

Weekly Commentary

7 June 2016



A finely balanced call

The Reserve Bank's upcoming interest rate decision, due for release on the morning of Thursday 9 June, is looking like a very finely balanced one. We've changed our call on what the RBNZ will do, and now expect that the Official Cash Rate will remain on hold in June. We continue to expect that the RBNZ will cut the OCR one more time this year. However, we've pushed the expected timing of the next (and likely last) rate cut for the year out to August.

In March, the RBNZ's policy statement signalled that they expected to cut the OCR to 2.00% in response to the subdued inflation outlook. And, as the RBNZ has shown a preference for changing rates when they also release their *Monetary Policy Statements* (allowing them greater scope to explain their thinking), it seemed most likely that this would occur in June. Reinforcing this expectation has been the NZ dollar, which has lingered at levels higher than the RBNZ had been anticipating, and has added to the downside for imported inflation.

But a range of developments in recent weeks have boosted the outlook for inflation. Consequently, even though the RBNZ may still need to reduce the OCR, the urgency to do so has diminished.

So what's changed? First of all, the global environment is looking less worrying. Challenges persist in many economies, but the fear and loathing that was prevalent when the RBNZ released its previous interest rate outlook has dissipated. The subsequent calming in financial markets has seen bank funding costs easing back, resulting in lower fixed mortgage rates.

The stabilisation in the global environment has also been supportive of commodity prices. This includes the prices for some of our key exports. Notably, prices in the GlobalDairyTrade auction have risen by 11% since March (though they remain below the break-even level for many

farmers). In addition, global oil prices have risen by 23% since the time of the March *MPS*. That's a big change from the start of this year, when oil price falls pulled inflation down to its lowest level in over 15 years. While oil prices are still well down on the levels we saw a few years ago, their recent lift means that the RBNZ is looking at a higher near-term inflation outlook than previously expected.

The Government's latest Budget announced upgraded plans for infrastructure spending, which will add to inflation in the construction sector (already the key source of upside inflation pressure) in coming years.

In addition, the Budget also announced large increases in the tobacco excise tax will continue for the next four years. The RBNZ looks through the direct price impact. However, the size and enduring nature of these tax increases will help to boost inflation expectations, which have fallen too far for the RBNZ's comfort.

The RBNZ will also be highly cognisant of the strength of the housing market. As the recent data from Realestate.co.nz and QVNZ highlight, the housing market remains hot. House prices in many parts of the country are rising at a rapid pace, and the inventory of homes available for sale is very limited. As we've been highlighting for some time, this is not just an Auckland story, with solid gains seen in the upper North Island, Wellington, and parts of the South Island.

A finely balanced call continued

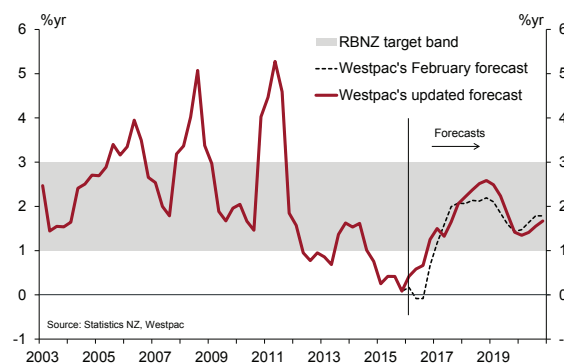
The RBNZ has already been factoring in a strong housing market. However, the related surge in household credit growth is likely to cause the RBNZ to pause for thought. The borrow-and-spend dynamic that has accompanied the strength in the housing market has buoyed household spending, signalling that monetary policy has gained traction. This dynamic also raises longer-term concerns for financial stability.

Finally, construction activity has continued to power ahead, with a large 5.3% gain in building work put in place in the March quarter. This was much stronger than we anticipated, and poses some upside risk to our 0.7% forecast for March quarter GDP growth. This data has likely come too late to be factored into the RBNZ's forecasts but, at the margin, it reinforces the case for an on-hold decision.

These inflation positive developments mean that, despite the strength of the exchange rate, the RBNZ is unlikely to feel the sense of urgency about OCR reductions that was prevalent earlier in the year. Nevertheless, we do expect that the RBNZ will eventually conclude that an OCR reduction to 2.00% is necessary. Hence, we consider market pricing for an OCR reduction by August – currently 50% – is undercooked.

