

FINANCIAL REVIEW NOVEMBER 2005

ADAM PARORE
MORTGAGES

FOR A BETTER DEAL



Adam Parore Mortgages • Level 3 • Gt South Rd • Greenlane • Auckland • Fax 09 523 0355 • Ph 0800 800 067 • email info@adamparore.co.nz • web www.adamparore.co.nz

POOR PRODUCTIVITY - ARE WE HEADING INTO AN INFLATIONARY ENVIRONMENT?

The ability to increase an economies productivity is seen as a key ingredient to sustainable economic growth. We heard much talk of capacity constraints and the like in the lead up to the election- tellingly despite almost all of the major political parties acknowledging the issue I heard very little in the way of solutions. The reason for this is that there simply isn't an easy solution.

IN A NUTSHELL THE PROBLEM IS AS FOLLOWS;

For a number of years we have enjoyed strong growth almost entirely on the back of greater use of existing labour resources (a reduction in unemployment as additional workers find jobs) and a running down of the spare quantity of resources like roading capacity and electricity. Now we are into what looks like a prolonged period when resources will be in short supply. Electricity usage has risen to the point that we now need to generate more, and find new ways to transport it to the areas where it is needed. Traffic congestion, particularly in Auckland, means that it now takes longer to get things done- this is particularly so in a business such as ours. We can no longer travel to as many appointments as we used to, and the appointments we do attend now take much longer. In short we are not as productive as we were. These issues are now common to almost everyone in our economy.

The solution to the problem is to become more productive. Productivity is the measure we use to determine how much output (production) we are getting for our input (resources). In layman's terms we need to find ways to get more bang for our buck! If we do so we can continue to grow our own businesses, and the economy, without producing inflation. If we can't, and instead just commit more resources to achieve the same level of output as previously, then we will create inflation. Alternatively we could slow growth to limit inflation but this is a poor second option. I want to grow my business as I'm sure everyone else does!

Politician's talk of the economy being 'capacity constrained' means that we have used up all our resources- to grow we need to get more out of what we have. Rising productivity is important because it improves the ability of employers to pay higher wages and it means that for any given rate of growth in one's resources — labour, infrastructure, raw materials, capital — our economy can grow faster without rising inflation.

Current inflation data supports the view that we have a productivity problem. With inflation presently at 2.8%, despite being suppressed by a 30% rise in the exchange rate, and forecast to head over 4% shortly you don't need to be a genius to work out that recent growth hasn't been as efficient as it might have been- if it had we wouldn't have the inflation issue we currently do!

We attempt a rough measure of productivity growth by comparing changes in hours worked from Household Labour Force Survey data with output from the production based GDP numbers. When we do this we see that over the past ten years productivity has grown by 1.3% pa on average. If we look at just the past five years we get growth averaging exactly the same. So there is no acceleration in productivity growth underway using this crude measure. If we look at just the past year to June we see that with the recently released GDP data thrown in productivity growth was only 0.5%. This is a very bad sign!

If we take it as given that it is unlikely (impossible) that we can suddenly increase our collective productivity, then the only other solution is that our economy's growth rate has to slow down pretty quickly. The fact that this is happening only slowly is where one gets the current inflation problem from. The risk is that if we bang inflation on the head hard enough (in the form of rising interest rates) we may knock economic growth as well. In the meantime productivity growth will remain as a key area of improvement if we are to avoid entering a period marked by on- going and sustained inflation.

SNAPSHOT

NZD\$		0.726US
OCR		7.00%
Interest Rates		Rising
Business Confidence		Low
Housing Market		Solid growth
Inflation		2.8%
Migration		net gain +2000/mth

INTEREST RATE VIEW

The Reserve Banks struggle to contain a rampant housing market has seen the OCR raised 8 times since January 2004 with little or no effect (as yet). For the record, as at the end of August registered banks had \$107b lent to households for home loans. 21% was at floating rates and 79% fixed. Not surprisingly the RB has enjoyed little success to date by using what appears to be an increasingly impotent monetary policy instrument.

Ironically it appears that increasing fixed rates will now work to slow the housing market. Fixed Rates are funded by a variety of channels including the eurokiwi and uridashi markets, where our local banks compete against the low interest rates of the European Central Bank and the Bank of Japan. The result of this has been over \$20b of low cost deposits used primarily to fund local banks fixed rate mortgage books.

