19 May 2014

Weekly Commentary

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The nature of democracy

Recent developments have allayed some of our concerns that the private sector would respond to the economic upswing by going on an unproductive spending spree. By contrast, we were disappointed to see the Government loosening its purse strings in Thursday's Budget – despite unchanged revenue forecasts. Ideally, the Government would be making more room for the economy to expand, and building bigger buffers for the eventual downturn.

Last week we published our latest Quarterly *Economic Overview,* a comprehensive discussion of the outlook for the New Zealand economy, interest rates and exchange rates. Along with our latest forecasts, you can download it from our website at http://www.westpac.co.nz/business/economic-updates/economic-and-financial-forecasts/.

For some time now, we have emphasised that while New Zealand is currently going through a period of strong economic growth, that upturn has a dark side. It's the temporary result of a post-earthquake rebuild and low interest rates, not a permanent improvement in New Zealanders' standard of living. Higher spending will eventually put strain on the economy's productive capacity, leading to inflation and higher interest rates. And there was always the risk of a nasty boom-bust scenario if consumers and businesses forgot those basic facts and went on a spending spree.

The May *Overview* continues that basic theme. It's as clear as ever that the Canterbury rebuild is temporary, and everyone now knows that the OCR is heading higher. But we have decided to give the economy a bit more credit where it's due. We have moderated our OCR forecast, to a peak of 5.25%, without significantly changing our GDP forecast.

As we explain in the *Overview,* the key reason is that we have become a bit more optimistic for the economy's capacity to grow without inflation. As we saw in the latest round of labour data, while employers are now hiring at a rapid clip, people are also piling into the workforce, meaning that demand can be met with less pressure on wages. Another feature of the current upturn is businesses have significantly ramped up their investment

The nature of democracy continued

in capital equipment. That will help make those workers more productive and allow businesses to produce more at less cost. Both these developments will help keep inflation in check as the economy expands.

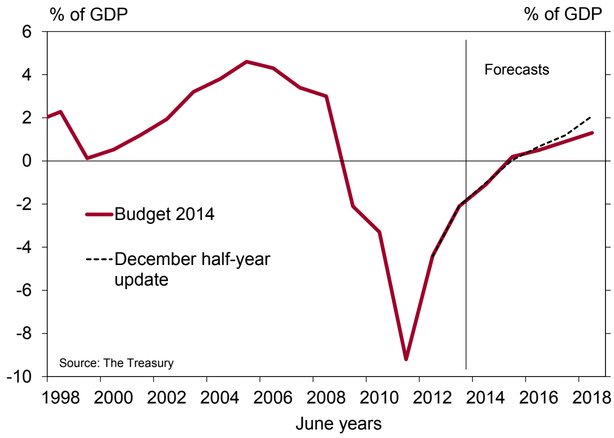
It has also been encouraging to see that consumers have stayed pretty prudent to date. While consumer confidence has risen to very high levels, consumers' actual spending appetites look healthy rather than exuberant. Indeed, last week's March quarter retail trade survey showed that spending slowed in 2014 after strong growth last year. The numbers can be volatile from quarter to quarter, but the details of the release support the idea that consumers' willingness to spend remains selective, with a strong element of bargain-chasing (sales of electronic goods continued to surge even as other categories slowed).

In our view, a slowdown in retail spending wouldn't be a coincidence, given the clear loss of momentum in the New Zealand housing market over the past six months. The clearest read on what's happened to house prices comes from the Quotable Value monthly index, which makes the most thorough adjustments for compositional changes. According to that measure, house prices went sideways over the first few months of 2014 after rising 10% over 2013.

The same measure says that house prices have more recently started rising again. That would be consistent with our call that the housing market would go through a brief and modest revival through the middle of the year. While the RBNZ's *Financial Stability Report* confirmed that the RBNZ doesn't expect to start removing LVR restrictions before late this year, the banks have already loosened up their own lending – and have room to do more without hitting the RBNZ's existing speed limits. Along with the recent lift in net migration, that will be a modest source of stimulus to the market. However, we remain confident that rising mortgage rates will cause a more definitive slowdown in house price inflation – to 5.5% this year, and 1% next. In turn, a slowing housing market is likely to keep consumers' borrowing and spending appetites moderate.

