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Dear All

Since the Global Financial Crisis in 2007/2008 the only consistency that appears to occur in the world is volatility.

Tony Alexander, Chief Economist at the Bank of New Zealand, is producing two publications during 2015.

The first is a monthly publication titled NZ Observer. This new publication is aimed squarely at small medium enterprises contemplating their likely operating environment over the short, medium and long term.

The second is a publication titled Sporadic. It is published any time Tony believes there is something important to comment on.

Back in May 2014 I spent a considerable amount of time reading various publications and talking to various bank economists and interest specialists.

With hindsight the general consensus of what interest rates were going to do for the next twelve months was completely wrong.

I have waited until now, to see if Tony's observations and projections since January 2015 are proving to be correct.

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 material. You may just want to refer to an issue that you are interested in.

<u>Comment made in November 2014</u>

Just to reinforce the idiocy of anyone thinking that economics can give you reliable forecasts of things post - GFC – no-one picked an over 30% collapse in oil prices at the same time as ISIS spreads through Syria and Iraq and Libya collapses. No-one picked an over 40% decline in Fonterra's payout this season. The sharp fall in Aussie's iron ore prices to five year lows has caught all companies out, many of which risk now going bankrupt. No-one picked the coming 60,000 NZ net migration inflow.

In this new world you must not develop a strategic plan highly dependent upon someone's forecasts proving correct. You need to emphasise flexibility in your hiring and remuneration practices, stocking levels, property leasing and so on. As an investor be wary of companies without such flexibility and perhaps with boards made up of staid individuals wedded to "The Plan".

<u>NZ Observer February 2015</u>

<u>What Lies Ahead?</u>

Our economy is experiencing at least six shocks, the effects of which we are just taking stabs at. These shocks are
- A near $7bn fall in dairy incomes this season.
- Drought
+ A migration boom
+ A 20% shock fall in petrol prices.
+ A sharp change in interest rate expectations – downward.
+ A renewed surge in Auckland house prices as the shortage we have noted for over half a decade goes further and further to the front minds of people. Plus lots of demographic changes are underway which we will write about somewhere else this issue or in a later one.

Being shocks we can only guess at their duration and what their effects will be. But in some cases such as investors searching for long-term yield they could be profound.

Here are the factors we expect to underpin growth over the next two years at least.

- Catch-up house construction in Auckland
- Catch-up infrastructure investment in Auckland
- Reconstruction in Christchurch
- Leaky building remediation, largely in Auckland
- Earthquake strengthening of buildings around the country
- Strong population growth courtesy of above average net migration inflows
- <u>The structural decline in interest rate expectations boosting investment, durables spending, debt tolerance.</u>
- The probable structural fall in petrol price expectations freeing up spending but curtailing investment in the energy sector – both oil and gas as well as green technologies.

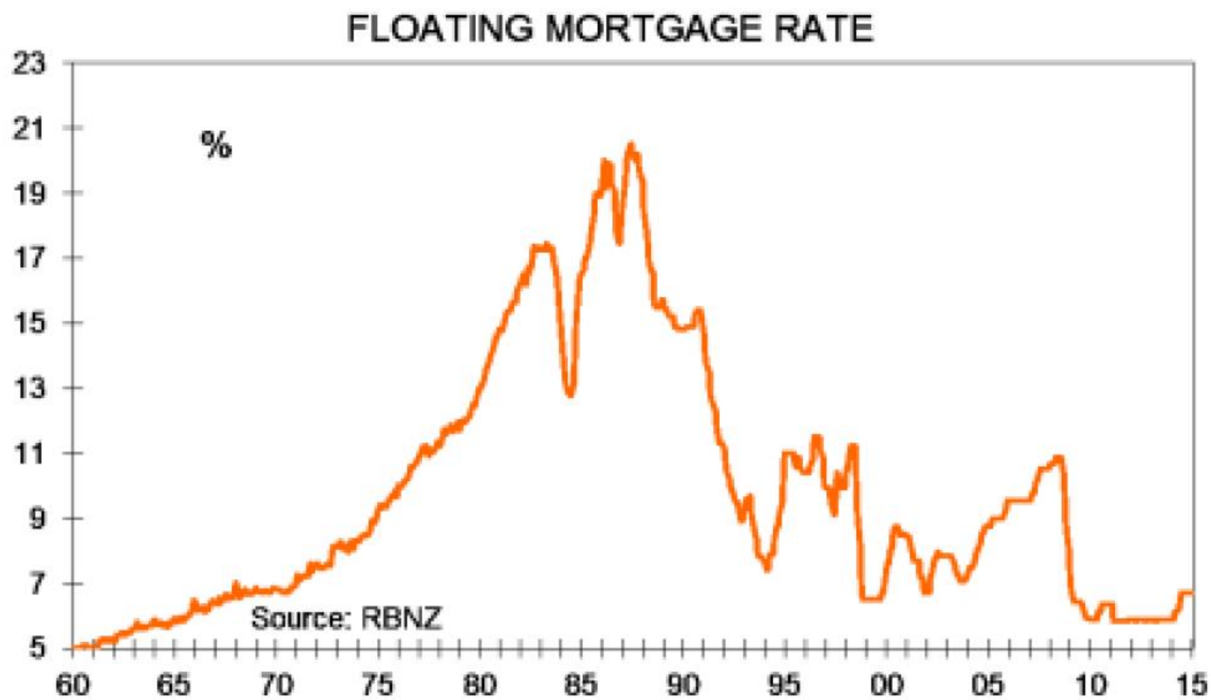
- Investment in farm irrigation schemes
- Continued dairy sector expansion though at a slower pace than before

These factors will act to restrain growth from getting much above 3.5%.

