Weekly Commentary

28 August 2017

A look at the books

The Government's accounts are on course for growing surpluses over the next few years, though smaller than was projected in the May Budget. That will constrain political parties' ability to make big promises during the election campaign.

The release of the Pre-election Economic and Fiscal Update (PREFU) last week provided an update on the nation's fiscal position ahead of the general election. The accounts reflect policy decisions that were signed off by Cabinet no later than 7 August. As such, the PREFU does not incorporate any new or upcoming policy announcements. The PREFU generally forms a baseline for the potential policy announcements from all parties as the election date approaches.

The highlight of this PREFU was the significant improvement in the government's fiscal position for the financial year 2016/17 relative to expectations in the May Budget. However, this improvement was partially offset by the less upbeat view of the economy over the next few years. This has led to lower predicted revenue in the later years of the five year forecast period compared to previous Treasury projections.

The operating balance (before gains and losses) (OBEGAL) for the June 2017 year is expected to reach $3.7 billion. This is considerably higher than Treasury had previously predicted, with both revenue and expenses coming in about $1bn better than previously forecast. However, the operating surplus is expected to drop back to $2.9bn in the June 2018 year, and future surpluses, while rising, are smaller than were forecast in the May Budget. The Treasury has downgraded its forecasts of nominal GDP growth over the next few years – mostly on the real activity side, but with slightly softer inflation forecasts as well. That implies a smaller tax base than expected over coming years, and a higher spending requirement to some degree.

The smaller predicted surpluses mean that political parties will now find it harder to promise new spending or tax cuts, while simultaneously committing to keep the books in the black. Overseas readers may require some context here – Kiwi voters are acutely averse to Government deficits. Even in the darkest days of the GFC, while other governments were trumpeting fiscal stimulus packages, the dialogue in New Zealand was about when the Government would return to surplus. But equally, voters appear to dislike large surpluses. During the mid-2000s, the Minister of Finance was lampooned as a Scrooge for running massive surpluses. So politics seems bound to push the Government's books in the direction of small surpluses (although though economic shocks will inevitably cause deviations from that path from time to time).

The Government has continued to focus on debt reduction. Core Crown debt fell by $1.3 billion in 2016/17, an even larger reduction than was estimated in the May Budget. Net debt as a share of GDP is set to continue its decline and is expected to be within the 10-15% target sooner than 2025 (14.9% by 2023). Notably, the much larger than expected surplus last year provides a tailwind for the net debt position, which has not necessarily been eroded by the less upbeat growth outlook in later years.

All of this is predicated on the Treasury's economic forecasts, which are more optimistic than our own. The Treasury is forecasting GDP growth for June 2019 at 3.7%. Treasury is placing a great deal of stock on the impact of

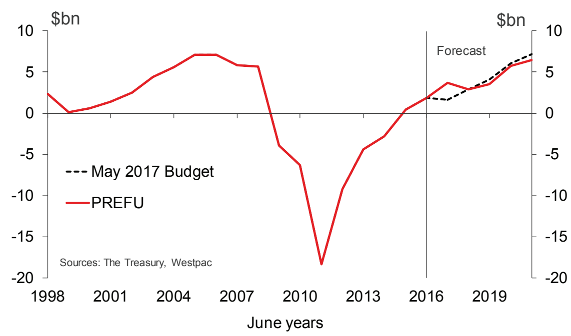
A look at the books continued

the planned tax cuts and Family Incomes Package, which come into effect next April. Treasury expects higher wages and stronger consumption spending to boost overall economic growth.

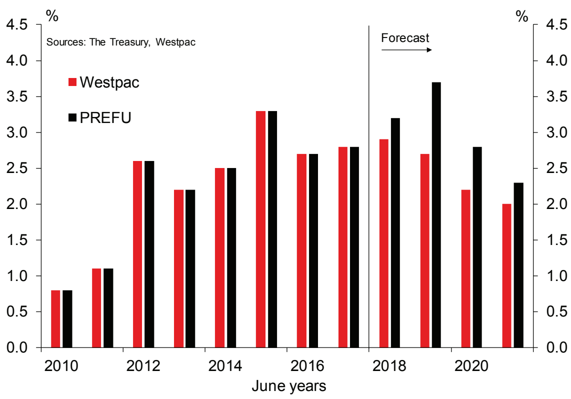
In contrast, we are forecasting 2.7% GDP growth for the same period. We are more circumspect than Treasury about the housing market. In our view, the main factor affecting house prices at present is the lift in mortgage rates over the past year. With mortgage rates expected to remain at current levels or move higher, we anticipate that house prices will be broadly flat to falling for some time. In turn, we expect the subdued housing market to crimp consumer spending and GDP growth.

