Weekly Commentary

11 September 2017

Moderate growth to continue

Recent indicators have provided more evidence of how New Zealand's economic growth has throttled back in the last year. It's by no means a gloomy outlook for the economy – we expect continued moderate growth over the next few years. But that stands in contrast with the Treasury and the Reserve Bank, whose views rest on a substantial acceleration in growth over the next couple of years.

Last week we received the last major inputs for June quarter GDP, which will be released on 21 September. Two of them in particular were on the softer side, removing what we felt was an upside risk to our forecast of 0.8% growth. We'll finalise our GDP forecast in our preview bulletin later this week.

The first indicator released last week was real building work, which fell by 0.5% in the June quarter, the second drop in a row. There were small declines in both residential building and the more volatile non-residential component. The level of building work is now down 1.3% on the same time a year ago.

As we have discussed in recent weeks, the building industry is struggling to deliver the significant amount of work that is in the pipeline, much of which is centred in Auckland. Rising costs, limited capacity and a tightening in credit conditions appear to be putting a brake on growth. We expect that homebuilding in Auckland will increase only gradually over the next few years.

Meanwhile, the post-earthquake rebuild in Canterbury is well into its wind-down phase. While it will take some time for the remaining repair work to be completed, Canterbury's homebuilding sector is gradually transitioning to a new post-rebuild level of activity. Building work has continued to rise in the rest of the country, where capacity constraints are less evident.

The second indicator last week was the manufacturing survey, which suggested only a small lift in output over the June quarter. Growth in food manufacturing was unsurprisingly strong, with large gains in dairy and meat processing on the back of more favourable farmgate prices. There was also a strong lift in other food and beverages. However, output was down across most of the other manufacturing categories, including a reversal of the large March quarter jump in transport and machinery.

If June quarter GDP growth reaches 0.8% as we expect, that would look reasonable on the face of it. But there are two caveats to this. The first is that this would follow two fairly soft quarters of growth – 0.4% in the December quarter and 0.5% in the March quarter – that were held back by temporary factors. Milk production was weak at the end of last year due to poor weather and low returns to dairying, but has since recovered. And transport in the South Island was disrupted by the Kaikoura earthquake last November, then the wildfires around Christchurch in February. Given that these factors are set to rebound in the June quarter, a 0.8% rise in GDP is not that impressive.

The second factor is that population growth, driven by record levels of net migration, continues to account for a substantial portion of the economy's growth. Per-capita GDP growth has slowed to less than 1% over the last year.

New Zealand is in its seventh straight year of growth

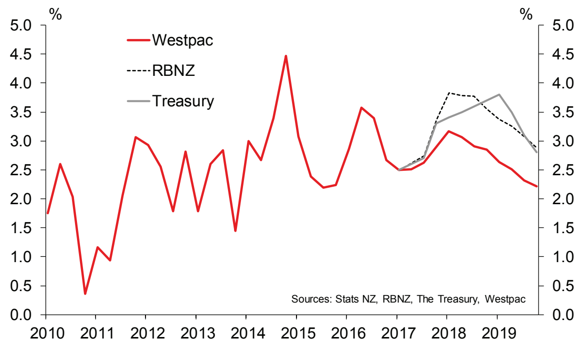
Moderate growth to continue cont.

since the Global Financial Crisis; it's normal for the pace of growth to slow as the economy reaches a more mature phase of the cycle. The sources of growth are rotating to some degree, with construction and consumer spending expected to be less of a driving force, but exports and fiscal policy providing more support in coming years. Confidence surveys suggest that both consumers and businesses remain in reasonably good spirits. And the rise in the terms of trade to near-record levels points to a solid lift in nominal incomes (if not necessarily in real activity) over the next year. Overall, we think the economy is on track for a continuation of the 2.5-3.0% rates of annual growth that we have experienced in recent years.

However, a continuation of the same pace of growth as before doesn't square with official forecasts of a rapid pickup over the next couple of years. We expect the economy to grow by about 3% over the next year; the Treasury's Pre-Election Update projected a lift in growth to 3.5%, while the Reserve Bank is even more optimistic at 3.8%. Moreover, much of the difference in views relates to growth in residential building, the very area where growth is falling short of expectations.

The absence of an acceleration in growth would be problematic for both the government and the Reserve Bank. For the government, a shortfall in GDP growth would risk a similar shortfall in the expected tax take over the coming years, which in turn affects the scope for new spending. (To be fair, it is nominal GDP growth that matters most for the tax take forecasts, and the near-term outlook for that is reasonably strong thanks to the rise in the terms of trade.)

