Emerald Lakes, Tongariro National Park

Weekly Commentary

In this issue

Speed limits

Last week's labour data provided further confirmation that the economy grew strongly in the September quarter, but also suggested that wage pressures are a way off yet. We remain comfortable with our view that RBNZ rate hikes won't begin until April – and that an extended period of rate increases will be required in the years ahead.

For once, the oft-divergent Household Labour Force Survey and (employer-based) Quarterly Employment Survey were in agreement: there was a big lift in demand for workers in the September quarter. On both measures, the annual pace of jobs growth was the fastest since late 2007/early 2008.

This took the unemployment rate down to 6.2%, the lowest since early 2010. There was also a rise in labour force participation as people re-entered the workforce – possibly reflecting the tightening of unemployment benefit criteria that came into effect in early July. But even if that's the case, the fact that those people got jobs rather than adding to the pool of unemployed is a sign that the labour market has picked up pace.

At the same time, wage inflation in the September quarter was pervasively, and surprisingly, soft. Our (and the RBNZ's) preferred measure of New Zealand wages, the private sector Labour Cost Index, slowed to 1.6% annually, compared to 2.1% a year earlier. What's more, labour cost pressures relating to the Canterbury rebuild remain confined to that region. Construction sector wage inflation outside Canterbury actually slowed from 2.1% to 1.6%.

Financial markets focussed on the better than expected jobs growth, with both the NZD and wholesale interest rates jumping up on the news. Markets are now more confident that the Reserve Bank will begin raising the Official Cash Rate in March.

That reaction seems premature to us. If anything, we reckon the Reserve Bank will regard the weak wage data as more important. While it's nice to see confirmation of the economic recovery, it shouldn't really surprise anyone, least of all the RBNZ. The debate

Speed limits continued

has moved on, the issue now being just when this stronger economic growth will generate inflation pressures.

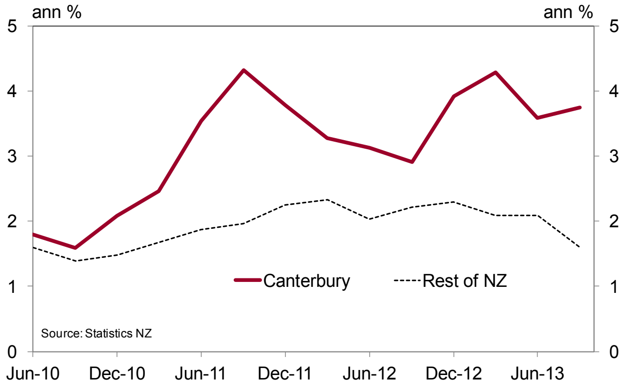
In this debate the Reserve Bank is definitely in the sanguine camp, and on that basis has been targeting April as a start date for OCR hikes. By suggesting that inflation pressures are minimal in the labour market, this week's data will have supported the RBNZ's view.

That said, we would not want to overstate the wage data's longer-term significance. Wages tend to provide a rear view mirror perspective on inflation pressure: pay reviews tend to be heavily influenced by recent inflation trends, and now that consumer prices have started to pick up, wages are likely to follow.

What's more, the fact that the economy still had spare capacity in September doesn't mean that it will still have spare capacity in a year's time. Drawing on our recent research on New Zealand's longer-term economic outlook, our latest quarterly *Economic Overview*, released last week, points out that New Zealand's trend rate of economic growth is probably lower now than in decades past. The population is aging, which is weighing on growth in the labour force, and based on the experience of the past few decades there is little reason to hope for an improvement in productivity trends to fill the gap. Compared to a decade ago, that will limit the economy's ability to smoothly absorb a construction boom, rising house prices, and an export commodity boom. Put another way, the 3.8% economic growth we forecast for next year is well above what we would regard as the economy's speed limit.

Hence we continue to expect that the Reserve Bank will eventually have to embark on an extended sequence of rate hikes. The *Economic Overview* puts this more precisely: to restrain the economy, the Official Cash Rate will eventually have to rise above its 'neutral' level – which itself is likely to rise in the next few years as inflation expectations rise, bank funding premia continue to narrow, and the 'deleveraging' dynamic that restrained spending after the Global Financial Crisis recedes into history. We estimate the relevant benchmark is about 5%. So the Official Cash Rate will have to rise above this level to keep inflation pressures in check – how far will depend on how late the Reserve Bank begins its hiking cycle.

