

17 August 2015



Weekly Commentary

Kea, Arthurs Pass National Park.

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The turning tide

Last week we launched our latest quarterly *Economic Overview*, titled “The tide has turned”. Our view of the New Zealand economy has evolved substantially over the last few months, as the downturn in world dairy prices has deepened and the post-earthquake rebuild in Christchurch appears to have plateaued sooner than expected. The unexpected loss of momentum in these two areas will be a blow to business and consumer confidence, which we expect will see GDP growth fall to below 2% and the unemployment rate rise to 6.5% by next year.

Crucially, however, all of this is happening in an environment of ongoing low inflation. This means that the Reserve Bank has plenty of scope to ease monetary conditions during this soft patch. Lower interest rates would also put downward pressure on the NZ dollar, which will be essential to bringing inflation back up towards the RBNZ’s target midpoint. Together, the expected stimulus of lower interest rates and a lower exchange rate mean that we are able to forecast a modest recovery in GDP growth from mid-2016 onwards.

We’d point out that the forecasts in our *Economic Overview* are based around a blow to confidence that originates in the business sector (especially in agriculture), with knock-on effects for the household sector over time. We had no expectation that households would be feeling the pinch at this stage, so last week’s batch of household-centric data doesn’t challenge our views one way or another.

The latest REINZ figures show that the housing market remained in fine form in July. House sales rose to a new cycle high, average time to sell fell to a new cycle low, and prices rose in most of the broad regions. Picking any turning point in house prices



The turning tide continued

is difficult due to the quality and volatility of the data. For instance, there have been a handful of measures suggesting that the median Auckland house price fell in July. But all of these can potentially be distorted by the composition of the houses being sold. And indeed, there's some evidence of a surge in sales of lower-end properties in July, which might suggest a flurry of demand from property investors ahead of the new lending and tax rules that come into force later this year. For this reason we prefer measures that attempt to adjust for quality, such as the REINZ's stratified house price index, which showed a further rise in Auckland house prices in July.

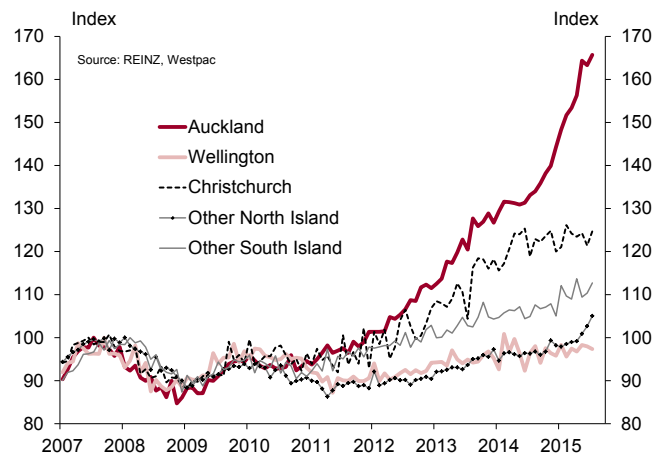
Retail spending growth slowed sharply in the June quarter, with volumes rising by only 0.1%, right in line with our forecast. That followed a 2.3% surge in the March quarter that was likely due to consumers spending the 'windfall' from a sharp drop in fuel prices. As petrol prices have risen back towards their previous levels, we've seen households reining back their spending again. The timelier electronic card spending figures for the July month confirmed that the stimulus from cheaper fuel has well and truly faded, with retail spending growing at a modest pace of just 0.4% for the month.

Considering the role that the dairying slump plays in our view of the New Zealand economy, there have been a few intriguing developments in the last week. International markets have understandably been focused on China, where a string of soft economic data was followed by a surprise devaluation of the yuan against the US dollar. The softness of Chinese demand certainly helps to explain the weakness of commodity prices in recent months, and the yuan devaluation has generally been seen by the market as a further negative for commodity prices, by making it more expensive for China to import those commodities.

