

Weekly Commentary

20 February 2017



Putting it on the house

In the last week we've received news on household spending and the housing market – two areas which are typically closely interlinked. While household spending looks to have made a firm start to 2017, the housing market has had a weak start. We're forecasting house price growth to slow this year, and we expect that growth in household spending will follow suit.

In New Zealand there's typically been a close relationship between growth in house prices and consumer spending. That reflects the importance of housing as a major portion of the wealth of New Zealand households. When house prices are rising and the market is turning over rapidly, Kiwis feel more inclined to borrow against some of that wealth and spend it. That means the housing market plays an important role in New Zealand's economic cycles, and therefore has important implications for the outlook for inflation and interest rates.

Over the past couple of years we had been surprised by the extent that the linkage between house prices and spending appeared to soften. House prices accelerated in 2015, while growth in per-capita spending slowed to a crawl. Some of the divergence may have reflected the narrow scope of house prices growth across regions, with gains dominated by Auckland over that time.

But the latest GDP figures showed a marked acceleration in household spending through the middle of last year. And along with substantial upward revisions to historical data, it now looks like the relationship between house prices and spending is alive and well. So with history now squaring up a little better, where to from here? Last week's data provided mixed signals on where we might be heading this year.

On the one hand, consumer spending looks firm. While retail spending disappointed a bit in the December quarter,

with core retail sales volumes rising only 0.6% in the quarter and 4.2% over the year, spending on debit and credit cards in January was particularly strong and will help put spending in the March quarter on firm footing. After a couple of subdued months, card spending rose a whopping 2.5% in January, taking growth back towards its recent trend of around 5% a year.

Of course, these measures of total spending are currently being bolstered by strong population growth and tourist arrivals. But on a per-person basis, the data suggest that a firm pace of spending growth was maintained in early 2017. A number of factors are certainly working in households' favour at the moment, including solid jobs growth and low interest rates. The marked improvement in the dairy sector outlook over the past six months will also remove the insidious drag that has plagued dairying regions for the past couple of years.

On the other hand, the housing market had a very weak start to the year. House sales (in seasonally adjusted terms) fell sharply in January, and after several months of decline are down over 20% from their peak last April. At a national level the rate of price growth has slowed considerably over the past few months. But there are again regional differences in the housing market's performance. In previous hotspots such as Auckland, Hamilton and Tauranga the rate of price growth has slowed since July. But the majority of regions have actually seen an acceleration

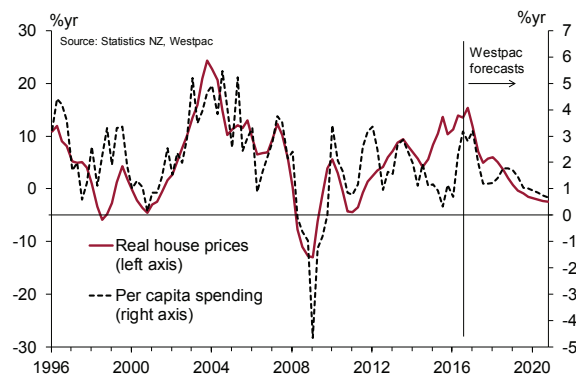
Putting it on the house continued

in house price growth since July; few regions in the North Island are running at below double-digit annual gains. This is somewhat at odds with the latest change to the LVR restrictions, which was to extend the limit on investor LVRs from Auckland to the rest of the country.

While LVRs look to have taken some heat out of the market, past lending restrictions have often had only a temporary impact on prices. In our minds, much more significant for the housing market is the rise in mortgage rates since November. Floating mortgage rates have risen 10bps, with two-year fixed rates nearly 40bps higher. That's a change from the last couple of years, when steady falls in interest rates added fresh fuel to the housing market. With the Reserve Bank expected to keep the OCR unchanged for some time, mortgage rates shouldn't increase dramatically from here (unless there's a significant further rise in US interest rates, which may occur if President Trump is successful in his efforts to promote growth). But the increase in mortgage rates that we've already seen suggests that house price growth should be much slower this year. We're forecasting a gain of 7% this year, compared to an estimated 15% rise in 2016 and 11% in 2015.

