2 February 2016

Weekly Commentary

Elephant Rocks. Near Duntroon,North Otago.

In this issue

Big Wednesday

Regular readers will know that since July last year, Westpac has been forecasting that the OCR would drop to 2.0% during 2016. To our mind, recent developments have pushed the case for cuts this year beyond reasonable doubt – the only remaining uncertainty is timing.

There have been four key developments in favour of OCR cuts. (1) Recent low inflation data, combined with low global oil prices, implies that inflation may drop below zero this year, and will not rise above 1% until 2017. (2) The recent turmoil in global financial markets has raised the possibility that prices for New Zealand's key export products could fall. Indeed, Fonterra has revised down its forecast of farmgate milk price to $4.15 per kg, from $4.60. (3) Recent data has shown that the previously-errant Auckland housing market has slowed sharply. And (4) the New Zealand dollar has remained higher than either the Reserve Bank or we would have expected.

The only compelling mark against OCR cuts is recent signs of strength in the New Zealand economy. A plethora of recent data, including last week's Services PMI, have shown that the local economy has plenty of zing at the moment. This is partly due to accelerating construction activity. And if last week's building consent numbers are anything to go by, there is plenty more to come in that front. Nationwide residential dwelling consent issuance has risen 10.2% over the past three months, which is incredibly strong when one considers that the residential part of the Canterbury rebuild is now flat. Commercial buildings are also being consented at a higher rate, up 16% over the past year. Furthermore, the Government's announcement that it will bring forward planned infrastructure spending will further boost the construction sector.

The key to the OCR outlook is weighing positives against negatives in ambiguous situations like this. Our analysis suggests that, relative to the Reserve Bank's December forecasts, the extra strength of the New Zealand economy is worth about a 25 basis point OCR hike. But the weaker housing market, lower inflation outlook, and higher exchange rate are together worth about 75 basis points of OCR reductions. In other words, we think that the Reserve Bank's forecasters will now be saying that the OCR needs to fall 50 basis points to 2.0% in order to meet the inflation target (compared to their previous assessment that 2.5% was sufficient).

Little wonder then, that the Reserve Bank last week altered its forward guidance on monetary policy. Last week's OCR Review marked a shift to an easing bias with the following key sentences:

"Some further policy easing may be required over the coming year to ensure that future average inflation settles near the middle of the target range. We will continue to watch closely the emerging flow of economic data."

With the Reserve Bank itself affirming the case for OCR cuts, the only remaining question to our minds is timing.

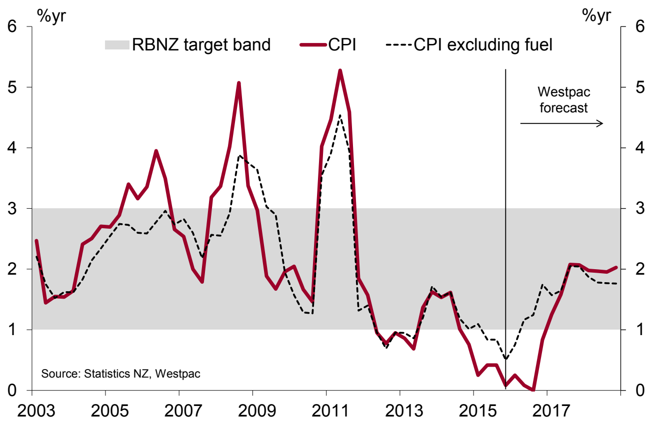
The RBNZ's forthright adoption of an easing bias, combined with our assessment that the case for cuts is now beyond doubt, has prompted us to alter slightly our thinking on timing. We have always considered either March or June this year the most likely start dates for renewed OCR reductions. We now regard March as the slightly more likely of the two dates (previously June).

However, our preference for March is only slight. The March OCR decision is currently knife-edged, and will depend crucially on data over coming weeks. "Big Wednesday" this week will deliver three crucial pieces of information.

First, we will receive the results of another GlobalDairyTrade auction. Futures markets are suggesting that the result will be another fall in milk prices.

Next we will get Statistics New Zealand's download on the state of the labour market in December 2015. We expect employment to rebound in December after a hard fall in September. The down/up pattern reflects a combination of survey volatility and a genuine change in the economy. However other aspects of the labour market report will be more downbeat. We are expecting unemployment to tick up from 6.0% to 6.1%, and annual wage growth to shift down from 1.7% to a paltry 1.5%.

