Weekly Commentary

12 December 2016

Tip top summer

There was a raft of developments on the political and economic fronts over the past week. On balance these developments mean that, although the economy continues to face some challenges, the growth outlook remains firm and fiscal headroom has increased. Nevertheless, we expect the OCR will remain low for some time yet.

First up, the past week saw the unexpected resignation of John Key as Prime Minister after eight years in office. The current Deputy Prime Minister Bill English is set to take the reins from Monday 12 December. Mr English has been Finance Minister for the past eight years, and is likely to maintain his relatively conservative approach to fiscal management. But the loss of a fairly popular political leader in the run up to an election does add an additional layer of uncertainty to the outlook. And at the margin, it has raised the odds of a snap election.

Turning to economic developments, there are still some clouds on the horizon. As we've discussed recently, conditions in the housing market and associated concerns around household debt have raised concerns about financial stability. On top of this, geopolitical developments in the US and Europe mean that there is lingering uncertainty around global financial and economic conditions.

But despite such challenges, the domestic economic outlook still looks positive. Low interest rates, a large pipeline of construction work, surging population growth, and strong tourist flows are all continuing to deliver powerful boosts to demand.

On top of those factors, the fortunes of the dairying sector – which had been a significant drag on growth over the past two years – have improved dramatically. Prices rose 3.5% in the latest GlobalDairyTrade auction, and are up a whopping 56% since July. As a result, we've revised up our forecasts for Fonterra's payout this season and next to $6.20 and $6.50 respectively. This should mean than most farmers' cash flows will be headed firmly back into the black. However, we don't expect to see a big rebound in farm-related investment and spending just yet. Many farmers have taken on additional debt in recent years, and this will need to be repaid.

Economic conditions have also been affected by the recent earthquakes near Kaikoura, especially in smaller regional centres in North Canterbury. In addition to the huge impact on people's lives, there has been damage to assets and disruption to activity in industries such as tourism, primary production and transportation. But while the impact on affected regions is pronounced, it is home to only a relatively small share of New Zealand's population. Overall conditions in the New Zealand economy are likely to remain resilient.

At this stage, the Treasury estimates that the direct cost to the Crown from the earthquakes will be around $2 to $3 billion, the majority of which relates to repairs to roading infrastructure. There will also be some costs for repairs to privately held assets, including several large buildings in the Wellington CBD. In both cases, insurance will cover much of the resulting spending. We estimate that the overall costs of reconstruction, are likely to be equivalent to around 2 to 3% of annual nominal GDP. While that's certainly

Tip top summer continued

not insignificant, it is manageable from a nationwide perspective, especially given the extent of insurance cover. As a comparison, reconstruction spending following the 2010/11 Canterbury earthquakes is expected to be equivalent to 15% of annual GDP.

The need for post-quake reconstruction reinforces the already strong outlook for construction activity. However, with the construction sector already stretched, reconstruction activity is may crowd out some existing planned work. In addition, we are likely to see an intensification of cost inflation in the sector. It is also worth remembering that, as we learnt from the Canterbury earthquakes, such events need to be thought of as a sequence, rather than one-off events. There is the risk of future earthquakes, and it can take some time for the ultimate costs of reconstruction to determined.

Taking recent developments on board, and we continue to expect growth of over 3% through 2017, following an estimated 3.4% growth this year. This solid economic performance, and likelihood that it will continue for some time, has seen the Government's fiscal position continuing to improve. Last week's *Half Year Economic and Fiscal Update* showed that the Government is now looking at a markedly stronger tax take than it had assumed at the time of the mid-year Budget, with Crown revenue expected to reach $89.9bn by 2020/21 (from $66.6bn in 2015/16).

With surpluses set to grow, the Government appears to have plenty of room for some kind of election year spend up, be it tax cuts or a family support package or a combination of both. However, population growth has dictated to some extent where additional spending will be required, with a big step up capital spending (including contributions to the NZ Super Fund in 2020/21) planned over the coming years. Reconstruction following the recent earthquakes will also reduce available funds. Nevertheless, it appears the Government's accounts are sufficiently robust to withstand some loosening of the purse strings.