GDP growth forecasts



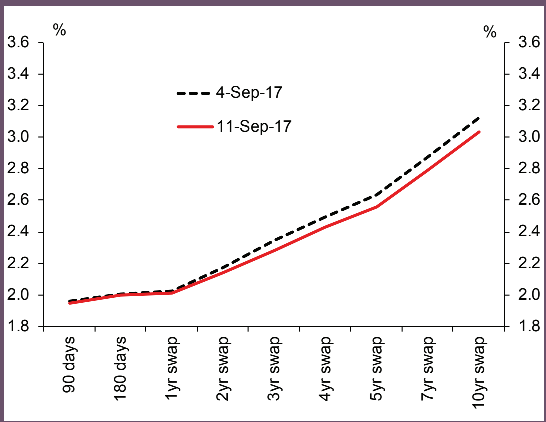
The RBNZ recognises that a sustained return to the 2% inflation target will require a lift in home-grown inflation, via strong economic growth. If that expected lift in the growth rate doesn't come about, the return to the inflation target is likely to be delayed further, and interest rates will need to remain low for even longer. We see little case for an OCR hike within the next two years, in contrast with market pricing for a hike by September next year.

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



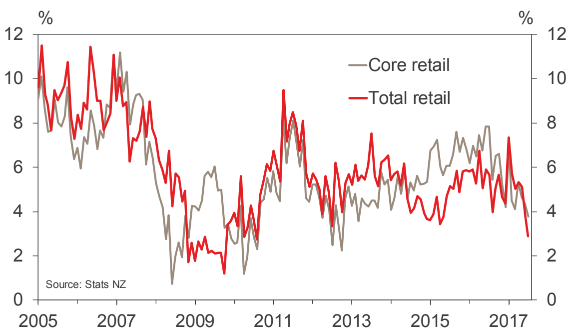
The week ahead

NZ August retail card spending

Sep 11, Last: -0.5%, WBC f/c: 0.5%, Mkt: +0.8%

- July saw a sharp pull back in overall retail spending. However, the result was strongly influenced by falls in petrol prices, with fuel spending down 6%. Looking through the volatility associated with fuel prices, spending on core categories was up 0.1%. Although that's a very muted increase, it comes on the back of a solid gain in the previous month.
- We continue to expect moderate, rather than spectacular, spending growth over coming months. The continuing slowdown in the housing market will dampen spending, particularly on durable household items like furnishings.

Card transactions, annual % change

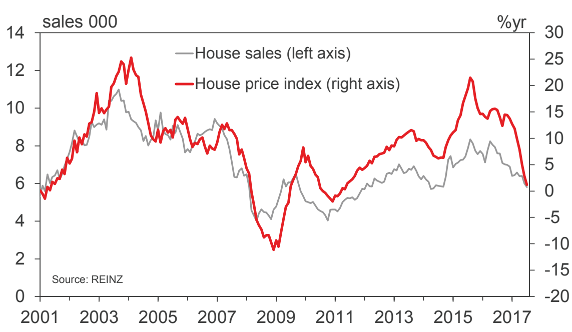


NZ Aug house prices and sales

Sep 11 to 15 (tbc), Sales last: -3.3%, Prices last: 1.2%yr

- New Zealand's housing market continued to weaken in July, with sales falling to a three-year low. Prices in Auckland are now down 4% from their peak, and they have been flat in other regions for the past two months.
- The slowdown in the housing market has been larger and more persistent than we've observed in the past when loan-to-value limits have been tightened, or when buyers may have been nervous about an election outcome. The more significant factor that has dampened house price growth is the rise in mortgage rates over the past year. The latest listings data signal ongoing near-term weakness, with few homes coming to market against a backdrop of low sales. We expect the housing market will remain soft through the remainder of this year.

REINZ house prices and sales



Aus Sep Westpac-MI Consumer Sentiment

Sep 13 Last: 95.5

- The **Westpac-Melbourne Institute Consumer Sentiment Index** declined 1.2% to 95.5 in August from 96.6 in July. The consumer mood has deteriorated over the last year with the survey detail showing increased pressures on family finances; concerns around interest rates; and deteriorating housing affordability in NSW and Victoria weighing on confidence despite an improved outlook for jobs.
- This month's survey is in the field over the week ended Sep 9. Concerns around interest rates may have eased after RBA comments made clear, that rate increases are not imminent. Economic data continues to show growth and solid job gains, although ongoing weakness in wage inflation and rising costs for key essentials such as electricity are continuing to pressure incomes.

