14 December 2015

Weekly Commentary

Lake Taupo

In this issue

One step closer

Last week the Reserve Bank delivered the expected cut to the Official Cash Rate, and signalled that while it is comfortable with current policy settings, it is prepared to act again if needed. Our view remains that economic conditions will shift enough to prompt further interest rate cuts next year.

The key line from the *Monetary Policy Statement* was: "We expect to achieve [the inflation target] at current interest rate settings, although the Bank will reduce rates if circumstances warrant." Financial markets appear to have latched on to the first part of that sentence, and have backed away from the idea of further rate cuts – the New Zealand dollar in particular has risen sharply since the OCR decision.

However, the second part of that sentence is just as important. It shows that the RBNZ has moved a step closer to the possibility of taking the OCR below its record-equalling low of 2.5%, an outcome that we have been consistently forecasting since July.

The crucial change has been in the RBNZ's inflation forecasts compared to the September *Monetary Policy Statement.* The recent upturn in the NZ dollar and falling oil prices mean that inflation is likely to remain very subdued in the near future – the RBNZ's latest forecasts don't see inflation reaching the 2% midpoint of its target range until the end of 2017, more than a year later than previously thought. But rather than trying to combat this near-term weakness, the RBNZ has chosen to make use of the flexibility within its policy target, which specifies a focus on average inflation of 1-3% over the medium term.

However, the risk is that by positioning itself at the lower end of its policy target, the RBNZ leaves itself with limited room to absorb any further shocks on the downside. Our view is that the RBNZ is likely to encounter such shocks in the coming months, with a focus on three areas:

One step closer continued

Inflation: The situation around oil prices is quite fluid at the moment, after OPEC's decision to effectively abandon production targets. But on current fuel prices alone, there is a very real chance that inflation will remain below the 1-3% target band until the end of next year, in contrast to the RBNZ's forecast that it will rise above 1% early next year. This continued underperformance would make it harder to keep inflation expectations well anchored around the 2% midpoint.

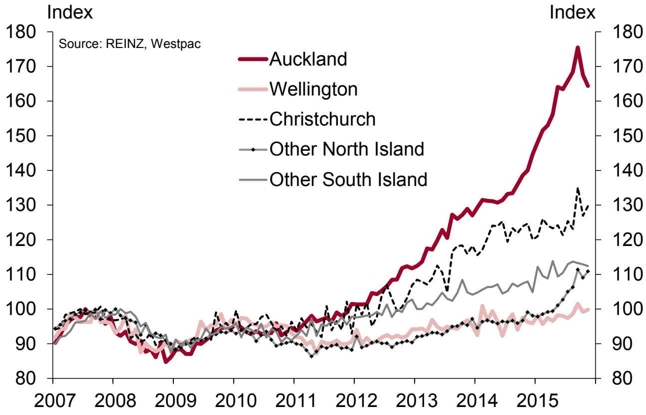
Housing: The RBNZ has assumed that the new tax rules and LVR limits will have only a temporary impact on the housing market. However, the latest figures from REINZ show that the heat is rapidly coming out of the Auckland housing market. Sales have fallen by 27% and prices have dropped by 6% since the new regulations came into force. We suspect that there is further adjustment to come, which should ease the RBNZ's reluctance to cut rates further on financial stability grounds.

Growth: We don't dispute that recent data points to the economy regaining some momentum compared to the first half of this year. Indeed, our forecast of a 0.9% increase in September quarter GDP (due Thursday) is a touch higher than the market average. But even this wouldn't fully make up for the disappointing GDP outturns over the previous two quarters, and even less so when you consider that most of the recent growth in GDP has been a product of population growth. What's more, we expect that the low dairy payout and an El Niño-led drought will further undermine growth over the first half of next year.

Consequently, we've kept our call for the OCR to be cut further to 2% next year, but we've decided to fine-tune the timing of this forecast. Previously we had pencilled in 25 basis point cuts in the March and June *Monetary Policy Statements.* But given the parameters the RBNZ has set out, it now seems that the more likely date for the next cut is June. Consequently, we are now shifting our forecast to OCR cuts in June and August next year.

That said, we still don't have a high level of conviction about the timing of any further rate cuts, and we would consider any of next year's OCR review dates to be 'live' – with the exception of the next review in January, which we consider would be too quick of a turnaround. Even so, we wouldn't be surprised if the RBNZ starts the new year trying to 'correct' the market's perception that further rate cuts are off the table. In particular, the RBNZ Governor delivers an annual speech to the Canterbury Employers' Chamber of Commerce shortly after the January OCR review; this speech has often been proven to be crucial in setting the tone for the rest of the year.

