



Weekly Commentary

7 February 2017



Staying on hold

This week the Reserve Bank will release its first *Monetary Policy Statement* for the year. Since their last *Statement*, global developments have resulted in tighter financial conditions, while domestic conditions have been more mixed. Weighing it all up, we expect that the RBNZ will keep the Official Cash Rate (OCR) on hold for some time yet.

At its last interest rate decision in November, the RBNZ cut the OCR to a record low of 1.75%. At the same time, they adopted a neutral stance, signalling that they expected to keep the OCR at that low level for an extended period in order to support economic activity and generate a lift in domestic inflation.

Since then, we've seen headline inflation rise back into the RBNZ's target band after lingering at sub-1% levels for the past two years. In part, this pick-up in inflation was due to earlier sharp declines in oil prices dropping out of the annual figures in December. However, there has also been a more general strengthening of prices, with measures of underlying inflation also rising over the past six months.

But while the pick-up in inflation will certainly be a welcome development for the RBNZ, generating a sustained rise back to the 2% target mid-point could be a more challenging task. First of all, the recent pickup in inflation came on the back of a sharp fall in the New Zealand dollar in late 2015. Exchange rate movements typically take the best part of a year to flow through into retail prices for imported goods, reflecting factors such as importers' currency hedging – hence the uptick in inflation over 2016. This situation has now completely turned: the NZ dollar has clawed back all of its losses, and more, in the last year. Given the usual lag, this points to a fresh wave of downward pressure on the prices of many consumer goods over 2017.

The continued softness in imported prices means that in order to meet their inflation target, the RBNZ will need to see a lift in home grown inflation. But this may be easier said than done. It's true that the economy has been growing at a rate of more than 3% per annum, and that sort of pace is expected to be sustained through the coming year. But much of this growth is coming on the back of record net migration. The resulting increase in the population is adding to demand in the economy. At the same time, it is boosting our productive capacity, allowing the economy to grow without a significant lift in cost pressures. Adjusting for population growth, GDP is only growing at around 1% a year – a rate that's just not that impressive by historic standards, and not really indicative of an economy that's at risk of overheating.

These trends were highlighted in the December labour market figures that were released over the past week. They showed that there has been solid growth in employment, with the number of fulltime equivalent employees up 3.2% over the past year. But despite this, the unemployment rate actually ticked up to 5.2% from 4.9% in September. And on top of this, there's no sign of wage growth picking up just yet.

It's also important to remember that while the economy may be growing at a firm pace, developments since November have been mixed rather than unambiguously positive. On the upside, world dairy prices have remained high after a stunning 50% rebound from their August lows,

Staying on hold continued

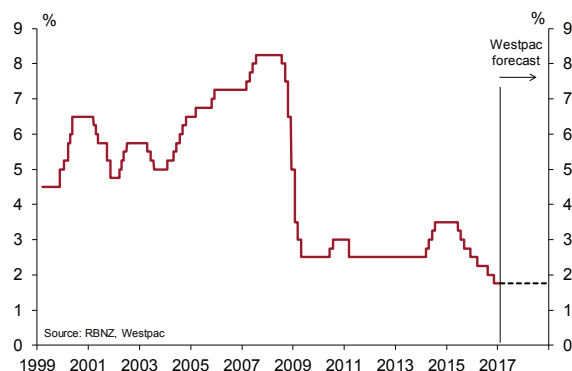
signalling a much improved outlook for demand in many regional centres.

But there have also been some big negatives. House price growth slowed by more than the RBNZ assumed in late 2016, and recent data points to a continued slowdown in the early part of 2017. For better or worse, house prices are an important transmission mechanism for monetary policy – rising house prices tend to support rising household spending, which boosts activity and inflation. The recent slowdown in house price growth suggests some softening in household spending could be on the cards in coming months.

Reinforcing the downside risk for activity and inflation is that borrowing rates have been creeping higher, even though the OCR has remained on hold. Rising global long-term interest rates have been passing through to higher domestic mortgage rates. This will see debt servicing burdens for many households climb in the months ahead as fixed rate mortgages are adjusted, and will further dampen activity in the housing market.

