

Weekly Commentary

18 December 2017



The shifting landscape

The past year has seen some big changes in the economic landscape, and further changes are on the cards over 2018. So as this year draws to a close, how is the New Zealand economy tracking, and what can we expect going forward?

How strong is the New Zealand economy looking?

This week's GDP report is expected to show that economic growth slowed to just 0.4% through the September quarter. In part, this slowdown reflects the impact of some temporary factors. Poor weather through the middle part of the year put a dampener on agricultural production. We've also seen earlier boosts to demand in the tourism and hospitality sectors fading following high profile sporting events in the first half of 2017.

However, even smoothing through those temporary disruptions, the New Zealand economy has lost some steam. We expect that GDP growth over 2017 as a whole will come in at just 2.4%. That's down from 3% over 2016. And after adjusting for rapid population growth over the past year, we're left with a picture of relatively flat per capita economic growth.

But while the pace of overall growth has eased off, the final months of the year have seen signs of resilience in some key parts of the economy. Most notably, the housing

market has found a new (though likely temporary) lease on life, with house sales posting solid gains through October and November. We've also seen a re-acceleration in house price inflation in parts of the country including Auckland. Importantly, this resurgence in the housing market appears to have also given spending a shot in the arm, with electronic cards transactions rising by more than expected in November.

Increasing headwinds expected over 2018

This resilience in activity late in 2017 is important, as it leaves the economy on a firmer footing as we enter what's shaping up to be a testing year. As we've been highlighting in recent weeks, headwinds for growth have been mounting. Among the more notable developments has been the downturn in net migration, which we expect to continue for some time and which will weigh on economic growth. At the same time, construction activity has flattened off in the face of difficulties sourcing finance, challenges accessing skilled labour, and rising costs.

Happy holidays!

This is the last Weekly Commentary for 2017. Later this week we will send out a Data Calendar to see you through the holiday season. The full Weekly Commentary will resume on 16 January 2018.

The shifting landscape continued

And of course, on top of those factors we're looking at significant changes in the policy environment over the coming years. That includes the coming introduction of a suite of policies that will dampen the housing market, and which will likely have flow-on downside impacts for consumption spending.

The above factors mean that GDP growth is likely to remain fairly modest over the coming year. We're forecasting economic output will rise by only 2.4% over calendar 2018.

Our forecast for subdued economic growth over the coming year is in stark contrast to forecasts in the Government's Half Year Economic and Fiscal Update (HYEFU), released this past week. That update provided us with our first detailed look at how the new coalition Government expects its policies will affect the economy. However, digging through the details of the HYEFU, we think the Government is being far too optimistic about the outlook over the next few years. In particular, the HYEFU forecast assumes an acceleration in GDP growth to 3.5% over 2018, underpinned by firmness in both investment spending and household consumption. Both of those assumptions look doubtful to us. As well as the downside risks for the housing market and household spending highlighted above, businesses we've spoken with in recent weeks have told us that they are extremely nervous about the outlook. We expect that this will be a significant drag on investment spending and hiring over the coming year.

If GDP growth doesn't accelerate to the extent that the Treasury is projecting, the risk is that future revenue will fall

short, requiring the Government to either rein in some of its spending plans, find additional sources of revenue, or abandon its commitment to reducing net debt so rapidly. This vulnerability isn't unique to the new Government: we made similar comments at the time of the May Budget. And since our point of disagreement relates to the outlook for economic growth several years ahead, it's likely that our concerns will remain for some time.

New year, new Governor

One of the lingering uncertainties about the economic outlook has been the potential impact of looming changes at the RBNZ. The most important question on this front is how policy will respond to the planned expansion of the RBNZ objectives to include a focus on employment.

We've been wary of the dual mandate as it might make it harder for the Reserve Bank to raise rates when inflation is too high, since that could conflict with a directive to maximise employment.

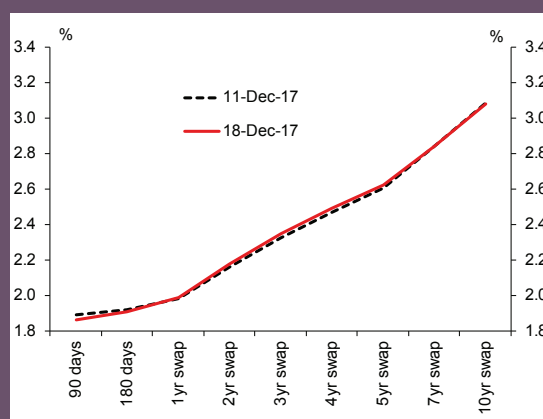
However, some of that uncertainty around the outlook for monetary policy has dissipated following the announcement that Adrian Orr will take over as RBNZ Governor in March. Mr Orr is currently the head of the NZ Super Fund. He has previously held senior roles at the RBNZ and was Chief Economist at Westpac. With his extensive experience in economic policy, we would expect that the RBNZ will remain realistic about what impact monetary policy can have on the economy in the long run, while still focusing on employment over the economic cycle.