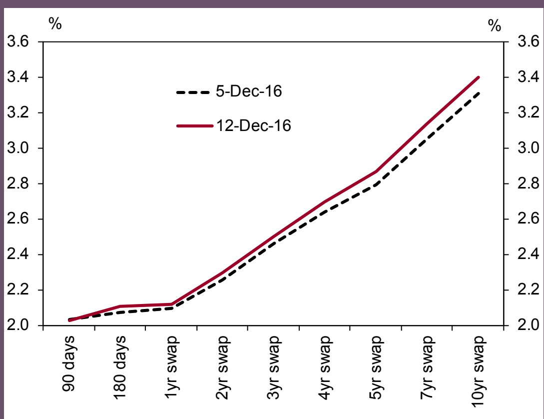
From a monetary policy perspective, signs of continued resilience in economic activity will be a welcome development. The RBNZ needs domestic activity to grow at a solid pace in order to hit its inflation target over the coming year. However, since the November *Monetary Policy Statement,* market pricing has shifted to incorporate a more-than-50% chance of a rate hike by the end of 2017. As we have previously noted, this appears too fast to us. The RBNZ needs rates to remain low to generate the required strength in domestic activity. Consistent with this, a speech last week from RBNZ Governor Wheeler poured cold water on the idea that the OCR was rising anytime soon, with his comments indicating that the RBNZ expects to keep the OCR at its current level for some time.

Fixed vs Floating for mortgages

For borrowers with a deposit of 20% or more, the best value lies in the two-year rate or shorter terms. Three- to five-year rates seem high relative to where we think short-term rates are going to go over that time. That said, these rates are most likely to be pressured higher by global market trends, so borrowers who prefer the security of a longer term should lock it in now.

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 Q3 building work put in place

Dec 15, Last: 5.5%, Westpac f/c: 2.4%

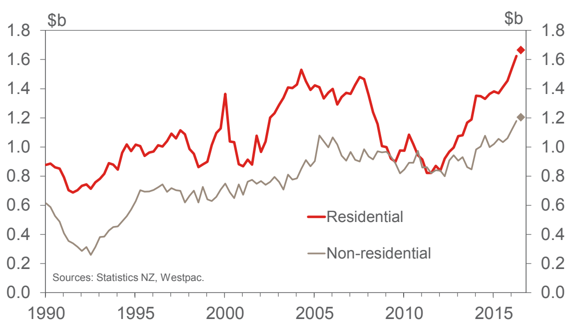
- New Zealand has enjoyed two consecutive quarters of very strong growth in building work put in place – up 5.7% and 5.5% for March and June respectively.
- Building consents continued to tick up through the June quarter, and we expect this will translate into additional solid growth in building work put in place in the September quarter.
- We expect to see growth of around 2.5% in residential building work put in place, and 2.1% in non-residential work. There is some upside risk to the residential component, but our assumption is a slower rate of delivery of new building due to rising capacity constraints in centres where construction demand is growing fastest

Aus Q3 residential property price index

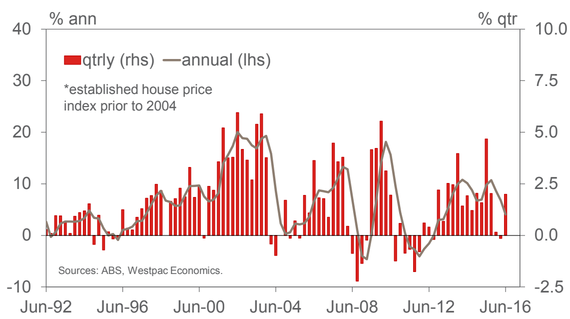
Dec 13, Last: 2.3%, WBC f/c: 0.5%
Mkt f/c: 2.5%, Range: 0.5% to 4.0%

- Note that the ABS residential property price index is more dated than private sector measures but still gains attention due to its 'official' tag. For Q2, it showed a 2.3% lift taking annual price growth to 4.6%, down from a peak of 11.4% in Q3 2015.
- Private sector measures registered Q3 price moves ranging from 1.5%qtr, 2.3%yr (APM), 2.2%qtr, 2.7%yr (Residex), and 2.9%qtr, 6.3%yr (CoreLogic). The ABS measure tends to track the APM series – a 1%qtr gain would bring it in line with APM's annual growth rate of 2½%. More timely data shows further price gains in Q4 with auction clearance rates in Sydney and Melbourne rallying strongly into year end, both near record highs in seasonally adjusted terms (clearance rates usually decline 4-5ppts through Nov-Dec).

