Weekly Commentary

4 June 2013

Looking for an out

Reading between the lines of the RBNZ's Governor's latest speech suggests the RBNZ is itching to try out its macro-prudential toolkit. Big question marks remain around what macro-prudential tools would actually do to the housing market. One thing seems clear – they're going to happen, and they could well happen before any change in the OCR.

Large parts of Governor Wheeler's speech to the Auckland Institute of Directors last week trod familiar ground. The central bank is caught between the rock of a rising housing market and the hard place of an overvalued exchange rate. It is painfully aware that the lowest mortgage rates in half a century are adding fuel to the housing market. But it is loath to raise the OCR given the risk the exchange rate could keep rising and push inflation further below the RBNZ's 1-3% target range.

But the speech also suggested the Governor has become more hopeful that macro-prudential tools might offer a way out of this dilemma, "increasing the degrees of freedom available to the Reserve Bank in conducting monetary policy".

The Governor gave particular attention to the potential benefits from restricting high loan-to-value ratio (LVR) lending. Specifically, the RBNZ now seems keen to explore a 'speed limit' on high-LVR lending – whereby it would restrict the share of new lending that banks can extend to borrowers with low deposits, rather than banning such loans altogether.

The Governor noted that LVR restrictions had been used overseas, pointed to research showing they could be effective in reducing the incidence of credit booms, and said that they "could have played a useful role" in reducing the housing/credit boom of the 2000s. This seems a shift in tone from earlier communication by the RBNZ, which focused on the practical and fairness issues around their implementation and seemed to give greater weight to some of the other tools.

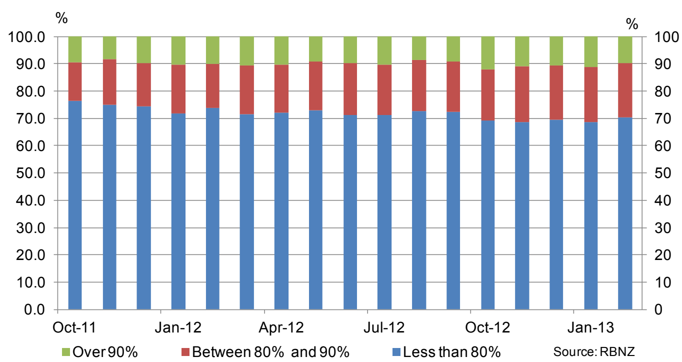
We have said for some time that other macro-prudential instruments (such as requiring banks to hold more regulatory capital against loans) would have only a very small impact on the cost of borrowing and hence on credit growth and the housing market. But what about LVR restrictions? It seems safe to say they would have a *bigger* impact, but at this stage we cannot say just how big. It all depends on how heavily the RBNZ clamps down on high LVR lending (currently about 20% of new lending is in the 80-90% LVR space, and 10% is greater than 90% LVR). It also depends on the extent to which rising LVRs, as opposed to low interest rates, have been driving the housing market – and specifically, what LVR restrictions would do to the all-important rental property investor segment.

We will keep you updated as we obtain new information. What is clear at this stage is that the RBNZ wants to give LVR restrictions the benefit of the doubt. They could be announced at short notice, they could well impact first home buyers, and the result could be to push out the timing of OCR hikes while the RBNZ waits and sees what the impact is on lending and the housing market.

Of course, whatever the RBNZ does with the OCR will also depend on the strength of New Zealand's self-sustaining recovery. On that score our confidence continues to grow. Specifically, the near-term impact of drought on the wider economy is shaping up to be less severe than we had feared, and the boost from surging global dairy prices could be even bigger than we had hoped.

We had been expecting GDP growth to slow to just 0.2% in the June quarter due to lost milk and meat production. However, the latest ANZ business confidence survey suggests that growth outside the agricultural sector has been rather stronger than we assumed. Like monthly consumer confidence, business confidence has proven remarkably resilient to the drought, bouncing back in May from fairly shallow declines.

New mortgage lending by loan-to-value ratio



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One reason why confidence has been fairly robust is the spike in global dairy prices that followed the New Zealand drought. A month or two ago we noted that the income boost from higher prices could end up offsetting the physical hit from lower production. That looks to be the way things are playing out.

