

Weekly Commentary

12 February 2018



Stay on target

As widely expected, the Reserve Bank left the OCR unchanged and repeated its neutral rhetoric in last week's Monetary Policy Statement. Any move in the OCR remains a long way off – we're not forecasting a rate hike until late 2019. One reason the RBNZ can afford to sit tight for a while yet is muted wage inflation. Last week Stats NZ reported that while the unemployment rate edged lower to 4.5% in the December quarter, there is little upward pressure on wages. Finally, dairy prices extended their strong start to the year, up 6% in the latest GlobalDairyTrade auction.

It was a steady as she goes statement from the Reserve Bank of New Zealand on Thursday. The key guidance paragraph was unchanged: *"Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly."* But scratch below the surface, and there was a subtly more dovish tone to the RBNZ's outlook. A downgraded assessment of how much the Government's spending plans will affect the economy, a higher exchange rate and a surprisingly weak inflation outturn in the December quarter all led to the acknowledgement that inflation is likely to be lower than previously thought. The RBNZ is now forecasting that inflation will remain a little below 2% until 2020. Yet despite this weaker inflation outlook, the RBNZ's OCR forecast was unchanged from November.

The Bank continues to walk a tightrope between keeping rates at stimulatory levels to boost domestically generated inflation, while at the same time being wary of reigniting the housing market – which has been showing renewed signs of life in recent months. For now, the RBNZ remains content to keep a watching brief, keeping the faith that a strong economy this year will boost non-tradables inflation and drag headline CPI back to 2%.

The downward revisions to the Bank's near-term GDP and inflation forecasts nudge the Bank a little closer to our own view of the economy. However, there is still a way to go yet before the two views align. We think that the RBNZ remains too optimistic in its growth forecasts for 2018. In our view, the slump in business confidence foreshadows a pullback in investment, capacity constraints in the construction sector will limit growth, and the housing market will slow more sharply than the RBNZ has allowed for. As GDP growth falls short of the RBNZ's optimistic expectations, we predict that the Bank will become progressively more dovish as the year progresses. However, we also expect the exchange rate to fall more sharply than the RBNZ anticipates, which will provide some offsetting inflation pressure and will prevent a cut to the OCR. On balance, we expect that OCR hikes will occur in late-2019, rather than mid-2019 as the RBNZ is currently forecasting.

Of course, at this horizon, mooted changes to the RBNZ's mandate may become an important consideration. This was Governor Spencer's last *Monetary Policy Statement* (though he has one more OCR Review) before his short tenure concludes. The new Governor, Adrian Orr, takes office on the 27th of March. The Government has clearly signalled that the new Governor will also have a new mandate, requiring the RBNZ to target both inflation and

Stay on target continued

support “maximum employment”. It remains to be seen how this directive will be enshrined in law. However, the change will bring labour market developments squarely into the spotlight. Information like last week’s Household Labour Force Survey, Quarterly Employment Survey and wage data is set to take an increasingly prominent role in the RBNZ’s discussion.

Last week’s releases showed the labour market tightened further in the December quarter. The unemployment rate fell to a nine-year low of 4.5%, the number of people employed edged higher and the participation rate only fell a little from its record high the previous quarter. The falling unemployment rate and surveys showing firms are finding it increasingly difficult to find labour have forecasters questioning how much further the labour market can tighten before wage growth starts accelerating. There’s no way to precisely determine where the tipping point lies, but for what it’s worth, an unemployment rate of 4.5% is within the range of what we, and the Reserve Bank, would consider ‘neutral’ territory. That is, any further drop in unemployment will likely lead to a faster pickup in wage growth - something we’ve seen little of to date. The Labour Cost Index has been rising at roughly the same pace for the last couple of years (one off pay settlements aside). If we don’t see a pickup in wage inflation, and there’s more slack in the economy than expected, there’s a risk non-tradables inflation undershoots the Bank’s forecasts.