House prices, seasonally adjusted



Aside from the remaining local data releases, there is one more event this year that will be crucial to the RBNZ's next move. On Thursday morning, the US Federal Reserve is expected to increase its policy rate for the first time since the GFC. On the face of it, higher interest rates should lift the US dollar and weaken the NZ dollar, which would help the RBNZ to meet its inflation target. But in practice it's highly uncertain how interest rate and currency markets will react, given that they have already had many months to factor in this decision. The key will be what the Fed says about its intended future path for interest rates, relative to the glacial pace of hikes that the market is currently pricing in.

Fixed vs Floating for mortgages

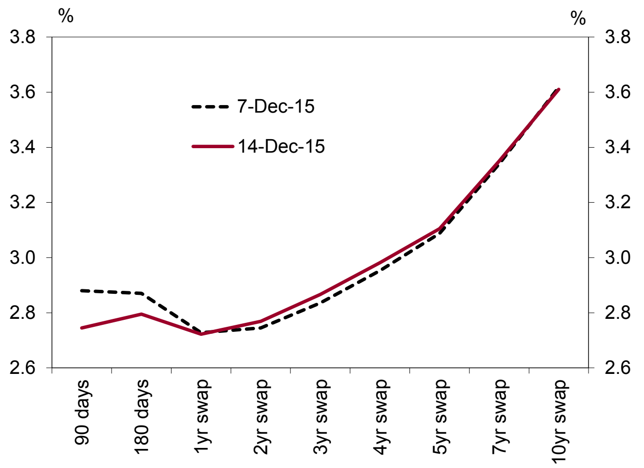
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

Longer-term fixed rates do offer the benefit of stability, but even those looking to fix may want to wait a while longer.

For borrowers with a deposit of 20% or more, the best value probably continues to lie in the two-year ahead and three-year ahead terms. Four- and five-year rates still seem high relative to where we think shorter-term rates are going to go over the next four or five years.

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

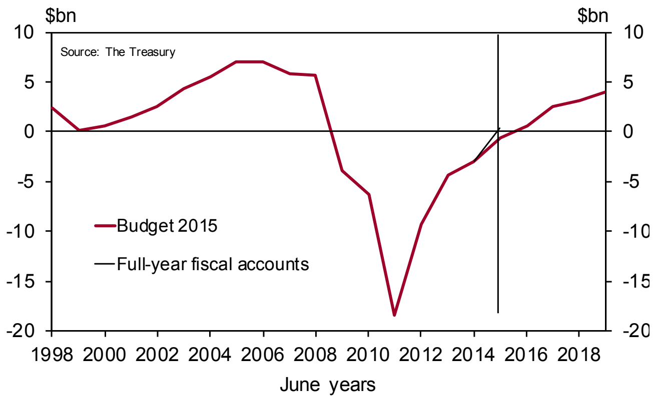


NZ Half-Year Fiscal and Economic Update

Dec 15, Last: $372mn

- The Government reported a wafer thin operating surplus of $0.4bn in the 2015 financial year.
- Since then, the Government's tax receipts have been running ahead of forecasts. Tax collected in the four months ended October was $799mn higher than forecast in May's Budget.
- However, going forward Treasury's Budget projections of tax revenue may be under pressure from expected downward revisions to their nominal GDP growth forecasts. In May, the Treasury was forecasting 5.3% nominal GDP growth in the year to March 2017. By comparison, Westpac is forecasting 3.5% GDP growth at this horizon.
- We would be surprised if the Government announced any significant changes to spending plans at the half year update.

