

Weekly Commentary

18 July 2016



The message

The past week has been characterised by a back-and-forth of views about where the Reserve Bank goes from here. Low inflation and the high exchange rate argue for interest rate cuts, but this would add to concerns about financial instability by stoking the already-hot housing market. Our view on how the RBNZ will resolve this tension remains unchanged: interest rates to deal with inflation, and lending restrictions to deal with the housing market.

Last week we detailed the speech by RBNZ Deputy Governor Spencer, which focused on the rising imbalances in the housing market and emphasised that both demand- and supply-side factors need to be addressed. The speech confirmed that further lending restrictions are in the pipeline, with the first step most likely being that the 70% loan-to-value ratio limit for property investors in Auckland will be extended to the rest of the country. The RBNZ is also looking to introduce a limit on debt-to-income ratios, but this tool is still under development and is more likely to be implemented next year.

Financial markets, however, honed in on a comment towards the end of the speech: that interest rate cuts could pose a risk to financial stability by inflaming the housing market even further. The market appeared to take this as a signal that the RBNZ was unwilling to cut the OCR further, and pricing for a cut at the August *Monetary Policy Statement* fell from around 60% to 30%.

We didn't agree with that interpretation. In the speech Spencer also emphasised that the inflation target remains the central focus of monetary policy. While the RBNZ's desire not to stoke the housing market even further is understandable, the reality is that good intentions must give way to the facts. And the key fact right now is that the New Zealand dollar is a lot higher than the RBNZ expected

it to be. The longer that the currency maintains its strength, the greater the risk that inflation will fall short of the target over the medium term.

The RBNZ is also clearly concerned by the market's interpretation of the speech. It has announced that it will release a "brief update on its economic assessment" on Thursday, just three weeks ahead of its full economic assessment in August. The statement will not include a decision on the OCR itself, but is likely to provide guidance on the direction of monetary policy, as in regular OCR review statements. (Recall that the RBNZ's previous guidance was: "Further policy easing may be required to ensure that future average inflation settles near the middle of the target range.") Markets have seen the writing on the wall, with the NZ dollar falling more than a cent and the odds for an August OCR cut rising again to 65%.

It's worth highlighting the market's reaction to that announcement, given the occasional claims that the RBNZ can't do anything about the high NZ dollar. It's true that there is no mechanical relationship between the OCR and the exchange rate. But expectations about the future of the OCR (more so than its current level) can still have a strong influence on the currency. Last week's price action is a case in point: the RBNZ has managed to take the edge off the NZ dollar just by making a statement about making a statement.

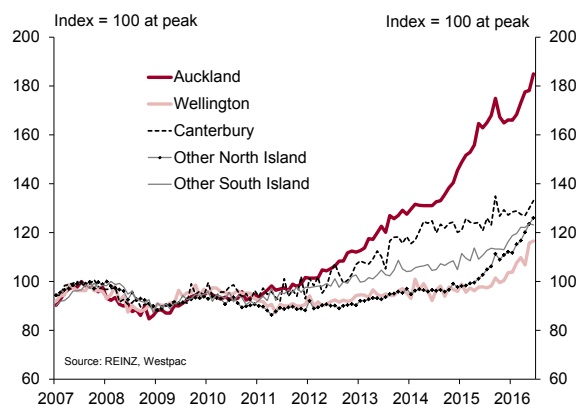
The message continued

So if lower interest rates are on the cards, what does that mean for the housing market? We have long emphasised that low interest rates have been the primary driver of the housing market upturn. The fact that prices are rising strongly across most of the country certainly bears that out. The REINZ report for house sales in June showed that average prices have risen almost 11% since the start of the year. The number of sales has waned slightly in the last two months, but that may reflect a shortage of listings, which in turn suggests that property owners are holding on in anticipation of further capital gains.

House price inflation is now clearly running ahead of the RBNZ's already very strong forecast. In one sense that does weaken the case for OCR cuts, if the rise in household wealth leads to stronger growth in consumer spending. The latest electronic card spending figures showed further strength in the retail sector, with spending up 1.2% in June. Core retail spending (i.e. looking through the sharp drop in fuel prices) was up 7.8% on last year, and the pace of growth has been accelerating over the last three years. We should note though that the surge in overseas visitor numbers over the last two years will account for at least some of this acceleration.

