

Weekly Commentary

13 February 2017



One era ends, another begins?

The Reserve Bank has now formally shifted from easing mode to a neutral stance. It even signalled that the next OCR move is likely to be up – just not for quite some time. The Bank also confirmed that Governor Graeme Wheeler will not seek a second term, and that the search for the next Governor will begin after the election on 23 September.

The February *Monetary Policy Statement* was similar in tone to the previous one in November. The RBNZ remains upbeat on the outlook for New Zealand, while wary of economic and geopolitical factors offshore. The latter is clearly a reference to the Trump administration, with an escalation of trade protectionism being singled out as a major risk.

Locally, the economy continues to grow at a solid pace, though with no real sense that it's exceeding its potential to any significant degree. Record net inflows of migrants are adding to demand, but they're also adding to the economy's productive capacity, especially given that arrivals are skewed towards prime working-age groups. Unemployment is expected to continue to recede gradually, with a muted pickup in wage growth.

Inflation is now back within the RBNZ's target range of 1-3%, having spent the previous two years below that. Perhaps more importantly, the RBNZ's inflation expectations 'scare' has now passed. In early 2016, surveyed inflation expectations fell sharply in response to a second year of very low headline inflation. The RBNZ became concerned that expectations could become unanchored from the 2% target midpoint, and responded with a further round of OCR cuts. However, with headline inflation popping higher again, expectations have followed suit, rising to 1.92% for two years ahead in the latest survey.

There's still a challenge ahead in getting inflation to

settle around 2% – in fact, the RBNZ doesn't expect this to happen until mid-2019, six months later than in its November forecasts. The tradables component of the CPI remains very soft, and with the strengthening of the New Zealand dollar over the last year or so, there's likely to be fresh downward pressure on the prices of imported and import-competing goods and services.

The onus remains on a lift in domestically-generated inflation in order to meet the overall target. And that means that monetary policy will need to stay accommodative for quite a while longer, to spur growth in domestic spending and investment.

Nevertheless, the RBNZ can now see the prospect of interest rate hikes on the distant horizon. The November *MPS* projected an OCR of 1.7% along the entire forecast horizon, implying a small change of another rate cut, but otherwise a firmly on-hold stance for the foreseeable future. The February *MPS* projection was revised up to 1.8% for the most part, before rising slightly to 2.0% at the end of three years. We suspect this isn't meant to be read literally – rather, the RBNZ is signalling that the next move will be up, but that it's too far away to be precise about the timing.

Earlier in the week, the RBNZ confirmed the long-running speculation that Governor Wheeler will not seek a second term after his first five-year term expires on 25 September. Since this is just two days after the recently-announced

One era ends, another begins? cont.

election date, the RBNZ Board has opted to avoid any potential conflicts by starting the search for a new Governor after the election. Grant Spencer, the current Assistant Governor and Head of Financial Stability, will serve as Acting Governor for six months after Mr Wheeler's term ends.

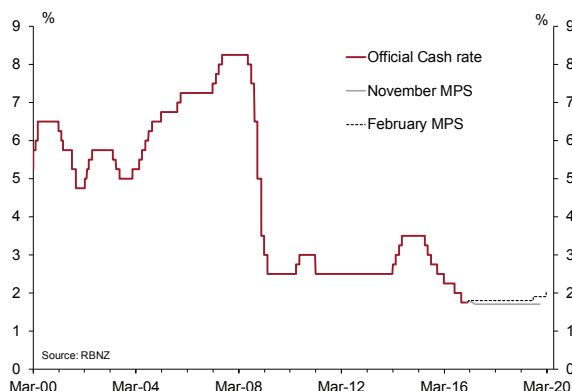
This announcement clears up one source of uncertainty for monetary policy, but another significant one remains. The Reserve Bank Act states that a new Policy Targets Agreement (PTA) must be negotiated and signed before a Governor's term begins. However, it also states that the PTA can be reviewed at any time, by mutual agreement between the Governor and the Minister of Finance.

In theory, it would have been possible to have this negotiation done and dusted before the election. But if the election then resulted in a change of government, it's likely that an incoming Minister of Finance would want to renegotiate the terms of the PTA yet again. So there's still the risk of a substantial overhaul of the RBNZ's targets, regardless of when the next Governor is appointed.