Construction sector labour costs, Canterbury and elsewhere

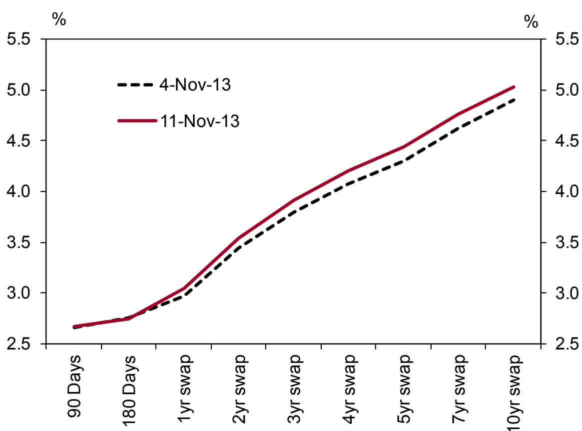


This week's data are likely to provide further signs of New Zealand's gathering economic momentum. We estimate that retail activity rose 0.9% in the September quarter and 5.5% over the year – which would be the fastest annual pace of growth since the Rugby World Cup in late 2011. Meanwhile, housing market data for October are unlikely to reveal any hit from the RBNZ's lending restrictions. Auckland figures released last week by a major real estate agency showed regional sales surging in the month – partly due to a lift in the supply of listings, but clearly not indicative of a drop-off in demand. That said, as we've noted in previous weeks, the pipeline of mortgage pre-approvals means it's unlikely that we'll see any drop in housing turnover before November at the earliest.

Fixed vs Floating for mortgages

We are now indifferent between fixing and floating. In our view, interest rate markets are now "fairly priced". We expect short-term rates to rise substantially over the next three years. The level of long-term fixed rates, which are higher than short-term rates, is in tune with that expectation. This means we can discern no obvious interest rate advantage in any particular term. The decision can be treated as a risk management choice according to individual circumstances.

NZ interest rates

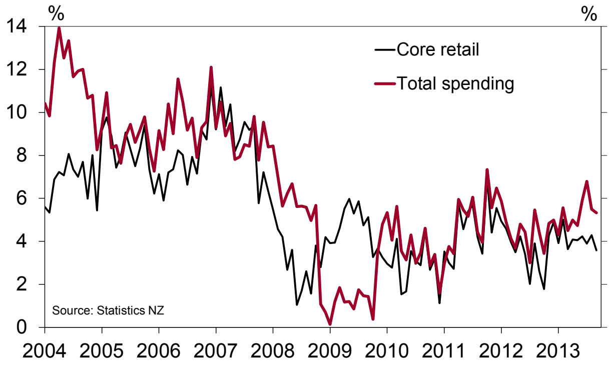


NZ Oct electronic card transactions

Nov 11, Last: –0.4%, WBC f/c: +1.0%, Mkt f/c: +1.3%

- Electronic card spending fell 0.4% in September, its first monthly decline since March. However, October figures from Paymark, the largest cards processor, suggest this was merely volatility within an upward trend that is now clearly accelerating.
- The October rebound is likely to be particularly strong in the core retail categories following a 1% drop in September. Meanwhile, lower petrol prices over the month will dampen non-core spending.
- Consumer spending growth typically has a strong correlation with house price growth in New Zealand. The recent strength in cards spending is consistent with the acceleration in the housing market over this year - noting that the effects of the RBNZ's new home loan restrictions are unlikely to have been felt as early as October.

