

# MyConsultant

NEWSLETTER JANUARY 2014



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James is an Investment Analyst and a member of the Australasian Equities research team.

Prior to joining JANA in 2010, James held the role of Investment Analyst at Plum Financial Services. In 2007, he commenced with MLC on a two-year Graduate program, which included a number of roles in Sales and Distribution, Strategy, Retail Investment Product and Business Superannuation.

James holds a Bachelor of Commerce and Bachelor of Science Degree from The University of Melbourne. James is also a CFA charter holder.



## The Kiwi drive to economic prosperity

There is barely a topic untouched by the Trans-Tasman rivalry but only rarely does New Zealand compare itself to Australia when it comes to economic performance.

Now is one of those times, however, that Kiwis will relish the comparison.

The New Zealand economy is in a sweet spot, and expected to be one of the fastest growing economies in the world in 2014 after delivering above trend GDP growth of 3.5% over the year to 30 September 2013. The Government is on track to deliver a small budget surplus in 2014-15 (forecasted to be NZ\$86 million). With surging economic growth forecast in the coming years this is expected to increase to NZ\$1.7 billion (1% of GDP), NZ\$3.1 billion (2% of GDP) and NZ\$5.6 billion (3% of GDP) in the following three years respectively – an astonishing turnaround from the economy's depths during the Global Financial Crisis (GFC).

Australia, on the other hand, has passed the peak of its resource boom and the hoped-for transition to a non-mining led expansion is looking increasingly fragile and unconvincing. Australia's budget position has significantly deteriorated with the deficit now expected to be in the order of A\$47 billion (3% of GDP) for 2013-14. It is now faced with an unsustainable fiscal position of a decade of budget deficits if current revenue and expenditure trends are maintained, and its elevated currency puts further pressure on its international competitiveness.

Who could have predicted the recent economic tale of the Trans-Tasman rivals? The two economies entered the GFC in 2008 in vastly different positions. Australia entered the GFC with no net debt, having significantly benefited from the mining boom and China's thirst for iron ore and coal. New Zealand entered it deep

in recession, facing a drought and significant international liabilities.

The prospects of the Australian and New Zealand economies have effectively switched since the GFC hit.

Below we outline a number of the key factors responsible for this turnaround in fortunes, and the key risks to the New Zealand economy. However, there are a number of lessons that can be learned from Australia's experience through the mining boom.

### 1. China's transition to its next stage of development

China's remarkable economic growth has had a significant impact on the global economy, and particularly the Australian economy, over the past decade.

China's extraordinary growth is well documented, with the country growing at an average of approximately 10% per year since initiating market reforms in 1978. Its urbanisation has been a particularly strong driver of demand for materials and energy. Somewhere between 15 to 20 million people per year are moving from rural to urban areas, attracted to the better standard of living and to urban incomes three times rural levels<sup>1</sup>.

With urbanisation comes demand for infrastructure, housing and commercial

<sup>1</sup> Robin Young, BlackRock, *China's future growth and its impact on Australia*

development. Australia's abundance of commodities, including iron ore, coal, gas and copper, has enabled it to benefit from this development, proving it once again the "lucky country" over the past decade.

Debate runs high as to the sustainability of China's growth after such a prolonged period. However, falling commodity prices and mining investment, along with China's signalled intent to shift its focus away from infrastructure investment, is evidence that the peak of the once-in-a-century mining boom has likely passed.

As China's urbanisation has benefited Australia for so long, it is now New Zealand's turn to enjoy the spoils. New Zealand's fertile soil and favourable growing conditions provide the ideal environment for agricultural activities. Agricultural commodities account for about half of all New Zealand's exports, and it is one of the top five dairy exporters in the world.

