

# Weekly Commentary

11 July 2016



## Flying kiwi

The rampant New Zealand housing market received much air time last week and was the focus of a speech by the Reserve Bank. The RBNZ stopped short of tightening lending restrictions, but some tightening is likely by year end. Markets reacted strongly to comments about the trade-offs across the RBNZ's monetary policy and financial stability objectives, with the market-implied probability of a rate cut in August falling below 50 percent. We disagree and think a cut in August is likely. While the housing market is a significant concern for the RBNZ, low inflation trumps considerations for monetary policy, and the surging NZ dollar is adding to the RBNZ's challenge to get inflation higher.

Momentum in New Zealand's housing market has continued to build. According to QV, annual house price inflation rose to 13.5 percent in June, with house prices accelerating in most regions. Record low interest rates have provided a substantial boost to housing demand, while housing supply has not kept up with population growth – especially in Auckland.

A speech last week by RBNZ Deputy Governor Grant Spencer focused on the rising imbalances in the housing market and outlined different policy options. The RBNZ's concerns around the housing market centre on financial stability, with the risk of a sharp correction in house prices increasing as prices accelerate from already elevated levels. While the RBNZ stopped short of tightening macroprudential policy last week, some tightening is expected by the end of this year. This will most likely be broadening the loan-to-value ratio (LVR) restrictions on investor lending in Auckland to the rest of the country. The RBNZ is also looking at two additional policy tools, including restrictions on debt-to-income ratios and a housing capital overlay that would require banks to hold more capital against housing lending. These additional tools would take longer to implement and it seems unlikely they would be in place by the end of this year.

The RBNZ is facing difficult trade-offs across its monetary policy and financial stability objectives, and this was noted several times in the speech. At the current juncture with low inflation and high (and rapidly rising) house prices, the key question is whether the RBNZ is willing to push the OCR lower, even while the inflation outlook warrants it, given it risks stoking the housing market further.

NZ wholesale interest rates and the NZ dollar moved higher following the speech. Market pricing now puts the probability of a rate cut in August at below 50 percent. The market's thinking seems to be that announcing a tightening of macroprudential policy now, would have smoothed the path to an OCR cut at the August *Monetary Policy Statement*; the lack of action on housing presumably makes it harder to justify a rate cut. We don't share that view. Inflation is the overarching influence on interest rate settings. The high NZ dollar already presents a serious challenge to the RBNZ's forecasts of a return to the inflation target; any further gains in the currency will only add to the case for lower interest rates.

It's worth noting that the RBNZ's latest forecasts in the June *MPS* signalled a further 25bp cut in the OCR over the coming year. Based on this, inflation was forecast to get back into the 1-3% target band by the end of this year,

# Flying kiwi continued

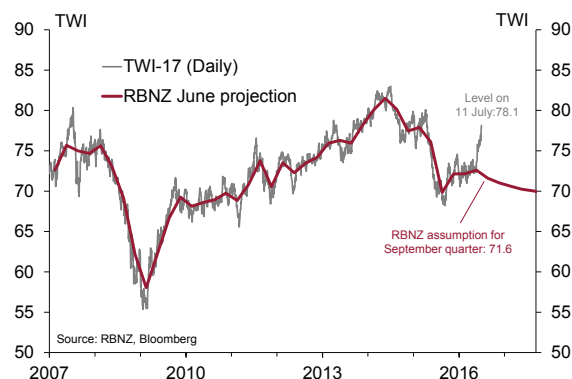
and increase to 2% by the end of 2017. Importantly, the projections assumed that the NZ dollar would depreciate, pushing tradables inflation higher. Since the June MPS, we've had Britain vote to leave the European Union, and the NZ dollar continuing to push higher, strengthening the case for an August cut. While house price inflation has increased, the RBNZ had already incorporated relatively strong house price forecasts in the June MPS.

