Weekly Commentary

22 February 2016

Window of opportunity

It's been another week of developments that have, on balance, supported our view that the Reserve Bank will need to cut interest rates further this year. Yet in promoting this view, we sometimes find ourselves having to take a step back and explain what it is that monetary policy is trying to achieve.

In July last year, we shifted our forecast to a low point in the OCR of 2.0%. This was a distinctly minority view at the time, but has gained some support as economic conditions have evolved. Interest rate markets are now pricing in at least one more OCR cut this year, from 2.50% currently.

We've been careful to emphasise that our forecast of further OCR cuts is not based solely on our view of economic activity. We're actually expecting solid, though not spectacular, GDP growth over the next couple of years, led by population growth, a wave of construction activity and a lift in tourism that will help to offset the headwinds from a sharp drop in dairying income.

Rather, our OCR forecast is based on a view of what is needed to return inflation to the 2% midpoint of the RBNZ's inflation target and maintain it there. Inflation has gradually sunk over recent years, reaching an extremely low level by the end of 2015. It's true that some of this is due to falling world oil prices, but even the various measures of core inflation reveal that there has been a sustained undershoot of the target midpoint for several years.

Moreover, this has happened against a backdrop of GDP growth that peaked at around 4%, high dairy export prices, falling unemployment, rising house prices, and more recently a sharply lower NZD. If these conditions weren't able to generate a return to 2% inflation, what are the prospects of reaching that mark in the future, when GDP growth is past its peak, the earthquake rebuild is gradually winding down, and dairy prices remain low? We feel that the window of opportunity for returning inflation to the target midpoint is rapidly narrowing, if it hasn't closed already.

In terms of the three main developments last week, two of them backed our current view and one was a genuine shocker. Firstly, retail sales volumes rose by 1.2% in the December quarter, close to our expectations. Retail prices were flat for the quarter, again highlighting that the stories of low inflation and solid growth go hand in hand to some degree, as low inflation gives consumers more bang for their buck. Secondly, the 2.8% fall in world dairy prices at the GlobalDairyTrade auction was consistent with our recently-revised forecasts for a farmgate milk price of $4/kg this season and $4.60/kg next season.

The real surprise was a sharp fall in the RBNZ's survey of inflation expectations two years ahead. There are a number of surveys of inflation expectations, but the two-year ahead measure is of particular interest for two reasons: it looks beyond the impact of temporary shocks such as the drop in oil prices, and it roughly matches the timeframe over which monetary policy is believed to have its greatest impact.

In a recent speech, RBNZ Governor Wheeler noted that: "Survey measures of inflation expectations have fallen and are now consistent with inflation settling at 2 percent in the medium term… we would not wish to see inflation expectations become unstable and decline significantly." The latest survey is clearly contrary to those wishes: expectations fell from 1.85% to 1.63% in the latest quarter. This is the second-lowest reading on record, and by far the

Window of opportunity continued

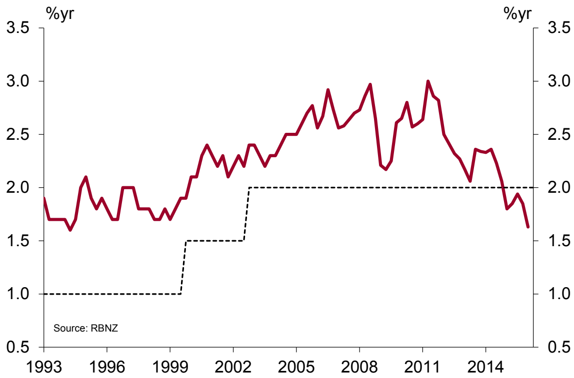
biggest shortfall relative to the midpoint of the inflation target. This result is a clear tick in favour of our view that inflation is not on track to meet the inflation target under current policy settings, and that further OCR cuts will be needed.

We acknowledge that there's some uncertainty as to how the RBNZ will choose to respond to recent developments. We're currently picking OCR cuts in June and August, though the fall in inflation expectations raises the odds of an earlier move. However, the Governor's speech also emphasised that the RBNZ intends to use the flexibility provided within the Policy Targets Agreement. The PTA specifies that the inflation target is to be met on average over the medium term, and provides some secondary considerations such as having regard to asset prices and financial stability, and avoiding setting policy in a way that creates unnecessary volatility.

These considerations are relevant in terms of short-term tactics. But it's a well-established proposition that in the long run, monetary policy can only influence inflation. A central bank may attempt to use interest rates to address other, perhaps conflicting goals, but in the end the demands of meeting an inflation target will win out.

Moreover, we're not convinced that these secondary considerations are all that binding at the moment. It's hard to argue that the RBNZ risks exacerbating a boom-bust cycle by lowering interest rates now. GDP growth is decent, but is hardly threatening to outrun the economy's sustainable potential; strong migration-led population growth means that the economy's capacity is growing at least as quickly. Nor does credit growth look particularly alarming at around 7% in the last year, about the same rate as growth in deposits.

RBNZ Survey of Expectations – inflation 2 years ahead



And if lowering interest rates does spark concerns about credit growth, there are other ways to address it. When the PTA was signed in 2012, the statements about asset prices and financial stability were obviously aimed at decisions on interest rates. But since then, the RBNZ has added a range of macroprudential tools to its toolkit which can target such concerns more directly. And that toolkit is far from being exhausted – for instance, the RBNZ has yet to try imposing higher sectoral capital requirements, which have been quite effective in cooling the Australian housing market recently.

