Rere Waterfall, Gisborne.

In this issue

Keeping the pressure on

The latest *Financial Stability Report* reveals that the Reserve Bank is far from relaxed about the risks emanating from the housing market, despite its success to date in slowing the rate of house price inflation. As subsequent data has shown, the risk of a resurgence in the housing market remains high, even without adding fuel to the fire by making it easier for people to borrow.

The RBNZ had been signalling for some time that the November Financial Stability Report would assess whether the cap on high loan-to-value ratio (LVR) mortgage lending, which was imposed last October, could now be loosened or removed. The high-LVR limit was always portrayed as a temporary measure, used to manage the risks to the financial system over the course of the cycle, and the RBNZ had set out three criteria for its removal: whether it had had the desired effects, whether removing it would risk a resurgence in the housing market, and whether it was creating distortions that outweighed its benefits.

The first criterion seems to have been met to date. The cap on high-LVR lending, along with the 100 basis points of OCR increases this year, meant that by September annual house price growth had slowed to around 5%, compared to 9.4% in the previous year. Similarly, housing credit growth had slowed to 4.7% in the year to September. These are more in line with household income growth, which suggests that the risks to the financial system posed by the housing market are at least no longer growing.

However, while the housing market may have been cowed in recent times, the RBNZ is far from convinced that it has been tamed altogether. Surging net inward migration – which we expect to reach a record 55,000 people by the middle of next year – will inevitably put some pressure on the housing market. In earlier times, the RBNZ had said that its aim was to slow housing demand until supply had a chance to catch up. Our research suggests that if anything they have moved further apart in the last year: while there has been a strong pickup in building activity, it has been comprehensively overtaken by population growth.

Keeping the pressure on continued

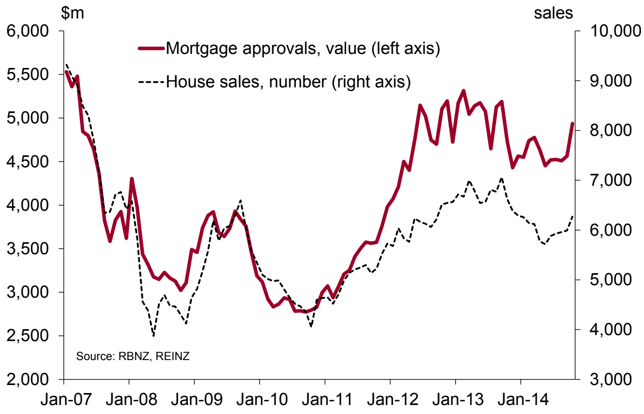
In addition, fixed-term mortgage rates have actually fallen substantially since the first OCR increase in March this year, due to diminishing expectations of future policy rate increases both here and overseas. Plus, banks have been making greater use of the high-LVR loan cap, which was set at 10% of new lending. The actual share fell as low as 3.6% in March, but has since picked up to 7.3% in September.

Indeed, with all of these factors in its favour, it's worth considering why the housing market has been so slow to pick up. House sales were fairly flat between June and September, while prices continued to rise but at a much slower pace than a year ago. One plausible explanation is that both buyers and sellers were holding back ahead of the 20 September general election – particularly given that a change of government would likely have meant a tightening of the tax treatment of investment properties. The story has changed markedly post-election: mortgage approvals, property listings and sales were all sharply higher in October, while a 0.6% rise in prices implies a modest acceleration compared to previous months.

As for the final criterion for the removal of the LVR cap, there's no real evidence that it has had unintended consequences, hence no great urgency for its removal. Banks have complied with the spirit of the policy, and while non-bank lenders are not subject to the cap, they remain a very small fraction of the financial system. The fact that first-time buyers are disproportionately affected by the cap – a recently launched RBNZ survey shows that first-time buyers account for 10% of all new lending but about a third of the high-LVR share – may be a PR problem. But from the perspective of financial system stability, you could argue that this is an intentional effect, since these borrowers may be the most at-risk if house prices fell substantially.

