



Weekly Commentary

2 October 2017



Behind closed doors

Post-election negotiations between the major political parties mean that the form of the next Government – and hence the mix of economic policy – won't be known to the public for another couple of weeks. Meanwhile, the Reserve Bank largely stuck to its lines in last week's OCR review, but hinted at a more substantial change to its forecasts in the November *Monetary Policy Statement*.

As expected, New Zealand's general election delivered no clear outcome. Neither the National Party nor the Labour/Green bloc has the numbers to form a government, leaving NZ First in a monarch-maker position. With negotiations going on behind closed doors, the form of the next Government may not be known for at least another couple of weeks. NZ First leader Winston Peters has said that he won't be making any decisions before 7 October, when the special vote count is announced.

We view a National/NZ First deal as the more likely outcome, in part because a two-way combination is likely to prove more workable than a three-way one. A National/NZ First government would have fewer implications for our economic forecasts, but we can already identify a few policy areas where changes are likely to be on the table:

Immigration: A key NZ First policy platform is to tighten immigration restrictions – Peters has stated he would prefer net immigration of 10,000 per annum, compared to over 70,000 per annum presently. Net immigration has already started to fall, and we are already forecasting that it will drop to 20,000 by the end of 2020. If some policy change prompted us to forecast a steeper decline in net immigration, we would also consider reducing our GDP growth forecast.

House prices: We suspect that the housing market would initially react positively to a National/NZ First Government

– that is, turnover would pick up and prices would be higher than otherwise. It's true that tighter limits on immigration would reduce expected future demand for housing. But we think that this effect would be outweighed by a 'relief rally', given the potential impact on house prices that Labour's proposed tax changes might have had. Beyond the near term, though, financial factors such as interest rates and macro-prudential lending restrictions will hold sway over house prices again.

Monetary policy: NZ First favours changing the Reserve Bank Act with an eye to generating a more exporter-friendly exchange rate. National favours the status quo of inflation targeting, and is unlikely to give any ground on that. However, NZ First's presence in government does make some sort of change at the Reserve Bank more likely – for example, a change from the present single-decision maker structure to a committee for monetary policy decisions.

Fiscal policy: NZ First's policies are expensive, and it has not signed up to any budget responsibility agreement. In the first instance we would expect that policy concessions to NZ First, such as its various regional development priorities, could be managed within the Government's existing budget. However, the direction of risk on fiscal policy is that this Government will hew towards smaller surpluses and more debt than otherwise.

Behind closed doors continued

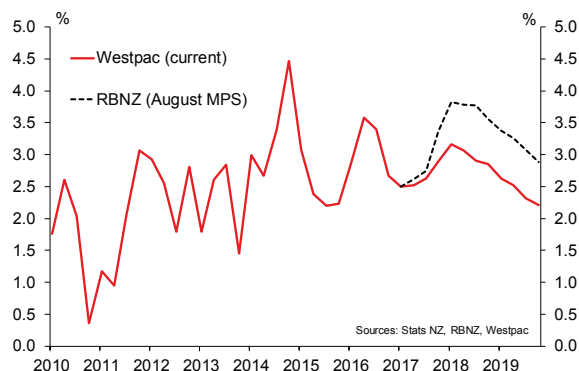
It's unclear what impact this policy mix would have on inflation pressures and the Official Cash Rate. However, longer-term interest rates may rise slightly if projections for fiscal surpluses are lowered and for public debt are raised.

Turning to the Reserve Bank itself, last week's OCR review was much as we expected. The OCR was left unchanged at 1.75%, and the press release retained much of the language of previous statements, including the bottom line: "Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly."

However, there were some notable changes in the details, the most important being a downgrade to the RBNZ's growth outlook. The RBNZ said that "growth is projected to maintain its current pace going forward." This is clearly weaker than the RBNZ's previous statement that "growth is expected to improve going forward." Construction activity has been weaker than expected in recent quarters, something that has also prompted us to revise down our GDP growth forecasts. The RBNZ also no longer describes population growth as "strong", which may be a veiled acknowledgement of the recent slowdown in net migration.

These comments suggest that the economic forecasts published in the November MPS could be meaningfully different from those in the August MPS. If the most recent quarterly GDP outturn were repeated each quarter, the annual percentage change in GDP would reach 3.2% by June 2018. That compares to the RBNZ's forecast of 3.8% growth in August. Slower growth implies a slower return to potential output, less inflation pressure, and a lower interest rate path than otherwise.