We should emphasise that this week's decision is a close one. Our expectation of a pause in June also reflects some consideration of tactics on the part of the RBNZ. With signs that the inflation outlook is firming, pausing now allows the RBNZ to retain its options as it confirms whether a further cut is required. In contrast, if they cut, the RBNZ would

CPI inflation forecasts



likely be stuck with a 2.00% cash rate for some time given their aversion to rapid changes in direction. Changes in the RBNZ's publication schedule also mean that both the June and August interest rate decisions will be accompanied by *Monetary Policy Statements*, allowing the RBNZ to fully explain their thinking on either date.

The RBNZ will be wary of a potential overreaction by financial markets that could send the NZ dollar even higher. Consequently, we expect they will tread very carefully in their communications. Whether they cut or hold, they will likely downplay the idea that we are at the end of the easing cycle. They are likely to signal that future OCR decisions remain conditional on future developments

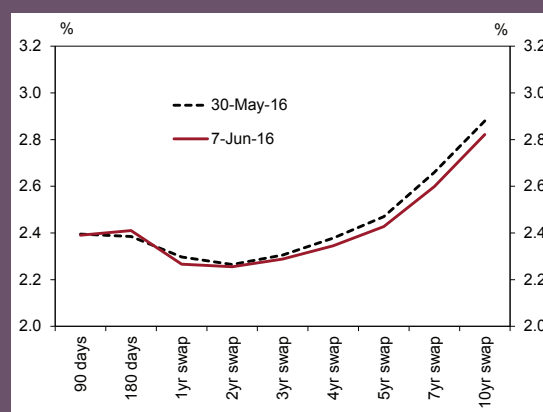
Fixed vs Floating for mortgages

Fixed rates have fallen a long way recently, and are becoming a more attractive option for borrowers.

For borrowers with a deposit of 20% or more, the best value probably lies in the two-year rate or shorter terms. Four- and five-year rates seem high relative to where we think shorter-term rates are going to go over the next four or five years. That said, fixing for a longer term does offer the borrower greater stability.

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



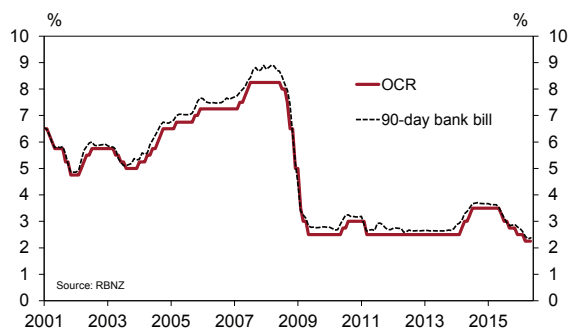
The week ahead

RBNZ Monetary Policy Statement

June 9, last: 2.25%, Westpac: 2.25%, Market: 2.00%

- Until recently it seemed likely that the RBNZ would cut the OCR at the June MPS. However, recent developments have diminished the urgency for OCR cuts.
- Inflation forecasts have risen, the Government's Budget was stimulatory, global dairy prices have risen, calmer global credit markets may reduce funding costs for NZ banks, and rapidly rising house prices have sparked an unexpected surge in household credit growth. These developments trump the exchange rate, which is higher than the RBNZ expected.
- We expect the RBNZ will pause in June. However, we ultimately expect that a cut to 2.0% will prove necessary. We now expect that cut to occur in August.

