

# Weekly Commentary

13 June 2016



## Holding fire

Last week the RBNZ hit the pause button on further interest rate cuts. It retained its easing bias, and a further cut in the August remains more likely than not, but this is by no means set in stone. Much will depend on what happens in the New Zealand economy (and offshore) over the next couple of months. In particular, the strength of the NZ dollar will be weighed against pressures emanating from a rampant housing market. This week we have GDP and current account data for Q1. We expect GDP growth slowed a little from the pace at the end of last year, but this is largely down to timing. Meanwhile, the current account is expected to narrow to 3% of GDP.

In last Thursday's *Monetary Policy Statement (MPS)*, the RBNZ decided to leave the OCR unchanged. Both the decision and the text of the Statement were much in line with what we had expected. The RBNZ retained its easing bias, stating "*Further policy easing may be required to ensure that future average inflation settles near the middle of the target range*", and retained the same downward sloping 90 day rate track that appeared in the March *MPS*.

But beneath the headlines, the tone of the *Statement* was a little more positive from the RBNZ, particularly on the inflation front. That should not come as much of a surprise – there have been a range of inflation positive developments recently. Rebounding oil and other commodity prices should see inflation head higher from here, to be sitting comfortably back within the 1-3% target band next year.

Rising inflation will also soothe the RBNZ's nerves on the inflation expectations front. The sharp fall in inflation expectations earlier in the year was a key catalyst for the Bank's decision to cut the OCR in March. Since then inflation expectations have stabilised, albeit at low levels, and the RBNZ anticipates expectations will rise as headline inflation tracks higher.

But persistent strength in the NZ dollar continues to cause headaches for the RBNZ. Its forecasts assume the TWI gradually depreciates to 69.7 by mid-2019, boosting tradable inflation. But in the near term at least, the risks are in the opposite direction. The NZD/USD rose a full cent following the RBNZ's announcement, and is now sitting above USD 0.70. And on a TWI basis, the currency is already more than 4% higher than the RBNZ assumes in its forecasts.

Of course it's not only RBNZ policy that influences the value of the NZ dollar. One reason the NZD/USD has been so strong recently has been shifting expectations of Federal Reserve policy. Very weak US labour market data has effectively put the kibosh on a rate hike as soon as this month. In our view it will be September before the Fed raises rates. This has led to the US dollar weakening, pushing up the NZD/USD. There is clearly a risk that the NZ dollar will stay stronger for longer than the RBNZ expects.

On the opposite side of the ledger, the key development favouring the RBNZ leaving interest rates unchanged is the rampant housing market and associated very strong credit growth. Indeed, financial stability concerns peppered both the *MPS* and the Governor's press conference. In the *MPS* the RBNZ pointed out that the Policy Targets Agreement

# Holding fire continued

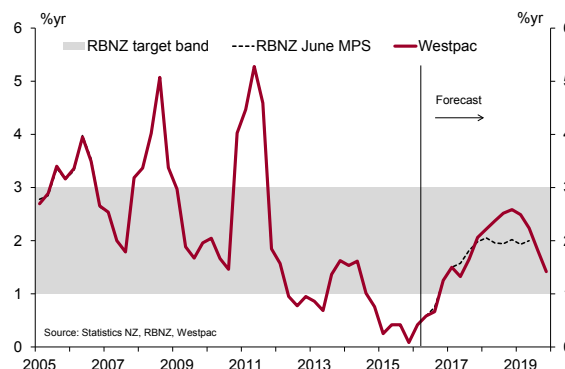
requires the Bank to have regard to financial stability. And in this respect, the high level of house prices relative to incomes in Auckland and the recent increase in house price inflation in many parts of the country will continue to warrant close attention, and could see the RBNZ thinking twice before lowering the OCR further.

The Governor was also closely questioned at the press conference about the possibility of changes to LVR mortgage lending restrictions and the potential for new debt-to-income restrictions. His comments led us to conclude that changes to the LVR restrictions, targeting investors, are likely before the end of the year. The introduction of debt-to-income rules would be further down the track.

