Weekly Commentary

Rere Waterfall, Gisborne.

In this issue

Waiting it out

With the economy continuing to grow at a solid pace, the RBNZ will still be thinking about the need to eventually hike rates. However, any increases could be a way off and are likely to occur gradually. This is because low inflation is giving the RBNZ ample time to continue mulling things over.

After hiking the OCR four times earlier in the year, the RBNZ paused in September and noted that a period of assessment and monitoring was now appropriate. But the RBNZ is still thinking about future hikes, with its November Financial Stability Report noting that "further increases in short-term interest rates may be required in the coming years." This certainly doesn't signal that rate hikes are imminent. But it does give us a clear idea of where the RBNZ's concerns lie. So what is it that the RBNZ wants to see before hikes are back on the table?

First of all, the RBNZ will want to be certain that the economy is continuing to grow at a healthy pace as the boost from last year's strong commodity prices continues to fade (on this front, prices were down another 3.1% in the latest Global Dairy Trade auction).

Recent developments do indicate that, although export earnings are softening, the domestic economy has remained firm. Our recent talks with businesses have had an upbeat tone to them. This has been reflected in surveys including the PMI and PSI which signal that output is continuing to expand at a robust pace.

Conditions also look pretty solid in the household sector. Following a strong 1.5% increase in retail spending the September quarter, spending remained firm in October, and consumer confidence is still at above-average levels.

On top of this, we're seeing signs that the housing market may be starting to pick up again. In October the seasonally-adjusted value of new mortgage approvals jumped 8%. New listings of houses for sale on realestate.co.nz jumped 12%, seasonally adjusted. And seasonally adjusted house sales were up 4.7%. Such developments are likely to be of particular interest to the RBNZ who highlighted the risks of a resurgence in the housing market as a key reason for maintaining the limits on high loan-to-value lending.

Waiting it out continued

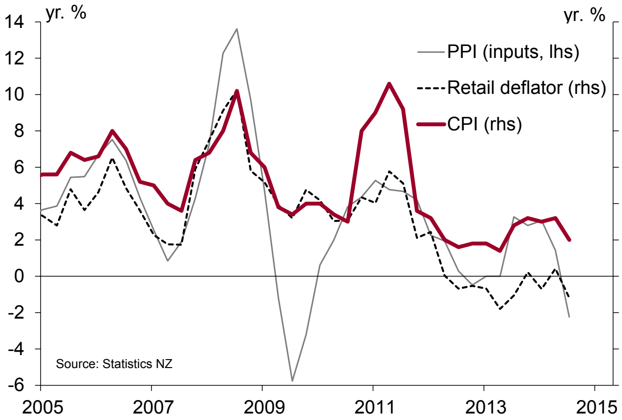
With continuing strength in activity, the next thing the RBNZ will be looking for are signs that inflation is increasing. And this is (still) the missing piece of the puzzle. Headline inflation was just 1% in the year to September – right at the bottom of the RBNZ's target band. Other price measures have also pointed to a subdued inflation environment. Retail prices were down 0.6% in the September quarter. Over the same period input price inflation outside of the construction sector remained low.

Some of the current low inflation is a result of international factors. Lingering softness in the global economy is placing downwards pressure on the prices for range of final and intermediate goods, including oil.

Of greater significance is the lack of a pick-up in the domestic components of inflation. In the past we've highlighted a range of possible reasons for this, including strong population growth and increases in capital spending by businesses. Recent revisions to GDP growth also shed some light on this issue. They showed that while the economy has been growing at a firm pace, growth did not accelerate since 2013 as had previously been estimated. Nevertheless, the lack of costs pressures in the domestic economy is still surprising given the strength of activity.

Low inflation is giving the RBNZ plenty of time to sit on its hands. We're not pencilling in another hike until the second half of 2015, and markets are only pricing in around 45 bps of tightening over the next two years. The outlook for interest rates could be wound back even further if inflation continues to undershoot expectations, as it has for the past three years. And given the recent declines in international oil prices, this is definitely a risk. However, we'd caution against being overly complacent with regard to inflation. Given the ongoing strength in the domestic economy, particularly the construction sector, we can't rule out the risk that inflation could eventually return with a vengeance.