NZ OCR and 90-day rate



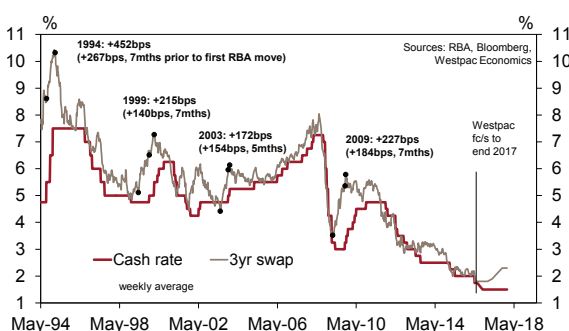
RBA June meeting

Jun 7, Last: 1.75%, WBC f/c: 1.75%

Mkt f/c: 1.75%, Range: 1.50% to 1.75%

- Next Tuesday's RBA meeting is unusual. Typically each quarterly meeting precedes the release of the latest GDP report by a day. In this instance however, the Bank will have had a chance to assess the report's detail.
- While the Q1 GDP headline outcome came in well above expectations, aggregate growth was almost entirely due to a strong contribution from net exports. The impact of contracting mining investment remained clear, with domestic demand flat.
- Importantly, the National Accounts corroborated the weak inflation pulse reported by the Q1 CPI. This set the stage for the Q2 CPI (in July) and the subsequent August RBA meeting when we anticipate a follow-up cut to May will be delivered. In the interim, the RBA will remain on hold.

RBA on hold till August

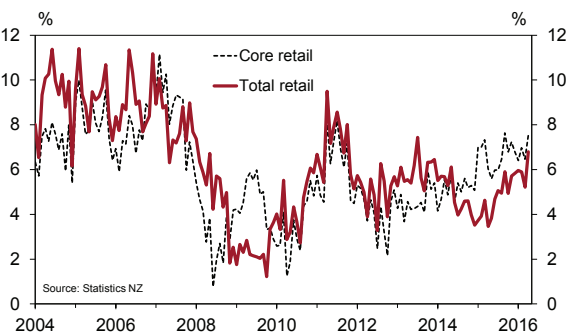


NZ May retail card spending

June 10, last: +0.9%, Westpac: 0.2%, Market: 0.5%

- April saw a solid 0.9% gain in spending on electronic cards. Strength in spending was widespread, with particularly strong gains in spending on services and online retailing. Core spending, which excludes the volatile vehicle and fuel categories, was up 0.4%.
- After April's strong gains, we expect some moderation in May. Increases in petrol prices will be a drag on spending in other areas. In addition, there's likely to be some reversal of the oversized gains in a number of areas that occurred last month. Together this leaves us expecting a 0.1% decline in total spending in May, with a modest 0.2% gain in the core categories. This still leaves us with solid growth in spending over the year.

Card transactions, annual % change



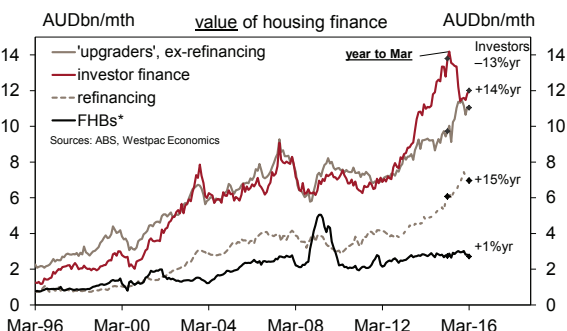
Aus Apr housing finance (no.)

Jun 8, Last: -0.9%, WBC f/c: 2.0%

Mkt f/c: 2.5%, Range: -2.0% to 4.0%

- Housing finance approvals dipped 0.9% in Mar but were still up 3.8%yr. Note that the headline measure is for owner occupier loans only and so does not capture the sharp slowdown in investor activity that drove the broader market slowdown in the second half of last year (if anything, tighter lending criteria for investors indirectly boosted owner occupier activity).
- The Apr update will be of particular interest given the mixed messages from timelier market measures – auction clearance rates have been firmer in 2016, but some monthly price measures have shown a surprisingly strong pick up. Industry data points to a modest gain in finance approvals – we expect the official figures to show a 2% rise. That suggests conditions are still subdued. Additional detail on the value of investor loans will also clearly be of interest.

