23 November 2015

Weekly Commentary

Church of the Good Shepherd, Lake Tekapo.

In this issue

Fine for now

Data continues to point to the NZ economy ticking along at a respectable pace through the middle part of this year. But recent forward looking indicators of activity are not looking nearly as encouraging, and leave us feeling a little more confident in our call for a December rate cut, which we previously viewed as a close call. Furthermore, inflation pressure remains notably absent. This supports our view that the RBNZ will eventually lower the OCR below 2.5%.

Last week was a pretty quiet one on the domestic data calendar. However, what little news we did receive continued to reinforce the theme we've been highlighting in recent weeks. That is, economic activity remains solid for now, but storm clouds are still brewing on the horizon. Clearly illustrating this theme last week were September quarter retail trade data and the latest GlobalDairyTrade auction.

As expected retail spending growth rebounded in the September quarter, after taking a breather back in June. The volume of goods sold rose 1.6%, leaving sales up 5.7% for the year. The combination of low interest rates and rapidly rising house prices is a favourable one for most consumers and has encouraged them to spend relatively freely. Add to this strong population growth, and retailers are benefitting from solid growth in spending.

But for retailers (and indeed the broader economy) the key question is how much longer can this pace of spending growth be maintained? Our view is probably not much longer. There are three areas which will prove particularly important in this regard.

Firstly – housing market developments. Recent data showed a marked slowing in the housing market in October, led by a dramatic drop in house sales and prices in Auckland. At least part of this move is likely to be unwinding of a particularly frothy

Fine for now continued

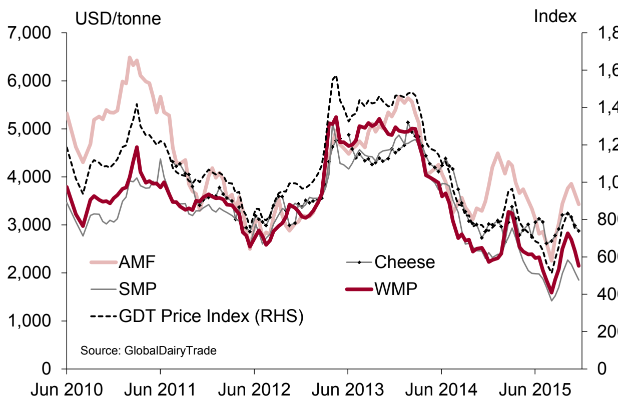
preceding few months as investors hurried to get in ahead of new tax changes and lending restrictions. Although mortgage rates remain very low, the Auckland housing market in particular is likely to stay off the boil over the coming months, dragging nationwide house price growth modestly lower. This in turn will prove a headwind to further growth in retail spending – especially on housing related items such as home furnishings and whiteware.

The second factor that will be important for consumer spending is the strength of net immigration flows. For now, New Zealand remains an attractive option for both New Zealanders returning home and new migrants, while Australia is still not nearly as attractive as it once was for New Zealanders shifting abroad. This situation won't change overnight, but we have already seen signs that jobs in New Zealand are becoming more difficult to find. A weaker labour market here (especially compared to Australia) will eventually reduce New Zealand's attractiveness to migrants and the current record pace of population growth will slow – but not just yet. This week's October net immigration data are likely to show ongoing record net immigration rates.

The third factor which will be critically important for domestic spending going forward is incomes. And in rural New Zealand in particular, the outlook for dairy incomes will be critical for spending decisions. Last week's 7.9% fall in international dairy prices certainly didn't provide any good news in this regard. Instead, this news, combined with an earlier string of disappointing GlobalDairyTrade auctions, has caused us to lower our farm gate milk price forecast for this season to $4.50 (a touch below Fonterra's current forecast of $4.60).

Even this updated milk price forecast remains contingent on some increase in auction prices over the back half of the season. That is something we continue to regard as likely – despite the direction of recent price moves. New Zealand dairy farmers are yet to feel the full brunt of the El Niño weather pattern, but if it does lead to a drought that hits milk production harder than people currently expect, dairy prices should rise, albeit temporarily. Looking further ahead, muted global demand, ample global milk supply and more than sufficient inventories are likely to keep pressure on dairy prices for some

International dairy prices



time yet. We're still only forecasting a modest improvement in next year's farm gate milk price, to $5.20.

