Weekly Commentary

22 July 2013

As low as it goes

Inflation was just as subdued as expected over the June quarter, with the strong New Zealand dollar helping to hold down prices for internationally-traded goods. The details hinted at some threats to the Reserve Bank's benign assumptions about future inflation, but nothing that would prompt a change to its firmly on-hold message in Thursday's OCR review.

The Consumer Price Index rose 0.2% in the June quarter, in line with our forecast but a touch below the market median and the RBNZ's pick of 0.3%. Annual inflation slowed from 0.9% to 0.7%, the lowest in nearly 14 years. This was the fourth straight quarter where annual inflation was below the Reserve Bank's 1-3% target range (though it will likely be the last, as we'll discuss shortly).

Within that headline figure, there was a marked divergence between tradables – imported or import-competing goods – and non-tradables inflation. Tradable goods prices fell 0.5% over the quarter, leaving them down 1.6% on a year ago. This was the steepest annual fall since a 2.3% drop in the year to March 2004, which in turn was the biggest decline on record going back to 1989. Excluding a drop in fuel prices – which has been more than reversed so far in July – tradable goods prices were down 1.4% on a year ago.

The cumulative effect of a rising New Zealand dollar has done much to depress import prices over the last year. While the dollar did start falling since May, the average level of the trade-weighted index over the June quarter was still the highest in the post-float era. That residual strength contributed to the fall in fuel prices, a 1.5% drop in car prices (the sharp rise against the yen was a likely factor here), ongoing falls in clothing and electronic goods, and a smaller than usual seasonal uptick in food prices.

For those items not exposed to international markets, however, it was a different story. Non-tradables prices rose 0.6% over the quarter, nudging the annual rate up from 2.4% to 2.5%. This is still well short of the 4%-ish pace seen regularly during the 2003-2007 boom, but any uptick deserves to be watched closely – non-tradables inflation tends to be quite persistent once it takes hold.

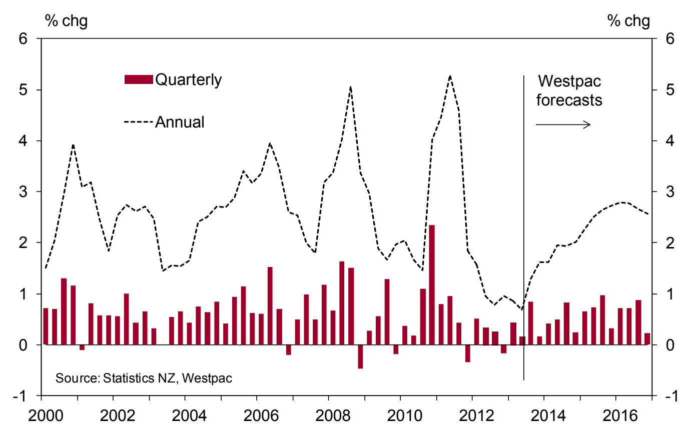
In particular, there was a clear picture of housing-related inflation picking up – something that we've been watching for as the Canterbury rebuild has progressed and the housing market has strengthened. The evidence to date has been patchy, but it came through in a rush in the June quarter, with strong price increases for new dwellings, property maintenance and real estate fees (though not rents, outside of Canterbury).

New house prices in Canterbury rose 2.9% for the quarter and were 11.7% higher than a year ago (this is quality-adjusted, so it doesn't merely reflect tougher building standards). What's more notable is that these price pressures seem to be spreading: new house prices in the North Island rose 1.5% in the June quarter, having risen by only 1.4% in the whole year prior. Our view has long been that construction cost pressures will spread more broadly as the Christchurch rebuild progresses, in contrast to the RBNZ's assumption that the localised and co-ordinated nature of the rebuild would contain price pressures.

What happens to inflation from here depends in large part on the exchange rate. The trade-weighted index has been trending higher at an average pace of 5% a year for the last three years. Unless it can re-establish that upward trend, its disinflationary impact will start to fade from here on. And if the currency were to fall substantially further (which we should note is not our central view) then inflation could be back towards 2% in short order.

