therefore very weak and frankly in line with the debt-aversion sentiment we encountered two weeks ago at Mystery Creek Fieldays.



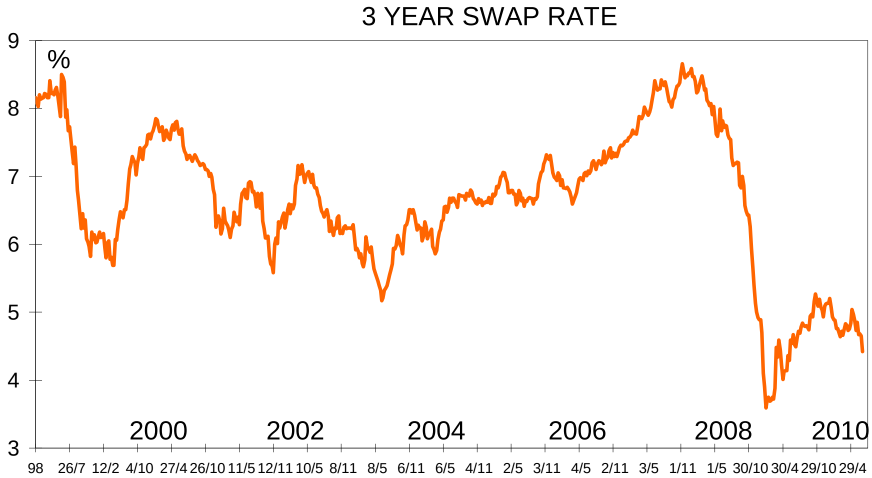
With regard to the household sector we find that debt in seasonally adjusted terms grew for the third month in a row by 0.2%. That is weak and means no acceleration in debt growth is underway. Household debt at the end of May was only 2.5% up from a year ago which is the weakest rate of growth since our records started in 1992.

The NZ economic recovery remains reasonably fragile and extremely patchy, though there is clear strength in areas like dairying, and manufacturing exports, upward trends in employment, residential construction, and surprisingly good support in tourism.

INTEREST RATES

Bank bill yields have climbed this week as we are a week closer to the next expected tightening of monetary policy on July 29. But swap rates have fallen to their lowest levels since the middle of last year in response to the markets continuing a process of scaling back expectations for when foreign monetary policies will tighten, and with global investors shifting out of equities again into fixed interest assets amidst deepening growth worries.

The yield on NZ 90-day bank bills has climbed to near 3.19% from 3.12% last week. The three year swap rate has fallen to 4.42% from 4.65% last week and 4.85% four weeks ago. The peak for this rate was 5.2% back in early November.



Where these long rates go from here is very unclear. As long as world growth optimism keeps getting pared back the risk is they go slightly lower, especially as risks for sharemarkets appear weighted downward in the short term. But there is also a clear risk that at some stage when growth worries ease off these long rates could jump up again quite sharply. Borrowers therefore who would like to get some extra medium to long term fixed rate funding on board may want to take advantage of the current period of low rates to boost their hedging.

Key Forecasts

- Tightening through to mid-2012.

