

Weekly Commentary

29 May 2017



Having your cake and eating it too

New Zealand's solid economic performance is allowing the Government to have its cake and eat it too. Budget 2017 provided for more spending and put money back in people's pockets. At the same time, the Government is still projecting growing surpluses and falling net debt over the coming years.

Fiscal projections

The Government's books are in good shape. Firm economic activity and a focus on cost control has seen the operating balance steadily improving since 2011, with surpluses in each of the past two years. This positive trend has continued into the current fiscal year. In fact, the Treasury has upgraded the projected surplus for FY2017 to \$1.6b, compared to a \$0.5b surplus in the Half-Year Economic and Fiscal Update (HYEFU) in December.

The surplus is expected to continue growing over the next few years, but at a more gradual pace than previously assumed. The Government is now forecasting an operating surplus of \$7.2b in 2021, down from the \$8.5b that was forecast in the HYEFU. A key reason for the more gradual improvement in the operating surplus over the coming years is that Budget 2017 has introduced a Family Incomes Package (described below) that includes adjustments to income tax thresholds. While this is assumed to boost activity and spending (which will support growth in tax revenue), the reduction in income tax pulls down core Crown tax revenues by \$6.3b over the forecast period.

Core Crown expenses are also expected to grow more rapidly than previously assumed. Budget 2017 allows for around \$1.8b of new operating spending expenditure in each of the next four years (up from \$1.5b as previously forecast). On top of this, allowances for new spending in future years have also been increased.

Despite the increase in spending, firm economic conditions mean that the Government continues to forecast a decline in debt levels. As a share of nominal GDP, core Crown debt is still forecast to fall below 20% in FY2021, though by slightly less than previously assumed. As already announced, the Government is aiming to reduce net debt to 10-15% of GDP by 2025.

Policy initiatives

The big policy announcement in Budget 2017 was the introduction of a \$2b Family Income Package targeting those on low to middle incomes. This package comes into effect from 1 April 2018. It has four key parts:

1. Income tax thresholds are being increased. The current \$14,000 threshold will be increased to \$22,000, and the current \$48,000 threshold will increase to \$52,000. In terms of cash in hand, those earning more than \$22,000 will now get an extra \$11 per week, rising to \$20 per week for those earning more than \$52,000.
2. The Independent Tax Earners credit of up to \$10 per week is being removed. This was available to those on lower incomes without families. But its removal will be offset by the change in tax thresholds.
3. Working for Families payments for those with children under 16 will be increased to the same level

Having your cake and eating it too

as those with older children. This will affect around 310,000 families.

4. Accommodation supplements will be increased for families and students.

On top of the policy changes themselves, there will be flow-on effects for superannuitants due to the link between after-tax wages and NZ Superannuation. The couples rate for superannuitants will increase by \$13/week from 1 April.

Budget 2017 also made allowances for increased spending in four key areas.

- Infrastructure: The Government is investing heavily in infrastructure, with \$11b in new capital spending assumed over Budgets 2017 to 2020 on top of existing plans. This includes \$4b of new spending in Budget 2017. The lion's share of the new infrastructure spending introduced in Budget 2017 relates to transport infrastructure. Other large areas of spending include prison capacity, defence, schools and classrooms, and health facilities.
- Public services: \$7b including spending on health services, education, law and order, and social services
- Business growth agenda: \$1b. This includes \$373 million as part of the Innovative NZ program, as well as spending to support increased trade, the tourism sector, and the film industry.
- Social investment: \$321m – social spending to support those in need including mental health support and support for vulnerable children.

Economic implications

The 2017 Budget is generally more stimulatory than last year's effort. Much of this stimulus was well signalled, and is already incorporated into the forecasts behind our recently-released Economic Overview.

The pickup in government spending comes at a useful time, when we expect some private sector sources of growth to be waning. For that reason, we don't think that this Budget will put significant upward pressure on inflation or interest rates.

Economic forecasts

There's a very optimistic view of the economy underpinning the fiscal forecasts. The Treasury expects average GDP growth of 3.1% a year over the next five years. That would actually be a faster pace than the previous five years, when the economy was rebounding from the financial crisis. As we've noted before, it would be highly unusual for growth to accelerate at this advanced stage of the cycle.