The NZ dollar, which typically trades lower in uncertain or volatile times, has shrugged off any concerns about risk to the global economy. The NZD / USD has risen to around 73c – the highest level in over a year. The strong kiwi dollar had already emerged as a real challenge to the RBNZ before the Brexit vote. Since then, the market's expectations for further easing by central banks around the globe, and for less tightening by the US Federal Reserve, have pushed the NZ dollar higher.

All up, the TWI is now 9% higher than the RBNZ had expected at the time of the June MPS. You'd have to go a long way back to find another surprise of that magnitude. This will be of real concern to the RBNZ, given the significant dent it will put into its inflation forecasts over the next year. If persistent, the high TWI will weigh on medium-term inflation pressures, as it drags on activity in export and import-competing sectors.

While financial markets have settled since the Brexit-induced volatility, Brexit adds another layer of uncertainty

NZ dollar TWI



and downside risk to an already-fragile global growth outlook. Importantly for New Zealand, lingering uncertainty may weigh commodity prices. It was reassuring there was no knee-jerk move lower in dairy prices in last week's GlobalDairyTrade auction with prices falling only 0.4 percent. Nonetheless, dairy prices remain low and are expected to remain broadly flat over the next few months as subdued demand growth combines with still-strong global dairy supply. The high NZ dollar is not helping matters for farm-gate prices; a third consecutive year of a low dairy payout looms.

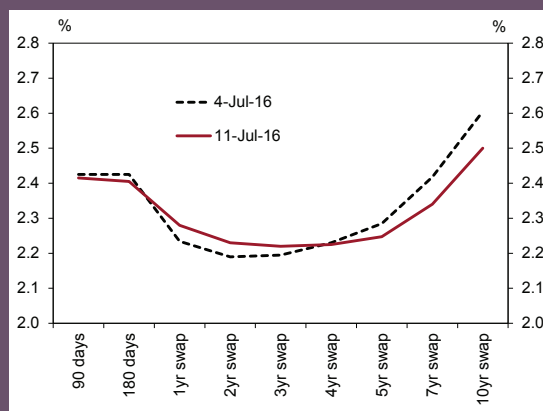
## Fixed vs Floating for mortgages

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



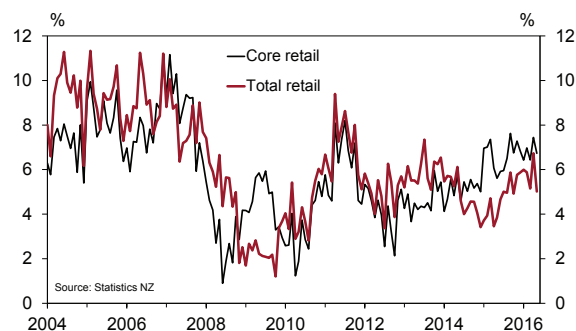
# The week ahead

## NZ June retail card spending

July 11, last: +0.3%, WBC: f/c +0.4%, Mkt f/c: 0.4%

- May saw a 0.3% decline in retail spending. In large part, this was a correction following some very large increases seen in April (which potentially reflected the early timing of Easter).
- We expect to see a return to moderate growth in retail spending in June. This is being supported by low interest rates, continued strength in the housing market, population growth and a strong tourist season.
- However, while a range of factors is supporting retail spending, there are growing questions about how strong the domestic spending appetite really is. On a per capita basis, growth in domestic consumption spending has been slow. Overall, spending levels have been boosted by a strong tourist season and strong population growth, both of which have boosted the economy's demand base.

## Card transactions, annual % change



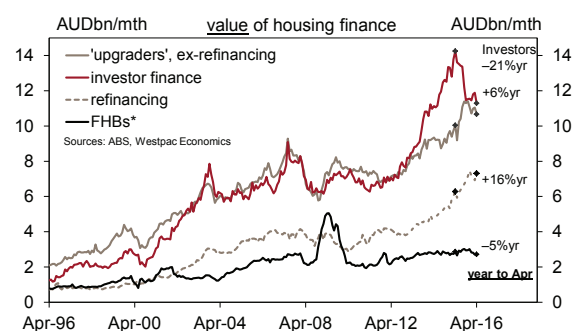
## Aus May housing finance (no.)