On balance we continue to favour another rate cut in August. But that is not set in stone. Much will depend on what happens in the economy between now and then. And certainly, the balance of risks to our 2% call has shifted. We now see more risk of the OCR remaining at 2.25% than of it falling below 2% this year.

One of the key data releases ahead of the August MPS is March quarter GDP, out on Thursday. We expect a 0.6% increase in GDP in the quarter. This is a little slower than the

CPI inflation forecasts



pace in the second half of last year, but would leave annual GDP growth at a respectable 2.7%. The biggest contribution to growth is likely to come from the construction sector and the main negative from meat processing. Over the second half of last year, low dairy prices and the possibility of an El Niño drought prompted a much larger than usual cull of both sheep and cattle. This boosted GDP over the September and December quarters, but we will see the payback for this in the March quarter.

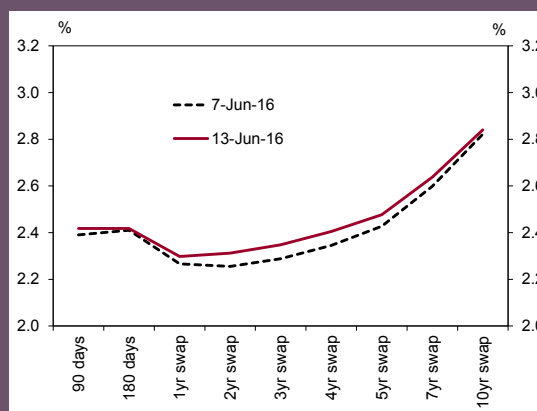
## Fixed vs Floating for mortgages

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



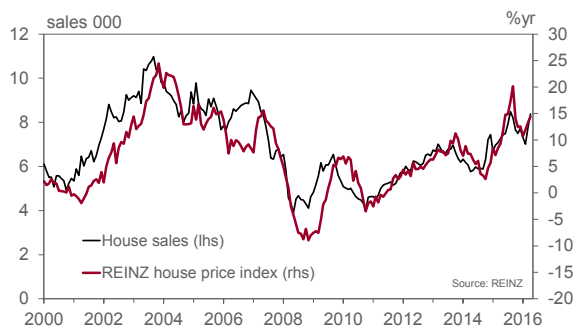
# The week ahead

## NZ May REINZ house prices and sales

Jun 13 (tbd), Sales last: 8.0%, Prices last: 14.5%yr

- The housing market has roared back into life in recent months, following a brief slowdown after the new regulations on property investment late last year. House prices are now above last year's peaks, and sales are not far behind.
- We expect the May report to show a continuation of this momentum, notwithstanding that sales in April may have been boosted by the absence of Easter holidays this year. Meanwhile, rising house prices should continue to spread across the country.
- 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 likelihood of further prudential policy measures.

## REINZ house prices and sales

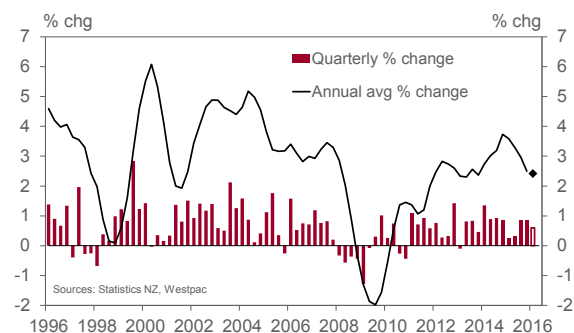


## NZ Q1 GDP

Jun 16, Last: 0.9%, Westpac f/c: 0.6%, Mkt f/c: 0.5%

- We expect a 0.6% increase in March quarter GDP, below the 0.9% quarterly pace seen in the second half of last year. The slower pace is largely attributable to meat processing, with higher than usual slaughter rates in late 2015 resulting in fewer animals available in early 2016.
- The strongest contribution is likely to come from the construction sector. Quake rebuild activity in Canterbury has peaked, but there is a strong pipeline of building work across the rest of the country.
- Consumers appear to have made a relatively modest contribution to growth over the quarter. This may have been a product of the subdued housing market at the start of the year, following last year's investor regulations.

