# Weekly Commentary

18 September 2017

# Down to the wire

It's a busy week in New Zealand, with Saturday's general election set to be a close race. Ahead of that, we'll receive a number key updates on the economy, including June quarter GDP figures. In this week's report, we also take a close look at the residential building industry.

## Economic developments

New Zealand general election will be held on Saturday 23 September. Current polling is pointing to a very close race between the incumbent right of centre National Party and the main centre-left opposition Labour Party. If the current government returns to power, it probably won't have a big impact on our forecasts. However, if there is a change in government, the stance of policy could shift in a number of important areas, including fiscal and monetary policy, the housing market, immigration, and environmental policy. We'll be taking a closer look at how things are stacking up on these fronts over the next few weeks.

Turning to economic developments, GDP figures for the June quarter will be released on Thursday 21 September. We expect that they will show the economy expanded by 0.8% over the quarter. That would leave the level of output in the economy up 2.8% over the past year. The expected firmness in the June quarter reflects a rebound from earlier temporary weakness in the agriculture and transport sectors. We also saw a strong gain in retail spending over the quarter, supported by very strong tourist arrivals.

With much of the June quarter rise in activity a result of temporary factors, this will likely be the high for GDP growth.

Looking to the remainder of 2017, we expect that growth will ease off. A key reason for this is that conditions in the housing market have really come off the boil. The August REINZ housing market update showed that sales are down 22% over the past year, and house price growth has essentially stalled. Furthermore, with the inventory of unsold homes continuing to climb, it looks like prices will remain soft for some time.

Earlier strength in the housing market underpinned much of the strong gains in households spending that we saw in previous years. Conversely, the slowdown that we're now experiencing will be a drag. Indeed, this appears to have been a key reason for the recent softness in retail spending. The latest card spending figures showed that retail spending was down 0.2% August, following a 0.6% rise in July. Looking at the longer-term trend in demand, we see that spending levels have been broadly flat for several months now. That includes only muted growth in spending on durable household items (like furnishings), spending on which is closely tied to the strength of the housing market.

## A look at the residential building industry

We're recently released only latest *Industry Insight Report* looking at New Zealand's residential building industry.[1] The industry is characterised by many small firms and a few large ones. Small firms typically employ fewer than five

[1] https://www.westpac.co.nz/assets/Business/Economic-Updates/2017/Bulletins-2017/Industry-Insight-Residential-Building-September-2017.pdf

# **Down to the wire** continued

people, operate at a localised level, build one home at a time and are heavily involved in alterations and remedial type work. Large firms on the other hand focus on large-scale projects and can build up to a thousand houses per year. They are usually regionally focused with some having national coverage.

Irrespective of size, these firms operate in an environment where demand is extremely variable. In part, this reflects the impact of cyclical factors, such as interest rate movements and changes in net migration. It also reflects the impact of disruptive factors, such as the 2011 Canterbury earthquake, which have had a big impact on demand for residential building activity over an extended length of time.

The industry is able to respond to this variability in demand because small firms, in particular, find it relatively easy to enter and exit the industry. By contrast, larger firms typically face higher barriers to entry. Better capitalised than their smaller counterparts and often with diversified interests, they tend to remain in the industry irrespective of changes in demand.

The ability of smaller firms to move in and out of the industry sets in motion a boom and bust cycle that has a number of adverse consequences. The main one is that it tends to encourage a short-term focus on operational issues. This is particularly true for those small firms that live a "hand to mouth" existence and so are unable to invest time and money in developing, learning and/or adopting new ways of doing things. Limited investment discourages innovation, which effectively caps productivity gains needed to improve industry competitiveness and reduce building costs. It also helps to perpetuate the boom and bust cycle.

However, this is not the case for most large firms. Although few in number, these firms actively adopt best practice work organisation and procurement methods to minimise unit costs of construction and improve levels of competitiveness. They are also ahead of the curve when it comes to developing and/or adopting new products, materials and approaches to building. Greater use of offsite prefabrication, for example, helps to speed up construction times and reduce building costs. It also provides some protection against the variability in demand referred earlier.

The ability to compete not only depends on generating operating efficiencies, but also which segments of the market that are being targeted. The building of standalone houses continues to be the bedrock on which the industry stands. However, large firms are increasingly focusing on medium and high-density residential buildings as customer preferences, shaped in part by affordability issues, change. Particular growth areas attracting high margins include terraced housing and low-level apartment blocks.

