

**MARCH 2008 NEWSLETTER**

Hi John,

**Finance more available – but more costly**

The interest rate announcements from the central banks this month show inflation continues to be their major concern. But they also comment on the fragility of the global financial markets.

Although the New Zealand Reserve Bank left our Official Cash Rate unchanged at 8.25%, their statement included “There is more uncertainty than usual at present, with downside risks to activity and upside risks to inflation” and “Given this outlook, we expect that the OCR will need to remain at current levels for a significant time yet to ensure inflation outcomes of 1 to 3 percent on average over the medium term.”

Two days earlier the Reserve Bank of Australia had increased its cash rate by 0.25% to 7.25% “in order to contain and reduce inflation over the medium term”.

Elsewhere, the European Central Bank held its rate at a 6 year high of 4% and the Bank of England kept its rate unchanged at 5.25%, after cutting it twice in the last 3 months. Japan held its rate at 0.50%. All mentioned inflationary pressures.

This is a sharp contrast to the U.S Federal Reserve which is attempting to stem the panic arising from the sub-prime crisis there. It has reduced its key rate five times in the last 6 months – including an emergency 0.75% cut on 22 January. And the futures markets are currently predicting a further 0.75% drop when the Fed meets on the 18th of March.

Looking at the various central bank official rates, we now have:

New Zealand 8.25%  
Australia 7.25%  
U.K. 5.25%  
Europe 4.00%  
Canada 3.50%  
U.S. 3.00%  
Japan 0.50%

But whatever’s happening outside New Zealand, one thing is sure – the cost of finance here is increasing. This is due to a number of factors.

- Generally speaking the days of easy cheap finance driven by the global savings glut have gone.
- Floating interest rates here increase according to the increase in the Official Cash Rate. Views on how long this will remain at current levels, vary (see below).
- Fixed rates are mainly driven from offshore via the “swap rates”. While there have been cuts in some rates – especially the U.S. – interest rates have been driven by increased concerns about risk and the “cost of credit” has increased. This has wiped out any affect lower official rates

offshore may have had for us here.

- The flight from finance company debentures in New Zealand has left a great hole for funding the likes of second mortgages, capitalised interest loans, and mezzanine debt for developments. This hole has yet to be filled to the level it was before. There are lenders around but they are picky and expensive.
- Banks globally are feeling the affects of the write downs incurred as a result of the sub-prime debacle. The securitisation virus has spread globally, nobody knows where it will end up next, and nobody knows how much the losses might be as the complicated financial instruments are illiquid and unable to be priced. And hey, this is not small stuff. UBS says the losses from credit market problems are likely to be in excess of US\$600 billion. Others say losses will be US\$1 trillion - being at least US\$500 billion mortgage related losses plus another US\$500 billion from other areas of dodgy credit that have been securitised.
- While the largest losses have been felt primarily by U.S. based banks, banks everywhere are scrambling to get their balance sheets and capital ratios in order. In New Zealand we're seeing the BNZ and the ANZ out in the market with listed "perpetual bonds" offering investors interest rates in the 10% range. While these are down the security chain and rate like shares, this is forcing non-bank lenders like finance companies to offer investors rates in excess of 10%.

If you listen to the Reserve Bank you'd not be expecting any reduction in interest rates this year or next. Others, like the ANZ and the NZX, believe a slowdown in the economy is really upon us and a reduction in the Official Cash Rate may be forced upon the Reserve Bank sooner than they expect. My view is that even in the unlikely event that happened, it would not be of much use to house owners. About 90% of residential mortgages are fixed and tied to wholesale rates – which if anything are rising because of the turmoil in the global financial markets.

Anecdotal evidence here is that consumer spending has slowed and business is starting to feel the effect. The growth in the housing market is definitely on the wane. QV February statistics show the annual growth rate in national property values was 7.7% over the 3 months – down from the 8.9% growth reported in January. Sales volumes are down and prices may follow. Even the Reserve Bank and treasury are commenting on the housing market. To see their views as reported by [www.interest.co.nz](http://www.interest.co.nz) click [here](#) and [here](#)

And there will be more blips in the residential market as over-leveraged investors – like those caught in the Blue Chip debacle – are forced to sell.

- As alluded to above, business is starting to feel the pinch. The BNZ's recent Confidence Survey shows a net 62.3% of respondents expect conditions to deteriorate. Tony Alexander notes there is a close relationship between their survey and the NBNZ Business outlook survey which will be released near the end of the month. To see NZX chief Mark Weldon's view on [www.stuff.co.nz](http://www.stuff.co.nz) click [here](#) If business is slow this will flow through to commercial and industrial property as business winds down or new premises are not sought.
- Capitalisation rates are increasing as interest rates rise. And the gap between cap rates for fully tenanted properties versus those partly tenanted or vacant, is widening. It's been an abnormal situation over the last few years where commercial property has been in great demand – no matter what the leases or tenants are, if any.
- We're also seeing cap rates varying between centres. For example, commercial properties in the Waikato - which is benefiting from the dairy boom and a tightly held commercial property market - are selling at lower capitalisation rates than Auckland.
- It's far easier to obtain finance for tenanted commercial and industrial property than it is for developments. Lenders are being more discriminating here as well with tighter conditions such as increased interest cover requirements.

The good news is there a number of lenders coming back into the market telling us they have money to lend. Investors are still placing money with institutions that have been around for a long time and that they trust. These include selected trustee lenders, building societies, and nominee lenders – not just banks.

To find out who give me a call.

Cheers

JP

A handwritten signature in black ink, appearing to read 'John Paine', written in a cursive style.

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