Weekly Overview

27 February 2014

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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.

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2014's Themes Update

Let's have a quick run-through our catch-all list here and see if anything needs changing five weeks after we listed it.

- Interest rates will rise

No need for change there. The data remain strong and March 13 is when the tightening cycle is still expected to kick-off.

- The NZD will remain highish.

Yes, it still looks high, our economic data are good, commodity prices high, and no shocks have come along.

- The labour market will tighten, pushing employment costs up.

The Household Labour Force Survey was stronger than expected for the December quarter so things definitely are moving into a tight phase.

- House prices will rise with gains spreading out of ChCh and Auckland.

The January data for REINZ showed prices falling, but for now we shall put that down to normal volatility. Our BNZ-REINZ Residential Market Survey has shown improvements for all our measures and the return of a seller's market.

- Construction will boom

Definitely no change there. Consent numbers are rising and the anecdotes for Christchurch tell us activity is really, really, picking up.

- World growth will improve with unprecedented uncertainty regarding monetary policies.

Yes, but the data for China and Japan recently have been wobbly, a bout of the heeby geebies has run through emerging economies generally, and some US data have been weaker than expected. The question is whether bad weather may have simply distorted the numbers for a while. This view of an improving world is the one which has been shattered many times these past four years and if anything in this list is going to prove well off the mark it will be this factor.

- Business capital spending will grow

The data do no show it yet but investment intentions measures are strong. So nothing really has altered here.

- Household spending growth will accelerate.

Actually, although consumer confidence remains at a very high level the December quarter Retail Trade numbers were not all that impressive. So accelerating growth in consumer spending remains a forecast, an article of faith, but one we firmly stick with given what is happening in the labour market.

Off To London

I had to skip my six monthly visit to London late last year but will be back there again from March 28 to speak with a range of groups keenly interested in what is happening back in our lovely cow-resplendent, employment blooming, and construction-driven economy. It has been suggested to me that people over there are starting to accept the high level of the NZD against the Pound, are not thinking in terms of doing nothing until they see 33 pence again, and so are looking at shifting to or back to NZ and as data released last week show are boosting their holidaying here.

I am interested in getting a good feel for how readers in the UK or on the continent are seeing things on the ground over there. So if you want to explore the opportunity for us to catch up send me an email. tony.alexander@bnz.co.nz

One of the talks which I will be doing is for employment company Global Career Link http://www.globalcareerlink.com/ and another is for employment company Potentia http://www.potentia.co.nz/

We always get a great turnout for Global Career Link. For Potentia there is a specific focus on the IT sector and I've been asked to publicise their event here (April 2 evening, NZ House). If you are in IT and would like to attend then please make contact with Cristina at cristina@potentia.co.nz

Recent Learnings

I have been travelling fairly extensively around the country recently and can offer the following comments.

- Queenstown is very, very busy with lots of tourist and fantastic – hot – weather. There still appears to be an over-supply of apartments but house building is picking up firmly. Businesses are showing more interest in expanding.
- In Christchurch, as noted about three weeks ago, there are no hopes that the CBD will look "normal" for a huge number of years, residential construction is now rising very strongly, and builders and developers expect the residential rebuild will take a lot longer than people are thinking. Labour shortages are biting.
- In Rotorua forestry is doing very well as is tourism.
- In Napier the growing season has been good but farmers are unhappy because they are worried about sheep getting facial eczema and some grass is going uneaten. The region is felt to be lagging many other parts of the country but businesses are looking at expanding. Sentiment overall appears very good and as with every other part of the country there is a noticeable lack of open expression about the high level of the NZD. People appear to have got used to it in the past four and a half years. Interesting.
- In Wellington commercial property is improving with rising interest from offshore in property investment generally. Plenty of developments appear to be under consideration.
- In Auckland activity appears to be picking up quite well in more than just the housing market where there is some confusion about underlying strength but continuing rapid growth in construction.

Just a quick comment on the report on the manufacturing sector released this week by ManufacturingNZ. While calling for special industry assistance from taxpayers for R&D subsidies plus weakening of the Reserve Bank's low inflation target in favour of exchange rate management (Labour Party policy), they claimed that manufacturing makes up 14.6% of GDP. It does – but only if you include the basic processing of primary products.

