



Weekly Commentary

13 November 2017



Glass half full

Last week's *Monetary Policy Statement* was very much in line with expectations. The Reserve Bank left the OCR unchanged at 1.75% and issued the same forward guidance it has used all year. Essentially, the OCR is on hold, and the RBNZ expects that it will remain on hold until 2019, although there are large uncertainties on both sides.

While the overall tone of the *MPS* was both neutral and much the same as previous missives, there was a lot going on beneath the surface. The RBNZ acknowledged that the housing market and construction activity were weaker than previously anticipated, and downgraded its forecasts in both areas. This downgrade was overdue – we had complained that the RBNZ was too optimistic on construction and house prices in its August *MPS*. But offsetting these downside developments, the RBNZ acknowledged that the lower exchange rate will support inflation, and that the Government's fiscal plans would stimulate the economy.

The standout for us was the RBNZ's extraordinary optimism about future GDP growth. The RBNZ estimated that the economy grew 0.7% in the September quarter this year, whereas our estimate is 0.4%. The RBNZ went on to forecast that GDP growth will be 0.9% in December 2017, rising to 1.2% in March 2018. That would make March the strongest quarter of GDP growth in four years. These are heroic forecasts, to say the least. In recent times we have seen business confidence dropping away, the housing market slow and construction activity stagnate. With the uncertainty associated with a change of Government lying ahead of us and population growth slowing sharply, we find it highly unlikely that the economy will reach these heights. Our own forecast for GDP growth in the March 2018 quarter is 0.5%.

The RBNZ was also very optimistic on GDP growth over a longer timeframe, based on the idea that the new Government's policies will tend to boost the economy. In turn, this will apply upward pressure to inflation, necessitating a higher OCR than otherwise. The RBNZ looked at four areas of proposed Government policy: extra spending on education and health, the Kiwibuild residential building programme, hikes to the minimum wage, and plans to reduce incoming migration to New Zealand. On balance it judged these to be a positive stimulus to inflation, necessitating an OCR perhaps 50 basis points higher than otherwise.

We broadly agree with the RBNZ on these areas, although we would quibble with their assumptions around Kiwibuild – we think it will mostly displace private sector activity and will therefore have little impact on overall construction activity.

But we suspect that the RBNZ has not allowed enough for the Government's plans around the property market. The Government is planning to restrict foreign purchases of residential property and to change the tax treatment of property investors. Furthermore, it plans to convene a tax working group that might recommend a capital gains tax or similar. We expect that these actual and prospective tax changes will cause the housing market to weaken noticeably next year.

Furthermore, the RBNZ is assuming that any weakness in the housing market will have little impact on consumer

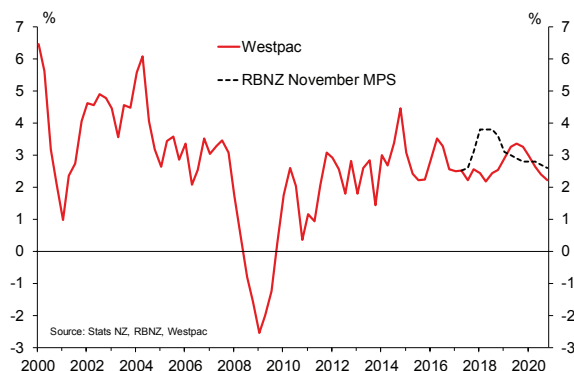
Glass half full continued

spending. Here we disagree strongly, and recent evidence is on our side. Last Friday's electronic card transactions data registered yet another very small rise in spending, despite booming population growth. Spending on durables has been particularly weak, falling 2% over the past three months. This looks to us like a classic response to a weak housing market, which could intensify next year if house prices remain soft.

The other area that the RBNZ may be disappointed in is export conditions. We expect New Zealand's export commodity prices to fall next year, due to an expected slowdown in China's economy. Indeed, dairy auction prices are already falling – this week's auction registered a 3.5% decline in the overall dairy price index, with whole milk powder down 5.5%. This is the latest in a string of auction price declines, which has cumulatively been enough for us to downgrade our forecast farmgate milk price for the 2017/18 season to \$6.20/kg (previously \$6.50). Fonterra's \$6.75/kg forecast is now looking well out of market. We have also published for the first time our milk price forecast for the 2018/19 season. We expect the payout to increase to \$6.50/kg, on the basis of a revival in the Chinese economy from late 2018 and supported by a lower average exchange rate over the season.