- A near $7bn fall in dairy incomes this season
- Drought in some parts of the country
- A firm NZ dollar against the currencies of Japan, Australia, and the Eurozone.
- Continued loan to value ratio restrictions and a high chance of further restrictions being imposed
- A continuation of the secular decline in the manufacturing sector
- Labour shortages – already apparent in a number of sectors

Borrowing Costs

Interest rates are low now largely because credit demand is weak.



Speaking of fixed interest rates – they have fallen in recent months which is 100% the opposite of what we all expected would happen. Take the three year fixed housing rate for instance as a gauge. It was 6.35% this time last year. It was 5.99% at the start of 2015 and is now 5.59%. Why the decline? Because bank borrowing costs have fallen in response to reductions in world growth forecasts and worries about global deflation. The benchmark United States ten year government bond yield for instance has fallen to near 2% from 2.85% a year ago and 2% at the end of last year. A couple of weeks ago the rate was below 1.7% but since then strong data on employment in particular have boosted expectations of US monetary policy tightening from the middle of this year.

NZ Observer March 2015

Borrowing Costs

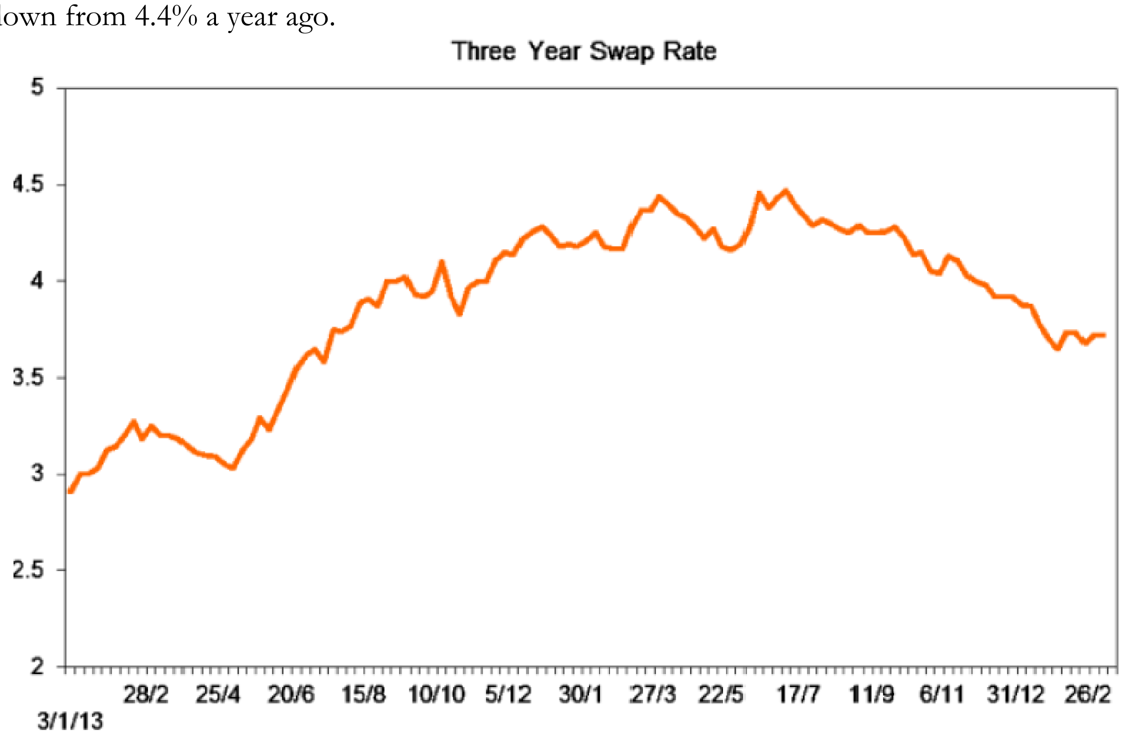
The key determinant of what you pay for your floating rate credit is the 90-day bank bill rate which reflects largely the current level of the Reserve Bank's official cash rate and where the markets think the cash rate will go in the coming year.

What about fixed rate borrowing costs? The key point you need to note about them is this. The longer the fixed term the less relevant the stance of monetary policy (official cash rate level) in New Zealand and the more relevant the expectations for monetary policy in the United States and the level of fixed rates over there.

In October last year the US Federal Reserve felt that the US economy was gaining enough momentum that they did not need to print any more money. So they stopped. They have since signalled that they are looking at when best to start taking away their extraordinarily low cash rate (funds rate) of 0% - 0.25%. The common pick is the middle of this year. But from week to week we see changes in this expectation and the most recent changes have been that tightening is more certain because the pace of employment growth in February was revealed to be quite robust, then that tightening is less certain because retail spending growth has been poor.

The key US ten year government bond yield has moved up to sit near 2.1% from about 2% a month ago and 1.8% two months ago. A year ago this rate was 2.8% and its fall helped push NZ fixed rate borrowing costs down against all our expectations last year.

