Weekly Commentary

23 January 2017

And we're back

For our first issue of the year, we'll recap what we see as the key themes for the New Zealand economy over 2017 and beyond. And along the way, we'll review how some of the recent economic data relates to those themes.

The economy has entered a more mature phase of the cycle. We're about to enter our seventh year of sustained GDP growth. The economy is now running close to what we would regard as its potential, and the scope for rapid rates of growth has largely been used up. In addition, the earthquake rebuild in Canterbury has passed its peak, and is no longer a driver of growth as it was in years past.

GDP growth peaked 3.4% in 2014, before slowing to 3% in the latest figures for the year to September 2016. The moderation in growth is even clearer once you account for population growth: per-capita GDP growth peaked back in 2012 at 2%, and has since slowed to 0.9% in the latest year.

Population growth will remain an important factor. Population growth has been boosted by record net migration, which seemed to gather fresh legs towards the end of 2016. While we expect some moderation over the coming year, it's likely that New Zealand will remain a relatively attractive destination.

Migration adds to demand in the economy, but it also adds to the supply side – particularly since the growth in arrivals is increasingly weighted towards those arriving on work visas. While the labour market is still tightening on balance, as evidenced by the unemployment rate falling below 5%, it's clear that migration is going some way towards meeting the rampant demand for more workers. The Quarterly Survey of Business Opinion shows that skill shortages are not emerging as a constraint to the extent that they did in the last cycle, and if anything they eased a bit in the latest survey.

This doesn't look like an economy that is at risk of overheating. The moderate pace of growth over this cycle means that economic activity has only recently risen to what we would regard as its sustainable potential. With the stark exception of the construction sector (more on that shortly), there is limited evidence of capacity constraints, and inflation has halted its decline only in the last year.

The December quarter CPI report, out this Thursday, is expected to show annual inflation back above 1% for the first time in over two years. A lot of the turnaround is due to fuel prices, which were falling hard in late 2015 whereas they rose in late 2016. The ex-fuel CPI series shows a slightly smoother path for inflation, but the general story is the same: inflation bottomed out at the end of 2015 and has gradually picked up since, but it remains low relative to history and to the Reserve Bank's target.

Inflation will remain subdued for at least another year. The RBNZ recognises that a sustained bout of growth is needed just to return inflation to the 2% midpoint of its target range. Generating 'too much' domestic inflation would require even stronger growth than we or anyone else are forecasting. On top of this, the New Zealand dollar has strengthened by 10% or so in the last year, recovering most of its late 2015 decline. This suggests that imported goods prices will face renewed downward pressure over 2017.

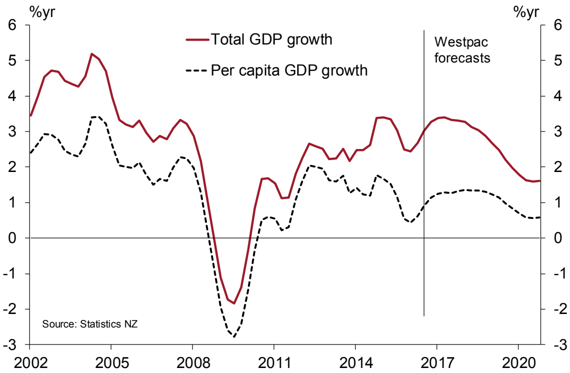
And we're back continued

Which means OCR hikes are a long way off. There's been some speculation about whether the cash rate could be hiked again as early as this year. We suspect this has more to do with markets' desire for action than anything else. There is very little risk that the RBNZ will need to act early to head off an overshoot of the inflation target.

Construction will be in the spotlight. The one area where cost pressures are clearly mounting is in the construction sector (though with no real sign of this spilling over into broader price pressures). Strong population growth and the poor productivity of the building industry have left the country with an estimated shortage of 35,000 homes, almost entirely centred in Auckland. While the pace of building has been picking up, it remains inadequate – in fact, the latest building consents data show that the pace in Auckland has actually slowed in recent months. This year should be a different story, with Auckland's Unitary Plan allowing for more and different kinds of building. But the size of the accumulated housing shortage means that builders can expect to be busy for years to come.