Excluding the processing of meat, dairy, seafood, beverages and tobacco the manufacturing sector shrinks from around 14.6% of GDP to 6.6% of GDP. That makes it just bigger than the primary sector (excluding processing of those primary products. Members of that primary sector were this week hinting they might seek money from taxpayers to offset the effects of one of the inevitable variables involved now and then in running a farm - drought conditions. Retailers have been a bit quiet recently but they appear interested in boosting costs to consumers through rules enforcing payment of GST on imported goods. Many sectors of our economy are oligopolistic in nature and companies in those sectors have shown high willingness to use their pricing power which wage earners have not enjoyed recently due to weak economic conditions – electricity companies, building materials suppliers, supermarkets.

The principle of using pricing power when you have it and claiming special privilege to extract money from other Kiwis now and then is well established in New Zealand. The reason I mention this is that the balance of power in the employment relationship is shifting right now and conditions are moving toward employees being able to demand large wage increases after years of their cost of living rising yet little being received in income growth.

Employers need to think back to the 2005 – 07 period when the unemployment rate fell to 3.5%. Employees found that they would come in on a Monday morning and someone new had been hired earning 10% - 15% more than they were. The lesson was that in order to get a decent income boost which your employer was not willing to give you or you were not brave enough to ask for was to change employers. Business owners should expect quite a lift in staff churn over the next two years.

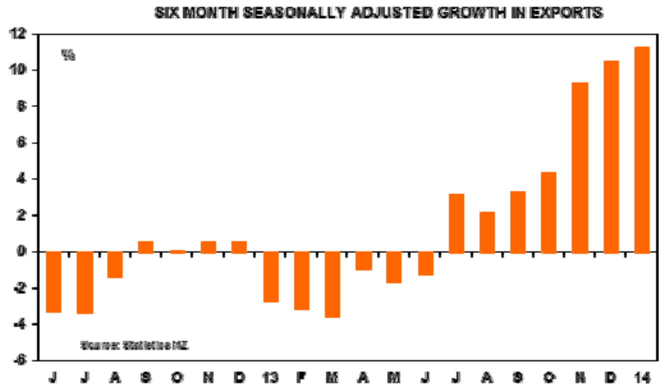
Businesses also need to think how decreasing staff availability will affect their ability to operate. For some the answer will be to seek higher profit through cutting output rather than paying an arm and a leg for lowly skilled, poorly motivated, uneducated staff once the unemployment rate heads toward 4%. Another part of the answer will be to raise prices 10% - 15% and see how customers react in a fast growing economy. If they stick around then do it again the following year.

This is why the Reserve Bank needs to raise interest rates. Fast growth in a poorly competitive economy such as ours will produce rising inflation. But as interest rates rise the question I want people to be asking themselves is this. How much economic activity will be curtailed by rising financing costs? The dairy income and investment boom? No. The rebuilding of Christchurch? No. The drive to catch-up on houses which should have been built in Auckland years ago to address a deepening social crisis? No. The central government drive to boost the quantity and quality of infrastructure around the country? No.

Watch your currently relaxed attitude toward how high borrowing costs go and your default assumptions that rates will start coming down in 2 -3 years and go back to these levels eventually. You're probably going to be wrong in all three of your assumptions/forecasts. Fix.

Exports Rising

New Zealand recorded a trade surplus in January of $306mn which was a huge change from a deficit of $294mn a year before and the highest January surplus on record. The result means that in the past year exports have risen by 6.8% while imports have risen by just 3.2%. In the month exports were ahead 22% from a year earlier and imports up by just 4%. While seasonally adjusted exports fell by 0.6% in January after declining by 2.8% in December, the underlying trend is upward as shown in the graph below which looks at six month changes. Where is the growth coming from?



In the three months to January exports of dairy products were ahead 54% from a year earlier (25% for the entire year), logs 25% (24% for the entire year), and 86% fruit (-1% for the year). Those are the big items which together accounted for 50% of all receipts in the three months to January and 40% for the year. Clearly some timing issues account for some of the recent surge, but not all of it.

