

Weekly Commentary

7 August 2017



Against the tide

Last week Stats NZ gave us the lowdown on New Zealand's labour market. The most striking aspect of the data was a 0.2% drop in employment, as measured by the Household Labour Force Survey. But we are not reading anything into that – it is probably survey volatility rather than the start of a new trend. The alternative Quarterly Employment Survey (which surveys employers) registered FTE employment growth of 0.7%, and we have observed no anecdotes or other data pointing to a sudden shift away from the long-established trend of robust employment growth.

Looking more broadly at the data, New Zealand's labour market story is much as it has been for a couple of years now. Jobs are certainly being created at a rapid pace, but that is only just enough to keep up with rapid population growth. Consequently, the unemployment rate is falling only gradually – it is now 4.8%, compared to 5.1% a year ago.

At these levels, unemployment is still too high to put significant pressure on employers, so wage growth remains slow. The labour cost index has registered just 1.6% wage growth over the past year – wage growth has been stuck at that slow pace since 2013.

From here we do expect the unemployment rate to fall further, but only slowly and not by enough to generate the sort of rapid wage growth we experienced in the mid-2000s. Our forecasts have the unemployment rate reaching a low point of 4.5% later this year, before rising again late in the decade as the economy digests the inevitable slowdown in earthquake-related construction work and a slower housing market.

Occasionally one hears suggestions that if only we dialled back on migration, then the resident population would have more of a shot at the available jobs and the unemployment rate would come down faster. That is known as the “lump of labour” fallacy – it wrongly assumes that the number of jobs available is fixed. In reality, New Zealand's rapid rate of

population growth at present is itself generating demand in the economy, and is therefore responsible for some of the employment growth. If the rate of net migration were to slow sharply, it is unclear whether the unemployment rate would rise (via job losses in construction, for example) or fall.

The devil is in the detail when it comes to assessing the impact of rapid population growth on the labour market. We suspect that the composition of net migration at present is affecting the distribution of income growth in New Zealand. More bodies on the ground means more sales for businesses such as retailers and construction firms. But the preponderance of low-wage workers in the current mix of net migration may well be negatively impacting low-skill wage rates in New Zealand.

The other key development last week was Fonterra's announcement that it has upgraded its forecast of the farmgate milk price for the current season to \$6.75. Demand conditions around the world are certainly positive at present, but we are wary of European and US farmers lifting production in response to high prices. We are also conscious that there is scope for New Zealand's milk production season to outstrip forecasts. With the possibility of extra supply hitting the market, we prefer to stick with our forecast of a \$6.50 milk price.

Against the tide continued

This week we are looking for the Reserve Bank to surprise markets with a dovish Monetary Policy Statement. Financial market pricing currently suggests that the OCR will begin rising from mid-2018, but the RBNZ has been sharply at odds with that view. The RBNZ sees the OCR as on hold for the foreseeable future, and is on the record saying it is equally likely that the next move in the OCR could be up or down.

Over the past few months there has been a run of soft data in New Zealand, including GDP, inflation, the housing market and building consents. At the same time, the exchange rate has risen to levels that the RBNZ will be finding uncomfortable.

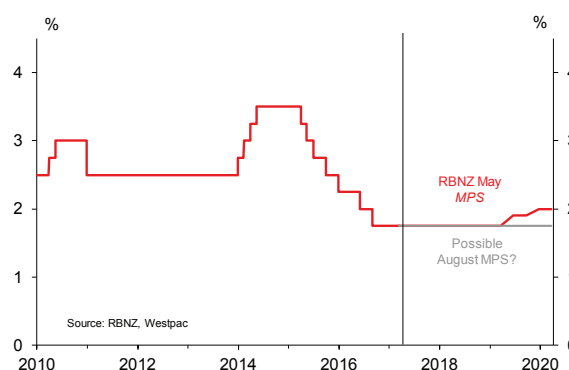
That said, we do not expect the Reserve Bank to make a big splash. The data has been soft, but the situation does not warrant the RBNZ altering its bottom-line guidance. We would expect the final sentence of this week's press release to be a virtual repeat of the past four:

"Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly."

