Richard J. Power

Richard J. Power B.Ag. Com., B.Com., C.A., N.Z.I.P.I.M.

CHARTERED ACCOUNTANTS

8 Memorial Avenue, Christchurch 8053
P.O. Box 2592
Christchurch 8140, New Zealand
Telephone (03) 379-4109
Mobile (027) 417 9832
Fax (03) 379-4192
Email: richard@rpower.co.nz

15 December 2015

Dear All

Newsletter December 2015

The last time I wrote to you was on the 8 July 2015.

In that publication I summarised Tony Alexander, Chief Economist of the Bank of New Zealand, observations and projections.

The following material covers the period 9 July 2015 to 12 December 2015.

I have only selected material that I believe is insightful, or explains a concept or an event that I believe, and hopefully you do too, is worthwhile understanding.

Because we all receive so much material to read today, I have below indexed the enclosed. You may just want to refer to an issue that you are interested in.

I recommend points **2, 3, 5, 6, 8, 11, 12, 13** and **14.**

Sporadic 13 – 8 July 2015

Reasons behind the failure of the New Zealand economy to perform as well as might otherwise be the case.

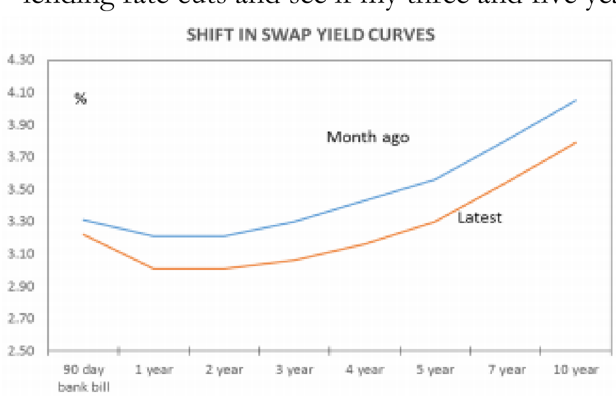
I mention this research because former Prime Minister and now Administrator of the United Nations Development Programme Helen Clark, gave essentially the same answer at the end of a session speaking with a group of us last week in Auckland. She noted the lack of attendance by any Kiwi businesspeople at an important global business gathering and how this reflected upon the determination of our businesspeople to succeed on the world stage. She also noted the big problem of Kiwi businesses selling up rather than growing bigger, the lack of plans within business-owning families for succession from one generation to another, and the need to keep talented young people in New Zealand.

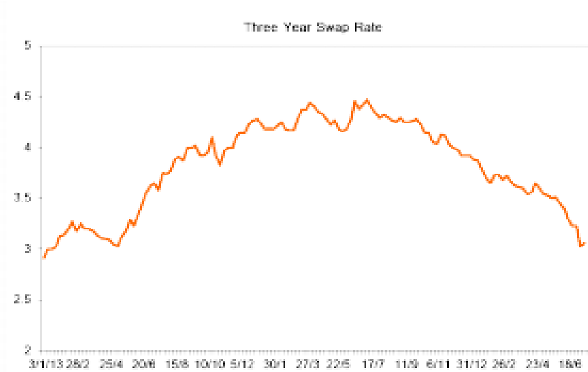
It is true and good for us that the centre of global economic activity is moving closer to us, Asia. But that means it is becoming easier for our talented young people to leave. Leaving previously meant an OE or Australia. Now many nations beckon us traditionals, the Asian young who have studied here, and their offspring who have been born since Asian immigration grew strongly after 1988 (my point). The risk is, Ms Clark noted, that we are seen simply as a nice place to raise a family and not much more. We rate very highly in quality of life surveys.

Sporadic 14 – 12 July 2015

If I Were a Borrower What Would I Do?

Swap rates, the base cost to us banks of borrowing at fixed rates to lend to you at fixed rates, have fallen substantially since Sporadic 13 in response to a wave of global growth worries caused by the situations in Greece and China. I would watch for another round of bank lending rate cuts and see if my three and five year targets of 5% and 5.5% might be reached.





Sporadic 15 – 23 July 2015

Here is a reminder about the importance of China to New Zealand's economy.

- Spending by Chinese visitors to New Zealand in the year to March rose by 61% from a year earlier to reach $1.2bn or 14.6% of all the $8.2bn of foreign visitor spending.
- Chinese account for about 28% of foreign students in New Zealand so contribute around $800mn to our economy.
- Exports of merchandise goods to China including Hong Kong SAR in the year to May added up to$9bn or 18.5% of all goods exports.

BNZ Confidence Survey – 6 August 2015

Dairy vs. The Rest

Welcome back to the results of our (resurrected) BNZ Confidence Survey. Clearly people had something they wanted to say because we received 778 industry comments at final cut-off time this morning while the average number from 2006 to 2014 was 266. The previous peak was 642 in March 2009 when we were all being badly affected by the Global Financial Crisis.

We have dropped the previous opening question regarding whether people feel that the outlook for the economy is getting better or worse. There are already plenty of such measures out there and they have fallen quite strongly in recent months. But here is the interesting thing which we glean from this month's results. Industry comments outside of dairying do not present a picture of an economy turning strongly downward.