The approaching end of the Governor's term, and the appointment of an Acting Governor, has raised some questions about whether the RBNZ is effectively a 'lame duck', unable to make any commitments on monetary policy until next March. We don't think that's the case. For one thing, the RBNZ's monetary policy decisions are closely tied to the forecasting process, more so than in other central banks. There will be a great deal of continuity in the advice provided to the Governors over the next year or so.

If there were already a clear course of action on interest

Official cash rate



rates, we have no doubt that an Acting Governor would carry through with it. This was certainly the case in 2002. Governor Don Brash had already hiked the OCR twice and signalled more to come before he resigned; Acting Governor Rod Carr delivered two more hikes during his five-month tenure.

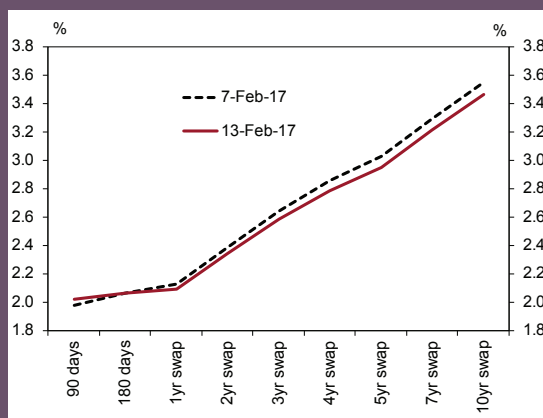
But today's situation is different. The case for OCR hikes rests on whether there's a risk of inflation breaching the top of the target range if the RBNZ doesn't take action. Instead, the RBNZ's forecasts point to inflation lurking in the lower half of the band for some time – and that's even if the OCR remains at its current level for the next two years. Unless the inflation picture changes dramatically, leaving the OCR on hold is the best course of action.

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



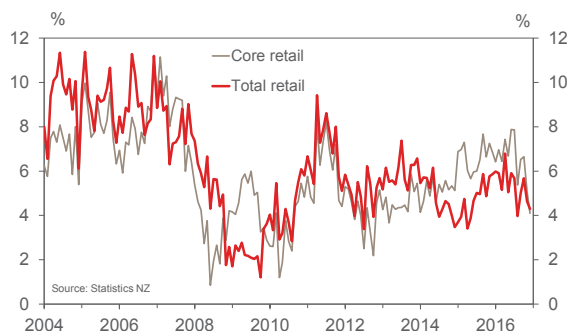
The week ahead

NZ Jan retail card spending

Feb 13, Last: -0.1, Westpac f/c: +0.8%, Mkt f/c: 0.6%

- December's modest fall in spending was particularly surprising. We had expected to see a rebound following earthquake-related disruptions in November. Weakness in spending mainly related to durables, and there was also a more modest reduction in spending on consumable items.
- A range of factors are continuing to support spending, including strong population growth. We expect that this will see spending levels recover in January.
- However, one of the big drivers of spending growth in recent years has been low interest rates and the flow-on to the housing market. Borrowing rates have risen in recent weeks and the housing market has cooled. While we don't expect a collapse in spending over the coming year, we may see a more gradual pace of growth over 2017.

Card transactions, annual % change

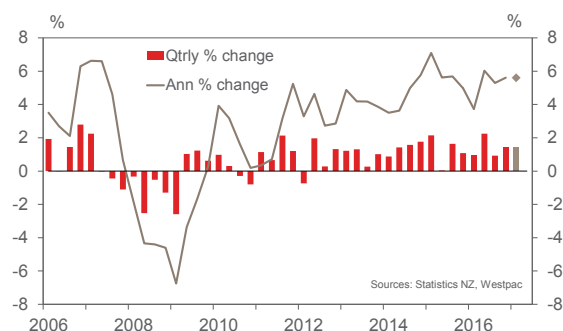


NZ Q4 real retail sales

Feb 17, Last: +0.9%, Westpac f/c: +1.4%, Mkt f/c: 1.0%

- Retail spending continued to push higher in the September quarter, with a 0.9% gain in overall sales volumes. That followed a large 2.2% gain in the June quarter, and left retail spending for the year up a solid 5.3%.
- Strength in retail volumes is expected to be sustained in the December quarter, with card spending data point to a 1.4% quarterly gain. Inflation, particularly for imported goods, has remained low, which is allowing households' incomes to stretch further. On top of this, firm population growth and tourist inflows, as well as low interest rates, have all been supporting spending.

