Weekly Commentary

9 May 2016

Devil and the deep blue sea

The latest labour market figures confirm that the New Zealand economy is doing well despite the dairy downturn, aided and abetted by low interest rates, rising asset prices and more borrowing. These trends are uncomfortable, but there is little New Zealand can do about them. The price of refusing to lower the OCR would be an unacceptably strong exchange rate. Instead, the RBNZ may respond to rising asset prices via macroprudential policy.

According to last week's March quarter Household Labour Force Survey (HLFS), the unemployment rate jumped from 5.4% to 5.7%. This came as no surprise to us – our forecast was 5.7%. Nevertheless, it was not a particularly meaningful development. Back in December the HLFS reported an implausibly sharp decline in unemployment. We suspected this was an artefact of survey sample errors or technicalities associated with seasonal adjustment. The March quarter rebound in unemployment confirmed our thinking.

Our overall take is that the labour market is strengthening. Employment growth in March was 1.2%, and the Quarterly Employers' Survey corroborated the picture of strong hiring. The unemployment rate has fallen from 6.0% to 5.7% over six months. And there was even a small tick higher in wage growth in the March quarter.

This serves as further confirmation that the New Zealand economy has been on a firm footing so far this year. We have been prompted to once-again upgrade our estimate of March quarter GDP growth, to 0.7%. And we have to admit that the economy is generally stronger than the expectations we laid out nine months ago, when we first expressed concern about the dairy downturn.

It is not that the dairy downturn isn't hurting – the dairy industry and associated downstream businesses are most certainly feeling the pinch. Land prices are falling, one major bank has announced significant provisioning for losses on dairy loans, and economic confidence has taken a battering in the most dairy-intensive regions.

But two powerful dynamics have emerged on the other side. One is that the services sector is thriving thanks to a global resurgence of services activity and the lower exchange rate. The other is that New Zealand is taking on debt to support spending. The second of these two is obviously less desirable and less sustainable – the beneficiaries of this "positive" dynamic should be aware that it won't last forever.

Low interest rates have sparked a surge in house prices across New Zealand. Last week's Quotable Value monthly house price report showed that prices are rising at an annualised pace of above 10% in most of New Zealand except Auckland and Christchurch. Talk of supply shortages and recalcitrant councils must now take a back seat in the house price debate, given that house prices are rising in locations with diverse population growth rates and no evidence of accommodation shortages. Instead, attention is turning to sources of housing demand. The finger is being pointed directly at investors, who are experiencing low borrowing costs and/or low returns on other investment options, due to low interest rates.

When house prices rise, New Zealand tends to go into borrow-and-spend mode. Home owners tend to spend some of the wealth windfall they feel when their house

Devil and the deep blue sea continued

value rises. Meanwhile, aspiring buyers must borrow more. The net effect is that New Zealand both borrows more and spends more.

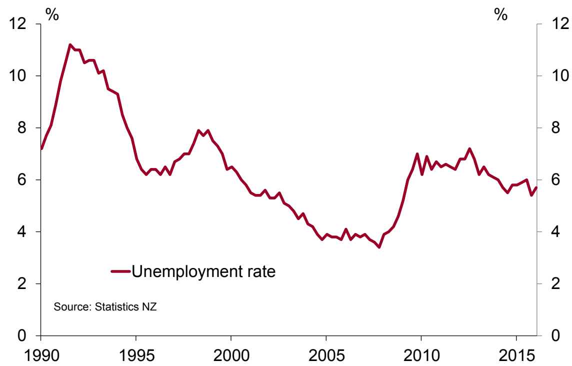
At present dairy farmers are also taking on more debt via working capital facilities, to make up for income shortfalls. Overall bank lending rose 7.2% over the year to April, a period in which nominal GDP rose by only about 3.3%.

This emerging borrow-and-spend dynamic is important for the Reserve Bank. For starters, it shows that monetary policy is working. Low interest rates are supporting aggregate demand, which in turn will help prevent inflation from lingering at a low level.

