24 August 2015

# Weekly Commentary

Kea. Arthurs Pass National Park.

In this issue



## Bright spots

A sharp bounce in the latest GlobalDairyTrade auction offered a ray of hope for New Zealand's dairy sector, but it is too early to draw any conclusions for this season's milk price payout. In the past week, we also published our latest thoughts on how far residential construction in Auckland can realistically ramp up – we think by about 30%.

The biggest news in what was a very quiet week in New Zealand markets was a sharp bounce in wholesale dairy prices at the latest GlobalDairyTrade auction. Whole milk powder (WMP) prices rose 19.1% to $1,856/MT, even more than futures markets had predicted, and futures markets are expecting another lift at the next auction on 1 September.

We are cautious about reading too much into one auction. For one thing, there's the vexing question of how much Fonterra's auction volume reduction and changes in production composition contributed to the result. And while the bounce was large, it still leaves prices 39% below where they were in March. Our forecast for a $3.70/kg farm gate milk price for the current season assumes a further lift in WMP prices, to well above $2,000/MT by season end. But there's no denying that this was a positive auction result, and we will be watching how the next few auctions play out with great interest.

While New Zealand's dairy industry is sorely in need of further good news, other parts of the economy are looking brighter. On Tuesday we published an in-depth dive into one particularly notable example – Auckland residential construction[1]. Our work concludes that there is sufficient pent-up demand in Auckland for 10,800 new dwellings a year over the next eight years, an increase of 30% on current levels.

As we have noted many times, we have not been building enough new housing in Auckland to meet existing demand. This is shown by an unsustainable increase in

1 See http://www.westpac.co.nz/assets/Business/Economic-Updates/2015/Bulletins-2015/Outlook-for-Auckland-residential-construction-August-2015.pdf

# Bright spots continued

people per dwelling. Since December 2008, the average number of people per dwelling in Auckland has risen strongly, reversing the trend seen in the city and across New Zealand over the previous decade. The rate of change has sharpened since September 2013, as migration has accelerated. A large part of this change is involuntary and is unsustainable over the long term.

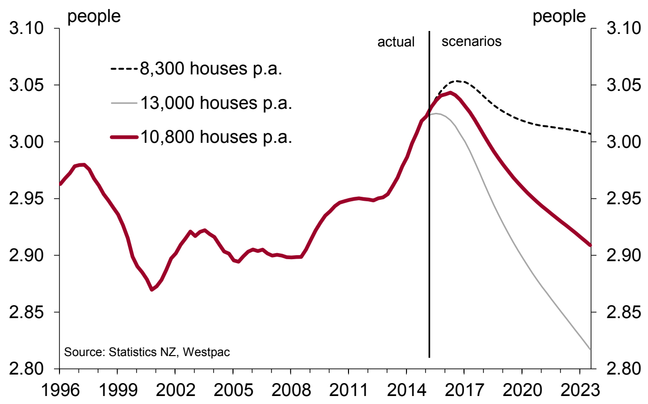
In our view, building 10,800 new dwellings a year to alleviate this shortage is both achievable and sustainable. It would comfortably accommodate expected population growth and bring the average number of people per dwelling down, without causing boom-bust scenarios for the construction industry or running up against feasibility constraints.

We estimate that Auckland's population will grow to 1.77 million by 2023, broadly in line with Statistics New Zealand's median scenario. On that forecast, if we only continue to deliver the current level of around 8,300 new dwellings a year, the number of people per dwelling will do little more than stabilise at current high levels (unless the housing shortage actually drives people away).

More optimistic targets of around 13,000 dwellings a year are recommended by the Auckland Housing Action Plan and the Proposed Auckland Unitary Plan. We believe these levels – which assume significantly higher population growth over the next decade than we think is likely – are both unsustainable and unachievable. On our population forecasts they would eventually lead to a housing over-supply, and potentially a boom-bust scenario for the industry. They are also unachievable in the current regulatory and capacity-constrained environment. The last time Auckland came close to building this many homes was in the wild-west days of the early-2000s, which spawned billions of dollars of leaky buildings.

Our estimate of 10,800 dwellings a year is a happy medium, which would see the number of people per Auckland dwelling shrink gradually over time. However, there are a number of impediments that could make even this rate of building a challenge. Perhaps surprisingly, a shortage of workers is not the main constraint. The additional 7,700 workers needed to ramp production up to 10,800 dwellings a year accounts for just 1.7% of Auckland's current non-working adult population.

