

Weekly Commentary

23 April 2018



So near and yet so far

The first inflation reading for this year was as subdued as we expected, with annual inflation dropping to 1.1%. We expect this dip to be short-lived, with several factors working to push inflation higher over the rest of this year. Yet a sustained return to the Reserve Bank's target midpoint remains elusive, particularly with signs that housing-related inflation may have already passed its peak.

Consumer prices rose by 0.5% for the March quarter, which was in line with our forecast but a touch below the Reserve Bank's estimate of a 0.6% rise. The quarterly result was by no means a weak one – in fact it was one of the stronger quarterly outturns in recent times. And that was even after the impact of the new Government policy of a year's free tertiary study, which knocked 0.14% off the inflation rate.

Tradables inflation remains weak, with prices in import-heavy categories such as clothing, furnishing and electronics all softer than we expected. That highlights the lack of inflation pressures among our trading partners, as well as the ongoing squeeze on New Zealand retailers' margins. The New Zealand dollar hasn't given much of an assist to import prices in recent times, with only a slight fall in the exchange rate over the last year.

In contrast, the more persistent non-tradables components were a little stronger than we expected (and quite a bit higher than the RBNZ's forecast). Non-tradables inflation has picked up a bit from its lows in the last couple of years, in keeping with an economy that is running closer to full capacity. However, it remains well below the levels we saw in the years before the financial crisis.

Annual inflation has dropped towards the lower end of the RBNZ's target range, but this move is likely to be temporary. It's partly a matter of timing – prices rose sharply in the

March quarter last year, but then were very soft through the middle part of the year. As those past readings drop out of the calculation, the year-on-year comparison will become more favourable for the RBNZ over the rest of this year.

We're also expecting a bit of a boost to tradables inflation in coming quarters. The lower New Zealand dollar should give a boost to retail prices (or limit price declines) with its usual lagged impact. In addition, planned increases in fuel taxes will add to the inflation rate in the second half of this year.

However, a sustained lift to the 2% mid-point of the RBNZ's target is a more daunting task. Weak tradables inflation is a global trend, and the boost to import prices that we expect from a lower NZD won't persist into next year. If imported price pressures are missing in action, then home-grown inflation will have to pick up a lot more than it has to date. But there are a number of headwinds to such a move as well.¹

There was one aspect of the March quarter CPI that particularly highlighted the difficulty of getting inflation higher. The housing-related components of the index, such as rents, newly-built homes and realtor services, are among the few that have consistently added to overall inflation in recent years. But these components have slowed as the housing market has cooled, and were notably subdued in the March quarter.

¹ Our recently released Bulletin ([available here](#)) looks at the longer-term drivers of our inflation forecasts.

So near and yet so far... continued

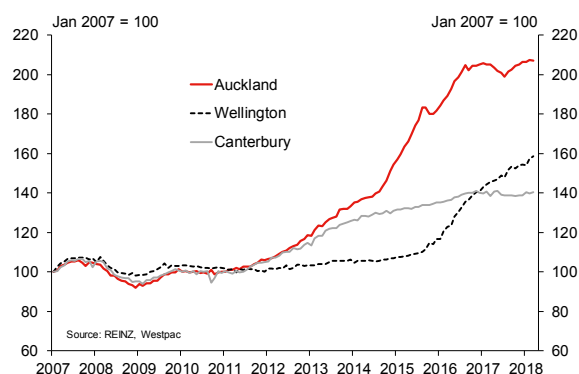
Rents rose by 0.6%, with a slowdown in Auckland offsetting a pickup in other parts of the country. Meanwhile, new home prices rose just 0.4%, the smallest quarterly rise in more than six years. This highlights that the upward pressure on building costs in recent years has not just been a product of capacity constraints; builders have more scope to raise their prices when existing home prices are running hot.

