BNZ Weekly Overview

20 August 2009

Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

In this week's issue….

The Weekly Overview is written by Tony Alexander. The views expressed are my own and do not purport to represent the views of the BNZ. To receive the Weekly Overview each Thursday night email me at tony.alexander@bnz.co.nz with 'Subscribe" in the Subject line.

What Do You Do Now With Your Business?

You are in business and you hear around you talk of the economy improving. You see house prices rising with easily supportable predictions of more to come. You read about the growing strength in Australia's economy, France and Germany growing during the June quarter, the US housing market turning up, sharemarkets soaring, and financial markets pricing in recovery through increased fixed borrowing costs and rising peripheral currencies. You also see commodity prices rising and talk re-emerging of oil prices going back to where they were.

But you also read a lot of other stuff. Some pundits say the improving data and markets are largely due to temporary and completely unsustainable monetary and fiscal policy settings. They talk of W-shaped recoveries. They warn that the housing market recovery will end in tears because prices are still high by historical standards. You hear talk about the newly rising oil prices leading to new Western economic weakness, governments needing to raise taxes to get deficits down, and the risk of inflation overseas because of money being printed at the moment.

What do you do with your business?

- Do you stay in lock down mode, trimming costs, delaying capital spending, laying off staff, cutting inventories, slashing debt, and selling assets?
- Do you stop doing these things?
- Do you actively start preparing for growth by raising inventories, hiring people, signing up for new premises, arranging finance for new capital spending, seeking new distribution licences, boosting product development…?

Obviously the answer to this question depends substantially upon what industry you are in. For the next 12 months things are likely to stay tight in tourism, dairying, and commercial property leasing. But things are definitely turning upward in residential construction and retailing.

But outside of those sectors we think the answer is this.

If you have got your cash flow under good control and reserves are building up,
if you have low debt/equity ratios,
if your staff need high skills,
if you struggled to get good people two years ago,
if you have had the beejeebers scared out of you and have vowed never to get your company as exposed as it was in the second half of last year, and
if you could quite comfortably keep things exactly as they are now and earn an unexciting but respectable return over the next five years,

then it is time to stride forth and grow. Why? First, if you are in the position just described you are the sort of business our economy vitally needs (regardless of the sector) and surviving to this point says something about your management ability. Second, you will have seen and still be seeing competitors in your sector falling over or radically downsizing because they went into the downturn under-capitalised and poorly managed, so you can easily grab their assets like people, premises, inventory, facilities, and licences at cheap prices.

Third, if you are in the described position then you are not going to undertake your expansion solely on the basis of borrowing easy money and assuming the world is a safe place so its back to the bad old ways. You are going to be looking over your shoulder all the time for signs of things going badly far more than you did in the past. Growth will be carefully managed.

What will help facilitate your expansion? Not just the opportunities presented by market growth at the same time competitors are still trimming down. You will be assisted by far more astute allocating/rationing of credit and capital by financiers and investors. Both these two groups have experienced shocks over the past two years and will have drawn up lists of things businesses must satisfy now (that they did not have to in the past) before they will allocate their funds. They will be more discerning and shy away completely from some businesses they might have considered in the past. But because they want to lend/invest, they will be actively looking for opportunities now amongst the businesses who have made it through the downturn.

Undoubtedly one must keep a close eye on the global and domestic trends and be aware that there will be bumps on the road ahead and one cannot blindly dismiss talk of W-shaped recoveries.

But from where we sit, conditions have now improved enough that it is time for the best capitalised and managed to actively shift resources under their management which others in recent years have not run so well. That means actively seeking out the better skilled and motivated people in the current marketplace, looking for better premises, and buying out cash-strapped competitors you know you can integrate into your organisation.

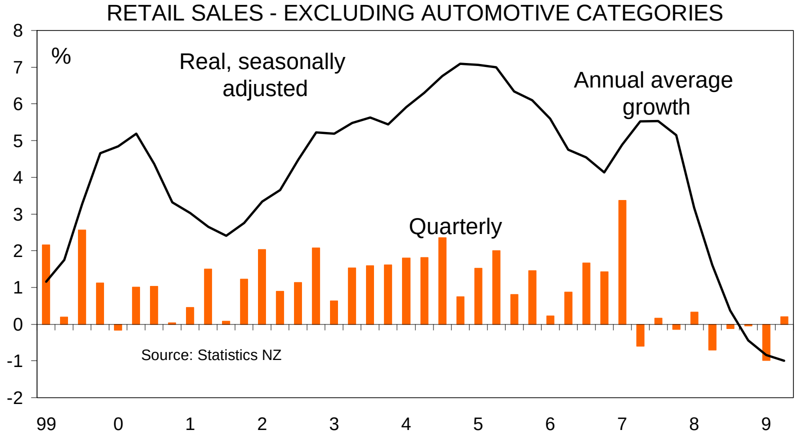
And what do you do if you are not in the group we have just described? Obviously all is not lost. For the vast majority the existence of restraints of one sort or another will mainly mean not having the ability to capitalise on the opportunities and bargains in the current environment rather than ongoing woe. For many the future will lie in merging with another business, perhaps for no other reason than that by yourself getting finance is now permanently more difficult and economies of scale may come into play.

