30 June 2014

Weekly Commentary

Mt. Taranaki, Mt. Egmont National Park.

In this issue

Second chances

Recent data give us no reason to expect the RBNZ to depart from the plans it set out in June. Those plans include a follow-up hike in July, but also suggest a subsequent period of 'taking stock'. In our view, that raises the risk of a renewed bout of market scepticism about the RBNZ's longer-term OCR forecasts – meaning that the recent opportunity for borrowers to lock in favourable rates may not be the last.

The clear message from the RBNZ's June *Monetary Policy Statement* was that the RBNZ had its eye on a further OCR hike in July, and that it would require significantly weaker data to persuade it otherwise.

Any residual doubts on that score have been largely dispelled: markets are now pricing a roughly 85% chance of a July hike, and we would choose similar odds. As we discussed last week, the March quarter GDP figures confirmed that the New Zealand economy has been growing at an above-trend pace. Consumer confidence has stayed remarkably resilient in the face of lower dairy prices and higher interest rates, while dairy prices themselves bounced modestly in the latest Fonterra auction. And net migration is as strong as ever. While monthly net departures to Australia may have finally found a floor – consistent with an Australian labour market that is no longer getting worse – they remain at historically extremely low levels. Unless the trend turns quickly, annual net migration is easily on track to exceed 40,000 by the end of the year, and to continue running ahead of the RBNZ's forecasts.

Of course, the main reason why the Reserve Bank cares about net immigration is because of what it means for the New Zealand housing market, and here the data have been less supportive. We have long felt that the Reserve Bank has overemphasised the role of net immigration (rather than financial conditions) in driving New Zealand house price cycles, and the recent housing data would seem to bear this out. Housing demand remains significantly weaker than last year, with sales down a further 1.1% in May and the stock of unsold homes now up 5% since the start of the year.

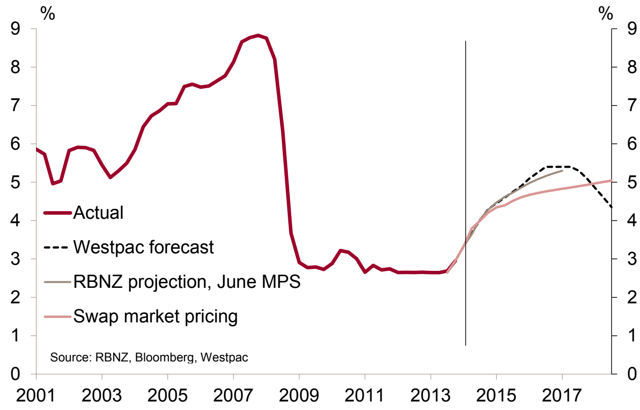
Second chances continued

But it's probably still too early for this to change the RBNZ's view that the migration boom risks giving the market a serious second wind – particularly as low-equity lending, which collapsed after the RBNZ introduced its LVR restrictions late last year, is now slowly picking up again. And the data continue to disagree on what the recent slowdown in housing demand has meant for prices. On balance, it seems that house price inflation has slowed, but not precipitously so – to anything between 6.5%yr (according to the REINZ stratified index) and 8.2% (according to the Quotable Value index).

So all in all, we see little reason for the RBNZ to deviate from the interest rate forecasts it put out in the June *MPS.* But while those forecasts imply a July hike, they also suggest just one more hike over the remainder of the year. Our initial reaction after the June *MPS* was that this meant follow-up hikes in October and January. On reflection – and especially in view of the uncertainties around the state of the housing market – we now think the more natural interpretation is that the RBNZ is keen to get an initial batch of hikes out of the way, before allowing itself some time to take stock. We have reverted to forecasting the OCR hikes in July and December.

If the RBNZ does issue a pause signal in July, markets may well react by sending swap rates lower. Our impression from talking to financial market participants in North America is that offshore investors remain sceptical of the RBNZ actually delivering the OCR hikes it is currently signalling. The market may misinterpret an RBNZ pause signal as a more fundamental loss of nerve, and could move to price out substantial further hikes.

