

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.

A Wobbly Start To The Year – But Not Here

Investors in shares and businesses exposed to mineral commodity prices have started the year on a bad note with some major price declines – record New Year falls in share prices in fact. The MSCI measure of global equities is almost officially into a 20% decline bear market from the peak last May and last night the Dow Jones shed another 1.3% to be down 9.5% since December 31 and 14% from the May peak.

The rout has been caused partly by worries about the Chinese economy, the lack of success of the authorities there in supporting growth, and recent ham-fisted efforts to stem the correction in Chinese share prices from unrealistically high levels. China's economy is transitioning away from dependence upon exports, manufacturing, and fixed asset investment toward private consumption. However while the former phase is underway the latter remains elusive and no-one knows when household spending will truly take over as the main growth driver. Before it does there could be long-lived ructions associated with excess capacity, high debt, bloated state-owned enterprises, and financial reregulation.

Conditions in the Middle East are also worsening whether measured by the deteriorating relationship between the two major players of Iran (Shite) and Saudi Arabia (Sunni), the war waged by ISIS across much of the region, Libya's instability, the continuing Israeli occupation and intifada, Turkey's fight with the Kurds, or plummeting oil receipts.

The European Union continues to show more signs of friction and falling apart than smoothing of disputes and cohesiveness against threats from Russia, terrorists, millions of culturally alien refugees and economic migrants etc. Borders are being reinstated, recently agreed fiscal rules are being resented and broken, the UK will vote on discontinuing EU membership, the Euro is still at risk of falling apart if Greece again needs more bailout money, and strongly regulated economies are poorly placed to adapt in a world where adaptability to change is more vital than ever before.

The United States' and Australian economies do however have some good underlying momentum with strong jobs growth in both and the Aussie services sector and tourism helping offset the worsening minerals sector downturn. But the effect and pace of US monetary policy tightening which started last month is a huge source of uncertainty facing the global economy this year, especially with regard to capital flows out of struggling and shrinking emerging economies.

Yet here in New Zealand, as we emphasised last year, we have plenty of reasons for not getting pessimistic about the impact of events offshore. House construction continues to grow with annual consent numbers now at a ten year high of 26,800 compared with only 13,500 in the middle of 2011. The value of non-residential building consents now stands at a record \$5.8bn compared with \$3.8bn three years ago. The tourism sector is booming with visitor numbers ahead by 9% in the past year and spending ahead a massive 38%. Most non-dairy exports are doing well. El Nino is even proving less severe in its impact than feared, though it remains a risk to agricultural production levels.

Business confidence has just improved according to the NZIER's quarterly survey to a net 15% optimistic from -15% in the September quarter and an average of +6%. A net 14% of businesses plan boosting staff numbers versus an average 6%. A net 10% plan boosting investment compared with an average of 2%. There is support for growth from the slowly weakening NZ dollar, and then there are low interest rates acting as a stimulus.

In fact yesterday we learnt that inflation for calendar 2015 was not the 0.3% forecast but only 0.1% courtesy of the December quarter average cost of living falling 0.5% rather than the expected 0.3%. The chances of even further monetary policy easing in NZ have risen, the currency edged lower following the data release, and low interest rates look set to be with us for many, many years.

Now lets throw booming net immigration into the mix – now at a gain of almost 64,000 in the year to November – and we see good growth ahead this year for the NZ economy. In other words, our central message last year of many factors underpinning NZ growth has not changed even taking into account the sharemarket wobbles, downside risk to dairy prices, and deeper worries about China's economy.

Businesses should continue to seek out good staff. Construction, retailing, tourism and the services sectors are likely to perform well, funding costs will stay low and perhaps decline further, and the NZD will be somewhat suppressed in spite of good NZ growth by China worries and weak global commodity prices.