There is certainly strong opinion on the ground in Christchurch that house building has peaked and potential over-supply beckons, while Christchurch commercial property is showing some weakness. And in the dairy sector people are struggling for adjectives to describe their woe. Our results came in almost entirely before the latest dairy auction result. But non-dairy export sectors look firm, practically all commentary about Auckland indicates strong economic activity, while Auckland housing strength is spreading solidly to some other locations. The lower NZ dollar has been greeted positively in many quarters. Few respondents mention interest rates. Skilled labour remains hard to find in numerous industries.

With regard to specific sectors the following broad comments can be made.

Accountancy
Accountants overwhelmingly report that clients are doing well and there is high demand for advisory services. Christchurch-based respondents identify some weakening in client activity recently, and at the margin some accountants more generally are seeing client accounts slightly worsen. Some farming clients weakening.

Advertising and Marketing
Bar one response all others seem on the weak side. Some farming clients weakening.

Business Consultancy and Services
A very diverse grouping of advisors, researchers, and business brokers. Quite positive comments noting strong client interest in learning more. "Lots of clients making investment and development decisions." And "Strong interest in better performance and international competitiveness firmly on the agenda". Results are consistent with accountants noting demand for advice.

Civil Construction/Infrastructure
Civil engineering comments are very positive, but some suggestion that a few projects may be getting deferred at the moment.

Construction
House building has peaked in Christchurch and there is open speculation of oversupply. But house construction is seen as very strong and rising in Auckland, Hamilton and Tauranga. In Christchurch non-residential construction however is picking up. Skilled labour is in short supply and things are expected to get worse.

Construction Related
This is a diverse grouping of construction-affected businesses. Comments coalesce around strong activity up north, weakening down south. Some good regional insights are provided which generally other sections in our don't deliver.

Education
International education is very strong. Tertiary education is seen as tough – which is what the comments almost always are for this sector.

Energy
Oil and gas extremely weak on the back of low global oil prices and cutbacks in exploration. Retail energy demand however is seen as good.

Engineering
Evidence of the lower NZ dollar starting to boost activity, helping offset dairy-related weakness. Finding staff is quite difficult. Slowing in Christchurch – boom over.

Farming
Dairy sector comments are astoundingly negative – except in one instance – the company focusing on value-added rather than bulk milk production. They are very optimistic. Wariness regarding potential El Nino weather pattern with some soils already dry. The beef sector is looking strong, sheepmeat could be better but not all that bad. Honey and venison good.

Farm Servicing
Weakness already evident in sales of tractors, farm bikes, farm machinery. Capital spending is falling away rapidly, but there are seen to be some people waiting in the wings to buy properties.

Financial Services
A very mixed bunch of comments including investors looking desperately for yield, home lending being busy (pick-up in the regions) but with demanding clients seeking discounts, some easing in business demand for financing of investments as confidence declines. Some anticipation of home credit demand easing soon in Auckland.

Forestry
Very weak at the moment but quite a few respondents optimistic of things improving soon, especially with the fall in the exchange rate.

Health
A very diverse range of comments have been captured in this section so summarising things is difficult. Positives include the lower NZD boosting exports, aging population boosting demand. Not too many negative comments.

Horticulture
A clear bright spot amongst the sectors and quite a contrast to dairying. Good comments regarding pipfruit, Kiwifruit, avocadoes, Happiness about the lower NZD.

Hospitality
Nothing too major but evidence of the Taranaki region's weakness affecting businesses.

ICT – Information Communications Technology
A more mixed set of comments than seen before for this category. Some respondents are doing very well while others see a lot of weakness around them.

Insurance
Nothing strong coming through. Some comments regarding rates easing off slightly.

Legal
All operators appear to be reasonably busy. Staff shortages continue.

Manufacturing
Some operators are doing very well. Only a few comments regarding benefits from the lower exchange rate. Construction supplying firms still looking okay, wariness regarding dairy sector activity however.

Media
The sector appears to be tough going at the moment except for one online information provider. A sign of the changes underway in the media sector probably.

Printing and Packaging
Lower NZD is raising costs, Australia still a bit tough though. Pullback in demand related to farming.

Property Development
Booming. The exact opposite of dairying. Auckland the strongest but some positive Wellington comments also.

Property Management/Investment
Strong investor and tenant demand in Auckland and Wellington, weak in Invercargill, weakening in Christchurch.

Property – Non-residential/Commercial
Mainly positive comments regarding rising rents, strong tenant demand, but as has been the case for some time Christchurch appears challenging and not for the faint-hearted.

Recruitment
The sector seems in good health but has produced far more positive comments in the past. Some caution appears to be creeping in even though candidate supply and suitability still seem constrained at the upper levels.

Residential Real Estate
Auckland is described as having crazy demand – but also some decrease in attendance at Open Homes, less obvious presence of Asian buyers, and seemingly a slight easing in price pressure with eyes toward the October 1 rule changes. Christchurch is getting sluggish. Hamilton and Tauranga are very strong, Hawkes Bay strengthening, Wellington improving, Rotorua active. Basically what has happened in previous cycles is well underway – buyers looking outside of Auckland following an Auckland boom.

Retail
Comments highly mixed but overall cautious with some respondents noting a recent weakening. Some wariness about how consumers will react to prices having to be raised because of the weaker currency.

Tourism
Not as positive as one might expect based upon the falling exchange rate and surge in visitor numbers and spending in the year to March. Some wariness about business travel as NZ growth slows.