The chances are that US monetary policy will be tightened mid-year and that the financial markets will price in further rises. That means further lifts in US fixed term borrowing costs and that means upward pressure developing on NZ fixed borrowing costs. If we take as our benchmark the three year swap rate which forms the base cost to banks of borrowing fixed rate money for lending three years fixed then we see that this rate sits currently near 3.7%, unchanged from a month ago, but down from 4.4% a year ago.



The interesting thing to note here is that our swap rate has not risen this past month in tandem with rising US rates. Why? Largely because of falling inflationary pressures in New Zealand with inflation at just 0.8% and expected to fall close to 0% when the next annual number comes out in the middle of April.

Eventually the expected rises in US rates will feed through here. That suggests that before the middle of this year we are likely to see something resembling a cyclical rise starting for fixed rate borrowing costs in New Zealand. Can we predict the speed with which our and therefore your fixed borrowing costs increase? Not at all. Apart from our forecasts of a 1% rise in the official cash rate last year essentially all other interest rate forecasts made here and overseas since 2007 have been wrong.

The message then is that for SMEs contemplating their debt costs, the incentive is to lock in some of one's core debt at a fixed rate before the middle of the year, but not all for one term. It is best to explicitly allow for the continuing low predictability of interest rates by taking a range of fixed rates from one out to perhaps five years.

NZ Observer April 2015

Why interest rates are higher for business owners compared to housing rates.

There are many reasons for this including

- the greater ease of registering and, in extremis, realising security for a housing loan versus a business loan,
- the greater ease of estimating worth of housing as loan security than business assets or cash flows,
- lower cost of drawing up and processing a home loan than a business loan,
- greater capital requirements imposed by the RBNZ for business than home loans, and
- the low default rate on home loans versus business loans.

To illustrate this latter point consider data from the RBNZ Financial Stability Report of November last year. In the year to September 2014 non-performing home loans (NPLS) amounted to just 0.4% of the total. For rural loans 1%, Commercial Property 1.4%, SMEs 1.6%, and Corporate 1.8%. In 2010 when the effects of the GFC were washing through these ratios were as shown in the second column below.

NPLS as % all

	2014	**2010**
Housing	0.4	1.2
Rural	1.0	3.9
Commercial Property	1.4	4.0
SMEs	1.6	2.7
Corporate	1.8	1.6

The outlier in this is not housing, but rural where strong competition for lending businesses produces rates which don't really seem commensurate with the risk – and maybe even more so going forward as rising dependence upon sales to China generates extra volatility in rural incomes because of China's often violent inventory cycles.

NZ Observer May 2015

What Has Changed?

Just briefly, every day we receive new information relevant to where the economy is likely to go, and this month we have decided to do a simple comparison of new information of importance in the past two or three months which will boost growth, against new information which suggests more caution is needed. On the **positive side** we have these recent changes.

1. Interest rate expectations have fallen. Not many forecasters now believe that the Reserve Bank will again raise interest rates this cycle and the markets are pricing in rate cuts in coming months. A lower interest rates outlook in a debtor country like NZ means improved confidence and improved willingness to spend.
2. Europe's growth has surprised on the positive side recently and although the Eurozone countries have major structural problems and long-term growth prospects do not look good, for now things look a tad better. This could however easily reverse when Greece defaults and probably leaves the Euro.
3. The Kiwi dollar has eased this past month assisted by the change in outlook for NZ interest rates along with lower dairy prices. This is a small positive for exporters.
4. Migration flows continue to surprise on the strong side. More people, more spending, more upward pressure on house prices and Aucklanders' perceived paper wealth.
5. Petrol prices have fallen and help explain why retail spending growth in other areas has been so strong over the December and March quarters.
6. Foreign visitor numbers have been surprising on the high side in recent months.
7. Consumer spending has strongly picked up with core retail sales up nearly 3% in the March quarter.

But on the **negative side** we have the following, and the first item needs to be monitored very closely.

1. Dairy prices have fallen 26% since the start of March in the Global Dairy Trade Auctions. Hopes of a decent rebound in prices later this year have decreased and forecasts for next season's pay out are being reduced. On top of that we have a forecast of El Nino coming back, plus huge uncertainty about how much European dairy production will rise now that production quotas have been removed, how much extra United States production will occur now that feed costs are falling courtesy of lower oil prices reducing demand for biofuel crops, and how much China slows. Russian import bans complicate things further. There is little chance that all these uncertain things move positively for New Zealand.
2. China's recent monthly economic numbers have been coming in weaker than expected and the People's Bank of China have now cut interest rates three times in the past six months. Housing restrictions have also been eased and the central government is making special efforts to assist local authorities resolve their debt issues. The chances are high that China will miss its 7% GDP growth target this year and this will tend to suppress prices for many commodities from iron ore to coal, dairy products, and meat.
3. The Reserve Bank from October 1 will require all investor mortgages in Auckland to have at least 30% deposits and nationwide all non-owner occupied houses sold within two years of purchase will now be assumed to have been bought for capital gain and tax will automatically apply. This is not a new tax but a change in the default assumption made about why a property was bought in the first place. These changes will apply some minor restraint to Auckland house price rises by discouraging the most over-geared inexperienced purchasers who have been

starting to feel they need to gear up in Auckland property to avoid feeling embarrassed a year from now should prices rise strongly again and they miss out.