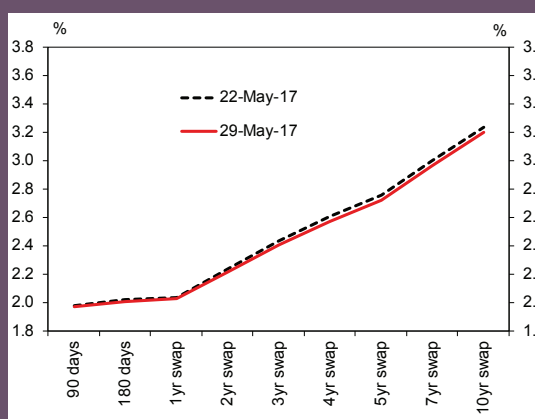
That may or may not prove to be a serious challenge to the fiscal projections. It's notoriously difficult to draw the link from GDP to tax revenue and spending requirements. Indeed, the story of the last year has been one of much stronger than expected tax revenue despite lower than expected GDP growth. So for now we'll note this as a risk that the next two (non-election year) Budgets could prove to be a bit more austere if growth doesn't live up to the Treasury's lofty expectations.

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



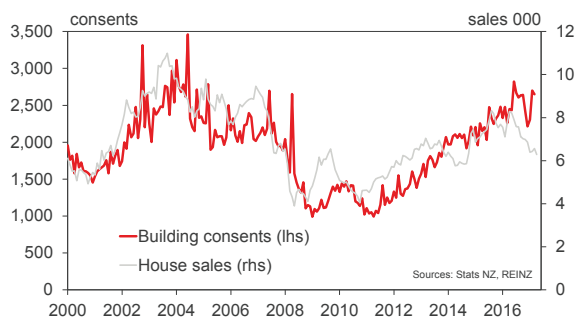
The week ahead

NZ Apr building consents

May 30, Last: -1.8%, WBC f/c: 2.5%

- Residential dwelling consent issuance paused for breath in March, with a 1.8% decline in the number of consents issued over the month. But after a large 17% jump in February, some pull back was to be expected. We expect a return to moderate growth in April, with strong demand in Auckland continuing to be the key driver.
- While there is a large pipeline of both residential and non-residential building work planned over the coming years, there is a question around how quickly work will occur. Capacity pressures in the building industry have already emerged, and both building costs and borrowing rates have been creeping higher. At the same time, house price growth has levelled off. While the outlook for building is positive, these factors may constrain the pickup in activity.

NZ housing activity

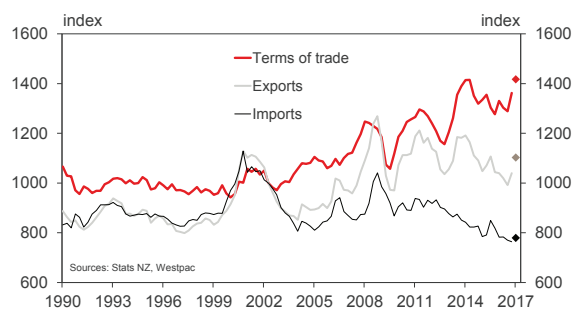


NZ Q1 terms of trade

Jun 1, Last: 5.7%, WBC f/c 4.0%, Mkt f/c: 4.0%

- We estimate that the terms of trade rose by 4% in the March 2017 quarter. This would put it marginally ahead of the previous multi-decade high that was reached in 2014.
- The rebound in world dairy prices in late 2016 continued to flow through into stronger export receipts in the March quarter. We expect a 6% rise in export prices, driven by an 18% rise in dairy, along with modest gains for meat and wood products.
- Fuel import prices rose an estimated 12% for the quarter, but other import prices remained muted. The New Zealand dollar was little changed over the quarter.