CPI inflation forecasts



And last, on Big Wednesday the RBNZ Governor will deliver his annual speech to the Canterbury Employers' Chamber of Commerce, titled 'The Global Economy, New Zealand's Economic Outlook, and the Policy Targets Agreement'. Judging by the title, we can expect a good rundown on the RBNZ's latest thinking about monetary policy, and a fuller articulation of the thinking behind the January OCR Review. We can also expect the RBNZ to explain why the current low level of inflation does not constitute a breach of its inflation target – a recurrent theme in RBNZ communications of late.

If Big Wednesday isn't enough, on Thursday the RBNZ's Assistant Governor and Chief Economist will deliver a speech titled *"Forward guidance – enhancing monetary policy in New Zealand",* although this sounds less like it will be focussed on the OCR outlook.

The final date we have marked with an asterisk is February 16th, when the RBNZ's survey of inflation expectations is released. The biggest question facing the RBNZ at present is whether or not inflation expectations fall now that inflation is expected to remain close to zero for so long. We note that a market-based measure of inflation expectations has already fallen 0.2 percentage points since December. If surveys corroborate that, the RBNZ will be concerned.

Fixed vs Floating for mortgages

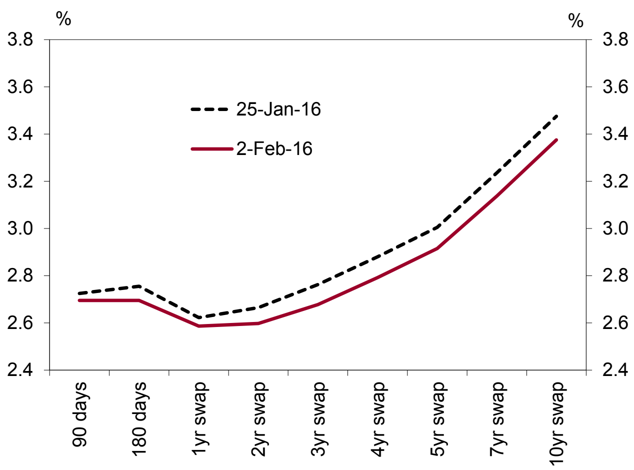
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

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

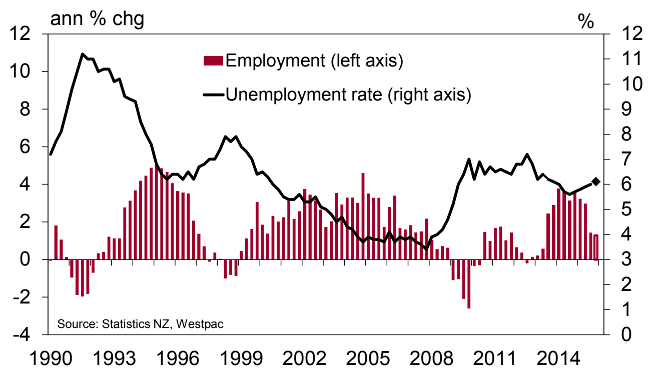


NZ Q4 Household Labour Force Survey

Feb 3, Employment, last: -0.4%, WBC f/c: +0.9%, Mkt f/c: +0.8%
Unemployment, last: 6%, WBC: 6.1%, Mkt f/c: 6.1%

- Employment growth is expected to rebound in the December quarter after a surprisingly soft outturn in September. We're expecting 0.9% growth in the quarter. Yet despite this strong quarterly gain, annual employment growth is expected to be just 1.3% - the slowest pace since mid-2013.
- We're also forecasting a lift in the participation rate in December, after a surprisingly sharp fall in the previous quarter. This, combined with ongoing strong population growth (on the back of a big lift in net immigration) is likely to mean that growth in the labour force continues to outpace employment growth.
- Consequently, the unemployment rate is expected to continue to grind higher in the December quarter. We're forecasting the unemployment rate to rise to 6.1%. This would be the fifth consecutive quarterly increase in the unemployment rate.

