HUGO*vision*

Assessing the economic and political environment in New Zealand

September 1 2014

Confidential to HUGO members

National's pain continues

Pages 2&3

There's still little evidence from opinion polls that the dirty politics saga is denting National's support, but with less than 3 weeks to polling day, the fallout from Judith Collins's departure threatens to remain a major campaign issue.

Summing up the polls

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Our aggregation of current polling shows National has slipped to just below 50%, still a position from which it could form a govt, especially as Labour has sagged too, to around 25%. The Greens look solid, Internet Mana is going nowhere, and NZ First looks to be holding just above the 5% threshold. We don't rate the Conservatives' chances.

Fiscal policy on track

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National, Labour and the Greens are all forecasting budget surpluses and a plunging net govt debt position through to 2021. However, Labour and the Greens have exhausted their spending caps already and depend on their proposed tax measures raising enough to meet their targets.

Fonterra's new China play

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Fonterra puts the 2008 SanLu melamine scandal well and truly in the past by partnering with Chinese infant and baby products maker Beingmate to supply its premium infant formula brand, Anmum, to the Chinese market, using Beingmate's existing consumer market supply chains.

Power companies' cash-rich dilemma

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The corporate earnings season revealed the extent to which the 'big four' power companies are stacking up cash following several years of system constraint and capital investment. With no need for new plant in at least the next five years, shareholders should expect cash back, but the politics could be ugly.

What to do about Kiwirail?

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The Crown has pumped roughly $1b of new capital into Kiwirail since its rescue plan was agreed in 2010, yet it continues to report huge losses, driven by asset writedowns. Downturns in global markets for two of its biggest customers – coal and dairy – aren't helping. Kiwirail has gone back to the Treasury to discuss the future of rail. Explicit subsidies appear to be on the agenda.

Forecasts at a glance

	INFLATION ann % change	GROWTH ann avg % change	$ v $US spot rate	$ v $A spot rate	WORLD GROWTH annual avg % change	TRADING PARTNERS annual avg % change
December 2015	2.7%	3.4%	73.0c	89.0c	3.2%	4.1%
December 2016	3.1%	1.8%	67.0c	88.5c	3.3%	4.2%
December 2017	2.7%	1.2%	63.1c	88.5c	3.1%	4.0%

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HUGOvision

September 1 2014

POLITICS AND POLICY

Collins' crash livens campaign but Winston is there to help

A senior minister's resignation under a cloud three weeks before an election is not in any campaign manager's script. We can't yet know whether it will add significantly to the small damage to National's result from the Nicky Hager book.

Judith Collins was gone by lunchtime on Saturday after yet another allegation of conduct unbecoming of a minister. The media feast was well stocked.

Does it presage derailment? National has dropped a bit in polls – 2% in two weeks. But it is too early to read into this a trend that might force it into Winston Peters' arms.

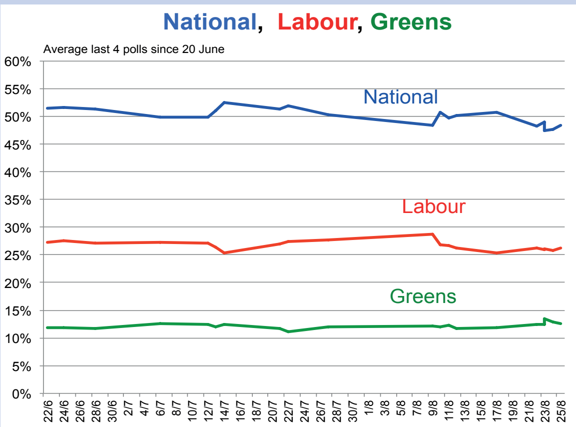
The past two weeks have been volatile. As National – and Labour – have lost ground, New Zealand First and the Conservatives have strengthened. New Zealand First's poll average was 5.2% in four polls up to August 25 (the midpoint of the last poll's interviewing). The Conservatives were 3.1%. Both were down a bit on the published averages up to late last week but that is essentially noise.

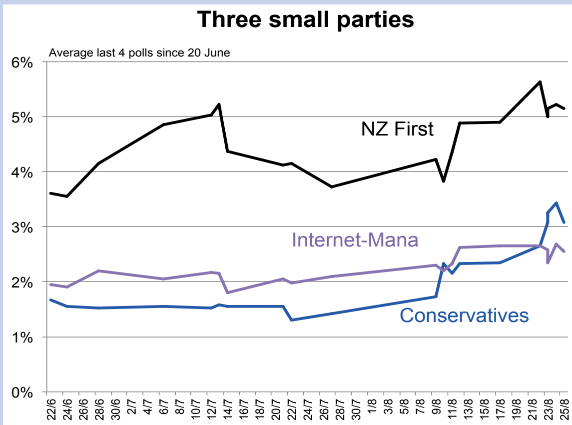
Notably, Internet-Mana has not got traction. Its poll average was 2.6%, enough to get Hone Harawira, Laila Harre and Annette Sykes (the three at the top of the list) into Parliament. Next on the list is John Minto. Together these four present an image of old activists, not young, tech-wise whizkids.

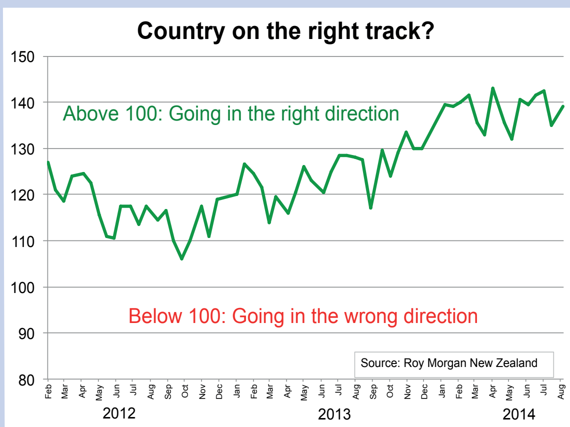
Also notably, Labour has not benefited from the Hager fallout (to the extent that there has been any). It looks like it is troughing but it also looked like it was troughing in July before it dropped in August.

But there may be more to come from the Whale Oil *et al* storehouse of intemperate emails. And there is still Kim Dotcom's threat of a big revelation on Sept 15 about NZ's involvement with US spy agencies (see p.3)

The Greens have come through the campaign most solidly so far. Their latest 12.5% average is close to its average all this year and would give them 16 seats, half Labour's 32. Other parties' seats on the latest averages are National 60, ACT and United one each, Maori party one, New Zealand First six and Internet-Mana three. That's a majority for National without Peters. But there are three weeks to go. While a strong performance in the first TV debate will have buoyed Cunliffe, he is leaving his run late to connect with voters.