Real retail sales



NZ Jan REINZ house prices and sales

Feb 13 (tentative date), Sales last: -1.3%, Prices last: 13.5%/yr

- December's REINZ sales figures pointed to fairly steady conditions in the housing market. For the third month in a row, sales fell slightly in seasonally adjusted terms, while prices continued to edge higher, albeit at a slower pace than in the first half of 2016.
- While house price growth has eased off in Auckland, it's picked up in other regions.
- Mortgage rates have been creeping higher since November. We think that this could have a more meaningful impact on house prices than last year's tightening in loan-to-value restrictions. We continue to expect that house price growth over 2017 will be much slower than in 2016.

REINZ house prices and sales

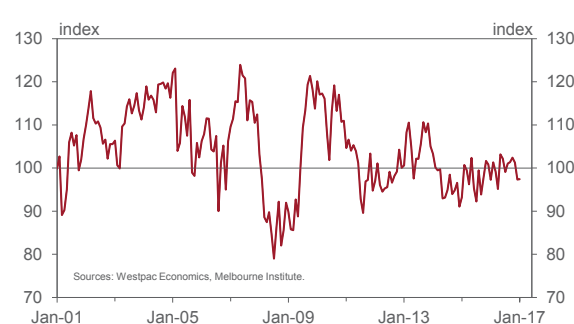


Aus Feb Westpac-MI Consumer Sentiment

Feb 15 Last: 97.4

- The **Westpac-Melbourne Institute Consumer Sentiment Index** was largely unchanged at 97.4 in Jan vs 97.3 in Dec. After a gradual firming into 'cautiously optimistic' territory through most of last year, sentiment was knocked back to 'cautiously pessimistic' levels in Dec-Jan, as renewed concerns about the economic outlook combined with signs of increased pressure on family finances.
- The Feb survey is in the field over the week ended Feb 11. The RBA left rates on hold at its Feb meeting with commentary emphasising little change in the outlook. That may ease consumer concerns about the economy. Other factors that often influence confidence look to be fairly benign this month: the ASX down 1% in the month, giving back some of the 10% gain over the previous two months; but the AUD has edged up 1.4c US to be back near its Nov levels.

Consumer Sentiment Index



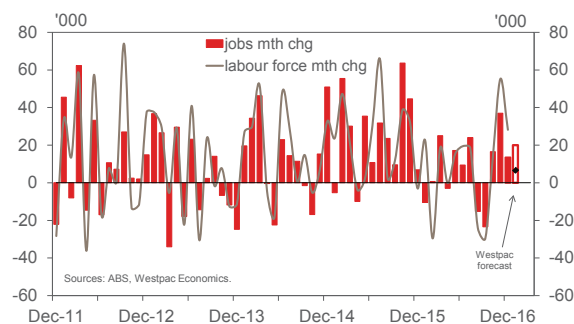
The week ahead

Aus Jan employment change

Feb 16 Last: 13.5k, WBC f/c: 20k, Mkt f/c: 10k, Range: -11k to 28k

- In Dec, the Labour Force survey reported a rise in total employment of 13.5k. Including revisions, total employment lifted 52.5k in the six months to Dec. Back in Nov the six month growth was 48.5k, Oct was 28.7k and the recent low was 9.1k in Sep. So while there is clear signal that the labour market has found a base, the sub-trend print in Dec suggests that we are yet to experience a more robust recovery.
- Annual employment growth lifted a touch in Dec, from 0.7%yr to 0.8%yr, but remains well under what our Jobs Index is suggesting it should be – about 2%yr. With revisions, the six month annualised pace lifted only a little from 0.8%yr Nov to 0.9%yr in Dec.
- Our forecast for +20k in Jan will lift the annual pace to 1.0%yr still well under the leading indicators.

Labour force vs. total employment

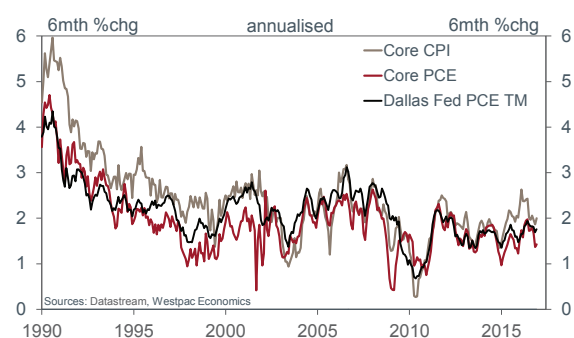


US Jan CPI

Feb 15, Last: 0.3%, WBC 0.3%

- US headline inflation has steadily accelerated in recent months as the previously deflationary influence of energy prices once again became a positive contributor to aggregate price growth.
- Annual headline inflation has now risen from a recent low of 0%yr at September 2015 to 2.1%yr in December. As a result, it has now come back into line with the core measure, which has remained a little above the FOMC's medium-term 2.0%yr target over the past twelve months. Apart from energy, key to the strength of inflation currently are rents; health costs; and higher minimum wage rates which have been priced into the price of goods and services to limit the impact on profit margins.
- Headline prices are likely to rise 0.3% in January, with core inflation a little more modest at 0.2%. In coming months, headline and core inflation will settle near the 2.0%yr figure.