The ongoing need to house a growing population will remain a key factor underpinning housing demand, making it difficult to see an outright decline in prices. Our estimate of the shortfall of houses has risen above 35,000, centred almost entirely in Auckland. And although the pace of building has picked up, it remains inadequate, meaning that

Household spending and house price growth



the shortage is expected to get worse before it gets better. Building consents were surprisingly weak in December, especially in Auckland where consents have fallen over the past few months. The city's Unitary Plan, which allows for more and different kinds of homebuilding, has recently cleared its legal hurdles, and should lead to a rebound in consents by mid-year.

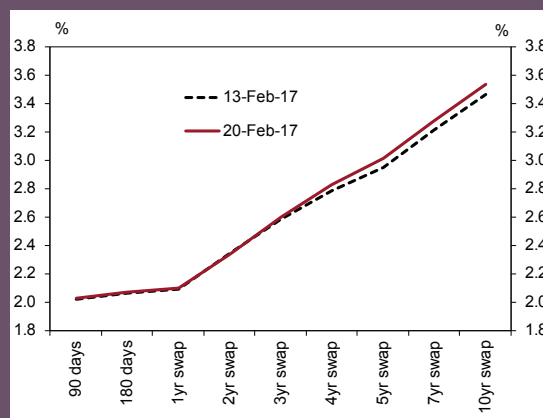
Pulling it together, if our view on house prices is correct, we'd expect to see the rate of growth in consumer spending slow from here. This argues for inflation pressures remaining well-contained, meaning that the Reserve Bank can remain on the sidelines for some time to come.

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



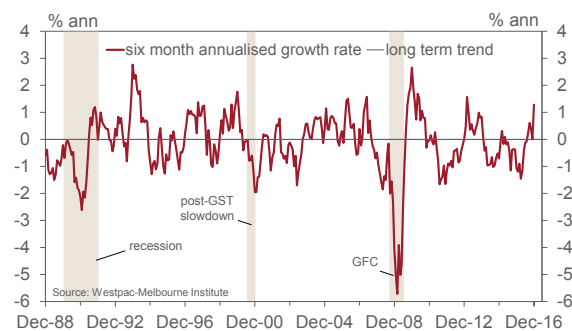
The week ahead

Aus Jan Westpac-MI Leading Index

Feb 22, Last: 1.28%

- The six month annualised growth rate in the Westpac-Melbourne Institute Leading Index surged from flat in November to 1.28% in December. The strong gain marked the fifth consecutive above or at trend reading and points to a significantly improved outlook for the first half of 2017.
- The Jan update will include a mixed bag of component moves. On the plus side: commodity prices continued to surge (up 4.1% in AUD terms vs 10% last month); and the Westpac-MI Consumer Expectations Index posted a small gain (1.8% vs 0.5% last month); as did total hours worked (0.6% vs 0.4% last month). Against this, the ASX200 dipped -0.8%; US industrial production dipped -0.3%; dwelling approvals declined -1.2%; the yield spread narrowing slightly and the Westpac-MI Unemployment Expectations Index deteriorated. Overall a consolidation on recent gains looks likely.

Westpac-MI Leading Index



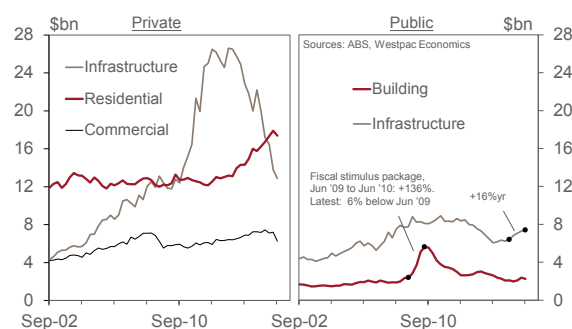
Aus Q4 construction work

Feb 22, Last: -4.9%, WBC f/c: -0.8%

Mkt f/c: 0.5%, Range: -3.9% to 3.0%

- Construction activity slumped in Q3, contracting by 4.9%, as the downturn in mining project work was exacerbated by surprising softness elsewhere. For Q4, we anticipate a modest contraction in construction work, of -0.8%.
- Private infrastructure work is expected to fall by 6.0%, not greatly different to last quarter, -6.6%.
- Total private building activity is expected to resume its upward trend, centred on housing, +1%. That follows a sharp 5.7% drop in Q3, only the 2nd quarterly decline since the start of 2014.
- Public construction activity is also expected to resume its uptrend, centred on infrastructure, following a flat Q3, prior to which the segment recorded four consecutive gains.

