BNZ Weekly Overview

22 October 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.

Visit To Hong Kong

Next week I travel to Tokyo to present at the 36th Japan New Zealand Business Council conference then fly to Hong Kong to have a look around as a first time visitor. While in Hong Kong I shall speak at a New Zealand Chamber of Commerce in Hong Kong function on the evening of November 4, but while there would love to meet any Hong Kong reader of the Weekly Overview who has time to spare for a coffee. If that is you then email me and we'll sort something out.

On more mundane matters, this week we have not learned anything truly startling about the NZ economy so if your time is of the essence close this file and get back to work. Otherwise here is some of the stuff we have leant.

First, the Kiwi dollar continues to soar with investors around the world scrambling for riskier and therefore higher yielding assets as they buy into the global recovery story. Assisting their willingness to buy the NZD has been a rising Aussie dollar underpinned by strong data and potentially rapidly tightening monetary policy. There seems few reasons for believing anything other than that the NZD will go above US 80 cents – assisted partly by weakness in the greenback. The USD is being weighed down by worries about a huge budget deficit which given the nature of the political system in the US seems very unlikely to be reduced to nice sustainable levels for a number of years. US dependence upon foreign financing will remain high for an extended period – but returns to investors from rising interest rates do not look imminent.

The Federal Reserve has made many comments indicating they will keep their interest rates low as long as humanly possible. That means in order to attract foreign investors to finance the deficit an increasingly low entry level against the USD is being demanded. In theory a low entry level should also be demanded by foreign lenders to us ridiculously debt hungry Kiwis. But in a financially shattered world we stick out as having a good banking system, an economy which shrank 3% during the downturn and not even the OECD average of 5%, plus good trade relations with Australia which didn't even have a recession!

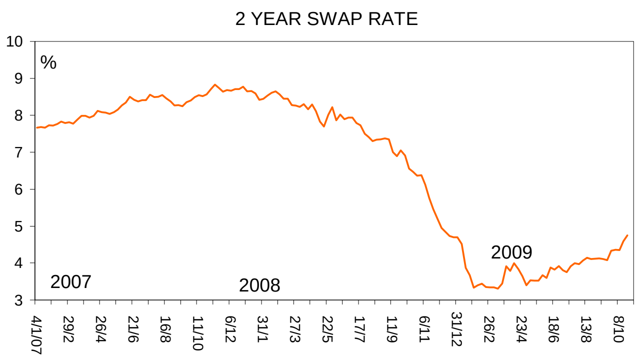
House prices rising 8% since January probably don't figure as too relevant a factor for supporting the currency, but the continuing increase in net migration inflows (people not leaving essentially) paints the same picture of support for the housing market now as we have been highlighting for well over a year. The Spring surge in listings some were expecting has not eventuated, and buyers continue to flock to open homes and auctions.

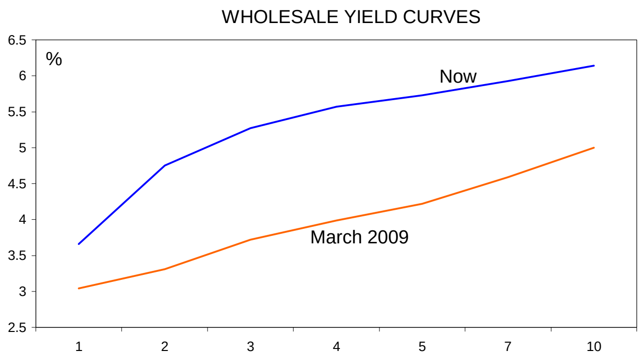
Four decade low interest rates, above 11,000 per annum average net migration inflows (now +17,000), lack of affordable housing, and the worst levels of new dwelling construction in four decades bespeak of continued house price rises along with improving construction soon. As construction recovers so too will manufacturing and distribution of building materials and household furnishings. But watch for an interesting period 1-2 years from now when the contractors are flocking across the Tasman to take part in a potential building boom there, causing rising construction costs in NZ and new delays in getting a house built which are not apparent at the moment. Watch also for a shortage of financing limiting development of new subdivisions.

INTEREST RATES

While 90-day bank bill yields remain anchored near 2.8% by the Reserve Bank's cash rate of 2.5%, further out along the wholesale yield curve rates continue to creep higher. These rises, which have been underway since March in stop-start fashion, reflect increasing expectations of the RB raising their cash rate far earlier than the late-2010 period they have indicated.

These rate rise expectations have been enhanced by stronger than expected economic data, the higher than forecast CPI rise for the September quarter, and the early policy tightening across the Tasman.