GDP growth forecasts



Concerns about near-term growth are unlikely to be alleviated by the latest building consents data. While the number of consents jumped by 10% in August, this largely related to the timing of apartment building consents. In particular, the bounce in Auckland consents followed a shockingly low number in July. The overall trend in consents has remained stalled over the past year.

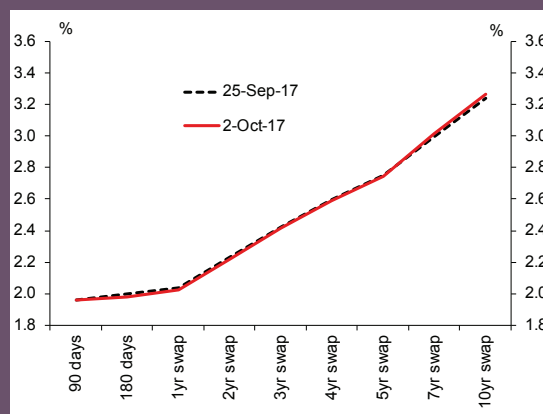
Weaker growth could be offset to some degree by a lower exchange rate, which has been lower than was assumed in the August MPS. If the decline in the currency persists, the RBNZ would be able to leave its OCR guidance unchanged. But if the exchange rate fails to fall by enough, the RBNZ may have to downgrade its OCR outlook.

Fixed vs Floating for mortgages

For borrowers with a deposit of 20% or more, the best value lies in the two-year rate or shorter terms. Three-to-five-year rates seem high relative to where we think short-term rates are going to go over that time. Some lending and deposit rates have been falling recently, so it may be worth waiting to see if there are further modest reductions in fixed-term rates.

Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates such as the six-month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

NZ interest rates



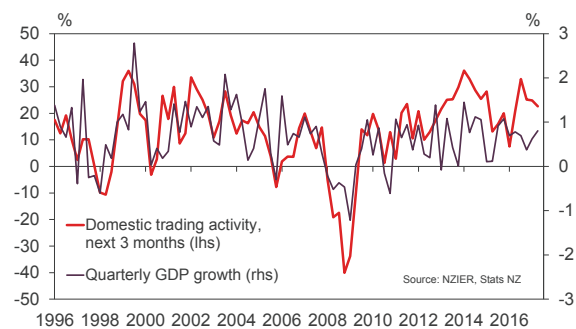
The week ahead

NZ Q3 Survey of Business Opinion

Oct 3, General Business Situation - last: +17.8

- Through the first half of the year, the Quarterly Survey of Business Opinion pointed towards firmness in economic activity. However, confidence has taken a bit of a knock recently, with uncertainty around the general election clouding the outlook. We expect that this will put a dampener on the September confidence report, surveying for which was conducted in the run up to the election.
- Looking through election related volatility, we'll be keeping a close eye on a number of the survey's key activity gauges. In particular, we'll be watching how activity in the construction sector is shaping up, and any headwinds the industry is highlighting. This sector has been a key driver of growth in recent years. However, we're now seeing growing signs that momentum in the construction activity is fading.

QSBO domestic trading activity and GDP



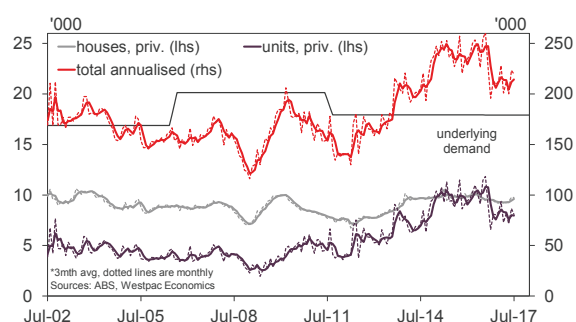
Aus Aug dwelling approvals

Oct 3, Last: -1.7%, WBC f/c: 2.0%

Mkt f/c: 1.0%, Range: -3.0% to 3.0%

- Dwelling approvals dipped 1.7% in July, but were coming off an 11.7% jump in June. Approvals are still down 13.9% vs their high a year ago but over recent months have shown signs of stabilisation for high rise and firming across non high rise segments.
- Construction-related housing finance approvals suggest the lift in non high rise activity gathered steam through the middle of the year, annual growth lifting above 10%. While we expect high rise approvals to take another leg lower, a strong lift in the considerably bigger non high rise segment is expected to dominate in the Aug month, producing a 2% rise in approvals overall. Potentially large offsetting moves make the estimate more uncertain than usual.

