

# Weekly Commentary

24 April 2017



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## Inflation at its highest level since 2011

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There has been a marked turnaround in New Zealand's inflation environment in recent months. After lingering below the Reserve Bank's 1 to 3% target band for much of the past two years, inflation jumped higher in the March quarter, with the annual rate climbing to 2.2%. This is the first time that inflation has been above the Reserve Bank's 2% target midpoint since September 2011.

Underlying much of the pick-up in inflation have been two big factors. First, the early part of 2017 saw strong increases in the prices of some fresh produce, such as apples and carrots. Those increases were related in part to climatic conditions. And with poor weather continuing in March and April, we're likely to see some further weather impacts on prices in the June quarter also. Nevertheless, this still represents only a temporary boost to inflation.

Second, petrol prices have risen over the past year in response to higher global oil prices, and they are currently around 12% higher than this time last year.

Both food and fuel prices can be volatile, with factors unrelated to the strength of domestic economy causing sharp swings (such as unseasonable weather conditions). However, even outside of these categories we've been seeing a firming in New Zealand's inflation environment. That's been reflected in the various measures of core inflation which track the underlying trend in price movements, and which have been rising steadily since mid-2016.

On top of this, there were a number of import-heavy areas – clothing, used cars, electronic goods – where prices didn't fall as much as expected in March. This could be a sign that firm domestic demand combined with a fall in import prices is allowing retailers to rebuild their margins. Recent business surveys have shown that retailers have

become more optimistic about their ability to raise prices. If that's the case, it could mean a bit more persistence in the inflation outlook than we previously thought.

Following the stronger than anticipated March quarter result, we now expect that inflation will remain around 2% through the remainder of 2017. That's a markedly stronger outlook for inflation than the Reserve Bank was expecting back in February when it released its latest set of projections. That will go a long way in terms of removing downside risks for inflation expectations, which had been a major bugbear for the RBNZ in recent years. It will also reinforce the outlook for wage inflation over the coming year, with higher costs of living adjustments and firm domestic activity expected to boost wage claims through 2017 and 2018.

In February, the Reserve Bank's projections assumed that the Official Cash Rate would remain on hold until 2019. But with inflation already at levels that the RBNZ wasn't expecting to see for another three years, it now seems unlikely that they will hold off on hikes for that long. We had previously pencilled in the first OCR hike for early 2019, which is on the later side of the range of market forecasts. But that timing will be under review in coming weeks, as part of a broader review of our forecasts.

We still expect that the OCR will be adjusted at a fairly gradual pace. Much of the recent pickup in inflation has

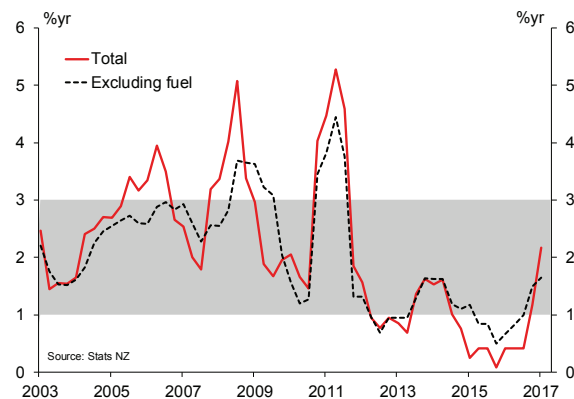
# Inflation at its highest level since 2011 continued

been due to temporary factors, with the impact of recent weather related food price increases and last year's petrol price gains set to fade over time.

What matters for the RBNZ is whether there are signs of a sustained lift in medium term inflation pressures. And that will require an extended period of strong domestic activity. It's true that we have seen some positive signs in terms of domestic activity. But there are a couple of important things to keep in mind. First, New Zealand's population is currently growing at some of the fastest rates we've seen since the 1970s. That alone should mean that we see firmer growth. It also means that we have a greater capacity to grow without a significant increases in inflationary pressures.

Next, and importantly for the RBNZ's policy stance, much of the strength that we've seen in both economic activity and inflation has been underpinned by earlier reductions in interest rates. But the argument runs in both directions: earlier interest rate hikes could see the momentum in activity and inflation fading quickly. In fact, we've already seen the housing market cooling in response to the lift in longer-term interest rates since late 2016.

