BNZ Weekly Overview

16 July 2009

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.

A Quick Warning About late-2010

It is school holiday time and what with travelling for talks and such time available to write stuff is limited. So here is one simple thought for the week.

Inflation is now 1.9% but it has taken first our own recession then the worst global recession since 1946 to achieve this. While the rapidly growing pile of spare resources will keep inflation suppressed for a number of years, the interest rate profile come late-2010 could be quite different from now

The Reserve Bank predict they will still be keeping the official cash rate down – and we agree - so floating and very short term fixed rates will still be low. Long rates could be higher than now however. And in a year the talk will be about a global recovery, NZ's labour market improving soon, and house prices rising as some think is already happening.

In that environment we could easily see people committing themselves to debt funded housing purchases working out their debt servicing costs for the next five years based on a rate somewhere near 6%. But, we see scope for the RB to raise its cash rate over 3% to almost 6% by the end of 2011 and the resulting jump in floating rates could catch out a whole new cohort of "investors".

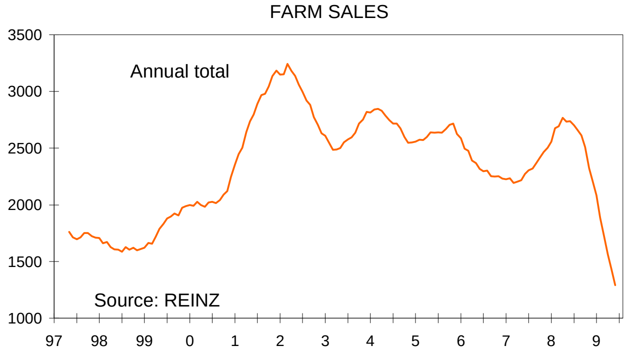
NZ ECONOMIC DEVELOPMENTS

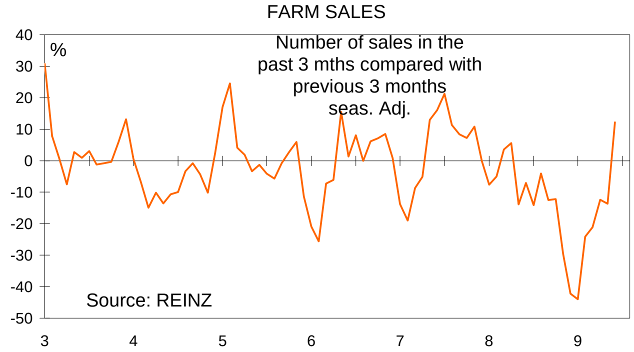
Thursday 9

Farm Real Estate In Weak State

Things are quite bad in the rural real estate market. In June there were only 80 farms sold around New Zealand. This was a 63% drop from 216 a year ago. In the year to June sales were down 53% from a year earlier. However, in very rough seasonally adjusted terms, after falling 13% in the September quarter last year, 42% in the December quarter, and 21% in the March quarter, sales actually bounced slightly by 12% in the June quarter.

Do we think an upward trend has therefore commence for farm sales, perhaps in response to low interest rates and the improved sheepmeat returns? Heck no. Worries about Fonterra's payout have strengthened, bank lending criteria are being tightened, and the cash flow pressure on dairy farmers is going to get more intense one suspects as the season progresses. Farm real estate looks like being weak for quite some time.



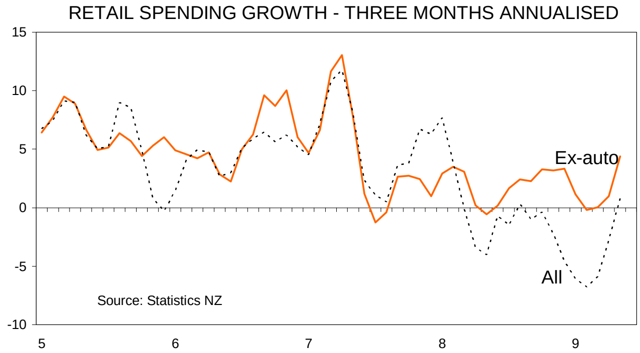


It would be good to be able to say to what extent land prices are falling – and they obviously are. But we cannot use the REINZ data as it gets too distorted by changes in farm sale location, size, type etc. Some people in the industry have suggested over 20% price falls so far with more to come.

Monday 13

Retailing Firm In May

Retail spending excluding the ever-volatile automotive sectors (fuel, cars largely) rose in seasonally adjusted terms by an unexpectedly strong 1.6% in May after sitting flat in April and rising 0.5% in March. The result is such that the annualised rate of growth in this important measure has now jumped to 4.4% which is the highest in exactly two years. Does the strong result mean that consumers are opening their wallets holus bolus and retailers can start smiling after two years of pain? Not really.



First, clothing store sales soared 12.3% in May probably because of the terribly cold weather. Without this move the rise in core retail spending would have been 1%. That is however still a good result and one suspects those commentating on this retailing number on the day of its release downplayed the strength a bit too much – probably because they have a dire view on the economy and are only interested in bad numbers. (In fact sometimes one notes a few analysts deliberately ignore the good stuff. Watch for that bias.)

Second, while it goes all over the place and Statistics NZ explicitly state "…Statistics NZ does not recommend using the ECT series as an indicator or predictor of the RTS series." Last week's Electronic Card Transactions data were weak. They showed a fall in core spending of 1.2%. This does however probably overstate the decline we suspect will be reported in four weeks in the Retail Trade Survey.

