

Weekly Commentary

15 May 2017



We shall not be moved

The Reserve Bank left the Official Cash Rate unchanged at 1.75% last week, and restated its view that interest rate hikes are a long way off. Inflation has been boosted for now by some temporary factors, but underlying inflation pressures are still seen to be subdued. The Reserve Bank's economic forecasts have many similarities with our own, and we still expect the OCR to remain hold until early 2019.

As in its two previous reviews, the RBNZ concluded its *May Monetary Policy Statement* by noting that "monetary policy will remain accommodative for a considerable period". This in itself is a fairly innocuous statement: no-one was expecting the OCR to rise above a 'neutral' level (which the RBNZ now pegs at somewhere below 4%) in the foreseeable future.

What was surprising, though, was that the RBNZ's interest rate projections were unchanged from the path produced in the February *Monetary Policy Statement*. The OCR was projected to remain on hold through until September 2019, and then rise gradually further ahead. In contrast, we and the rest of the market had expected the RBNZ to bring forward the expected timing of an OCR hike to some degree.

So what stayed the RBNZ's hand? Firstly, the RBNZ has looked through the recent rise in inflation back above 2%, attributing it largely to higher food and fuel prices, both of which will only have a temporary impact on inflation. Consistent with this, the RBNZ's forecasts show inflation falling to as low as 1.1% in early 2018, as food prices drop back from elevated to normal levels.

Nevertheless, this isn't the horizon where monetary policy should be focusing. What's more important is the longer-term outlook and the strength of domestic activity. And on this point, the Reserve Bank has become a little more downbeat. GDP growth was softer than expected over the

second half of 2016. And although activity is expected to expand at a reasonable pace over the next few years, the RBNZ is of the view that there is a bit more spare capacity than it had previously been factoring in.

On top of this, much of the recent and expected growth is coming on the back of strong population increases. While that's adding to demand, it's also boosting the economy's supply potential, meaning only a limited rise in the associated inflation pressures.

In addition, the RBNZ has conceded that the slowdown in house prices is more than just temporary. The tightening of loan-to-value limits for property investors, and a rise in mortgage rates since late last year, have together seen house price gains slow to a crawl. This will have a dampening impact on the outlook for demand more generally.

Lastly, the RBNZ remains very conscious of the softness in global inflation. Around the world, headline inflation has been boosted by the rebound in oil prices from unsustainable lows. However, 'core' measures of inflation have yet to show any substantial upturn. So even though a lower New Zealand dollar will add to import prices to some extent, tradables inflation is projected to rise only gradually over the coming years.

Putting all this together, the RBNZ is forecasting inflation to drop below 2% again by the end of this year, and not to return to that mark on a sustained basis until mid-2019

We shall not be moved continued

– the same as in the February MPS. In fact, the RBNZ’s statement noted that: “Developments since the February *Monetary Policy Statement* on balance are considered to be neutral for the stance of monetary policy.”

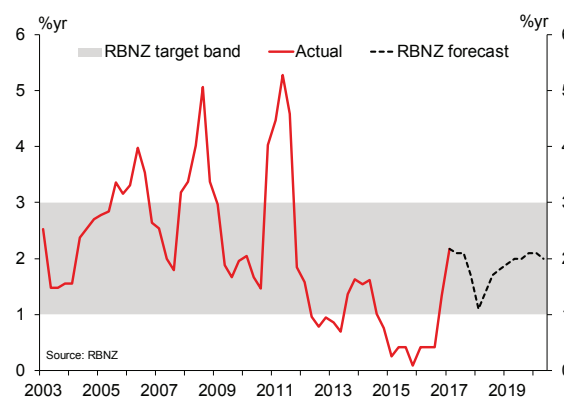
Overall, the RBNZ’s latest forecasts have a lot in common with our own. There are some points of difference: for instance, the RBNZ’s terms of trade forecast, and the implications for national income, still look a bit anaemic compared to what dairy prices have been doing lately. And the RBNZ has made some cautious assumptions about fiscal stimulus ahead of the Budget next week.

On the other hand, the RBNZ’s GDP growth forecasts, which were already on the high side of the market, are still stronger than ours. And its forecast of a 5% rise in nationwide house prices this year may still be on the optimistic side – it would require an acceleration from the pace of recent months.

