Weekly Commentary

30 January 2018

Dollar up, inflation down

With inflation surprising to the downside, we continue to expect that OCR hikes will come later than financial markets anticipate. However, we've brought our expectations for the Fed Funds rate forward, and revised our forecasts for the NZ dollar upwards.

Revised views on the Fed and NZ dollar

When we finalised our forecasts in late-2017, we expected that the Federal Funds rate would increase in both June and December of 2018 to reach 1.875% by year's end. However, we now expect that the Fed will raise the Funds rate 25bps at its March, June and September meetings. That would take the Funds Rate to 2.125%, leaving it a little above neutral levels. Underlying this change are several factors: recent US economic data has been positive; there has been an unexpected 4% drop in the USD that will help to support US manufacturing; finally, recent changes to US taxation rules are expected to boost investment spending.

The corollary of the US dollar's recent weakness has been a rise in other currencies, including the NZ dollar. At the same time, some of the nervousness that we saw following last year's election has faded and prices for some of our key commodity exports have lifted. Combined, these factors have seen the NZ dollar grinding higher in the early part of 2018, and at the time of writing the NZD/USD was trading at over 73 cents – much higher than we previously expected. We still expect the NZ dollar will depreciate over 2018 as the Fed hikes rates and the RBNZ stays pat. However, with the NZ dollar starting from a higher than expected point, our revised target for NZD/USD by the end of 2018 is now USD 0.65 cents (vs. 63 cents previously).

Soft December quarter inflation

Consumer prices rose by just 0.1% in the December quarter. That was below analysts' and our own forecasts for a 0.4% increase. It was also lower than the Reserve Bank's November forecast for a 0.3% rise. This soft result saw the annual inflation rate dropping back from 1.9% down to 1.6%.

Underlying this softness was widespread weakness in the prices of tradable goods, which are mostly imported. Prices in this group fell by 0.3% over the quarter, with virtually every item with some imported content coming in below our forecasts (the exception was fuel prices, which rose 6%).

There are two possible culprits here. The first is the New Zealand dollar, which strengthened through the middle part of 2017. Exchange rate movements typically affect retail prices with a lag of two to four quarters. It's likely that earlier gains in the New Zealand dollar are still flowing through into retail prices of imported products. That said, the rise in the exchange rate last year wasn't a particularly large or sustained one.

However, there continues to be a lack of price pressures for internationally-traded goods more generally. Softness in global inflation has puzzled forecasters for many years since the global financial crisis. With the world economy now on a stronger footing, many have been expecting higher inflation to follow – and a few central banks such as

Dollar up, inflation down continued

the US Federal Reserve have already started to lift interest rates in anticipation. However, there is little evidence of that inflation emerging yet. It's true that inflation rates have risen from the near-zero levels that prevailed a couple of years ago, as oil prices have been rising sharply instead of falling. But we haven't seen signs of price pressures passing through to the retail prices for the goods that New Zealand imports. That's consistent with ongoing reports of strong competitive pressures through the retail sector.

In contrast, the more persistent non-tradables component (which relates mainly to domestically produced goods and services) rose by 0.5% in the December quarter. Rents and new dwelling prices continued their steady rise. However, even in these groups, it is notable that annual inflation has failed to break higher over the past year. Annual non-tradables inflation is currently sitting at 2.5% - broadly where it has been for the past 18 months, and still below its long run average.

RBNZ to stay on the sidelines for some time yet

We expect some of the softness in December's inflation result will reverse in the early part of this year. Nevertheless, it's looking very likely that inflation will remain below the RBNZ's 2% target mid-point through 2018.

While there are signs that the period of very weak global inflation that we saw in recent years is dissipating, we're certainly not in an environment where imported inflation is about to rocket higher. In addition, the continuation of strong competitive pressures in the retail sector means that the domestic prices of imported consumer goods are likely to remain soft for an extended period. The recent appreciation of the NZD since the start of this year also reinforces our expectation for softness in tradables prices through mid-2018.