*Auckland people per dwelling - three scenarios*




A more worrying obstacle is build quality, which has already come under scrutiny. The proportion of Council building inspections that fail because of sloppy work is high. New workers will need to be adequately trained and supervised. This will have the added benefit of freeing up Council resources to inspect more new dwellings as re-inspections are reduced.

Other major constraints that will require action to achieve 10,800 dwellings a year include the slow pace at which land is brought to market. Land-owners need to be incentivised, via carrot or stick, to bring land to market faster. Councils need to reduce over-regulation of new subdivisions, which dramatically slows delivery of land. Builders, designers and Council need to work together to clarify what details need to be included in building consent applications to speed up the consent process, and need to reduce the number of inspections failed.

With the local data flow remaining light, the main item of interest this week will be a speech by RBNZ Deputy Governor Spencer on Auckland's housing market on Monday afternoon. The RBNZ has now responded to submissions to its proposed lending restrictions for Auckland property investors, with the main change being that the new rules will now become effective on 1 November this year, one month later than initially proposed.

# **Fixed vs Floating** for mortgages

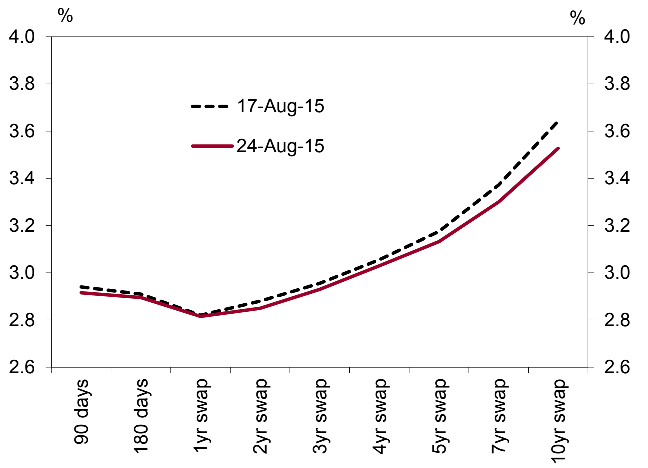
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

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*

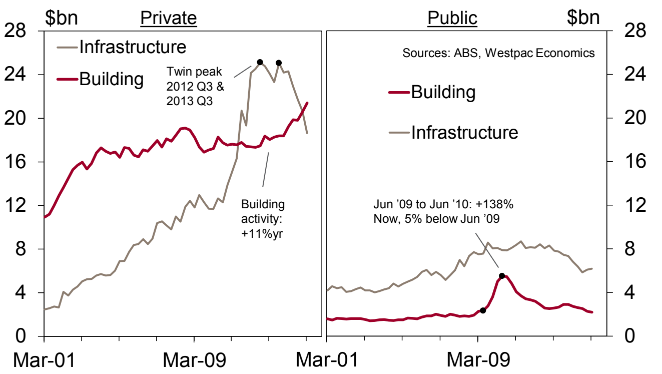


## Aus Q2 construction work done

**Aug 26, Last: –2.4%, WBC f/c: –1.5%**
**Mkt f/c: –1.5%, Range: –4.5% to 3.5%**

- Construction activity weakened in 2014, a trend that extended into 2015. For Q2, construction work is forecast to decline by 1.5%, following a 2.4% fall in Q1, to be 8% below a year ago.
- Private infrastructure is retreating from record highs as mining investment turns down. After a 10% slump in Q1, we're anticipating a more modest 4% fall in Q2. Public works is another area of weakness, down –0.3%qtr, –12.5%yr in Q1, with a further fall likely in Q2.
- Home building is responding to record low and falling interest rates. Total private home building work rose 4.6%qtr, 13.7%yr in Q1 and will make further gains in Q2. Against this, private non-residential building activity may have begun to turn down in Q2 as suggested by a drop in approvals.