As for the other aspect of the RBNZ's housing concerns – that is, the risk of financial instability if house prices correct lower – ideally, this shouldn't be conflated with monetary policy

REINZ house price indexes, seasonally adjusted



considerations. The RBNZ has a range of macroprudential tools available to take the edge off the housing market, and it is working on adding another one to the toolkit. The effectiveness of these tools is an open question, and probably has more to do with how they're calibrated than with the form of the tool itself – for instance, the loan-to-value limit applied to Auckland investors last year doesn't seem to have been binding. But it's highly likely we'll see some form of policy tightening before year-end, especially if house prices continue to rise at their recent pace.

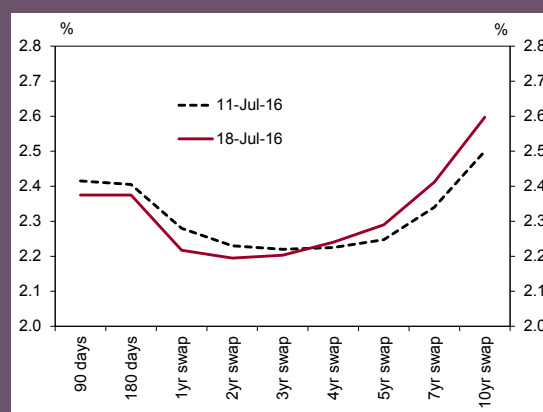
Fixed vs Floating for mortgages

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



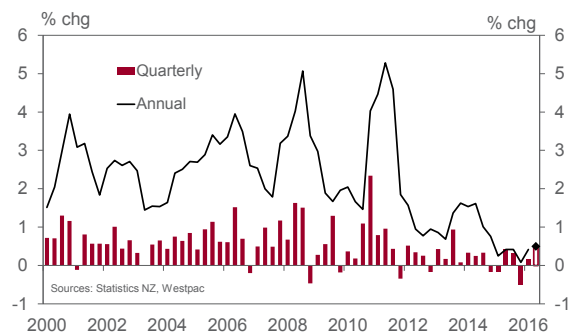
The week ahead

NZ Q2 CPI

Jul 18, Last: 0.2%, Westpac f/c: 0.5%, Mkt f/c: 0.5%

- We expect a 0.5% increase in the June quarter CPI. That would also lift annual inflation to 0.5%, a second modest gain after falling to a record low of 0.1% at the end of 2015.
- A rebound in fuel prices from their early-year plunge accounts for about half of the expected increase for the quarter. Price pressures are most pronounced in the housing group, but remain muted elsewhere.
- Our estimate is slightly below the Reserve Bank's forecast of 0.6%. A small miss on this number would be of less concern to the RBNZ than the fact that the New Zealand dollar has risen sharply in recent weeks which, if sustained, will undermine inflation over the coming year.

NZ CPI inflation

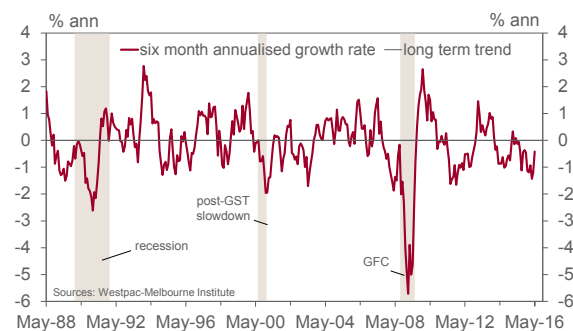


Aus Jun Westpac-MI Leading Index

Jul 20, Last: -0.42%

- The six month annualised growth rate in the Westpac-Melbourne Institute Leading Index rose from -1.19% in April to -0.42% in May. Although the index continues to point to sub-trend growth, the May update showed a material improvement and marks the best reading since October.
- The June reading will include mostly softer monthly updates: the ASX200, down -2.7% vs +2.4% last month; the Westpac-MI Consumer Expectations Index, down -2.9% vs -2.9% last month; commodity prices down -0.7% (in AUD terms) vs +3.8% last month; dwelling approvals down -5.2% vs +3.3% last month; the yield spread, narrowed 5.2bps vs a 5.7bps widening last month; the Westpac-MI Unemployment Expectations Index, up 1.9% vs -0.1% last month; and total hours worked, -0.3% vs +1.5% last month.