## Production-based GDP

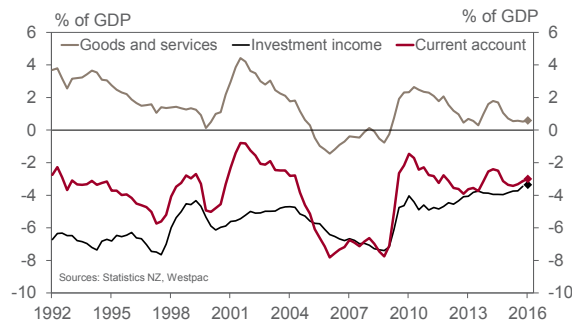


## NZ Q1 current account % of GDP

Jun 15, Last: -3.1%, Westpac f/c: -3.0%, Mkt f/c: -3.0%

- We expect the annual current account deficit to narrow slightly to 3.0% of GDP. Weak dairy prices have undermined export earnings in the last two years, but there has been a variety of offsetting positives in that time.
- World oil prices plunged over the March quarter, sharply reducing New Zealand's import bill. Meanwhile, rising tourist numbers have continued to boost the surplus on trade in services.
- We expect the deficit to widen again over the course of this year, but to remain significantly below its pre-GFC levels.

## Annual current account balance



## Aus Jun Westpac-MI Consumer Sentiment

June 15 Last: 103.2

- The **Westpac-Melbourne Institute Consumer Sentiment Index** surged 8.5% in May, dominated by a positive response to the RBA's surprise interest rate cut, additional questions suggesting little impact from the May Budget. The monthly gain is at the high end of historical rate cut responses and takes the index to its highest level since Jan 2014. That said, at 103.2 the index is 'cautiously positive' rather optimistic.
- The June survey is in the field over the week ended June 10. Sentiment often retraces the month following a rate cut boost although that is by no means assured. Other factors that may also influence including: the RBA's decision to leave rates on hold, offering no indication of an immediate follow up move; and a better than expected Q1 GDP result, albeit with much of the detail still weak. Financial markets have been a touch firmer although news from offshore has been downbeat.

## Consumer Sentiment Index



# The week ahead

## Aus May employment change

Jun 16, Last: 10.6k, WBC f/c: 17k, Mkt f/c: 15k, Range: -7K to 35k

- The April Labour Force Survey set a modestly positive tone for the labour market – total employment rising 10.8k compared to a market median of +12k and a range of -5k to +38k. Total employment has lifted 244.7k (or 2.1%yr) on a year ago and remains broadly in line with our preferred leading indicators.
- Full-time (-9.3k) and part-time (+20.2k) employment in April continued the trend for part-time employment to outpace full-time employment (160.9k/4.5%yr vs. 83.8k/1.0%yr).
- In April the Westpac Jobs Index hit 52.3 and while it eased a touch to 52.1 in May this is still the second strongest reading since June 2010. Our forecast for 17k will see a small dip in the annual pace of growth to 1.9%. Given the surge in employment through late 2015 a period of underperformance relative to the Jobs Index is to be expected.

## Jobs Index continues to firm

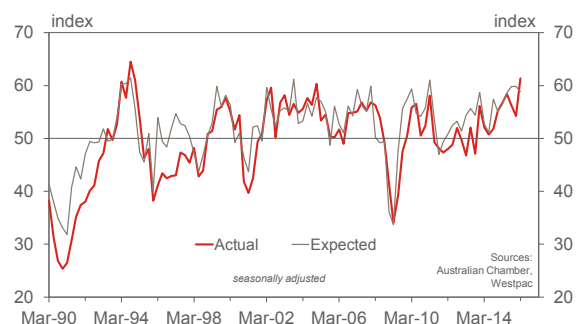


## Aus Q2 Australian Chamber-Westpac survey

Jun 16, Last: 61.4

- The Australian Chamber-Westpac survey of the manufacturing sector provides a timely update on conditions in the sector, with insights into economy-wide trends. The Actual Composite tracks household demand, highlighting the key linkages between the consumer, home building and manufacturing.
- In Q1, the Actual Composite jumped to an historically high 61.4, up 7.1pts from Q4. Strength is centred on a lift in new orders and output, as well as an increase in overtime. The Q1 result may have been inflated by a clustering of new orders, delayed by heightened market volatility in earlier months. 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 from the sharply lower currency. However, the mining investment downturn is a major headwind.