For now our view remains that the first tightening will come in the middle of next year as inflation will be suppressed by the rising NZD and spare capacity in the economy. But the risk is the move occurs earlier than this and those who have positioned for the fairly obvious direction of this risk will have secured some nice cheap long term funding many months ago. As they say, a bird in the hand is worth two in the bush – meaning it was better to lock in long term funding at levels no sane person was expecting a year earlier than hang out for another 0.25% or 0.5% rate fall.

From current levels the risk is the yield curve moves higher, but a pivot point is appearing just beyond the seven year mark – which is not really relevant as hardly anyone in NZ ever has enough foresight to lock their debt costs in that length of time anyway.

Key Forecasts

- Tightening by mid-2010 at the ultimate latest.
- Medium to long term housing rates to keep on rising.

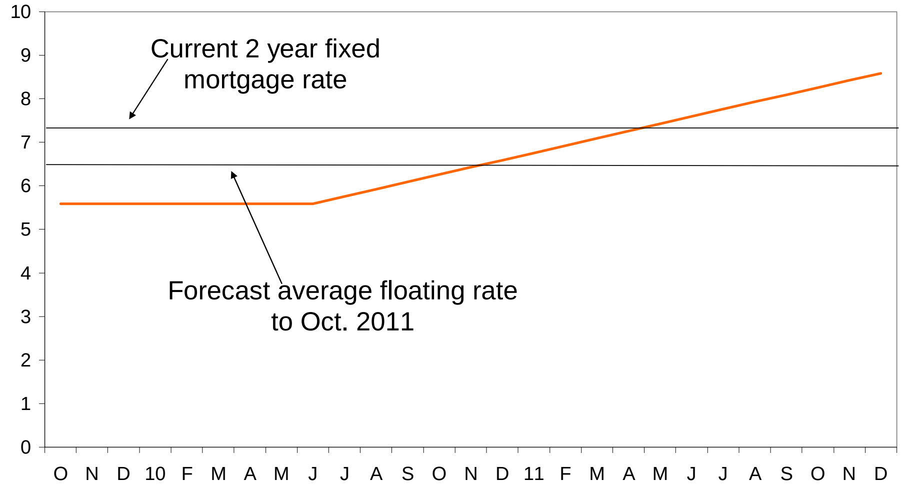
FINANCIAL MARKETS DATA

	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	7.50	6.2
90-day bank bill	2.82%	2.78	2.80	2.82	7.01	6.5
10 year govt. bond	5.76%	5.53	5.64	5.73	5.92	6.2
1 year swap	3.66%	3.58	3.32	3.13	6.40	6.7
5 year swap	5.73%	5.66	5.57	5.45	6.52	7.0

If I Were a Borrower What Would I Do?

Feedback indicates that some people believe that when we say they should budget for floating mortgage rates rising 3% between the middle of next year and the end of 2011 we mean the rates will be 3% higher in the middle of next year. Believing that, some people have been calculating the expected average rate for sitting floating for the next two years and getting 7.5%. That is wrong.

If we take the current Total Money floating mortgage rate of 5.59% and hold it there until June 2010, then raise it to 8.59% by December 2011 (the orange line below) we get an average mortgage rate of just 6.5%.



Therefore when presented with the choice of floating or fixing two years the choice is a no-brainer. One floats. The same goes for fixing one year. That rate is now 5.99% but we expect the floating Total Money rate to average 5.7% between now and October 2010.

The equation has now become very simple. If you have not fixed by now you have missed the boat. You will now be riding the cycle and the next interesting period for you is going to come in 2012. What will happen then is that floating rates will be over 3% higher and maybe the fixed rates will be looking relatively attractive again. But be careful (not that anyone then will remember what we are writing now). When floating rates get above fixed rates people tend to switch from floating to fixed for the cash flow savings.

This is fine for a while. But a point is often reached where the yield curve is quite inversely sloped and the cheapest fixed rates are around five years. When that happens people tend to jump off floating and fix five years. It happened in 1998 and it happened again last year. On both occasions we wrote not to touch fixed rates with a bargepole because if floating rates are so horribly high above 10% then the economy is eventually going to slow substantially and monetary policy will be eased. This easing will take floating rates down sharply.

The 1998 cycle saw floating rates fall from about 11.25% to 6.5%. Last year they fell from about 10.5% to initially 6.5% and now below 6% as competition in the marketplace between banks is leading to discounted floating rather than fixed rates.

