

Weekly Commentary

10 July 2017



Charting our own course

One of the big questions that economies around the globe are wrestling with right now is whether the extraordinary degree of monetary stimulus that has been introduced in recent years is still necessary. While conditions are varied, most of our trading partner economies have seen a strengthening in economic activity, and (some) lift in underlying inflation pressures. New Zealand is no exception.

While the Official Cash Rate isn't at the same sort of 'extreme' levels as policy rates in other economies like the UK, the OCR has been at record lows for an extended period. Now, with headline inflation back around the mid-point of the RBNZ's target band and a rise in hawkish sentiment globally, market pricing for OCR hikes has increased over the past few weeks. To be clear, this doesn't imply a shift to 'tight' policy, or even neutral settings. Rather, it's a question of whether there is scope for monetary policy to shift to slightly less stimulatory, but still very accommodative, levels.

At the heart of this discussion are two interconnected concerns. First, is economic growth self-sustaining, or is it still dependent on support from monetary policy? Second, is there a risk that inflation could rise to levels that would raise concerns about longer-term price stability if policy settings remain unchanged? Related to both of these questions is whether there are other risks associated with an extended period of highly stimulatory policy, like a run up in debt levels.

With regards to the first issue (i.e. the strength of activity), recent surveys of both household and business activity are pointing towards positive demand conditions in the economy. Our own Westpac McDermott Miller survey showed that confidence among households has risen to its highest levels since 2015, with gains spread across the country. At the same time, businesses across the economy

are reporting strength in activity. Importantly, this strength is expected to be sustained over the coming months, and has contributed to a rise in both hiring intentions and plans for capital expenditure.

However, while the positive tone of recent economic data is certainly a welcome development, much of the strength in economic conditions is still being underpinned by the low level of interest rates. Low rates have been particularly important in terms of encouraging strength in areas like construction, which has been a key driver of economic growth and employment in recent years. The low level of interest rates is also an important factor that is encouraging investment spending.

Monetary policy isn't the only factor supporting demand, however. The outlook for commodity export earnings has improved over the past year, with global demand and supply conditions supporting prices. Fiscal policy is set to become more expansionary over the coming years. And migration inflows are continuing to add to the economy's demand base (at least for now). But even with these factors in play, economic growth has actually been quite modest on a per-capita basis, underscoring the need for continued support from monetary policy.

The case for continued low interest rates is being reinforced by the creep higher in global interest rates, which has seen domestic borrowing costs push higher in recent months.

Charting our own course continued

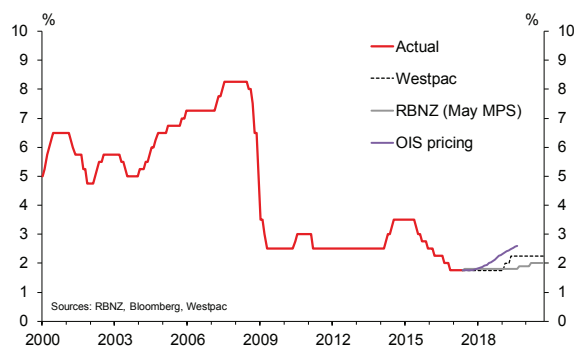
That brings us to the second question: whether there is a risk that inflation will rise to levels that would threaten the upper bound of the RBNZ's target range. With strengthening economic activity, we have seen a firming in inflation. In fact, looking through the temporary volatility associated with recent moves in produce and fuel prices, core inflation measures have lifted and are now running at levels close to the mid-point of the RBNZ's target band.

However, this firming in inflation follows the earlier reduction in the OCR to a record low that has boosted domestic demand. Even then, domestic inflation remains below its long run average.

Looking forward, the latest updates on business sector conditions don't indicate much for the RBNZ to get worried about. On the cost front, we have seen a gradual rise in the number of businesses reporting increases over the past year, but only to average levels. That's despite increases in capacity pressures and growing difficulty finding labour. Similarly, while the number of businesses that have been raising prices has increased over the past year, that's been off very low levels in 2016.