But we’re broadly in agreement with the RBNZ’s view that annual inflation will drop back below 2% next year, and that domestic inflation pressures over the medium term are still subdued. The economy is not growing at the sort of pace that led to overheating and a surge in inflation in previous cycles.

So we are sticking with our call the OCR will remain on hold until early 2019. That’s earlier than the RBNZ’s projection, but later than what markets have been pricing in – even after last week’s statement, interest rate markets are priced for a hike by mid-2018.

RBNZ inflation forecast

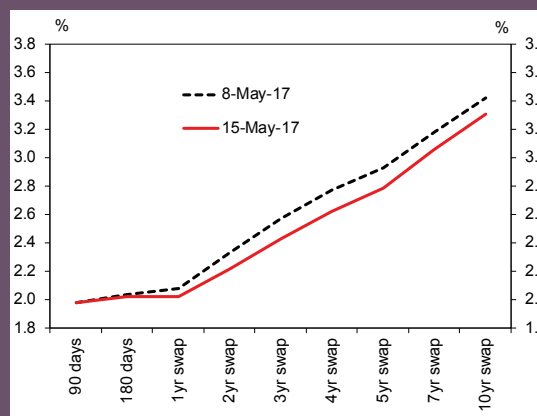


Fixed vs Floating for mortgages

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



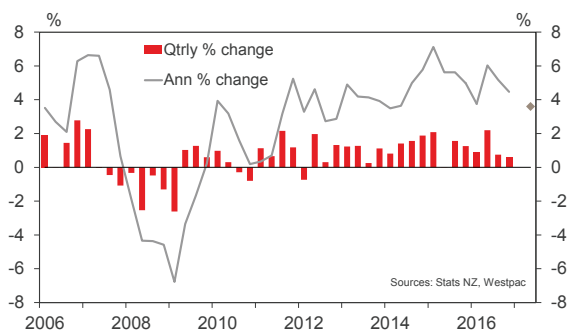
The week ahead

NZ Q1 real retail sales

Mar 15, Last: +0.8%, Westpac f/c: flat, Mkt f/c: 0.9%

- While nominal spending has continued to climb in the early part of 2017, this is coming against a backdrop of rising prices. Consumer prices rose by more than expected in the March quarter, with large contributions from the prices of necessities like food and fuel. On top of this, increases in borrowing rates and the related slowdown in the housing market is weighing on households' spending appetites.
- Providing some offset to the above headwinds are continued strong population growth and a strong tourist season.
- Putting it altogether, we expect overall spending growth to remain flat in the March quarter. On a per-capita basis, spending has been soft for some time.

Real retail sales

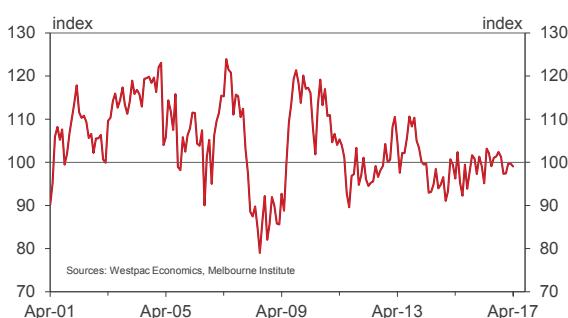


Aus May Westpac-MI Consumer Sentiment

May 17 Last: 99.0

- The **Westpac-Melbourne Institute Consumer Sentiment Index** dipped 0.7% in April to 99.0 from 99.7 in March. That was a surprisingly resilient result given intense media attention about housing concerns, bank moves to increase interest rates for some mortgage borrowers and more disappointing updates on labour markets.
- This month's survey is in the field May 8-13 and will capture reactions to the Federal Budget delivered on the night of May 8. It's likely to be a clear read with other developments mostly minor - the RBA left both rates and its 'firmly on hold' stance unchanged this month and the ASX is unchanged, albeit with some volatility and big sectoral shifts along the way. Labour markets are looking a little better but still unconvincing. The AUD is off 2¢ vs the USD but current moves can have an ambiguous impact on sentiment.

Consumer Sentiment Index



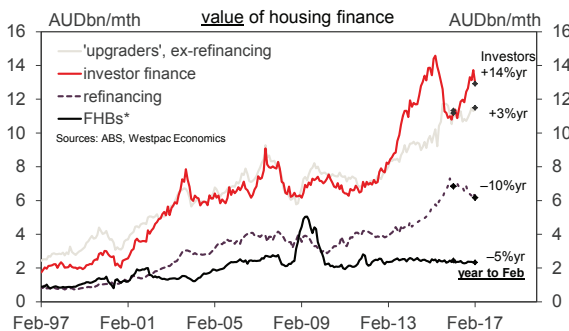
Aus Mar housing finance (no.)

