Weekly Commentary

31 January 2017

Back in the band

The main local news last week was the Consumer Price Index for the December quarter. Consumer prices rose by 0.4% in the quarter, with annual inflation jumping up to 1.3%, finally back in the Reserve Bank's target range of 1-3%. On Wednesday, we get labour market data for the December quarter, which are expected to show the continuation of solid employment growth with the unemployment rate forecast to edge lower to 4.8%.

Inflation's return back within the Reserve Bank's target range has been a long time coming. Annual inflation has been below 1% for two years straight, partly because of the plunge in oil prices since mid-2014. That's now come to an end, and in fact global oil prices have risen over the past couple of months in anticipation of production cuts by OPEC members.

But setting aside swings in oil prices that can throw headline inflation around, inflation has been gradually rising over the past year. The various measures of "core" inflation, which attempt to smooth through volatile movements to capture the underlying trend in inflation, all more or less agree that inflation bottomed out in late 2015 and has been gradually picking up since. This matches up with an economy that has been strengthening, and looks to have used up its spare capacity in the last year or so.

Annual GDP growth rose to 3.5% in the September quarter. And a decent pace of growth looks to have been maintained moving into 2017 as record levels of net immigration, rising visitor arrivals, a solid pipeline of construction and an improved outlook for the dairy sector all support demand.

In turn, solid growth in activity has driven improvement in the labour market as firms scale up staff levels. We expect Wednesday's Household Labour Force Survey to show that employment increased by 0.6% in the December quarter. Employment growth is expected to be widespread across sectors, with the largest gains expected in services (such as professional services) and construction. One notable risk to employment in the quarter is the disruption from the Kaikoura earthquakes, which struck in mid-November. These events had a severe impact on some smaller centres in the upper part of the South Island, and caused disruptions in Wellington.

At the same time as we've seen solid employment growth, improving labour prospects have encouraged more people to enter the labour force, with the labour force participation rate at record highs. But even with strong growth in the labour force, the labour market has been tightening. The unemployment rate fell to 4.9% in September – the first time below 5% since 2008 – and we're tipping that this edged down to 4.8% in the December quarter.

However, the penny hasn't yet dropped for wages. Wage growth has remained subdued so far, with wages rising an estimated 1.6% over the past year. That's partly because with inflation near zero, there has been less of a call for cost of living adjustments. But with inflation now rising and workers remaining in hot demand, wage inflation should begin to rise over the coming year. Indeed, with firms continuing to report that it is acutely difficult to find workers, workers should find themselves with a little more bargaining power in wage negotiations. Construction firms are reporting the most difficulty in finding staff and this is likely to become more acute, especially in Auckland where

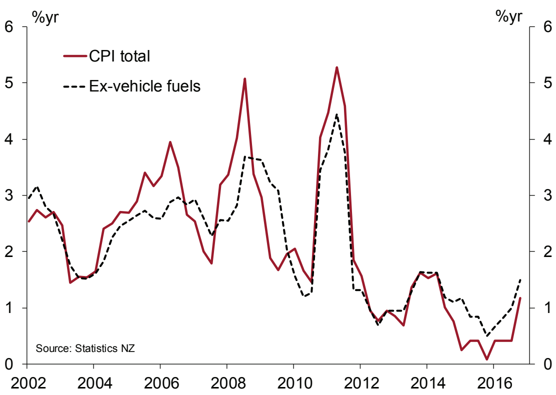
Back in the band continued

the demand to build is the greatest. Anecdotally, firms are already finding it difficult to convince staff to relocate to Auckland, and inevitably attracting workers to New Zealand's most expensive city will probably require an improved pay packet.

But at the same time as domestic inflation looks to be moving higher, imported inflation is likely to remain subdued. The NZ dollar has risen nearly 12% on a trade-weighted basis over the past year, and this will place renewed downward pressure on imported goods prices. We expect this will keep inflation in the lower half of the 1-3% target range over 2017. And consequently, in our view, it's unlikely that that the Reserve Bank will be stirred into reversing any of its rate cuts any time soon – in contrast to market pricing for a 25 basis point OCR hike before year end.