The chances of a significant rise in domestic inflation also look slim. Recently released GDP figures showed that the New Zealand economy had been growing at a solid pace in recent years, with growth topping out at 4% through 2016. But even with solid domestic activity and rising pressures in the construction sector, we did not see a material lift in non-tradables inflation.

Now, growth has eased off, and recent business sector indicators point to a further softening in activity through the early part of 2018. Combine those conditions with changes in government charges (like reduced costs for tertiary education and doctors' visits), and a strong rise in domestic inflation over the coming year looks like a longshot.

We are now well past the period of very weak inflation that we saw in the wake of the financial crisis. Nevertheless, inflation remains stubbornly below average. Furthermore, it's looking very doubtful inflation will rise back to 2% by mid-2018 like the RBNZ was expecting at the time of their November *Monetary Policy Statement*. Coming on top of signs that the momentum in GDP growth is fading, this makes it hard to argue for an OCR hike anytime soon.

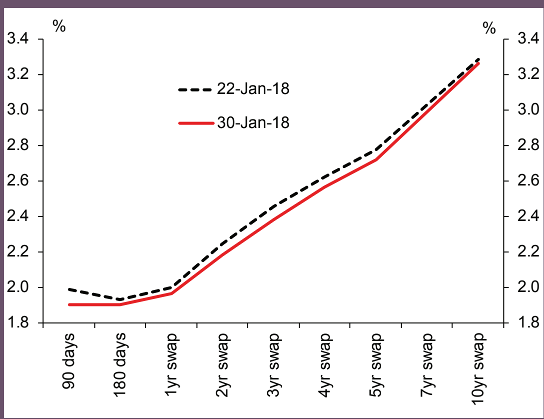
Market pricing for an OCR hike edged back following the softer than expected CPI result and is consistent with a rate increase in the first quarter of 2019. We still think that is too soon, and maintain our forecast for the OCR remain on hold until the final quarter of 2019.

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



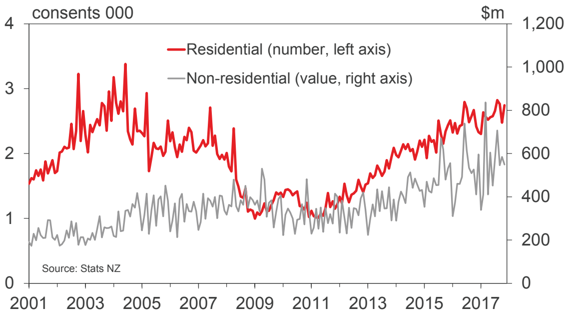
The week ahead

NZ Dec residential building consents

Feb 2, Last: 10.8%, WBC f/c: 2.0%

- Residential consent issuance rebounded in November, rising 10.8% over the month. In part, this strong result reflected some payback following earlier softness.
- Smoothing through recent month-to-month volatility, consent issuance remains at firm levels. We expect a further modest gain of 2% in December. Much of the recent strength in issuance has been centred on Auckland where there continues to be a significant shortfall of housing.
- We expect that the level of residential building activity will remain elevated for some time. However, we continue to expect that building activity will increase at a gradual pace over the next few years. As we've highlighted for some time, rising costs, as well as difficulties sourcing skilled labour and credit are acting as a brake on activity.