Value of finance approvals by segment



Data calendar

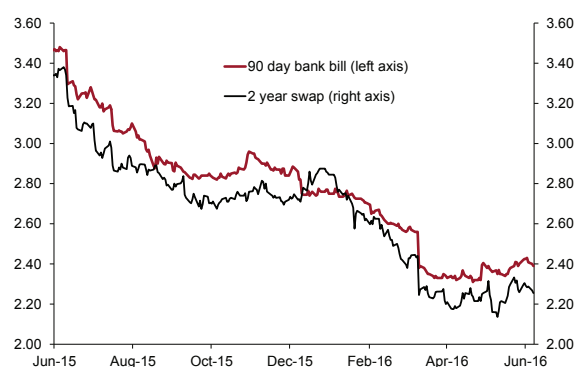
		Last	Market median	Westpac forecast	Risk/Comment
Tue 7					
Aus	RBA policy decision	1.75%	1.75%	1.75%	On hold till August, awaiting Q2 CPI.
Chn	May foreign reserves \$bn	3219	3200	-	Stock of reserves has stabilised in recent months.
Eur	Q1 GDP	0.5%	0.5%	0.5%	Third and final estimate for quarter.
Ger	Apr industrial production	-1.3%	0.6%	-	Apr to see a partial rebound from Mar.
UK	May Halifax house prices	-0.8%	-	-	House price inflation has pulled back following the stamp duty increase.
US	Apr consumer credit	29.7	18.0	-	Student and auto loans continue at pace.
Can	May Ivey PMI	53.1	-	-	Possible disruption from wildfires.
Wed 8					
NZ	Q1 survey of manufacturing	1.3%	-	-	Meat processing likely to be weak after an early cull last year.
Aus	Apr housing finance	-0.9%	2.5%	2.0%	Industry figs ticked up in Apr though headline only covers own-occupiers.
Chn	May trade balance USDbn	45.56	55.70	-	Highly volatile in recent months; Apr was disappointing.
	May foreign direct investment %yr	6.0%	-	-	Tentative date 8-12 June.
UK	Apr industrial production	0.3%	0.1%	-	Manufacturing activity has moderated in the face of soft demand.
US	Apr JOLTS job openings	5757	-	-	Quits and hires continue to show strength.
Thu 9					
NZ	RBNZ policy decision	2.25%	2.00%	2.25%	NZD higher than expected, but inflation outlook has firmed.
Chn	May CPI %yr	2.3%	2.3%	-	Food has provided impetus in 2016; elsewhere pulse weak.
	May PPI %yr	-3.4%	-3.2%	-	Commodity prices continue to have major impact.
Ger	Apr trade balance €bn	26.2	21.3	-	Euro and soft global growth have ongoing negative impact.
UK	Apr trade balance, £bn	-3.8	-3.6	-	Weakness in export demand a drag.
US	Initial jobless claims	267k	-	-	Claims at low very low levels.
	Apr wholesale inventories	0.1%	0.1%	-	Inventories unlikely to provide sharp jump in growth in Q2 '16.
Can	Apr new housing price index	0.2%	-	-	Oil's impact on household incomes a major issue in some regions.
Fri 10					
NZ	May electronic retail card spending	0.9%	0.5%	0.2%	A moderation in growth following last month's oversized gain.
Chn	May aggregate financing, CNYbn	751.0	950.0	-	Tentative date 10-15 June.
	May new loans, CNYbn	555.6	750.0	-	Tentative date 10-15 June.
	May M2 money supply %yr	12.8%	12.5%	-	Tentative date 10-15 June.
Ger	May CPI %yr	0.1%	0.1%	-	Final read for May.
US	Jun Uni. of Michigan sentiment	94.7	94.5	-	Remains at robust levels; job market key
	May monthly budget statement	-60.5	-	-	Jobs growth and capital gains continue to aid bottom line.
Sun 12					
Chn	May industrial production ytd %yr	5.8%	5.9%	-	Manufacturing remains under significant pressure.
	May retail sales %yr	10.1%	10.1%	-	Consumer hopeful vis a vis job market.
	May fixed asset investment ytd %yr	10.5%	10.4%	-	Greater support now coming from public sector, for utilities & transport.

New Zealand forecasts

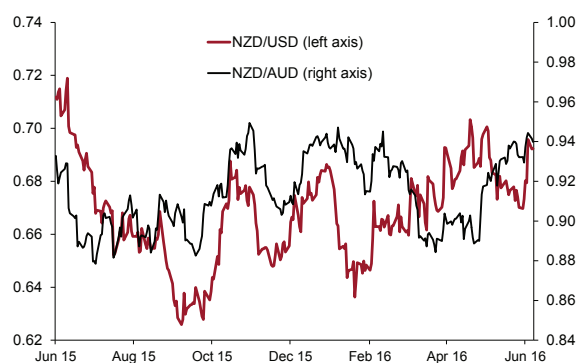
Economic Growth Forecasts	March years				Calendar years			
	% change	2014	2015	2016f	2017f	2014	2015	2016f
GDP (Production) ann avg	2.7	3.6	2.4	2.6	3.7	2.5	2.7	2.6
Employment	3.8	3.2	2.0	2.5	3.6	1.4	2.9	2.4
Unemployment Rate % s.a.	6.0	5.8	5.7	5.4	5.8	5.4	5.7	5.0
CPI	1.5	0.3	0.4	1.5	0.8	0.1	1.3	2.1
Current Account Balance % of GDP	-2.5	-3.4	-3.0	-3.7	-3.1	-3.1	-3.5	-4.0