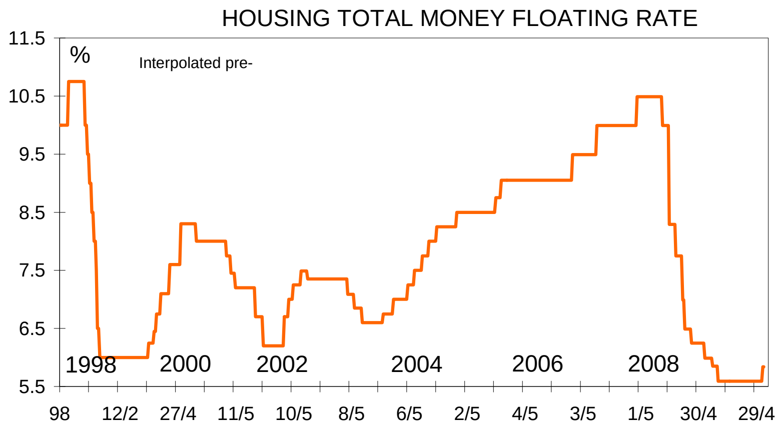
FINANCIAL MARKETS DATA

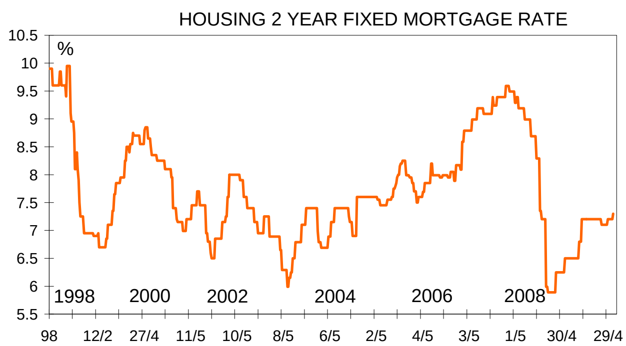
	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	2.75%	2.75	2.50	2.50	2.50	6.2
90-day bank bill	3.19%	3.13	3.03	2.73	2.81	6.5
1 year swap	3.75%	3.80	3.78	3.54	3.01	6.7
5 year swap	4.85%	5.09	5.31	5.36	5.32	7.0
180-day term depo	4.90%	4.90	4.80	4.90	3.15	6.0
Five year term depo	6.75%	6.75	6.75	6.75	6.00	6.5

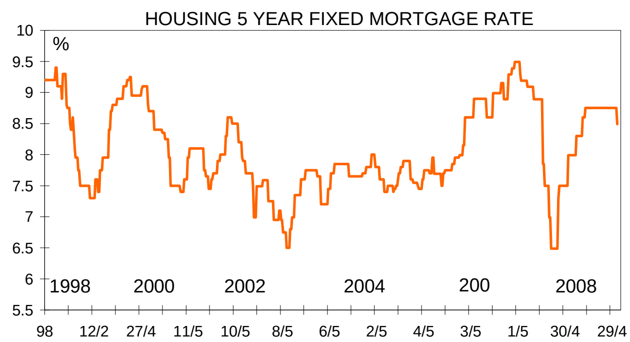
If I Were a Borrower What Would I Do?

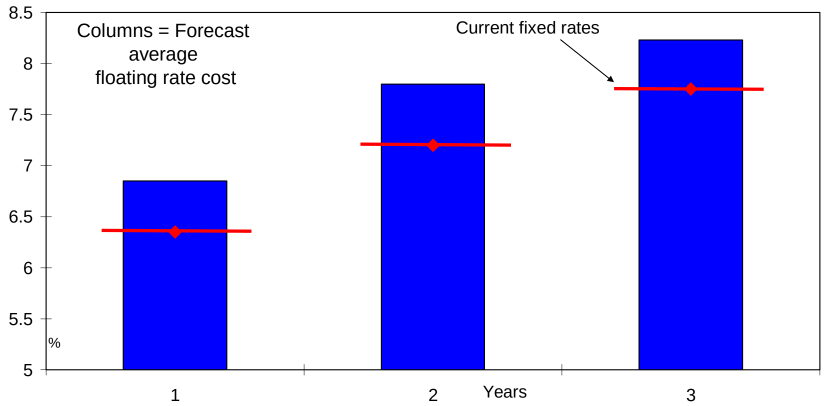
I would still largely toss a coin between floating and fixing for one or two years, maybe three. The strict comparison between current fixed rates and our forecasts for floating rates over the next 1, 2, and 3 year periods say there is value in fixing (first graph next page). But my suspicion is that with the economy's recovery being so weak, patchy, wobbly, words like that, and with major problems still in existence internationally, that the Reserve Bank is at risk of not raising the cash rate as quickly as we have pencilled in. That risk offsets the current benefits of fixing and generates the coin toss scenario. Personally, I'd at a pinch stay floating and go for the ride hoping that when the floating rates are at their peaks 2-3 years from now I do not panic and lock in then a fixed rate which now I would not touch with a bargepole. If I were to not float I would probably fix at 7.3% for two years.