Putting all of this together, we expect that the RBNZ will be surprised by slow GDP growth, weak house prices and falling export commodity prices over 2018. If we are correct, the RBNZ will become more dovish.

GDP growth forecasts



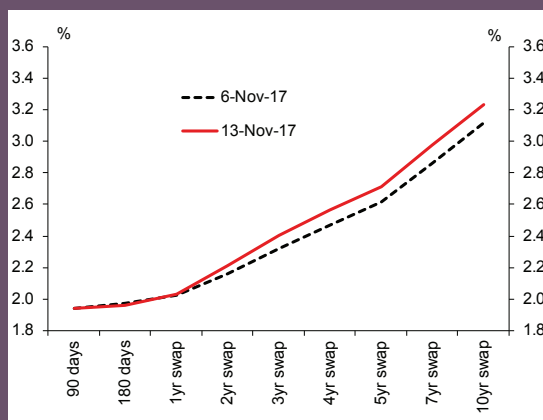
There could be a couple of other knock-on effects to consider. First of all, the exchange rate would fall even further in these conditions, providing some offset from an inflation point of view. Second, a weak housing market could prompt the RBNZ to loosen macro-prudential policy. The RBNZ Governor this week said that the criteria under which the LVR mortgage lending restrictions may be loosened will be outlined at the Financial Stability Report on 29 November. Any loosening would likely be incremental, but still might have a positive influence on the housing market.

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. Some lending and deposit rates have been falling recently, so it may be worth waiting to see if there are further modest reductions in fixed-term rates.

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 Oct house sales and prices

Nov 15, Sales last: -6.9%, Prices last: 2.1%/yr

- The housing market weakened over much of 2017, with prices falling in Auckland and nearby regions. But over August and September there were signs of the housing market perking up in the REINZ data. Prices rose by 1% in September.
- Other sources of data corroborate the idea of the market improving slightly. Available stock on a real estate website has dropped, and another website has reported a rising average asking price.
- While uncertainty around post-election outcomes (a coalition agreement was announced on 19 October) may have kept housing turnover in check, the October REINZ data might show a further lift in house prices.

REINZ house prices and sales



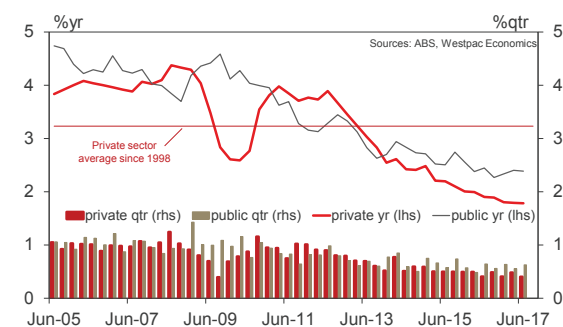
Aus Q3 Wage Price Index

Nov 15, Last: 0.5%, WBC f/c: 0.7%

Mkt f/c: 0.7%, Range: 0.5% to 0.8%

- Wages have lagged the recovery in the Australian labour market. While it is part of a global phenomenon of wage deflation, there are domestic considerations as well. Rising part-time employment and underemployment have a role to play particularly in Victoria which has the fastest population growth and higher rate of employment growth.
- The rise in the national Minimum Wage has an impact in the September quarter Wage Price Index. The RBA has estimated a direct impact of 0.5ppt boost in the quarter due to the increase. Given that the previous Minimum Wage increases contributed 0.3ppt, the net impact of the increase is a 0.2ppt boost to the underlying pace. Our 0.7%qtr forecast will lift the annual pace to 2.3%/yr, the fastest pace since September 2015.