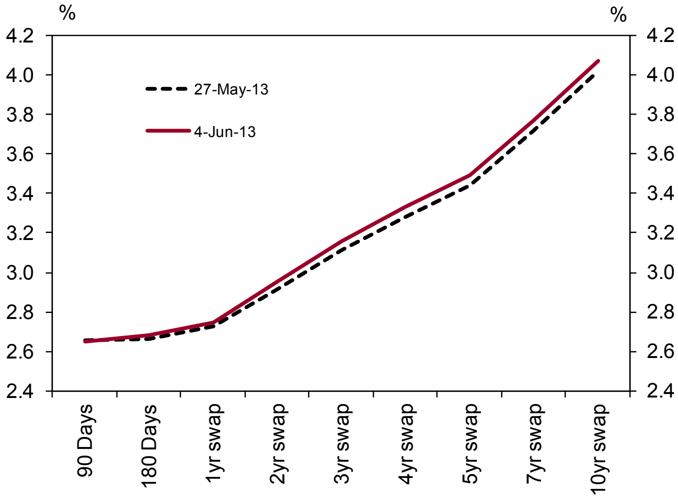
The impact can be seen in the March quarter terms of trade figures, which surged 4.1%, breaking a run of six consecutive falls. Dairy prices rose 6.8% over the quarter, and this is only the beginning – we can expect even larger increases over the next couple of quarters. In addition, meat and manufactured goods prices held up better than expected. With global inflation likely to stay low we could easily see New Zealand's terms of trade push back towards record highs by the end of this year.

Fonterra has now provided its take on the dairy price surge in its latest dairy payout forecasts. According to Fonterra, it will be a game of two seasons. For this season, Fonterra left its milk price forecast unchanged at $5.80 per kg of milk solids. This was a bit lower than expected, with recent soft production volumes reducing the extent to which the global price spike will feed through to the season average payout.

But in its first estimate for the 2013/2014 payout, Fonterra announced a whopping $7.00 milk price forecast, comfortably exceeding even our expectations for a $6.20 milk price. If Fonterra's optimistic projections hold true, 2013/14 would turn out to be a bumper season for NZ dairy farmers. Time will tell.

Fixed vs floating for mortgages: Fixed-term rates out to two years are currently well below floating rates, while three-year and longer fixed rates are only slightly higher. So staying on floating would only be the better option if the RBNZ actually cut the OCR – which we regard as unlikely. That said, there is little upward pressure on banks' funding costs, and fixed-rate 'specials' remain a feature of the mortgage market. Consequently, while we favour fixing over floating for the next couple of years, there's scope to time your entry to take advantage of further fixed-rate deals.

NZ interest rates



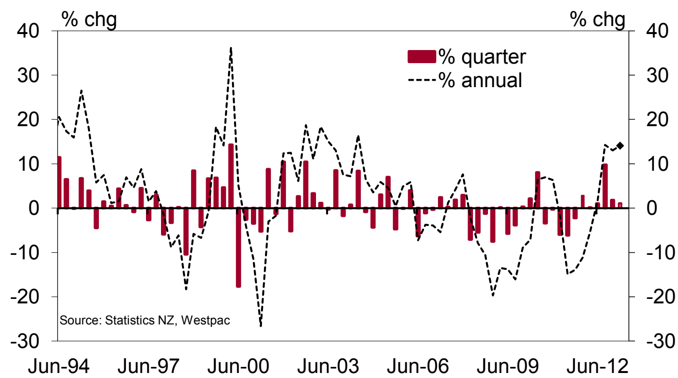
Key Data Previews

NZ Q1 building work put in place

Jun 5, Last: 1.8%, WBC f/c: 1.0%

- We expect a 5% rise in residential building work for the March quarter, maintaining the annual rate of growth at around 14%. Activity is ramping up in Canterbury, as the post-earthquake rebuild proceeds; and in Auckland, which has suffered more than other regions from under-building in recent years.
- Partly offsetting this, we estimate that non-residential building fell by 3%. Non-residential construction ramped up much more sharply than expected in the second half of 2012, suggesting that the industry was chewing through a significant share of the pipeline of consented work.
- The building activity survey is sampled from building consents, so it is likely to understate the level of non-consented work going on in Canterbury. However, we suspect that consented rebuilds and alterations are now the greater source of growth.