NZ building consents

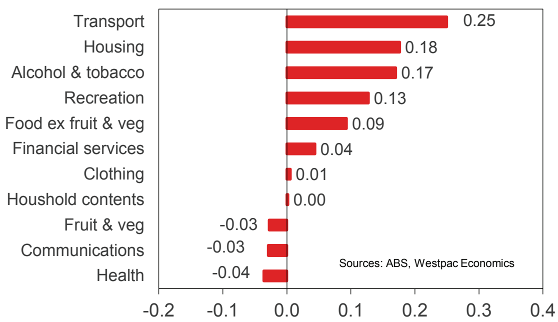


Aus Dec CPI

Jan 31, Last: 0.6%, WBC f/c: 0.8%
Mkt f/c: 0.7%, Range: 0.4% to 1.4%

- The September quarter CPI came in broadly as we expected printing 0.6%qtr compared to Westpac's forecast of 0.7%. The market median was 0.8%. The annual rate moderated to 1.8%yr compared to 1.9%yr in Q2 and 2.1% in Q1. The average of the core measures, which are seasonally adjusted and exclude extreme moves, rose just 0.4%qtr and, in annual terms, was flat on Q2 at 1.9%yr.
- With a solid bump up from tobacco, auto fuel & domestic holidays but not much else, Westpac's forecast for the headline CPI is 0.8%qtr lifting the annual pace from 1.8%yr to 2.1%yr. Core inflation is forecast to print 0.5%qtr (0.54% at two decimal places) lifting the annual rate to 2.0%yr. The trimmed mean is forecast to rise 0.52%, while the weighted median forecast is 0.57%.

Contributions 2017Q4 CPI forecast

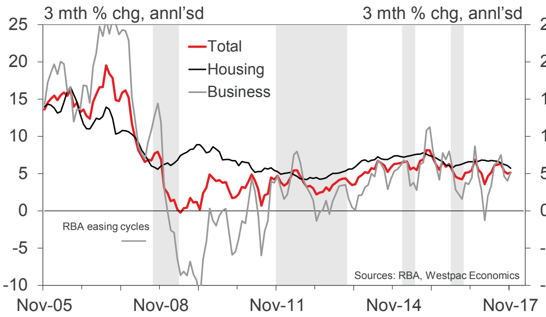


Aus Dec private credit

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

- Credit to the private sector grew by 0.5% in November, a touch above the 0.4% monthly average for 2017. For December, we anticipate a rise of 0.4%.
- Housing credit is slowing gradually, a trend that is likely to continue at this late stage of the cycle as the sector responds to tighter lending conditions. The 3 month annualised pace is 5.7% currently, down from 6.8% in March. In November, housing credit grew by 0.44%, 6.4%yr.
- Business credit is volatile month to month around a moderate upward trend as businesses expand investment. The November outcome was an above par increase of 0.7%. For December, we anticipate a result more in line with the 2017 monthly average of 0.3%.

Credit: momentum shift

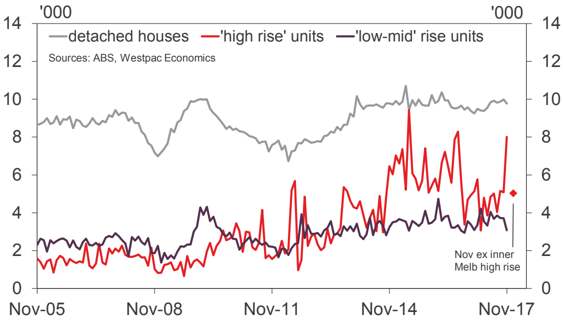


Aus Dec dwelling approvals

Feb 1, Last: 11.7%, WBC f/c: –8.0%
Mkt f/c: -7.6%, Range: -12.5% to -3.0%

- Dwelling approvals posted a surprise surge in Nov, up 11.7% vs expectations of a decline. The result was driven by an extraordinary spike in Vic high rise approvals that more detailed data shows centred on the CBD, Docklands and Southbank. While not down to one single 'mega project', the spike almost certainly relates to a handful of very large projects in the inner city. Approvals across the rest of Australia were much weaker, down 2.0% in the month following Oct's 8.3% drop. There looks to be some residual strength in the Vic market, with site purchases – a reasonable lead indicator for high rise activity – up in 2016-17 but still well below their 2015 peak. That said, Nov high rise approvals were an extreme high well above the state's previous peaks. As such, with conditions softening across other markets and segments, there is a risk of a sharp correction lower in Dec. We expect an 8% pull back, but a double digit monthly fall is plausible.