*Construction work: divergent trends*

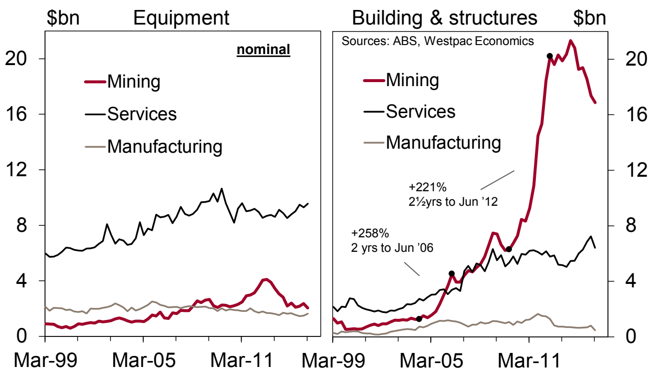



## Aus Q2 private business capex

**Aug 27, Last: –4.4%, WBC f/c: –2.5%**
**Mkt f/c: –2.5%, Range: –15.0% to 1.0%**

- Private business capex has trended lower from mid-2012, centred on the downturn in mining investment.
- In Q1, private business capex fell sharply, down –4.4%qtr, –5.3%yr, as building & structure work slumped. For Q2, we anticipate another sizeable decline in capex, down 2.5%qtr, to be 8% lower than a year ago.
- Building & structures will again be a source of weakness, with a fall in mining infrastructure likely to be reinforced by a turning down of commercial building.
- Equipment spending advanced by 7% in 2014, led higher by the service sectors. However, a soft spot has emerged in 2015, following the economy's loss of momentum in 2014H2. Down 0.5% in Q1, we anticipate a further fall of 0.5% in Q2.

*CAPEX: by industry by asset*

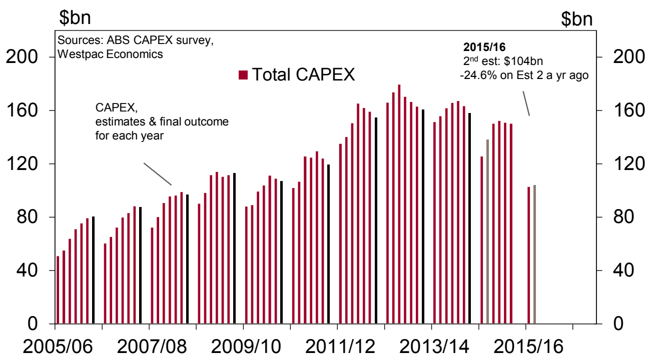



## Aus 2015/16 capex expectations, AUDbn

**Aug 27, Last: 104.0**

- This update will include Estimate 3 of capex plans for 2015/16. Business capex will fall for a third consecutive year, led lower by mining. The uncertainty is the rate of decline.
- Estimate 2 points to the risk of a rapid and widespread downturn, being some 24.6% lower than Est 2 for 2014/15, at $104.0bn. By industry: mining, $52.2bn, –35%; services, $45.6bn, –10.0%; and manufacturing, $6.3bn, –13%. The March survey, conducted during April and in early May, was ahead of the RBA's follow-up rate cut and the Budget's small business package. However, the mixed demand environment and tumbling commodity prices are major negatives.
- In 2014/15, the upgrade between the 2nd and 3rd estimate was 8.6%, in line with the 5 year average. For 2015/16, a 3rd estimate of $113bn, 8.6% up on $104bn, would still be 25% below the corresponding estimate a year ago.

*Total CAPEX: estimates & actuals*

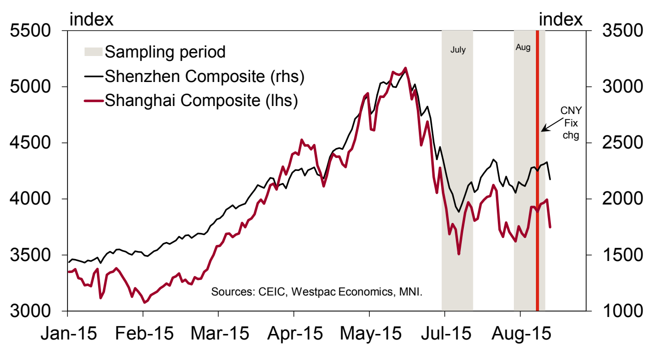



## Chn Aug Westpac MNI China Consumer Sentiment

**Aug 29, Last: 114.5**

- The Westpac MNI China Consumer Sentiment Indicator increased by 2.2pts from 112.3 in June to 114.5 in July, which was 0.3% lower than a year ago. That result confounded expectations that households would take fright from the turmoil in the equity market, which reached a crescendo during the July sampling period.
- The basic tone of the July report was of modest improvement, with broad-based gains seen across family finances, forward looking business conditions and the housing market. The pessimistic outliers were the employment outlook and current business conditions. The latter observation correctly presaged the reversal of the June IP bounce in July.
- The CNY reform move (Aug 11) and the Tianjin explosion (Aug 12) are relevant for the survey sampling period. Also, we note that news-based "policy uncertainty" spiked in July.