Jul 11, Last: 1.7%, WBC f/c: -2.0%

Mkt f/c: -2.0%, Range: -2.9% to 1.0%

- Housing finance approvals continue to point to subdued conditions, with April reporting a small 1.7% rise in the number of owner occupier approvals and a 5% drop in the value of investor loan approvals.
- Industry figures suggest owner occupier activity was again soft in May - we expect the official figures to show a 2% dip. That is despite other market indicators suggesting some firming - auction clearance rates improved over Apr-June, with some price measures also suggesting a pick-up. Investor activity may help 'square the circle', although it would be surprising to see strong gains in investor lending. Note that it usually takes several months for interest rate moves to impact, so May is far too early to expect any impact from the RBA's latest rate cut.

## Value of approvals, by segment

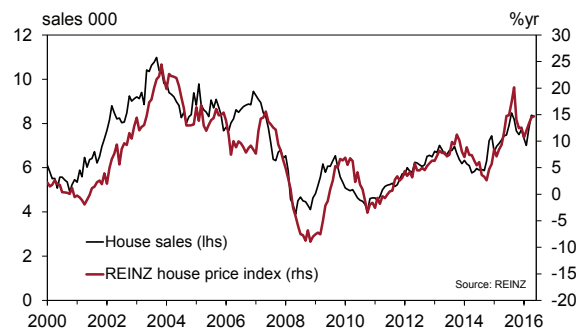


## NZ Jun REINZ house prices and sales

Jul 11-14 (tbd), Sales last: -0.5%, Prices last: 14.7%yr

- The housing market has roared back to life in recent months, with average prices now well above the levels seen before last year's clampdown on property investment. Prices are now rising strongly across the majority of regions.
- Mortgage approvals have accelerated since mid-May, when the RBNZ signalled that it was looking into further macroprudential measures, such as debt-to-income ratio limits. As with previous lending restrictions, we may be seeing the start of a 'rush to the door' as buyers try to get in ahead of any new regulations.
- We continue to regard low interest rates as the key driver of the housing market upturn.

## REINZ house prices and sales

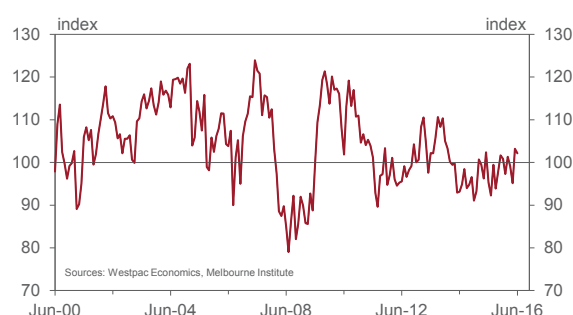


## Aus Jul Westpac-MI Consumer Sentiment

Jul 13 Last: 102.2

- The **Westpac-Melbourne Institute Consumer Sentiment Index** dipped 1% in June to 102.2 from 103.2. Coming after an 8.5% surge in May, the decline mostly represents a consolidation at improved levels. Last month's surprise rate cut from the RBA was the main catalyst behind May's rally.
- The July survey is in the field over the week ended July 10. Sentiment is likely to be buffeted by two major events: the surprise 'Brexit' vote in the UK, and the inconclusive Federal election result locally. Despite both events, the ASX is only down about 1½% since the June survey, while the AUD is actually up ½¢ vs the USD.

