

Weekly Commentary

17 October 2016



Is the bottom in sight?

How low will the RBNZ go? With inflation lingering below the target band for two years now, a rate cut is on the cards for November. However, the economic environment is changing. Domestic activity is strengthening and inflation is set to rise gradually over coming quarters. As a result, following the anticipated November cut, the RBNZ is likely to keep the Official Cash Rate on hold for some time. Nevertheless, the risks for the OCR are still to the downside.

We expect that the September quarter CPI figures (due for release on 18 October) will show that prices rose by only 0.2% over the past year.¹ That would mean that we've had two full years with inflation below the bottom of the RBNZ's target band.

With inflation lingering at low levels, and associated downside risk for inflation expectations, another cut in the OCR is on the cards for November. Consistent with this, a recent speech by RBNZ Assistant Governor McDermott's reiterated the Bank's earlier guidance "that further policy easing will be required to ensure that future inflation settles near the middle of the target range." This will take the OCR to a new record low of 1.75%.

But while a November rate cut is a near certainty, there is more of a question about whether the OCR will need to be cut even further. The RBNZ's last set of published forecasts from September straddled the line between one and two more OCR cuts, and the accompanying policy statement noted that the stance of policy would be dependent on the evolution of economic conditions. So how have things been shaping up?

In terms of domestic activity, the past few weeks have seen a wave of positive news. Most recently, the latest retail card spending figures showed a strong pick-up in

spending through September, with particularly large gains in spending on durables and hospitality. On top of this, REINZ house sales figures for September showed that house prices in most regions are continuing to push higher despite the tightening of restrictions on lending. Combined with a modest tick-up in consumer confidence, all of this leaves us with an increasingly positive picture of household sector activity after subdued spending growth in the first half of the year.

Conditions in the business sector are also looking more upbeat. The latest PMI and business confidence surveys point to strengthening economic activity through the second half of the year, including some pick-up in hiring.

But while activity in the New Zealand economy is continuing to strengthen, the RBNZ is ultimately focused on inflation. On this front, Dr McDermott's speech provided a timely reminder of some of the factors that the RBNZ is currently balancing up.

Firstly, he reiterated that the RBNZ's focus is on medium term inflation. There's little monetary policy can do to offset current or near-term weakness in inflation. That's important as much of the current low inflation is an artefact of sharp falls in oil prices and one-off reductions in government charges that occurred in recent years. The impact of those

¹ A detailed preview of the September quarter CPI can be found here: <https://www.westpac.co.nz/assets/Business/Economic-Updates/2016/Bulletins-2016/Q3-CPI-Preview-October-2016.pdf>

Is the bottom in sight? continued

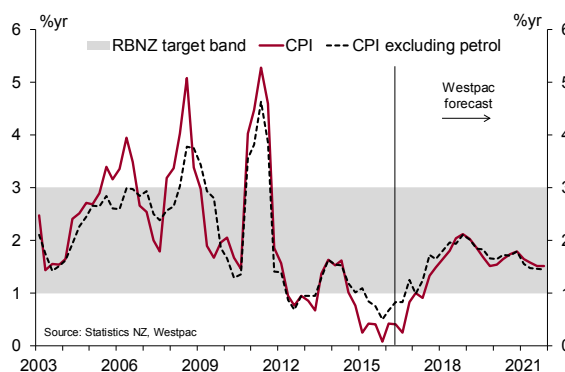
earlier declines is slowly passing out of annual figures. And as this occurs, we should see inflation rising back within (or at least close to) the RBNZ's target band over the next few quarters.

Next, he highlighted that global factors are playing an important role in holding inflation down. Softness in global demand and weakness in the prices of internationally traded goods have meant that import prices in New Zealand have remained low. Those are trends which are beyond the control of domestic monetary policy, and that are likely to persist for some time.

Finally, he noted that New Zealand's productive capacity has been growing in recent years, in part due to very strong population growth on the back of record net migration inflows. This has meant that domestic economic output has been able to expand without significant pressure on output prices.