That said, it is notoriously difficult to draw the link from GDP to tax revenue and spending requirements over the economic cycle. In fact, the latest fiscal accounts show, once again, a higher than expected tax take despite lower than expected GDP over the last year. Nevertheless, we see a risk that the next two (non-election year) Budgets could prove to be a bit tighter than the Treasury's expectations.

Operating balance (excluding gains and losses)



Gross Domestic Production

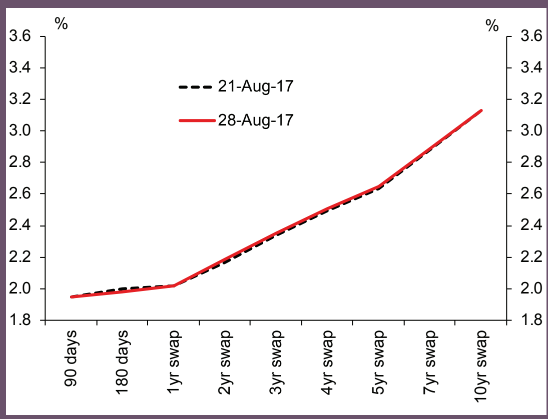


Fixed vs Floating for mortgages

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 Aug business confidence

Aug 31, Last: 19.4

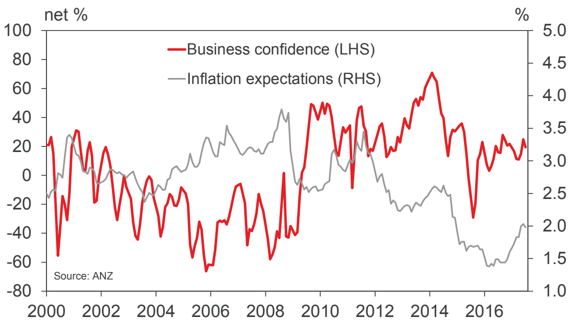
- Business confidence fell back a bit in July. We expect that it will remain firm in August. Economic growth is expected to continue to at a healthy pace for some time, held up by strong population growth. However, the economy is facing some challenges, including growing capacity constraints in some sectors.
- In addition, the upcoming election is adding to uncertainty around the economic outlook. Historically, elections tend to cause a few gyrations in business confidence, and recent developments in the political sphere may exacerbate the usual uncertainties.
- We will also be keeping an eye on the survey's measures of inflation expectations and pricing pressures. We are yet to see any material pickup on this front.

NZ Jul building consents

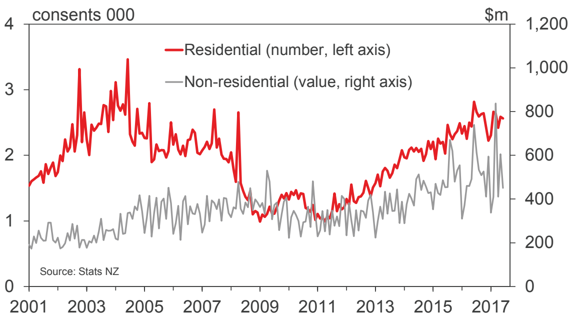
Aug 30, Last: -1.0%, WBC f/c: flat

- Residential building consents fell 1% in June, after a solid gain in May. We expect numbers to remain broadly flat in July. Looking through recent volatility, consent issuance has lost momentum though mid-2017, levelling off at around 2,600/month. In part this reflects the structural (but expected) downtrend in Canterbury, as post-earthquake reconstruction continues to gradually wind down. More notable, however, is the very limited growth in Auckland housing consents. Issuance in Auckland has failed to materially accelerate over the past year, and remains below the levels needed to keep up with population growth. Constraining the rise in building activity are capacity constraints, rising costs pressures and tighter credit conditions. Pre-election uncertainty may also be having some dampening impact. While we expect Auckland issuance to rise over time, it looks like this will occur gradually.

