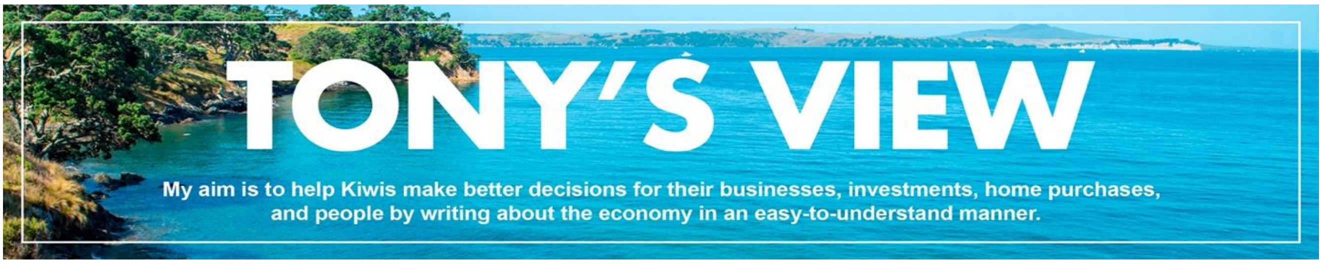

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ISSN: 2703-2825 Thursday 16 March 2023
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The new-build downturn

There has been a boom in the building of dwellings in New Zealand since 2011 when activity fell to the lowest levels since the 1960s. The trouble with a boom however is that it always ends, and the question becomes will there be a bust or will the pullback from unsustainable heights be something gradual? And when one has a grasp for the nature of the decline the question then is how long will one have to wait for better conditions to appear.

The popular way of gaining insight into where house construction is headed is to look at changes in the number of consents issued by local authorities around the country. But the reliability of these numbers as a leading indicator of construction volumes has fallen in recent times.

Many people have secured building consents simply with the intention of boosting the potential value of the land which the dwelling(s) will sit on. The aim is to preserve land value in a market of declining land demand and pricing.

Many consents have been issued for projects which will never realistically see the light of day because pricing is now out of whack with what a buyer can get an established dwelling for. That is, average construction costs for the past year have risen 13% but prices for existing dwellings have declined by more than that.

Many projects no longer stack up financially – especially as buyers have 28,000 listings of existing dwellings to pick and choose from compared with fewer than 14,000 in the middle of 2021.

We can gain some insight into where buyer demand is going for new builds by looking not just at consents data but also the many indicators created from my various monthly surveys.

For instance, my monthly survey of mortgage brokers shows a record 59% observing more first home buyers entering the market. But my monthly survey of existing property investors shows decreasing desires to undertake one's own property development and decreasing interest in buying a new build.

If you are one of the hundreds or probably thousands of builders and property developers wondering what lies ahead following the mother of all surges in activity in recent years, I'd suggest looking at the details in my surveys and gathering them plus other indicators together to gain some coalface insights into the nature of this cycle's pullback.

Putting the boot in

There is a lot of focus on high bank profits at the moment and strong chance of an enquiry into the situation which will lead to no meaningful change but deliver good money for the people involved and votes for politicians pushing the issue.

Why is there a focus on banks currently? Many reasons.

First, this is an election year and senior bankers know that while as a rule you stay out of the media for all but achievement-focussed puff pieces in normal years, in an election year you shut up shop completely. There is basically no downside for any politician sticking the boot into banks because we Kiwis love borrowing other people's money and hope that maybe some action could be taken to limit the cost.

Second, monetary policy is tight and being tightened further. This is the part of the cycle when people put forward generally unworkable ideas for alternatives to high interest rates as a means of reducing inflation. When interest rates are falling those ideas are not brought forward. Some people are in financial pain because interest rates are rising and it is only human that we should feel discontent towards those we have to pay extra money to every fortnight.

Third, New Zealand is a small country with insufficient competition in a wide range of sectors. These include groceries, petrol, domestic air travel, building materials, and banking. These sectors have oligopolistic structures and that means lower prices on average than when an unregulated monopoly exists, but higher average prices than when strong competition and easy entry and exit is present.

Fourth, businesses are currently having their profits badly squeezed by sharp increases in costs for materials and staff. They also face difficulties managing the stress associated with these issues and the discontent of customers not receiving the level of service and timeliness of goods delivery and quality that they expect. Yet banks continue to report very strong profits. Their relative outperformance and ease of achievement grates with people.

Fifth, there is extra resentment towards banks created by the government's ham-fisted reform of the Credit Contracts and Consumer Finance Act and the Reserve Bank's extra-tight Loan to Value Ratio rules. People are struggling to get credit and as we all believe we are worthwhile borrowers we resent banks for not seeing ourselves the way we do.

Sixth, whenever a sector or locality is placed under strain one of the first things politicians say is that they hope banks will continue to support their clients. The assumption they convey to people is that banks are cruel and will pile on the pain when challenges come along by tightening credit availability. We all have examples of this very thing being done so such comments automatically trigger us back towards disliking banks as fair-weather friends.