Construction work: divergent trends



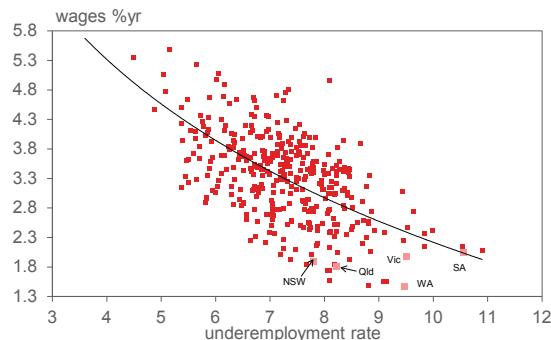
Aus Q3 wage price index

Feb 22, Last: +0.4%, WBC: f/c +0.4%

Mkt f/c: 0.5%, Range: 0.4% to 0.7%

- The soft state of the Australian labour market is reflected in the low rate of wage inflation. Total hourly wage rates ex bonuses (WPI) lifted just 0.4% in Q3, below market and Westpac's expectations for 0.5%. The Sep quarter print followed on from a rise of 0.5% in each of the previous three quarters. The annual pace of wage inflation dipped to 1.9%yr, a record low. Wages are underperforming what the broader indicators of the labour market suggest. Even if you use the broadest indicator of labour market slack, underemployment, wages growth is significantly softer than what you would expect it to be. If wage inflation was comparable to the underemployment rate "Phillips Curve" it would be running around a 2½%yr pace. We think little has changed hence our 0.4% forecast which will take the annual pace down to 1.58%yr.

Private wages & underemployment by state



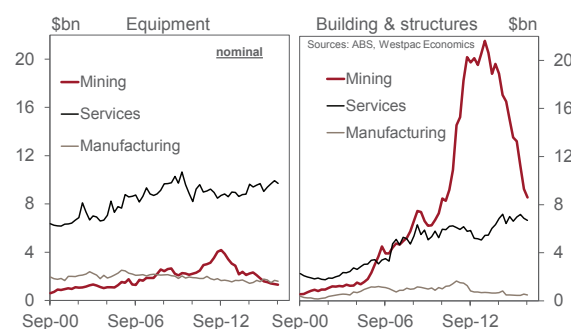
Aus Q4 private business capex

Feb 23, Last: -4.0%, WBC f/c: -2.5%

Mkt f/c: -0.5%, Range: -5.8% to 3.4%

- Private business capex is falling, led lower by mining. In Q3, capex fell by 4.0%, with building & structures -5.7% and equipment -1.9%. By industry, mining -7% and services -2%.
- For Q4, we expect capex to fall by 2.5%.
- Building & structures, looks set for another sizeable fall, down a forecast 4.5%. Weakness will be in mining, while we're anticipating a stabilisation in commercial building after a corrective sharp fall in Q3.
- Equipment spending prospects are more difficult to gauge. In Q3, spending weakened as businesses delayed plans due to uncertainty around the July Federal election. Prior to this, a lift in spending by the service sectors was providing some support. For Q4, lingering uncertainty could see a flat result.