But the RBNZ could still strike a dovish tone by issuing a completely flat OCR forecast (the previous incarnation featured a gradual drift higher in the OCR from 2019). The RBNZ might also sum the situation up with a catch-all phrase along the lines of:

"Developments since the May Monetary Policy Statement have on balance softened the outlook for medium term inflation."

RBNZ Official Cash Rate forecasts



And finally, the RBNZ will almost certainly lambast the high exchange rate, possibly going so far as to say that if the exchange rate fails to fall, the outlook for monetary policy will need to be reassessed.

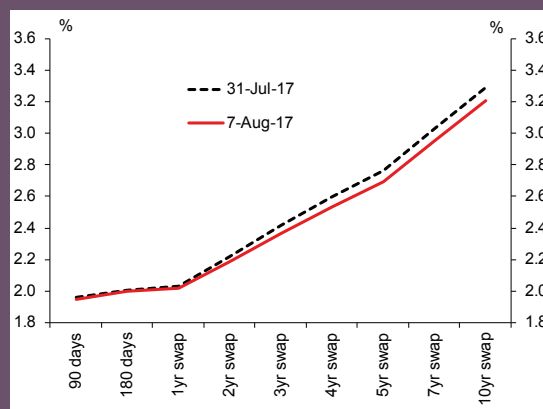
The other key piece of data to watch out for, out later today, is the RBNZ's survey of inflation expectations. This popped higher last quarter, but is expected to pull back this quarter. A surprise on inflation expectations in either direction could well influence the RBNZ's MPS later in the week.

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 Jul house prices and sales

Aug 7-11 (tbc), Sales last: -9.9%, Prices last: 2.8%/yr

- The housing market has continued to cool this year, as mortgage rates have risen and loan-to-value ratio restrictions have held back investors. Uncertainty about housing and tax policy after next month's election may also be suppressing activity.
- House prices are now down slightly on year-ago levels in Auckland and Christchurch, and further declines seem likely. Elsewhere, prices have continued to rise, but the pace is slowing in most regions.
- House sales have fallen by 25% over the last year. Industry figures suggest that this was followed by a sharp drop in new listings in July – property owners don't sell into a falling market if they don't have to.

REINZ house prices and sales

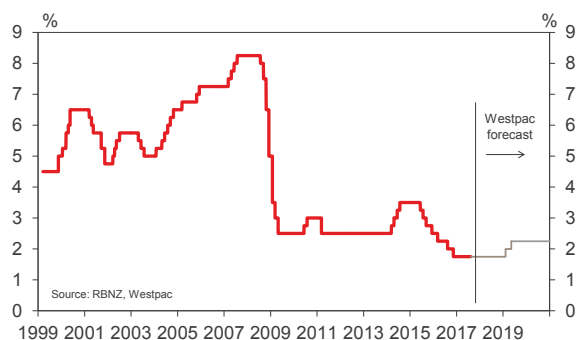


NZ RBNZ Monetary Policy Statement

Aug 10, last: 1.75%, Westpac f/c: 1.75%, Mkt f/c: 1.75%

- We expect the RBNZ will leave the OCR at 1.75% and reiterate that monetary policy is on hold for the foreseeable future.
- The press release will probably emphasise the softer tone to recent data, and the RBNZ's discomfort with the high exchange rate.
- The RBNZ may expunge any hint of hikes from its OCR forecast, and issue slightly more dovish guidance in the press release.
- An MPS along these lines would surprise financial markets, possibly causing swap rates and the exchange rate to fall on the day.