NZ Terms of Trade

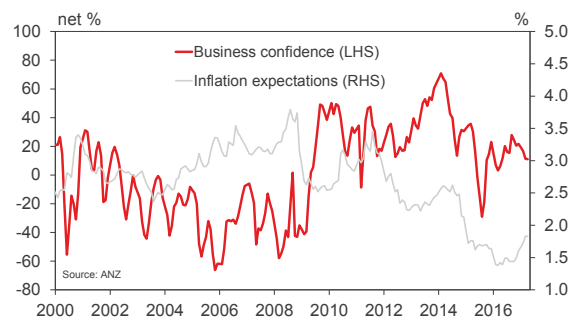


NZ May business confidence

May 31, Last: 11.0

- Business confidence held steady between March and April. Activity indicators show businesses remain upbeat about their own prospects and this is likely to pass into stronger hiring. With the recovery in dairy prices, the sentiment around exports is expected to remain firm.
- Businesses' view of the underlying inflation pulse in the economy is looking firmer. Inflation expectations have picked up, and that's passing through into an increase in the number of businesses looking to raise prices this year. Since the last survey, we've seen a strong Q1 inflation outcome and that's likely to see inflation expectations rising in the May survey. We'll be watching to see how business pricing behaviour will respond to the rise in inflation.

NZ business confidence and inflation expectations



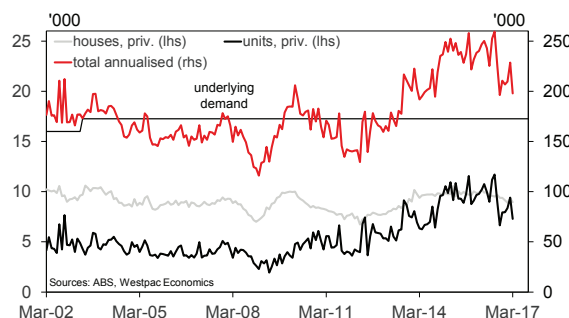
Aus Apr dwelling approvals

May 30, Last: -13.4%, WBC f/c: 1.0%

Mkt f/c: 3.0%, Range: -1.0% to 10.0%

- Dwelling approvals fell heavily in March, a 13.4% drop more than reversing the 10% rise over Dec-Feb and taking total approvals back near their October 2016 low. The detail showed a 50% slump in 'high rise' approvals to the lowest level since July 2013 and a material 4.3% pull-back in private sector house approvals. The state breakdown shows particularly big swings in NSW and Qld in recent months, with weather events likely impacting in March.
- While approvals are now clearly in a downturn, the scope for further hefty declines in the high rise segment leading the cycle now look to be limited. Meanwhile, the extent of softening in other segments and the impact of state specific factors such as weather events are both uncertain. On balance we suspect trend approvals are taking another leg lower but April should see a slight 1% gain.

Dwelling approvals



The week ahead

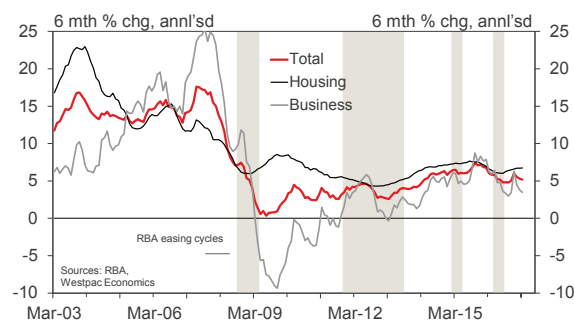
Aus Apr private credit

May 31, Last: 0.3%, WBC f/c: 0.4%

Mkt f/c: 0.4%, Range: 0.3% to 0.5%

- Private credit growth slowed in the opening quarter of 2017, to 0.3% per month on average, as business weakened, -0.5%qtr, after a blistering Q4, +2.2%qtr. For April, we expect credit growth to round up to 0.4%, supported by a small rise in business. Annual growth edges down from 5.0% to 4.9%, the slowest pace since May 2014. Housing credit grew by 0.55%mt, 6.5%yr in March. A similar result is likely for April, ahead of a slowing in coming months in response to out of cycle rate increases and tighter lending conditions. Note that annual housing credit growth peaked at 7.5% back in November 2015. Business credit in March was 0.0%mt, 3.4%yr, continuing a volatile pattern after borrowing appetite was temporarily impacted by the July 2016 Federal election. New lending (commercial finance) rebounded over the past couple of months, pointing to a small rise in business credit in April.