The Collins resignation - is it enough?

In a perfect world, a Saturday morning in dead media time would be the best time for the less than ideal job of dispensing with a Cabinet Minister just before an election. However, this is not a perfect world. John Key may have hoped to reset the campaign agenda by accepting Judith Collins's resignation and moving on quickly. Her resignation cauterises the primary source of damage caused by the Dirty Politics saga, but his capacity to move on looks compromised. This week, the third to last of the campaign, will be dominated in its first half by setting the terms of inquiry for the investigation into Collins. And beyond that is the Inspector-General of Security and Intelligence's inquiry, 9 days before polling day, followed by the potential for Kim Dotcom's Sept 15 "big reveal" on more spying allegations. The opinion polls to date have shown little impact for National from all of this, but it is a heavy onslaught for any campaign to sustain.

Nonetheless, Key is at least relatively insulated now from Collins, having been handed evidence by Whaleoil plotter Cathy Odgers, who appears to have decided to fall on her sword by supplying the damning Adam Feeley email to Key's office. The Feeley allegations don't taint Key directly, unlike the Jason Ede allegations, which allowed him to act swiftly at last against Collins. Meanwhile, Labour has apparently found its voice on the issue. Its failure to capitalise on the govt's weakened position to date is one reason the polls have stayed so solid for National.

Key is also assisted – as is Collins – by the fact that journalists named in the "smoking gun" email have been quick to deny Cameron Slater's version of events relating to the campaign against Feeley, a former SFO head. So was Sunday's statement from SSC head Iain Rennie that it was "appropriate" for Collins to raise with him the issue of Feeley's consumption of a bottle of champagne originally owned by Bridgecorp at the conclusion of the Bridgecorp prosecutions.

Even if exonerated in an inquiry that will not even get under way in earnest before the election, Collins has blown her ambition to lead the National Party and be PM one day. However, backers for the launch of a news website, edited by Slater and bankrolled by former MEGA chief executive Tony Lentino, appear to be rolling on.

Key's next hurdle: Sept 15 Dotcom "revelations"

The damage inflicted on National from within makes the threat from the Dotcom/Glenn Greenwald expose on Sept 15 potentially more difficult to ignore, since it will play into the dirty politics theme, which seems destined to roll on, at least for the news media. NSA leaker Edward Snowden and Wikileaks founder Julian Assange are said to be involved .

Our best guess is that the leaks in question relate to the latest evidence from Snowden that the "Five Eyes" partners – the US, UK, Canada, Australia and NZ – share metadata from one another's countries to circumvent rules preventing countries spying on their own citizens.

National Security Agency slides released by Snowden show a system called "ICReach" has been accumulating Five Eyes metadata. While the practice is controversial and in principle an invasion of privacy, it's doubtful that detail on this alone would shift voting patterns. Spy agency stories over the last two years have energised the left without denting political support on the right. Key has also indicated he may expect the Dotcom material to relate to spying in the Pacific – he made comments on that issue hours before Dirty Politics was published.

Elsewhere, Kim Dotcom lost his final bid to test the validity of the warrants used to mount the raid on his mansion in 2012. The Supreme Court declined to consider his appeal.

PREFU provokes outbreak of fiscal rectitude

The pre-election fiscal and economic update, released Aug 19, showed the govt heading into the election with its Budget surplus target intact, albeit smaller, delivering a set of economic and fiscal forecasts marginally revised from May to reflect weaker commodity prices and a lower tax take.

The Treasury now forecasts a surplus this year of $300m, down from the $375m it projected in the May Budget and has shaved 20 basis points off its forecast for gross domestic product in the year ending March 31, 2015, to 3.8%, from the 4% Budget forecast to reflect a faster decline in the terms of trade from the highest levels in 40 years and a slower pace of domestic inflation. The sustainable rate of economic growth is revised down to 2.5% p.a.

Labour accordingly trimmed its new spending plans by about $300m a year, seeking to take the issue of fiscal responsibility off the table to allow focus on the different economic policy mix that it offers from National's.

That said, while Labour's surplus and net govt debt reduction tracks look similar, in some cases better, than National's, it remains the case that Labour is anticipating a net additional $1b of spending, paid for by a range of tax increases and cuts to some programmes, such as halving the grants scheme run by Callaghan Innovation and channelling funds to r&d tax credits instead.

Labour also cut back its spending promises, making the elderly wait an extra six months to April 1, 2017, to be eligible for free doctors' visits and prescriptions and axing some seven minor spending announcements. Labour says it has only one major spending policy still to announce before the election.

"We will run a surplus every year unless there an unforeseen crisis," said Cunliffe.

Labour says it would reduce net government debt, including the assets of the NZ Super Fund, more quickly than National's forecasts, with net debt reaching 3% of GDP in 2020/21, compared with 4.9% for National.

Labour's assumes $100m a year of additional new spending for its partners in govt.

On the revenue front, the top personal income tax rate would rise to 36%, along with the trust tax rate; a capital gains would raise $1b by 2020/21. New revenue from targeting tax avoidance, especially by multi-nationals, and ring-fencing losses are forecast to collect $335m extra revenue by 2020/21.

Labour would resume contributions to the Super Fund and borrow $1.5b at the peak to create a revolving fund for its KiwiBuild plan to construct and sell 10,000 affordable homes a year.

Supermarket inquiry quietly grinds on

The Commerce Commission's inquiry into allegations made in Parliament by then Labour MP Shane Jones into supermarket price-gouging of suppliers is quietly continuing. Food industry research specialists Coriolis gave evidence in the last fortnight, and we understand their position was dismissive of Jones's contentions.

Their view is apparently that large suppliers have plenty of leverage with supermarket chains, while the supermarkets themselves are more than happy to devote shelf space to high quality, high margin goods since so many of their product lines carry either very slender margins or are sold on a loss-leading basis.

EPA clears first EEZ oil drilling consent

The oil and gas sector will be pleased that OMV has been granted the marine consent it applied for under the new EEZ regime for permission to drill its Whio-1 exploration well, offshore Taranaki. Oil industry majors were starting to look with concern at the EPA's handling of seabed mining applications (see separate article). This approval should put that concern to rest, although it's worth noting Whio-1 has already been drilled, plugged and abandoned, with most of the activity on the well occurring during a period of transitional provisions. OMV also has an application in train for development drilling programme in the Maari field in the South Taranaki Bight. The decision-making committee hearing that application has asked for more information on oil spill risk management, with hearings set back a month to Oct 29.