Housing

I'll write more about housing next week. Suffice to say that the central themes discussed last year as relevant for 2016 remain unchanged – investors flocking to the regions and boosting prices there, raising the risk of the RB following behind and imposing Auckland's 30% investment purchase deposit requirement. Interest rates staying low encouraging more people to buy. Booming net immigration raising demand. Supply everywhere but Auckland particularly constrained by shortages of builders and land, land banking, and red tape.

Here is something I penned for someone over the summer break. Why have house price pessimists got it wrong for three decades?

1. Thinking buying a house is solely a financial decision of comparing rent with mortgage servicing and maintenance costs
2. Failing to realise most people are in NZ for the lifestyle not maximising disposable income and part of that is home ownership.
3. Low interest rates boosting what are considered "affordable" prices because people calculate affordability based on debt servicing costs, not debt versus income.
4. Quarter of a century of messages to people that they need to save and boost assets for their retirement.
5. Lengthening life expectancy and need for income in retirement.
6. High profile sharemarket failures wiping out wealth of people who for one reason or another failed to diversify.
7. Strengthening average net migration inflows.
8. Internationalisation of the Auckland housing market (foreign buyers).
9. Ever rising construction costs and hassles of building.
10. Decreased availability of builders.

NZ Dollar

Logic says that the NZD will decline this year and our official view is that come December we will be near US60 cents from close to 65 cents currently. The logical reasons are a narrowing interest rate differential between NZ and the US, falling commodity prices, heightened global risk, and selling of Australasian currencies as proxies for the Chinese currency. Such logic helps explain why the rate is so far down from US88 cents back in 2014.

But where do the risks lie? Both ways frankly because one cannot rule out world growth falling away quite a bit this year. But in the absence of a global recession many other fundamentals are actually quite supportive of the NZD. These include the strong housing market and an economy supported by construction, tourism, services sector growth, and non-dairy exports generally. Booming net immigration is a plus as is the good state of government finances, low current account deficit, distance from deepening geo-political problems elsewhere, and low air pollution which is becoming increasingly a source of concern for growing middle classes in the emerging economies.

What this adds up to is perhaps a suggestion to exporters that when the NZD does dip to 60 cents it may be a good idea to lock in a good level of cover rather than holding back in anticipation of 55 cents or 50.

You will find current spot rates here. <http://www.xe.com/currency/nzd-new-zealand-dollar>

If I Were A Borrower What Would I Do?

As noted above, for six years our message on interest rates has been not to base your risk management decisions strongly upon a set of forecasts proving correct. That message then gained the addendum of no-one having in fact got their interest rate forecasts correct since 2007 with predictions of rate rises proving wrong over and over again. Two recent examples are US bond yields falling rather than rising after the Fed. ceased printing money in 2014, and the 1% rise in NZ's official cash rate last year being completely reversed.

Now we have the same thing happening again. US monetary policy was tightened 0.25% a month ago and as a result bond yields have not risen but instead gone down courtesy of a long-overdue correction in global sharemarkets bringing downgrades to expectations for world growth, world inflation, and interest rates everywhere. Now lets add in for the NZ case the new falls in petrol prices and only 0.1% inflation last year and we have inflation once again coming in less than the Reserve Bank has been forecasting.

What this all adds up to is this. As we noted more and more in the second half of last year and as the Finance Minister also said, the chances are that NZ interest rates are going to stay at very low levels for a number of years. We probably won't see NZ monetary policy tightening until 2018 – if that. Will the OCR be cut soon? That is possible but we still feel the RB is reluctant to do so. Yet if they cut their inflation forecasts again they may have no choice. In that case raise your expectations of extra restraints on lending for housing purchases because lower interest rates will stimulate even further the regional markets and reignite the Auckland market.

I recently was a borrower for the first time since writing this section some years ago and fixed two years at 4.35% if I recall rightly. Now the BNZ have on offer a rate of 4.49% for three years. Given a choice between that and the two year rate at 4.39% I would take the three year rate. It is a very low rate which offers cash outflow certainty for three years.