What about things which the import data can tell us? Does it look like wholesalers expect consumer spending to surge? Not at all. The value of consumer goods imports in January was down 1% from a year earlier and for the three months to January the change was a rise of only 2% from a year before. What about imports of investment goods? Are they soaring yet? Not soaring, but there is growth. The value of machinery and plant imports in the three months to January was 8% ahead of a year earlier.

In seasonally adjusted terms imports of mechanical and electrical machinery and equipment fell 1.8% in the three months ending in January and were ahead just 4.2% from a year ago. One still cannot find solid evidence that an investment surge is underway. But the underlying trend is upward. That is the same comment we make for consumer spending based on retail trade measures.

Key offshore debates

United States – Growth lifting to 2.8% from 1.9% in 2013 but could interest rates jump as tapering proceeds?
China – Impact of non-performing loans following the 2009+ credit boom, ability to switch from export and fixed asset investment as growth-driving forces toward consumption, impact of loosening controls on outward capital flows.
Australia – ability of strengthening retailing and housing to offset the resource sector investment decline plus vulnerability to China shocks.
United Kingdom – Construction is picking up along with manufacturing, but worries exist regarding the 2017 referendum on EU membership, and the risk of premature policy tightening by the BOE.
Japan – Tension with China is growing as Japan breaks away from its post WW2 accepted pacifist shackles to confront its traditional regional competitor. Conflict appears probable with potentially severe economic consequences.
Eurozone – growth is picking up but will it be strong enough over the cycle to seriously dent entrenched unemployment, especially of youth? If not will the resulting social deterioration foster more radicalism?

There is greater than normal angst currently about the pace of growth in **China's** economy brought on partly by underlying worries about emerging economies taking a back seat to the developed world for a while, but substantially because of worries about bank bad debts. China insulated itself and helped the world's battle against the Great Depression scenario from 2009 by encouraging banks to lend as much as possible. The result was a surge in construction and infrastructure investment which helped Australia avoid recession. But much of the lending has been for non-viable projects and it is feared that eventually China's almost completely state-owned banks will have to reveal the true extent of their losses.

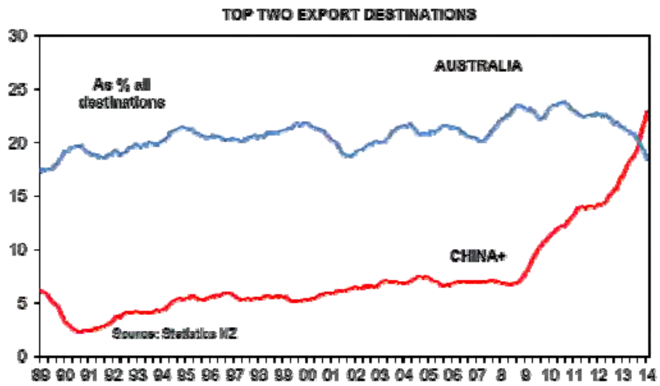
They probably will, but not before a bail-out package has been put in place as has happened roughly every ten years already. But while the markets wait for that to happen a lot of attention is on China's pace of growth with periods of optimism followed by pessimism then back again. This week pessimism reigns with the preliminary PMI gauge of the manufacturing sector released by HSBC coming in at a seven month low of 48.3 rather than the 49.5 expected.

Ironically, part of the problem for China is that although there was a surge in lending it was not to the private sector which remains largely starved of cash and dependent upon high cost financing from non-bank sources. Bad lending there may also be rather large but the key issue is that over the past decade the role of SOEs in the economy has increased and the private sector has become a smaller part of the economy. Hence we get another of the sources of concern about China's economy – insufficient funding of innovative, quick, private sector SMEs.

Worries about China deepened also this week when a couple of large property developers announced that they were discounting stock. And at the same time the Yuan fell reasonably sharply by its standards against the greenback in a move which traders are struggling to understand. The decline in the Yuan may have been engineered by the PBOC to try and burn off speculators continually betting on appreciation of the Yuan. Or it could be that the PBOC wishes to offset weakness in domestic activity by giving exporters an income lift. If so then that would represent a stepping back from plans to shift the driver of growth from exports and fixed asset investment toward consumption. Consumption growth may not be seen as likely to be sufficient to keep the economy's growth rate above 7% so reliance.