NZ ECONOMIC DEVELOPMENTS

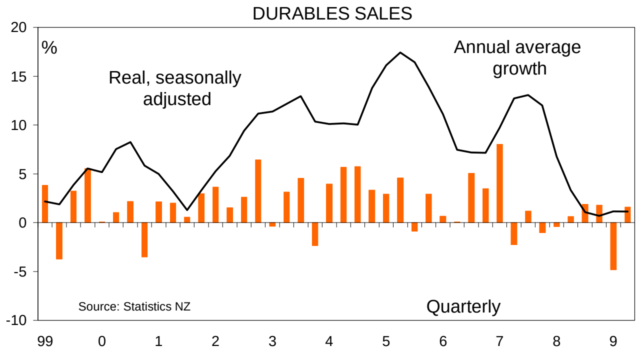
Friday 14

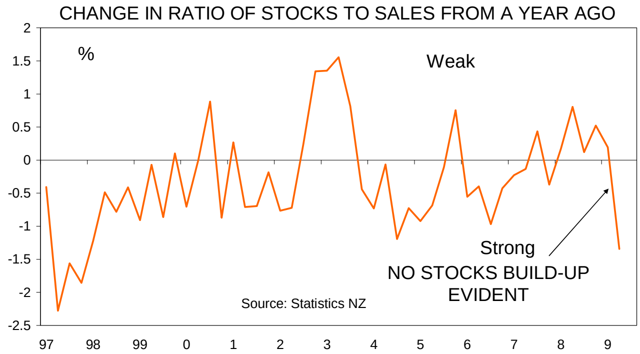
Retail Spending Growing Again

It is not a boom or even a return to average, but during the June quarter retail spending after removing seasonal and inflation factors managed to grow by 0.4% after shrinking 2.7% in the March quarter. The core measure which excludes motor vehicles and fuel grew by 0.2% after falling 1% last quarter. This measure was still 0.9% weaker than a year earlier and in levels terms things remain weak. But the result was better than expected and is another sign that the NZ economy is probably now out of recession with only a small decline in GDP likely to eventually be reported for the June quarter now well and truly behind us.

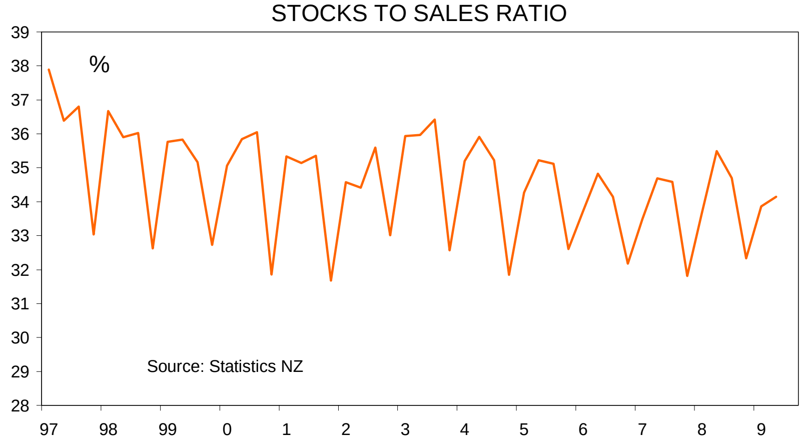


One test for the seriousness of a retailing increase is to look at what is happening with durable goods. We see that during the June quarter sales of durable goods improved 1.5%. But this followed a large 4.8% fall during the March quarter so clearly there is an element of bounce back in there. In addition the numbers will have been thrown around perhaps by hefty discounting.





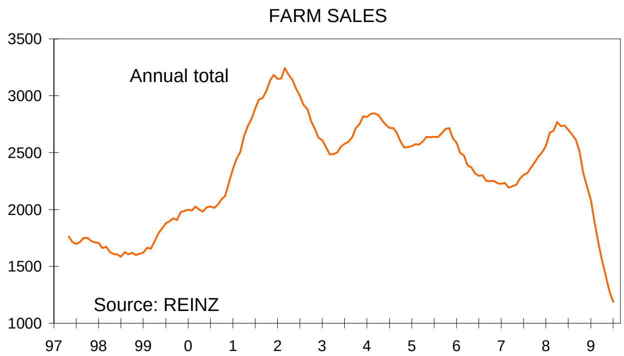
One interesting number however is the stocks to sales ratio. This was 1.3% lower at the end of the quarter than a year earlier and at 34.1% the ratio is lower than one would have expected. This suggests retailers have had some success at getting rid of inventories which then means one might want to start thinking about the omnipresent sales ending perhaps before the end of the year.

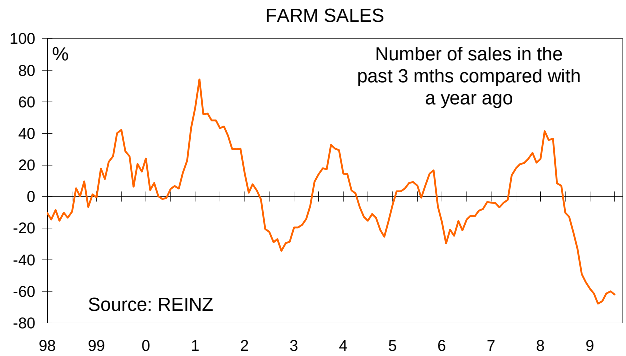


We don't read the retail numbers as a sign that good growth is at hand or even just ahead of us. But they do support the recovery story.

Farm Real Estate Weak

In July there were only 52 farms sold around New Zealand. This was a 6% decline from last year which followed a 63% fall in June and means that in the year to July farm sales were down 56% from a year earlier. The collapse in rural real estate comes on the back of much lower dairy prices along with a drying up of the easy credit conditions farmers enjoyed ahead of the Lehman Brothers investment bank collapse in September last year. Going forward while we expect farm sales activity will improve the gains will initially be very slow in coming. In fact because the traditional cyclical rise in farm profitability is being hampered this cycle by the early rise in the NZ dollar the lift in farm turnover in the next three years is likely to be quite limited.





INTEREST RATES

Given the way the data have fallen over the past week it remains reasonable to continue to expect wholesale interest rates to slowly drift higher in coming months.