4. In Taranaki there is evidence of the fall in oil prices leading to layoffs in the exploration and extraction sector along with engineering companies.
5. For each of the past three months the number of dwelling consents issued in Canterbury has been lower than a year earlier.

On balance the drift of risks appears to be toward the weaker side mainly because of slowing growth in China and the easing off of confidence about next season's incomes in the dairy sector. Hence the easing NZ dollar and decline in interest rate expectations.

NZ Observer June 2015

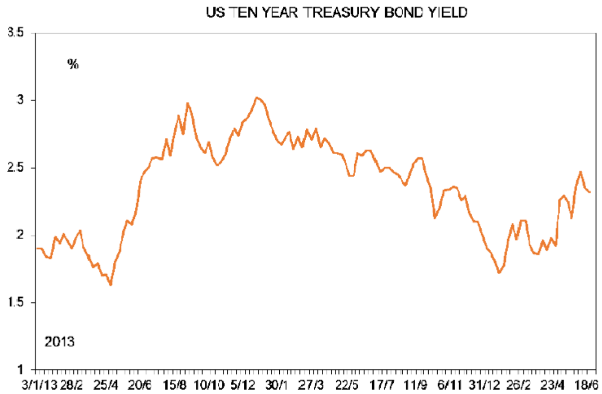
Borrowing Costs – Interest Rate Risk Management Strategy

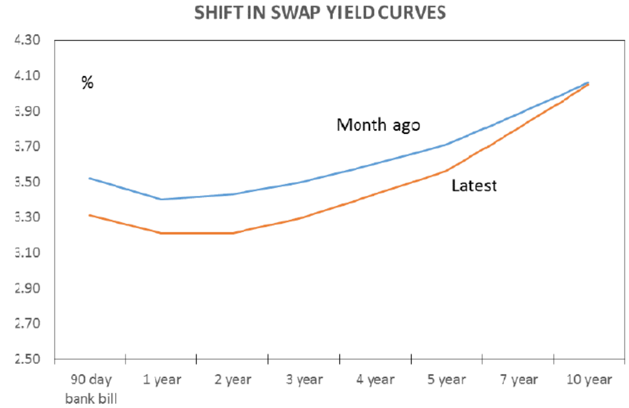
In Sporadic 9 issued on June 3 we looked at developments since the start of the year and concluded that the outlook for the New Zealand economy had got worse, substantially because of the continuing decline in global dairy prices and ongoing slowdown in China. The Reserve Bank looks to have done the same analysis, looked at the 0.1% inflation rate, and concluded that some and perhaps all of the 1% increase applied to the official cash rate between March and July of last year warrants being removed.

Therefore, for the second time following a post-GFC tightening they have embarked on a process of unwinding what they just did. The first time was in March 2011 when following some weak economic data and the second Canterbury earthquake they cut the cash rate from 3% back to the 2.5% the rate was taken to in early-2009. It had been lifted to 3% in mid-2010. On June 11 last week the RB cut the 3.5% cash rate to 3.25% and we expect a further cut to 3% at the next review on July 23. Cuts after that will, as the RB have noted, be dependent upon data.

Assuming that the RB have faith in their housing measures and if we see dairy prices falling further, then the full 1% increase in the cash rate could be gone by the end of the year though at this stage we thing just 0.5% worth of cuts is likely. Does this mean borrowers should simply float their debt and eschew fixing? Not necessarily. There are two key points to note as you consider your interest rate risk management strategy.

First, it is highly likely that monetary policy in the United States will be tightened before the end of the year. This will apply upward pressure on NZ fixed interest rates. In fact, with US tightening expectations lifting over the past 2 – 3 weeks we have seen the highly-watched ten year US government bond yield rise from 2.13% three weeks ago to near 2.35% now. And while the cash rate cut in NZ has helped push the NZ one year swap rate down to 3.21% from 3.4% and the three year rate from 3.5% to 3.3%, the five year rate has fallen only from 3.65% to 3.56%.





The yield curve is steepening and there is more to come. Thus within a few months the cost of moving from floating to fixed rates may become prohibitive for most people and the fixed rates from about the three year term will likely be higher than they are now.

Thus, if you are looking to fix beyond three years it may pay to do it sooner rather than later.

Second, if you place high credence in what we have just written about where floating and fixed rates might go over the remainder of this year then you are forgetting what I started writing five and a half years ago. This was and is that a person would be foolish to base their interest rate risk management decisions strongly upon a particular set of interest rate forecasts proving accurate. Essentially everyone has got their rate forecast wrong since 2007. The GFC has not just thrown traditional relationships between key economic variables into disarray as we humans have altered our behaviour, it has also produced an unprecedented surge in global liquidity about which central banks can only guess as to the ongoing effects. Predictability of financial variables went out the window a long time ago.