And yet, milk powder futures prices on the NZX exchange have surged higher in the last few days, ahead of next week's GlobalDairyTrade auction. Although we're sceptical about the predictive power of these futures, it does reinforce the sense that dairying's current woes are to a large degree specific to dairying.

The most likely reason for the jump in prices is on the supply side. The market has focused on the fact that, in recent weeks, Fonterra has reduced the volume of dairy products that it

House prices, seasonally adjusted



expects to sell through the GDT auction over the next year by a combined 13%. But this is less important for dairy prices. All else equal, less sold through the auction means that more has to be sold outside the auction, and buyers will be well aware of this.

Of more importance is that Fonterra has also forecast that its milk collection for this season will be down 2% on last season, as farmers respond to low milk prices by culling their herds and buying less feed. We've emphasised in the past that the global dairy market is very sensitive – in both directions – to marginal changes in the supply of milk. For instance, when dry weather in New Zealand early this year led Fonterra to forecast a 3% drop in milk production, world dairy prices quickly jumped by 30%. Of course, that production forecast proved to be too pessimistic and dairy prices subsequently plunged again, but the point was amply demonstrated.

Bottom line: the number to focus on is not the 13% drop in volumes through the auction – that's a tactical decision – but the 2% expected drop in milk production, and whether that forecast proves to be accurate. If so, it would be a real, binding constraint on the global dairy market.

Fixed vs Floating for mortgages

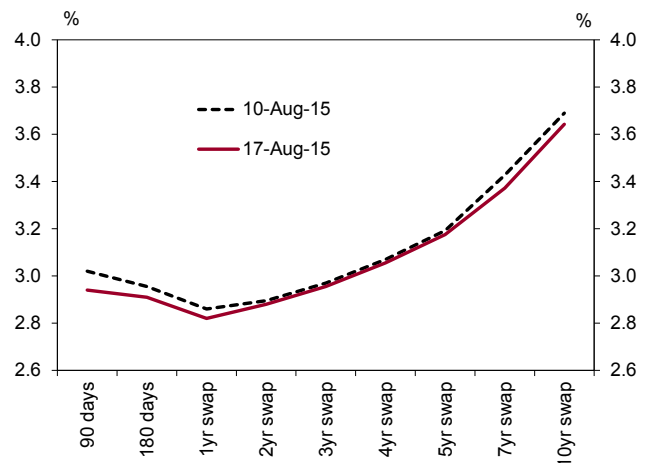
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

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 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

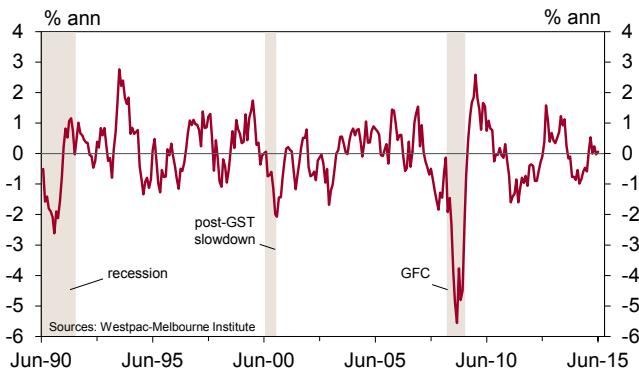


Aus Jul Westpac-MI Leading Index

Aug 19, Last: +0.06%

- The 6 month annualised growth rate of the Index swung from -0.02% in May to +0.06% in June. Despite the slight improvement, the Index is still showing a loss of momentum since the start of the year – the average growth rate over Jan-Apr was +0.21% .
- The July reading will again see a mix of positive and negative developments across components with solid rebounds for the ASX 200 (+4.2% vs -5.6% in June), the Westpac-MI Consumer Expectations Index (+7.3% vs -2.3% last month); and the Westpac Unemployment Expectations Index improving a further 2%. Against this, dwelling approvals were down sharply (-8.2%), commodity prices were off 1.7% in AUD terms, aggregate hours worked dipped 0.2% and the yield spread narrowed slightly.