It's interesting to note that the largest gains in the NZ dollar over the past month have come against the US dollar. After the US election in November the market's initial assessment was that Trump would boost the US economy through spending on infrastructure and tax cuts, and that would strengthen the US dollar against other currencies. But markets are now back-pedalling on that assessment a little. Consequently, the NZD/USD has risen from around 69 cents at the end of December to 72 cents, which is just shy of the level that prevailed prior to the US election. On a trade-weighted basis, the NZ dollar is at its highest level in nearly two years. We suspect that as long as New Zealand remains one of the relative bright spots in the world economy, the NZ dollar is going to remain strong.

CPI inflation

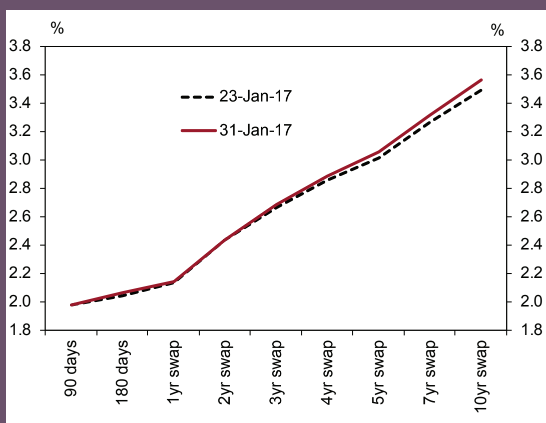


Fixed vs Floating for mortgages

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

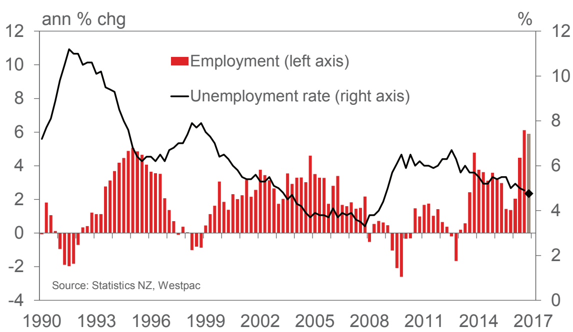
NZ Q4 household labour force survey

Feb 1, Employment, last: 1.4%, WBC f/c: 0.6%, Mkt f/c: +0.8%

Feb 1, Unemployment, last: 4.9%, WBC: 4.8%, Mkt f/c: 4.8%

- We expecting to see 0.6% growth in employment in December. While that's a bit slower than what we've seen in the past few quarters, it's still a healthy clip consistent with the recent firm growth in economic activity. Note that methodological changes in June mean that annual employment growth will appear exaggerated.
- Labour force participation is expected to nudge higher again in December, taking it a record high of 70.2%. Job growth has encouraged more people to enter the labour market. This has been reinforced by strong net migration. Even with strong growth in the labour force, increases in economic activity over the past year have seen the labour market tightening. We expect the unemployment rate pushed down again to 4.8% in the December quarter.

Household Labour Force Survey

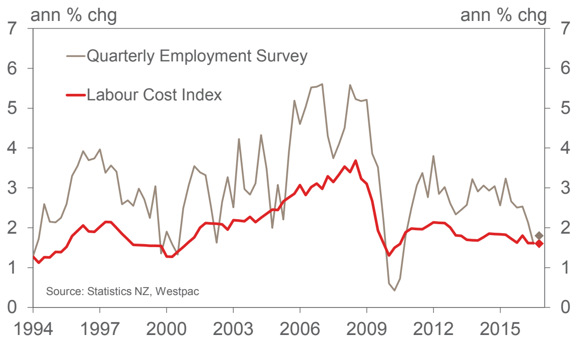


NZ Q4 labour cost index

Feb 1, Private sector (incl. overtime), last: 0.4%, WBC f/c: 0.4%, Mkt f/c: 05%

- While the labour market has been strengthening, this hasn't translated into higher wage inflation just yet. We're expecting December's Labour Cost Index to show that wage rates rose by only 1.6% over the past year, while the broader QES measure of average hourly earnings growth is expected to have risen by 1.7% - both largely unchanged from last quarter and still low.
- But while wage growth is currently low, this won't be the case forever. We expect that strong demand for workers, as well as increasing cost of living adjustments will contribute to rising wage inflation over the coming year.