How the RBNZ will treat the exchange rate's recent decline depends on two factors, as it detailed in the June *Monetary Policy Statement.* The first is whether the fall reflects a 'portfolio shock' – a change in assessment by global investors – rather than a weakening in New Zealand's economic fundamentals. We can safely tick the box on this one: high-yield currencies like

NZ CPI inflation



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the New Zealand dollar have fallen as investors have anticipated the end of quantitative easing in the US. The second factor is that the NZD's fall would have to be sustained in order to have a significant impact on the medium-term outlook for inflation. Only time will tell on that, and we suspect the RBNZ will withhold making this judgement until the September *MPS.*

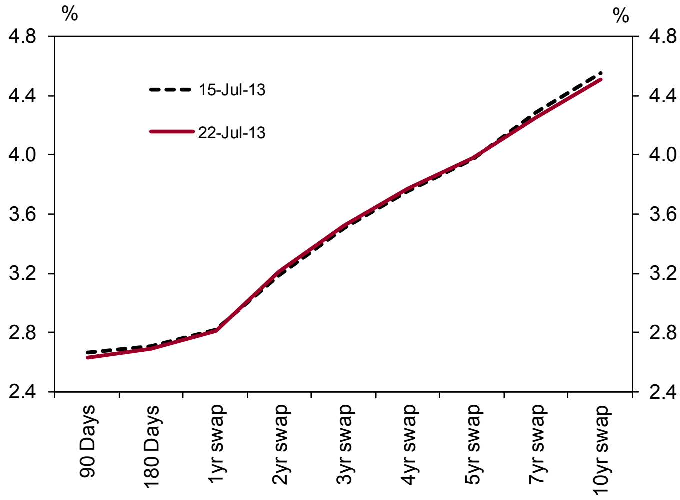
Of course, a lower NZ dollar is not the only consequence of the shifting sands of US monetary policy. Long-term interest rates in the US have risen substantially as the Federal Reserve has signalled an end to its bond buying programme, and this has been transmitted to interest rates around the world. As a result, we've already seen a couple of rounds of increases in fixed-term mortgage rates in New Zealand. In our estimation, the lower exchange rate and the rise in interest rates since June would largely offset each other if the RBNZ re-ran its forecasts today.

Consequently, this Thursday's OCR review is likely to hew closely to the June statement, repeating that "we expect to keep the OCR unchanged through the end of the year". There may be some temptation to talk down market expectations for interest rate hikes, as some other central banks have done, but the divergence is not substantial – markets are pricing an OCR hike by April next year, while the RBNZ's projections suggested more like next September.

We don't expect any comment on the day about the use of loan-to-value ratio (LVR) limits – RBNZ Governor Wheeler has generally been careful to keep the issues of monetary policy and financial stability separate. Of course, once LVR restrictions are in place they will form part of the backdrop for monetary policy decisions, in much the same way that fiscal policy does. But the overseas experience suggests that LVR limits would, at best, slow the rate of increase in house prices. If so, the implications for medium-term inflation would be limited, and they're unlikely to prove a game-changer for monetary policy.

Fixed vs floating for mortgages: We favour fixing over floating. Fixed-term rates out to two years are currently below floating rates, while three-year and longer fixed rates are only slightly higher. Staying on floating would only be the lower-cost option if the RBNZ actually cut the OCR, which we regard as unlikely. In fact, we expect the floating mortgage rate to rise significantly over the 2014 to 2016 period. There may be value in fixing sooner rather than later. Wholesale interest rates have risen sharply in recent weeks, and fixed mortgage rates are already rising in response. We think fixed mortgage rates may rise further in the near term.

