

Weekly Commentary

7 March 2016



Step by step

Since July last year we've highlighted the need for the Official Cash Rate (OCR) to fall below 2.5% in order to return inflation to target on a sustained basis. We don't expect this to happen at this week's RBNZ interest rate announcement. But we do expect that the RBNZ will take a step closer to cutting the OCR below its current record low.

The RBNZ will release its latest *Monetary Policy Statement (MPS)* on Thursday, at which time we expect they will keep the OCR on hold. However, after opening the door to lower rates at the time of their January interest rate review, we expect that their rhetoric will become even more dovish. In addition, the accompanying interest rate forecasts are likely to be revised down, consistent with rate cuts over the coming year.

Underlying this increased dovishness is a much softer inflation environment than the RBNZ was factoring in at the time of their previous *MPS* in December. Since that time we've seen annual inflation drop to a lower-than-expected rate of 0.1%. In addition, falls in global oil prices mean that inflation is now expected to remain close to zero through most of 2016 (in contrast, the RBNZ had previously assumed inflation would rise above 1% in March this year).

It also important to remember that it's not just oil prices that are pulling down inflation. In fact, even excluding petrol prices, inflation has been below 1% for most of the past year. In part, this weakness in inflation is because the New Zealand dollar has lingered at higher than expected levels, and has not provided the helping hand in generating inflation that was expected. Domestic factors, such as increased price competition in the retail sector, have also dampened inflation.

On top of this, the extended period of low inflation in New Zealand in recent years has put downward pressure on

inflation expectations. This has been reflected in several key measures of inflation expectations, including last week's ANZBO measure of businesses' inflation expectations which dropped to a record low of 1.4%. That's a big concern for the RBNZ. Inflation expectations are a key influence on wage and price setting decisions, and their continued downshift will make generating a sustained pick-up in inflation that much harder.

And it's not just inflation that's causing the RBNZ headaches. We're also looking at a tougher outlook for exporters, particularly in the dairying sector. Dairy export prices were up a modest 1.4% in the latest *GlobalDairyTrade*. However, that still leaves them at very low levels. Furthermore, there remain few signs of a marked turnaround in the fundamentals which have pushed dairy prices to such low levels. In particular, global milk supply remains plentiful, with supply from Europe continuing to grow particularly strongly.

On top of this, rocky conditions in the global economy have seen bank funding costs rise. This could result in upward pressure on borrowing costs.

Of course, it's certainly not all doom and gloom. The New Zealand economy is actually growing at a reasonable clip, and is expected to continue doing so over the coming year. In large part this reflects the continued strength in construction. Building activity increased by a solid 6% over the past year, and there's a large pipeline of work to come

Step by step continued

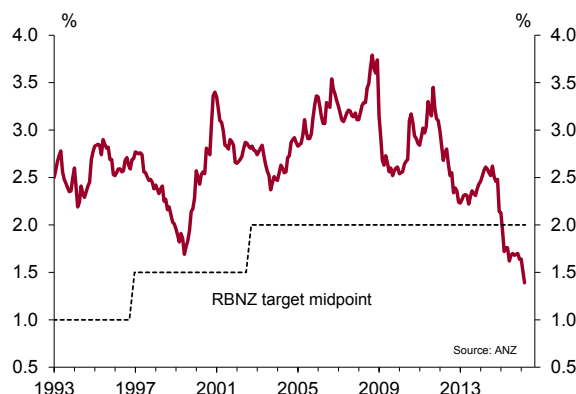
over the next few years. In addition, strong population growth and increases in households' purchasing power are underpinning continued growth in spending.

Nevertheless, developments in recent weeks have, on balance, reinforced the need for OCR cuts. But there's still a question as to when cuts will occur. On this front, there are a couple of key concerns that the RBNZ will be conscious of.