NZ business confidence and inflation expectations



NZ building consents



NZ Q2 terms of trade

Sep 1, Last: 5.1%, WBC f/c 3.0%,

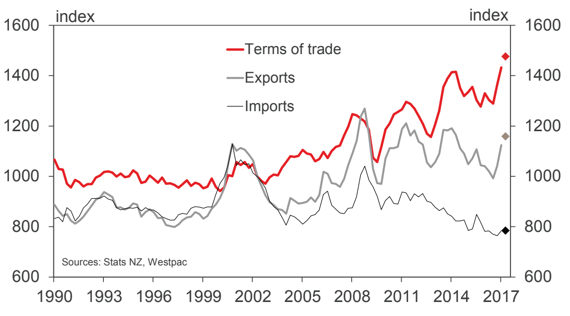
- We expect a 3% rise in the terms of trade for the June quarter, taking it to a fresh 43-year high. We estimate that export prices rose 3%, while import prices were flat.
- The rebound in world dairy prices over the last year continued to flow through into export prices over the June quarter. We also expect a strong gain in meat prices and modest gains for most other commodity exports.
- A slightly lower exchange rate over the quarter added to prices of manufactured goods imports. However, this is likely to be offset by a drop in oil prices.

Aus Jul dwelling approvals

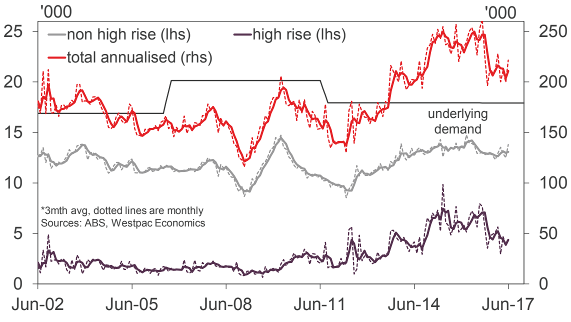
Aug 30, Last: 10.9%, WBC f/c: –4.0%
Mkt f/c: –5.0%, Range: –12% to +1%

- Dwelling approvals posted a surprisingly strong 10.9% rebound in June, coming off a 5.4% drop in May. High rise approvals jumped 14% but non-high rise segments also posted a strong gain.
- The high rise move is most likely monthly volatility that will unwind in July. The firming in other segments may be more enduring though with construction-related finance approvals showing a notable lift in Q2 (the number of approvals for construction up 7.2%qtr). The combined effect is likely to see only a partial retracement in July with total approvals expected to be down 4% but still up on May levels, reflecting the lift in non-high rise segments.

NZ Terms of Trade



Dwelling approvals



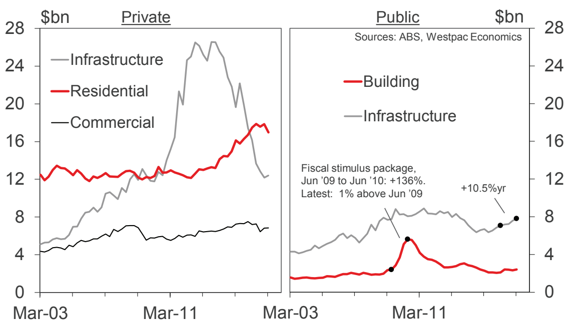
The week ahead

Aus Q2 construction work

Aug 30, Last: –0.7%, WBC f/c: 1.0%
Mkt f/c: 1.0%, Range: –3% to +1%

- Construction activity weakened over the past three years as the downturn in private infrastructure (centred on mining) outweighed gains elsewhere. In 2017, the first half was a choppy one. Work fell in Q1, -0.7%, dented by weather disruptions. In Q2, work rose by a forecast 1.0%, with the return to more normal conditions.
- Private infrastructure (about 25% of the total) is expected to report a solid (but not rapid) fall, -4%, as the winding down of work on gas projects nears its end. Private building activity advances by a forecast 3%. Residential should rebound from the weather disrupted -4.8% in Q1 and commercial building is also likely to rise.
- Public works (around 20% of the total) should be a positive, led by transport projects, increasing by a forecast 3%.