## Westpac-AusChamber composite indexes



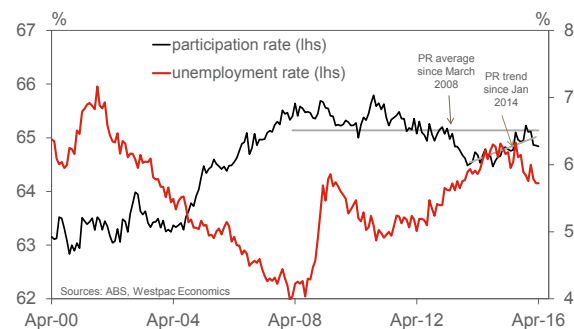
## Aus May unemployment rate

Jun 16, Last: 5.7%, WBC f/c: 5.7%,

Mkt f/c: 5.7%, Range: 5.6% to 5.8%

- In April, it was somewhat surprising that the participation rate was flat at 64.9%. This means we can now observe a trend decline in participation, from an average of 65.09% in Q4 to 64.95% in Q1. With a 64.84% print in April the average is set to dip again in Q2.
- At two decimal places it was a small fall from 64.86% in March to 64.84% in April which was why the unemployment rate held flat despite the sluggish 10.8k rise in employment. Normally, a flat participation rate (as reported at one decimal place) would require an 18k gain on employment to match the growth in the labour force.
- In May we are looking for the participation rate to round up to 64.9% which will result in only a slightly larger than trend lift in the labour force holding the unemployment rate steady at 5.7%.

## Unemployment and participation rates

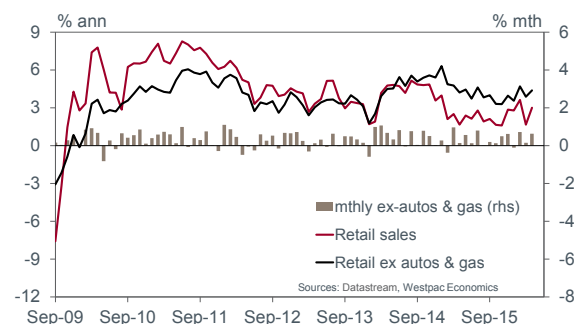


## May US retail sales

Jun 14, Last: 1.3%, WBC 0.4%

- After a disappointing first quarter in which total retail sales averaged a monthly contraction of -0.2%, activity jumped 1.3% in the month of April, leaving annual growth at 3.0%yr.
- Much of the gain in April was the result of a jump in auto sales – up 3.2% in the month following a 3.2% fall in March – and stronger gasoline sales, the latter partly due to higher prices. Core retail sales rose by a more modest 0.6%, but because this series was unaffected by lower oil prices in prior months annual growth in core sales remains more robust at 4.4%yr.
- While there was initially hope that April's momentum could be sustained through Q2, market expectations have softened. The market anticipates a 0.3% headline gain and a similar-sized rise for core sales. On the whole, we concur, expecting a 0.4% rise in total and core sales.