Putting all this together, we still think the OCR should remain on hold for some time yet and are not forecasting a rise through 2017 or 2018. While we are seeing some positive signs in terms of economic activity, monetary policy is still playing an essential role in terms of supporting demand. In addition, while inflation has firmed, it's not at alarming

OCR expectations



levels, and continued monetary stimulus will be required to ensure it remains around the RBNZ's target mid-point over the longer term.

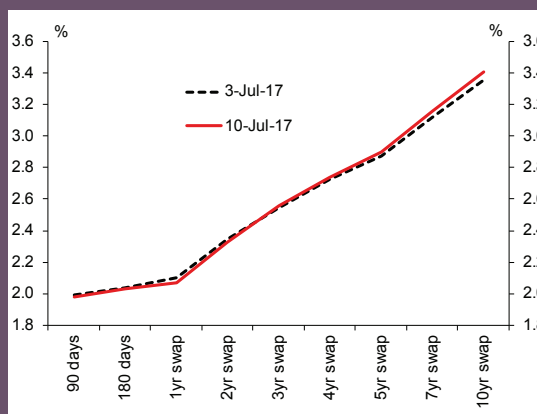
While we think low interest rates are appropriate given the strength of activity and inflation, there are associated risks. Most notably, low interest rates have been a key factor that has encouraged a build-up of household debt, with much of this leveraged against housing assets. There's nothing inherently wrong with debt – it's part of any modern economy. However, there are risks associated with very high levels of debt. These include the increased vulnerability to external shocks, and an eventual drag on growth as debt is repaid.

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 Jun house prices and sales

Jul 10-14 (tbc), Sales last: +1.3%, Prices last: 5.0%/yr

- The housing market has slowed substantially since the Reserve Bank lightened loan-to-value limits for property investors in July, and mortgage rates started to rise late last year. House sales are down more than 20% from their 2016 peaks, and average house price growth has slowed sharply.
- That said, there are marked difference across regions. House prices have slowed in previous hotspots like Hamilton and Tauranga, and have even fallen a little in Auckland. However, double-digit annual price gains are still prevalent across the rest of the North Island.

REINZ house prices and sales

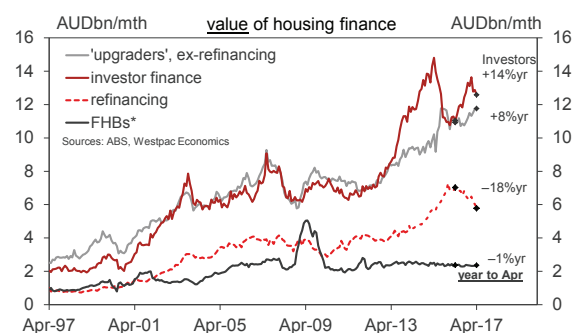


Aus May housing finance (no.)

Jul 11, Last: -1.9%, WBC f/c: 1.0%
Mkt f/c: 1.5%, Range: -1.0% to 2.5%

- Approvals for owner occupier loans declined 1.9% in Apr but posted a milder 0.7% fall ex refi. The value of investor loans fell 2.3%, annual growth holding at 14.1%/yr.
- Note that this was the first observation after APRA's macro prudential tightening announced in late March. The measures prompted banks to increase rates in late March, with larger rises for investor and 'interest only' loans with a second round of moves coming in late June. Industry data points to a small 1% rise in the number of owner occupier approvals in May which may be due to switching between investor and owner occupier loan products (both from new borrowers and existing borrowers refinancing). Hence the main focus will be on the value of investor loans and total value of loans in coming months.