Of course many readers, and the RBNZ itself, will be dismayed at the way monetary policy is working. Everybody would prefer it if the inflation target were met more via a lower exchange rate than via rising asset prices. Unfortunately that doesn't appear to be an option right now. Low inflation, low interest rates and high asset prices is a global trend. The Reserve Bank of New Zealand can no more stand in the way of this trend than King Canute could prevent the tide. Many central banks are reducing interest rates, and consequently these countries' exchange rates are tending to weaken. This leaves New Zealand with a stark choice. If we refuse to reduce interest rates the exchange rate will rise and inflation could slump further. If we do reduce interest rates, we will endure rising asset prices. The latter is probably less damaging than the former.

The best New Zealand can do is prepare itself for the possible fallout from high asset prices. One day global interest rates could rise, and if they do, global asset prices could come under downward pressure. In New Zealand the possible manifestation would be rising mortgage rates and falling house prices. The Reserve Bank must ensure that New Zealand's financial system is strong enough to withstand such a possibility.

Unemployment rate



This will be the topic of this week's RBNZ Financial Stability Report. We expect that the RBNZ will discuss its macroprudential options, which include requiring banks to hold more capital, strengthening the current loan-to-value (LVR) restrictions on mortgage lending, or introducing new restrictions on mortgage lending such as a maximum debt-servicing-to-income ratio. We would be mildly surprised if the RBNZ committed to any of those options as early as next week. However, we do expect the RBNZ to announce some form of macroprudential tightening before the year is out.

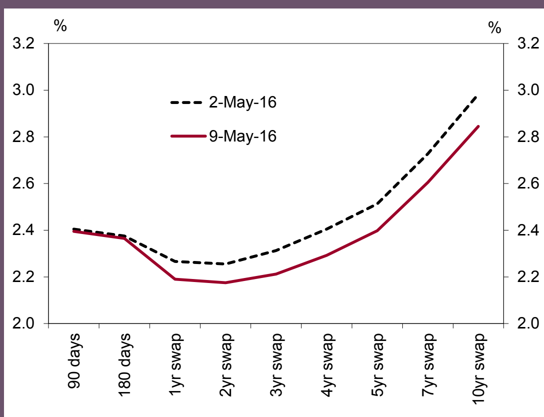
Fixed vs Floating for mortgages

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



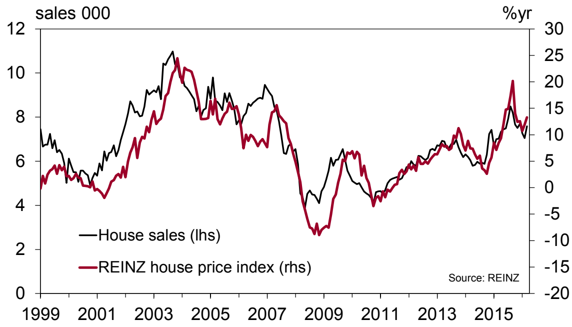
The week ahead

NZ Apr REINZ house prices and sales

May 9-13 (tbd), Sales last: 7.6%, Prices last: 2.2%

- The Auckland housing market slowed at the end of last year after a batch of new regulations, aimed at property investors in particular, were introduced. But since then, the Auckland market has roared back into life. Meanwhile prices have been steadily accelerating in most other regions.
- The REINZ report for April, due sometime in the next week, is expected to show a continuation of this momentum. Strong growth in mortgage approvals in April suggest that we should also see a lift in house sales, which rose in March but remain well below their pre-regulation levels.
- We regard low interest rates as the key driver of the housing market's current upturn. We expect house price inflation to remain strong over the course of this year, even with the growing likelihood of further tax and/or prudential policy measures.

