Weekly Commentary

5 June 2018

Wait for it

The Reserve Bank has held fire for now on any changes to its restrictions on bank mortgage lending. We still think that the case for an easing of the restrictions will be made by the end of this year, as a range of government policies weigh on house prices. A softer housing market will also have a bearing on the wider economy, where confidence in the outlook is already fragile.

This week the Reserve Bank released its six-monthly Financial Stability Report, a wide-ranging review of New Zealand's financial system. The overall conclusion was that the risks to the system were little changed from six months ago, with the main areas of concern being household debt, dairy sector debt and exposure to international shocks.

The main area of interest for us was whether there would be any further changes to the macro-prudential restrictions on housing lending. In the last review in November, the RBNZ loosened the loan-to-value ratio (LVR) restrictions slightly, allowing investors to borrow up to 65% of the value of a house, and increasing the share of loans to owner-occupiers that can be made at an LVR above 80%.

The RBNZ also indicated that it would ease the restrictions further if it was satisfied that house price and credit growth had slowed to around the rate of household income growth, and that there was a low risk of the housing market taking off again. It's a close call as to whether those conditions have been met. House prices are up 3.8% in the last year, while credit growth is running at 5.7%yr. Comparable figures for household income growth aren't yet available, but last year it was running just above 5%.

In the event, the RBNZ decided against any changes to the LVR restrictions for now. However, it appeared more conservative than before on the prospect of an easing, highlighting concerns about the high level of household debt (rather than just the rate of growth). The RBNZ was also notably less specific about the conditions for easing, commenting that: "The rules will be eased in the future if housing market risks decline and banks maintain prudent mortgage lending standards".

Despite the imprecision of these criteria, we still think that the conditions for an easing of the LVR restrictions will be met before the end of this year. The Government is introducing a series of new policies aimed at cooling investor demand for housing, one of which is already in play: the extension of the 'bright line' test for taxation of capital gains came into effect at the end of March. Later this year a ban on foreign purchases of residential property will come into force, and the Government has signalled that the use of negative gearing by property investors will start to be phased out from next year.

Together, we think that these policies will have a significant impact on housing demand over the coming years. We expect annual house price growth to slow to zero by the end of this year, in contrast to the RBNZ's assumption of low but positive house price growth. The April house price and sales figures already showed some signs of softening, and we expect that the accumulated evidence over the next six months will satisfy the RBNZ's concerns.

We should note that we don't expect the LVR restrictions to be removed altogether. The RBNZ, under successive Governors, has made it clear that lending restrictions are

Wait for it... continued

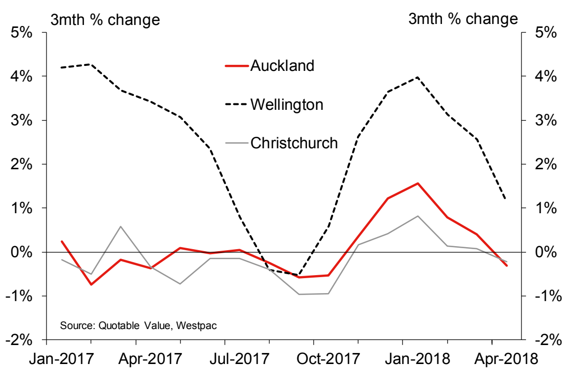
likely to be part of the landscape. Instead, the RBNZ will look to move from the current 'tight' settings to something closer to neutral. 'Neutral' in this instance is hard to define, but it implies a set of lending restrictions that are not particularly binding at the time, but would guard against a future loosening of bank lending standards.

The consequences of the LVR restrictions extend beyond the stability of the financial sector. Housing makes up a significant part of household wealth in New Zealand, and consumer spending tends to wax and wane in line with house price inflation. The cooling in the housing market over the last year and a half has also seen a slowdown in the rate of growth in consumer spending, and we expect both house prices and spending to remain subdued in the coming years.

The latest business confidence survey suggests that retailers are already feeling the pinch. Confidence has been weak since last year's election, and has taken another step lower in the last two months, with retailers feeling particularly downbeat in May. And as we've noted previously, card spending and car sales were markedly weaker in April.