NZ interest rates



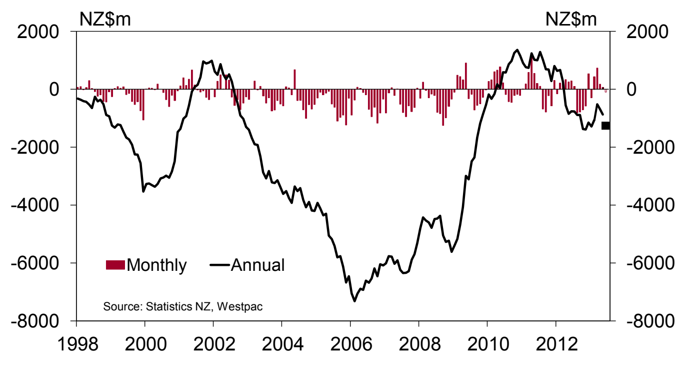
Key Data Previews

NZ Jun merchandise trade

Jul 24, Last: $71m, WBC f/c: -$100m, Mkt f/c: $100m

- The effects of the drought earlier this year will continue to play havoc with the monthly trade figures. Low milk powder volumes could be more than offset by sharply higher world prices - only a fraction of the spike in dairy auction prices has shown up in the export figures to date. Meat volumes are also likely to be sub-par, with no relief from higher prices.
- Our forecast implies a seasonally adjusted deficit of around $300m, a slight improvement on the $350m deficit in May.
- Looking ahead, the trade balance should improve by year-end as dairy production recovers from drought-affected levels. However, imports of materials and equipment needed for the Christchurch rebuild are expected to drive persistent trade deficits through 2014.

NZ merchandise trade balance

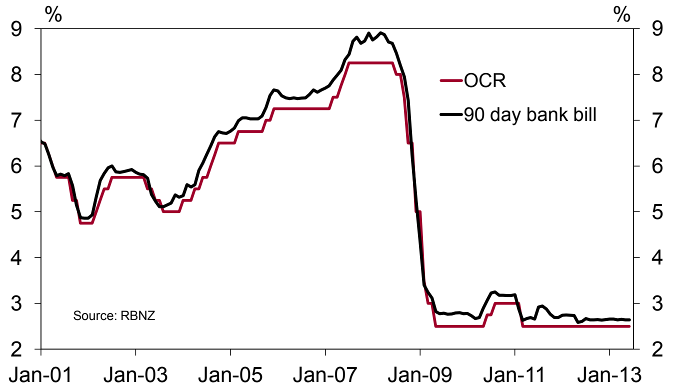


RBNZ Official Cash Rate review

Jul 25, Last: 2.50%, WBC f/c: 2.50%, Mkt f/c: 2.50%

- In the June Monetary Policy Statement the RBNZ repeated that the OCR was on hold for the rest of this year, while noting the sensitivities around the hot housing market and the strong NZ dollar.
- Developments since then have been broadly balanced. The NZD trade-weighted index is tracking 4% below the RBNZ's June assumptions, but fixed-term mortgage rates have risen - both the product of global investors' reassessment of US monetary policy.
- The RBNZ has been careful to separate the issues of monetary policy and financial stability, so although loan-to-value ratio restrictions are almost certainly on the way in the near future, we don't expect any further insight on the matter in this one-page statement.

NZ OCR and 90 day rate

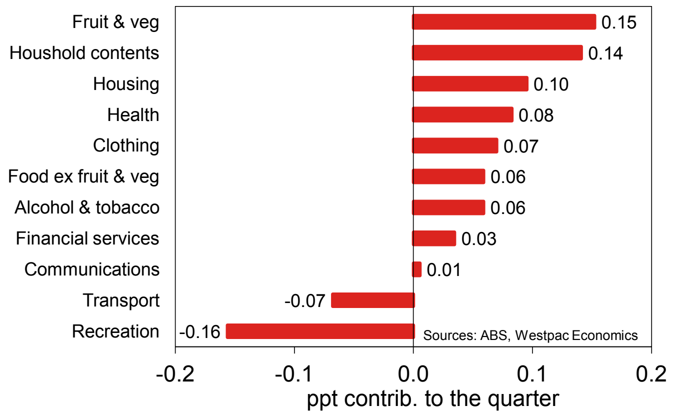


Aus June qtr Consumer Price Index

Jul 24, Last: 0.4%qtr, WBC f/c: 0.5%qtr, Mkt f/c: 0.5%qtr

- The Q2 CPI surprised the market with a very modest 0.4%qtr rise. Weakness in food, household goods, motor vehicles, audio visual and holidays outweighed the normal seasonal positives and an outsized gain in dwelling costs.
- Our Q2 forecast of 0.5%qtr/2.5%yr is based on the usual seasonal softness in electricity and pharmaceuticals. But just as critical is the fall in fuel and a moderation in new dwelling price inflation which are partly offsetting the seasonally unusual rise in fruit & vegetables. The seasonally adjusted CPI is forecast to rise 0.6%qtr.
- Core inflation, as measured by the average of the trimmed mean and weighted median, is forecast to rise 0.5%qtr/2.3%yr in the June quarter. This is a slight moderation from the 2.4%yr pace reported in Q1.

