Weekly Commentary

27 November 2017

Growth slowdown under way

Our latest quarterly *Economic Overview,* released last week, traces the contours of growth that we expect for the New Zealand economy over the coming years. We've revised down our GDP forecast for 2018, but upgraded our forecasts for 2019 and 2020. These changes reflect the impact of the new Government's policies, but also the tone of the recent data.

Market opinion generally seems to be that the new Government's policies will boost GDP, inflation and the OCR. We agree with that, but only up to a point. Increased government spending will certainly boost activity, but the crowding-out of private activity must also be considered. Meanwhile, the Government's plans to cool the housing market and reduce net migration will weigh on the economy next year. Our view remains that the Reserve Bank will not need to raise interest rates until late 2019.

Last week's data releases highlighted some of the conditions we see for a slowdown in growth in the near term. Retail spending eked out a modest gain of just 0.2% in the September quarter, after a 1.8% rise in the June quarter. This was partly a comedown from major sporting events such as the Lions rugby tour in the June quarter, reflected in particular in a sharp drop in accommodation and hospitality spending in September. But there has also been a more widespread slowdown in spending growth compared to recent years, especially in housing-related categories such as furniture and hardware.

In New Zealand, consumer spending growth tends to be closely correlated with the strength of the housing market. The latest slowdown in retail spending suggests that the relationship is alive and well. House sales are down by about a third from last year's peak, and the double-digit house price growth we saw in previous years has given way to a period of quite subdued gains.

We think that the recent housing slowdown will persist for some time. To be fair, nationwide house prices have perked up in the last few months, and we wouldn't be surprised to see a further rise in the near term – there have been some reductions in fixed-term mortgage rates, and there could be a short-lived rush to get into the housing market ahead of the new Government's restrictions on non-resident buyers. But we think that other policy changes, such as the planned extension of the 'bright line' test for taxing capital gains on investment properties, will push house prices lower again over 2018 and beyond. If we're right, that implies a significantly slower pace of spending growth than retailers have been used to over recent years.

Another factor that will dampen spending growth in coming years is a slowdown in migration-led population growth. While net migration in the month of October was a little higher than we expected, the details support our view that the balance has passed its peak.

Departures of non-New Zealand citizens have been steadily rising since mid-2016 and are now 30% higher than this time last year. This group includes people who would have come over in recent years on temporary work and student visas. Those who come over on these programs typically stay for around three to four years. Given that the surge in foreign arrivals began in 2013, we've been expecting to see a corresponding surge in departures. This trend looks likely to continue for some time yet, and will drive a substantial

Growth slowdown under way continued

downturn in total net migration over the coming year.

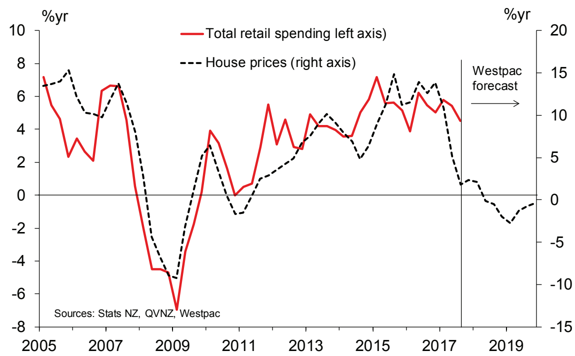
We expect annual net migration to slow from around 70,000 people now to a low of 10,000 people by 2021. Most of the expected change is due to natural forces that drive net migration (such as the strength of the global economy), and has been a feature of our forecasts for some time. However, the new Government's proposed changes to visa requirements for students and low-skilled workers has given us reason to revise our forecast even lower.

The slowdown in net migration will have a number of significant impacts on the economy. Most notably, it will result in population growth slowing from 2.1% currently to 0.8% – a huge reduction in the rate of potential GDP growth and a key reason that we expect lower GDP growth over time.

The other notable development last week was a further fall in dairy prices at the latest GlobalDairyTrade auction. The decline in dairy product prices since the middle of this year, despite cuts to milk production forecasts in that time, suggests that the weakness lies on the demand side of the equation.

We noted in our latest Economic Overview that while global growth as a whole is improving, the mix of growth is not quite as favourable for New Zealand's exporters. China – the

Retail spending and house prices



dominant market for many of our agricultural exports – is starting to slow, as it looks to reorient away from the credit-fuelled investment that has driven growth in recent years.