Credit: momentum shift



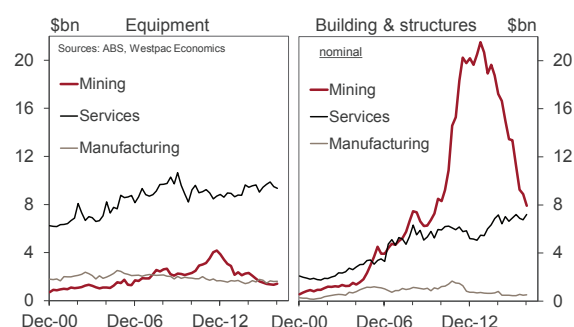
Aus Q1 private capex

Jun 1, Last: -2.6%, WBC f/c: 0.5%

Mkt f/c: 0.5%, Range: -5.5% to 2.5%

- Business spending on capex contracted in each of the past four years, including a -15.5% for 2016, led lower by mining. Perhaps surprisingly then, we expect a positive start to 2017, albeit a small one, forecasting a rise of 0.5% for Q1. The mining investment drag has diminished and some businesses appear to be responding modestly to improved conditions: with incomes boosted by higher commodity prices; global growth having strengthened; and the domestic economy having emerged from the mid-2016 slowdown. Building & structures is expected to be flat in Q1, after a 25% fall in 2016. The Construction Work (CW) survey was +1.2% for Q1, but we're mindful that the capex at times undershoots CW. Equipment spend is forecast to rise by 1.2%, after a Q4 result of 0.4%qtr, 1.5%yr, with gains expected in mining and services.

CAPEX: by industry by asset



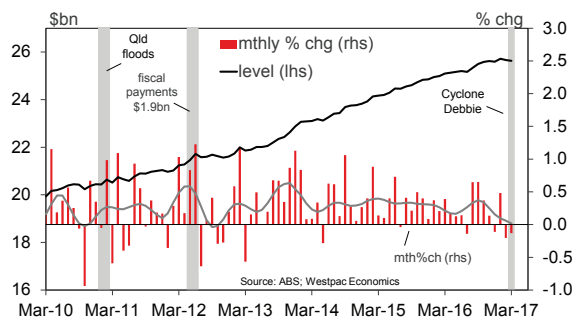
Aus Apr retail trade

Jun 1, Last: -0.1%, WBC f/c: 0.3%

Mkt f/c: 0.3%, Range: -0.1% to 0.6%

- Retail sales dipped 0.1% in March following a 0.2% decline in Feb and a 0.5% gain in Jan. Cyclone Debbie and abnormally wet weather over the eastern states had a significant impact in March - Qld, the hardest hit, saw retail sales fall 1.3%.
- April will clearly see some rebound from weather effects. However, this is against a weak consumer backdrop with sentiment weakening in early 2017 amid increased pressures on family finances. Private sector business surveys continue to point to retail underperforming non-retail consumer sectors as well. With price discounting an ongoing drag on nominal sales as well we expect the rebound in monthly retail sales to be fairly muted with just a 0.3% gain overall.