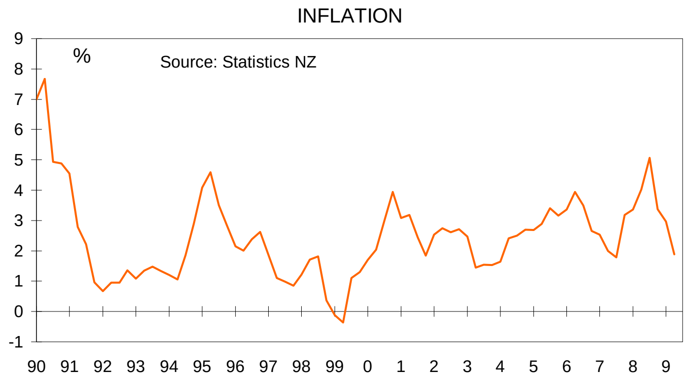
Third, rising unemployment, weak dairy incomes and slow wages growth will limit retail spending improvements this year.

However we think the corner has most definitely been turned on retail spending with assistance from accelerating population growth courtesy of booming net immigration, no longer falling and possibly now rising average house prices, and the simple passage of time wearing out our couches. But the real test of whether one thinks the outlook is good or not is this. What can we say with confidence to retailers regarding management decisions in the near future? Is the outlook acceptable enough for us to say good operators should snap up good premises which become available? Yes. Is the outlook safe enough to launch new products and engage in a deep marketing campaign? Yes.

But, the time is not yet right to pull back from cutting less profitable lines from the shelves. And the outlook is most definitely not yet good enough for one to say with reasonable confidence to a retailer that they should boost their inventories in anticipation of strong sales late this year. In fact, given the high uncertainty which still persists we still think a valid business strategy in this environment is to keep stocks low in 100% knowledge that when strong demand does come it could be unexpected and it will leave one scrambling for stock for a while. It still seems better to plan for a period of stock (and even staff) shortage than to plan for better times now and be caught out by a fresh global downturn.

Thursday 16
Inflation Eases

New Zealand's annual rate of inflation has fallen to 1.9% in the June quarter from 3% in the March quarter and 4% a year ago. This is the lowest rate since September 2007 and below the 3.1% average for the past four years. The fall came about as a 0.6% average rise in consumer prices during the quarter was far less than a 1.6% rise a year ago. Food prices jumped 7.5% but even excluding food the increase was still 0.5% - and still a bit worrying.



This is because when one considers that our economy has been in recession for an estimated six quarters inflation would have been 3% still excluding fuel. Having said that, during the quarter non-tradeables inflation was just 0.5% for the quarter and 3.3% for the year. The quarterly movement is the lowest since 2001 and will please the Reserve Bank because it is primarily this measure which they can influence – eventually if they try really really hard. And that is where we revert back to this being something of a problem.

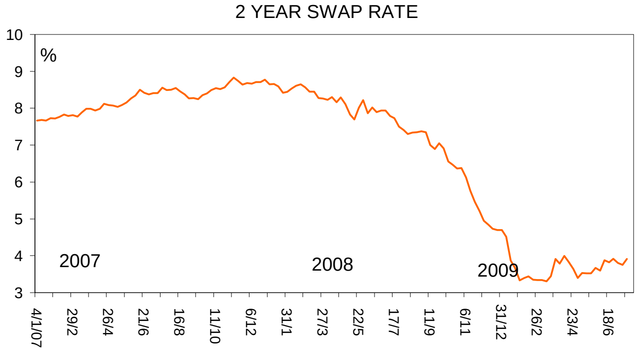
It has taken first our fixed mortgage rates going to almost 10% and a massively over-valued currency early last year, plus drought and collapsing finance companies, plus the biggest global economic downturn since 1946 to produce inflation not even at the mid-point of the 1% - 3% band.

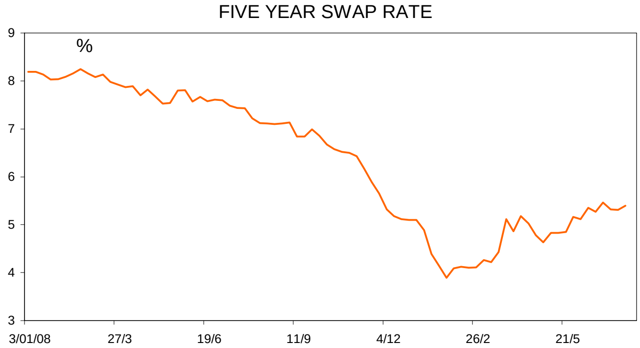
For the moment the inflation genie is weak. However in light of the still above average level of inflation one can easily understand why when the opportunity presents itself the Reserve Bank warns householders not to get overly bullish and start borrowing in anticipation of house price gains. They have already fired the first shots of their next monetary policy tightening cycle even though for now their concerns are couched in terms of what is good for New Zealand over the long term – we borrow less and save more.

And that is why personally I would like some hedging against the interest rate risk 2-3 years from now and why locking in as long as one could manage back in the middle of March as we advised was such a good thing to do.

INTEREST RATES

The swap rates which form the base from which bank term borrowing costs start to get calculated have risen over the week in spite of this morning's slightly better than expected June quarter inflation outcome. The one year swap rate has edged up to near 3.13% from 3.04% last week, the three year rate to near 4.63% from 4.49%, and the five year rate to around 5.4% from 5.31%.





Only the one year rate is at a higher level than four weeks ago but even that rate is not as high as in early-April. In other words, the rate rises over the past week seem easily lost within fluctuations seen over recent weeks and do not represent the start of a new jump up in swap rate levels which might prompt a fresh round of fixed lending rate increases.

The main cause of rate rises over the week – apart from a small contribution from the strong retailing release – was a sell-off in US bond markets overnight on the back of a lift in economic growth sentiment discussed in the FX section below.

The US ten year government bond yield for instance ended last night near 3.62% from 3.3% last week.

Going forward we continue to expect to see borrowing costs very slowly rise in response to slowly improving economic sentiment. But there will be periods when this sentiment temporarily reverses and that is when borrowers with deals priced directly off the wholesale yield curve (not home buyers) may want to get some extra hedging on board if that is their current desire.

Key Forecasts

- No more monetary policy easing this cycle.
- Medium to long term housing rates have seen their multi-year lows – stop-start rises now lie ahead. Speed unclear.