Card transactions, annual % change

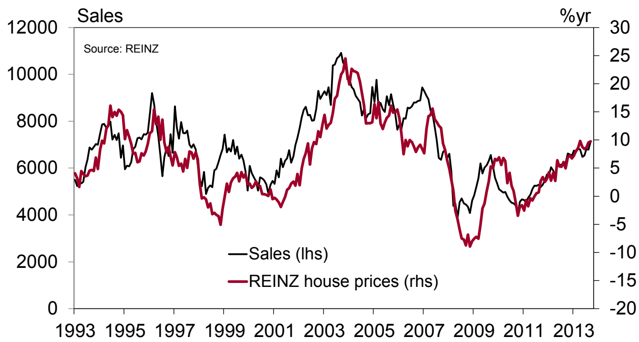


NZ Oct REINZ house prices and sales

Nov 13 (tbc), Sales last: +5.2%, Prices last: +9.8%yr

- The housing market has gone from strength to strength this year, with price inflation almost reaching double digits.
- The RBNZ's restrictions on high loan-to-value mortgage lending took effect from 1 October. Also, fixed mortgage rates rose sharply from July to September. In our opinion, this combination will slow the housing market. However, as we have mentioned in the past, we don't expect to see the first sign of any slowdown until at least the November data. The first sign of a slowdown would be a drop in turnover; a lower rate of house price inflation may follow in early 2014.
- Partial data already seen on mortgage approvals and Auckland house sales suggest that this week's October housing data will remain strong – possibly a further lift in sales, but certainly ongoing rapid price gains.

REINZ house prices and sales

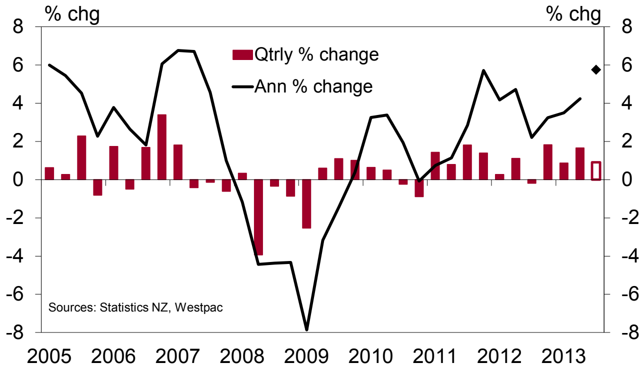


NZ Q3 real retail sales

Nov 14, Last: +1.7%, WBC f/c: +0.9%, Mkt f/c: +0.9%

- Retail sales volumes surged in the June quarter, with particularly strong growth in those categories where the strong NZD has given consumers more bang for their buck, such as department stores, electronic goods and hardware.
- We expect a solid 0.9% rise in volumes for the September quarter. Notably, our estimate of nominal spending growth (1.2%) is almost identical to the June quarter; the difference is a 0.4% rise in the price deflator this time compared to a 0.6% drop in June. Fuel prices account for most of these movements.
- The monthly card spending figures point to growth in spending across most of the broad categories, with the exception of a drop in clothing spending due to the mild winter. Vehicle sales are likely to rise strongly based on registrations data, although this is only a loose indicator.

Real retail sales

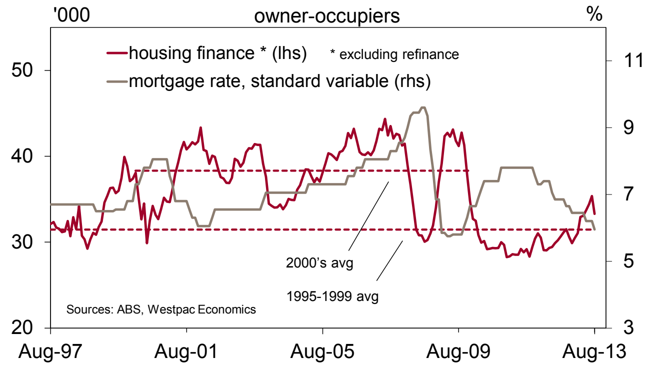


Aus Sep housing finance (no.)

Nov 11, Last: –3.9%, WBC f/c: 5.0%
Mkt f/c: 3.5%, Range: 2.0% to 5.0%

- Housing finance approvals recorded a 3.9% pull-back in Aug after strong gains over the previous 12mths (+15.6% in the year to Jul). The monthly decline was broadly based, although over the year, the Eastern states continue to outperform. FHB activity remains very weak.
- Price growth and auction activity strengthened between Jul and Oct. As such, the Aug pull-back looks like a temporary aberration. Accordingly, we expect a strong rebound in Sep to reinstate the solid uptrend in finance approvals. Indeed, there may even be upside risk to our 5%mth forecast.