The first is the strength of the housing market, particularly in Auckland where earlier strong price gains have raised concerns about financial stability. The Auckland housing market has slowed sharply since October when new regulations around property investment came into force. The latest QVNZ house price figures show that prices were down another 0.3% in the 3 months to February. However, some of the heat in the market prior to October was due to investors rushing to beat the new regulations, so it's not surprising that we're seeing a post-regulation hangover now. The RBNZ will be wary of reigniting pressure in the Auckland housing market, so will want to be sure things have cooled off.

The other consideration affecting the RBNZ's thinking is their medium-term focus. In practice, this means the RBNZ will tend to look through sharp temporary swings in inflation associated with volatile items. Instead, they typically focus on longer-term trends and how the economy could evolve over the next two to three years. With this in mind, the RBNZ has recently been drawing attention to its own model-derived estimate of core inflation, which smooths through temporary volatility in prices. This measure has remained comfortably within the 1-3% target range.

ANZBO – inflation 1 year ahead (businesses' expectations)



However, as we discussed in a recent report¹, this measure has been below 2% for several years and points to a very subdued underlying inflation environment.

Given these concerns, we've pencilled in rate cuts in June and August of this year. By then, the RBNZ will have more detailed information on the housing market, and an additional read on headline (and core) inflation. However, given the extent of softness in inflation and broader concerns about the outlook, both next week's interest rate review and the following April decision should also be considered potential dates for OCR cuts.

¹ Available here: <http://www.westpac.co.nz/assets/Business/Economic-Updates/2016/Bulletins-2016/Core-workout-February-2016.pdf>

Fixed vs Floating for mortgages

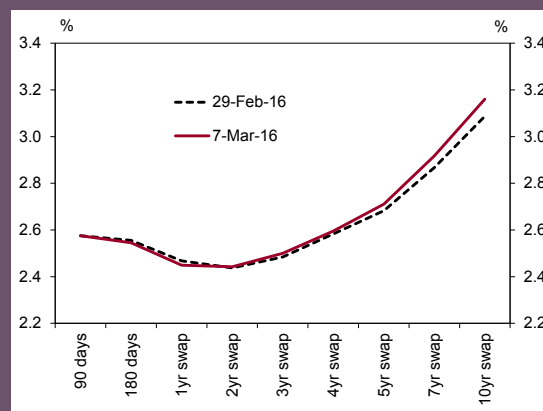
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

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 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



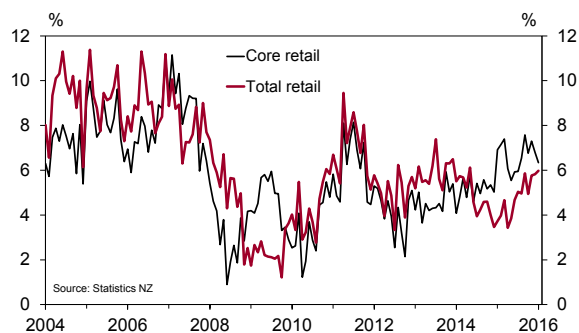
The week ahead

NZ Feb retail card spending

Mar 9, last +0.3%, WBC f/c +0.5%

- Overall retail spending was up 0.3% in January. Combined with earlier solid gains, that left the level of retail spending up 5.2% over the past year. While that's down a bit from the rates seen over 2015, it's still a healthy rate of spending growth, especially as low inflation means that consumers' earnings are stretching further.
- We expect to see continued firm growth in retail card spending of 0.5% in February, supported by low interest rates, strong population growth, and strong tourist inflows (the latter being a key pillar of support for spending on hospitality and related services). Low petrol prices will also have put a bit more money back in households' pockets, which should see a solid 0.6% gain in core spending (which excludes spending on fuel and motor vehicles).