*Equities, CNY & the CSI sampling period*



## US July durable goods orders

**Aug 26, Last: 3.4%, WBC f/c: –0.7%**

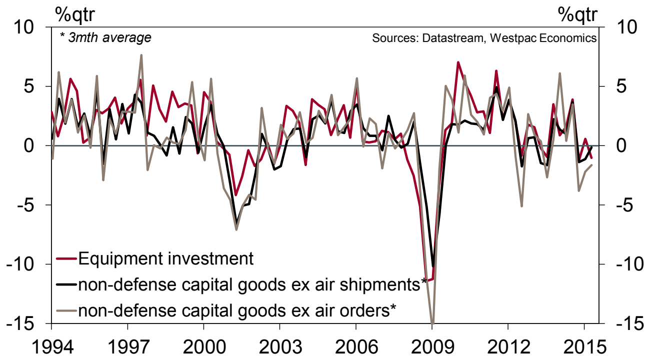
- Durable goods orders jumped in June on the back of strong transport activity. Nonetheless, total orders remained 3.0% lower than a year ago. Excluding transport and defence, the June gain was a sedate 0.7%, leaving core orders down 4.9%.
- The poor underlying trend in core orders (and shipments) points to US firms remaining unwilling to expand capacity. Instead they continue to focus on efficiency. The sharp decline in the price of oil is clearly a factor but so too is the strength of the USD and uncertainty over the outlook for domestic demand (particularly given the interest rate outlook). All of these restraints are likely to persist for the foreseeable future.
- With support from the transport sector minimal, expect another weak headline durables outcome in July, –0.7%.

## US July personal income and spending

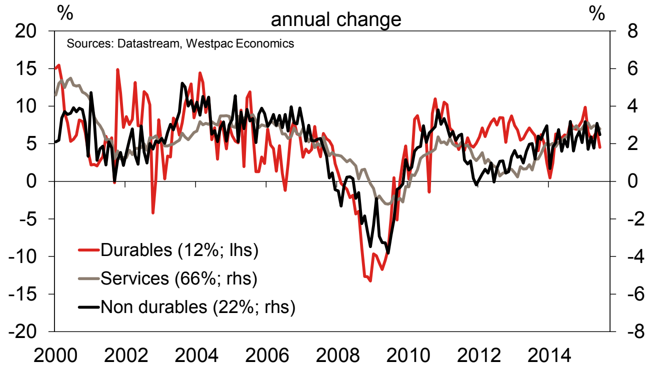
**Aug 28, personal income, Last: 0.4%, WBC f/c: 0.3%**
**Aug 28, personal spending, Last: 0.2%, WBC f/c: 0.4%**
**Aug 28, PCE deflator, Last: 0.2%, WBC f/c: 0.1%**

- Household consumption remains the driving force behind the FOMC's growth outlook. Stronger wage growth; a belated boost from lower oil prices; and greater confidence in the outlook are all expected to stoke demand.
- Yet June was a bit of a disappointment, with real spending unchanged despite ongoing solid growth in real incomes.
- July retail sales data points to a pick-up in momentum last month for durable and non-durable purchases; and services spending growth likely maintained its recent pace. Total spending then likely rose 0.4% in July. As per the CPI, PCE price momentum was likely soft around 0.1%; and income growth arguably remained solid but not spectacular at 0.3%.