Owner-occupier finance & the rate cycle

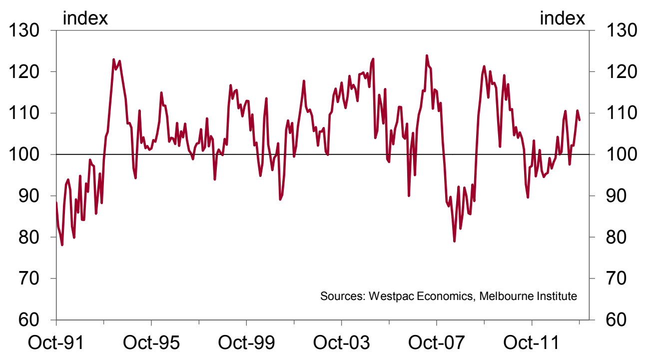


Aus Nov Westpac-MI Consumer Sentiment

Nov 13, Last: 108.3

- Consumer Sentiment edged lower in Oct but remained in solidly optimistic territory overall. The apparent uplift in Aug due to the Federal election result appeared to carry into Oct. The detail remains less positive though with views around family finances still weak in particular.
- The Nov survey is in the field from Nov 4 to 10. Factors that may influence sentiment include: the RBA's decision to leave rates on hold; clear signs of a pick-up in the housing sector, but another soft reading on the labour market; and further gains in financial markets (ASX up 4% since the Oct survey and up over 20%yr). The election-related boost may also start to subside – evidence from the past suggests this can last several months.

Consumer Sentiment

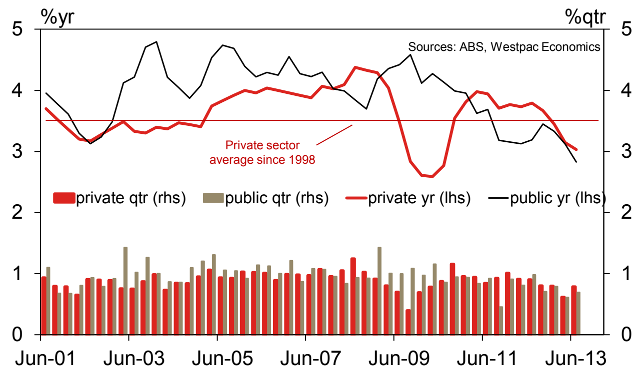


Aus Wage Cost Index %qtr

Nov 13, Last: 0.7%, WBC f/c: 0.6%
Mkt f/c: 0.7%, Range: 0.6% to 0.8%

- Total hourly wage rates ex bonuses (WPI) rose 0.7% in Q2, spot on Westpac and market consensus expectations.
- Wage inflation in the private sector has continued to ease as the labour market softens. The private sector WPI (ex bonuses) rose 0.8%qtr, a lift from the 0.6%qtr reported in Q1. However, the annual pace continued to moderate, to 3.0%yr from 3.1%yr in Q1, suggesting there may be some residual seasonality in the quarterly numbers. Private sector wage inflation was 3.4%yr in 2012 Q4, down from a recent peak of 4.0%yr in 2011 Q1.
- There has been a broad softening in wage inflation across the nation and between sectors. We are now seeing the lagged effects of the soft labour market on wage negotiations; many enterprise agreements are negotiated for three years. We expect wage inflation to continue to moderate, falling to 2.8%yr in Q3, the slowest pace since the series started in 1997.

Private vs. public sector wages

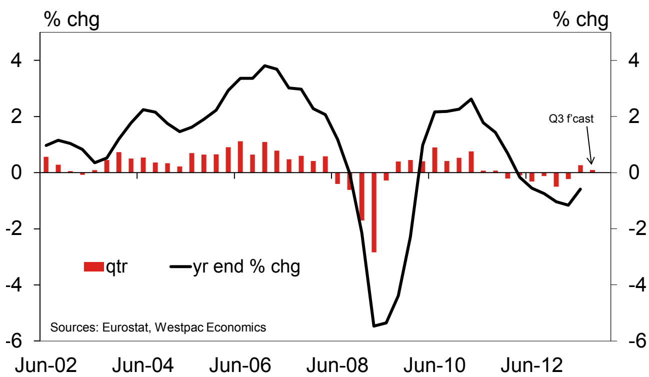


Eurozone GDP to slow in Q3.

Nov 14, Last: 0.3%, WBC f/c: 0.1%

- Euroland GDP grew by 0.3% in Q2 after 6 quarters of shallow recession. Q2 benefited from improved weather in Germany which had weighed on Q1 construction growth, but that won't be repeated in Q3. Further, despite PMI surveys back in expansionary territory, hard data on exports, production and retailing all suggest growth in other sectors slowed. We expect German growth slowed from 0.7% to 0.2% in Q3.
- Spain has already reported modest 0.1% Q3 growth after more than 2 years of recession, but Portugal won't repeat its surprise 1.1% Q2 jump in output. French uncompetitiveness is setting in according to partial data, implying a stalled economy after 0.5% growth in Q2, and Italy probably contracted modestly again.
- We see Q3 Eurozone growth rounding up to 0.1%, confirming it is out of recession, but the recovery is fragile and at risk.