Importantly for consumer spending, on our payout forecast for this season many farmers will be facing a second consecutive year where cash flows are below breakeven levels. Unsurprisingly, this is causing a big cost cutting drive. Items commonly on the chopping block include spending on supplementary feed, expenditure on staff and capital investment. These cutbacks will reverberate through dairy support industries and regional economies, especially in parts of the country where dairy dominates such as the Waikato and Southland.

So the upshot is that while the economic environment might be fine for now, some of the storm clouds brewing on the horizon have darkened. Indeed, last week's data leave us feeling a little more confident in our call for a December cut, which we previously viewed as a close call. Yet no matter what happens in December, as we discussed last week, the inflation outlook remains weak. We've recently lowered our December 2015 quarter forecast to -0.2% which leaves us forecasting just 1% inflation for September next year. Consequently, we remain comfortable forecasting further cuts in the OCR.

Fixed vs Floating for mortgages

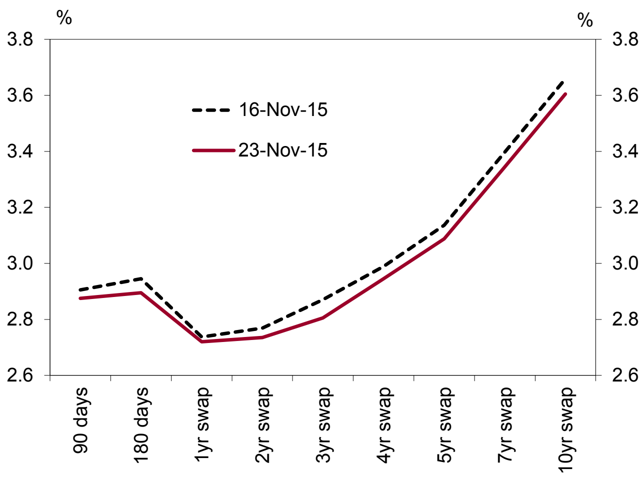
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

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

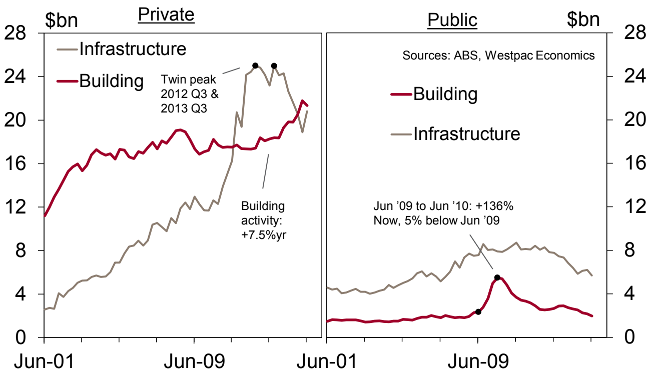


Aus Q3 construction work done

Nov 25, Last: 1.6%, WBC f/c: –2.0%
Mkt f/c: –2.0%, Range: –6.1% to 3.5%

- Construction activity weakened in 2014 and into 2015, notwithstanding a bounce of 1.6% in the June quarter.
- We anticipate a further weakening of construction work in the September quarter, declining by a forecast 2.0%, led lower by mining.
- Private infrastructure activity is forecast to fall by 7.0%. Note, in Q2, the CWD survey reported a surprise 10% rise - however, that was not reflected in the national accounts, which instead reported a fall, down 0.8%.
- Elsewhere, work is likely to strengthen on balance, up around 1.5%, led by the surge in home building and notwithstanding an expected decline in non-residential building work, both public and private.

