

JUNE 2008 NEWSLETTER

Hi John,

Bubbles and inflation

The interesting thing about economic “bubbles” is that as soon as they have burst you realise how obvious it was that they would.

An excellent article by Rodney Dickens entitled “The idiots guide to investing” talks about some of the bubble bursts we have seen here – like Angora Goats - and highlights the current precarious position of house and section prices. This is great reading in Rodney’s inimitable style. To do so [click here](#)

The point is of course that all sound investments are based on future revenue streams. And if these are unsustainable then the value of the asset generating them will eventually go down in value. And property is no exception – whether the revenue comes from the sale of the sections in the subdivision, or the tenants the property owned can attract.

In Rodney’s latest Housing Prospects newsletter - for a sample report [click here](#) - he says it looks like the trough in house sales is not far off. But the downturn for residential investors will be protracted and the gap between house prices and rents and incomes is so large that “it will be years rather than months or quarters before housing offers genuinely cheap buying opportunities”.

In the meantime owner occupiers are happy to sit where they are, or if they are changing houses there’s no difference if they’re selling or buying on the same market. And all the scaremongering articles that tens of thousands of people are going to lose their homes from high interest rates is nonsense. BNZ economist Tony Alexander, in his latest Weekly Overview, shows how the numbers quoted in one article don’t stack up. To see this [click here](#) and go to page 15.

But there is another consequence of the end of the housing boom. The economy over the last five or six years has been consumer driven – largely by the increase in the value of their houses. According to a recent Westpac article, housing equity withdrawal - people tapping into the wealth gains from the increase in value of their houses - peaked at \$5.7 billion in the year to June 2007. They estimate maybe 25% of that wealth effect was used to fund consumption. Indications are housing equity withdrawal is mainly attributable to households involved in property transactions. So with house sales 50% of what they were a year ago expect tougher times.

In any event it’s clear that the housing boom is over, and the worst of the global credit crunch seems to be passing (although there’s still some debate about that). So globally the central banks’ attention is back on to inflation fears - driven now by surging oil and food prices.

Typical of this concern is the announcement last week by the European Central Bank in a report released to commemorate its 10th anniversary. “A firm anchoring of inflation expectations remains of the essence and is given highest priority” it said. And in the U.S. Fed Vice Chairman Kohn while commenting that the current monetary policy stance was appropriate said “If longer term inflation expectations were too become unmoored ... we would be facing a serious situation.”

Yesterday the Reserve Bank of Australia held it’s cash rate at 7.25%. the statement accompanying the decision was also typical of the times. “Given the opposing forces at work, considerable uncertainty remains about the outlook for demand and inflation. On balance, the Board’s current assessment is that demand growth will be moderate this year. In the short term, inflation is likely to remain relatively high, but

it should decline over time provided demand evolves as expected. Should demand not slow as expected, or should expectations of high ongoing inflation begin to affect wage and price setting, that outlook would need to be reviewed."

Tomorrow the Reserve Bank of New Zealand will announce its Monetary Policy Statement and with the opposing forces of a slowing economy but high inflationary expectations they are expected to keep the official cash rate the same at 8.25%. One would expect a similar statement as to that the Aussies gave above.

Of course inflation means different things to different people. Tony Alexander's Weekly Overview mentioned above, demonstrates how the overall CPI increase of 12.5% over the last 4 years is made up. This shows "if you buy lots of audio visual and computing goods, send your children to childcare facilities, and have an Imelda Marcos like fixation for shoes, your inflation rate will be substantially less than someone who eats lots and lots of food, sits in front of the electric heater all day and spends the evenings driving their car for hours." To check out his list of items and their inflation rates over that time [click here](#) It's on page 8.

So are we now facing runaway inflation driven by high oil and food prices? Will this keep interest rates high? Or are these price rises just another "bubble"?

To us here in New Zealand, the increase in food prices are a hassle but the increased income from the dairy industry is a huge blessing - not just to the dairy farmers but the rural communities that are experiencing excellent growth, and to the country itself. And it's not as though we have to import food to survive.

More important to us is the increase in oil prices which affects everyone from Air New Zealand shareholders, to transport operators, to our tourism industry (according to some horror articles that have recently appeared in the paper).

Well there's several interesting articles I've just read that look at other not so obvious effects of increasing oil prices and provoke the question of whether this is another bubble driven by speculators.

The first - for those of you interested in politics - is from John Maudlin's Investors Insight newsletter where he posts an article by George Friedman on the Geopolitics of \$130 oil. This examines the shifts in global power. To read this [click here](#)

The second is a far more sobering article in The Australian by Anatole Kaletsky, associate editor of The Times and a leading commentator on economics. In his view "The present commodity and oil boom shows all the classic symptoms of a financial bubble." To read the article [click here](#)

The third, by Neville Bennett Senior Lecturer in History at the University of Canterbury, in an article in the latest National Business Review entitled, "Speculators inflate oil bubble". He is of the view that the spot price of oil is controlled by traders, who are removed from the real economy. Although his conclusion is "high prices are here to stay because of increasingly expensive supply."

And finally, George Soros in an interview with Britain's Telegraph gives his view. Speculation... is increasingly affecting the price," he said. "The price has this parabolic shape which is characteristic of bubbles." To read this [click here](#)

Could oil be the bubble we can't wait to see burst?

Cheers

JP



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