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 fixed 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

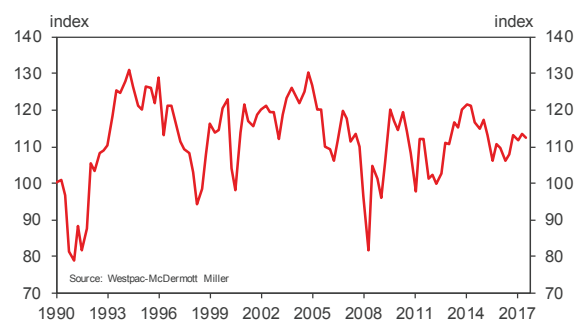
NZ Q4 Westpac McDermott Miller

Consumer Confidence

Dec 19, Last: 112.4

- The Westpac McDermott Miller Consumer Confidence survey softened to a level of 112.4 in September, down from 113.4 in June. Given normal quarter-to-quarter volatility, that was a fairly small decline. And following gains earlier in the year, it left household confidence at firm levels.
- The December survey will provide an update on how consumer confidence has fared following the election of the new Government and related changes in the outlook for economic policy.

Westpac-McDermott Miller consumer confidence

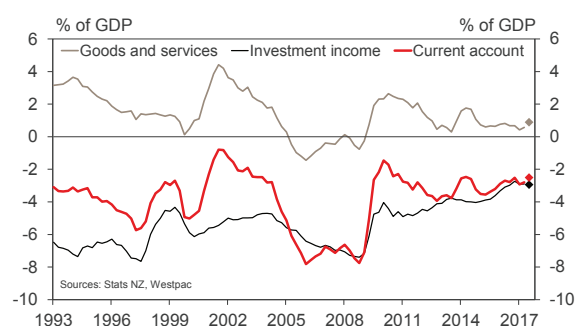


NZ Q3 current account, % of GDP

Dec 20, Last: -2.8%, Westpac f/c: -2.5%, Mkt f/c: -2.5%

- We expect the annual current account deficit to narrow to 2.5% of GDP in the September quarter. Part of the improvement is due to base effects, with dairy export prices and volumes higher than they were a year earlier.
- For the quarter, goods exports were steady, while import prices and volumes fell. Services exports dropped back from the previous quarter's rise, when tourism was boosted by the Lions rugby tour.
- We expect the investment income deficit to widen, due to higher profits for overseas-owned firms.

Annual current account balance

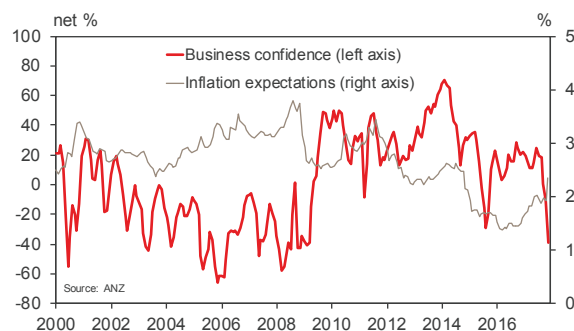


NZ Dec business confidence

Dec 19, Last: -39.3

- Business confidence plunged in November, falling to its lowest level in nine years. Some of the drop was likely a knee-jerk reaction to the change of government – we find that business confidence averages about 20 points lower under left-wing governments. However, the November drop was even larger than this, and confidence has been falling since July. While the fall in confidence may prove to be an overreaction, expectations do matter. Our forecasts include a hiatus in business investment in 2018, one of the reasons why we expect subdued GDP growth next year.
- Inflation expectations rose sharply in November, presumably on a view that the new Government will be inflationary. We agree with that view over the long term, but not the one-year ahead horizon that the survey covers – in fact, the balance of Government policies is likely to reduce inflation over 2018.