We received monthly trade data today so here is an update on our growing export and economic exposure to China's economy.

In the year to January the value of merchandise goods exports to China including Hong Kong was $11.2bn. This was a rise of 44.3% from a year earlier compared with a 0.8% fall in receipts from the rest of the world. China+ now accounts for 22.9% of all NZ export receipts, up from 16.9% a year ago and 7.1% back in October 2008 when the Free Trade Agreement came into effect.



China is our largest export destination followed by Australia – which ranked first until October – at 18.6%. Where might this end? Australia gets about 35% of its export receipts from China.

For which exports is China vastly important? China+ takes 27.7% of our primary sector exports and just 4.3% of our non-primary exports. Some 96.6% of all exports to China+ are primary products.

	% all	Year growth	Year before
Live animals	38%	-43%	31%
Dairy	37%	90%	16%
Seafood	33%	4%	4%
Meat	19%	93%	66%

These four account for 60% of export receipts from China+.

The Bank of England last week lifted their forecast for **United Kingdom** growth this year to a healthy 3.4%. But some data releases have been surprising on the downside, most notably retail sales which fell by a relatively large 1.5% in January. This still leaves the volume of sales 4.3% ahead of a year earlier so perhaps it was just the result of usual volatility plus weather effects which are distorting data also in the likes of the United States.

The Bank of **Japan** noted in meeting minutes released this week that they have no intention of backing away from their money printing policy for at least the next two weeks. In the absence of structural reforms to their economy the Japanese authorities are relying on yet another fiscal stimulus and sloshing as much money around as possible in the hope someone will borrow and spend it. One outcome is highly likely to be further depreciation of the Yen.

While the new PM and LDP have a Plan A for retaining power by pursuing Mr Abe's 'Three Arrows" policy of monetary and fiscal stimuli plus deregulation, the unannounced Plan B (nationalism) got a boost this week. Japan's Chief Cabinet Secretary this week announced that the 1993 Kono apology for the wartime use of women as sex slaves may be revised. He announced that evidence of the practice given by 16 women is to be re-examined.

The apology was an important gesture to countries from which the women came – mainly Korea but also China, Indonesia, the Philippines and Taiwan. The announcement, coming so soon after the visit by the Prime Minister on December 26 to the Yasukuni Shrine to Japan's war dead which includes some recognised war criminals, can only aggravate already deteriorating relations with China and South Korea in particular. The region is heating up. China for the first time ever sent a naval patrol to conduct exercises recently south of Indonesia.

The **Eurozone** PMI, like China's, came in lower than expected in February with a reading of 53 rather than the 54 of January which was expected to persist. The number is in growth territory and had it come in at 54 there would have been a reduction in expectations of further policy easing from the ECB, talk of improving labour markets, budget deficits, and debates about whether governments should pull back on their austerity programmes. But the failure of the Eurozone economy to display a reasonable head of steam right at the start of the year has injected new caution regarding the common forecast of growth at or above 1% this year following shrinkage of 0.4% last year.

IF I WERE A BORROWER WHAT WOULD I DO?

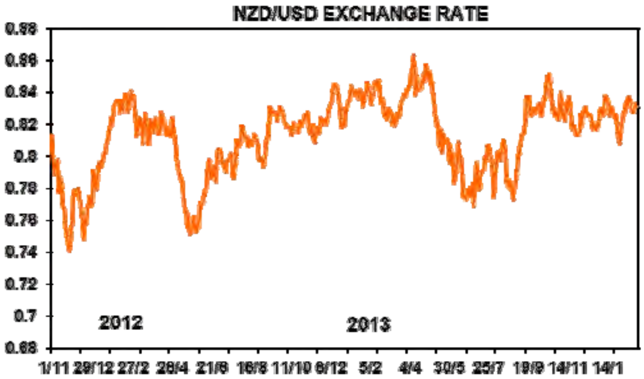
Longer term wholesale interest rates have pulled back slightly this week as some doubts grow about the speed of growth in the US economy this year. But the falls are not large enough to lead one to expect a round of cuts in bank fixed lending rates – especially not when lenders continue to focus their competition fight on short-term fixed rates and analysts are growing concerned about the profit impact of people shifting from floating to fixed. Banks earn lower margins on fixed rate loans than floating rate loans.