Euro zone GDP growth

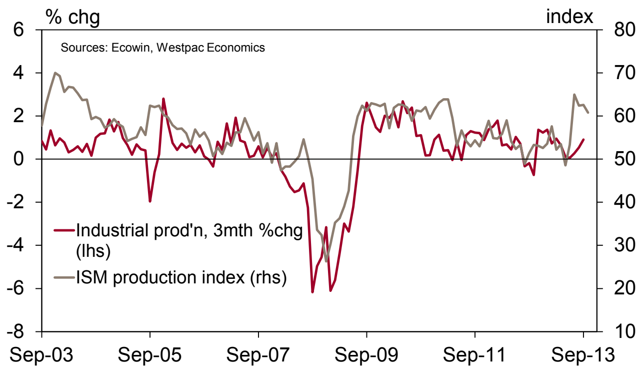


US Oct industrial production

Nov 15: Last: 0.6%, WBC f/c: –0.1%

- Industrial production rose 0.6% in Sep, supported by a 4.4% jump in utilities output (first rise in 6 months), but factory output was up just 0.1%.
- Factory hours worked data will not be available for Oct until after we go to press. Auto sales slipped a little further after being down 5% in Sep, when auto orders were down 0.3%. Core capital goods orders had been rising steadily until June, but fell at an 8.4% annualised pace in Q3. The ISM factory index edged up from 56.2 to 56.4 in Oct, its highest in two and a half years, continuing to out-perform the official factory data which has averaged 0.1% per month through Q1 and Q2, and less than that (0.067%) in Q3. Our Oct 0.1% IP forecast fall assumes a pull-back in utilities more than offsets another meagre gain in factory production, given the mostly negative signals this month.

