



# INTERESTING TIMES

## Sample Report

### CONTENTS OF THE REPORTS

The reports cover: the game the Reserve Bank is playing; economic growth prospects; inflation prospects; exchange rate prospects (NZD TWI only); international inflation, economic growth and interest rate prospects, with a focus on the implications for NZ interest rates and the NZD TWI; and our recommendations for borrowers and fixed interest investors over whether they focus more on short-term, medium-term or longer-term maturities. The **Forex Prospects** report contains our analysis of prospects for the NZD/USD, NZD/AUD and NZD/Y|JPY, while contact me if you want to know about our hedging advisory service for the NZD/USD.

### Why pay for an economic report when banks provide them free?

Why pay for our monthly **Interesting Times** reports, even if they are New Zealand's premium economic report, when the major banks, the Reserve Bank (RBNZ) and Treasury provide free economic reports?

Our quick answer is that the reports by the bank economists and other economic forecasters more often than not contain poor analysis and misleading predictions, which makes them a negative value proposition even though they are free. By comparison, we have a proven track record at providing rigorous and insightful analysis that will be of considerable value to you for business risk management and/or investment strategy. All delivered in plain English and with a bit of fun had along the way. But don't take our word, if you read this **Sample Report** you will learn why our analysis and predictions are often dramatically superior to those of the bank economists.

Of course, forecasting the future is an art not a science, so even armed with the best analytical techniques in the world we will not always get it right. Who knows when "nuclear bombs" might start falling on Chicken Licken's head. However, we can confidently assert that our track record in our specialist areas is matched by none, while in the event of a major shock we will issue a **Special Report** to help clients negotiate the chaos.



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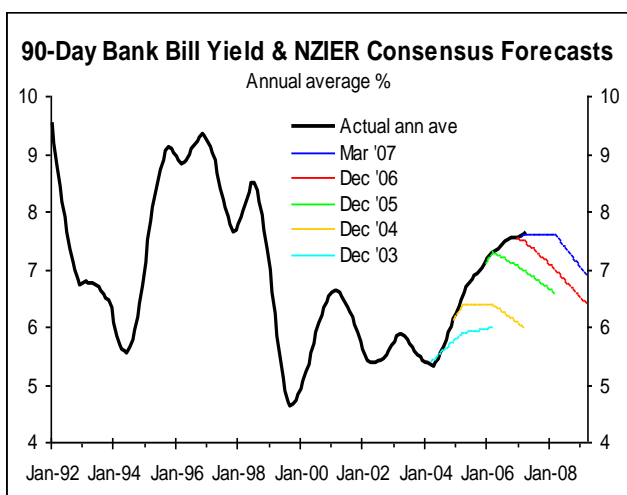


### THE TRACK RECORD TELLS THE STORY

Consider what the economists have been forecasting for the 90-day bank bill yield, the key short-term wholesale interest rate, over the last few years (see the chart below). The coloured lines in the chart are based on surveys NZIER conducted of the bank economists and some other mainstream economic forecasters, including the Reserve Bank, Treasury and NZIER.

When the 90-day bill yield was below 6% in 2003 most economists predicted that it would increase to around 6% (see the light blue line, which is based on the average of what the economists surveyed by NZIER were predicting in December 2003). The 90-day bill yield increased to 7% over the period the economists were predicting that it would increase to 6%, but at least they got the direction right.

Ever since the 90-day bill yield increased to above 6% in 2004 the consensus view of the economists has been that it would fall back towards 6% (see the orange, green, red and dark blue lines, with the associated dates being when the surveys were conducted by NZIER). Over the last few years the 90-day bank bill yield has ended up well above what the economists have been predicting. By contrast, throughout this period - during much of which time my advice was penned in ASB colours - I warned that short-term interest rates would end up increasing to as high as 9%. And this warning remains in force, although it may not be achieved until after the 2008 election.