Inflation measures



What's the China-Australia free trade agreement mean for New Zealand?

Australia and China recently completed negotiations for a bilateral free trade agreement (FTA) that includes the removal tariffs on a range of agricultural and manufactured goods. The benefits to both countries will be significant.

For New Zealand, the main impact of the China-Australia FTA is likely to be some downwards pressure on the prices for our exports, particularly dairy and meat, as tariffs are gradually phased out. However, it could also create a number of positive second-round effects for New Zealand. These include increases in the size of Chinese market for meat and dairy products in response to lower prices, and a boost to Australian incomes which will benefit New Zealand firms that export to Australia.

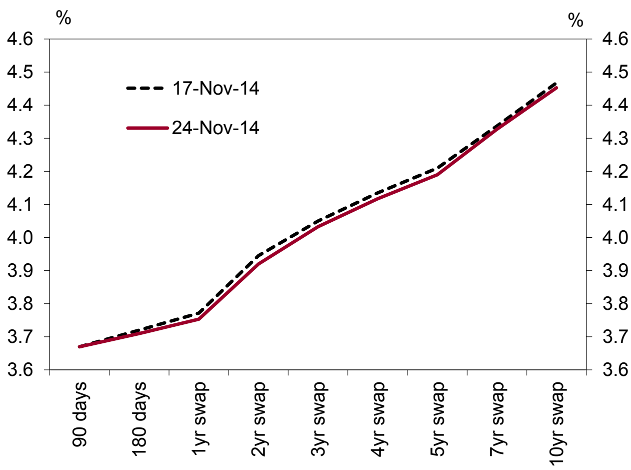
The magnitude of these effects, both positive and negative, will depend to some degree on Australia's ability to ramp up production for the Chinese market. As Australian exporters are already deeply involved with China, it's not obvious that an FTA will prompt a significant supply response.

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



NZ Oct business confidence

Nov 28, Last: 26.5

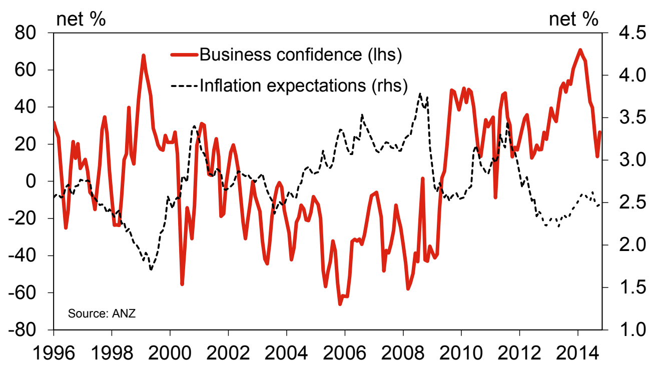
- Business confidence picked up in October, with businesses appearing to respond positively to the relative stability in New Zealand's political landscape.
- Recent data suggests that domestic activity has remained healthy in the last few months. In contrast, the outlook for the agricultural sector has darkened as world dairy prices have continued to slide. On balance, business sentiment is likely to remain robust in late 2014.

NZ Oct building consents

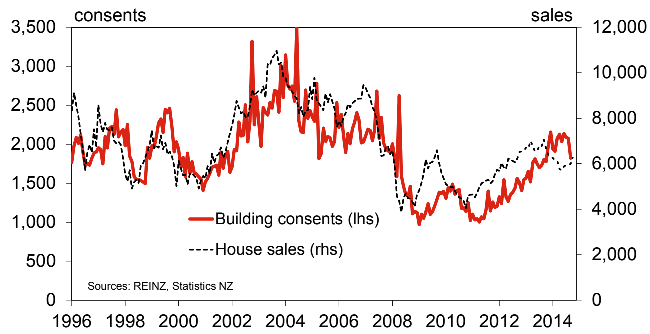
Nov 28, Last: -12.2%, Westpac f/c: +15.0%

- The 12% plunge in residential building consents in September was a shocker, with no fundamental reason for its downfall. "Pre-election uncertainty" is something of a cliché but there's growing evidence that it was a genuine factor this year, particularly given that a change of government would have meant a sterner tax treatment for property.
- We also note that in the history of this series, moves of more than 10% in either direction are almost always reversed the following month. With the 20 September election providing decisive support for the status quo, we think it's reasonable to expect a complete return to business as usual by October.