Against this backdrop of relative private sector sobriety, we were slightly disappointed to see the Government loosening its purse strings in last week's Budget, without any matching lift

Government operating balance



in its forecast revenues. In an ideal (and politically unrealistic) world, the Government would be restraining its spending as the economic outlook improved, to give the rest of the economy more room to expand. This Budget did the opposite, increasing spending just as the economy has developed momentum. Treasury analysis suggested the extra spending since the December half-year update could be worth 15-30 basis points of OCR hikes. This will not go unnoticed by the RBNZ, which will now have to incorporate extra Government spending into its deliberations. And while our own forecasts did anticipate an upgrade to the Government's spending plans, the Budget went further than we expected – though not enough to prompt a formal change to our GDP and interest rate forecasts.

Of course, more spending and unchanged revenue forecasts also means smaller projected surpluses. To be sure, the Government's finances remain very healthy overall, and the Government is still on track to reduce public debt to 20% of GDP by 2020. But smaller surpluses will leave us with less of a buffer to deal with any unforeseen events. That's particularly concerning as we continue to expect a significant economic slowdown later this decade, as the New Zealand economy is hit by the trifecta of rising interest rates, a cooling housing market, and the wind-down of the Canterbury rebuild.

Fixed vs Floating for mortgages

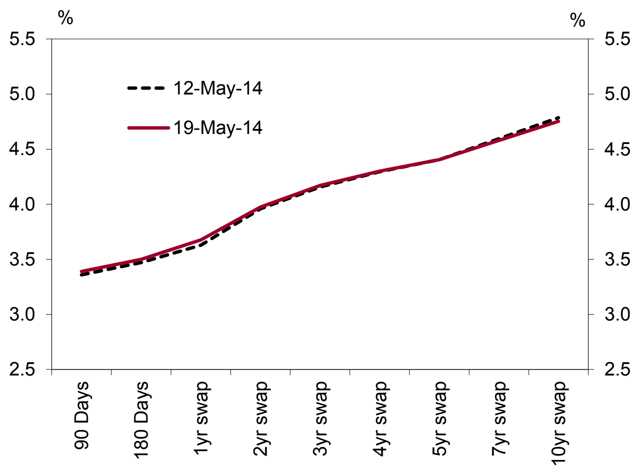
Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates, such as the six month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

For those who are looking to fix, there is little to gain from waiting. Fixed rates are more likely to rise than fall over the next few months.

Among the standard fixed rates, anything from six months to three years appears to offer similar value. Three-year rates are higher, but this is a fair reflection of where we think shorter-term rates are going to go over the next few years.

Fixing for four or five years may result in higher interest payments over the life of the loan than opting for shorter-term fixed rates. However, these longer-term fixed rates may still be preferred by those who are willing to pay for certainty.

NZ interest rates

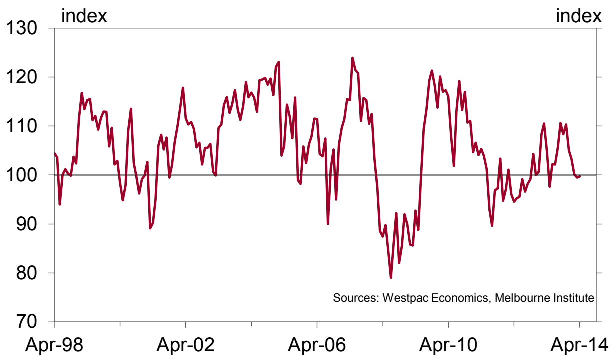


Aus May Westpac-MI Consumer Sentiment

May 21 Last: 99.7

- After a post-election surge in confidence late last year, the Westpac-Melbourne Institute Consumer Sentiment Index has reversed back to neutral levels in 2014, holding flat in Apr. Optimism around a change of Government have given way to renewed concerns about job security and the economic outlook.
- This month's survey is delayed to capture reactions to the Budget, with responses collected between May 12 and 18. The relationship between previous Budgets and sentiment has not always been clear cut. However, Budget 2014-15, with its theme of repairing the Government's finances and savings measures affecting a wide range of programmes, looks set to have a significant influence.

Consumer Sentiment Index

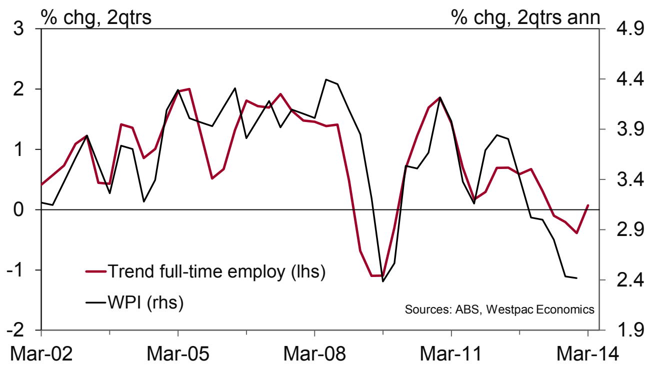


Aus Q1 Wage Price Index (WPI)