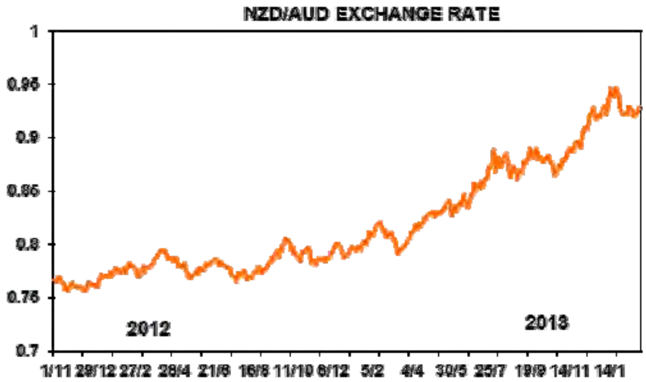
FINANCIAL MARKETS DATA

	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	2.50	4.9
90-day bank bill	2.98%	2.95	2.89	2.70	2.70	5.2
1 year swap	3.52%	3.53	3.53	3.22	2.81	5.3
3 year swap	4.17%	4.18	4.18	4.11	3.18	5.5
5 year swap	4.56%	4.59	4.61	4.58	3.52	5.7
7 year swap	4.85%	4.88	4.90	4.91	3.76	5.8

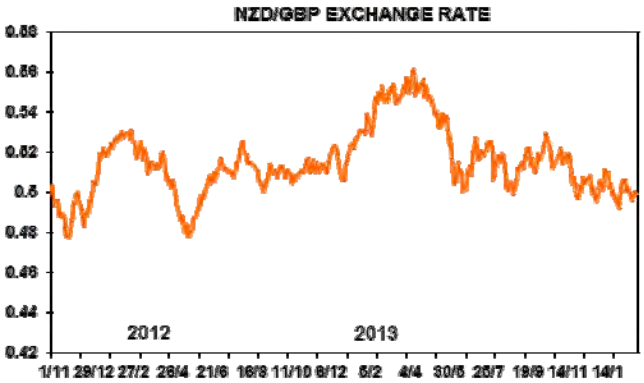
NZD Well Supported

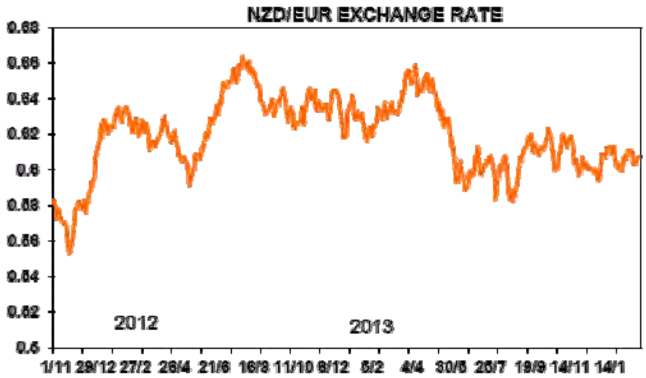
The Kiwi dollar has risen slightly on all its crosses this week but remains well within recent trading ranges. No earth-shattering news relevant to FX rates has appeared over the past week though there is a lot of attention on US economic data which is swinging from positive to negative and back again with questions as to how much of a depressing effect recently very bad weather has had. Confusion in other words.