Dwelling approvals: houses, low-mid & high rise



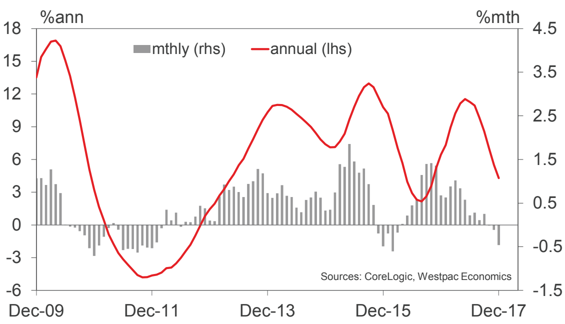
The week ahead

Aus Jan CoreLogic home value index

Feb 1, Last: –0.5%, WBC f/c: –0.3%

- Australia's housing market posted a weak finish to 2017, with prices nationally dipping 0.1% in Nov and a further 0.5% in Dec to be down 0.6% over the final quarter, the first negative quarterly result since early 2016. Annual growth slowed to 4.3%yr, an abrupt slowdown on the 11.5% peak in May. The daily index points to a further softening in January, with prices down about 0.3% nationally. As always, housing data should be treated with extra caution around the summer holiday low season as light trading means information can be less reliable. More generally, early 2018 is shaping as a key test for the market, with 'transitional' impacts from last year's macro prudential tightening set to ease. With weakening foreign buyer demand, downbeat buyer sentiment and surging apartment supply also in the mix, the market's post holiday opening performance will be an important tone setter for 2018.

Australian dwelling prices

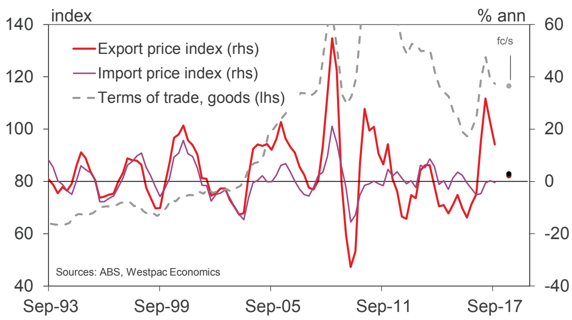


Aus Q4 import price index

Feb 1, Last: -1.6%, WBC f/c: 3.5%
Mkt f/c: 1.5%, Range: -1.5% to 5.0%

- Prices for imported goods were little changed over the past year, edging 0.4% lower, notwithstanding a drop of 1.6% in the September quarter.
- Roll forward to the December quarter, import prices likely took a step higher, increasing by a forecast 3.5%.
- The cost of imports rose as the Australian dollar dipped in the final quarter of 2017, a move which has since been reversed. In Q4, the Aussie fell almost 3% to average US76.8¢ and declined by the same magnitude on a TWI basis.
- In addition, the bill for fuel imports rose as global energy prices increased in the period.

Import & export goods prices

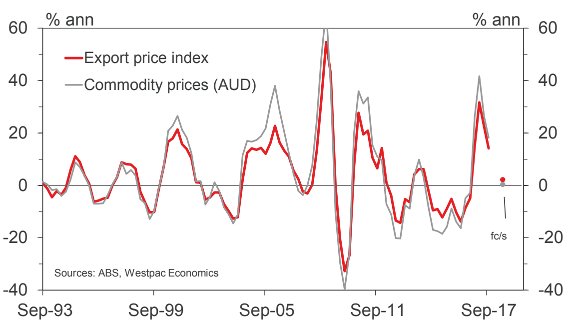


Aus Q4 export price index

Feb 1, Last: –3.0%, WBC f/c: 2.7%
Mkt f/c: 2.0%, Range: -3.5% to 3.0%

- The sharp rebound in export prices during 2016 and into early 2017 was punctuated by meaningful falls in the June and September quarters (-5.7% and -3.0%), as commodity prices eased back from recent highs. In the December quarter, global commodity prices took on a more resilient tone. In the period, the RBA commodity price index increased by 2.9% in AUD terms and was broadly flat in US dollar terms.
- For Q4, we expect export prices to increase by 2.7% and be 2% higher than at the end of 2016. The terms of trade for goods, on these estimates, declined by 0.8% in the quarter, to be 2.5% 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 March 6.