Construction work: divergent trends

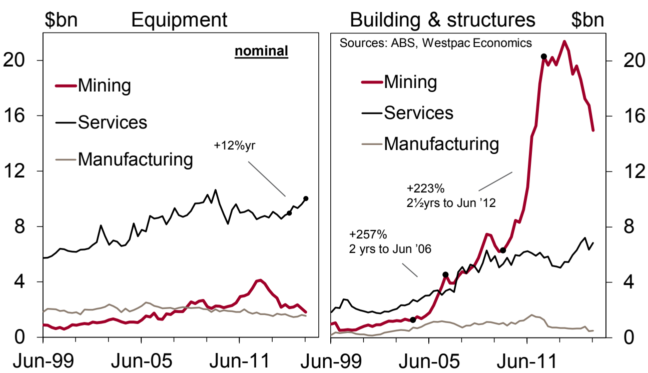


Aus Q3 private business capex

Nov 27, Last: –4.0%, WBC f/c: –4.0%
Mkt f/c: –2.9%, Range: –9.6% to 2.0%

- Private business capex has trended lower from mid-2012, centred on the downturn in mining investment.
- In Q2 2015, capex fell a sizeable –4.0%qtr, –10.5%yr.
- For Q3, more of the same is likely, down a forecast –4%qtr, –14%yr, to be 21% below the peak of mid-2012.
- Building & structures is the source of weakness, with a fall in mining infrastructure likely to be reinforced by a turning down of commercial building. B&S fell 6% a quarter over the first half of 2015 and we expect this rate of decline to continue.
- As for equipment spending, we anticipate a broadly flat Q3, following a mixed year, +5% over 2014H2 but –2% in 2015H1.

CAPEX: by industry by asset

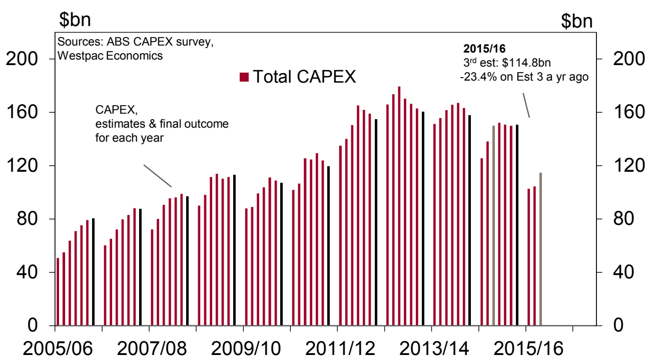


Aus 2015/16 capex expectations, AUDbn

Nov 27, Last: 114.8

- This update will include Estimate 4 of capex plans for 2015/16. Business capex will fall for a third year, led lower by mining. The initial 3 estimates have been particularly weak and the risk is that the fourth estimate is weak as well.
- If Estimate 4 were to print at $116.5bn, that would be 23.4% below the corresponding estimate of a year ago.
- The September survey, conducted during October and early November, occurs as business conditions in the service sectors have strengthened, boosted by a lower dollar, but as concerns around China's growth outlook remain. Private surveys suggest that capex plans for the service sectors are lagging behind the improvement in business conditions.

Total CAPEX: estimates & actuals

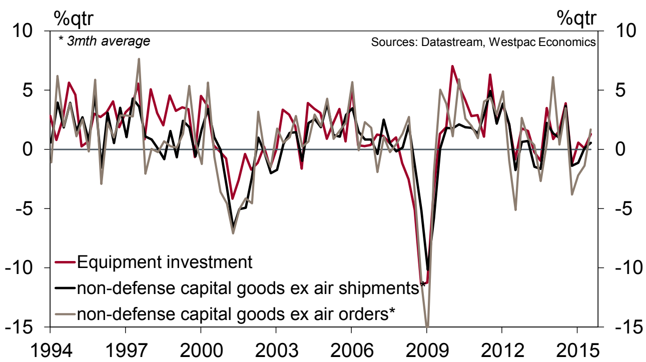


US Oct durable goods orders

Nov 25 Last: –1.2%, WBC f/c: 1.0%

- Durable goods orders have maintained a persistently weak trend over the past year. September was no different, with total orders falling 1.2% and core orders (ex transport and defence) broadly flat (–0.1%) to be down 7.0%yr.
- Business investment in the US has been impacted by the sharp decline in energy prices and the consequent reduction in extraction and exploration. More broadly, the stronger US dollar has reduced US firms' competitiveness, limiting their willingness to expand capacity.
- This poor trend is not expected to turn in October. Stronger activity in the transport sector should provide a boost to total orders (around +1.0%); but core orders will be little changed, with a marginal positive outcome (0.4%) likely.