House price gains to slow. The housing market has slowed down in recent months after the latest round of loan-to-value restrictions. But the bigger issue for the housing market is that mortgage rates are now rising, a change from the steady decline over the previous couple of years. The scale of the housing shortage makes it hard to forecast an outright decline in house prices, but we expect the rate of increase to slow significantly to around 5% this year, compared to a 15% increase last year.

GDP growth forecasts



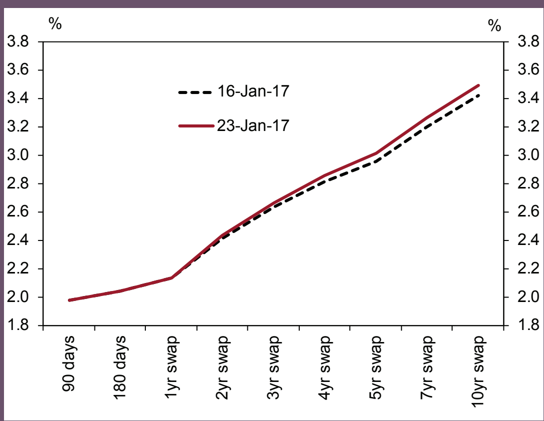
And of course it's an election year, made even more intriguing by the sudden departure of a popular Prime Minister last year. Regardless of which of the major parties ends up forming a government, we suspect that the policy mix will tilt towards more public spending. And there are areas that would clearly benefit from extra resourcing such as roading, public transport, housing infrastructure and tourist facilities, to accommodate the stronger than expected population growth of recent years.

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 Q4 CPI

Jan 26, Last: 0.3%, Westpac f/c: 0.2%, Mkt f/c: 0.3%

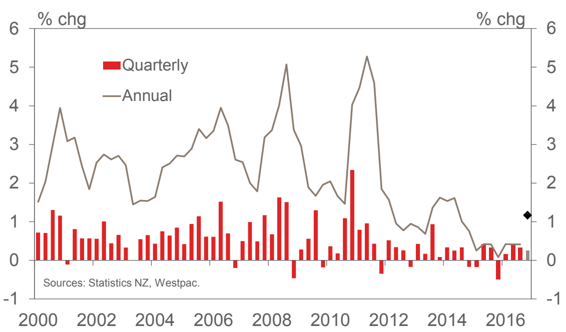
- We expect a 0.2% rise in the Consumer Price Index in Q4 2016. This would lift annual inflation to 1.2%, bringing it back within the RBNZ's target range for the first time in more than two years.
- A rebound in fuel prices accounts for most of the rise in the annual rate. Setting this aside, inflation has been gradually picking up from its lows over the past year.
- The RBNZ will take some comfort from a return to the 1-3% target band. But the renewed strength of the New Zealand dollar means that inflation will remain subdued for some time yet.

Aus Dec Westpac–MI Leading Index

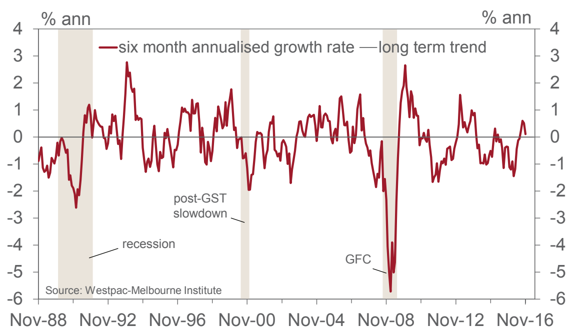
Jan 25, Last: 0.11%

- The six month annualised growth rate in the Westpac-Melbourne Institute Leading Index fell from 0.51% in October to 0.11% in November. Despite the loss of momentum, the update marked the fourth consecutive month of above trend momentum – a run that followed fifteen months of below trend reads.
- The Dec update will include: the ASX200, up 4.2% vs 2.3% last month; the Westpac-MI Consumer Expectations Index, +0.5% vs -3.1% last month; US industrial production, +0.8% vs -0.4% last month; commodity prices, up 9.3% (in AUD terms) vs 11.8% last month; dwelling approvals, +7.0% vs -11.8% last month; the yield spread, widened 6bps vs a 29.3bps widening last month; the Westpac-MI Unemployment Expectations Index, –0.8% vs –0.8% last month; and total hours worked, +0.4% vs -0.6%.