90-day interest rate forecasts



That raises the spectre of the mid-2000s, when financial market participants – particularly offshore – continually doubted that the RBNZ would take the OCR much further. The result was an inverted yield curve, with longer-term fixed mortgage rates falling below short-term. That allowed New Zealanders to lock in low mortgage rates, and ultimately forced the RBNZ to go even harder on the OCR.

While the RBNZ would not want to see a repeat of this scenario, the takeout for borrowers is that while the window to lock in rates at favourable terms is closing now, it may yet reopen – if only briefly. Keep watching this space.

Fixed vs Floating for mortgages

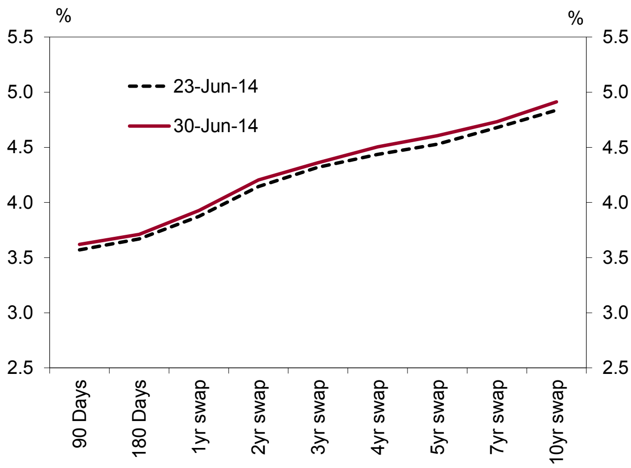
Fixing for two to three years seems likely to prove the cheapest option.

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.

Fixed rates are now on the rise, but in our view 2-3 year rates are still good value, given where we think shorter-term rates are likely 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



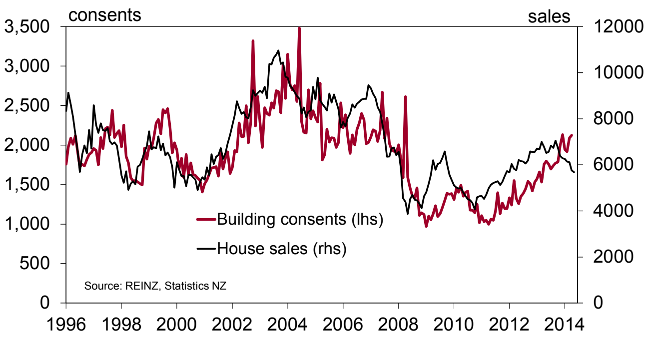
The week ahead

NZ May building consents

Jun 30, Last: +1.5%, Westpac f/c: -4.0%

- Total residential building consents in April were inflated by a sharp jump in the volatile apartment units category (432 consents, against a monthly average of around 200). Ex-apartment consents fell by 5.2%, consistent with our view that the Easter/Anzac holiday period may have produced a greater than usual lull in activity this year, and that building consents would be especially vulnerable to such an effect.
- So far, the activity data for May has generally shown a post-Easter rebound, though not unanimously. We feel comfortable in predicting a reversal of the April results in May: a solid 7% rebound in ex-apartment consents, returning them to their upward trend, but overshadowed by a pullback in apartment units to around average levels.

NZ housing activity

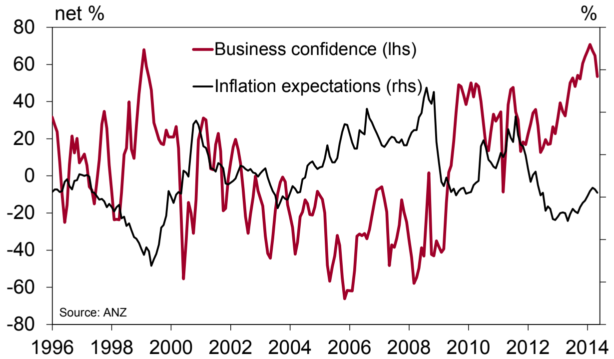


NZ Jun business confidence

Jun 30, Last: 53.5

- Having reached a two-decade high early in the year, business confidence has edged down in the last few months, with the May survey recording a particularly large drop in general sentiment (firms' own intentions were much more robust).
- It's possible that firms' responses in May were coloured by the Easter-related lull in activity that was apparent in much of the April data, in which case the drop in confidence could prove to be temporary. However, given that in our view the economy has probably already reached its peak rate of growth, we're on alert for evidence of a genuine slowdown.
- Inflation expectations and pricing intentions both fell in the May survey, a typical reaction to the softer than expected inflation figures published in late April. With fuel prices nearing record highs, we wouldn't be surprised if these inflation measures started to nudge higher again.