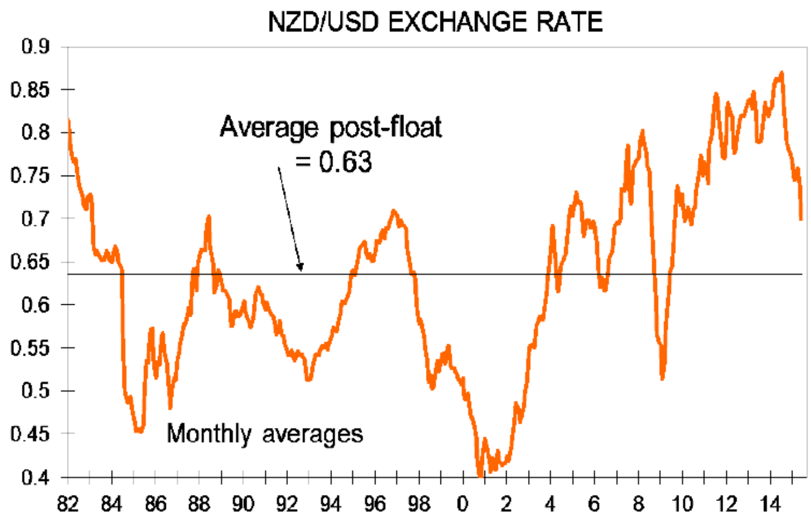
Therefore you must not place faith in anyone's interest rate forecasts (or exchange rates for that matter). Instead you should explicitly recognise that the world has changed, forecastability has plummeted, and you need to adopt a risk management strategy which reflects this. You start by figuring out your bottom line vulnerability to rate changes then decide how much of that volatility risk to hedge away with fixed interest rates, or more sophisticated products for business borrowers. If you feel you could easily handle a 2% movement in rates in any direction then you might choose to stay floating or fix just 25% of your debt. If 1% could be handled but not 2% then maybe you fix half your debt and do it at a mix of terms from say one year to five years.

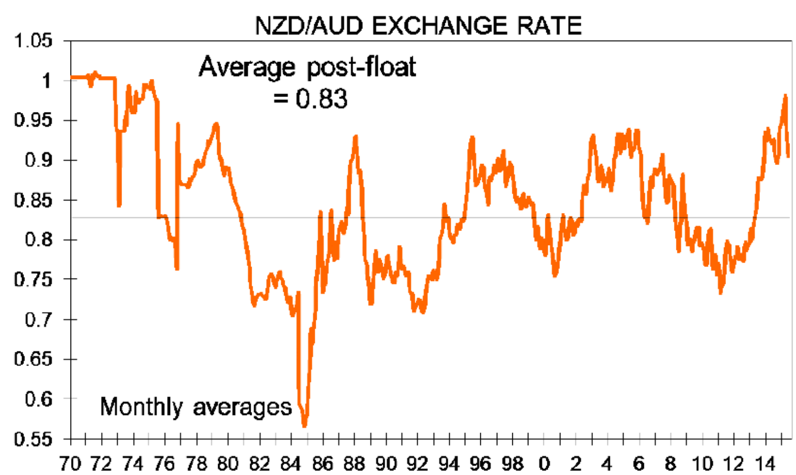
If you could not handle a 1% rate change then your incentive is to fix perhaps up to 80% of your debt – again at a range of terms.

Good luck and remember to count your blessings that as a modern borrower you are paying the lowest rates since the 1960s, as opposed to those of us who took out our first mortgages in the late-1980s at 18.5% and up to 23% for some unfortunately people. The offset for you however is that if you are borrowing to buy a house then the house price is a lot higher compared with incomes because affordability has been boosted by lower borrowing costs. The market has factored that cost reduction into house prices, with an extra boost from higher incomes due to more joint family incomes. The big winners from the lower interest rate environment are not home buyers but businesspeople. As always, before you decide, independent financial advice is always good to get.

NZ Dollar

The deterioration in outlook for the NZ economy and easing of monetary policy have caused the NZD to take a step downward over the past month. The NZD has declined by three cents against the greenback to sit below 70 cents from 78 cents at the start of the year. Against the Australian dollar we have fallen to near 89 cents from 94 cents a month ago and 96 cents in early-January. Against the British pound we have fallen to near 44 pence from 47 pence four weeks ago and 42 pence in January. Against the Japanese Yen we are near 85 from 89 a month ago and 93 in January, and against the Euro 61 centime from 66 and 66.





Sporadic 3 - 13 April 2015

In this Sporadic, Tony publishes some reminders about the importance of China to our economy.

20% of our goods export receipts come from China+

28% of foreign students studying in NZ come from China+, bringing us about $800mn.

14% of foreign tourism spending comes from China+, bringing us over $1bn.

7% of non-student migrants to NZ come from China+

China+ means China and Hong Kong.

To read the full article please go to:
http://tonyalexander.co.nz/wp-content/uploads/2015/04/Sporadic-3-April-13-2015.pdf

Sporadic 10 – 11 June 2015

Fieldays 2015

This week I am doing my usual three day stint in the BNZ tent at National Farm Fieldays in Mystery Creek, Hamilton. That is not by itself worth writing a Sporadic about given my aim to only write something here which I think differs from all the other stuff out there. The feedback so far in that regard has been good. Thanks for that.

But what is it that I have learnt from Fieldays which merits mention here? Just a few things.

Firstly, while I have received many questions regarding where I think the NZD will go, not a single person has ventured the opinion to me that it is too high. Even dairy farmers and people in the dairy support sector, while acknowledging that the NZD/USD rate has fallen and believing like myself that it will fall further, don't whinge. They just reckon the fall won't be enough to save the payout this season and they are tightening their belts – or stopping spending completely according to one of my conversants.