CAPEX: by industry by asset



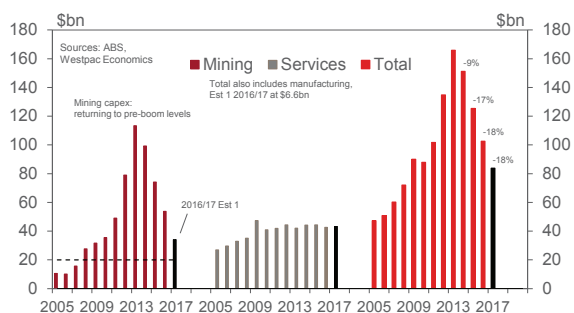
The week ahead

Aus private capex expectations, AUDbn

Feb 23, Last: Est 4 for 2016/17: 107, -14.3%

- Business capex is falling, led lower by mining. This survey, in the field during January and February, will include Estimate 1 for 2017/18.
- To recap: Est 4 for 2016/17 was \$107bn, -14% vs Est 4 a year ago. Avg realisation ratios (RRs) imply -15%, down \$19.5bn. By industry, based on avg RRs: mining -34%, down \$18bn; services -2%; and manufacturing -2%.
- Estimate 1 has been very weak for the past four years, relative to Est 1 the year earlier, at -9%, -17%, -18% and -18%. For 2017/18, expect another negative, but a smaller rate of decline as the mining drag wanes. Prospects for investment ex mining remains uncertain. Potentially we could see an Est 1 in the order of \$80bn, which is 5% below Est 1 a year ago, with weakness centred on mining. Also of interest will be the results implied by avg RRs.

Capex plans, by industry: Estimate 1



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 20					
NZ	Jan BusinessNZ PSI	58.4	-	-	Conditions in the service sector have been firm.
Eur	Feb consumer confidence	-4.9	-	-	Remains at multi year highs.
UK	Feb Rightmove house prices	0.4%	-	-	House price inflation has slowed. Brexit uncertainty a drag.
US	Fedspeak	-	-	-	Mester on monetary policy in Singapore.
Can	Dec wholesale trade	0.2%	-	-	Business conditions, including orders have been firming.
Tue 21					
Aus	RBA minutes of February Board meeting	-	-	-	Likely to reaffirm the more confident tone from recent commentary.
Eur	Feb Markit manufacturing PMI	55.2	-	-	Manufacturers benefitting from USD uptrend ...
	Feb Markit services PMI	53.7	-	-	... while services receive the bulk of benefit from domestic demand.
Ger	Feb Markit manufacturing PMI	56.4	-	-	In very strong shape ...
	Feb Markit services PMI	53.4	-	-	... but services demand base more fickle.
UK	Jan public sector borrowing £bn	6.4	-	-	Jan is a key month for receipts, important for revised revenue targets.
US	Feb Markit manufacturing PMI	55.0	54.7	-	Post Trump euphoria, will USD begin to bite?
	Feb Markit service PMI	55.6	55.7	-	Buoyant in January.
	Fedspeak	-	-	-	Kashkari on economy and Harker on the economic outlook.
Wed 22					
NZ	GlobalDairyTrade auction results	1.3%	-	-	Whole milk powder futures point to a small fall in prices.
Aus	RBA Governor Philip Lowe speaking	-	-	-	Australia-Canada Forum, Sydney, 8:30am, topic tba.
	Jan Westpac-MI Leading Index	1.28%	-	-	Pointing to a significant lift in momentum near term.
	Q4 wage cost index	0.4%	0.5%	0.4%	Wages underperforming even the soft Australian labour market.
	Q4 construction work done	-4.9%	0.5%	-0.8%	Q3, surprisingly sharp fall. Q4, expect gains ex private infrastructure.
Chn	China January property prices	-	-	-	Tier 1 quickest growth, albeit moderating as Tier 2&3 sustain gains.
Eur	Jan CPI	0.5%	-	-	Headline inflation on robust uptrend; but core pressures absent.
Ger	Feb IFO business climate survey	109.8	-	-	Strength likely to persist.
UK	Q4 GDP	0.6%	0.6%	0.6%	Household spending resilient. Manufacturing (esp. exporters) firm.
US	Jan existing home sales	-2.8%	1.1%	-	Will be important to watch for interest rate impact in 2017.
	FOMC meeting minutes	-	-	-	May offer insight about March prospects and later projections.
	Fedspeak	-	-	-	Williams speaks to students and Powell on the economic outlook.
Thu 23					
Aus	Q4 private new capital expenditure	-4.0%	-0.5%	-2.5%	Building & structure led lower by mining, equipment flat.
	2016/17 capex plans, AUDbn	107	84.8	-	Est 4 was 14% below Est 4 a yr ago, mining downturn.
	2017/18 capex plans, AUDbn	-	-	-	Initial estimate for 2017/18. Mining drag waning.
US	Jan Chicago Fed activity index	0.14	-	-	Continues to point to growth near trend.
	Initial jobless claims	239k	-	-	At historic lows.
	Dec FHFA house prices	0.5%	-	-	Still running at a robust pace.
	Feb Kansas City Fed index	9	-	-	Production and new orders have improved.
	Fedspeak	-	-	-	Lockhart on his 10yr tenure at the Fed.
Fri 24					
Aus	RBA Governor Philip Lowe	-	-	-	Half yearly testimony, Parliamentary Committee, Sydney 9:30am.
US	Jan new home sales	-10.4%	6.9%	-	Will be important to watch for interest rate impact in 2017.
	Feb Uni. of Michigan sentiment	95.7	96.0	-	Likely to receive benefit from Trump for at least a few more months.
Can	Jan CPI %yr	1.5%	1.6%	-	Inflation pressure benign.