CRP cries foul

Chatham Rock Phosphate is crying foul over the EPA's decision to release a staff report on its plan to mine phosphate nodules from the seafloor on the Chatham Rise, the second application for seabed mining under the new EEZ regime. Trans Tasman Resources was the first applicant, seeking permission to mine ironsands in the southern Taranaki Bight. Its application was rejected in June, much to the surprise of the minerals sector and prompting TTR to appeal. TTR has since raised additional capital, laid off much of its NZ staff to preserve cash, and has reported to the Companies Office the departure of Zhang Xiangqing, a representative of Chinese firm Rockcheck Steel Group, prospective customer for TTR's titano-magnetite resource.

CRP's managing director Chris Castle claims the staff report is deficient and inaccurate, and that its inability to recommend in favour of the plan is "premature" since hearings before the EPA-appointed decision-making committee were the place where unresolved questions could be tested.

More seriously, Castle contends EPA staffer David Weller was the staff report's primary author and that his appearance as a signatory on a Greenpeace petition some years ago opposing deep-sea oil drilling makes the report biased. Key Ministers have been briefed, although an attempt to have the SSC investigate failed. The complaint from CRP was sent back to the EPA.

While the EPA's caution on deep-sea mining lends credibility to its role as a protection authority for the environment, Ministers are concerned that NZ may gain a reputation as a place where millions of dollars can be spent on investigating certain types of EEZ projects without a realistic expectation that they will ever gain approval. Watch this space. John Key was surprisingly solid in his support for a full review of oceans policy, if re-elected, at a fisheries conference last month. Such a policy would force the debate on where and what activities are acceptable to NZers in the EEZ.

Meantime, the backers of a marine sanctuary around the Kermadec Islands are growing frustrated by inaction on Continental Shelf applications, originally granted in 2007 and 2011 respectively to prospective seabed mining firms Nautilus and Neptune, and requiring reprocessing under the new EEZ regime.

Telcos miffed at RBI extension

Telecommunications service providers were none too pleased to learn they would continue to be levied to fund the rollout of ultra-fast broadband to the rural heartland under an election-focused extension of the Rural Broadband Initiative announced by Communications Minister Amy Adams.

Assuming re-election, National would extend the RBI scheme by three years and would levy a further $150m over that period until June 2019.

"Of that $150m, National will make $100m available through a contestable fund to enhance connectivity outside the UFB footprint, which the govt is funding through a revolving fund.

National will also create a $50 million fund to extend mobile coverage in remote areas and black spots on main highways and in key tourist areas.

Dairy industry

China dairy strategy

Fonterra is embarked on a major new strategy to capture some of the forecast growth in infant formula demand in China. By teaming with Shenzhen stock exchange-listed Beingmate, it gains a partner with deep distribution in China and a track-record of expansion that suggests it is well regarded by Beijing. The Fonterra move is important because it signals that the 2008 SanLu scandal is a thing of the past, as much for the Chinese leadership as for Fonterra itself. That said, the partnership is somewhat novel for Fonterra, which will buy 20% of Beingmate in a tender supported by chairman Wang Zhentai. Beingmate gets exclusive rights to sell Fonterra's Anmum brand infant and maternity food in China under licence. In return, Fonterra will get royalties and its share of Beingmate's dividends, which have amounted to 50-60% of profit. The other leg of the deal is a joint venture that will own Fonterra's high-tech plant at Darnum, Victoria. This is the plant where tainted PPC80, processed at the NZ plant where last year's false botulism scare originated, was processed into formula. One of the lessons from that saga is that Fonterra will, in future, send any questionable product destined for high margin products to low value products, such as animal feeds, or jettison it, rather than risk the reputational damage experienced last year.

Crucially, Beingmate will own 51% of the Darnum plant, which needed a customer after Danone dropped it as a supplier after the WPC80 scare. Beingmate needed a reputable source of infant formula base materials that satisfied China's strict new food quality rules. As majority owner, Beingmate wears the risk of future food scares, but as ex-pat China hand David Mahon notes, Beingmate has never suffered a food tainting scandal, unlike many of its competitors.

The move is, in other words, entirely consistent with Beijing's desire not only to use reputable international partners to meet local demand for infant formula, but also to build trust in Chinese brands – the one party regime's ultimate goal in a country wracked by food, environmental, political and other failures of public trust.

The deal does look fully priced. Beingmate shares have fallen about 25% this year and at 18 yuan per share, Fonterra is paying a premium of around $180m for its stake. However, it is not a large transaction relative to Fonterra's balance sheet. The big question is how effectively it delivers market penetration for high margin Fonterra-branded products in a market where Fonterra has in the past only played at scale as an ingredients supplier to other global brands.

Credit rating agency Fitch cut Fonterra's A+ rating by one notch to A, reflecting the greater risk appetite implied by the Beingmate deal.

Tough going for A2 as Aussie/kiwi cross bites

A2 Milk is also eying the Chinese market after a frustrating year where its manufacturing and packaging partners were awaiting Chinese registration. New Zealand New Milk, which has been packing the product for A2, did achieve registration in July, after the end of the financial year, but A2's major, 'joined-at-the-hip' partner is Synlait Milk, which hopefully will get registration in September. Synlait received NZ regulatory approval to pack and export retail-ready product from its manufacturing site last week, having met the New Zealand food safety requirements of the Animal Products Act 1999. The only exception is for exports of finished infant formula to China. Synlait sent documentation to Chinese regulators last week.

The first significant shipment of A2 Platinum infant formula would be made in the first half of the current year, assuming all these ducks line up in a row. A2 is a New Zealand company in listing and headquarters only, since 96 percent of its revenue is generated in Australia, a market whose cash flow it plans to use to drive sales into the US, Asia and the UK. The massive skew of revenue to Australia meant it suffered an almost unique currency impact once sales were converted into a strong kiwi dollar, resulting in annual profit of just $10,000. The company is considering an ASX listing.

DOMESTIC ECONOMY

Westland forecasts payout below Fonterra's for 2014/15

Fonterra has affirmed its forecast Farmgate Milk Price for 2014/2015 of $6/kgMS, saying it expects global dairy prices to revive. Westland Milk Products matched Fonterra when it first lowered the forecast in July and the Hokitika-based dairy cooperative has since gone further, reducing its projected payout to between $5.40 and $5.80/kgMS. Chief executive Rod Quin says Westland is more exposed to the price of skim milk, which has been more volatile than whole milk powder.