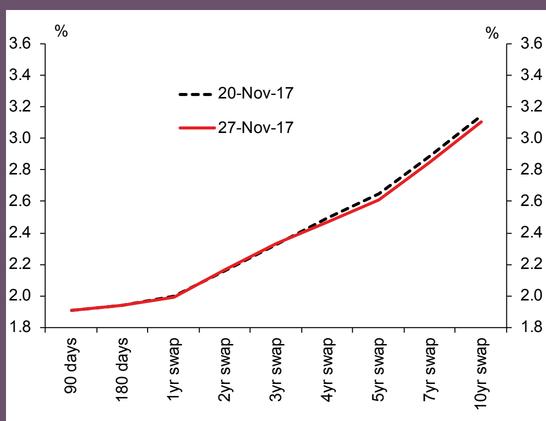
The outlook for dairy isn't gloomy by any means – we expect a farmgate milk price of $6.20/kg for this season, which is close to the average of the last decade. But it's likely to leave farmers cautious about new spending and more focused on debt reduction, after two very poor seasons in 2015 and 2016 that put a severe strain on dairy farm balance sheets.

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

NZ RBNZ Financial Stability Report

Nov 29

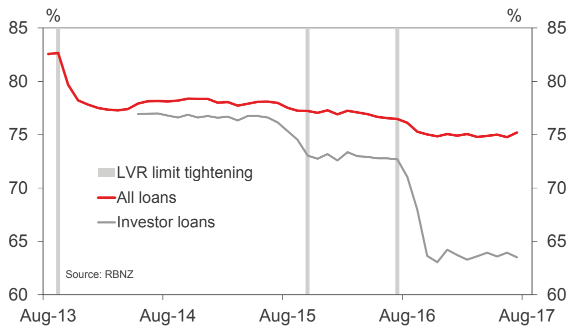
- The RBNZ's six-monthly review of the state of the financial system is likely to be relatively sanguine. Banks are well capitalised, loan impairments remain low, and mortgage lending growth has slowed.
- The RBNZ has said it is reviewing the criteria for easing the loan-to-value ratio restrictions on mortgage lending. We think the key hurdle is whether easing the LVR restrictions would lead to a resurgence in housing market pressures. For now the RBNZ has taken a cautious view as to whether the new Government's policies will suppress house prices, but on our forecasts there should be sufficient evidence of this by mid-2018.

NZ Oct residential building consents

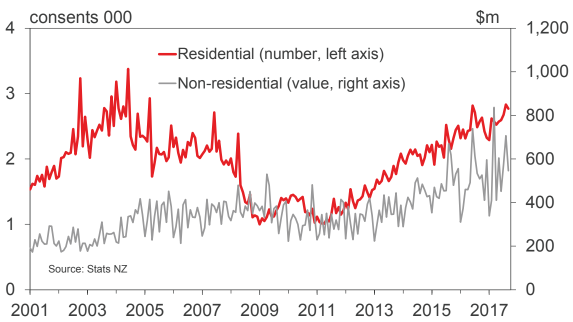
Nov 30, Last: -2.3%, WBC f/c: -2.0%

- Consent issuance softened in September, but remained at a firm level. Much of the recent strength in consents relates to the apartments/multiple category. Issuance in this category can be lumpy on a month-to-month basis. And following a large rise in recent months, we expect a moderation in this group will pull total consent issuance down 2% in October.
- Issuance in Auckland will warrant close attention. If the pick-up we saw in recent months is sustained, Auckland would finally start eating into its significant shortage of housing.
- While a large amount of work is being consented, there are questions about capacity in the construction sector. We expect that the level of building activity will remain elevated for some time, but future increases may be gradual.

Average LVR of new loan commitments



NZ building consents



NZ Nov business confidence

Nov 30, Last: -10.1

- Business confidence has been dropping since August, falling into negative territory in October. A key reason for this was uncertainty ahead of September's general election. New Zealand business confidence is expected to decline further in November reflecting nervousness around the policy environment following the formation of the Labour-led government. On the activity front, we anticipate that capacity constraints will continue to hinder activity in a range of sectors, particularly construction. In addition, tightness in credit conditions, difficulties accessing skilled labour and slowing economic growth will continue to weigh on businesses' expectations for activity over the coming months. Putting this together, we expect businesses' investment intentions will soften going into 2018 as businesses adjust to the new policy environment. Inflation expectations are expected to remain close to the RBNZ's target midpoint.