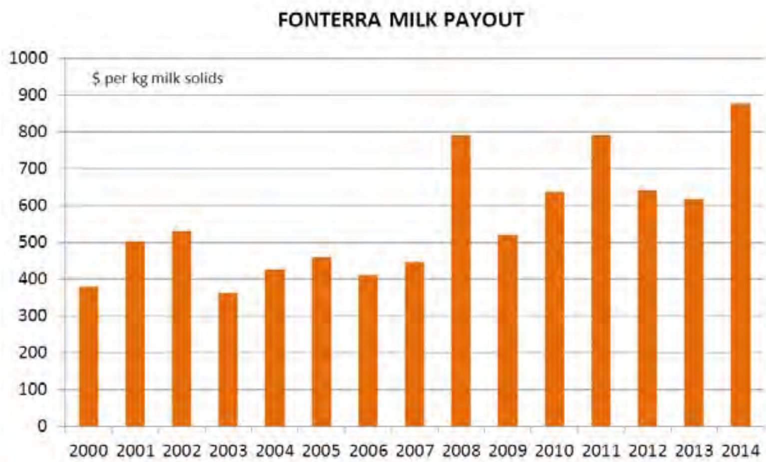


Confusion also exists regarding the immediate pace of growth in China's economy with some data coming in weaker than expected (not exports though), but the PBOC facilitating some unusual weakness in the Yuan for reasons unclear.





Through all of this we received one piece of news this morning which helps explain why the NZD is high and why it is likely to stay very high for a long period of time. Fonterra announced yet another increase in their forecast payout for this season, this time a rise of 35 cents to $8.75 in total including a token dividend of 10 cents. Last season's payout was $6.16 all up and this season's extra income including from higher production amounts to $5.6bn or 2.6% of GDP. That is a huge boost to economic activity on top of surging residential construction and a migration turnaround.



Exchange Rates	This Week	Week ago	4 wks ago	3 Mths ago	Yr ago	10 yr Average
NZD/USD	0.832	0.828	0.824	0.819	0.826	0.726
NZD/AUD	0.931	0.92	0.946	0.896	0.806	0.839
NZD/JPY	85.2	84.8	84.4	82.9	75.9	72
NZD/GBP	0.499	0.496	0.499	0.506	0.546	0.423
NZD/EUR	0.608	0.603	0.602	0.604	0.632	0.545
NZDCNY	5.10	5.03	4.98	4.99	5.15	5.1
USD/JPY	102.40	102.42	102.43	101.22	91.89	99.3
GBP/USD	1.67	1.67	1.65	1.62	1.51	1.72
EUR/USD	1.37	1.37	1.37	1.36	1.31	1.33
AUD/USD	0.89	0.90	0.87	0.91	1.02	0.87
USD/RMB	6.1244	6.0764	6.0484	6.0919	6.2296	7.15

For more detailed FX analysis including the ‘BNZ Markets Outlook”, “BNZ Strategist” “BNZ Commodities Wrap” and lots more go here. https://research.bnz.co.nz/Research/NewZealand/Pages/NZpublications.aspx

Housing Market Update

Additional analysis and commentary are available fortnightly in the NZ Property Press and monthly in the NZ Property Investor magazine.

Asian Buying, Accelerating Population Growth

The anecdotes continue regarding Asian buying of property in Auckland here is one example.

“Hi there Tony - thought I would give you some feedback on my experiences over the last two weeks in looking to purchase an entry level 3 bedroom property in Glenfield Auckland

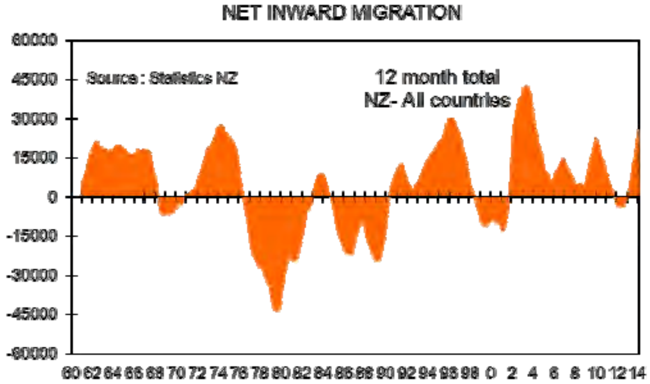
The first auction we attended (100 sm 3 bedroom one bathroom small garage on 600sm site - 32 years old close to Glenfield Mall) - July 2011 CV $435K . Mix of buyers approximately 30/70 Kiwi/Asian. Expectations of Agent $540K - end bidders were 3 Asians with the winner at $620K on the phone to his client in China who not only hadn’t seen the property but has never been here before. Price Paid 42% above 2011CV