Operating balance (excluding gains and losses)

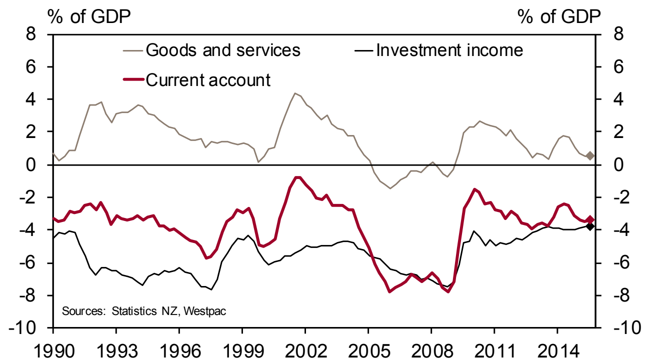


NZ Q3 current account, % of GDP

Dec 16, Last: –3.5%, WBC f/c: –3.4%, Mkt f/c: –3.4%

- We estimate that the annual current account deficit narrowed slightly from 3.5% to 3.4% of GDP.
- In seasonally adjusted terms, we expect the goods balance to slide further into deficit. Export prices and volumes rose for the quarter, but these were more than offset by a sharp rise in the import bill due to the weaker New Zealand dollar.
- In contrast, trade in services is expected to move further into surplus, due to the rapid growth in tourist spending over the past year.

Annual current account balance

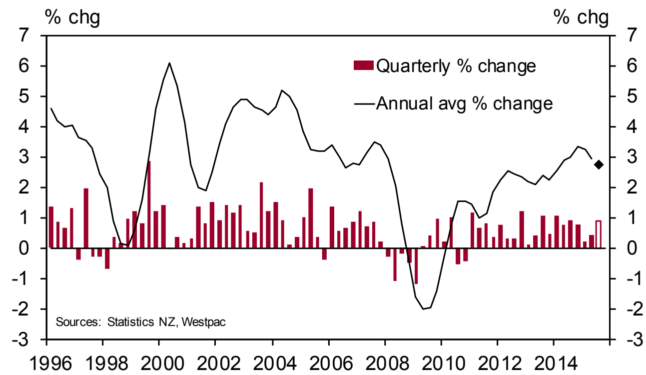


NZ Q3 GDP

Dec 17, Last: 0.4%, WBC f/c: 0.9%, Mkt f/c: 0.8%

- September quarter GDP is set to improve on the two surprisingly soft reads in the first half of this year. The final sectoral indicators published this week have pushed our forecast up to 0.9% growth, a touch above the market median.
- While activity in the primary sectors looks to have been softer across the board, we expect to see strong gains across manufacturing and services for the quarter.
- A strong GDP outturn, as we expect, might seem to weaken the case for further interest rate cuts. However, it's clear that the trend pace of growth has softened, and even more so once we consider population growth of around 2% a year. Slack in the domestic economy is building and inflation pressures will remain subdued.

Production-based GDP

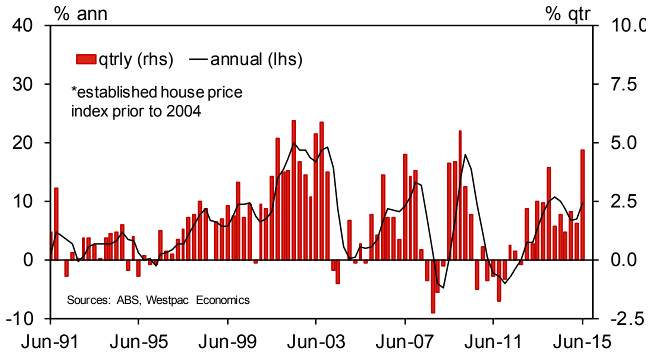


Aus Q3 residential property price index

Dec 15, Last: 4.7%, WBC f/c: 1.2%
Mkt f/c: 2.0%, Range: 1.0% to 3.5%

- The ABS residential property price measure showed a 4.7%qtr rise in Q2, lifting annual growth nationally to 9.8%.
- The Q3 wash-up from private sector measures showed gains ranging from 3.6%qtr, 11.1%yr (Residex), to 0.2%qtr, 10%yr (APM) and 4.1%qtr, 11.3%yr (CoreLogic RP Data), 2.3%qtr, 12.6%yr (REIA, houses only). The ABS measure tends to track the APM series more closely due to a similar methodology. Accordingly we expect the official measure to show a material slowing in the quarter with a 1.2%qtr gain holding annual growth steady at 9.8%. Private sector measures already suggest the Q4 update of the official ABS measure – not due out until Mar 2016 – will show an outright fall in prices with a particularly sharp slowdown in Sydney and Melbourne.