Monthly retail sales

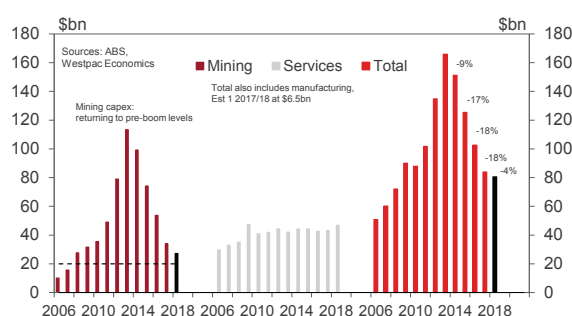


Aus 2017/18 capex plans, AUDbn

Jun 1, Last: 80.6

- Capex plans for 2017/18 will be the key focus, although the final outcome for 2016/17 will not be known until late August. Est 1 for 2017/18 capex is \$80.6, -3.9% vs Est 1 a year earlier. Or, -\$3.3bn, fully accounted for by mining, -\$6.8bn and -20%. An Est 2 of around \$86bn would be a 'neutral' result in our view. This is an upgrade of almost 7% on Est 1, broadly in line with the recent historical average (weighted by industry). However, Est 2 on Est 2 would print at -6% on this number, thus appearing to be a deterioration on 3 months earlier. The key point, in 2016/17 there was an unusually large upgrade between Est 1 and Est 2, of 8.8%. The Est 1 survey that year (conducted in Jan/Feb 2016) was when the iron price was at a low of \$40/t and China's share market fell 24% in 4 weeks. Applying average realisation ratios, we calculate Est 1 for 2017/18 implies a fall of 11% on 2016/17. An Est 2 of \$86bn would be broadly comparable, implying a fall of 10%.

Capex plans, by industry: Estimate 1



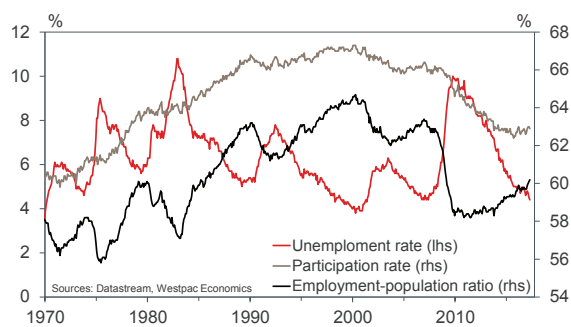
The week ahead

US May employment report

Jun 2, nonfarm payrolls Last: 211k, WBC 170k

- The nonfarm payrolls survey has continued to report strong employment growth through 2017, despite some volatile months. At 185k, the 2017 average monthly gain for payrolls is broadly unchanged from 2016.
- The household survey has been similarly strong, the unemployment rate falling to 4.4% in April. That figure is a material improvement from January's 4.8%, and is also below estimates of full employment. The share of the population employed is at its highest level since early-2009.
- Come May we expect another robust gain circa 170k, a touch below the 2017 average. Given stable participation, the unemployment rate should also be unchanged in the month.

