27 July 2015

Weekly Commentary

Sunrise over Mt. Ruapehu crater.

In this issue

A turn for the worse

Last week the Reserve Bank reduced the OCR a quarter of a percentage point to 3.0%, and firmly signalled some further reduction with the following policy guidance sentence:

"At this point some further easing seems likely."

This was less conditional than June's *"We expect further easing may be appropriate. This will depend on the data."* We take this to mean that the RBNZ will cut the OCR again in September. But beyond that there is no way to be sure what the RBNZ is intending to do.

The reasons given for the Reserve Bank's change of stance were falling global dairy prices and an assessment that the Canterbury rebuild has peaked. On both fronts, we concur. We have discussed both topics in recent weeks, but both are important enough to warrant further emphasis.

Immediately after the last dairy auction we revised our forecast for this season's farmgate milk payment to dairy farmers to $4.30 per kg of milksolids. But over the past week we have observed yet another sharp drop in dairy futures prices, and we have had a chance to thoroughly assess the outlook. It is looking increasingly likely that we will reduce our farmgate milk price forecast below $4.00. Open Country, a smaller dairy processor, has already come out with a forecast of $3.65 to $3.95.

This is terrible news for New Zealand's dairying regions, which are already struggling with the fallout from last season's $4.40 farmgate milk price. It is also bad news for the wider New Zealand economy. The dairy industry has been a driving force for business investment and confidence in recent years –both are likely to drop away over the remainder of this year.

The Reserve Bank has evidently drawn the same conclusion as we did on the Canterbury rebuild.[1] Over the past three years burgeoning construction activity in Canterbury has underwritten economic growth in New Zealand. But the rebuild has peaked nine months earlier than previously anticipated. It will provide no significant

A turn for the worse continued

impetus to economic growth over the year ahead, and will detract from economic growth from late-2016. That is going to make the whole economy feel quite different over the years ahead than it felt between 2012 and 2014.

Clearly, the deteriorating economic outlook is going to make it harder for the Reserve Bank to push inflation up from 0.3% to its 2% target. However, in this week's OCR Review the RBNZ argued that the plunging exchange rate would help do the job instead. The RBNZ said *"Annual CPI inflation is expected to be close to [two percent] in early 2016, due to recent exchange rate depreciation" and as the decline in oil prices drops out of the annual figure."*

This comment removed any sense of urgency from the OCR Review, and took markets by surprise. Markets are now pricing a 25 basis point cut in September, but only approximately a 50% chance of further cuts beyond that point – probably as good as any guess as to the RBNZ's current thinking. Governor Wheeler is giving a speech on Wednesday that will further clarify the RBNZ's current position.

We are surprised the Reserve Bank is so sanguine. Non-tradables inflation is currently weak, and the faltering growth outlook suggests any material pick-up is still a way off. In this environment, getting inflation to two percent will require quite a hefty lift in the price of tradable goods and services, when many of these prices have been falling for years. Our analysis suggests that the exchange rate would have to fall a good deal further to generate inflation of two percent by early-2016. But that won't happen if the RBNZ cuts the OCR by only another quarter percent or so.

Even if the exchange rate does fall much further, it would only generate a transitory burst of inflation. To achieve two percent inflation "on average over the medium term", as required by the RBNZ's Policy Target's Agreement, the RBNZ is going to have to stimulate non-tradables inflation via stronger economic growth. Not an easy task in the midst of a deflating construction boom. We remain very comfortable calling for a low-point in the OCR of 2.0%.

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The immediate question on many minds is what will happen to the housing market? In addition to falling interest rates, we must also consider: the RBNZ plans tighten mortgage lending restrictions in Auckland but loosen them elsewhere; that capital gains on investment property resold within two years will soon be taxed; and that economic confidence is about to take a big knock.

This is a complex set of developments for the housing market to digest. It is very tough to predict exactly what is going to happen, but at present our thinking on the outlook for housing markets around New Zealand is as follows:

Dairying regions such as Waikato and Southland: The dairy downturn will probably outweigh falling interest rates and easier access to mortgage lending, resulting in a housing market slowdown.