Dwelling approvals

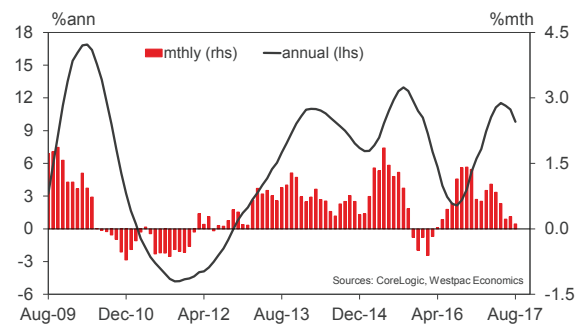


Aus Sep CoreLogic home value index

Oct 3, Last: 0.1%, WBC f/c: 0.2%

- The overhauled CoreLogic measures provide a much more reliable guide to price changes. Whereas previously it would take 3-6mths and/or multiple measures to confirm a market shift, the new series appear to give clear signals on a month to month basis. As such, and with the CoreLogic estimates already provided much earlier than other measures, we will now be treating these as the 'benchmark' for Australian house prices and reporting/previewing on a more regular basis.
- The index showed a 0.1% gain in Aug, the 3mth annualised pace slowing abruptly to just 2.5% from 10.2% in May. The daily index points to a similarly subdued 0.2% gain in Sep. Note that Aug and Sep are seasonal highs for prices suggesting 'underlying' moves are likely small negatives.

CoreLogic home value index



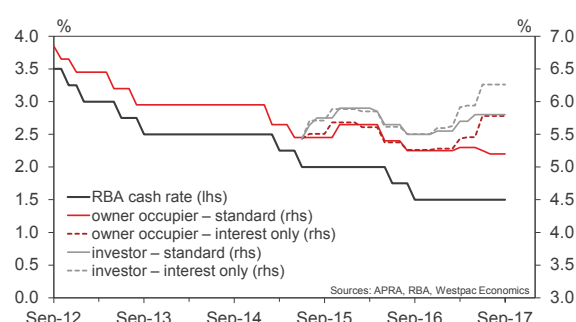
Aus RBA policy announcement

Oct 3, Last: 1.50%, WBC f/c: 1.50%

Mkt f/c: 1.50%, Range: 1.50% to 1.50%

- The RBA is certain to leave rates unchanged again at its October meeting. The Bank has left the cash rate unchanged since August last year. Over the past year, economic growth has been patchy (albeit with a lift in momentum recently), annual core inflation is below the target band, there is still significant slack in the labour market, notwithstanding the recent jobs surge, and wages growth is at historic lows. With a number of these trends likely to persist, we expect rates to remain on hold throughout 2017 and 2018. However, market pricing is for two rate hikes in 2018. The 2018 outlook is critical to the rates debate. The RBA's central case forecast is for growth to accelerate to be above trend in 2018 and into 2019. We are less convinced, expecting growth to slow to below trend in 2018. See page 2 for a more detailed discussion.

RBA cash rate and mortgage interest rates



The week ahead

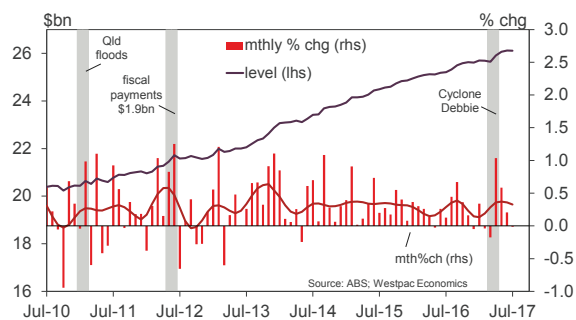
Aus Aug retail trade

Oct 5, Last: flat, WBC f/c: 0.2%

Mkt f/c: 0.3%, Range: -0.3% to 0.6%

- The August retail report shapes up as a particularly important one for gauging the consumer. Retail sales have stalled through June-July suggesting the Q2 rebound from a weather affected Q1 has faded quickly and that 'underlying' conditions remain weak. The August update will give a clearer indication of just how weak.
- Consumer sentiment remained soft in August with finances again under pressure and consumer caution elevated. While the labour market has seen solid job gains, weak wages growth and structural shifts are seeing a muted impact on incomes. Business surveys also point to weaker retail conditions through July-August although spending on 'non retail' consumer services still appears to be buoyant. Overall that suggests a disappointing gain. We expect retail sales to be up just 0.2% in the month.