In other developments last week, there was a solid increase in dairy prices. Prices rose 6% in the most recent fortnightly auction, meaning prices have now risen almost 14% since the start of the year. This has led us to upgrade our payout forecast to \$6.50 KgMs for this season, broadly in line with Fonterra’s current estimate of \$6.40 KgMs. But while farmers are sure to welcome the prospect of improved prices, sentiment in the sector remains gloomy. Farmers are wary of the impact of proposed environmental regulations and uncertain how this will affect their operations going forward.

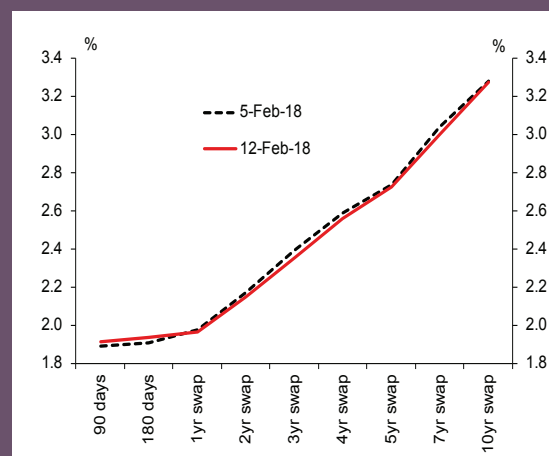
Looking ahead to this week, the key focus will be January REINZ housing data. The housing market has shown a renewed lease of life over the last few months, and this could well extend into January. However, we don’t expect this momentum to continue as the year progresses. In our view, the Government’s upcoming changes to the tax treatment of investment housing, the foreign buyer ban, gradually rising fixed mortgage rates and lower net migration will all act as a drag on the housing market this year.

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 fixed 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 Jan house sales and prices

Due the week starting 12 Feb, Sales last: +1.5%, Prices last: +3.8%/yr

- With the election out of the way and mortgage rates trickling lower, we've recently seen a rebound in the housing market. Sales are up 12% over the past three months (though they are still down 10% on a year earlier). Price growth has also firmed, with the gains spread fairly evenly across the country.
- We expect the positive trend in the housing market to continue for a few more months as buyers rush to beat looming regulatory and tax changes, as mortgage rates fall, and as banks loosen lending requirements following the RBNZ's LVR changes.
- However, we continue to expect that the housing market will slow over the coming year in response to looming changes in the policy environment.

REINZ house prices and sales

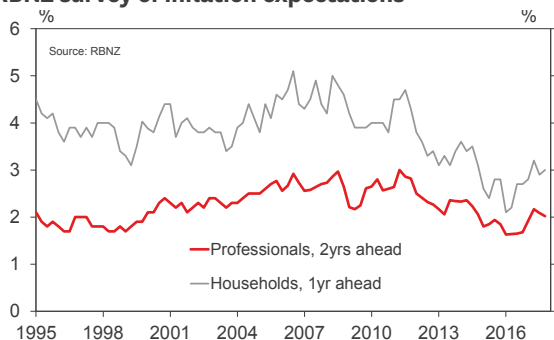


NZ Q1 RBNZ survey of inflation expectations

Feb 14, Two years ahead, last: 2.02%

- The importance of the Reserve Bank's survey of inflation expectations has varied in recent years. A sharp fall in this survey was cited as a key reason for the OCR cuts in 2016, but since then, the RBNZ has tended to downplay the two-year ahead survey in favour of longer-term measures.
- The timing of the survey was changed last year, so that it is now held directly after the quarterly CPI release. Annual inflation fell from 1.9% to 1.6% in the March quarter, well below market forecasts. It's likely that surveyed expectations will follow the CPI lower; the question is to what extent the 2% midpoint of the inflation target serves as an anchor.