Contributions to 0.5% qtr Q2 CPI print

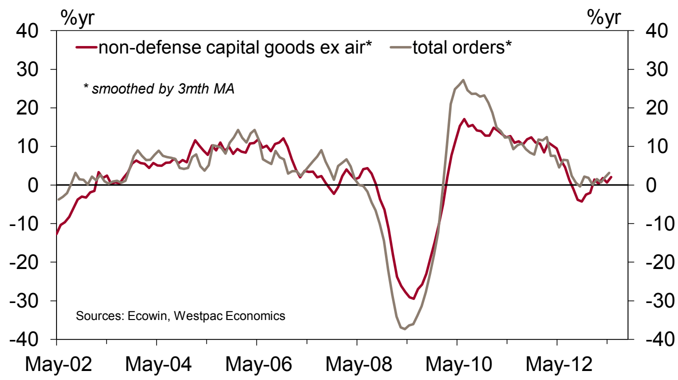


US durable goods orders up again in June

Jul 24, Last: 3.7%, WBC f/c: 2.0%

- US durable goods orders rose 3.7% in May, replicating their April gain, buoyed once again by a further rebound in aircraft orders (+51%). However, auto orders were down 1.2%, their first decline for 2013. Most other sectors recorded gains; ex transport saw a 0.7% rise, such that April-May saw this sub-index more than recover its back-to-back declines in Feb-Mar. Core capital goods orders excluding aircraft and defence posted a third straight gain of just over 1%.
- ISM factory orders were about stalled in May-June at 50.4 (avg), down from 51.9 in Mar-Apr. Boeing took 287 orders in June from 232 in May. Auto sales rose 4.2% and production was up 1.3% in June; business equipment output edged up 0.5% last month. These signals point to a headline 2% rise in durable orders; outside of transport some momentum should persist, but core capital orders may only be flat in the month.

US durable goods orders



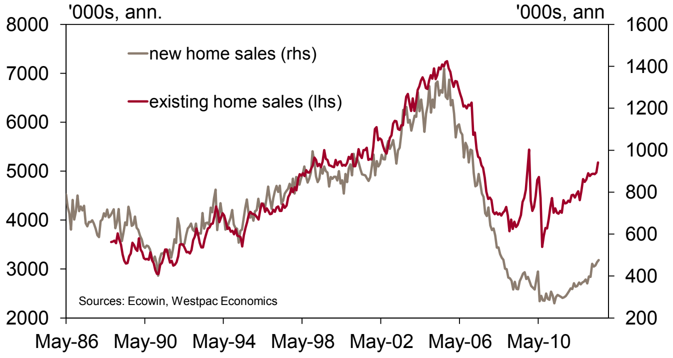
US existing and new home sales upswing at risk

Jul 22, Existing: Last: 4.2%, WBC f/c: 3.0%

Jul 24, New: Last: 2.1%, WBC f/c: 0.5%

- Existing home sales rose 4.2% in May, hitting a new cycle high (though still down 29% from the 2005 sales record); cash buyers and investors remain over-represented relative to the norm. Pending home sales jumped 6.7% in May to be up 11% so far in 2013 vs 6% ytd (Dec to May) for completed sales suggesting near-term upside for existing sales. Sharply higher mortgage rates show signs of impacting on sales since the middle of the year however.
- New home sales rose 2.1% in May and revisions were positive; that resulted in an annualised sales pace of 476k, a new post-recession high and up 21% ytd, with many buyers crowded out of the established market by investors. But despite rising homebuilder confidence, single family housing starts are down 6% since the start of the year. This should show up in slower sales, also at risk of stumbling as higher mortgage rates bite.