Westpac-MI Leading Index

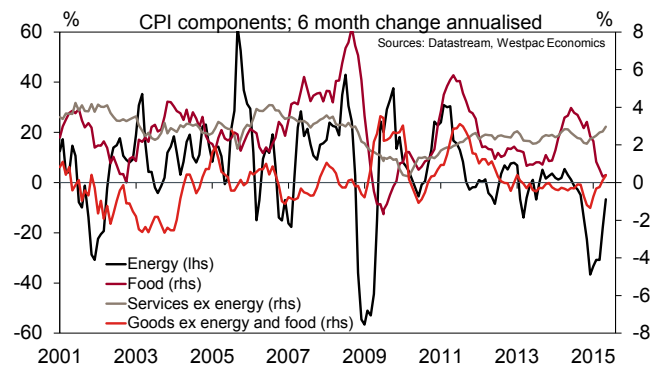


US July CPI

Aug 19, Last: 0.3%, WBC f/c: 0.2%

- A central expectation of the FOMC is that the deflationary impulse associated with the weak oil price and strong USD will abate, seeing inflation tend to their 2.0% medium-term target.
- While annual headline inflation continues to be restrained, coming in at just 0.1%yr in June, available information on core inflation pressures are more robust. Annual core inflation printed at 1.8%yr in June; and six-month annualised inflation was stronger still at 2.3%yr.
- Key to this underlying price pressure is rents, with the shelter component of the CPI continuing to grow at a rapid clip – 3.2% in six-month annualised terms in June. Other ex-energy services are also seeing robust price growth. In July, food and energy prices likely had an insignificant impact; headline and core prices are therefore expected to rise 0.2%.