May 15, Last: -0.5%, WBC f/c: 0.0%

Mkt f/c: 0.0%, Range: -2.0% to 3.0%

- The Feb housing finance report recorded a 0.5% dip in the number of owner occupier approvals and a sharp 5.9% pull back in the total value of investor lending. Note that the latter predates the recent tightening in 'macro-prudential' regulation and suggests lenders were already moving to ensure growth in total investor credit - i.e. the stock of loans - stayed below the existing 10%/yr guideline.
- Industry data points to a steady result for owner occupier finance approvals in March. The value of investor loans will again be of close interest although the most recent macro prudential measures (10% guide should be met 'comfortably', 'interest only' loans capped) only come into play from April on.

Value of finance approvals by segment

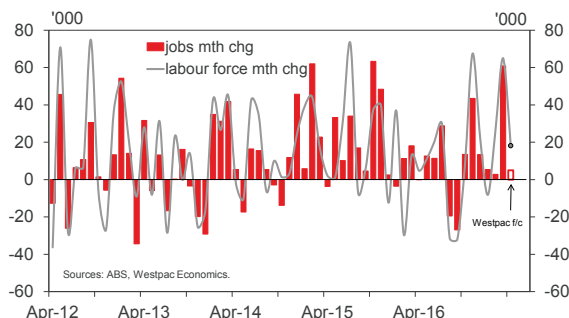


Aus April Labour Force - employment '000

May 18, Last: 60.9k, WBC f/c: 5.0k, Mkt f/c: 5.0k, Range: -20k to 20k

- In March employment surged 60.9k compared to the market's forecast of +20k. There was a promising sign in the 74.5k surge in full-time employment and 0.2% gain in hours worked. However, it's too early to call a more positive turnaround and the annual pace for each is just 0.8%/yr for both. Normally, a strong rise in both employment and participation points to sample roll being behind a strong number. However, in original terms the incoming group had a lower employment to population ratio than the group it replaced so sample rotation was behind the better than expected outcome. Despite our Jobs Index pointing to upside risks for near-term employment gains, we are expecting survey volatility to drive a pull-back in employment momentum after the 60.9k gain in March due to survey volatility. We have pencilled in +5k, rather than a negative as the underlying growth in population should be enough generate a positive print.

Labour force vs. total employment



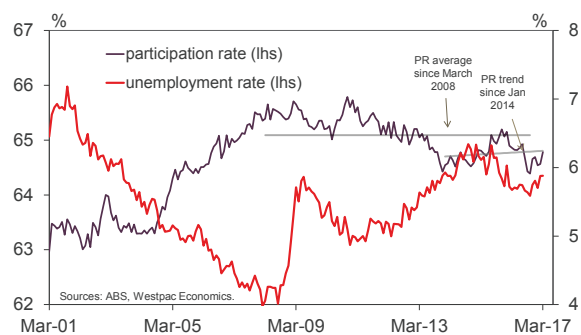
The week ahead

Aus April Labour Force - unemployment %

May 18, Last: 5.9%, WBC f/c: 6.0%, Mkt f/c: 5.9%, Range: 5.7% to 6.0%

- In March the unemployment rate was flat at 5.9% (5.88% at two decimal places for both months) as a 0.2ppt lift in the participation rate to 64.78 (from 64.56) resulted in 64.9k bump in the labour force. There was a jump in both male and female participation but the underlying trend of rising female participation and declining male participation remains. The relatively more positive female labour market may be part of the reason but the female participation is greater than what you would expect given the current pace of female employment. Steady participation will see an 18k gain in the labour force and the unemployment rate tick up a bit to 6.0%. It is possible that soft employment print may be associated with falling participation holding the unemployment rate steady. However, we also note that a larger gain in employment is likely to be associated with a rise in participation and thus we are unlikely to see a fall in unemployment.