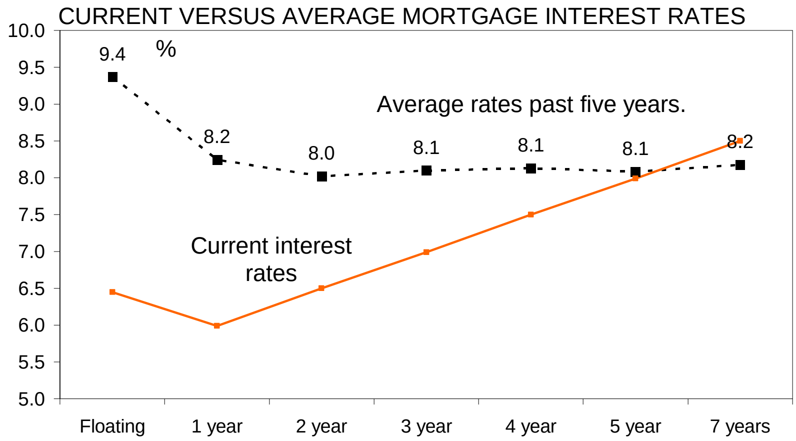
FINANCIAL MARKETS DATA

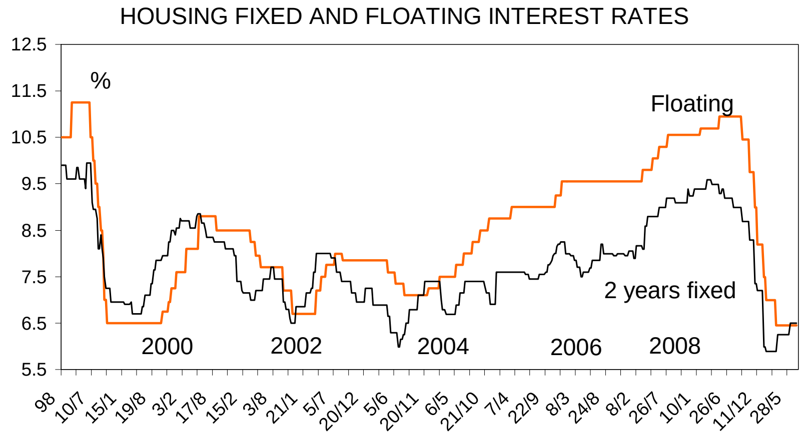
	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	2.50%	2.50	2.50	3.00	8.25	6.2
90-day bank bill	2.83%	2.83	2.85	3.16	8.45	6.5
10 year govt. bond	5.70%	5.62	5.96	5.26	6.01	6.2
1 year swap	3.13%	3.04	3.01	3.13	8.01	6.7
5 year swap	5.40%	5.31	5.27	5.03	7.34	7.0

If I Were a Borrower What Would I Do?

Personally I would like some hedging against the risk that rates get higher than people currently don't want to think about 2-3 years from now. So I would fix three years at 6.99%. But most people don't think that far ahead and will currently be assuming low rates continue for a long time because the Reserve Bank have indicated they will keep their cash rate low until some point late in 2010. Maybe.

So most people are currently either floating or fixing just 1-2 years. This is fine. Just make sure you budget for higher borrowing costs in the future and perhaps take the chance to get your principal down as much as possible. And just be careful of something in a year's time. Come mid-2010 things will look a lot better and talk will have been underway quite some time regarding the employment situation improving. You will still be able to get a low floating rate and you will start to think in terms of it being a good idea to get debt levels up high again. If you think that way you risk getting badly burnt once floating interest rates get back to above average levels again for all terms from some point probably late in 2011.





HOUSING MARKET UPDATE

Housing Tracking Largely As Anticipated

Last year there were three things we said in relatively strong terms regarding the NZ housing market over the coming year or so.

1. House prices would fall but not by any amount remotely approaching the 33% fall so far recorded on average in the United States. The data would appear to support our view with prices so far officially down just 9% from their peak using the quarterly QVNZ data, and the REINZ calculated median dwelling sales price now rising from $325,000 in January to $340,000 in June.
2. If you were planning to make a canny purchase in the housing market to take advantage of the downturn you should get it done before the middle of this year because by then the excess supply would largely be cleared out and the best bargains soaked up. The REINZ data would also appear to support this with sales of dwellings soaring since February and in the June quarter sitting 41% ahead of a year ago. In addition dwellings are now selling at almost exactly the average pace they have achieved over the past ten years and not sitting on the market for an excessive number of days.
3. New Zealand has a fundamental shortage of dwellings which would be made worse by a relatively sharp decline in residential construction. We originally picked a fall in annual dwelling consent numbers from 26,000 over 2007 to a low-point of 18,000 sometime this year. We then revised that down to 16,000, and now numbers are at 14,455 in the year to May. We suggested – and continue to suggest – that anyone thinking about getting a house built would be advised to do it now because once construction starts lifting builder shortages are going to potentially quickly reappear.

This last view has been backed up over the past fortnight by a couple of reports. First, the “2009 New Zealand Institute of Building/Hays Construction Salary Guide” noted continuing shortages of some in the building sector. For instance, 62% of respondents rated estimators as very difficult or hard to find.
http://www.nbr.co.nz/article/building-skill-shortages-remain-despite-construction-downturn-104557

The Building and Construction Industry Training Organisation estimates that 10,000 new people need to be trained each year to meet building demand and that this year 1,700 fewer apprentices than in 2008 are in training. The issue however is not just fewer people training, but the likelihood that when our residential construction sector starts humming again an even greater upturn will occur in Australia.
http://www.radionz.co.nz/news/stories/2009/07/14/1245bbdffec8

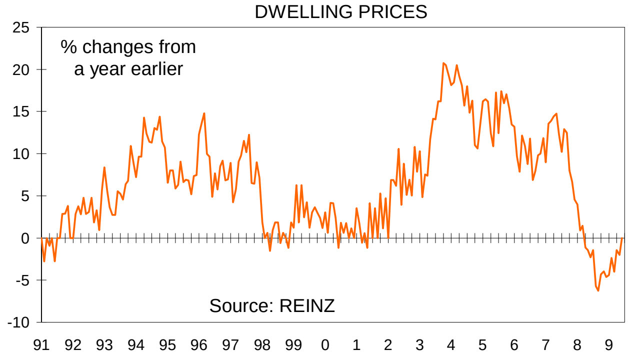
Across the Tasman the shortage of dwellings is far greater than here and we can expect that come late-2010 perhaps and certainly through 2011 we will see skilled tradespeople leaving NZ to take part in Australia’s residential construction upturn.