Value of finance approvals by segment

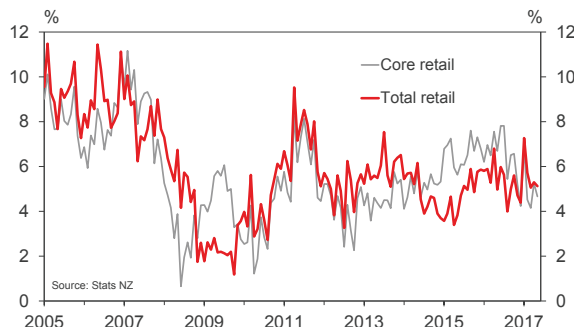


June retail card spending

July 11, Last: -0.4%, Westpac f/c: +1.0%, Market f/c: 0.8%

- Last month's fall in spending followed gains earlier in the year, and doesn't have any implications going forward.
- We're forecasting a 1% rise in retail spending in June, underpinned by a solid 1.4% gain in core spending. The current Lions' tour has boosted spending across the country, especially in sectors like hospitality and accommodation. More generally, strong population growth has continued to support demand and spending in the economy.
- While core spending is rising at a firm pace, falls in petrol prices over the past month mean overall spending growth is likely to be more modest. But while such price declines will dampen nominal spending in the near term, this will put money back into consumers' pockets, which bodes favourably for spending later in the year.

Card transactions, annual % change

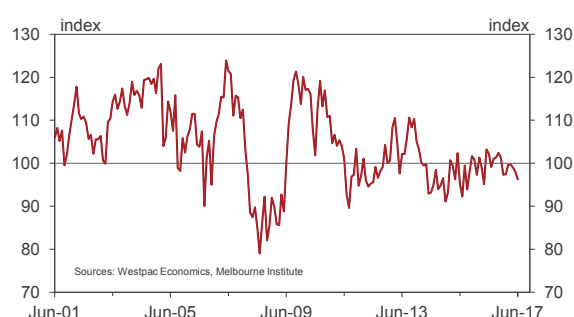


Aus Apr Westpac-MI Consumer Sentiment

Jul 12 Last: 96.2

- The **Westpac-Melbourne Institute Consumer Sentiment Index** fell 1.8% to 96.2 in June from 98.0 in May. The index is now back in firmly pessimistic territory with the June reading the weakest since the RBA's 2016 rate cuts. Although confidence is not overly weak it has shown a clear downtrend since mid-2016.
- The July survey is in the field July 3-8. Factors that may influence confidence include: another round of mortgage rate changes, interest only loans up an avg +32bps but standard owner occupier rates down slightly (avg -6bps); but a significantly better tone to labour markets with official figures showing another strong jobs gain in May and a surprise fall in the unemployment rate to 5.5%, and a lift in dwelling prices in June, recovering from a July dip. Significant increases in retail electricity prices may also factor with average increases of around 18%.

Consumer Sentiment Index



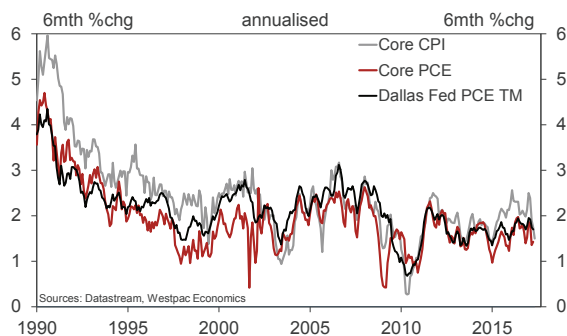
The week ahead

US June CPI

Jul 14, Last: -0.1%, WBC 0.1%

- Inflation (or the lack thereof) has been front and centre of the policy debate in recent months. People have queried, is it simply due to one-off factors that will quickly dissipate? Or has there been a structural shift post-GFC? We will only really know for sure in time, but our guess is that it is a mix of both temporary and permanent factors.
- In May, headline prices fell 0.1% as energy prices weighed heavily, partially offset by food. Core inflation (ex food and energy) gained 0.1%, a repeat of the April result. As a consequence, annual headline inflation fell below the 2.0%yr medium-term target to 1.9%yr, while core inflation was a little more subdued at 1.7%yr.
- Come June, we expect another modest result. Core prices should rise 0.2% in the month, with the headline price gain limited to 0.1% by autos and gasoline.