Early this week we learnt two important things. First, as discussed in depth in our Housing section, house prices are now officially rising again in New Zealand. They gained 1% in July and 2.2% in the three months to July. The time taken to sell a dwelling is now the best compared with average since late-2007, and anecdotes continue to bespeak of listings shortages. This means prices are likely to continue to creep up.

This development is important because we Kiwis pay close attention to house price movements and the gains in prices fairly much wipe out concerns some will have been having about rising unemployment being the key determinant of house price changes and everything else in the economy. As we have pointed out, the labour market lags the economy, it does not lead it. That means if you forecast the economy on the basis of what the labour market is doing you are actually looking backward rather than forward.

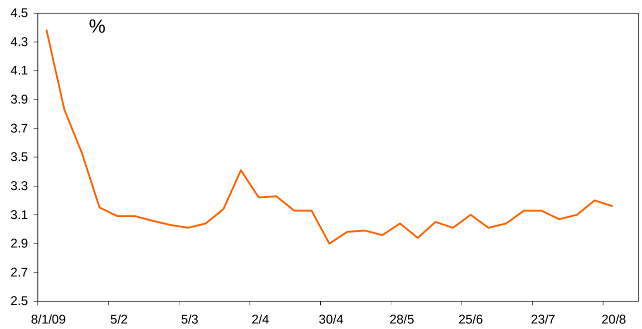
The other large piece of news was retail spending growing in seasonally adjusted volume terms by 0.4% during the June quarter This is still a weak result by historical standards but better than the 0.2% decline expected in the markets and the strongest result since the March quarter of 2007 (when sales ballistically soared 3.7%!).

The data come in a week when we have also learnt that the EU economy shrank only 0.1% during the June quarter with France and Germany each growing by 0.3%. Japan also grew 0.9% during the June quarter.

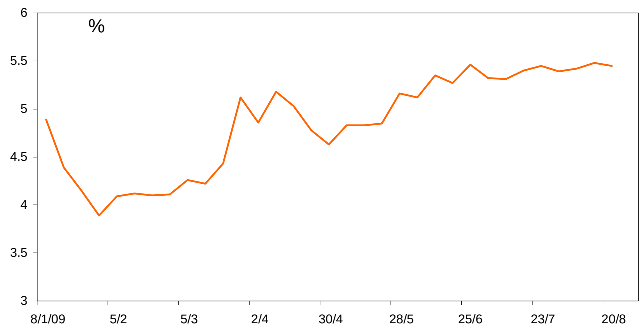
The results add up to further support for the global recovery story therefore further upward pressure on share prices, growth and risky currencies like the NZD and AUD, and of course interest rates. But rate rises will not be linear. There will be substantial reversals at times as doubts occasionally appear about the strength of the economic recovery. In particular one must be wary of the impact which the unwinding of unsustainably stimulatory fiscal and monetary policies will have next year and through 2011.

In fact those concerns have dominated this week with the result that after initially jumping skyward wholesale interest rates have finished today down very slightly from where they were a week ago. The one year swap rate is near 3.15% from 3.20% last week and 3.15% a month ago. The three year rate is near 4.80% from 4.85% last week and 4.70% four weeks ago. The five year rate is near 5.45% from 5.50% and 5.45%.

ONE YEAR SWAP RATE



FIVE YEAR SWAP RATE



Key Forecasts

- No more monetary policy easing this cycle.
- Medium to long term housing rates have seen their multi-year lows – stop-start rises now lie ahead. Speed unclear.

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	8.00	6.2
90-day bank bill	2.79%	2.83	2.83	2.82	8.12	6.5
10 year govt. bond	5.81%	5.91	5.74	5.45	6.18	6.2
1 year swap	3.16%	3.20	3.13	2.96	7.70	6.7
5 year swap	5.45%	5.48	5.45	4.85	7.10	7.0

If I Were a Borrower What Would I Do?

First one needs to recognise that in these still very uncertain times one cannot take a reasonable stab at where fixed rates will be in one, two, and three years time. That means it would be risky to base one's decision upon what to do at the moment on someone's forecast of where things will go in the future. Just because we called it right with regard to catching the low-point for fixed rates in March does not mean we can reasonably say where those rates will be while the global crisis continues to unfold.

The upshot of recognising such uncertainty is that one should be prepared to pay a premium for certainty in the form of a higher rate for fixing long term than short term. The question is however whether the current premium for fixing three years and beyond, when mixed with an assumption of higher rates in the future, justifies fixing medium to long term.

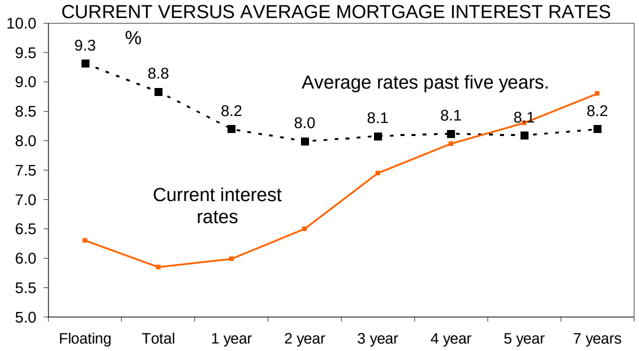
First, would I take the five year fixed housing rate at 8.3%? No I would not. It is 0.2% above the average for that rate over the past five years and although we think fixed rates will average higher over the next five years than the past five, the rate looks expensive.

Would I fix three years at 7.45%? Three weeks ago when this rate was 6.99% my answer was yes I would. But at 7.45% one is paying quite a premium above floating at 5.89% under the Total Money package, fixing 18 months at 6.09%, or fixing one year at 5.99%. For an above average risk averse person fixing at 7.45% for three years looks good in the current environment. But I would not.