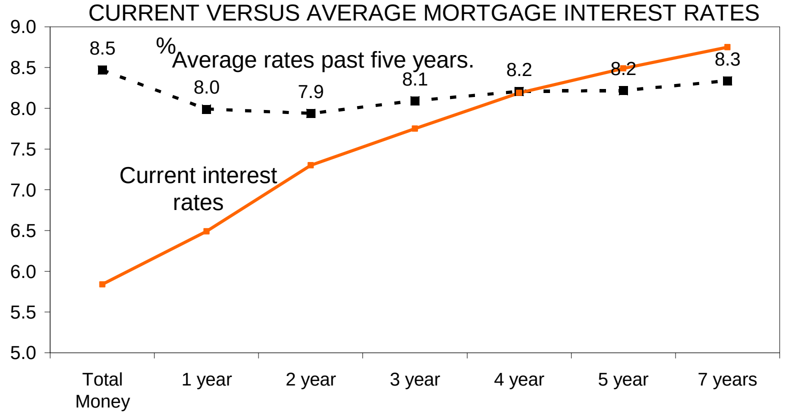
Note that forecasts internationally for long term interest rates are being pushed lower in response to reduced expectations that the Federal Reserve, the European Central Bank and the Bank of England will be able to start their monetary policy tightening phases anytime soon. Extra fiscal policy tightening in the EU and UK in particular takes some of the pressure off monetary policy – as does the concern about the debt situation and its impact on confidence. In the US worries are building about the state of the housing sector – at the same time however as indicators for the manufacturing sector get better and better.











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

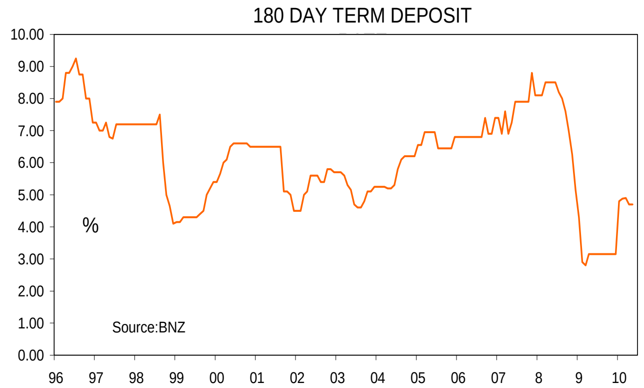
I've waited and waited, and although lots of emails have appeared on other matters, no-one has touched the issue of whether there is an inconsistency between the apparent interest rate-driven decisions for what I would do as a borrower versus what I would do as a term deposit investor.

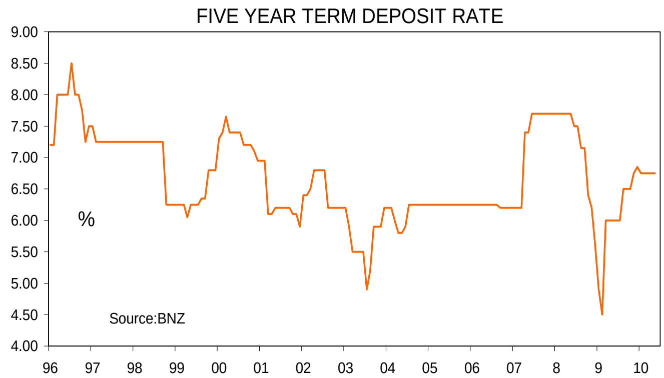
As a borrower my view is that I would at a close pinch stay floating willing to punt that floating rates do not rise as quickly as we are currently forecasting – the cash rate getting to 6% in early 2012 from 2.75% currently. As a depositor I am willing to invest short looking to lock in a better long term rate somewhere down the track. But as each month goes by and I receive less than 5% for a 180-day deposit I sacrifice 6.75% for a five year deposit.

Actually the views are not incompatible. The borrower one is not driven by a view on long term rates but on floating rates for the next three years. The depositor view is not driven by a view on the short term rates (such as they may soar soon, which they won't) but on the long term rates. I have a view that I will be able to get a better long term rate than 6.75% sometime in the next few months as a result of rising short term rates and banks competing for funds pushing up those long rates.

