Weekly Commentary

24 October 2017

The shape of things to come

After nearly a month of negotiations, New Zealand finally knows the form of the next Government: New Zealand First will support the Labour Party to form a minority coalition government. The Green Party will support the new government on confidence and supply.

No policy positions have been formally announced yet. However, comments by the various party leaders have highlighted some key areas where we are likely to see changes. These are discussed below.

Policy details so far suggest some downside risk to our GDP forecast for 2018 and upside risk to our GDP forecasts for 2019 and 2020, but this could change as new information comes to light.

Labour's planned fiscal stimulus, on its own, could add around 20bps to the RBNZ's longer term forecast for the OCR, although other as yet unannounced policy changes will also have an effect.

Housing, taxation and investment

How the tax treatment of property changes under the new Government is crucial to the outlook – not only for house prices themselves, but also for the economic cycle and the long-run health of the economy.

Labour has said that they plan to convene a tax working group that might recommend some variation on a capital gains tax, land tax or deemed rate of return tax on property excluding the family home. We have long argued that such tax changes would help address some of New Zealand's economic imbalances and housing affordability issues. Such changes could have a material negative affect on house prices, but it is far from certain that the coalition government will go ahead with Labour's plan. The Greens are probably in support, but New Zealand First said before the election that ruling out a capital gains tax would be a bottom line in any coalition negotiation.

Labour has also signalled that it would like to introduce other changes that would affect the attractiveness of residential property as an investment (such as removing property investors' ability to write off losses on rental properties against their personal income). If these measures do survive the coalition negotiations, they might reduce house prices by a little, but the effect would be small.

Labour planned to start an investment fund charged with building 100,000 affordable houses (and the associated infrastructure) over ten years. In our assessment, this would have only a small effect on average house prices, although it would skew the mix of new construction towards smaller/cheaper dwellings. The investment fund would probably cause us to lift our construction forecasts, and therefore our GDP forecasts. But the effect would probably be small in the short run, because in these times of a capacity constrained construction industry some private sector activity will be squeezed out.

The one housing-related policy that has been announced by the Prime Minister elect is a ban on foreign buyers of residential property and tighter restrictions on the sale of rural land. This could have a downward impact on house prices, but based on international experience, the impact is likely to be fairly small.

Closing New Zealand off to foreign direct investment in the farm sector or business sector would be a more worrying

The shape of things to come continued

development. The OECD has identified that New Zealand's poor productivity performance is partly due to our isolation, and so improving connectivity to larger overseas economies would be of benefit. While lifting exports is part of that, the OECD singled out our restrictive foreign investment regime as a particular impediment to productivity growth. Restricting FDI could isolate New Zealand further.

Migration

Both Labour and NZ First campaigned on reductions in net immigration. Labour estimated that its policies would reduce net immigration by 20,000 to 30,000 people per year, focused on lower skilled arrivals and students. However, net immigration has already turned. Departures have picked up, as those came over in earlier years on temporary visas are now departing. On top of this, new arrivals have fallen. Going forward, we are already forecasting a substantial reduction in net immigration, from over 70,000 now to around 20,000 by the end of 2020. If immigration regulations were tightened, we would reduce our net immigration forecast even further. In turn, this would reduce our GDP forecast.

Fiscal policy

The new coalition looks set to spend more than the previous Government, only partly funded by extra tax. Spending will be weighted towards education and health. It will be partly funded by cancelling the income tax cuts that were legislated to take effect on April 1 and by introducing new taxes. The balance would be funded by an additional $7bn of net core Crown debt over the next four years.

If the coalition sticks roughly to Labour's proposed fiscal policy, the changes would be fairly immaterial for ratings agencies and would not lead to significantly higher government bond rates.

Monetary Policy

Both Labour and New Zealand First campaigned on changing the focus of the Reserve Bank. In particular, New Zealand First had pushed what they termed a "Singaporean" model, requiring the RBNZ to target a favourable level of the exchange rate, rather than the inflation rate. However, in his press conference last week, Mr Peters said that Labour had not agreed to this model.