Second, while debt in the dairy sector has been the focus of some discussions, the farmers which I have been speaking with have tended to view the expected failure of some late-cycle buying highly-indebted operators as a natural capitalistic process – and as noted above they hope to buy their land cheap. In other words, while the Reserve Bank has rightly expressed concern about a possible fall in dairy land prices and the impact on some indebted operators, plenty of folk are ready and waiting for the land auctions. To quote the RBNZ's recent Financial Stability report….

"Dairy incomes have declined significantly in the current season. Milk prices remain well below their peak in early 2014, and continued weakness in prices could markedly increase financial stress in the dairy sector. This vulnerability is exacerbated by high levels of dairy debt, concentrated among a small number of more vulnerable borrowers, and the potential for farm land prices to fall significantly……there is a significant risk that milk prices remain low for an extended period."

Third, as I have discovered in Auckland, when it comes to those selling property, they have little problem with foreign buyers coming in and delivering them extra largess. In fact in Auckland people who have a house which failed to sell have a growing tendency to call their agent and complain about the lack of Asian buyers at their auction.

Fourth, farmers, being regionally based, have at the margin backed up the view that people are increasingly buying residential property outside of Auckland. It has happened in past cycles so this is nothing new.

Fifth, and this is something which I picked up more last week when in Hastings for the Horticultural Fieldays. Dairying may be in for two weak seasons in a row, and sheep meat prices are off their highs, but pip fruit is into its third good year, wine its second, and Kiwifruit is making a very good comeback. Throw in a booming tourism sector which enjoyed a 21% rise in international receipts in the year to March and one sees that although the dairy crunch will affect the economy, the export sector is not munted. The exchange rate is not looking set for a major decline.

What is it that I am saying to the farmers? Apart from an expectation that the NZD will oscillate lower but not plunge, and that the interest rates outlook is benign but to watch rising fixed rates as US monetary policy gets tightened later this year, I also talk about dairying. I have not been giving a payout forecast. (Tried that, bombed out spectacularly some years back. Mucho trouble!)

Instead I have been pointing out the complete impossibility of attaching credence to anyone's forecast of what the payout will be because there are some huge factors in play about which we know next to nothing.

Specifically, consider this list.

1. Caps on European Union dairy production disappeared on April 1. No-one seems to have the foggiest idea how much European dairy production will rise. All we know is that the Irish have a goal of doubling their production by 2020 and are well on the way to doing so.
2. No-one knows to what extent the world's biggest dairy producer by far, the United States, will boost output because feed costs have fallen because biofuel producer demand has fallen because biofuel prices have fallen because oil prices have fallen because the oil industry's economics have been changed forever by cheapening shale oil extraction.
3. China is our biggest buyer. Growth forecasts for the Chinese economy keep getting cut and the Beijing authorities keep loosening fiscal, monetary and housing policies trying to restimulate things. So far without much success and hence still downward growth revisions. No-one knows when these downward revisions will end therefore one cannot yet say that dairy demand, to the extent it is related to economic growth in a country filled with lactose-intolerant people, will revive.
4. Based on commentary from those trying to explain why prices keep fall at the Global Dairy Trade auctions, no-one seems to know the true level of milk powder inventories in China. That is a big problem given the huge effect on prices which stock level changes can have.
5. There is an ongoing depressing impact on prices of the Russian ban on imports of Western dairy products. No-one knows when the ban will end and to what extent it will continue to exert downward pressure this season. Given the returning Cold War this ban could stay for many years.
6. With oil prices not only down but expected to stay low, no-one can be sure to what extent dairy demand from oil exporting countries will decline.
7. The Australian Bureau of Meteorology considers it highly likely that a potential strong El Nino weather pattern will strike this year. If it does food prices risk rising a lot, but production will be slashed in largely eastern parts of New Zealand. Maybe, maybe not.

And it pays to remember that Fonterra's initial forecasts of $7 for each of the past two seasons ended up at $8.40 and $4.40. What then is the lesson here? Predictability of the dairy payout is out the window. Dairy farmers, bankers, and the growing number of businesses in the dairy support sector need to explicitly factor this income volatility into the level of debt they consider safe, the types of input supply contracts they sign themselves up to, and the prices they pay for land and animals. It also pays to remember that in the world of financial markets, if a thing has high volatility attached to its potential income stream, the up-front price goes down. One wonders if farm buyers have truly factored this altered income dynamic into their bidding prices for land?

Sporadic 11 – 25 June 2015

How Much Are We Slowing?

In Sporadic 9 ("The Wind Shifts Direction") issued on June 3, I looked at how prospects for growth in the NZ economy were deteriorating. Eight days later the Reserve Bank eased monetary policy as they also acknowledged that since the start of the year the negative developments have outweighed the positive ones. Is that still happening? That is, has the news we have received since June 3 been weighted toward the good side or yet again the bad side? Let's run through the items.

The Negatives

Dairy

Global dairy prices have continued to slide with the average GDT measure falling another 1.3% on June 16. Experts in the field are pushing out their timing of an expected recovery in prices and feedback from farmers at Fieldays shows that discretionary spending is being reined in and hopes of a lift in the payout from Fonterra's initial projection of $5.25 are fading. Note however that as written in Sporadic 9 and 10, forecastability of the payout is close to zero. One day we will get a positive surprise as Chinese buyers start rebuilding their inventories. One day.