Assessed against the RBNZ's three criteria, it seems clear that any removal of the LVR cap, even a phased one, could be some time away. That would be in line with the experiences of LVR limits overseas, which we surveyed in an article last year. While a few countries have loosened and tightened LVR limits over the course of the cycle, we're not aware of any country that has been able to justify removing them altogether – even after a decade or more of their use.

Housing turnover



There's another criterion that we'd add to the list: the interaction between prudential and monetary policy. Last year, the housing market was booming, but CPI inflation was running below the 1-3% target range. The RBNZ concluded that it would have been inappropriate at the time to address the housing market through higher interest rates – hence the introduction of the LVR cap. By early this year, inflation looked to be on the rise again, and the RBNZ felt comfortable in using higher interest rates to keep both inflation pressures and house prices in check.

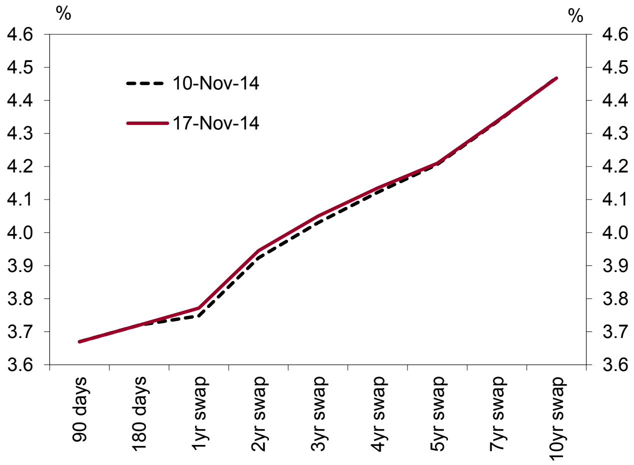
But as inflation has turned out softer than expected – once again threatening the lower end of the target range – the RBNZ's dilemma is starting to look similar to last year. If the housing market re-accelerates in coming months, it might not be appropriate to address it through higher interest rates, at least not at this stage. In this situation, the LVR cap would continue to play a useful role; it would certainly make little sense to remove it.

Fixed vs Floating for mortgages

Among the standard fixed rates, the best deal for borrowers with a deposit of 20% or more is the two-year term, which offers substantial value relative to where we expect short-term rates to go over the next two years. Current three-year rates offer slightly less value, but it may be worth waiting a few weeks for further 'specials' that could make them the most appealing option. Four- and five-year rates seem high relative to where we think shorter-term rates are going to go over the coming four or five years, though they do offer stability.

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



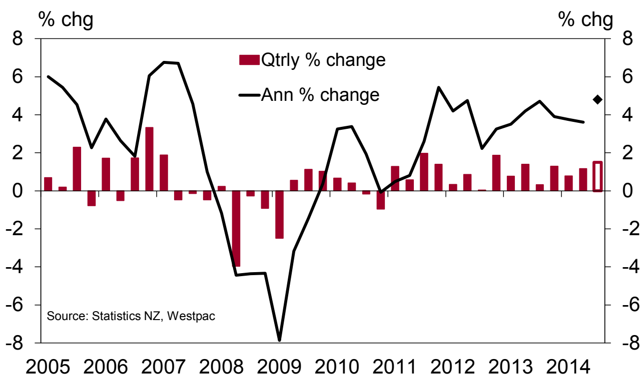
The week ahead

NZ Q3 real retail sales

17 Nov, last: 1.2%, Westpac f/c: 1.5%

- We estimate that retail activity grew 1.5% in the September quarter. There was a decent lift in electronic card spending, and we estimate that falling prices further boosted sales volumes.
- Statistics NZ is introducing a new approach to seasonal adjustment this quarter. We expect this will boost the September quarter number at the expense of June (data seasonally adjusted using the new method showed June revised down from 1.2% to 1.0%).
- Vehicle sales remain a wild card. Car registrations have been surging for some time, but this has not translated into an equivalent lift in sales, perhaps due to a changing mix of sales. Our forecasts assume that car sales continued to undershoot in the September quarter.