NZ real building work put in place

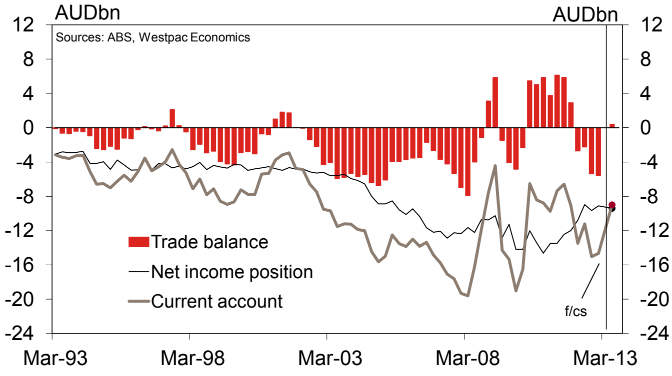


Aus Q1 current account, AUDbn

Jun 4, Last: –14.7, WBC f/c: –9.0
Mkt f/c: –9.0, Range: –8.2 to –1.3

- Australia's current account deficit narrowed in the March quarter as the trade balance swung into surplus.
- A deficit of $9.0bn is expected in Q1, a sharp improvement from a $14bn plus deficit in Q4. Note, Q4's current account may be revised lower given changes to trade data.
- Trade improved sharply in Q1, swinging to a $0.4bn surplus from a revised $5.2bn deficit in Q4 (downgraded from an originally reported deficit of $5.6bn). Higher commodity prices boosted the terms of trade while import volumes slumped.
- The net income deficit moderated to $9.1bn in Q4, down from $9.7bn the quarter prior. The risk is that this dip will be partially reversed in Q1.

Current account: Q1 f/c –$9.0bn

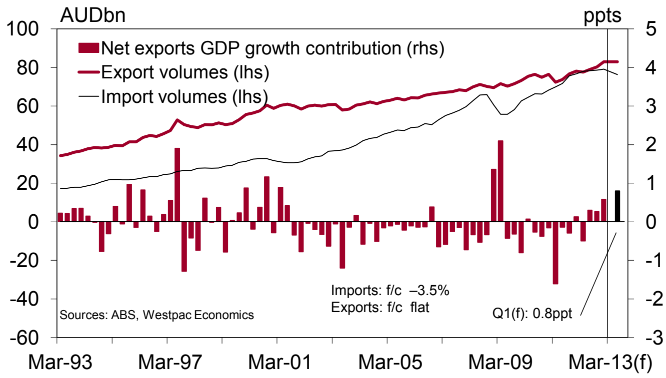


Aus Q1 net exports, ppts cont'n

Jun 4, Last: 0.6, WBC f/c: 0.8
Mkt f/c: 0.8, Range: 0.0 to 1.2

- Net exports are likely to make a positive contribution to quarterly GDP growth for a 4th consecutive quarter. This is a sharp turnaround from negatives over recent years.
- We expect net exports to add 0.8ppts to quarterly GDP growth in Q1 and to add 1.9ppts to annual growth.
- Export volumes consolidated in the quarter, on our estimates. This follows a 3.3% gain in Q4 on an improvement in global conditions. Annual growth is likely to be around 7%.
- Import volumes slumped in Q1, down an estimated 3.5%. Capital goods and gold were sharply lower, intermediate goods fell, as did services, but consumption goods advanced reasonably strongly.