REINZ house prices and sales

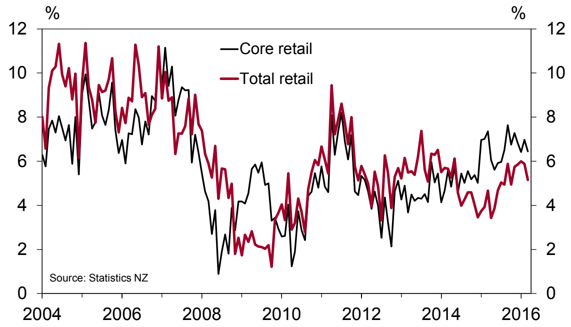


NZ April retail card spending

May 10, last: +0.1%, WBC: f/c +0.3%, Mkt f/c: 0.4%

- After solid gains earlier in the year, consumers paused for breath in March. Spending on electronic cards was up just 0.1% in March, with core spending (which excludes the volatile motor vehicle and fuel categories) up 0.2%. Weighing on spending in March were increases in fuel prices, as well as a pullback in spending on apparel.
- We expect April's figures will show a modest pick-up in spending as some of the softness seen in March reverses. However, with increases in petrol prices limiting households' spending on other goods and services, we expect only a modest lift.

Card transactions, annual % change

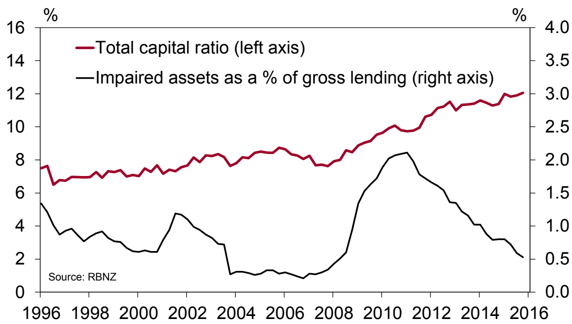


RBNZ Financial Stability Report

May 11

- The Financial Stability Report is the Reserve Bank's six-monthly update on the state of the financial system. In general, New Zealand banks have remained in a strong position, with rising capital ratios and low impaired loans (albeit with some stress in dairy lending coming through in recent updates).
- Markets will pay particular attention to whether the RBNZ will introduce further restrictions to counter the resurgence in the housing market. We expect some commentary but no firm decisions in the May report. As recently as March the RBNZ said that it was not considering further macro-prudential measures, and house prices haven't actually exceeded the very strong forecast that the RBNZ was making at the time. However, we do see a strong chance of further policy measures at some point this year - a decision that need not coincide with the Financial Stability Report.

NZ registered bank ratios

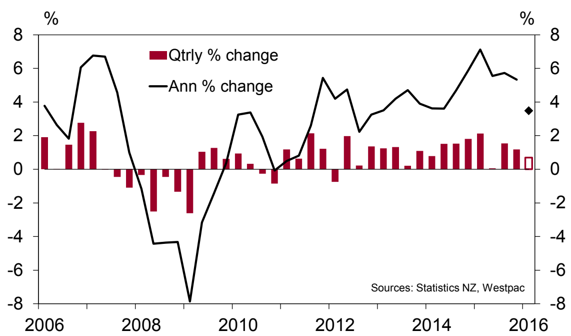


NZ Q1 retail sales

May 13, Sales volumes - Last: +1.2%, Westpac f/c: +0.7%, Mkt f/c: 1.0%

- Following solid gains through the latter part of 2015, retail spending growth eased off a bit in early 2016. We expect the Q1 report to show sales volumes up 0.7%. Combined with softness in prices (including sharp falls in petrol prices earlier in the year), this would result in 0.5% growth in nominal spending over the quarter.
- Some of the softness in Q1 reflects a normal pull back in spending following earlier strong growth in areas such as durables. Smoothing through such volatility, spending continues to be supported by softness in prices and low borrowing costs (both of which are allowing households' budgets to stretch further), as well as gains in the housing market. On top of this, record levels of tourist inflows are giving a lift to spending in sectors such as hospitality.