CPI inflation



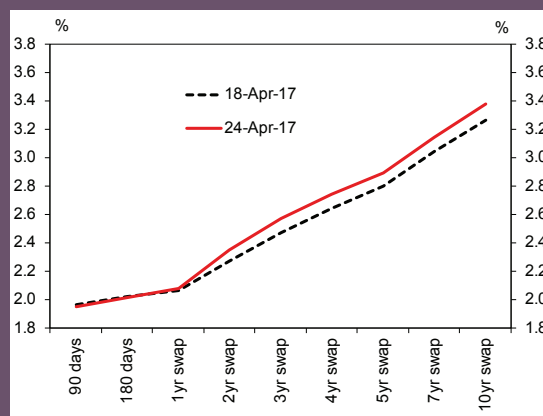
This means that to ensure there is enough momentum in activity to generate the lift in inflation that they are looking for, the RBNZ will need to keep the OCR at low levels for some time yet. The RBNZ will also be wary of adding to the upside pressure on the NZ dollar.

## 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



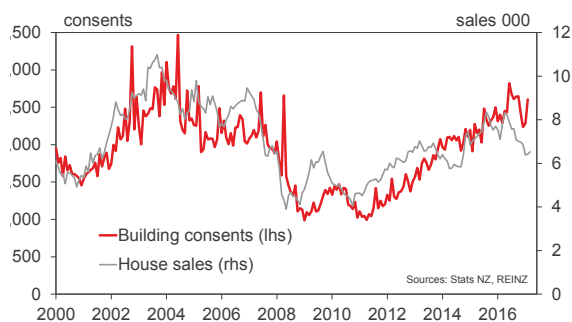
# The week ahead

## NZ Mar building consents

Apr 28, Last: 14.0%, Westpac f/c: -4%

- Residential dwelling consent issuance rebounded in February, rising 14%. That followed a small rise in January and some large falls in late 2016.
- Much of February's increase was centred on Auckland, where despite a growing housing shortage, consent issuance in recent months had been subdued. However, with the Unitary Plan having now cleared many legal hurdles, construction activity appears to be lifting. We've also seen gains in other regions, with the notable exception of Canterbury.
- With much of February's rebound related to multi-unit consents, which can be lumpy on a month-to-month basis, we expect to see some easing in issuance in March. However, smoothing through such volatility, the general trend in issuance is expected to remain positive over the coming months.

## NZ housing activity



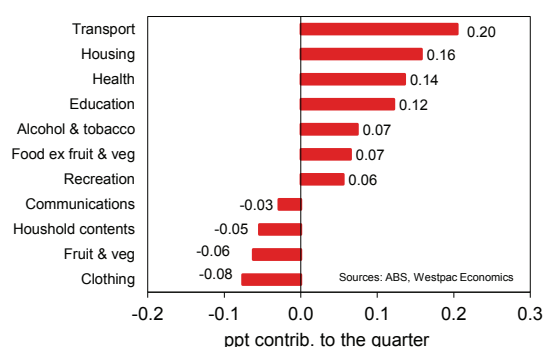
## Aus Q1 Consumer Price Index

Apr 26, Last: 0.5%, WBC f/c: 0.6%

Mkt f/c: 0.6%, Range: 0.3% to 0.8%

- The Q4 CPI printed 0.5% compared to Westpac's forecast for 0.7%. The December quarter presented a clearly softer inflation profile compared to the more mixed results from the September quarter. Early signs of AUD pass-through faded and discounting in the consumer space returned. Westpac's forecast is 0.6%qtr lifting the annual pace to 2.3%/yr from 1.5%/yr. March is a seasonally softer quarter with the ABS seasonal factors boosting our seasonally adjusted estimate to 0.8%qtr.
- We are forecasting a reversal in fresh fruit & vegetable prices, further declines in clothing & footwear plus household contents & services while housing costs remain contained. Offsetting is seasonal jump in pharmaceuticals, the bump in auto fuel prices and signs that the energy crisis is feeding into higher utility bills.