Real retail sales

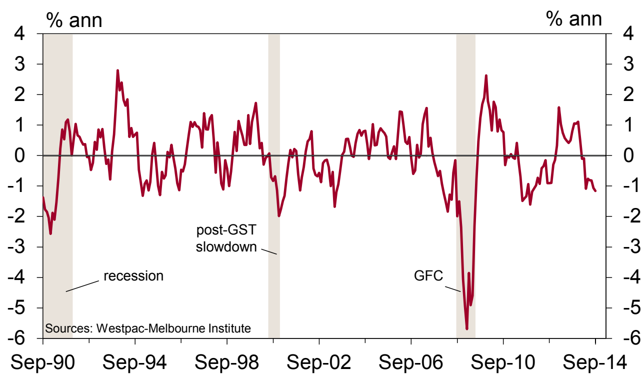


Aus Oct Westpac–MI Leading Index

19 Nov, Last: –1.16%

- The six-month annualised growth rate of the Index, which indicates the likely pace of economic growth 3-to-9 months into the future, fell from –1.07% in Aug to –1.16% in Sep. This marks the 8th consecutive month of below-trend growth momentum, and the most negative reading since 2011.
- Several Index components recorded sharp falls in Sep but recovered in Oct, including: the ASX (+3.9% after a sharp 5.8% fall in Sep); total hours worked (+1.6% after a 1.2% fall in Sep - both moves being particularly large for this normally more stable component); and commodity prices (+0.7% after a 1.1% fall in Sep in AUD terms). Other components are more mixed, with the yield gap narrowing; dwelling approvals down sharply (–11%); consumers' unemployment expectations deteriorating; but the CSI Expectations Index rising 5.2%.

Westpac-MI Leading Index

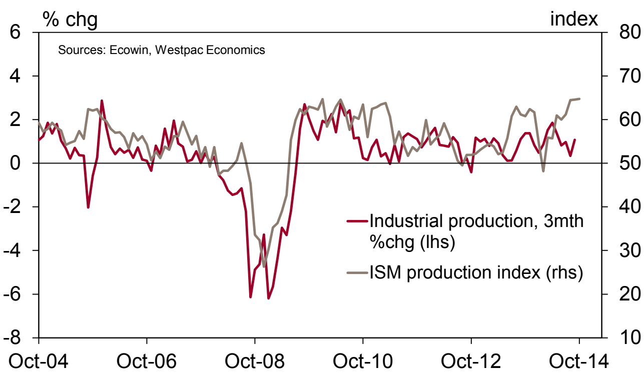


Oct US industrial production

Nov 17, Last: 1.0%, WBC f/c: 0.1%

- Industrial production rose 1.0% in September. There was a 0.5% recovery in manufacturing despite a further decline in auto output (down 7% in Aug and 1.4% in Sep), supplanted by a 3.9% surge in utility output (mostly electricity) and an above-trend 1.8% mining boost.
- The Sep factory gain featured solid 1.4% rises in defence and business supplies output. Orders data suggests some resilience in defence-related manufacturing, but with Oct factory hours worked rising just 0.1%, pockets of at least temporary softness must be emerging in some sectors. Also, Aug-Sep auto assemblies are still running above the Q2 pace, so no reason to expect an imminent rebound.
- Add in pullbacks in utilities and mining (as energy prices fell) and the overall IP gain should be modest, despite solid ISM survey readings for October.