Westpac-MI Leading Index



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 18					
NZ	Jun BusinessNZ PSI	56.9	-	-	Service sector conditions have been firm through mid-2016.
	Q2 CPI	0.2%	0.5%	0.5%	Fuel and housing boosting inflation; muted pressures elsewhere.
Chn	Jun property prices	-	-	-	Tier-1 price growth rampant; everywhere else modest to weak.
UK	Jul Rightmove house prices	0.8%	-	-	Heightened uncertainty and policy changes dampening house prices.
	BoE's Weale	-	-	-	Speaking in London, Brexit impact on monetary policy.
US	Jul NAHB housing market index	60	60	-	Sector remains robust; low long-term rates and employment supporting.
	May total net TIC flows	80.4	-	-	Long-term bond data flows.
Tue 19					
Aus	RBA minutes of July Board meeting	-	-	-	Any hints of a likely August rate cut in response to low inflation.
Eur	Jul ZEW survey of expectations	20.2	-	-	Investor appetite supported by policy easing. But Brexit?
UK	Jun CPI	0.2%	0.2%	-	Inflation rising from low levels; lower pound will feed in over coming year.
US	Jun housing starts	-0.3%	0.5%	-	Remain volatile month to month...
	Jun building permits	0.7%	1.2%	-	... with multiples a key factor... but trend flattening.
Wed 20					
NZ	GlobalDairyTrade auction	-0.4%	-	-	Futures prices remain flat.
Aus	Jun Westpac-MI Leading Index	-0.42%	-	-	Below trend, improved materially in May but latest monthly data looks soft.
UK	May ILO unemployment rate	5.0%	5.0%	-	Uncertainty ahead of the Brexit vote appears to have dampened hiring.
Thu 21					
NZ	RBNZ update on economic conditions	-	-	-	A brief assesment of economic conditions, but no OCR decision.
	Jun migration	5,500	-	5,530	Monthly net migration is elevated but past its peak; will ease over time.
Aus	Q2 NAB business survey	-	-	-	June monthly survey was upbeat, condition rose 2pts to +12.
Eur	ECB policy decision, deposit rate	-0.4%	-0.4%	-0.4%	Only time will tell eventual impact of Brexit on EU.
UK	Jun retail sales	0.9%	-0.4%	-	Retail spending (esp. food) has lost momentum.
	Jun public sector borrowing, £b	9.1	-	-	Fiscal targets were looking doubtful even before the referendum.
US	Jun Chicago Fed national activity index	-0.51	-	-	Points to below trend growth.
	Initial jobless claims	254k	-	-	Remains at very low levels.
	Jul Philly Fed survey	4.7	5.0	-	Has picked up, but remains at modest levels.
	May FHFA house price index	0.2%	0.4%	-	Continuing to maintain robust momentum.
	Jun existing home sales	1.8%	-1.2%	-	Trending higher on confidence and low rates.
Can	May wholesale trade	0.1%	-	-	Q2 sales have been subdued, with some impact from wild fires.
Fri 22					
Eur	Jul Markit manufacturing PMI flash	52.8	52.0	-	Improvement in momentum expected for manufacturing...
	Jul Markit services PMI flash	52.8	52.3	-	... and for services.
Ger	Jul Markit manufacturing PMI flash	54.5	53.9	-	Stronger than the broader Euro Area measure...
	Jul Markit services PMI flash	53.7	53.2	-	... though, given low unemployment, should probably be stronger.
US	Jul Markit manufacturing PMI	51.3	51.5	-	Both the manufacturing and services variant point to soft growth.
Can	Jun CPI	0.4%	0.5%	-	Inflation remains well contained though core prices have lifted.