## Contributions 2017Q1 CPI forecasts

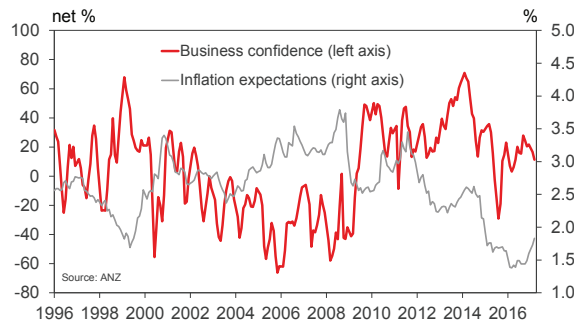


## NZ Apr business confidence

Apr 28, Last: 11.3

- Business confidence declined in March. However, activity indicators showed that firms remained upbeat in terms of their own economic prospects, which is indicative of the strong growth potential in 2017. We'd expect this positive sentiment to continue into Q2. Export intentions demonstrated the greatest jump in optimism from February to March. Last month sentiment around construction pulled back, so we'll be watching to see whether this is sustained.
- Annual inflation jumped to 2.2% in Q1, the first time since 2011 that inflation has been above 2%. The rise was driven by food and fuel price inflation, which are expected to be transitory. In light of this, the survey's pricing gauges will give an indication of the underlying inflation pulse in the economy and firms' willingness to raise prices going forward.

## NZ business confidence and inflation expectations



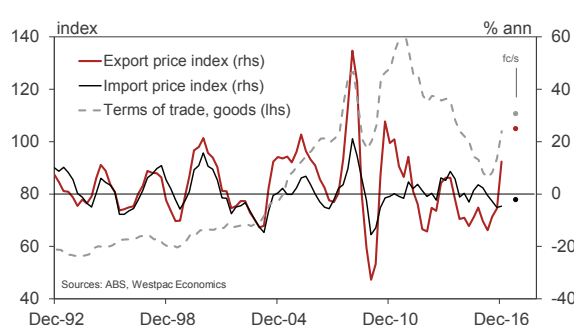
## Aus Q1 import price index

Apr 27, Last: 0.2%, WBC f/c: -0.4%

Mkt f/c: -0.5%, Range: -1.0% to 1.0%

- In the March quarter, the price of imported goods most likely edged lower, down a forecast 0.4%. This continues the downward trend of late, to have prices 2% below the level of a year ago.
- Import prices weakened over the past year largely because of the partial rebound in the Australian dollar.
- In Q1, the Australian dollar appreciated by almost 2% on a TWI basis to be about 7% higher than a year ago. However, higher energy prices in the period will provide a partial offset to the dampening impact of the stronger currency. Gasoline price rose by around 10% in the opening quarter of 2017, extending the rebound since mid-2016.

## Import & export goods prices



# The week ahead

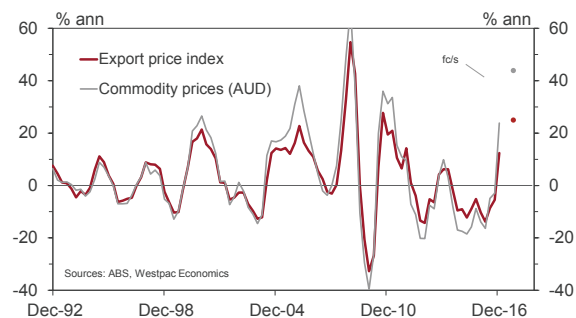
## Aus Q1 export price index

Apr 27, Last: 12.4%, WBC f/c: 6.0%

Mkt f/c: 8.0%, Range: 2.5% to 14.0%

- Export prices rebounded over the past year as commodity prices bounced off the lows prevailing early in 2016.
- The export price index rose by a forecast 6% in Q1, with upside risks, to be around 25% higher than a year ago.
- That would still have the export price index around 13% below the peak of late 2011.
- Commodity prices made sizeable gains in the opening quarter of 2017, up 8.5% in AUD terms on the WCFI measure, and posting even stronger gains as measured on the RBA commodity price index.
- The terms of trade for goods, on these estimates, increases by around 6.5% in the quarter to be 28% above a year ago.