Unemployment and participation rates



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 15					
NZ	Apr performance services index	59.0	-	-	Expected to continue its upward expansionary trend.
	Q1 real retail sales	0.6%	0.9%	0.0%	Nominal spending up, but volumes soft due to price gains.
	RBNZ Asst Governor McDermott	-	-	-	Speech "The value of forecasting in an uncertain world".
Aus	Mar housing finance	-0.5%	0.0%	0.0%	Industry figs show steady own-occ loans. Focus on investor figs.
Chn	Apr retail sales %yr	10.9%	10.9%	-	Employment prospects positive over services and industry.
	Apr fixed asset investment ytd %yr	9.2%	9.1%	-	Acceleration in private investment welcome.
	Apr industrial production ytd %yr	6.8%	6.9%	-	PMI's supportive of outlook for manufacturing.
UK	May Rightmove house prices	1.1%	-	-	Post-Brexit uncertainty weighing on house prices, esp. in London.
US	May Fed Empire state index	5.2	7.5	-	Slowed materially in April from March's 2-year high.
	May NAHB housing market index	68	68	-	Home builders remain very positive on outlook.
Tue 16					
Aus	Apr new vehicle sales	1.9%	-	-1.0%	Sales have been tracking a moderate downtrend so far in 2017.
	RBA minutes	-	-	-	On hold, housing and the labour market remain in focus.
Eur	Mar trade balance €bn	19.2	-	-	Remains positive, driven by large German surplus.
	May ZEW survey of expectations	26.3	-	-	Investors likely to remain positive given Euro & US g'th f'casts.
	Q1 GDP (2nd estimate)	0.5%	0.5%	0.5%	Strong flash estimate to be confirmed.
UK	Apr CPI	0.4%	0.4%	-	Earlier fall in currency to keep annual inflation.
	Mar house price index, %yr	5.8%	-	-	Uncertainty weighing on prices, but low supply limiting downside.
US	Apr housing starts	-6.8%	2.9%	-	Uptrend remains intact despite...
	Apr building permits	4.2%	0.2%	-	... considerable monthly volatility for starts & permits.
	Apr industrial production	0.5%	0.4%	-	Disconnect between ISMs and real data clear.
Wed 17					
NZ	GlobalDairyTrade auction	3.5%	-	-	Dairy futures are pointing to a slight fall in the GDT to come.
	Apr net migration	6100	-	5900	Flows expected to remain firm, annual inflows around record highs.
Aus	May Westpac-MI Consumer Sentiment	99.0	-	-	First post-Budget read on sentiment. Surprisingly resilient in April.
	Q1 wage cost index	0.5%	0.5%	0.5%	Wages are subdued and there is little to suggest this will change.
Eur	Apr CPI, %yr (final)	1.5%	1.9%	1.9%	Energy has created volatility of late; core stable circa 1.2%/yr.
UK	Mar ILO unemployment rate	4.7%	4.7%	-	Hiring slowing, unemployment to remain low.
	NY Fed Q1 Household Credit Report	-	-	-	Update on household debt and credit data.
Thu 18					
NZ	May ANZ consumer confidence	-2.8%	-	-	Consumer confidence is moderating, but remains firm.
Aus	Apr employment, mth ch.	60.9k	5k	5k	Some moderation from Mar spike but sound trend to remain.
	Apr unemployment rate	5.9%	5.9%	6.0%	With flat participation unemployment set to rise to 6.0%.
Chn	Apr property prices	-	-	-	Tier 1 continues to moderate, tier 2 stable.
Eur	ECB Draghi speaks	-	-	-	Conferral of honorary PhD to Mario Draghi by Tel Aviv Uni.
UK	Apr retail sales	-1.8%	-	-	Likely to recover after last month's fall, rising prices still a drag.
US	May Initial jobless claims	236k	-	-	Persists at historic low.
	May Philly Fed index	22.0	19.5	-	Has halved since Feb 33-year high, but still very positive.
	Apr leading index	0.4%	0.3%	-	Points to a continuation of at-trend growth.
	Fedspeak	-	-	-	Mester Speaks to Economic Club of Minnesota.
Can	Mar new housing price index	0.4%	-	-	Strength centred on Toronto.
Fri 19					
Eur	Mar ECB current account, €b	37.9	-	-	Annual surplus quite large at 3.4% of GDP.
	May consumer confidence (advance)	-3.6	-3.0	-	Consumers optimistic.
US	Fedspeak	-	-	-	Bullard to Speak about U.S. Economy and Monetary Policy.
Can	Apr CPI %yr	0.2%	-	-	Core inflation has been easing, consistent with excess capacity.