Transport and Storage
Winter is the usual quiet time. Auckland seems fine, but in the regions activity is being negatively affected by the dairy downturn. Overall comments are on the weakish side.

Vehicles
Activity levels appear to have eased slightly recently but no-one is overly despondent and plenty of respondents expect things to improve soon.

Wine
Basically in a good state. Strong positivism though no boom as one would write for property development for instance.

BNZ Confidence Survey Results – September 2015

Other surveys show businesses in New Zealand to be very down in the mouth – which is perhaps not surprising considering the decline in our previous rock star sector – dairy – and the worries being expressed about our previous rock star export destination – China. But unlike countries where things which are exported are usually made from many smaller things which have been imported, the fall in our currency is providing a clear net boost to many export sectors. Tourism particularly is being turbocharged, but operators are also happy about the lower currency and noting improving sales in manufacturing, education, wine, Kiwifruit, advertising, business consultancy, retailing and packaging. Growth in our economy is slowing and interest rates will be cut again. But balancing factors are already in play so a recession scenario remains of very low probability.

No Sign of Panic, Lower NZD Welcomed

There is no obvious sign of a new deterioration in how businesses are seeing their current operating environment revealed in our monthly BNZ Confidence Survey. In fact although a number of respondents mentioned concerns about developments overseas and dairying remains very weak, far more people noted how the weaker NZ dollar is benefitting their business. These latter comments covered tourism, manufacturing, education, wine, Kiwifruit, advertising, business consultancy, retailing and packaging.

On the housing front there are a few more comments regarding Auckland easing slightly off the boil though remaining fundamentally strong. And movement of buyers to the regions continues apace.

With regard to specific sectors the following broad comments can be made.

Accountancy
Things going steady by and large but at the margin it is clear that a few accountants are starting to see client numbers deteriorating.

Advertising and Marketing
A dominance of comments saying things are quiet.

Business Consultancy and Services
Responses largely positive. No strong signs of clients slashing spending to focus only on short-term cash flows.

Civil Construction/Infrastructure
Positive comments overall, Auckland strong.

Construction
Overall activity may have peaked in many places but the volume of work remains strong.

Education
Good comments regarding the international student market, not so positive on domestic numbers.

Energy
Oil and gas very weak.

Engineering

Positive comments on work expected as a result of the lower NZ dollar. Volumes of work strong overall.

Farming
Dairy comments overwhelmingly negative again – unsurprisingly given the fall in the projected payout. Beef good.

Forestry
Export not strong but domestically still okay. Mixed comments on investment in the sector.

Horticulture
Kiwifruit in a very good state.

ICT – Information Communications Technology
More negative comments than for some time in this sector with redundancies noted in telecommunications.

Legal
Busy as ever it seems. Not that I am suggesting it is great for the economy that the lawyers are busy.

Manufacturing
Mixed as ever but with an interestingly high number of positive comments regarding the fall in the NZ dollar.

Printing and Packaging
Some growth but not really signalling anything much.

Property Development
Very strong but it is location-focussed.

Property Management/Investment
Obvious upward pressure on rents.

Property – Non-residential/Commercial
Generally falling yields. Nowhere near enough responses to say anything much, especially about any particular location.

Recruitment
Busy, with good candidates hard to find.

Residential Real Estate
Wellington short of stock with prices rising and buyers increasingly apparent. Auckland slightly coming off the boil with a little caution kicking in, though price pressure remains upward and listings hard to get. Positive comments regarding markets in Hamilton, Northland, Tauranga, Hawkes Bay, Whakatane.

Retail
Steady to slightly less than steady. Mixed as ever of course.

Tourism
Positive overall though maybe not as much in Marlborough.

Vehicles
If the economy were tanking then we would expect one of the first sectors to feel the pain to be vehicle sales. This is not happening.

Sporadic 19 – 10 September 2015

The Reserve Bank this morning cut its official cash rate by .25%. So it now sits at 2.75%.

Repeatedly here in NZ and offshore things have not turned out as all of us forecasters have been expecting. It is not just that our growth predictions have been too high, and that on the basis of that our employment forecasts have been too optimistic. It is that even with good jobs growth wages growth has failed to accelerate. And businesses have tended not to use stronger sales growth to boost selling prices.

Why are Forecasts Proving Wrong

There are many reasons and the **first** and most obvious one is that the period leading up to the GFC of 2008-09 proved we do not at all well understand the linkages between financial flows, the finance sector, and real economic activity. Finance globally moves far more quickly into various assets these days than before, and using asset prices as a gauge for what market participants consider to be the true worth of something is not valid in many cases.

Second, our behaviour as economic individuals has changed post-GFC. We are more sensitive to price changes than before and will more willingly back out of a purchase if prices rise, looking for the same or a similar good or service online, offshore, or via price comparison apps. Businesses do not have the same pricing power as in the past and have to think twice before putting up a price.

Third, as employees we have changed. Our willingness to ask for a wage rise has declined as we see continuing news about high unemployment overseas, economic shocks and turbulence. We are unwilling to have the boss call our bluff and be forced to leave to risk being last-on, first-off elsewhere in the event of an economic downturn.