*US durable goods underlying trend very weak*




*Consumer to offset investment & global uncertainty*



# Data calendar

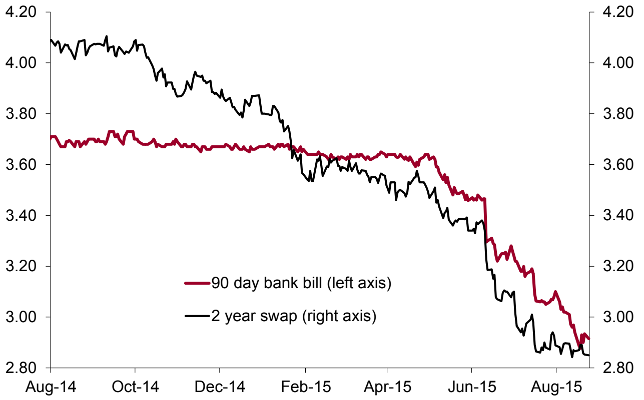
| | | Last | Market median | Westpac forecast | Risk/Comment |
|---|---|---|---|---|---|
| **Mon 24** | | | | | |
| **NZ** | RBNZ Deputy Governor Spencer speaking | – | – | – | On the record speech looking at RBNZ views on the property market. |
| **US** | Jul Chicago Fed activity index | 0.08 | – | – | There was a modest improvement in indicators last month. |
| **Tue 25** | | | | | |
| **NZ** | Q3 RBNZ 2yr inflation expectations | 1.85% | – | – | Inflation expectations have fallen to low levels. |
| **Ger** | Aug IFO business survey | 108.0 | 107.5 | – | Current conditions yet to spark similar strength in expectations. |
| **US** | Fedspeak | – | – | – | Fed's Lockhart speaks to Public Pension funding forum. |
| | Jun FHFA house price index | 0.4% | 0.4% | – | A lesser-watched survey on house prices. |
| | Jun S&P/C-S 20 city house prices | –0.18% | 0.03% | – | Annual growth robust around 5.0%; but last few months soft. |
| | Aug Markit services PMI - provisional | 55.7 | 54.0 | – | Momentum softening; but still points to robust growth. |
| | Aug Markit composite PMI - provisional | 55.7 | – | – | Services activity has been stronger than manufacturing for some time. |
| | Jul new home sales | –6.8% | 6.0% | 5.0% | To bounce back after Jun's decline. |
| | Aug consumer confidence | 90.9 | 93.0 | – | Conference board measure; has softened to near long-run average. |
| | Aug Richmond Fed manufacturing survey | 13.0 | 9.0 | – | Has risen sharply in recent months. |
| **Wed 26** | | | | | |
| **NZ** | Jul trade balance, NZDbn | –60 | –600 | – | Lower dairy X's and higher capital M's have seen the deficit widen. |
| **Aus** | Q2 construction work done | –2.4% | –1.5% | –1.5% | Weakening of mining projects & public works outweigh housing upturn. |
| | RBA Governor Stevens speaking | – | – | – | National Reform Summit, hosted by The Australian and the AFR, Sydney. |
| **Chn** | Aug Westpac MNI Consumer Sentiment | 114.5 | – | – | Shrugged off equity turmoil in July - see box for full preview. |
| **US** | Fedspeak | – | – | – | Dudley answers question at press briefing on local economy. |
| | Jul durable goods orders | 3.4% | –0.4% | –0.7% | Underlying investment trend weak; and likely to stay that way. |
| **Thu 27** | | | | | |
| **Aus** | Q2 private capex | –4.4% | –2.5% | –2.5% | Declining Building & Structures (centred on mining) & Equipment soft. |
| | 2015/16 capex plans, AUDbn | 104 | – | – | Plans point to sharp fall. Est 2, $104bn is –25% on Est 2 for 2014/15. |
| **UK** | Aug Nationwide house prices | 0.4% | – | 0.4% | The housing market has been showing signs of stabilising. |
| **Eur** | Jul M3 money supply yr% | 5.0% | 5.0% | 4.8% | Credit data also due. |
| **US** | Q2 GDP (annualised) - 2nd estimate | 2.3% | 3.2% | 3.0% | Inventories supportive of upward revision; consumption ticks higher. |
| | Initial jobless claims | 277k | – | – | Has picked up in recent weeks, but remains low. |
| | Jul pending home sales | –1.8% | 1.5% | 1.0% | Lead indicator for existing home sales; solid gains continue. |
| **Fri 28** | | | | | |
| **Chn** | Jul industrial profits %yr | –0.3% | – | – | Margins firmed a little in Q2, input costs down faster than output prices. |
| **UK** | Aug UK consumer confidence | 4.0 | 4.0 | 4.0 | Consumer confidence has been trending upwards. |
| | Q2 GDP - 2nd estimate | 0.7% | 0.7% | 0.7% | Preliminary estimate showed a rebound in growth. |
| **Eur** | Aug consumer confidence | 104.0 | 103.5 | 103.5 | Consumers focused on growth story not Greece. |
| | Aug business confidence | 0.4 | – | – | Conditions still quite mixed across continent. |
| **Ger** | Aug CPI - provisional | 0.2% | flat | flat | Inflation pressures absent. |
| **US** | Fedspeak | – | – | – | Jackson Hole conference hosted by the Kansas Fed. |
| | Aug Kansas City Fed manuf' survey | –7.0 | – | – | Has picked up in recent months, but remains low. |
| | Jul personal income | 0.4% | 0.4% | 0.3% | Discretionary incomes continue to grow at solid pace. |
| | Jul personal spending | 0.2% | 0.4% | 0.4% | Retail sales signal positive; services growth to persist. |
| | Jul core PCE deflator | 0.2% | 0.1% | 0.1% | CPI a little softer than expected in Jul; PCE to follow suit. |
| | Aug consumer confidence - final | 92.9 | 93.3 | – | Uni of Michigan measure; above long-run average. |