The creeping issue however is that in recent months prospects for those long rates going up have pulled back quite a bit as a result of new worries about the world economy reducing foreign monetary policy tightening expectations which are relevant to where our long rates go (relevant but not wholly determining). For instance, the US ten year government bond yield is currently near 2.85% from 3.15% a week ago and 3.7% two months ago.

So if you have decided to lock in a long term deposit rate rather than take a short rate for now and punt on the long rate rising then there is no problem with that course of action as you are beating my strategy straight away by almost 2%. Maybe I shall jump out to a longer rate earlier than I am thinking. Tricky.



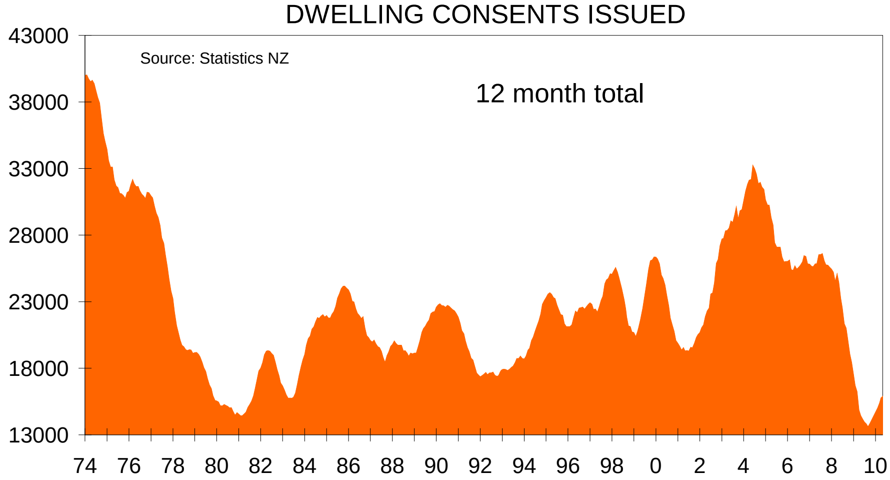


HOUSING MARKET UPDATE

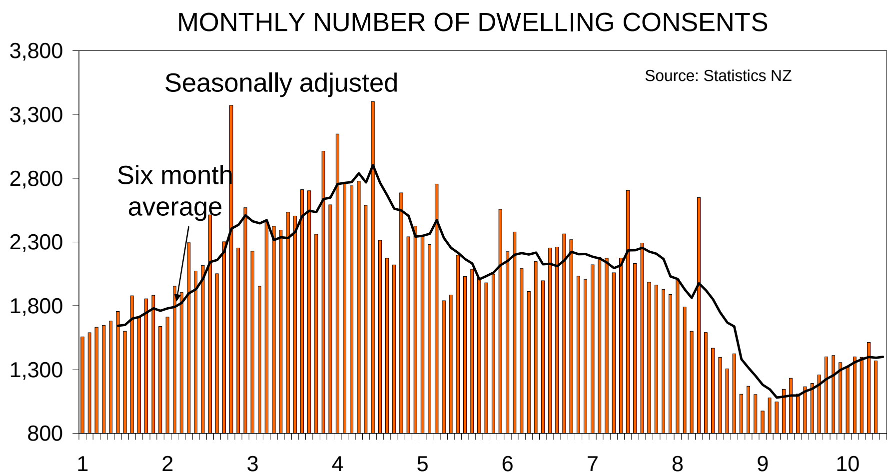
House Supply Rebound Spluttering

One of our views in the area of housing is that given the size of the population in New Zealand and its growth in recent years there is not an over-supply of housing and therefore potential for price weakness is limited – especially going forward. We feel that although residential construction will continue to recover from four decade lows the growth in housing supply will remain below required levels for quite a bit longer than people may be thinking and this will place upward pressure on prices (in Auckland in particular and less so the regions) even though population growth is now slowing and mortgage rates rising.

And so to the May building consent numbers. They showed that in seasonally adjusted terms after rising 8.3% in April the number of dwelling consents issued declined 9.5% in May. This result shows that there is not a straight line strong construction recovery underway, but something moving in a stop-start spluttering pattern around an upward trend.