Real retail sales



The week ahead

Aus May Westpac-MI Consumer Sentiment

May 11 Last: 95.1

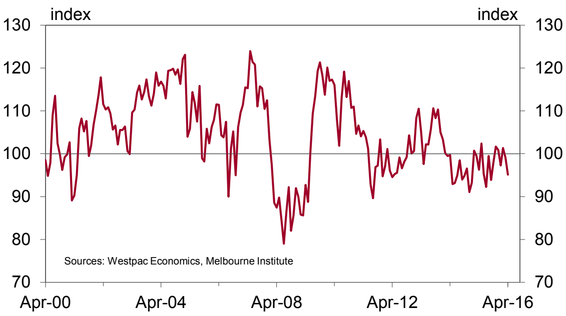
- The **Westpac-Melbourne Institute Consumer Sentiment Index** fell 4% in Apr, to 95.1 from 99.1 in Mar. The moves takes sentiment back into 'cautiously pessimistic' territory after a period in which it appeared to be settling into a firmer range around 'neutral'.
- The May survey is in the field over the week ended May 8 and will capture initial reactions to the Federal Budget and the RBA's surprise 25bp rate cut – both delivered on May 3 (responses to an additional question on the Budget impact should go some way towards disentangling the impact of these two events). Other factors that may also come into play are: housing markets, which have shown some improvement including a solid price rise in Apr; and the ASX, which has rallied nearly 7% since the Apr survey. Although not typically a sentiment driver, the surprisingly weak Q1 CPI may also factor.

Aus Mar housing finance (no.)

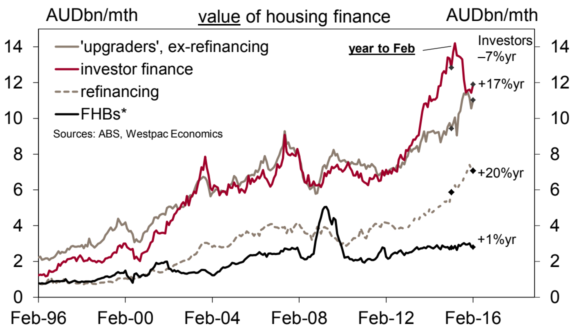
May 11, Last: 1.4%, WBC f/c: –1.0%
Mkt f/c: –1.5%, Range: –3.0% to 1.7%

- Housing finance approvals ticked up in Feb, the number of owner occupier approvals rising 1.7%, recovering about half of Jan's 4.8% fall (noting that monthly housing data is much choppier and less reliable around the holiday period).
- Despite signs of firming conditions in early 2016 – auction clearance rates and price growth both improving – industry data points to a dip back in approvals in March. We expect the official figures to show a 1% decline. Industry figures are also pointing to a somewhat sharper pull-back in 'construction related' loans. The soft owner-occupier picture may be a sign that investors were more active early in the year – there will again be interest in the value of investor loans (down sharply in second half of last year) and the 'total value of loans' which provides a broader measure of activity.