Trade balance turns negative – watch this trend

It wasn't unexpected, but the turnaround in the July trade balance was significant, not only because the excess of imports over exports at $692m was larger than the consensus forecast of a $475m deficit, but also because the July figures left out the expected impact of Air NZ importing a new 787.

Had the plane, worth around $300m, been in the statistics, the trade deficit for the month would have been closer to $1b. It will, however, turn up in the current account figures for the June quarter, reflecting the date at which Air NZ took possession of the aircraft.

Reflecting the increasing sensitivity of currency markets to negative news out of NZ, the trade figures appeared to soften sentiment towards the kiwi, against a backdrop of speculation about intervention by the RBNZ in currency markets, as presaged in the July monetary policy update.

Monetary policy – the paradox of intervention

Evidence of central bank intervention in currency markets won't become available until after the general election, with the next publication date for its foreign exchange transactions scheduled for Sept 29.

There's a certain paradox if the RBNZ does prove to have been intervening, since the tightening bias in its interest rate policy would tend to underpin a stronger currency. The central bank, at least in theory, ends up working against itself in this circumstance. It's also inconsistent with oft-cited publication by the RBNZ in 2005 of guidance suggesting intervention should "roughly coincide with the broad thrust of interest rate settings." That advice concluded there was "little sense to intervene to try and push the exchange rate lower when the bank believes that higher interest rates may be required in the near future to control inflation pressures."

On the other hand, a lower kiwi might allow the bank more scope to reach its goal of "normalising" interest rates sooner rather than later, since the OCR may need to push higher to contain inflationary pressures if imports become more expensive, thanks to a weaker currency.

It's also worth noting the nostrum above was ignored in 2007, when then governor Alan Bollard intervened to drop the currency during a tightening phase. Also important is the fact that those interventions had little long term impact. While they made money for the NZ taxpayer, the evidence remains that the RBNZ can't defend or sink the currency in anything other than a short term fashion.

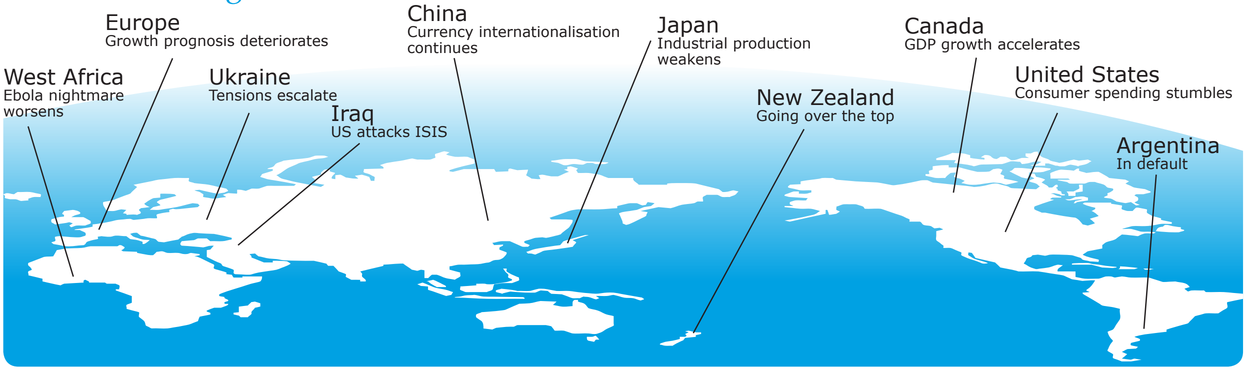
Powercos awash with cash

The electricity generator-retailers all reported respectable profits, although the most publicly pilloried by Labour's energy spokesman David Shearer was arguably the most tenuous performer.

MightyRiver declared an 84% increase in net profit, but that was thanks to non-cash writedowns the previous year, where it cleared the books pre-IPO of its marginal American geothermal investments.

On an EBITDA basis, MRP barely exceeded its IPO forecasts, posting operating earnings just 3% above the previous year.

The world at a glance



The clearest winners were Contact Energy and Meridian, albeit for somewhat different reasons.

Both companies, along with Tekapo hydro assets owner Genesis, enjoyed the capacity to send power freely up the refurbished Cook Strait cable for the first time in six years, a circumstance that coincided with full hydro lakes in the south and a record low inflow to Taupo that curtailed MRP's generation on its chain of Waikato River hydro stations.

Contact benefited at last from a seven year capex programme that has reduced its reliance on natural gas to produce electricity. Instead, it opened new geothermal capacity at Te Mihi, partially replacing the elderly Wairakei plant, and received a $53m payment from McConnell Dowell for its late start.

Contact has also completed its lengthy and, at times, fraught IT systems upgrade, cutting over to SAS for customer relationship management in April. That led to $50m of billing problems, often with complex commercial and industrial accounts, and provisions of up to $2m for bills that may never be paid. However, the company reckons that was within the bounds of anticipated teething problems.

The key point for electricity companies is that they are all comparatively awash with cash, now that none expect to make capex commitments to new generation in NZ for some years.

Contact will almost certainly make a capital return at some stage, as its Aust majority owner Origin Energy has long wanted a better return from its foray into the NZ electricity market in 2003.

Genesis slightly outperformed prospectus forecasts, although it's been playing catch-up on competitors and hiking its tariffs in a competitive environment, which has caused the country's largest electricity retailer to suffer larger customer number losses than it is likely to be comfortable with. Analysis by Deutsche Bank's Grant Swanepoel suggests Genesis may undershoot 2014/15 prospectus earnings as it is forced to discount later in the year to maintain customer numbers.

Meridian's NPAT was 22% below the last financial year, but ahead of prospectus forecasts and allowed the company to pay a special dividend of 2cps, along with a 6.82cps final dividend, for total payments during the year of 13.01cps.

Note that while TrustPower and Meridian both hope to pursue new renewables opportunities in Australia, they are waiting first for the outcome of the Renewable Energy Targets subsidy scheme review. The Australian newspaper has been reporting the scheme may be frozen until there's a recovery in electricity demand on the other side of the Tasman, where sagging industrial and mining sector output has seen wholesale power prices falling.

The rail/coal nexus plays out

Friday last week saw the nexus between the coking coal sector's global downturn and its impact on NZ's marginal rail system.

Bathurst Resources, which finally got resource consents to mine on the Denniston Plateau above Westport last year, wrote down the full value of its Buller Coal Project assets and most of its equipment, reflecting uncertainty about when the development opportunity will make commercial sense.