NZ business confidence and inflation expectations

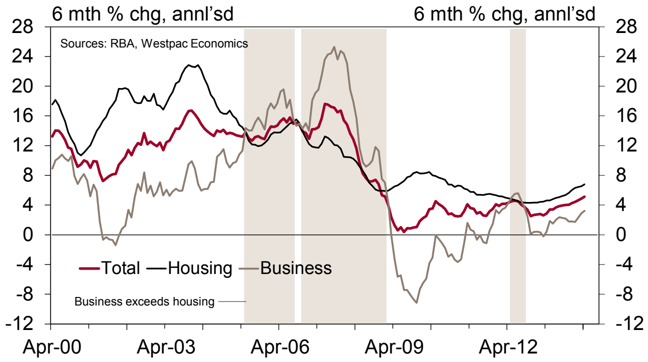


Aus May private credit

Jun 30 Last: 0.5%, WBC f/c: 0.4%
Mkt f/c: 0.4%, Range: 0.4% to 0.5%

- Credit growth has improved in 2014 as business credit advances. Annual growth is now 4.6%, up from 3.1% a year ago.
- Credit is forecast to rise 0.4% in May. Such an outcome is in line with the average of the past 5 months, and an uptick from a monthly average of 0.3% for the bulk of 2013. Note, the April outcome was a soft 0.5%, at 0.46%.
- Business credit rose 1.6% over the past five months, with monthly increments ranging between 0.2% and 0.4%. Commercial finance has strengthened, centred on a lift in non-residential building approvals, although many firms remain focussed on paying down revolving credit facilities.
- Housing credit rose 0.60% in April, following gains of 0.51% in February and March. In May, the risk is for a slight tick lower.

Credit momentum

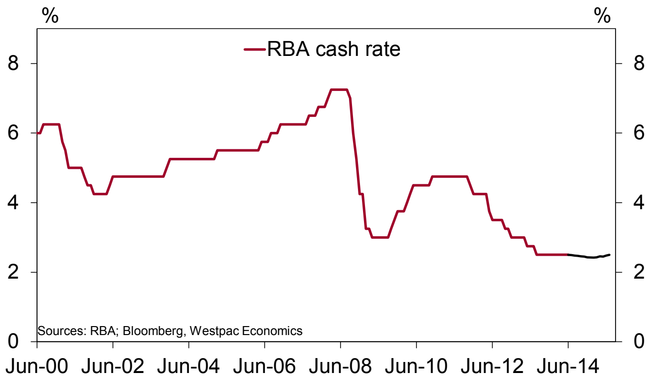


Aus RBA policy decision

Jul 1, Last: 2.50%, WBC f/c: 2.50%
Mkt f/c: 2.50%, Range: 2.50% to 2.50%

- The RBA is expected to again leave the cash rate on hold at 2.5% at its July meeting. The Bank has kept rates unchanged since Aug with the Governor's statement accompanying the June decision indicating that "the current accommodative stance of policy was likely to be appropriate for some time yet". However, there has been a shift in tone in recent months with more pointed comments on the AUD and the minutes to the June meeting highlighting a more uncertain outlook.
- Developments since the RBA's June meeting have likely added to these tensions with the Q1 national accounts showing softer than expected domestic demand, the AUD firming despite further falls in commodity prices, consumer sentiment failing to bounce back from its post-Budget fall and more signs of a cooling off in housing markets. See p2 for more detail.