Four, we are more sensitive to our debt levels than before and this not only reduces our willingness to borrow at low interest rates, it also makes us less willing to run the risk of periods of no wage income – thus feeding back into the point just above.

Five, and this is a key problem in the United States and more so in Europe, businesses are far less willing to undertake capital expenditure than before. This has the very bad effect of reducing long term productivity growth and is a key factor behind reductions in assumptions about where economic growth rates will average in the future. But it also means less short-term growth and again more so offshore than here, less willingness to boost payroll numbers.

Six, governments are aware of their high debt levels and the need to rebuild the fiscal buffer for when the next national and/or global economic crisis comes along – and one always does at least once a decade. Thus as growth strengthens in an economy businesses know the pace will not lift all that much above the norm because fiscal policy will be tightened (and interest rates will be raised).

Seven, inflationary pressures are naturally being suppressed by a lot of excess capacity which has built up in many sectors across many countries, most notably the emerging economies and China in particular. To whatever extent a commodity super-cycle existed from 2008 it has now well and truly ended and there is a structural shift down in energy costs underway along with prices for most commodities stretching from coal, iron ore, aluminium, to milk.

Eight, technological developments and their application appear to be becoming more dominant influences in economies, usually with downward pressure on prices for goods and services produced by existing longstanding providers.

Nine, the GFC has revealed deep structural problems in many economies – notably in southern Europe – and every now and then the implications of those problems and the reluctance of the population to fix them butts up against the willingness of people to lend more money down the gurgler and a crisis erupts – usually involving Greece.

Ten, chickens are coming home to roost and sapping growth in a number of emerging economies which previously boomed on the back of either high oil prices or unsustainable fixed asset investment growth. Brazil, Russia, China. India has been no more or less corrupt than normal in recent years and it alone among the BRIC economies is escaping a big adjustment.

Eleven, for many years we have noted one of New Zealand's special characteristics which is that average gross emigration and immigration flows as a proportion of the population are perhaps the highest of all countries. On average each year we lose about 1.7% of the NZ population overseas and gain 2.0%. These flows can change quickly resulting in big fluctuations in the rate of growth in the NZ population, labour force, and housing requirements. Currently the record net migration gain of 60,000 people resulting from a 2.6% of population inflow and just 1.3% outflow is boosting housing demand while suppressing wages growth and generalised inflation pressures through boosting the size of the workforce. At some stage we will receive a shock from these flows reversing. Don't know when.

Twelve, related to the first point, it is not just that we do not understand linkages between the financial sector and real economic activity. Worse is that the world is awash with liquidity looking for a home courtesy of hefty money printing in the United States (now ended) and continuing printing in the Eurozone and Japan with no end date on the latter and probable extension beyond September 2016 of the former.

Thirteen, as long predicted we have now entered a period when Baby Boomers are retiring. The passage of this cohort of hundreds of millions from working life into retirement will have profound impacts upon consumer and asset markets, but in ways which are difficult to predict. For instance do retirees sell investment property to free up cash, or buy more to fund a longer retirement than earlier anticipated, especially with bank deposit returns now so low?

Fourteen, increasing globalisation of markets for goods, services, capital and labour mean shocks in individual economies are more quickly transmitted with greater impact to other economies than in the past.

Sporadic 20 – 23 September 2015

Why has growth slowed down and why do we see the annual pace slipping below 2% next year? There are the pluses which we have highlighted here many times of the lower NZ dollar and reversal of monetary policy tightening, along with good performances in most non-dairy export sectors, strong construction and the boost from above average population growth. However the story for 2015 is mainly one of negatives appearing and that is what we should be paying most attention to for the remainder of this year.

So let's run through some of the things occupying the minds of many people currently, starting with the United States. Growth in the US is okay with good growth in employment in particular with full-time job numbers regaining their pre-GFC peak (we are ahead 6%). But there is no evidence of an acceleration in the pace of wages growth, the sharemarket is well off its peaks with some obvious continuing wobbles and worries about high valuations, businesses remain reluctant to invest, and the rising US dollar is sapping some export sector strength.

Encapsulating the more cautious mood regarding the US economy was the Federal Reserve last week which decided not to raise interest rates for the first time since 2006. Specifically the Fed. cited worries about the Chinese economy.

China is failing to make the desired transition from growth being driven by exports, investment, and house building to private consumption. In fact there seems little hope of this happening in the near future with worries about falling house prices amidst estimates of potentially 22 million empty apartments, huge
sharemarket wobbles and weakness, and absence of welfare, education, and health reforms which would encourage people to reduce their high savings rates.

It has become commonly accepted now that China's growth numbers are works of fiction and estimates go as low as just above 3.5% for growth rather than the reported 7%. Recession in China in the near future is unlikely. But the monthly numbers continue to get worse and it is likely that after five cuts in interest rates since late last year, extra infrastructure spending, and easing of housing sector constraints that there will be further stimulus measures announced. Risks for now however lie on the downside and more attention is on China's immediate growth prospects than prospects for any other country.

That includes Japan where growth numbers are also coming in weaker than expected, inflation is falling away again and analysts openly talk of money printing failing and the third arrow of Prime Minister Abe's economic policy – deregulation – not being big enough.

Perhaps the Brace Blossoms' rugby performance this week shows what the Japanese economy might be able to achieve if it opened itself to the presence of more foreigners.