RBNZ survey of inflation expectations

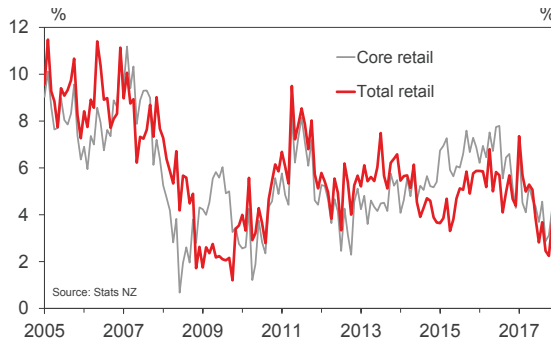


NZ Jan retail card spending

Feb 12, Last: +0.5%, WBC f/c: +0.6%

- Recent spending figures have been thrown around by changes in fuel prices, as well as the growing prevalence of 'Black Friday' sales in New Zealand. With regards to the latter of those factors, increased discounting saw spending brought forward in November, with a corresponding pull back in December.
- Following the volatility in recent months, we expect a return to trend in January. We're forecasting a 0.6% rise in retail spending. That includes a solid 0.8% gain in core spending, which is expected to offset softness in fuel related spending.
- Spending continues to be supported by firm population growth and the recent second wind in housing. However, we expect that the impulse from both of these factors to ease off over the coming year.

Card transactions, annual % change



Aus Feb Westpac-MI Consumer Sentiment

Feb 14 Last: 105.1

- The Westpac-Melbourne Institute Consumer Sentiment Index rose 1.8% to 105.1 in Jan from 103.3 in Dec. Sentiment has continued to recover from the weakness in Q3 last year, bolstered by a less threatening outlook for interest rates and improving confidence around the economy and jobs. While the mood is 'cautiously optimistic' rather than buoyant, the Jan update was the best monthly index read since late 2013 and the most positive start to a calendar year since 2010.
- The Feb survey is in the field over the week ended Feb 10. Sentiment is likely to be affected by increased financial market turbulence in recent weeks with a sharp sell-off in global equities. The S&P500 is down 5% and the ASX200 is down nearly 3% since the Jan survey, the biggest monthly falls since late 2016.

Consumer Sentiment Index



The week ahead

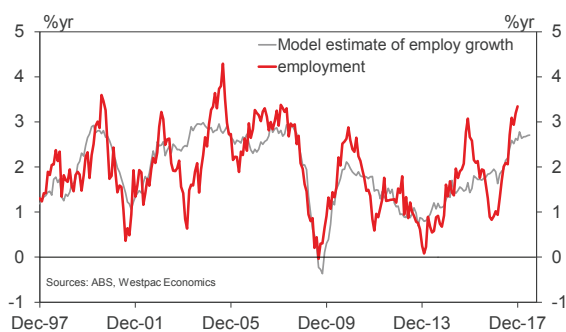
Aus Jan Labour Force - employment '000

Feb 15, Last: 34.7k, WBC f/c: 15k

Mkt f/c: 15k, Range: 4k to 38k

- December sealed a solid year for the labour market. Employment rose 34.7k, well above both the market's (+15k) and Westpac's (-10k) expectations. In the year total employment gained 403k or 3.3%.
- December also saw further solid gains in full-time employment (+15.1k). In the year, full-time employment gained 303.4k. Part-time employment rose 19.5k to be up 99.7k/2.61%yr. Total hours worked did ease back a touch (-0.2%mo) but they are still up a solid 3.2%yr.
- This was the 15th consecutive monthly gain in employment matching the longest period of consecutive employment which ended July 1994. Will we see a 16th consecutive gain in January? Statistical volatility may prevent it but with our leading indicators remaining very robust there is little to point to a negative print this month.