May 21, Last: 0.7%, WBC f/c: 0.5%
Mkt f/c: 0.7%, Range: 0.5% to 0.9%

- The 2012 Q4 WPI surprised with a 0.7% gain compared to expectations for a 0.6% rise. Annual growth printed at 2.6%yr, materially below the December 2008 peak of 4.3%yr.
- The upside surprise came as a result of a 0.9% increase in public sector wages following Q3's 0.5% gain. The annual pace of growth was 2.7%yr, a little higher than Q3's 2.5%yr but well below the most recent peak of 4.6%yr (Q3 2009).
- Private sector wage growth was broadly as expected in Q4, rising by 0.6% to leave annual growth at 2.5%yr. Annual wage growth is now a little weaker than the GFC low of 2.6%yr, experienced over the six months to March 2010. Further, it is also well below the annual growth pace of 2012 (3.4%yr) and 2011 (3.8%yr). Ongoing weakness in private sector wages underpins our 0.5%qtr forecast.

Soft labour market, wage pressures ease

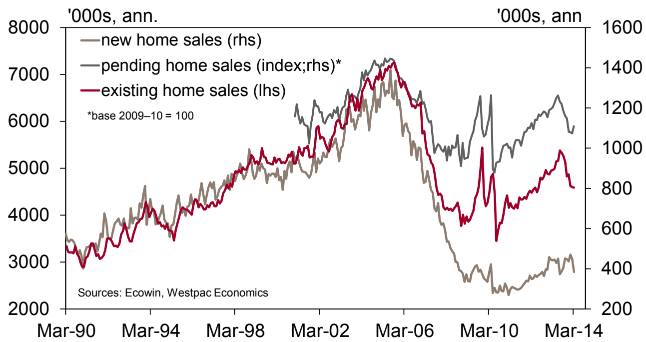


US existing/new home sales in April

May 22, Existing: Last: –0.2%, WBC f/c: 2.2%
May 23, New: Last: –14.5%, WBC f/c: 3.0%

- Existing home sale have fallen 15% since July last year, with most of that decline seen before winter. Feb and Mar cumulate to a modest 0.6% decline and, given the 1-2 months between signing and closure (when EHS are recorded), snow may have weighed on these months' sales. Pending home sales recovered 3.4% in March; some of these sales will have closed in April.
- New home sales plunged 14.5% in March for an annualised sales pace of 384k, the second lowest since late 2012. Sales peaked most recently at 470k in February this year. Affordability, a lack of workers and lots on which to build are all factors at play. Weather can't be blamed for the latest fall. Underlying fragility in the US housing market is showing through. This series will be substantially revised; assuming the March fall is halved to –7%, we expect a 3% rise in April.