NZ CPI inflation



Westpac-MI Leading Index



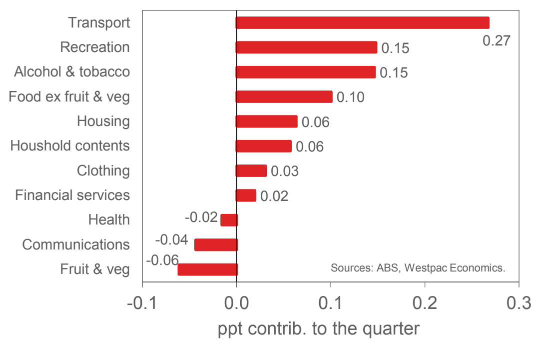
Aus Q4 Consumer Price Index

Jan 25, Last: 0.7%, WBC f/c: 0.7%

Mkt f/c: 0.7%, Range: 0.3% to 1.0%

- The Q3 CPI printed at 0.7% for an annual rate of 1.3%yr, up from 1.0%yr in Q2. The June quarter was the lowest rate of annual inflation since June 1999. The core measures rose 0.3%, with the annual pace at 1.5%yr, from 1.6%yr in Q2 (originally reported as 1.5%yr). Modest gains in housing have been fundamental to holding down core inflation, but there were some signs of AUD depreciation being passed through.
- In the December quarter, a modest reversal of fresh fruit & vegetable prices along with the seasonal decline in pharmaceuticals will partially offset price rises for tobacco, auto fuel and domestic holidays. Our forecast for the headline CPI is 0.7%qtr/1.6%yr, with the core measures forecast to rise an average of 0.6%qtr/1.7%yr.

Contributions 2016 Q4 CPI forecast

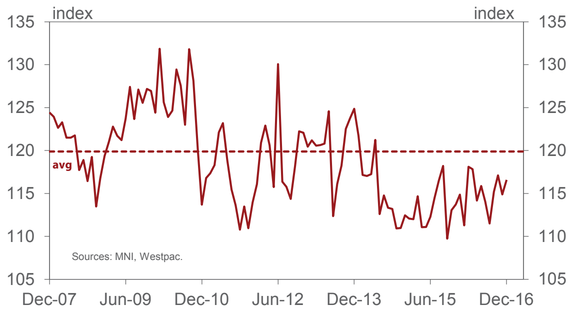


Chn Dec Westpac–MNI Consumer Sentiment

Jan 25, Last: 114.9

- The **Westpac MNI China Consumer Sentiment Indicator** rose 1.5% in December, reversing most of November's 1.9% decline. At 116.6, the Indicator is up 2.5% on a year ago but still below its long run average of 120.
- The January survey was in the field over the first half of the month.

Westpac MNI China CSI



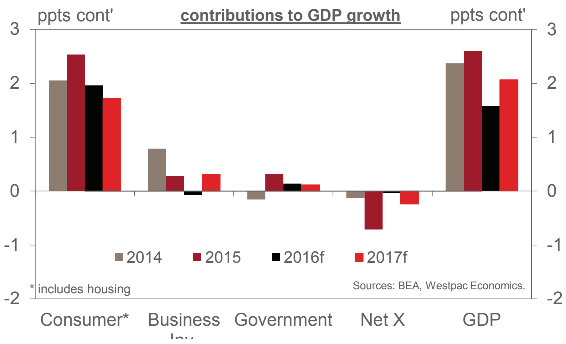
The week ahead

US Q4 GDP

Jan 27, Last: 3.5%, WBC 2.3%

- US GDP has had a tumultuous year, a gain of 3.5% annualised in Q3 following growth of 1.4% and 0.8% in Q2 and Q1 respectively. Annual growth remains soft at 1.6%yr, while the six-month annualised pace sits a little above potential, at 2.3%.
- To September, household consumption growth held up, running at a 2.9% annualised pace. However, business investment has been persistently weak through 2016, while dwelling investment and government spending were broadly flat. There is a heightened degree of uncertainty over the Q4 outcome. The Atlanta Fed's nowcast points to a 2.8% annualised gain, but the NY Fed's estimate is just 1.9%. To our mind, a more modest gain for household consumption and a continuation of the trends in other key sectors is most likely to result in growth of around 2.3% annualised. To this figure, the risks are likely skewed (modestly) to the upside.