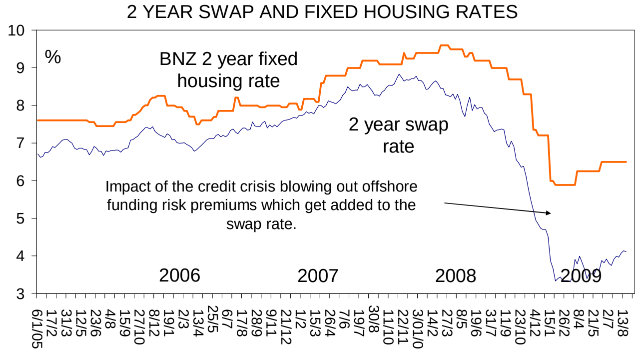
Given my belief that floating rates are very unlikely to fall further I would be choosing between fixing 18 months at 6.09% or two years at 6.5%. I would fix 18 months and use the cash flow freed up by taking this low rate to get my principal down as much as humanly possible over the coming year and a half. I would do that because based on our expectation of the official cash rate rising from 2.5% at the moment to 5.75% by the end of 2011 one should expect the floating and out to 18 month fixed rates also to rise about 3% between now and the end of 2011.

One can comfortably float or fix short now for good cash flow – but be ready for higher rates down the track. Do not fall into the trap of the Americans who when floating at 2% in 2003-04 assumed these rates would remain low and not go back to historical levels above 5%.

CURRENT VERSUS AVERAGE MORTGAGE INTEREST RATES



2 YEAR SWAP AND FIXED HOUSING RATES

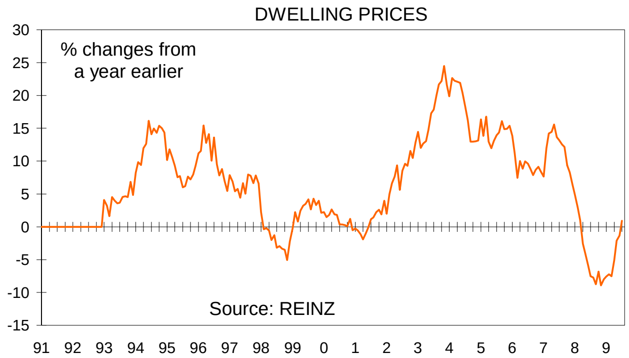


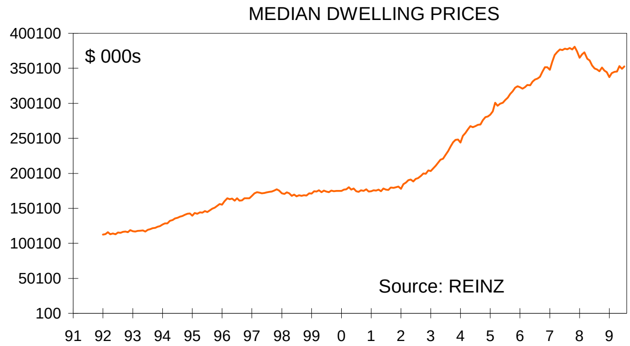
HOUSING MARKET UPDATE

House Prices Are Rising Again

Its official. House prices in New Zealand are now rising again. The newly created monthly House Price Index released by REINZ in conjunction with the Reserve Bank stratifies house prices to get rid of the distortion which can arise from many expensive houses being sold one month and then not many the next month. That means this measure becomes akin to the good quarterly one released with a substantial lag by Quotable Value NZ. This measure will then become the one we shall use when talking about the latest house price movements in NZ while retaining the quarterly QVNZ release for historical work.

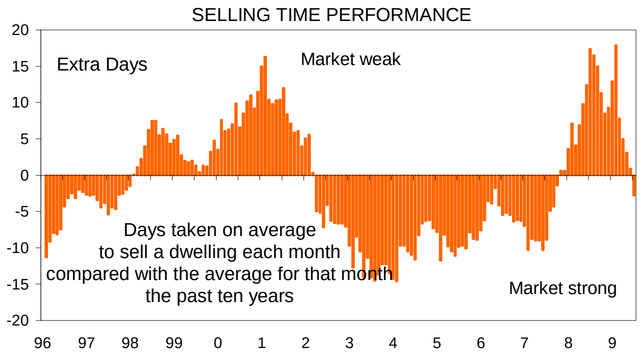
The REINZ measure shows that average NZ house prices increased 1% in July and were up by 2.2% in the three months to July compared with the three months to April. The index shows house prices are down on average 7.3% from their peak in November 2007 and up 0.9% from a year ago.

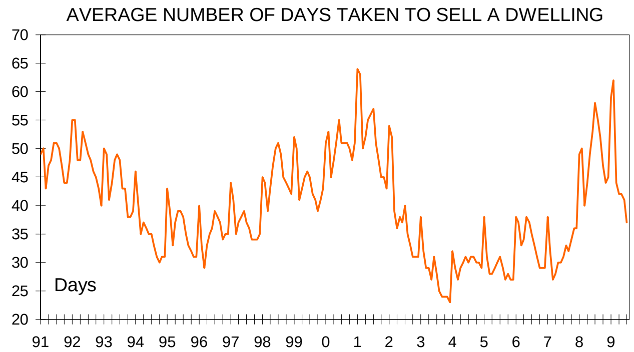




In July there were 6,014 dwellings sold around the country. This was a 34% rise from a year earlier and in rough seasonally adjusted terms was a small gain following about a 5% rise in June. So sales are tracking upward though the pace of growth has slowed since the burst of activity between February and April due to a shortage of listings.

How do we know listings are in short supply? First we have the anecdotes. Second we can calculate listings to sales ratios from the monthly Barfoot and Thompson data for Auckland. Third we can look at how long on average it is taking to sell a property – and it is there that we get a really good picture of what is going on at the moment.