Commodity prices & export price index

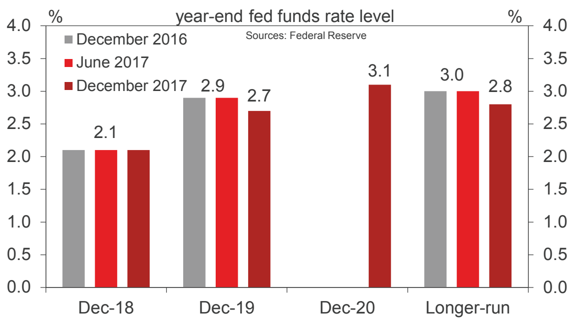


US FOMC Jan policy meeting

Jan 30–31, fed funds rate last 1.375%, WBC 1.375%

- Following the BoJ and ECB's meetings last week, this week sees the first meeting of the FOMC for 2018. It will also be Chair Yellen's last.
- The January meeting is a simple affair, the decision statement the only method of communication. Since December, a weaker US dollar; little change in term interest rates; and the passing of tax reform all warrant greater short and medium-term optimism over the outlook.
- Due to the above factors, we have revised our expectations for the FOMC.
- We look for 25bp hikes at the March; June and September meetings. At that point, the fed funds rate will be above neutral and the balance sheet unwind in full effect. This will be an appropriate time to pause and assess.

FOMC plans to keep raising interest rates



The week ahead

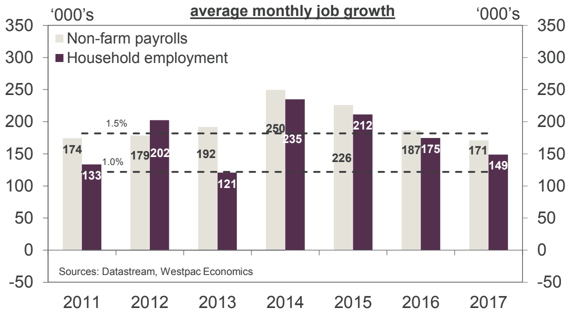
US Jan employment report

Feb 2, nonfarm payrolls, last 146k, WBC 170k

Feb 2, unemployment rate, last 4.1%, WBC 4.1%

- Month to month volatility in nonfarm payrolls remains significant. In the December quarter, gains of 211k and 252k in October and November were followed by a 148k rise in December. The average for the quarter was 204k, a step up from the average of the past six months and 2017 overall.
- We believe this acceleration at end-2017 is noise rather than signal, particularly given the economy is at full employment and the pace of employment growth in 2017 was well ahead of population growth. As a consequence, we look for a (still strong) 170k outcome in January. Looking ahead, 2018 is likely to see a further deceleration in employment growth to circa 155k per month, down from around 190k in 2016 and 170k in 2017.