## US retail sales, momentum needed



# The week ahead

## Jun US Fed policy decision

Jun 14-15, Last: 0.375%, WBC 0.375%

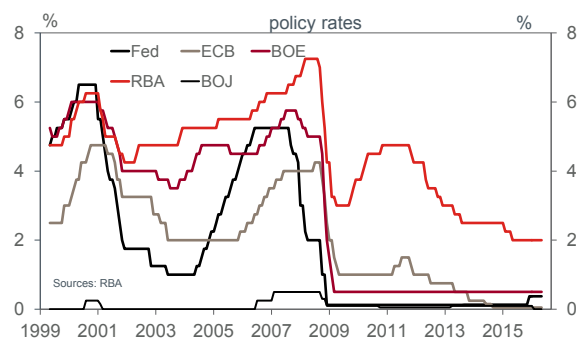
- Less than a fortnight ago, FOMC and market participants were talking about the next rate hike being delivered in “coming months”, meaning that meetings in June or July were both live. Yet following May’s very disappointing employment report, we now find Chair Yellen optimistic but more noncommittal on the outlook for rates.
- The poor May payrolls outcome, negative prior-month revisions and inflation still well below target has given the FOMC much to think about. Receding global risks are not an offset, with the Committee squarely focused on the domestic economy.
- At the beginning of May, we pushed back our expected timing for the next Fed Funds Rate hike from June to September. The market now also expects this to be the next ‘live’ meeting. But almost all would argue there is risk of further delay.

## May US CPI

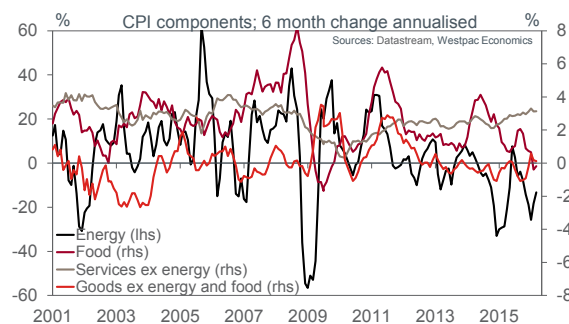
Jun 16, Last: 0.4%, WBC 0.3%

- The headline CPI rose by 0.4% in April, aided by higher gasoline prices. However prior weakness in this component remained the dominant factor for annual inflation which was still soft at 1.1%/yr.
- Abstracting from oil price volatility, core price pressures were robust, rising 0.2% in April, 2.1%/yr. Unlike the deceleration in the labour market, core inflation pressures are persisting, thanks to rising rents and other service costs.
- In coming months, it seems likely that both headline and core inflation pressures will converge towards the FOMC’s 2.0%/yr medium-term target. But, still affected by the US dollar and with oil prices unlikely to extend their uptrend, headline inflation should remain below target. In the month of May, headline and core price gains are likely to be similar, with gains of 0.3% and 0.2% respectively.