Over the past year consent numbers have risen 10% and at 15,894 in the year to May consent numbers were up from the four decade low of 13,616 in September last year. But this is so far a mild rebound though in seasonally adjusted terms consents were up 20% annualised in the three months to May. Growth is happening but it is patchy.



Looking ahead we expect the recovery in housing construction is going to be limited by lack of finance due to the collapse of finance companies, lack of sections eventually in some parts of the country (not rural or seaside), lack of tradespeople from some point in 2011 (definitely not now, there is an over-supply), and low willingness by investors to build given the depreciation change and low rental yields.

The upshot as noted will be continued containment of the price fallout resulting from the tax changes, then mild upward price pressure next year in a simple Economics 101 interaction between demand and supply. Is anyone still paying any attention to the drips who said prices would collapse 40%? Actually yes, which just goes to show that history will repeat itself. Meaning, at some stage the weirdos coming out of the woodwork will no longer be the sky is falling crowd but the golden summer never ending bunch (odds on them being the same product pushers?) and folk will jump into the cyclically rising housing market again.

Having said that, at this stage one must say that finance availability will be less generous next upward leg than in recent years. That sounds obvious and everyone nods their heads. But comments such as that are predicated upon the unspoken assumption that the institutional structure of the finance system currently in place will essentially be the same in the future. But it is very likely that come the next upward leg in the cycle there will be new lenders, new investment vehicles which maybe no-one has even got around to designing yet. Or maybe they were in play quite a few years ago and will get resurrected.

And will people jump into such vehicles and go to such lenders? Of course they will. After all, as each year goes by more and more people in the Baby Boomer generation reach the age where they realise they are not going to retire with a decent amount of cash and they will feel they have no choice other than to try and get a late-stage boost to their savings by jumping on what will sound like a high return joy ride. Like high yielding finance companies, contributory mortgage schemes, unitised commercial properties, tax effective apartment purchase schemes…

And just to finish off the comment about new finance providers and vehicles appearing but not being factored into current projections, the same thing happens in commodity markets. We look at where we think demand is going and make price projections. But we almost always fail to take into account how supply of that commodity will change not just for the coming season due to weather, strikes, or whatever, but over coming years due to entirely new developments.

In economics ceteris paribus rules. It means “other things remaining unchanged”. We economists have this drummed into us at university in order to allow the development and study of models attempting to explain the interrelationships between humans in the fields of finance, trade in goods and services, and factors of production. But in reality ceteris paribus almost never applies – or in this context it applies for only a short time. Then as we all know in all aspects of our lives, other things do change. And when they do and we realise they are changing we then often over-extrapolate them to a supply surge lasting forever.

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

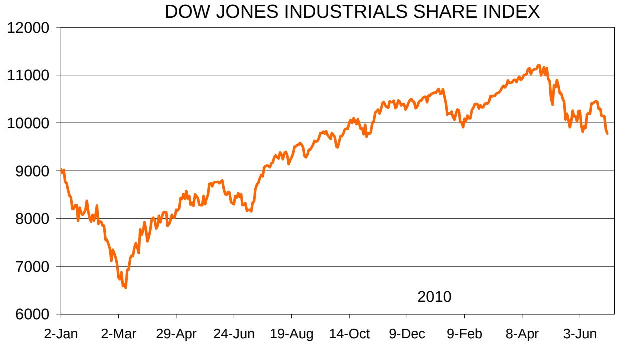
- Dwelling consent numbers to recover now with potentially good activity from late-2010.
- House prices edging higher after tax change effects wend their way through.