House price inflation also has a bearing on the incentives to build. Confidence in the construction sector has been particularly weak in recent months, although it picked up a little in the May survey. There is clearly a need for an extended period of strong homebuilding activity, and the Government's KiwiBuild programme provides an additional source of demand for affordable homes. But skill shortages, thin profit margins, rising costs and difficulties in accessing finance present significant constraints on growth.

QV house price inflation



That said, the latest data suggests that the homebuilding industry has made some progress. Building consents held up surprisingly well in April, down by just 3.7% after a 13% rise in March. Consents for multiples (such as apartments and townhouses) in Auckland have been particularly strong in the last two months.

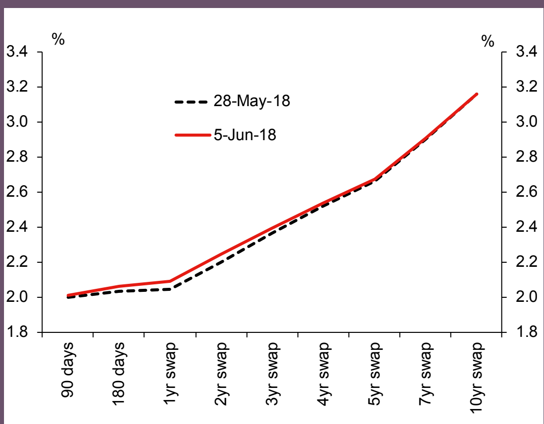
Multiple consents are lumpy by nature, and two months of gains are not enough to establish whether the trend has changed. Nevertheless, the recent numbers are impressive given that the aforementioned constraints would seem to be most pressing for large developments in Auckland. For now, we're sticking with our forecast that actual building work will pick up only gradually this year (March quarter figures are released on Wednesday; we expect a 0.5% rise).

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 Q1 building work put in place

Jun 6, Last: +1.4%, Westpac f/c: +0.5%

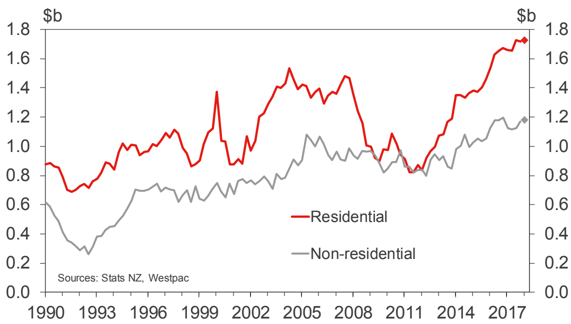
- Construction activity continued to trend higher in late 2017, with gains in both residential and non-residential building activity. Looking forward, we expect that the level of activity will remain elevated for an extended period, with a large amount of residential and infrastructure work planned over the coming years. However, after an extended period of strong activity, capacity in the building sector has become stretched. In addition, difficulties accessing finance and nervousness about policies that will dampen house price growth are providing a brake on building activity. As a result, we expect only a 0.5% rise in construction through the March quarter, with only modest gains in both residential and non-residential work expected.

Aus Q1 net exports, ppts cont'n

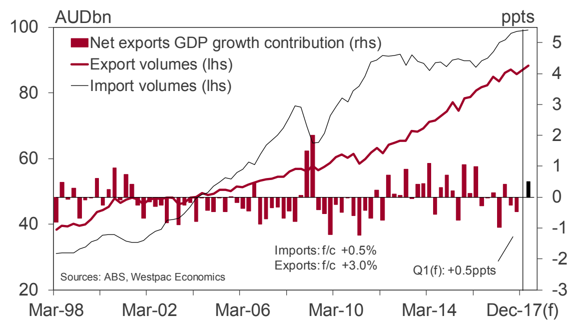
Jun 5, Last: -0.5, WBC f/c: +0.5
Mkt f/c: 0.5, Range: 0.2 to 0.7

- Net exports, as with inventories, have been volatile of late largely due to a choppy export profile as supply disruptions impact shipments (notably for coal). In Q4, export shipments recorded a surprise decline, at odds with the current uptrend, declining by 1.8%. This, along with a 0.5% rise in imports, saw net exports subtract a hefty 0.5ppts from activity in the period. A reversal is evident in Q1, with net exports forecast to add 0.5ppts to activity. Exports advanced in Q1, increasing by a forecast 3%qtr, 5.6%yr, with a strong lift in resources (across coal, LNG, gold, as well as metals and iron ore) and gains in manufactured goods and services.Imports are forecast to rise by around 0.5%, 4%yr in Q1, with a rebound in both capital goods and gold.