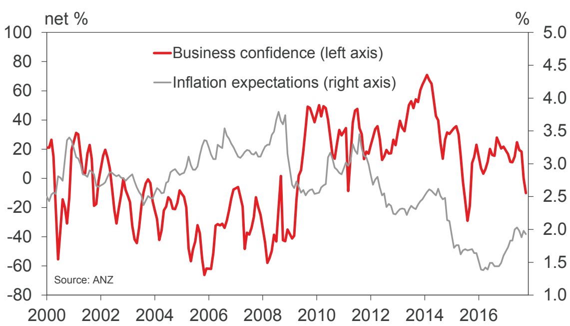
NZ Q3 terms of trade

Dec 1, Last: 1.5%, WBC f/c 1.5%

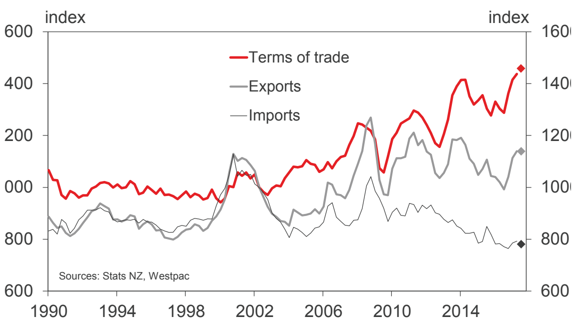
Mkt f/c: 1.3%, Range: 0.0% to 3.7%

- New Zealand's terms of trade rose 1.5% in the June quarter, falling just shy of setting a new 66-year high. We expect it to reach that milestone in the September quarter.
- We estimate that export prices were flat overall for the quarter. Dairy prices were unchanged after a strong surge in the previous few quarters. Meat and log prices were up slightly, while the stronger currency suggests lower prices for manufactured goods exports.
- We expect a 1.5% fall in import prices, largely due to a 6% fall in petroleum products.

NZ business confidence and inflation expectations



NZ Terms of Trade



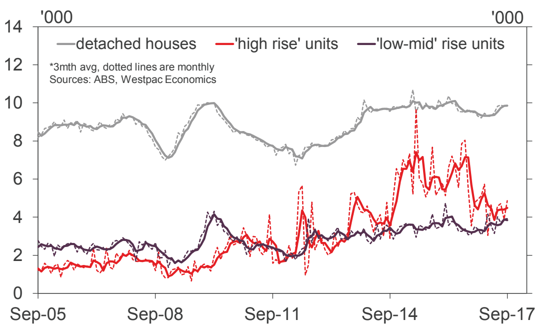
The week ahead

Aus Oct dwelling approvals

Nov 30, Last: 1.5%, WBC f/c: –1.5%
Mkt f/c: -1.0%, Range: -4.0% to 2.0%

- Sep dwelling approvals came in above expectations with total approvals up 1.5% and the detail showing a surprise 20% jump in high rise and a modest gain for non high rise approvals.
- Both high rise and non high rise segments are still pointing to likely slowdowns in the months ahead. Site purchases point to a further wind down in high rise projects. Meanwhile construction-related housing finance approvals – a reasonable proxy for non high rise approvals – pulled back sharply through Aug-Sep. Of course, linking these indicators to month to month moves in approvals is difficult, particularly for high rise activity. On balance we expect approvals to retrace 1.5% but the high rise jump in Sep could see a sharper pull back depending on the 'lumpy' projects in this segment.

Dwelling approvals: houses, low-mid & high rise

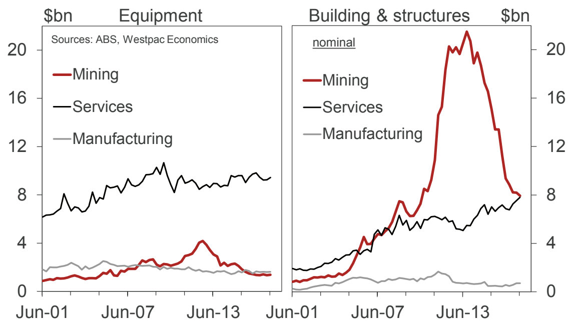


Aus Q3 business capex

Nov 30, Last: 0.8%, WBC f/c: –0.3%
Mkt f/c: 1.0%, Range: –5.5% to 3.0%

- Business spending on capex increased by 0.8% in the June quarter, to be 3% below the level of a year ago. Weakness is centred in mining, -15%yr, with a partial offset from services, +3.7%yr.
- Equipment spending rebounded in the June quarter, +2.7%, led by services, to be flat over the year.
- There is an emerging stabilisation in building & structures with the mining investment wind-down almost complete. The Q2 outcome was -0.6%qtr, -5%yr.
- For Q3, we anticipate a 0.3% decline in capex spend, including: a rise in equipment (+0.8%), led by services; and only a relatively small decline in building & structures, -1.2%.