Core inflation modestly below target

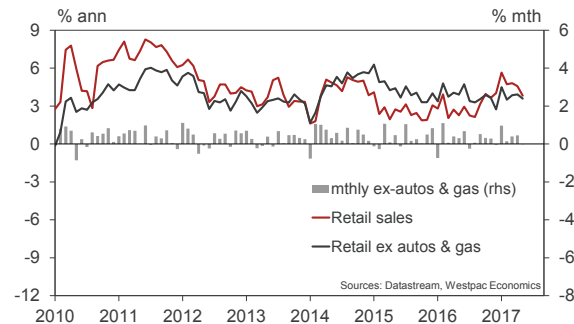


US June retail sales

Jul 14, Last: -0.3%, WBC 0.2%

- May saw the weakest outcome for retail sales since January 2016 as activity fell 0.3%. The decline was also well below the consensus expectation of +0.1%.
- Gasoline and auto sales both subtracted from total sales growth in the month, but even core sales were weak - unchanged in the month following a soft 0.2% rise in March.
- The weak underlying trend is not expected to reverse in the near future. Rather, growth is set to persist at or near current levels.
- Total sales growth near 4% is certainly not strong, but nor is it overly weak. What makes the recent and expected pace of growth surprising is that it comes at a time of full employment and very strong confidence. In a relative sense, the current underlying pace of sales is very disappointing.

Retail sales solid but not strong



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 10					
NZ	Jun REINZ house sales	1.3%	-	-	Due this week. Turnover to remain subdued.
	Jun REINZ house prices, %yr	5.0%	-	-	House price growth has cooled in previous hotspots.
Chn	Jun CPI %yr	1.5%	1.6%	-	Inflation to mark time, well below target of 3.0%.
	Jun PPI %yr	5.5%	5.5%	-	PPI likely to soften, in line with commodity prices.
	Jun M2 money supply %yr	9.6%	9.5%	-	Tentative date, 10-15 July.
	Jun new loans, CNYbn	1110	1300	-	Tentative date, 10-15 July.
	Jun aggregate financing, CNYbn	1062.5	1425.0	-	Tentative date, 10-15 July.
Eur	Jul Sentix investor confidence	28.4	28.2	-	Very positive on outlook for the Continent.
Ger	May trade balance €bn	18.1	18.3	-	Exports and imports both up around 1% in Apr.
US	Jun labor market conditions index	2.3	-	-	Aggregate measure of momentum, still robust.
	May consumer credit	8.2	13.0	-	Student and auto loans still leading the charge.
Tue 11					
NZ	Jun retail card spending	-0.4%	0.8%	1.0%	Boost to hospitality spending from the Lions rugby tour.
Aus	May housing finance approvals	-1.9%	1.5%	1.0%	Ind figs point to slight lift but may be due to 'switching'.
	Jun NAB business survey	12	-	-	Conditions elevated, broadly based, up from 2016H2 avg.
US	Jun NFIB small business optimism	104.5	-	-	Very strong recently.
	May JOLTS job openings	6044	-	-	Hires; fires; quits; and openings.
	May wholesale inventories	0.3%	0.3%	-	Set to remain volatile.
	Fedspeak	-	-	-	Williams in Syd at ABE lunch; Brainard on balance sheet normalisation.
Wed 12					
Aus	Jul Westpac-MI Consumer Sentiment	96.2	-	-	Trended back to moderately pessimistic levels over 2017 H1.
Eur	May industrial production	0.5%	0.3%	-	Up 1.4% for the year.
UK	May ILO unemployment rate	4.6%	4.6%	-	Has trended down since Brexit vote, wage pressure still muted.
US	FOMC Chair Yellen	-	-	-	Testifies before House panel.
	Fedspeak	-	-	-	George on economic outlook and Fed's balance sheet.
	Federal Reserve's Beige book	-	-	-	A qualitative perspective on growth across the districts.
Thu 13					
NZ	Jun food prices	2.4%	-	0.6%	Vege prices remain elevated after recent flooding.
	Jul ANZ consumer confidence	127.8	-	-	Household confidence has firmed through mid-2017.
Aus	Jul MI inflation expectations, %yr	3.6%	-	-	Spiked to 4.3%yr in January, moderated since then.
Chn	Jun trade balance USDbn	40.8	43.0	-	Exports up 9%yr in May, Imports up 15%yr.
Ger	Jun CPI %yr (final)	1.5%	-	-	Despite strong growth, inflation still well below target.
UK	Jun RICS house price balance	17%	15%	-	Housing market has softened, low supply limiting downside.
	FOMC Chair Yellen	-	-	-	Testifies before Senate banking panel.
	Fedspeak	-	-	-	Evans at an Econ summit; Brainard at Econ research inst.
	Jun PPI	0.0%	0.0%	-	Up 2.4%yr. US dollar and commodities offsetting.
	Initial jobless claims	248k	-	-	Very low.
Can	May new housing price index	0.8%	-	-	Have risen 4% over past year.
Fri 14					
NZ	Jun BusinessNZ manufacturing PMI	58.5	-	-	Business conditions have strengthened, employmt intentions up.
Eur	May trade balance €bn	19.6	-	-	Surplus narrowed in Apr on weaker exports.
US	Jun CPI	-0.1%	0.1%	0.1%	Core likely up 0.2% in month. Annual inflation below target.
	Jun retail sales	-0.3%	0.1%	0.2%	Another soft month; autos a drag.
	Jun industrial production	0.0%	0.3%	-	Business surveys pointing to strong momentum.
	Jul Uni. of Michigan sentiment	95.1	95.0	-	Consumers in a very positive mood.
	May business inventories	-0.2%	0.3%	-	Set to remain volatile.
	Fedspeak	-	-	-	Kaplan on Fed and monetary policy in Mexico City.