NZ real building work put in place



Net exports: f/c +0.5ppts, exports rebound



Aus Q1 current account, AUDbn

Jun 5, Last: -14.0, WBC f/c: -10.3
Mkt f/c: -9.9, Range: -12.7 to -7.4

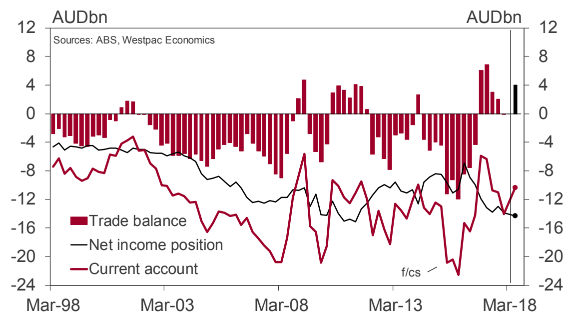
- Australia's current account deficit widened in the December quarter, to \$14.0bn from \$11.0bn. This was largely as the trade surplus evaporated (from +\$2.0bn to -\$0.1bn). In the March quarter, the current account position improved, fully reversing the Q1 deterioration, with the deficit narrowing to a forecast \$10.3bn. The trade position returned to surplus in Q1, to the tune of \$4.0bn, a turnaround from a revised deficit of \$1.0bn for Q4.
- Export earnings rose by around 7½%, boosted by higher commodity prices. The import bill grew by a more modest 2%, including a lift in prices. The terms of trade lifted by an estimated 2.6%, after a 1% decline in Q4. The net income deficit is expected to widen a little, to \$14.3bn from \$13.9bn, on rising returns to foreign investors.

Aus Q1 public demand

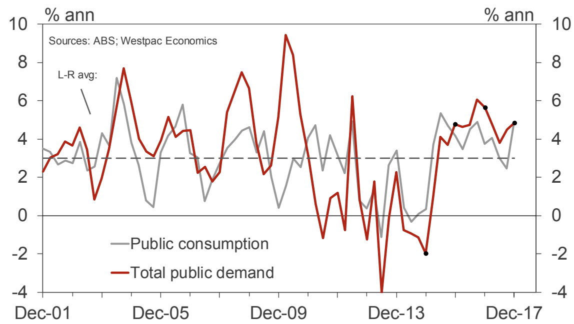
Jun 5, Last: 1.1%, WBC f/c: 1.0%

- Public demand is a key growth driver, expanding at a well above trend pace in 2015, 2016 and 2017, with annual growth at 4.8%, 5.6% and 4.9%, respectively. Momentum is set to extend in to 2018 and beyond. An upswing in public investment is underway, lifting from recent lows, as governments commit to additional projects (particularly transport infrastructure) now that earlier fiscal pressures have receded. In addition, spending on health is increasing at a robust pace, including on the NDIS. In Q4, public demand increased by 1.1%, led by a sharp rise in consumption (which accounts for 80% of total public demand), up 1.7%, only partially offset by a modest pull-back in the often volatile investment segment, -1.3%. For Q1, we expect public demand to expand by 1.0% on higher investment, +3%, as well as a modest gain in consumption, +0.5%.