LCI and QES wages

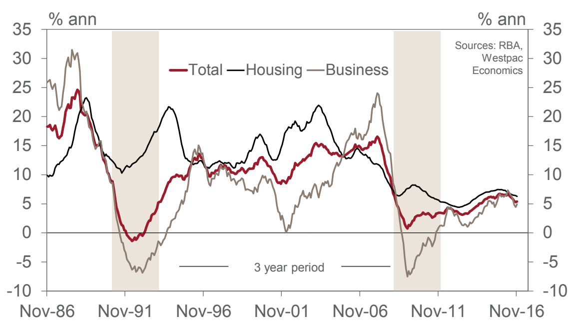


Aus Dec private sector credit

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

- Credit to the private sector has lost momentum, with a rise of 6.4% in 2015 giving way to a 4.9% increase in the year to November 2016. Key to this trend are: tighter lending conditions in the housing market during the second half of 2015; and businesses delaying borrowing plans ahead of the July Federal election. Rate cuts by the RBA in 2016 have cushioned the slowdown.
- In November, credit grew by 0.5%, with housing and business both increasing by 0.5%.
- For December, we expect credit to expand by 0.5%. Housing is being supported by RBA rate cuts, although the impact is relatively modest. Business credit growth has rebounded from the mid-year lull associated with the election.

Credit: annual growth peaked in 2015

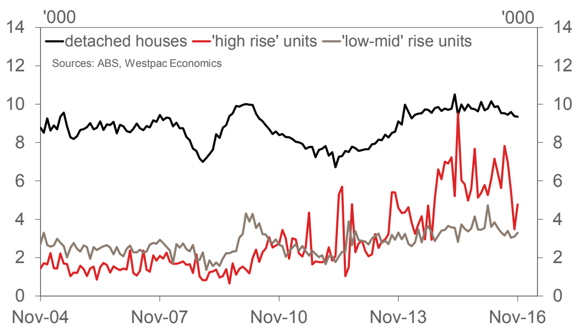


Aus Dec dwelling approvals

Feb 2 Last: 7.0%, WBC f/c: –1.0%
Mkt f/c: –1.5%, Range: –5.0% to 5.0%

- Dwelling approvals bounced 7% in Nov after a sharp 21% slide over the previous 3mths. That initial move marked the first definitive sign that Australia's high rise driven building boom was starting to turn down. The Nov bounce scales back the pace of the decline but leaves the downtrend intact – trend approvals are now down 10%yr. The Dec update will go a long way towards confirming the pace of decline. We expect the high rise component to track lower at around 20-25%yr but other segments to hold up much better. A 1% dip in approvals in Dec would be broadly consistent with this profile bearing in mind that month to month approvals are often much more volatile. *Note that the summer hiatus makes housing market data notoriously unreliable over Jan-Feb so it will be a few more months before we get a clear read on trends in early 2017.*

Dwelling approvals: houses, low-mid & high rise



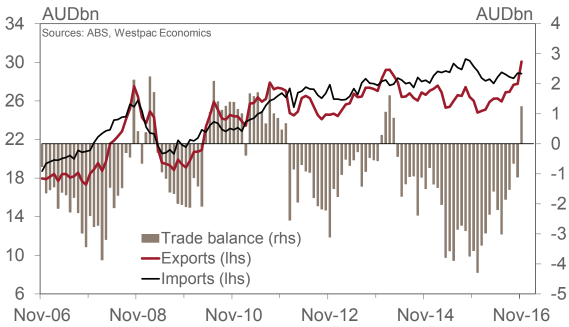
The week ahead

Aus Dec trade balance, AUDbn

Feb 2, Last: +1.2, WBC f/c: +1.5
Mkt f/c: +2.0, Range: +1.0 to +3.5

- Australia's trade account has moved into surplus as a spike in commodity prices boosts export earnings. A $1.2bn surplus in November, a $2.4bn turnaround from October, was the first surplus since March 2014.
- For December, we expect a consolidation, a surplus of $1.5bn.
- Export earnings are forecast to rise by 1.3%. Expected gains in coal (volumes), iron ore (prices) and services outweigh a pull-back in rural (which jumped $0.6bn last month).
- Imports are expected to edge higher, 0.5%, +$0.14bn.
- *NOTE: Since January, there is additional uncertainty around the import and trade forecast. The ABS no longer publishes the customs goods imports ahead of the trade release.*