Private sector wages languishing

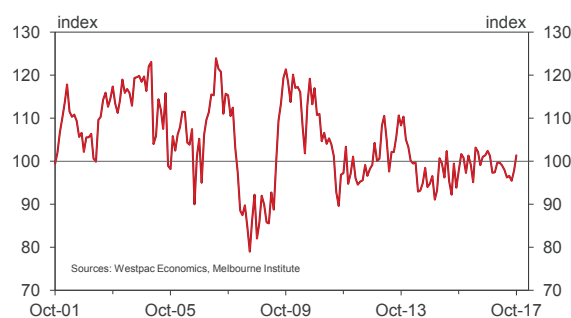


Aus Nov Westpac-MI Consumer Sentiment

Nov 15 Last: 101.4

- The Westpac-Melbourne Institute Consumer Sentiment Index rose 3.6% to 101.4 in Oct, the first time since Nov last year that optimists have outnumbered pessimists and the highest level since Oct 2016. The lift has come from an improving global economy, easing concerns about rising interest rates and over-heated housing markets, and improving labour market conditions. However, confidence is still not particularly strong, with views on family finances a clear weak spot.
- This month's survey is in the field over the week ended Nov 11. Factors that may influence confidence include: the RBA's decision to again leave rates on hold; more signs of cooling across Australia's major housing markets; disappointing retail updates; and renewed political instability. Notably, the ASX is also up over 5% since Oct.

Consumer Sentiment Index



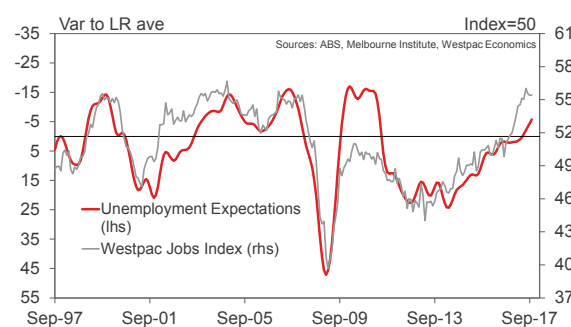
Aus Oct Labour Force - employment '000

Nov 16, Last: 19.8k, WBC f/c: 20k

Mkt f/c: 18k, Range: -10k to 30k

- Total employment increased by 19.8k in September, broadly in line with the market median forecast of +15.0k and Westpac's forecast of +25.0k. Part-time employment grew 13.7k, while full-time rose 6.1k, though importantly hours worked posted a solid 0.7% gain. September's result was consistent with the positive momentum seen over 2017. After the Australian labour market went through a soft patch in 2016, employment gathered steam as we moved through 2017 rising 371k or 3.1% through the year to September.
- Westpac's forecast of a 20k rise will be a record breaking 13th consecutive monthly gain in employment. It may be tempting to look for a statistical correction but the strength of the labour market indicators in both consumer and business surveys suggest the underlying momentum remains very robust.

Near term indicators are robust for employment



The week ahead

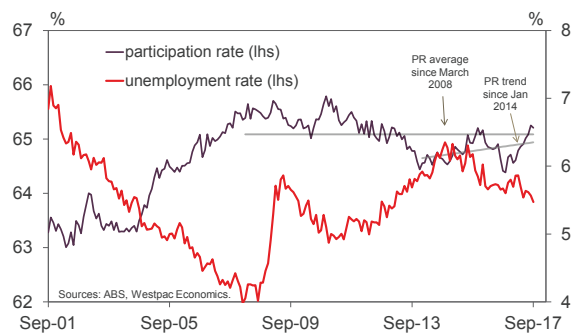
Aus Oct Labour Force - unemployment %

Nov 16, Last: 5.5%k, WBC f/c: 5.5%

Mkt f/c: 5.5%, Range: 5.4% to 5.6%

- The unemployment rate fell to 5.5% with the participation rate holding at 65.2% though August's number was revised lower from 65.3%. In the month the labour force increased just 7.9k. Note that at two decimal places, participation fell slightly to 65.21% from 65.25%, with male participation falling to 70.7% from 70.8% and female participation falling to 59.8% from 59.9%.
- We are expecting the continuing robust growth in employment to draw more people into the labour force, particularly females. This is behind our forecast for a small rise in participation to 65.3% which will hold the unemployment rate flat at 5.5%.