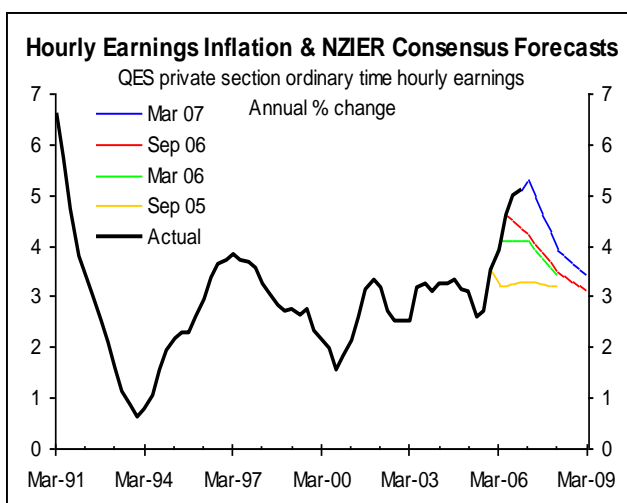


Even worse for followers of the free advice, over the last few years most bank economists and economic advisors in general have been recommending that clients borrow short-term because they expected interest rates to fall. Any borrowers who followed these recommendations will be starting to pay dearly. By contrast, we have been advising borrowers to lock in a good proportion of their debt for longer periods, which is reaping handsome rewards for borrowers.

But how can our conclusions about interest rates prospects and our advice to borrowers and investors be so different from the views of most if not all economists? The answer lies in the rigorous and systematic analytical framework we have developed over the past 25 years.

### THE ANSWER LIES IN THE ANALYSIS

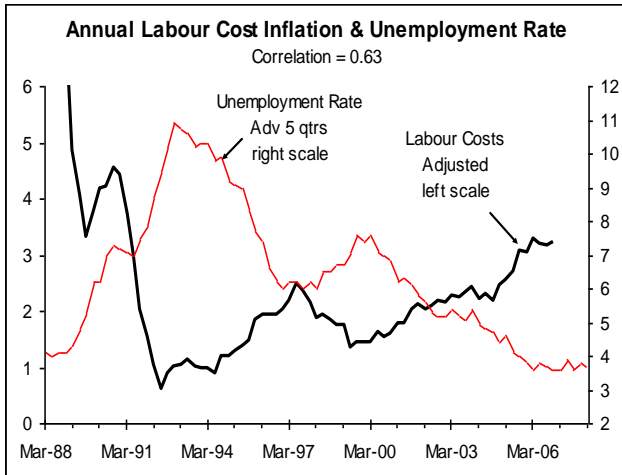
Critical to the outlook for short-term interest rates is inflation, while labour costs, the single largest cost component for most firms, are at the heart of inflation. According to the economists the labour cost problem that is now plaguing most businesses should not have happened. The chart below shows what the economists have been forecasting for one measure of annual wage inflation over the last couple of years.



When NZIER surveyed the economic forecasters in September 2005 the consensus view was that the annual increase in hourly earnings would stabilise at just over 3% (see the orange line). This measure of labour cost inflation subsequently increased to over 5%. As this measure of labour cost inflation kept increasing the economists persisted in predicting it would fall, as they continue to do (see the green, red and dark blue lines, again the dates associated with the coloured lines relate to when the surveys were conducted by NZIER).

The economists can't get their interest rate forecasts right in part because they can't forecast labour cost inflation to save themselves. This is also why they are regularly too pessimistic about consumer spending prospects.