So float now, but be aware that in all probability you will need to stay floating until after the floating rates next go above 10%, then fall back to 6% or so at which point we will again be advocating fixing long term. Frankly, at this stage we think it is impossible to reasonably predict not just when interest rates will be back at low levels again, but when and where they will peak this cycle. Good luck to all you floaters.

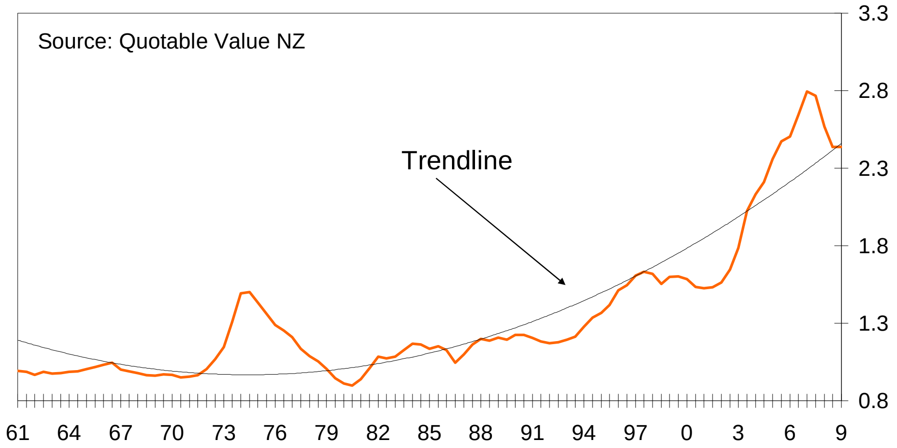
HOUSING MARKET UPDATE

Rising Prices Confirmed

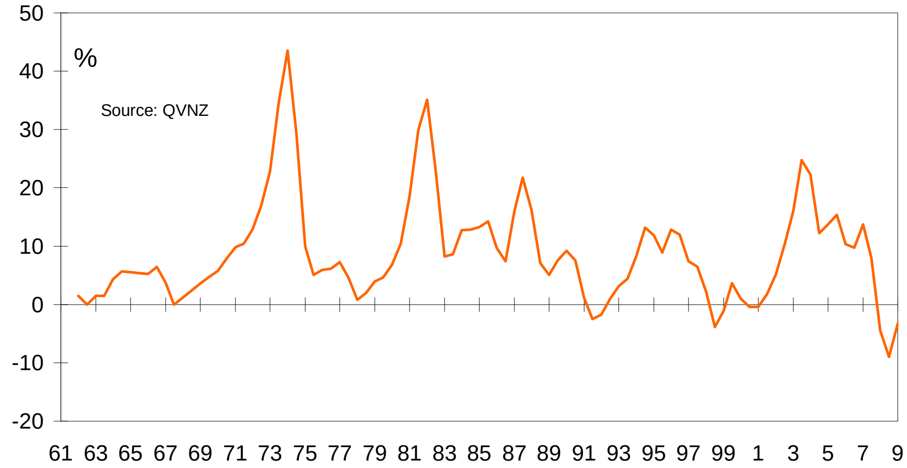
The monthly REINZ stratified prices index which removes distortions caused by changes in the mix of houses sold from month to month showed a fall of 1.7% during the March quarter. The long running Quotable Value NZ series fell 1%. During the June quarter the REINZ measure rose 2.2% and this week we learnt the “official” measure as it were from QVNZ rose 1.9% in the June quarter. Given that we already know the REINZ measure rose another 2.5% during the September quarter we can reasonably assume the QVNZ measure to be reported in three months time will rise by about the same amount.

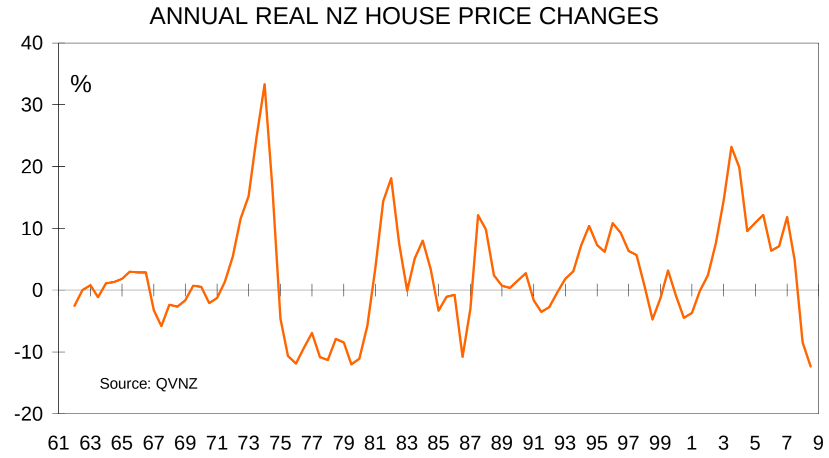
Just for fun, here are some graphs showing very long term house price movements. Just remember that last time we looked household composition, average house size, what is in a house, single versus double income families, building standards, section sizes and prices were all different this past decade from earlier years.