In our second biggest export destination of Australia growth is commonly seen chugging along above 2% with good growth in non-mining sector investment offsetting the ending of mining investment associated with the commodity super cycle which has now ended and probably won't return for a generation. Dwelling construction is strong in Australia and businesses might have gained some hope that economic reform will be undertaken following the change in leadership of the governing party. However the new leadership's ability to get legislation through the Senate may be as poor as the previous top team so the chances of Australia boosting productivity, cutting its relatively high labour costs, and boosting output in the near future still do not seem all that high. (This is highly relevant for our migration flows – discussed below.)

But with the NZ dollar settling below 90 cents for now many NZ exporters can have a reasonable expectation of good sales of goods and services across the ditch in the coming year.

In Europe forecasts have actually been raised ever so slightly recently by the likes of the OECD. But still growth of only near 1.5% is expected and the opportunity afforded to governments by the sense of crisis surrounding the GFC to introduce deep economic reforms has been blown. The financial sector remains bogged down with insufficient levels of bank capital, banks retreating to focussing on their home countries, labour markets remain rigid, debt levels are still high and rising, and as is the case with most other parts of the planet the ability of the Eurozone to cushion the economy in the event of a shock – such as a Chinese recession – is minimal. Interest rates are already near zero and money printing since early this year has failed to drive growth or even inflation upward. There is now open speculation that the European Central Bank may extend money printing beyond the current planned end-date of September 2016.

Russia and Brazil are sinking into deeper recessions as the effects of corruption and plummeting energy export receipts wash their way through their economies. India is okay.

The world economy is growing at a slightly below average pace with downside risks which the IMF and World Bank are likely to highlight next month when they update their economic outlooks. We should keep an eye on developments offshore, and as noted, in China in particular.

On a positive note dairy prices on the Global Dairy Trade auction site have improved 48% in the past three auctions – which just goes to show that we cannot actually use the auction results in any strong way to gauge what the payout is likely to be for the season. There is too much volatility. But at least for the moment it is now looking like this season will have a marginally higher payout than last season. Dairying will nonetheless remain a drag on the economy this coming year through 2016.

Another drag, almost, is construction in Christchurch. The reconstruction period took longer to get started than we all thought, but it seems to have peaked earlier than we were all thinking. An over-supply of houses appears to have developed with part of that being a price mismatch between what earthquake-displaced people can afford and the new houses which have been built.

Up until recently we thought rising commercial building would more than offset the residential construction decline which is now underway and likely to persist for maybe three years. But the feedback coming out of the commercial sector is that construction costs are so high and so many businesses have either got comfortable outside the CBD or have already signed up to new premises in the inner ring outside the CBD that they are unwilling to pay the prices developers need in order to go ahead and get their projects rising from the earth. And with the infrastructure rebuild over 75% done probably the best we can expect is a plateau in Christchurch construction activity in the coming year. The risk however is that the city becomes a negative contributor to GDP – which is not a bad thing necessarily, it is just happening sooner than most of us were expecting, by around two years.

BNZ Confidence Survey Results – October 2015

Most Sectors Doing Okay

Our latest BNZ Confidence Survey has found that in most sectors respondents are seeing things as either steady or improving. Construction and engineering are strong, manufacturing doing well, farming is weak but dairy farmers are pulling back from the brink. The Auckland residential real estate market is cooling, but elsewhere things look firm.

With regard to specific sectors the following broad comments can be made.

Accountancy
Appears as steady as ever. No indication of any downturn.

Advertising and Marketing
Some restructuring pressures amongst the big players but customer demand appears good.

Construction
Overwhelmingly strong comments nationwide.

Education
Strong offshore demand to study in NZ.

Engineering
Very strong.

Farming
A pullback from the brink in dairying bringing some smiles, but no optimism of strong returns in the near future.

Forestry
Three comments, all positive.

Horticulture
Strong.

Legal
Firm, nothing really changing.

Manufacturing
All bar two comments indicate things good and/or getting better. A sector still going through a reasonably good period.

Property Management/Investment
Some evidence of willingness of investors to buy easing off for now.

Property – Non-residential/Commercial
Rents rising, but comments on conditions highly variable – probably reflecting regional factors.

Recruitment
Highly mixed comments. No firm evidence of any major easing in employee demand.

Residential Real Estate
In Auckland – far fewer people at Open Homes, auction clearance rates down, fewer Asian buyers in evidence. Outside Auckland strong.

Retail
Farm area spending down, but apart from that things look okay. It pays to remember however that this is a sector with many operators who can experience vastly different operating conditions even located right next to each other.

Tourism
The lower NZ dollar is definitely helping sales.

Weekly Overview – 5 November 2015

Credit Availability

Before financial deregulation of 1984-85 the risk associated with having a mortgage was getting one in the first place. Credit was rationed so you had to have a good relationship with your bank built up through having a good savings record stretching over a number of years. Deregulation changed that, credit availability boomed, but previously steadyish interest rates went on a grand roller coaster ride.

We are now heading back to the pre-1984 environment. Your interest rate risk is much lower than at any period since 1984. The world is facing deflationary rather than inflationary pressures. Central banks remain largely worried about their economies' growth prospects so they are keeping interest rates low and fear the unknown impact post-GFC of raising rates.