Card transactions, annual % change

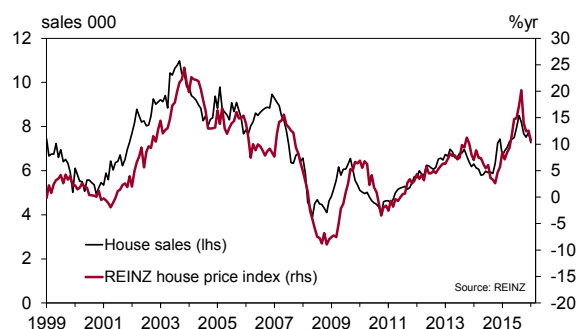


NZ Feb REINZ house prices and sales

Mar 10 (tentative) Sales last: -5.9%, Prices last: 10.7%/yr

- House sales have slowed significantly, especially in Auckland, since a range of new rules around property investment were introduced in October and November last year.
- However, it remains unclear whether this reflects a temporary hole in demand, as purchases were brought forward to beat the regulations, or whether it reflects a sustained slowdown. The February report will be informative, as previous months may have also been affected by the holiday-period lull.
- House prices have fallen from their peaks in Auckland, but have accelerated in many other parts of the North Island. We expect the national average house price to rise by 5% this year, after a 15% rise last year.

REINZ house prices and sales

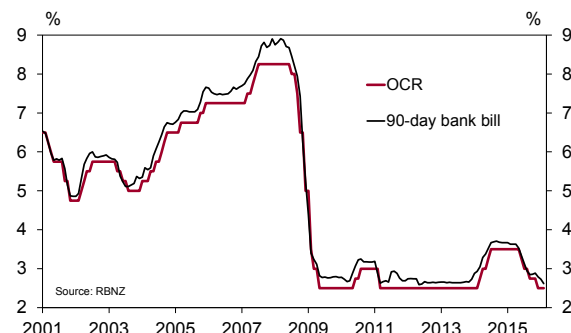


RBNZ Monetary Policy Statement

Mar 10 Last: 2.50%, WBC f/c: 2.50%, Market: 2.50%

- In January, the RBNZ opened the door to cutting the OCR below 2.5%. However, the timing of cuts remains in question.
- Continued softness in inflation and inflation expectations, a rocky global outlook, and weakness in dairy prices mean that there is a strong case for cutting now. However, the RBNZ's communications in recent weeks have highlighted that they are not in a rush. This reflects their concerns about reigniting housing market pressures in Auckland, and their focus on ensuring medium-term stability in prices, output and the exchange rate.
- We expect an on-hold decision next week, but with a strong signal for rate cuts over the coming months. However, given the extent of softness in inflation and broader concerns about the outlook, both next week's interest rate review and the following April decision should be considered potential dates for OCR cuts.

NZ OCR and 90-day rate



Aus Mar Westpac-MI Consumer Sentiment

Mar 9 Last: 101.3

- The **Westpac-Melbourne Institute Consumer Sentiment Index** rose 4.2% in Feb, recovering all of the ground it lost in January, when financial market turmoil drove a 3.5% fall. The index is back a touch above 100, indicating optimists slightly outnumber pessimists.
- The Mar survey is in the field over the week ended Mar 6. Financial markets remain unsettled but have generally firmed over the last month, the ASX up 0.4% and the AUD 0.9c higher vs the USD since the Feb survey. The better than expected Q4 GDP update, lower petrol prices (down another 4c since the Feb survey) and a solid start for housing markets in 2016 may also support sentiment. Against this, polling suggests the boost from last year's leadership change may be starting to fade, with tax policy issues again in the media - the focus this time being on potential changes to negative gearing arrangements.

Consumer Sentiment Index



The week ahead

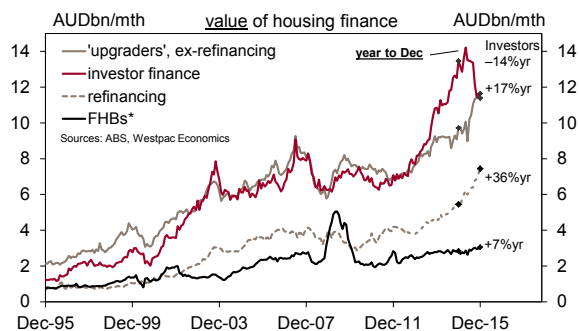
Aus Jan housing finance (no.)