Putting all of the above together, we expect that the RBNZ will keep the OCR on hold next week and retain the neutral stance of its November statement: “*Current policy settings will see growth strong enough to have inflation settle near the middle of the target range*”. We also expect the

Official Cash Rate forecast



accompanying projections for the OCR to remain flat at 1.7% (this projection is only published to one decimal place).

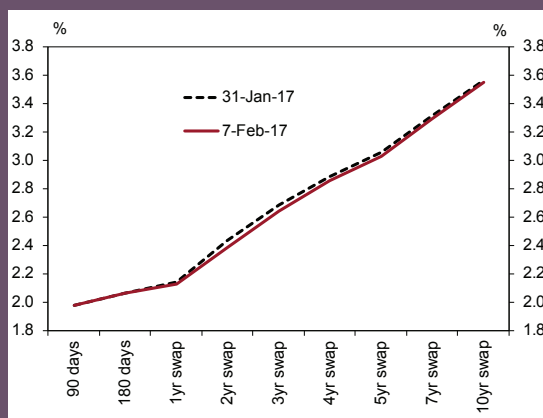
While markets have moved to price in a rise in the OCR over the coming year, we doubt the RBNZ will give credence to such suggestions, either in the Statement or its interest rate projection. The RBNZ needs the domestic economy to continue growing at a strong pace to boost inflation, and that requires continued low interest rates. Endorsing the idea of OCR hikes in the foreseeable future would risk pushing financial conditions even further in an undesired direction.

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. That said, these rates are most likely to be pressured higher by global market trends, so borrowers who prefer the security of a longer term still have a chance to lock in at historically quite low levels.

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



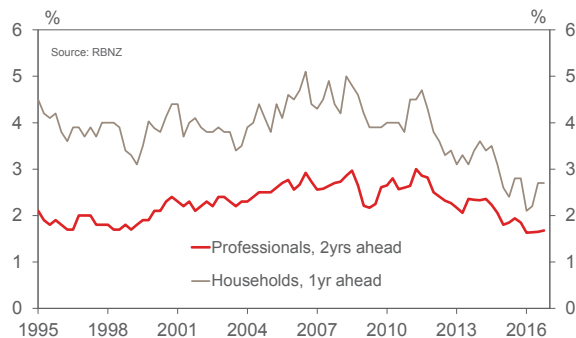
The week ahead

NZ Q1 survey of inflation expectations

Feb 7, Two years ahead, last: 1.68%

- Inflation expectations fell sharply in early 2016, in the midst of a second year of below-target inflation outturns. This was a key motivation behind last year's OCR cuts. Expectations have since stabilised and picked up a bit in recent surveys.
- The latest survey was held immediately after the latest CPI report, where annual inflation was slightly stronger than expected at 1.3%. With inflation back within the 1-3% target band, the RBNZ will be less concerned about the risk that expectations could become unanchored. However, it's likely that the RBNZ will still want to see expectations settle near the 2% midpoint of the target.

NZ Official Cash Rate

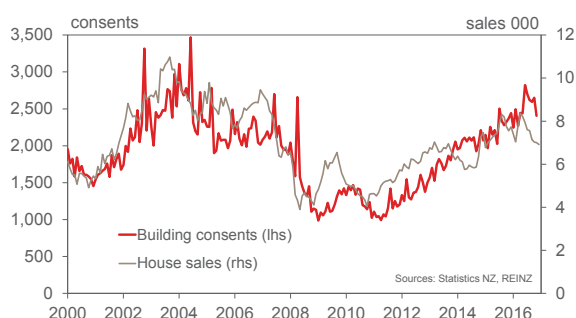


NZ Dec building consents

Feb 9, Last: -9.2%, Westpac f/c: 6.0%

- Dwelling consent issuance fell sharply in November. In part this was due to the impacts of the Kaikoura earthquakes that struck in mid-November. The result also reflected a normal pull-back following earlier strength.
- We expect to see some bounce in consent issuance over December as quake-related disruptions ease. However, there is some risk of ongoing delays to building activity.
- The key area to watch will continue to be Auckland. Building activity in Auckland is expected to rise in response to favourable economic conditions. However, in recent months we have seen consent issuance flatten off at levels below what is needed to keep up with population growth.