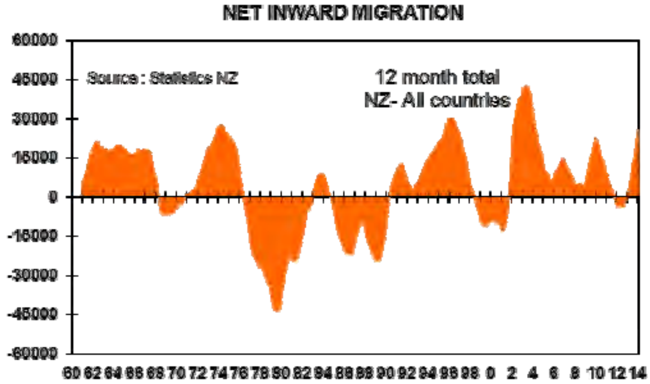
Two other Auctions attended (Glenfield) were similar stories with a two bedroom house in Glenfield selling for $575K - 35% above 2011CV and a very small (80SM) three bedroom house selling for $585K 42% above 2011CV - both purchasers were Asian (very little English if any) - the Kiwis there had little involvement in proceedings although we were in the early mix for two of the three

Probably the most startling observation was another Glenfield open home last evening attended by my wife and son where up to 50 punters were present in the 20 minutes or so they were there - all were Asian - only other white Kiwis were two of the three Agents

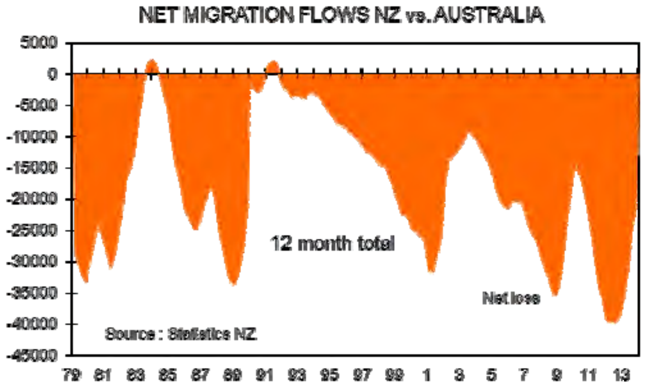
Not sure if this reflects a sea change here (the huge number of Asians looking to purchase) as we have only been in the market for 3 weeks or so (since mid-2012) but interesting to note this area is well outside the top school zones on the Shore”

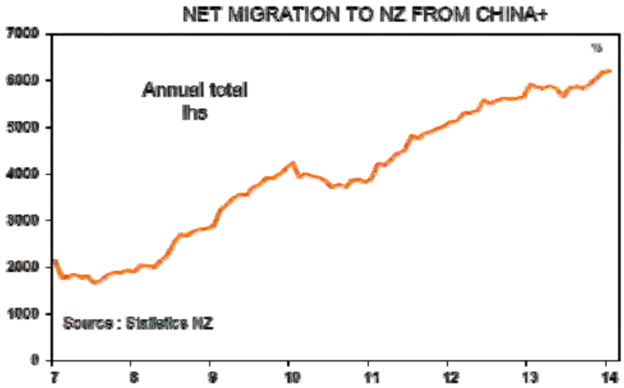
During the month of January there was a net gain to New Zealand’s population from permanent and long-term migration flows of 3,873. This was massively up from just 675 in January 2013 and means that the annual net migration flow has now soared to 25,666 from just 12 in the year to January 2013 and a loss of 3,134 a year before that. If we annualise the seasonally adjusted flows over the past three months then you can say we are running at an annual pace of about 35,000. That is probably where we will finish this year roughly.





Why the massive turnaround of near 26,000 in the past year? Almost 21,000 of it is due to a sharp fall in the net loss across the ditch to 17,084 from 37,936. Net migration from China including Hong Kong has risen by just 268 people over the past year to reach 6,193.





More people means more support for retail spending, demand for telecommunications and financial services, plus of course more need for accommodation. Is it any wonder that investors (offshore and onshore) are buying, especially considering that the Reserve Bank has helped the transfer of NZ property ownership to investors and offshore by placing a big deposit roadblock in the front of the new generation of Kiwi buyers coming through looking to keep their roots here. Something very much seems wrong here.

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Tony.alexander@bnz.co.nz 04 474-6744, 029 609-8960