Unemployment and participation rates

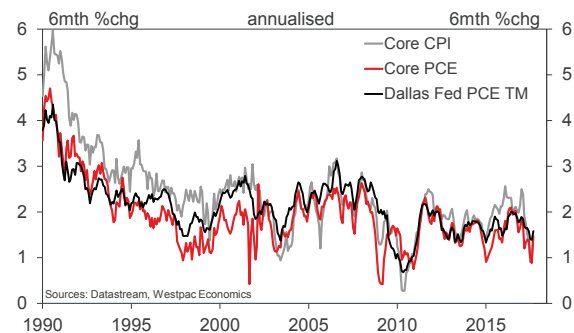


US Oct CPI

Nov 15, last 0.5%, WBC 0.1%

- September's headline CPI outcome was dominated by Hurricanes Harvey and Irma. Following a 0.4% gain in August (also hurricane affected), prices rose 0.5% in September. That left the annual pace at 2.2%/yr.
- Of the monthly gain, 75% of the increase reportedly came from a surge in gasoline prices after refining operations were heavily impacted by the weather.
- Abstracting from this factor, inflation pressures remained benign. The core CPI rose by just 0.1%, leaving the annual rate unchanged at 1.7%/yr for a fifth consecutive month.
- The headline and core CPI outcomes are expected to be soft in October, with both likely to print at 0.1%. On both a CPI and PCE basis, there is no cause for concern on inflation.

Core inflation set to remain below target

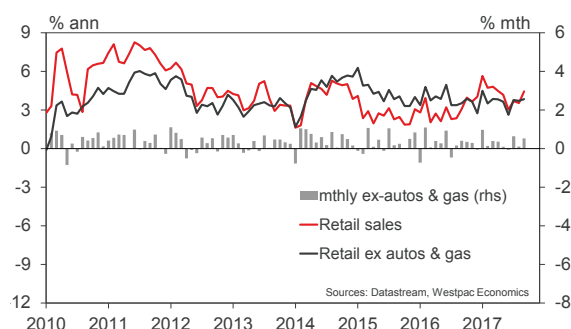


US Oct retail sales

Nov 15, last 1.6%, WBC 0.3%

- Retail sales received a large boost from restocking in the month of September in the aftermath of Hurricanes Harvey and Irma.
- There were two particularly notable weather effects in the month: (1) car sales surged in affected areas as consumers replaced vehicles written off in the storm; and (2) the surge in gasoline prices flattered total nominal sales.
- Both effects will be largely absent in October. Hence our expectation that sales will rise by just 0.3% following September's 1.6% jump. The market forecast of 0.1% points to some downside risk. Broadly, it has long been hoped that confidence and job gains will drive stronger sales. However, soft wages growth continues to get in the way.