Nevertheless, we are likely to see some change in monetary policy on two key fronts. First is a likely broadening of the policy considerations. Labour favours a dual mandate for the Reserve Bank, with a focus on full employment as well as price stability. New Zealand First has long advocated for a greater focus on the export sector. However, in the absence of numerical targets for either unemployment or the exchange rate, requiring the RBNZ to account for these considerations is unlikely to make a significant difference to how monetary policy is run as a whole. The RBNZ already factors in such concerns when it sets policy.

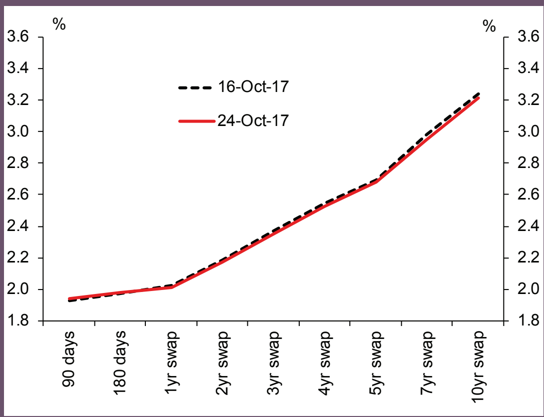
Second, we're likely to see a shift from the single decision maker model to a committee, with Labour proposing a mix of four internal and three external members. Again, this is unlikely to lead to substantially different monetary policy decisions – the RBNZ already operates an internal committee for monetary policy decisions. There has been no mention of raising or widening the existing inflation target range.

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. 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

Aus Q3 Consumer Price Index

Oct 25 Last: 0.2%, WBC f/c: 0.7%
Mkt f/c: 0.8%, Range: 0.7% to 1.2%

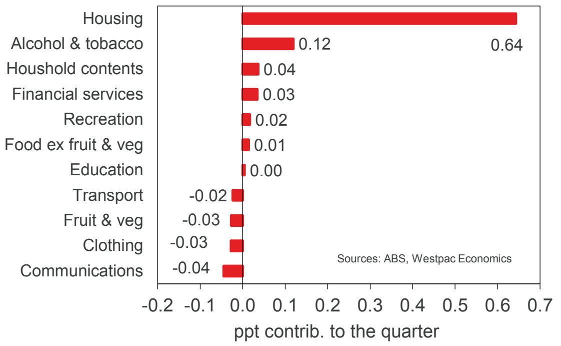
- The Q2 CPI printed 0.2% compared to the market median of 0.5%. The annual rate moderated to 1.9%yr from 2.1%yr in Q1. The core measures rose as expected at 0.5%qtr highlighting just how modest the broader inflation picture is outside of housing or health. The annual pace of the average of the core measures was flat at 1.8%yr.
- Westpac is forecasting a 0.74% Q3 rise in the headline CPI of which, 0.47ppts come from energy. Ex-energy (household electricity and gas) inflation rises 0.27%. Core inflation is forecast to print 0.3%qtr (0.29%) holding the annual rate flat at 1.8%yr. The trimmed mean forecast is 0.27% while the weighted median forecast is 0.32%. The two quarter annualised pace of core inflation decelerates to 1.7%yr from 2.1%yr, below the RBA's target band.

Aus Q3 import price index

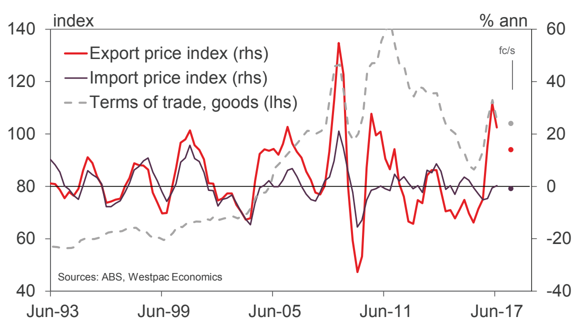
Oct 26, Last: –0.1%, WBC f/c: –2.0%
Mkt f/c: -1.8%, Range: -3.0% to 0.0%

- Import goods prices were little changed over the past year, with a Q2 result of –0.1%qtr, +0.3%yr.
- For the September quarter, goods imports likely became cheaper, declining by a forecast 2.0%qtr, as the currency strengthened.
- In Q3, the Australian dollar increased by 3.0% on a TWI basis and jumped 4¢ to US79¢, a 5% increase. Global energy prices in Q3 fell modestly, in AUD terms, down around 3%.