But while they keep rates low risks in asset markets are growing. They want to reduce these risks but can't use interest rates to do it. So they are experimenting with credit controls. They are returning to the pre-1984 era where your ability to access funds to do what you want is being tightened up. In New Zealand so far we have the loan to value ratio rules introduced in October 2013. We have the 30% minimum deposit for buying an Auckland investment property introduced last month.

This is just the start. If the Reserve Bank wants to slow not just the Auckland market but newly surging regional markets (they will let those markets have their head for a while), then they will tighten again – but not via interest rates.

Your challenge as a borrower going forward is shifting from managing your interest rate risk to getting the credit you want when you want it. So my question to you is this – how much effort are you putting into your relationship with your bank? At the moment we are trying our best to lend as much as possible to you. But in
coming years our discrimination between borrowers will grow. Get ready.

Weekly Overview – 26 November 2015

Migration and Tourism

A couple of very large numbers made their appearance this week. One came from the International Visitor Survey which showed a massive 38% rise in spending by visitors to New Zealand over the past year. The tourism sector is in very good health and this is one of the important offsets to weakness in the dairying sector which will keep overall economic growth up and discourage the Reserve Bank from contemplating rate cuts beyond probably one more 0.25% reduction.

The other number was the net migration gain of 62,477 people this past year. For Auckland the net gain was near 38,000 for which 12,700 extra houses are needed. But in the past year only 8,700 or so building consents have been issued. The Auckland shortage is still getting worse and that is why this current lull in the market as buyers look for bargains elsewhere is only temporary.

BNZ Confidence Survey Results – December 2015

Our last BNZ Confidence Survey for 2015 has produced a highly mixed range of responses neither consistent with weak economic growth or extra strong growth. Sentiment overall is positive but varies from strong in construction, property development, horticulture, business consultancy, engineering and tourism to okay in accounting, manufacturing, ICT, printing and packaging, hospitality, and retail to weak in dairying, and sheepmeat.

The two pages of responses in the residential real estate section easily reveal the two strong underlying trends in real estate currently – Auckland easing off and the regions rising strongly. Listings shortages are apparent near everywhere and uncertainty exists regarding whether the Auckland slowdown will prove temporary. Property developers report that costs are rising as the very strong construction sector runs into staffing shortages.

With regard to specific sectors the following broad comments can be made.

Accountancy
Reasonably good activity levels. No fresh sign of any general deterioration in business conditions though some elements of caution in places.

Business Consultancy and Services
Operators in this sector appear to be generally quite busy, which is a good sign of underlying strength in the economy and a forward-looking perspective.

Construction
Very high activity levels, expectations that this will continue, shortages of staff.

Engineering
Busy but with staff shortages.

Farming
Generally weak, especially dairy and sheepmeat. The lower currency is seen however as quite a positive factor.

Horticulture
Kiwifruit strong.

ICT – Information Communications Technology
Overall positive but with more negative comments than usually appear in this category.

Legal
Busy as ever.

Manufacturing
Positive overall.

Printing and Packaging
Neither looking strong nor weak. This sector can be a leading indicator of the economy overall and results tell us little change in the pace of economic growth lies immediately ahead.

Property Development
Activity in this category is particularly buoyant but there are growing concerns about rising costs and whether some planned developments actually go ahead.

Property Management/Investment
Generally rising rents but a few properties starting to take longer than usual to rent.

Property Valuation
Fewer requests for valuations in Auckland as activity cools. Strong elsewhere.

Recruitment
Very busy. Good people hard to find.

Residential Real Estate
The listings shortage has spread out of Auckland as have the buyers and the price action. Two pages of anecdotes basically backing up what the various data sources are now showing.

Retail
Tight margins and the tone of comments less positive than recent data have been. A sector still experiencing many challenges.

Tourism
Very strong foreign visitor flows but less so for Kiwi customers.

Weekly Overview – 10 December 2015

Sustained Low Interest Rates In Our Time

The main piece of news on the short-term economic front this week was the review of the official cash rate this morning by the Reserve Bank. Before discussing what they did, maybe one can ask the question whether it really matters if the cash rate falls another 0.25% or not. Borrowing costs facing most people in New Zealand are now the lowest they have ever seen. If you need rates lower than they were last week to stay in business or take out a mortgage then you are not in a sustainable/debt raiseable position.

Reacting to the low interest rates household debt growth is averaging 0.7% a month seasonally adjusted or near 8.5% annualised. That 8.5% easily exceeds income growth. Household spending is growing at a well above average pace as proxied roughly by the annualised rate of growth in the value of debit and credit card transactions. That growth rate is 9% compared with average growth for this measure of 5.6%. The housing market is also very firm in most parts of New Zealand.

Thus you can't run the argument that the household sector is depressed and needs lower interest rates. What about the business sector? Borrowing costs are irrelevant to the performance of the retailers falling over this past year – they are simply being out-competed by better operators and shoppers more able to make price comparisons than ever before. The construction sector and the huge number of service industries it drives is booming so no rate cut stimulus is needed there.

A net 15% of businesses in the latest ANZ Business Outlook survey say they intend boosting spending on capital goods which is above the average reading of 11%. A net 14% say they plan hiring more people which is above the average of 7%.

As mentioned previously, outside of dairying and sheepmeat most other exporters are doing well. These include the pipfruit industry, Kiwifruit, beef, education, wine, and tourism which is rising very strongly.