## Commodity prices & export price index



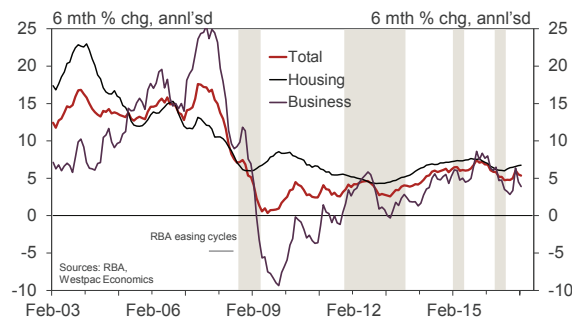
## Aus Mar private sector credit

Apr 28, Last: 0.3%, WBC f/c: 0.4%

Mkt f/c: 0.5%, Range: 0.4% to 0.6%

- Credit to the private sector has begun 2017 on a softer note, weighed down by the volatile business segment. For March, we expect a modest gain of 0.4%, on the heels of a rise of 0.3% in February and a gain of 0.2% in January. By comparison, in 2016, credit grew by an average of 0.5% per month to be 5.6% higher over the year. Business credit expanded by 5.5% in 2016, but has hit a soft spot, continuing the stop-start pattern of late. For March, we expect a small gain on the back of a modest rebound in commercial finance, after business credit fell in both January, -0.4%, and February, -0.1%. Housing credit, boosted by RBA rate cuts in 2016, increased by 0.57% in February and grew by 6.8% annualised over the past three months. A similar result is likely in March, ahead of the dampening impact from tighter regulatory controls.

## Credit: momentum shift



## US Q1 GDP

Apr 28, Last: 2.1%, WBC 1.6%

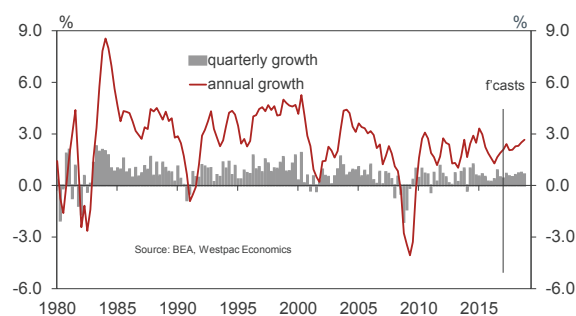
- In Q4, US GDP disappointed expectations, coming in at 2.1% annualised. The consumer was solid and residential investment bounced back after a weak six months, but business investment was lacklustre. Had it not been for inventories, the headline outcome would have been sub-trend.
- Come 2017, there were expectations that growth would firm, particularly given the rapid rise of consumer and business confidence. However, partial data points to this not being the case. The market is now forecasting annualised growth only marginally above 1%. We are more positive at 1.6%.
- A softer consumer and still subdued business investment are the key themes. Inventories should subtract. Note that the nowcasts point to risks being greater than normal.

## US Q1 Employment Cost Index

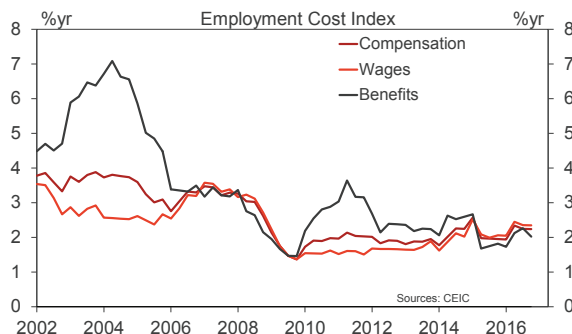
Apr 28, Last: 0.5%, WBC 0.6%

- Last quarter the ECI disappointed again as compensation rose just 0.5% in the quarter to be up 2.2%yr over the year.
- Key in recent quarters has been weakness in benefit growth in the private sector which is being used as an offset against wages growth across many industries.
- Come Q1, a slightly more robust gain is expected in total compensation, circa 0.6%. However, it remains the case that the private sector will continue to mitigate rises in their total labour cost bill.
- In this key measure of household incomes, a pass-through from jobs growth and full employment is yet to be seen.