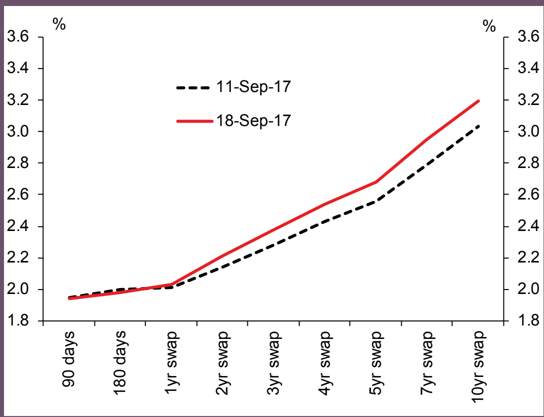
Given the competitive dynamics at play, we think that the industry will morph into something more like that of Australia's, where larger residential firms dominate. We expect that the ability to generate greater economies of scale will over time result in larger firms dominating all market segments, except perhaps for alterations, repairs and maintenance work, where a declining number of smaller players will operate. This does not mean that smaller players will disappear from home building altogether, but we think they will become increasingly marginalised.

# 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 Q3 Westpac McDermott Miller Consumer Confidence

**Sep 19, Last: 113.4**

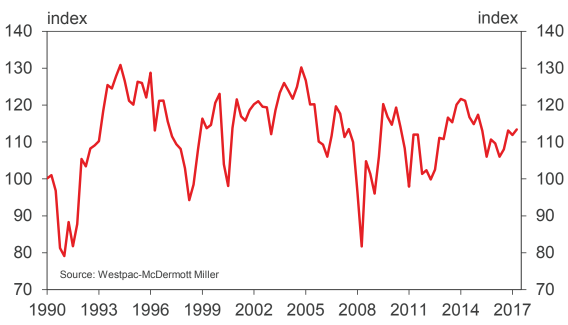
- The Westpac McDermott Miller Consumer Confidence survey rose by 1.5 points in the June quarter. That took the index to 113.4 - its highest level since early 2015. Looking into the breakdown of the survey, gains in confidence were widespread, both geographically and by income levels.
- June's rise in consumer sentiment was underpinned by improved confidence in the economic outlook.

### NZ Q2 current account, % of GDP

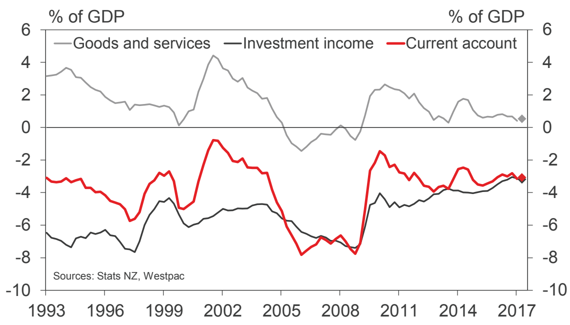
**Sep 20, Last: -3.1%, Westpac f/c: -3.1%, Mkt f/c: -3.0%**

- We expect the annual current account deficit to remain around 3.1% of GDP. In seasonally adjusted terms, last quarter's deterioration in the goods balance is set to reverse, with the goods deficit expected to narrow from $1bn to $400m. Underpinning this recovery has been a lift in dairy exports volumes and prices following weakness in the previous two quarters.
- The services balance is expected to continue rising from already firm levels. This mainly reflects ongoing strong growth in tourism exports, with a record inflow of international visitors over the past year. Tourism exports are likely to be particularly strong in the June quarter as a result of the boosts to spending from the Masters Games and Lions tour.
- The investment income deficit is expected to remain stable.

#### Westpac-McDermott Miller consumer confidence




#### Annual current account balance




### NZ Q2 GDP

**Sep 21, Last: 0.5%, Westpac f/c: 0.8%, Mkt f/c: 0.8%**

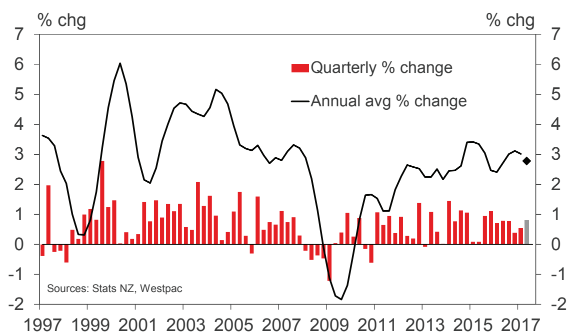
- GDP growth is expected to rebound following a couple of quarters of softer growth. We are forecasting a 0.8% rise in Q2 GDP, which is below the RBNZ's forecast of 0.9%.
- In part, the expected firmness in Q2 reflects a rebound from the earlier softness in the agricultural and transport sectors. Moreover, firmer retail spending in Q2 underpinned by strong population growth and tourism is expected to lend a boost to GDP growth.
- Balanced against these upside factors, we are seeing signs of softness within the construction and manufacturing sectors.