The housing market has regained some momentum after a slowdown in the first half of last year. Auckland house prices have recovered all of their decline, and prices have continued to rise in much of the rest of the country. (Canterbury is the main exception, as the housing stock has been restored to pre-earthquake levels.) An easing in lending conditions – both lower mortgage rates and a loosening of loan-to-value restrictions – have helped to lift housing demand in recent months.

But there is an array of new Government policies lined up against the housing market, including:

- An extension of the ‘bright line’ test. In 2015 a new rule required people to pay tax on capital gains if they resold an investment property within two years. This has now been extended to five years, a significant holding period for investors.
- A ban on foreign buyers of residential property, probably from the middle of this year.
- The phasing out of ‘negative gearing’ – the ability of property investors to use losses from rental properties to reduce their overall tax bill – from next year. This will reduce (but not eliminate) the tax advantage that

House price indices by region



investors have over first-home buyers and over other forms of investment.

- A reduction in net migration.
- The likelihood that the Tax Working Group will recommend a capital gains tax excluding the family home. This would not be introduced until the Government’s next term.

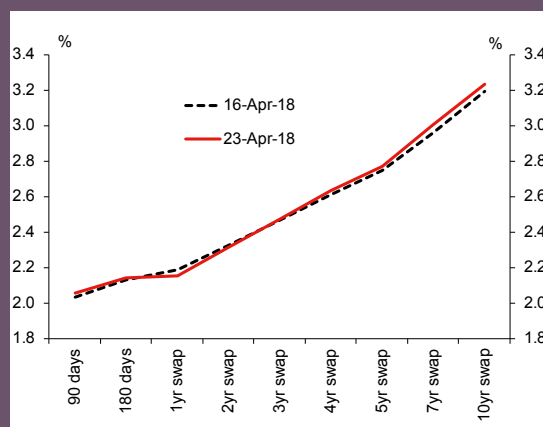
On top of these policy moves, we think that mortgage rates are more likely to rise than fall in the coming years, in an environment of rising global interest rates. All together, we are forecasting a small decline in house prices in the second half of this year, and for prices to remain subdued in the following years. In those circumstances, it is hard to see the housing components of the CPI as a greater source of inflation than they already have been to date.

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

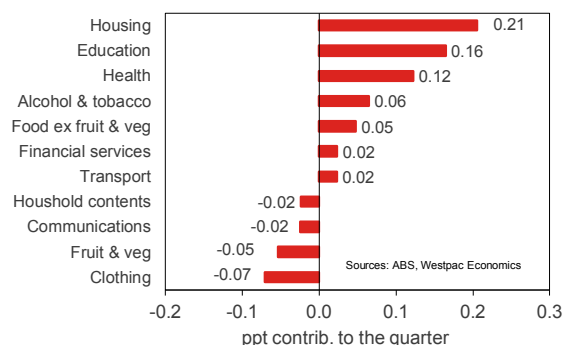
Aus Q1 CPI

Apr 24, Last: 0.6%, WBC f/c: 0.5%

Mkt f/c: 0.5%, Range: 0.3% to 0.9%

- Westpac's forecast for the headline CPI is 0.5%qtr holding the annual pace flat at 1.9%yr. Core inflation is also forecast to print 0.5%qtr (0.50% at two decimal places) holding the annual pace flat at 1.9%yr. In the March quarter the increasing perseverance of post-Christmas sales now overwhelms an historical seasonal uplift associated with the re-pricing of administered prices and the resetting of the Pharmaceutical Benefits Scheme. The ABS estimates a seasonal factor of slightly more than -0.1ppt.
- Core inflation remains below the bottom of the RBA target band and with the expected moderation in dwelling purchases price inflation through 2018, along with consumer goods still captive to a competitive deflationary cycle, it is hard to see core inflation breaking much higher.