US housing sales



Key Data and Events

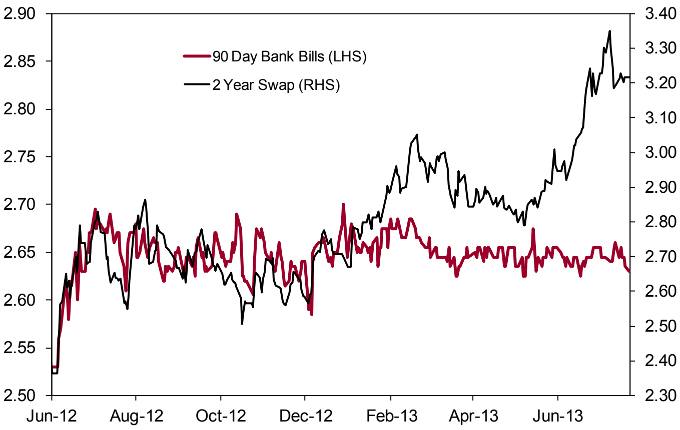
		Last	Market median	Westpac forecast	Risk/Comment
Mon 22					
US	Jun Chicago Fed national activity index	–0.30	–	–	Based on 80 or so data inputs, not a business survey.
	Jun existing home sales	4.2%	1.7%	3.0%	Sales upswing driven by investors; at risk from rising mortgage rates.
Tue 23					
Eur	Jul consumer confidence	–18.8	–18.1	–18.0	Recent uptrend in confidence rose at risk from Portugal, Spain, France
UK	Jun mortgages no.	36.1k	–	–	BBA data covering about 70% of the market. Approvals up sharply in May.
US	Jul Richmond Fed factory index	8	6	0	Jun upswing not sustainable on our view of the economic outlook.
	May house prices	0.7%	0.8%	–	FHFA index.
Can	May retail sales	0.1%	0.3%	–	A lack of momentum apparent, particularly for ex auto sales.
Wed 24					
NZ	Jun merchandise trade	\$71m	\$100m	–\$100m	Drought still weighing on primary export volumes.
Aus	Q2 consumer price index %qtr	0.4%	0.5%	0.5%	A weaker A$ impact on Q3 not Q2; auto fuel falling & housing moderates.
Chn	Jul HSBC flash manufacturing PMI	48.2	48.5	–	Weak detail in June, new orders to inventories ratio in adverse position.
Eur	Jul PMI manufacturing advance	48.8	49.0	48.4	Has shown signs of improvement, but sector still contracting.
	Jul PMI services advance	48.3	48.7	48.0	Persistent lack of demand for services unlikely to improve much.
UK	Jul CBI industrial trends survey	–18	–14	–	Total orders series; quarterly business optimism series also due.
US	Jun new home sales	2.1%	1.1%	0.5%	Up 21% year to date but risk of slower sales ahead. See text box.
Thu 25					
NZ	RBNZ official cash rate	2.50%	2.50%	2.50%	Firmly on hold, with higher mortgage rates balancing out lower NZD.
Eur	Jun money supply M3 %yr	2.9%	3.0%	–	Slowed from 3.9% r peak in Oct 2012, LTRO paybacks a factor.
Ger	Jul Ifo business climate index	105.9	106.4	105.8	German economy just growing marginally on most indicators.
UK	Q2 GDP advance	0.3%	0.5%	0.6%	Partial data point to accelerated recovery in Q2.
US	Initial jobless claims w/e Jul 20	334k	–	340k	Claims always distorted in July due summer auto plant shutdowns.
	Jul Kansas City Fed factory index	–5	–	–2	Eight sub zero readings in Oct-Jun except in May.
	Jun durable goods orders	3.7%	1.0%	2.0%	Recent headline strength due aircraft; underlying story improved.
Can	May average weekly earnings	2.2%	–	–	Uptrend since late 2011 now stabilised.
Sat 27					
Chn	Jun industrial profits %ytd	12.3%	–	–	Q2 survey profitability index took off, out of synch with everything else.