RATIO OF ALL-NZ HOUSE PRICE INDEX TO CPI



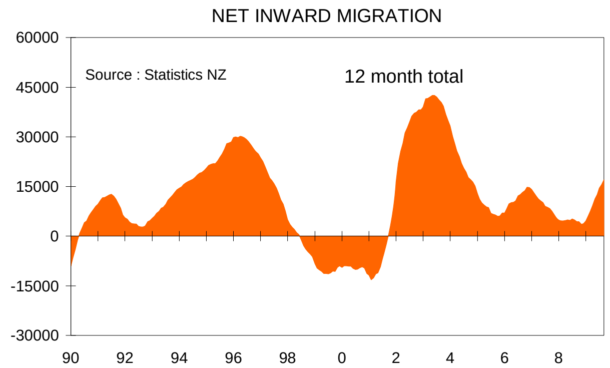
ANNUAL NOMINAL NZ HOUSE PRICE CHANGES

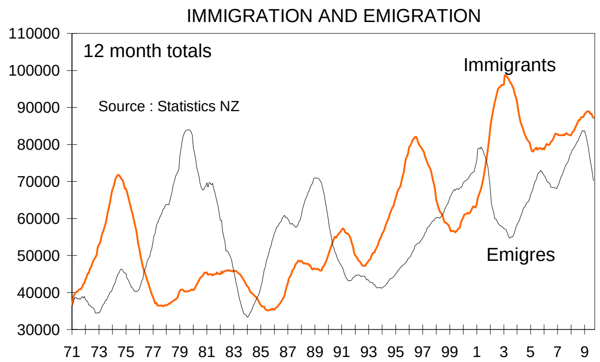




Population Growth Keeps Accelerating

This week we learnt that in September there was a net gain to New Zealand's population from permanent and long term migration of 3,107 people. In September a year ago the gain was 1,706 and two years ago 2,241. The gain means that in the year to September migration flows added 17,043 people to the population which is up from 15,642 in August and a low of 3,569 in November last year.





Rising net migration inflows is one of the factors we have cited for well over a year now as reason for limiting the falls in NZ house prices and eventually applying fresh upward pressure. There is little sign as yet that the increase in net migration inflows is easing so it remains reasonable to expect house prices to keep rising given that new house supply is running at four decade lows and interest rates also are at their lowest levels since the 1960s.

For the record, in the year to September the number of immigrants was actually only ahead 0.6% from a year earlier. But emigrant numbers were down by 14.7%. In the September quarter these annual rates of change were -4.6% and -28%. So the migration change is essentially due to people staying put rather than a flood of people coming here. Whether that flood eventuates is hard to say given some signs of economic recovery offshore and the effect which a high NZ dollar will have on the purchasing power of people's money if they are coming here to buy a house.

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

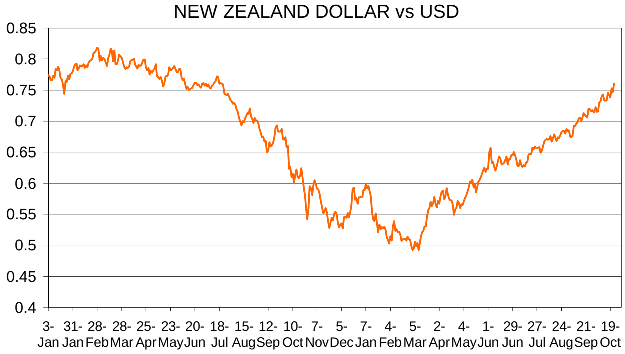
- Dwelling consent numbers to recover now with potentially good activity from late-2010.
- Real estate sales continuing to increase but the rise limited by listings shortages.
- House prices edging higher.