Where does all this leave the RBNZ? With the temporary factors that had previously dampened inflation gradually passing and domestic economic activity looking increasingly solid, inflation is set to rise. Generating a sustained lift in inflation to 2%, especially in the face of lingering weakness in imported prices, will still be a challenging task. Nevertheless, in contrast to the past few years when they were faced with a persistent undershoot of inflation, the challenge the RBNZ is facing is evolving into one of a very slow return to target. And that means that the Bank can afford to take a more gradual approach to its price

Inflation and inflation ex-petrol



stability goal, and can avoid pouring further fuel on the already hot housing market. As a result, we think that after a cut in November, the RBNZ is likely to keep the OCR on hold for some time.

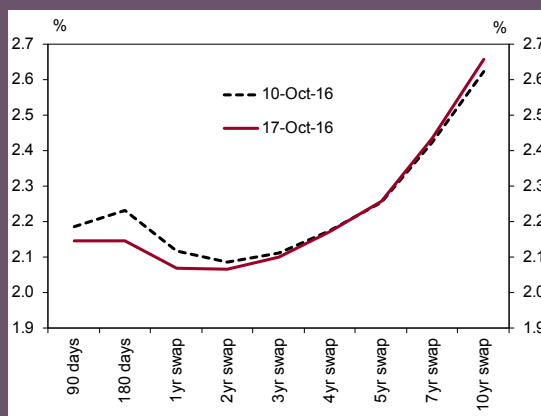
The risks for the OCR are still to the downside. The RBNZ will be very wary of the possibility the NZD could push higher over the coming months. In addition, there is the potential for heightened volatility in global financial markets associated with events such as the US election and the negotiations around Brexit. On top of those factors, the RBNZ will be highly cognisant of the risks around inflation expectations. Shorter term expectations are already at low levels, and the low September quarter read will add to the risk that they fall further.

Fixed vs Floating for mortgages

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



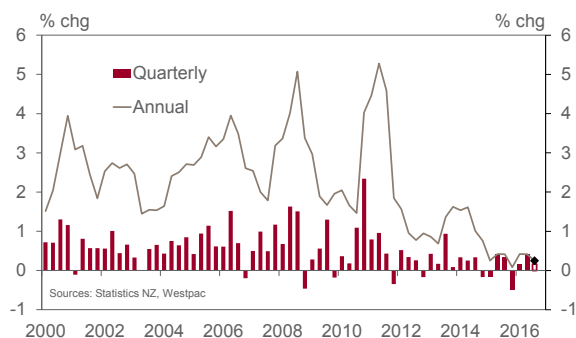
The week ahead

NZ Q3 CPI

Oct 18, Last: 0.4%, Westpac f/c: 0.2%, Mkt f/c: flat

- We expect a 0.2% rise in the Consumer Price Index for the September quarter. This would see the annual inflation rate fall from 0.4% to 0.2%.
- The transport categories account for most of the soft outcome, with cheaper fuel, airfares and vehicle registrations. The housing-related groups will continue to record the biggest price gains.
- The slowdown in annual inflation is due to temporary factors, and will not come as a surprise to the RBNZ. Annual inflation is expected to gradually move back within the RBNZ's target band over coming quarters although a sustained return to the target is by no means assured.

NZ CPI inflation

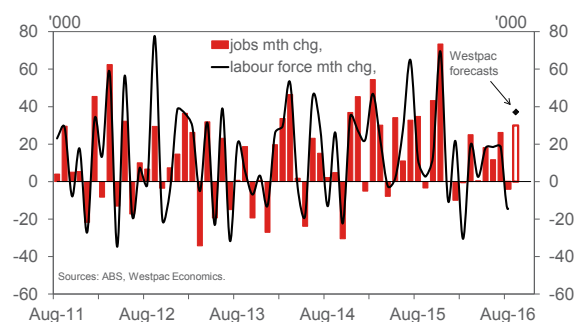


Aus Sep employment

Oct 20 Last: -3.9k, WBC f/c: 30k, Mkt f/c: 15k, Range: -7.4k to 30k

- Total employment fell 3.9k in Aug, weaker than the market's forecast for a 15k gain. Best described as a flat print, the result pulled the annual rate down to 1.5%/yr. In the year to August total employment has grown 180.4k.
- Given a six month run of positive-to-flat employment prints, a negative was always a possibility. But it does appear that Aug's soft result was more about sample or survey volatility than the start of a new trend. In particular sample rotation appears to explain the lower attachment to the labour force, i.e. the combination of lower employment and lower participation.
- If the cohort rolling into the sample is more like the average for the total sample there should be a positive kick to both employment and participation, hence our +30k forecast for Sep.