US durable goods underlying trend weak

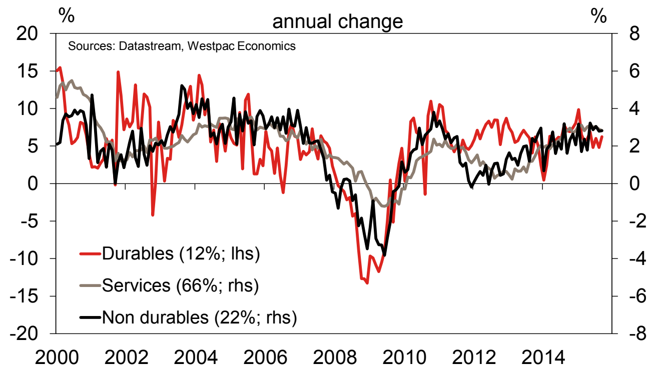


US Oct personal income and spending

Nov 25 personal income, Last: 0.1%, WBC f/c: 0.3%
Nov 25 personal spending, Last: 0.1%, WBC f/c: 0.2%
Nov 25 PCE deflator, Last: –0.1%, WBC f/c: 0.2%

- Despite having seen (at best) modest wage gains for many years and a more limited lift in discretionary spending from the declining oil price than anticipated, consumption continues to provide robust support to aggregate growth.
- Freely available credit has remained a persistent support for durables; and of late, services growth has fimed somewhat. Meanwhile, non-durables momentum is moderating.
- In October, we expect another solid outcome for spending, helped by improved income growth. However, a disappointing October outcome for retail suggests risks are to the downside. On the inflation front, expect momentum to (begin to) firm.

Consumer offseting investment & global uncertainty

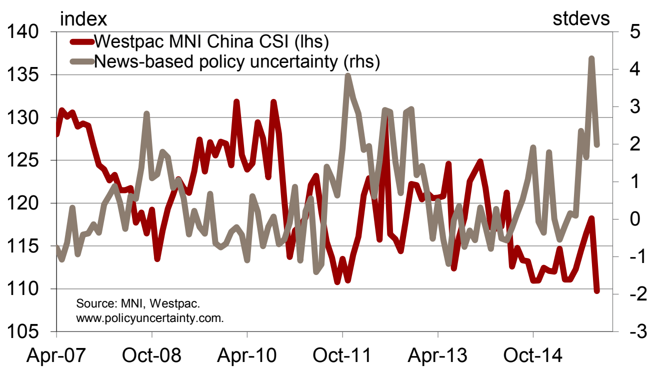


Chn Nov Westpac MNI China Consumer Sentiment

Nov 25, Last: 109.7

- The Westpac MNI China CSI decreased by 8.5pts from 118.2 in September to 109.7 in October. The CSI is now 1.1% lower than a year ago and 8.8% below its long run average. That survey was conducted prior to the most recent interest rate cut, which will have its impact on the forthcoming November survey.
- We interpreted October's steep correction as a somewhat overdue 're–set' for the household sector. All told, the fact that confidence is now 1.1% lower than a year ago feels about right.
- Besides the rate cut, news-based 'uncertainty' has declined from its peak but remains high, the Plenum announced a 2-child policy, and financial markets have been relatively stable (FX reserves rose for the first time since April). However, the general tone of the economic data deteriorated further. Single's Day (Nov 11) comes right at the end of the survey period (10 business days from the beginning of the month).