Residential property price index, ABS measure



Aus 2015/16 Federal budget, mid-yr update, $bn

Dec 15, Prelim: –35.1, WBC f/c: –39
Mkt f/c: –38, Range: –42 to –36.5

- In the Mid-Year Economic & Fiscal Outlook (MYEFO) the economic forecasts will be downgraded due to (1) weaker nominal GDP growth centred on lower commodity prices; and (2) slower trend growth, reflecting slower population trends.
- The budget deficit for 2015/16 will be revised higher, by around $4bn to $39bn (–2.4% of GDP). The deterioration over four years is around $36bn. Despite these revisions, the forecasts will continue to anticipate a gradual narrowing of the deficit, to around $19bn (–1.0% of GDP) by 2018/19.
- Net public debt rises to $350bn, 18.4% of GDP by mid 2018.

Key forecasts		'15/16	'16/17	'17/18	'18/19
Real GDP	Budget	2.75	3.25	3.50	3.50
(% chg)	MYEFO *	2.75	3.00	3.00	3.00
Nominal GDP	Budget	3.25	5.50	5.25	5.50
(% chg)	MYEFO *	2.25	4.50	5.00	5.25
Cash balance	Budget	–35.1	–25.8	–14.4	–6.9
($bn)	MYEFO *	–39	–35	–25	–19
Net public debt	Budget	286	313	324	325
($bn)	MYEFO *	278	315	336	350

* Westpac's expectation of Government forecasts to appear in MYEFO

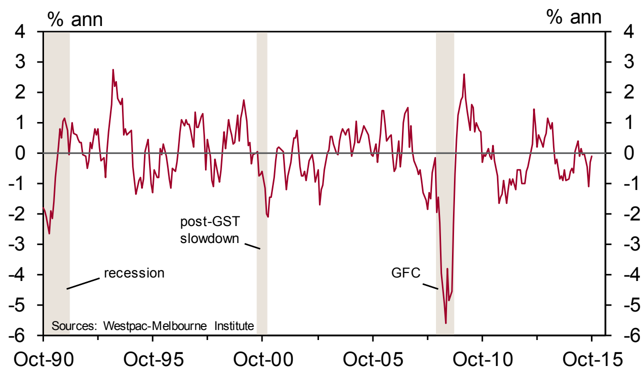
Sources: Budget papers, ABS, Westpac Economics

Aus Oct Westpac–MI Leading Index

Dec 16, Last: –0.08%

- The 6mth annualised growth rate of the Leading Index lifted from –0.30% in September to –0.08% in October. Although the growth pulse remains below trend it has improved materially since August.
- The November read will include updates on: the ASX200, –1.4% vs +3.6% last month; the Westpac-MI Consumer Expectations Index, down -3.4% vs +5.5% last month; commodity prices, down a further 3.9% (in AUD terms) vs –2.6%; dwelling approvals, up 4% vs 2.2% last month; the yield spread, +21bps vs a 5.2bps narrowing last month; the Westpac-MI Unemployment Expectations Index, up 1.7% vs 3.3% (higher readings indicating a deterioration); and total hours worked, down -0.8% vs 1.2% last month.

Westpac-MI Leading Index

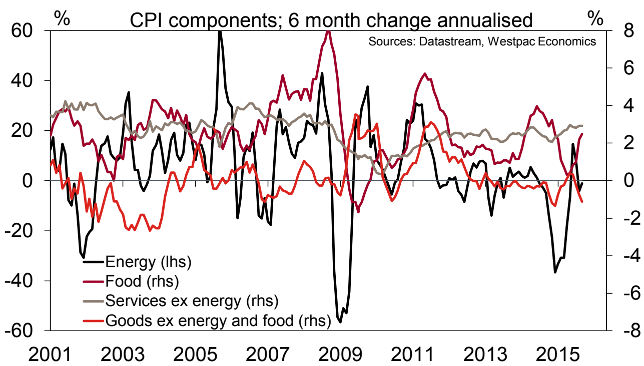


US Nov CPI

Dec 15 Last: 0.2%, WBC f/c: flat

- US headline inflation continues to be restrained by ongoing declines in the oil price as well as the impact of the stronger US dollar on import prices. The effect of both factors is abating, but only slowly.
- In Nov, energy prices are again expected to be a drag, one that should see a broadly flat monthly headline outcome. The annual pace of headline inflation will firm; however, it will remain well below 1.0%yr.
- In contrast, core pressures will continue to rise at a robust pace, circa 0.2%, leaving annual core inflation in line with the FOMC's 2.0%yr medium-term target. For core inflation, the key drivers remain housing (primarily rents), health and insurance; momentum in all three components should persist.