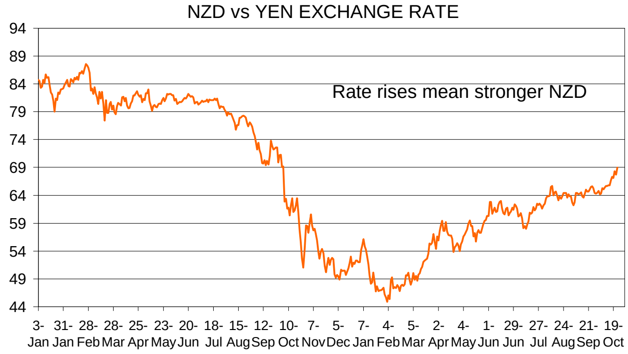
Exchange Rates & Foreign Economies

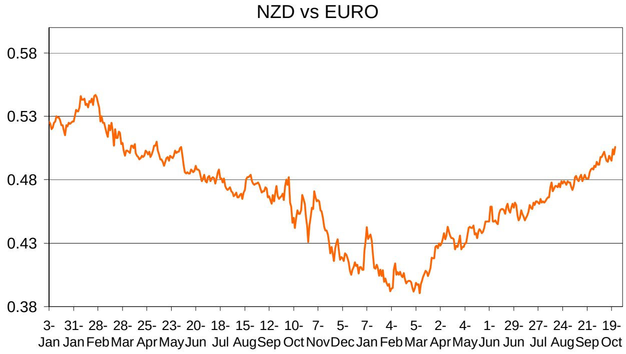
Exchange Rates	This Week	Week ago	4 wks ago	3 mths ago	Yr ago	Consensus Frcsts yr ago	10 yr average
NZD/USD	0.754	0.746	0.706	0.654	0.608	0.603	0.592
NZD/AUD	0.815	0.812	0.818	0.802	0.898	0.831	0.856
NZD/JPY	68.600	66.700	65.000	61.300	61.000	64.340	66.8
NZD/GBP	0.454	0.465	0.436	0.398	0.364	0.357	0.345
NZD/EUR	0.502	0.499	0.481	0.460	0.465	0.453	0.51
USD/JPY	90.981	89.410	92.068	93.731	100.329	106.700	113.9
USD/GBP	1.661	1.604	1.619	1.643	1.670	1.688	1.709
USD/EUR	1.502	1.495	1.468	1.422	1.308	1.331	1.156
AUD/USD	0.925	0.919	0.863	0.815	0.677	0.726	0.69

NZD Above US 76 cents

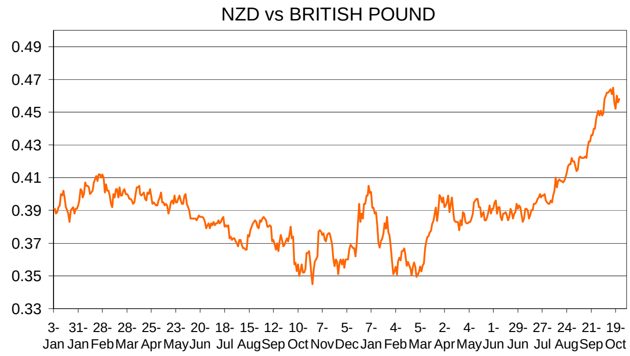
The Kiwi dollar traded above 76 cents earlier today compared with 74.6 cents last week and 70.6 cents a month ago. We also rose firmly against the Yen this week ending late today near a 13 month high of 68.6 from 66.7 last week while against the Euro we also firmed a tad to near 50.2 centimes from just below 50 last week.

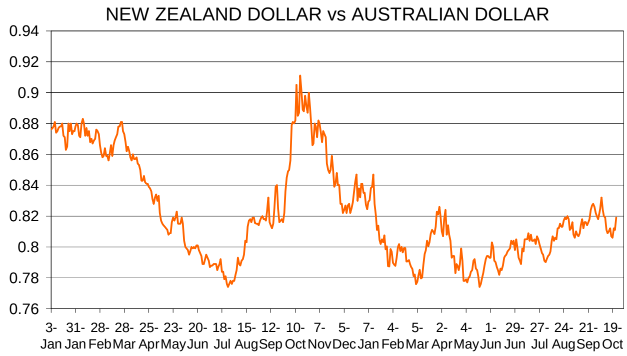






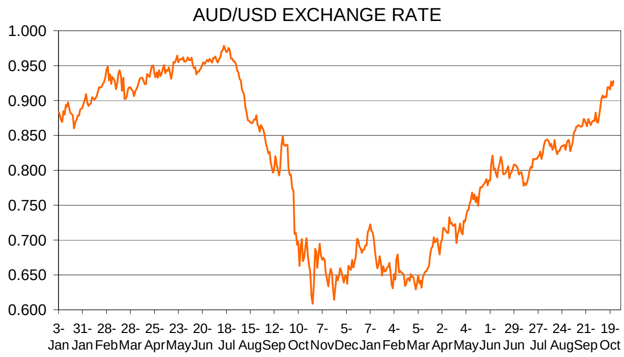
But against the pound we have slipped slightly to 45.4 pence from 46.5 last week while against the AUD we have spent most of the week down but firmed a tad overnight to end near 81.5 cents from 81.2 last week.