## Developed world policy interest rates



## Developed world policy interest rates



# Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
<b>Mon 13</b>					
<b>NZ</b>	May REINZ house sales	8.0%	-	-	Due this week. Turnover has rebounded from last year's regulations.
	May REINZ house prices %yr	14.5%	-	-	House price gains are becoming increasingly widespread.
<b>Aus</b>	Queen's Birthday	-	-	-	Public holiday, celebrated by all states except Qld and WA.
<b>Tue 14</b>					
<b>NZ</b>	May food prices	0.3%	-	-0.3%	Temporary lift in produce prices should start to fade.
<b>Aus</b>	May NAB business survey	9	-	-	Conditions at +9 in April, > LR avg, boosted by low rates & lower AUD.
	RBA Assist Governor Financial Markets	-	-	-	Guy Debelle, remarks, Market Liquidity conference, HK, 10:50am AEST.
<b>Eur</b>	Apr industrial production	-0.8%	0.5%	-	EUR and global demand continue to weigh.
<b>UK</b>	May CPI	0.1%	0.3%	-	Gradual rise expected, supported by oil price increases.
	Mar ONS house prices	-	-	-	New calculation approach takes effect this month.
<b>US</b>	May NFIB small business optimism	93.6	93.6	-	Has been trending down in recent months on USD and softer growth.
	May import price index	0.3%	0.8%	-	Imported inflation pulse modest.
	May retail sales	1.3%	0.3%	-	Hopes that April momentum would persist has faded.
	Apr business inventories	0.4%	0.2%	-	Wholesale surprised to upside; will broader measure follow suit?
<b>Can</b>	May Teranet/Nat Bank house prices	1.2%	-	-	House price inflation has been accelerating.
<b>Wed 15</b>					
<b>NZ</b>	Q1 current account % of GDP	-3.1%	-3.0%	-3.0%	Cheaper oil imports and rising tourism earnings.
<b>Aus</b>	Jun Westpac-MI Consumer Sentiment	103.2	-	-	RBA's surprise rate cut generated a solid sentiment bump in May.
	Jun Westpac-MI unemployment expns	-5.8%	-	-	Expectations improved in the year but still worse than long run average.
<b>Eur</b>	Apr trade balance €bn	22.3	-	-	EUR and global demand continue to weigh.
<b>UK</b>	Apr ILO unemployment rate	5.1%	-	-	The recent softening in activity will likely weigh on employment growth.
<b>US</b>	FOMC policy decision, midpoint	0.375%	0.375%	0.375%	Expectations surrounding FOMC decision have flipped.
	Jun Empire manufacturing survey	-9.0	-5.0	-	Regional manufacturing gauges have moderated.
	May industrial production	0.7%	-0.2%	-	Apr surprised on manufacturing; likely to reverse in May.
	Apr total net TIC flows	-98.3	-	-	Long-term demand for US Treasuries.
	May PPI	0.2%	0.3%	-	Input prices, including oil, have been lifting.
<b>Thu 16</b>					
<b>NZ</b>	Q1 GDP	0.9%	0.5%	0.6%	Modest growth, led by a surge in construction.
	GlobalDairyTrade auction	3.4%	-	-	Futures suggest prices will remain around current levels.
<b>Aus</b>	May employment, '000 chg	10.6k	15k	17k	Soft patch in early 2016 has given way to trend growth which with ...
	May unemployment rate	5.7%	5.7%	5.7%	... broadly flat participation is enough to hold unemp rate well below 6%.
	May new vehicle sales	-2.5%	-	-2.0%	FCAI data points to another dip in sales, trend now basically flat.
	Q2 AusChamber-Westpac survey	61.4	-	-	Manufacturing benefitting from housing + lower AUD.
	RBA Deputy Governor Philip Lowe	-	-	-	Speech, Economic Society business lunch, Brisbane, 12:30pm.
	Q2 RBA Bulletin	-	-	-	Quarterly bulletin, includes research articles.
<b>Eur</b>	May CPI %yr	-0.1%	-0.1%	-0.1%	Final estimate for month.
<b>UK</b>	May retail sales	1.3%	-	-	Some moderation likely after last month's bounce.
	BoE rate decision	0.5%	0.5%	0.5%	Brexit uncertainty and softening activity will keep rates on hold.
<b>US</b>	Initial jobless claims	264k	-	-	Remain near record lows.
	Jun Philly Fed index	-1.8	1.0	-	Eight negative readings in past nine months.
	May CPI	0.4%	0.3%	0.3%	Annual inflation tending very slowly toward the FOMC's 2.0%yr target.
	Jun NAHB housing market index	58	59	-	Remains at elevated levels, relative to history.
<b>Fri 17</b>					
<b>NZ</b>	May BusinessNZ PMI	56.5	-	-	Domestic business conditions have firmed in recent months.
<b>US</b>	May housing starts	6.6%	-1.9%	-	Despite strong gains in the month of April...
	May building permits	4.9%	1.3%	-	... starts and permits trend has flattened out.
<b>Can</b>	May CPI %yr	1.7%	1.7%	-	Headline and core inflation have both firmed in recent months.
<b>Sat 18</b>					
<b>Chn</b>	May property prices	-	-	-	Imbalance between Tier 1 to 3 remains key theme.