RBNZ official cash rate forecasts



NZ Q3 survey of inflation expectations

Aug 7, Two years ahead, last: 2.17%, Westpac f/c: 2.0%

- The Reserve Bank's survey of inflation expectations has attracted a great deal of market attention recently, having played a key role in the RBNZ's decision to cut the OCR last year. Now the tables have turned: expectations of inflation two years ahead rose to 2.2% in the latest quarter, back above the 2% target midpoint for the first time since 2014. However, the RBNZ has been eager to point out that it doesn't respond to the survey mechanically, and recent RBNZ research suggests that expectations have become more backward-looking. That's probably even more true now that the survey is held immediately after the CPI release; the drop in the actual inflation rate from 2.2% to 1.7% in Q2 will have been front of mind for respondents this time. Consequently, we think that inflation expectations will also pull back this quarter, to something like 2% (which was also our submission to the survey).

RBNZ survey of inflation expectations

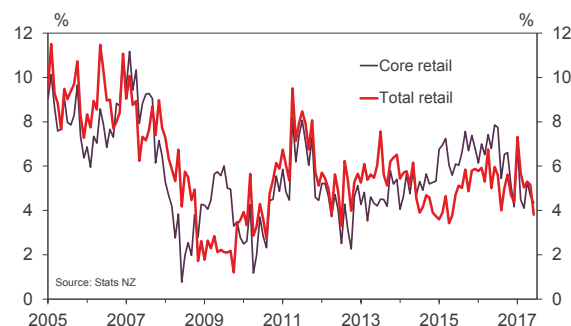


NZ Jun retail card spending

Aug 10, Last: flat, Westpac f/c: +0.1%

- Overall retail spending was flat in June. However, the headline result was strongly influenced by sharp falls in petrol prices over the month. Spending in core categories was actually up 0.8%, underpinned by a solid 2.4% gain in hospitality spending on the back of the Lions tour and related strength in tourism.
- We're forecasting a subdued 0.1% gain in total spending in July. In part, this reflects continued declines in fuel prices that have weighing on nominal spending. Core spending is expected to have risen by a modest 0.3% over the month. While interest rates are still low, they have been pushing upwards. In addition, the slowdown in the housing market will dampen spending in a number of areas.

Card transactions, annual % change



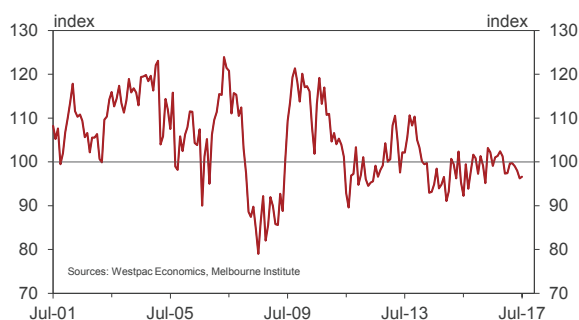
The week ahead

Aus Aug Westpac-MI Consumer Sentiment

Aug 9, Last: 96.6

- The **Westpac-Melbourne Institute Consumer Sentiment Index** rose 0.4% from 96.2 in June to 96.6 in July. Despite the lift, sentiment has tended to drift lower in 2017, the survey detail pointing to renewed pressures on finances.
- The Aug survey is in the field over the week to Aug 6. Developments over the last month look mostly positive for sentiment including: the RBA's decision to leave rates unchanged at its Aug meeting, the Governor also sending a clear signal that rate rises were unlikely any time soon; a terrorist bomb plot allegedly foiled in Sydney; a strong rally in the AUD (up near 4¢ US vs the July survey); a further modest recovery in the ASX (up 0.7% since July but still below its April highs); another solid 1.6% rise in dwelling prices; a continued improvement in labour market conditions and lower petrol prices.

Consumer Sentiment Index



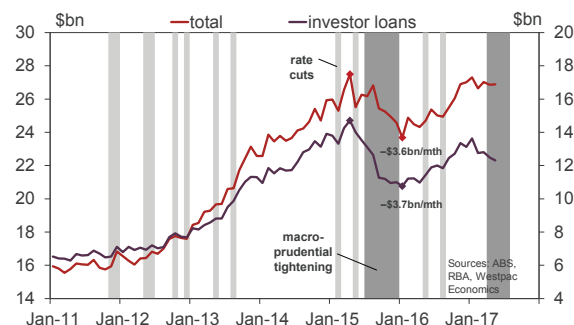
Aus Jun housing finance (no.)