Chinese consumer: confidence & uncertainty



Data calendar

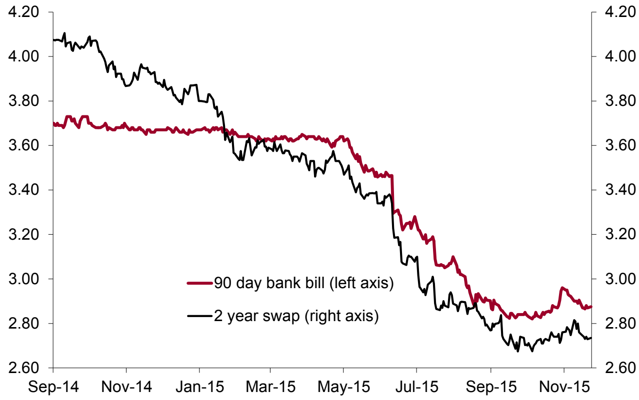
		Last	Market median	Westpac forecast	Risk/Comment
Mon 23					
NZ	Oct net migration	5550	–	5460	NZ population growth now at its highest since 1974.
Eur	Nov Markit manufacturing PMI (provisional)	52.3	52.2	–	External demand a major impediment to momentum.
	Nov Markit services PMI (provisional)	54.1	54.0	–	Composite measure at solid 53.9.
Ger	Nov Markit manufacturing PMI (provisional)	52.1	51.8	–	Not seeing as strong a pulse in manufacturing as hoped.
	Nov Markit services PMI (provisional)	54.5	54.3	–	Domestic conditions remain favourable.
US	Oct Chicago Fed national activity index	–0.37	–	–	Points to moderate activity.
	Nov Markit manufacturing PMI (provisional)	54.1	54.3	–	Continues to point to stronger momentum than ISM.
	Oct existing home sales	4.7%	–2.7%	–2.0%	Sales momentum moderating.
Tue 24					
Aus	RBA Governor Glenn Stevens speaking	–	–	–	Speech to Australian Business Economists (ABE), Sydney 8:00pm
Ger	Nov IFO business climate survey	108.2	108.0	–	Current conditions seen as being particularly robust.
	Q3 GDP, final	0.3%	0.3%	0.3%	Partial detail becomes available.
US	Q3 GDP, second (annualised)	1.5%	2.0%	1.9%	Despite likely upward revision, Q3 still a weak quarter on inventories.
	Sep S&P/C–S 20 city house prices	0.1%	0.6%	–	Continues to suggest circa 5% annual price growth.
	Nov consumer confidence	97.6	99.2	–	Remains robust.
	Nov Richmond Fed manuf index	–1	0	–	Has moderated, external conditions are a drag.
Wed 25					
Aus	Q3 construction work done	1.6%	–2.0%	–2.0%	Downturn to resume, as fall in mining outweighs home building upswing.
	RBA Assist. Governor (Financial Markets)	–	–	–	Guy Debelle, FX Week Europe conference, London 9:20pm AEDT
Chn	Nov Westpac–MNI Consumer Sentiment	109.7	–	–	Drastic re–set in October. Rate cut, 2–child policy relevant for Nov.
US	Oct personal income	0.1%	0.4%	0.3%	Households are starting to experience fimer wages growth.
	Oct personal spending	0.1%	0.3%	0.2%	Services the key determinant; retail activity suprised to downside.
	Oct PCE deflator	–0.1%	0.1%	0.2%	Inflation still modest; but services price pressures building.
	Oct durable orders	–1.2%	1.5%	1.0%	Investment trend remains weak; affected by oil and USD.
	Initial jobless claims	271k	–	–	Claims have remained low for an extended period.
	Sep FHFA house price index	0.3%	0.4%	–	A helpful cross check; albeit one not focused on by markets.
	Nov Markit services PMI (provisional)	54.8	–	–	Signals more modest services momentum than ISM.
	Oct new home sales	–11.5%	6.8%	5.0%	Trend broadly flat.
	Nov Uni of Michigan consumer sentiment	93.1	93.1	–	Remains robust.
Thu 26					
NZ	Oct merchandise trade balance, NZDmn	–1,222	–	–1,300	Previous bounce in dairy prices will boost exports values.
Aus	Q3 private business capex	–4.0%	–4.0%	–4.0%	Building & structures (mining), another large fall. Equipment f/c flat.
	Q3 capex expectations, 2015/16 AUDbn	114.8	–	–	Plans are particularly weak. Est 3 is –23.4% vs Est 3 a yr ago.
Eur	Oct M3 money supply %yr	4.9%	4.8%	–	Credit data also due.
US	Thanksgiving Day	–	–	–	Public holiday. Markets closed.
Fri 27					
Chn	Oct industrial profits %ytd	–0.1%	–	–	Margins have stabilised in aggregate, but revenue growth still slowing.
Eur	Nov economic confidence	105.9	105.9	–	The ECB and its pro–active policy stance is key for confidence.
	Nov consumer confidence	–7.7	–	–	Broad improvement in labour market and credit supportive.
	Nov business climate indicator	0.44	0.44	–	A question over longevity of domestic growth remains.
UK	Nov GFK consumer confidence	2	2	–	Consumer confidence has lingered at elevated levels in recent months.
	Q3 GDP, provisional	0.5%	0.5%	0.5%	Domestic demand is underpinning GDP growth.