US industrial sector

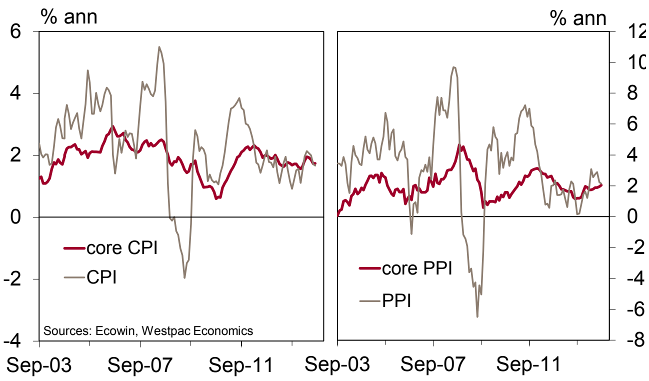


US Oct producer final demand & consumer prices

Nov 18, PPI: Last: –0.1%, WBC f/c: –0.2%
Nov 20, CPI: Last: 0.1%, WBC f/c: –0.1%

- The Sep final demand PPI fell 0.1% in September, its first fall in over a year, with goods prices down 0.2%, led by food and energy (both off 0.7%) and services prices down 0.1%, perhaps due to lower fuel costs. Very benign inflation signals here, most of which should extend into Oct, and which tend to show up in the CPI eventually.
- The Sep CPI rose 0.1% for both the headline and core rates in October. Food prices rose further, but gasoline keeps falling, and the stronger dollar is starting to show up in flat/falling clothing/auto prices. Rents have been rising slightly less than trend lately. Sub-0.2% core outcomes usually require some of autos, clothing, tobacco, rents and medical care to be falling or below trend. Some are due a random bounce, but with dollar appreciation and lower energy costs impacting all over, we see a 0.1% core in Oct and a small headline CPI fall.

US price inflation

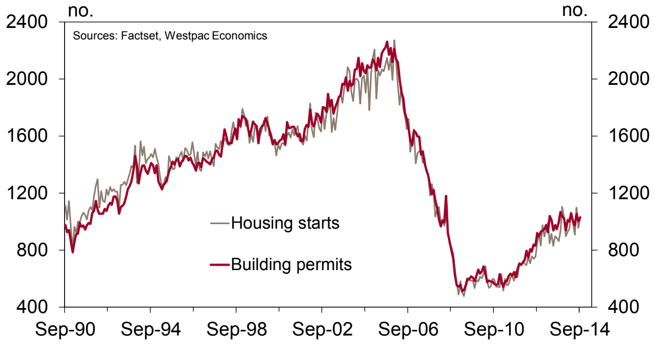


US Oct housing starts, permits and sales

Nov 19, Starts/Permits: Last: 6.3%/2.8%, WBC f/c: –2.0/0.0%
Nov 20, Existing sales: Last: 2.4%, WBC f/c: –2.0%

- Housing starts rose 6.3% in Sep, reflecting a 17% bounce in multiples (5 of the past 6 months saw swings in excess of +/-10%) and a more modest 1.0% rise in single-family starts after a 2.0% decline in Aug. Housing permits are up 2.8%, with multiples again the driver, seeing a 5% Sep gain. Single-family permits slipped modestly for the third month running, for an annualised Q3 pace of 627k. That is lower than starts on 646k, potentially acting as an ongoing constraint for starts in Q4. Compared to a year ago, single-family permits were down 0.5% versus starts +11%yr; that is also not supportive of sustained starts growth, outside of multiples volatility.
- Existing home sales rose 2.4% in Sep, taking sales to a 5.17mn annualised pace, the highest yet for 2014 and about 4% below the recent peak sales pace, seen in mid 2013. But the pipeline of pending sales has thinned out, so an Oct fall is likely.