Contributions 2018Q1 CPI forecast



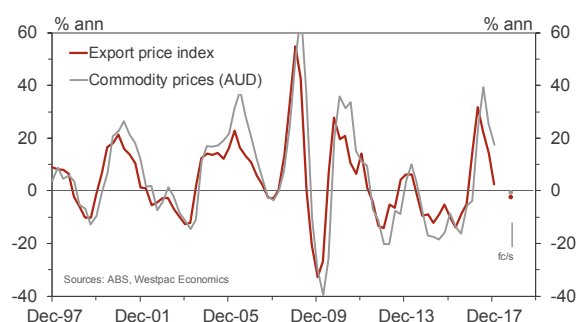
Aus Q1 export price index

Apr 26, Last: 2.8%, WBC f/c: 3.7%

Mkt f/c: 4.1%, Range: 2.5% to 5.0%

- Export prices moved higher late in 2017, +2.8% in Q4, after a mid-year slump, -5.7% in Q2 and -3.0% in Q3. For the 2017 year as a whole, export prices rose by 2.4% to be 24% above the low at the start of 2016, reflecting the rebound in commodity prices, up from historic lows. For the March quarter, export prices are expected to increase by 3.7% supported by higher commodity prices in the period. Despite this, export prices would still be 2.5% below the level of a year ago. The terms of trade for goods, on these estimates, increased by almost 3% in the March quarter. That still leaves the index 4.5% below the level of a year ago. As to prices for services, an update will be available with the release of the Balance of Payments on June 5.

Commodity prices & export price index



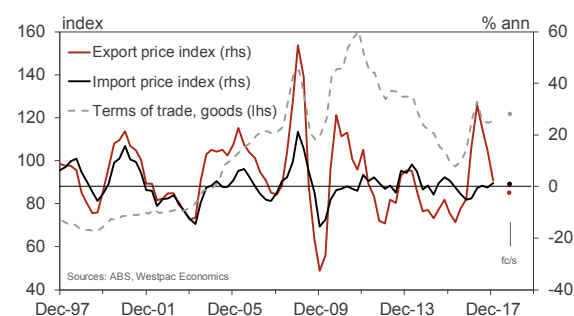
Aus Q1 import price index

Apr 26, Last: 2.0%, WBC f/c: 0.8%

Mkt f/c: 1.2%, Range: 0.0% to 3.0%

- Prices for imported goods increased by 2.0% in the December quarter impacted by the lower currency in the period. Over the 2017 year, import prices lifted by a modest 1.4%, boosted by higher global energy prices.
- For the March quarter of 2018, we expect a 0.8% rise in import prices, with the annual change moderating to 1.0%.
- The currency slipped in the quarter on a TWI basis, declining by 0.7% to 64.2, some 2.7% below the level of a year ago.
- In addition, the bill for fuel imports rose in Q1 as global energy prices increased a little further in the period.

Import & export goods prices

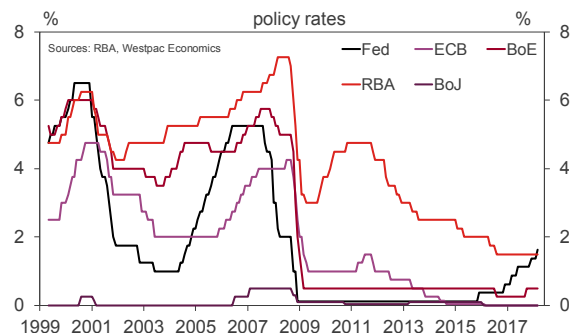


ECB April meeting

Apr 26, last -0.40%, WBC -0.40%

- Increasingly, it is becoming evident that Euro Area growth is past its peak. The outlook for the ECB will depend heavily on the pace of slowing seen across the region. If inflation is to move towards trend, then above-trend growth must persist throughout the forecast period. While not anticipating a collapse in growth by any means, we continue to believe that remaining slack in the Euro Area combined with a softening growth pace (from 1.25ppts above trend in 2017 to closer to 0.25ppts in 2019). To our mind, this will not be enough to drive inflation to target, but will see it move closer than it has been. The consequence of the above outturn should be a slow end to asset purchases, extended to December, followed by an unwinding of negative interest rates in H1 2019, and an eventual rise in the refinancing rate, in Q4 2019. In the near term, the tone of language will be all that changes.