Aug 9, Last: 1.0%, WBC f/c: 1.5%

Mkt f/c: 1.5%, Range: 0.5% to 3.0%

- The number of owner occupier loans rose 1% in May to be down 3.5%yr. This was the second monthly observation since APRA's macro prudential tightening in late March and associated increases in rates for investor and 'interest only' loans. Some of the rise in owner occupier loans is likely due to switching between investor and owner occupier products. A lift in refinancing suggests we may also be seeing existing borrowers move from interest only to standard loans. Notably both the value of investor loans and the total value of loans also held up a bit better than expected (down 1.4% and up 0.1% respectively). For June, industry data points to another lift in owner occupier loans, which we expect to be up 1.5%mt. Note that a second round of mortgage rate increases for 'interest only' loans came through late in the month.

Housing finance approvals

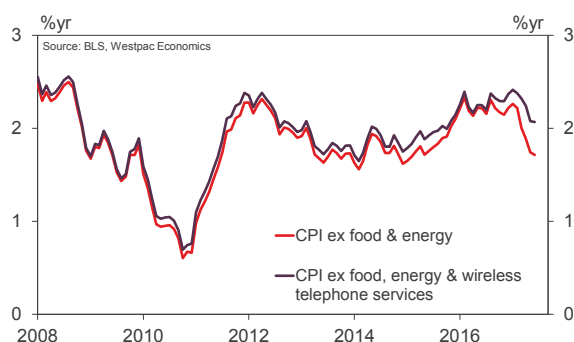


US Jul CPI

Aug 11, Last: 0.0%, WBC 0.1%

- Growing doubts over the US inflation pulse has materially reduced market expectations of further policy action by the FOMC. Heralding the start of the second half of 2017, the July CPI report will be a critical outcome for the market.
- Recently we highlighted that the vast majority of the deceleration in annual inflation, from 2.8%yr in February to 1.6%yr in June, had been due to transitory factors – most notably weak energy prices and an unusually large decline in the price of wireless telephone services. Abstracting from these two factors, annual core inflation at June was 2.1%yr. There is therefore little reason to be concerned that disinflation will become entrenched.
- That said, strong inflation is also unlikely anytime soon as wage growth remains modest. We look for a 0.1% rise in headline prices; excluding food and energy, a 0.2% gain is expected.