Australia: a $1.2bn trade surplus in November

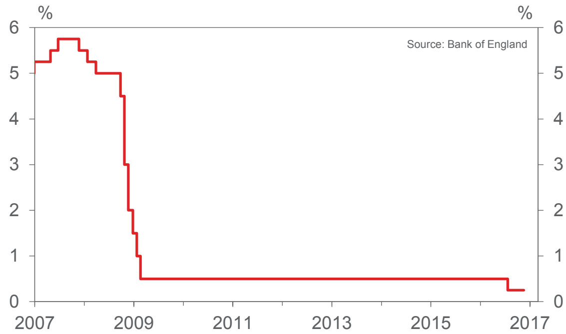


UK Bank of England policy decision

Feb 2, Last: 0.25%, WBC f/c: 0.25%

- Late last year the Bank of England shifted to a neutral policy stance, noting that "Monetary policy can respond, in either direction." We expect a similar tone in February. Thus far the economy has been resilient to the heightened uncertainty around the economic outlook since the Brexit referendum. However, at least some of the strength in economic conditions is a result of policy easing by the BoE. And there is a risk of increased uncertainty and volatility in economic conditions when Brexit negotiations begin.
- The elephant in the room is inflation, which has been pushing higher. Over time this will erode households' purchasing power and push up operating costs. While the BoE can look through some of this pick-up, they cannot completely ignore it. The BoE will face a challenging balancing act in relation to rising inflation and an uncertain economic outlook for some time yet.

Bank of England Bank Rate

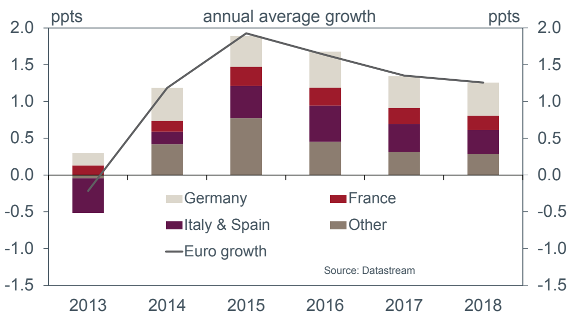


Euro Area Q4 GDP

Jan 31, Last: 0.3%, WBC 0.3%

- Euro Area GDP growth has been solid in 2016, as was the case in 2015. However, momentum slowed through mid-year, Q1's 0.5% followed by a pair of 0.3% gains in Q2 and Q3. Annual growth currently stands at 1.7%yr.
- By sector, growth continues to be driven by the consumer, with sporadic support also coming from investment. By nation, growth has been strongest in Spain and Germany, and this is likely to remain the case in coming quarters.
- For Q4, another gain of 0.3% seems the most likely outcome. Confidence amongst the household sector remains robust and is sentiment is also constructive amongst firms. But retail and credit data have lost momentum in recent months.
- *Note though recent PMI data does signal that risks are to the upside, so there is also a decent probability of a 0.4% gain.*

Contribution to Euro area annual growth

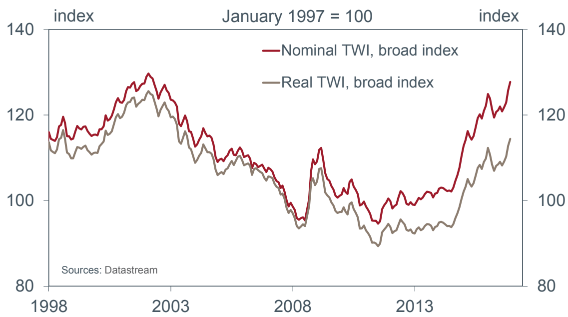


US FOMC policy decision

Feb 1, Last: 0.625%, WBC 0.625%

- The December FOMC meeting saw the delivery of the second rate hike of this tightening cycle, a year after the first.
- The tone of the statement that accompanied the decision was very constructive on the outlook, but not urgent. Clearly the Committee believe they will achieve their 2.0%yr inflation target, but that it wont be at risk for the foreseeable future.
- There also remains a degree of anxiety over the impact each and every hike will have on the economy, particularly given the strong USD uptrend that set in through late 2016. As such, the FOMC is hoping to engineer a slow and steady rate hike cycle that will allow a rate buffer to build, in case a negative shock is felt in the future.
- The FOMC believes three hikes will be seen in 2017; we favour two, the first coming in June. Much depends on President Trump's real economic impact.