Retail sales to slow after hurricane surge



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 13					
Aus	RBA Deputy Gov Debelle speaking	-	-	-	'Business Investment in Australia', Sydney 9.15am.
US	Fedspeak	-	-	-	Harker on balance sheet unwind in Tokyo.
Tue 14					
Aus	Oct NAB business survey	14	-	-	Conditions elevated (eg construction) but uneven (retail weak).
Chn	Oct retail sales %yr	10.3%	10.4%	-	Holding up despite softer employment prints in PMIs.
	Oct fixed asset investment ytd %yr	7.5%	7.3%	-	Investment growth to decelerate further into 2018.
	Oct industrial production ytd %yr	6.7%	6.7%	-	PMIs point to robust momentum for manufacturing.
Eur	Sep industrial production	1.4%	-0.6%	-	Euro and existing competitiveness +ves for manufacturers.
	Nov ZEW survey of expectations	26.7	-	-	Confidence very strong across countries and sectors.
	Q3 GDP 2nd estimate	0.6%	0.6%	-	Second estimate to confirm flash gain.
	Draghi, Yellen, Carney and Kuroda	-	-	-	Speak on central bank communication at ECB event.
UK	Oct CPI	0.3%	-	-	Lower pound to provide support for inflation outcomes.
	Sep house price index	5.0%	-	-	Housing rents subdued but housing market finding a base.
US	Oct NFIB small business optimism	103	104.5	-	Optimism sustained in recent months.
	Oct PPI	0.4%	0.1%	-	Upstream price pressures limited.
	Fedspeak	-	-	-	Evans at ECB conf, Bullard on US econ, Bostic on outlook.
Wed 15					
NZ	Oct REINZ house sales	-6.9%	-	-	Election uncertainty may have weighed on turnover.
	Oct REINZ house prices, %yr	2.1%	-	-	Prices picked up in the last two months, but outlook is soft.
Aus	Nov Westpac-MI Consumer Sent'	101.4	-	-	Surprise lift over 100 in Oct - will it sustain?
	Q3 wage cost index	0.5%	0.7%	0.7%	The rise in the Minimum Wage to boost growth by 0.2ppt.
	Oct new vehicle sales	-0.5%	-	flat	Industry figs show lift in cons. sales offset by other segments.
	RBA Assistant Gov Ellis speaking	-	-	-	Topic TBA, University of Melbourne 6.00pm.
Eur	Sep trade balance €bn	21.6	-	-	Trade balance narrowed on strong imports last month.
	ECB Praet, BOE Haldane & DNB RD	-	-	-	On "What is on central bank's communication agenda?"
UK	Sep ILO unemployment rate	4.3%	-	-	Strong labour supply and demand supports a firmer rate.
US	Oct CPI	0.5%	0.1%	0.1%	Gasoline accounted for 75% of gain in Sep.
	Nov Fed Empire state index	30.2	24.9	-	Conditions strong in NY.
	Oct retail sales	1.6%	0.1%	0.3%	Sales to fall back after hurricane restock.
	Sep business inventories	0.7%	0.0%	-	A big positive in Q3 to date.
	Fedspeak	-	-	-	Evans Speaks at European Conference in London.
Thu 16					
NZ	Nov ANZ consumer confidence	126.3	-	-	Slipped in Oct; Nov will be first read after new government.
Aus	Nov MI inflation expectations	4.3%	-	-	Have been drifting higher with rising power bills and fuel.
	Oct employment, '000 chg	19.8	18k	20k	Will we get a record breaking 13th consecutive gain?
	Oct unemployment rate	5.5%	5.5%	5.5%	Rising participation will offset the robust employment print.
Eur	Oct CPI %yr final	1.4%	1.4%	-	Broad slowdown evident in Oct flash.
UK	Oct retail sales	-0.8%	-	-	Retail spending flat for most categories, with downside risks.
US	Sep total net TIC flows	125.0	-	-	Long-term bond flows.
	Initial jobless claims	239k	-	-	Very low.
	Nov Philly Fed index	27.9	24.0	-	Manufacturers very positive...
	Oct industrial production	0.3%	0.4%	-	... but industrial production data lacks solid momentum.
	Nov NAHB housing market index	68	68	-	Rate hikes have had little impact.
	Fedspeak	-	-	-	Mester on future of monetary policy, Kaplan in Q&A.
Fri 17					
NZ	Oct manufacturing PMI	57.5	-	-	Has been consistently strong over 2017.
	Q3 PPI	1.3%	-	1.0%	Lift in dairy payout, higher wholesale electricity prices.
Eur	ECB Draghi speaks	-	-	-	On "Europe into a new era - how to seize the opportunities".
US	Oct housing starts	-4.7%	5.4%	-	Abstracting from month to month volatility...
	Oct building permits	-4.5%	1.4%	-	... trend flat.
	Nov Kansas City Fed index	23	-	-	Another very positive manufacturing survey.
	Fedspeak	-	-	-	Brainard on fin. stability, Williams at Asia econ. policy conf.
Sat 18					
Chn	Oct property prices	-	-	-	Impact of tighter regulation spreading across tiers.
US	Fedspeak	-	-	-	Williams Speaks with Reporters.

New Zealand forecasts

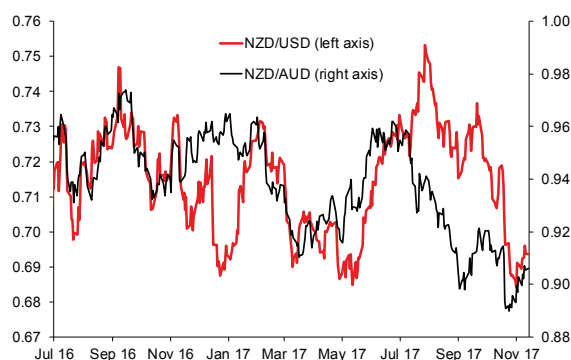
Economic Forecasts	2017				Calendar years			
	% change	Jun	Sep	Dec	Mar	2015	2016	2017f
GDP (Production) ann avg	0.8	0.7	0.6	0.8	2.5	3.0	2.6	2.9
Employment	-0.1	1.1	0.4	0.6	1.4	5.8	2.6	1.8
Unemployment Rate % s.a.	4.8	4.6	4.7	4.7	4.9	5.2	4.7	4.6
CPI	0.0	0.5	0.3	0.3	0.1	1.3	1.8	1.3
Current Account Balance % of GDP	-2.8	-2.7	-2.8	-2.5	-3.2	-2.5	-2.8	-3.3