Tauranga: The Tauranga housing market was hit especially hard in 2008, and took longer than others to recover. It is currently in "catch-up" mode, and we expect that will continue.

Christchurch: We suspect that house prices will soon start to fall. Housing supply is rising, the waning rebuild may herald a moderation in housing demand, and the dairy downturn will be a further challenge.

Auckland: We expect the housing market to gradually cool over the months ahead. Auckland has been singled out for tighter mortgage lending restrictions, and the tax rule changes may have more of an impact in Auckland than elsewhere. One key driver of Auckland house prices have been expectations that the city's population will intensify, which has driven up the price of land in central districts of the city. As the economy cools ebullient beliefs about the value of Auckland land will be challenged.

Other regions including Wellington: The outlook is a little more positive for these regions. Falling interest rates and looser LVR rules may outweigh declining economic confidence and present some modest upside to the housing market.

1 Our recent article "Peak or Plateau: Update on the Canterbury rebuild" looks at conditions in Canterbury's construction sector. It is available here: http://www.westpac.co.nz/assets/Business/Economic-Updates/2015/Bulletins-2015/Update-on-the-Canterbury-Rebuild-July-2015.pdf

Fixed vs Floating for mortgages

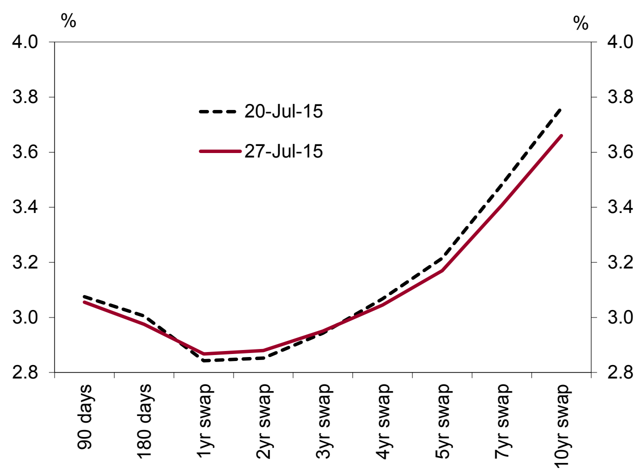
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

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



The week ahead

NZ June building consents

30 July, Building consents – last 0.0%, Westpac f/c: 2.5%

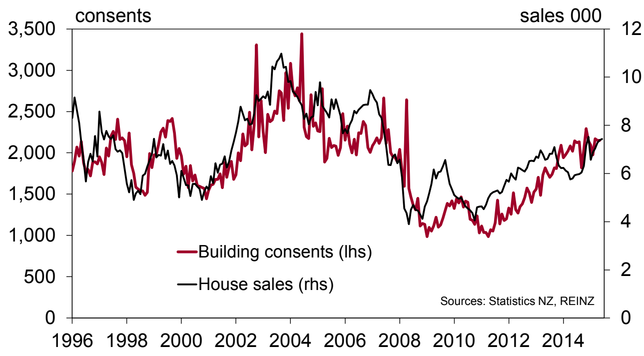
- Nationwide building consent issuance has been levelling off. In part this is due to capacity constraints in the construction sector. However, we are also seeing a switch in the geographic concentration of activity. Issuance has remained firm in Auckland, while activity in Canterbury has been slowing. We expect this trend to continue and become more pronounced over time.
- We expect that residential building consent numbers will increase by 2.5% in June. This pick-up is expected to be supported by an increase in the number of multiple consents (apartments, townhouses, etc).