The $449.9m writedown was offset somewhat by a non-cash benefit gained by wiping $169m of royalty and other payments that had been anticipated, had the development occurred as originally planned.

Meanwhile, state-owned Solid Energy, which is the primary source of income for Kiwirail on the trans-alpine rail route from the South Island's west coast to the port of Lyttelton, is exporting less.

That is one of the reasons state-owned Kiwirail reported a $248m net loss for the year to June, although the primary driver was asset writedowns of $338.5m ($399.3m the previous year), reflecting a decision as part of the Kiwirail rescue plan agreed in 2010 to write down a large proportion of assets each year rather than claim depreciation.

These writedowns indicate the extent of state subsidy required to keep the rail system operating, since the Crown has injected $1b-odd of capex into KiwiRail since 2010. Similarly large annual writedowns are expected to continue "for the foreseeable future", according to Kiwirail's senior management.

No wonder the company is back in talks with the Treasury about its future. The plan appears to be to convince a govt to accept that if the country wants rail, with its claimed benefits in keeping freight off the roading system, it will have to subsidise it explicitly.

The company argues Kiwirail is inevitably exposed to a limited number of customers, with the dairy, coal and import/export sectors supplying 40% of total income, making rail a commodity-dependent business.

When either or both of those key sectors – dairy and coal – go through downturns, rail will inevitably

Eric and Kathy Hertz Scholarship

The lives of former 2degrees ceo Eric Hertz and his wife Kathy will be memorialised through a US$140,000 endowment to AUT for scholarships to be granted to Maori and Pacific Island students. A former Hugo Group member, Eric died with Kathy in a plane crash off the west coast of the North Island in March last year. Over the next three to five years, the fund will make up to 10 NZ$5,000 p.a. scholarships available for study in both NZ and the US or Canada. Trilogy International Partners, owners of 2degrees, are endowing the fund.

be negatively affected, with little capacity to turn to other customers, Kiwirail argues.

Coal has been in the doldrums for a couple of years. While dairy volumes remain significant, prices are falling and could ultimately affect rail volume.

In other words: the same questions are being asked as have prevailed since the railways were corporatised in the 1980's and privatised in the 1990's, and which were only half-answered when the last Labour govt bought Kiwirail back from Toll Holdings.

Supreme Court rules against IAG in quake claim

Insurance Australia Group has had a loss in the Supreme Court that has the potential to affect many, but by no means all, insurance cover for commercial property. The degree of exposure lies in the range of policy wordings that deal with how multiple events are covered by a single policy.

In the case of Ridgecrest NZ, a property investor, the issue was a Christchurch building damaged in four successive earthquakes. Ridgecrest argued entitlement to maximum cover of $1.98m for the final quake on June 13, 2011, that damaged the building beyond repair, and also for losses caused by the three preceding quakes.

IAG, which hadn't been able to complete repair work from the earlier quakes by the time each new one hit, maintained it was only liable to pay the maximum cover for the final 'happening' and only for cost of repairs actually undertaken in the three previous quakes. The High Court found in IAG's favour and the Court of Appeal came to the same conclusion, albeit on different grounds.

Supreme Court justices John McGrath, William Young, Susan Glazebrook, Peter Blanchard and Andrew Tipping unanimously allowed the appeal. They found that Ridgecrest was entitled to be paid out to the policy limit of $1.98 million in each of the earlier quakes and that the merger principle did not apply. They also concluded that the indemnity principle didn't apply because the policy limit was below the replacement value of the building.

However, they did find that Ridgecrest wasn't entitled to recover more than replacement value of the building or to double-count its losses.

Fed's uncertainty on US labour market

The annual retreat for world central bank governors at Jackson Hole, Wyoming, last month cast more heat than light on the US Federal Reserve's likely timing for interest rate rises. On balance, commentary suggests rate hikes are more likely in the first half of 2015 than the second, but the performance of the US labour market has the Fed scratching its head.

Fed chair Janet Yellen's position appeared to show a more neutral position on the how much spare capacity exists in the US labour market, but highlighted huge uncertainty about how quickly inflation might pick up once job growth starts occurring.

Trading partner growth

(2013 actual; 2014-15 Consensus Forecasts; 2016-17 figures Hugo estimates)

Trading partners		GDP Growth (ann avg %)					CPI Inflation (ann avg %)				
	Weights %	2013	2014	2015	2016	2017	2013	2014	2015	2016	2017
China	25.2	7.7	7.3	7.2	7.1	7.3	2.6	2.4	2.9	3.1	2.8
Australia	23.1	2.4	3.1	2.8	3.2	2.9	2.4	2.8	2.6	2.8	2.7
United States	10.3	1.9	1.6	3.0	3.0	2.4	1.5	2.0	2.1	2.2	2.0
Japan	7.2	1.5	1.5	1.3	1.1	1.4	0.4	2.7	1.8	1.8	1.7
Eurozone	7.2	-0.4	1.1	1.6	1.6	1.0	1.3	0.7	1.2	1.1	1.1
United Kingdom	3.5	1.7	3.0	2.6	2.2	2.4	2.6	1.7	2.0	2.4	2.2
South Korea	4.1	3.0	3.6	3.7	3.7	3.5	1.3	1.8	2.4	2.6	2.0
Indonesia	2.2	5.8	5.3	5.7	5.8	5.7	6.4	6.2	5.7	5.1	5.9
Hong Kong	2.0	2.9	3.1	3.4	3.6	3.3	4.3	3.9	3.5	3.3	3.8
Taiwan	2.2	2.1	3.3	3.5	3.6	3.1	0.8	1.3	1.8	1.7	1.4
Singapore	2.6	3.9	3.7	4.0	4.1	3.9	2.4	2.1	2.6	2.3	2.4
Malaysia	2.3	4.7	5.3	5.0	5.3	5.1	2.1	3.3	3.6	3.1	3.0
Philippines	1.9	7.2	6.2	6.2	6.0	6.4	2.9	4.3	4.0	4.1	3.8
Thailand	1.8	2.9	1.1	4.1	4.5	3.2	2.2	2.4	2.8	3.0	2.6
India	1.7	4.7	5.4	6.2	6.4	5.7	9.5	8.0	6.9	6.8	7.8
Viet Nam	1.2	5.4	5.6	5.8	6.0	5.7	6.6	5.4	6.4	7.0	6.4
Canada	1.3	2.0	2.2	2.5	2.5	2.3	1.0	2.0	2.0	2.0	1.8
NZ Trading Partners	100.0	3.8	4.0	4.1	4.2	4.0	2.3	2.6	2.7	2.8	2.6
Forecasts for New Zealand											
Consensus		2.9	3.6	3.0	2.6	3.0	1.1	1.7	2.2	2.4	1.9
BNZ Forecasts		2.9	4.1	3.5	1.8	1.2	1.1	1.5	2.2	3.1	3.1
The World		2.5	2.6	3.2	3.3	3.1	2.7	3.2	3.1	3.2	3.0

Analysis by UBS was especially doubtful of the Fed's use of a new indicator – the Labour Market Conditions Index (LMCI) – which Yellen said "supports the conclusion that the labor market has improved significantly over the last year, but it also suggests that the decline in the unemployment rate over this period somewhat overstates the improvement in overall labor market conditions."