New Zealand forecasts

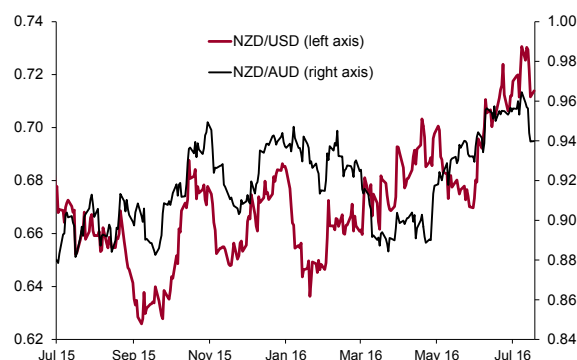
Economic Growth Forecasts	March years				Calendar years			
	% change	2014	2015	2016	2017f	2014	2015	2016f
GDP (Production) ann avg	2.7	3.6	2.4	2.9	3.7	2.5	2.9	2.7
Employment	3.8	3.2	2.0	2.5	3.6	1.4	2.9	2.4
Unemployment Rate % s.a.	6.0	5.8	5.7	5.4	5.8	5.4	5.7	5.0
CPI	1.5	0.3	0.4	1.4	0.8	0.1	1.2	2.1
Current 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	2.20	2.30	2.40	2.60	2.70	2.70
10 Year Bond	2.20	2.30	2.40	2.60	2.70	2.80
NZD/USD	0.70	0.68	0.65	0.64	0.63	0.62
NZD/AUD	0.96	0.96	0.96	0.94	0.91	0.89
NZD/JPY	72.1	69.4	65.7	64.6	64.3	64.5
NZD/EUR	0.64	0.63	0.61	0.61	0.59	0.58
NZD/GBP	0.54	0.53	0.51	0.50	0.49	0.48
TWI	75.7	74.4	72.2	71.2	69.8	68.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 18 July 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.25%	2.25%	2.25%
30 Days	2.33%	2.38%	2.31%
60 Days	2.35%	2.40%	2.33%
90 Days	2.38%	2.43%	2.35%
2 Year Swap	2.20%	2.19%	2.29%
5 Year Swap	2.29%	2.29%	2.41%

NZ foreign currency mid-rates as at Monday 18 July 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7139	0.7164	0.7075
NZD/EUR	0.6462	0.6435	0.6244
NZD/GBP	0.5410	0.5409	0.4894
NZD/JPY	75.25	73.54	74.09
NZD/AUD	0.9399	0.9619	0.9520
TWI	76.37	76.69	75.44

International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015	2016f	2017f
Australia						
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	2.0	1.5
Unemployment %	5.3	5.8	6.2	5.8	5.6	5.5
Current Account % GDP	-4.4	-3.4	-3.0	-4.8	-4.7	-4.7
United States						
Real GDP %yr	2.2	1.5	2.4	2.4	1.9	1.9
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	4.8	4.6
Current Account %GDP	-2.9	-2.3	-2.3	-2.4	-2.4	-2.4
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	1.5	1.2
United Kingdom						
Real GDP %yr	1.2	2.2	2.9	2.2	1.1	0.5
China						
Real GDP %yr	7.7	7.7	7.3	6.9	6.4	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 15 July 2016

Interest Rate Forecasts	Latest	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
Australia						
Cash	1.75	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.96	1.80	1.80	1.80	1.80	1.80
10 Year Bond	1.98	1.95	2.15	2.20	2.30	2.45
International						
Fed Funds	0.375	0.375	0.625	0.625	0.875	0.875
US 10 Year Bond	1.52	1.50	1.70	1.80	2.00	2.10
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	0.7620	0.73	0.71	0.68	0.68	0.69
USD/JPY	105.50	103	102	101	101	102
EUR/USD	1.1116	1.10	1.08	1.07	1.05	1.06
AUD/NZD	1.0660	1.04	1.04	1.05	1.06	1.10

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