NZ real building work put in place



Residential property price index, ABS measure



Aus Dec Westpac-MI Consumer Sentiment

Dec 14 Last: 101.3

- The **Westpac-Melbourne Institute Consumer Sentiment** Index dipped 1.1% from 102.4 in October to 101.3 in November. Overall though the Index continues to hold in a narrow band in slightly positive territory and has trended slightly higher over the last year.
- This month's survey is in the field over the week ended Dec 10. Several, potentially offsetting, developments are likely to impact, namely: the surprise election result in the US; the strong surge in global sharemarkets (ASX up 7% since the last survey); and, during the survey week, a Q3 GDP result showing a surprise contraction in the Australian economy. The RBA left rates on hold at its Dec meeting as expected, although some lenders have raised rates on interest-only and fixed rate loans. Labour market conditions and household incomes remain soft but house prices have continued to firm albeit with performances varying widely across different regions.

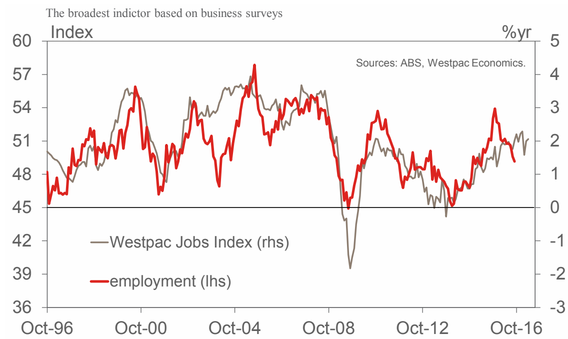
Aus Nov employment ch, '000

Dec 15, Last: 10.9k, WBC f/c: 20k
Mkt f/c: 17.5k, Range: 5k to 35k

- Employment rose 9.6k in October but benchmarking revisions since then have resulted in a revision to 10.9k with the –9.8k decline in September now reported as –30.6k. The annual pace of growth was just 0.8%yr in October compared to the original reported pace of 1.4%yr in September (it is now reported as 1.2%yr). Employment has expanded by just 93k in the year to October compared to 139.6k to September (and this was revised from 163.1k). The annual pace of growth is currently well under what our Jobs Index is suggesting.
- The economy hit soft patch in Q3 as the economy was buffeted by an extended Federal election and global uncertainty. There is no reason to think that this is now entrenched as our leading indicators remain quite positive and we expect employment to lift towards those indicators as the year ends.

Consumer Sentiment Index

Westpac jobs index



The week ahead

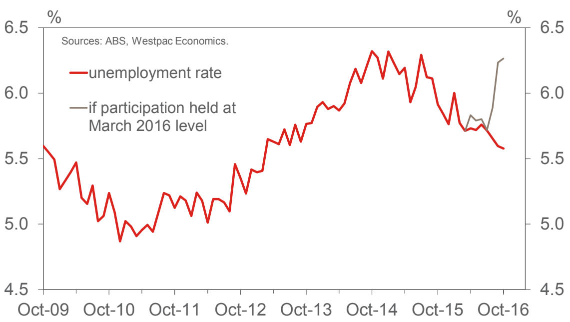
Aus Nov unemployment rate

Dec 15, Last: 5.6%k, WBC f/c: 5.6%

Mkt f/c: 5.6%, Range: 5.5% to 5.7%

- The unemployment rate was flat at 5.6%. Normally we look to the unemployment rate to provide some guidance to the overall state of the labour market but in 2016 we take a more pragmatic approach as the ongoing decline in participation makes this approach somewhat problematic. If the participation rate had held at 64.87%, as it was reported to have been last March, then the soft patch in employment would have lifted the unemployment rate to 6.3% in October.
- While some of the decline in participation is structural, ie. disillusioned workers retiring from the workforce, our analysis suggests a large part of it is cyclical, that is associated with the soft patch in the labour market. As such, stronger employment outcomes should be associated with a rise in participation hence our forecast for a flat 5.6% unemployment rate.