Labour force vs. total employment

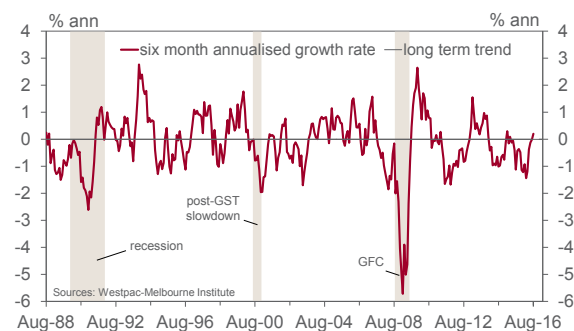


Aus Sep Westpac-MI Leading Index

Oct 19, Last: 0.20%

- The six month annualised growth rate in the Westpac-Melbourne Institute Leading Index rose from -0.01% in July to +0.20% in August, the first positive, above trend reading since April 2015. Resurgent commodity prices have been a key positive over the last 6mths.
- The September update looks likely to maintain the more positive tone. Latest component updates include: the ASX200 up 0.1% vs -2.3% last month; the Westpac-MI Consumer Expectations Index, flat vs -2% last month; commodity prices, up 2.3% (in AUD terms) vs 1.2% last month. On the soft side, dwelling approvals were down -0.9% vs 12.3% last month; US industrial production declined -0.5% vs +0.6% last month and the yield spread widened further (usually viewed as a more positive growth signal). Labour market components look to be largely unchanged.

Westpac-MI Leading Index

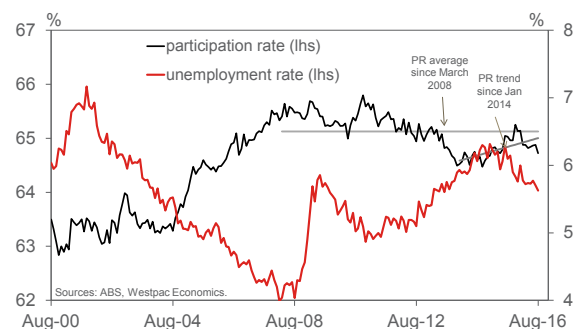


Aus Sep unemployment rate

Oct 20 Last: 5.6%, WBC f/c: 5.7%, Mkt f/c: 5.7% Range: 5.6% to 5.8%

- In Aug, the unemployment rate rounded down to 5.6% which was a surprising decline from 5.7% in July given the flat print on employment. There was a sharp pull back in the participation rate to 64.72% from 64.88% which meant that the labour force contracted 14.4k. It was this contraction in the labour force, the denominator for the unemployment rate, that was behind the dip.
- For Sep our robust 30k forecast is, in part, due to the sample volatility in regards to attachment to the labour force. As such it will be associated with a rise in participation to 64.8% which will see the labour force rise by 37k. This will be enough to see the unemployment rate round up to 5.7% (it rounded down to 5.6% in Aug).