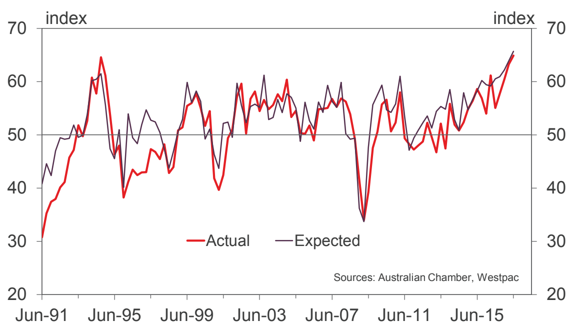
Consumer Sentiment Index

Aus Q3 AusChamber-Westpac survey of Industrial Trends

Sep 14, Last: 65.0

- The Australian Chamber-Westpac survey of the manufacturing sector provides a timely update on conditions in the sector and insights into economy-wide trends. The Actual Composite tracks a range of demand related measures including investment and employment. The Q3 survey was conducted during August and the start of September. In Q2, the Actual Composite rose to 65.0 from 63.2 in March, continuing the rebound from a dip in June to 55.0. Strength is centred on a lift in new orders and output as well as increased overtime and an emerging trend in employment.
- Manufacturing is benefitting from a rise in construction, stronger world growth and the significant improvement in the competitiveness of exporters and import competing firms. However, weaker consumption constrained by low wage growth is a significant headwind.

Westpac-AusChamber Composite indexes



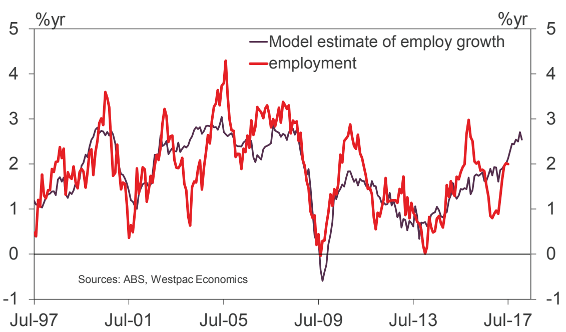
The week ahead

Aus Aug Labour Force, employment '000

Sep 14, Last: 27.9k WBC f/c: 20k, Mkt f/c: 20k, Range: 10k to 75k

- Total employment rose 27.9k in Jul. The Australian labour market went through a soft patch in 2016, particularly from Aug to Nov but it saw a solid uplift as we moved through 2017. The annual pace accelerated from 0.9%yr in Feb to 2.0%yr in May where it held that pace through Jun and July. In the year to Feb total employment grew 106.8k; that has since lifted to 239.3k in the year to Jul. Full-time employment fell 20.3k in Jul following a 69.3k surge in Jun and a solid 53.9k gain in May. Over the year full-time employment gained 197.7k/2.4%yr. Part-time employment rose 48.2k following a 49.3k contraction in June and –14.3k in May. In the year to July, part-time rose 41.6k/1.1%yr. The current momentum looks set to continue into 2018 with our Jobs Index pointing annual employment growth of around 2¾%yr by end 2017 to early 2018. As such we are looking for current momentum to hold with a 20k forecast for August lifting the annual pace to 2.3%yr.

Jobs Index model of employment

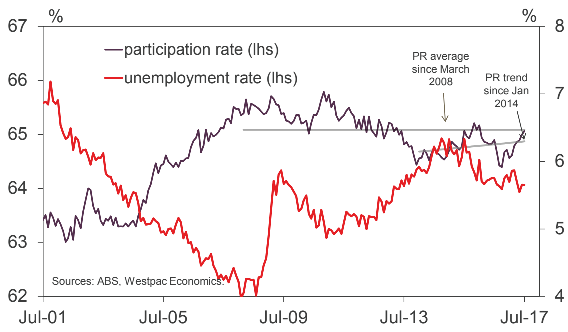


Aus Aug Labour Force, unemployment %

Sep 14, Last: 5.6% WBC f/c: 5.7%, Mkt f/c: 5.6%, Range: 5.5% to 5.7%

- In July, unemployment fell 0.1ppt to 5.6% (June was revised up to 5.7%) as the participation rate nudged up 0.1ppt to 65.1% driving a rise in the labour force. At two decimal places the unemployment rate was 5.65%. By state, Qld was the main source of the gain in total employment (27.0k) with the rest soft or mixed (NSW +0.5k, Vic –2.2k, SA +0.8k and WA –1.3k). Unemployment rose in NSW (5.0%) and Vic (6.1%) while it fell in Qld (6.2%), SA (6.2%) and WA (5.4%).
- Participation has lifted since the Oct 2016 low of 64.8 and is getting back towards the recent high of 65.2% seen in Nov 2015. We expect the solid employment outcomes to continue to drag the participation rate higher over time but in Aug it will round down to 65.1%. This will see the unemployment rate to round up to 5.7%.