Household Labour Force Survey

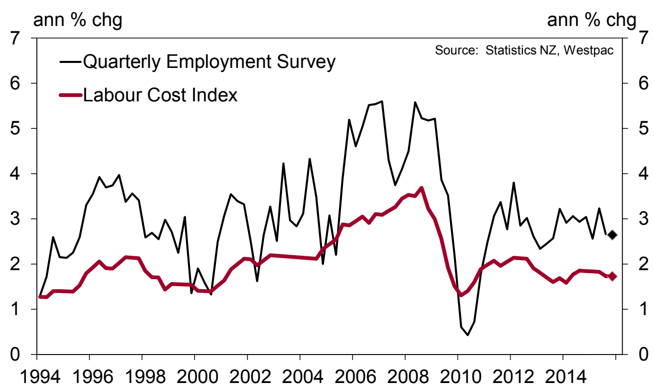


NZ Q3 labour Cost Index

Feb 3, Private sector (incl. overtime), last: 0.4%, WBC f/c: 0.5%, Mkt f/c: 0.5%

- A rising unemployment rate and subdued inflation backdrop is likely to translate into ongoing subdued growth in wages. We're forecasting a 0.5% lift in the private sector LCI, which would leave annual wage inflation at 1.7% on this measure.
- Subdued wage growth (and a rising unemployment rate) is an important signal of the degree of spare capacity in the domestic economy. In this regard, the RBNZ will be on high alert for any unanticipated signs of weakness which could call into question how quickly inflation will return to its 1-3% target band.

LCI and QES wages

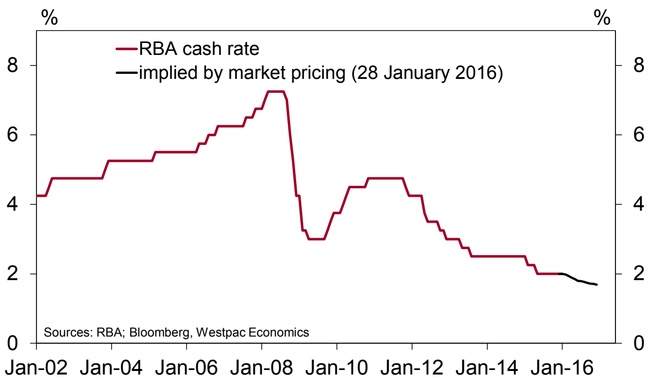


Aus RBA policy decision

Feb 2, Last: 2.00%, WBC f/c: 2.00%
Mkt f/c: 2.00%, Range: 1.75% to 2.00%

- The Reserve Bank, having last lowered rates in May, is widely expected to remain on hold for the eighth consecutive meeting.
- While economic conditions are uneven and overall growth a little disappointing, it has been jobs friendly activity. Housing and the service sectors have performed well, supported by lower rates and a lower dollar. Employment reportedly grew by 2.6% in 2015, accelerating from 1.5% in 2014, and unemployment declined to 5.8% from 6.2% a year earlier.
- The RBA is forecasting GDP growth to strengthen to an above trend 3.0% in 2016. Having said that, risks remain and the RBA has the scope to lower rates if need be. Ongoing global fragilities represent a key risk, particularly as global commodity prices tumble, denting Australia's national income.

RBA cash rate & market pricing

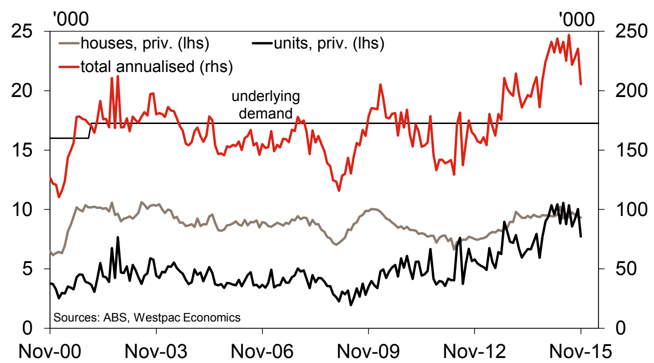


Aus Dec dwelling approvals

Feb 3 Last: –12.7%, WBC f/c: 3.5%
Mkt f/c: 4.0%, Range: 0.1% to 10.0%

- Dwelling approvals fell sharply in Nov, the 12.7%mth drop driven by a big pull-back in high rise units (we estimate down over a third in seasonally adjusted terms). 'Low-mid rise' unit approvals also recorded a sizeable fall (we estimate down 9.4%) but detached house approvals were more stable, down just 0.5%. The broad picture is of a boom that has passed its peak. The rate of decline remains uncertain though with big falls mainly confined to high rise approvals to date, a lumpy segment that often has volatile month to month readings.
- We expect Dec to retrace some of Nov's fall but the 3.5% forecast bounce will still leave a clear slowdown in place.