The NZD has been pushed higher over the past week by some further weakness in the greenback against the Euro and Pound, and some emerging selling of Japanese yen and buying of higher yielding currencies like the NZD. In addition there remain the underlying themes of rising commodity prices and improving global risk tolerance.

Of key relevance to the path of the NZ dollar against the USD is where the AUD goes against it. This afternoon the AUD was buying US 92.8 cents compared with 90.5 cents a week ago, 86 cents a month ago, and 63 cents back in March.



The Aussie dollar has been aggressively boosted by some strong recoveries in commodity prices in recent months, increased expectations in just the past few weeks of further price rises as the world economy improves, and the fact Australia managed to avoid a recession during the global crisis. But most significantly recently, the RBA increased their cash rate from 3% to 3.25% two weeks ago and the markets are now debating whether the next month in November will be 0.25% or 0.5%.

The debate rages because comments from the senior RBA people indicate a strong determination to keep inflation in check as growth accelerates with views expressed along the lines of not needing extraordinarily low rates when clearly there is no longer an extraordinary threat to the Australian economy.

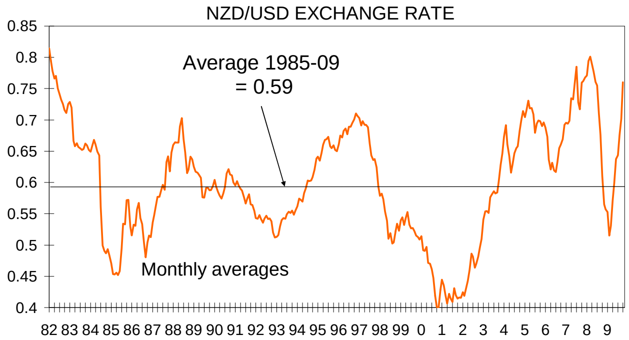
While the NZD tends to move in a broad 20 cent range against the AUD, we do tend to go in the same direction they do against the greenback. That means that with increasing support for the AUD and a rise to parity with the greenback looking possible for the AUD in coming months, the NZD is going to go along for the ride while we probably now shed some ground against the AUD having recovered from 77.5 cents back in June to peak just over 83 cents early this month.

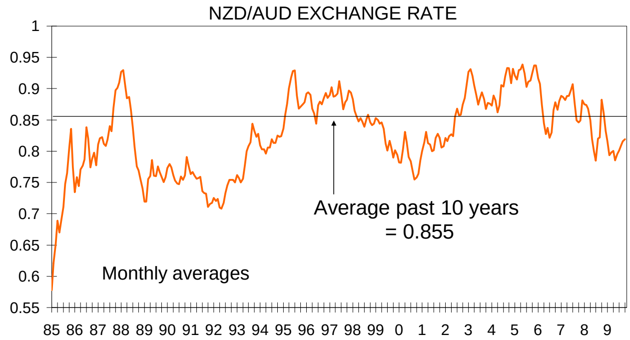
One further factor which helped the NZD up especially last night was buying following comments by the Reserve Bank Governor yesterday that the rising NZD was not necessarily an impediment to raising the official cash rate. While the Governor also noted he feels the markets are getting ahead of themselves in positioning for policy tightening, the comments are almost certainly the first step toward an eventual official backing off from repeated statements that the cash rate will remain low until the latter part of 2010.

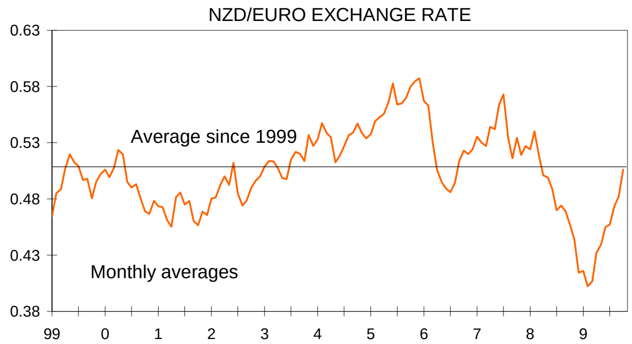
From here we can only say that risks for the NZD continue to lie on the upside.