NZ July ANZ Survey of Business Opinion

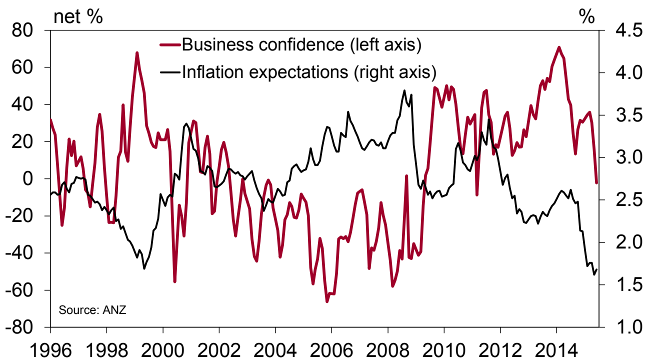
31 July, Business confidence last -2.3%, Activity outlook – last 23.6%

- Business confidence has pulled back in recent months. And since the time of the last survey, we've seen increased volatility in the global economy and sharp declines in dairy prices. In this sort of environment, it wouldn't be surprising to see confidence remaining low, or pushing down further.
- The survey's pricing gauges will be closely watched. Petrol prices have risen and the NZD is down. We'll be looking to see how these factors are affecting businesses' pricing intentions.

NZ housing activity



NZ business confidence and inflation expectations



Aus Jun dwelling approvals

Jul 30 Last: 2.4%, WBC f/c: –1.0% Mkt f/c: –0.9%, Range: –5.0% to 2.6%

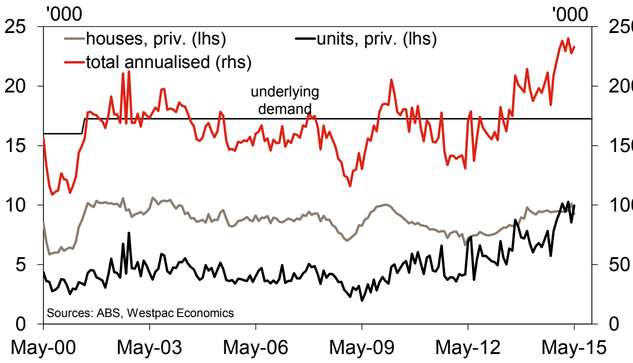
- Dwelling approvals recorded a stronger than expected 2.4% rise in May, led by a big rebound in 'high rise' approvals which hit a new record. Other components were mixed though, with volatility making underlying trends uncertain.
- The June result is a difficult call. On the one hand, the big lift in high-rise approvals in May, softening homebuyer sentiment and flattening construction-related finance approvals suggest June could see a decline consistent with a softening underlying trend. Against this, investor activity remains strong. There also appears to be a pull-forward going on in Vic approvals ahead of the introduction of a new Metropolitan Planning Levy on July 1 (costing 0.13% of the value of developments over $1m within metro council areas, affecting an estimated 6% of annual approvals). That should carry into June, but reverse sharply in July. On balance, we expect approvals to show a 1% dip in June.

Aus Q2 import price index

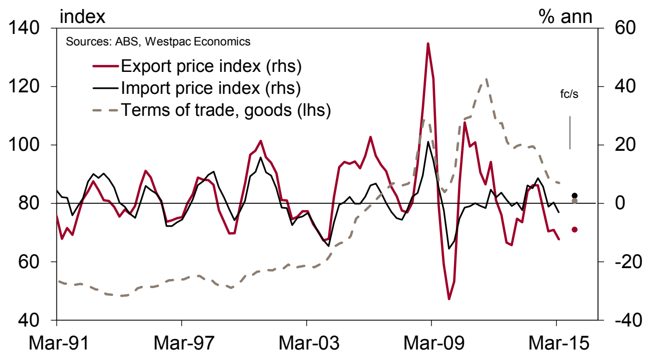
Jul 30, Last: –0.2%, WBC f/c: 2.7%
Mkt f/c: 1.5%, Range: 0.5% to 5.0%

- Import goods prices are expected to rise in the June quarter, led higher by a rebound in energy costs.
- The import price index is forecast to rise by 2.7% in the quarter. That would see the index 2.6% higher than a year ago.
- Oil prices rebounded by around 15% in the quarter, only partially reversing falls of 20% in the December quarter, and 20% in the March quarter.
- The currency was little changed in the June quarter. The Trade Weighed Index averaged 64.3 in Q2, 0.6% below the average for Q1, to be 10% down on the levels of a year ago.