US industrial sector



Data calendar

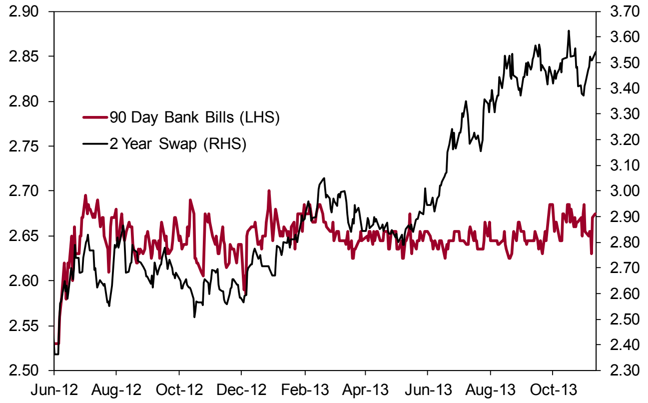
		Last	Market median	Westpac forecast	Risk/Comment
Mon 11					
NZ	Oct electronic card transactions	–0.4%	1.3%	1.0%	Consumer spending now entering a strong upward trend.
Aus	Sep housing finance	–3.9%	3.5%	5.0%	Aug decline looks to be an aberration. Housing activity clearly on the up.
UK	Oct RICS house price balance	54%	36%	–	Optimism back in UK housing market. RICS at highest since 2002.
Tue 12					
Aus	Oct NAB business confidence	12.3	–	–	Election related bounce in confidence but conditions still weak at –4.2.
UK	Oct CPI %yr	2.7%	2.5%	2.6%	Shop prices subdued; CPI to drift lower as one off factor impact abates.
	UK house prices %yr	3.8%	–	–	ONS series. Accelerating due to subsidies to borrowers and lenders.
	Oct PPI %yr	0.7%	0.7%	–	Core output measure.
US	Oct NFIB small business optimism	93.9	93.3	94.1	Recovery post government shutdown.
	Oct Chicago Fed national activity index	0.14	–	–	Most US indicators losing headway except some business surveys.
	Fedspeak	–	–	–	Kockerlakota, Lockhart.
Wed 13					
NZ	RBNZ Financial Stability Report	–	–	–	Main outlet for discussing macroprudential policy, but early days yet.
	Oct REINZ house sales	5.2%	–	–	Date to be confirmed. Housing market still strong in Oct.
	Oct REINZ house price index %yr	9.8%	–	–	LVR limits to hit sales from Nov and prices early next year.
Aus	Nov Westpac–MI Consumer Sentiment	108.3	–	–	Critical reading heading into Christmas.
	Nov Westpac–MI unemploy. expect.	0.6%mth	–	–	The small lift last month did not alter a trend improvement, now down 6%yr.
	Q3 wage cost index %qtr	0.7%	0.7%	0.6%	The soft labour market continues to weigh on wage negotiations.
Eur	Sep industrial production	1.0%	–0.2%	0.0%	PMIs expanding but Aug gain in output unlikely to be repeated in Sep.
UK	Oct jobless claims change	–42k	–30k	–	Claimant count unemployment tumbling as economy accelerates.
	Q3 employment change	155k	82k	90k	ILO jobless rate to edge lower to 7.6% as jobs firm over summer.
	BoE inflation report	–	–	–	Policy guidance likely to bring forward eventual tightening to 2015.
US	Oct monthly budget statement, $bn	–104.0	–	–	Interesting to see the shutdown impact.
Can	Oct house prices	0.0%	–	–	Teranet measure; prices up 2.7%yr in Sep.
Thu 14					
NZ	Oct manufacturing PMI	54.3	–	–	Has been consistently strong so far in 2013.
	Q3 real retail sales	1.7%	0.9%	0.9%	Picking up speed, although fuel prices were a drag compared to Q2.
Aus	Nov MI inflation expectations	2.0%	–	–	Inflationary expectations are very benign.
	Oct new motor vehicle sales	–0.1%	–	–1.0%	Sales down 3.1%yr to Oct after 12.2% rise year before.
Ger	Q3 GDP advance	0.7%	0.3%	0.2%	Slowdown from weather bounce in Q2.
Eur	Q3 GDP advance	0.3%	–	0.1%	Weak growth in Spain, weaker growth in core. See text box.
UK	Oct retail sales incl fuel	0.6%	0.1%	0.3%	Private sector retail surveys for Oct sluggish or softer.
US	Initial jobless claims w/e 8/11	336k	330k	330k	Slowly recovering from collateral damage from govt shutdown.
	Q3 non-farm productivity	2.3%	1.2%	2.0%	Productivity growth ongoing as GDP growth faster than hours worked.
	Sep trade balace $bn	–38.8	–39.0	–	Exports and imports both flat in Aug.
	Fedspeak	–	–	–	Chair Bernanke to teachers; Plosser on policy.
Can	Sep new house prices	0.1%	–	–	Running slower 1.8%yr pace.
	Sep trade balance C$bn	–1.3	–1.3	–	Exports and imports both up around 2% in Aug.
Fri 15					
Eur	Oct CPI final %yr	1.1% a	1.1%	1.1%	Core rate was 0.8%yr in Oct, putting renewed pressure on ECB to ease.
US	Oct import prices	0.2%	–0.5%	–1.0%	Oil prices down sharply during month.
	Nov NY Fed factory survey	1.5	5.0	3	Post govt shutdown bounce.
	Oct industrial production	0.6%	0.1%	–0.1%	IP yet to reflect strong ISM factory survey. See text box.
	Sep wholesale inventories	0.5%	0.3%	–	Restocking picking up in Q3 after essentially stalled since Jan.
Can	Oct existing home sales	0.8%	–	–	Recently established series with just over a year of data.
	Sep manufacturing sales	–0.2%	0.2%	–	Aug fall due food sales.