Energy stabilises; USD impact to lessen



Data calendar

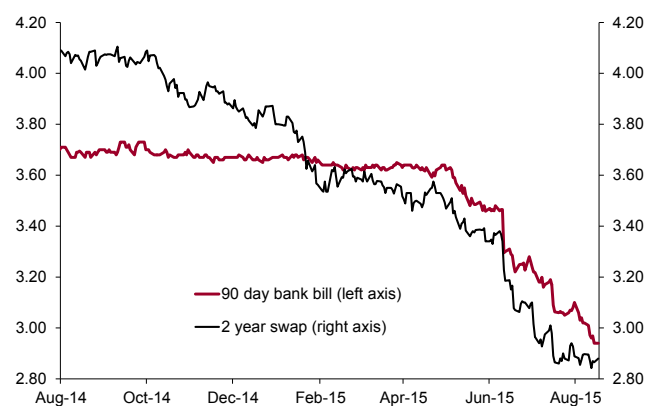
		Last	Market median	Westpac forecast	Risk/Comment
Mon 17					
NZ	Jul Performance of Services Index	58.2	–	–	Has remained elevated in recent months.
Eur	Jun trade balance, €bn	21.2	–	–	Euro supportive over past year.
UK	Aug house prices	0.1%	–	–	Rightmove measure; prices up 5.1% over past year.
US	Aug Empire manufacturing survey	3.9	5.0	–	Has picked up, but remains moderate.
	Aug NAHB housing market index	60	61	–	Firmed from Mar to Jun and has stabilised thereafter.
Tue 18					
Aus	Jul new vehicle sales	3.8%	–	–1.5%	Jun lift was an end of financial year boost from small business package.
	RBA minutes	–	–	–	Detail around latest RBA thinking following forecast revisions in SoMP.
Chn	Jul 70-city new house prices %net bal	–2.9	–	–	Prices still down in the majority of cities, as stock overhang persists.
	Jul 70-city 2'ndary house prices %net bal	32.9	–	–	Striking gains in Tier-1 and modest ones rising number of smaller cities.
UK	Jul CPI	0.0%	–	–	Low inflation has mainly been due to imported factors.
	Jun house prices, %yr	5.7%	–	–	ONS measure; dated relative to market measures.
US	Jul housing starts	9.8%	2.2%	1.0%	Strong of late; much more modest growth to come in near-term.
	Jul building permits	7.0%	–9.5%	–6.5%	Recent spike on multiples to correct lower; but level still strong.
Wed 19					
NZ	GlobalDairyTrade auction	–9.3%	–	–	Fonterra has reduced expected milk volumes for the year ahead.
Aus	Jul Westpac–MI Leading Index	+0.06%	–	–	Still showing loss of momentum since Q1; Jul components were mixed;
Eur	Jun ECB current account, €bn	18.0	–	–	Euro supportive over past year.
US	Jul CPI	0.3%	0.2%	–	Core price pressures to dominate in Jul, particularly shelter.
	Minutes from July 28-29 FOMC meeting	–	–	–	Fedspeak has signalled general agreement on near-term hike.
Thu 20					
Chn	Aug MNI business indicator	48.8	–	–	Listed firms in manuf & services - fell in sympathy with stocks in July.
UK	Jul retail sales	–0.2%	0.4%	–	Low inflation means the trend in sales remains positive.
US	Fedspeak	–	–	–	Fed's Kocherlakota speaks at Bank of Korea event.
	Fedspeak	–	–	–	Fed's Williams speaks in Indonesia.
	Initial jobless claims	274k	270k	–	Claims have remained very low in recent weeks.
	Aug Philadelphia Fed business outlook	5.7	7.0	–	Business indicators pulled back in July.
	Jul existing home sales	3.2%	–1.3%	–2.0%	Has seen strong run; partial pull back seems likely.
Can	Jun wholesale trade	–1.0%	–	–	Signs the Canadian economy is slowing have been accumulating.
Fri 21					
NZ	Jul net migration	4800	–	4700	Net migration is expected to remain elevated.
Eur	Aug consumer confidence	–7.1	–	–6.9	Impact of Greece minimal; growth providing broad sentiment support.
UK	Jul public sector borrowing, £bn	8.6b	–	–	Borrowing is expected to fall over the coming year. Ex banking £9.4bn.
US	Aug Markit US manufacturing PMI	53.8	–	–	Preliminary reading. Has come more into line with ISM of late.
Can	Jul CPI	0.2%	–	–	Excess supply is continuing to dampen prices.

New Zealand forecasts

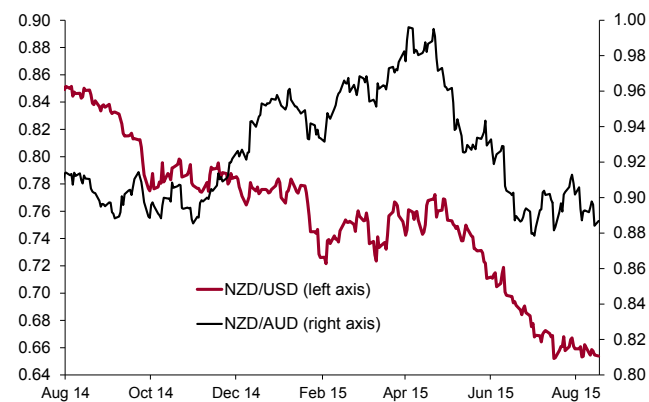
Economic Growth Forecasts	March years				Calendar years			
	2014	2015	2016f	2017f	2013	2014	2015f	2016f
% change								
GDP (Production) ann avg	2.5	3.2	2.1	2.0	2.2	3.3	2.2	1.8
Employment	3.8	3.2	0.5	2.1	2.9	3.6	0.9	1.8
Unemployment Rate % s.a.	6.0	5.8	6.5	6.3	6.1	5.7	6.4	6.3
CPI	1.5	0.1	1.6	1.3	1.6	0.8	0.7	1.7
Current Account Balance % of GDP	-2.6	-3.6	-5.4	-4.4	-3.3	-3.3	-4.8	-4.8