CAPEX: by industry by asset

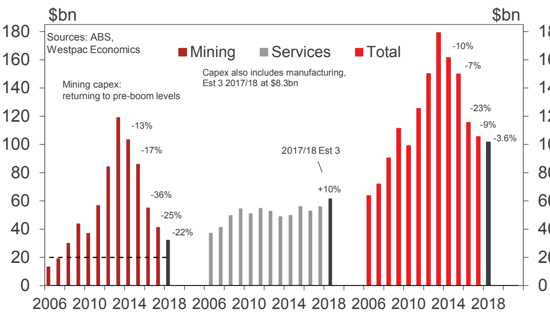


Aus 2017/18 capex plans, AUDbn

Nov 30, Last (Est 3): 101.8, Mkt f/c: 105.4, Range: 103.0 to 110.0

- Capex spend will inevitably decline in 2017/18, with the final stages of the mining investment wind-down the key force. Recall that Est 3 for 2017/18 is $101.8bn, which is 3.6% below Est 3 a year ago, a decline of $3.8bn. That was an improvement on -6.4% for Est 2.
- Est 3 by industry is: mining -22%, -$9.2bn; services +10% (upgraded from +6%); and manufacturing -2.6%. Est 4 of 2017/18 capex plans is likely to paint a broadly similar picture: mining lower and services advancing, led by a rise in non-residential building work as indicated by the lift in approvals (notably for offices, particularly in Victoria).
- An Est 4 of around $104n would be 3% below Est 4 a year ago, broadly equivalent to the -3.6% for Est 3 on Est 3. It would represent a near 3% upgrade on Est 3, matching the average for the previous four years.

Capex plans, by industry: Estimate 3

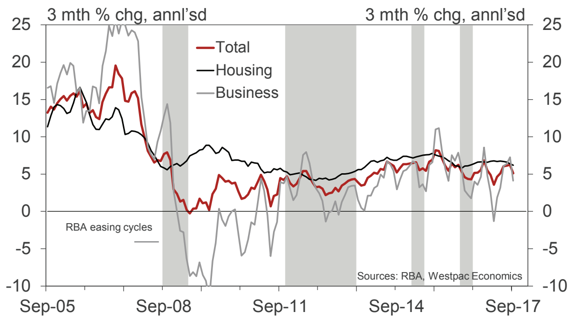


Aus Oct private credit

Nov 30, Last: 0.3%, WBC f/c: 0.4%
Mkt f/c: 0.4%, Range: 0.2% to 0.6%

- Credit to the private sector grew by a more modest 0.3% in September, down from a 0.45% average over Q2 and Q3. Over the past year, credit expanded by 5.4%.The September outcome was largely driven by a softer month for business (a +0.1% down from the recent average of 0.4%). Notably, commercial finance has pulled back, partially reversing earlier gains. Over the past year, business credit rose by 4.3% as business investment expands. For October, we anticipate a 0.4% rise in credit, constrained by another relatively soft update for business. Housing credit is slowing gradually, a trend that is likely to continue at this late stage of the cycle as the sector responds to tighter lending conditions. In September, housing credit grew by 0.48%, 6.6%yr, with the 3 month annualised pace at 6.2%, down from a peak of 6.8% in May.

Credit: momentum shift



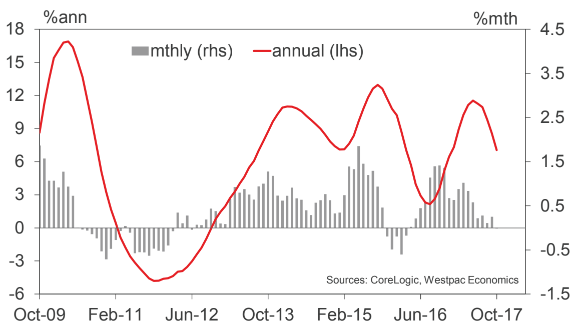
The week ahead

Aus Nov CoreLogic home value index

Dec 1, Last: flat, WBC f/c: –0.1%

- The CoreLogic home value index held flat in Oct taking annual growth to 7%yr, an abrupt slowdown from the 11.4%yr peak in May. Policy measures continue to have a material impact. Although official rates remain near historic lows, regulators introduced a new round of 'macro prudential' tightening measures in late March. Meanwhile a range of other changes have also seen a progressive tightening of conditions facing foreign buyers.
- The daily measure points to another weak month in Nov with prices nationally looking to have dipped –0.1%. That would drag annual price growth down to around 5.5%yr, the slowest pace since this time last year.