Employed share of population on the rise



Data calendar

	Last	Market median	Westpac forecast	Risk/Comment	
Mon 29					
Eur	Apr M3 money supply %yr	5.3%	5.2%	-	Credit data also due.
	ECB Draghi speaks	-	-	-	Speaks at European Parliament Economic Committee.
UK	May Nationwide house prices	-0.4%	-	-	Price growth has eased, low supply and rates limiting downside.
US	Memorial Day	-	-	-	Markets closed. Start of the summer vacation season.
	Fedspeak	-	-	-	Williams gives keynote on Asian banking & finance in Singapore.
Tue 30					
NZ	Apr building permits	-1.8%	-	2.5%	Home building levels continuing to rise, esp. in Auckland.
Aus	Apr dwelling approvals	-13.4%	3.0%	1.0%	Slight bounce from March's fall, but trend taking leg lower?
Eur	May economic confidence	109.6	110.1	-	Sentiment very robust...
	May business climate indicator	1.09	1.12	-	... across businesses...
	May consumer confidence	-3.3	-3.3	-	... and consumers.
Ger	May CPI %yr	2.0%	1.6%	-	Has fluctuated in recent months; broadly at target.
US	Apr personal income	0.2%	0.4%	-	Income growth is solid, but lacks upward momentum...
	Apr personal spending	0.0%	0.4%	-	... spending should bounce in Q2.
	Apr PCE deflator %yr	1.8%	1.7%	-	Core price pressures to hold a little below FOMC target.
	Mar S&P/CS home price index	0.7%	0.8%	-	Robust overall, but signs high flyers may be faltering.
	May consumer confidence index	120.3	119.9	-	Set to remain strong.
	May Dallas Fed index	16.8	15.0	-	Manufacturing surveys volatile but strong.
	Fedspeak	-	-	-	Brainard speaks on the economy and policy at a luncheon.
Wed 31					
NZ	RBNZ Financial Stability Report	-	-	-	DTI limits, bank capital requirements still under development.
	May ANZ business confidence	11.0	-	-	Business conditions expected to remain firm.
Aus	Apr private sector credit	0.3%	0.4%	0.4%	Growth to round higher, business to advance after weak qtr.
Chn	May manufacturing PMI	51.2	51.0	-	Likely to lose ground in coming months...
	May non-manufacturing PMI	54.0	-	-	... though momentum to remain solid.
Eur	Apr unemployment rate	9.5%	9.4%	-	Slowly trending down.
	May CPI %yr	1.9%	1.5%	-	Volatility aside, headline inflation near target; core still soft.
UK	May GfK consumer confidence	-7.0	-	-	Confidence has eased, rising inflation is weighing on households.
	Apr net lending on sec. dwellings, £b	3.1	3.1	-	Lending has essentially been flat since the referendum...
	Apr mortgage approvals	66.8k	66.3	-	... with demand softening despite low rates.
US	May Chicago PMI	58.3	57.0	-	Manufacturing surveys volatile but strong.
	Apr pending home sales	-0.8%	1.0%	-	Lead for established; starting to soften.
	Federal Reserve's Beige book	-	-	-	Conditions across the 12 districts.
	Fedspeak	-	-	-	Kaplan in a Q&A at the Council of Foreign Relations.
Thu 1					
NZ	May QV house prices, %yr	11.1%	-	-	House prices have flattened out in the last six months.
	Q1 terms of trade index	5.7%	4.0%	4.0%	Continued rebound in dairy export prices.
Aus	Apr retail sales	-0.1%	0.3%	0.3%	Weather impact in March to unwind. Underlying conditions soft.
	Q1 private capex	-2.1%	0.5%	0.5%	Small rise after run of falls (incl. equipment +1.2%).
	2017-18 capex plans, AUDbn	80.6	-	-	Est 1, -4% vs yr ago, incl. mining -20%.
	May CoreLogic home value index	0.1%	-	-1.0%	To show first monthly fall since Nov 2015, led by Syd & Melb.
	May AiG manufacturing PMI	59.2	-	-	Index elevated, +ves: low AUD, construction, agri, mining.
Chn	May Caixin China PMI	50.3	50.2	-	Lags the official measure, but still helpful as cross check.
Eur	May Markit manufacturing PMI final	57.0	57.0	-	Conditions have been very strong of late...
Ger	May Markit manufacturing PMI final	59.4	59.4	-	... despite EUR's rise.
UK	May Markit manufacturing PMI	57.3	56.1	-	Lower pound continues to boost manufacturing and exporting.
	May Markit construction PMI	53.1	52.7	-	Continues to point towards moderate building activity.
US	May ADP employment change	177k	180k	-	Occasionally useful as a lead for payrolls.
	Initial jobless claims	234k	-	-	Very low.
	May Markit manufacturing PMI final	52.5	-	-	Softer than ISM measure in recent months.
	May domestic auto sales (millions)	13.1	13.2	-	Car loans a burgeoning risk to consumer outlook?
	May ISM manufacturing	54.8	54.6	-	Strength arguably represents sentiment as much as activity.
	Apr construction spending	-0.2%	0.5%	-	Structures had a good Q1; some offset likely in Q2.
	Fedspeak	-	-	-	Williams speaks on global economic issues at Bank of Korea conf.
Fri 2					
US	Apr trade balance US\$bn	-43.7	-44.0	-	Inventory data disappointed in Apr; indicator for trade?
	May non-farm payrolls	211k	176k	170k	Strong employment gains to continue...
	May unemployment rate	4.4%	4.4%	4.4%	... on constant participation, unemployment rate unchanged.
	Fedspeak	-	-	-	Powell talks on the normalisation of monetary policy.