RBA cash rate



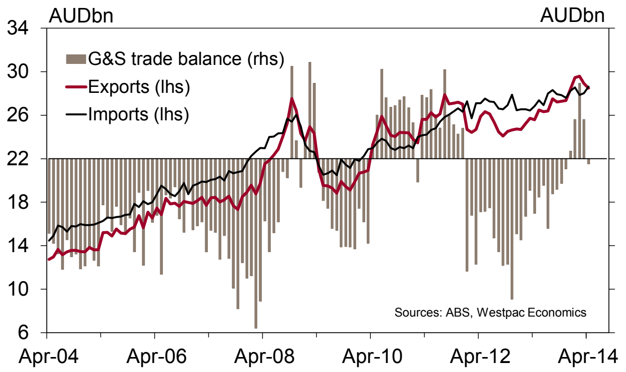
The week ahead

Aus May trade balance, AUDmn

Jul 2 Last: –122, WBC f/c: –250
Mkt f/c: –200, Range: –1100 to +530

- Australia's trade balance slid into deficit in April as export earnings were dented by lower commodity prices and on higher imports. We see the risk that the accounts remain in deficit for a second month.
- The trade balance in May is forecast to be a deficit of $250mn, following a $122mn deficit in April.
- Imports are forecast to decline by 0.6%. This follows a 2.2% rise in April, an increase which suggested a lift in volumes.
- Exports are forecast to decline by 1.0%. Weakness is centred on iron ore, down on lower prices and volumes. This follows a particularly strong run for iron ore volumes.

Australia's trade balance: –$122mn in April

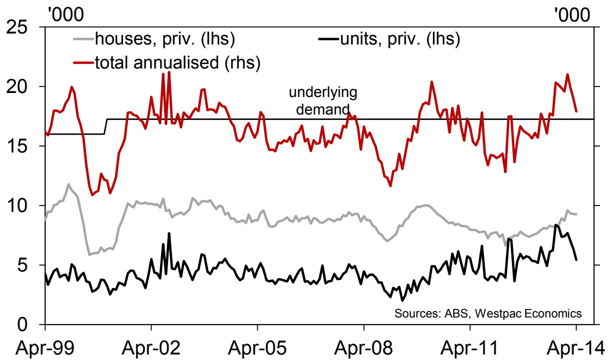


Aus May dwelling approvals

Jul 3, Last: –5.6%, WBC f/c: 3.0%
Mkt f/c: 3.2%, Range: –2.0% to 10.0%

- Dwelling approvals fell 5.6% in Apr extending similar declines in Mar and Feb which in turn followed a strong rise over the second half of 2013. The pattern is being dominated by high rise approvals which surged in late 2013 and held at high levels for an unusually long period but now appear to be pulling back. Other components are flattening out rather than falling. The Apr fall also appeared to have a significant negative impact from reduced working days due to the timing of Easter in 2014.
- The reversal of holiday timing effects should give a decent lift in May. Construction-related finance approvals point to a more moderate downtrend in non-high rise projects. We expect the net result to see a 3% partial rebound in approvals in May. As always there significant risks to the number both from potential upward revisions to Apr and a further pull-back in high rise.

Dwelling approvals

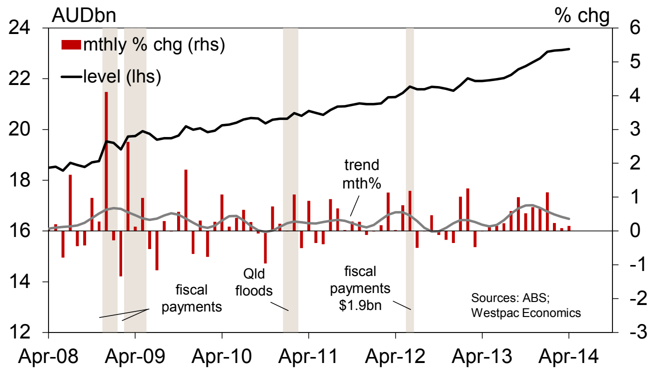


Aus May retail trade

Jul 3, Last: 0.2%, WBC f/c: 0.2%
Mkt f/c: flat, Range: –0.5% to 0.4%

- Despite a promising and comparatively well-sustained surge since mid-2013, retail sales have lost momentum in 2014 with nominal sales gains averaging just 0.2% between Feb and Apr.
- That moderation followed a similar cooling in consumer sentiment which had been riding high in late 2013 but was back around neutral by Apr. Sentiment fell sharply following the Federal Budget in May and remained in pessimistic territory in Jun. Although some of this is likely to be a temporary over-reaction, the weakening is clearly not good news for retailers.
- Anecdotes suggest moderate growth in sales continued in May: we expect the data to show a 0.2% gain. The late Easter may have a slight positive impact in May. The drag in Apr looked to be negligible overall but was apparent in a couple of segments. Against this, the abnormally warm Autumn saw slower sales for clothing retailers and department stores.

