

INTEREST RATES

The Reserve Bank review their official cash rate next Thursday morning and it is our expectation that they will raise it another 0.25% thus taking the rate to 3%. That will mean another round of increases in floating bank lending rates though what happens with medium to long term rates will depend upon the commentary they attach to the rate move. They can either make reference to continuing worries about Europe, signs of US household spending easing back again, and weakness in the NZ domestic economy, or they can note upturns in IMF world growth forecasts, above average consensus predictions of our trading partner growth, increasingly good NZ business balance sheets, the interestingly firming NZ labour market, upturns in car and commercial vehicle registrations, and firm indicators for the service and manufacturing sectors.

So we wait, and in the meantime this week the yield on 90-day bank bills has crept a tad higher to near 3.29% from 3.24% but the mid-range two year swap rate has eased to near 4.28% from 4.32%.

Just for your guide, the swap rate can be thought of as the cost to us banks of borrowing money here in NZ to lend at fixed interest rates. Note however that this is not actually the rate we finally end up paying because when we borrow offshore for about 40% of the lending we do in NZ we pay a risk premium above swap rates to foreign investors of another 2% or so. Also old relationships between wholesale interest rates and the rates borrowers end up paying continue to change not just because of the higher offshore risk premium but because strengthening competition for NZ deposits has pushed term deposit costs well above historical norms versus wholesale rates. Plus we have to hold more and more capital in this increasingly risk averse world following the global financial crisis.

Key Forecasts

- Tightening through to mid-2012.

FINANCIAL MARKETS DATA

	This Week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	2.75%	2.75	2.50	2.50	2.50	5.9
90-day bank bill	3.19%	3.19	3.13	2.67	2.76	6.2
1 year swap	3.87%	3.87	3.80	3.51	3.13	6.3
5 year swap	4.90%	4.96	5.09	5.31	5.45	6.6
180-day term deposit	4.10%*	4.10	4.80	4.90	3.15	6.0
Five year term deposit	6.75%	6.75	6.75	6.75	6.00	6.5

* 150 days = 5%

If I Were a Borrower What Would I Do?

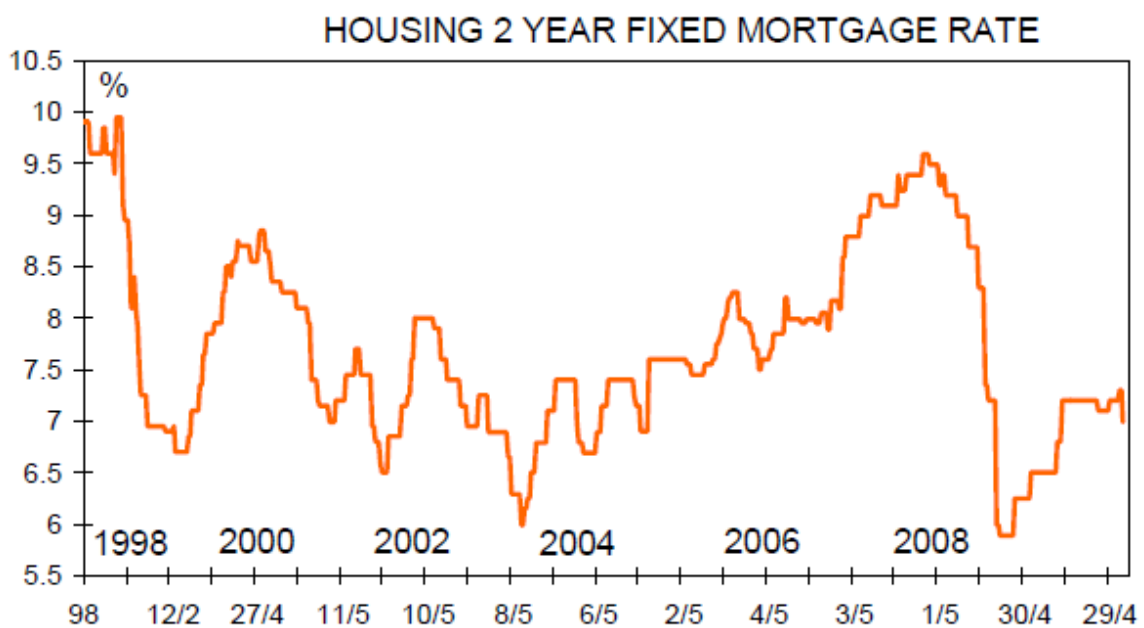
It would be great to say I would definitely do this or certainly do that. But at the moment it is still almost the toss of a coin for myself between fixing two/three years and staying floating. Given that I have a low tolerance of risk my personal inclination is to fix. But most people will not be able to bring themselves to do this because it involves increasing one's interest cost straight away in moving from a floating rate near 6% to a fixed rate of either 7% or 7.3%.