## Consumer Sentiment index



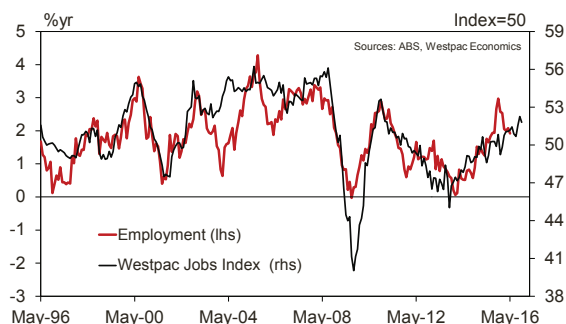
# The week ahead

## Aus June employment, change

Jul 14 Last: 17.9k, WBC f/c: 12.0k, Mkt f/c: 10k, Range: -30k to 20k

- The May Labour Force Survey was on 'trend', with a 17.9k rise in total employment. Westpac was forecasting 17k, while the market was expecting 15k. Total employment has lifted 224.8k (or 1.9%/yr) in the year, and is in line with our preferred leading indicator. Full-time employment was flat (0.0k) as part-time rose 17.9k. The growth in part-time employment continues to outpace full-time employment (160.1k/4.4%/yr vs. 64.7k/0.8%/yr).
- For June, Westpac's forecast of +12k for total employment is enough to hold the annual rate at 1.9%/yr. The Jobs Index has continued to strengthen, suggesting we are in store for a pick-up in employment growth; but we think this is more likely to come in Q4. For June, uncertainty around the Federal election and potentially some lingering correction to the 2015H2 overshoot suggests near-term gains are likely to be modest.

## Jobs index continues to firm

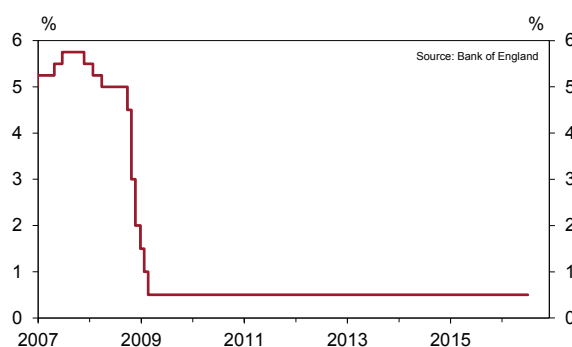


## UK Bank Of England policy decision

July 14, last 0.50%, WBC: f/c 0.25%, Mkt f/c: 0.25%

- Heightened uncertainty following the unexpected Brexit referendum result has seen the BOE move swiftly to calm markets and support the banking system. This includes £250bn of liquidity through existing facilities; weekly indexed Long-Term Repo operations to September 2016; and a 0.5% reduction in the countercyclical capital buffer rate to raise banks' lending capacity by circa £150bn.
- BOE Governor Carney has noted that "the economic outlook has deteriorated and some monetary policy easing will likely be required over the summer". He went on to note that the "Committee will make an initial assessment on 14 July, and a full assessment... [with new forecasts] will follow in the August Inflation Report." We expect that the BOE will cut the Bank Rate by 25bps in July to support confidence and follow up in August by announcing a new asset purchase program.

## Bank of England Bank Rate

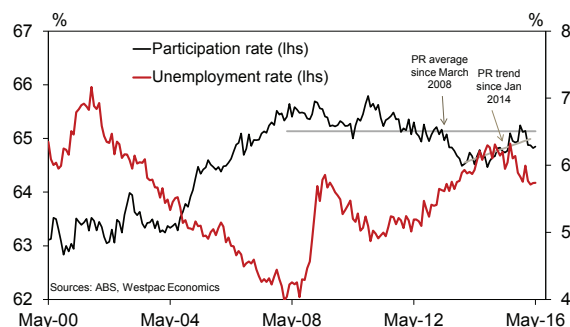


## Aus June unemployment rate

Jul 14 Last: 5.7%, WBC f/c: 5.7%, Mkt f/c: 5.8%, Range: 5.6% to 5.8%

- In May, the participation rate was flat at 64.8. After declining from an average of 65.10 in 2015Q4 to 64.96 in 2016Q1, with the two prints of Q2 to date coming in at 64.8, the average is set to dip again.
- The unemployment rate was unchanged in May at 5.7% (5.74% at two decimal places) as flat participation saw the labour force rise by 19.5k, in line with the 17.9k gain in jobs.
- For June, we are forecasting flat participation, but note that the recent weaker trend, plus our modest employment estimate, suggests very modest downside risks for participation. Given that, our forecast modest rise in employment will be enough to hold the unemployment rate at 5.7% for the third consecutive month.