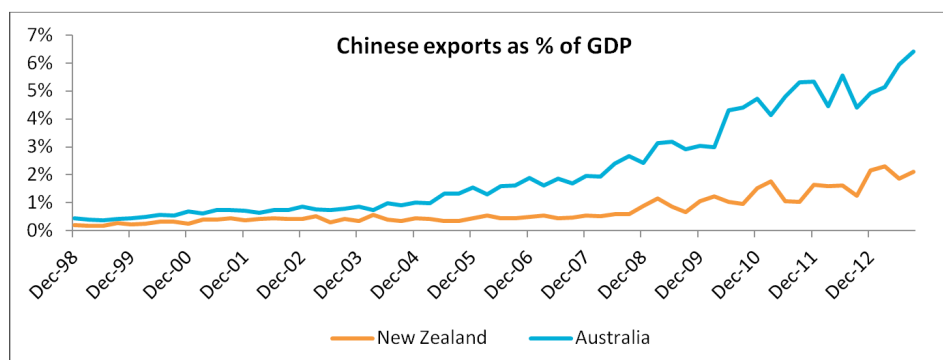
New Zealand's terms of trade – the relative price of a country's exports in terms of its imports – is now at its highest level in 40 years. This has been driven by soaring export prices, particularly from the dairy sector. Milk powder prices have risen by almost 60% over the past year due to China's insatiable demand, which has come as a result of the rapid growth of its middle class. Adding further impetus is China's lack of confidence in its own product following the 2008 milk scandal in which Chinese manufactured milk and infant formula was found to be laced with melamine, resulting in 300,000 victims and six infant deaths. New Zealand's ability to negotiate a free trade agreement with China in 2008, the first developed country to do so, has also assisted trade relations.

As China's urban population increases by the size of New Zealand's total population every three months, this demand for New Zealand's dairy and other food products is almost certain to continue.

The key risk is that New Zealand farmers cannot keep up with the demand – Fonterra, the world's largest dairy exporter, has already indicated difficulty in keeping up with demand. In addition, New Zealand may become too reliant on China. Chart 1 shows Chinese exports as a percentage of GDP for both Australia and New Zealand.

The chart shows the significant reliance that Australia has developed on China as an export partner following the decade-long mining boom. New Zealand doesn't have anywhere near the same reliance on China at this point in time, but the recent trajectory has been

Chart 1



Source: FactSet

stronger as its exposure to China's next stage of development accelerates. The strong growth of exports to China has led to it now being New Zealand's number one export destination – providing not only dairy, but meat and forestry products.

## 2. The effects of the Christchurch earthquake

The construction industry has been the other major contributor to economic growth in New Zealand, which has been largely driven by the \$40 billion rebuild of Christchurch following the devastating earthquake in February 2011.

The construction sector has benefited significantly, but the rebuild is also having strong flow-on effects on related business services.

Better conditions in New Zealand have also seen it enjoy strong net migration inflows. The traditional flow of skilled workers leaving New Zealand for better paid jobs in Australia is now starting to trend the other way in favour of New Zealand.

The recent influx of migrants is also assisting in New Zealand's extraordinary housing boom. House prices have soared somewhere in the order of 11% over the year to 30 November 2013, largely centred in the Auckland and Canterbury regions. The key driver of the housing boom has been the lack of supply. This combined with the favourable low interest rate environment, favourable tax laws on New Zealand property investment and the unrestricted access that foreign investors have to New Zealand housing have all put upward pressure on prices.

The positive benefits of the construction boom will flow through the economy for some time. Household confidence will also rise as a result of the positive wealth effects from higher housing prices, but such booms have a

habit of lasting only a number of years. While the Reserve Bank of New Zealand's actions to try and slow the pace of the growth in house prices appears to have had only limited success to date, hopefully these actions will prevent a bubble from emerging.

## 3. Government and Central Bank approaches to tackle the GFC

The policy actions of the Australian and New Zealand authorities have enabled both countries to escape the worst of the GFC. These actions included sizeable fiscal stimulus, significant reductions in interest rates and a range of bank guarantees and facilities to protect and restore confidence in the banking sector.

Australia performed particularly well through the GFC and its aftermath due to its strong trade links with China and timely fiscal stimulus.

Some argue that the significant fiscal spending was needed to stimulate the demand necessary to navigate the economy out of trouble.

Others argue that looser monetary policy, a lower exchange rate and China's fiscal stimulus would have been enough to avoid a recession. The Grattan Institute claimed that Australia did not save enough of the windfall from the mining boom and over committed to unsustainable expenditure<sup>2</sup>. It argues the lack of saving has put additional pressure on trade-exposed industries by maintaining a relatively high real exchange rate.