Construction work: divergent trends

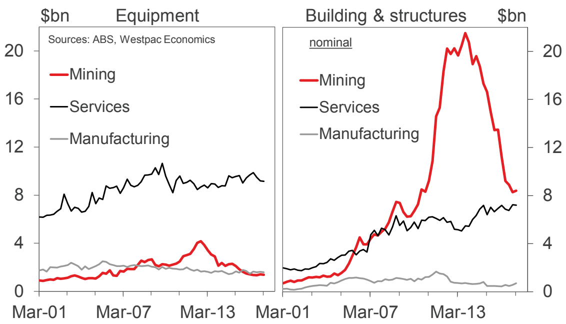


Aus Q2 private capex

Aug 31, Last: 0.3%, WBC f/c: –0.8%
Mkt f/c: 0.2%, Range: –4% to +2.5%

- Business spending on capex contracted in each of the past four years, including a -15% for 2016, led lower by mining.
- The descent in capex spend is likely to resume in Q2 after a rare rise in Q1, up 0.3%. That said, the rate of decline is slowing as work on gas projects draws towards a close.
- Total capex is forecast to fall by -0.8%qtr, -4.6%yr in Q2.
- Building & structures is expected to fall by almost 2%, more than reversing a surprise 0.7% rise in Q1, to be 42% below the level of three years earlier.
- Equipment spend is forecast to edge 0.6% higher, reversing small declines over the past half year. A modest lift in spending by the service sectors is expected to outweigh a further decline in mining.

CAPEX: by industry by asset

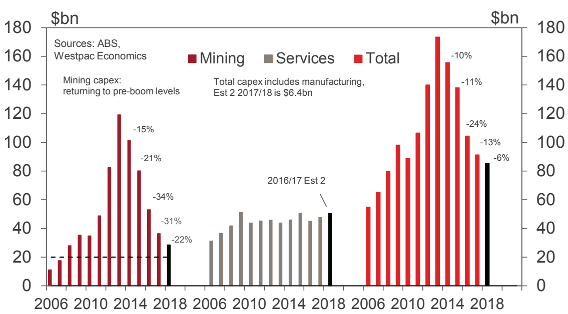


Aus 2017/18 capex plans, AUDbn

Aug 31, Last: 85.4

- Capex spend will inevitably decline in 2017/18, building on falls in each of the four previous years. Est 2 for 2017/18 is $85.4bn, 6.4% below Est 2 of a year ago. This is a decline of $5.9bn, due to a -$7.9bn for mining. We anticipate an Est 3 of about $96bn, a 12% upgrade on Est 2. This is an above par upgrade, with the recent average at 8.4%. This reflects the backdrop of improved business conditions domestically and globally.
- However, this is short of the 15.7% upgrade for Est 3 in 2016/17. That was the largest Est 3 upgrade since 2010/11 and occurred as the business mood turned around after the turmoil of early 2016 when iron ore was at only $40/t.
- Importantly an Est 3 of $96bn is 9.4% below Est 3 a year ago. That is, on our numbers, the 'Est-on-Est' comparison deteriorates from -6.4% for Est 2 to -9.4% for Est 3, due to unfavourable base effects.