Monthly retail sales



US Jun ISM surveys

Jul 1, ISM manufacturing Last: 55.4, WBC f/c: 55.0
Jul 3, ISM non-manufacturing Last: 56.3, WBC f/c: 56.9

- The ISM factory survey rose 0.5pts in May, with production and orders higher, jobs lower. The regional Fed factory surveys were mixed, with Phily and NY in the high teens (as they have been many times since the last recession only to subsequently fall sharply) but Richmond and Kansas City were lower. The Markit PMI was higher in June but it has not tracked the ISM well, so taking guidance from Richmond, to whom we turn when we really aren't sure, we expect a lower ISM factory index.
- The ISM non-manufacturing rose from its lowest in four years in Feb to its highest since Aug last year in May. Business activity and orders rose to multi-year highs of 62.1 and 60.5, but jobs remained subdued at 52.4. The advance Markit PMI for June soared and it tracks reasonably with the non-manufacturing ISM so we expect a further rise in June.

US ISMs

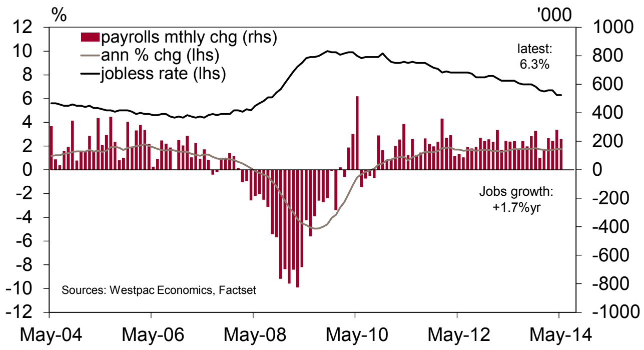
The week ahead

US Jun non-farm payrolls

Jul 3, Payrolls: Last: 217k, WBC f/c: 160k

- Payrolls grew by more than a million in the first five months of the year. That just does not sit well with the 2.9% plunge in GDP growth in Q1, and the fall in business investment shown in the detail. GDP fell a modest 1.3% in Q1 2011 with growth averaging 3% either side of that quarter and payrolls were very weak in May-June, as reported at the time, and even after revisions the first five months of 2011 saw just 874k payroll jobs.
- The household survey employment measure has been softer of late, averaging just 36k in Apr-May.
- A weaker payrolls number is due soon. Our 160k forecast reflects that view, though it could come in the form of a downward revision to April-May, or maybe not until benchmark revisions are published next February.

US payrolls

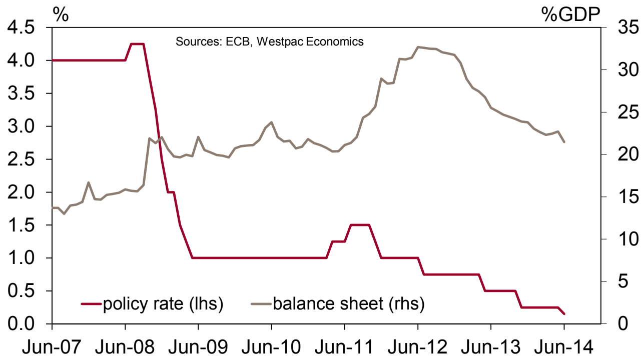


ECB policy decision

Jul 3, ECB Last: 0.15%, WBC f/c: 0.15%

- On June 5 the ECB cut rates 10bp including taking the deposit rate to a penalising –0.1%; will no longer sterilise legacy SMP bond holdings (effectively printing €170bn as the term deposits are repaid); announced a €400bn TLTRO intended to fund bank lending to corporates and households (ex mortgages); and strongly hinted that an asset purchase program including packaged up bank loans would be implemented if justified by the inflation outlook, once technical and regulatory issues have been resolved. This program should encourage banks to make TLRTO lending, in the knowledge they are likely to be able to sell the loans back to ECB once the APP is formalised.
- The Draghi presser should be a quiet affair compared to June, as the ECB has reached the effective lower bound for rates and the APP is unlikely to be ready before the end of the year at the earliest.