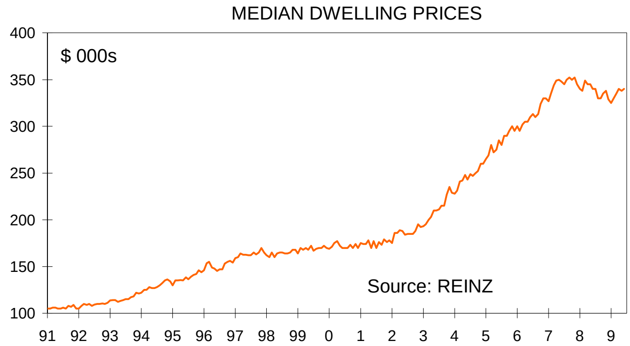
The implications of a probable builder shortage further out (not now of course) are that firstly, now is a good time to build a house. Second, scope for house prices to fall is limited – and that influence has been in action over the past year. But one must extend this to saying that scope for house prices on average to rise is enhanced.

But it is very politically incorrect to write about house prices rising at the moment. One thinks of the silly attacks we received last year and early this year when daring to suggest NZ would not have a housing collapse like America’s and one imagines the poor wallies who made those ridiculous 40% house price decline forecasts last year would have hernias if we forecast actual price gains!

No Evidence Average Prices Are Still Falling

Last Thursday the REINZ reported that in June the median dwelling sales price increased to $340,000 from $338,000 in May and a low of $325,000 back in January. An optimist might look at this five month movement and conclude that prices are rising – especially as one can argue there is a downward bias to the REINZ measure because of strong sales in the lower priced bracket. But we think the best interpretation is that prices are no longer falling – though probably before the end of the year there will be a small upward trend in place.



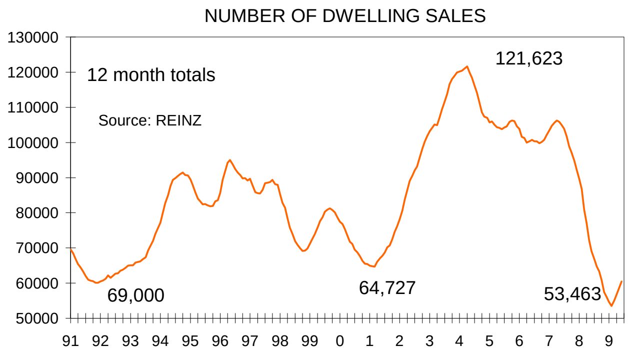


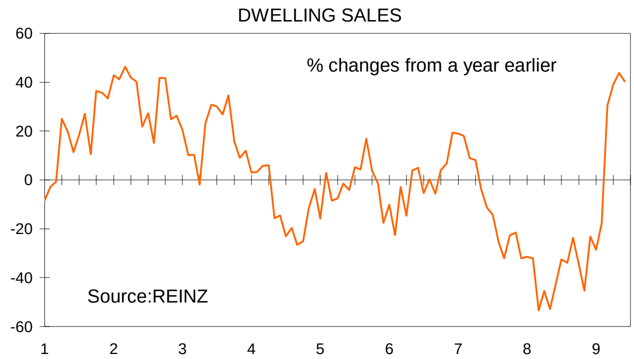
This trend will be driven by the same things which have limited NZ average house price declines to "just" 9% according to the quarterly QVNZ data.

- We started the global downturn with a dwelling shortage which prompted the Commerce Select Committee to examine ways of accelerating construction and lowering costs.
- The shortage is being made worse by construction running at about 14,500 dwellings per annum whereas we need about 23,000 to meet average population growth.
- Population growth is moving above average as a result of booming net inward migration – driven mainly by Kiwis staying home rather than folk flocking here so far.
- Interest rates are at low levels by historical standards.

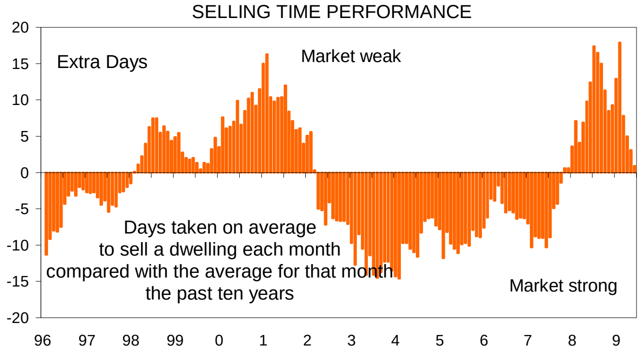
But we cannot ignore restraint on prices in the near future from rising unemployment and tighter bank lending standards. So there remains a strong need for investors to remain focussed on positive cash flows and boosting yield through property improvements rather than the old myopic way of buying to flick for a quick capital gain.