Unemployment could have been a lot higher

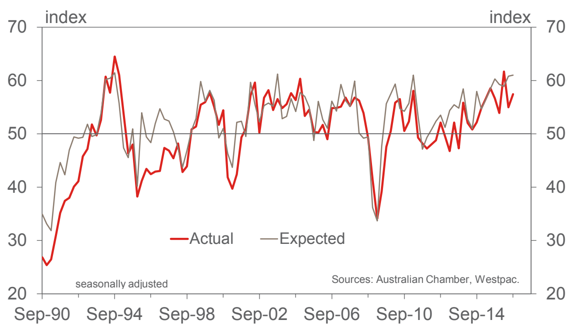


Aus Q4 Australian Chamber-Westpac survey

Dec 15, Last: 57.4

- The Australian Chamber-Westpac survey of the manufacturing sector provides a timely update on conditions in the sector and insights into economy-wide trends. The Actual Composite tracks household demand, highlighting the key linkages between the consumer, home building and manufacturing. The Q4 survey was conducted during November / early December. In Q3, the Actual Composite rebounded to 57.4, after dipping to 55.0 in June. Strength is centred on a lift in new orders and output, as well as increased overtime and an emerging resilience in employment.
- Manufacturing is benefitting from the strong upswing in new home building activity, in response to low interest rates, and the significant improvement in competitiveness of exporters and import competing firms. However, the mining investment downturn remains a major headwind.

Westpac-Aus Chamber Composite indexes

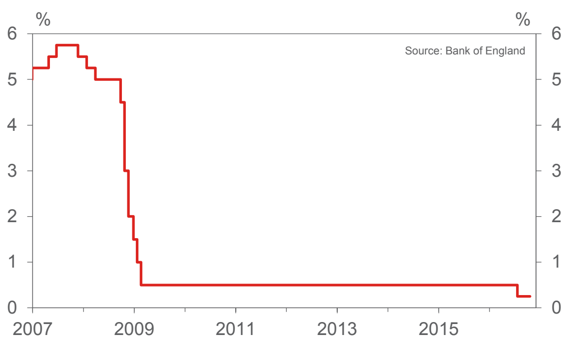


UK Bank of England policy decision

Dec 15, Last: 0.25%, WBC f/c: 0.25%

- At its November policy meeting, the Bank of England kept both the Bank rate and its bond purchase programme unchanged. However, it wound back its previously stated easing bias, adopting a more neutral stance. This shift was prompted by resilience in activity following the Brexit referendum, as well as the sharp drop in the pound which has seen import prices rising rapidly.
- There is still the very real risk of a slowdown in UK GDP growth over the coming year as uncertainty weighs on hiring and investment, and rising prices erode households' purchasing power. However, activity is holding up for now. As a result, we expect the Bank of England will keep rates on hold at its upcoming December rate decision. Complicating matters for the BOE is the lower pound, which is likely to result in inflation rising about the 2% target for some time over the coming year.

Bank of England Bank Rate

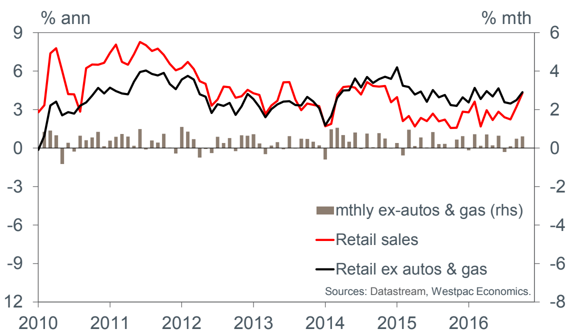


US Nov retail sales

Dec 14, Last: 0.8%, WBC 0.6%

- US retail sales recorded two consecutive robust gains in September and October, respectively 1.0% and 0.8%. That followed a volatile six months during which monthly growth averaged just 0.3%.
- Whereas core retail sales also rose 0.3% on average through the six months to August, in September and October they did not see as large an improvement as the headline measure. Instead, gains of 0.5% and 0.6% were reported. The key point here is that, while the headline gains of the past two months are certainly welcome, to a degree they are the result of stronger energy prices not activity.
- Come November, headline retail sales growth is expected to pull back to a 0.6% pace, with gasoline and auto sales likely to be neutral. The steady pace of the core series is likely to persist, also registering growth of 0.6% in the month.