Dwelling approvals



Import & export prices (excluding services)



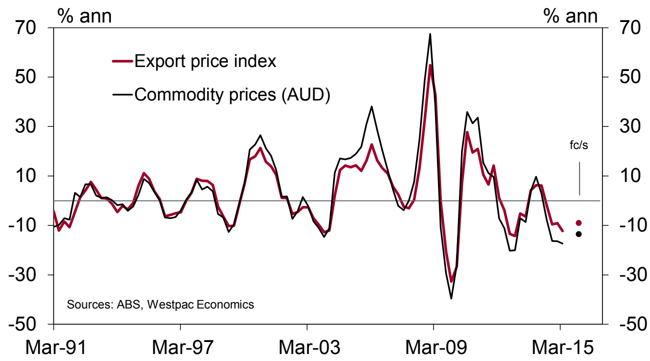
The week ahead

Aus Q2 export price index

Jul 30, Last: –0.8%, WBC f/c: –4.5%
Mkt f/c: –4.0%, Range: –5.5% to 0.0%

- Export prices have come under pressure from weaker global commodity prices, particularly for iron ore.
- The export price index is forecast to slump by 4.5% in the June quarter, to be 9% lower than a year ago.
- In Q2, global commodity prices fell in excess of 5% in US dollar terms. There was little offset from the currency in the June quarter, edging 1% lower against the US dollar, to US78¢.
- The terms of trade for goods, on these estimates, declined by 7% in the quarter, and fell by 11% over the year.
- A word of caution about the reliability of this indicator. For Q1, the export price index printed –0.8%; but in the key balance of payments release, the estimate was much weaker, at –3.5%.

Commodity prices & export price index

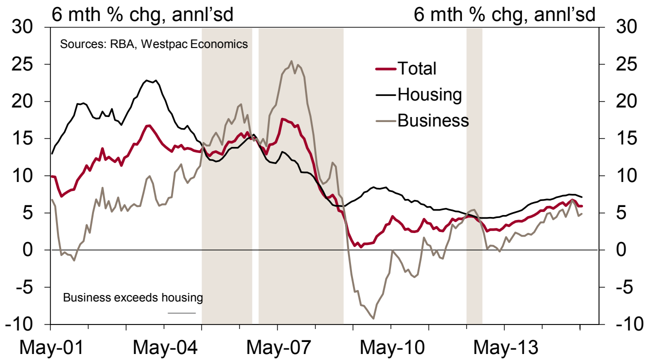


Aus Jun private sector credit

Jul 31, Last: 0.5%, WBC f/c: 0.5%
Mkt f/c: 0.5%, Range: 0.4% to 0.8%

- Credit to the private sector grew by 6.2% in the year to May, accelerating from a 4.7% increase over the previous year as households and businesses responded to lower rates.
- In the month of May, credit expanded by 0.5%, matching the average outcome over the previous year. Housing grew by 0.5%mth, 7.2%yr, and business increased by 0.4%mth, 5.2%yr.
- This followed more modest gains of 0.4% in March and 0.3% in April, constrained by a consolidation in business credit (up only +0.2% in March, then flat in April).
- For June, we expect credit to increase by 0.5%, a repeat of the May outcome. Demand for credit will be supported by falling interest rates, with the RBA easing policy in February and May, having been on hold since August 2013.