Net exports: f/c +0.8ppts in Q1

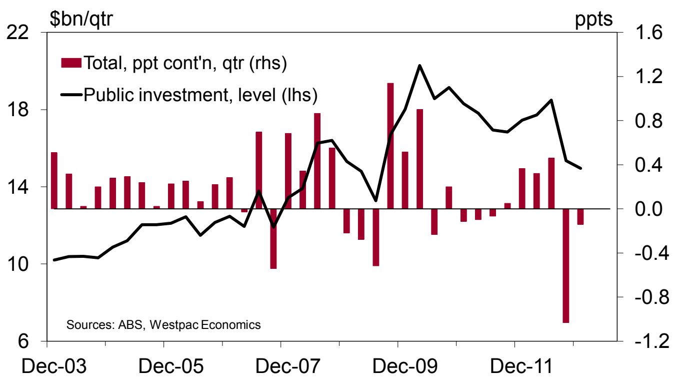


Aus Q1 public demand

Jun 4, Last: –0.6%, WBC f/c: –0.3%

- Public demand, 22% of overall domestic demand, declined over the second half of 2012, reflecting timing issues and underlying weakness.
- The weakness may well have extended into early 2013. We anticipate a decline of 0.3%, following a 0.6% fall in Q4. This brings the decline over the year to 3.4% (pending revisions). Such a fall is in line with the lows of past cycles (the early 1980s and early 1990s).
- Investment most likely continued to trend lower as aggressive fiscal stimulus is unwound. Construction data reported a 5.4% fall in public works in the quarter. We anticipate that consumption is broadly flat in Q1, as well as over the year, as governments either reduce or cap public servant numbers.

Public demand: volatile around weak trend



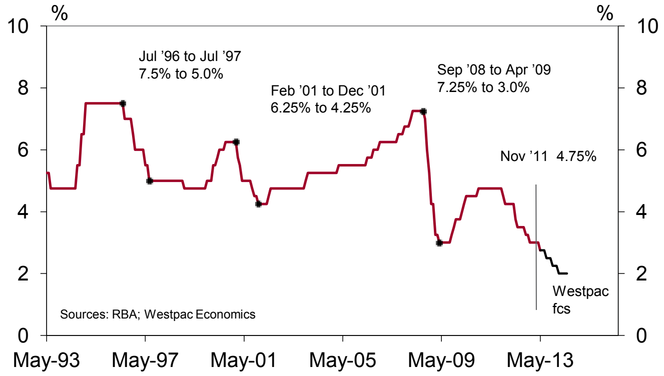
Aus RBA policy announcement

Jun 4, Last: 2.75%, WBC f/c: 2.75%

Mkt f/c: 2.75%, Range: 2.50% to 2.75%

- After a 5mth pause, the RBA Board cut the cash rate again in May, lowering it 25bps to a new low of 2.75%. The Governor's statement accompanying the decision noted that the inflation outlook afforded scope to ease and that the Board had chosen to use **some** of that scope in May – an indication that future meetings may see more easing.
- Despite the RBA's clear easing bias, weak reads on business and consumer confidence and Q1 data showing a fall in investment, we expect it to leave rates on hold at its Jun meeting. The resilience of reported Capex intentions and the AUD slide will encourage the Bank that a smooth transition from mining to non-mining led growth is still achievable. We are less optimistic and expect more rate cuts in 2013/14, taking the cash rate to a low of 2%.

RBA cash rate: easing cycles



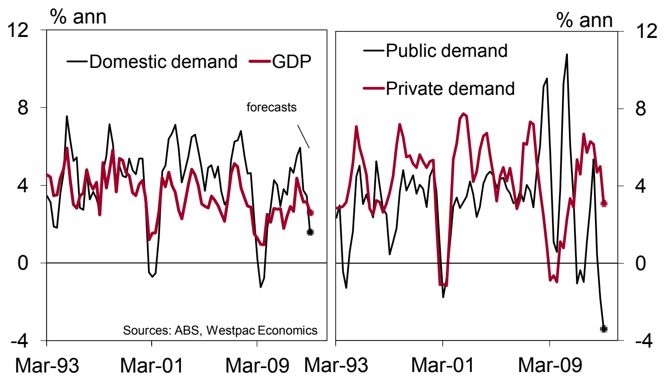
Aus Q1 GDP

Jun 5, Last: 0.6%qtr, 3.1%yr, WBC f/c: 0.7%qtr, 2.6%yr

Mkt f/c: 0.8%, Range: 0.4% to 1.0%

- Australia's economic expansion continues at a sub-par pace. We forecast Q1 GDP growth to be 0.7%. Annual growth will slip to 2.6%, from 3.1% in Q4 (subject to revisions).
- Domestic demand growth was most likely anaemic for a third quarter: flat in Q3; +0.3% in Q4; and a forecast +0.2% in Q1. Annual growth slows to 1.6% from 3.5%, the weakest since 2010. A burst of retail sales, +2.2%, was a bright spot. But, there was a dip in housing activity, while we expect both business investment and public demand to decline.
- Net exports will save the day, a forecast +0.8ppts, with export volumes flat but imports down 3½%. We expect inventories to shave 0.2ppts off growth.