For Noting

Every year in the days leading up to Christmas we see the publication of figures from a company called Paymark which processes about 75% of all electronic payment transactions in New Zealand. Here is a New Year example. <http://www.stuff.co.nz/business/75605714/card-spending-jumps-on-back-of-economic-growth-paymark-says>

The tone of the articles is always one of the numbers being high, people doing lots of spending, craziness potentially prevailing in the malls (same type of coverage on TV), and perhaps a tone of disappointment at the focus on consumerism. The desire to give at Christmas has morphed into the need to buy. Giving seems secondary.

But it pays to sit back a tad sometimes and question some of the numbers. For instance, in the Dominion Post of Boxing Day it was reported that in the weekend before Christmas spending was 3.8% higher than a year earlier. That is a nominal figure and we need to adjust it first of all for population growth of almost 2% in the past year. Then there is inflation of 0.4%. That leaves growth on last year's spending of about 1.4% in volume terms per capita. But there is another adjustment to make.

The growing use of contactless cards means we are doing more electronic spending for small items. There is no way of knowing how big this factor is but probably not all that large. Perhaps however this use of contactless cards helps explain why the average size of an electronic purchase was \$55 compared with \$60 last year.

Nevertheless, the pre-Christmas tone of commentary is always that you and I are spending too much, we will rue our spending when the credit card bills come in, and we have lost track of the true meaning of Christmas. And then eventually we get Statistics NZ data on what was really happening and the truth is somewhat different.

Spending using debit and credit cards in seasonally adjusted terms fell by 0.4% in December compared with November for core purchases. In fact during the December quarter the annualised pace of card spending slowed to 4.5% from 8% in the September quarter. We did not go ballistic with our money – though come December this year that will once again be the key media theme.

You need to apply a filter to take out the media bias when reading a lot of economic commentary. That is especially the case for housing. The bias in media is toward commenting that price rises are unsustainable, and having interviewed the latest show pony for the rent-don't-buy crowd reporters will try to scare us into holding off buying and perhaps selling to avoid the rush. Actual analysis of fundamentals usually goes out the window, and as pointed out here many times in recent years, if you have bought into the price collapse bias you have missed out on a lot of wealth gain plus perhaps securing a family home at an affordable price.

There is bias also in discussions about exchange rates. We are encouraged to believe that a falling NZ dollar is good because some exporters will make more money. Actually a rising exchange rate will make most of us better off as long as the NZ dollar is not being pushed up by hikes in interest rates.

Another filter which I have tried strongly to encourage you to apply these past few years is that of reasonable credibility when it comes to forecasting economic and financial variables. Since the global financial crisis our economic models no longer work because of technological changes reducing the costs of searching for alternative prices and supplies of consumer goods and services and business inputs, and because how people react to changes in key things has altered. For example the responsiveness of you and I to interest rate changes has altered. Our ability to forecast things has collapsed.

In fact, here is a list of some things which people can't forecast – meaning not just economists but everyone else.

- Oil prices
- Gold prices
- Iron ore prices
- Coal prices
- Dairy product prices
- Exchange rates
- Interest rates
- Share prices
- China's growth rate this year

Do not develop a set of business, investment, or personal consumption plans which are highly sensitive to forecasts proving wrong. In fact this is the sixth year in which we have explicitly written here that you would be foolish to develop an interest rate hedging strategy based strongly upon a particular set of interest rate forecasts coming right. Spread your risk with a range of fixed and floating rates.

Want a money-making idea? Buy Nespresso capsules in Australia and sell them here. I bought two containers of Roma for AUD13.60 at Robina on the Gold Coast. That equates to NZD 14.55 using a 93.5 cent exchange rate. I then bought the same containers at the bottom of Queen Street in Auckland for \$19.40. That is exactly 33% more than the Aussie cost. It would pay one to buy a few thousand containers whilst across the Tasman and flog them off back here for a simple arbitrage gain.

The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. 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 please sign up at www.tonyalexander.co.nz To change your address or unsubscribe please click the link at the bottom of your email. Tony.alexander@bnz.co.nz

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