Composition of US growth: consumer key



Data calendar

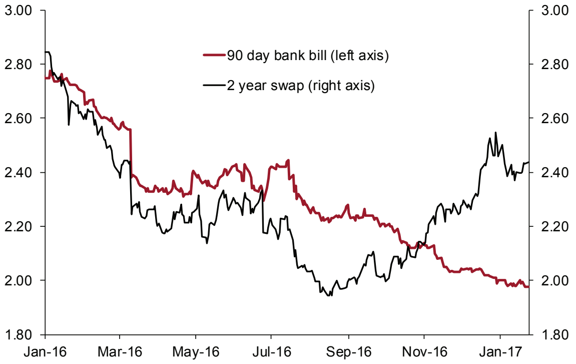
		Last	Market median	Westpac forecast	Risk/Comment
Mon 23					
Eur	Jan Euro Commission consumer conf.	–5.1	–	–	Continues to be supported by ECB and improved conditions.
	ECB President Draghi	–	–	–	Speaking in Torino, Italy.
Can	Nov wholesale trade	1.1%	–	–	Businesses are reporting firming conditions, including orders.
Tue 24					
NZ	Dec BusinessNZ PSI	57.9	–	–	Service sector conditions firm, with sales and orders up.
Eur	Jan Markit manufacturing PMI	54.9	54.8	–	EUR/USD increasing competitiveness.
	Jan Markit services PMI	53.7	53.7	–	Improved domestic climate aiding services.
Ger	Jan Markit manufacturing PMI	55.6	55.4	–	Receives benefit of domestic demand strength and EUR gains.
	Jan Markit services PMI	54.3	54.5	–	Very positive outlook for German service firms.
UK	Dec public sector borrowing £bn	12.2	–	–	Borrowing targets have increased, risk of overshoot remains.
US	Dec existing home sales	0.7%	–1.1%	–1.5%	Impact of higher interest rates to show in coming months.
	Jan Markit manufacturing PMI	54.3	54.3	–	Trump confidence currently outweighing USD impact.
	Jan Richmond Fed index	8	–	–	Manufacturing conditions positive across the country.
Wed 25					
Aus	Dec Westpac–MI Leading Index	0.11%	–	–	Lost a bit of momentum in Oct–Nov but still tracking above trend.
	Q4 CPI	0.7%	0.7%	0.7%	Fuel a positive boost, pharmaceuticals & fresh fruit & veg the offset.
Chn	Westpac–MNI Consumer Sentiment	114.9	–	–	Up 2.5%yr, but below the long-run average.
Ger	Jan IFO business climate survey	111.0	111.3	–	Current conditions strong and outlook improved.
US	Nov FHFA house prices	0.4%	0.3%	–	Price growth will also be hit by higher interest rates.
Thu 26					
NZ	Q4 CPI	0.3%	0.3%	0.2%	Boost from fuel prices; annual inflation to rise to 1.2%.
Aus	Australia Day – Public Holiday	–	–	–	Markets closed.
Chn	Dec industrial profits %yr	14.5%	–	–	Commodity and steel prices have seen industrial profits storm higher.
UK	Q4 GDP	0.6%	0.5%	0.6%	Retail spending up, lower GBP supporting manufacturing and exports
US	Dec wholesale inventories	1.0%	–	–	Continues to create noise for GDP.
	Initial jobless claims	234k	–	–	To remain at record lows.
	Jan Markit service PMI	53.9	–	–	Conditions constructive for growth.
	Dec new home sales	5.2%	–1.0%	–2.0%	Confidence high, but affordability increasingly questionable.
	Dec leading index	0%	0.5%	–	Growth at or a little above trend.
	Dec Chicago Fed national activity index	–0.27	–	–	Points to only moderate growth.
	Jan Kansas City Fed manufacturing index	11	–	–	Strong gains in recent months, including new orders.
Fri 27					
Aus	Q4 PPI	0.3%	–	–	Seasonally soft construction prices will offset rising energy costs.
	Q4 export price index	3.5%	–	–	Rising iron ore & coal prices provide a solid boost in the quarter.
	Q4 import price index	–1.0%	–	–	Rising fuel prices & weaker AUD should boost import prices.
Eur	Dec M3 money supply %yr	4.8%	4.9%	–	Credit data also due.
US	Q4 GDP	3.5%	2.1%	2.3%	Softer consumption growth; investment to remain weak.
	Dec durable goods orders	–4.5%	2.9%	2.0%	Headline continues to bounce around; but underlying trend poor.
	Jan Uni. of Michigan sentiment	98.1	98.1	–	Sentiment riding high.
Sat 28					
UK	Jan Nationwide house prices	0.8%	–	–	Tentative date, 28/1–4/2.