Current account: narrows to a f/c –\$10.3bn



Public demand: well above trend growth



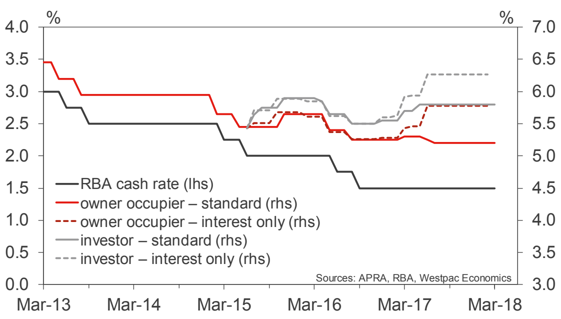
The week ahead

Aus Jun RBA decision

Jun 5, Last: 1.50% WBC f/c: 1.50%
Mkt f/c: 1.50%, Range: 1.50% to 1.50%

- The RBA will hold rates unchanged at their June meeting, as they have since they last cut rates in August 2016.
- The Governor has stated that: "further progress in reducing unemployment and having inflation return to target is expected, although this progress is likely to be gradual". The case for patience has been reinforced by recent labour market updates, with unemployment stuck around 5.5%, and wages, which remain sluggish thereby constraining consumer spending. Moreover, tighter lending standards have been helpful in containing the build-up of risk in household balance sheets. This has seen a cooling of the housing sector, which is a headwind for the economy. We continue to expect the RBA to leave the cash rate unchanged at 1.50% throughout 2018 and 2019.

RBA cash rate and mortgage interest rates

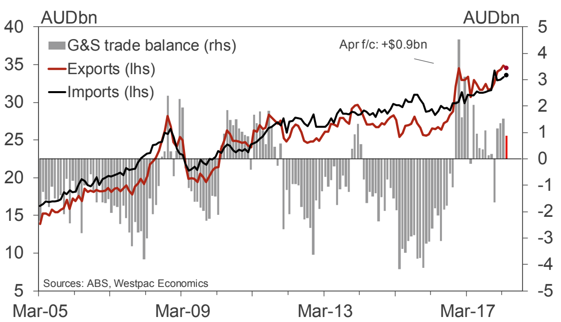


Aus Apr trade balance, AUDbn

Jun 7, Last: 1.5, WBC f/c: 0.9
Mkt f/c: 1.0, Range: 0.4 to 1.8

- Australia's trade account was in surplus in the opening quarter of 2018, supported by a lift in commodity prices and rising export shipments.
- For April, we anticipate another trade surplus, albeit narrowing from $1.5bn to $0.9bn.
- The import bill is expected to increase by 1%, +$0.3bn, on higher prices (notably for oil) and a lift in volumes.
- Export earnings are expected to moderate in the month, down a forecast 0.9%, -$0.3bn. LNG is a likely plus, on higher prices and volumes, but we expect this to be more than offset by falls across coal (price and volumes), iron ore (prices), as well as gold and rural (coming off a high base).

Australia's trade balance

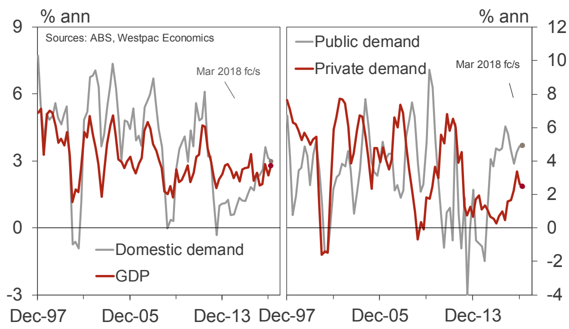


Aus Q1 GDP

Jun 6, Last: 0.4%qtr, 2.4%yr; WBC f/c: 0.9%qtr, 2.8%yr
Mkt f/c: 0.8%, Range: 0.2% to 1.2%

- Real GDP grew by a forecast 0.9%qtr, 2.8%yr in Q1, an improvement on a Q4 result of 0.4%qtr, 2.4%yr. The key swing factor is net exports, which add a forecast 0.5ppts, a turnaround from a -0.5ppts impact. Exports resumed their uptrend, f/c +3%, after a temporary dip, -1.8%.
- Domestic demand grew by a forecast 0.6%, matching the Q4 result, while inventories are expected to subtract 0.1ppts from activity in Q1. Consumer spend likely slowed (0.6% after a 1.0%) on a softer wage income result. More supportive are home building (+1.0% after a -1.3%) and business investment (+0.5% following a -1.0%). Public demand growth most likely remained above trend, at a forecast 1.0%, with investment in an upswing and health spending on the rise.