Monthly retail sales



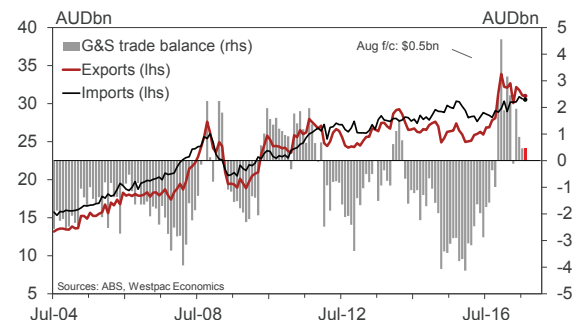
Aus Aug trade balance, AUDbn

Oct 5, Last: 0.46, WBC f/c: 0.5

Mkt f/c: 0.9, Range: 0.1 to 1.5

- Australia's trade balance has been in surplus in eight of the past nine months. For August, we expect the trade surplus to remain unchanged at \$0.5bn.
- Export earnings are expected to be little changed, -0.2%, reflecting the balance of countervailing forces. The main plus, the iron ore spot price rose to US\$76/t, up from \$67. Against that are lower volumes for coal and LNG, as well as a sharp pull-back in rural commodity prices.
- The import bill declines by an anticipated 0.3%, as prices fall in association with the stronger currency. The Australian dollar made further gains in the month, increasing by 1.6% to 79US¢ and up 0.6% on a TWI weighted basis.

Australia's trade balance



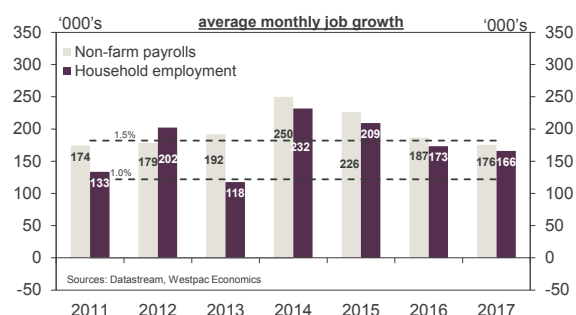
US Sep employment report

Oct 6, nonfarm payrolls, last 156k, WBC 100k

Oct 6, unemployment rate, last 4.4%, WBC 4.4%

- August nonfarm payrolls surprised to the downside, with only 156k new jobs created in the month and a cumulative 41k in downward revisions to June and July. The BLS reported that Hurricane Harvey had no discernable impact on employment in the month.
- September is likely to be a different story, with many workers in affected areas forced to stay away. However, continued robust job growth across the rest of the nation should beget a moderate positive outcome overall. Note that weather-affected prints can be subject to material revisions. Hence it is best to focus on 3 and 6 month averages, both of which continue to show strength.
- Household employment is less affected by the weather, so expect the unemployment rate to remain unchanged at 4.4%.