# New Zealand forecasts

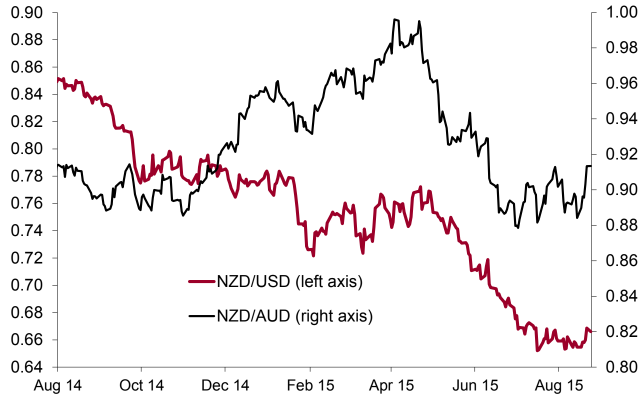
| Economic Growth Forecasts | March years | | | | Calendar years | | | |
|---|---|---|---|---|---|---|---|---|
| % change | 2014 | 2015 | 2016f | 2017f | 2013 | 2014 | 2015f | 2016f |
| GDP (Production) ann avg | 2.5 | 3.2 | 2.1 | 2.0 | 2.2 | 3.3 | 2.2 | 1.8 |
| Employment | 3.8 | 3.2 | 0.5 | 2.1 | 2.9 | 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 24 August 2015*

| Interest Rates | Current | Two weeks ago | One month ago |
|---|---|---|---|
| Cash | 3.00% | 3.00% | 3.00% |
| 30 Days | 3.06% | 3.11% | 3.12% |
| 60 Days | 2.98% | 3.07% | 3.09% |
| 90 Days | 2.92% | 3.02% | 3.06% |
| 2 Year Swap | 2.85% | 2.90% | 2.88% |
| 5 Year Swap | 3.13% | 3.19% | 3.17% |

*NZ foreign currency mid-rates as at Monday 24 August 2015*

| Exchange Rates | Current | Two weeks ago | One month ago |
|---|---|---|---|
| NZD/USD | 0.6660 | 0.6615 | 0.6570 |
| NZD/EUR | 0.5852 | 0.6029 | 0.5980 |
| NZD/GBP | 0.4248 | 0.4269 | 0.4235 |
| NZD/JPY | 81.15 | 82.14 | 81.26 |
| NZD/AUD | 0.9134 | 0.8927 | 0.9036 |
| TWI | 71.83 | 70.36 | 70.15 |

## 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 | 2.14 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 |
| 10 Year Bond | 2.57 | 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 | 2.06 | 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 | 0.7312 | 0.71 | 0.70 | 0.70 | 0.70 | 0.71 |
| USD/JPY | 122.92 | 125 | 127 | 127 | 128 | 129 |
| EUR/USD | 1.1285 | 1.06 | 1.05 | 1.05 | 1.05 | 1.06 |
| AUD/NZD | 1.1045 | 1.11 | 1.11 | 1.13 | 1.11 | 1.09 |

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# Disclaimer continued

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