That's as may be, says UBS, which finds the LMCI has "a low correlation with both the labor force participation rate and with wages", the two key areas of concern for the Fed. UBS worries Yellen will find herself stuck in a "dangerous middle", where data uncertainties could cloud monetary policy judgements that will affect global economic conditions, depending on how the Fed reacts. One area lacking clarity is the extent to which changes in the US labour market are cyclical or structural.

"The middle ground – that the labor market has suffered a shock that could extend beyond the Fed's forecast horizon of six to eight quarters but not change permanently – appears to be missing," says UBS. The risk is that if stimulatory monetary policy doesn't drive job growth, the Fed will be setting the stage for a stronger inflationary burst once a US recovery takes hold, implying higher interest rates for the US over the medium term.

Also at Jackson Hole, the ECB president, Mario Draghi, gave the clearest signal yet that the Eurozone's central bank will move into a quantitative easing phase, amid signs that inflation is stuck below desirable levels. He called also for easier fiscal policy to promote growth across the Eurozone.

Australia: mining and manufacturing weakness persist

Continued weakness in the Aust mining sector capex was hardly unexpected, but investment in manufacturing remains very weak, according to the latest real capex statistics, released last week. That may see an undershoot on anticipated GDP growth in Q2 of 0.6%, although capex growth in the rest of the economy , around 50% of total capex, remains consistent with a 10% uplift over 2014/15.

This "other" category showed 3.4% growth in Q2, the second consecutive quarterly increase, to give a 6% yoy increase, while mining investment was flat for the quarter and manufacturing fell 6% to give a negative yoy print of 6%.

Overall, private real capex was up 1.1% for Q2, beating market expectations of a 0.5% fall, having fallen 8% over the prior two quarters.

Airline earnings

Air NZ posted a 45% gain in full-year profit, carrying more passengers and improving yield on short and long-haul routes. The airline, which had some $1.2b in cash or equivalent at year end, gave shareholders an extra bonus with a special dividend, doubling its payments for the year to 20 cents a share. The strong profits prompted a rebuke from the Airports Association, which wants the Commerce Commission to investigate the fares Air NZ applies to regional routes where it has a monopoly. It was an opportunity for the airports to counter criticism that they in turn charge monopoly rents to airlines and deserve the regulated profit cap they work under. Qantas's full-year results show another reason why Air NZ is gaining ground. Its discount Jetstar unit lost market share in NZ last year and now has 20.7% of the market, down from 22.4% in the previous year. Jetstar made a loss across all its markets though not on the scale of parent Qantas, which reported a full-year loss of A$2.84 billion after writing down the value of its international fleet, and recognising one-time restructuring and redundancy costs. Qantas chief executive Alan Joyce says the airline is over the hump with its restructuring and expects a return to profitability in 2015.

Farming investment

Landcorp is keen to reduce its exposure to volatile dairy prices, having benefited from a surge in milk revenue in its latest year. The state-owned agricultural group, NZ's biggest corporate farmer, has a strategy of increasing focus on red meat, perhaps widening the variety of livestock from lamb, beef and venison and building direct relationships with customers. The Landcorp 'story' is already included in marketing for Silver Fern Farms meat sold to supermarket chain Tesco for its house brand. Landcorp is also finding a niche in the high end of the US beef market, where there is demand for grass-fed, antibiotic-free meat that commands a similar premium to organic. According to Landcorp, American consumers aren't as wedded to the taste of grain-fed, marbled beef as Asian markets are. Landcorp is also watching with interest as Shanghai Pengxin Group progresses the purchase of the Lochinver Station in the central North Island, given its sharemilking partnership over the former Crafar farms. It would be interested in a management role at Lochinver although that farm's existing management are well regarded.

Mortgage market

The Reserve Bank's restrictions on low equity home

Continued p12

HUGOvision

September 1 2014

ECONOMY AT A GLANCE

New Zealand economy

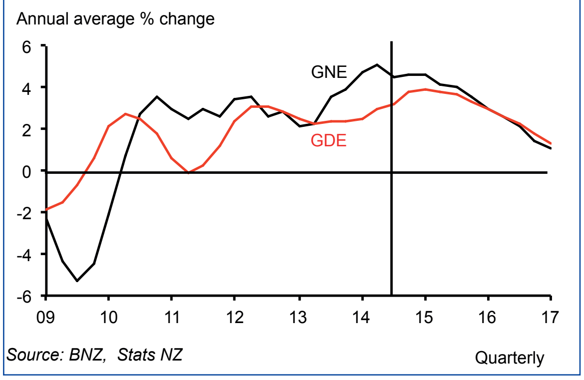
(% change on previous year
Calendar year except where indicated)