New Zealand forecasts

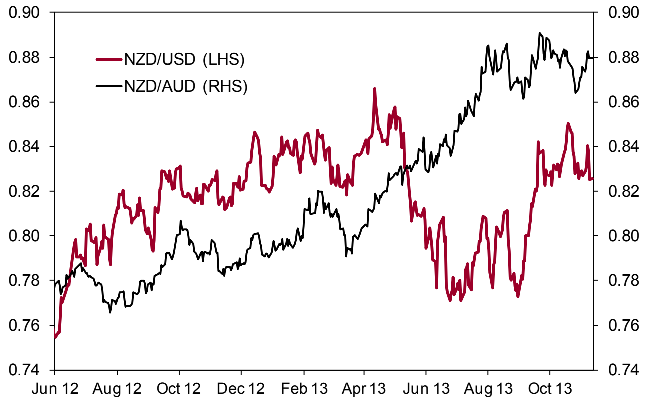
Economic Growth Forecasts	March years				Calendar years			
% change	2012	2013f	2014f	2015f	2011	2012	2013f	2014f
GDP (Production) ann avg	1.9	2.7	3.0	3.8	1.4	2.7	2.8	3.8
Employment	1.0	0.4	2.6	2.7	1.5	-1.4	3.8	2.8
Unemployment Rate % s.a.	6.8	6.2	5.6	5.1	6.3	6.8	5.7	5.0
CPI	1.6	0.9	1.3	2.2	1.8	0.9	1.5	1.9
Current Account Balance % of GDP	-3.8	-4.5	-3.8	-4.9	-3.6	-4.7	-3.9	-4.4

Financial Forecasts	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Cash	2.50	2.50	3.00	3.25	3.50	3.75
90 Day bill	2.65	2.90	3.25	3.50	3.75	4.00
2 Year Swap	3.50	3.70	3.90	4.10	4.40	4.60
5 Year Swap	4.50	4.60	4.70	4.80	4.90	5.00
10 Year Bond	4.60	4.70	4.75	4.80	4.85	4.90
NZD/USD	0.85	0.84	0.82	0.79	0.77	0.76
NZD/AUD	0.89	0.90	0.91	0.91	0.90	0.90
NZD/JPY	82.5	80.6	77.9	74.3	71.1	70.4
NZD/EUR	0.63	0.63	0.64	0.64	0.64	0.63
NZD/GBP	0.52	0.52	0.51	0.51	0.50	0.48
TWI	78.5	78.3	77.8	76.3	74.7	74.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 11 Nov 2013

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.50%	2.50%
30 Days	2.66%	2.65%	2.65%
60 Days	2.67%	2.66%	2.67%
90 Days	2.68%	2.67%	2.68%
2 Year Swap	3.54%	3.41%	3.52%
5 Year Swap	4.44%	4.28%	4.49%

NZ foreign currency mid-rates as at Monday 11 Nov 2013

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8256	0.8299	0.8291
NZD/EUR	0.6182	0.6016	0.6114
NZD/GBP	0.5159	0.5138	0.5189
NZD/JPY	81.91	81.06	81.44
NZD/AUD	0.8797	0.8667	0.8802
TWI	77.19	76.36	77.02

International forecasts

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2009	2010	2011	2012	2013f	2014f
Australia						
Real GDP % yr	1.4	2.5	2.4	3.7	2.5	2.3
CPI inflation % annual	2.1	2.8	3.0	2.2	2.4	2.6
Unemployment %	5.6	5.2	5.2	5.3	5.8	6.4
Current Account % GDP	-4.2	-2.9	-2.3	-3.7	-2.6	-3.0
United States						
Real GDP %yr	-3.1	2.4	1.8	2.8	1.6	1.6
Consumer Prices %yr	-0.3	1.6	3.1	2.1	1.5	1.7
Unemployment Rate %	9.3	9.6	8.9	8.1	7.5	7.3
Current Account %GDP	-2.7	-3.0	-2.9	-2.7	-2.5	-2.6
Japan						
Real GDP %yr	-5.7	4.9	-0.5	1.9	1.8	1.7
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	1.9	1.6	-0.6	-0.5	-0.1
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	1.1	0.9
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 8 November 2013						

Interest Rate Forecasts	Latest	Dec 13	Mar 14	Jun 14	Sep 14	Dec 14
Australia						
Cash	2.50	2.50	2.25	2.00	2.00	2.00
90 Day Bill	2.58	2.60	2.35	2.10	2.10	2.10
10 Year Bond	4.14	3.75	3.60	3.40	3.80	4.00
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.60	2.35	2.40	2.40	2.80	3.00
ECB Repo Rate	0.25	0.25	0.25	0.25	0.25	0.25

Exchange Rate Forecasts	Latest	Dec 13	Mar 14	Jun 14	Sep 14	Dec 14
AUD/USD	0.9463	0.96	0.94	0.92	0.92	0.90
USD/JPY	98.17	97	96	95	94	93
EUR/USD	1.3409	1.38	1.34	1.31	1.31	1.28
AUD/NZD	1.1366	1.13	1.12	1.11	1.11	1.11

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