Credit momentum

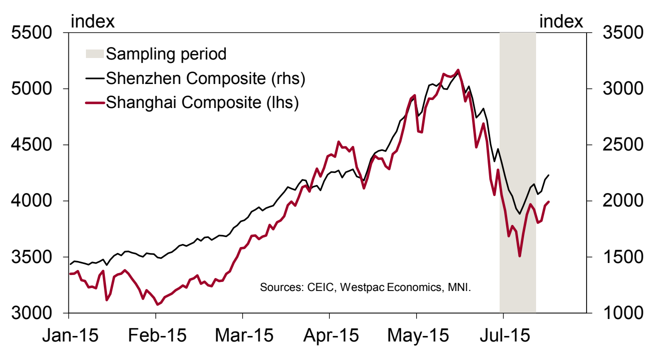


Chn Jul Westpac MNI China Consumer Sentiment

Jul 29, Last: 112.3

- The Westpac MNI China Consumer Sentiment Indicator, hereafter the CSI, increased by 1.2pts to 112.3 in June, which was 0.3% lower than a year ago and 7.7% below the long-run average.
- The most important thing to know about the July survey is that it was in the field whilst the equity market collapse was at its most extreme. This timing transforms this edition of the survey into a brilliant natural experiment testing the importance of the equity market for the collective consumer psyche.
- There are any number of themes to watch against this backdrop. One of the more interesting will be the impact on other asset classes in the "wisest place for savings" question. Will other risk seeking avenues (like housing, which is rallying in the Tier-1 cities) get a lift, or will the equity collapse drive unanimous risk aversion?

The share market & the CSI sampling period

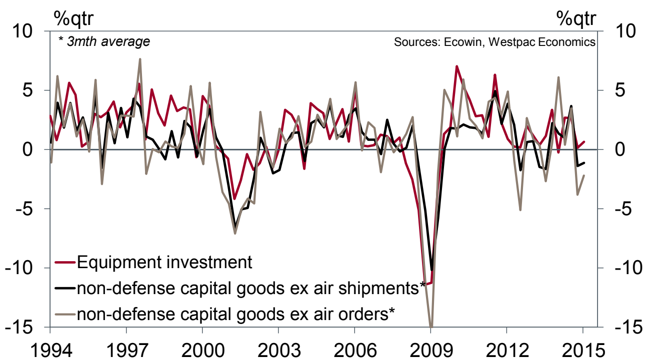


US June durable orders and shipments

Jul 27, Last: –2.2%, WBC f/c: 2.0%

- The underlying trend for business investment in the US lost considerable momentum over the six months to March 2015; available partial data suggest this trend persisted into Q2.
- Total durable goods orders fell 2.2% in May following a 1.7% decline in Apr. Excluding defence and aircraft, the decline over the prior two months was less severe, at –0.7% and –0.4% respectively. However, that still implies a static outlook for equipment investment (at best).
- In June, we anticipate a 2.0% gain for total orders as transport orders bounce back from their Apr/May slump. But the underlying weak trend is unlikely to turn, given the impact of the strengthening US dollar and weak oil price. Expect a broadly flat core outcome in June.

US durable goods underlying trend very weak

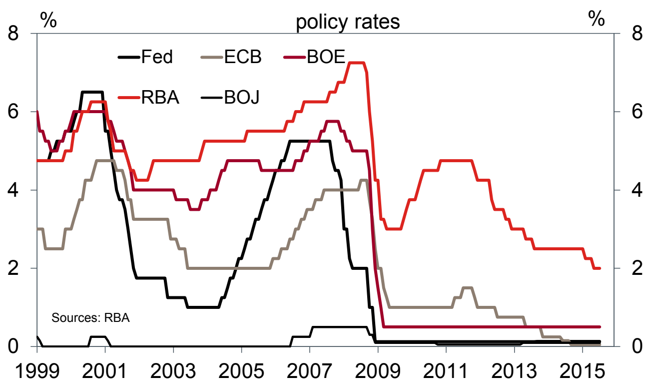


US July FOMC policy meeting

Jul 28–29, Last: 0.00–0.25%, WBC f/c: 0.00–0.25%

- Recent communications from the FOMC have maintained an optimistic hue despite obvious anxieties over the global backdrop – the decline in the Chinese equity market and uncertainty over Greece's position in the Euro Area.
- Key to the outlook for policy in the US is the health of the consumer. While consumption has not been as strong as the FOMC had hoped in 2015, persistent job growth; signs of stronger wages; and elevated confidence are all constructive for the outlook. US equities and house prices are also supportive.
- Being the last meeting before an anticipated September commencement to the rate normalisation process, expect the FOMC to maintain a data-dependent but positive perspective on the outlook, signalling a readiness to act in the near term.