US housing starts & permits



Data calendar

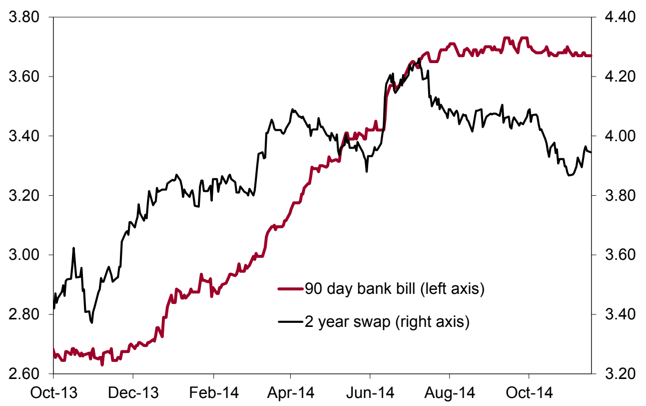
		Last	Market median	Westpac forecast	Risk/Comment
Mon 17					
NZ	Q3 real retail sales	1.2%	0.8%	1.5%	Falling retail prices boosted sales volumes.
	Oct Performance of Services Index	58.0	–	–	Manu and services surveys both strong in the last few months.
Aus	Oct new vehicle sales	2.9%	–	–2.0%	Industry figs suggest sales fell back again in Oct, down 1.5%yr.
Eur	Sep exports	–0.9%	–	0.0%	Exports down in five of last six months. IP data showed weak Sep rise.
UK	Nov house prices %yr	7.6%	–	–	Rightmove index of asking prices.
US	Nov NY Fed factory survey	6.1	12.0	12.0	Sharply lower Oct headline mirrored previous years' patterns.
	Oct industrial production	1.0%	0.2%	0.1%	Factory hours worked rose 0.1% in Oct.
Can	Oct existing home sales	–1.4%	–	–	Have not posted a decline since Jan.
Tue 18					
Aus	RBA minutes	–	–	–	Tone unlikely to differ from November SoMP.
	RBA Governor Stevens	–	–	–	Annual CEDA dinner, 7:25pm AEDT; topic yet to be announced.
Chn	Oct property prices - new, net bal%	-98.6%	–	–	Previous trough -75.7% net bal. Growth: Tier 1 -0.2%yr, Tier 2 -1.5%yr.
	Oct property prices - 2ndary, net bal%	-100.0%	–	–	Previous trough -70.0% net bal. Growth: Tier 1 +0.4%yr, Tier 2 -1.7%yr.
Ger	Nov ZEW analysts' expectations	–3.6	0.9	0.0	Oct reading lowest in two years. Current situation weakest in 4+ years.
UK	Oct PPI %yr	0.8%	0.8%	–	Core output measure.
	Sep ONS house prices %yr	11.7%	–	–	Fastest pace of gain since 2007 in July-August, likely to slip from here.
	Oct CPI %yr	1.2%	1.2%	1.1%	BRC shop price index dipped back to –1.9% yr cycle low in Oct.
US	Oct PPI final demand	–0.1%	–0.1%	–0.2%	Energy prices down sharply, also other imported goods prices.
	Nov NAHB housing market index	54	55	54	Upswing since June has stalled recently.
	Sep TIC data $bn	52.1	–	–	Net long-term TIC flows.
	Fedspeak	–	–	–	Kocherlakota.
Wed 19					
NZ	GlobalDairyTrade auction	–0.3%	–	–	Some signs of stabilisation at low levels.
Aus	Oct Westpac–MI Leading Index	–1.16%	–	–	Sep was 8th sub-trend reading in a row and weakest since 2011.
Chn	Nov MNI business indicator	51.7	–	–	Has, at times, correctly predicted flash PMI.
Eur	Sep construction output	1.5%	–	–0.7%	Construction fell 1.2% in Ger; Spanish/French Aug gains may reverse.
	Sep current account balance €bn	18.9	–	–	Surplus averaging ~ €20bn since early last year.
UK	Nov BoE minutes	7:2	–	9:0	Inflation report dovish; Dissenters may have dropped rate hike vote.
US	Oct housing starts	6.3%	0.8%	–2.0%	Starts pace for single-family dwellings at 646k in Q3 running above
	Oct building permits	2.8%	0.6%	0.0%	permits on 627k.
	FOMC minutes, Oct 28-29	–	–	–	What backing was there for Kocherlakota's dissent.
Thu 20					
NZ	Q3 producer prices (outputs)	–0.5%	–	–1.0%	Cut to dairy payout forecast the main contributor.
Chn	Nov HSBC manufacturing PMI	50.4	50.3	–	Soggy detail in Oct survey despite the rise in the headline.
Eur	Nov PMI factory adv	50.6	50.9	51.5	Holding in mildly expansionary territory; prospect of further stimulus
	Nov PMI services adv	52.3	52.4	51.9	from ECB may help sentiment. Composite PMI fact/ser was 52.1 in Oct.
	Nov consumer confidence advance	–11.1	–	–	Peaked in May at –7.1. Fell in June-Sep but stabilised in Oct.
Ger	Oct producer prices %yr	–1.0%	–1.0%	–	Declining at 1% pace for most of 2014.
UK	Oct retail sales incl fuel	–0.3%	0.3%	0.4%	CBI survey quite solid, BRC less weak.
	Nov CBI industrial trends	–6	–	–	Total orders index.
US	Initial jobless claims w/e 16/11	290k	–	295k	Potential for distortion in weeks incl. public holidays (Veterans' Day).
	Oct CPI	0.1%	–0.1%	–0.1%	Gasoline prices falling, food prices growing slowly, import prices
	Oct CPI core	0.1%	0.2%	0.1%	lower, other core pressures mild.
	Nov Philadelphia Fed factory survey	20.7	18.5	13.0	Can out-performance relative to NY, Richmond Fed surveys persist?
	Oct existing home sales	2.4%	–0.4%	–2.0%	Pending sales up 1% in June-Sep, existing sales up 5%, unsustainable.
	Oct leading index	0.8%	0.6%	–	Has not posted a fall since Jan.
	Nov PMI factory adv	55.9	56.5	–	Markit surveys, more firms than ISM and and release earlier.
Can	Sep wholesale sales	0.2%	0.6%	–	Machinery, wood and metal products.
Fri 21					
Ger	Nov Ifo business climate index	107.4	10.7	107.5	Stalled in recent months as recovery struggles to gain traction.
UK	Oct PSNCR £bn	17.7	–	–	Public sector net credit requirement. PSNB ex intv'ns £11.8bn in Sep.
US	Nov Kansas City Fed factory index	4	–	6	in downtrend, but still in expansionary territory after turn-of-year slump.
Can	Oct CPI %yr	2.0%	2.0%	–	Core rate was 2.1%yr in Sep.