NZ business confidence and inflation expectations

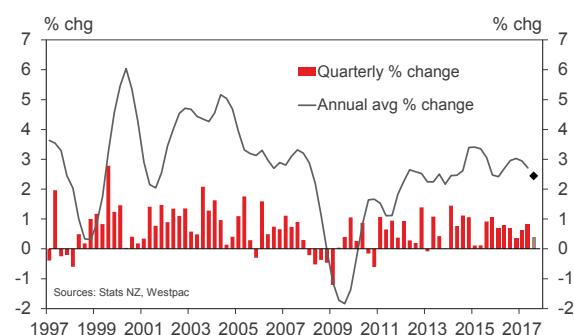


NZ Q3 GDP

Dec 21, Last: 0.8%, Westpac f/c: 0.4%, Mkt f/c: 0.6%

- We expect a subdued 0.4% rise in GDP for the September quarter. Much of the expected weakness is due to lower primary sector activity. Milk production made a slow start to the new season, and oil and gas extraction has continued its natural decline.
- On the positive side, we expect strong contributions from non-food manufacturing, construction and personal services.
- The September quarter is likely to mark the low point for growth this year. The June quarter benefited from a pickup in milk production and a spike in tourist numbers during the Lions rugby tour. Similarly, we expect some rebound in December quarter growth, with a number of near-term indicators showing signs of life.

Production-based GDP



The week ahead

Aus Federal budget, 2017/18 mid-year update, AUDbn

Dec 18, Last: -29.4 (pr), WBC f/c: -27, Mkt f/c: tba, Range: tba

- The Federal Government's Mid-Year Economic and Fiscal Outlook is expected to confirm the broad profile for the budget balance, as set out in the May Budget.
- On the economy: forecast nominal GDP growth for 2017/18 is likely to be upgraded to 4.5% from 4.0% at Budget time, on upside to commodity prices; while real GDP growth is on track for the forecast 2.75%. For the out years, the economic forecasts are likely to be little changed.
- The stronger starting position for the economy boosts revenues, while a likely small undershoot on expenditures could be used to fund modest new initiatives.
- On our figuring, the forecast budget deficit for 2017/18 is \$2.4bn smaller, at \$27.0bn vs \$29.4bn at budget time.

	'17/18	'18/19	'19/20	'20/21
Budget forecasts				
Cash balance, underlying	-29.4	-21.4	-2.5	7.4
% of GDP	-1.6	-1.1	-0.1	0.4
Net public debt	355	375	375	366
% of GDP	19.5	19.8	18.9	17.6
MYEFO*				
Change in cash balance	2.4	1.4	1.0	1.1
Cash balance, underlying	015027.0	015020.0	01501.5	8.5
% of GDP	01501.5	01501.0	01500.1	0.4
Net public debt	350	369	367	357
% of GDP	19.0	19.4	18.4	17.1

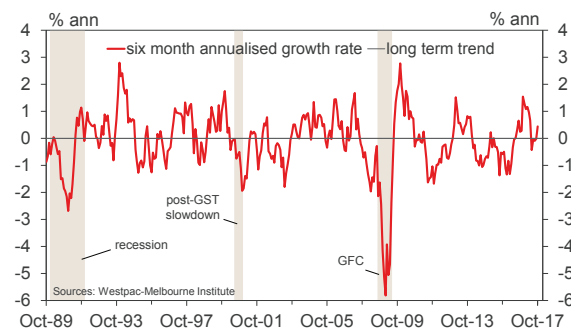
* Westpac's expectation of MYEFO forecasts

Aus Oct Westpac-MI Leading Index

Dec 20, Last: +0.44%

- The six month annualised growth rate in the Leading Index lifted from -0.02% in September to +0.44% in October, marking the first above trend reading on momentum since mid-year and suggesting some of the headwinds to growth evident earlier in 2017 have eased.
- The Nov index will include mostly positive component updates including: the Westpac-MI Consumer Expectations Index, up 3.4% vs -1.8% last month; commodity prices, up 2.2% in AUD terms vs -0.4% last month; the Westpac-MI Unemployment Expectations Index, down -2.4% vs 1.2% last month (declines mean an improved read); and total hours worked, up 0.6% vs 0.3% last month.

Westpac-MI Leading Index



US Dec Personal income and expenditure

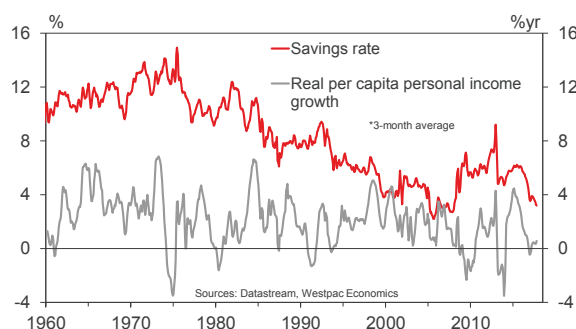
Dec 22, personal income, last 0.4%, WBC 0.4%