Financial Forecasts	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
Cash	2.25	2.00	2.00	2.00	2.00	2.00
90 Day bill	2.35	2.20	2.20	2.20	2.20	2.20
2 Year Swap	2.30	2.20	2.20	2.30	2.30	2.30
5 Year Swap	2.50	2.50	2.60	2.70	2.80	2.80
10 Year Bond	2.60	2.70	2.80	2.90	3.00	3.10
NZD/USD	0.67	0.66	0.64	0.62	0.61	0.61
NZD/AUD	0.92	0.92	0.91	0.91	0.90	0.88
NZD/JPY	73.7	73.9	73.6	72.5	73.2	73.2
NZD/EUR	0.59	0.60	0.59	0.58	0.58	0.57
NZD/GBP	0.48	0.48	0.47	0.46	0.44	0.43
TWI	70.6	70.7	69.6	68.4	67.4	66.8

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Tuesday 7 June 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.25%	2.25%	2.25%
30 Days	2.28%	2.27%	2.29%
60 Days	2.36%	2.31%	2.34%
90 Days	2.39%	2.38%	2.40%
2 Year Swap	2.26%	2.29%	2.18%
5 Year Swap	2.43%	2.51%	2.40%

NZ foreign currency mid-rates as at Tuesday 7 June 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6923	0.6766	0.6823
NZD/EUR	0.6096	0.6038	0.5987
NZD/GBP	0.4793	0.4666	0.4729
NZD/JPY	74.47	74.55	73.10
NZD/AUD	0.9398	0.9369	0.9274
TWI	74.02	73.06	72.81

International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015f	2016f	2017f
Australia						
Real GDP % yr	3.5	2.0	2.6	2.5	2.8	2.8
CPI inflation % annual	2.2	2.7	1.7	1.7	1.7	2.1
Unemployment %	5.3	5.8	6.2	5.8	5.6	5.5
Current Account % GDP	-4.4	-3.4	-3.0	-4.6	-4.4	-4.5
United States						
Real GDP %yr	2.2	1.5	2.4	2.4	2.0	2.1
Consumer Prices %yr	2.1	1.5	1.6	0.1	1.1	1.7
Unemployment Rate %	8.1	7.4	6.2	5.3	4.7	4.5
Current Account %GDP	-2.9	-2.3	-2.2	-2.3	-2.3	-2.3
Japan						
Real GDP %yr	1.7	1.4	0.0	0.5	0.7	0.7
Euroland						
Real GDP %yr	-0.9	-0.3	0.9	1.6	1.4	1.3
United Kingdom						
Real GDP %yr	1.2	2.2	2.9	2.2	1.9	2.1
China						
Real GDP %yr	7.7	7.7	7.3	6.9	6.5	6.2
East Asia ex China						
Real GDP %yr	4.6	4.2	4.1	3.7	3.9	4.1
World						
Real GDP %yr	3.5	3.3	3.4	3.1	3.3	3.5

Forecasts finalised 13 May 2016

Interest Rate Forecasts	Latest	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Australia						
Cash	1.75	1.75	1.50	1.50	1.50	1.50
90 Day Bill	2.00	2.05	1.80	1.80	1.80	1.80
10 Year Bond	2.23	2.40	2.50	2.60	2.65	2.75
International						
Fed Funds	0.375	0.375	0.625	0.625	0.875	0.875
US 10 Year Bond	1.80	2.00	2.15	2.25	2.35	2.50
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40

Exchange Rate Forecasts	Latest	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
AUD/USD	0.7237	0.73	0.72	0.70	0.68	0.68
USD/JPY	108.58	110	112	115	117	120
EUR/USD	1.1157	1.14	1.10	1.08	1.06	1.06
AUD/NZD	1.0594	1.09	1.09	1.09	1.08	1.10

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