Contributions 2017Q3 CPI forecast



Import & export goods prices



Aus Q3 export price index

Oct 26, Last: –5.7%, WBC f/c: –3.2%
Mkt f/c: -4.0%, Range: -6.0% to 3.0%

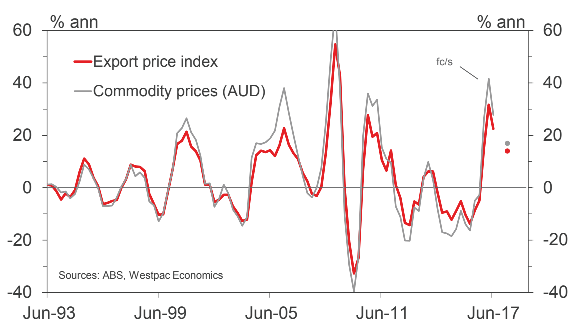
- The sharp rebound in export prices during 2016 and into early 2017 was punctuated by a meaningful fall in the June quarter, as commodity prices eased back from recent highs.
- In Q2, the export goods price index fell by 5.7%, to still be 22.5% above the level of a year earlier.
- For Q3, export goods prices are expected to decline by around 3.2%. The RBA reports that commodity prices were flat in US dollar terms for the period and down around 5% in Aussie dollar terms.
- The terms of trade for goods, on these estimates, fell by a touch over 1% in the third quarter, to be around 11% higher than a year ago. Note, we expect this fall to be partially offset by a rise in the terms of trade for services.

ECB October policy meeting

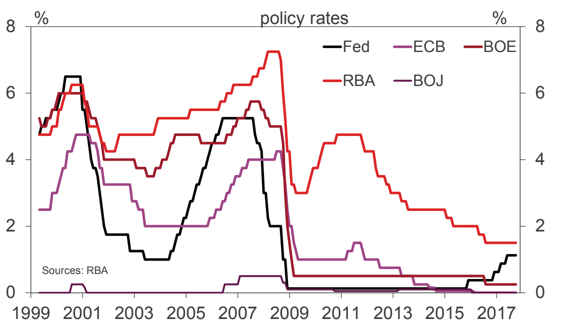
Oct 26, deposit rate, last –0.40%, WBC –0.40%

- All eyes remain on the ECB Governing Council as they near the end of their current asset purchase program, which is due to expire in December.
- At the October meeting, some formal announcement of an extension of the program for 2018 is anticipated. Whether all the detail is made available remains an open question.
- To our mind, the most logical program structure would be to taper from €60bn to €40bn in the first half of 2018, then to €20bn in the second six months. That would allow a smooth transition to a flat balance sheet come 2019. The alternative would be a circa €30bn pace through the entire year. Either way, some €360bn in additional liquidity would be provided to markets and the economy during 2018. Interest rates will remain unchanged in 2018 and early 2019.

Commodity prices & export price index



ECB rates on hold; asset purchases to continue



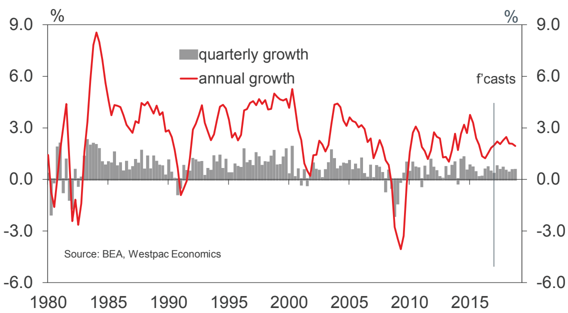
The week ahead

US Q3 GDP

Oct 27, last 3.1%, WBC 2.2%

- The September quarter was a tumultuous time for the US economy, owing to the arrival of Hurricanes Irma and Harvey.
- The largest impact is likely to be seen in household consumption and secondly construction. Consumption growth is expected to be quite modest, while construction's contribution to growth, if any, will be negligible. Recent durables goods data implies equipment spending started the quarter well; so even with the storms, it should provide a solid contribution to growth in the quarter.
- Overall, we look for growth of 2.2% annualised in the quarter, down from 3.1% in Q2. A bounce back towards 3.0% is then anticipated in Q4 as restocking occurs. The post-hurricane rebuild will aid growth in 2018, albeit likely only at the margin.