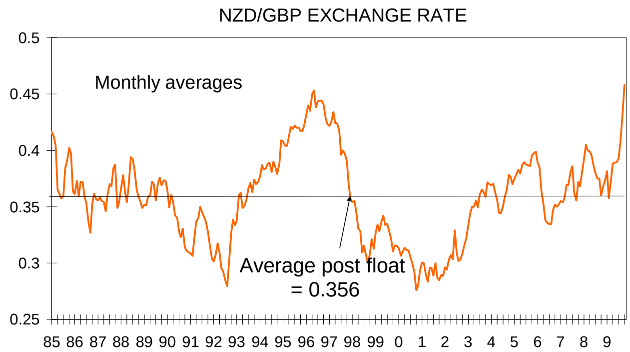
If I Were An FX Receiver What Would I Do?

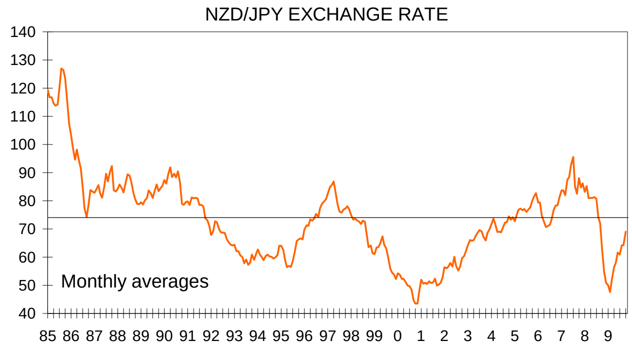
Keep hedging with slowly increasing use of options. Nothing new to say frankly beyond what we have been saying for about five months now. The only way one could reasonably have stood still and held off hedging is if one believed the world was going back into a deep depression threat. But that has not been a reasonable position to take since the green shoots appeared in March. So exporters who currently find themselves grossly unhedged have almost only themselves to blame – especially as it pays to remember we are not of the view that one can successfully forecast exchange rates so strong hedging to account for the inherent volatility of the NZD is advisable practically all the time.