Core CPI ex wireless still at target



Data calendar

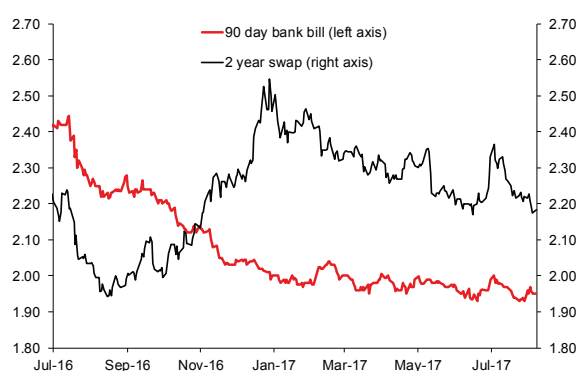
		Last	Market median	Westpac forecast	Risk/Comment
Mon 7					
NZ	Jul REINZ house sales	-9.9%	-	-	Due this week. Sales slowed sharply since LVR limits.
	Jul REINZ house prices, %yr	2.8%	-	-	Falling in Auckland; slowing in the rest of the country.
	Q3 RBNZ inflation expt'ns survey	2.17%	-	2.0%	Edging back after below expectations Q2 inflation result.
Aus	Jul ANZ job ads	2.7%	-	-	Ads have recovered to a sound 10%/yr annual pace.
	NSW bank holiday	-	-	-	Banks closed in NSW & ACT, Picnic Day NT.
UK	Jul Halifax house prices	2.6%	-	-	House price inflation softening on economic uncertainty.
Eur	Aug Sentix investor confidence	28.3	-	-	Index has maintained positivity established earlier in 2017.
Chn	Jul foreign reserves \$bn	3056.8	-	-	Authorities' control of outflows clear for all to see.
	Q2 current account balance	18.4	-	-	Dated, but offers considerable detail on trade/ financials.
US	Jul labor market conditions index	1.5	-	-	Aggregate measure of momentum in labour market.
	Jun consumer credit \$bn	18.4	16.0	-	Autos and students loans continue to support.
	Fedspeak	-	-	-	Bullard on economy and policy; Kashkari in a Q&A.
Tue 8					
Aus	Jul NAB business survey	15	-	-	Conditions strengthened in 2017, lift across most industries.
Chn	Jul trade balance USDbn	42.80	-	-	Gains for global trade aiding manufacturers.
	Jul foreign direct investment %yr	2.3%	-	-	Limited appetite for investment at the moment.
US	Jun JOLTS job openings	5666	-	-	Hires; fires; quits and job openings. A month behind payrolls.
	Jul NFIB small business optimism	103.6	103.8	-	Conditions reportedly deteriorated in June.
Wed 9					
Aus	Westpac-MI Consumer Sentiment	96.6	-	-	Mostly positive developments in August?
	Jun housing finance	1.0%	1.5%	1.5%	Owner occupiers indirectly boosted by investor clampdown.
	RBA Assistist Gov' Financial Mkts	-	-	-	Chris Kent, Bloomberg Address, Sydney, 8:35am
Chn	Jul CPI %yr	1.5%	1.5%	-	Consumer inflation pressures benign while...
	Jul PPI %yr	5.5%	5.6%	-	... upstream prices being supported by commodity prices.
US	Jun wholesale inventories (final)	0.6%	0.6%	-	Little changed in first half of 2017.
Thu 10					
NZ	RBNZ OCR decision	1.75%	1.75%	1.75%	Inflation has moderated & economic conditions softened.
	Jul retail card spending	0.0%	-	0.1%	Moderate growth in core spending, fuel prices down.
Aus	Aug MI inflation expectations	4.4%	-	-	Picked up in 2017 but may moderate with falling fuel prices
UK	Jul RICS house price balance	7.0%	-	-	Housing cond. softened, supply limits downside on prices.
	Jun industrial production	-0.1%	0.0%	-	Output has been subdued despite the lower GBP...
	Jun construction output	-1.2%	1.2%	-	... as Brexit uncertainty clouds the outlook for investment.
	Jun trade balance, £b	-11863	-11000	-	Lower GBP boosting exports.
US	Jul PPI	0.1%	0.1%	-	Weaker dollar likely to see producer prices rise.
	Initial jobless claims	-	-	-	Very low.
	Jul monthly budget statement	-90.2	-	-	Focus now turning to debt ceiling debate Sep/Oct.
Fri 11					
NZ	Jul BusinessNZ manuf. PMI	56.2	-	-	Remains at levels consistent with firm activity.
	Jul food price index	0.2%	-	-	Weather-related spike in vege prices is now reversing.
Aus	RBA Governor Philip Lowe	-	-	-	Parliamentary testimony, Melbourne, 9:30am.
US	Jul CPI	0.0%	0.2%	0.1%	Another benign outcome; food & energy to weigh.
	Fedspeak	-	-	-	Kashkari Q&A; Kaplan speech; Dudley on wage inequality.