NZ housing activity

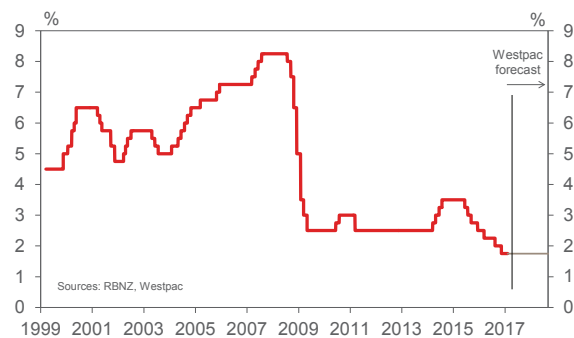


RBNZ Monetary Policy Statement

Feb 9, last: 1.75%, Westpac: 1.75%, Market: 1.75%

- We expect the Reserve Bank to hold the OCR at 1.75%, and to retain the neutral tone of the November statement.
- The RBNZ will take some comfort from the fact that inflation is finally back within the target range. But there are still some significant barriers to a further pickup in inflation from here. Rising mortgage rates and a stronger New Zealand dollar mean that financial conditions have already tightened by more than the RBNZ intended.
- RBNZ Governor Wheeler's term ends in September. A statement about whether he will stand for another term is expected soon.

RBNZ survey of inflation expectations

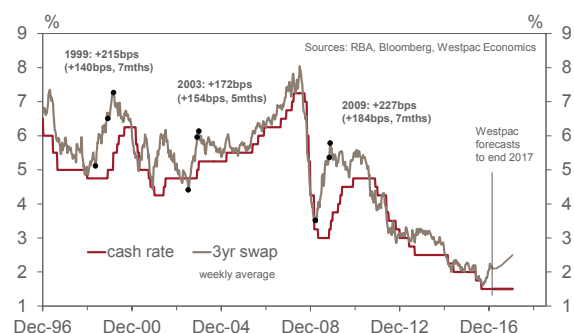


RBA February policy meeting

Feb 7, Last: 1.50%, WBC 1.50%

- The most recent Board minutes for the December meeting emphasised the concern the Board has with balancing the risks around financial stability and the possible need to further support a deteriorating economy.
- A reasonable interpretation of this discussion is that the "hurdle" to cut rates is high. Further, the minutes put a positive spin on the current economic outlook: consumer spending passing through a soft patch; non-mining investment being a bit stronger than the most recent CAPEX survey; the fall in the unemployment rate being consistent with hours worked; and the drag from mining investment being likely to ease markedly in 2017.
- This sentiment is certainly consistent with our long-held view that rates are likely to remain on hold over the course of 2017.