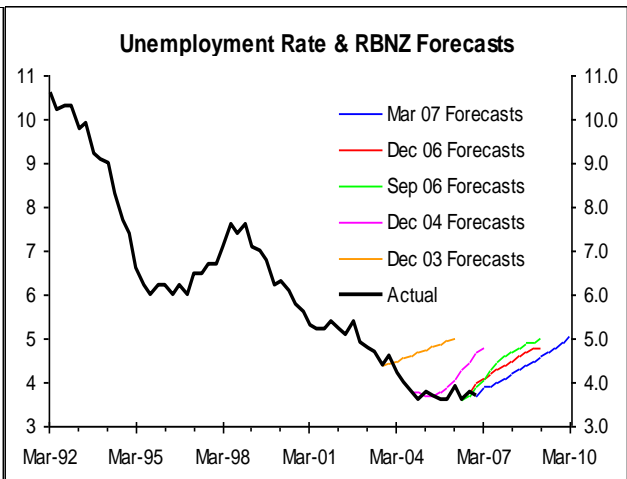
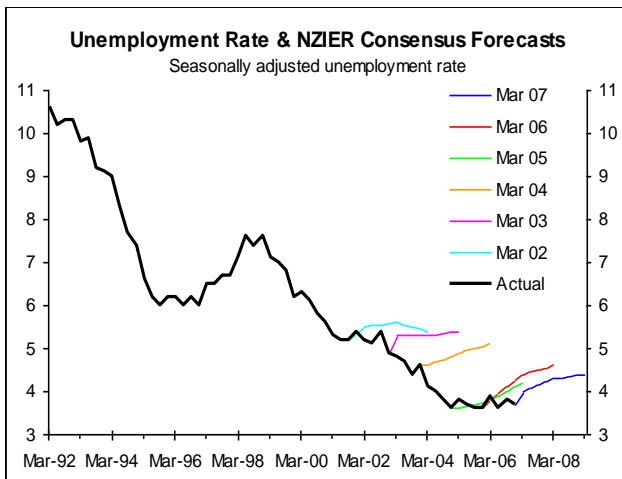
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By contrast, we use the adjacent leading indicator chart to help predict labour cost inflation. The red unemployment line has been advanced or shifted to the right by five quarters, reflecting how long it takes changes in the unemployment rate to impact on this measure of labour cost inflation (the black line). The falling unemployment rate since 2000, which gave increased bargaining power to employees relative to employers, predicted the increase in labour cost inflation that has unfolded.

The chart currently predicts continued high labour cost inflation, contrary to the fall the economists are predicting. However, our fact finding from the coal-face of the labour market points to labour cost inflation exceeding the predictions of this chart.

To complete the circle the economists keep predicting a rising unemployment rate (see the two charts below, the first one reports the consensus forecasts from NZIER's surveys of economists while the second chart reports the RBNZ's forecasts). Dating back to 2003 the economists' circular logic (or illogic) has run something like this: wage inflation will be low so it will only take small interest rate increases to hurt consumer spending and economic growth more generally, so the unemployment rate will rise, which means there will be only modest pay increases.



Despite wage inflation consistently being higher than they predicted and the unemployment rate lower than they predicted the economists kept rolling out the same views because when it comes to learning economists have much in common with old dogs.

Our big picture view has run like this: until very recently interest rates have been below average, which has created a supercharged economy that was always going to push the unemployment rate down and lead to high labour cost inflation; the RBNZ's experiment with low interest rates would create a housing boom and deliver windfall tax gains to the government, and the subsequent increase in housing wealth and the inevitable welfare/spending handouts by the government would keep the supercharged economy rolling on for much longer than the economists and RBNZ predict; while higher inflation and in time higher interest rates would be inevitable consequences of the supercharged economy.

**USING ONLY THE RELIABLE LEADING INDICATORS**

The section above shows that our use of a reliable leading indicator of labour cost inflation paid off relative to the economists' inclination to base their forecasts on misguided circular logic. Our use of reliable leading indicators of economic growth and inflation prospects gives us a major advantage over the economists. This is especially the case because we supplement this by regular sampling at the coal-face of the economy, through our contact with a wide range of firms in many locations and industries. By contrast, the