US GDP to average a little over 2% in 2017



Data calendar

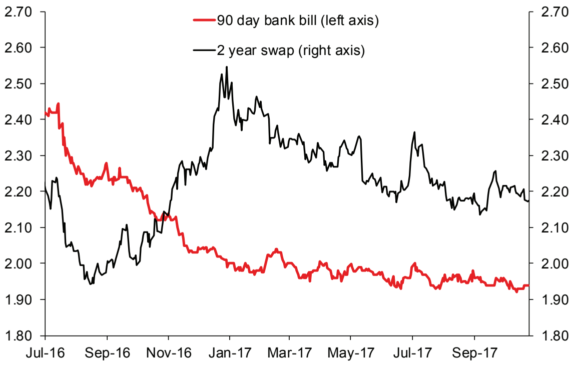
		Last	Market median	Westpac forecast	Risk/Comment
Tue 24					
Eur	Oct Markit manufacturing PMI flash	58.1	57.7	–	At very elevated levels…
	Oct Markit services PMI flash	55.8	55.8	–	… strength broad based.
US	Oct Markit manufacturing PMI flash	53.1	53.0	–	Significant disparity between ISMs and Markit…
	Oct Markit services PMI flash	55.3	55.0	–	… for both surveys.
	Oct Richmond Fed index	19	16	–	Considerable strength shown by regional surveys.
Wed 25					
Aus	Q3 CPI	0.2%	0.8%	0.7%	Ex housing and energy, CPI rises just 0.1%qtr. Core inflation…
	Q3 core CPI (avg RBA measures)	0.5%	0.5%	0.3%	… should print 0.3%qtr/1.8%yr as broader pressures are absent.
UK	Q3 GDP (advanced)	0.3%	0.3%	–	Softness in activity (esp. household spending) continuing.
US	Sep durable goods orders prelim.	2.0%	1.3%	1.0%	Robust through first two months of Q3 after soft first half.
	Aug FHFA house prices	0.2%	0.4%	–	Solid annual growth continues.
	Sep new home sales	–3.4%	–1.8%	–1.0%	Housing sales data has levelled out.
Thu 26					
NZ	Sep trade balance, $m	–1235	–1260	–800	Pickup from unusually low dairy export volumes in August.
Aus	Q3 import price index	–0.1%	–1.8%	–2.0%	A higher AUD, +5% vs USD, made imports cheaper.
	Q3 export price index	–5.7%	–4.0%	–3.2%	Export prices also down, dented by higher AUD.
	RBA Deputy Governor Guy Debelle	–	–	–	"Uncertainty", lecture at Sydney University, 6:45pm.
Eur	Sep M3 money supply %yr	5.0%	5.0%	–	Credit data also due.
	ECB policy decision	–0.4%	–0.4%	–0.4%	We hope to see clarity on 2018 plans at Oct meeting.
US	Sep wholesale inventories prelim.	0.9%	–	–	Likely to see greater volatility in coming months.
	Initial jobless claims	222k	–	–	Very low.
	Sep pending home sales	–2.6%	0.3%	–	Have been weaker than existing sales.
	Oct Kansas City Fed index	17	–	–	Considerable strength shown by regional surveys.
Fri 27					
Aus	2016–17 annual national accounts	–	–	–	Annual detail often foreshadows revisions to quarterly GDP est's.
	Q3 PPI	0.5%	–	–	Could be useful for further insights into energy costs.
Chn	Sep industrial profits %yr	24%	–	–	Commodity/steel prices continuing to benefit profits.
US	Q3 GDP 1st estimate %annualised	3.1%	2.5%	2.2%	Hurricanes to impact consumer/construction.
	Oct Univ. of Michigan sentiment	101.1	101.0	–	Less positive than Conference Board, but still above average.
Sat 28					
UK	Nationwide house prices	0.2%	–	–	Housing market remains soft, but may now be finding a base.