New Zealand forecasts

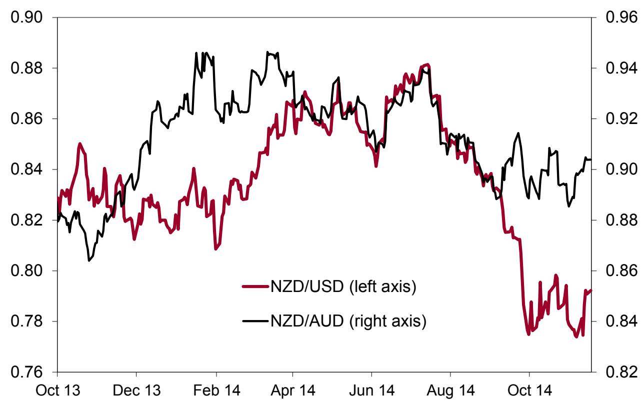
Economic Growth Forecasts	March years				Calendar years			
% change	2013	2014	2015f	2016f	2013	2014f	2015f	2016f
GDP (Production) ann avg	2.3	3.2	3.5	3.1	2.8	3.6	3.2	2.9
Employment	0.4	3.8	2.8	2.6	2.9	3.0	2.7	2.0
Unemployment Rate % s.a.	6.2	5.9	5.2	4.8	6.0	5.4	4.9	4.5
CPI	0.9	1.5	1.3	2.2	1.6	1.0	2.2	2.4
Current Account Balance % of GDP	-3.8	-2.7	-4.6	-5.8	-3.3	-3.4	-5.9	-5.0