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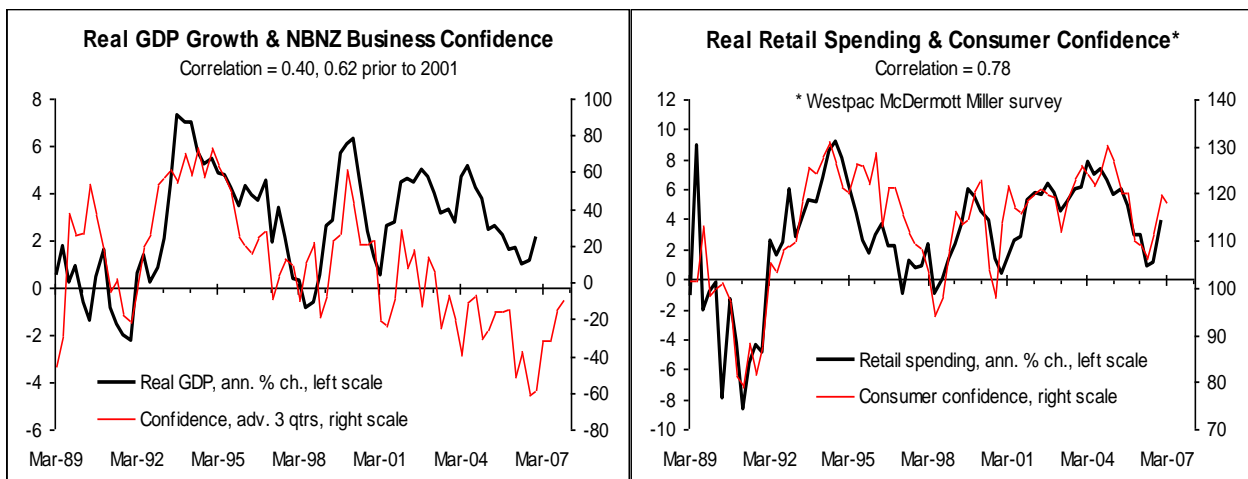


economists seem to spend most of their time debating stupid assumptions with their computers and indulging in wishful thinking about how they would like things to turn out.

We do our homework to check which leading indicators are reliable. For example, over the last several years we disregarded the business confidence surveys because they become “politicised” in 2001 and are no longer reliable indicators of economic growth, while the economists have for much too long continued to give credence to them. The left chart below shows that prior to 2001 the National Bank’s survey of business confidence was a pretty good leading indicator of economic or GDP growth, with the best fit or highest correlation being with the business confidence survey leading by three quarters. Prior to 2001 we took notice of what the business confidence surveys were saying. However, as the chart shows, since 2001 the relationship has broken down and according to the level of business confidence economic growth should have been negative since 2003.

Interestingly, it was around 2001 that the RBNZ starting mentioning that it was monitoring business confidence surveys as an economic indicator in its Monetary Policy Statements. It seems that this gave respondents to the surveys an incentive to tick the negative box in the business confidence question, while some firms will no doubt be using the confidence surveys, which get lots of media coverage, as vehicles to give the fingers to the government.

By contrast, we continue to put lots of weight on the Westpac-McDermott Miller consumer confidence survey because the relationship between it and annual growth in retail sales remains as good as it has ever been (see the right chart). The economists and the RBNZ have been surprised by the strength of the recent rebound in growth in retail spending (the black line), but they should not have been because of the earlier sharp rebound in consumer confidence. Again, we make full use of the information content of the reliable leading indicators of both economic growth and inflation, while the economists often focus too much on misleading surveys and don’t have enough faith in the reliable ones. No wonder economics is called the dismal science by some!



Our use of only the reliable leading indicators also applies to our analysis of international developments that impact on NZ interest rates and the exchange rate. The **Interesting Times** reports contain reliable leading indicators of international economic growth and inflation prospects, and show both the role these leading indicators play in determining international interest rates and how international interest rates impact on NZ rates. The reports also look at what drives the gap or premium between NZ and overseas interest rates. This analysis draws in part on time spent working at the Bank of England in London in the mid-1980s analysing the behaviour of international interest rates.

### SAMPLING FROM THE COAL FACE OF THE ECONOMY

Most economists spend far too much time scratching their heads and not enough time checking to see if their views on economic growth and inflation prospects are consistent with what is happening at the coal-face of the economy. However, the RBNZ visits many firms on fact finding missions during the year, much as we do, but we have good reason to believe that the RBNZ does not always get told the truth, the whole truth and nothing but the truth, especially about issues like the extent of the current labour inflation problem. And that is quite understandable. Why would a firm tell the RBNZ that the labour shortage problem has become of epidemic proportions when it knows that will only encourage the RBNZ to hike the OCR?!