New Zealand forecasts

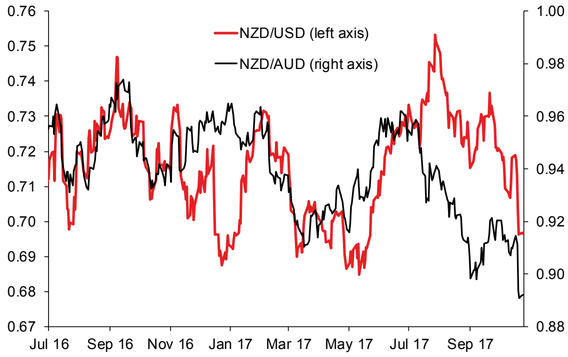
Economic Forecasts	2017				Calendar years			
% change	Jun	Sep	Dec	Mar	2015	2016	2017f	2018f
GDP (Production) ann avg	0.8	0.7	0.6	0.8	2.5	3.0	2.6	2.9
Employment	-0.1	1.1	0.4	0.6	1.4	5.8	2.6	1.8
Unemployment Rate % s.a.	4.8	4.6	4.7	4.7	4.9	5.2	4.7	4.6
CPI	0.0	0.5	0.3	0.3	0.1	1.3	1.8	1.3
Current Account Balance % of GDP	-2.8	-2.7	-2.8	-2.5	-3.2	-2.5	-2.8	-3.3

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	2.15	2.20	2.30	2.40	2.50
5 Year Swap	2.70	2.80	2.90	3.00	3.10	3.20
10 Year Bond	2.95	3.10	3.20	3.30	3.40	3.45
NZD/USD	0.70	0.69	0.68	0.67	0.66	0.66
NZD/AUD	0.92	0.92	0.92	0.93	0.94	0.94
NZD/JPY	77.7	77.3	76.8	76.4	75.9	75.4
NZD/EUR	0.60	0.59	0.59	0.59	0.58	0.58
NZD/GBP	0.55	0.54	0.54	0.54	0.54	0.54
TWI	74.5	73.9	73.4	72.9	72.6	72.2

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 24 October 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.81%	1.85%	1.84%
60 Days	1.87%	1.90%	1.89%
90 Days	1.94%	1.95%	1.96%
2 Year Swap	2.18%	2.21%	2.23%
5 Year Swap	2.68%	2.74%	2.75%

NZ foreign currency mid-rates as at 24 October 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6965	0.7057	0.7316
NZD/EUR	0.5927	0.6014	0.6143
NZD/GBP	0.5277	0.5394	0.5424
NZD/JPY	79.00	79.50	82.12
NZD/AUD	0.8922	0.9098	0.9213
TWI	73.76	75.12	76.79

International forecasts

Economic Forecasts (Calendar Years)	2014	2015	2016	2017f	2018f	2019f
Australia						
Real GDP % yr	2.8	2.4	2.5	2.3	3.0	2.5
CPI inflation % annual	1.7	1.7	1.5	2.1	2.5	2.8
Unemployment %	6.2	5.8	5.7	5.7	6.1	6.0
Current Account % GDP	-3.0	-4.7	-2.7	-1.6	-2.6	-2.7
United States						
Real GDP %yr	2.6	2.9	1.5	2.1	2.1	1.8
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	4.2	4.3
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	0.8	0.7
Euroland						
Real GDP %yr	1.3	2.0	1.8	2.1	1.8	1.6
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	6.7	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	3.6	3.6	3.5
Forecasts finalised 13 October 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	1.70	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.77	2.75	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	2.35	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	0.7846	0.76	0.75	0.74	0.72	0.70	0.70	0.70
USD/JPY	113.15	113	114	114	115	115	116	116
EUR/USD	1.1816	1.17	1.16	1.15	1.14	1.13	1.13	1.13
AUD/NZD	1.1228	1.09	1.09	1.09	1.07	1.06	1.06	1.07

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