US core inflation near target

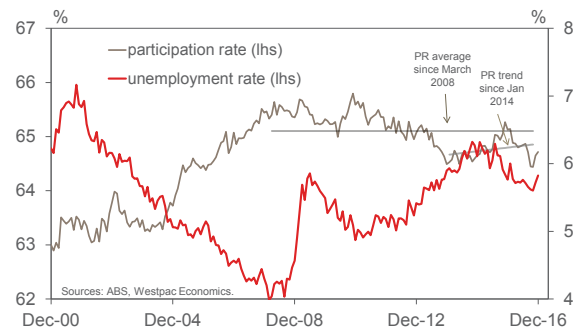


Aus Jan unemployment rate

Feb 196, Last: 5.8%, WBC f/c: 5.7%, Mkt f/c: 5.8%, Range: 5.7% to 5.9%

- Due to a steady decline in participation we have been cautious in interpreting the unemployment rate. Our own research suggests the decline has both cyclical (i.e. weak employment conditions leading to a decline in participation) and structural (i.e. a lump of retirees exiting the workforce) components to it. As such, we had expected participation to lift as the labour market improved and that has been the case of late.
- The 13.5k Dec increase in employment was reported with 0.1ppt gain in the unemployment rate to 5.8% due to a 0.06ppt lift in the participation rate. This lift in participation was in response to 28.2k gain in the labour force.
- Westpac's forecast for a 20k gain in employment in Jan is combined with a flat participation rate forecast, which after rounding, will see the unemployment rate drop to 5.7%.

Unemployment and participation rates

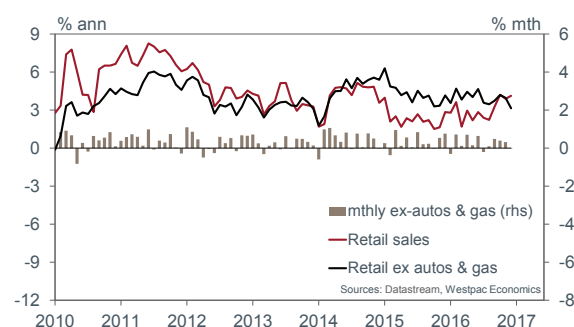


US Jan retail sales

Feb 15, Last: 0.6%, WBC 0.2%

- Retail sales have been a little disappointing of late, with momentum struggling to pick up. While energy prices and auto sales provide a positive boost in December, seeing headline sales rise 0.6%, sales growth excluding autos & gas were flat.
- Over the year, headline sales are up a modest 4.1%yr; core sales are weaker, having risen 3.1%yr. Consumers should be in a position to spend. Following Trump's election to the presidency, confidence is high. Jobs growth continues at pace and, while not strong, income growth is still supportive. Still it seems that US households are reluctant to increase their discretionary spending.
- Come January, gas prices are likely to remain supportive, but auto sales should pull back, seeing total sales rise 0.2%. Core sales growth should be better, but don't expect a strong gain, with growth of 0.4% likely.