ECB prudence, patience and persistence



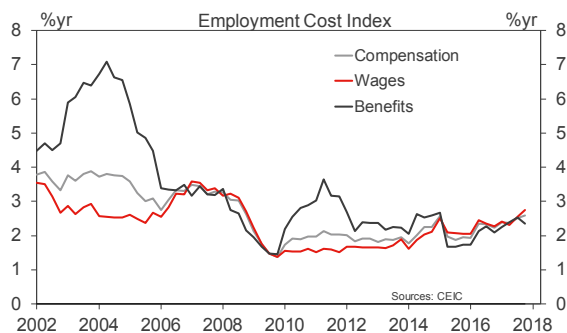
The week ahead

US Q1 employment cost index

Apr 27, last 0.6%, WBC 0.7%

- Emerging across all wage and compensation measures for the US economy is a slow but sustained uptrend. Over the past year, annual growth in the employment cost indexes' total compensation measure has accelerated from 2.2%/yr to 2.6%/yr, the result of stronger wages and benefits for most workers in both the public and private sector. Come Q1 2018, while the annual growth pace will slow a touch to 2.5% owing to a base effect, we anticipate that the quarterly growth pace will accelerate (from 2.4% annualised to 2.8%). This uptrend will persist through 2018, though progress will remain slow.
- Worth keeping an eye on are the spread of conditions across private industries and the public sector. Conditions are likely to remain variable, limiting the benefit of higher wages and conditions to some.

Compensation growth remains stable

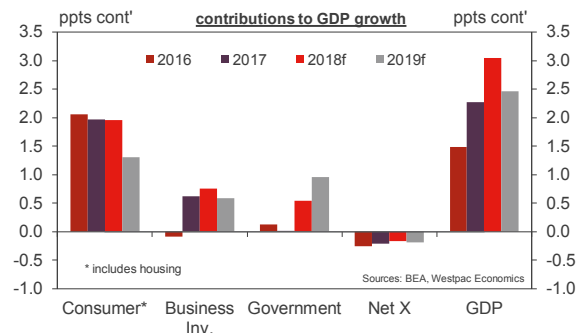


US Q1 GDP

Apr 27, last 2.9%, WBC 2.8%

- The detail of the Q4 GDP outcome was much stronger than the headline reading made out. This was true of the first estimate of 2.6% annualised as it was the third at 2.9%. In comparison, Q4 domestic final demand growth came in at 4.8% annualised, driven higher by strength across household consumption; residential investment; and business investment as well as an uplift in government spending. Come Q1 2018, a similar outcome is expected, circa 2.8%. However, the make-up of growth will be quite different. Retail and PCE data point to a soft consumer; and business investment has struggled to move higher. It is also likely too early for the government to add materially to growth. The component that is like to fill the gap is inventories which have exhibited strength of late. Domestic final demand is therefore likely to come in at 2.3% annualised – or lower.