## US GDP outlook: another soft quarter



## Benefit growth weighing on compensation



# Data calendar

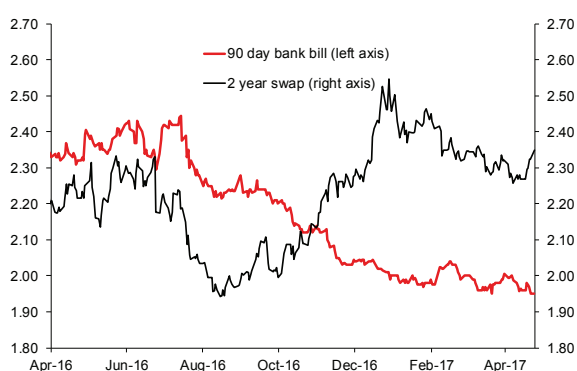
		Last	Market median	Westpac forecast	Risk/Comment
<b>Mon 24</b>					
<b>UK</b>	Apr Rightmove house prices	1.3%	-	-	Low supply is offsetting softer demand.
<b>US</b>	Mar Chicago Fed activity index	0.34	-	-	Up from -0.2 in Jan, indicating just above trend growth.
	Apr Dallas Fed index	16.9	17.5	-	Manufacturing conditions remain strong.
	Fedspeak				Kashkari at investment conf. and Q&A on 'too big to fail'.
<b>Tue 25</b>					
<b>NZ, Aus</b>	Public Holiday, ANZAC Day	-	-	-	Markets closed.
<b>UK</b>	Mar public sector borrowing £bn	1.1	-	-	Deficit to narrow, but softening activity is a headwind.
<b>US</b>	Feb FHFA house prices	0.0%	-	-	Momentum in housing continues...
	Feb S&P/CS home price index	0.86%	0.70%	-	... to be maintained...
	Mar new home sales	6.1%	-0.7%	-	... with new stock quickly absorbed by the market.
	Apr consumer confidence index	125.6	123.7	-	At very strong levels.
	Apr Richmond Fed index	22	17	-	Manufacturing conditions remain strong.
<b>Wed 26</b>					
<b>NZ</b>	Mar net migration	6000	-	-	Mth flows firm, ann. migration to remain around record.
<b>Aus</b>	Q1 CPI	0.5%	0.6%	0.6%	The Q4 surprised to the downside & a stronger AUD.
	Q1 core CPI (avg RBA measures)	0.4%	0.5%	0.5%	Presents downside risks offsetting rising energy costs.
<b>Thu 27</b>					
<b>Aus</b>	Q1 import price index	0.2%	-0.5%	-0.4%	Down on stronger AUD, higher oil prices a partial offset.
	Q1 export price index	12.4%	8.0%	6.0%	Up on commodity prices sharp bounce from recent lows.
	RBA speak	-	-	-	Gov. Lowe speaking at Renminbi Global Cities Dinner.
<b>Chn</b>	Mar industrial profits %yr	8.5%	-	-	Industrial sector has benefitted from commodity prices.
<b>Eur</b>	Apr consumer confidence (final)	-	-	-	Consumers remain buoyant...
	Apr business climate indicator	0.82	-	-	... as do most businesses.
	ECB policy decision	-0.4%	-	-	On hold for foreseeable future.
<b>US</b>	Mar wholesale inventories	0.4%	0.3%	-	Volatility to persist.
	Mar durable goods orders	1.8%	1.5%	-	Investment trend remains poor, though g'th is positive.
	Initial jobless claims	244k	-	-	Remains at historic lows.
	Mar pending home sales	5.5%	-0.5%	-	A lead on existing sales two months out.
	Apr Kansas City Fed index	20	-	-	Strong conditions.
<b>Fri 28</b>					
<b>NZ</b>	Mar building permits	14%	-	-4%	Some moderation after last month's strong gains.
	Mar trade balance \$m	-18	370	370	Boosted by dairy and a recovery in meat exports.
	Apr ANZ business confidence	11.3	-	-	Activity metrics healthy, inflation expectations rising.
<b>Aus</b>	Mar private sector credit	0.3%	0.5%	0.4%	Softer tone of late, hit by often volatile business segment.
	Q1 PPI	0.5%	0.7%	0.5%	Stronger AUD offsetting impact of rising energy costs.
<b>Eur</b>	Mar M3 money supply %yr	4.7%	-	-	Credit data also due.
	Apr CPI %yr (advance)	1.5%	-	-	Flash estimate; inflation pulled back in March.
<b>UK</b>	Apr GfK consumer sentiment	-6	-	-	Rising inflation likely to dampen household sentiment.
	Q1 GDP (advance)	0.7%	-	-	Manuf/exporting offsetting softer domestic demand.
	Apr Nationwide house prices	-0.3%	-	-	Uncertainty and income squeeze weighing on prices.
<b>US</b>	Q1 employment cost index	0.5%	0.6%	-	Continues to see solid gains; benefits a drag.
	Q1 GDP (annualised)	2.1%	1.2%	-	Greater than usual uncertainty for Q1 release
	Apr Chicago PMI	57.7	56.9	-	Points to robust growth for manufacturers.
	Apr Uni. of Michigan sentiment	98.0	98.4	-	Republican/ Democrat divide persists.
	Fedspeak	-	-	-	Harker on 'How STEM can get you anywhere'.
<b>Sun 30</b>					
<b>Chn</b>	Apr manufacturing PMI	51.8	-	-	Momentum looks likely to abate...
	Apr non-manufacturing PMI	55.1	-	-	... in coming months.