Unemployment and participation rates

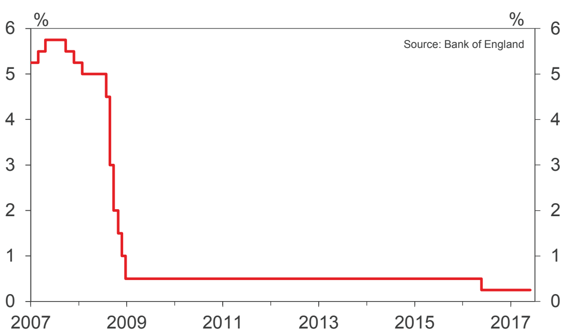


UK Bank of England policy decision

Sep 14, Last: 0.25%, WBC f/c: 0.25%

- The BoE continues to face a challenging balancing act. On one hand, spare capacity is being eroded and the earlier drop in sterling means inflation will linger at high levels for some time. On the other hand, growth is sluggish and the impact of Brexit is still a significant downside risk for the economy. Balancing these factors, we expect that the BoE will keep the Bank Rate on hold at its upcoming meeting.
- The bigger question is what the BoE does in terms of forward guidance. In August, the BoE's policy statement had a mild tightening bias; we expect that this will be maintained in September. However, there is some risk of a more hawkish tilt.

Bank of England Bank Rate

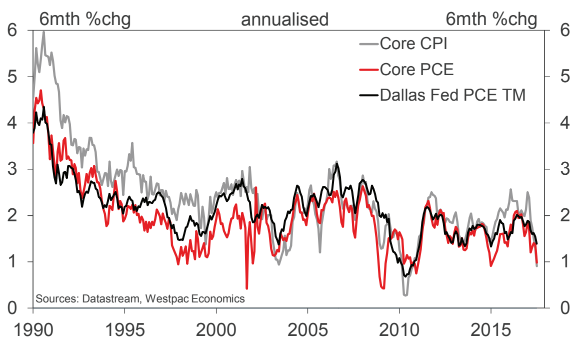


US Aug CPI

Sep 14, last 0.1%, WBC 0.3%

- Of late, inflation data for the US has regularly disappointed, with one 'transitory' disinflationary pressure followed by another. While the FOMC remains of the view that inflation will accelerate to target, increasingly the market has been asking whether disinflation is a structural phenomenon.
- There is one positive that can be gleaned from the monthly data points: they are heading in the right direction; May's –0.1% followed by a flat outcome in June and a 0.1% gain in July. During that period, core inflation (excluding food and energy) rose 0.1% per month. For both headline and core inflation, annual inflation was 1.7%yr at July.
- Come August, we expect that inflation will quicken a touch as energy prices add to subdued but stable core inflation. Core prices are expected to rise 0.2%; the headline index 0.3%.

US inflation trend to improve



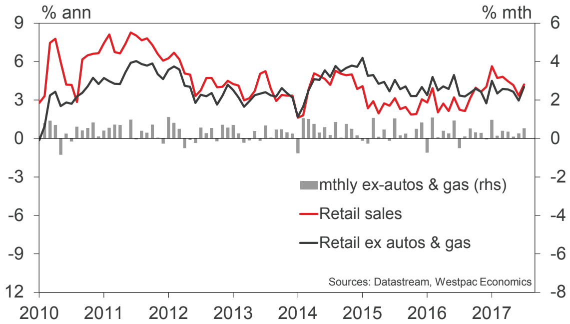
The week ahead

US Aug retail sales

Sep 15, last 0.6%, WBC 0.3%

- US retail sales growth has been sporadic in 2017, leaving the annual rate of gain for headline sales at a subdued 4.2%. The July outcome was certainly better, a 0.6% gain being recorded thanks to broad-based momentum.
- Since the July retail sales release, Q2 GDP has been revised up, principally because of stronger consumption. This sets the stage for a continuation of current momentum into Q3.
- We expect a 0.3% gain in the month, with core sales; autos; and gasoline all contributing. That would not be a strong result by any means, but would indicate that the consumer remained willing to spend. The market is more downbeat, anticipating a 0.1% rise. There is a chance that the figures will be affected by Hurricane Harvey, but the storm came very late in the month.