Developed world policy interest rates

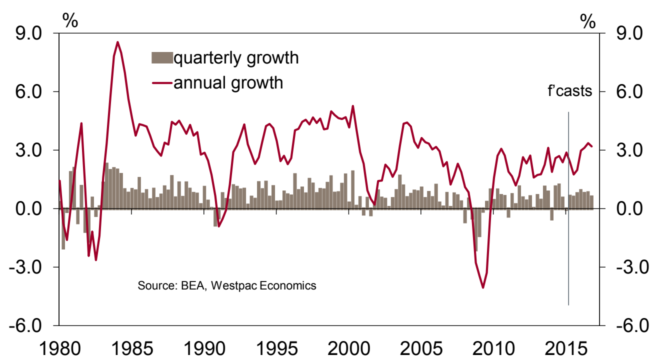


US Q2 GDP

Jul 30, Last: –0.2%, WBC f/c: 2.6%

- US GDP data has been particularly volatile estimate to estimate over the past year. In Q1, while the first GDP estimate printed at +0.2% annualised, it was subsequently revised to –0.7% in the second estimate, and then to –0.2% in the third.
- It was initially hoped that Q2 would see a strong bounce back in growth to make up for Q1. However, based on the partial data to hand, this seems unlikely. At 2.6%, our forecast is best characterised as solid, but not strong; it leaves six-month annualised growth at just 1.2%.
- The Q2 detail is likely to single out the consumer as the key driver of growth. Business investment; government spending; and net exports will provide little-to-no support in the quarter. Inventories are likely to be a (small) drag.