Dwelling approvals

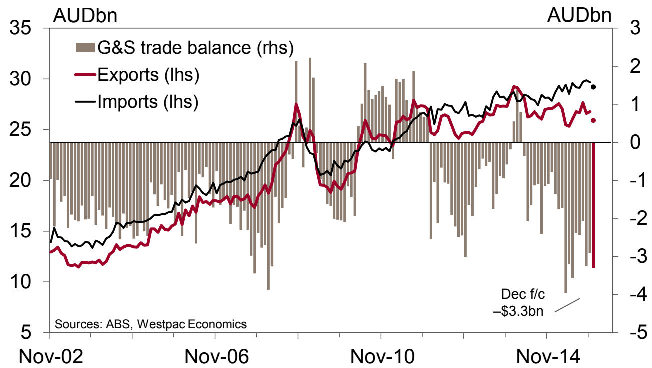


Aus Dec trade balance, AUDbn

Feb 3, Last: –2.9, WBC f/c: –3.3 Mkt f/c: –2.5, Range: –3.7 to –1.8

- Australia is running sizeable trade deficits as sharply lower commodity prices hit export earnings, offsetting a lift in export shipments.
- For December, we anticipate a deficit of $3.3bn, a $0.4bn deterioration on November.
- Imports are expected to decline by 1.6% (down almost $0.5bn), with the ABS advising that goods fell by 2.0%. Note that the currency strengthened in December, up 1.6% on a TWI basis, placing downward pressure on import and export values.
- Export earnings are forecast to fall by 3.2%, almost $0.9bn lower, with iron ore a key source of weakness on falling prices and fewer shipments, as well as a partial pull-back in "other" rural after a jump of 36% (+$580mn).

Australia's trade position

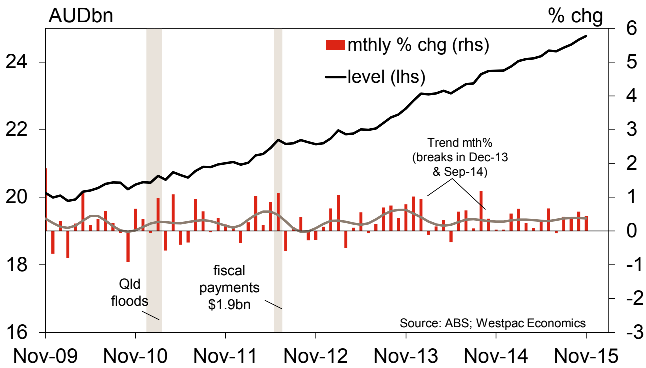


Aus Dec retail sales

Feb 5, Last: 0.4%, WBC f/c: 0.4% Mkt f/c: 0.4%, Range: 0.2% to 0.6%

- Retail sales posted a 0.4% rise in Nov with the detail a little better, including a solid gain of 0.5% in non-food retail which has seen annual sales growth tick up to 4.9%.
- Consumer sentiment posted a reasonably solid finish to 2015, with consumers' job loss fears still easing notably and signs that Christmas spending plans were more upbeat than previous years. That said, the tone from private sector business surveys softened in Dec for consumer-related sectors, albeit from a high starting point that was never really matched by retail sales. The monthly pattern may reflect some impact from mortgage rate increases in previous months although the cash flow effect of these would have been offset by lower fuel prices (note that retail excludes spending on fuel). On balance we expect retail sales momentum to continue at the solid but unspectacular pace with a 0.4% gain.