### Aus Aug Westpac–MI Leading Index

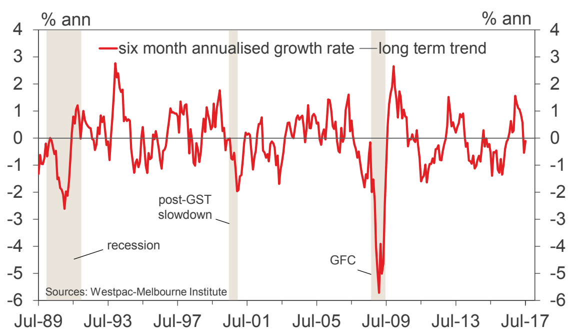
**Sep 20, Last: –0.32%**

- The Leading Index has swung sharply in recent months from well above trend to back below trend, the six month annualised growth rate coming in at 0.32% below trend in July. The turnaround mainly reflects swings in Australia's commodity prices and to a lesser extent a shift to a rising yield curve implying tightening financial conditions.
- The August read will include a mix of updates: the ASX200 largely unchanged; the Westpac-MI Consumer Expectations Index and US industrial production both up slightly again; total hours worked, up 0.4% (vs -0.5% last month); and commodity prices up 1% vs -3% last month. Against this, dwelling approvals were down -1.7% (vs +11.7% last month) the yield spread narrowed a touch and the Westpac-MI Unemployment Expectations Index deteriorating slightly.

#### Production-based GDP




#### Westpac-MI Leading Index



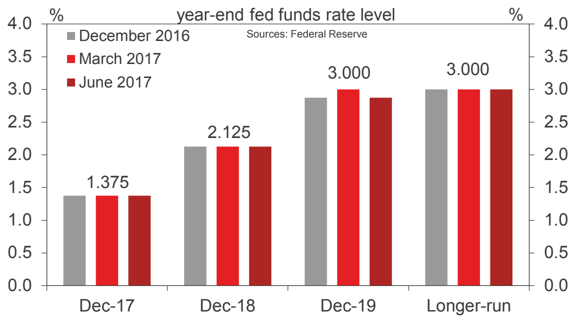
# The week ahead

### US Sep FOMC meeting

**Sep 21, last 1.125%, WBC 1.125%**

- It has been a tumultuous month for the US economy and indeed the FOMC, with Vice Chair Fischer announcing is resignation effective October 2017. This decision will have no impact on the September meeting, the formal starting point for balance sheet normalisation. At the end of this meeting, a specific date will be given at which time the already outlined plan of the FOMC will be put into action. It is intended that this will reduce the balance sheet by around USD2trn over the next five or so years.
- For the outlook, the more important output of the September meeting will be revised forecasts. The two particular areas of note will be the forecasts for inflation and for the fed funds rate, which recent communications indicate might come under pressure. We retain our December 2017; June and December 2018 rate hike view.