In addition it is not very hard to make an argument that the world economy in many respects is still so wobbly that the Reserve Bank will not be able to increase short term interest rates as rapidly or as much as we think. So continuing to take a punt by sitting floating could be a wise thing.

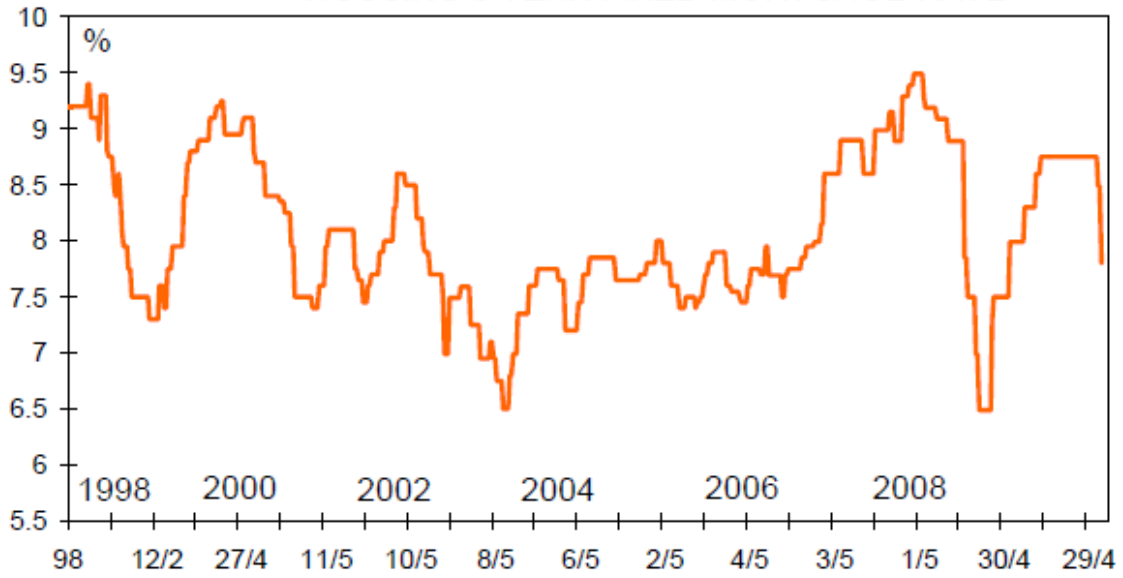
But then again we see an economy here which is growing partly on the back of exposure to the Asian part of the world which is doing well and with fewer spare resources than normally seen at this point following a recession and weak enough business investment that low productivity cost increases threaten inflation further out.

In other words it is still largely the toss of a coin. But for the record, based on our monetary policy forecasts but adopting a scenario where the RB pause in their tightening cycle in December and January I would expect to be paying less fixing two years than floating come May next year and than floating than fixing three years come June.

