

Hi John,

Economy looks better - but credit doesn't

I've been down so long it looks like up to me

For the Nancy Sinatra – Lee Hazlewood song [click here](#).

Recovery's on the way

A year ago, in the August 08 GLOBAL VIEW, I talked about the three stages of corrections to shocks to the economy like the current credit crunch. They're

- Initial shock,
- realisation and rationalisation,
- and recovery.

I questioned where we were then and how long the realisation and rationalisation phase would last for. To read that issue [click here](#)

So are we now in recovery mode or not? Well certainly we're seeing some signs of it.

Globally it seems the recession has reached its trough. Asia is looking good - especially China where output grew at an annualised rate of 16% between April and June. Germany and France are technically out of recession, and even in the U.S. - where it all started - the Federal Reserve says it appears the U.S. economy has halted the longest period of decline since the Great Depression. To see articles on the U.S. economy [click here](#) and on the global economy [here](#).

The Aussie economy is looking stronger. And consumer confidence is at a two year high. The Australian Reserve Bank's cash rate has been reduced by a total of 4.25% since the credit crunch really hit in September last year but has remained unchanged at 3% since last April. There's even talk of a rise in the cash rate there. In a speech to the House of Representatives, RBA Governor Glen Stevens said "*there will come a time when the exceptional monetary stimulus in place at present will no longer be needed. It will then be appropriate for the Board to do what it has done on past such occasions, namely to start adjusting interest rates back towards normal levels*".

Here in New Zealand the economy appears to be turning the corner. The Westpac economists put much of that to migration as fewer New Zealanders leave here and more return home. This has a positive effect on construction, rents and house prices. To see the article and their discussion as to why the home-grown recovery is on its way [click here](#).

And - as I reported in last month's GLOBAL VIEW - the housing market is already out of the doldrums. This is important, as the residential property market does lead the way as a major driver of New Zealanders' investment sentiment.

House sale volumes are up 41% over the June quarter compared with the previous year, and the median time to sell a house dropped to 41 days in June compared with a high of 58 days in July last year.

Infometrics have just released a report forecasting house prices will rise 11% in the coming year and 24% over the next 3 years. That surprises me. But in BNZ economist Tony Alexander's latest Housing Market Update, he compares the alternative investments available to the punter wanting to put some money away for the next decade or so. He says "*as undesirable as it may be from a social equity point of view we Kiwis are going to keep buying houses. Prices will rise over the next three years by some unguessable*

amount. Policy-makers will wring their hands in angst – and do practically nothing to reduce construction costs or free up resources because the same hand-wringers also lobby for greater undeveloped land spaces and more environmentally – meaning expensive – planning and constructions policies.”

His Confidence Survey – reported in the same Weekly Overview – reveals “*continuing listings shortages around the country, multiple bidding with quickening sales of properties rising in some areas, but with a few more vendors indicating perhaps they are ready to go back into the market*”. Anecdotal evidence from numerous residential real estate agents I know strongly supports this view.

The same survey showed a net 42% of respondents are positive about the economy over the next 12 months. He says the results “*tell us that in spite of exporters concerns about the high New Zealand dollar businesses believe there is definitely light at the end of the tunnel*”.

To read Tony’s latest Weekly Overview [click here](#).

Even the New Zealand Reserve Bank’s talking about recovery. In a speech to the Hawke’s Bay Chamber of Commerce in mid July, Alan Bollard said “*Now, we and the world appear to be on our way to recovery*”. To see this [click here](#)

But it’s not going to be fast

All the signs are it’s going to be a slow climb out of recession. It started in the financial sector but is now moving through all aspects of the global economies.

All the offshore global news and comments I read expect the recovery to be slow. An article by Gary Shilling in John Maudlin’s “Outside the Box” newsletter talks about this and says “*the next economic recovery, which will probably start in 2010, will likely be so subdued that it may not feel like the recession has ended.*” I’ve been down so long it looks like up to me.

It’s quite a long and rather academic article but if you’re looking for something to read on the plane its worth printing out. To see it [click here](#)

Here in New Zealand I think we can expect a slow recovery too, but let’s understand the last decade was abnormal with cheap money and easy credit. We’re back to normality, where to obtain funds borrowers need to put forward a proper presentation showing debt servicing ability and a repayment strategy.