Unemployment and participation rates



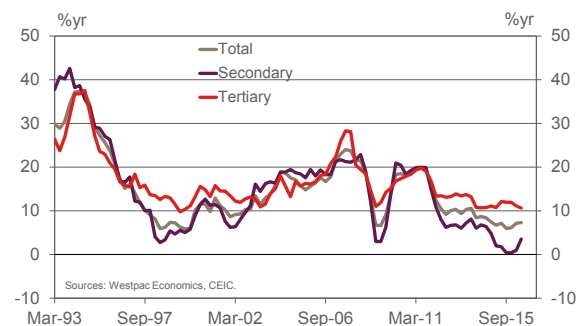
The week ahead

China Q3 GDP

Oct 19, Last: 6.7%, WBC 6.7%

- China GDP for Q2 2016 came as a positive surprise to the market, annual growth unchanged at 6.7%yr versus expectations that it would slow to 6.6%yr. While quarterly growth firmed to 1.8% in Q2, taken together with Q4 2015's 1.2%, growth over the past six months has averaged 1.5% or 6.0% annualised.
- In nominal terms, growth in the secondary sector (manufacturing; construction) rebounded from just 0.9%yr to 8.0%yr – the highest since end-2013. Meanwhile, tertiary sector activity firmed from 11.2%yr to 12.3%yr.
- Q3 is likely to see a repeat of Q2, with real growth again coming in at 1.8%, leaving annual growth unchanged at 6.7%yr. The make-up of growth is also likely to again favour services, with moderate momentum in the secondary sector kept intact. Authorities are on track to meet their 2016 growth target.

China: the old and the new economy

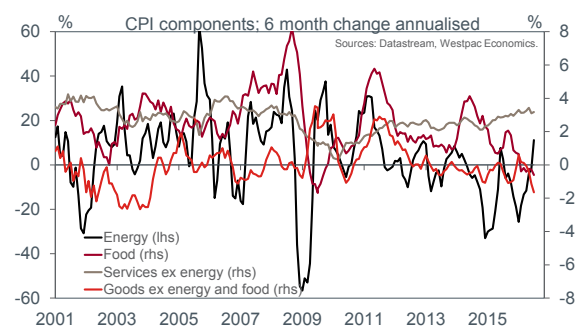


US Sep CPI

Oct 18, Last: 0.2%, WBC 0.3%

- August saw another solid gain for consumer prices, both on a headline and core basis. In the month, core prices rose 0.3%, while mildly deflationary food and energy prices resulted in a 0.2% gain for the headline series.
- On an annual basis though, the significant disparity between the headline and core series remained intact, annual core inflation coming in at 2.3%yr versus a 1.1%yr result for total.
- Come September, we are likely to see a material narrowing in the gap between these two key measures as base effects become favourable for headline inflation. An outcome closer to 1.5%yr is anticipated for headline inflation.
- Underlying strength in inflation continues to emanate from the services sector, partly offset by goods disinflation. Amongst services, rent and insurance remain key.