New Zealand forecasts

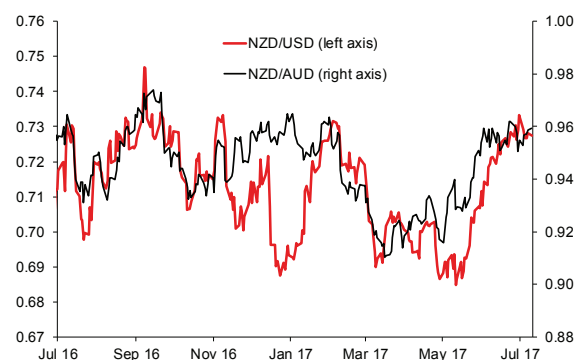
Economic Forecasts	2017				Calendar years			
	% change	Mar (a)	Jun	Sep	Dec	2015	2016	2017f
GDP (Production) ann avg	0.5	1.0	0.9	0.7	2.5	3.1	2.8	3.2
Employment	1.2	0.3	0.5	0.5	1.4	5.8	2.5	1.9
Unemployment Rate % s.a.	4.9	4.9	4.6	4.4	4.9	5.2	4.4	4.5
CPI	1.0	0.2	0.4	0.2	0.1	1.3	1.8	1.9
Current Account Balance % 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 10 July 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.86%	1.85%	1.85%
60 Days	1.91%	1.90%	1.89%
90 Days	1.98%	1.96%	1.94%
2 Year Swap	2.33%	2.21%	2.20%
5 Year Swap	2.90%	2.68%	2.69%

NZ foreign currency mid-rates as at Monday 10 July 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7275	0.7283	0.7209
NZD/EUR	0.6384	0.6503	0.6430
NZD/GBP	0.5648	0.5725	0.5668
NZD/JPY	82.86	80.98	79.52
NZD/AUD	0.9592	0.9643	0.9568
TWI	78.44	78.70	77.79

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	2.0	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	2.1	1.8
Unemployment Rate %	7.4	6.2	5.3	4.9	4.4	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	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 16 June 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	1.70	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.72	2.75	2.85	3.05	3.20	3.35	3.30	3.15
International								
Fed Funds	1.125	1.375	1.375	1.625	1.625	1.875	1.875	1.875
US 10 Year Bond	2.39	2.55	2.65	2.90	3.10	3.30	3.30	3.15
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	0.7578	0.74	0.73	0.72	0.69	0.68	0.65	0.67
USD/JPY	113.72	112	114	114	115	116	116	118
EUR/USD	1.1413	1.10	1.08	1.05	1.03	1.02	1.01	1.00
AUD/NZD	1.0402	1.04	1.04	1.04	1.03	1.03	1.02	1.05

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- (ii) physical separation of various Business/Support Units;
- (iii) and well defined wall/cell crossing procedures;
- (iv) a "need to know" policy;
- (v) documented and well defined procedures for dealing with conflicts of interest;
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