Commercial property prices more realistic

The commercial property sector will be interesting. Internationally it’s a matter for concern as the recession bites deeper in that sector of the economy. New Zealand will be less affected by the downturn as lending has been less sophisticated and aggressive than some places offshore. But here, as house prices move down, then consumers stop spending, so businesses stop leasing premises, and then vacancies occur, and the value of commercial buildings drops.

Accordingly we can look forward to a more realistic pricing of commercial property based on the strength of the leases – which will be reflected in a greater range of capitalisation rates, or yields, between fully tenanted and other properties. This will bring up some good buys for punters who have faith in the recovery – which incidentally I do.

The recession has also seen private investors back in the market as institutions and listed trusts withdraw or re-align their asset allocations. To see the Herald article [click here](#)

Fixed interest rates rising

The New Zealand Reserve Bank is committed to a low Official Cash Rate for the foreseeable future so we can expect floating rates to remain low. Residential floating mortgage rates are the lowest for 40 years. Kiwibank just announced a rate of 5.79% and the BNZ has reduced its standard rate to 6.3%

But fixed rates are rising driven by growing acceptance that the global economy is recovering. For a graph showing the way these rates have been moving [click here](#)

I’m of the view the economy is still fragile and the spectre of inflation is some way off. So we might be

seeing more borrowers stick with the floating rate rather than jump in and fix before the rates rise more (which may well have accounted for the recent rises as the demand to fix grew).

The Credit Crunch is still here

In Australia and New Zealand we have not experienced the financial excesses seen offshore - in the U.S. and the U.K. especially. They're in a liquidity trap there. The governments have flooded their banking systems with huge amounts of money. But instead of providing it to private and corporate borrowers they have taken the opportunity to repair their own balance sheets.

The situation here in New Zealand is not much better. Moody's Investor Services say the New Zealand banks are not out of the woods yet. *"Non-performing loans, measured as non-accrual loans and loans more 90 days past their repayment date, had risen dramatically as delinquencies increased."* [Click here](#) to see article

Quite apart from the toughening of their credit criteria the banks do have less funds available to lend and are favouring existing clients. So it's tough getting a bank loan for anything other than the most vanilla of proposals.

Now we all know how the demise of the finance companies has reduced dramatically the amount of non-bank and second tier finance available. But what's not so well known is that most of those remaining are changing their lending policies. Interest only loans are hard to get as lenders concentrate more on repayment requirements. They are requiring far more stringent rules and clear "exit strategies" for new loans. On existing interest only loans many lenders are now not rolling them interest only but are looking for reductions in the loan, or principle and interest repayments.

The two high profile finance companies Marac and South Canterbury Finance have respectively ceased completely, or reduced dramatically, their lending to the property sector – largely as a result of their existing exposure there. We've all seen the recent reduction to their credit ratings.

But what's really worrying for many of the non-bank lenders is the uncertainty of what's going to happen when the government's retail deposit guarantee scheme expires on 12 October next year. This uncertainty is a real problem for both depositors and finance companies. As the deadline approaches - without any government policy announcement - depositors will continue to lend shorter, lenders will have to do the same, and all of a sudden there's a huge mismatch in this part of the financial sector.

Some non-bank lenders have already stopped lending completely until the government announces their policy.

Bernard Hickey from interest.co.nz estimates finance companies covered by the retail deposit guarantee scheme owe retail depositors up to NZ\$5.85 billion. And that's without the building societies, solicitor nominee companies, credit unions and other lenders that do not qualify for the guarantee. To see Bernard's article [click here](#)

An article by John Kidd of McDouall Stuart Securities says the Crown faces a major problem in how to unwind the scheme without itself disturbing credit markets. The cold turkey option of simply not continuing the scheme in any form beyond October next year would be very high risk. He says they way this is done *"will be one of the government's key policy challenges over the next few months, and probably years. Irrespective of how exactly this unfolds, the ongoing silence from policymakers on how they propose to deal with the October 2010 expiry is already resulting in serious and increasingly urgent concern among lenders and those that rely on funding for their businesses."* To see this [click here](#)

Unless the future of the retail deposit guarantee scheme is sorted out soon, this could result in an even worse Credit Crunch than we're now experiencing. The worst hit could well be small businesses that rely on non-bank finance.

Cheers

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