US growth to depend on gov't spend in 18/19



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 23					
Eur	Apr Markit manufacturing PMI flash	56.6	56.0	-	Remain at an elevated level...
	Apr Markit services PMI flash	54.9	54.8	-	... thanks to broad based domestic and foreign demand.
US	Mar Chicago Fed activity index	0.88	0.25	-	US economy on solid footing.
	Apr Markit manufacturing PMI flash	55.6	55.0	-	Has held back of late as ISM manufacturing rallied.
	Apr Markt services PMI flash	54.0	54.0	-	Services measure has followed ISM higher.
	Mar existing home sales	3.0%	0.2%	-	Highly volatile; limited supply a real issue.
Tue 24					
NZ	Mar net migration	4970	-	5560	Annual migration still elevated, but moving downwards.
Aus	Q1 CPI	0.6%	0.5%	0.5%	Outside of the seasonal lift in health & education...
	Q1 core CPI (avg RBA measures)	0.4%	0.5%	0.5%	... there is little sign of a broader lift in prices.
	RBA Assist Governor Financial Markets	-	-	-	Chris Kent, at Housing Industry Assoc., Sydney, 8am AEST
UK	Mar public sector net borrowing, £b	-0.3	-	-	Borrowing requirements modest despite headwinds.
US	Feb FHFA house prices	0.8%	0.5%	-	Continued robust momentum...
	Feb S&P/CS home price index	0.75%	0.63%	-	... seen in prices, on all measures.
	Mar new home sales	-0.6%	1.1%	-	Demand for new housing remains robust.
	Apr Richmond Fed index	15	16	-	Has been trending higher of late. Tax/ spending aiding.
	Apr consumer confidence index	127.7	126.0	-	As goes the labour market, so confidence.
Wed 25					
Aus/NZ	ANZAC Day	-	-	-	Public holiday.
Thu 26					
Aus	Q1 import price index	2.0%	1.2%	0.8%	Global energy prices up, AUD lower on TWI basis.
	Q1 export price index	2.8%	4.1%	3.7%	Commodity price rally extended into Q1.
Eur	ECB policy decision	-0.40%	-0.40%	-	Biding their time until Q3.
US	Mar wholesale inventories preliminary	1.0%	-	-	Jan and Feb both saw robust gains in inventory.
	Mar durable goods orders preliminary	3.0%	1.1%	-	Yet to see evidence uptick in investment is sustainable.
	Initial jobless claims	232K	-	-	Very low.
	Apr Kansas City Fed index	17	-	-	Also has been trending higher of late.
Fri 27					
NZ	Apr ANZ consumer confidence	128.0	-	-	Changes in Govt policy on incomes starting to roll out.
	Mar trade balance, \$m	217	200	350	Typically the seasonal high point for the trade balance.
Aus	Q1 PPI	0.6%	-	-	Costs rose from lift in oil prices.
Chn	Mar industrial profits %oyr	10.8%	-	-	Commodity prices providing significant support.
Eur	Apr economic confidence	112.6	112.0	-	Across the household sector...
	Apr business climate indicator	1.34	-	-	... businesses... and the market, it is difficult to find...
	Apr consumer confidence final	0.1	-	-	... someone in Europe that lacks confidence.
UK	Apr GfK consumer confidence	-7	-6	-	Picked up, buoyed by improved household finances.
	Q1 GDP	0.4%	0.3%	-	Growth sluggish, esp. in services. Poor weather a drag.
US	Q1 employment cost index	0.6%	0.7%	0.7%	Annual g'th to edge lower, but q'tly momentum sustained.
	Q1 GDP %annualised	2.9%	2.1%	2.8%	Detail mixed, but headline to create positive mood.
	Apr Uni. of Michigan sentiment	97.8	98.0	-	As goes the labour market, so too confidence.

New Zealand forecasts

Economic Forecasts	Quarterly				Annual			
	2017	2018			Calendar years			
% change	Dec(a)	Mar	Jun	Sep	2016	2017	2018f	2019f
GDP (Production)	0.6	0.6	0.6	0.7	4.0	2.9	2.7	3.0
Employment	0.5	0.4	0.4	0.4	5.8	3.7	1.4	1.0
Unemployment Rate % s.a.	4.5	4.4	4.4	4.4	5.3	4.5	4.5	4.7
CPI	0.1	0.5	0.4	0.6	1.3	1.6	1.7	1.5
Current Account Balance % of GDP	-2.7	-2.2	-2.3	-2.5	-2.2	-2.7	-2.4	-2.7