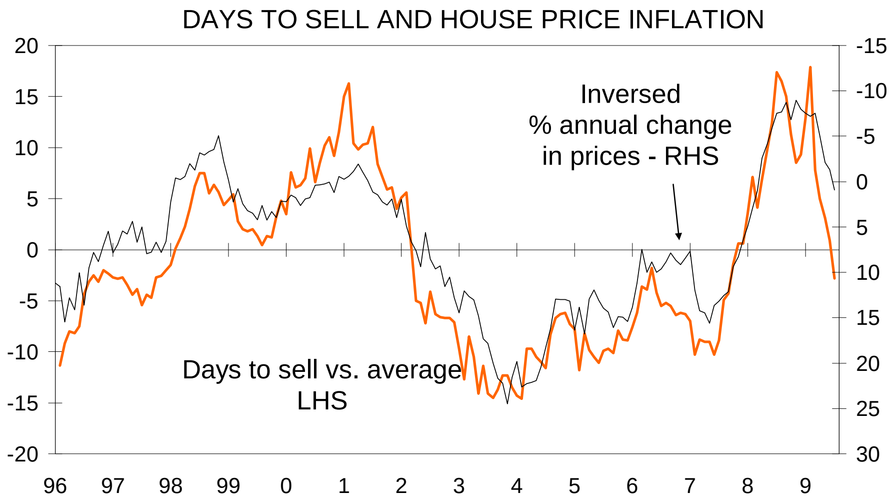
On average in July it took 37 days to sell a dwelling. That was down from 41 days in June but that is not an important comparison. A better one is with July last year. Back then it took on average 58 days to sell a dwelling. The improvement of 21 days is the biggest such annual rate of improvement on record. But the best measure comes by comparing July with the average for July over the past ten years. Doing that we see that for the first time since October 2007 the number of days taken to sell a dwelling was below average – in this case by 2.8 days.

Where do we go from here? If you have been reading this section since the second half of this year then nothing following will be new.

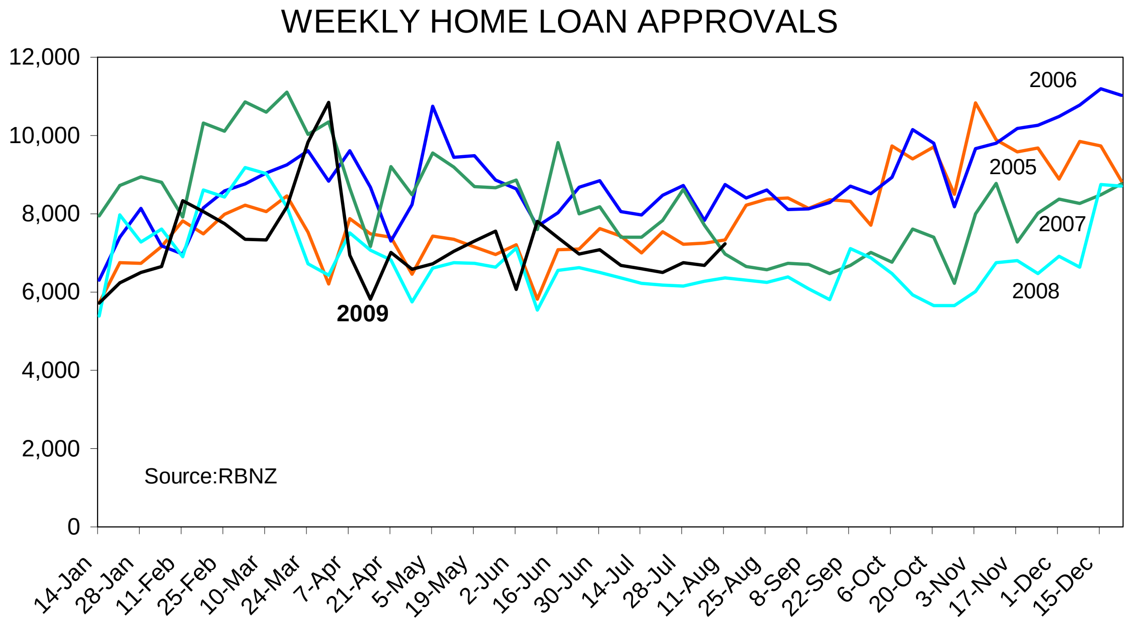
- New Zealand has a shortage of dwellings and not an over-supply like the US, Ireland, Spain etc. That means the extent to which house prices would fall this cycle was always going to be limited.
- Construction is at its weakest levels since 1965 near 14,000 per annum whereas 25,000 has been the average for the past decade.
- Population growth is accelerating courtesy of rising net immigration (fewer people leaving so the mix is different from what we thought last year).
- Interest rates are at very low levels – 40 year lows for floating mortgage rates.
- The ability of housing construction to respond this cycle will be limited by the collapse of the finance company sector and its generous loans of money to property developers, plus tighter lending criteria by banks.
- Investors have seen their equity investments and many others torn apart. The relative attractiveness therefore of housing from a psychological point of view has increased.

While Spring will bring some more properties onto the market there is now momentum – and that counts for a lot in an asset market. And unless the Reserve Bank alters bank rules for housing exposure there is nothing they can do to stop this ball rolling because they want to keep the official cash rate low to help business cash flows and suppress further gains in the NZ dollar.

We will see house construction rising soon but a return to near 25,000 annual consent numbers seems extremely unlikely before late-2010 at the extreme earliest. And for prices the implications are obvious now and have been obvious for a long time. They will keep rising. The graph here shows where things are going. It displays the very good correlation between how many days it takes to sell a dwelling versus the average and annual changes in house prices.