Australian dwelling prices



Data calendar

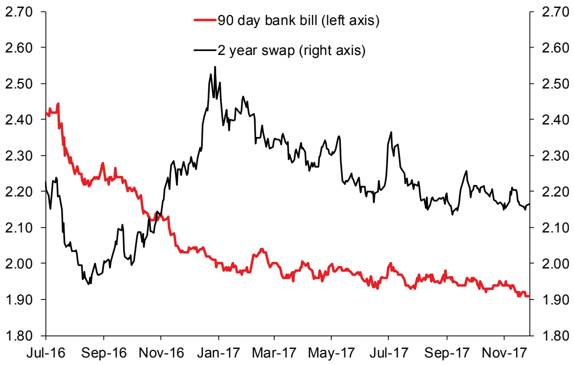
		Last	Market median	Westpac forecast	Risk/Comment
Mon 27					
Chn	Oct industrial profits %yr	27.7%	–	–	Profits reported to have continued to rise.
US	Oct new home sales	18.9%	–6.5%	–	Volatile of late, but trend broadly flat.
	Nov Dallas Fed index	27.6	24.0	–	Still strong.
Tue 28					
Eur	Oct M3 money supply %yr	5.1%	–	–	Credit data also due.
UK	Nov Nationwide house prices	0.2%	–	–	Price growth continues to be dampened by uncertainty.
US	Oct wholesale inventories	0.3%	0.4%	–	A big positive for Q3; what will Q4 bring?
	Sep FHFA house prices	0.7%	0.5%	–	Both measures of house price growth...
	Sep S&P/CS home price index	0.45%	0.30%	–	... pointing to solid gains.
	Nov consumer confidence index	125.9	123.5	–	Set to remain above average.
	Nov Richmond Fed index	12	14	–	Manufacturing currently very happy across the country.
	Federal Reserve	–	–	–	Senate Banking Committee on confirming new Fed Chair.
	Fedspeak	–	–	–	Dudley on US econ. Harker on aging population finances.
Wed 29					
NZ	RBNZ Financial Stability Report	–	–	–	LVR restrictions may be eased next year as housing cools.
Eur	Nov economic confidence	114	–	–	Sentiment across all sectors...
	Nov business climate indicator	1.44	–	–	... is very positive....
	Nov consumer confidence final	0.1	–	–	... despite clear differences in labour markets.
UK	Nov BRC shop price index	–0.1%	–	–	Earlier fall in GBP boosted prices; impulse to wane in time.
	Oct net lending sec. dwellings, £bn	3.8	–	–	Softness in housing market is constraining credit growth...
	Oct mortgage approvals	66.2K	–	–	... though policy changes may boost demand over 2018.
US	Q3 GDP 2nd estimate	3.0%	3.2%	3.3%	Second estimate to tick higher on consumer spending.
	Oct pending home sales	0.0%	1.1%	–	Softer pulse has now passed to existing sales.
	Federal Reserve's Beige book	–	–	–	Conditions across the regions.
	Fed Chair Yellen speaks	–	–	–	Yellen before Joint Economic Committee of Congress.
	Fedspeak	–	–	–	Dudley on economy. Williams on annual outlook.
Thu 30					
NZ	Oct building consents	–2.3%	–	–2.0%	Earlier gains in multiples consents expected to reverse.
	Nov ANZ business confidence	–10.1	–	–	Political developments continuing to weigh on sentiment.
Aus	Oct dwelling approvals	1.5%	–1.0%	–1.5%	High rise to retrace Sep jump, non-high rise also softening.
	Q3 private capex	–3.0%	1.0%	–0.3%	Decline in building to offset rise in equipment.
	2017/18 cape plans, Est 4, AUDbn	101.8	105.4	–	Est 3 –3.6% vs Est 3 a year ago (on mining).
	Oct private credit	0.3%	0.4%	0.4%	Gradual loss of momentum, centred on business.
Chn	Nov manufacturing PMI	51.6	51.5	–	Jobs remain the one soft area...
	Nov non-manufacturing PMI	54.3	–	–	... for both manufacturing and services.
Eur	Oct unemployment rate	8.9%	–	–	Labour markets continue to improve.
	Nov CPI %yr preliminary	1.4%	–	–	Annual rate ticked down in Oct.
UK	Nov GfK consumer confidence	–10	–	–	Credit growth levelled off, but debt levels remain elevated.
US	Initial jobless claims	239k	–	–	To remain at historic lows.
	Oct personal income	0.4%	0.3%	0.3%	Income continuing to grow at solid pace.
	Oct personal spending	1.0%	0.2%	0.4%	Spending to fall back after Hurricanes.
	Oct PCE deflator	0.4%	0.1%	0.2%	Headline PCE inflation circa 1.6%yr; core near 1.4%yr.
	Nov Chicago PMI	66.2	62.0	–	Pointing to robust gains for Chicago industry.
	Fedspeak	–	–	–	Quarles on payment systems. Kaplan at real estate event.
Fri 1					
NZ	Nov QV house prices, %yr	3.9%	–	–	House prices ticked up recently, but new govt policy looms.
	Q3 terms of trade index	1.5%	1.3%	1.5%	Lower import prices to propel terms of trade to 66yr high.
Aus	Nov AiG PMI	51.1	–	–	Manuf'g index off highs, sector boosted by construction.
	Nov CoreLogic home value index	flat	–	–0.1%	Annual price growth to slow to around 5.5%yr.
Chn	Nov Caixin China PMI	51.0	–	–	Dated relative to yesterday's official PMIs.
Eur	Nov Markit manufacturing PMI final	60.0	–	–	Conditions strong across region...
UK	Nov Markit manufacturing PMI	56.3	–	–	Earlier fall in GBP is supporting manufacturing and exports.
US	Nov Markit manufacturing PMI final	54.6	–	–	Less positive than ISM...
	Nov ISM manufacturing	58.7	58.3	–	... which continues to signal 5%+ growth – not being seen.
	Oct construction spending	0.3%	0.5%	–	Structures investment has improved, but gain still subdued.
	Fedspeak	–	–	–	Bullard on econ. Kaplan in Q&A. Harker on inclusive growth.