USD gains a competitiveness issue?



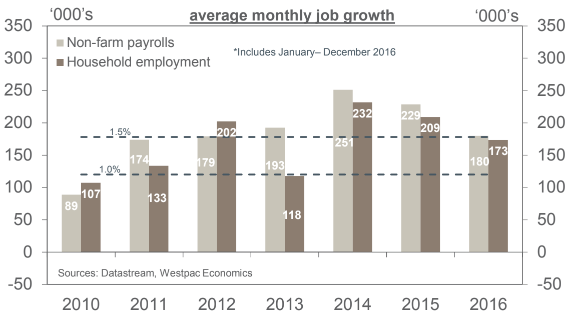
The week ahead

US Jan nonfarm payrolls

Feb 3, Last: 156k, WBC 170k

- The December nonfarm payrolls result came in a little below market expectations at 156k; however, it came with 19k in upward revisions which offset the disappointment.
- The past three months has seen an average monthly gain of 165k, well in excess of that necessary to hold the unemployment rate constant. However, an uptick in participation saw the unemployment rate edge higher in December to 4.7%.
- Come January, a gain of around 170k is again expected, though risks are arguably skewed marginally to the downside. With the economy at full employment, it is inevitable that employment growth will slow, at some stage.
- *Note that the January nonfarm payrolls release will include historic revisions – these can be substantial.*