For your guide, the value of weekly home loan approvals jumped quite strongly in the week ending August 14 to $929m from $871m in the previous week. The outcome was in fact the highest since the last week in May and ends a period when things looked like they were slowing a tad. The black line in the graph below is for this year and the kick up in the latest week is in line with 2006 but firm by the terms of 2007 and 2008.



Key Forecasts

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

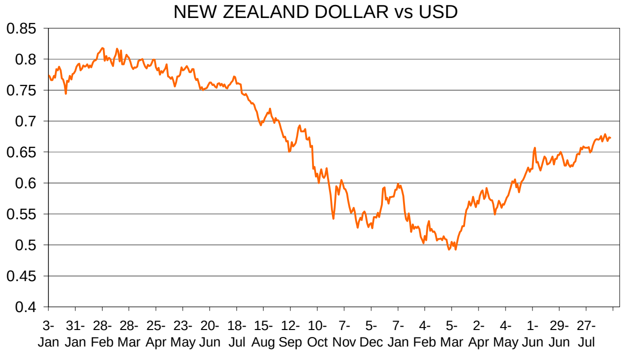
Exchange Rates & Foreign Economies

EXCHANGE RATES	This week	Week ago	4 wks ago	3 months ago	Yr ago	Consensus* Frcst Yr Ago	10 yr average
NZD/USD	0.673	0.672	0.646	0.602	0.714	0.684	.592
NZD/AUD	0.813	0.806	0.804	0.776	0.818	0.774	.856
NZD/JPY	63.4	64.5	60.9	57.8	78.2	72.6	66.8
NZD/GBP	0.408	0.408	0.395	0.389	0.382	0.366	.345
NZD/EUR	0.474	0.473	0.457	0.441	0.482	0.47	.51
USD/JPY	94.2	96.0	92.3	96.0	109.5	106.1	113.9
USD/GBP	1.65	1.647	1.635	1.547	1.87	1.87	1.709
USD/EUR	1.42	1.421	1.41	1.365	1.48	1.458	1.156
AUD/USD	0.828	0.834	0.803	0.776	0.873	0.884	0.69

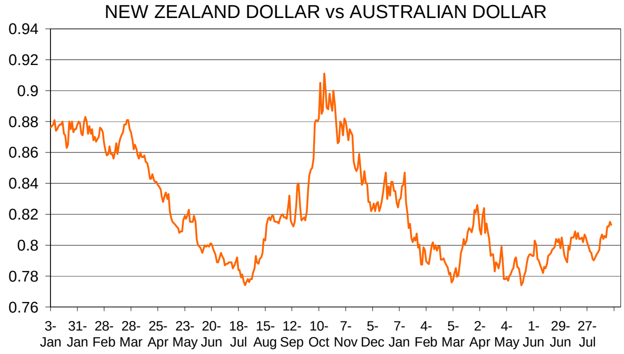
NZD Still Strong

The NZD has basically spent the week going up and down in response to up and down movements in global risk tolerance. At times the markets have become worried about what lies ahead and sharemarkets have weakened (most notably in Asia this week) and risky currencies like the NZD have fallen. But at other times – usually during the same trading session – sentiment has been good and risky currencies have been bought back up again.

NEW ZEALAND DOLLAR vs USD

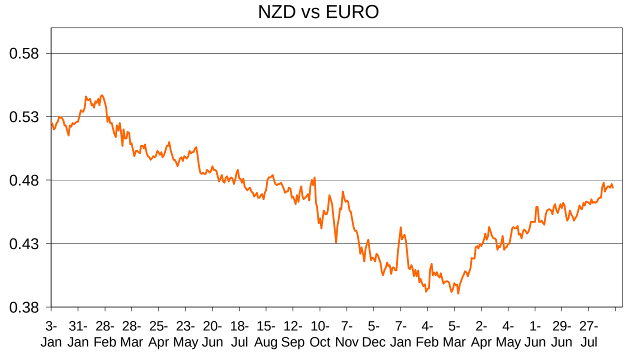


NEW ZEALAND DOLLAR vs AUSTRALIAN DOLLAR

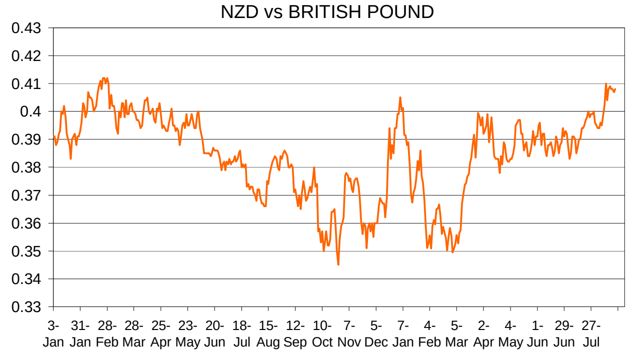


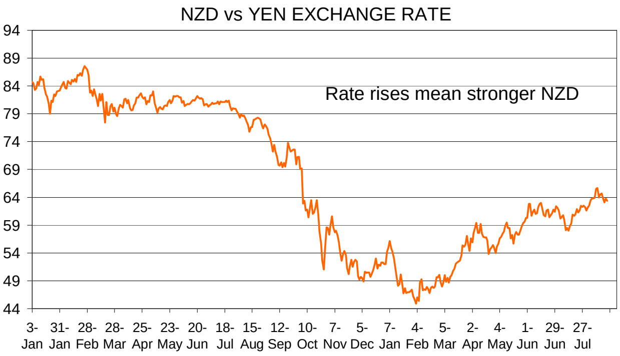
The upshot of all the toing and froing is that the NZD sits today exactly unchanged from a week ago near US 67.3 cents. We are also completely unchanged against the Euro near 47.3 centimes, unchanged against the British Pound near 40.8 pence, down slightly against the Yen near 63.4 from 64.5, and up slightly against the Aussie dollar to 81.3 cents from 80.6.