NZ business confidence and inflation expectations



NZ housing activity



Aus Q3 construction work done

Nov 26, Last: –1.2%, WBC f/c: –1.8%
Mkt f/c: –1.9%, Range: –3.5% to 0.6%

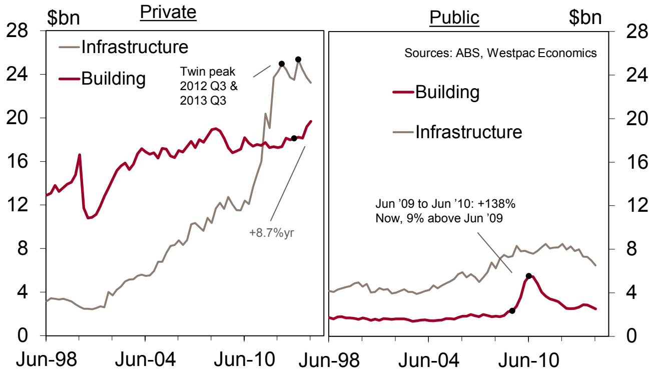
- Construction work softened in the June quarter, falling –1.2%, and is expected to decline further in the September quarter, down a forecast –1.8%qtr, –5%yr.
- Private infrastructure activity, having formed a twin peak in 2012 Q3 and 2013 Q3, looks set to fall for a fourth consecutive quarter as mining investment turns down. For 2014 Q3 we anticipate, –3.5%qtr, –11.5%yr. The segment accounts for 45% of total construction work.
- Private new home building work, having jumped 12% over the first half of 2014, is expected to move a little higher in Q3. Private non-residential building has further near-term upside.
- Public works (17% of total construction) fell 23% over the past 3 years, post the fiscal stimulus package. A further fall is likely.

Aus Q3 (private business) capex

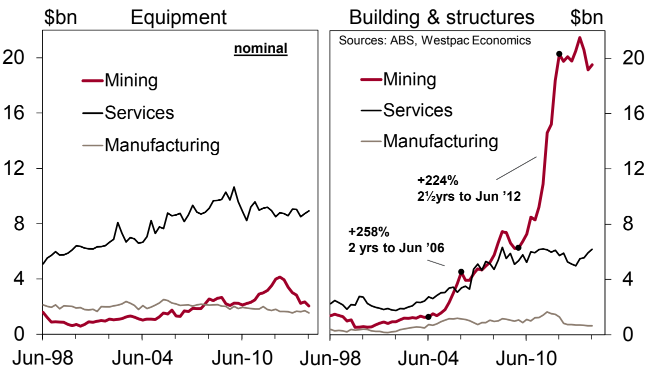
Nov 27, Last: 1.1%, WBC f/c: –1.0%
Mkt f/c: –1.9%, Range: –6.1% to 3.0%

- In the June quarter, the capex survey reported a 1.1% rise in private business capex. This included a 2.0% rise in building & structures, offsetting a 0.9% fall in equipment. However, the national accounts recorded a 0.3% drop in private non-residential construction and a 2.5% decline in equipment.
- For the September quarter, we expect a fall in private business capex, down 1.0%. This factors in a reversal in building & structures, down 2%.
- As for equipment, this is forecast to rise, up 1%. We are looking for a stabilisation in equipment spending by mining and manufacturing, following sharp cuts in Q2, –12% and –9% respectively. We expect a lift in equipment investment by the service sectors.