ECB policy settings



Data calendar

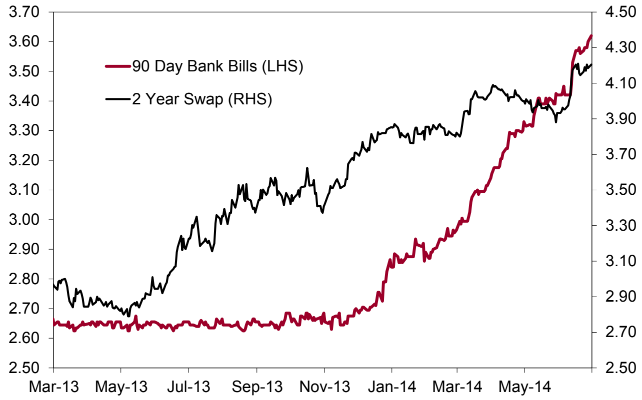
		Last	Market median	Westpac forecast	Risk/Comment
Mon 30					
NZ	Q2 Westpac-MM employ. confidence	108.4	–	–	Q1 survey was a post-recession high.
	May building consents	1.5%	–2.5%	–4.0%	Inflated by apartments in Apr, but underlying picture should improve.
	Jun ANZ business confidence	53.5	–	–	Confidence in recent months has come off a 20-year high.
	May private sector credit %yr	4.2%	–	–	Housing lending continues to slow; business has also been soft.
Aus	Jun TD-MI inflation gauge	0.3%	–	–	Annual pace has accelerated to 2.9%yr.
	May private sector credit	0.5%	0.4%	0.4%	Growth ticked higher in 2014 as business advances.
Eur	Jun CPI flash %yr	0.5%	–	0.6%	Ger Jun CPI due 27/6 is expected to rise, but Spain CPI to fall.
	May money supply M3 %yr	0.8%	0.7%	–	Credit to private residents the focus, contracted 2.5%yr in Apr.
Ger	May retail sales	–0.9%	0.8%	0.5%	Partial bounce but late Easter in April will limit May upside.
UK	May net mortgage lending £bn	1.7	1.6	–	BoE/Treasury have just announced controls designed to take some ...
	May net consumer credit £bn	0.7	0.9	–	... of the excess out of the mortgage market.
	May M4 money supply ex IOFCs ann %	4.5%	–	–	Rising into upper part of 2.5-5.3% range that has prevailed for a year.
US	Jun Chicago PMI	65.5	63.0	60.0	Some of the regionals surveys are much stronger than national ISM.
	Jun Milwaukee NAPM	63.5	–	–	May bounce unlikely to be sustained.
	May pending home sales	0.4%	1.3%	2.5%	New and existing home sales point to a further gain.
	Jun Dallas Fed factory index	8.0	–	–	May still the third strongest reading since early 2012.
	Fedspeak	–	–	–	Williams.
Can	Apr GDP %yr	2.1%	–	–	Annual growth has decelerated from 2.9%yr in Oct 2013.
Tue 1					
Aus	Jun AiG PMI	49.2	–	–	Manufacturing index sub 50, averaged 47.4 year to date.
	Jun RP Data–Rismark home price index	–1.9%	–	1.0%	May's drop looks to be seasonality amplified bump in milder slowdown.
	RBA policy decision	2.50%	2.50%	2.50%	Likely to repeat "prudent course" language, but what about the $A?
Chn	Jun NBS manufacturing PMI	50.8	51.0	–	Should improve a touch on more favourable orders/inventory balance.
	Jun HSBC manufacturing PMI - final	50.8	50.8	–	0.3pt downward revision between flash & final in May, so it can happen.
Eur	Jun PMI factory final	51.9 a	51.9	51.8	Stalled or weaker PMIs likely in countries without advance PMIs too
	May unemployment rate %	11.7%	11.7%	11.6%	Steady German jobless rate but declines possible elsewhere.
Ger	Jun unemployment change	24k	–10k	–10k	May saw first rise in 6 months.
UK	Jun house prices %yr	8.7%	–	–	Tentative date for Halifax index due first week of month.
	Jun factory PMI	57.0	56.7	–	Economic growth pace to moderate in second half of 2014.
US	Jun factory PMI final	57.5 a	–	–	Running at multi-year high.
	Jun ISM manufacturing	55.4	55.5	55.0	Mixed regionals: NY/Philly up, Richmond/Kansas down.
	May construction spending	0.2%	0.5%	0.6%	Residential upswing led by multiples underway.