New Zealand forecasts

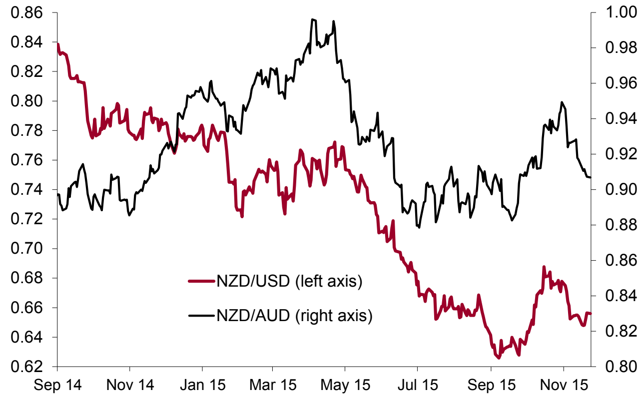
Economic Growth Forecasts	March years				Calendar years			
% change	2014	2015	2016f	2017f	2013	2014	2015f	2016f
GDP (Production) ann avg	2.5	3.2	2.1	2.1	2.3	3.3	2.3	2.0
Employment	3.8	3.2	1.5	2.0	2.9	3.6	2.0	1.5
Unemployment Rate % s.a.	6.0	5.8	6.4	6.2	6.1	5.7	6.1	6.3
CPI	1.5	0.3	1.1	1.5	1.6	0.8	0.3	1.7
Current Account Balance % of GDP	-2.6	-3.4	-4.4	-4.3	-3.2	-3.1	-3.9	-4.5

Financial Forecasts	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Cash	2.50	2.25	2.00	2.00	2.00	2.00
90 Day bill	2.60	2.30	2.10	2.10	2.10	2.10
2 Year Swap	2.60	2.40	2.20	2.20	2.20	2.20
5 Year Swap	3.10	3.10	3.10	3.20	3.20	3.20
10 Year Bond	3.30	3.40	3.50	3.70	3.80	3.80
NZD/USD	0.64	0.63	0.62	0.62	0.62	0.62
NZD/AUD	0.94	0.95	0.94	0.93	0.90	0.89
NZD/JPY	78.1	77.5	76.9	77.5	78.1	76.3
NZD/EUR	0.60	0.61	0.60	0.59	0.58	0.57
NZD/GBP	0.43	0.43	0.42	0.42	0.41	0.40
TWI	70.5	70.4	69.3	69.0	68.1	67.5

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 23 November 2015

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.75%	2.75%	2.75%
30 Days	2.85%	2.89%	2.87%
60 Days	2.84%	2.90%	2.86%
90 Days	2.88%	2.92%	2.87%
2 Year Swap	2.74%	2.81%	2.74%
5 Year Swap	3.09%	3.11%	3.03%

NZ foreign currency mid-rates as at Monday 23 November 2015

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6560	0.6508	0.6789
NZD/EUR	0.6164	0.6064	0.6145
NZD/GBP	0.4319	0.4322	0.4423
NZD/JPY	80.56	80.18	82.16
NZD/AUD	0.9068	0.9262	0.9366
TWI	71.26	71.16	73.05

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	2.2	2.7
CPI inflation % annual	3.0	2.2	2.7	1.7	1.6	2.3
Unemployment %	5.2	5.3	5.8	6.2	6.3	6.0
Current Account % GDP	-2.8	-4.4	-3.4	-3.0	-4.0	-4.0
United States						
Real GDP %yr	1.6	2.2	1.5	2.4	2.4	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	4.9
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	1.3
Euroland						
Real GDP %yr	1.6	-0.8	-0.3	0.9	1.5	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	3.5	4.0
World						
Real GDP %yr	4.2	3.4	3.3	3.4	3.0	3.6
Forecasts finalised 6 Nov 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	2.27	2.20	2.20	2.20	2.20	2.20
10 Year Bond	2.88	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	2.25	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	0.7190	0.68	0.66	0.66	0.67	0.69
USD/JPY	122.90	122	123	124	125	126
EUR/USD	1.0710	1.06	1.04	1.04	1.05	1.07
AUD/NZD	1.0930	1.06	1.05	1.06	1.08	1.11

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