New Zealand forecasts

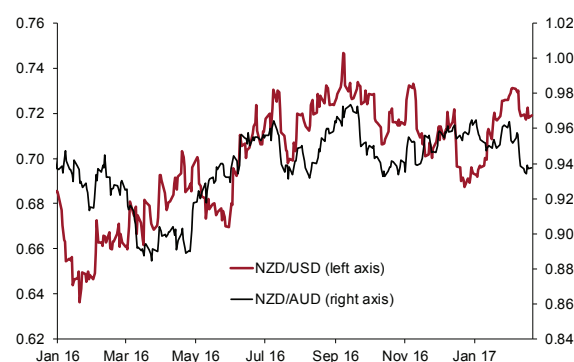
Economic Forecasts	March years				Calendar years			
	% change	2015	2016	2017f	2018f	2014	2015	2016f
GDP (Production) ann avg	3.4	2.4	3.5	3.6	3.4	2.5	3.3	3.6
Employment	3.2	2.0	5.3	2.1	3.6	1.4	5.8	2.3
Unemployment Rate % s.a.	5.4	5.2	4.8	4.4	5.5	4.9	5.2	4.4
CPI	0.3	0.4	1.7	1.5	0.8	0.1	1.3	1.5
Current Account Balance % of GDP	-3.5	-3.1	-2.8	-2.7	-3.2	-3.4	-2.8	-2.7

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	2.60
5 Year Swap	3.00	3.15	3.20	3.30	3.35	3.45
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	0.66	0.65
NZD/AUD	0.93	0.92	0.91	0.91	0.92	0.93
NZD/JPY	82.4	82.6	80.7	80.4	80.5	80.6
NZD/EUR	0.68	0.68	0.68	0.67	0.66	0.66
NZD/GBP	0.58	0.57	0.56	0.55	0.55	0.54
TWI	78.1	77.5	76.4	75.5	75.1	75.0

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 20 February 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.85%	1.83%	1.84%
60 Days	1.94%	1.92%	1.92%
90 Days	2.03%	1.98%	1.98%
2 Year Swap	2.34%	2.39%	2.44%
5 Year Swap	3.01%	3.03%	3.01%

NZ foreign currency mid-rates as at Monday 20 February 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7192	0.7318	0.7172
NZD/EUR	0.6779	0.6810	0.6695
NZD/GBP	0.5793	0.5870	0.5791
NZD/JPY	81.16	81.83	81.91
NZD/AUD	0.9375	0.9558	0.9482
TWI	78.52	79.64	78.64

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	1.5	1.9	1.9
Unemployment %	5.8	6.2	5.8	5.7	5.6	5.8
Current Account % GDP	-3.4	-3.0	-4.8	-2.9	-1.2	-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	1.2	1.7	1.7
Unemployment Rate %	7.4	6.2	5.3	4.9	4.6	4.5
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	1.5	1.3
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	3.2	3.5	3.5

Forecasts finalised 17 February 2017

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	1.78	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.79	2.95	2.95	3.00	3.05	3.15	3.25	3.40
International								
Fed Funds	0.625	0.625	0.875	0.875	1.125	1.125	1.375	1.375
US 10 Year Bond	2.45	2.55	2.65	2.75	2.85	3.00	3.10	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	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
AUD/USD	0.7693	0.76	0.76	0.75	0.74	0.72	0.70	0.68
USD/JPY	113.28	116	118	118	120	122	124	126
EUR/USD	1.0669	1.05	1.03	1.01	1.00	1.00	0.99	0.98
AUD/NZD	1.0664	1.07	1.09	1.10	1.10	1.11	1.06	1.05

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- (i) Chinese Wall/Cell arrangements;
- (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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