Mar 9, Last: 2.6%, WBC f/c: -1.5%

Mkt f/c: -2.8%, Range: -5.0% to 1.5%

- The number of owner occupier finance approvals firmed in Dec, up 2.6% to be up 9.8%yr. Notably, the value of new investor loans and the broader total value of new loans measure (covering both investors and owner occupiers) were both up in Dec as well (+0.6%mt and +0.8%mt respectively), suggesting 'switching effects' and the drag from tighter conditions for investor loans have now largely run their course.
- Industry figures suggest owner-occupier approvals declined in Jan - we expect a -1.5% fall. Note that, as with other housing market data, Jan figures are a less reliable guide to activity due to the impact of the holiday low-season.

Value of finance approvals by segment

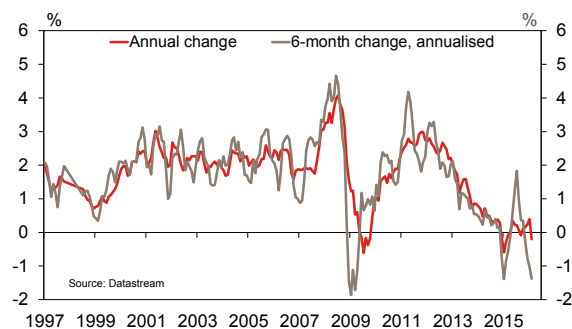


ECB March policy meeting

Mar 10 Deposit rate, Last: -0.30%, WBC -0.40%

- Over the past year, real economic growth has not been the Euro Area's concern. While unbalanced across the region, GDP growth has remained solid.
- Credit conditions have also become more constructive, the rise in consumer credit being particularly helpful for growth. Nonetheless, at their March meeting, the ECB looks set to undertake further policy easing, most likely in the form of another cut in the deposit rate, and an extension of QE.
- The reason: headline inflation has weakened again, to -0.2%yr in February, or -1.4% in 6-month annualised terms; market-based inflation expectations also continue to trend down. All the while, global uncertainties linger, raising the risk of a further knock to the inflation (deflation) trend. Expect a continuation of these themes throughout 2016.