Retail sales momentum solid but not yet strong



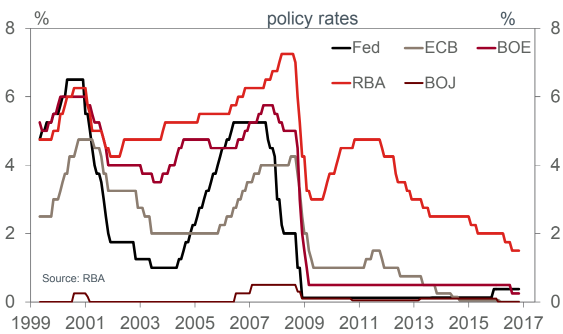
The week ahead

US FOMC policy decision

Dec 14, Last: 0.375%, WBC 0.625%

- Despite all the turmoil surrounding the election of Trump to the presidency as well as the significant uncertainties that remain vis a vis his policies, a 25bp rate in December is certain. Arguably the economic data has argued for a rate hike for a number of months: PCE and CPI inflation converging toward the FOMC's 2.0%yr medium term target; strong employment growth; and now in November, an unemployment rate at 4.6%, a rate that can only be categorised as full employment. Further, having now passed all of the year's risk events (with net gains for risk assets), there is no other reason to delay.
- Indeed, given that the outcome of the meeting is effectively known, the market's attention will be focused on the FOMC's view of 2017, particularly for inflation. This assessment will shape term interest rate expectations and therefore the market rates that matter to consumers and businesses.

Developed world policy interest rates

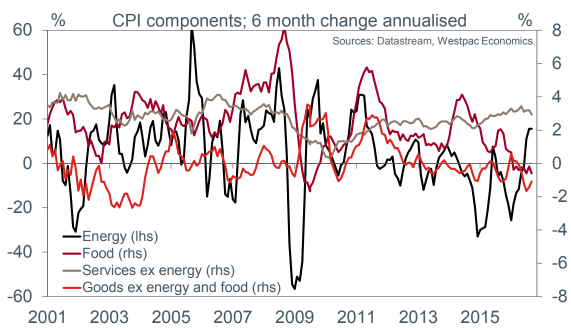


US Nov CPI

Dec 15, Last: 0.4%, WBC 0.2%

- September and October saw a firming in headline inflation as energy prices rose. Having averaged 0.1% over the four months to August, gains of 0.3%/0.4% were subsequently reported. As a result, annual headline inflation has continued to converge toward the FOMC's 2.0%yr medium-term target, now 1.6%yr.
- Notably, the fluctuations associated with energy prices continue to mask even stronger inflation in core prices, with ex food & energy remaining above 2.0%yr throughout 2016.
- As we have often mentioned, the primary driver of this strength in core inflation is services ex energy, and within this sub-sector rent inflation. Within services, the effect of higher minimum wages in leisure and hospitality have also been a factor. Come November, a 0.2% gain for headline and core prices is expected, with the annual pace of core inflation at target