US job creation remains strong



Data calendar

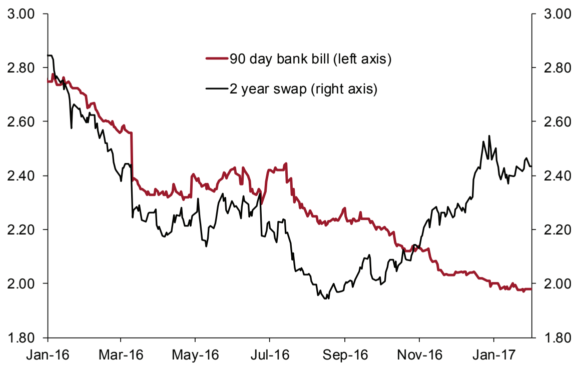
		Last	Market median	Westpac forecast	Risk/Comment
Mon 30					
NZ	Dec trade balance, $m	–705	–	–230	Exports improve from soft Nov, although meat exports remain a drag.
Eur	Jan economic confidence	107.8	107.8	–	Aided by ECB's ongoing support…
	Jan consumer confidence (final)	–4.9	–	–	… with some impact on consumers …
	Jan business climate indicator	0.79	0.83	–	… and for business, Trump effect on EUR.
Ger	Jan CPI	1.7%	2.0%	–	Annual inflation has firmed materially, but remains in check.
US	Dec personal income	0.0%	0.4%	0.4%	Incomes to bounce after weak November.
	Dec personal spending	0.2%	0.5%	0.3%	Spending has disappointed of late; stronger month due.
	Dec PCE deflator	0.0%	0.3%	0.2%	Underlying annual inflation nears 2%yr medium–term target.
	Jan Dallas Fed index	15.5	15.5	–	Manufacturing robust across the US.
	Dec pending home sales	–2.5%	1.5%	–	Uptrend in sales abating.
Tue 31					
NZ	Net migration	6220	–	6000	Annual migration at record levels; low departures and strong arrivals.
Aus	Dec private sector credit	0.5%	0.5%	0.5%	Housing supported by RBA rate cuts, business rebounded post election.
	Dec NAB business survey	5	–	–	Conditions potentially rebounded from election lull – AiG surveys suggest.
Eur	Dec unemployment rate	9.8%	9.8%	–	Employment growth lacks momentum.
	Q4 GDP	0.3%	0.4%	0.3%	Growth has been ok, but continent uninspired.
	Jan CPI %yr	1.1%	1.5%	–	Slack clearly remains apparent.
UK	Jan GfK consumer confidence	–8	–7	–	Still at firm levels despite easing; rising prices will be a challenge.
	Dec mortgage approvals	67.5k	67.9k	–	Low borrowing rates supporting demand.
US	Q4 employment cost index	0.6%	0.6%	0.7%	Wages have firmed, but weaker benefit growth offsets.
	Nov S&P/CS home price index	0.63%	0.6%	–	How great an impact will higher rates have on prices?
	Jan Chicago PMI	53.9	55.0	–	Momentum robust.
	Jan consumer confidence index	113.7	112.8	–	Conference Board measure; will Trump gain be sustained?
Wed 1					
NZ	Q4 employment growth	1.4%	0.8%	0.6%	Jobs growth continuing; follows solid gains earlier in 2016.
	Q4 unemployment rate	4.9%	4.8%	4.8%	Continuing to push down as labour demand strengthens.
	Q4 LCI private wages (incl. overtime)	0.4%	0.5%	0.4%	Firming labour market is yet to pass through to wage growth.
Aus	Jan AiG PMI	55.4	–	–	Manufacturing a solid expansion (+1.2pts in Dec) – housing, lower AUD.
	Jan CoreLogic home value index	1.4%	–	0.3%	Other measures confirming lift in price growth. Jan data less reliable.
Chn	NBS manufacturing PMI	51.4	51.2	–	Robust uptrend seen through second half of 2016 …
	NBS non–manufacturing PMI	54.5	–	–	… with both official PMI's trending to near long–run averages.
Eur	Jan Markit manufacturing PMI	55.1	55.1		EUR becoming a clear positive.
Ger	Jan Markit manufacturing PMI	56.5	56.5		Only a little stronger than rest of continent.
UK	Jan Markit manufacturing PMI (final)	56.1	56.0	–	Firms reporting solid activity, lower GBP a support.
US	Jan ADP employment change	153k	160k	160k	Softer pace of job gains to continue in January.
	Jan Markit manufacturing PMI	55.1	–	–	Strong readings of late.
	Dec construction spending	0.9%	0.2%	–	Another weak read likely.
	Jan ISM manufacturing	54.5	55.0	–	Big business hopeful, and content with current momentum for now.
	FOMC policy decision, midpoint	0.625%	0.625%	0.625%	Next hike not until June.
Can	Jan RBC Canadian Manufacturing PMI	51.8	–	–	Modest growth continuing, with CAD and oil price effects offsetting.
Thu 2					
Aus	Dec dwelling approvals	7.0%	–1.5%	–1.0%	Nov gain followed a 20% slide prev 3mths. High rise boom ending.
	Dec trade balance, AUDbn	+1.2	+2.0	+1.5	Consolidation in surplus, after $2.4bn improvement in Oct.
UK	Bank of England Bank rate	0.25%	0.25%	0.25%	Activity resilient and lower pound boosting inflation.
US	Initial jobless claims	259k	–	–	Remain at historic lows.
Fri 3					
NZ	Jan ANZ commodity prices	0.7%	–	–	Improving off the back of last year's sharp rise in dairy prices.
Aus	Jan AiG PSI	57.7	–	–	A strong end to 2016. The 6.6pts jump in Dec may be overdone.
Chn	Caixin manufacturing PMI	51.9	51.8	–	External conditions reported to have improved materially.
Eur	Jan Markit services PMI	53.6	53.6	–	Domestic slack impeding progress.
Ger	Jan Markit services PMI	53.2	53.2	–	Surprisingly soft given labour market strength.
UK	Jan Markit services PMI (final)	56.2	55.9	–	Businesses are reporting increased turnover.
US	Jan nonfarm payrolls	156k	168k	170k	Annual revisions due. Can change history materially.
	ISM non–manufacturing	56.6	57.0	–	Very robust momentum of late.
	Jan Markit services PMI (final)	55.1	–	–	Decent post election bounce.
	Dec factory orders	–2.4%	1.4%	–	Choppy in recent months.
	Fedspeak	–	–	–	Evans discusses economic conditions and monetary policy in Illinois.