Monthly retail sales

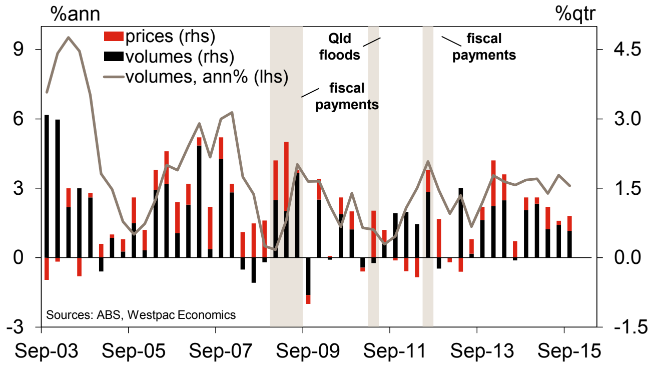


Aus Q4 real retail sales

Feb 5, Last: 0.6%, WBC f/c: 0.9% Mkt f/c: 0.9%, Range: 0.5% to 1.2%

- Real retail sales rose 0.6% in Q3, following a 0.7% rise in Q2 and a 0.6% rise in Q1 – annual growth holding at 3.1%yr.
- The picture for Q4 is somewhat better. Nominal sales have lifted and are on track for a 1.4% gain vs 0.9% in Q3. Some of this reflects slight firmer prices: the detail from the Q4 CPI points to a 0.5% rise in retail prices in Q4 vs 0.3% in Q3 with the lower AUD generating a slightly bigger pulse in key tradables categories. That points to a 0.9%qtr gain in real retail sales, which would see annual growth slip slightly to 2.8%yr. There is some risk around the price-volume split for the quarter with the CPI detail showing a surprisingly strong 7.4% jump in tobacco prices. These spikes are typically dampened in the retail survey as spending switches in response to relative prices – we have assumed that will be the case in Q4 but a fuller pass-through could easily shave a couple of bps off the quarterly move.

Quarterly retail volumes and prices

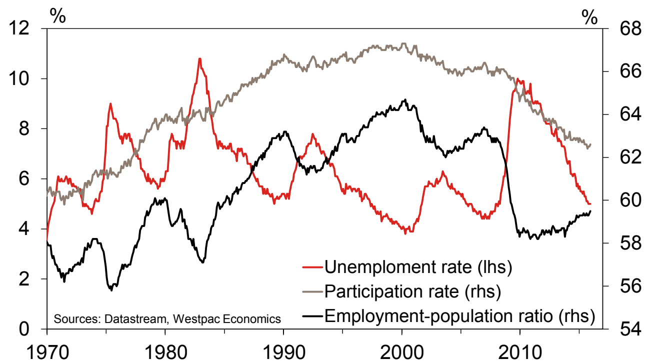


US January nonfarm payrolls and unemployment

Feb 5, Last: 292k , WBC f/c: 190k Feb 5, Last: 5.0%, WBC f/c: 5.0%

- After a brief patch of soft growth in Aug/Sep, nonfarm payrolls bounced back in Q4, averaging a monthly gain of 284k.
- Through Q4, strengthening household survey employment and a stable participation rate sustained the unemployment rate at 5.0%, broadly in line with its full employment level. A near-term dip below 5.0% now seems highly likely.
- January will again see robust employment growth, albeit at a more modest pace than in Q4. Initial jobless claims have lifted, and the business surveys' employment indicators have lost momentum in recent months. The weather is also against the January result. Overall, we forecast a 190k gain for payrolls.
- Note that revisions to back history will be more significant in January, with the annual nonfarm payroll benchmarking due.