Underlying inflation pressures robust



Data calendar

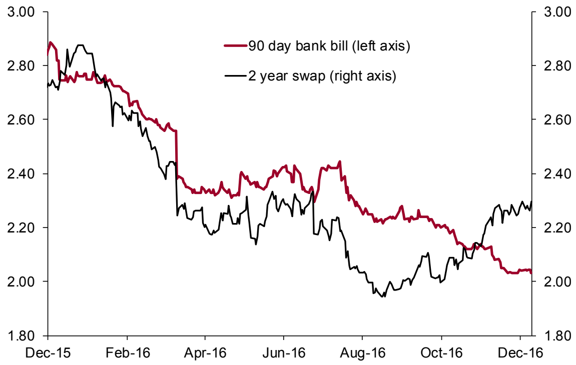
		Last	Market median	Westpac forecast	Risk/Comment
Mon 12					
UK	Dec Rightmove house prices	-1.1%	–	–	Price growth has eased off following the referendum and policy changes.
US	Nov monthly budget statement, $b	-44.2	-99.5	–	All is well with the deficit for now.
Tue 13					
NZ	Q3 survey of manufacturing	2.5%	–	–	Declines in meat and milk processing to weigh on food manufacturing.
Aus	Nov NAB business survey	6	–	–	Conditions index -2pts to +6, extending moderation emerged in July.
Chn	Nov industrial production	6.1%	6.1%	–	PMI's point to an improvement in activity ahead.
	Nov retail sales %yr	10.0%	10.2%	–	Growth has been stable around 10%yr of late.
	Nov fixed asset investment ytd %yr	8.3%	8.3%	–	Hope to see private investment find a base in coming months.
Eur	Dec ZEW investor confidence	15.8	–	–	Investors' confidence boosted by Trump and now ECB.
US	Nov NFIB small business optimism	94.9	96.5	–	Have not been as optimistic as big business of late.
Wed 14					
Aus	Dec Westpac-MI Consumer Sentiment	101.3	–	–	US election, sharemarket surge, and surprise Aus GDP fall to impact.
	Nov new vehicle sales	-2.4%	–	-1.0%	Industry figures a touch softer in Nov, about flat on a year ago.
UK	Oct ILO unemployment rate	4.8%	4.8%	–	The labour market has been resilient since the Brexit vote.
US	Nov retail sales	0.8%	0.3%	–	A more modest gain anticipated in Nov; little support from gas/autos.
	Nov industrial production	0.0%	-0.2%	–	Growth weak and likely to remain so.
	FOMC policy decision, mid-point	0.375%	0.625%	0.625%	Focus to be on tone of statement and press conference.
Thu 15					
NZ	Nov BusinessNZ PMI	55.2	–	–	Business sector gauges are pointing to firm activity through late 2016.
	Q3 building work put in place	5.5%	2.1%	2.4%	Residential and non-residential activity lifting.
Aus	Dec MI inflation expectations %yr	3.2%	–	–	Has fallen below trend pace of 3.4% so inflation remains subdued.
	Nov employment ch	10.9k	17.5k	20.0k	The economy went through a soft patch in Q3 but the leading jobs...
	Nov unemployment rate	5.6%	5.6%	5.6%	... indicators are still quite postitive so some improvement expected.
	Q4 AusChamber-Westpac survey	57.4	–	–	Manufacturing benefitting from home building upswing & lower AUD.
Eur	Dec Markit manufacturing PMI (provisional)	53.7	53.6	–	Positive tone across both surveys in Nov...
	Dec Markit services PMI (provisional)	53.8	53.7	–	... likely to be sustained in Dec.
UK	Bank of England policy decision	0.25%	0.25%	0.25%	Activity resilient and lower pound boosting inflation.
US	Q3 current account balance, $b	119.9	111.0	–	Extremely dated data.
	Dec Empire manufacturing	1.5	2.6	–	Regional manufacturing surveys have been lifting.
	Nov CPI	0.4%	0.2%	–	Underlying inflation near 2%yr target; preferred PCE still below.
	Initial jobless claims	258k	–	–	Claims remain at historically low levels.
	Dec Philly Fed business outlook survey	7.6	9.0	–	Points to a pick-up in activity in late 2016.
	Dec NAHB housing market index	63	63	–	Manufacturing activity has been firming.
Fri 16					
NZ	Dec ANZ consumer confidence index	3.5%	–	–	Has firmed, consistent with strength in household spending.
Eur	Oct trade balance, €bn	24.9	–	–	Lower EUR necessary to spur competitiveness and export cont'n.
US	Nov housing starts	25.5%	-7.0%	–	Significant pullback in starts expected after Oct surge ...
	Nov housing permits	2.9%	-1.4%	–	... permits also likely to pull back.
	Fedspeak	–	–	–	Lacker speaking on the economic outlook on panel in Charlotte.

New Zealand forecasts

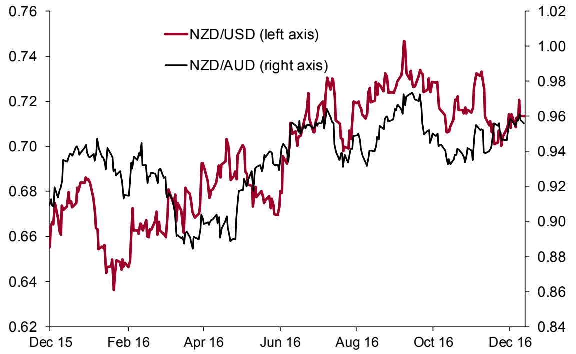
Economic Forecasts	March years				Calendar years			
% change	2015	2016	2017f	2018f	2014	2015	2016f	2017f
GDP (Production) ann avg	3.6	2.5	3.5	3.2	3.8	2.5	3.4	3.2
Employment	3.2	2.0	4.8	2.2	3.6	1.4	5.8	2.0
Unemployment Rate % s.a.	5.4	5.2	5.0	4.3	5.5	5.0	4.8	4.5
CPI	0.3	0.4	1.3	1.2	0.8	0.1	1.2	1.1
Current Account Balance % of GDP	-3.5	-3.1	-2.9	-2.8	-3.2	-3.4	-2.9	-2.8