US retail struggling for clear momentum



Data calendar

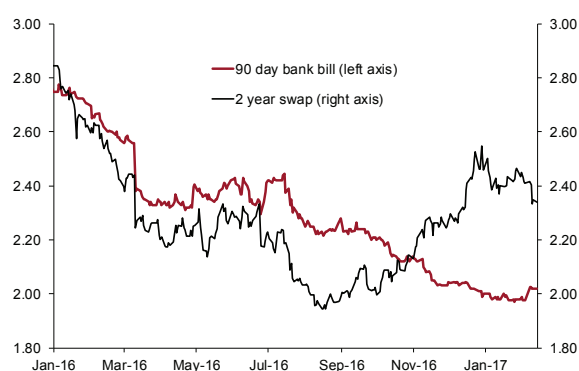
| | | Last | Market median | Westpac forecast | Risk/Comment |
|---------------|---------------------------------------|--------|---------------|------------------|---|
| Mon 13 | | | | | |
| NZ | Jan REINZ house sales | -1.3% | - | - | Due this week. Sales remain sluggish after the latest LVR restrictions. |
| | Jan REINZ house prices %yr | 13.5% | - | - | House price gains have accelerated in many regions. |
| | Jan electronic card spending | -0.1% | 0.5% | 0.8% | Fuel prices up, as well as gains in other categories. |
| Tue 14 | | | | | |
| NZ | Jan food prices | -0.8% | - | 1.3% | Annual growth still tracking close to zero. |
| Aus | Jan NAB business survey | 11 | - | - | Conditions saw end of year flourish, +5pts to 11. Jan a partial reversal? |
| Chn | Jan CPI %yr | 2.1% | 2.4% | - | Holding steady though a slight drop in November. |
| | Jan PPI %yr | 5.5% | 6.6% | - | Producer prices strong, highest annual growth since 2011. |
| Eur | Dec industrial production | 1.5% | -1.5% | - | Choppy month to month but annual growth lifting to a 2-3% pace. |
| | Q4 GDP (second estimate) | 0.5% | 0.5% | 0.5% | Flash estimate surprised to the upside. |
| | Feb ZEW survey of expectations | 23.2 | - | - | Confidence robust, supported by ECB and Trump. |
| Ger | Jan CPI (final) | 1.9% | 1.9% | 1.9% | End of energy disinflation has created a strong uptrend. |
| UK | Jan CPI | 0.5% | -0.5% | - | Lower pound pushing annual rate close to BoE's target. |
| | Dec house price index, %yr | 6.7% | - | - | Low supply and rates supporting prices. |
| US | Jan NFIB small business optimism | 105.8 | 105.0 | - | Soared in December following Trump's victory. |
| | Jan PPI | 0.3% | 0.3% | - | Food & energy positive in Dec; neutral over year. |
| | Fed Chair Yellen speaking | - | - | - | Before Senate banking panel. |
| | Fedspeak | - | - | - | Lacker in Delaware, Lockhart in Alabama, and Kaplan in Houston. |
| Can | Jan Teranet house prices | 0.3% | - | - | Conditions very mixed across the nation. |
| Wed 15 | | | | | |
| Aus | Feb Westpac-MI Consumer Sentiment | 97.4 | - | - | Shifted to 'cautiously pessimistic' in Dec-Jan. |
| | Jan new vehicle sales | 0.3% | - | -0.5% | Soft start to the year for vehicle sales after 1.3% contraction in Q4. |
| | RBA Head Econ Analysis Heath speaking | - | - | - | Panel at ABE Forecasting Conf, Sydney 7.50am AEDT. |
| Eur | Dec trade balance €bn | 22.7 | 23.3 | - | US dollar trend will be key for trade outlook. |
| UK | Dec ILO unemployment rate | 4.8% | 4.8% | - | Trending down since late 2011. |
| US | Feb Fed Empire state index | 6.5 | 7.0 | - | Solid growth for manufacturing in NY state likely to continue. |
| | Jan CPI | 0.3% | 0.3% | 0.2% | Headline and core measures converging. |
| | Jan retail sales | 0.6% | 0.1% | - | Consumer spending was disappointing in Q4. |
| | Jan industrial production | 0.8% | flat | - | December saw fastest gain in 2 years. |
| | Feb NAHB housing market index | 67 | 68 | - | Builder confidence holding firm. |
| | Dec business inventories | 0.7% | 0.4% | - | To remain volatile through 2017. |
| | Fed Chair Yellen speaking | - | - | - | Speaking before House Financial Services Committee. |
| | Fedspeak | - | - | - | Rosengren to NY Association of Business Economics, Harker in Philly. |
| Thu 16 | | | | | |
| NZ | Feb ANZ consumer confidence | 128.7 | - | - | Holding Q4's strong gains. |
| Aus | RBA Assist Governor Ellis speaking | - | - | - | Panel at Housing Researchers Conference, Melbourne 9.00am AEDT. |
| | Feb MI Inflation Expectations | 4.3%yr | - | 4.3%yr | Jan was the highest read since May '14 so closely watching the trend. |
| | Jan employment | 13.5k | 10k | 20k | Employment has firmed but annual growth still soft - our 20k forecast ... |
| | Jan unemployment rate | 5.8% | 5.8% | 5.7% | ... lifts the annual pace to 1.0%yr with a small dip in unemployment. |
| US | Jan housing starts | 11.3% | 0.3% | - | Dec bounce offset most of Nov fall... |
| | Jan building permits | -0.2% | 0.2% | - | ... permits suggest future growth will be softer. |
| | Initial jobless claims | 234k | - | - | At historic lows. |
| | Feb Philly Fed index | 23.6 | 17.5 | - | Surged in Jan, likely to pull back in Feb. |
| Fri 17 | | | | | |
| NZ | Jan BusinessNZ PMI | 54.5 | - | - | Has lost some momentum, but still points to solid activity. |
| | Q4 real retail sales | 0.9% | 1.0% | 1.4% | Core spending firm, vehicles spending up. |
| Eur | Dec current account, €b | 36.1 | - | - | Surplus hit an all time high in November. |
| UK | Jan retail sales | -1.9% | 0.0% | - | Spending growth has been resilient; rising prices will be a headwind. |
| US | Jan leading index | 0.5% | 0.4% | - | Suggests growth to remain at or near trend. |