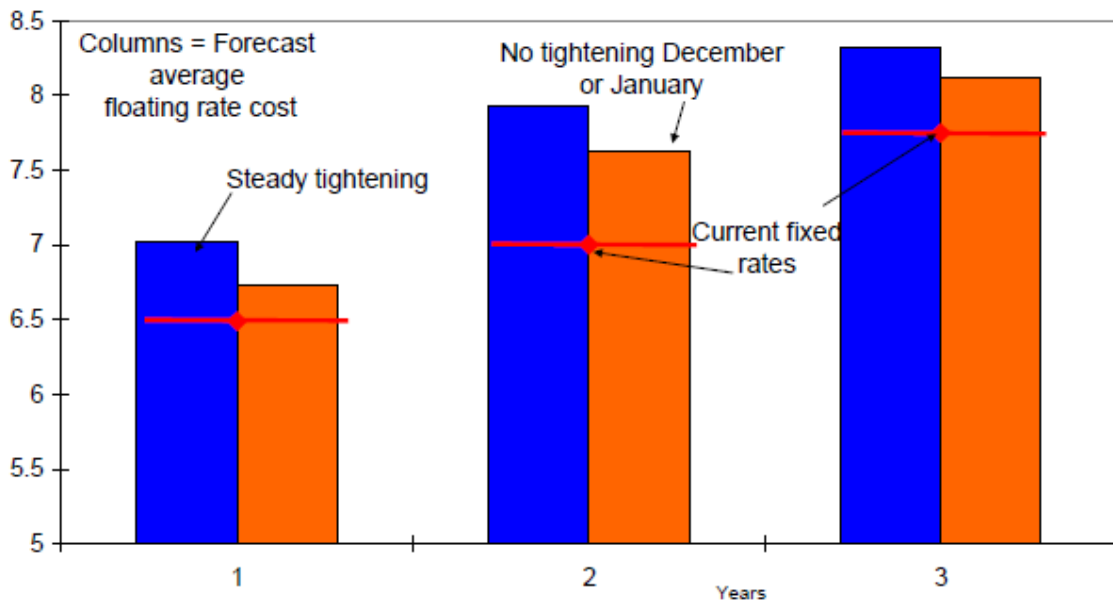
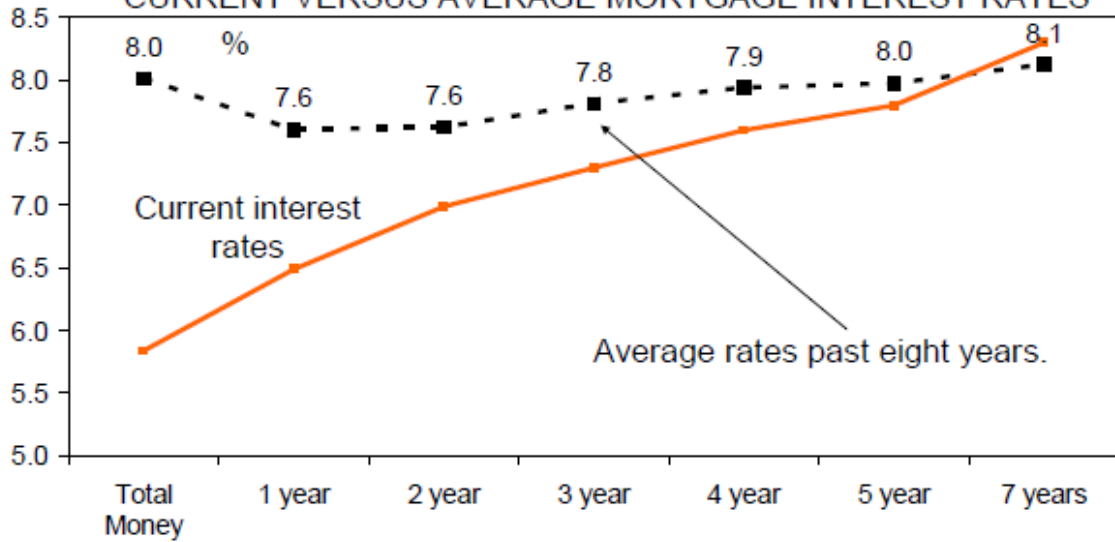
Perhaps for many people the optimal decision would be some floating and some fixed. As the economy improves and small businesspeople in particular get some lump sum income the floating part can be paid down without penalty.