New Zealand forecasts

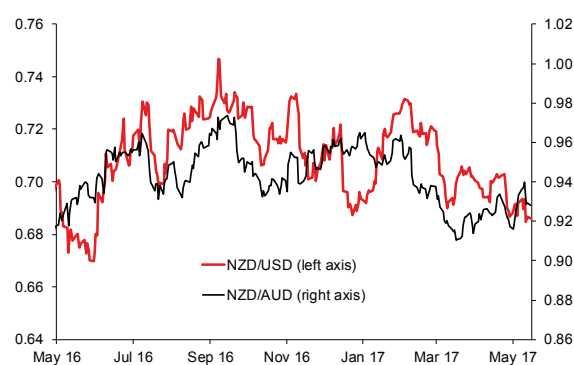
Economic Forecasts	March years				Calendar years			
	% change	2015	2016	2017f	2018f	2015	2016	2017f
GDP (Production) ann avg	3.4	2.4	3.1	3.3	2.5	3.1	3.2	3.4
Employment	3.2	2.0	5.7	1.9	1.4	5.8	2.7	1.8
Unemployment Rate % s.a.	5.4	5.2	4.9	4.5	4.9	5.2	4.4	4.4
CPI	0.3	0.4	2.2	1.5	0.1	1.3	2.0	2.1
Current Account Balance % of GDP	-3.5	-3.1	-2.5	-2.1	-3.4	-2.7	-2.0	-2.7

Financial Forecasts	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-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	2.50	2.50	2.60	2.70	2.80	2.90
5 Year Swap	3.10	3.20	3.30	3.40	3.50	3.55
10 Year Bond	3.30	3.50	3.60	3.70	3.80	3.90
NZD/USD	0.68	0.68	0.68	0.67	0.66	0.65
NZD/AUD	0.93	0.93	0.93	0.93	0.96	0.96
NZD/JPY	75.5	76.2	77.5	77.7	77.2	76.7
NZD/EUR	0.65	0.65	0.66	0.66	0.65	0.65
NZD/GBP	0.56	0.57	0.57	0.57	0.56	0.55
TWI	75.2	75.6	76.2	75.7	75.8	75.2

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 15 May 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.88%	1.85%	1.84%
60 Days	1.93%	1.91%	1.90%
90 Days	1.98%	1.99%	1.96%
2 Year Swap	2.21%	2.31%	2.27%
5 Year Swap	2.79%	2.89%	2.80%

NZ foreign currency mid-rates as at Monday 15 May 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6860	0.6865	0.7008
NZD/EUR	0.6273	0.6300	0.6584
NZD/GBP	0.5322	0.5311	0.5577
NZD/JPY	77.63	76.48	76.35
NZD/AUD	0.9279	0.9207	0.9233
TWI	74.93	74.80	76.24

International forecasts

Economic Forecasts (Calendar Years)	2013	2014	2015	2016	2017f	2018f
Australia						
Real GDP % yr	2.1	2.8	2.4	2.5	2.6	2.8
CPI inflation % annual	2.7	1.7	1.7	1.5	2.2	2.1
Unemployment %	5.8	6.2	5.8	5.7	6.3	6.2
Current Account % GDP	-3.4	-3.0	-4.7	-2.7	-0.6	-2.5
United States						
Real GDP %yr	1.5	2.4	2.6	1.6	2.2	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	4.5	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	0.8	1.0
Euroland						
Real GDP %yr	-0.3	0.9	1.6	1.7	1.6	1.2
United Kingdom						
Real GDP %yr	2.2	2.9	2.2	2.0	1.9	1.5
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 13 April 2017

Interest Rate Forecasts	Latest	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
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	2.62	2.85	3.00	3.05	3.15	3.25	3.40	3.40
International								
Fed Funds	0.875	1.125	1.125	1.375	1.625	1.625	1.875	1.875
US 10 Year Bond	2.38	2.55	2.75	2.85	3.00	3.10	3.30	3.30
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40

Exchange Rate Forecasts	Latest	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
AUD/USD	0.7378	0.73	0.73	0.73	0.72	0.69	0.68	0.65
USD/JPY	113.73	111	112	114	116	117	118	118
EUR/USD	1.0869	1.05	1.04	1.03	1.02	1.01	1.00	0.99
AUD/NZD	1.0787	1.07	1.07	1.07	1.07	1.05	1.05	1.03

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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;
- (vi) steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

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