Australian economic conditions



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Tue 5					
Aus	Q1 net exports, ppts cont'n	-0.5	0.5	0.5	Exports uptrend resumes, +3%, after Q4 stumble.
	Q1 current account balance, $bn	-14.0	-9.9	-10.3	Deficit narrow as trade position moves back into surplus.
	Q1 public demand	1.1%	-	1.0%	Above trend growth, investment upswing, health spending.
	May AiG PSI	55.2	-	-	Strength across business service segments.
	RBA policy announcement	1.50%	1.50%	1.50%	On hold, progress on achieving targets very gradual.
Chn	May Caixin China PMI services	52.9	52.9	-	Official measure showed robust activity, but soft jobs.
Eur	May Markit services PMI	53.9	53.9	-	If manufacturing PMI recedes further....
UK	May Markit services PMI (final)	52.8	-	-	Weather disruptions easing, underlying demand still soft.
US	May Markit services PMI	55.7	-	-	Strong growth expected through mid-2018.
	Apr JOLTS job openings	6550	-	-	Hires; fires; quits; and job openings.
	May ISM non-manufacturing	56.8	58.0	-	Very positive.
Wed 6					
NZ	GlobalDairyTrade auction	1.9%	-	-	Prices likely to remain relatively stable, seasonally low vols.
	Q1 building work put in place	1.4%	0.5%	0.5%	Capacity and difficulties accessing finance limiting growth.
	May ANZ commodity prices	1.0%	-	-	Broad-based strength to continue.
Aus	Q1 GDP	0.4%	0.8%	0.9%	Key swing factor, export rebound. Strength in public demand,
	Q1 GDP, %yr	2.4%	2.7%	2.8%	Housing & business invest' advance, but consumer spend slows.
US	Q1 productivity	0.7%	0.7%	-	A persistent headwind for activity and income.
	Apr trade balance US$bn	-49.0	-50.5	-	Trade rhetoric more the focus than the data.
Thu 7					
Aus	Apr trade balance $bn	1.5	1.0	0.9	Export earnings slip, lower prices for iron ore and coal.
Chn	May foreign reserves $bn	3125	-	-	Under control. Stability intended.
Eur	Q1 GDP 3rd estimate	0.4%	0.4%	0.4%	Third estimate. Full detail becomes available - finally.
UK	May Halifax house prices	-3.1%	-	-	Housing weak, low supply limiting downside for prices.
US	Initial jobless claims	221k	-	-	Very low.
	Apr consumer credit	11.6	14.0	-	Higher rates to curb demand, eventually.
Fri 8					
Chn	May trade balance USDbn	28.4	-	-	Trade rhetoric more the focus than the data.
	May foreign direct investment %yr	-1.1%	-	-	Will be a source of development in future.
US	Apr wholesale inventories	0.0%	-	-	Remains the swing variable for growth.
Sat 9					
Chn	May PPI %yr	3.4%	-	-	Commodities driven...
	May CPI %yr	1.8%	-	-	... but pass-through to consumer limited.

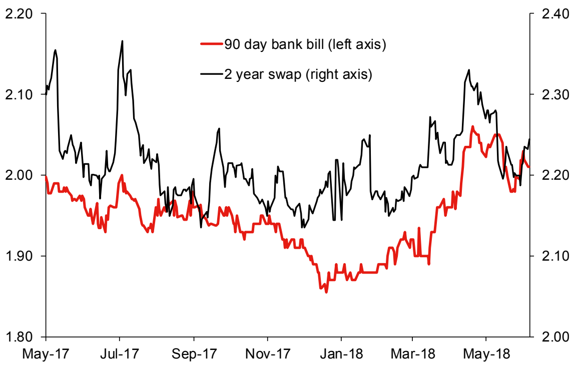
New Zealand forecasts

Economic Forecasts	Quarterly				Annual			
	2017	2018			Calendar years			
% change	Dec(a)	Mar	Jun	Sep	2016	2017	2018f	2019f
GDP (Production)	0.6	0.5	0.7	0.8	4.0	2.9	2.6	3.2
Employment	0.4	0.6	0.2	0.3	5.8	3.7	1.4	1.4
Unemployment Rate % s.a.	4.5	4.4	4.4	4.5	5.3	4.5	4.6	4.6
CPI	0.1	0.5	0.6	0.7	1.3	1.6	2.1	1.4
Current Account Balance % of GDP	-2.7	-2.7	-3.1	-3.5	-2.2	-2.7	-3.6	-3.7