The New Zealand economy entered recession in early 2008, and deteriorated further following the intensification of the GFC in September 2008. The timing of the GFC could not have been worse for New Zealand.

<sup>2</sup> Jim Minifie, *The mining boom: impacts and prospects*, Grattan Institute, July 2013

The country experienced a drought over the 2007/2008 summer and, by global standards, had a particularly heavy reliance on the global system for debt finance.

Fortunately, New Zealand entered the GFC with fairly healthy government accounts following years of budget surpluses, meaning its levels of public debt were among some of the lowest of any OECD country, and allowed it the flexibility to aggressively utilise fiscal policy. New Zealand was also fortunate to enter the GFC with a relatively high interest rate starting position, which allowed the Reserve Bank of New Zealand (RBNZ) to aggressively cut interest rates.

Without the benefits of a resources boom the New Zealand Government had to be particularly prudent in rebuilding the economy out of recession. They confronted it by adopting the philosophy that new budget spending must be offset by reductions elsewhere.

It is important that fiscal prudence is maintained by the New Zealand Government. The NZ economy is in a particularly strong position; however complacency cannot be afforded at this time as there are still risks that

lie ahead. Australia's experience shows that commodity booms do not last forever and dairy prices may retract at some point. Likewise with the construction boom.

A strong emphasis on discipline will assist in maintaining an accommodative monetary policy setting and so reduce the pressure on the RBNZ needing to hike rates. While inflation remains under control, this is a sound approach.

The importance of good management cannot be understated, whether it is of a company or a country, and investors have been in agreement.

The recent relative Trans-Tasman economic fortunes are exemplified by the surge in the NZD against the Australian dollar (AUD), with the NZD/AUD appreciating 15% over the past twelve months to 31 December 2013.

Chart 2 highlights the expensive nature of the NZD, at extreme levels against the Trade Weighted Index. While the New Zealand dollar typically stays higher or lower for longer than other foreign currencies, there is an expectation from the RBNZ that the currency may drift lower from its current elevated levels.

## Conclusion

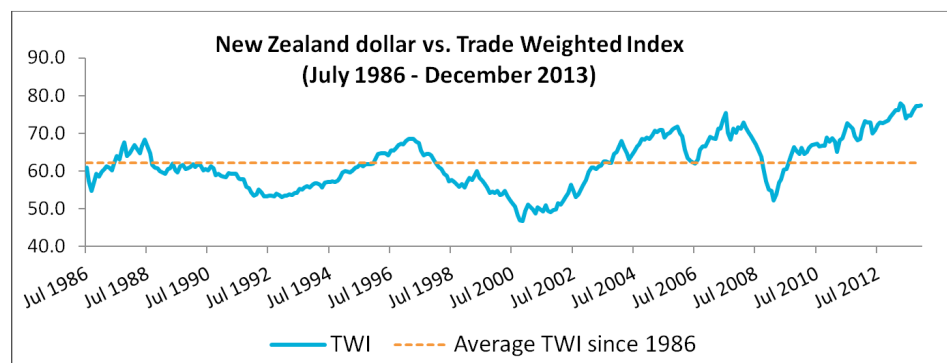
The New Zealand economy is in a real sweet spot, which is a remarkable turnaround in fortune since the economy entered the GFC deep in recession.

The booming dairy and construction sectors have been primarily responsible for the turnaround and are largely the reasons for the positive outlook. Prudent economic management can also be thanked for setting up the improved fiscal position today.

The real positive is that the dairy and construction stories, led by the Canterbury rebuild, are only in their early stages, meaning the upside to New Zealand economic growth is certainly strong. The real risk is that the narrowly based growth may lead to imbalances in the economy. While the soaring dairy prices have cushioned the blow for dairy farmers, the high New Zealand dollar is leading to heightened international competitive pressures on tradeable sectors including manufacturing.

How should New Zealand investors read the current environment? With the New Zealand dollar at high levels on a historical basis, and the tendency for currencies to revert around their long-run averages, now would be a good time for New Zealand investors to consider increasing their exposure to foreign currency. With the market pricing in a lot of the good news already, we believe it is a prudent approach for the long-term investor.

Chart 2



Source: Reserve Bank of New Zealand, Reuters, NZFMA

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