New Zealand forecasts

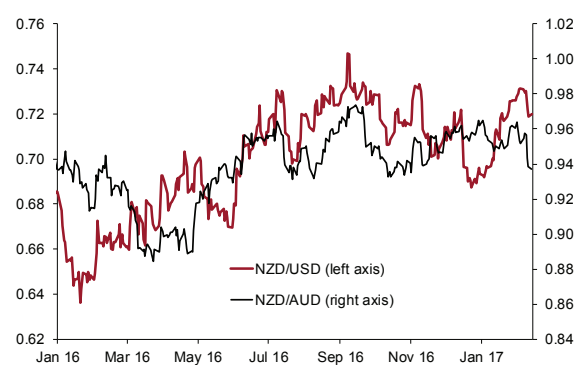
| Economic Forecasts | March years | | | | Calendar years | | | |
|----------------------------------|-------------|------|------|-------|----------------|------|------|-------|
| | % change | 2015 | 2016 | 2017f | 2018f | 2014 | 2015 | 2016f |
| GDP (Production) ann avg | 3.4 | 2.4 | 3.4 | 3.3 | 3.4 | 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 | 4.4 | 4.2 | 5.5 | 4.9 | 5.2 | 4.3 |
| CPI | 0.3 | 0.4 | 1.6 | 1.2 | 0.8 | 0.1 | 1.3 | 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 Monday 13 February 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 | 1.93% | 1.91% | 1.92% |
| 90 Days | 2.02% | 1.98% | 1.98% |
| 2 Year Swap | 2.34% | 2.44% | 2.41% |
| 5 Year Swap | 2.95% | 3.05% | 2.96% |

NZ foreign currency mid-rates as at Monday 13 February 2017

| Exchange Rates | Current | Two weeks ago | One month ago |
|----------------|---------|---------------|---------------|
| NZD/USD | 0.7198 | 0.7283 | 0.7108 |
| NZD/EUR | 0.6773 | 0.6809 | 0.6695 |
| NZD/GBP | 0.5768 | 0.5836 | 0.5916 |
| NZD/JPY | 81.74 | 82.73 | 81.31 |
| NZD/AUD | 0.9372 | 0.9646 | 0.9495 |
| TWI | 78.59 | 79.89 | 78.38 |

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 | 2.70 | 2.95 | 2.95 | 3.00 | 3.05 | 3.15 | 3.25 | 3.40 |
| International | | | | | | | | |
| Fed Funds | 0.75 | 0.625 | 0.875 | 0.875 | 1.125 | 1.125 | 1.375 | 1.375 |
| US 10 Year Bond | 2.41 | 2.55 | 2.65 | 2.75 | 2.85 | 3.00 | 3.10 | 3.30 |
| ECB Deposit Rate | 0.00 | -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 | 0.7646 | 0.74 | 0.74 | 0.73 | 0.72 | 0.70 | 0.70 | 0.68 |
| USD/JPY | 113.65 | 116 | 118 | 118 | 120 | 122 | 124 | 126 |
| EUR/USD | 1.0662 | 1.05 | 1.03 | 1.01 | 1.00 | 1.00 | 0.99 | 0.98 |
| AUD/NZD | 1.0628 | 1.04 | 1.06 | 1.07 | 1.08 | 1.07 | 1.06 | 1.05 |

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