New Zealand forecasts

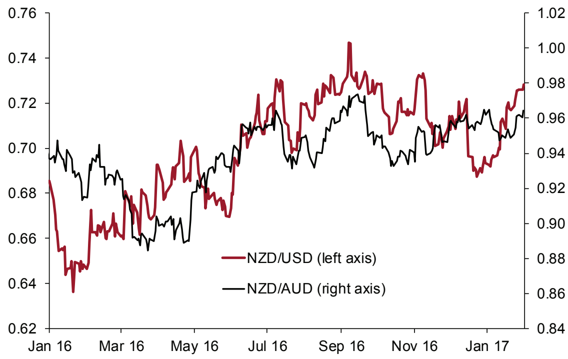
Economic Forecasts	March years				Calendar years			
% change	2015	2016	2017f	2018f	2014	2015	2016f	2017f
GDP (Production) ann avg	3.4	2.4	3.4	3.3	3.4	2.5	3.3	3.3
Employment	3.2	2.0	4.9	2.0	3.6	1.4	5.8	2.1
Unemployment Rate % s.a.	5.4	5.2	4.9	4.4	5.5	5.0	4.8	4.5
CPI	0.3	0.4	1.4	1.2	0.8	0.1	1.2	1.2
Current Account Balance % of GDP	-3.5	-3.1	-2.7	-2.7	-3.2	-3.4	-2.7	-2.6

Financial Forecasts	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-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	2.50	2.50	2.50	2.50	2.50
5 Year Swap	3.00	3.15	3.25	3.30	3.35	3.40
10 Year Bond	3.30	3.45	3.50	3.60	3.65	3.75
NZD/USD	0.71	0.70	0.68	0.67	0.65	0.66
NZD/AUD	0.96	0.95	0.93	0.93	0.93	0.94
NZD/JPY	82.4	82.6	80.2	80.4	79.3	81.8
NZD/EUR	0.68	0.68	0.67	0.67	0.65	0.67
NZD/GBP	0.58	0.57	0.56	0.55	0.54	0.55
TWI	78.6	78.0	76.4	75.9	74.4	76.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Tuesday 31 January 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.83%	1.85%	1.85%
60 Days	1.91%	1.92%	1.93%
90 Days	1.98%	1.98%	2.00%
2 Year Swap	2.44%	2.41%	2.50%
5 Year Swap	3.05%	2.96%	3.05%

NZ foreign currency mid-rates as at Tuesday 31 January 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7283	0.7108	0.6927
NZD/EUR	0.6809	0.6695	0.6609
NZD/GBP	0.5836	0.5916	0.5629
NZD/JPY	82.73	81.31	81.29
NZD/AUD	0.9646	0.9495	0.9648
TWI	79.89	78.38	77.63

International forecasts

Economic Forecasts (Calendar Years)	2013	2014	2015	2016f	2017f	2018f
Australia						
Real GDP % yr	2.1	2.8	2.4	2.2	2.1	2.8
CPI inflation % annual	2.7	1.7	1.7	1.6	1.7	2.5
Unemployment %	5.8	6.2	5.8	5.7	5.4	5.3
Current Account % GDP	-3.4	-3.0	-4.8	-3.0	-1.7	-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	1.2	1.7	1.7
Unemployment Rate %	7.4	6.2	5.3	4.8	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	0.6	0.7
Euroland						
Real GDP %yr	-0.3	0.9	1.6	1.6	1.4	1.3
United Kingdom						
Real GDP %yr	2.2	2.9	2.2	2.1	1.6	1.4
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	3.9	3.9
World						
Real GDP %yr	3.3	3.4	3.1	3.2	3.5	3.5
Forecasts finalised 16 December 2016						

Interest Rate Forecasts	Latest	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.78	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.70	2.95	2.95	3.00	3.05	3.15	3.25	3.40
International								
Fed Funds	0.625	0.625	0.875	0.875	1.125	1.125	1.375	1.375
US 10 Year Bond	2.39	2.55	2.65	2.75	2.85	3.00	3.10	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	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
AUD/USD	0.7534	0.74	0.74	0.73	0.72	0.70	0.70	0.68
USD/JPY	114.94	116	118	118	120	122	124	126
EUR/USD	1.0675	1.05	1.03	1.01	1.00	1.00	0.99	0.98
AUD/NZD	1.0393	1.04	1.06	1.07	1.08	1.07	1.06	1.05

Contact the Westpac economics team

Michael Gordon, Acting Chief Economist +64 9 336 5670

Satish Ranchhod, Senior Economist +64 9 336 5668

Sarah Drought, Economist +64 9 336 5696

Any questions email: economics@westpac.co.nz

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