US job creation still strong



Data calendar

| | | Last | Market median | Westpac forecast | Risk/Comment |
|--------------|------------------------------------|--------|---------------|------------------|--|
| Mon 2 | | | | | |
| Aus | Public Holiday | - | - | - | NSW, ACT, Qld, and SA. |
| | Sep CoreLogic home value index | 0.1% | - | 0.2% | Now the clear benchmark measure for dwelling prices. |
| | Sep AiG Manufacturing PMI | 59.8 | - | - | Manufacturing strong upswing, construction & AUD support. |
| | Sep MI inflation gauge | 2.6% | - | - | Has been running ahead of the CPI so read with caution. |
| Eur | Sep Markit manufacturing PMI final | 58.2 | - | - | Conditions very strong. |
| | Aug unemployment rate | 9.1% | - | - | Will continue to track down slowly. |
| UK | Sep Markit manufacturing PMI | 56.9 | 56.2 | - | Lower sterling helping to support demand. |
| US | Sep Markit manufacturing PMI final | 53.0 | - | - | Weaker than ISM measure which has show further strength. |
| | Sep ISM manufacturing | 58.8 | 57.5 | - | ISM respondents point to boom-time conditions. |
| | Aug construction spending | -0.6% | 0.4% | - | Subdued appetite to invest amongst corporates. |
| | Fedspeak | - | - | - | Kaplan in a moderated Q&A. |
| Tue 3 | | | | | |
| NZ | Q3 Qrty Survey of Business Opinion | 17.8 | - | - | Election related uncertainty weighing on business confidence. |
| Aus | Aug dwelling approvals | -1.7% | - | 2.0% | Lift in non high-rise to more than offset high rise decline. |
| | Sep ANZ job ads | 2.0% | - | - | Momentum building with 6mth pace at a 6½yr high. |
| | RBA policy decision | 1.50% | 1.50% | 1.50% | Remains on hold, as households remain under pressure. |
| UK | Markit/CIPS construction PMI | 51.1 | 50.8 | - | Softness in private residential and industrial spending. |
| Wed 4 | | | | | |
| NZ | GlobalDairyTrade auction | 0.9% | - | - | WMP dairy futures signalling a slight rise in dairy prices. |
| | Sep ANZ commodity price index | -0.8% | - | - | Flat dairy prices & softer meat prices to ebb index to offer result. |
| Aus | Sep AiG Services PSI | 53.0 | - | - | Still upbeat, despite -3.4pts in Aug, led by business services. |
| Eur | Sep Markit services PMI final | 55.6 | - | - | Services not as strong as manufacturing... |
| UK | Sep Markit/CIPS services PMI | 53.2 | 53.1 | - | Softness in the consumer sector has been a drag. |
| US | Sep ADP employment change | 237k | 160k | 170k | Softer pulse, but still strong given full employment. |
| | Sep domestic auto sales | 12.48 | 12.50 | - | Higher interest rates to weigh on activity in future. |
| | Sep Markit services PMI final | 55.1 | - | - | Services experiencing mixed conditions... |
| | Sep ISM non-manufacturing | 55.3 | 55.1 | - | ... given recent doubts over consumer. |
| | Fed Chair Yellen speaking | - | - | - | Opening remarks at community banking conference. |
| Thu 5 | | | | | |
| Aus | Aug retail sales | 0.0% | 0.3% | 0.2% | Surveys suggest weak retail conditions carried into August. |
| | Aug trade balance, AUDbn | 0.46 | 0.9 | 0.5 | Exports -0.2%, despite rise in iron ore price. |
| US | Initial jobless claims | 272k | - | - | Very low. |
| | Aug trade balance US\$bn | -43.7 | -43.9 | - | Little net change anticipated. |
| | Aug factory orders | -3.3% | 0.7% | - | Underlying investment trend remains subdued. |
| | Fedspeak | - | - | - | Williams at community banking conference. |
| | Fedspeak | - | - | - | Harker at 'Investing in America's Workforce' conference. |
| Fri 6 | | | | | |
| Eur | Sep ECB minutes | - | - | - | Further detail on plans to taper? |
| UK | Sep Halifax house prices | 1.1% | - | - | Housing market remains soft, but may be finding a base. |
| US | Sep non-farm payrolls, '000 | 156 | 70 | 100 | Hurricane season to impact payroll employment. |
| | Sep unemployment rate | 4.4% | 4.4% | - | But unemployment likely unchanged. |
| | Aug wholesale inventories | 0.6% | 0.4% | - | A modest support to growth in recent months. |
| | Aug consumer credit \$bn | 18.5 | 16.0 | - | Continues to be driven by autos and student loans. |
| | Fedspeak | - | - | - | George, Bostic & Kaplan at 'Workforce' conference. |
| | Fedspeak | - | - | - | Dudley on policy outlook and importance of education. |
| Sat 7 | | | | | |
| Chn | Sep foreign reserves \$bn | 3091.5 | - | - | Very stable in 2017, thanks to tighter policy. |
| US | Moody's US sovereign debt review | - | - | - | Periodic review. Washington to dictate long-term outcome. |
| Sun 8 | | | | | |
| Chn | Sep foreign direct investment %yr | 9.1% | - | - | Not a focus for markets. |