Jobs Index Model of Employment

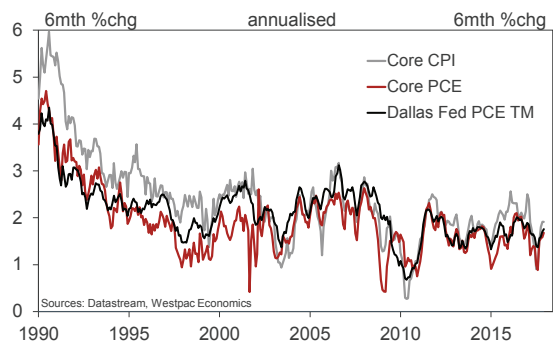


US Jan CPI

Feb 14, last 0.2%, WBC 0.4%

- Core inflation (excludes food and energy) printed its strongest increase in 11 months in December as prices rose 0.3%. Price gains were broad based across the sub sectors, with the most significant contributions coming from autos; health and rents. Overall, the December outcome gave further support to the view that the inflation pulse is strengthening. Over the year to December, core prices were up 1.7%yr, headline inflation 2.1%yr.
- Come January, a similar result is expected, albeit with momentum in core inflation being a little more modest. Core prices are expected by Westpac and the market to rise 0.2%, leaving annual inflation at 1.7%yr. Headline prices are likely to rise 0.4% in the month thanks to strength in energy inflation. Base effects should still see annual headline inflation tick down to 2.0%yr, from 2.1%yr in December.

Core inflation tending toward target



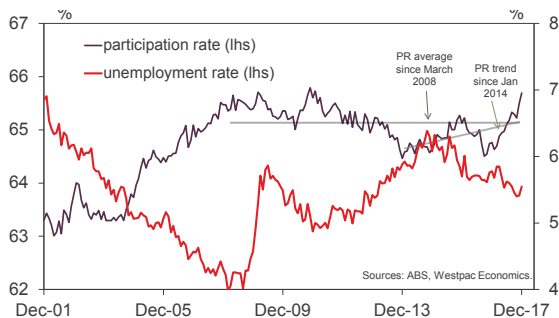
Aus Jan Labour Force - unemployment %

Feb 15, Last: 5.5%, WBC f/c: 5.5%

Mkt f/c: 5.5%, Range: 5.4% to 5.6%

- In the month unemployment rose to 5.5% (5.55% at two decimal places vs. 5.41% in November) with a 0.2ppt gain in participation driving a further 55.16k surge in the labour force. This surge in participation has been driven mostly by the incredible jump in females to a new high of 60.6%.
- Female employment lifted on the back of strong growth in the services sectors. Of the top five sectors for employment in 2017, four have a higher than average share of female employees. And this robust demand for labour has drawn more females into the workforce and/or encouraged others to extend their working life. That is as demand for female labour has risen, so too has supply.
- We do see a small pullback in participation, from 65.7% to 65.6%, which moderates the January gain in the labour force. Thus the +15k on employment will see the unemployment rate hold flat at 5.5%.

Unemployment and participation rates

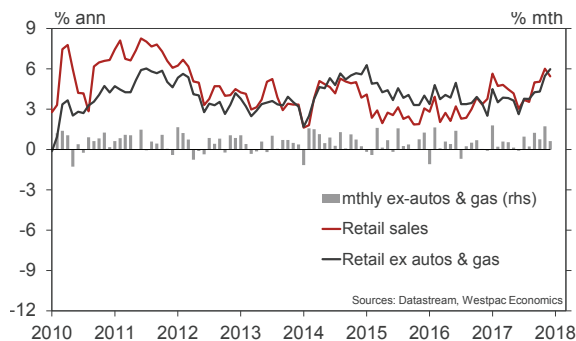


US Jan retail sales

Feb 14, last 0.4%, WBC 0.4%

- Retail sales growth accelerated in late 2018. This was partly due to hurricane damage in Texas and surrounding states (which created a need to replace cars and other durable goods). Energy prices were also supportive of nominal spending over the period.
- That said, underlying demand is also robust and broad based. Indeed, the December report included an upward revision to core sales in November.
- Another solid headline gain is anticipated in January, 0.4%. This is despite autos acting as a drag and limited support from energy prices. Core sales are likely to have risen by 0.5% in the month.