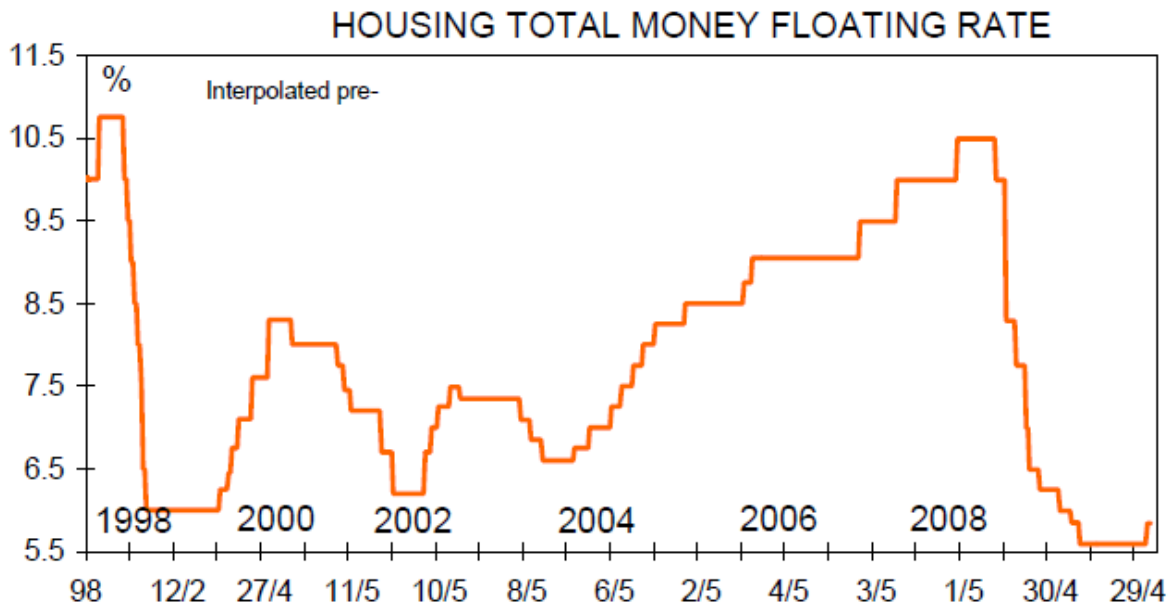


HOUSING 5 YEAR FIXED MORTGAGE RATE



CURRENT VERSUS AVERAGE MORTGAGE INTEREST RATES

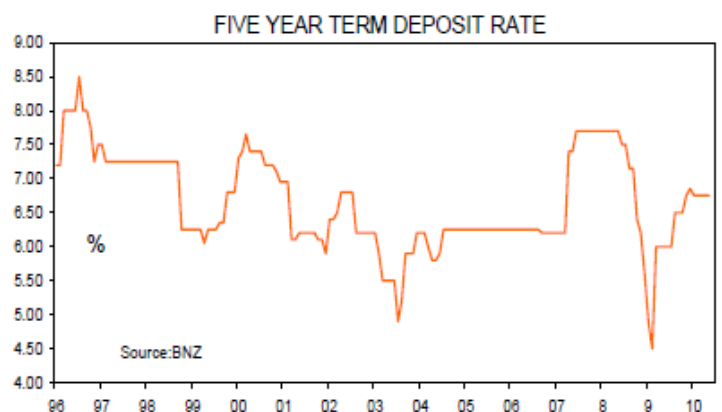
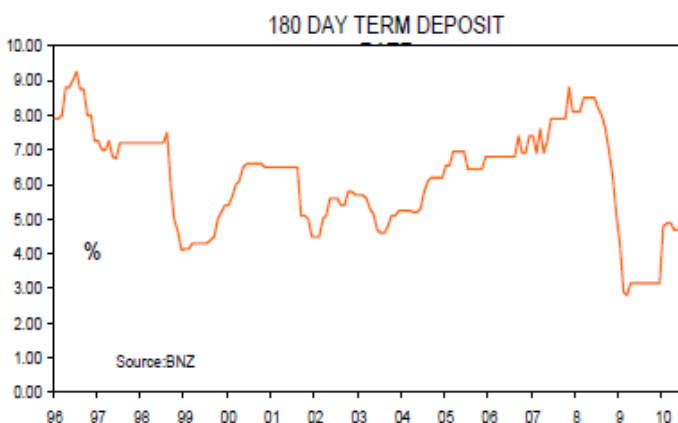




If I Were a Term Deposit Investor What Would I Do?

No new factors have appeared this week to alter our view that short term deposit rates will rise over the next couple of years while long term rates will also rise but by a smaller amount. The potential for immediate rises in those long rates has fallen in recent weeks in light of some renewed worries about the world economy leading to a scaling back in expectations for when monetary policies will tighten overseas and how quickly our own central bank takes the official cash rate up.