Euro deflation a pressing concern for ECB



Data calendar

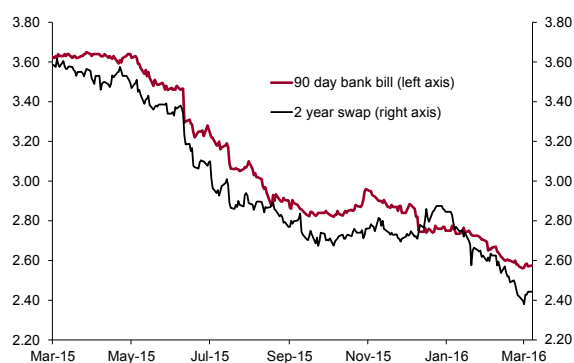
		Last	Market median	Westpac forecast	Risk/Comment
Mon 7					
Aus	Feb ANZ job ads	1.0%	-	-	Has been more mixed recently, but annual pace a healthy 10.8%/yr.
Chn	Feb foreign reserves \$bn	3231	3190	-	Capital outflows remain a threat; reserves still significant.
Eur	Mar Sentix investor confidence	6	8.8	-	ECB key to market confidence.
US	Feb labor market conditions index	0.4	-	-	FOMC indicator of broad labour market momentum.
	Jan consumer credit, US\$b	21.3	16.8	-	Auto and student loan growth remains robust.
	Fedspeak	-	-	-	Brainard speaks at international banking conference.
	Fedspeak	-	-	-	Fischer Speaks at Annual NABE Conference in Washington
Tue 8					
NZ	Q4 survey of manufacturing	4.2%	-	-	Early cow cull boosted meat processing in Q3.
Aus	RBA Deputy Governor Philip Lowe	-	-	-	Speaking at Urban Development Institute, Adelaide, 10:20am AEDT
	Feb NAB business survey	5	-	-	Conditions index -5pts past 2mths to a still above avg level of +5.
Chn	Feb trade balance \$bn	63.3	50.8	-	X'pts continue to weaken (-11.2%/yr Jan); M'pts decline easing (-18.8%).
	Feb foreign direct investment %yr	3.2%	3.0%	-	Tentative date, 8-12/3.
Eur	Q4 GDP	0.3%	0.3%	0.3%	Growth outcomes still vary considerably across region.
Ger	Jan industrial production	-1.2%	0.5%	-	Jan likely to only see partial retracement of Dec fall.
US	Feb NFIB small business optimism	93.9	94.2	-	Recent trend decline has followed ISMs lead.
Wed 9					
NZ	Feb electronic card spending	0.3%	0.3%	0.5%	Boosted by increases in purchasing power and the population.
Aus	Mar Westpac-MI Consumer Sentiment	101.3	-	-	Bounced back in Feb from Jan's financial market turmoil driven dip.
	Mar Westpac-MI unemployment expns	1.9%	-	-	Down just 1.7%/yr as the improvement in labour market stalls.
	Jan housing finance	2.6%	-	-1.5%	Low season means monthly readings less reliable in Jan.
UK	Jan industrial production	-1.1%	0.5%	-	Soft external demand a drag.
US	Jan wholesale inventories	-0.1%	-0.2%	-	Inventories a risk to growth in Q1/Q2.
Can	Bank of Canada policy decision	0.5%	0.5%	0.5%	Global headwinds and commodity prices will be key concerns.
Thu 10					
NZ	RBNZ Monetary Policy Statement	2.50%	2.50%	2.50%	Inflation, global conditions and the housing market are key concerns.
	Feb REINZ house sales	-5.9%	-	-	Tentative date. Sales slowed sharply after investor regulations in Nov.
	Feb REINZ house prices	-0.1%	-	-	Prices easing in Auckland, but picking up in many other regions.
Aus	Mar MI inflation expectations	3.6%	-	-	Off the Dec 15 high of 4%, but trend up from 3.4% in Aug to 3.7% in Feb.
Chn	Feb CPI %yr	1.8%	1.8%	-	Consumer inflation benign.
	Feb PPI %yr	-5.3%	-4.9%	-	Raw material prices weighing heavily on upstream prices.
	Feb aggregate financing CNYbn	3417	1780	-	Tentative date 10-15/3.
	Feb new loans CNYbn	2510	1200	-	Tentative date 10-15/3.
	Feb M2 money supply %yr	14.0%	13.7%	-	Tentative date 10-15/3.
Eur	ECB policy decision	-0.30%	-0.40%	-0.40%	Deposit rate to be cut again; QE timeline extended.
Ger	Jan trade balance €bn	19.0	15.7	-	Has disappointed in recent months; global growth key.
UK	Feb RICS house price balance	49%	51%	-	Demand firm, rush to beat stamp duty increase is boosting sales.
US	Initial jobless claims	278k	-	-	Claims have remained at very low levels for an extended period.
	Feb Federal Monthly budget, \$b	-200	-	-	Deficit remains in check; trend improvement likely as wages pick up.
Can	Jan new housing price index	0.1%	-	-	House price inflation has remained subdued.
Fri 11					
NZ	Feb BusinessNZ manufacturing PMI	57.9	-	-	Manufacturing conditions have firmed, at healthy levels.
	Feb food prices	2.0%	-	0.0%	Annual food price inflation to remain near zero.
Ger	Feb CPI	-0.1%	-0.1%	-	Final reading, just 0.1% higher over year.
UK	Jan trade balance, £b	-2.7	-3.1	-	Drags from soft external demand and strength in the GBP.
US	Feb import price index	-1.1%	-0.8%	-	USD gains has resulted in persistent falls in import prices.
Sat 12					
Chn	Feb industrial production	6.1%	5.6%	-	Manufacturing sector remains under duress.
	Feb fixed asset investment ytd %yr	10.0%	9.4%	-	Willingness to invest questionable.
	Feb retail sales ytd %yr	10.7%	11.0%	-	Job losses putting consumer spending at risk.