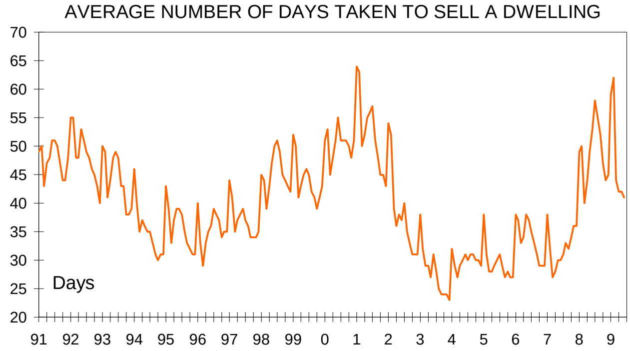
During June there were 6,040 dwellings sold around the country. This was a 40% gain from a year ago and in rough seasonally adjusted terms represented a 5% rise following a 5% fall in May, with June quarter sales up about 20% seasonally adjusted. The anecdotal feedback we have been receiving continues to suggest there is a shortage of dwellings and while we have no nationwide listings measure from REINZ, we do have the days to sell gauge.

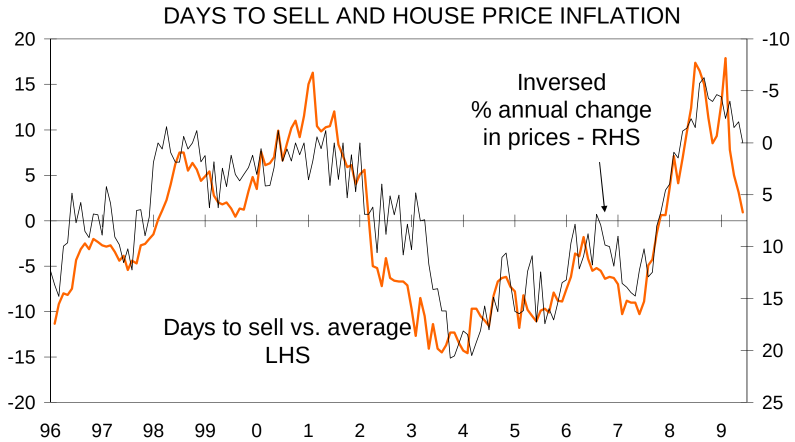




In June on average it took 41 days to sell a dwelling. This was 12 days faster than a year ago which is the biggest such annual improvement since 2003. In addition, the 41 days was only 1 day above the June average which is better than May's 42 days which was three days above average, five days in April, and a whopping 18 days above average in February. When properties come on the market they are tending to sell more and more rapidly.







Key Forecasts

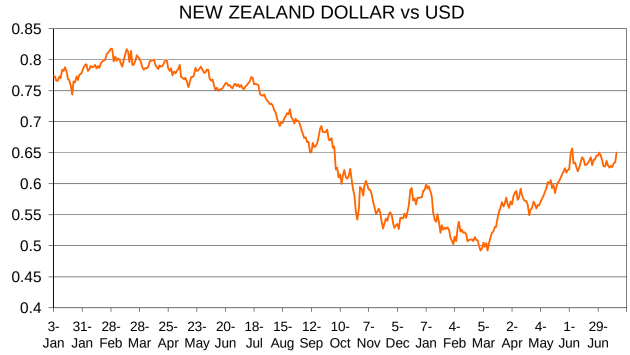
- Dwelling consent numbers to slowly recover from the middle of this year.
- Real estate sales have bottomed for this cycle. Activity is likely to fluctuate and begin a drift upward before year end with potentially firm activity over 2010.
- House prices stabilising, rising slightly over 2010.

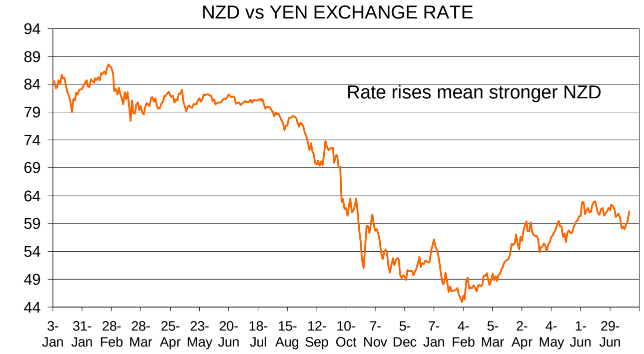
Exchange Rates & Foreign Economies

EXCHANGE RATES	This week	Week ago	4 wks ago	3 months ago	Yr ago	Consensus* Frcst Yr Ago	10 yr average
NZD/USD	0.646	0.626	0.63	0.575	0.772	0.693	.592
NZD/AUD	0.808	0.805	0.794	0.793	0.789	0.793	.856
NZD/JPY	60.9	58.1	60.8	56.9	81.1	73.3	66.8
NZD/GBP	0.394	0.39	0.384	0.384	0.385	0.371	.345
NZD/EUR	0.46	0.451	0.456	0.436	0.486	0.48	.51
USD/JPY	94.3	92.8	96.4	99.0	105.1	105.8	113.9
USD/GBP	1.639	1.605	1.643	1.50	2.01	1.867	1.709
USD/EUR	1.40	1.39	1.38	1.32	1.59	1.443	1.156
AUD/USD	0.799	0.778	0.795	0.725	0.978	0.874	0.69

Kiwi Falls – Then Soars

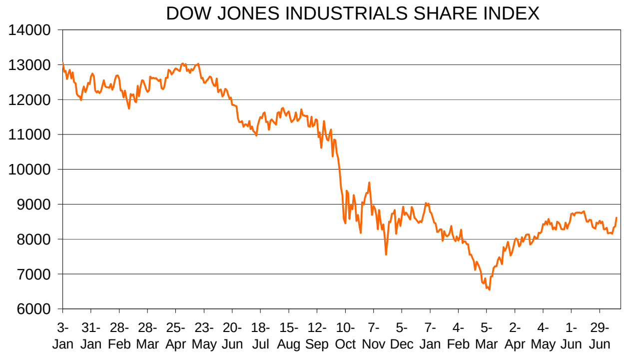
In the largely unpredictable world of exchange rates this past week we have seen occur two of the things we have been warning about over the past few weeks. The first was a long-awaited pullback in the NZD driven by renewed questioning of the likely strength of the economic improvements offshore. There was a weak business sentiment number out of Germany, worries about US company earnings, upwardly revised unemployment forecasts and so on. All of these things and pure profit-taking saw some global buying of the current safe-haven currencies – the US dollar and the Japanese Yen.