## Unemployment and participation rates

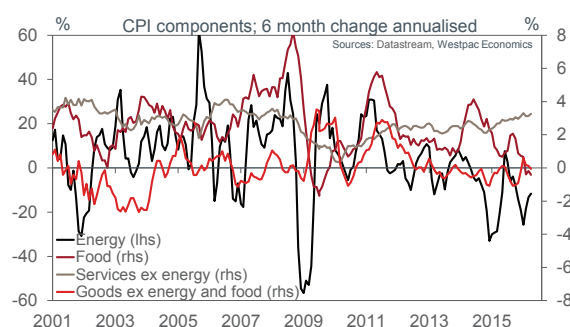


## US June CPI

Jul 15 Last: 0.2%, WBC f/c: 0.2%

- For the US (and indeed developed nations across the globe), the path back to a 'normal' rate of inflation is proving a protracted affair. At May, headline inflation stood at just 1.0%/yr.
- However, now that energy prices look to have stabilised, higher headline inflation is in the offing. May saw a 0.2% gain for headline and core measures as food and energy had a neutral impact. A similar result is likely in June.
- Most probable is another 0.2%/0.2% result for headline/core inflation. In annual terms, that would keep core inflation around 2.0%/yr as headline inflation edges higher to 1.1%/yr. Risks to the headline reading are (marginally) to the upside, a 0.3% outcome being possible.

## Services inflation the driving force



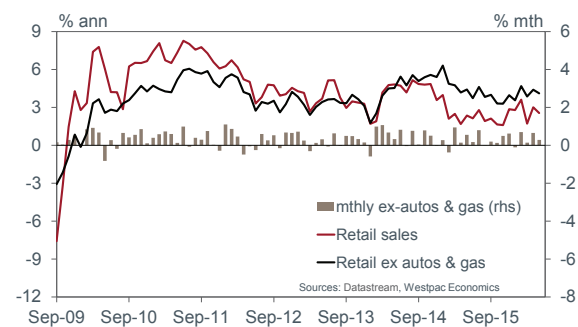
# The week ahead

## US June retail sales

Jul 15 Last: 0.5%, WBC f/c: 0.2%

- After starting the March quarter with a robust 1.3% gain – in large part due to higher energy prices and auto sales – retail sales momentum slipped back in May. Total sales rose 0.5% as core sales (excluding autos and gasoline) gained 0.3%.
- Taking a longer perspective, total sales have risen just 2.5% over the past year; core sales are a little better at 4.1%/yr, but that is still a very soft (nominal) trend.
- Come June, another soft outcome is anticipated, circa 0.2%. Autos are likely to drag on the aggregate pulse, while gasoline will only be positive at the margin. Core sales are likely to maintain a circa 0.3% pace. These are not outcomes you would expect when unemployment is below 5.0%; yet the weak trend persists.