Construction work: divergent trends



CAPEX: by industry by asset

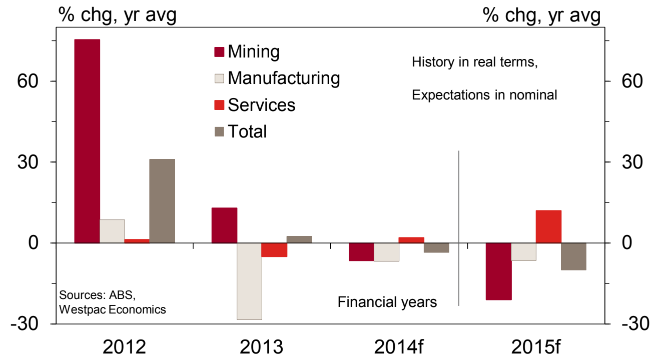


Aus 2014/15 capex plans

Nov 27, Last: $145bn

- Business capex is set to fall in 2014/15, as mining investment declines. This is confirmed by the capex survey.
- Est 3 of capex plans for 2014/15 is $145bn, some 10% below Est 3 for 2013/14. Mining, accounting for 57% of capex spending in this survey, is particularly weak, at –21%. Manufacturing is also weak, at –6.5%. By contrast, the service sectors are positive, at +12%.
- Est 4 for 2014/15 is likely to repeat these broad themes. That said, the risk is that the service sectors scale back their plans from the +12% in Est 3. The broad fundamentals for an upswing in service sector investment are in place - notably, household demand expanded by 3% over the past year. However, a deal of uncertainty persists. Also, we note that non-residential building approvals have retreated of late, reversing earlier strength.

CAPEX plans by industry

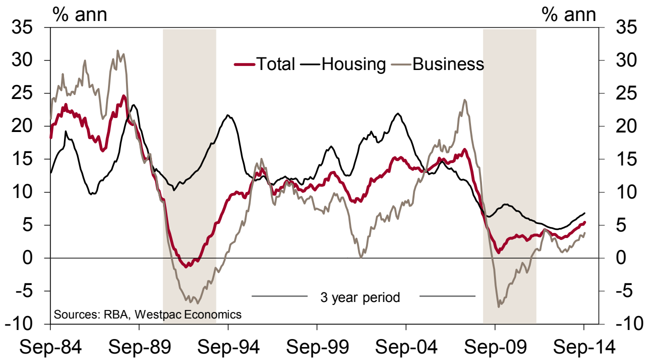


Aus Oct private credit

Nov 28, Last: 0.5%, WBC f/c: 0.4% Mkt f/c: 0.5%, Range: 0.3% to 0.7%

- Private credit is growing at a slightly faster pace this year than in 2013 as households and business take advantage of historically low interest rates.
- Annual credit growth in September was 5.4%, up from 3.3% a year earlier. For housing the figures are, 6.8% up from 4.8%, and for business, 3.8% up from 1.0%.
- In the month of September, credit increased by 0.5%, including an oversized increase in business credit of 0.5%, which can be lumpy from month-to-month.
- For October, we anticipate a 0.4% rise in total credit, which would see annual growth hold at 5.4%. We doubt that business credit can repeat the strong +0.5% result of September, particularly given the recent dip in commercial finance.