Consumer Sentiment Index



Value of finance approvals by segment



Data calendar

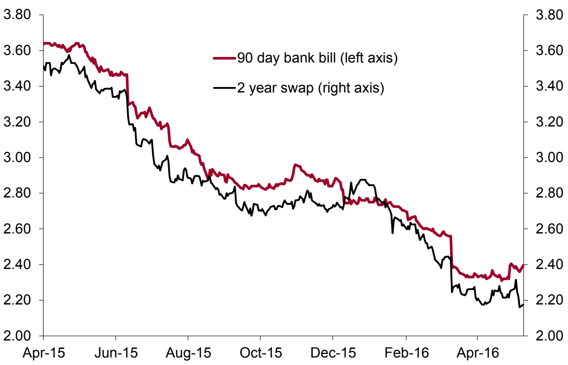
		Last	Market median	Westpac forecast	Risk/Comment
Mon 09					
Aus	Apr ANZ job ads	0.2%	–	–	Not a great indicator but continues to point to solid employment growth.
Eur	May Sentix investor confidence	5.7	6.2	–	European investors view on market.
UK	Apr Halifax house prices	2.6%	–0.3%	–	Increases in stamp duty will weigh on house prices.
US	Apr labor market conditions index	–2.1	–	–	Barometer of aggregate labour market momentum.
	Fedspeak	–	–	–	Evans, Kashkari.
Tue 10					
NZ	Apr retail card spending	0.1%	0.5%	0.3%	Some reversal of the soft March result, but petrol prices still a drag.
	Apr REINZ house price index	2.2%	–	–	Due this week. Prices rebounding from last year's investor regulations.
	Apr REINZ house sales	7.6%	–	–	Sales picked up in March but remain well below pre-regulation levels.
Chn	Apr CPI %yr	2.3%	2.3%	–	Pork prices supported in March; risk of another downside surprise.
	Apr PPI %yr	–4.3%	–3.8%	–	Upstream price pressures still very weak, though losses moderating.
	Apr aggregate financing, CNYbn	2336	1285	–	Tentative date 10–15 May. Credit a key focus at present.
	Apr new loans, CNYbn	1370	830	–	Tentative date 10–15 May. Credit a key focus at present.
	Apr M2 money supply %yr	13.4%	13.5%	–	Tentative date 10–15 May.
Ger	Mar industrial production	–0.5%	–0.2%	–	Mar was disappointing; orders were also down 1.2% in month.
	Mar trade balance €bn	20.2	20.5	–	Mar saw 1.3% gain for exports against 0.4% rise in imports.
UK	Feb trade balance, £b	–4.8	–	–	Soft external demand is weighing on manufacturing.
US	Apr NFIB small business optimism	92.6	93.1	–	Has been trending lower.
	Mar wholesale inventories	–0.5%	–0.1%	–	Inventories have been weak of late; how will Q2 look?
	Mar JOLTS job openings	5445	–	–	Strong in recent months; sign of health of economy.
Wed 11					
NZ	May RBNZ Financial Stability Report	–	–	–	Watch for signal of further macro-prudential measures on housing.
Aus	May Westpac-MI Consumer Sentiment	95.1	–	–	Key gauge of consumer reaction to rate cut and Budget.
	Mar housing finance	1.5%	–1.5%	–1.0%	Industry figs show soft owner-occupier approvals but markets firmer?
UK	Mar industrial production	–0.3%	–	–	External demand and Brexit concerns have dampened demand.
Thu 12					
NZ	Apr BusinessNZ PMI	54.7	–	–	Manufacturing conditions have been softening.
	Apr food prices	0.5%	–	–0.6%	Food price deflation to resume as spike in produce prices eases.
Aus	RBA Assist. Gov Edey speaking	–	–	–	Cards & Payments Australia conference, Melbourne, 9.00 am AEST.
	May MI inflation expectations	3.6%	–	–	Of considerably more interest given RBA's revised inflation outlook.
Eur	Mar industrial production	–0.8%	1.1%		Weak global demand continues to weigh on momentum.
UK	BoE rate decision and inflation report	0.5%	0.5%	0.5%	Uncertainty regarding Brexit and global demand will keep rates on hold.
US	Apr import price index	0.2%	0.1%	–	USD continues to keep lid on import prices.
	Initial jobless claims	274k	–	–	Remains at multi-decade lows (good news on jobs).
	Fedspeak	–	–	–	Mester, Rosengren, George.
Can	Mar new housing price index	0.2%	0.2%	–	Continue to see gains despite energy sector weakness.
	Apr Teranet house prices	0.8%	–	–	Robust annual gains, circa 7%yr.
Fri 13					
NZ	Q1 retail sales volumes	1.2%	1.0%	0.7%	Modest spending growth following earlier firms gains.
Eur	Q1 GDP	0.6%	0.6%	0.6%	Second estimate for quarter.
Ger	Apr CPI %yr	–0.3%	–	–	Flash showed surprising fall of 0.3%yr in April.
UK	Mar construction output	–0.3%	–0.3%	–	Construction sector gauges have softened recently.
US	Apr retail sales	–0.3%	0.9%	0.40%	A bounce expected; but trend to remain weak.
	Apr PPI	–0.1%	0.3%	–	Annual pace remains weak at 1.0%yr.
	Mar business inventories	–0.1%	–	–	Inventories have been weak of late; how will Q2 look?
	May Uni. of Michigan sentiment	89.0	89.9	–	Confidence remains robust.
Sat 14					
Chn	Apr industrial production	5.8%	6.1%	–	PMI's disappointed in Apr; IP remains under pressure.
	Apr retail sales %yr	10.5%	10.6%	–	Consumer impacted by weakness in secondary sector.
	Apr fixed asset investment ytd %yr	10.7%	11.0%	–	Remains under significant pressure outside of Tier 1.
US	Fedspeak	–	–	–	Williams.