## US retail sales, momentum needed

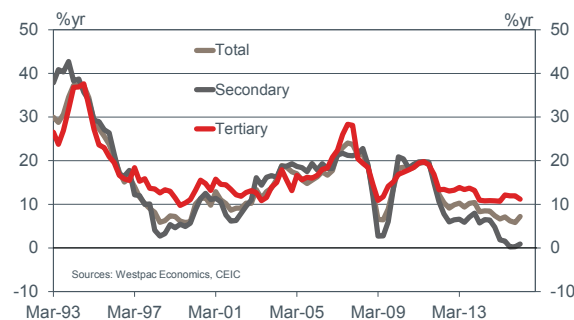


## China Q2 GDP

Jul 15 Last: 6.7%, WBC f/c: 6.6%

- In Q1, China GDP came in broadly as expected, annual growth edging lower from 6.8%/yr in Q4 to 6.7%/yr. Q1 was the weakest quarterly outcome for annual growth back to Q1 2009 – and before that, Q1 2000.
- Nominal growth actually accelerated to 7.2%/yr in Q1, but this was only the result of a sharp jump in primary sector momentum, from 4.2%/yr to 13.3%/yr. Growth in the secondary sector only managed to edge higher, from 0.2%/yr to 0.9%/yr, while tertiary momentum maintained a robust pace of 11.2%/yr.
- In Q2, the overarching narrative for growth will remain intact. The secondary sector remains under pressure, with external demand weak and pockets of housing strength having failed to broaden. The service sector remains key for growth. Real GDP growth should print at 1.5% q/q and 6.6%/yr.