New Zealand Economic and Financial Forecasts

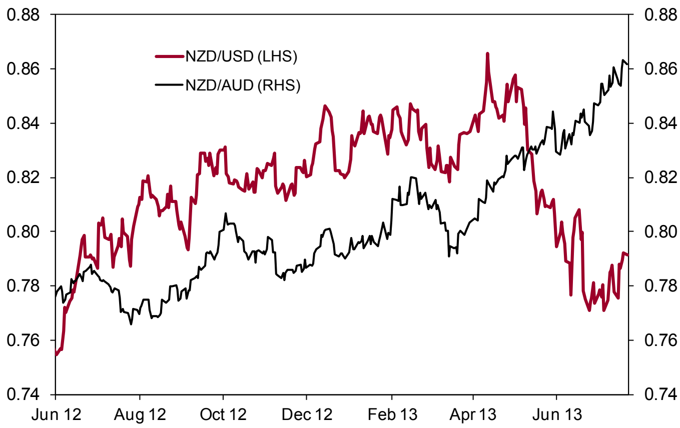
Economic Growth Forecasts	March years				Calendar years			
% change	2012	2013f	2014f	2015f	2011	2012	2013f	2014f
GDP (Production) ann avg	1.9	2.5	2.6	3.7	1.4	2.7	2.4	3.6
Employment	1.0	0.4	2.4	2.8	1.5	-1.4	3.3	3.2
Unemployment Rate % s.a.	6.7	6.2	5.8	5.0	6.3	6.8	6.2	5.1
CPI	1.6	0.9	1.5	2.3	1.8	0.9	1.5	2.0
Current Account Balance % of GDP	-4.4	-4.8	-4.3	-5.4	-4.0	-5.0	-4.2	-5.1

Financial Forecasts	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
Cash	2.50	2.50	2.75	3.00	3.25	3.50
90 Day bill	2.70	2.75	3.00	3.25	3.50	3.75
2 Year Swap	3.20	3.20	3.40	3.60	3.80	4.00
5 Year Swap	3.90	3.80	3.90	4.00	4.20	4.40
10 Year Bond	4.10	3.90	3.90	4.00	4.10	4.20
NZD/USD	0.80	0.83	0.83	0.81	0.80	0.80
NZD/AUD	0.85	0.86	0.87	0.87	0.87	0.86
NZD/JPY	80.0	82.2	81.3	78.6	76.8	76.0
NZD/EUR	0.61	0.62	0.64	0.64	0.64	0.63
NZD/GBP	0.52	0.52	0.53	0.51	0.51	0.49
TWI	75.3	77.1	77.9	76.7	76.2	75.4

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 22 July 2013

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.63%	2.65%	2.65%
60 Days	2.63%	2.65%	2.65%
90 Days	2.63%	2.65%	2.65%
2 Year Swap	3.22%	3.28%	3.22%
5 Year Swap	3.98%	4.07%	3.93%

NZ foreign currency mid-rates as at Monday 22 July 2013

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7915	0.7693	0.7736
NZD/EUR	0.6023	0.6004	0.5908
NZD/GBP	0.5181	0.5168	0.5029
NZD/JPY	79.41	77.87	75.76
NZD/AUD	0.8619	0.8501	0.8400
TWI	75.08	73.87	73.06

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	2.3	2.6
Unemployment %	5.6	5.2	5.2	5.4	6.1	6.0
Current Account % GDP	-4.2	-2.9	-2.3	-3.7	-2.4	-2.6
United States						
Real GDP %yr	-3.1	2.4	1.8	2.2	1.6	1.6
Consumer Prices %yr	-0.3	1.6	3.1	2.1	1.6	1.8
Unemployment Rate %	9.3	9.6	8.9	8.1	7.7	7.6
Current Account %GDP	-2.7	-3.0	-3.0	-2.8	-2.8	-2.9
Japan						
Real GDP %yr	-5.7	4.9	-0.5	1.9	1.7	2.2
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	1.5	-0.5	-0.9	-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	0.5	0.4
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 5 July 2013

Interest Rate Forecasts	Latest	Sep 13	Dec 13	Mar 14	Jun 14	Sep 14
Australia						
Cash	2.75	2.50	2.25	2.00	2.00	2.00
90 Day Bill	2.72	2.55	2.30	2.10	2.10	2.10
10 Year Bond	3.68	3.60	3.40	3.30	3.20	3.10
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.48	2.40	2.20	2.10	2.00	2.00
ECB Repo Rate	0.50	0.50	0.50	0.50	0.50	0.50

Exchange Rate Forecasts	Latest	Sep 13	Dec 13	Mar 14	Jun 14	Sep 14
AUD/USD	0.9189	0.94	0.97	0.95	0.93	0.92
USD/JPY	100.37	100	99	98	97	96
EUR/USD	1.3145	1.32	1.33	1.30	1.27	1.25
AUD/NZD	1.1612	1.18	1.17	1.14	1.15	1.15

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