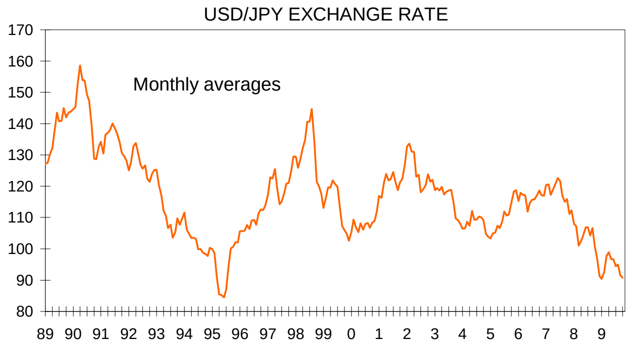


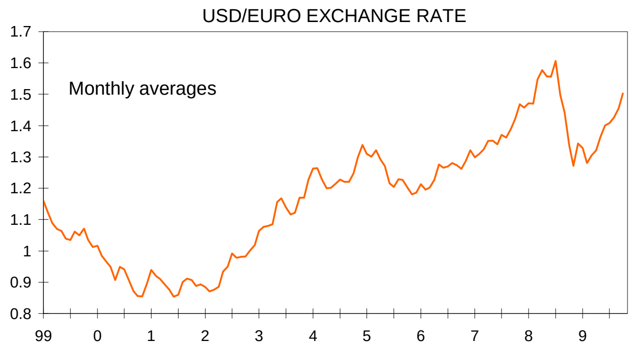


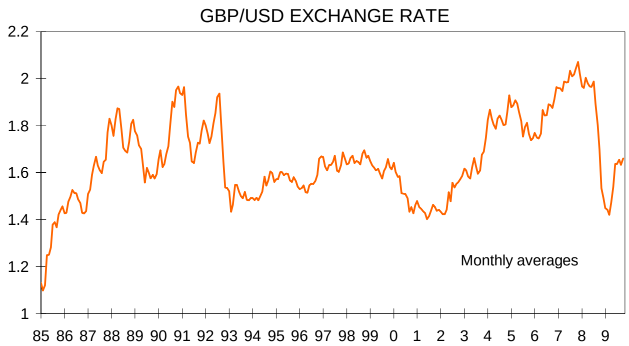












*Sourced from Consensus Economics. http://www.consensuseconomics.com/

ECONOMIC DATA

All %		Latest qtr only	Previous qtr only	Latest year	Year ago	2 Yrs ago
Inflation	RBNZ target is 1% - 3% on average	1.3%	0.6	1.7	5.1	1.8
GDP growth	Average past 10 years = 3.0%	+0.1	-0.8	-1.8	2.5	2.3
Unemployment rate	Average past 10 years = 5.3%	6.0	5.0	......	4.0	3.7
Jobs growth	Average past 10 years = 1.9%	-0.5	-1.4	-0.9	0.8	1.5
Current a/c deficit	Average past 10 years = 5.5% of GDP	5.9	8.1	......	8.3	8.2
Terms of Trade		-8.9	-2.7	-13.1	10.7	2.3
Wages Growth	Stats NZ analytical series	0.6	0.8	4.6	5.6	4.6
Retail Sales ex-auto	Average past 9 years = 3.8%.	0.2	-1.0	-1.0	1.6	5.5
House Prices	REINZ Stratified Index	1.6	1.8	0.7	-7.0	13.1
Net migration gain	Av. gain past 10 years = 11,700	+17,043	12,515yr	......	4,403	8,319
Tourism – an. av grth	10 year average growth = 5.0%. Stats NZ	-1.8	-2.8	-1.8	-0.3	3.8
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 2%. Colmar survey	57	38	-9	23	-8
Business activity exps	10 year average = 26%. NBNZ	32.0	26	-21	17	17
Household debt	10 year average growth = 11.3%. RBNZ	2.4	2.6	4.2	8.5	13.7
Dwelling sales	10 year average growth = 3.5%. REINZ	43.7	39.3	30.5	-23.7	-32.0
Floating Mort. Rate	(Total Money) 10 year average = 7.6%*	5.59	5.59	6.49	10.49	9.99
3 yr fixed hsg rate	10 year average = 7.9%	7.95	7.45	6.59	8.69	8.75

ECONOMIC FORECASTS

Forecasts at Sept. 17 2009	**March Years**					**December Years**				
(CPI updated 15/10)	2008	2009	2010	2011	2012	2007	2008	2009	2010	2011
GDP - annual average % change										
Private Consumption	3.3	-0.7	-0.5	1.8	2	4.1	0	-1.3	1.7	2
Government Consumption	4.3	3.4	3	2.8	1.9	3.9	3.9	2.9	2.9	2.2
Investment	4.3	-8.9	-16.4	6	8.9	5	-5.1	-17.8	1.1	9.7
GNE	4.2	-2	-3.9	3.3	3.4	4.5	0	-5.4	2.5	3.6
Exports	2.9	-3.4	-0.4	0.5	4.9	3.8	-1.6	-1.8	-0.4	4.7
Imports	9.6	-4.4	-14	2.3	5.9	8.6	2	-17.1	0.4	5.6
GDP	3.1	-1	-1	3	3.1	3.2	0.2	-1.9	2.3	3.3
Inflation – Consumers Price Index	3.4	3	2.5	1.1	2.6	3.2	3.4	2.6	1.4	2.1
Employment	-0.3	0.8	-1.6	2.6	3.2	2.3	1	-2.9	1.7	3.4
Unemployment Rate %	3.8	5	7.3	7.2	6.1	3.5	4.7	6.9	7.3	6.3
Wages	4.4	5.1	2.4	1.5	3.8	4	5.1	3.1	1.3	3.3
EXCHANGE RATE ASSUMPTIONS										
NZD/USD	0.8	0.53	0.73	0.75	0.71	0.77	0.56	0.72	0.75	0.72
USD/JPY	101	98	102	108	110	112	91	100	108	110
EUR/USD	1.55	1.31	1.5	1.46	1.36	1.46	1.34	1.49	1.47	1.4
NZD/AUD	0.87	0.8	0.82	0.84	0.85	0.88	0.83	0.82	0.84	0.84
NZD/GBP	0.4	0.37	0.42	0.43	0.41	0.38	0.37	0.42	0.43	0.42
NZD/EUR	0.52	0.41	0.49	0.51	0.52	0.53	0.41	0.48	0.51	0.51
NZD/YEN	81.1	51.8	74.5	81	77.9	86.3	50.9	72	81	79.1
TWI	71.6	53.8	67.3	70.3	68.8	71.6	55.1	66.3	70.1	69
Official Cash Rate	8.25	3	2.5	4.25	6.25	8.25	5	2.5	3.75	5.75
90 Day Bank Bill Rate	8.91	3.24	2.7	4.62	6.62	8.9	5.23	2.75	4.12	6.12
10 year Govt. Bond	6.36	4.77	5.75	6.4	7	6.4	4.88	5.7	6	6.8

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.

*extrapolated back in time as Total Money started in 2007