New Zealand forecasts

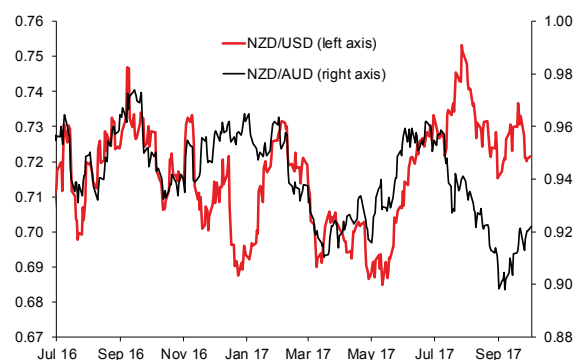
| Economic Forecasts | 2017 | | | | Calendar years | | | |
|----------------------------------|----------|------|------|------|----------------|------|------|-------|
| | % change | Jun | Sep | Dec | Mar | 2015 | 2016 | 2017f |
| GDP (Production) ann avg | 0.8 | 0.7 | 0.6 | 0.8 | 2.5 | 3.0 | 2.6 | 2.9 |
| Employment | -0.1 | 1.1 | 0.4 | 0.6 | 1.4 | 5.8 | 2.6 | 1.8 |
| Unemployment Rate % s.a. | 4.8 | 4.6 | 4.7 | 4.7 | 4.9 | 5.2 | 4.7 | 4.6 |
| CPI | 0.0 | 0.5 | 0.3 | 0.3 | 0.1 | 1.3 | 1.8 | 1.3 |
| Current Account Balance % of GDP | -2.8 | -2.7 | -2.8 | -2.5 | -3.2 | -2.5 | -2.8 | -3.3 |

| Financial Forecasts | Dec-17 | Mar-18 | Jun-18 | Sep-18 | Dec-18 | Mar-19 |
|---------------------|--------|--------|--------|--------|--------|--------|
| Cash | 1.75 | 1.75 | 1.75 | 1.75 | 1.75 | 1.75 |
| 90 Day bill | 1.95 | 1.95 | 1.95 | 1.95 | 1.95 | 1.95 |
| 2 Year Swap | 2.10 | 2.15 | 2.20 | 2.30 | 2.40 | 2.50 |
| 5 Year Swap | 2.70 | 2.80 | 2.90 | 3.00 | 3.10 | 3.20 |
| 10 Year Bond | 2.95 | 3.10 | 3.20 | 3.30 | 3.40 | 3.45 |
| NZD/USD | 0.70 | 0.69 | 0.68 | 0.67 | 0.66 | 0.66 |
| NZD/AUD | 0.92 | 0.92 | 0.92 | 0.93 | 0.94 | 0.94 |
| NZD/JPY | 77.7 | 77.3 | 76.8 | 76.4 | 75.9 | 75.4 |
| NZD/EUR | 0.60 | 0.59 | 0.59 | 0.59 | 0.58 | 0.58 |
| NZD/GBP | 0.55 | 0.54 | 0.54 | 0.54 | 0.54 | 0.54 |
| TWI | 74.5 | 73.9 | 73.4 | 72.9 | 72.6 | 72.2 |

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 2 October 2017

| Interest Rates | Current | Two weeks ago | One month ago |
|----------------|---------|---------------|---------------|
| Cash | 1.75% | 1.75% | 1.75% |
| 30 Days | 1.84% | 1.82% | 1.85% |
| 60 Days | 1.90% | 1.88% | 1.90% |
| 90 Days | 1.96% | 1.94% | 1.96% |
| 2 Year Swap | 2.22% | 2.21% | 2.17% |
| 5 Year Swap | 2.75% | 2.68% | 2.63% |

NZ foreign currency mid-rates as at Monday 2 October 2017

| Exchange Rates | Current | Two weeks ago | One month ago |
|----------------|---------|---------------|---------------|
| NZD/USD | 0.7217 | 0.7278 | 0.7150 |
| NZD/EUR | 0.6119 | 0.6100 | 0.6016 |
| NZD/GBP | 0.5396 | 0.5366 | 0.5517 |
| NZD/JPY | 81.33 | 80.88 | 78.26 |
| NZD/AUD | 0.9221 | 0.9095 | 0.8999 |
| TWI | 76.31 | 76.14 | 74.98 |