Dec 22, personal spending, last 0.3%, WBC 0.5%

Dec 22, personal deflator, last 0.1%, WBC 0.3%

- Despite very strong employment growth which has seen both the unemployment rate and underutilisation decline rapidly, wages growth in the US remains subdued. Indeed, on a real discretionary basis, household incomes are up only around 0.5%/yr. It is therefore unsurprising that the savings rate has been falling.
- While sentiment has also been supportive, the budget reality that households face is restricting spending, which slowed in the September quarter and remained subdued in October. We expect November might see a bounce in services, but risks are to the downside. Inflation remains well contained. The core CPI disappointed expectations in Nov, +0.1% and the PCE variant is likely to follow suit. Energy will add in November.

Savings from salary income limited



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 18					
NZ	Nov performance services index	55.6	-	-	Conditions eased, firms increasingly nervous about outlook.
	Dec ANZ consumer confidence	-2.1%	-	-	Has softened in recent months, but still at firm levels.
Aus	Nov new vehicle sales	flat	-	0.5%	ABS release to be discontinued from December.
	Mid-Year budget update, AUDbn	-29.4(p)	tba	-27	2017/18 Federal budget deficit to be trimmed.
Chn	Nov property prices	0.0%	-	-	Authorities keen to keep regional markets in check.
	Central Economic Work Conference	-	-	-	18-20, discussion of economic policies led by Xi.
Eur	Nov CPI %yr final	1.4%	1.5%	1.5%	Headline edged higher in flash; core stable at 1.1%.
US	Dec NAHB housing market index	70	-	-	Home builders very positive on outlook.
Tue 19					
NZ	Q4 Westpac MM consumer conf.	112.4	-	-	Has moderated, but remains at firm levels.
	Dec ANZ business confidence	-39.3	-	-	Confidence to remain subdued after plunging in November.
Aus	RBA minutes	-	-	-	Further detail, perhaps on change in FX language.
US	Nov housing starts	13.7%	-3.3%	-	Highly volatile...
	Nov building permits	7.4%	-3.5%	-	... and likely to remain that way.
Wed 20					
NZ	GlobalDairyTrade auction	0.4%	-	-	Futures suggest lift in prices in response to dry weather.
	Nov net migration	5580	-	5300	Monthly trending down as departures rise & arrivals flatten.
	Nov trade balance, \$m	-871	-650	-500	Meat and dairy exports picking up.
	Q3 current account GDP ratio	-2.8%	-	-2.5%	Import prices and volumes were both down for the quarter.
Aus	Nov Westpac-MI Leading Index	0.44%	-	-	Drag on momentum has eased for now.
US	Nov existing home sales	2.0%	0.7%	-	Oct gain came after string of weak outcomes.
Thu 21					
NZ	Q3 GDP	0.8%	0.6%	0.4%	Slowdown mainly due to temporary factors on agriculture.
Eur	Dec consumer confidence	0.1	-	-	Households have a lot to be positive about in Europe.
UK	GfK consumer confidence	-12	-	-	Lingering uncertainty weighing on sentiment.
	Nov public sector net borrowing, £b	7.5	-	-	Borrowing has been coming in lower than expected.
US	Q3 GDP 3rd estimate %annualised	3.3%	3.3%	3.3%	Third estimate unlikely to show revision.
	Initial jobless claims	225k	-	-	Very low.
	Dec Philly Fed index	22.7	21.0	-	Regional fed surveys strong..
	Nov Chicago Fed activity index	0.65	-	-	... in line with ISM.
	Oct FHFA house prices	0.3%	-	-	Robust price growth to continue.
	Nov leading index	1.2%	0.4%	-	Points to growth remaining above trend.
Fri 22					
UK	Q3 GDP (final)	0.4%	-	0.4%	Despite firming, domestic demand remains sluggish.
US	Nov durable goods orders	-0.8%	1.7%	2.0%	Ex transport and defence, core orders growth modest.
	Nov personal income	0.4%	0.4%	0.4%	Soft growth in real disposable income...
	Nov personal spending	0.3%	0.4%	0.5%	... limiting support for consumption.
	Nov PCE deflator	0.1%	0.3%	0.3%	Core inflation set to remain very subdued, up 0.1% in month.
	Nov new home sales	6.2%	-5.1%	-7.0%	High degree of volatility month to month; trend softening.
	Dec Uni. of Michigan sentiment	96.8	97.3	-	Consumers remain positive on outlook.
	Dec Kansas City Fed index	16	-	-	Regional fed surveys remain strong.