US retail sales to see another solid rise



Data calendar

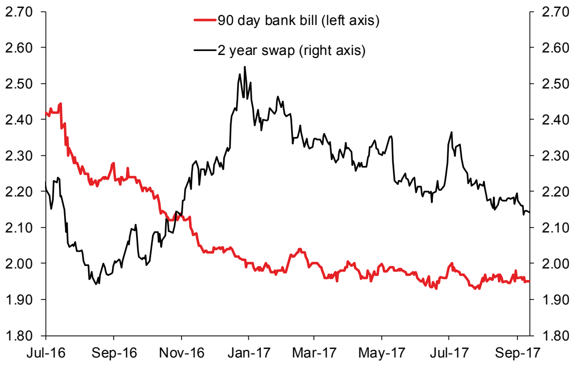
		Last	Market median	Westpac forecast	Risk/Comment
Mon 11					
NZ	Jul REINZ house sales	–3.3%	–	–	Due this week. Sales slowed sharply since latest LVR limits.
	Jul REINZ house prices, %yr	1.2%	–	–	Prices falling in Auckland and slowing in the rest.
	Aug retail card spending	–0.5%	0.5%	0.8%	Slowing housing market set to dampen household spending.
Tue 12					
Aus	Aug NAB business survey	15	–	–	Conditions elevated (overdone?), construction upswing.
UK	Aug CPI	–0.1%	0.4%	–	Earlier fall in GBP keeps annual inflation high for some time.
	Jul house price index, %yr	4.9%	–	–	Uncertainty dampening prices; low supply limiting downside.
US	Aug NFIB small business optimism	105.2	105.0	–	Optimism over order outlook driving sentiment.
	Jul JOLTS job openings	6163	5950	–	Hires; fires; quits; and job openings.
Wed 13					
NZ	Aug food prices	–0.2%	–	–	Price gains likely to ease after weather hit earlier this year.
Aus	Sep Westpac–MI Consumer Sentiment	95.5	–	–	Sentiment has deteriorated steadily in 2017.
Eur	Jul industrial production	–0.6%	0.2%	–	Disappointed in June, but should bounce back.
UK	Jul ILO unemployment rate	4.4%	4.4%	–	Wage inflation tepid despite labour market and rise in CPI.
US	Aug PPI	–0.1%	0.3%	–	Upstream price pressures sedate.
	Aug monthly budget statement $bn	–42.9	–124.0	–	Debt ceiling fight delayed to December.
Thu 14					
NZ	Aug ANZ consumer confidence	126.2	–	–	Still at firm levels despite cooling housing market.
Aus	Aug employment change	27.9k	20k	20k	The leading indicators suggest the current momentum can…
	Aug unemployment rate	5.6%	–	5.7%	… persist to year end, while unemployment rounds up in Aug.
	Sep MI inflation expectations	4.2%	–	–	Trend has been around 4% since January this year.
	RBA Deputy Governor speaks	–	–	–	Debelle at a workshop at King & Wood Mallesons, Sydney.
	Q3 Westpac–AusChamber survey	65.0	–	–	Manufacturing in an upswing.
Chn	Aug industrial production ytd %yr	6.8%	6.8%	–	PMIs remain positive.
	Aug retail sales YTD %yr	10.4%	10.4%	–	Robust but lacking capacity to accelerate.
	Aug fixed asset investment ytd %yr	8.3%	8.2%	–	To remain modest in 17/18.
UK	Aug RICS house price balance	1%	–	–	Uncertainty continuing to dampen prices, esp. in London.
	Bank of England Bank Rate	0.25%	0.25%	0.25%	On hold, but guidance may tilt up.
US	Sep initial jobless claims	298K	–	–	Very low relative to history.
	Aug CPI	0.1%	0.3%	0.3%	Modest uptrend in monthly figures should continue.
Fri 15					
NZ	Aug BusinessNZ manufacturing PMI	55.4	–	–	Still at firm levels, but momentum has eased.
Eur	Jul trade balance, €b	22.3	–	–	Global lift supporting exports.
	Q2 labour costs, yr%	1.5%	–	–	Wages growth is weak.
US	Sep Fed Empire state index	25.2	19.0	–	Has been very strong. Will probably ease in September.
	Aug retail sales	0.6%	0.1%	0.4%	Most of Jul's momentum to continue into August.
	Aug industrial production	0.2%	0.1%	–	Has failed to show momentum ISM allude to.
	Sep Uni. of Michigan sentiment	96.8	96.5	–	Consumers positive, but gap between measures emerging.
	Jul business inventories	0.5%	0.2%	–	Flat through first half. Likely to add in Q3.