Australian economic conditions



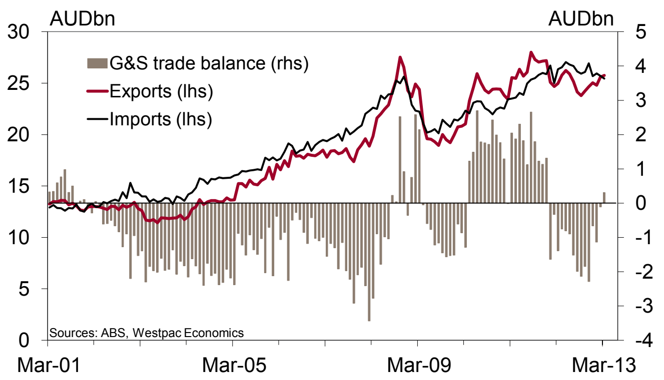
Aus Apr trade balance, AUDbn

Jun 6, Last: 0.3, WBC f/c: 0.1

Mkt f/c: 0.2, Range: –0.6 to 0.7

- Australia's trade balance moved into surplus in the month of March, the first time since December 2011.
- Will Australia make it back-to-back surpluses? It is likely to be a close run thing in our view. We've taken the optimistic view, anticipating a $0.1bn surplus in April. *Note, we've allowed for a slight upward revision to the March surplus, inferred from limited information published by the ABS last week.*
- Imports are forecast to rise by around 0.7%, with the ABS advising that goods rose 0.6% on a rebound in capital items and a moderation of consumption goods.
- Export earnings are forecast to decline by 0.7%, down $180mn. This largely reflects lower prices for rural goods, gold, base metals and fuel, together potentially a hit of around $300mn.

Australia's trade position

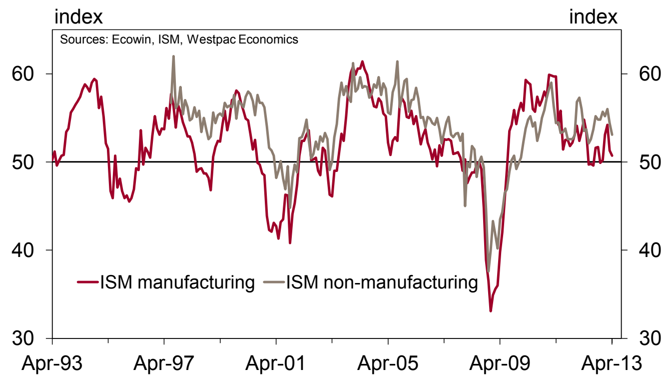


US ISM non-manufacturing

Jun 5, Last 53.1, WBC f/c: 52.5

- The ISM non-manufacturing index also fell in April, from 54.4 to 53.1 – the lowest level since July 2012. The monthly decline was broad based with weaker readings for business activity, employment, supplier deliveries, and new orders (albeit marginal).
- Conditions in non-manufacturing look to be lagging those in the manufacturing sector. We expect a further decline in the index to 52.5 in May.

US ISMs

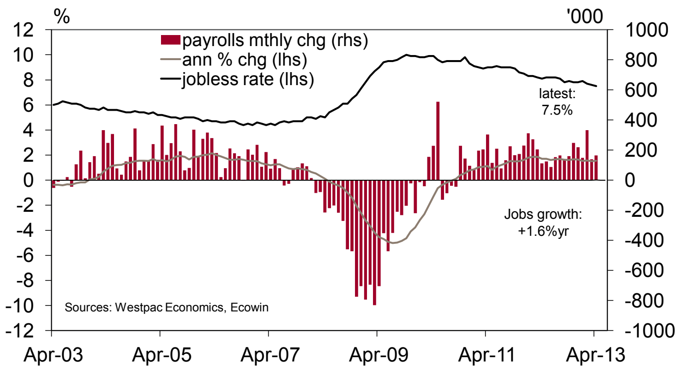


US employment report

Jun 7, non-farm payrolls: Last: 165k, WBC f/c: 150k
Jun 7, unemployment rate: Last 7.5%, WBC f/c: 7.5%

- The April non-farm payrolls report was received by market participants with great cheer; it signalled to many the beginnings of a stronger upturn in employment. The above-expectations print combined with favourable revisions saw average monthly jobs growth for 2013 rise to 196k.
- The unemployment rate ticked down to 7.5% in April, but at just 69k, average household survey employment growth for 2013 is much weaker than payrolls. This discrepancy concerns us, particularly as the household survey often leads payrolls.
- With the Fed openly discussing potentially tapering their asset purchases, this release has moved from high profile to critical. How the discrepancy between the two surveys narrows will be key for the policy outlook. We remain pessimistic and expect payrolls to slowly conform to the household survey.