	2013A	2014F	2015F	2016F	2017F
GDP components					
Consumption	2.9	2.7	2.9	1.4	0.9
Investment	9.7	11.0	6.4	2.1	1.1
Stocks (contribution to growth)	-0.1	0.4	-0.2	-0.1	0.0
GNE	3.9	4.6	3.5	1.5	0.9
Exports	0.7	4.7	3.3	4.1	3.8
Imports	6.2	6.3	3.9	2.9	2.7
Activity					
Real GDP (production)	2.9	4.0	3.4	1.8	1.2
Output Gap	0.3	1.3	1.7	0.2	-0.3
Labour productivity growth	0.7	0.4	0.2	0.3	0.7
Employment growth (annual % change)	3.0	3.1	2.7	1.0	0.6
Unemployment rate (S.A. % as at Dec Q)	6.0	5.2	4.9	5.3	5.9
Inflation (% increase from Dec Q previous year)					
Consumer prices	1.6	1.4	2.7	3.1	2.7
Average hourly earnings	3.2	3.3	3.9	3.2	2.7
Terms of trade	20.2	-9.5	-0.5	4.1	1.1
Financial sector					
Operating balance (OBEGAL)					
(as % of GDP – June Year)	-2.1	-1.1	0.1	0.3	0.7
Net debt (as % of GDP – June)	26.2	25.9	26.8	26.7	25.8
90 day bank bill (%) (1)	2.7	4.1	5.0	5.3	4.4
5 yr NZGS yield (%) (1)	4.2	4.2	5.0	4.4	4.9
10 yr NZGS yield (%) (1)	4.8	4.6	5.3	4.9	5.4
External sector					
$NZ/$US(1)	0.823	0.800	0.730	0.670	0.631
$NZ/$A(1)	0.915	0.909	0.890	0.885	0.885
$NZ/Y(1)	85.1	86.4	85.4	83.1	78.2
TWI(1)	77.5	77.5	73.8	71.5	68.2
Trade balance $(m)	1307	1451	-1883	161	2455
Current account $(m)	-7622	-9155	-13323	-11448	-9467
(as % of GDP)	-3.4	-3.8	-5.3	-4.4	-3.5