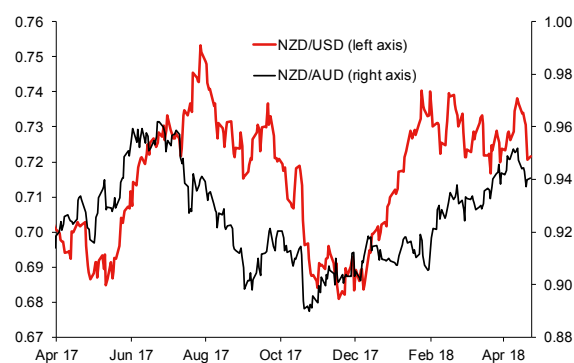
¹ Annual average % change

Financial Forecasts	Jun-18	Sep-18	Dec-18	Mar-18	Jun-19	Sep-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	2.05
2 Year Swap	2.20	2.20	2.30	2.40	2.55	2.70
5 Year Swap	2.70	2.75	2.90	3.05	3.15	3.25
10 Year Bond	2.90	3.00	3.20	3.30	3.35	3.40
NZD/USD	0.72	0.70	0.68	0.66	0.65	0.64
NZD/AUD	0.94	0.92	0.92	0.92	0.92	0.91
NZD/JPY	77.8	76.3	75.5	73.3	72.2	70.4
NZD/EUR	0.59	0.57	0.56	0.55	0.54	0.52
NZD/GBP	0.53	0.53	0.54	0.54	0.53	0.52
TWI	74.5	73.0	71.7	70.3	69.6	68.6

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 23 April 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.88%	1.88%	1.86%
60 Days	1.97%	1.92%	1.91%
90 Days	2.06%	1.98%	1.96%
2 Year Swap	2.32%	2.25%	2.23%
5 Year Swap	2.77%	2.69%	2.66%

NZ foreign currency mid-rates as at 23 April 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7217	0.7275	0.7237
NZD/EUR	0.5883	0.5919	0.5860
NZD/GBP	0.5154	0.5160	0.5119
NZD/JPY	77.83	77.79	75.73
NZD/AUD	0.9406	0.9468	0.9395
TWI	74.61	75.09	74.71

International forecasts

Economic Forecasts (Calendar Years)	2014	2015	2016	2017	2018f	2019f
Australia						
Real GDP % yr	2.6	2.5	2.6	2.3	2.7	2.5
CPI inflation % annual	1.7	1.7	1.5	1.9	2.1	1.9
Unemployment %	6.2	5.8	5.7	5.5	5.5	5.6
Current Account % GDP	-3.0	-4.7	-3.1	-2.3	-2.8	-3.8
United States						
Real GDP %yr	2.6	2.9	1.5	2.3	3.0	2.5
Consumer Prices %yr	1.6	0.1	1.3	2.1	2.5	2.0
Unemployment Rate %	6.2	5.3	4.9	4.4	4.0	3.8
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	1.5	1.3	1.0
Euroland						
Real GDP %yr	1.3	2.0	1.8	2.5	2.1	1.6
United Kingdom						
Real GDP %yr	3.1	2.2	1.8	1.7	1.6	1.6
China						
Real GDP %yr	7.3	6.9	6.7	6.9	6.3	6.1
East Asia ex China						
Real GDP %yr	4.2	3.8	3.9	4.5	4.3	4.3
World						
Real GDP %yr	3.6	3.4	3.2	3.8	3.9	3.7

Forecasts finalised 6 April 2018

Interest Rate Forecasts	Latest	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	2.07	2.02	1.98	1.94	1.90	1.88	1.86	1.85
10 Year Bond	2.82	2.75	2.95	3.15	3.20	3.10	3.10	3.10
International								
Fed Funds	1.625	1.875	2.125	2.125	2.375	2.625	2.625	2.625
US 10 Year Bond	2.91	2.90	3.10	3.35	3.50	3.50	3.40	3.30
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.20	0.00	0.00	0.00

Exchange Rate Forecasts	Latest	Jun-18	Sep-18	Dec-18	Mar-18	Jun-19	Sep-19	Dec-19
AUD/USD	0.7715	0.77	0.76	0.74	0.72	0.71	0.70	0.70
USD/JPY	107.63	108	109	111	111	111	110	110
EUR/USD	1.2341	1.22	1.22	1.21	1.19	1.21	1.23	1.26
AUD/NZD	1.0651	1.07	1.09	1.09	1.09	1.09	1.09	1.08

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