RBA cash rate, 3 year swap



Data calendar

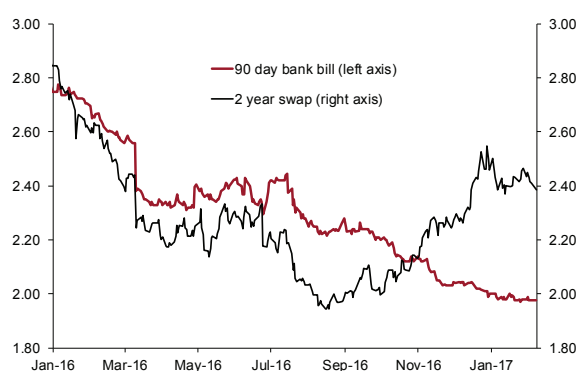
		Last	Market median	Westpac forecast	Risk/Comment
Tue 7					
NZ	Q1 RBNZ inflation expectations (2 yrs ahead)	1.68%	-	-	Has stabilised at low levels. Expected to rise only gradually.
Aus	RBA policy decision	1.5%	1.5%	1.5%	Firmly on hold through 2017.
Chn	Jan Caixin China PMI services	53.4	-	-	Increasing since Aug. Dec new orders rose the most in 17 months.
	Jan foreign reserves \$bn	3010.5	3010.5	-	Reserves fell \$320 bn in 2016. Capital controls strengthening.
Ger	Dec industrial production	0.4%	0.4%	-	Fundamentals of the German economy are strong.
UK	Jan Halifax house prices	1.7%	0.2%	-	Reduced supply and low mortgage rates cushioning prices.
US	Dec trade balance US\$bn	-45.2	-45.0	-	Looks to have narrowed in Dec, with capital good exports supportive.
	Dec JOLTS job openings	5522	-	-	Hires, fires, quits and openings.
	Dec consumer credit, \$bn	24.5	20.0	-	Student and auto loans dominate.
	Fedspeak	-	-	-	Harker speaking on payment systems in San Diego.
Can	Jan Ivey PMI	60.8	-	-	Prices rising, employment softening.
Wed 8					
NZ	GlobalDairyTrade auction results	0.6%	-	-	Futures point to a small decline in prices.
Chn	Jan foreign direct investment %yr	5.7%	-	-	Inflow rose 5.7% Dec. Authorities considering reducing restrictions.
Thu 9					
NZ	RBNZ OCR decision	1.75%	1.75%	1.75%	RBNZ to maintain neutral bias, signal OCR on hold for some time.
	Jan building consents	-9.2%	-	6.0%	Expected to rebound following November's quake related decline.
Aus	Q4 NAB business survey	5	-	-	Dec monthly survey reported conditions rebounded to +11 in Dec.
	RBA Governor Lowe	-	-	-	Speech in Sydney.
Ger	Dec trade balance €bn	22.7	19.7	-	Exports surged in November, strongest gain in nearly 5 years.
UK	Jan RICS house price balance	24%	24%	-	Reduced supply helping to balance softer demand.
US	Initial jobless claims	246k	-	-	Claims remain at very low levels.
	Dec wholesale inventories (final)	1.0%	1.0%	-	Set to remain volatile.
	Fedspeak	-	-	-	Bullard and Evans on the economy and policy.
Can	Dec new housing price index	0.2%	-	-	Inflation firm in Ontario, softer elsewhere.
Fri 10					
Aus	Dec housing finance	0.9%	1.0%	1.0%	Modest gains for owner-occupier loans. Investor activity resurgent.
	RBA Statement on Monetary Policy	-	-	-	Updated forecasts for growth and inflation. View on risks?
Chn	Jan trade balance USDbn	40.82	-	-	Last print saw exports fall 6.1%yr in dollar terms.
	Jan M2 money supply %yr	11.3%	-	-	Tentative date, 10 -15 Feb.
	Jan new loans, CNYbn	1040.0	-	-	Tentative date, 10 -15 Feb.
	Jan aggregate financing, CNYbn	1630.0	-	-	Tentative date, 10 -15 Feb.
UK	Dec trade balance, £mn	-4167	-3500	-	The lower pound has been supporting manufacturing and exports.
	Dec industrial production	2.1%	-	-	Businesses reporting positive conditions in recent months.
	Dec construction output	-0.2%	1.0%	-	Housing and infrastructure gains; commercial activity soft.
US	Jan import price index	0.4%	0.4%	-	USD mitigating import price growth.
	Feb Uni of Mich. consumer confidence	98.5	97.8	-	Continues to ride high following Trump's win.
	Jan monthly budget statement, \$bn	-27.5	33.0	-	Deficit stable for now; but will be watched through 2017.
Sat 11					
US	Fedspeak	-	-	-	Vice Chair Fischer to speak at economics conference in UK.

New Zealand forecasts

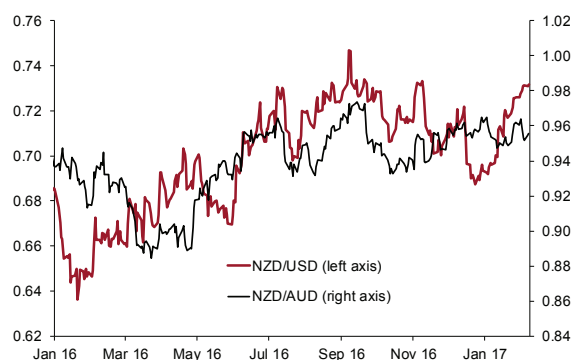
Economic Forecasts	March years				Calendar years			
	% change	2015	2016	2017f	2018f	2014	2015	2016f
GDP (Production) ann avg	3.4	2.4	3.4	3.3	3.4	2.5	3.3	3.3
Employment	3.2	2.0	4.9	2.0	3.6	1.4	5.8	2.1
Unemployment Rate % s.a.	5.4	5.2	4.9	4.4	5.5	5.0	4.8	4.5
CPI	0.3	0.4	1.4	1.2	0.8	0.1	1.2	1.2
Current Account Balance % of GDP	-3.5	-3.1	-2.7	-2.7	-3.2	-3.4	-2.7	-2.6