	Jul IBD-TIPP economic optimism	47.7	–	49.0	Weekly data point to confidence upswing through June.
	Jun auto sales mn annualised	16.7	16.4	–	Sales uptrend may be levelling off.
Wed 2					
NZ	GlobalDairyTrade auction	0.9%	–	–	Prices stabilised in late June after a 26% decline since Feb.
	Jun ANZ commodity price index	–2.2%	–	–2.5%	Declines in May-Jun dairy auctions will weigh on the index.
Aus	May trade balance, AUDmn	–122	–200	–250	Risk of another deficit. X -1% on lower prices, M -0.6% following +2.2%.
	RBA Assist. Gov Debelle speaking	–	–	–	To FT Camp Alphaville Conference, London, 9.05pm AEST. Topic TBA
Eur	May PPI %yr	–1.2%	–	–1.1%	German PPI edged up from –0.9% to –0.8% yr in May.
UK	Jun PMI construction	60.0	59.8	59.4	Construction sector surge has moderated since late last year.
US	Jun ISM New York	55.3	–	–	Down 4.7 pts in May but still below Jan peak for year so far of 64.4.
	May factory goods orders	0.7%	0.2%	–0.4%	Durables known down 1% in May.
	Jun ADP private payrolls	179k	205k	190k	ADP more believable than payrolls given Q1 GDP slump.
	Jun corporate layoffs %yr	45.5%	–	–	Challenger series.
	Fedspeak	–	–	–	Janet Yellen lecture at IMF in Washington.
Can	Jun factory PMI	52.2	–	–	Has slowed from recent peak of 55.6 in Oct last year.
Thu 3					
Aus	May retail sales	0.2%	flat	0.2%	Weaker sentiment, warm weather keep sales subdued.
	May dwelling approvals	–5.6%	3.2%	3%	Unwinding high-rise surge and Easter timing hit in May.
	RBA Governor Stevens speaking	–	–	–	Australian Conference of Economists and ESAM, Hobart, 11.00am AEST.
Chn	Jun NBS non-manufacturing PMI	55.5	–	–	Long run average is 56.8. PBoC's corporate survey was flat in Q2.
	Jun HSBC services PMI	50.7	–	–	May saw exceptionally stable activity detail but a drop in expectations.
Eur	Jun PMI services final	52.8 a	52.8	52.7	German/French services PMI weakness may be replicated elsewhere.
	Jun PMI composite final	52.8 a	–	52.6	Already down two months running for lowest in 2014 so far.
	May retail sales	0.4%	0.2%	0.2%	German –0.9% fall in April to partially reverse but France to weaken.
	ECB rate decision	0.15%	0.15%	0.15%	Given June's announcements, ECB in holding pattern for now.
UK	Jun PMI services	58.6	58.1	57.5	Rate rise talk, mortgage controls, may impact.
US	May trade balance $bn	–47.2	–45.0	–41.0	Exports slipped 0.2% in Apr, but imports rose 1.2%, after Mar surges.
	Initial jobless claims, w/e 28/6	312k	–	315	Downtrend may be levelling off.
	Jun non-farm payrolls ch'	217k	210k	160k	Payrolls running too fast given Q1 slump in GDP growth. This may
	Jun unemployment rate	6.3%	6.3%	6.3%	show up in downward revision to May if June is 200k+.
	Jun ISM non-manufacturing	56.3	56.0	56.9	Markit PMI services suggests further upswing.
	Jun PMI services final	61.2 a	–	–	Has tracked services ISM better than factory PMI tracks factory ISM.
Can	May trade balance C$bn	–0.6	–0.3	–	Exports down 1.8% in Apr, imports up 1.4%.
Fri 4					
Ger	May factory orders	3.1%	–1.0%	–	Apr jump corrected for Mar fall so should not be fully reversed.
US	Independence Day holiday	–	–	–	Markets closed.