US job creation slowing, but still strong



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Tue 30					
NZ	Dec trade balance, $m	–1193	–	–	Dairy exports reaching their seasonal peak.
Aus	Dec NAB business survey	–	–	–	Business conditions elevated, uneven. Confidence at average levels.
Eur	Jan economic confidence	116	–	–	Very supportive of growth.
	Jan business climate indicator	1.66	–	–	Led by Germany, but optimism broad based.
	Jan EC consumer conf. (final)	1.3	–	–	Labour market and incomes key.
	Q4 GDP	0.6%	–	–	First estimate for Q4; no detail.
UK	Dec net mortgage lending £bn	3.5	–	–	The cooling in the housing market and a rise in interest rates...
	Dec mortgage approvals	65.1k	–	–	... have dampened lending growth.
	BOE Governor Carney speaking	–	–	–	Appearing before the UK's Economic Affairs Committee.
US	Nov S&P/CS 20 city house prices	0.7%	0.7%	–	Annual growth robust at 6.45%yr.
	Jan consumer confidence	122.1	123.1	–	Conference Board measure; remains strong.
Wed 31					
Aus	Q4 CPI, %qtr	0.6%	0.7%	0.8%	There will be a tobacco excise boost along with rising auto...
	Q4 CPI, %yr	1.8%	2.0%	2.1%	... domestic holiday travel & steady gains in housing. However...
	Q4 core CPI, %yr	1.9%	1.9%	2.0%	... competitive pressures are keeping a lid on core inflation.
	Dec private sector credit	0.5%	0.5%	0.4%	Housing slowing, business volatile around moderate trend.
Chn	Jan NBS manufacturing PMI	51.6	51.5	–	External demand a key support...
	Jan NBS non-manufacturing PMI	55.0	55.0	–	... employment the variable to watch.
Eur	Dec unemployment rate	8.7%	–	–	Will continue to drift lower.
	Jan CPI %yr	1.4%	–		Core inflation remains below 1%yr.
UK	Jan GfK consumer confidence	–13	–	–	Households remain nervous about the economic outlook.
US	Q4 employment cost index	0.7%	0.5%	0.6%	Annual rate to hold around 2.5%yr.
	Jan Chicago PMI	67.8	63.5	–	Regional indices are falling back.
	Dec pending home sales	0.2%	0.5%	–	Supply of houses for sale to remain an issue.
	FOMC policy decision (mid-point)	1.375%	1.375%	1.375%	Chair Yellen's last meeting. Positive outlook to be maintained.
Thu 1					
Aus	Dec dwelling approvals	11.7%	–7.6%	–8%	Melb high rise spike to unwind, other segments weak.
	Jan CoreLogic home value index	–0.4%	–	–0.3%	Price softening continues. Jan data often less reliable.
	Q4 import price index	–1.6%	1.5%	3.5%	Import costs rise as AUD falls & global energy prices climb.
	Q4 export price index	–3.0%	2.0%	2.7%	Export prices up on lower currency.
	Jan AiG manufacturing PMI	56.2	–	–	Manuf'g sector up on construction and foods & beverages.
Chn	Jan Caixin China PMI	51.5	51.5	–	A good cross-check of conditions v's NBS measure.
Eur	Jan Markit manufacturing PMI (final)	59.6	–	–	Manufacturing very strong...
UK	Jan Markit manufacturing PMI (final)	56.3	–	–	Watch for Sterling impact in coming months.
US	Jan Markit manufacturing PMI (final)	55.5	–	–	More believable than ISM.
	Dec construction spending	0.8%	0.4%	–	Uncertainty over rates to limit further growth.
	Jan ISM manufacturing	59.7	58.9		Over estimating strength in economy.
	Initial jobless claims	–	–	–	Very low level.
Fri 2					
NZ	Jan ANZ consumer confidence	121.8	–	–	Confidence has eased of late, partly due to political changes.
	Dec building consents	10.8%	–	2.0%	Demand firm, but constraints will limit the rise in activity.
	Dec net migration	5610	–	5200	Annual migration still elevated, but is easing back.
Aus	Q4 PPI	0.2%	–	–	Continues to show modest upstream price pressures.
US	Jan non-farm payrolls	148k	180k	170k	Employment growth to slow but remain strong...
	Jan unemployment rate	4.1%	4.1%	4.1%	... will see unemployment rate move lower in time.
	Dec factory orders	1.3%	0.6%	–	Underlying trend subdued; revisions to durables also due.
	Jan consumer confidence	94.4	95.0	–	Uni of Michegan measure; remains strong.
	Fedspeak	–	–	–	Williams speaking in San Francisco (incl. media Q+A)