The result was that the NZ dollar early in the week fell just below US 62 cents from 62.6 last week while against the Japanese Yen we fell below 58. But then the second thing we have been speaking about kicked in – volatility. The NZD has jumped skyward again to sit this afternoon near US 64.6 cents and 61.2 Yen.

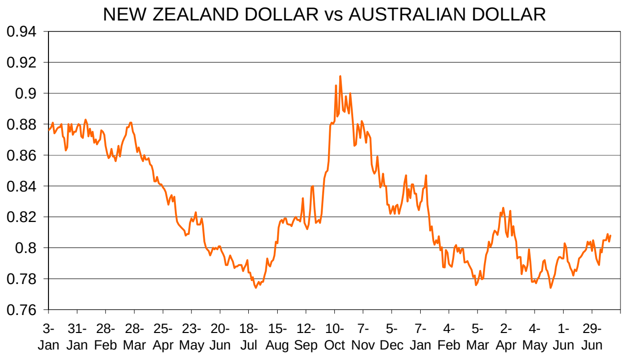
The Kiwi dollar is a risky currency so when the world shifts funds temporarily into then currently perceived safe-havens the NZD tends to fall a lot. Then when investors and traders feel things are not so dire the funds leave those currencies and drift back toward growth and risky assets. And so it was last night following the Federal Reserve revising upward its forecast for growth in the US economy over 2010, good profit numbers from Goldman Sachs two nights ago, and better than expected numbers plus an upbeat outlook from Intel.

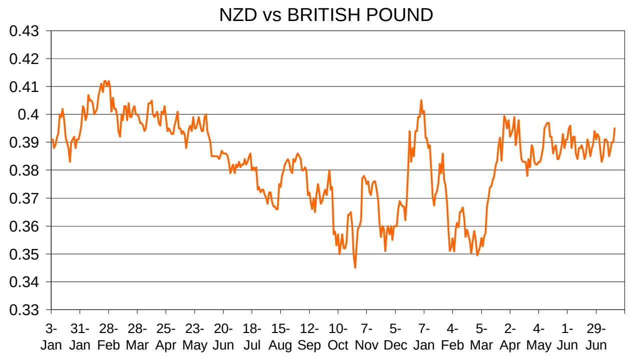


The good news has seen the Dow Jones Industrial Index close last night at 8,616 which is a 5.3% gain from a week ago and the highest close in a month. The rise in sharemarkets overnight represents a shift in funds back toward growth assets. The rise in the NZD to 65 cents represents a shift in funds toward risky assets.

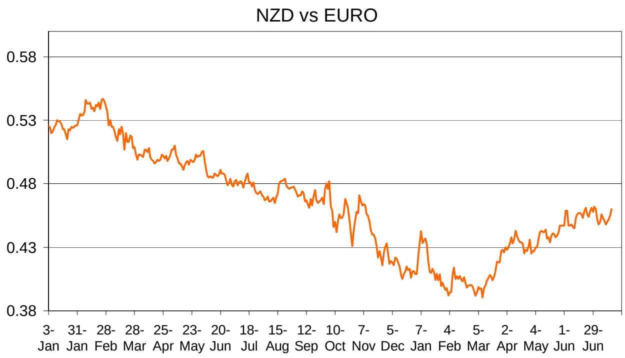
Where do we go from here? High volatility is going to continue because there remains major uncertainty about the path the world economy will take back to good growth and what exactly good growth will be in the future.

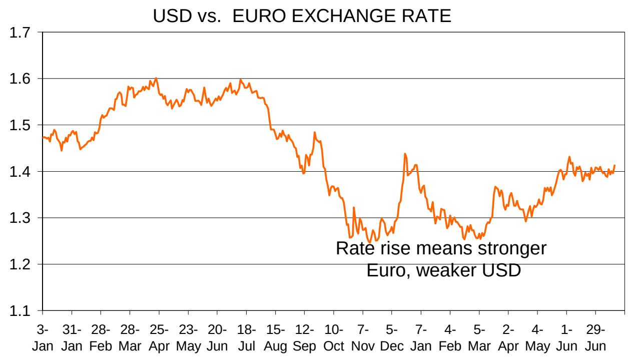
With the rise in the NZD being driven by the risk tolerance factor we have hardly budged against the Aussie dollar during the week which is also viewed as a risky currency. We have ended near 80.8 cents from 80.5. Against the British pound there was little chance for exporters to build cover at better levels during the week and we have ended near 39.4 pence from 39. We repeat that nothing jumps out to suggest to us a great move in the NZD against the pound one way or the other and one should be aware that major uncertainty and worries still surround the UK economy.





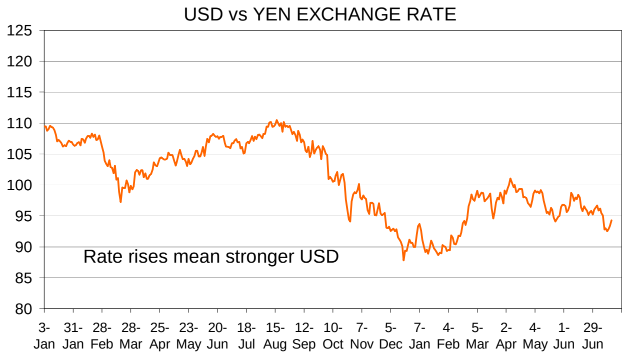
Europe also faces very troubled times going forward and as we noted last year is widely viewed as likely to lag significantly behind the US in the timing and probably even strength of economic recovery from the crisis. Against the Euro we have ended near 46 centimes from 45.1.