New Zealand forecasts

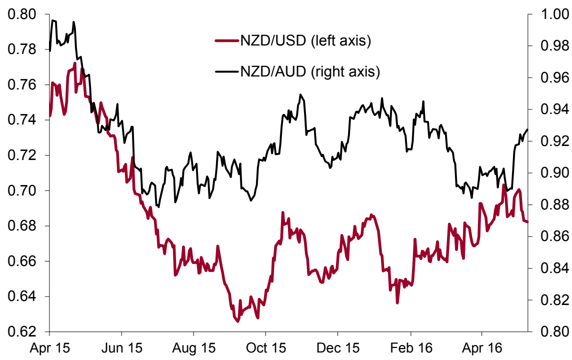
Economic Growth Forecasts	March years				Calendar years			
% change	2014	2015	2016f	2017f	2014	2015	2016f	2017f
GDP (Production) ann avg	2.7	3.6	2.4	2.8	3.7	2.5	2.8	2.6
Employment	3.8	3.2	1.4	2.5	3.6	1.4	2.7	1.5
Unemployment Rate % s.a.	6.0	5.8	5.8	5.6	5.8	5.3	5.6	5.9
CPI	1.5	0.3	0.3	1.1	0.8	0.1	0.7	2.2
Current Account Balance % of GDP	-2.5	-3.4	-3.2	-3.4	-3.1	-3.1	-3.4	-3.7

Financial Forecasts	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day bill	2.10	2.10	2.10	2.10	2.10	2.10
2 Year Swap	2.10	2.10	2.10	2.10	2.10	2.10
5 Year Swap	2.60	2.70	2.80	2.90	3.00	3.10
10 Year Bond	3.00	3.10	3.20	3.40	3.50	3.60
NZD/USD	0.65	0.65	0.62	0.62	0.62	0.62
NZD/AUD	0.88	0.88	0.87	0.87	0.86	0.85
NZD/JPY	71.5	72.8	71.3	72.1	74.2	74.4
NZD/EUR	0.60	0.60	0.58	0.58	0.58	0.57
NZD/GBP	0.47	0.47	0.45	0.45	0.45	0.44
TWI	69.3	69.5	67.4	67.3	67.3	66.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 9 May 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.25%	2.25%	2.25%
30 Days	2.29%	2.26%	2.26%
60 Days	2.34%	2.31%	2.31%
90 Days	2.40%	2.32%	2.33%
2 Year Swap	2.18%	2.22%	2.19%
5 Year Swap	2.40%	2.49%	2.46%

NZ foreign currency mid-rates as at Monday 9 May 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6823	0.6855	0.6809
NZD/EUR	0.5987	0.6084	0.5968
NZD/GBP	0.4729	0.4733	0.4822
NZD/JPY	73.10	76.25	73.59
NZD/AUD	0.9274	0.8886	0.9024
TWI	72.81	72.48	72.12

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	1.8	2.0
Unemployment %	5.3	5.8	6.2	5.8	5.5	5.3
Current Account % GDP	-4.4	-3.4	-3.0	-4.6	-4.3	-3.9
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	1.3	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	1.3	1.3
United Kingdom						
Real GDP %yr	1.2	2.2	2.9	2.2	2.2	2.2
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 29 Apr 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	2.29	2.60	2.75	2.75	2.90	3.10
International						
Fed Funds	0.375	0.375	0.625	0.625	0.875	0.875
US 10 Year Bond	1.75	2.00	2.15	2.25	2.50	2.80
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	0.7382	0.75	0.74	0.73	0.72	0.70
USD/JPY	107.06	110	112	115	117	120
EUR/USD	1.1417	1.11	1.09	1.09	1.07	1.06
AUD/NZD	1.0784	1.15	1.14	1.18	1.17	1.13

Contact the Westpac economics team

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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