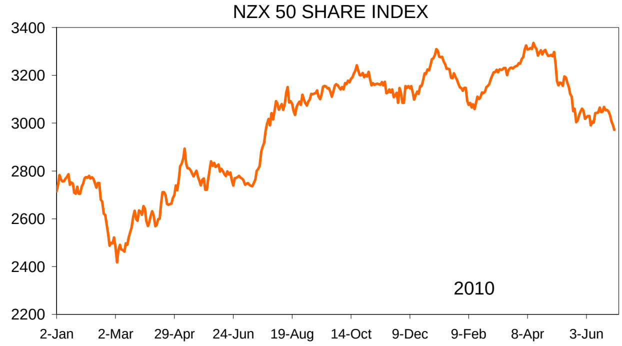
Exchange Rates & Foreign Economies

Exchange Rates	This Week	Week Ago	4 wks ago	3 mths ago	Yr ago	Consensus Frcsts yr ago*	10 yr average
NZD/USD	0.685	0.712	0.680	0.710	0.645	0.610	0.592
NZD/AUD	0.815	0.814	0.804	0.773	0.8	0.770	0.856
NZD/JPY	60.60	64.00	61.90	66.30	62.1	61.366	66.8
NZD/GBP	0.459	0.475	0.467	0.468	0.392	0.380	0.345
NZD/EUR	0.560	0.577	0.553	0.525	0.46	0.445	0.51
USD/JPY	88.47	89.89	91.03	93.38	96.28	100.600	113.9
USD/GBP	1.492	1.499	1.456	1.517	1.645	1.607	1.709
USD/EUR	1.223	1.234	1.230	1.352	1.402	1.372	1.156
AUD/USD	0.840	0.875	0.846	0.918	0.806	0.792	0.69

Nerves Frayed Again

The general theme running through global financial markets at the moment is a fairly solid questioning of some of the earlier optimism regarding the strength of the economic recovery following the global financial crisis. This is leading to the occasional bouts of sharemarket weakness we have seen in recent months along with the fairly frequent battering downward of risk currencies such as the Kiwi dollar.





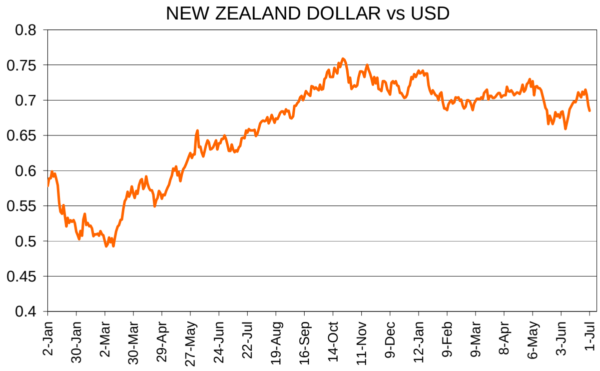
Looked at over a period of nine months one can coalesce these periods of growth questioning around some specific events such as the Dubai debt crisis and then the European crisis. But more generally there has been in recent weeks a build-up of concern about the strength of the US economy and the housing market in particular with some fairly weak numbers on dwelling construction and turnover. In China there are continuing worries about how much growth will slow as a result of central efforts to contain the seemingly inevitable inflationary pressures resulting from a fiscal stimulus package equal to about 16% of GDP implemented to combat the effects of the GFC.

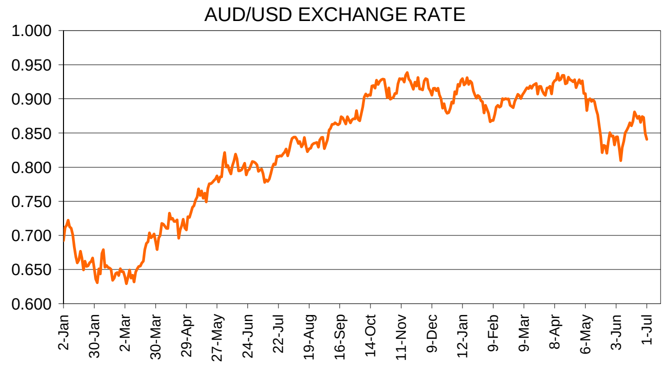
This past week we have seen some additional downward pressure on growth and risk assets arising because of things such as very weak consumer confidence in the US. The monthly Conference Board Consumer Confidence Index fell to 52.9 in June from 62.7 in May. A result near May's had been expected so the latest reading is taken as yet another big question mark around the idea that the US recovery has become "self-sustaining" – though there may be a downward bias to the result because of the oil spill.