Financial Forecasts	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Cash	3.50	3.50	3.50	3.75	4.00	4.25
90 Day bill	3.70	3.70	3.75	4.00	4.25	4.50
2 Year Swap	3.80	3.90	4.10	4.50	4.70	4.80
5 Year Swap	4.10	4.20	4.40	4.70	4.90	5.00
10 Year Bond	3.90	4.00	4.20	4.50	4.70	4.80
NZD/USD	0.77	0.77	0.78	0.79	0.80	0.81
NZD/AUD	0.88	0.86	0.85	0.85	0.85	0.85
NZD/JPY	89.3	90.1	91.3	94.0	96.8	98.8
NZD/EUR	0.62	0.61	0.61	0.61	0.62	0.62
NZD/GBP	0.49	0.47	0.47	0.47	0.46	0.46
TWI	76.2	75.3	75.7	76.4	77.2	77.8

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 17 November 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	3.64%	3.66%	3.66%
60 Days	3.66%	3.68%	3.67%
90 Days	3.67%	3.70%	3.68%
2 Year Swap	3.95%	3.87%	3.97%
5 Year Swap	4.21%	4.16%	4.22%

NZ foreign currency mid-rates as at Monday 17 November 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7922	0.7757	0.7922
NZD/EUR	0.6319	0.6203	0.6214
NZD/GBP	0.5049	0.4861	0.4919
NZD/JPY	92.33	87.57	84.91
NZD/AUD	0.9039	0.8878	0.9056
TWI	78.35	76.34	76.93

International forecasts

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2011	2012	2013	2014f	2015f	2016f
Australia						
Real GDP % yr	2.6	3.6	2.3	3.2	3.2	3.5
CPI inflation % annual	3.0	2.2	2.7	1.8	2.5	2.7
Unemployment %	5.2	5.3	5.8	6.3	5.9	5.2
Current Account % GDP	-2.8	-4.4	-3.3	-3.1	-2.4	-1.2
United States						
Real GDP %yr	1.6	2.3	2.2	2.2	2.5	3.2
Consumer Prices %yr	3.1	2.1	1.5	1.8	1.8	2.0
Unemployment Rate %	8.9	8.1	7.4	6.3	5.7	5.2
Current Account %GDP	-2.9	-2.9	-2.4	-2.3	-2.2	-2.2
Japan						
Real GDP %yr	-0.3	1.5	1.5	1.0	1.4	1.6
Euroland						
Real GDP %yr	1.6	-0.6	-0.4	0.7	0.9	1.0
United Kingdom						
Real GDP %yr	1.1	0.3	1.7	3.0	2.5	2.7
China						
Real GDP %yr	9.3	7.7	7.7	7.4	7.5	7.8
East Asia ex China						
Real GDP %yr	4.5	4.5	4.3	4.1	5.1	5.7
World						
Real GDP %yr	4.1	3.4	3.3	2.9	3.7	4.5
Forecasts finalised 7 November 2014						

Interest Rate Forecasts	Latest	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
Australia						
Cash	2.50	2.50	2.50	2.50	2.75	3.00
90 Day Bill	2.77	2.65	2.55	2.65	3.00	3.25
10 Year Bond	3.32	3.50	3.70	4.00	4.50	4.60
International						
Fed Funds	0.125	0.125	0.125	0.125	0.250	0.500
US 10 Year Bond	2.34	2.50	2.60	2.80	3.20	3.30
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
AUD/USD	0.8693	0.88	0.88	0.90	0.91	0.92
USD/JPY	116.04	116	117	117	119	121
EUR/USD	1.2455	1.23	1.23	1.24	1.25	1.26
AUD/NZD	1.1074	1.14	1.14	1.15	1.15	1.15

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Disclaimer continued

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