US housing sales



Data calendar

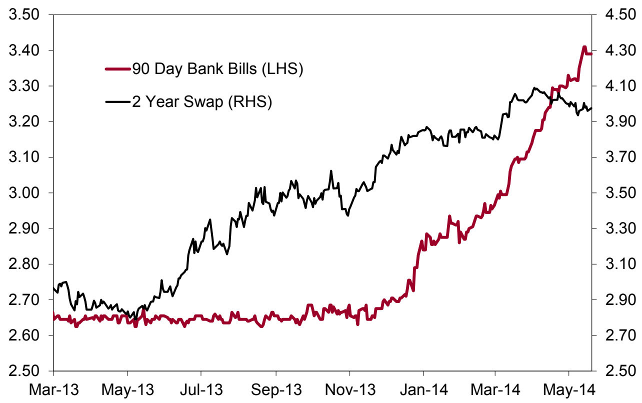
		Last	Market median	Westpac forecast	Risk/Comment
Mon 19					
NZ	Apr Performance of Services Index	58.3	–	–	March reading was the highest since 2007.
	Q1 producer prices (outputs)	-0.4%	–	0.5%	Seasonally higher electricity prices.
Eur	Mar construction output	0.1%	–	–	Dec and Jan surged 1.6% and 1.6% so Q1 very solid even if March falls.
UK	May house prices %yr	7.3%	–	–	Rightmove index.
Tue 20					
Aus	RBA minutes released	–	–	–	Tone to be in line with SoMP.
Ger	Apr PPI %yr	–0.9%	–	–	Downtrend in annual pace of deceleration may have stalled.
UK	Mar ONS house prices %yr	9.1%	–	–	Former DCLG series.
	Apr PPI %yr	1.0%	1.0%	–	Core output measure
	Apr CPI %yr	1.6%	1.7%	1.5%	Lower shop prices suggest CPI to decelerate further.
US	Fedspeak	–	–	–	Plosser on the economy in Washington.
Can	Mar wholesale sales	1.1%	–	–	Feb rise due to autos.
Wed 21					
NZ	GlobalDairyTrade auction	–1.1%	–	–	Prices may be stabilising after a 20% drop in Mar-Apr.
	Apr net immigration	3,840	–	3,700	Net inflows on track to exceed 40k this year.
Aus	May Westpac–MI Consumer Sentiment	99.7	–	–	Delayed a week to capture impact of Federal Budget.
	May Westpac–MI Unemploy. Expect.	–3.2%	–	–	The annual growth rate peaked at 17.7% in Mar but trend is still rising.
	Q1 Wage Price Index %qtr	0.7%	0.7%	0.5%	Q4 was boosed by a very strong growth in public wage rates.
Eur	Mar current account €bn	21.9bn	–	–	Surplus looks to have peaked for time being in Jan at €25.4bn.
	May consumer confidence adv	–8.6	7.9	–	Highest since 2007.
UK	May BoE minutes	–	–	–	Inflation report suggested BoE firmly on hold till mid 2015.
	Apr retail sales incl fuel	0.1%	0.5%	1.0%	Late Easter tends to boost April sales (as in 2011).
US	Apr 29-30 FOMC minutes	–	–	–	Was Yellen's dovish testimony reflective of consensus on FOMC?
	Fedspeak	–	–	–	Yellen, George, Kocherlakota
Thu 22					
NZ	Q2 RBNZ 2yr inflation expectations	2.3%	–	2.2%	Possible small fall following weak inflation data.
Aus	May MI inflation expectations	2.4%	–	–	Inflationary expectations have lifted but still remain well contained.
Chn	May HSBC manufacturing PMI flash	48.1	48.3	–	Forward looking aspects of April weak in levels, but up a touch on March.
Eur	May PMI factory adv	53.4	53.5	54.0	Prospect of ECB easing and potential for depreciating euro may boost
	May PMI services adv	53.1	53.0	53.5	business surveys.
UK	Apr PSNCR £bn	15.7	–	–	Public sector net credit requirement.
	Q1 GDP revision	0.8% a	0.8	0.9%	Sticking with our forecast from a month ago.
	May CBI industrial trends	–1	1	–	Total orders index.
	Q1 business investment	2.4%	–	–	Measured on different basis to national accounts component.
US	Apr Chicago Fed national activity index	0.20	–	–	Based on data previously released, not surveyed.
	May 17 initial jobless claims	297k	–	305k	Hint of an uptrend emerging again in recent swings?
	Apr existing home sales	–0.2%	2.0%	2.2%	Pending sales suggest a gain. See text box.
	Apr leading index	0.8%	0.3%	–	Apr will be strong given readings on some of its components.
	May Markit factory PMI	55.4	55.4	–	Totally different message to that of ISM factory survey.
	May Kansas City Fed factory index	7	–	5	Mar-Apr strongest pair of readings since Jan-Feb 2012.
Can	Mar retail sales	0.5%	0.2%	–	Feb was led by pharmacies; continued recovery from Dec blizzard fall.
Fri 23					
Ger	Q1 GDP revision	0.8% a	–	0.8%	More detail on the surge in Q1 GDP growth.
	May IFO business climate index	111.2	111.0	112.0	Prospect of ECB easing and potential for depreciating euro supportive.
US	Apr new home sales	–14.5%	11.3%	3.0%	See text box. Forecast assumes March fall revised to –7%.
Can	Apr CPI %yr	1.5%	2.0%	–	BoC core rate was 1.3% yr in Mar.