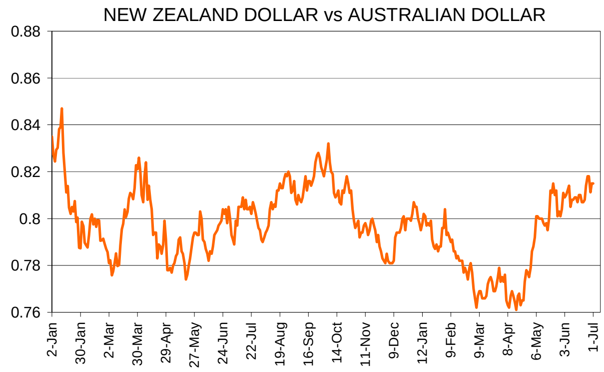
Nevertheless, the number came when some investors were cutting positions ahead of last night's end of the quarter and because of concern that Friday night's non-farm payrolls report could be weak like the one for May was after one strips out over 400,000 temporarily employed census workers.

A key concern in Europe this week was the ECB's decision to go ahead with the withdrawal of one of their liquidity measures, and worries about the ability of banks to remain smoothly functioning as they repaid the special one year loans. These worries have pushed three month interbank lending rates to nine month highs. These rates can be taken as a measure of the willingness of banks to lend to each other with that willingness dented additionally at the moment by worries that bank stress tests being conducted currently could reveal some in Europe unable to withstand any new crisis scenario – which is exactly our fear and why in the near future substantial equity market and Kiwi dollar weakness and volatility appear quite probable.

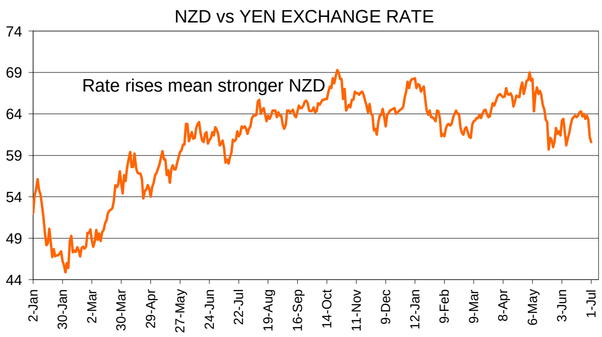
So these concerns – plus lots we have not mentioned but which can easily read about on the thousands of FX commentary sites (Moody's warning of a Spanish debt downgrade, worries about monthly PMI reports) – have pushed the NZD down back to where it was against the greenback two weeks ago near 68.5 cents from 71.5 cents just three days ago. Commensurate with our currency's decline the Aussie dollar has fallen from US 88 cents to 84 cents leaving us unchanged against the AUD from a week ago near 81.5 cents.

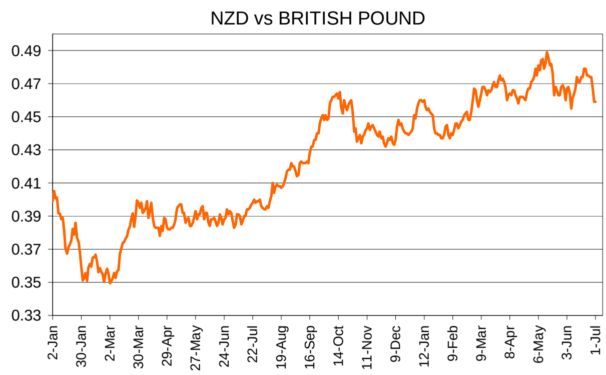


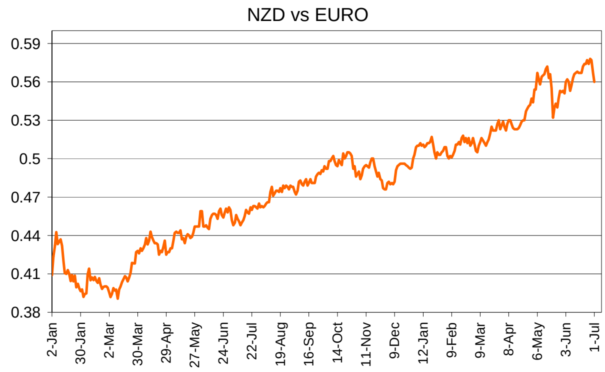




We have also fallen on the crosses to 60.6 Yen from 64, 45.9 pence from 47.5, and 56 centimes from 57.7.