Capex plans, by industry: Estimate 2

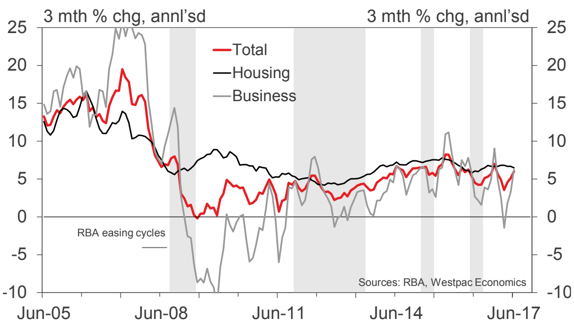


Aus Jul private credit

Aug 31, Last: 0.6%, WBC f/c: 0.5%
Mkt f/c: 0.5%, Range: 0.4% to 0.7%

- Private credit growth appears to have emerged from the soft spot of Q1, when monthly gains averaged only 0.3%. For July, credit growth is expected to be 0.5%, matching the average for the June quarter. A choppy profile for the business segment is the key driver of this short-term shift in momentum, as is often the case. Business credit is moving forward again (+1.5% in Q2 after a -0.4% for Q1), supported by low interest rates and a lift in business investment (albeit a modest one). Housing credit grew by 0.50% in June, moderating from a 0.54% average for the initial five months of the year. There are tentative signs that the sector is beginning to cool in response to tighter lending standards, e.g. lower auction clearance rates. That said, to date, housing finance appears to have stabilised rather than declined.

Credit: momentum shift



The week ahead

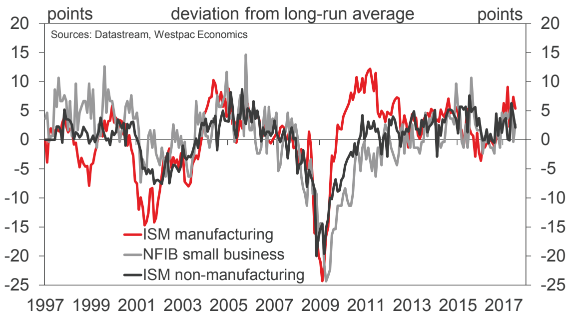
US Aug employment report

Sep 1, nonfarm payrolls, Last: 209k, WBC 170k

Sep 1, unemployment rate, Last: 4.3%, WBC 4.4%

- Nonfarm payrolls rose 209k in July following a 231k gain in June and a 145k increase in May. That leaves the average monthly gain for 2017 at 184k, broadly in line with that of 2016. Given we are now 'past' full employment, this is a very strong pace of job growth which should begin to ease. On this point, each of the business survey employment indexes did pull back in July, potentially signalling a softer pace of growth in August. Yet all remain well above their long-run average levels; hence, even if growth does slow, it will still remain robust. We expect a 170k gain in August.
- From the household survey, the unemployment rate is due for a participation-induced uptick to 4.4% from 4.3% in July. But, given the strength of household survey employment growth, there is every chance it will instead hold at 4.3%.