### FOMC to keep raising rates, but at what pace



# Data calendar

| | | Last | Market median | Westpac forecast | Risk/Comment |
|---|---|---|---|---|---|
| **Mon 18** | | | | | |
| **NZ** | Aug performance services index | 56.0 | – | – | Services facing some headwinds, but activity remains firm. |
| **Aus** | Aug new vehicle sales | –2.0% | – | –0.5% | FCAI figs point to a soft month but sales still up ~2%yr. |
| **Chn** | Aug property prices | – | – | – | Tier 1 moderation to persist. |
| **Eur** | Aug CPI final %yr | 1.3% | – | – | Germany and Spain have strengthened. |
| **UK** | Sep Rightmove house prices | –0.9% | – | – | Broad uncertainties leading to softer prices, esp. in London. |
| | BoE Governor Carney speaks | – | – | – | IMF event speech followed by conversation with Lagarde. |
| **US** | Sep NAHB housing market index | 68 | 67 | – | Conditions strong. |
| | Jul total net TIC flows $bn | 7.7 | – | – | Long–term bond flows. |
| **Tue 19** | | | | | |
| **NZ** | Q3 Westpac consumer confidence | 113.4 | – | – | June quarter saw widespread gains in consumer confidence. |
| **Aus** | RBA minutes | – | – | – | More colour on the Board's deliberations. |
| | Q2 house price index | 2.2% | 1.3% | 1.2% | More timely measures show clear softening. |
| **Eur** | Jul ECB current account, €b | 21.2 | – | – | Export sectors benefiting from uplift in global trade. |
| | Jul construction output | –0.5% | – | – | Still mixed across the Continent. |
| | Sep ZEW survey expectations | 29.3 | – | – | Remain robust. |
| | ECB economic bulletin | – | – | – | Detailed assessment of economy by ECB. |
| **US** | Aug import price index | 0.1% | – | – | US dollar weakness to support. |
| | Aug housing starts | –4.8% | 2.2% | – | Starts activity looks to be stabilising... |
| | Aug building permits | –3.5% | –0.8% | – | ... so too permits. |
| **Wed 20** | | | | | |
| **NZ** | GlobalDairyTrade auction | 0.3% | – | – | WMP futures signalling softness in dairy at next auction. |
| | Q2 current account GDP ratio YTD | –3.1% | –3.0% | –3.1% | Lift in goods and services exports set to narrow deficit. |
| **Aus** | Aug Westpac–MI Leading Index | –0.32% | – | – | Back below trend on weaker commodity prices. |
| | RBA Assist Gov Economic Ellis | – | – | – | Topic tbc, ABE conference, Sydney 1.05 pm AEST. |
| **UK** | Aug retail sales | 0.3% | 0.2% | – | Stronger pound balanced with softer housing keep sales flat. |
| **US** | Aug existing home sales | –1.3% | 0.6% | – | Has lost momentum in recent months. |
| **Thu 21** | | | | | |
| **NZ** | Q2 GDP | 0.5% | 0.8% | 0.8% | Rebound in Q2 growth, driven by transport and agriculture. |
| | Aug net migration | 5800 | – | 5900 | Annual inflow remains elevated; arrivals high, departures low. |
| **Aus** | RBA Governor Lowe speaking | – | – | – | 'The Next Chapter', Perth, 3.10 pm AEST. |
| **Eur** | Sep consumer confidence – adv. | –1.5 | – | – | Buoyant. |
| | ECB President Draghi speaks | – | – | – | In capacity as Chair of the European Systemic Risk Board. |
| | ECB Chief Economist Praet speaks | – | – | – | Chairs panel at the 'Understanding inflation' conference. |
| **US** | FOMC policy decision, midpoint | 1.125% | 1.125% | 1.125% | Balance sheet normalisation to begin. Watch the dots. |
| | Jul FHFA house prices | 0.1% | – | – | Price growth momentum remains robust. |
| | Initial jobless claims | 284k | – | – | Very low. |
| | Sep Phily Fed index | 18.9 | 17.0 | – | Still strong. |
| | Aug leading index | 0.3% | 0.2% | – | Growth at trend. |
| **Fri 22** | | | | | |
| **Eur** | Sep Markit manufacturing PMI | 57.4 | – | – | At an elevated level. |
| | Sep Markit services PMI | 54.7 | – | – | Services also fairing well. |
| | ECB VP Constancio speaks | – | – | – | Final remarks at the 'Understanding inflation' conference. |
| **US** | Sep Markit manufacturing PMI | 52.8 | – | – | Results for broad industry surveys... |
| | Sep Markit service PMI | 56.0 | – | – | ... have become more mixed. |
| | Fedspeak | – | – | – | Williams speaks to media after SNB event. |
| | Fedspeak | – | – | – | George at Dallas/Kansas City Fed oil conference. |
| | Fedspeak | – | – | – | Kaplan at Q&A at Dallas/Kansas City Fed oil conference. |
| **Sat 23** | | | | | |
| **NZ** | General election | – | – | – | Results of the General Election. |