International forecasts

| Economic Forecasts (Calendar Years) | 2013 | 2014 | 2015 | 2016 | 2017f | 2018f |
|-------------------------------------|------|------|------|------|-------|-------|
| Australia | | | | | | |
| Real GDP % yr | 2.1 | 2.8 | 2.4 | 2.5 | 2.5 | 3.0 |
| CPI inflation % annual | 2.7 | 1.7 | 1.7 | 1.5 | 2.0 | 2.5 |
| Unemployment % | 5.8 | 6.2 | 5.8 | 5.7 | 5.7 | 6.1 |
| Current Account % GDP | -3.4 | -3.0 | -4.7 | -2.7 | -1.3 | -2.2 |
| United States | | | | | | |
| Real GDP %yr | 1.5 | 2.4 | 2.9 | 1.5 | 2.1 | 2.1 |
| Consumer Prices %yr | 1.5 | 1.6 | 0.1 | 1.3 | 2.0 | 1.8 |
| Unemployment Rate % | 7.4 | 6.2 | 5.3 | 4.9 | 4.4 | 4.3 |
| Current Account %GDP | -2.3 | -2.3 | -2.3 | -2.6 | -2.7 | -2.8 |
| Japan | | | | | | |
| Real GDP %yr | 1.4 | 0.0 | 0.5 | 0.6 | 1.1 | 1.0 |
| Euroland | | | | | | |
| Real GDP %yr | -0.3 | 0.9 | 1.6 | 1.8 | 2.1 | 1.7 |
| United Kingdom | | | | | | |
| Real GDP %yr | 2.2 | 2.9 | 2.2 | 2.0 | 1.6 | 1.6 |
| China | | | | | | |
| Real GDP %yr | 7.7 | 7.3 | 6.9 | 6.7 | 6.7 | 6.2 |
| East Asia ex China | | | | | | |
| Real GDP %yr | 4.2 | 4.1 | 3.7 | 3.7 | 4.0 | 3.9 |
| World | | | | | | |
| Real GDP %yr | 3.3 | 3.4 | 3.2 | 3.2 | 3.6 | 3.5 |

Forecasts finalised 15 September 2017

| Interest Rate Forecasts | Latest | Dec-17 | Mar-18 | Jun-18 | Sep-18 | Dec-18 | Mar-19 | Jun-19 |
|-------------------------|--------|--------|--------|--------|--------|--------|--------|--------|
| Australia | | | | | | | | |
| Cash | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 |
| 90 Day Bill | 1.71 | 1.80 | 1.80 | 1.80 | 1.80 | 1.80 | 1.80 | 1.80 |
| 10 Year Bond | 2.83 | 2.70 | 2.75 | 2.85 | 2.95 | 3.00 | 3.00 | 3.00 |
| International | | | | | | | | |
| Fed Funds | 1.125 | 1.375 | 1.375 | 1.625 | 1.625 | 1.875 | 1.875 | 1.875 |
| US 10 Year Bond | 2.32 | 2.40 | 2.60 | 2.75 | 2.90 | 3.00 | 3.00 | 3.00 |
| ECB Deposit Rate | -0.40 | -0.40 | -0.40 | -0.40 | -0.40 | -0.40 | -0.30 | -0.30 |

| Exchange Rate Forecasts | Latest | Dec-17 | Mar-18 | Jun-18 | Sep-18 | Dec-18 | Mar-19 | Jun-19 |
|-------------------------|--------|--------|--------|--------|--------|--------|--------|--------|
| AUD/USD | 0.7842 | 0.76 | 0.75 | 0.74 | 0.72 | 0.70 | 0.70 | 0.70 |
| USD/JPY | 112.64 | 111 | 112 | 113 | 114 | 115 | 115 | 116 |
| EUR/USD | 1.1780 | 1.17 | 1.16 | 1.15 | 1.14 | 1.13 | 1.13 | 1.14 |
| AUD/NZD | 1.0873 | 1.09 | 1.09 | 1.09 | 1.07 | 1.06 | 1.06 | 1.07 |

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