New Zealand forecasts

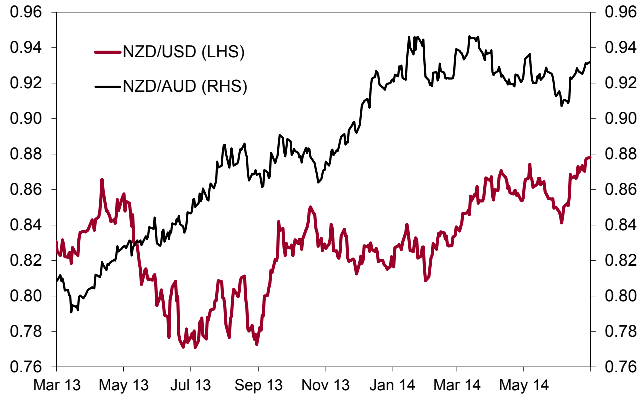
Economic Growth Forecasts	March years				Calendar years			
% change	2013	2014e	2015f	2016f	2012	2013	2014f	2015f
GDP (Production) ann avg	2.3	3.3	3.7	3.1	2.5	2.9	3.8	3.2
Employment	0.4	3.8	2.5	2.0	0.4	2.9	2.9	2.4
Unemployment Rate % s.a.	6.2	6.0	5.3	4.9	6.8	6.0	5.5	4.9
CPI	0.9	1.5	1.9	2.6	0.9	1.6	1.7	2.6
Current Account Balance % of GDP	-3.9	-2.8	-4.0	-4.4	-4.1	-3.4	-3.0	-4.6

Financial Forecasts	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15
Cash	3.25	3.50	3.75	4.25	4.25	4.50
90 Day bill	3.40	3.70	4.00	4.30	4.45	4.60
2 Year Swap	4.20	4.40	4.60	4.80	4.90	5.00
5 Year Swap	4.60	4.80	5.00	5.10	5.20	5.30
10 Year Bond	4.50	4.60	4.80	4.90	5.00	5.05
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	87.7	86.4	85.0	84.8	85.7	86.5
NZD/EUR	0.63	0.63	0.64	0.64	0.63	0.63
NZD/GBP	0.51	0.51	0.52	0.51	0.51	0.51
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 30 June 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.25%	3.25%	3.00%
30 Days	3.43%	3.43%	3.31%
60 Days	3.53%	3.49%	3.39%
90 Days	3.62%	3.54%	3.42%
2 Year Swap	4.21%	4.18%	3.94%
5 Year Swap	4.61%	4.58%	4.37%

NZ foreign currency mid-rates as at Monday 30 June 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8780	0.8667	0.8452
NZD/EUR	0.6437	0.6400	0.6216
NZD/GBP	0.5155	0.5106	0.5047
NZD/JPY	89.04	88.46	86.54
NZD/AUD	0.9320	0.9227	0.9142
TWI	81.48	80.73	79.04

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	3.2	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	-3.2	-2.5	-2.0
United States						
Real GDP %yr	2.5	1.8	2.8	1.9	1.7	2.6
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	-2.3	-2.3
Japan						
Real GDP %yr	4.9	-0.3	1.5	1.5	1.3	1.3
Euroland						
Real GDP %yr	2.0	1.6	-0.6	-0.4	0.8	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 6 June 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	2.71	2.60	2.55	2.55	2.55	2.65
10 Year Bond	3.54	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	2.51	2.60	2.70	2.80	3.00	3.20
ECB Repo Rate	0.15	0.15	0.15	0.15	0.15	0.15

Exchange Rate Forecasts	Latest	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
AUD/USD	0.9437	0.92	0.91	0.90	0.90	0.92
USD/JPY	101.35	102	101	100	101	102
EUR/USD	1.3634	1.36	1.35	1.32	1.32	1.33
AUD/NZD	1.0757	1.07	1.06	1.06	1.07	1.10

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