Credit mix: annual growth

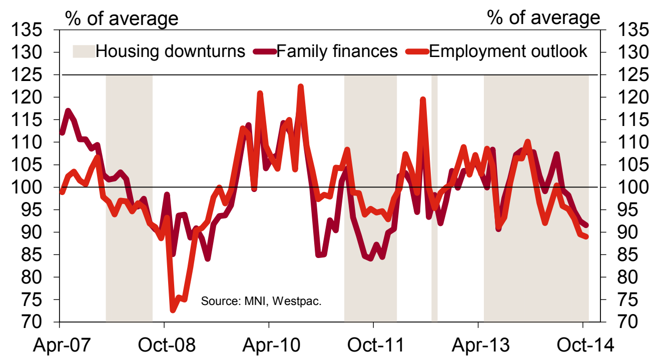


China Nov Westpac-MNI Consumer Sentiment

Nov 26 Last: 110.9

- The headline index fell close to all-time lows a month ago. Concern about jobs and housing were prominent themes in the detail, as they were throughout Q3.
- We will be looking for the following in November: 1) Updated views on the labour market, with the modest momentum in September IP having reversed course in October; 2) The evolving attitude of consumers towards the ongoing housing correction, in the context of easier policy, noting not only that the initial reception was lukewarm in the previous survey, but that a range of other sources are exhibiting tentative signs of stabilisation; 3) New developments in savings attitudes (avenues and motivations) against this backdrop. 4) Any signs that lower inflation is filtering into perceptions of better household finances. 5) Any sign that HK-Shanghai Connect is altering attitudes to the local and foreign sharemarkets.

Westpac MNI China CSI & housing downturns



Data calendar

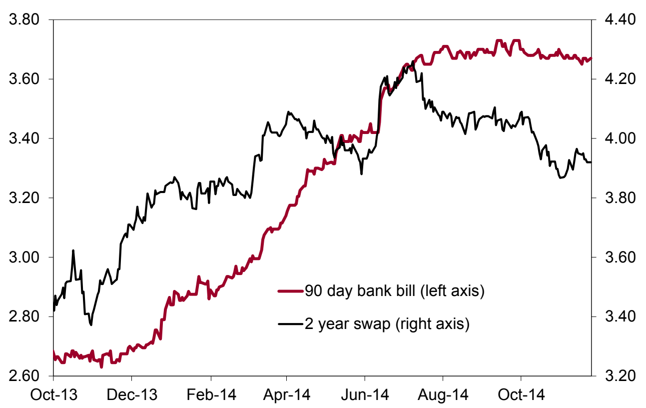
		Last	Market median	Westpac forecast	Risk/Comment
Mon 24					
NZ	Oct net immigration	4,670	–	4,670	Net immigration is expected to remain at an elevated level.
US	Oct Chicago Fed national activity index	0.47	–	–	A composite measure rather than a separate survey.
	Nov Markit services PMI	57.1	57.3	–	Eased back from June's high of 61.
	Nov Dallas Fed survey	10.5	8	–	Steady, modest positives since April.
Tue 25					
NZ	Q4 RBNZ 2yr inflation expectations	2.23%	–	–	Likely to fall further after surprisingly weak Q3 CPI.
Aus	RBA Deputy Gov Lowe speaking	–	–	–	Speaking at ABE annual conference dinner, Sydney 8pm, topic tba.
US	Q3 GDP, second estimate	3.5%	3.2%	–	Slight downgrade expected but still a solid positive pace.
	Sep S&P/Case Shiller home price index	5.6%	4.7%	–	Price growth clearly moderating in 2014 ...
	Sep FHFA home price index	0.5%	0.5%	–	... according to both of these measures.
	Nov consumer confidence	94.5	93.0	–	Conference Board measure now at 7½yr high.
	Nov Richmond Fed index	20	16	–	Strong surge since June.
Wed 26					
Aus	Q3 construction work done	–1.2%	–1.9%	–1.8%	Private infrastructure to decline, so too public works.
Chn	Nov Westpac MNI China CSI	110.9	–	–	Close to record lows. Hope to see signs the bottom has been reached.
US	Oct durable goods orders	–1.1%	–0.6%	–	Dip in aircraft orders expected to weigh in Oct.
	Oct personal income	0.2%	0.3%	–	Oct employment report points to solid gain in aggregate income ...
	Oct personal spending	–0.2%	0.2%	–	... while vehicle and retail sales point to better spending gain.
	Oct core PCE deflator	0.1%	flat	–	Annual core inflation holding at 1.5%.
	Initial jobless claims w/e 23/11	291k	–	–	Still holding at low levels, consistent with reduced lay-offs.
	Nov Chicago ISM	66.2	63.0	–	Has been running well above other measures recently.
	Nov Uni. of Mich. sentiment, final	89.4	90.0	–	Showing a decent improvement in Nov.
	Oct new home sales	0.2%	0.6%	–	Downside risk given soft Oct NAHB reading.
	Oct pending home sales	0.3%	0.8%	–	Can give a guide to next month's existing home sales number.
Thu 27					
Aus	Q3 private new capital expenditure	1.1%	–1.9%	–1.0%	Building & structures expected to decline.
	2014/15 capex expectations, AUDbn	145	–	–	Est 3 on Est 3, –10%. Mining down sharply, services up.
NZ	Oct Merchandise trade ($mil)	–1,350	–625	–700	Pickup from seasonal lows and $430m of plane imports in Sep.
US	Thanksgiving	–	–	–	Public holiday
Fri 28					
Aus	Oct private sector credit	0.5%	0.5%	0.4%	Business, +0.5% in Sep, such strength back-to-back unlikely.
NZ	Oct building consents	–12.2%	–	15%	Pre-election caution likely to be reversed.
	Nov ANZ business confidence	26.5	–	–	Indicators for domestic activity have remained healthy.
	Oct private sector credit %yr	4.4%	–	–	Housing lending has moderated this year due to slower housing turnover.