Looking ahead we make the same comment we made last week. If worries about Europe and other things increase the Kiwi dollar will decline. If those worries fall then the NZD will go up. Such worries are likely to be jumping in and out of the front of investors' and traders' minds for months therefore very high currency volatility is likely looking ahead with a clear risk that we have not yet seen the bottom of this current period of weakness for the Dow Jones (below 9,000 doesn't seem too tough a call unless the jobs report is really strong), and therefore downside risk for the NZD still looms. But with rising NZ interest rates and strong commodity prices the underlying medium drift for the NZD is upward. Good luck trading those influences.

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/

ECONOMIC DATA

All %		Latest qtr only	Previous qtr only	Latest year	Year ago	2 Yrs ago
Inflation	RBNZ target is 1% - 3% on average	0.4%	-0.2	2.0	3.0	3.4
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%	6.0	7.1	......	5.1	3.9
Jobs growth	Average past 10 years = 2.0%	1.0	0.0	-0.1	0.7	-0.3
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	+17,967	21,618yr	......	11,202	4,938
Tourism – an. av grth	10 year average growth = 3.2%. Stats NZ	3.1	2.4	3.1	-2.6	1.3
		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	39	45	37	8	-4
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	-17.2	-16.2	41.5	43.9	-45.5
Floating Mort. Rate	(Total Money) 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%	7.75	7.75	7.95	6.99	9.09

ECONOMIC FORECASTS

Forecasts at May 20 2010	March Years					December Years				
	2008	2009	2010	2011	2012	2007	2008	2009	2010	2011
GDP - annual average % change										
Private Consumption	3.2	-1.1	0.5	2.8	1.9	3.9	-0.3	-0.6	2.8	2
Government Consumption	4.9	4.2	0.8	2.2	2	4.4	4.8	1.4	1.8	2.1
Investment	5.5	-7.2	-9.9	5.8	8.9	5.5	-3.6	-12.3	2.6	9.5
GNE	4.6	-1.6	-3.3	5.4	3.2	4.6	0.4	-5.1	4.9	3.4
Exports	3.1	-3.4	2.5	1.6	5	3.8	-1.4	0	1.5	4.8
Imports	10	-4.7	-9.9	7.9	4.7	8.9	1.9	-14.9	7.9	4.6
GDP	2.9	-1.4	-0.3	3.6	3.2	2.8	-0.2	-1.6	3.1	3.5
Inflation – Consumers Price Index	3.4	3	2	4.6	2.8	3.2	3.4	2	4.3	2.7
Employment	-0.2	0.7	-0.1	2.6	2.8	2.3	1	-2.4	2.7	3.2
Unemployment Rate %	3.9	5.1	6	6.1	5.4	3.5	4.6	7.1	6.3	5.5
Wages	4.3	5.1	1.6	1.8	3.6	4	5	3.1	0.8	3.2
EXCHANGE RATE ASSUMPTIONS										
NZD/USD	0.8	0.53	0.7	0.72	0.66	0.77	0.56	0.72	0.73	0.68
USD/JPY	101	98	91	99	105	112	91	90	97	103
EUR/USD	1.55	1.31	1.36	1.21	1.25	1.46	1.34	1.46	1.21	1.24
NZD/AUD	0.87	0.8	0.77	0.83	0.84	0.88	0.83	0.79	0.82	0.83
NZD/GBP	0.4	0.37	0.47	0.46	0.4	0.38	0.37	0.44	0.49	0.42
NZD/EUR	0.52	0.41	0.52	0.6	0.53	0.53	0.41	0.49	0.6	0.54
NZD/YEN	81.1	51.8	63.7	71.3	69.3	86.3	50.9	64.2	70.8	69.5
TWI	71.6	53.8	65.1	70.7	66.1	71.6	55.1	64.7	71.3	67.2
Official Cash Rate	8.25	3	2.32	4.25	6	8.25	5	2.5	3.75	5.75
90 Day Bank Bill Rate	8.91	3.24	2.67	4.57	6.15	8.9	5.23	2.78	4.07	6.07
10 year Govt. Bond	6.36	4.77	5.86	6.3	7	6.4	4.88	6.02	6.1	6.8

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

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*extrapolated back in time as Total Money started in 2007