New Zealand forecasts

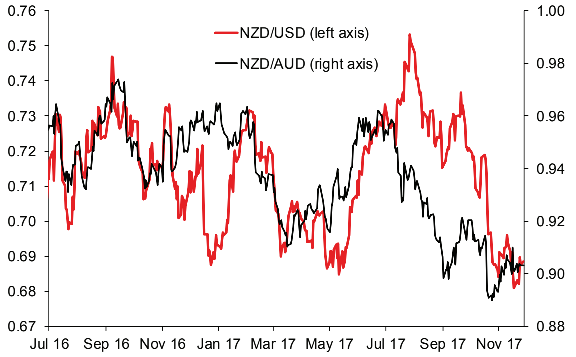
Economic Forecasts	2017				Calendar years			
% change	Jun	Sep	Dec	Mar	2015	2016	2017f	2018f
GDP (Production) ann avg	0.8	0.4	0.7	0.5	2.5	3.0	2.4	2.4
Employment	-0.1	2.2	-0.2	0.6	1.4	5.8	3.1	1.6
Unemployment Rate % s.a.	4.8	4.6	4.5	4.5	5.0	5.3	4.5	4.7
CPI	0.0	0.5	0.6	0.3	0.1	1.3	2.1	1.4
Current Account Balance % of GDP	-2.8	-2.4	-2.3	-1.9	-3.2	-2.5	-2.3	-2.5

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 27 November 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.77%	1.78%	1.79%
60 Days	1.84%	1.86%	1.87%
90 Days	1.91%	1.94%	1.95%
2 Year Swap	2.17%	2.21%	2.17%
5 Year Swap	2.61%	2.72%	2.69%

NZ foreign currency mid-rates as at 27 November 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6885	0.6935	0.6878
NZD/EUR	0.5768	0.5947	0.5927
NZD/GBP	0.5161	0.5257	0.5243
NZD/JPY	76.71	78.71	78.19
NZD/AUD	0.9033	0.9061	0.8957
TWI	72.65	73.73	73.22

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	1.73	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.50	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	2.33	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	0.7624	0.76	0.75	0.74	0.72	0.70	0.69	0.68
USD/JPY	111.31	114	114	115	116	116	117	118
EUR/USD	1.1849	1.15	1.15	1.14	1.13	1.12	1.11	1.10
AUD/NZD	1.1063	1.12	1.12	1.12	1.12	1.11	1.10	1.08

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