US GDP: improvement depends on consumer



Data calendar

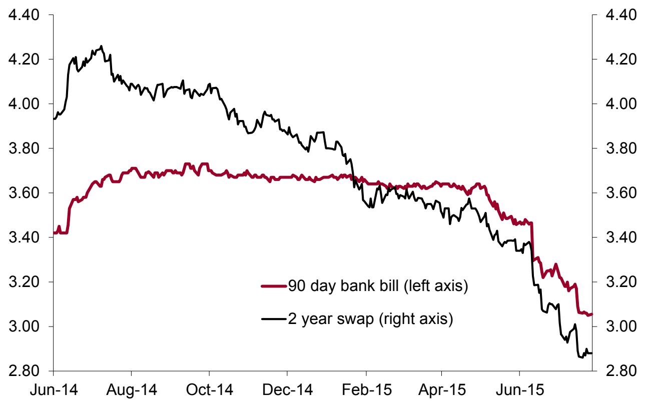
		Last	Market median	Westpac forecast	Risk/Comment
Mon 27					
Chn	Jun industrial profits %yr	0.6%	–	–	Nominal activity firmed in Q2, profit cycle turning ex a few weak links.
Eur	Jun M3 money supply	5.0%	–	–	Monetary financial institutions credit data also due.
Ger	Jul IFO business climate	107.4	107.5	–	Jun a disappointment, with index at four-month low.
US	Jun durable good orders	–2.2%	2.5%	2.0%	Due to bounce on transport; core orders and shipments to remain weak.
	Jul Dallas Fed manufacturing index	–7.0	–4.0	–	An improvement likely; but activity to remain soft.
Tue 28					
UK	Q2 GDP	0.4%	0.7%	–	First estimate for Q2; in Q1, annual growth stood at 2.9%yr.
	Jul house prices	–0.2%	0.5%	–	Nationwide measure, momentum has clearly slowed; tentative date.
US	May house prices	0.3%	0.2%	–	S&P/CS measure; prices up 4.9% over past year – a solid pace.
	Jul US composite PMI	54.6	–	–	Preliminary reading; services index at robust 54.8 in Jun.
	Jul consumer confidence	101.4	100.0	–	Conference Board measure of sentiment; Jun gain broad based.
Wed 29					
NZ	RBNZ Governor Wheeler	–	–	–	On the record speech from the RBNZ Governor.
Chn	Jul Westpac MNI Consumer Sentiment	112.3	–	–	A referendum on the importance of equities to Chinese households.
Ger	Aug GfK consumer confidence	10.1	10.1	–	Income expectations firm, but Greece likely key factor for headline print.
UK	Jun net lending sec. on dwellings, £bn	2.1	2.0	–	Consumer credit detail also released, up £1.0bn in May.
US	Jun pending home sales	0.9%	1.1%	–	Existing home sales beat in June; pending point to further gains.
	FOMC meeting	0–0.25%	0–0.25%	0–0.25%	September still the most likely month for first hike.
Thu 30					
NZ	Jun building consents	0.0%	–	2.5%	Activity is shifting from Canterbury to Auckland.
Aus	RBA Governor Stevens speaking	–	–	–	Asia Financial Cooperation Conference, Sydney 11.00am AEST, topic TBA.
	Jun dwelling approvals	2.4%	–0.9%	–1.0%	June difficult to call. July likely to see fall on reversal in Vic.
	Q2 import price index	–0.2%	1.5%	2.7%	Up on a partial rebound in oil prices. AUD, on TWI basis, –0.6%.
	Q2 export price index	–0.8%	–4.0%	–4.5%	Export prices weakened as global commodity prices slumped.
Eur	Jul economic confidence	103.5	103.5	–	Ticked lower in Jun; interesting to see scale of Greece effect.
	Jul consumer confidence	–7.1	–	–	Flash read reported deterioration in Jul, but better than in prior years.
Ger	Jul CPI, %yr	–0.2%	0.3%	–	Flash estimate; impact of oil to continue receeding.
US	Q2 GDP	–0.2%	2.5%	2.6%	Activity to bounce, but not as robustly as hoped.
	Initial jobless claims	255k	–	–	Pace of firing remains historically weak.
Fri 31					
NZ	Jul ANZ business confidence	–2.3%	–	–	Confidence has fallen, expected to remain low.
Aus	Q2 PPI	0.5%	–	0.6%	Up 1.3%yr, we should be seeing more pass through from weaker AUD.
	Jun private sector credit	0.5%	0.5%	0.5%	In May, 0.5%, 6.2%yr - June likely to be similar, supported by lower rates.
Eur	Jun unemployment rate	11.1%	–	–	Divergence between France and Germany a growing concern.
	Jul CPI, %yr	0.2%	0.2%	0.4%	Flash estimate; annual core inflation at 0.8%yr in Jun.
UK	Jul GfK consumer confidence	7	5	–	Confidence reached a 15-year high in Jun; can it be sustained?
US	Q2 employment cost index	0.7%	0.6%	0.6%	ECI to maintain solid growth; no real implications for inflation.
	Jul MNI Chicago PMI	49.4	50.8	–	Stronger than most regional measures, but still soft overall.
	Jul consumer confidence	93.3	94.0	–	Uni of Mich Jul final; flash a little lower than Jun's 5-month high.
Sat 1					
Chn	Jul manufacturing PMI	50.2	–	–	Stability in headline & activity last month, lurch lower in prices.
	Jul non-manufacturing PMI	53.8	–	–	New business up in June among broad lift in activity, but prices lower.