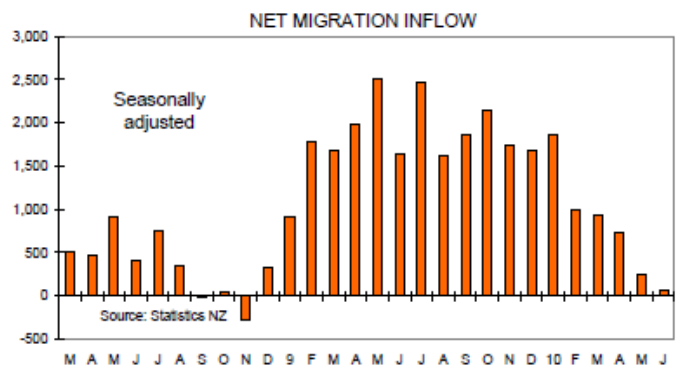
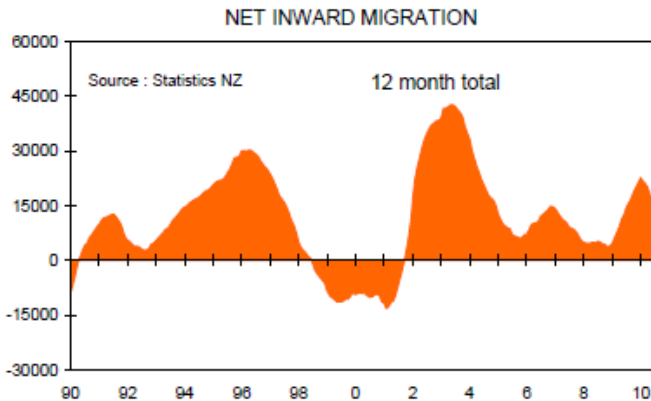
So for the term deposit part of my portfolio I am still willing to hold most of it short but would not be averse to boosting the average yield by moving some a tad further out along the yield curve.



HOUSING MARKET UPDATE

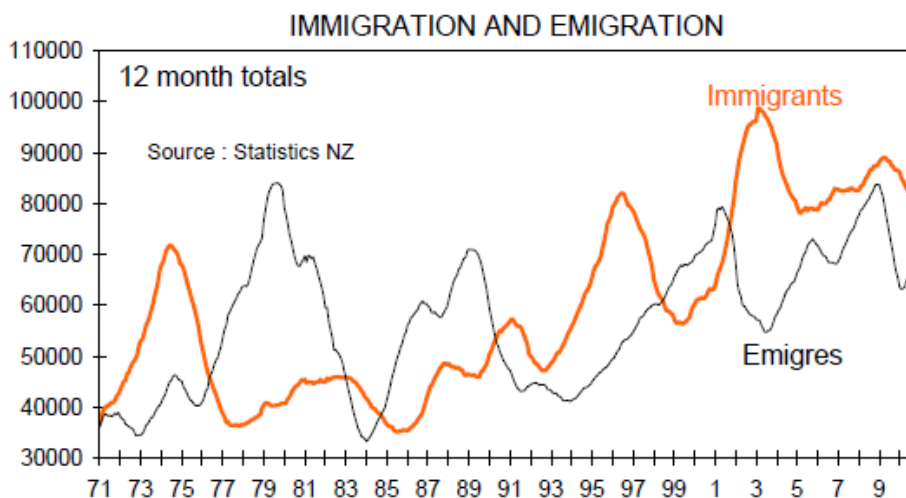
Migration Flows Will Contain Housing Recovery

One of the factors which will limit recovery in the housing market in the near future is the rapid turnaround in net migration flows. In the year to June the country received a net inflow of people amounting to 16,504. This was above the ten year average of 14,093 and therefore acted as above normal housing and retailing support. But back in January the net gain was 22,588 for the year and in the June quarter the monthly seasonally adjusted gain averaged just 343 compared with 1,263 in the March quarter and 1,850 in the December quarter.