Financial Forecasts	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16
Cash	2.75	2.25	2.00	2.00	2.00	2.00
90 Day bill	2.70	2.20	2.10	2.10	2.10	2.10
2 Year Swap	2.60	2.30	2.20	2.10	2.10	2.10
5 Year Swap	2.90	2.70	2.70	2.60	2.60	2.70
10 Year Bond	3.10	2.90	2.90	3.00	3.10	3.20
NZD/USD	0.64	0.63	0.62	0.63	0.65	0.67
NZD/AUD	0.90	0.90	0.89	0.91	0.92	0.92
NZD/JPY	79.4	79.4	78.1	80.6	83.2	86.4
NZD/EUR	0.60	0.60	0.59	0.60	0.61	0.62
NZD/GBP	0.43	0.43	0.42	0.43	0.43	0.43
TWI	70.0	69.4	68.3	69.9	71.2	72.6

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 17 August 2015

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.00%	3.00%	3.25%
30 Days	3.09%	3.13%	3.13%
60 Days	3.03%	3.11%	3.10%
90 Days	2.94%	3.11%	3.08%
2 Year Swap	2.88%	2.86%	2.85%
5 Year Swap	3.18%	3.23%	3.22%

NZ foreign currency mid-rates as at Monday 17 August 2015

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6539	0.6605	0.6520
NZD/EUR	0.5883	0.6014	0.6019
NZD/GBP	0.4178	0.4223	0.4179
NZD/JPY	81.26	81.85	80.87
NZD/AUD	0.8868	0.9032	0.8840
TWI	70.24	70.41	69.36



International forecasts

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2011	2012	2013	2014	2015f	2016f
Australia						
Real GDP % yr	2.7	3.6	2.1	2.7	2.4	3.0
CPI inflation % annual	3.0	2.2	2.7	1.7	2.2	2.2
Unemployment %	5.2	5.3	5.8	6.2	6.5	6.2
Current Account % GDP	-2.8	-4.4	-3.3	-2.8	-3.7	-4.2
United States						
Real GDP %yr	1.6	2.3	1.5	2.4	2.2	2.8
Consumer Prices %yr	3.1	2.1	1.5	1.6	0.2	2.0
Unemployment Rate %	8.9	8.1	7.4	6.2	5.4	5.1
Current Account %GDP	-2.9	-2.9	-2.2	-2.2	-2.4	-2.4
Japan						
Real GDP %yr	-0.5	1.8	1.6	-0.1	1.0	1.7
Euroland						
Real GDP %yr	1.6	-0.8	-0.3	0.9	1.3	1.1
United Kingdom						
Real GDP %yr	1.6	0.7	1.7	3.0	2.5	2.5
China						
Real GDP %yr	9.3	7.8	7.8	7.4	7.0	6.8
East Asia ex China						
Real GDP %yr	4.4	4.5	4.3	4.1	3.7	4.0
World						
Real GDP %yr	4.2	3.4	3.4	3.4	3.1	3.6
Forecasts finalised 7 Aug 2015						

Interest Rate Forecasts	Latest	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16
Australia						
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.15	2.20	2.20	2.20	2.20	2.20
10 Year Bond	2.78	3.00	3.10	3.25	3.40	3.60
International						
Fed Funds	0.125	0.375	0.625	0.875	1.125	1.375
US 10 Year Bond	2.17	2.60	2.80	3.00	3.20	3.40
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16
AUD/USD	0.7370	0.71	0.70	0.70	0.70	0.71
USD/JPY	124.40	125	127	127	128	129
EUR/USD	1.1150	1.06	1.05	1.05	1.05	1.06
AUD/NZD	1.1280	1.11	1.11	1.13	1.11	1.09

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Satish Ranchhod, 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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