Energy & USD impact to lessen

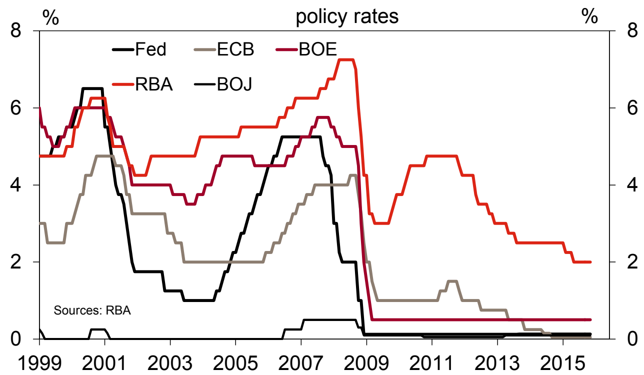


US Dec FOMC meeting

Dec 15–16 Last: 0.00–0.25%, WBC f/c: 0.25–0.50%

- In its recent communications, the FOMC has clearly telegraphed that the December meeting will see the first US rate hike in almost 10 years.
- On the labour market, unemployment has now fallen to 5.0%, and nonfarm payrolls employment continues to print at levels well in excess of current population growth. Wages are also beginning to firm, indicating considerably reduced slack.
- For inflation, while the US dollar and the oil price are still impacting headline inflation, the underlying pulse is much closer to the FOMC's medium-term target of 2.0%yr.
- Consequently, while risks remain and the path ahead will be anything but smooth, now is the time to begin removing accommodation and test the strength of the US economy.