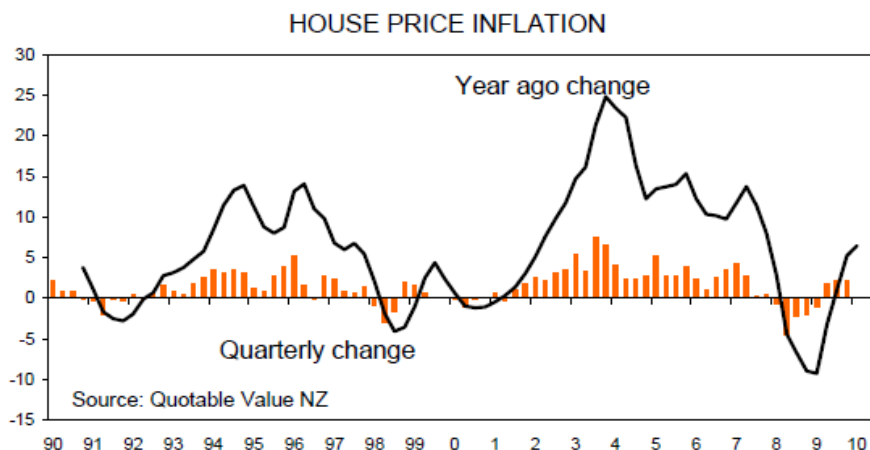
At the rate these numbers are declining the quarterly seasonally adjusted average will turn negative over the September quarter and that means come the middle of next year we could be looking at a net loss of people.

The turnaround is happening as a result of fewer arrivals and more departures. In the June quarter the number of people moving here was down by 11.6% from a year earlier and off 6.7% for the year to June. The number of us leaving was up 15.6% in the June quarter from a year ago but down 13.1% for the year.



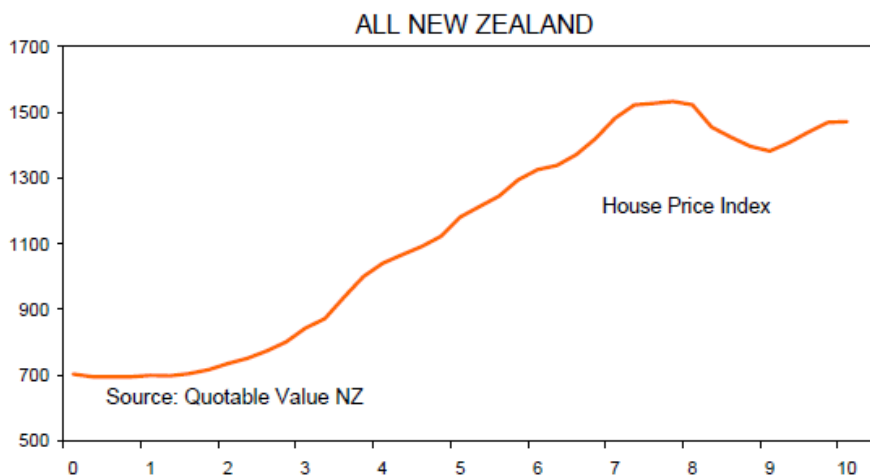
Where the annual flows will end up in a couple of years is difficult to figure out because for the coming year we suspect there will be a downward bias to the flows as those of us who held off leaving in the past year because of worries about foreign economies choose to depart this year. But clearly the change in flows will restrain the housing market as we have been noting for quite some time now in the context of a market still underpinned price-wise by low construction levels and rising construction costs.

Just for your guide, three months ago the REINZ stratified house price index told us that average NZ house sale prices fell by 1.3% in the March quarter after rising 2.8% during the December quarter. Yesterday the definitive measure of house price changes was released by Quotable Value NZ and they showed us that in fact during the March quarter average prices rose 0.1% after rising 2.1% during the December quarter.



The REINZ measure tends to be more volatile than the belatedly released but accurate QVNZ measure however on average they both go the same way with the QVNZ measure for the entire 12 months to March ahead 2.3% and the REINZ measure 3.1%.

The QVNZ release gels with the comment we have been making here that looking through the bumps we think house prices are sitting largely flat. For the record, compared with a year earlier the QVNZ index was up 6.4% and exactly 4% down from the peak in the December quarter of 2007. The average Auckland price change was 9.6% for the year and 1.6% off the peak. The Wellington gain was 7.1% and 2.4% off the peak. The Christchurch gain was 7% for the year and 3.4% off the peak. The Dunedin gain was 6.8% for the year and 3.9% off the peak.



Given these annual increases and the 6.4% nationwide gain one can easily see the countryside is lagging behind the cities.