A quick look at the yield on 90-day bank bills shows they have moved out to 7.35% from 7.16% in September. Combine this with major moves in the 1-5yr Swap rates (the rates at which banks borrow to lend fixed) and it appears that our view that fixed rates have been 1.00- 1.50% undervalued for 12 months appears to be correct. For example the 2 year rate has jumped to 7.27% from 6.7% in September. As a consequence the bargain basement fixed rates of recently have now been reprised at closer to 8.10%.

Adding to the upward pressure on swap rates are worries in the US of rising inflation and the Federal Reserve having to raise interest rates more than generally expected to date. As a consequence the US ten year government bond yield has risen to 4.59% from 4.46% a week ago and 4.28% a month ago.



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OCR REVIEW

As had been anticipated in the financial markets the Reserve Bank tightened monetary policy for the eighth time this cycle in October by raising the official cash rate another 0.25% to 7.0%. Perhaps of greater concern was Allan Bollards comments as to the future direction of monetary policy and his now stated determination to bring the housing market to its knees.

“The most serious risk to medium term inflation is the continuing strength of household spending, supported by a relentless housing market and rapid growth in mortgage lending. Significant dissaving by the household sector is showing through in a worsening current account deficit, now 8 per cent of GDP. Borrowers and lenders alike need to recognise that the current rate of debt accumulation is unsustainable. The correction of these imbalances and associated inflation pressures will require a slowdown in housing, credit growth and domestic spending. We also expect a significantly lower exchange rate. The longer these adjustments in behaviour and asset prices are deferred, the more disruptive they are likely to be.”

OF MOST INTEREST HOWEVER WAS THE STATEMENT;

“The prospect of further tightening may only be ruled out once a noticeable moderation in housing and consumer spending is observed. Certainly, we see no prospect of an easing in the foreseeable future if inflation is to be kept within the 1 per cent to 3 per cent target range on average over the medium term.” What does this mean? Effectively the RB is telling us that interest rates are going up by 0.25% every 6 weeks until they see some sign that the spending binge, and the runaway housing market,

are starting to weaken. On this basis a further rise in December to 7.25% is a certainty and unless things calm down over Christmas, when retail spending is at its seasonal peak, they will go again in January 2006. For those of you looking for a reason to take it easy on the Christmas shopping this year it doesn't get to look any better than this...

For my money I think things have already begun to slow significantly, and this will be apparent to all by early next year, meaning we should escape that extra paddle on the behind in January.

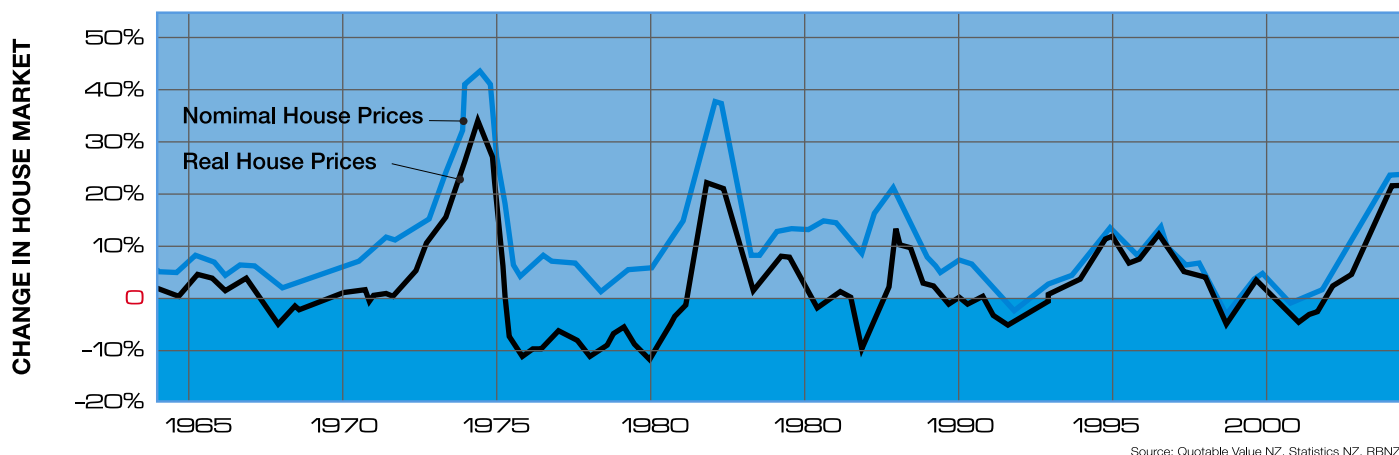
IF I WAS A BORROWER WHAT WOULD I DO?