## Nominal GDP: total & by broad sector



# Data calendar

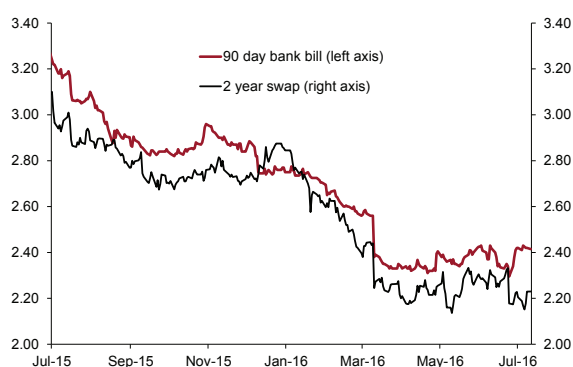
		Last	Market median	Westpac forecast	Risk/Comment
<b>Mon 11</b>					
<b>NZ</b>	Jun retail card spending	-0.3%	0.4%	0.4%	Tourism, population growth and low rates are all supporting spending.
	Jun REINZ house sales	-0.5%	0.5%	-	Due this week. Mortgage approvals remain strong.
	Jun REINZ house prices %yr	14.7%	-	-	House prices rising nationwide, buoyed by low interest rates.
<b>Aus</b>	May housing finance	1.7%	-2.0%	-2.0%	Industry figures point to a soft month despite firmer market conditions.
<b>US</b>	Jun labor market conditions index	-4.8	-	-	Aggregate indicator of momentum; pulse has slowed.
	Fedspeak	-	-	-	George speaks on the economy in Missouri.
<b>Tue 12</b>					
<b>Aus</b>	Jun NAB business survey	10	-	-	Conditions at +10 > LR avg, but confidence slipped in May to < LR avg.
	RBA Head of Fin. Stability Ellis speaking	-	-	-	Sydney Banking and Financial Stability Conference, 1.30 pm AEST.
<b>Ger</b>	Jun CPI	0.1%	0.1%	-	Inflation pressures absent despite historically strong labour market.
<b>US</b>	Jun NFIB small business optimism	93.8	94.0	-	Opportunities hindered by USD; energy; and competition.
	May wholesale inventories	0.6%	0.2%	-	Remain a key swing factor for GDP.
	May JOLTS job openings	5788	-	-	Quits; fires; and hires. Note a month behind payrolls.
	Fedspeak	-	-	-	Mester (Sydney); Tarullo; and Bullard in St Louis.
<b>Wed 13</b>					
<b>NZ</b>	Jun food prices	-0.5%	-	1.5%	Produce prices jump in winter. Annual food inflation close to zero.
	RBNZ Assist. Gov McDermott	-	-	-	Speech on how the RBNZ makes OCR decisions, 12.30pm NZST.
<b>Aus</b>	Jul Westpac-MI Consumer Sentiment	102.2	-	-	'Brexit' & Federal election result to hit?
<b>Chn</b>	Jun trade balance USDbn	49.98	-	-	Continues to provide mixed signals month to month.
<b>Eur</b>	May industrial production	1.1%	-0.7%	-	External demand to remain a major concern.
<b>US</b>	Fedspeak	-	-	-	Kashkari; Mester (Sydney); and Kaplan.
	Jun import price index	1.4%	0.5%	-	May saw fastest gain since 2012; rising oil prices and softer USD.
	Federal Reserve's Beige book	-	-	-	Conditions across the Fed regions.
<b>Can</b>	Jun Teranet house prices	1.8%	-	-	Conditions mixed across nation; energy weighing heavily in some parts.
	Bank of Canada decision	0.50%	0.50%	0.50%	Temporary hit to activity from wildfires, but oil prices up.
<b>Thu 14</b>					
<b>NZ</b>	Jun BusinessNZ manufacturing PMI	57.1	-	-	Surveys have pointed to firm activity through mid-2016.
<b>Aus</b>	Jul MI inflation expectations	3.5%	-	-	Consumer inflation expectations are subdued.
	Jun employment, change	17.9k	10k	12k	Following the moderation in Q1 total employment is growing around a
	Jun unemployment rate	5.7%	5.8%	5.7%	2%yr pace, in line with the Job Index & enough to steady unemployment.
	Jun new vehicle sales	-1.1%	-	4.0%	FCAI reported record sales for June month after lacklustre April-May.
	RBA Head of Fin. Stability Ellis speaking	-	-	-	Panel, 2016 FMA Asia/Pacific Conference, Sydney, 4.15 pm AEST.
<b>UK</b>	Jun RICS house price balance	19%	0%	-	Heightened uncertainty and policy changes dampening house prices.
	Bank of England Bank rate	0.50%	0.25%	0.25%	The BOE is attempting to boost confidence in the economy.
<b>US</b>	Jobless claims	254k	-	-	Claims remain at very low levels.
	Jun PPI	0.4%	0.3%	-	Core input prices have been rising.
	Fedspeak	-	-	-	Harker; Lockhart; and George.
<b>Can</b>	May new housing price index	0.3%	-	-	Price growth has remained limited.
<b>Fri 15</b>					
<b>Chn</b>	Jun industrial production %yr	6.0%	5.9%	-	External demand continues to weigh; housing more supportive.
	Jun retail sales %yr	10.0%	9.9%	-	Household labour market expectations have firmed recently.
	Jun fixed asset investment ytd %yr	9.6%	9.4%	-	SOE activity has strengthened; but other activity soft.
	Q2 GDP %yr	6.7%	6.6%	6.6%	Private sector investment and external demand weak.
<b>Eur</b>	May trade balance Ebn	28.0	-	-	Brexit may give competitiveness a boost via currency in time.
	Jun CPI %yr	0.1%	0.1%	-	Inflation on a very slow uptrend; target a long time coming.
<b>US</b>	Jun retail sales	0.5%	0.1%	0.2%	Trend to remain soft.
	Jun CPI	0.2%	0.2%	0.2%	Headline inflation remains near 1.0%yr.
	Jul Empire manufacturing	6.0	5.0	-	Regional manufacturing gauges have been strengthening.
	Jun industrial production	-0.4%	0.2%	-	USD continues to weigh on activity.
	Jul Uni of Michigan sentiment	93.5	93.5	-	Above average, supported by labour.
	Fedspeak	-	-	-	Kaplan; Kashkari and Bullard.

# 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	2.9	3.7	2.5	2.9	2.7
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	1.6	0.8	0.1	1.3	2.1
Current Account Balance % of GDP	-2.5	-3.4	-3.0	-3.7	-3.1	-3.2	-3.3	-3.9

Financial Forecasts	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day bill	2.20	2.20	2.20	2.20	2.20	2.20
2 Year Swap	2.10	2.20	2.30	2.30	2.30	2.30
5 Year Swap	2.40	2.50	2.60	2.70	2.80	2.90
10 Year Bond	2.50	2.60	2.70	2.90	3.00	3.10
NZD/USD	0.68	0.66	0.64	0.63	0.62	0.62
NZD/AUD	0.94	0.94	0.94	0.93	0.90	0.89
NZD/JPY	70.0	67.3	64.6	64.3	63.9	65.7
NZD/EUR	0.62	0.61	0.60	0.59	0.58	0.58
NZD/GBP	0.52	0.51	0.49	0.48	0.47	0.47
TWI	73.6	72.0	70.5	69.6	68.4	68.2