Employment g'th sees unemp rate trend down



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Tue 2					
NZ	Jan commodity prices	–1.8%	–	–	Broad based softness to drag headline lower.
Aus	RBA policy decision	2.00%	2.00%	2.00%	RBA on hold since May, jobs strength a plus, but global fragilities persist
Eur	Dec unemployment	10.5%	10.5%	–	Remains near historic highs despite employment gains.
US	ISM New York	62.0	–	–	Remains at firm levels.
	Fedspeak	–	–	–	George speaks on the economy in Kansas.
Wed 3					
NZ	GlobalDairyTrade auction results	–1.4%	–	–	Prices likely to remain weak.
	Q4 unemployment rate	6.0%	6.1%	6.1%	Solid employment growth more than offset by higher participation.
	Q4 employment	–0.4%	0.8%	0.9%	Rebound in employment growth after surprisingly weak Q3.
	Q4 LCI wage inflation (pvte, ordinary time)	0.4%	0.5%	0.5%	Rising unemployment and low inflation headwinds to wage growth.
	RBNZ Governor Graeme Wheeler	–	–	–	Speaking on NZ's economic outlook and the Policy Targets Agreement.
Aus	Dec dwelling approvals	–12.7%	4.0%	3.5%	High-rise driven pull-back Nov. Underlying slowdown somewhat gentler.
	Dec trade balance, AUDbn	–2.9	–2.5	–3.3	Exports f/c -3.2% on lower prices & volumes, while imports f/c -1.6%.
	Jan AiG PSI	46.3	–	–	Dec -1.9pts, services sector index 3rd consecutive mth of contraction.
Chn	Jan Caixin services PMI	50.2	–	–	Services will remain key for aggregate growth in 2016.
Eur	Jan Markit services PMI (final)	53.6	53.6	–	In Jan, slipped to 53.6 from 54.2 in Dec, but up from 51.6 at end 2014.
UK	Jan Markit services PMI	55.5	55.3	–	Domestic demand conditions have been firm.
US	Jan ADP employment change, '000	257	195	190	A softer month likely as payback for above-expectations Dec print.
	Jan Markit services PMI (final)	53.7	–	–	Unlike for manufacturing, Markit services measure...
	Jan ISM non-manufacturing	55.3	55.3	–	... continues to undershoot ISM non-manufacturing.
Thu 4					
NZ	RBNZ Assist. Governor John McDermott	–	–	–	Speaking in Sydney on Forward Guidance in NZ and monetary policy.
Aus	Q4 NAB business survey	–	–	–	Dec monthly reported conditions -3pts to +7, confidence -2pts +3.
UK	Bank of England bank rate decision	0.50%	0.50%	0.50%	Low inflation is keeping the BOE on the side lines.
US	Initial jobless claims	278k	–	–	Has picked up, but is still low. Risk of volatility due to poor weather.
	Dec factory orders	–0.2%	–1.3%	–	Durables slumped in Dec, –5.1%; investment trend very weak.
Fri 5					
Aus	Dec retail trade	0.4%	0.4%	0.4%	Christmas sales look to have been a mixed bag.
	Q4 real retail trade	0.6%	0.9%	0.9%	Decent improvement in volumes price growth also firmer.
	RBA Statement on Monetary Policy	–	–	–	Quarterly update of growth and inflation forecasts.
UK	Jan Halifax house prices	1.7%	0.3%	–	Tentative date. Low interest rates are supporting demand.
US	Dec trade balance, US$bn	–43.4%	–42.7	–	Stronger USD weighing; as is soft external demand.
	Jan non-farm payrolls, '000	292	200	190	Annual benchmark revisions due for payrolls.
	Jan unemployment	5.0%	5.0%	5.0%	Almost but not quite for break of 5.0% level.
	Dec consumer credit, US$bn	14.0	15.5	–	Still all about auto and student loans.
Can	Jan Ivey PMI	49.9	–	–	Commodity price weakness has been a drag.
Sun 7					
Chn	Jan foreign reserves $bn	3330	–	–	Have been depleted by recent FX intervention.

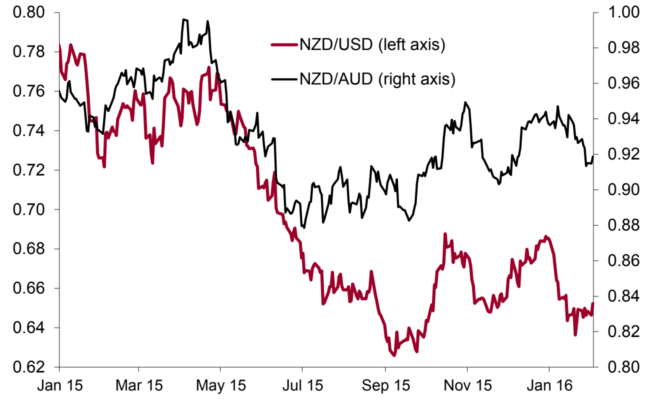
New Zealand forecasts

Economic Growth Forecasts	March years				Calendar years			
% change	2014	2015	2016f	2017f	2014	2015e	2016f	2017f
GDP (Production) ann avg	2.7	3.6	2.2	2.2	3.7	2.4	2.0	2.9
Employment	3.8	3.2	1.1	2.4	3.6	1.2	2.1	2.1
Unemployment Rate % s.a.	6.0	5.8	6.4	6.3	5.7	6.3	6.4	6.1
CPI	1.5	0.3	0.3	1.3	0.8	0.1	0.8	2.1
Current Account Balance % of GDP	-2.5	-3.4	-3.3	-2.7	-3.1	-3.3	-2.9	-3.0