US payrolls

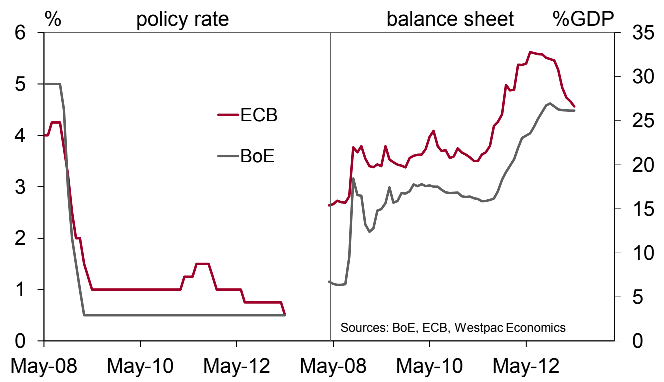


ECB and BOE policy meetings

Jun 6, ECB policy decision: Last: 0.5%, WBC f/c: 0.5%
Jun 6, BOE policy decision: Last: 0.5%, WBC f/c: 0.5%

- At its May meeting, the ECB cut its refinancing rate to 0.5% and the marginal lending facility rate to 1.0% in response to persistent weakness across the region.
- It was apparent from the Q&A that the ECB continues to maintain an easing bias, although its optimistic outlook for activity is clouding its judgement, delaying further action. The stance of policy will be left unchanged at the June meeting, but further action will prove necessary later in 2013.
- The Bank of England maintained its existing policy stance at the May meeting, but the minutes to the meeting made clear that the decision was not unanimous – the minority remain keen for additional asset purchases. June is the last meeting before Carney's arrival after which further policy easing seems only a matter of time.