Russia

The Russians have announced that they will extend their ban on imports of Western food for another six months from August. This is negative largely for dairying.

China

At the margin things are a tad less positive. Although the annual pace of growth in retail sales lifted to 10.1% in May from 10% in April, and industrial production rose 6.1% versus 5.9%, investment in fixed assets slowed to a 15 year low of 11.4%, and employment gauges in the HSBC flash Purchasing Managers Index have deteriorated. Things are still slowing down in China and further policy easing looks likely.

Consumer Sentiment

Measured by the monthly ANZ Roy Morgan survey consumer sentiment has declined to a two year low of 119.9 in June from 123.9 in May and 126.5 six months ago.

Business Sentiment and Intentions

The ANZ Business Outlook confidence measure has declined to a net 16% positive in May from 30% in April and 32% six months ago. Employment intentions have declined to their lowest levels in two years at 17% from 22% in April and 20% six months ago.

GDP

The official measure of NZ economic growth, the change in gross domestic product, slowed to a far weaker than expected 0.2% in the March quarter from 0.7% in the December quarter and 1% in the September quarter. The pace is the weakest in two years. Investment in plant, machinery and equipment fell 11% in the quarter.

The Positives

United States

The most recent data for the US economy have been better than expected, including for employment, wages growth, consumer confidence, retail sales, and home sales.

Interest Rates
The Reserve Bank have cut the official cash rate 0.25% and are highly likely to cut again on July 23. It is not inconceivable that they cut another 0.5% after that. Lower borrowing costs will tend to boost economic activity though perhaps not by all that much given general reluctance to take on debt.

Exchange Rate
The NZ dollar was almost at parity against the Australian dollar on Tuesday 7 April. It is now near 89 cents which is the lowest level since November last year and not too much above the ten year average of 84 cents. Against the US dollar we are near 69 cents (ten year average 75 cents!) which is the lowest rate in five years. There will be little immediate impact from this decline and the falls against other currencies including the British pound where we are now near a four year low. But there will be a quick lift in spending by the growing number of visitors to the country and tourism's already good prospects are now better. The decline will do little to improve dairy sector sentiment, but will boost confidence in primary sectors doing well such as pipfruit, Kiwifruit and wine production.

Migration
Net migration inflows continue to grow with the seasonally adjusted gain rising to 5,140 in May from 4,770 in April and 5,000 in March.

Cold
Winter has started cold and this is good for sales of winter-related items such as heaters, clothing etc.

On balance, compared with June 3, things are slightly weaker – hence one reason for weakness in the NZD in particular. Will this pattern of a deteriorating outlook continue? Not necessarily. It pays to remember that for the next 2 – 3 years while weakness will flow from dairying, easing house construction in Christchurch, labour shortages, a trend decline in manufacturing, developing El Nino, and geo-political tensions, there will be very strong growth support from factors we have long cited. Catch-up spending in Auckland on housing, infrastructure, and office buildings, infrastructure around the country, Christchurch non-residential construction, leaky building repairs, earthquake strengthening, low interest rate expectations, a cyclical NZD decline, migration, plus strength in specific sectors including pipfruit, Kiwifruit, wine, tourism, and ICT.

Expect to see further tightening of the labour market, don't expect further substantial weakness against the USD though some decline is likely, watch for additional measures aimed at restraining Auckland house price rises, don't get greedy regarding fixed interest rates, look for some regional housing markets turning upward as investors here and from offshore scramble for yield, consider how to benefit from Auckland's long-term growth and development, an aging/living longer population, rising Asian population in Auckland, aging boomers looking to sell their businesses, the government eventually scrambling to address poor low cost housing quality. Examine exploitation of our massive unpatented agritech resource, think about how someone will disrupt your service delivery through technology changes, and develop and strengthen your own firm's innovation chain.

Sporadic 12 – 2 July 2015

Why there is so much volatility

Post-GFC Behavioural Changes
You and I, businesses and governments are more sensitive to prices and debt levels than before the GFC. This affects our willingness to alter how much we spend in response to changes in interest

rates, exchange rates, personal incomes, lump sum receipts etc. These are really important coefficients in economic models developed over modern times of the 1980s – 2000s. Our altered behaviour is probably still altering and we do not have enough data to produce accurate, model-generated forecasts of where things like investment, consumption, growth, wages, inflation, interest rates, etc. will go. It may take a generation for things to settle down.

China

As discussed on and off for three years now, the more we are reliant upon China as a destination for our primary sector exports like dairy, forestry, meat, fish etc., the greater will be the volatility in primary producer incomes, investment, spending, regional economies, and eventually the overall economy. This arises because China tends to have some very large inventory cycles. Everyone buys at once because others are buying, everyone stops stocking up at the same time because others have stopped stocking up. Hence big cycles for iron ore, coal, wool, forest products and of course milk powder. But on top of that, in the case of milk powder at least, no-one seems to know what level stocks are actually at! If you have income in any way dependent upon primary sector exports (rural contracting, rural financial services etc.) you face higher volatility than before and you should adjust for that by lowering your debt to income limits, diversifying across primary sectors, showing a preference for fixed supply contracts…

And just to top it off, volatility from China is enhanced by lack of knowledge regarding how China's transition from export and investment-led to consumption-led growth will go (badly so far), how financial liberalisation and capital flows will affect Chinese asset markets and economic growth rates (witness the current official panic regarding the Shanghai sharemarket boom and bust), and what China's growth rate and labour market strength really are. The data are rubbish.