Developed world policy interest rates



Data calendar

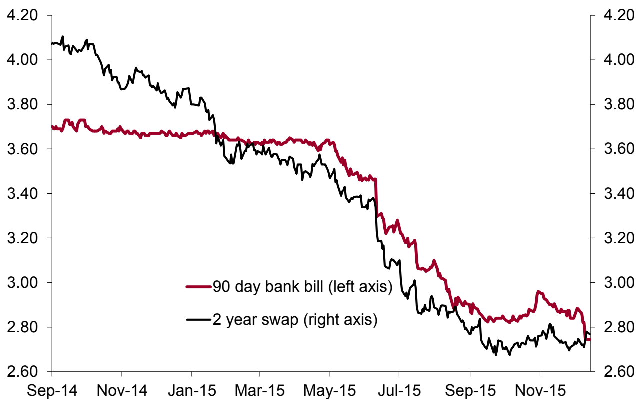
		Last	Market median	Westpac forecast	Risk/Comment
Mon 14					
NZ	Nov BusinessNZ PSI	56.2	–	–	Service sector conditions have remained firm in recent months.
Eur	Oct industrial production	–0.3%	0.2%	–	Hope of further EUR depreciation holds promise for 2016.
UK	Dec Rightmove house prices	–1.3%	–	–	Low interest rates have been boosting the housing market.
Can	Nov Teranet/National Bank house prices	0.1%	–	–	Prices climbing in Toronto and Vancouver; softer elsewhere.
Tue 15					
NZ	HYEFU	–	–	–	Half year update on the Government's fiscal position.
Aus	RBA Minutes, December meeting	–	–	–	Discussions around A$, labour market & the consumer of keen interest.
	Q3 residential property prices (ABS)	4.7%	2.0%	1.2%	Last hurrah ahead of what looks to be an abrupt slowdown in Q4.
	Nov new motor vehicle sales	–3.6%	–	flat	Industry figures point to a flat month but sales still up 6.9%yr.
	2015/16 Federal Budget, mid-yr update	–35.1 (p)	–38	–39	2015/16 budget, a $4bn deterioration, largely on lower commodity prices
Eur	Dec ZEW survey expectations	28.3	–	–	Appetite for risk to falter post ECB.
UK	CPI	0.1%	–0.1%	–	Import prices and strength in the GBP are weighing on inflation.
	Oct ONS house price inflation %yr	6.1%	–	–	ONS measure; dated relative to other measures. Has been moderate.
US	Dec Empire fed survey	–10.7	–5.5	–	External headwinds are continuing to weigh on manufacturing.
	Nov CPI	0.2%	0.0%	0.0%	Oil's deflationary impulse lessens; annual growth rises to 0.5%.
	Dec NAHB housing market index	62	63	–	Remains at historically high levels.
Wed 16					
NZ	GlobalDairyTrade auction results	3.6%	–	–	Futures point to an increase in prices.
	Q3 current account (% of GDP)	–3.5%	–3.4%	–3.4%	Growth in tourist spending offsetting weak dairy exports.
Aus	Nov Westpac-MI Leading index	–0.08%	–	–	Still sub-trend but improved vs Aug. Component updates a mixed bag.
	RBA Assist Governor (Financial Markets)	–	–	–	Guy Debelle, "Some Effects of the New Liquidity Regime" Sydney, 11am.
Eur	Dec Markit manufact. PMI (provisional)	52.8	52.5	–	Services PMI expected to be little changed at 54.0.
	Dec trade balance	20.1b	–	–	External demand remains crucial for longevity of growth.
	Nov CPI	0.1%	–0.2%	–	Annual headline unchanged at 0.1%yr; core measure at 0.9%yr.
Ger	Dec Markit manufact. PMI (provisional)	52.9	52.5	–	Moderate momentum persists in manufacturing.
	Dec Markit services PMI (provisional)	55.6	55.3	–	Historically low unemployment a key support for services.
UK	Oct ILO unemployment rate	5.3%	55.3	–	Strengthening domestic activity has been boosting labour demand.
US	Nov housing starts	–11.0%	7.6%	5.2%	Volatility persists; but trend momentum abating.
	Nov building permits	4.1%	–0.7%	flat	Housing sector cautious ahead of rate hikes.
	Nov industrial production	–0.2%	–0.1%	–	USD and energy sector material impediments to growth.
	Dec Markit manufact. PMI (provisional)	52.8	52.8	–	Remains more optimistic than ISM.
	FOMC policy decision, midpoint	0.125%	0.375%	0.375%	Set for first rate hike in US in almost a decade.
Thu 17					
NZ	Q3 GDP	0.4%	0.8%	0.9%	A bounce from a weak first half of 2015, but trend growth slowing.
Aus	Dec RBA Bulletin	–	–	–	RBA quarterly bulletin includes latest research articles.
Ger	Dec IFO business climate survey	109.0	109.0	–	Current assessment robust; but a question over expectations.
UK	Nov retail sales	–0.6%	0.5%	–	Strength in the labour market and low rates are boosting spending.
US	Q3 current account balance, $bn	–109.7	–123.0	–	USD impacting competitiveness; global growth still unhelpful.
	Dec Philly Fed survey	1.9	1.5	–	Points to moderate activity; external conditions a drag.
	Initial jobless claims	282k	–	–	Claims have lifted (possibly due to holiday volatility) but remain low.
Fri 18					
NZ	Dec business confidence	14.6	–	–	Confidence has increased, but remains at moderate levels.
Chn	Nov 70-city new dwelling prices %net bal	-8.6%	–	–	October regression made concrete our fears on turnover slowdown.
	Dec MNI business indicator	49.9	–	–	Listed services and manufacturing; question pool broader than a PMI.
Eur	Oct current account balance	29.4b	–	–	ECB measure.
US	Dec Markit services PMI (provisional)	56.1	–	–	As per ISM, services sector is where the growth is.
	Dec Kansas city Fed manuf. Activity	1	–	–	Has picked up, but only to average levels.
	Fedspeak	–	–	–	Lacker gives 2016 economic outlook in Charlotte.
Can	Oct wholesale trade sales	–0.1%	–	–	Auto production has been weighing on sales.
	Nov CPI	0.1%	–	–	Overall inflation remains low, but core has been firmer.

New Zealand forecasts

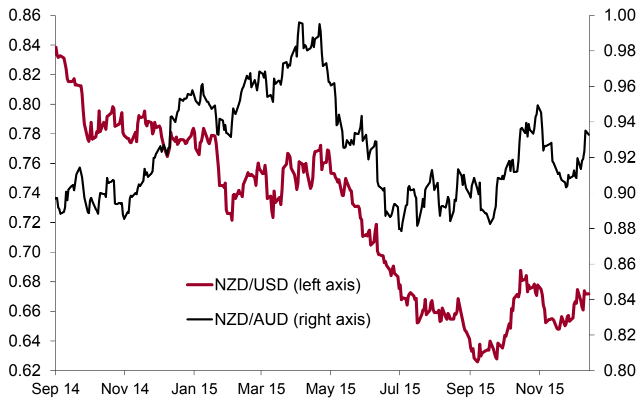
Economic Growth Forecasts	March years				Calendar years			
% change	2014	2015	2016f	2017f	2013	2014	2015f	2016f
GDP (Production) ann avg	2.5	3.2	2.2	2.2	2.3	3.3	2.4	2.0
Employment	3.8	3.2	1.0	2.3	2.9	3.6	1.2	2.1
Unemployment Rate % s.a.	6.0	5.8	6.4	6.3	6.1	5.7	6.3	6.4
CPI	1.5	0.3	1.1	1.5	1.6	0.8	0.3	1.7
Current Account Balance % of GDP	-2.6	-3.4	-3.7	-3.5	-3.2	-3.1	-3.4	-3.7