The trend in US interest rates is now undeniably upwards, which means upward pressure on our fixed rates. With the Reserve Bank now signaling the beginning of a fight to the death over inflation it is now obvious that all borrowing costs will rise. The odds are that the likes of 2-3 year fixed housing rates will go to 8.5% in the next few months from about 8% currently. So if one wants the security of a fixed rate, and given the state of floating rates you would be mad not to, then now is the time to grab them while the going is good. I would go for 3 years now which is a change from my view of the past 12 months that 2 years was the place to be.

For those borrowers currently approaching the end of their existing facilities breaking a rate with 2-3 months left and getting one of the current rates looks to be a good idea. If you hang in there and let your current arrangement run its course you may be in for a nasty shock.

HOUSING MARKET

HOUSE PRICES SOMETIMES FALL



This is definitely beginning to look like the dog that won't die. Given we've all had a pretty fair go at it over the last few years, and those of you who own homes are more than likely sitting on a capital gain of at least 50% it is probably time to get your head around the fact that the end of the golden weather must be nigh. Particularly so given the Reserve Bank's determination to bring the housing market to a stop. So, what happens next? Will house prices fall? A look at the graph below suggests that house prices do indeed fall from time to time, but not often!

If you cast your eye to 2000 you can see that house price growth for the last 5 years has been +5%, 0, +8%, +18%, +22%. Add in the current 16% for this year and you have an increase in average house prices of 69% since 2000. Based on these numbers if we got a decrease of 5% next year, and then again maybe again the year after you would still have to be pretty happy wouldn't you?

So where's the danger? The danger is for those who have not participated in the last 5 years of gains- ie. recent house buyers. Who is most at risk? As always those who are highly leveraged. Consider the following scenario:

You are a 1st home buyer, and have had the misfortune to buy at the peak of the cycle. In fact, the instant you purchase the inevitable retreat of the housing market begins. Your first year of ownership sees house prices retreat, wiping out your 5% equity (you had saved years for that 5% deposit to allow you to buy using a 95% LVR product aimed especially at 1st home buyers). Your second year of ownership sees a further 5% wiped off the value of your home- you are now in negative equity territory. If you sell now you will actually have to come up with another 5%, in cash, before the bank will release its mortgage and allow the sale to proceed.

Is this a problem? Only if you lose your job- consider the likely scenario that as the economy slows, the job you accepted when your employer's business was full steam ahead, and new contracts were coming in the door daily, is now starting to labour under much less expansive conditions. Will you survive? Do you need the pressure of having to?

The above is a real world scenario that will face hundreds of home owners at some stage in the immediate future- it happens to

someone every time we enter a down phase in the property cycle. It is the reason that economists all over the country are urging caution. Now is not the time to be borrowing aggressively...

Outside of this scenario a fall will be far from the end of the world. At present house values are running at about 20% ahead of the long term trend. Does this imply a sudden and drastic correction? The graph shows clearly that residential housing can exist outside of equilibrium for decades before slowly reverting to trend- this was the scenario right through the 1970's. It appears likely that over the years to come we will gradually drift back to the long term average, rather than the boom/ bust scenario some were advocating a few years back.

THE ECONOMY IN BRIEF

**The New Zealand economy
is in a very sweet spot.**

In the year to September, the economy grew 4.6%

We are in the top 10 for growth in the OECD.

**Growth has averaged 3.9% per annum
for the past five years.**

**Strong labour market = consumer spending,
borrowing and housing-related activity.**

**Profits are strong= investment and employment,
which in turn drives consumer spending
and profitability.**

**Forecast growth is projected
to settle back to around 3%.**

**Supply constraints (labour, resources)
will remain for some time.**