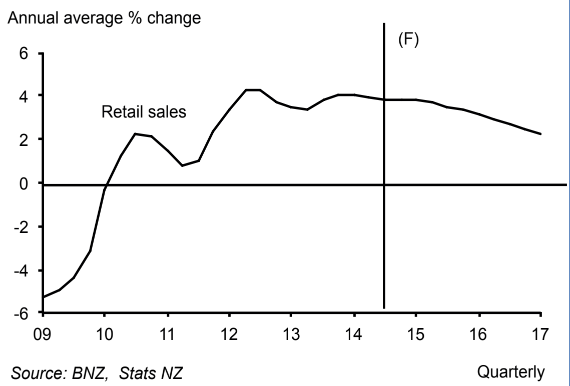
(1) Average for month of December

(2) Using current prices

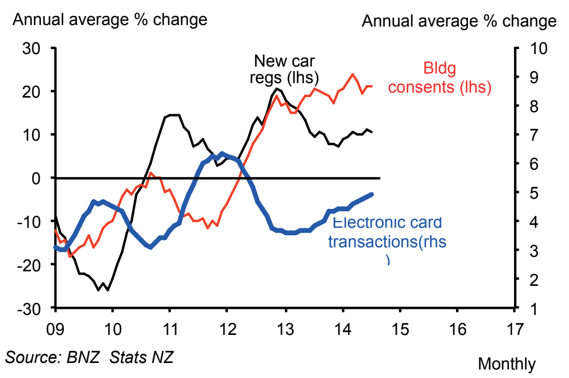
Economic growth



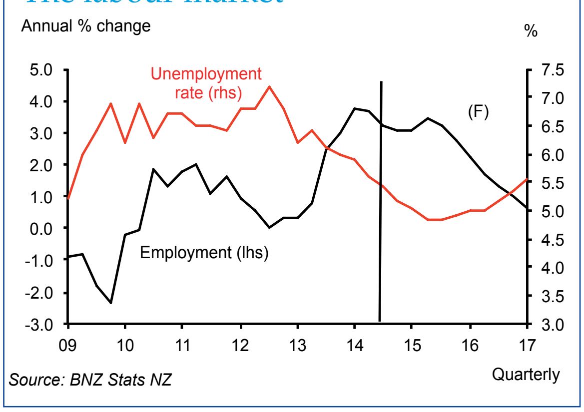
Retail sales



Partial indicators

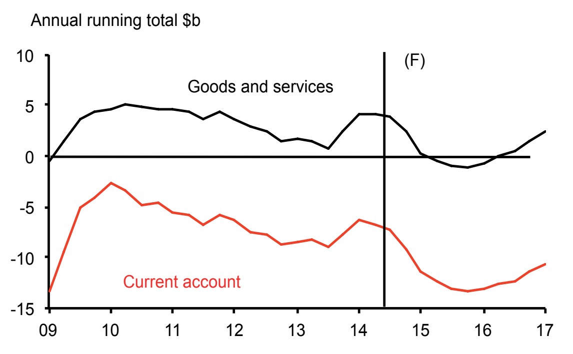


The labour market



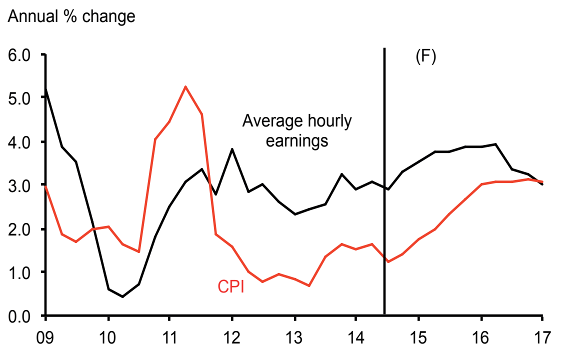
ECONOMY AT A GLANCE

Balance of payments



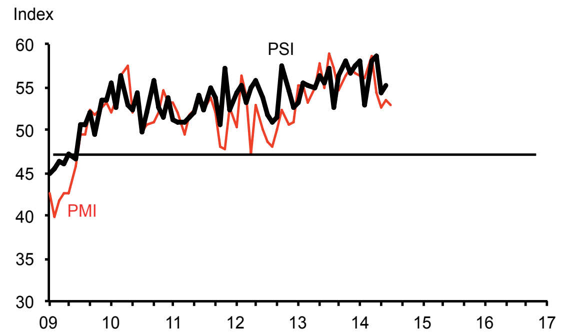
Source: BNZ, Stats NZ Quarterly

Inflation



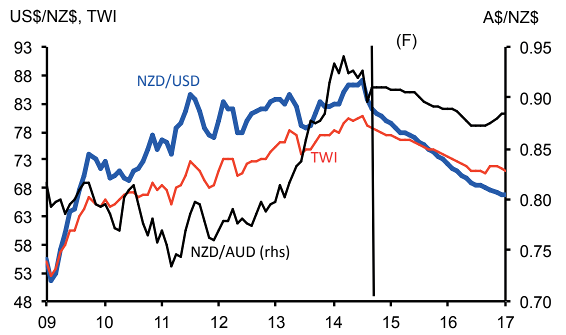
Source: BNZ, Stats NZ Quarterly

PSI and PMI



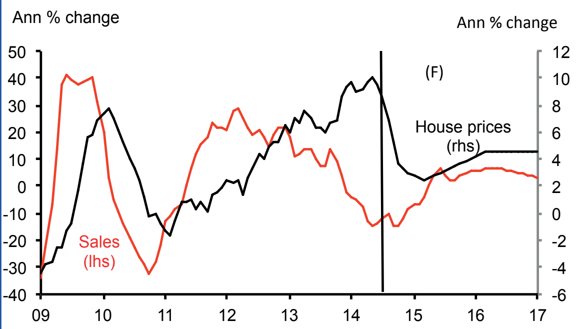
Source: BNZ Monthly

Exchange rates



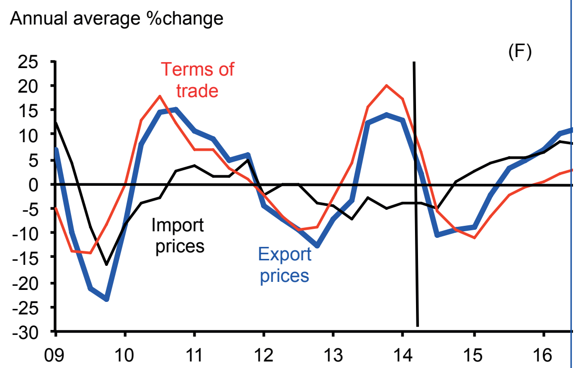
Source: BNZ Monthly

Housing market (three month average)

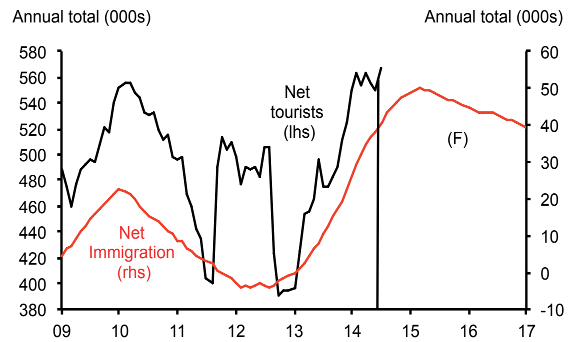


Source: BNZ REINZ Monthly

Terms of trade

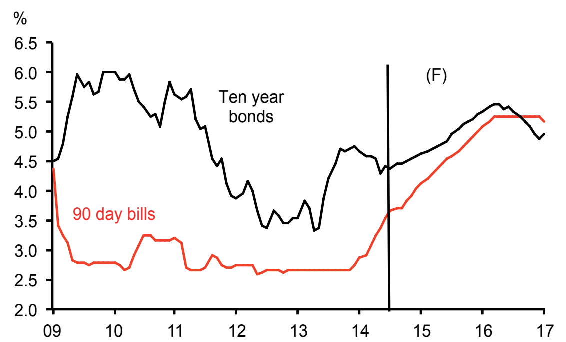


Net migration flows



Source: BNZ Stats NZ Monthly

Interest rates



Source: BNZ Monthly

Continued from p9
loans may be finding equilibrium after 10 months of the policy. For July, loans of 80% or more of a property's value accounted for 6.5% of total new mortgages, down from 6.7% in June and up from as low as 3.6 percent in January and March this year. Real Estate Institute figures show sales of properties of less than $400,000 fell 22% in July from a year earlier, after falling 17% in June. The policy has worked more effectively than even the Reserve Bank had expected and expectations are that house price inflation, already well past its peak, will continue to cool in the coming year, especially given the RBNZ's pause in hikes to the OCR may only last through the end of this year. Lenders are likely to push back toward the central bank's 10% cap on high LVR loans as they adjust to the policy and competition heats up in the mortgage market.

NXT market for SMEs

NZX is awaiting Financial Markets Authority registration and approval of the rules for its new NXT market for small and medium sized companies of $10m to $100m market capitalisation. Once up and running, the NZX won't accept new members of its existing small cap NZAX market. The stock market operator has taken lessons from the NZAX, which never attracted the interest that was hoped. The design of the market was made possible by the new regulatory regime allowed under the Financial Markets Conduct Act, which came into effect this year, providing flexibility to develop markets for different types of companies and investor groups. To drive interest in NXT, the bourse will appoint market makers and research providers. The new market will offer something of a learners listing for companies, with a requirement to appoint a "sponsor" in an advisory role for the first three years of listing.

Earnings season

The NZX 50 Index reached a record high last week and has climbed more than 1% in the past month, although financial results of listed companies have been relatively subdued given the strong track of economic data this year.

Fletcher Building achieved an 11% increase in underlying, full-year earnings, with revenue meeting expectations of a 1% decline. The biggest company on the NZX 50 Index has managed down expectations over recent years. Returns were dented by a strong kiwi against the Aust dollar, and in local currency terms, sales across the Tasman rose a modest 2%, reflecting little new resource investment or state government spending and some pick up in residential housing.

There's still profit to be had in Australia. **Ebos's** game-changing acquisition of drugs distributor Symbion led to a tripling of annual profit to $92.1m although margins across its businesses were down. The well-run Ebos will produce more modest results this year, without a repeat acquisition, as regulatory changes put pressure on drug margins.

Vector's 17% decline in full-year profit reflected regulated price cuts on its monopoly lines as well as weaker electricity and gas consumption. The Auckland-based lines company is far from at peace over the Commerce Commission's position on an acceptable return on assets.

Auckland International Airport met guidance with an 11% gain in underlying full-year earnings to $169.9m but on that measure sees the potential for earnings growth to stall in the current year, with guidance of $160m to $170m.

NZ Oil & Gas is chasing new reserves, with a disappointing lack of new gas or oil shows at its Makatu well near Taranaki. Exploration and evaluation investment costs jumped 77% to $75m, contributing to a 61% percent profit decline.

Chorus posted a 14% decline in full-year profit, meeting analyst expectations by reining in costs of its ultra-fast broadband rollout but the key uncertainty remains the regulator's final position on pricing of copper line network services. The price cuts are due to start in December.

Sky Network Television beat expectations with a 21% gain in annual profit, suggesting it is yet to feel serious impact from the host of new entrants to the content market.

Port of Tauranga and **Ports of Auckland** both posted buoyant results, which also reflected the decision by Maersk to switch its Southern Star service from one to another. Tauranga's profit rose 1.3% while Auckland's soared 90%, with Tauranga's container volume dropping 10% owing to the loss of Southern Star, while Auckland's volumes rose about 18%. That's set to reverse because Tauranga has won back the service after a deal with Fonterra Cooperative Group and Silver Fern Farms-led logistics company Kotahi.

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