On the basis of the state of the NZ economy you cannot make a case for lower interest rates. But from the Reserve Bank's point of view, as long as they "seek to avoid unnecessary instability in output, interest rates, and the exchange rate" the pace of growth in the economy is only relevant to the extent that it influences the rate of inflation. And that is where things have come unstuck for our central bank since the GFC.

Inflation in New Zealand is only 0.4% - not the 1.6% rate the RB forecast it would be over a year ago. Inflation is not reaching levels we would have seen with our economy growing near 2.5% if this were the pre-GFC environment. But it isn't and for a wide range of reasons inflation here and overseas is staying very low. Worryingly low still in the case of the Eurozone and Japan where money printing continues unabated in an attempt to boost growth and price pressures.

Based on our inflation rate of just 0.4% the case is very strong for cutting the cash rate to 2.5%. But what if inflation is still low in a year's time while the economy grows 2.5%? Does the RB then cut to 1.5%? That seems ridiculous because of the extra stimulus which would be given to house price rises and household debt. Controlling that debt growth is why our central bank and others are introducing non-interest rate means of influencing household debt growth. These measures so far include the loan to value ratios and the 30% deposit requirement for buying an investment property in Auckland. There will be more, probably eventually the debt to income restrictions in place in the United Kingdom and Ireland, plus extension of the 30% deposit requirement outside of Auckland.

Changes in the official cash rate are no longer available to the Reserve Bank to use as the primary means of promoting stability in the financial system. They are increasingly reverting to direct credit controls. Changes in the OCR are also minimally effective in boosting inflation. As noted, this is a problem overseas as well and we are not unique. The way that well above average retail spending growth is not producing rapidly rising retail prices illustrates the impact of changed buyer attitudes post-GFC and the impact of technology allowing easy price comparisons.

As repeatedly noted this past year we should expect to see more rationalisation in the retailing sector as sellers adjust to the changed environment of consumer choice and buyer power.

As it turns out the Reserve Bank met the expectations of most forecasters this morning by cutting the cash rate 0.25%. The rate is now back to where it was taken during the full throes of the GFC in 2009, and where it was taken back to in 2011 when the 0.5% rise to 3% of 2010 proved premature in hindsight. It is very unlikely that they will cut the rate again. In fact the RB said they expect to get inflation back to the middle of the 1-3% target range with no further change in interest rates. That compares with six weeks ago when the RB said "...some further reduction in the OCR seems likely."

When will the rate go up? Don't bother asking. There is not a single forecaster any of us can point to and say they have got their predictions on interest rates generally right since 2007. We have all proven that as yet in the post-GFC environment we have not regained the ability to predict sustained interest rate changes. The chances are that low interest rates will be around for a large number of years.

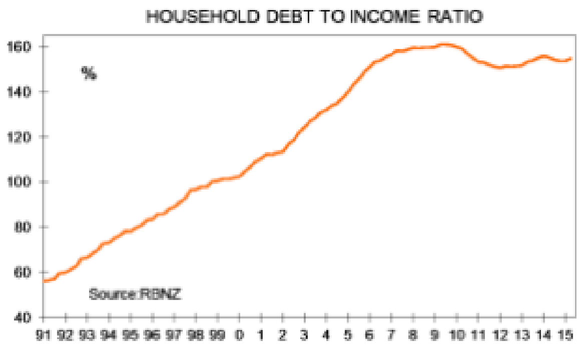
Housing

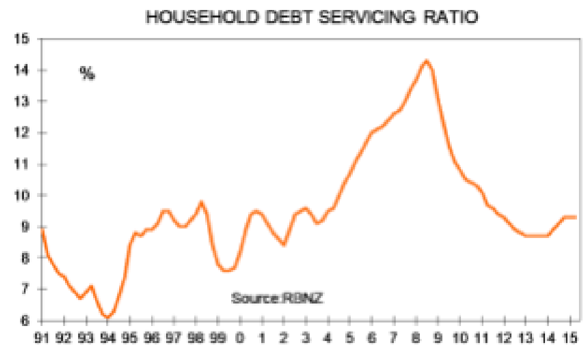
Here is a reminder of some of the key things going on in the wider NZ housing market.

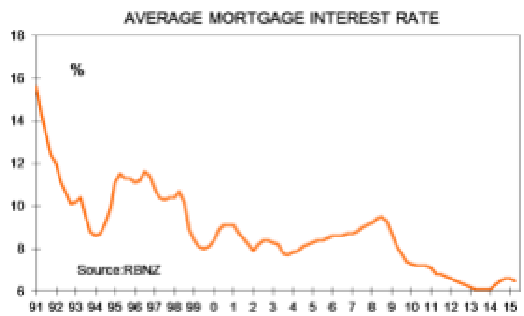
- There is a supply shortage at current prices in Auckland and not enough builders available to allow that shortage to be eradicated for perhaps a generation. Prices will rise further.
- Currently in Auckland we are in the part of the cycle where investors look at other centres for yield and smaller mortgages. This expected effect is being amplified by the 30% deposit requirement in Auckland, and Auckland being depressed a tad by Chinese buyers being less able to get funds out of China for the moment as the authorities undertake an anti-corruption drive and stem plummeting FX reserves.
- The stack of frustrated young buyers in Auckland is as large as ever and for the next few months they will face fewer competitors at auctions and a greater range of properties on offer. But they won't get any bargains.
- In the regions the first wave of Auckland buyers has probably already snapped up the low to midpriced places sitting unsold or on/off the market for the past three years.
- As regional markets get hotter more locals will join in the buying, sections will be increasingly snapped up, and house construction will rise in the regions. This will reduce further the quantity of builders able to boost construction in Auckland.
- Eventually when the economy next has a recession (no idea when) some regional investors will suffer most through unsold sections, empty spec. properties, and absence of the ongoing population growth which Auckland will enjoy.
- The Reserve Bank will continue to experiment with quantitative controls in the housing market. If Auckland booms anew they will take the 30% deposit requirement to 50%. If the regions get really ballistic they will get a 30% rule. Work will begin on introducing debt to income rules.
- The crisis in housing for lower socioeconomic groups in Auckland will become much worse than it is now.