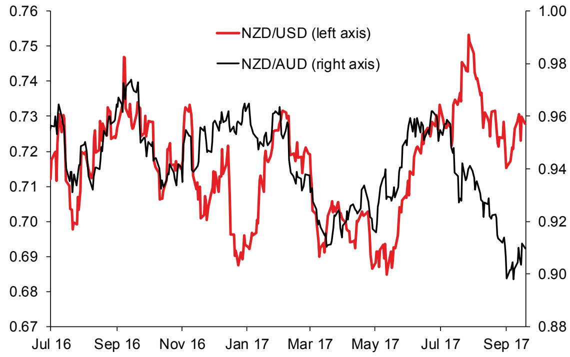
# New Zealand forecasts

| Economic Forecasts | 2017 | | | | Calendar years | | | |
|---|---|---|---|---|---|---|---|---|
| % change | Mar (a) | Jun | Sep | Dec | 2015 | 2016 | 2017f | 2018f |
| GDP (Production) ann avg | 0.5 | 0.8 | 0.7 | 0.6 | 2.5 | 3.1 | 2.6 | 2.9 |
| Employment | 1.1 | -0.1 | 1.1 | 0.5 | 1.4 | 5.8 | 2.6 | 1.8 |
| Unemployment Rate % s.a. | 4.9 | 4.8 | 4.6 | 4.7 | 4.9 | 5.2 | 4.7 | 4.6 |
| CPI | 1.0 | 0.0 | 0.5 | 0.3 | 0.1 | 1.3 | 1.8 | 1.3 |
| Current Account Balance % of GDP | -3.2 | -3.1 | -3.1 | -3.2 | -3.3 | -2.8 | -3.2 | -3.7 |

| 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 | 0.55 | 0.54 | 0.54 | 0.54 | 0.54 |
| **TWI** | 76.4 | 74.5 | 73.9 | 73.4 | 72.9 | 72.6 |

2 Year Swap and 90 Day Bank Bills


NZD/USD and NZD/AUD




NZ interest rates as at market open on Monday 18 September 2017

| Interest Rates | Current | Two weeks ago | One month ago |
|---|---|---|---|
| **Cash** | 1.75% | 1.75% | 1.75% |
| **30 Days** | 1.82% | 1.85% | 1.84% |
| **60 Days** | 1.88% | 1.90% | 1.89% |
| **90 Days** | 1.94% | 1.96% | 1.95% |
| **2 Year Swap** | 2.21% | 2.17% | 2.17% |
| **5 Year Swap** | 2.68% | 2.63% | 2.64% |

NZ foreign currency mid-rates as at Monday 18 September 2017

| Exchange Rates | Current | Two weeks ago | One month ago |
|---|---|---|---|
| **NZD/USD** | 0.7278 | 0.7150 | 0.7314 |
| **NZD/EUR** | 0.6100 | 0.6016 | 0.6220 |
| **NZD/GBP** | 0.5366 | 0.5517 | 0.5686 |
| **NZD/JPY** | 80.88 | 78.26 | 79.98 |
| **NZD/AUD** | 0.9095 | 0.8999 | 0.9223 |
| **TWI** | 76.14 | 74.98 | 77.29 |

# International forecasts

| Economic Forecasts (Calendar Years) | 2013 | 2014 | 2015 | 2016 | 2017f | 2018f |
|---|---|---|---|---|---|---|
| **Australia** | | | | | | |
| Real GDP % yr | 2.1 | 2.8 | 2.4 | 2.5 | 2.5 | 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 | -1.3 | -2.2 |
| **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 | 1.8 | 2.1 | 1.7 |
| **United Kingdom** | | | | | | |
| Real GDP %yr | 2.2 | 2.9 | 2.2 | 2.0 | 1.6 | 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 | 4.0 | 3.9 |
| **World** | | | | | | |
| Real GDP %yr | 3.3 | 3.4 | 3.2 | 3.2 | 3.6 | 3.5 |
| Forecasts finalised 15 September 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 | 1.72 | 1.80 | 1.80 | 1.80 | 1.80 | 1.80 | 1.80 | 1.80 |
| 10 Year Bond | 2.75 | 2.70 | 2.75 | 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 | 2.18 | 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 | Sep-17 | Dec-17 | Mar-18 | Jun-18 | Sep-18 | Dec-18 | Mar-19 |
|---|---|---|---|---|---|---|---|---|
| AUD/USD | 0.7993 | 0.76 | 0.75 | 0.74 | 0.72 | 0.70 | 0.70 | 0.70 |
| USD/JPY | 110.37 | 111 | 112 | 113 | 114 | 115 | 115 | 116 |
| EUR/USD | 1.1907 | 1.17 | 1.16 | 1.15 | 1.14 | 1.13 | 1.13 | 1.14 |
| AUD/NZD | 1.1054 | 1.09 | 1.09 | 1.09 | 1.07 | 1.06 | 1.06 | 1.07 |

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