Retail sales growth has built momentum



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 12					
NZ	Jan REINZ house prices, %yr	3.8%	-	-	Due this week. Lower mortgage rates likely to see prices lift again...
	Jan REINZ house sales	1.4%	-	-	...but turnover remains much softer than a year ago.
	Jan retail card spending	0.5%	-	0.6%	A return to trend after volatility related to discounting.
US	Jan monthly budget statement \$bn	51.3	50.0	-	Deficit will receive greater attention in 2018/19.
Tue 13					
Aus	RBA Assistant Governor Economic	-	-	-	Luci Ellis speaking at ABE conference, Sydney.
	Jan NAB business survey	13	-	-	Conditions above avg but uneven, confidence up above avg.
UK	Jan CPI	0.4%	-0.6%	-	Annual CPI high, but impact of earlier fall in GBP fading.
	Dec house price index, %yr	5.1%	-	-	Econ uncertainty remains a drag on prices, esp. in London.
US	Jan NFIB small business optimism	104.9	106.0	-	Sentiment remains strong; investment to follow?
	Fedspeak	-	-	-	Mester on monetary policy and economic outlook in Ohio.
Wed 14					
NZ	Jan food prices	-0.8%	-	1.6%	Fruit/veg seasonal jump but less weather-affected than in 2017.
	Q1 RBNZ 2yr ahead inflation exptns	2.02%	-	-	Softness in actual inflation will be a drag.
Aus	Feb Westpac-MI Consumer Sentiment	105.1	-	-	Optimism has risen in the past few months.
Eur	Dec industrial production	1.0%	-0.2%	-	Underlying demand for manufacturing remains strong.
	Q4 GDP 2nd estimate	0.6%	0.6%	-	Spain and Germany continue to drive aggregate.
Ger	Jan CPI final %yr	1.6%	1.6%	-	Despite strong economy, inflation still below target.
US	Jan CPI	0.2%	0.4%	0.4%	Energy contributing half the expected gain.
	Jan retail sales	0.4%	0.3%	0.4%	Autos a drag at the margin.
	Dec business inventories	0.4%	0.3%	-	Key source of volatility for GDP.
Thu 15					
Aus	Jan employment, chg	34.7k	15k	15k	A record 16th consecutive gain? Model says yes!
	Jan unemployment rate	5.5%	5.5%	5.5%	Females driven participation higher but set to level out.
	Feb MI inflation expectations	3.7%	-	-	Expectations trended down in 2017 & set to continue.
	Dec industrial production	2.7%	-	-	... but PMIs indicate a strong manufacturing sector.
Eur	Dec trade balance €bn	-	-	-	Global growth and Euro supportive.
	ECB chief economist Praet	-	-	-	Speaks on panel in Paris.
US	Feb Fed Empire state index	17.7	17.9	-	At elevated level.
	Jan PPI	-0.1%	0.4%	-	Upstream price pressures contained.
	Initial jobless claims	221k	-	-	At historically low level.
	Feb Philly Fed index	22.2	21.0	-	At elevated level.
	Jan industrial production	0.9%	0.2%	-	Followed ISMs higher through 2017/18.
	Feb NAHB housing market index	72	72	-	Very strong conditions being reported.
Fri 16					
NZ	Jan BusinessNZ manufacturing PMI	51.2	-	-	Dec saw sharp post-election drop. Some recovery likely.
Aus	RBA Governor Lowe testimony	-	-	-	Parliament, half yearly testimony, Sydney, 9:30am.
UK	Jan retail sales	-1.5%	0.5%	-	Real income squeeze weighing on spending.
US	Dec total net TIC flows \$bn	33.8	-	-	Will higher rates see greater offshore demand?
	Jan import price index	0.1%	0.6%	-	Energy and US dollar weakness supporting.
	Jan housing starts	-8.2%	2.8%	-	Highly volatile...
	Jan building permits	-0.2%	0.0%	-	... the level of new projects marking time.
	Feb Uni. of Michigan sentiment prelim.	95.7	95.5	-	Households confident thanks to labour market.