Financial Forecasts	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
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	2.15	2.20	2.30	2.40	2.50
5 Year Swap	2.70	2.80	2.90	3.00	3.10	3.20
10 Year Bond	2.95	3.10	3.20	3.30	3.40	3.45
NZD/USD	0.70	0.69	0.68	0.67	0.66	0.66
NZD/AUD	0.92	0.92	0.92	0.93	0.94	0.94
NZD/JPY	77.7	77.3	76.8	76.4	75.9	75.4
NZD/EUR	0.60	0.59	0.59	0.59	0.58	0.58
NZD/GBP	0.55	0.54	0.54	0.54	0.54	0.54
TWI	74.5	73.9	73.4	72.9	72.6	72.2

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 13 November 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.78%	1.79%	1.81%
60 Days	1.86%	1.87%	1.87%
90 Days	1.94%	1.95%	1.93%
2 Year Swap	2.21%	2.17%	2.19%
5 Year Swap	2.72%	2.69%	2.69%

NZ foreign currency mid-rates as at 13 November 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6935	0.6878	0.7170
NZD/EUR	0.5947	0.5927	0.6069
NZD/GBP	0.5257	0.5243	0.5390
NZD/JPY	78.71	78.19	80.11
NZD/AUD	0.9061	0.8957	0.9097
TWI	73.73	73.22	75.56

International forecasts

Economic Forecasts (Calendar Years)	2014	2015	2016	2017f	2018f	2019f
Australia						
Real GDP % yr	2.8	2.4	2.5	2.3	3.0	2.5
CPI inflation % annual	1.7	1.7	1.5	2.1	2.5	2.8
Unemployment %	6.2	5.8	5.7	5.7	6.1	6.0
Current Account % GDP	-3.0	-4.7	-2.7	-1.6	-2.6	-2.7
United States						
Real GDP %yr	2.6	2.9	1.5	2.1	2.1	1.8
Consumer Prices %yr	1.6	0.1	1.3	2.0	1.8	1.8
Unemployment Rate %	6.2	5.3	4.9	4.4	4.2	4.3
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
Japan						
Real GDP %yr	0.3	1.1	1.0	1.3	0.8	0.7
Euroland						
Real GDP %yr	1.3	2.0	1.8	2.1	1.8	1.6
United Kingdom						
Real GDP %yr	3.1	2.2	1.8	1.6	1.6	1.5
China						
Real GDP %yr	7.3	6.9	6.7	6.7	6.2	5.9
East Asia ex China						
Real GDP %yr	4.2	3.8	3.9	4.1	4.1	4.2
World						
Real GDP %yr	3.6	3.4	3.2	3.6	3.6	3.5

Forecasts finalised 13 October 2017

Interest Rate Forecasts	Latest	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.73	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.61	2.65	2.85	2.85	2.95	3.00	3.00	3.00
International								
Fed Funds	1.125	1.375	1.375	1.625	1.625	1.875	1.875	1.875
US 10 Year Bond	2.34	2.40	2.60	2.75	2.90	3.00	3.00	3.00
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.30	-0.30

Exchange Rate Forecasts	Latest	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
AUD/USD	0.7681	0.76	0.75	0.74	0.72	0.70	0.69	0.68
USD/JPY	113.45	114	114	115	116	116	117	118
EUR/USD	1.1644	1.15	1.15	1.14	1.13	1.12	1.11	1.10
AUD/NZD	1.1070	1.12	1.12	1.12	1.12	1.11	1.10	1.08

Contact the Westpac economics team

Dominick Stephens, Chief Economist +64 9 336 5671

Michael Gordon, Senior Economist +64 9 336 5670

Satish Ranchhod, Senior Economist +64 9 336 5668

Shyamal Maharaj, Economist +64 9 336 5669

Paul Clark, Industry Economist +64 9 336 5656

Any questions email: economics@westpac.co.nz

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