New Zealand forecasts

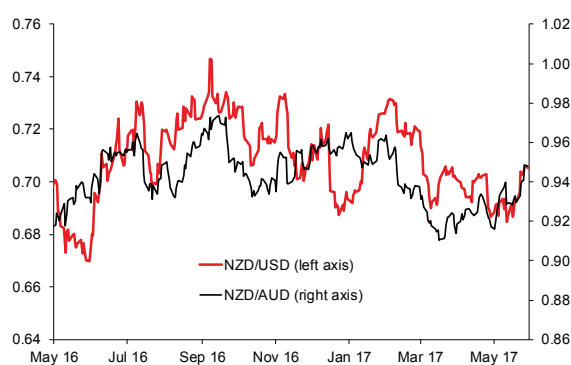
Economic Forecasts	March years				Calendar years			
	% change	2015	2016	2017f	2018f	2015	2016	2017f
GDP (Production) ann avg	3.4	2.4	3.0	3.0	2.5	3.1	2.9	3.1
Employment	3.2	2.0	5.7	1.9	1.4	5.8	2.7	1.8
Unemployment Rate % s.a.	5.4	5.2	4.9	4.5	4.9	5.2	4.4	4.4
CPI	0.3	0.4	2.2	1.3	0.1	1.3	1.8	1.8
Current Account Balance % of GDP	-3.5	-3.1	-2.7	-2.3	-3.4	-2.7	-2.4	-2.8

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	2.50	2.50	2.60	2.70	2.80	2.90
5 Year Swap	3.10	3.20	3.30	3.40	3.50	3.55
10 Year Bond	3.30	3.50	3.60	3.70	3.80	3.90
NZD/USD	0.68	0.68	0.68	0.67	0.66	0.65
NZD/AUD	0.93	0.93	0.93	0.93	0.96	0.96
NZD/JPY	75.5	76.2	77.5	77.7	77.2	76.7
NZD/EUR	0.65	0.65	0.66	0.66	0.65	0.65
NZD/GBP	0.56	0.57	0.57	0.57	0.56	0.55
TWI	75.2	75.6	76.2	75.7	75.8	75.2

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 29 May 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.87%	1.88%	1.85%
60 Days	1.91%	1.93%	1.91%
90 Days	1.97%	1.98%	1.99%
2 Year Swap	2.22%	2.21%	2.31%
5 Year Swap	2.72%	2.79%	2.89%

NZ foreign currency mid-rates as at Monday 29 May 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7051	0.6860	0.6865
NZD/EUR	0.6312	0.6273	0.6300
NZD/GBP	0.5508	0.5322	0.5311
NZD/JPY	78.46	77.63	76.48
NZD/AUD	0.9479	0.9279	0.9207
TWI	76.55	74.93	74.80

International forecasts

Economic Forecasts (Calendar Years)	2013	2014	2015	2016	2017f	2018f
Australia						
Real GDP % yr	2.1	2.8	2.4	2.5	2.5	2.7
CPI inflation % annual	2.7	1.7	1.7	1.5	2.1	2.2
Unemployment %	5.8	6.2	5.8	5.7	6.0	6.2
Current Account % GDP	-3.4	-3.0	-4.7	-2.7	-0.5	-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	1.3	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
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	1.7	1.4
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	6.6	6.0
East Asia ex China						
Real GDP %yr	4.2	4.1	3.7	3.7	3.8	3.8
World						
Real GDP %yr	3.3	3.4	3.1	3.3	3.5	3.5

Forecasts finalised 16 May 2017

Interest Rate Forecasts	Latest	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
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	2.41	2.75	2.95	3.05	3.15	3.25	3.40	3.40
International								
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	-0.30	-0.30	-0.20	-0.20

Exchange Rate Forecasts	Latest	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
AUD/USD	0.7425	0.73	0.73	0.73	0.72	0.69	0.68	0.65
USD/JPY	111.59	114	115	116	119	120	122	122
EUR/USD	1.1204	1.08	1.07	1.05	1.03	1.02	1.00	1.00
AUD/NZD	1.0588	1.07	1.07	1.07	1.07	1.05	1.05	1.03

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