New Zealand forecasts

Economic Forecasts	Quarterly				Annual			
	2017		2018		Calendar years			
% change	Sep(a)	Dec(a)	Mar	Jun	2016	2017	2018f	2019f
GDP (Production)	0.6	0.7	0.5	0.6	4.0	2.9	2.5	3.2
Employment	2.2	0.2	0.6	0.4	5.8	3.5	1.6	1.2
Unemployment Rate % s.a.	4.6	4.5	4.5	4.6	5.3	4.5	4.7	4.6
CPI	0.5	0.1	0.7	0.3	1.3	1.6	1.9	1.7
Current Account Balance % of GDP	-2.6	-2.9	-2.7	-3.0	-2.5	-2.9	-3.4	-2.8

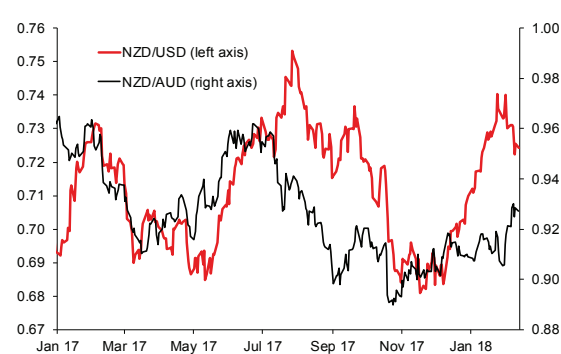
¹ Annual average % change

Financial Forecasts	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	1.90	1.90	1.90	1.90	1.90	1.90
2 Year Swap	2.20	2.20	2.30	2.40	2.50	2.60
5 Year Swap	2.75	2.80	2.95	3.05	3.15	3.25
10 Year Bond	2.95	3.10	3.30	3.40	3.45	3.50
NZD/USD	0.71	0.69	0.67	0.65	0.63	0.64
NZD/AUD	0.91	0.91	0.91	0.90	0.90	0.90
NZD/JPY	80.2	79.4	78.4	76.1	73.7	74.9
NZD/EUR	0.60	0.59	0.58	0.57	0.55	0.55
NZD/GBP	0.53	0.52	0.52	0.51	0.50	0.51
TWI	74.1	73.0	71.9	70.5	68.7	69.5

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 12 February 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.80%	1.79%	1.78%
60 Days	1.85%	1.84%	1.83%
90 Days	1.92%	1.91%	1.90%
2 Year Swap	2.15%	2.18%	2.21%
5 Year Swap	2.73%	2.72%	2.71%

NZ foreign currency mid-rates as at 12 February 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7243	0.7318	0.7252
NZD/EUR	0.5914	0.5908	0.5945
NZD/GBP	0.5243	0.5202	0.5278
NZD/JPY	78.82	79.73	80.56
NZD/AUD	0.9273	0.9036	0.9171
TWI	74.78	74.71	75.08

International forecasts

Economic Forecasts (Calendar Years)	2014	2015	2016	2017f	2018f	2019f
Australia						
Real GDP % yr	2.6	2.5	2.6	2.3	2.5	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	2.3	2.2	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	1.4	1.1	0.9
Euroland						
Real GDP %yr	1.3	2.0	1.8	2.4	2.0	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	4.2	4.2	4.2
World						
Real GDP %yr	3.6	3.4	3.2	3.8	3.7	3.6

Forecasts finalised 14 December 2017

Interest Rate Forecasts	Latest	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.76	1.77	1.78	1.78	1.78	1.78	1.78	1.78
10 Year Bond	2.87	2.90	2.90	2.90	3.10	3.25	3.40	3.40
International								
Fed Funds	1.375	1.625	1.875	2.125	2.125	2.125	2.125	2.125
US 10 Year Bond	2.83	2.80	2.90	3.00	3.25	3.25	3.20	3.15
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.20	0.00	0.00

Exchange Rate Forecasts	Latest	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
AUD/USD	0.7774	0.78	0.76	0.74	0.72	0.70	0.71	0.72
USD/JPY	108.79	112	115	117	117	117	117	118
EUR/USD	1.2249	1.20	1.17	1.15	1.15	1.15	1.17	1.18
AUD/NZD	1.0770	1.10	1.10	1.10	1.11	1.11	1.11	1.11

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