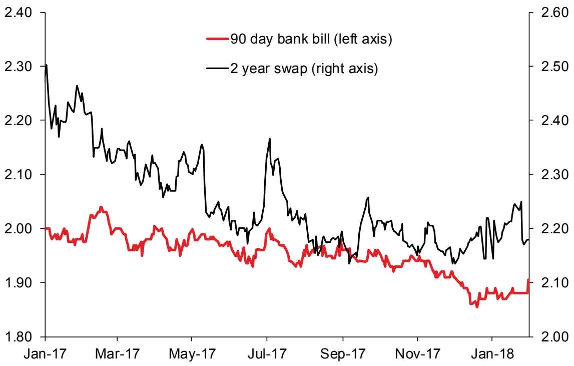
New Zealand forecasts

Economic Forecasts	Quarterly				Annual			
	2017		2018		Calendar years			
% change	Sep(a)	Dec	Mar	Jun	2016	2017f	2018f	2019f
GDP (Production)	0.6	0.7	0.5	0.6	4.0	2.9	2.6	3.2
Employment	2.2	-0.2	0.6	0.4	5.8	3.1	1.6	1.2
Unemployment Rate % s.a.	4.6	4.5	4.5	4.6	5.3	4.5	4.7	4.7
CPI	0.5	0.5	0.5	0.2	1.3	2.0	1.5	1.8
Current Account Balance % of GDP	-2.6	-2.6	-2.3	-2.4	-2.5	-2.6	-2.8	-2.3

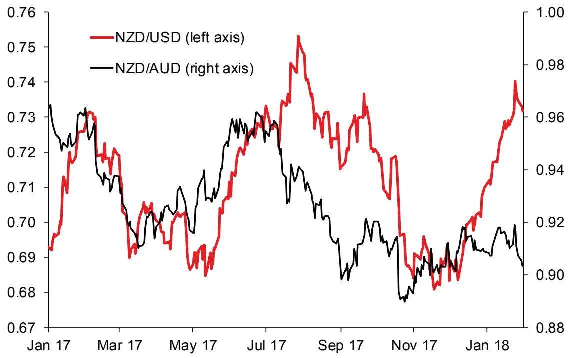
[1] Annual average % change

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	2.70	2.80	2.95	3.05	3.15	3.25
10 Year Bond	2.95	3.10	3.25	3.40	3.45	3.50
NZD/USD	0.67	0.66	0.64	0.63	0.63	0.63
NZD/AUD	0.89	0.89	0.89	0.90	0.91	0.93
NZD/JPY	77.1	76.6	75.1	74.3	74.3	74.3
NZD/EUR	0.58	0.58	0.57	0.57	0.57	0.56
NZD/GBP	0.51	0.51	0.51	0.50	0.50	0.50
TWI	71.4	70.9	69.8	69.3	69.6	69.8

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 30 January 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.79%	1.78%	1.79%
60 Days	1.84%	1.83%	1.83%
90 Days	1.91%	1.90%	1.88%
2 Year Swap	2.18%	2.21%	2.14%
5 Year Swap	2.72%	2.71%	2.68%

NZ foreign currency mid-rates as at 30 January 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7318	0.7252	0.7098
NZD/EUR	0.5908	0.5945	0.5906
NZD/GBP	0.5202	0.5278	0.5263
NZD/JPY	79.73	80.56	79.90
NZD/AUD	0.9036	0.9171	0.9091
TWI	74.71	75.08	74.11

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	1.79	1.77	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.83	2.70	2.75	2.90	2.85	3.00	3.10	3.05
International								
Fed Funds	1.375	1.625	1.875	2.125	2.125	2.125	2.125	2.125
US 10 Year Bond	2.65	2.60	2.75	3.00	3.00	3.00	2.90	2.75
ECB Deposit Rate	–0.40	–0.40	–0.40	–0.40	–0.40	–0.30	–0.30	–0.20

Exchange Rate Forecasts	Latest	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
AUD/USD	0.8074	0.78	0.76	0.74	0.72	0.70	0.71	0.72
USD/JPY	109.11	113	115	117	117	117	117	118
EUR/USD	1.2399	1.20	1.17	1.15	1.15	1.15	1.17	1.18
AUD/NZD	1.0873	1.10	1.10	1.10	1.11	1.11	1.11	1.11

Contact the Westpac economics team

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