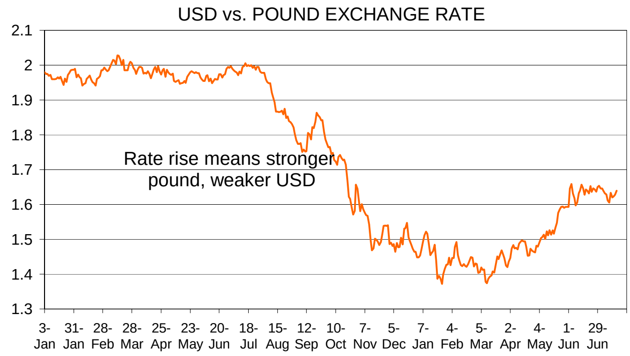




The greenback has finished at a one month high against the Euro near $1.404 from $1.388 last week with the earlier safe haven buying during the week only being slightly wiped out by the reduced risk haven demand overnight. As the second graph above shows there is no obvious trend in place for the USD against the Euro.

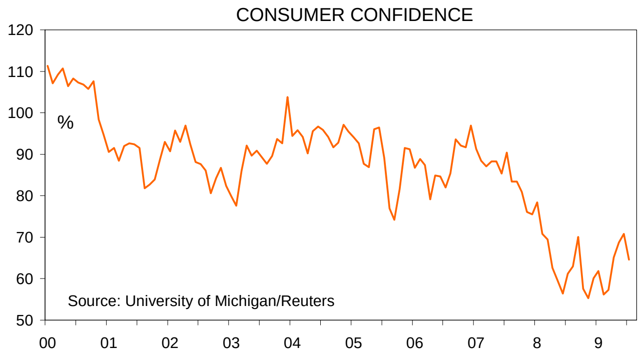
Against the Japanese Yen the USD has pulled back from five month lows due to last night's positive sentiment. It is currently near 94.3 from 92.8 last week. Were it not for Japan's continuing large current account surplus the extremely poor state of the Japanese economy would likely have produced extreme Yen weakness by now. But with so many investors in Japan the desire to have funds close to home during the current crisis has easily supported the Yen. That means that as the world settles down these funds will start to fly further afield and the Yen is likely to back off strongly against most other currencies. The carry trade is also likely to be reactivated.





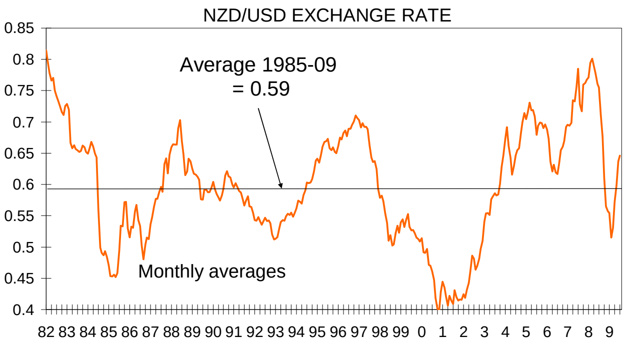
Speaking of Japan’s economy, sometimes small indicators get seized upon as evidence that a particular thing may be happening in an economy, and that was the case this week in Japan. There was a positive reception to data showing Japanese are sending more parcels through the post now including golf clubs and this is being read as a sign that the economy might be growing again. Shrinkage in the Japanese economy over the past few quarters has been so bad that the economy is now the size it was back in 1992.
http://www.bloomberg.com/apps/news?pid=20601068&sid=aM7JBjrfdPFU

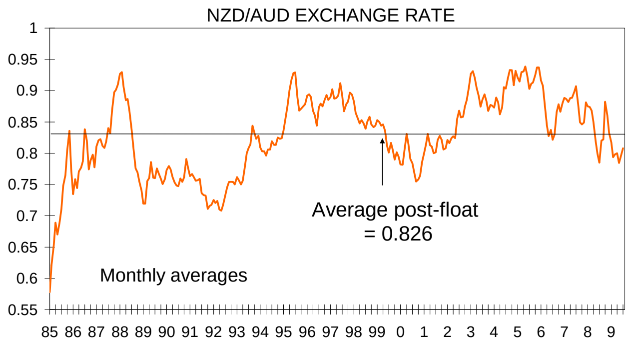
With regard to interesting stuff learnt about the US economy this week, consumer confidence unexpectedly dipped in July as measured by the University of Michigan index. It declined to 64.6 from 70.8 in June showing clearly that there is no reason for believing the general arrival of green shoots and a rising sharemarket are indicators of firm growth as such in the near future.

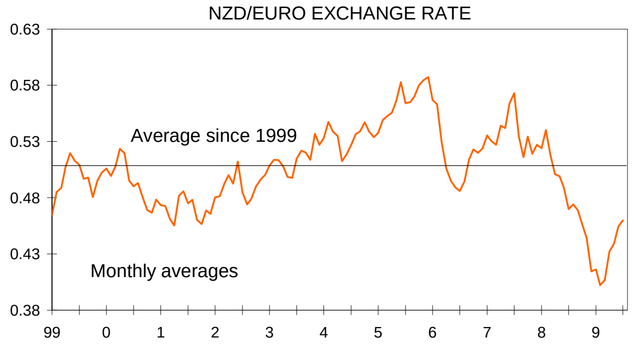


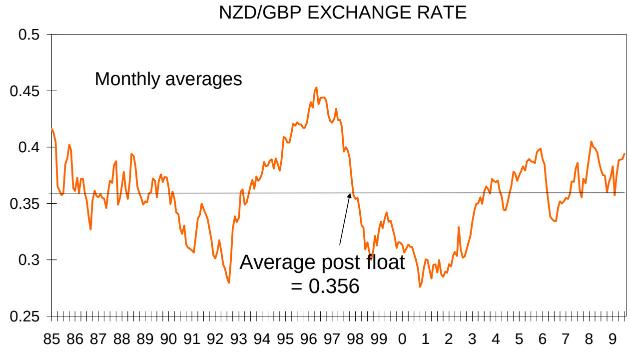
If I Were An FX Receiver What Would I Do?