New Zealand forecasts

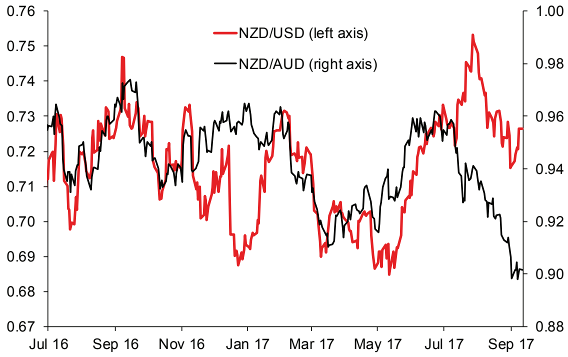
Economic Forecasts	2017				Calendar years			
% change	Mar (a)	Jun	Sep	Dec	2015	2016	2017f	2018f
GDP (Production) ann avg	0.5	0.8	0.9	0.7	2.5	3.1	2.6	3.0
Employment	1.1	-0.1	1.3	0.5	1.4	5.8	2.8	1.8
Unemployment Rate % s.a.	4.9	4.8	4.5	4.5	4.9	5.2	4.5	4.5
CPI	1.0	0.0	0.5	0.4	0.1	1.3	1.9	1.5
Current Account Balance % of GDP	-3.1	-2.9	-2.9	-3.0	-3.4	-2.8	-3.0	-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	1.95	1.95	1.95	1.95	1.95	1.95
2 Year Swap	2.10	2.10	2.15	2.20	2.30	2.40
5 Year Swap	2.65	2.70	2.80	2.90	3.00	3.10
10 Year Bond	2.90	2.95	3.10	3.20	3.30	3.40
NZD/USD	0.72	0.70	0.69	0.68	0.67	0.66
NZD/AUD	0.92	0.92	0.92	0.92	0.93	0.94
NZD/JPY	79.2	77.7	77.3	76.8	76.4	75.9
NZD/EUR	0.62	0.60	0.59	0.59	0.59	0.58
NZD/GBP	0.57	0.56	0.56	0.55	0.55	0.55
TWI	76.4	75.0	74.3	73.8	73.4	72.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 11 September 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.84%	1.83%	1.85%
60 Days	1.88%	1.88%	1.90%
90 Days	1.95%	1.95%	1.96%
2 Year Swap	2.14%	2.18%	2.16%
5 Year Swap	2.56%	2.65%	2.63%

NZ foreign currency mid-rates as at Monday 11 September 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7264	0.7241	0.7309
NZD/EUR	0.6045	0.6061	0.6181
NZD/GBP	0.5509	0.5601	0.5621
NZD/JPY	78.60	79.06	79.77
NZD/AUD	0.9016	0.9143	0.9260
TWI	75.51	76.11	77.13

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	2.5
Unemployment %	5.8	6.2	5.8	5.7	5.7	6.1
Current Account % GDP	-3.4	-3.0	-4.7	-2.7	-1.2	-2.1
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	1.7	1.9	1.5
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	6.7	6.2
East Asia ex China						
Real GDP %yr	4.2	4.1	3.7	3.7	3.7	3.8
World						
Real GDP %yr	3.3	3.4	3.2	3.2	3.5	3.5
Forecasts finalised 11 August 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	1.74	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.57	2.75	2.80	2.90	2.95	2.95	3.00	3.00
International								
Fed Funds	1.125	1.125	1.375	1.375	1.625	1.625	1.875	1.875
US 10 Year Bond	2.03	2.40	2.50	2.75	2.85	2.90	3.00	3.00
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	0.8109	0.78	0.76	0.75	0.74	0.72	0.70	0.70
USD/JPY	107.93	110	111	112	113	114	115	115
EUR/USD	1.2079	1.17	1.17	1.16	1.15	1.14	1.13	1.13
AUD/NZD	1.1077	1.08	1.09	1.09	1.09	1.07	1.06	1.06

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