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Our travels in the weeks prior to writing this **Sample Report** took us to Wellington, the Waikato, Auckland and Northland. There was a consistent view coming from the various firms we meet. Being that recruiting staff had got harder and increasingly firms had to poach them from competitors, which generally involved both getting the cheque book out and sharpening the pencil. Consequently, new employees in numerous firms are getting paid substantially more than existing staff doing the same or similar jobs.

This is an untenable situation (i.e. it will not last). Some existing employees are starting to shoulder-tap bosses to extract larger pay increases, while others will search to find out what they are worth on the market. We have entered a period of discovery (i.e. employees in many cases discovering how much more competitors will pay them than their existing employers).

However, employers need not worry too much about rising labour costs as a result of the excruciatingly tight labour market. The RBNZ and the bank economists have assumed away the sort of behaviour we are hearing about on our fact finding missions and describe above. Of course, the reality is that labour cost inflation is heading higher than our leading indicator chart at the top of page 3 predicts, which means it will end up materially above what the RBNZ and the economists are predicting.

Our leading analysis and our coal-face research are screaming out that until the unemployment rate is much higher, like above 6%, bargaining power will remain in the hands of employees and labour cost inflation will remain elevated. That is the conclusion that our rigorous and insightful approach to analysis shouts out loud and clear, while the economists would rather assume this prospect away, based on a combination of shallow and/or incompetent analysis (or, as often as not, unsubstantiated assertions).

Sampling what is going on at the coal-face, which is a critical supplement to our use of reliable leading indicators, is only useful if it is done with an open mind, not a head full of preconceptions. Consequently, the conclusions we draw from our contact with firms operating in the real world are often materially different from the conclusions the RBNZ draws. However, reality will eventually catch up with even the RBNZ, and people and firms who are forearmed with our analysis before this happens will be much better off.

### **WHAT REALLY DRIVES THE EXCHANGE RATE?**

We have an advantage over the economists on three fronts. Not only do we identify and only use the reliable leading indicators, and undertake open-minded research at the coal-face of the economy, we also check how things actually work before making our predictions. The exchange rate is the best example of economists producing forecasts based on a poor or partial understanding of what really drives it.

The general view of what drives the NZ dollar is interest rate differentials, while some economists also focus on the state of the external accounts (which is close to being a complete waste of time). If it is expected that the RBNZ will hike the OCR and push NZ rates higher relative to US rates then every commentator and his/her dog predicts that the NZ dollar will appreciate relative to the US dollar. Equally, it is conventional wisdom that the NZ dollar will not fall until the RBNZ starts cutting the OCR.

These views run so deep it is frightening, especially because they have a fundamental flaw. "Finance Minister Michael Cullen ... said yesterday he doubted the exchange rate would fall back to "realistic" levels until the Reserve Bank stopped raising interest rates." (Source: The Press, 17 April 2007)

In the **Rodney's Ravings** section of our website you will find a report titled, "**What really drives exchange rate cycles**". We strongly recommend that anyone who has dealings in the NZ dollar reads this eye-opening report because the lessons it teaches, based on actual events, including the 1997 Asian Crisis, will provide you with a profound new understanding of what drives the NZ dollar.

This report shows that the conventional view about the link between the exchange rate and interest rates is not well founded. The missing link is the state of the economy and in particular the domestic/housing sector. In short, if NZ interest rates increase relative to US/overseas interest rates the NZ dollar will generally appreciate provided the interest rate and exchange rate increases do not do too much damage to economic growth prospects. However, if indicators of economic growth, like consumer confidence, house sales, house prices, building consents and retail sales, start diving, the NZ dollar is more likely to fall than rise even if the RBNZ pursues further rate hikes. Equally, OCR cuts do not automatically mean a lower NZ dollar, with the response by the exchange rate depending on prospects for economic growth.

But why does the exchange rate behave like this? Best you visit our website to find out, while the **Interesting Times** reports and more so the **Forex Prospects** reports make use of this understanding to help firms exposed to the exchange rate make better decisions.

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