Ratios

I saw a quote from an economist during the week that in NZ currently the ratio of mortgage interest costs to income is near record levels. Wrong. At the end of the June quarter according to RBNZ data the ratio of household debt to income was 154.9% which is quite high but down from 155.4% a year earlier. This is shown in the first graph below. The ratio of interest payments to income was 9.3% which was up from 8.9% a year ago. However as the second graph shows this is well below levels in many years in the past and this helps explain why house prices are so high. We borrow as much money as we can to get the best house we can. If interest rates are low we borrow more. Thus the structural decline in interest rates over the past quarter of a century accounts for a large part of the structural rise in house prices and explains why you should pay no attention to measures showing house prices overvalued when those measures are based upon the past era of higher interest rates – which is basically every year between financial deregulation in the mid-1980s and 2007. And remember – every single prediction of house prices falling because of poor affordability or high prices relative to incomes has been wrong these past three decades.





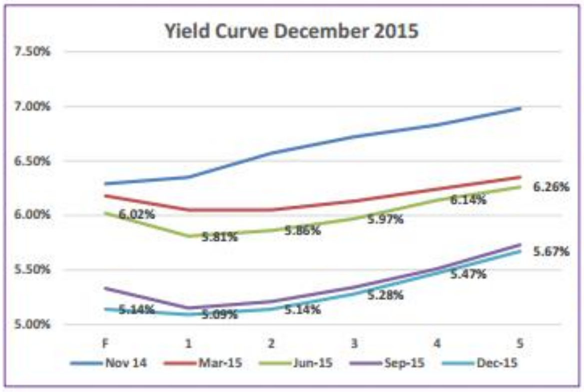


Interest Rates: Time to Fix Some? – 12 December 2015

- The Reserve Bank reduced the Official Cash Rate yesterday from 2.75% to 2.50%.
- The RB signalled that the OCR could be at this level for “some time”.
- Three-year fixed rates are only 10 points (0.1%) higher than floating rates and 5-year rates around 50 points (0.5%) higher.
- By contrast, strong economic data out of the USA suggests that the Federal Reserve will lift interest rates in an announcement next week, for the first time in 9 years.
- So while short-term rates look likely to stay low while the NZ economy is recovering, 3-5 year rates may start moving up by the first quarter of next year.
- The Reserve Bank has indicated that it expects short-term rates to remain “steady” for 18 months – 2 years.

Indicator Retail Rates

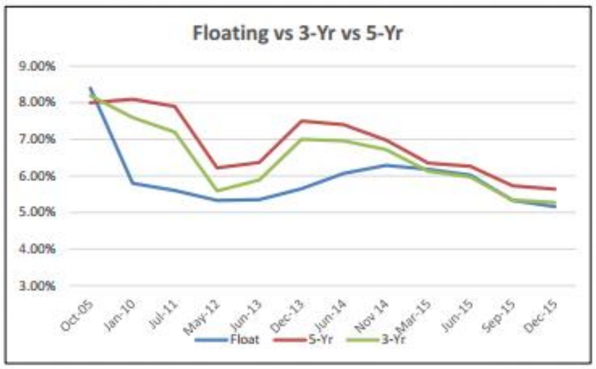
The following graph shows indicative retail rates for rural lending, representing an average of five main banks.



The blue line at the bottom of the graph indicates the spread of rates as at 11th December, i.e. average floating rate 5.14%, 3-year = 5.28% and 5-year 5.67%.

The rate that might apply to your account will depend on your particular business profile including security margin, debt-to-income ratio and interest-cover ratio.

Gap between Floating and Fixed Rates



The closest gap between floating and the 3- & 5-year fixed rates was in March of this year.

But at that time, the floating rate was 6.18% and the 5-year rate 6.35%, vs. 5.16% and 5.64% today.

What to Do?

It's now time to start fixing some of the portfolio, because these record low fixed rates are likely to start rising, and because the differential between floating and fixed is still relatively low, fixing some of the portfolio shouldn't have a large impact on the overall cost of funds.

- So maybe it's time to look at fixing a proportion of debt. If you already have a portion fixed, look at when it is due to come off fixed and perhaps look at fixing more now and allowing the already-fixed portion revert to floating to keep the mix right.
- Ultimately this decision will depend on the debt profile in your business and your own particular appetite for risk.

Yours sincerely

Richard J Power