New Zealand forecasts

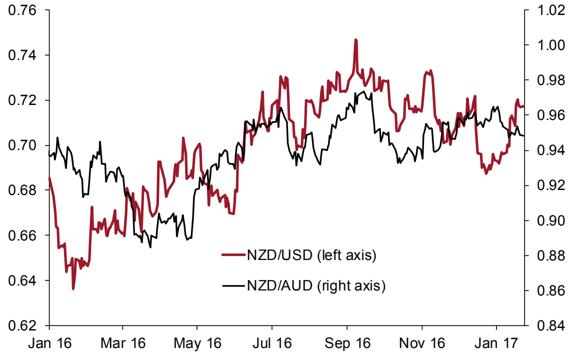
Economic Forecasts	March years				Calendar years			
% change	2015	2016	2017f	2018f	2014	2015	2016f	2017f
GDP (Production) ann avg	3.4	2.4	3.4	3.3	3.4	2.5	3.3	3.3
Employment	3.2	2.0	4.9	2.0	3.6	1.4	5.8	2.1
Unemployment Rate % s.a.	5.4	5.2	4.9	4.4	5.5	5.0	4.8	4.5
CPI	0.3	0.4	1.4	1.2	0.8	0.1	1.2	1.2
Current Account Balance % of GDP	-3.5	-3.1	-2.7	-2.7	-3.2	-3.4	-2.7	-2.6

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	2.50
5 Year Swap	3.10	3.25	3.35	3.40	3.40	3.40
10 Year Bond	3.40	3.60	3.70	3.80	3.85	3.85
NZD/USD	0.71	0.71	0.70	0.69	0.67	0.66
NZD/AUD	0.96	0.96	0.96	0.96	0.96	0.94
NZD/JPY	82.4	83.8	82.6	82.8	81.7	81.8
NZD/EUR	0.68	0.69	0.69	0.69	0.67	0.67
NZD/GBP	0.58	0.58	0.57	0.57	0.56	0.55
TWI	78.6	79.1	78.6	78.2	76.7	76.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 23 January 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.84%	1.85%	1.85%
60 Days	1.92%	1.92%	1.93%
90 Days	1.98%	1.99%	2.01%
2 Year Swap	2.44%	2.43%	2.46%
5 Year Swap	3.01%	3.00%	3.11%

NZ foreign currency mid-rates as at Monday 23 January 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7172	0.6968	0.6912
NZD/EUR	0.6695	0.6624	0.6616
NZD/GBP	0.5791	0.5730	0.5630
NZD/JPY	81.91	81.56	80.89
NZD/AUD	0.9482	0.9523	0.9567
TWI	78.64	77.65	77.31

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	1.6	1.7	2.5
Unemployment %	5.8	6.2	5.8	5.7	5.4	5.3
Current Account % GDP	-3.4	-3.0	-4.8	-3.0	-1.7	-2.5
United States						
Real GDP %yr	1.5	2.4	2.6	1.6	2.1	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	4.8	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	0.6	0.7
Euroland						
Real GDP %yr	-0.3	0.9	1.6	1.6	1.4	1.3
United Kingdom						
Real GDP %yr	2.2	2.9	2.2	2.1	1.6	1.4
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	3.9	3.9
World						
Real GDP %yr	3.3	3.4	3.1	3.2	3.5	3.5
Forecasts finalised 16 December 2016						

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	3.05	3.15	3.25	3.40	3.50	3.65
International								
Fed Funds	0.625	0.625	0.875	0.875	1.125	1.125	1.375	1.375
US 10 Year Bond	2.46	2.55	2.65	2.75	2.85	3.00	3.10	3.25
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	0.7574	0.74	0.74	0.73	0.72	0.70	0.70	0.68
USD/JPY	114.75	116	118	118	120	122	124	124
EUR/USD	1.0678	1.05	1.03	1.01	1.00	1.00	0.99	0.98
AUD/NZD	1.0512	1.04	1.04	1.04	1.04	1.04	1.06	1.06

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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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