Booming Global Liquidity

The Global Financial Crisis showed us all in the field of economics that we do not well enough understand the links between financial sector expansion and real economic activity. Ahead of the GFC and helping to cause it was a surge in private sector generated credit. Since then we have seen a surge in public sector generated credit as central banks have injected trillions of dollars into their and the world's financial systems to first ensure liquidity and then boost asset prices, hopefully lower interest rates, hopefully spur investment, hopefully avoid deflation, and hopefully give economic growth enough momentum that things can return to normal.

No country has reached that new normal point yet. In the United States money printing has stopped but the key question being asked is whether things are now "normal" enough to allow the Federal Reserve to raise interest rates and not have the economy turn down again. After all, that is exactly what has happened twice in New Zealand. Based on our experience you'd give perhaps a 50% chance to Fed rate rises in the coming year being followed quickly by rate cuts from late-2016.

The likes of the IMF, Bank for International Settlements and our own Reserve Bank have all recently expressed concern about financial stability stemming from the world being awash in capital and no-one knowing quite where it will pop up the disappear again. It is interesting to note in the context of this capital looking for a home that back in 2001 5% of managed fund assets were in non-core classes like residential property, hedge funds, commodities etc. Now that proportion is 25%.

Disruptive Technologies

New technology has completely changed the economics of the oil industry forever. The combining of 3D ground imaging, fracking, and horizontal drilling has allowed exploitation of shale oil reserves previously not accessible. The outcome is a structural adjustment downward in oil prices, plus a sharp lift in the speed of future oil supply response to any rise in prices. Companies are still drilling shale wells yet capping them right away. When oil prices rise they will uncap them and run down their in the ground inventory. Compare that with years and billions of dollars needed to develop traditional large oil fields.

Uber has disrupted taxis services, Netflix television, Airbnb accommodation and so on.

More disruptive technologies will appear and render unprofitable existing service delivery models and maybe even other basic dirty industries like oil extraction.

Shocks
Yes it seems true that there are more shocks occurring these days such as terrorist attacks, diseases, debt mountain collapses, and so on. But the bigger issue from here on may be shocks combined with a radical reduction in the ability of authorities to mitigate their impact. Interest rates are already low if not zero, or in the case of the ECB deposit rate, negative 0.2%. Government annual deficits are less than over 2008-11 but debt levels are higher. Ability to absorb shocks with deficit spending is reduced.

In contrast to the case that a collapse in Greece now would (will) do far less damage than if it had happened in 2010, a new Lehman Brothers Bank collapse could cause more because of this lack of fiscal and monetary buffers. Money printing would attempt to fill the gap along with unwinding of the many macroprudential controls central banks are putting in to do a job previously they used interest rate rises for.

The upshot of these many factors affecting the economic environment in which we operate is as noted above.

<u>The Past Week</u>

Nothing much positive is there?

- The ANZ Business Outlook Survey showed a decline in business confidence to a net 2.3% negative – the lowest reading since March 2011. Employment intentions are at a net 15%, a two year low, investment intentions 12%, similar but with both measures still above ten year averages.
- Greece has defaulted, and no-one knows what happens next.
- China’s main sharemarket has fallen 25% the past two weeks and things are so bad interest rates have been cut for the fourth time in about seven months.
- Russia has extended its ban on importing Western food including dairy by another 6 months.
- Westpac’s employment gauge fell to a two year low and wage expectations to a six year low.
- Dairy prices fell another 5.9% to sit 34% below early-March and the lowest since 2009.

Hence – NZD lower still, interest rates to be cut further, sentiment gauges to decrease more.

<u>If I Were A Borrower What Would I Do?</u>
I cannot give you a forecast of where interest rates will be in a year’s time that I would be willing to back to the hilt. I simply maintain the position spelled out in my NZ Observer issued on February 24. To whit…

“Currently the drift in rates is downward, assisted strongly by banks trying to boost market share. Were I borrowing at the moment I would hold off for another round of cuts in fixed rates. If someone offered me a four or five year rate at 5.5% I would take it today. A three year rate at 5% would win my business right away also."

Currently the BNZ three year rate is 5.29% and the five year rate 5.75%, compared with 5.59% and 5.79% in February. The three year swap rate which forms the base of our funding cost was back then 3.73% and the five year swap rate 3.79%. Those rates are now 3.23% and 3.5% respectively – drops of 0.5% and 0.29% respectively. To date bank competition for mortgages has concentrated in the one to two year terms. Hence as the one and two year swap rates have fallen from 3.63% and 3.64% in February to 3.14% and 3.15% (0.49% falls) the same term fixed mortgage rates have declined 0.7% and 0.4% to 5.19% and 4.99%.

I personally would remain willing to take a punt that with China looking worse, Greece imploding, NZ consumer, employment, and business sentiment measures worsening, and dairying having a downward correction, the rates I seek will eventually be reached. So as in February I remain waiting for slightly lower three and five year fixed rates before I jump.

But were I not prepared to wait – and admittedly in the past my behaviour has been more conservative than this as a borrower - I would lock in the bulk of my debt at 4.99%.

Yours Sincerely

Richard J Power