# New Zealand forecasts

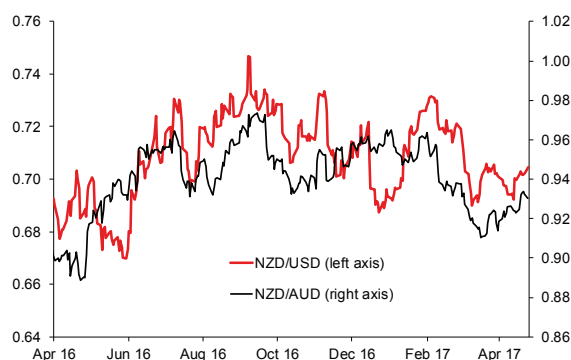
Economic Forecasts	March years				Calendar years			
	% change	2015	2016	2017f	2018f	2015	2016	2017f
GDP (Production) ann avg	3.4	2.4	3.1	3.3	2.5	3.1	3.2	3.4
Employment	3.2	2.0	5.3	2.1	1.4	5.8	2.3	1.5
Unemployment Rate % s.a.	5.4	5.2	4.9	4.7	4.9	5.2	4.7	4.7
CPI	0.3	0.4	2.0	1.5	0.1	1.3	1.8	2.1
Current 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	2.40	2.40	2.40	2.50	2.60	2.70
5 Year Swap	3.00	3.10	3.15	3.25	3.35	3.50
10 Year Bond	3.30	3.50	3.60	3.65	3.75	4.00
NZD/USD	0.69	0.68	0.67	0.66	0.64	0.63
NZD/AUD	0.91	0.91	0.91	0.91	0.92	0.93
NZD/JPY	81.4	80.2	80.4	80.3	79.7	79.4
NZD/EUR	0.66	0.66	0.66	0.66	0.65	0.64
NZD/GBP	0.57	0.57	0.56	0.56	0.54	0.53
TWI	76.2	75.8	75.4	74.9	74.2	73.6

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 24 April 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.83%	1.88%	1.83%
60 Days	1.89%	1.93%	1.90%
90 Days	1.95%	1.99%	1.98%
2 Year Swap	2.35%	2.27%	2.32%
5 Year Swap	2.90%	2.83%	2.93%

NZ foreign currency mid-rates as at Monday 24 April 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7047	0.6936	0.7009
NZD/EUR	0.6513	0.6552	0.6469
NZD/GBP	0.5493	0.5601	0.5617
NZD/JPY	77.86	77.02	77.64
NZD/AUD	0.9302	0.9268	0.9204
TWI	76.67	76.03	76.33

# International forecasts

Economic Forecasts (Calendar Years)	2013	2014	2015	2016	2017f	2018f
<b>Australia</b>						
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
<b>United States</b>						
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
<b>Japan</b>						
Real GDP %yr	1.4	0.0	0.5	0.6	0.8	1.0
<b>Euroland</b>						
Real GDP %yr	-0.3	0.9	1.6	1.7	1.6	1.2
<b>United Kingdom</b>						
Real GDP %yr	2.2	2.9	2.2	2.0	1.9	1.5
<b>China</b>						
Real GDP %yr	7.7	7.3	6.9	6.7	6.6	6.0
<b>East Asia ex China</b>						
Real GDP %yr	4.2	4.1	3.7	3.7	3.8	3.8
<b>World</b>						
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
<b>Australia</b>								
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	2.54	2.85	3.00	3.05	3.15	3.25	3.40	3.40
<b>International</b>								
Fed Funds	0.875	1.125	1.125	1.375	1.625	1.625	1.875	1.875
US 10 Year Bond	2.24	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	0.7530	0.76	0.75	0.74	0.72	0.70	0.68	0.66
USD/JPY	109.21	111	112	114	116	117	118	118
EUR/USD	1.0716	1.05	1.04	1.03	1.02	1.01	1.00	0.99
AUD/NZD	1.0762	1.10	1.10	1.10	1.09	1.09	1.08	1.06

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