New Zealand forecasts

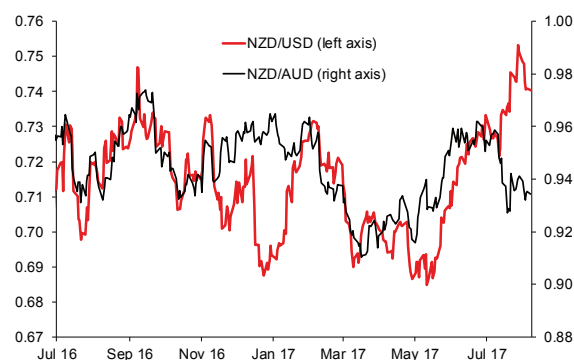
Economic Forecasts	2017				Calendar years			
	% change	Mar (a)	Jun	Sep	Dec	2015	2016	2017f
GDP (Production) ann avg	0.5	1.0	0.9	0.7	2.5	3.1	2.8	3.2
Employment	1.1	-0.2	1.3	0.5	1.4	5.8	2.8	1.9
Unemployment Rate % s.a.	4.9	4.8	4.6	4.4	4.9	5.2	4.4	4.5
CPI	1.0	0.0	0.4	0.2	0.1	1.3	1.6	1.9
Current Account Balance % of GDP	-3.1	-3.1	-3.1	-3.2	-3.4	-2.8	-3.2	-3.3

Financial Forecasts	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-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	2.15
2 Year Swap	2.30	2.35	2.40	2.45	2.50	2.60
5 Year Swap	2.90	3.00	3.10	3.20	3.30	3.40
10 Year Bond	3.15	3.30	3.50	3.70	3.80	3.85
NZD/USD	0.71	0.70	0.69	0.67	0.66	0.64
NZD/AUD	0.96	0.96	0.96	0.97	0.97	0.98
NZD/JPY	79.5	79.8	78.7	77.1	76.6	74.9
NZD/EUR	0.65	0.65	0.66	0.65	0.65	0.63
NZD/GBP	0.56	0.56	0.56	0.54	0.54	0.53
TWI	77.8	77.5	77.1	75.9	75.4	74.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 7 August 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.86%	1.82%	1.86%
60 Days	1.90%	1.87%	1.91%
90 Days	1.95%	1.94%	1.98%
2 Year Swap	2.19%	2.22%	2.33%
5 Year Swap	2.69%	2.76%	2.90%

NZ foreign currency mid-rates as at Monday 7 August 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7404	0.7450	0.7275
NZD/EUR	0.6289	0.6385	0.6384
NZD/GBP	0.5677	0.5728	0.5648
NZD/JPY	82.01	82.75	82.86
NZD/AUD	0.9344	0.9421	0.9592
TWI	78.27	78.85	78.44

International forecasts

Economic Forecasts (Calendar Years)	2013	2014	2015	2016	2017f	2018f
Australia						
Real GDP % yr	2.1	2.8	2.4	2.5	2.3	3.0
CPI inflation % annual	2.7	1.7	1.7	1.5	2.1	2.3
Unemployment %	5.8	6.2	5.8	5.7	5.7	6.2
Current Account % GDP	-3.4	-3.0	-4.7	-2.7	-1.7	-3.3
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	1.3	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	1.7	1.8	1.4
United Kingdom						
Real GDP %yr	2.2	2.9	2.2	2.0	1.8	1.6
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	3.8	3.8
World						
Real GDP %yr	3.3	3.4	3.1	3.3	3.5	3.5

Forecasts finalised 14 July 2017

Interest Rate Forecasts	Latest	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.69	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.62	2.90	2.95	3.05	3.20	3.35	3.30	3.30
International								
Fed Funds	1.125	1.375	1.375	1.625	1.625	1.875	1.875	1.875
US 10 Year Bond	2.22	2.55	2.65	2.90	3.10	3.30	3.30	3.30
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.30

Exchange Rate Forecasts	Latest	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
AUD/USD	0.7956	0.74	0.73	0.72	0.69	0.68	0.65	0.65
USD/JPY	110.09	113	114	115	115	116	116	118
EUR/USD	1.1876	1.13	1.13	1.11	1.10	1.08	1.07	1.06
AUD/NZD	1.0706	1.04	1.04	1.04	1.03	1.03	1.02	1.02

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