Employment forward indicators have eased



Data calendar

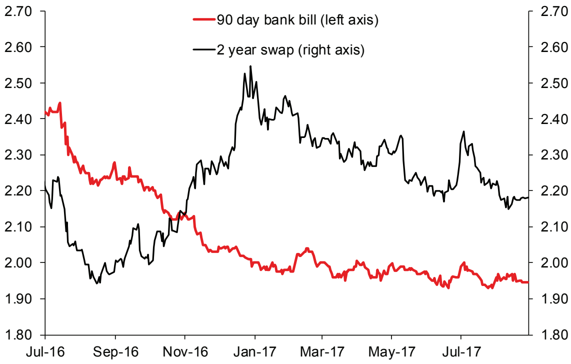
		Last	Market median	Westpac forecast	Risk/Comment
Mon 28					
Eur	Jul M3 money supply %yr	5.0%	4.9%	–	Credit data also available.
US	Jul wholesale inventories	0.7%	0.3%	–	Jumped higher last month; growth likely to slow.
	Aug Dallas Fed index	16.8	–	–	Still strong.
Tue 29					
UK	Aug Nationwide house price index	0.3%	–	–	Uncertainty continuing to dampen housing demand.
US	Jun S&P/CS home price index	0.1%	–	–	Growth over year robust.
	Aug consumer confidence index	121.1	120.0	–	Views of current circumstances super strong.
Wed 30					
NZ	Jul building permits	–1.0%	–	0.0%	Uplift in Auckland remains gradual.
Aus	Jul dwelling approvals	10.9%	–5.0%	–4.0%	High rise jump to reverse but non high rise segments firming.
	Q2 construction work done	–0.7%	1.0%	1.0%	Work in Q2 boosted by rebound from weather disruptions.
Eur	Aug economic confidence	111.2	111.3	–	Domestic and external demand supportive...
	Aug business climate indicator	1.05	1.07	–	... of businesses and...
	Aug consumer confidence – final	–1.5	–1.5	–	... consumers alike.
US	Aug ADP employment change	178k	185k	195k	Volatile but strong in trend terms.
	Q2 GDP – second estimate	2.6%	2.7%	–	A negligible revision likely.
	Fedspeak	–	–	–	Powell on "The Role of Boards at Large Financial Firms".
Thu 31					
NZ	Aug ANZ business confidence	19.4	–	–	Business conditions expected to remain firm.
Aus	Q2 private new capital expenditure	0.3%	0.2%	–0.8%	Descent in capex spend likely to resume.
	2017/18 capex plans, AUDbn	85.4	95.9	96.0	Est 2 –6.4% vs Est 2 a yr ago, on mining weakness.
	Jul private sector credit	0.6%	0.5%	0.5%	Growth off Q1 lows as business segment advances.
	RBA's Deputy of FM infrastructures	–	–	–	Sarah Harris on Panel, Risk Australia conference, Sydney 1pm.
Chn	Aug manufacturing PMI	51.4	51.2	–	External demand has been key to momentum....
	Aug non–manufacturing PMI	54.5	–		... employment the series to watch for both sectors.
Eur	Jul unemployment rate	9.1%	9.1%	–	Continues to track down; income growth remains an issue.
	Aug CPI %yr advance	1.3%	1.4%	1.4%	Still little real evidence of inflation pressures.
US	Initial jobless claims	234k	–	–	Very low.
	Jul personal income	0.0%	0.3%	0.4%	To bounce following weak June.
	Jul personal spending	0.1%	0.4%	0.4%	Prices and activity supportive of spending...
	Jul PCE deflator	0.0%	0.1%	0.2%	... though price pressures still subdued.
	Aug Chicago PMI	58.9	58.3	–	Conditions very healthy.
	Jul pending home sales	1.5%	0.6%	–	A lead for existing sales two to three months down the line.
Fri 1					
NZ	Aug QV house prices, yr%	6.4%	–	–	Tight credit continues to sap momentum in housing market.
	Q2 terms of trade	5.1%	3.0%	3.0%	Higher dairy export prices to take the ToT to a new high.
Aus	Aug AiG manufacturing PMI	56.0	–	–	Sector boosted by lift in construction, low AUD, agri.
	Aug CoreLogic home value index	1.5%	–	0.6%	CoreLogic to also launch revised and expanded indexes.
Chn	Aug Caixin manufacturing PMI	51.1	51.0	–	Delayed versus official measures, but helpful as cross check.
Eur	Aug Markit manuf. PMI – final	57.4	57.4	–	Very strong.
UK	Aug Markit/BME manufacturing PMI	55.1	55.0	–	Lower GBP has been a boon for manufacturers.
US	Aug non–farm payrolls	209k	180k	170k	Business survey employment indexes have fallen back.
	Aug unemployment rate	4.3%	4.3%	4.4%	Higher participation to offset job growth.
	Aug Markit manuf. PMI – final	52.5	–	–	More modest than ISM...
	Aug ISM manufacturing	56.3	56.4	–	... with big businesses in this index still very positive.
	Aug Uni. Michigan sentiment – final	97.6	97.3	–	More reserved than Conference Board of late.
	Jul construction spending	–1.3%	0.6%	–	Investment still very modest versus history.

New Zealand forecasts

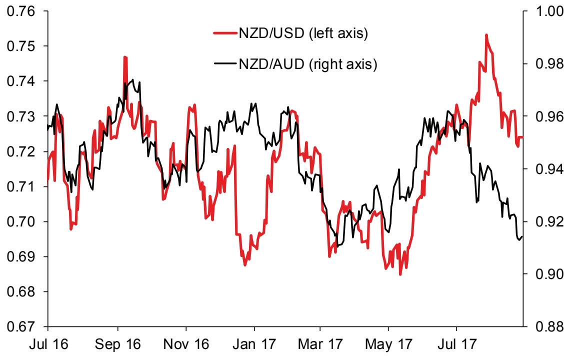
Economic Forecasts	2017				Calendar years			
% change	Mar (a)	Jun	Sep	Dec	2015	2016	2017f	2018f
GDP (Production) ann avg	0.5	0.8	0.9	0.7	2.5	3.1	2.6	3.0
Employment	1.1	-0.1	1.3	0.5	1.4	5.8	2.8	1.8
Unemployment Rate % s.a.	4.9	4.8	4.5	4.5	4.9	5.2	4.5	4.5
CPI	1.0	0.0	0.5	0.4	0.1	1.3	1.9	1.5
Current Account Balance % of GDP	-3.1	-2.9	-2.9	-3.0	-3.4	-2.8	-3.0	-3.3