NZD vs EURO

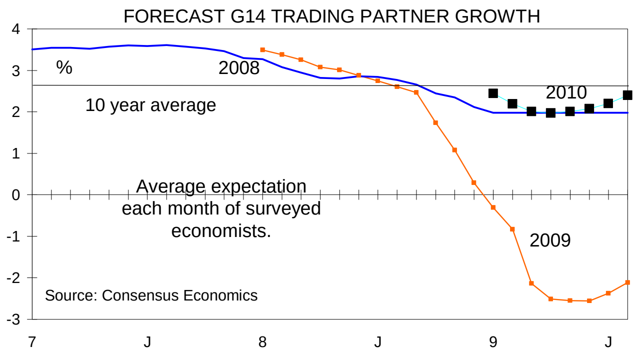


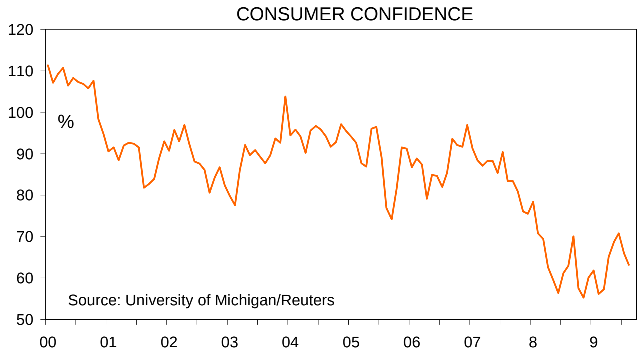
NZD vs BRITISH POUND





This week we learnt that the consensus expectation for growth in our top 14 export destinations has this month risen to 2.4% for 2010 from 2.2% in the July Consensus Economics survey. This rate is still below the 3.1% average achieved over the past decade but the direction of change is positive and further upward revisions are likely in light of some positive data recently released offshore. Not that all the data seen recently has been good however. For instance this week sentiment in the markets offshore got off to a bad start following data showing that the University of Michigan US consumer confidence measure unexpectedly fell in August to a reading of 63.2 from 66 in July with an outcome of 69 having been expected.



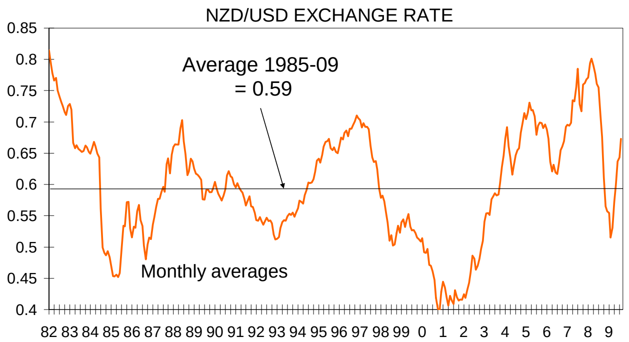


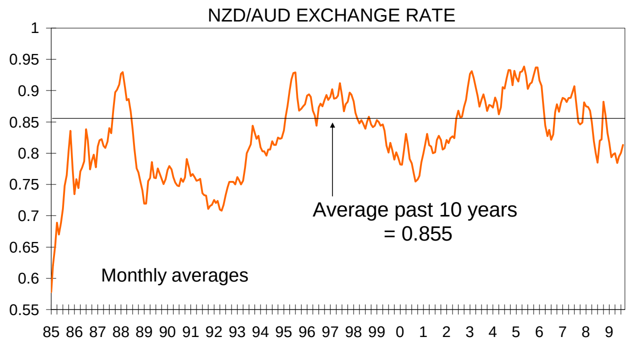
Strong doubts still remain about the willingness of US consumers to raise spending while all around the world questions are being asked about how much of the recent improvement in growth will be lost once central banks and governments remove their stimulatory policy settings.

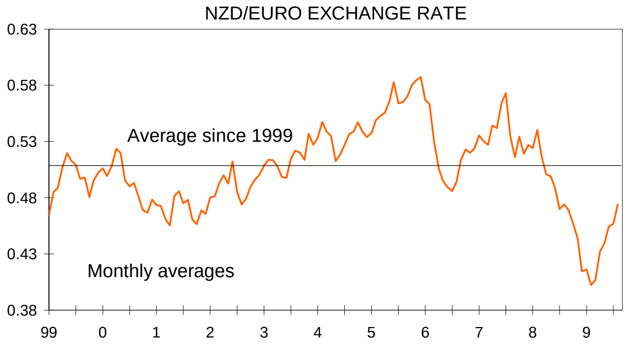
In this sort of environment we should expect continued uncertainty about where exchange rates will track. Our view for the NZD at the moment is that the drift from here over the next two years will be upward, but at any time a decent pullback of a few cents could easily occur as global risk tolerance whips around.

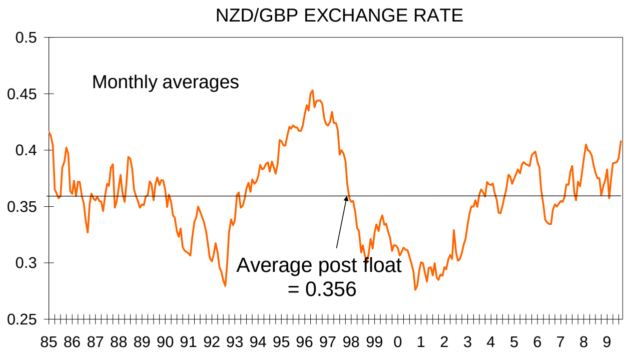
If I Were An FX Receiver What Would I Do?