Detail mixed, but core pressures robust



Data calendar

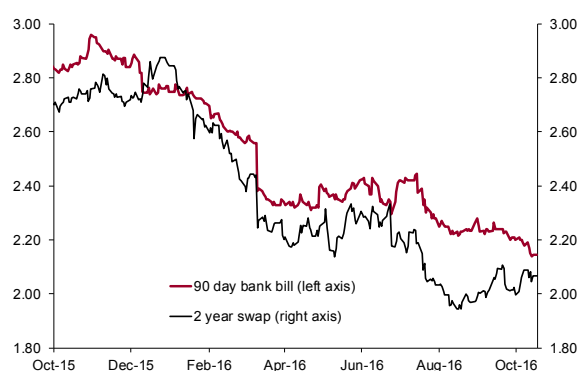
		Last	Market median	Westpac forecast	Risk/Comment
Mon 17					
NZ	Sep Performance of services index	57.9	-	-	Business sector conditions have been strengthening.
Eur	Sep CPI	0.1%	0.4%	0.4%	Flash showed headline inflation at 0.4%/yr; core at 0.8%/yr.
UK	Oct Rightmove house prices	0.7%	-	-	Housing market has softened, post-Brexit nerves dampening activity.
US	Oct Empire manufacturing survey	-2.0	1.0	-	Regional manufacturing surveys remain at subdued levels.
	Sep industrial production	-0.4%	0.2%	-	Production growth remains soft.
Tue 18					
NZ	Q3 CPI	0.4%	flat	0.2%	Annual inflation to slow to 0.2% on temporary factors.
Aus	RBA Governor Lowe speaking	-	-	-	Topic TBA, Citi's Investment Conference, Sydney 8.10 am AEDT.
	RBA minutes	-	-	-	Governor's decision statement kept neutral stance in October.
	Sep new vehicle sales	0.1%	-	3.0%	On track for a solid positive for Q3, reversing Q2 drop.
UK	Sep CPI	0.3%	-	-	Weakness in sterling is boosting inflation.
US	Sep CPI	0.2%	0.3%	0.3%	Annual headline inflation beginning to lift on base effect.
	Oct NAHB housing market index	65	63	-	Conditions robust for developers.
Wed 19					
NZ	GlobalDairyTrade auction	-3.0%	-	-	Reduction in product on offer likely to support prices.
Aus	Sep Westpac-MI Leading Index	0.20%	-	-	Tipped back above trend in Aug, resurgent commodity prices a big +ve.
Chn	Sep industrial production %yr	6.3%	6.4%	-	Manufacturers still hopeful that demand will pick up.
	Sep retail sales %yr	10.6%	10.7%	-	Consumer spending needs greater support from jobs and confidence.
	Sep fixed asset investment ytd %yr	8.1%	8.2%	-	Private investment remains very weak.
	Q3 GDP %yr	6.7%	6.7%	6.7%	Q3 looks to be a repeat of Q2, with growth of 1.8%.
UK	Aug ILO unemployment rate	4.9%	-	-	Post-Brexit uncertainty will weigh on hiring.
US	Sep housing starts	-5.8%	2.9%	3.0%	Likely to bounce after weak Aug outcome.
	Sep building permits	0.7%	0.9%	1.5%	Permit outcomes more stable; a modest uptrend apparent.
	Federal Reserve's Beige book	-	-	-	Conditions across the regions.
	Fedspeak	-	-	-	Williams speaks in New Jersey.
Can	Bank of Canada policy decision	0.50%	0.50%	0.50%	Hoping weaker currency will offset oil-price related weakness.
Thu 20					
Aus	Sep employment, '000 chg	3.9k	15k	30k	Sample volatility in regards to attachment to the labour force explains ...
	Sep unemployment rate	5.6%	5.7%	5.7%	... a large part of Aug volatility hence our forecast for a Sep rebound.
	Q3 NAB business survey	2	-	-	Sep mthly survey reported conditions at +8, confidence at +6.
Eur	ECB policy decision, deposit rate	-0.40%	-0.40%	-	Whatever it takes mantra still intact, but big questions for policy in '17.
	Aug current account, €b sa	21	-	-	Surplus has narrowed over the last year.
UK	Sep retail sales	-0.2%	-	-	Spending resilient, with the lower GBP boosting tourist spending.
US	Initial jobless claims	246k	-	-	Have been at historically low level for an extended period.
	Oct Philly Fed business outlook survey	12.8	5.0	-	Pull-back expected after last month's sharp rise.
	Sep existing home sales	-0.9%	0.3%	1.0%	Very modest uptrend intact.
	Sep leading index	-0.2%	0.2%	-	Points to about-trend growth.
Fri 21					
NZ	Sep net migration	5600	-	5300	While still elevated, monthly net migration inflows are starting to soften.
Chn	Sep property prices	-	-	-	August showed broadening of momentum, albeit still led by investors.
Eur	Oct consumer confidence (final)	-8.2	-8.0	-	Confidence remains robust.
UK	Sep public sector borrowing, £b	10.1	-	-	A re-think of debt reduction aims is on the cards post-referendum.
US	Fedspeak	-	-	-	Williams gives keynote at Federal Home Loan Bank conference.
Can	Sep CPI %yr	1.1%	-	-	Prices fell in Aug, thanks to weakness amongst food & energy.