Financial Forecasts	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
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	2.15	2.20	2.30	2.40
5 Year Swap	2.65	2.70	2.80	2.90	3.00	3.10
10 Year Bond	2.90	2.95	3.10	3.20	3.30	3.40
NZD/USD	0.72	0.70	0.69	0.68	0.67	0.66
NZD/AUD	0.92	0.92	0.92	0.92	0.93	0.94
NZD/JPY	79.2	77.7	77.3	76.8	76.4	75.9
NZD/EUR	0.62	0.60	0.59	0.59	0.59	0.58
NZD/GBP	0.57	0.56	0.56	0.55	0.55	0.55
TWI	76.4	75.0	74.3	73.8	73.4	72.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 28 August 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.83%	1.85%	1.84%
60 Days	1.88%	1.90%	1.89%
90 Days	1.95%	1.96%	1.96%
2 Year Swap	2.18%	2.16%	2.22%
5 Year Swap	2.65%	2.63%	2.77%

NZ foreign currency mid-rates as at Monday 28 August 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7241	0.7309	0.7513
NZD/EUR	0.6061	0.6181	0.6388
NZD/GBP	0.5601	0.5621	0.5713
NZD/JPY	79.06	79.77	83.04
NZD/AUD	0.9143	0.9260	0.9404
TWI	76.11	77.13	79.25

International forecasts

Economic Forecasts (Calendar Years)	2013	2014	2015	2016	2017f	2018f
Australia						
Real GDP % yr	2.1	2.8	2.4	2.5	2.3	3.0
CPI inflation % annual	2.7	1.7	1.7	1.5	2.0	2.5
Unemployment %	5.8	6.2	5.8	5.7	5.7	6.1
Current Account % GDP	-3.4	-3.0	-4.7	-2.7	-1.2	-2.1
United States						
Real GDP %yr	1.5	2.4	2.9	1.5	2.1	2.1
Consumer Prices %yr	1.5	1.6	0.1	1.3	2.0	1.8
Unemployment Rate %	7.4	6.2	5.3	4.9	4.4	4.3
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	1.1	1.0
Euroland						
Real GDP %yr	-0.3	0.9	1.6	1.7	1.9	1.5
United Kingdom						
Real GDP %yr	2.2	2.9	2.2	2.0	1.8	1.6
China						
Real GDP %yr	7.7	7.3	6.9	6.7	6.7	6.2
East Asia ex China						
Real GDP %yr	4.2	4.1	3.7	3.7	3.7	3.8
World						
Real GDP %yr	3.3	3.4	3.2	3.2	3.5	3.5
Forecasts finalised 11 August 2017						

Interest Rate Forecasts	Latest	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.71	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.65	2.75	2.80	2.90	2.95	2.95	3.00	3.00
International								
Fed Funds	1.125	1.125	1.375	1.375	1.625	1.625	1.875	1.875
US 10 Year Bond	2.19	2.40	2.50	2.75	2.85	2.90	3.00	3.00
ECB Deposit Rate	-0.40	–0.40	–0.40	–0.40	–0.40	–0.40	–0.40	–0.30

Exchange Rate Forecasts	Latest	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
AUD/USD	0.7897	0.78	0.76	0.75	0.74	0.72	0.70	0.70
USD/JPY	109.63	110	111	112	113	114	115	115
EUR/USD	1.1795	1.17	1.17	1.16	1.15	1.14	1.13	1.13
AUD/NZD	1.0947	1.08	1.09	1.09	1.09	1.07	1.06	1.06

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