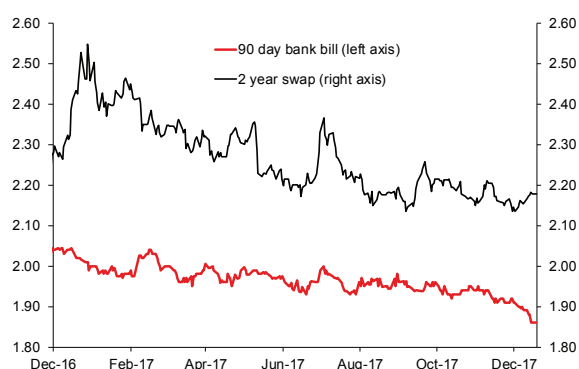
New Zealand forecasts

Economic Forecasts	Quarterly				Annual			
	2017			2018	Calendar years			
	Jun	Sep	Dec	Mar	2015	2016	2017f	2018f
GDP (Production)	0.8	0.4	0.7	0.5	2.5	3.0	2.4	2.4 ¹
Employment	-0.1	2.2	-0.2	0.6	1.4	5.8	3.1	1.6
Unemployment Rate % s.a.	4.8	4.6	4.5	4.5	5.0	5.3	4.5	4.7
CPI	0.0	0.5	0.5	0.4	0.1	1.3	2.0	1.5
Current Account Balance % of GDP	-2.8	-2.5	-2.4	-2.0	-3.2	-2.5	-2.4	-2.5

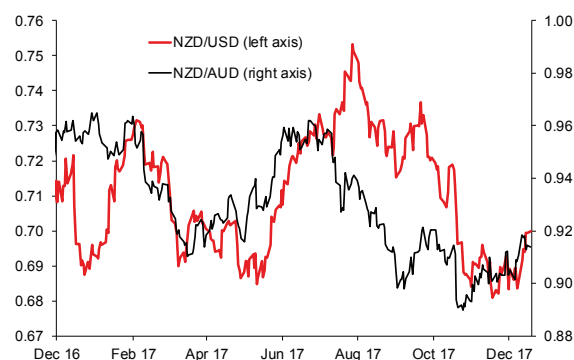
¹ Annual average % change

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	2.10	2.20	2.30	2.40	2.50
5 Year Swap	2.60	2.70	2.80	2.95	3.10	3.20
10 Year Bond	2.95	3.10	3.20	3.35	3.40	3.45
NZD/USD	0.68	0.67	0.66	0.64	0.63	0.63
NZD/AUD	0.89	0.89	0.89	0.89	0.90	0.91
NZD/JPY	77.5	76.4	75.9	74.5	73.1	73.7
NZD/EUR	0.59	0.58	0.58	0.57	0.56	0.57
NZD/GBP	0.52	0.51	0.51	0.51	0.50	0.50
TWI	72.6	71.8	71.2	69.9	69.2	69.6

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 18 December 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.77%	1.77%	1.76%
60 Days	1.81%	1.84%	1.83%
90 Days	1.86%	1.91%	1.91%
2 Year Swap	2.18%	2.14%	2.16%
5 Year Swap	2.62%	2.57%	2.65%

NZ foreign currency mid-rates as at 18 December 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7000	0.6873	0.6804
NZD/EUR	0.5957	0.5793	0.5774
NZD/GBP	0.5249	0.5111	0.5152
NZD/JPY	78.82	77.54	76.31
NZD/AUD	0.9139	0.9057	0.8989
TWI	74.06	72.74	72.33

International forecasts

Economic Forecasts (Calendar Years)	2014	2015	2016	2017f	2018f	2019f
Australia						
Real GDP % yr	2.8	2.4	2.5	2.5	3.0	2.5
CPI inflation % annual	1.7	1.7	1.5	1.7	2.0	2.0
Unemployment %	6.2	5.8	5.7	5.5	6.1	6.0
Current Account % GDP	-3.0	-4.7	-2.7	-1.6	-2.2	-2.6
United States						
Real GDP %yr	2.6	2.9	1.5	2.2	2.1	2.0
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	4.1	4.1
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	1.1	0.9
Euroland						
Real GDP %yr	1.3	2.0	1.8	2.2	1.8	1.7
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	6.8	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	3.7	3.6	3.6

Forecasts finalised 10 November 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	1.75	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.53	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	2.37	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	0.7514	0.76	0.75	0.74	0.72	0.70	0.69	0.68
USD/JPY	113.35	114	114	115	116	116	117	118
EUR/USD	1.1767	1.15	1.15	1.14	1.13	1.12	1.11	1.10
AUD/NZD	1.0991	1.12	1.12	1.12	1.12	1.11	1.10	1.08

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