New Zealand forecasts

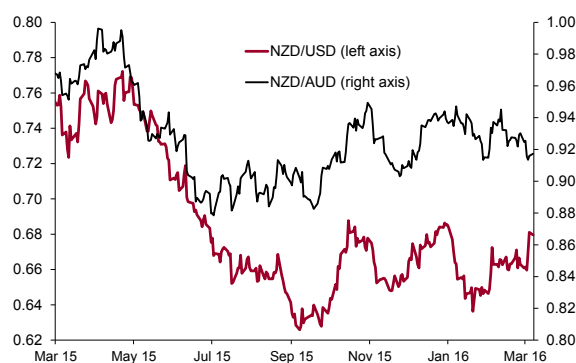
Economic Growth Forecasts	March years				Calendar years			
	% change	2014	2015	2016f	2017f	2014	2015e	2016f
GDP (Production) ann avg	2.7	3.6	2.2	2.2	3.7	2.4	2.0	2.9
Employment	3.8	3.2	1.1	2.4	3.6	1.2	2.1	2.1
Unemployment Rate % s.a.	6.0	5.8	5.8	5.2	5.7	5.3	5.3	5.3
CPI	1.5	0.3	0.3	1.3	0.8	0.1	0.8	2.1
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	2.50	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	2.90	2.90	3.00	3.00	3.10	3.10
10 Year Bond	3.10	3.30	3.50	3.70	3.70	3.70
NZD/USD	0.65	0.63	0.61	0.61	0.62	0.62
NZD/AUD	0.93	0.93	0.92	0.91	0.90	0.89
NZD/JPY	79.5	77.7	75.9	76.5	75.9	75.9
NZD/EUR	0.61	0.61	0.59	0.58	0.57	0.57
NZD/GBP	0.44	0.44	0.43	0.42	0.41	0.40
TWI	71.1	70.1	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 Monday 7 March 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.50%	2.50%
30 Days	2.51%	2.54%	2.56%
60 Days	2.55%	2.57%	2.60%
90 Days	2.58%	2.61%	2.64%
2 Year Swap	2.44%	2.49%	2.57%
5 Year Swap	2.71%	2.75%	2.84%

NZ foreign currency mid-rates as at Monday 7 March 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6796	0.6643	0.6622
NZD/EUR	0.6179	0.5972	0.5916
NZD/GBP	0.4778	0.4660	0.4588
NZD/JPY	77.46	74.71	76.68
NZD/AUD	0.9173	0.9289	0.9348
TWI	73.26	72.25	72.34

International 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	1.9	3.1
Unemployment %	5.3	5.8	6.2	5.8	6.1	5.9
Current Account % GDP	-4.4	-3.4	-3.0	-4.4	-5.0	-4.6
United States						
Real GDP %yr	2.2	1.5	2.4	2.4	2.4	2.1
Consumer Prices %yr	2.1	1.5	1.6	0.1	1.7	1.8
Unemployment Rate %	8.1	7.4	6.2	5.3	4.7	4.4
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	1.3	0.7
Euroland						
Real GDP %yr	-0.8	-0.3	0.9	1.5	1.3	1.4
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	6.9	6.5	6.2
East Asia ex China						
Real GDP %yr	4.6	4.2	4.1	3.7	3.9	4.3
World						
Real GDP %yr	3.4	3.3	3.4	3.0	3.4	3.5

Forecasts finalised 12 Feb 2016

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	2.29	2.20	2.20	2.20	2.20	2.20
10 Year Bond	2.40	2.50	2.70	2.90	3.30	3.55
International						
Fed Funds	0.375	0.375	0.625	0.875	1.125	1.375
US 10 Year Bond	1.83	1.80	2.20	2.60	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	0.7371	0.70	0.68	0.66	0.67	0.69
USD/JPY	113.64	117	119	121	123	125
EUR/USD	1.0948	1.11	1.10	1.08	1.05	1.03
AUD/NZD	1.0918	1.08	1.08	1.08	1.10	1.12

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