Westpac

Institutional Bank

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The scuttlebutt from Europe

Notes from a tour of Europe in March 2015

I recently returned from two weeks visiting customers in the United Kingdom and Europe – this brief note describes the mood in UK and European dealing rooms, as well as summarising Northern Hemisphere perspectives on New Zealand.

London's economy is palpably booming – and notably more so than last year. However, people were quick to note the contrast with the remainder of the United Kingdom, where the economy is much slacker. Conversation quickly turned to concern about the outrageous pace of increase in London property prices, and the role that foreign buying is playing. All of this sounded extremely familiar to the Kiwi ear, and served to remind me that Auckland's house price boom is far from unique – house prices are rising in the largest cities of many countries. And macroprudential tightening is an increasingly common solution.

By contrast with London, the mood in mainland Europe was gloomy. People didn't seem overly concerned about the latest shenanigans in Greece. But there was much conversation about social and political tensions, and a great deal of worry about Russia and Ukraine. That said, a few customers thought they saw green shoots in European economic data and anticipated better times ahead.

The Swiss were especially downbeat following the recent sharp appreciation of the Swiss franc. Apparently some ski resorts are already applying for the Swiss equivalent of Chapter 11, and workers have been asked to work 45 hours per week instead of 42 to make up for the change in the exchange rate.

I had some very interesting conversations about the effects of the European Central Bank's looming Quantitative Easing (QE) programme, and the associated negative interest rate environment. The firm consensus was that QE would do little to aid the real economy, but that it would encourage riskier lending, and would turbo-charge asset prices as investors look to alternative assets. Although corporates had not yet responded, it was thought they will soon realise that they can take on much more debt at little extra cost. This extra debt is more likely to fund mergers and acquisitions than physical investment in growth assets, given that economic growth is so low.

These conversations reinforced my conviction that the fabled Belgian Dentist will soon revisit New Zealand. There will be a huge flow of funds out of Europe, seeking some form of return elsewhere in the world. I remain very comfortable with our forecast for the NZD to strengthen further against the Euro (and against the Yen, for the same reasons).

Some customers pointed out that by boosting asset prices, QE could worsen social tensions in Europe. How will the unemployed youth react when they see asset owners getting even wealthier and home ownership moving even further out of reach?

To converge or not to converge

The level of interest in New Zealand seemed a little lighter than last year – people were more interested in Australia (and they were generally quite downbeat on Australia).

Most hedge fund customers were downbeat on New Zealand, and felt that the RBNZ might soon join the plethora of central banks that have eased monetary policy in recent months. This view was generally motivated by poor global dairy prices, a belief that China would continue to slow and therefore commodity prices would remain subdued, and an observation that inflation had been surprisingly low in many jurisdictions and therefore could surprise on the downside in New Zealand.

Of course, I don't share the view that the RBNZ will cut. My rejoinder was that although New Zealand does have a lot in common with other countries, it also has features that set it apart, such as the Canterbury rebuild (which is yet to peak) and rampant population growth. I also pointed out that dairy is not New Zealand's only export – the overall terms of trade have not fallen nearly as far as dairy prices alone.

In some quarters my views received only a luke-warm reception. And that reinforces a very important point. My European tour has left me convinced that New Zealand markets will be "twitchy" over coming months – the merest hint of weak data could see markets leap to price in OCR cuts. And we will indeed see the odd bout of weak data over the months ahead – March quarter

CPI, which prints in April, could be close to zero. Other data points may be adversely affected by the recent drought.

Real money customers generally viewed New Zealand inflation-linked and nominal bonds as great value thanks to our higher interest rates and perceived low risk. In particular, the stability of the political environment was noted as a counterpoint to Australia.

Many customers felt that New Zealand's long-term real interest rates were unsustainably high and would converge towards the lower real interest rates on offer elsewhere in the G-10. As a short-run proposition, this idea seems reasonable to me. The weight of money fleeing ultra-low interest rates in the G3 will provide a pool of willing lenders to New Zealand, which will keep bond rates down. It will also keep the New Zealand dollar strong against many other currencies, thereby forcing the Reserve Bank to keep the OCR lower than otherwise.

But sometimes the argument was extended to imply that New Zealand yields will converge towards G3 yields on a sustained basis. Here I am sceptical. So long as New Zealand is a net debtor nation, we will always have to persuade foreigners to lend to us – and that would not be easy if we were offering similar interest rates to the G3 economies. One customer pointed out that Swiss investors face a four-fold increase in volatility if they choose to invest in New Zealand bonds rather than Swiss bonds. Other customers commented on lack of liquidity in the New Zealand bond market. Investors are put off by such volatility and illiquidity, and require a hefty premium before they will commit to such a market. So in my view, so long as New Zealand is a net debtor we will continue to face higher interest rates than many of the countries we like to compare ourselves to.

There was a real mix of views on the exchange rate. Some felt that New Zealand currently stands out like a sore thumb and that the New Zealand dollar would go much higher against everything except the US dollar. This group often asked whether a stronger trade-weighted exchange rate could cause the RBNZ to cut the OCR (I said yes, but only if the increase in the TWI was both significant and inconsistent with NZ fundamentals). Of course, those who were more sceptical about New Zealand's economic prospects were also sceptical about the ongoing strength of the New Zealand dollar.

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