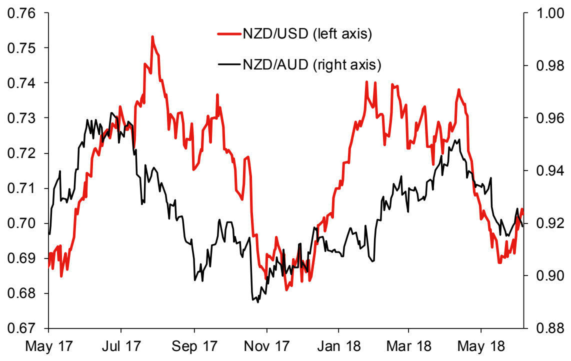
[1] Annual average % change

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	2.00	2.00	2.00	2.00	2.00	2.10
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	0.69	0.68	0.67	0.65	0.65	0.64
NZD/AUD	0.92	0.91	0.91	0.90	0.90	0.91
NZD/JPY	75.9	75.5	75.0	74.1	73.5	71.7
NZD/EUR	0.58	0.57	0.57	0.56	0.55	0.53
NZD/GBP	0.51	0.52	0.53	0.53	0.53	0.52
TWI	72.1	71.4	70.9	69.5	69.6	68.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 5 June 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.89%	1.88%	1.85%
60 Days	1.95%	1.94%	1.94%
90 Days	2.01%	2.00%	2.04%
2 Year Swap	2.25%	2.23%	2.28%
5 Year Swap	2.68%	2.73%	2.74%

NZ foreign currency mid-rates as at 5 June 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7027	0.6921	0.7021
NZD/EUR	0.6009	0.5879	0.5867
NZD/GBP	0.5277	0.5138	0.5188
NZD/JPY	77.1600	76.78	76.64
NZD/AUD	0.9189	0.9201	0.9312
TWI	73.8100	73.05	73.55

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	-2.7	-3.8
United States						
Real GDP %yr	2.6	2.9	1.5	2.3	2.8	2.5
Consumer Prices %yr	1.6	0.1	1.3	2.1	2.6	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	0.4	1.4	0.9	1.7	1.3	1.0
Euroland						
Real GDP %yr	1.3	2.1	1.8	2.3	2.1	1.6
United Kingdom						
Real GDP %yr	3.1	2.3	1.9	1.8	1.2	1.5
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	3.5	3.2	3.8	3.8	3.7
Forecasts finalised 4 May 2018						

Interest Rate Forecasts	Latest	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.99	1.94	1.90	1.88	1.86	1.85	1.83	1.83
10 Year Bond	2.69	2.90	3.05	3.20	3.10	3.10	3.00	3.00
International								
Fed Funds	1.625	2.125	2.125	2.375	2.625	2.625	2.625	2.625
US 10 Year Bond	2.87	3.10	3.35	3.50	3.50	3.40	3.20	3.10
ECB Deposit Rate	−0.40	−0.40	−0.40	−0.40	−0.30	−0.30	−0.20	−0.10

Exchange Rate Forecasts	Latest	Sep-18	Dec-18	Mar-18	Jun-19	Sep-19	Dec-19	Mar-20
AUD/USD	0.7551	0.75	0.74	0.72	0.72	0.70	0.70	0.72
USD/JPY	109.17	111	112	114	113	112	110	109
EUR/USD	1.1682	1.17	1.16	1.15	1.16	1.18	1.20	1.21
AUD/NZD	1.0789	1.10	1.10	1.11	1.11	1.09	1.08	1.09

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