ECB & BoE



Key Data and Events

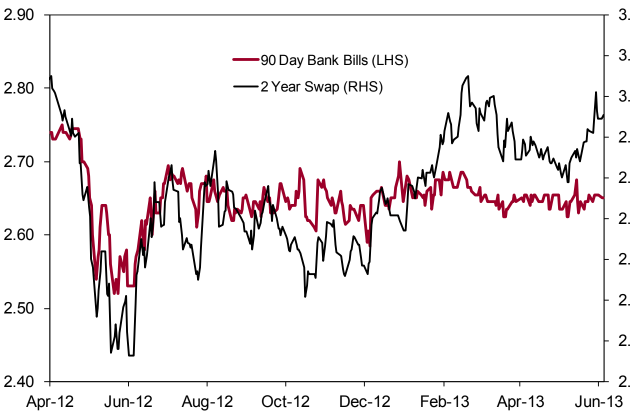
		Last	Market median	Westpac forecast	Risk/Comment
Tue 4					
Aus	Q1 current account balance, AUDbn	–14.7	–9.0	–9.0	Narrows as trade balance swings into surplus.
	Q1 net exports, ppt cont'n	0.6	0.8	0.8	Sizeable contribution on import slump, –3½%, exports flat.
	Q1 public demand	–0.6%	–	–0.3%	Weakness extends into 2013, see textbox.
	RBA policy announcement	2.75%	2.75%	2.75%	To hold, encouraged by resilient Capex plans, AUD slide.
Eur	Apr PPI	–0.2%	–0.2%	–0.2%	Annual pace benign at 0.7%yr in March.
UK	May BRC sales %yr	–2.2%	–	–	Same–store sales.
	May PMI construction	49.4	49.6	49.5	Activity to remain lacklustre in soft growth, tight credit environment.
US	Apr trade balance, USDbn	–38.8	–41.0	–42.0	Stronger dollar will impact deficit in coming months.
	Jun IBD/TIPP optimism	45.1	50.0	–	Confidence on the up with stockmarket?
Wed 5					
NZ	Q1 building work put in place	1.8%	–	1.0%	Residential work rising, non–residential correcting lower.
Aus	Q1 GDP	0.6%	0.8%	0.7%	Net exports +0.8ppts key +ve in Q1. Domestic demand soft, +0.2%.
Chn	May HSBC services PMI	51.1	–	–	Profitability rebound looks to have matured already.
Eur	May PMI services	47.5	47.5	47.5	Persistent weakness broad based across all sectors.
	Q1 GDP, second est	–0.2%	–0.2%	–0.2%	Q1 to be confirmed as sixth consecutive qtr of contraction.
UK	May BRC prices	0.4%	–	–	Shop price index.
	May PMI services	52.9	53.2	53.0	Modest growth continues in service sector.
US	May ADP employment survey	119k	170k	160k	Disappointed in Apr; what will May bring?
	Apr factory orders	–4.9%	1.4%	1.7%	Durable orders up 3.3%; core up more modest 1.2%.
	May non–manufacturing ISM	53.1	53.5	52.5	Further modest decline seems likely in May.
	Fed 'beige book', Jun 18–19 FOMC	–	–	–	Liaison from on the ground in the regions.
Can	Apr building permits	8.6%	–2.3%	–	Partial reversal of Mar gain.
Thu 6					
Aus	Apr trade balance, AUDbn	0.3	0.2	0.1	Imports +0.7%. Exports –0.7% on lower commodity prices (see textbox)
EU	ECB policy decision	0.5%	0.5%	0.5%	No change this month, but more accomodation to come.
UK	BoE policy decision	0.5%	0.5%	0.5%	Last month before Carney's arrival.
US	May Challenger job cuts	–6.0%	–	–	Claims May rise suggests greater job cuts.
	Initial jobless claims	354k	345k	350k	Look to have stabilised a little above Apr level after brief jump in May.
Fri 7					
NZ	Q1 wholesale sales	1.9%	–	–	Sectoral indicator for GDP, though one of the less reliable ones
Ger	Apr exports	0.5%	–0.8%	–1.0%	External demand crucial for Germany and Europe more broadly.
	Apr industrial production	1.2%	0.3%	0.2%	Lingering malaise in Euroland continues to restrict IP.
UK	Apr trade balance, £bn	–9.1	–8.8	–	Weak Europe a persistent burden for UK exports.
US	May non–farm payrolls	165k	168k	150k	Disparity to HH survey to narrow in HH survey's favour.
	May unemployment rate	7.5%	7.5%	7.5%	Dependent on participation rate.
	Apr consumer credit, USDbn	8.0	14.0	–	All about student and auto loans.
Can	May employment	12.5k	18.0k	–	Unemployment rate at 7.2% in Apr; likely little change in May.

New Zealand Economic and Financial Forecasts

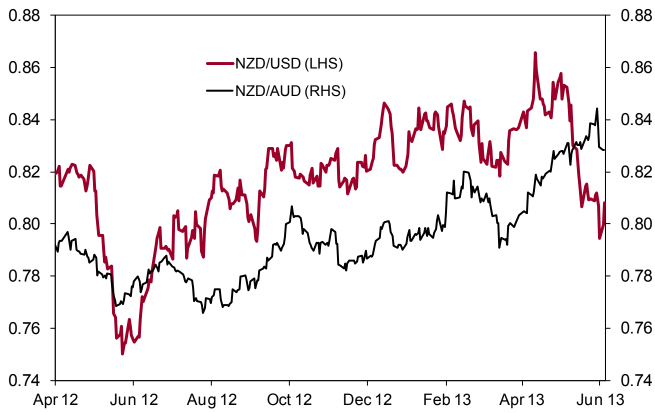
Economic Growth Forecasts	March years				Calendar years			
% change	2012	2013f	2014f	2015f	2011	2012	2013f	2014f
GDP (Production) ann avg	1.9	2.5	2.9	3.7	1.4	2.5	2.8	3.6
Employment	1.0	0.4	2.4	2.8	1.5	-1.4	3.2	3.2
Unemployment Rate % s.a.	6.7	6.2	5.7	4.8	6.3	6.8	6.1	5.0
CPI	1.6	0.9	1.4	2.5	1.8	0.9	1.3	2.3
Current Account Balance % of GDP	-4.4	-4.9	-4.6	-5.6	-4.0	-5.0	-4.5	-5.3