Recently we have been struck by some big events so the triggers are activated. This reinforces the upside to politicians of attacking banks.

An enquiry of some sort is likely. Nothing will change unless competition grows. But the sector is so heavily regulated it is very hard to set up a new bank and grow. Just ask KiwiBank.

SVB collapse

You've probably all read a great deal about the collapse of the Silicon Valley Bank in the United States. In summary this is what happened and why.

Created in 1983 TVP specialised in lending to tech sector startups and did strong business as all tech-related entities did during the pandemic. In particular they took a lot of deposits from tech companies doing well. But they got more deposits than they needed.

What did they do with this spare money? They put it into fixed interest securities such as US government bonds and higher yielding mortgage backed bonds. All good so far. But in the United States you don't have to mark your bank bond asset book to market as in NZ. That meant that as the Fed. tightened monetary policy and interest rates rose, SVB did not have to report losses on their large bond portfolio. Those losses for all US banks at the end of 2022 stood at over US$600bn.

This accounting treatment might have been fine if the Treasurer for SVB had hedged the fixed rate products back into floating. They did not. Doh.

This past year the tech sector has been correcting downward in a post-pandemic pullback. The thousands of tech businesses with their large deposits in TVP had to withdraw some of their deposits to pay ongoing expenses and fund growth no longer easily able to be done through issuing new shares as investors backed away from tech businesses.

As the deposits went out SVB's door in a normal non-worrying manner they had to sell some bonds. That meant they had to record losses accrued from market yields on those bonds rising.

SVB's losses became so great they decided it would be best to raise an extra $2bn in capital. However, investors have little interest in tech-related stocks currently and as their efforts from last Wednesday to raise capital were seen to be floundering depositors got wary. Those tech business depositors started withdrawing funds as quickly as their typing figures would allow and got over $40bn out which SVB had to fund by selling more bonds, racking up more losses, and ultimately wiping out all their capital.

This was a classic run on the bank started by the depositors now being bailed out but caused ultimately by the accounting rules for banks in the US, a special Trump-era exemption for banks with assets below $250bn like SVB to not stress test their liquidity holdings, and the decision by SVB not to hedge away their exposure to rising yields/falling prices on their massive bond holdings.

The SVB depositors have had their holdings bailed out by the US authorities but SVB shareholders and holders of their own bonds will lose all their money. So this is not a bailout of the bank's owners as happened in the GFC. The issue is tech sector specific but SVB was the 16th biggest bank by assets in the US and the largest bank failure since 2008. Investors worry that other investors will worry about other investors selling shares of other banks and withdrawing deposits, and this fragile confidence matters.

The end result looks like reduced scope for US monetary policy to be tightened further because of new exposed risks involved and that means lower interest rates in New Zealand than people were expecting before last weekend. This will help lift our housing market.

If I were a borrower, what would I do?

For the first time in a while wholesale interest rates in New Zealand have fallen by appreciable amounts this week. The declines come about in response to developments in the United States.

First, although jobs growth in February was still strong at 311,000 people, the wages growth measure increased by slightly less than expected. This is leading to confidence that the labour market is easing off as a source of inflationary pressure in the US.

Second, a Californian bank which funds tech and health start up ventures was taken over by the authorities and this has raised concerns about the banking sector overall. Such concerns have led to falls in share prices and likely will dent consumer and business sentiment with the result being some extra hesitation to raise prices and slight cutbacks in spending plans.

The situation is quite fluid and there is talk of this first banking collapse since 2008 representing potential for a repeat of the problems seen back then. But that seems like a stretch too far considering the absence of any obvious credit blowout in a large sector such as happened for housing in the years leading into 2008. The losses accrued by the bank SVB are driven not by loans going bad but by the reduced value of their bond portfolio in response to increases in interest rates engineered by the Federal Reserve, and exposure to the post-pandemic downwardly correcting tech sector.

At the same time as the FDIC has taken control of SVB, a bank which extensively funded crypto businesses has chosen to go into liquidation.

Because of these developments emerging thoughts that the Fed. might raise it's funds rate by 0.5% at the next review in a week's time have backed off and just a 0.25% rise is once again expected – or none at all.

The outcome so far has been that the benchmark US ten year government bond yield has retreated to near 3.45% from just below 4% a week ago. The two year yield has fallen to near 3.9% from just under 5%.

Here in New Zealand some of the rate changes which we have seen include these. The one year swap rate at which banks borrow fixed to lend fixed has fallen from 5.65% to near 5.3%.

The three year swap rate has fallen to near 4.75% from 5.25%.

The next cash rate review in New Zealand happens on April 5. The chances remain strong that the Reserve Bank will lift the cash rate – but by how much will be a fluctuating thing between now and then. 0.25% is likely and 0.5% is possible.

If I were borrowing at the moment I would fix one year but not totally discount fixing a portion for two years. Inflation is proving harder to suppress than hoped internationally so we have to be open to the possibility that monetary policy here does not ease as soon as many of us have pencilled in for 2024.

Nothing I write here or anywhere else in this publication is intended to be personal advice. You should discuss your financing options with a professional.