New Zealand forecasts

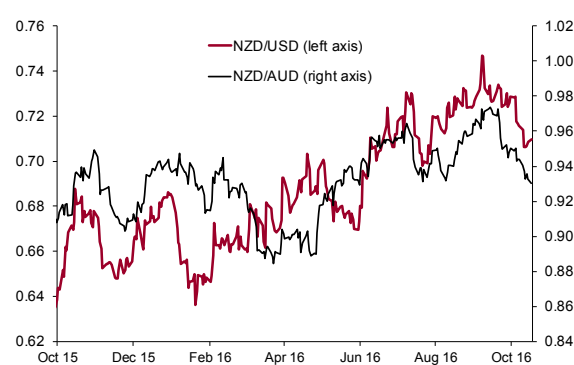
Economic Forecasts	March years				Calendar years			
	% change	2015	2016	2017f	2018f	2014	2015	2016f
GDP (Production) ann avg	3.6	2.5	3.5	2.9	3.8	2.5	3.4	3.1
Employment	3.2	2.0	3.9	1.6	3.6	1.4	4.7	2.0
Unemployment Rate % s.a.	5.4	5.2	5.0	4.5	5.5	5.0	5.1	4.6
CPI	0.3	0.4	1.0	1.7	0.8	0.1	0.8	1.5
Current Account Balance % of GDP	-3.5	-3.1	-3.3	-3.8	-3.2	-3.4	-3.1	-3.9

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	1.90	1.90	1.90	1.90	1.90	1.90
2 Year Swap	2.00	2.10	2.10	2.10	2.10	2.00
5 Year Swap	2.30	2.40	2.50	2.50	2.50	2.50
10 Year Bond	2.50	2.50	2.60	2.70	2.80	2.80
NZD/USD	0.70	0.69	0.67	0.65	0.63	0.62
NZD/AUD	0.95	0.95	0.94	0.94	0.93	0.91
NZD/JPY	72.1	69.7	69.7	68.3	66.2	65.7
NZD/EUR	0.64	0.64	0.64	0.63	0.61	0.60
NZD/GBP	0.56	0.56	0.55	0.53	0.51	0.51
TWI	75.7	75.2	73.8	72.2	70.3	69.3

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 17 October 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.00%	2.00%	2.00%
30 Days	2.18%	2.18%	2.19%
60 Days	2.16%	2.20%	2.22%
90 Days	2.15%	2.21%	2.25%
2 Year Swap	2.07%	2.00%	2.08%
5 Year Swap	2.26%	2.14%	2.25%

NZ foreign currency mid-rates as at Monday 17 October 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7096	0.7278	0.7262
NZD/EUR	0.6468	0.6480	0.6509
NZD/GBP	0.5843	0.5631	0.5586
NZD/JPY	74.04	73.66	74.21
NZD/AUD	0.9302	0.9506	0.9702
TWI	76.47	77.42	77.84

International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015	2016f	2017f
Australia						
Real GDP % yr	3.6	2.0	2.7	2.4	3.0	3.0
CPI inflation % annual	2.2	2.7	1.7	1.7	1.5	1.8
Unemployment %	5.3	5.8	6.2	5.8	5.6	5.8
Current Account % GDP	-4.4	-3.4	-3.0	-4.7	-3.3	-4.2
United States						
Real GDP %yr	2.2	1.5	2.4	2.4	1.5	2.1
Consumer Prices %yr	2.1	1.5	1.6	0.1	1.2	1.7
Unemployment Rate %	8.1	7.4	6.2	5.3	4.9	4.6
Current Account %GDP	-2.9	-2.3	-2.3	-2.6	-2.7	-2.6
Japan						
Real GDP %yr	1.7	1.4	0.0	0.5	0.6	0.5
Euroland						
Real GDP %yr	-0.9	-0.3	0.9	1.6	1.6	1.2
United Kingdom						
Real GDP %yr	1.2	2.2	2.9	2.2	1.6	0.6
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	3.7	3.9
World						
Real GDP %yr	3.5	3.3	3.4	3.1	3.2	3.4

Forecasts finalised 14 October 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	1.75	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.26	2.20	2.20	2.30	2.45	2.65	2.75	2.80
International								
Fed Funds	0.375	0.625	0.625	0.875	0.875	1.125	1.125	1.375
US 10 Year Bond	1.74	1.70	1.80	2.00	2.10	2.25	2.35	2.40
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	0.7583	0.74	0.73	0.71	0.69	0.68	0.68	0.68
USD/JPY	104.15	103	101	104	106	105	106	106
EUR/USD	1.1026	1.10	1.07	1.05	1.04	1.03	1.03	1.03
AUD/NZD	1.0673	1.06	1.06	1.06	1.06	1.08	1.10	1.11

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