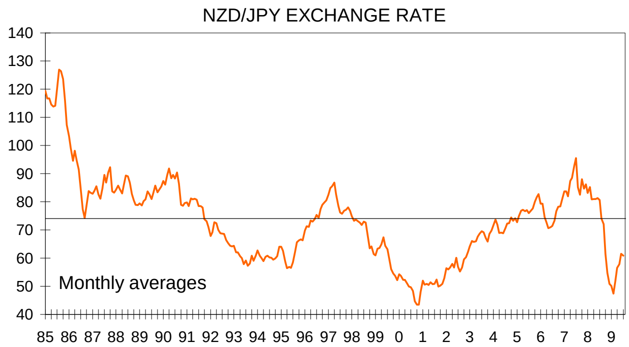
The pullback in the NZD against the USD which we have been writing about for many months now – since a level of about US 55 cent – probably happened in the past week and if you missed it then hanging off for a pullback now would seem more of a gamble than before. If I were an exporter I would be inclined to continue to slowly build hedging as the risk is the NZD drifts upward over the coming 2-3 years.











*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	0.6%	0.3	1.9	4.0	2.0
GDP growth	Average past 10 years = 3.0%	-1.0	-1.0	-1.0	3.1	1.8
Unemployment rate	Average past 10 years = 5.3%	5.0	4.7	......	3.8	3.8
Jobs growth	Average past 10 years = 1.9%	-1.1	0.6	0.8	-0.2	2.1
Current a/c deficit	Average past 10 years = 5.5% of GDP	8.5	9.0	......	8.0	8.5
Terms of Trade		-3.0	-1.0	-5.2	11.6	4.5
Wages Growth	Stats NZ analytical series	1.5	1.1	5.3	4.8	5.1
Retail Sales ex-auto	Average past 9 years = 3.8%.	-1.2	-0.0	-0.8	3.2	4.9
House Prices	Long term average rise 5% p.a. QVNZ	-2.0	-2.1	-8.9	8.0	9.7
Net migration gain	Av. gain past 10 years = 10,400	+11,202	6,160yr	......	4,938	10,680
Tourism – an. av grth	10 year average growth = 5.0%. Stats NZ	-2.6	-2.4	-2.6	1.3	2.4
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 2%. Colmar survey	3	-9	3	-34	-4
Business activity exps	10 year average = 26%. NBNZ	8.3	3.8	-21.5	-4.0	14.8
Household debt	10 year average growth = 11.3%. RBNZ	2.7	2.7	4.9	9.4	13.8
Dwelling sales	10 year average growth = 3.5%. REINZ	43.9	-39.1	-45.4	-52.9	-3.7
Floating Mort. Rate	10 year average = 8.1%	6.49	6.49	9.75	10.95	10.05
3 yr fixed hsg rate	10 year average = 7.9%	6.99	6.75	8.49	9.49	8.80

ECONOMIC FORECASTS

Forecasts at June 25 2009	March Years					December Years				
	2007	2008	2009	2010	2011	2006	2007	2008	2009	2010
GDP - annual average % change										
Private Consumption	2.8	3.2	-0.6	-0.2	1.8	2.6	4	0.1	-1	1.7
Government Consumption	4	4.3	3.7	3.3	2.8	4.6	3.9	4	3.4	2.9
Investment	-0.6	4.3	-10.2	-15.8	6.1	-0.4	5	-5.7	-18.1	1.7
GNE	1.4	4.4	-2.2	-3.1	3.2	1.4	4.5	-0.3	-4.5	2.4
Exports	3.1	2.9	-3.2	-3.4	1	1.8	3.8	-1.8	-3.3	-1
Imports	-1.6	9.6	-2.8	-10.9	2.2	-2.6	8.6	2.5	-13.1	0.2
GDP	1.8	3.1	-0.8	-1	2.9	2	3.2	0.2	-1.7	2.2
Inflation – Consumers Price Index	2.5	3.4	3	2.1	1	2.6	3.2	3.4	2.5	1
Employment	2.1	-0.2	0.8	-3.2	2.9	1.7	2.3	0.9	-4	2.9
Unemployment Rate %	3.8	3.8	5	7.5	7.2	3.8	3.5	4.7	7	7.2
Wages	5.5	4.4	5.1	2.4	1.5	5.5	4	5.1	3.1	1.3
EXCHANGE RATE ASSUMPTIONS										
NZD/USD	0.7	0.8	0.53	0.67	0.69	0.69	0.77	0.56	0.65	0.69
USD/JPY	117	101	98	102	108	117	112	91	100	107
EUR/USD	1.32	1.55	1.31	1.41	1.43	1.32	1.46	1.34	1.4	1.43
NZD/AUD	0.88	0.87	0.8	0.8	0.81	0.88	0.88	0.83	0.79	0.81
NZD/GBP	0.36	0.4	0.37	0.39	0.39	0.35	0.38	0.37	0.39	0.39
NZD/EUR	0.53	0.52	0.41	0.48	0.48	0.52	0.53	0.41	0.46	0.48
NZD/YEN	81.9	81.1	51.8	68.3	74.5	81	86.3	50.9	65	73.3
TWI	68.6	71.6	53.8	63.3	65.6	68	71.6	55.1	61.7	65.1
Official Cash Rate	7.50	8.25	3.00	2.5	4.25	7.50	8.25	5.00	2.5	3.75
90 Day Bank Bill Rate	7.78	8.82	3.24	2.7	4.62	7.64	8.77	5.23	2.7	4.12
10 year Govt. Bond	5.91	6.35	4.77	5.75	6.4	5.77	6.38	4.88	5.7	6

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

The BNZ Weekly Overview is prepared by Tony Alexander, Chief Economist at the Bank of New Zealand. Ph 04 474-6744.