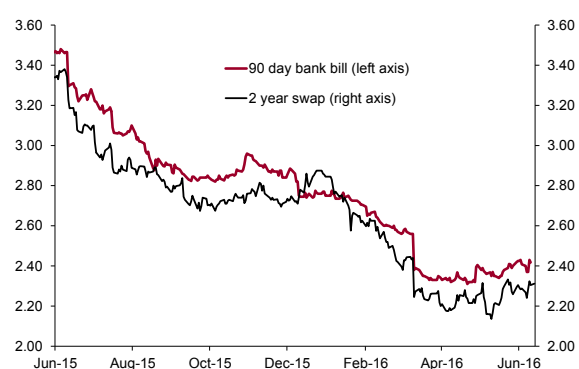


# New Zealand forecasts

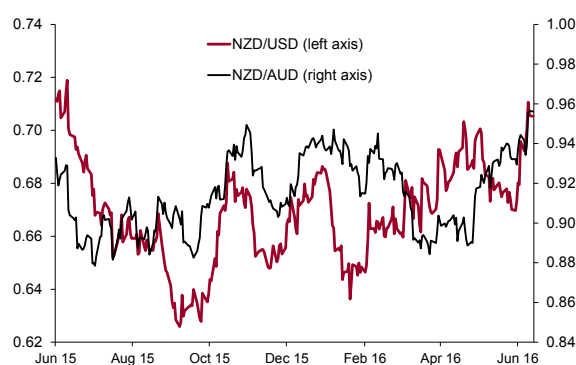
Economic Growth Forecasts	March years				Calendar years			
	% change	2014	2015	2016f	2017f	2014	2015	2016f
GDP (Production) ann avg	2.7	3.6	2.4	2.6	3.7	2.5	2.7	2.6
Employment	3.8	3.2	2.0	2.5	3.6	1.4	2.9	2.4
Unemployment Rate % s.a.	6.0	5.8	5.7	5.4	5.8	5.4	5.7	5.0
CPI	1.5	0.3	0.4	1.5	0.8	0.1	1.3	2.1
Current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

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

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 13 June 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.25%	2.25%	2.25%
30 Days	2.31%	2.25%	2.27%
60 Days	2.35%	2.33%	2.32%
90 Days	2.42%	2.40%	2.36%
2 Year Swap	2.31%	2.27%	2.23%
5 Year Swap	2.48%	2.47%	2.45%

NZ foreign currency mid-rates as at Monday 13 June 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7053	0.6693	0.6766
NZD/EUR	0.6269	0.6022	0.5983
NZD/GBP	0.4943	0.4582	0.4712
NZD/JPY	75.36	73.90	73.51
NZD/AUD	0.9562	0.9323	0.9316
TWI	75.55	72.42	72.70

# International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015f	2016f	2017f
<b>Australia</b>						
Real GDP % yr	3.5	2.0	2.6	2.5	2.8	2.8
CPI inflation % annual	2.2	2.7	1.7	1.7	1.7	2.1
Unemployment %	5.3	5.8	6.2	5.8	5.6	5.5
Current Account % GDP	-4.4	-3.4	-3.0	-4.6	-4.4	-4.5
<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	4.7	4.5
Current Account %GDP	-2.9	-2.3	-2.2	-2.3	-2.3	-2.3
<b>Japan</b>						
Real GDP %yr	1.7	1.4	0.0	0.5	0.7	0.7
<b>Euroland</b>						
Real GDP %yr	-0.9	-0.3	0.9	1.6	1.4	1.3
<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	3.9	4.1
<b>World</b>						
Real GDP %yr	3.5	3.3	3.4	3.1	3.3	3.5

Forecasts finalised 13 May 2016

Interest Rate Forecasts	Latest	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
<b>Australia</b>						
Cash	1.75	1.75	1.50	1.50	1.50	1.50
90 Day Bill	2.01	2.05	1.80	1.80	1.80	1.80
10 Year Bond	2.10	2.40	2.50	2.60	2.65	2.75
<b>International</b>						
Fed Funds	0.375	0.375	0.625	0.625	0.875	0.875
US 10 Year Bond	1.68	2.00	2.15	2.25	2.35	2.50
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40

Exchange Rate Forecasts	Latest	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
AUD/USD	0.7415	0.73	0.72	0.70	0.68	0.68
USD/JPY	106.98	110	112	115	117	120
EUR/USD	1.1302	1.14	1.10	1.08	1.06	1.06
AUD/NZD	1.0449	1.09	1.09	1.09	1.08	1.10



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# Contact the Westpac economics team

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**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](mailto:economics@westpac.co.nz)

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