Financial Forecasts	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Cash	2.25	2.00	2.00	2.00	2.00	2.00
90 Day bill	2.30	2.10	2.10	2.10	2.10	2.10
2 Year Swap	2.40	2.20	2.20	2.20	2.20	2.20
5 Year Swap	2.90	3.00	3.10	3.20	3.20	3.20
10 Year Bond	3.10	3.30	3.50	3.70	3.70	3.70
NZD/USD	0.62	0.61	0.61	0.61	0.62	0.62
NZD/AUD	0.91	0.92	0.92	0.91	0.90	0.89
NZD/JPY	75.9	75.3	75.9	76.5	75.9	75.9
NZD/EUR	0.58	0.59	0.59	0.58	0.57	0.57
NZD/GBP	0.42	0.43	0.43	0.42	0.41	0.40
TWI	68.2	68.4	68.4	68.0	67.7	67.1

2 Year Swap and 90 Day Bank Bills

NZD/USD and NZD/AUD



NZ interest rates as at market open on Tuesday 2 February 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.50%	2.50%
30 Days	2.59%	2.60%	2.64%
60 Days	2.65%	2.67%	2.70%
90 Days	2.70%	2.74%	2.77%
2 Year Swap	2.60%	2.71%	2.80%
5 Year Swap	2.92%	3.05%	3.18%

NZ foreign currency mid-rates as at Tuesday 2 February 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6523	0.6422	0.6739
NZD/EUR	0.5988	0.5873	0.6201
NZD/GBP	0.4518	0.4505	0.4518
NZD/JPY	78.98	74.98	81.65
NZD/AUD	0.9187	0.9397	0.9390
TWI	71.69	71.39	73.59

International forecasts

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015f	2016f	2017f
Australia						
Real GDP % yr	3.5	2.0	2.6	2.3	2.8	2.8
CPI inflation % annual	2.2	2.7	1.7	1.7	2.2	2.2
Unemployment %	5.3	5.8	6.2	6.0	6.1	6.1
Current Account % GDP	-4.4	-3.4	-3.0	-4.3	-5.5	-5.5
United States						
Real GDP %yr	2.2	1.5	2.4	2.5	2.8	2.0
Consumer Prices %yr	2.1	1.5	1.6	0.1	1.7	1.7
Unemployment Rate %	8.1	7.4	6.2	5.3	4.8	4.8
Current Account %GDP	-2.9	-2.3	-2.2	-2.3	-2.3	-2.3
Japan						
Real GDP %yr	1.7	1.6	-0.1	0.6	1.4	1.8
Euroland						
Real GDP %yr	-0.8	-0.3	0.9	1.4	1.1	1.3
United Kingdom						
Real GDP %yr	0.7	1.7	3.0	2.5	2.5	2.0
China						
Real GDP %yr	7.7	7.7	7.3	7.0	6.6	6.4
East Asia ex China						
Real GDP %yr	4.6	4.2	4.1	3.6	3.8	4.6
World						
Real GDP %yr	3.4	3.3	3.4	3.1	3.5	3.7
Forecasts finalised 8 Dec 2015						

Interest Rate Forecasts	Latest	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
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	2.66	3.00	3.00	3.10	3.30	3.55
International						
Fed Funds	0.375	0.625	0.875	1.125	1.375	1.625
US 10 Year Bond	1.98	2.50	2.70	2.90	3.00	3.25
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
AUD/USD	0.7100	0.68	0.66	0.66	0.67	0.69
USD/JPY	118.97	122	123	124	125	122
EUR/USD	1.0925	1.07	1.04	1.04	1.05	1.08
AUD/NZD	1.0950	1.10	1.08	1.08	1.10	1.11

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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