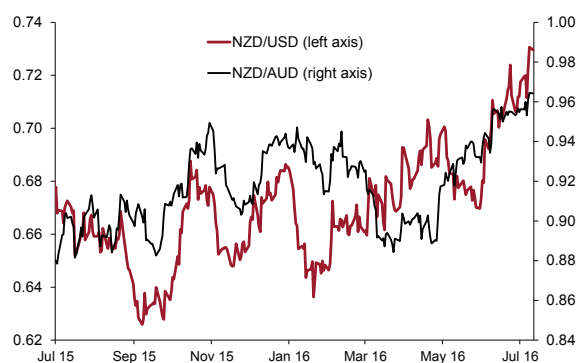
2 Year Swap and 90 Day Bank Bills



NZ interest rates as at market open on Monday 11 July 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.25%	2.25%	2.25%
30 Days	2.37%	2.31%	2.31%
60 Days	2.40%	2.33%	2.35%
90 Days	2.42%	2.32%	2.42%
2 Year Swap	2.23%	2.21%	2.31%
5 Year Swap	2.25%	2.33%	2.48%

NZD/USD and NZD/AUD



NZ foreign currency mid-rates as at Monday 11 July 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7296	0.7074	0.7053
NZD/EUR	0.6602	0.6421	0.6269
NZD/GBP	0.5634	0.5267	0.4943
NZD/JPY	73.42	71.82	75.36
NZD/AUD	0.9642	0.9537	0.9562
TWI	78.05	75.92	75.55

# International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015f	2016f	2017f
<b>Australia</b>						
Real GDP % yr	3.5	2.0	2.7	2.5	3.0	3.0
CPI inflation % annual	2.2	2.7	1.7	1.7	1.9	1.7
Unemployment %	5.3	5.8	6.2	5.8	5.6	5.4
Current Account % GDP	-4.4	-3.4	-3.0	-4.8	-4.7	-4.7
<b>United States</b>						
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	4.9	4.7
Current Account %GDP	-2.9	-2.3	-2.3	-2.4	-2.4	-2.4
<b>Japan</b>						
Real GDP %yr	1.7	1.4	0.0	0.5	0.7	0.5
<b>Euroland</b>						
Real GDP %yr	-0.9	-0.3	0.9	1.6	1.6	1.4
<b>United Kingdom</b>						
Real GDP %yr	1.2	2.2	2.9	2.2	1.9	2.1
<b>China</b>						
Real GDP %yr	7.7	7.7	7.3	6.9	6.5	6.2
<b>East Asia ex China</b>						
Real GDP %yr	4.6	4.2	4.1	3.7	3.8	4.1
<b>World</b>						
Real GDP %yr	3.5	3.3	3.4	3.1	3.3	3.5

Forecasts finalised 17 June 2016

Interest Rate Forecasts	Latest	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
<b>Australia</b>						
Cash	1.75	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.97	1.80	1.80	1.80	1.80	1.80
10 Year Bond	1.89	2.15	2.25	2.30	2.45	2.75
<b>International</b>						
Fed Funds	0.375	0.625	0.625	0.875	0.875	1.125
US 10 Year Bond	1.38	1.70	1.80	1.90	2.15	2.40
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40

Exchange Rate Forecasts	Latest	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
AUD/USD	0.7503	0.72	0.70	0.68	0.68	0.69
USD/JPY	100.74	103	102	101	102	103
EUR/USD	1.1075	1.10	1.09	1.07	1.06	1.06
AUD/NZD	1.0327	1.06	1.08	1.08	1.10	1.11



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