New Zealand forecasts

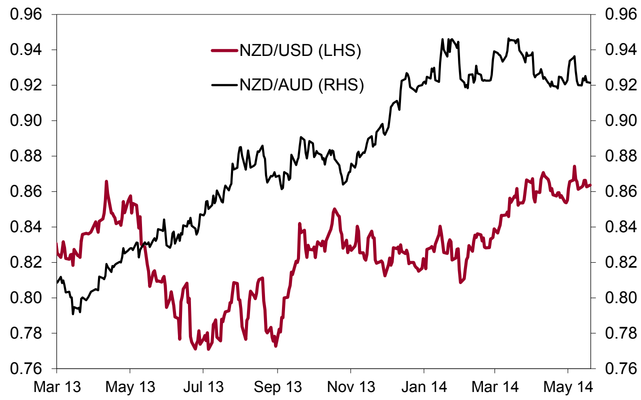
Economic Growth Forecasts	March years				Calendar years			
% change	2013	2014e	2015f	2016f	2012	2013	2014f	2015f
GDP (Production) ann avg	2.3	3.1	3.9	3.1	2.6	2.7	3.9	3.3
Employment	0.4	3.8	2.5	2.0	0.4	2.9	2.9	2.4
Unemployment Rate % s.a.	6.2	6.0	5.3	4.9	6.8	6.0	5.5	4.9
CPI	0.9	1.5	1.8	2.6	0.9	1.6	1.6	2.6
Current Account Balance % of GDP	-3.9	-2.9	-4.1	-4.5	-4.1	-3.4	-3.2	-4.7

Financial Forecasts	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15
Cash	3.25	3.50	3.75	3.75	4.00	4.25
90 Day bill	3.40	3.70	3.90	4.00	4.20	4.45
2 Year Swap	4.10	4.30	4.50	4.70	4.90	5.00
5 Year Swap	4.60	4.80	5.00	5.10	5.20	5.25
10 Year Bond	4.60	4.80	4.90	5.00	5.05	5.10
NZD/USD	0.86	0.86	0.85	0.84	0.84	0.84
NZD/AUD	0.93	0.94	0.94	0.93	0.91	0.90
NZD/JPY	86.9	85.5	85.0	84.8	85.7	86.5
NZD/EUR	0.62	0.63	0.63	0.63	0.62	0.62
NZD/GBP	0.50	0.50	0.50	0.48	0.46	0.45
TWI	79.9	79.9	79.9	78.9	78.3	78.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 19 May 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.00%	3.00%	2.75%
30 Days	3.26%	3.18%	3.16%
60 Days	3.33%	3.25%	3.23%
90 Days	3.39%	3.32%	3.30%
2 Year Swap	3.98%	4.00%	4.07%
5 Year Swap	4.41%	4.52%	4.62%

NZ foreign currency mid-rates as at Monday 19 May 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8636	0.8679	0.8565
NZD/EUR	0.6307	0.6251	0.6209
NZD/GBP	0.5136	0.5141	0.5101
NZD/JPY	87.70	88.68	87.89
NZD/AUD	0.9214	0.9339	0.9183
TWI	80.25	80.60	79.67

International forecasts

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2010	2011	2012	2013	2014f	2015f
Australia						
Real GDP % yr	2.2	2.6	3.6	2.4	3.0	3.0
CPI inflation % annual	2.8	3.0	2.2	2.7	2.5	2.6
Unemployment %	5.2	5.2	5.3	5.8	6.2	5.9
Current Account % GDP	-3.5	-2.8	-4.1	-2.9	-2.5	-1.2
United States						
Real GDP %yr	2.5	1.8	2.8	1.9	1.8	2.5
Consumer Prices %yr	1.6	3.1	2.1	1.5	1.6	1.6
Unemployment Rate %	9.6	8.9	8.1	7.4	6.5	5.9
Current Account %GDP	-3.0	-2.9	-2.7	-2.3	-2.7	-2.6
Japan						
Real GDP %yr	4.9	-0.3	1.5	1.5	1.3	1.3
Euroland						
Real GDP %yr	2.0	1.6	-0.7	-0.4	0.9	1.0
United Kingdom						
Real GDP %yr	1.7	1.1	0.3	1.8	2.6	2.1
China						
Real GDP %yr	10.4	9.3	7.7	7.7	7.2	7.6
East Asia ex China						
Real GDP %yr	7.8	4.4	4.0	4.0	4.2	5.0
World						
Real GDP %yr	5.2	3.9	3.2	3.0	3.1	3.7
Forecasts finalised 9 May 2014						

Interest Rate Forecasts	Latest	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
Australia						
Cash	2.50	2.50	2.50	2.50	2.50	2.50
90 Day Bill	2.70	2.60	2.55	2.55	2.55	2.65
10 Year Bond	3.71	3.90	4.00	4.10	4.30	4.50
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.49	2.60	2.70	2.80	3.00	3.20
ECB Repo Rate	0.25	0.25	0.25	0.25	0.25	0.25

Exchange Rate Forecasts	Latest	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
AUD/USD	0.9337	0.92	0.91	0.90	0.90	0.92
USD/JPY	102.33	101	100	100	101	102
EUR/USD	1.3770	1.38	1.36	1.34	1.34	1.35
AUD/NZD	1.0822	1.06	1.06	1.06	1.07	1.10

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