New Zealand forecasts

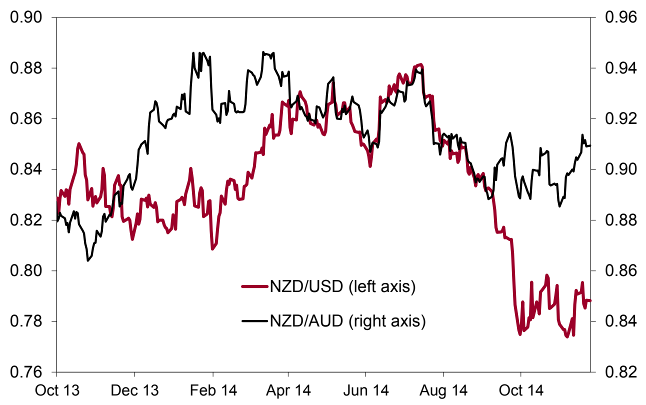
Economic Growth Forecasts	March years				Calendar years			
% change	2013	2014	2015f	2016f	2013	2014f	2015f	2016f
GDP (Production) ann avg	2.7	2.8	3.2	3.1	2.6	3.3	3.1	2.9
Employment	0.4	3.8	2.8	2.6	2.9	3.0	2.7	2.0
Unemployment Rate % s.a.	6.2	5.9	5.2	4.8	6.0	5.4	4.9	4.5
CPI	0.9	1.5	1.3	2.2	1.6	1.0	2.2	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	0.88	0.87	0.87	0.87	0.87
NZD/JPY	89.3	90.1	91.3	94.0	96.8	98.8
NZD/EUR	0.63	0.63	0.63	0.63	0.63	0.64
NZD/GBP	0.49	0.47	0.47	0.47	0.46	0.46
TWI	76.4	76.3	76.7	77.4	78.1	78.8

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 24 November 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	3.64%	3.64%	3.65%
60 Days	3.66%	3.66%	3.67%
90 Days	3.67%	3.67%	3.68%
2 Year Swap	3.92%	3.92%	3.92%
5 Year Swap	4.19%	4.21%	4.20%

NZ foreign currency mid-rates as at Monday 24 November 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7882	0.7776	0.7894
NZD/EUR	0.6373	0.6231	0.6212
NZD/GBP	0.5041	0.4895	0.4895
NZD/JPY	92.92	88.91	85.04
NZD/AUD	0.9094	0.8981	0.8967
TWI	78.54	76.89	76.68

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	2.76	2.65	2.55	2.65	3.00	3.25
10 Year Bond	3.26	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	2.33	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	0.8642	0.88	0.88	0.90	0.91	0.92
USD/JPY	117.77	116	117	117	119	121
EUR/USD	1.2553	1.23	1.23	1.24	1.25	1.26
AUD/NZD	1.0958	1.14	1.14	1.15	1.15	1.15

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