Financial Forecasts	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	2.00	2.00	2.00	2.00	2.00	2.00
2 Year Swap	2.40	2.50	2.50	2.50	2.50	2.50
5 Year Swap	3.00	3.15	3.25	3.30	3.35	3.40
10 Year Bond	3.30	3.45	3.50	3.60	3.65	3.75
NZD/USD	0.71	0.70	0.68	0.67	0.65	0.66
NZD/AUD	0.96	0.95	0.93	0.93	0.93	0.94
NZD/JPY	82.4	82.6	80.2	80.4	79.3	81.8
NZD/EUR	0.68	0.68	0.67	0.67	0.65	0.67
NZD/GBP	0.58	0.57	0.56	0.55	0.54	0.55
TWI	78.6	78.0	76.4	75.9	74.4	76.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Tuesday 7 February 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.83%	1.84%	1.85%
60 Days	1.92%	1.92%	1.92%
90 Days	1.98%	1.98%	1.99%
2 Year Swap	2.39%	2.44%	2.43%
5 Year Swap	3.03%	3.01%	3.00%

NZ foreign currency mid-rates as at Tuesday 7 February 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7318	0.7172	0.6968
NZD/EUR	0.6810	0.6695	0.6624
NZD/GBP	0.5870	0.5791	0.5730
NZD/JPY	81.83	81.91	81.56
NZD/AUD	0.9558	0.9482	0.9523
TWI	79.64	78.64	77.65

International forecasts

Economic Forecasts (Calendar Years)	2013	2014	2015	2016f	2017f	2018f
Australia						
Real GDP % yr	2.1	2.8	2.4	2.2	2.1	2.8
CPI inflation % annual	2.7	1.7	1.7	1.6	1.7	2.5
Unemployment %	5.8	6.2	5.8	5.7	5.4	5.3
Current Account % GDP	-3.4	-3.0	-4.8	-3.0	-1.7	-2.5
United States						
Real GDP %yr	1.5	2.4	2.6	1.6	2.1	2.4
Consumer Prices %yr	1.5	1.6	0.1	1.2	1.7	1.7
Unemployment Rate %	7.4	6.2	5.3	4.8	4.5	4.4
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	0.6	0.7
Euroland						
Real GDP %yr	-0.3	0.9	1.6	1.6	1.4	1.3
United Kingdom						
Real GDP %yr	2.2	2.9	2.2	2.1	1.6	1.4
China						
Real GDP %yr	7.7	7.3	6.9	6.7	6.6	6.0
East Asia ex China						
Real GDP %yr	4.2	4.1	3.7	3.7	3.9	3.9
World						
Real GDP %yr	3.3	3.4	3.1	3.2	3.5	3.5

Forecasts finalised 16 December 2016

Interest Rate Forecasts	Latest	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.77	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.78	2.95	2.95	3.00	3.05	3.15	3.25	3.40
International								
Fed Funds	0.625	0.625	0.875	0.875	1.125	1.125	1.375	1.375
US 10 Year Bond	2.48	2.55	2.65	2.75	2.85	3.00	3.10	3.30
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40

Exchange Rate Forecasts	Latest	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
AUD/USD	0.7644	0.74	0.74	0.73	0.72	0.70	0.70	0.68
USD/JPY	112.68	116	118	118	120	122	124	126
EUR/USD	1.0758	1.05	1.03	1.01	1.00	1.00	0.99	0.98
AUD/NZD	1.0505	1.04	1.06	1.07	1.08	1.07	1.06	1.05

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