Financial Forecasts	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	2.10	2.10	2.10	2.10	2.10	2.10
2 Year Swap	2.30	2.40	2.50	2.50	2.50	2.50
5 Year Swap	2.70	2.80	2.90	3.00	3.00	3.00
10 Year Bond	3.00	3.10	3.20	3.25	3.30	3.25
NZD/USD	0.72	0.72	0.71	0.70	0.68	0.66
NZD/AUD	0.94	0.95	0.96	0.96	0.94	0.94
NZD/JPY	76.3	77.8	78.1	77.0	76.2	75.2
NZD/EUR	0.66	0.67	0.68	0.67	0.67	0.65
NZD/GBP	0.58	0.59	0.58	0.57	0.56	0.55
TWI	77.9	78.6	78.6	78.0	76.7	75.3

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 12 December 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.88%	1.92%	1.97%
60 Days	1.96%	1.98%	2.01%
90 Days	2.03%	2.04%	2.09%
2 Year Swap	2.30%	2.26%	2.27%
5 Year Swap	2.87%	2.79%	2.74%

NZ foreign currency mid-rates as at Monday 12 December 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7134	0.7041	0.7106
NZD/EUR	0.6769	0.6640	0.6562
NZD/GBP	0.5678	0.5641	0.5644
NZD/JPY	82.22	79.58	75.94
NZD/AUD	0.9563	0.9455	0.9420
TWI	78.81	77.77	77.42

International forecasts

Economic Forecasts (Calendar Years)	2013	2014	2015	2016f	2017f	2018f
Australia						
Real GDP % yr	2.0	2.7	2.4	2.9	3.0	2.8
CPI inflation % annual	2.7	1.7	1.7	1.6	1.8	2.5
Unemployment %	5.8	6.2	5.8	5.5	5.5	5.4
Current Account % GDP	-3.4	-3.0	-4.7	-2.9	-2.6	-2.5
United States						
Real GDP %yr	1.5	2.4	2.6	1.5	2.1	2.1
Consumer Prices %yr	1.5	1.6	0.1	1.2	1.7	1.7
Unemployment Rate %	7.4	6.2	5.3	4.9	4.6	4.5
Current Account %GDP	-2.3	-2.3	-2.6	-2.7	-3.0	-3.1
Japan						
Real GDP %yr	1.4	0.0	0.5	0.6	0.6	0.7
Euroland						
Real GDP %yr	-0.3	0.9	1.6	1.6	1.2	1.3
United Kingdom						
Real GDP %yr	2.2	2.9	2.2	2.1	1.6	1.4
China						
Real GDP %yr	7.7	7.3	6.9	6.7	6.5	6.0
East Asia ex China						
Real GDP %yr	4.2	4.1	3.7	3.7	3.9	3.8
World						
Real GDP %yr	3.3	3.4	3.1	3.3	3.5	3.4
Forecasts finalised 11 November 2016						

Interest Rate Forecasts	Latest	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.77	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.82	2.65	2.70	2.75	2.80	2.90	2.95	3.00
International								
Fed Funds	0.375	0.625	0.625	0.875	0.875	1.125	1.125	1.375
US 10 Year Bond	2.43	2.25	2.30	2.35	2.40	2.50	2.55	2.60
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40

Exchange Rate Forecasts	Latest	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
AUD/USD	0.7463	0.77	0.76	0.74	0.73	0.72	0.70	0.70
USD/JPY	114.35	116	118	118	120	122	124	124
EUR/USD	1.0615	1.08	1.07	1.05	1.04	1.02	1.01	1.00
AUD/NZD	1.0409	1.07	1.06	1.07	1.09	1.11	1.09	1.09

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