New Zealand forecasts

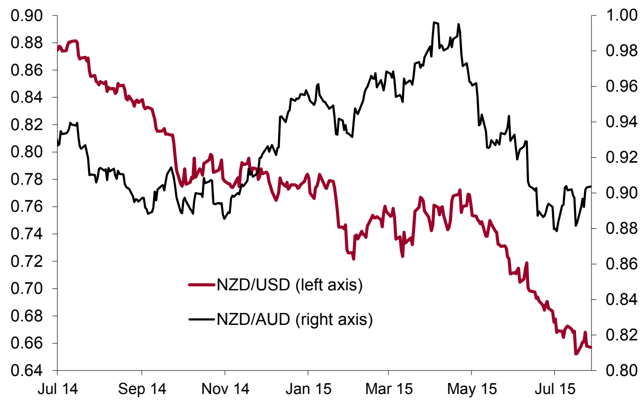
Economic Growth Forecasts	March years				Calendar years			
% change	2014	2015	2016f	2017f	2013	2014	2015f	2016f
GDP (Production) ann avg	2.5	3.2	2.4	3.3	2.2	3.3	2.4	3.1
Employment	3.8	3.2	3.0	2.3	2.9	3.6	2.8	3.0
Unemployment Rate % s.a.	6.0	5.8	4.9	4.4	6.1	5.8	5.2	4.3
CPI	1.5	0.1	1.7	1.9	1.6	0.8	0.8	2.2
Current Account Balance % of GDP	-2.6	-3.6	-4.6	-4.3	-3.3	-3.3	-4.2	-4.4

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	2.65	2.30	2.10	2.10	2.10	2.10
2 Year Swap	2.70	2.30	2.20	2.30	2.40	2.50
5 Year Swap	3.10	2.80	2.90	3.10	3.30	3.40
10 Year Bond	3.30	3.20	3.30	3.50	3.70	3.90
NZD/USD	0.63	0.62	0.62	0.63	0.64	0.65
NZD/AUD	0.86	0.86	0.86	0.88	0.88	0.88
NZD/JPY	76.2	76.3	76.3	78.1	80.0	81.9
NZD/EUR	0.58	0.58	0.58	0.59	0.59	0.60
NZD/GBP	0.42	0.42	0.41	0.42	0.41	0.41
TWI	67.9	67.4	67.3	68.5	69.1	69.8

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 27 July 2015

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.00%	3.25%	3.25%
30 Days	3.12%	3.22%	3.34%
60 Days	3.09%	3.19%	3.31%
90 Days	3.06%	3.17%	3.26%
2 Year Swap	2.88%	2.98%	3.05%
5 Year Swap	3.17%	3.32%	3.40%

NZ foreign currency mid-rates as at Monday 27 July 2015

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6570	0.6713	0.6838
NZD/EUR	0.5980	0.6047	0.6210
NZD/GBP	0.4235	0.4327	0.4358
NZD/JPY	81.26	82.11	83.88
NZD/AUD	0.9036	0.9044	0.8958
TWI	70.15	70.80	71.71

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	2.5	2.5
Unemployment %	5.2	5.3	5.8	6.2	6.5	6.3
Current Account % GDP	-2.8	-4.4	-3.3	-2.8	-3.4	-3.4
United States						
Real GDP %yr	1.6	2.3	2.2	2.4	2.0	3.2
Consumer Prices %yr	3.1	2.1	1.5	1.6	0.1	2.0
Unemployment Rate %	8.9	8.1	7.4	6.2	5.3	5.0
Current Account %GDP	-2.9	-2.9	-2.2	-2.2	-2.3	-2.3
Japan						
Real GDP %yr	-0.5	1.8	1.6	-0.1	1.3	1.8
Euroland						
Real GDP %yr	1.6	-0.8	-0.4	0.8	1.4	1.2
United Kingdom						
Real GDP %yr	1.6	0.7	1.7	2.6	2.5	2.7
China						
Real GDP %yr	9.3	7.8	7.8	7.4	7.0	7.0
East Asia ex China						
Real GDP %yr	4.4	4.5	4.3	4.1	4.2	5.0
World						
Real GDP %yr	4.2	3.4	3.4	3.4	3.2	4.0
Forecasts finalised 10 July 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	2.97	3.00	3.10	3.25	3.40	3.55
International						
Fed Funds	0.125	0.375	0.625	0.875	1.125	1.375
US 10 Year Bond	2.36	2.60	2.80	3.00	3.20	3.30
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	0.7410	0.73	0.72	0.72	0.72	0.73
USD/JPY	124.10	121	123	123	124	125
EUR/USD	1.0880	1.08	1.07	1.07	1.07	1.08
AUD/NZD	1.1366	1.16	1.16	1.16	1.14	1.14

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Disclaimer continued

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