Financial Forecasts	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Cash	2.50	2.50	2.25	2.00	2.00	2.00
90 Day bill	2.70	2.60	2.20	2.10	2.10	2.10
2 Year Swap	2.70	2.50	2.30	2.20	2.20	2.20
5 Year Swap	3.10	3.10	3.10	3.20	3.20	3.20
10 Year Bond	3.40	3.50	3.60	3.70	3.80	3.80
NZD/USD	0.64	0.63	0.62	0.62	0.62	0.62
NZD/AUD	0.91	0.93	0.94	0.93	0.90	0.89
NZD/JPY	78.7	78.1	77.5	78.1	78.7	76.9
NZD/EUR	0.60	0.60	0.60	0.60	0.60	0.59
NZD/GBP	0.43	0.43	0.42	0.42	0.41	0.40
TWI	70.0	69.8	69.6	69.4	68.7	68.0

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 14 December 2015

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.75%	2.75%
30 Days	2.65%	2.81%	2.89%
60 Days	2.70%	2.82%	2.90%
90 Days	2.75%	2.85%	2.91%
2 Year Swap	2.77%	2.71%	2.77%
5 Year Swap	3.11%	3.05%	3.14%

NZ foreign currency mid-rates as at Monday 14 December 2015

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6718	0.6537	0.6530
NZD/EUR	0.6117	0.6173	0.6082
NZD/GBP	0.4413	0.4347	0.4288
NZD/JPY	81.33	80.29	79.87
NZD/AUD	0.9328	0.9086	0.9183
TWI	73.12	71.27	71.18

International forecasts

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2011	2012	2013	2014	2015f	2016f
Australia						
Real GDP % yr	2.7	3.5	2.0	2.6	2.3	2.8
CPI inflation % annual	3.0	2.2	2.7	1.7	1.7	2.2
Unemployment %	5.2	5.3	5.8	6.2	6.0	6.1
Current Account % GDP	-2.8	-4.4	-3.4	-3.0	-4.3	-5.5
United States						
Real GDP %yr	1.6	2.2	1.5	2.4	2.5	2.8
Consumer Prices %yr	3.1	2.1	1.5	1.6	0.1	1.7
Unemployment Rate %	8.9	8.1	7.4	6.2	5.3	4.8
Current Account %GDP	-2.9	-2.9	-2.3	-2.2	-2.3	-2.3
Japan						
Real GDP %yr	-0.5	1.7	1.6	-0.1	0.6	1.4
Euroland						
Real GDP %yr	1.6	-0.8	-0.3	0.9	1.4	1.1
United Kingdom						
Real GDP %yr	1.6	0.7	1.7	3.0	2.5	2.5
China						
Real GDP %yr	9.5	7.7	7.7	7.3	7.0	6.6
East Asia ex China						
Real GDP %yr	4.5	4.6	4.2	4.1	3.6	3.8
World						
Real GDP %yr	4.2	3.4	3.3	3.4	3.1	3.5
Forecasts finalised 8 Dec 2015						

Interest Rate Forecasts	Latest	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16
Australia						
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.37	2.20	2.20	2.20	2.20	2.20
10 Year Bond	2.85	2.85	2.90	3.00	3.10	3.30
International						
Fed Funds	0.125	0.375	0.625	0.875	1.125	1.375
US 10 Year Bond	2.24	2.35	2.50	2.70	2.90	3.00
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16
AUD/USD	0.7250	0.70	0.68	0.66	0.66	0.67
USD/JPY	122.05	123	124	125	126	127
EUR/USD	1.0930	1.07	1.05	1.03	1.03	1.04
AUD/NZD	1.0755	1.09	1.08	1.06	1.06	1.08

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Anne Boniface, Senior Economist
+64 9 336 5669

David Norman, Industry Economist
+64 9 336 5656

Any questions email:
economics@westpac.co.nz

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Disclaimer continued

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