Financial Forecasts	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14
Cash	2.50	2.50	2.50	2.75	3.00	3.25
90 Day bill	2.65	2.70	2.75	3.00	3.25	3.50
2 Year Swap	2.90	3.00	3.10	3.30	3.50	3.70
5 Year Swap	3.40	3.45	3.50	3.60	3.70	3.85
10 Year Bond	3.30	3.40	3.45	3.50	3.55	3.60
NZD/USD	0.82	0.84	0.85	0.85	0.84	0.83
NZD/AUD	0.84	0.84	0.86	0.88	0.88	0.86
NZD/JPY	82.0	83.2	83.3	82.5	80.6	78.9
NZD/EUR	0.63	0.64	0.66	0.68	0.68	0.67
NZD/GBP	0.54	0.54	0.54	0.55	0.54	0.52
TWI	76.8	77.9	79.2	80.2	79.4	78.2

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Tuesday 4 June 2013

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.64%	2.63%	2.64%
60 Days	2.65%	2.64%	2.64%
90 Days	2.65%	2.65%	2.64%
2 Year Swap	2.96%	2.86%	2.84%
5 Year Swap	3.50%	3.34%	3.28%

NZ foreign currency mid-rates as at Tuesday 4 June 2013

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.8081	0.8100	0.8533
NZD/EUR	0.6182	0.6306	0.6508
NZD/GBP	0.5277	0.5332	0.5483
NZD/JPY	80.43	82.91	84.64
NZD/AUD	0.8285	0.8303	0.8284
TWI	75.58	76.47	78.67

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2009	2010	2011	2012	2013f	2014f
Australia						
Real GDP % yr	1.4	2.5	2.4	3.6	2.5	2.3
CPI inflation % annual	2.1	2.8	3.0	2.2	2.0	2.8
Unemployment %	5.6	5.2	5.2	5.4	6.2	6.0
Current Account % GDP	-4.2	-2.9	-2.3	-3.7	-2.6	-3.3
United States						
Real GDP %yr	-3.1	2.4	1.8	2.2	1.7	1.6
Consumer Prices %yr	-0.3	1.6	3.1	2.1	1.9	2.0
Unemployment Rate %	9.3	9.6	8.9	8.1	7.7	7.7
Current Account %GDP	-2.7	-3.0	-3.1	-3.0	-3.1	-3.2
Japan						
Real GDP %yr	-5.7	4.9	-0.4	2.0	1.3	1.9
Consumer Prices %yr	-1.3	-0.7	-0.3	0.0	-0.2	0.1
Unemployment Rate %	5.2	5.1	4.5	4.3	4.3	4.3
Current Account %GDP	2.8	3.6	2.0	2.1	2.0	2.0
Euroland						
Real GDP %yr	-4.4	2.0	1.4	-0.6	-0.8	-0.6
Consumer Prices %yr	0.3	1.7	2.7	2.2	1.4	1.2
Unemployment Rate %	9.5	10.0	10.1	11.7	12.4	13.0
Current Account %GDP	-0.2	-0.1	0.0	0.9	1.0	1.0
United Kingdom						
Real GDP %yr	-4.0	1.8	0.9	0.2	0.7	0.2
Consumer Prices %yr	2.2	3.2	4.0	2.8	2.3	1.8
Unemployment Rate %	7.6	7.8	8.4	8.0	8.5	8.5
Current Account %GDP	-1.3	-2.5	-1.9	-3.8	-2.5	-1.5

Forecasts finalised 10 May 2013

Interest Rate Forecasts	Latest	Jun 13	Sep 13	Dec 13	Mar 14	Jun 14
Australia						
Cash	2.75	2.75	2.50	2.25	2.00	2.00
90 Day Bill	2.77	2.55	2.55	2.30	2.10	2.10
10 Year Bond	3.37	3.20	3.40	3.25	3.10	2.85
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.11	2.00	2.20	2.10	2.00	1.80
ECB Repo Rate	0.50	0.50	0.50	0.50	0.50	0.50

Exchange Rate Forecasts	Latest	Jun 13	Sep 13	Dec 13	Mar 14	Jun 14
AUD/USD	0.9649	0.98	1.00	0.99	0.97	0.96
USD/JPY	100.79	100	99	98	97	96
EUR/USD	1.3041	1.30	1.31	1.29	1.25	1.24
AUD/NZD	1.1933	1.20	1.19	1.16	1.14	1.14

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