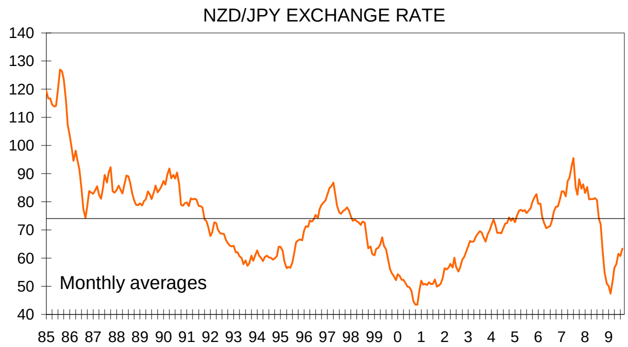
Nothing new to write here. I'd be boosting hedging still though not in an aggressive fashion. I'd keep an eye on changes in the cost of options as an additional hedging tool.











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

ECONOMIC DATA

All %		Latest qtr only	Previous qtr only	Latest year	Year ago	2 Yrs ago
Inflation	RBNZ target is 1% - 3% on average	0.6%	0.3	1.9	4.0	2.0
GDP growth	Average past 10 years = 3.0%	-1.0	-1.0	-1.0	3.1	1.8
Unemployment rate	Average past 10 years = 5.3%	6.0	5.0	......	4.0	3.7
Jobs growth	Average past 10 years = 1.9%	-0.5	-1.4	-0.9	0.8	1.5
Current a/c deficit	Average past 10 years = 5.5% of GDP	8.5	9.0	......	8.0	8.5
Terms of Trade		-3.0	-1.0	-5.2	11.6	4.5
Wages Growth	Stats NZ analytical series	0.6	0.8	4.6	5.6	4.6
Retail Sales ex-auto	Average past 9 years = 3.8%.	-1.2	-0.0	-0.8	3.2	4.9
House Prices	Rise > inflation since 1992 = 5% p.a. QVNZ	-2.0	-2.1	-8.9	8.0	9.7
Net migration gain	Av. gain past 10 years = 10,400	+12,515	7,482yr	......	4,735	10,080
Tourism – an. av grth	10 year average growth = 5.0%. Stats NZ	-2.8	-3.9	-2.8	0.9	3.4
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 2%. Colmar survey	38	3	-9	6	-8
Business activity exps	10 year average = 26%. NBNZ	12.6	8.3	-20.8	-8.2	12.4
Household debt	10 year average growth = 11.3%. RBNZ	2.4	2.6	4.2	8.5	13.7
Dwelling sales	10 year average growth = 3.5%. REINZ	43.9	-39.1	-45.4	-52.9	-3.7
Floating Mort. Rate	(Total Money) 10 year average = 7.6%*	5.85	5.99	6.99	10.49	9.99
3 yr fixed hsg rate	10 year average = 7.9%	7.45	6.99	5.99	9.09	9.10

ECONOMIC FORECASTS

Forecasts at July 23 2009	March Years					December Years				
	2007	2008	2009	2010	2011	2006	2007	2008	2009	2010
GDP - annual average % change										
Private Consumption	2.8	3.3	-0.7	-0.5	1.8	2.6	4.1	0	-1.3	1.7
Government Consumption	4	4.3	3.4	3	2.8	4.6	3.9	3.9	2.9	2.9
Investment	-0.6	4.3	-8.9	-15.1	5.9	-0.4	5	-5.1	-16.8	1.4
GNE	1.5	4.2	-2	-3.9	2.9	1.5	4.5	0	-5.3	2
Exports	3.1	2.9	-3.4	-2.9	1	1.8	3.8	-1.6	-3.8	-0.4
Imports	-1.6	9.6	-4.4	-12.8	2.3	-2.6	8.6	2	-16.2	0.7
GDP	1.8	3.1	-1	-1.2	3	2	3.2	0.2	-2.1	2.3
Inflation – Consumers Price Index	2.5	3.4	3	2.2	0.7	2.6	3.2	3.4	2.2	0.8
Employment	2.1	-0.2	0.8	-2.7	2.9	1.7	2.3	0.9	-3.5	2.9
Unemployment Rate %	3.8	3.8	5	7.3	7	3.8	3.5	4.7	6.8	7
Wages	5.5	4.4	5.1	2.4	1.5	5.5	4	5.1	3.1	1.3
EXCHANGE RATE ASSUMPTIONS										
NZD/USD	0.7	0.8	0.53	0.67	0.69	0.69	0.77	0.56	0.65	0.69
USD/JPY	117	101	98	102	108	117	112	91	100	107
EUR/USD	1.32	1.55	1.31	1.41	1.43	1.32	1.46	1.34	1.4	1.43
NZD/AUD	0.88	0.87	0.8	0.8	0.81	0.88	0.88	0.83	0.79	0.81
NZD/GBP	0.36	0.4	0.37	0.39	0.39	0.35	0.38	0.37	0.39	0.39
NZD/EUR	0.53	0.52	0.41	0.48	0.48	0.52	0.53	0.41	0.46	0.48
NZD/YEN	81.9	81.1	51.8	68.3	74.5	81	86.3	50.9	65	73.3
TWI	68.6	71.6	53.8	63.4	65.6	68	71.6	55.1	61.7	65.1
Official Cash Rate	7.50	8.25	3.7	2.5	4.25	7.50	8.25	6.25	2.5	3.75
90 Day Bank Bill Rate	7.78	8.82	3.67	2.7	4.62	7.64	8.77	6.3	2.7	4.12
10 year Govt. Bond	5.91	6.35	4.6	5.75	6.4	5.77	6.38	5.49	5.7	6

All actual data excluding interest & exchange rates sourced from Statistics NZ.

The BNZ Weekly Overview is prepared by Tony Alexander, Chief Economist at the Bank of New Zealand. Ph 04 474-6744.

*extrapolated back in time as Total Money started in 2007