Fixed vs Floating for mortgages

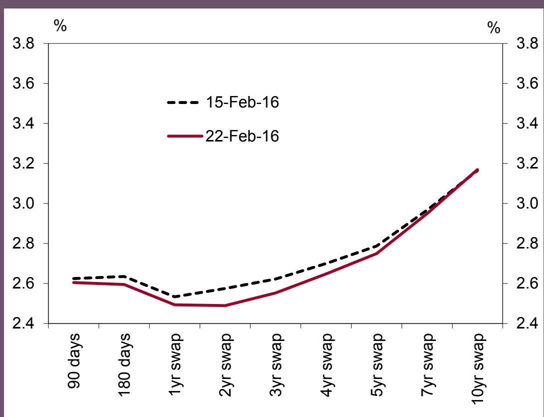
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

Longer-term fixed rates do offer the benefit of stability, but even those looking to fix may want to wait a while longer.

For borrowers with a deposit of 20% or more, the best value probably continues to lie in the two-year ahead and three-year ahead terms. Four- and five-year rates still seem high relative to where we think shorter-term rates are going to go over the next four or five years.

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



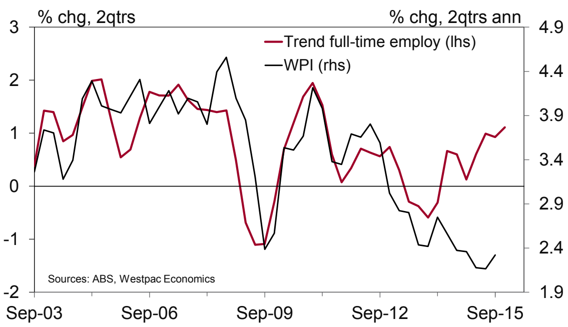
The week ahead

Aus Q4 Wage Price Index

Feb 24, Last: 0.6%, WBC f/c: 0.6%
Mkt f/c: 0.6%, Range: 0.5% to 0.9%

- In Q3, total hourly wage rates ex bonuses (WPI) rose by 0.6%, as expected. Indeed wage rates have been stable of late, growing by 0.6% each quarter through June 2014 to September 2015, with the one exception, a 0.5% rise in March 2015.
- Annual growth is holding at 2.3%, the slowest pace in the history of the WPI series, dating back to the late 1990s. Private sector wage rates are softer, at 0.5%qtr, 2.1%yr in Q3 2015.
- A key dynamic in the Australian economy currently is that wages are underperforming relative to labour market indicators, such as full-time employment and hours worked, as the declining terms of trade squeezes national income. With a continuation of this likely in Q4, we expect the WPI to print at 0.6%qtr 2.3%yr.

Wages fail to respond to stronger employment

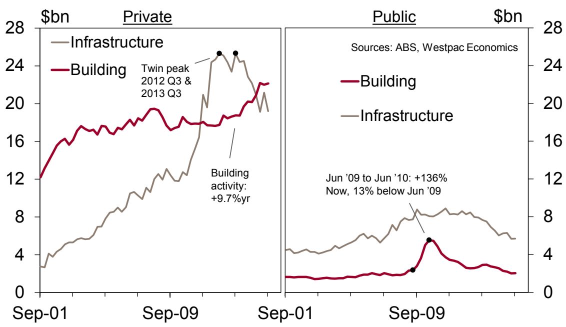


Aus Q4 construction work done

Feb 24, Last: –3.6%, WBC f/c: –2.0%
Mkt f/c: –2.0%, Range: –3.9% to 0.5%

- Construction activity, having peaked in 2012, is trending lower from an historic high as work on mining projects nears completion.
- For Q4, total construction work is forecast to decline by –2.0%qtr, –4.5%yr. This represents a more modest fall than the –3.5% decline in Q3, which included a –9.2% plunge in private infrastructure and a surprise dip in home renovations.
- Private construction activity is expected to fall by 2.5% in Q4, with infrastructure work down a forecast –7%; reinforced by a downturn in commercial building, –2%; more than offsetting a rise in home building activity, around 2.5%.
- Public activity, accounting for 15% of total work, is expected to rise by 1.5%, following a 0.3% gain in Q3, led higher by an emerging upturn in transport projects.

Construction work: divergent trends

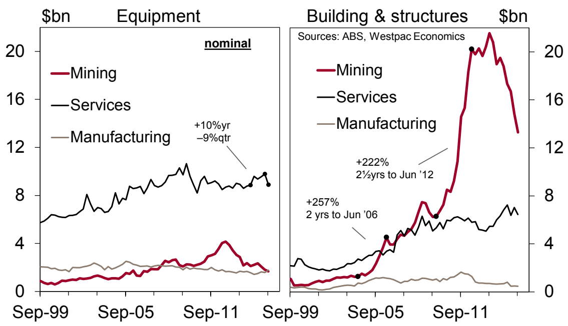


Aus Q4 private business capex

Feb 25, Last: –9.2%, WBC f/c: –4.0%,
Mkt f/c: –3.0%, Range: –9.6% to 0.5%

- Private business capex slumped 9.2% in Q3, extending the downturn that began in earnest during 2013.
- In Q3, Building & Structures took another sharp leg lower, –9.8%, centred on the mining investment downturn. The surprise in Q3 was an 8.2% fall in equipment spending, in contrast to a rise of 0.8% over the previous year. For Q4, total capex is expect to fall by –4%qtr, with risks skewed to the downside.
- The sharp downturn in building & structures will continue, –6.5%qtr, –23%yr. Equipment spending prospects are less clear. We anticipate a flat outcome, with fundamentals pointing to a partial rebound in spending by the service sectors, offsetting weakness in mining and manufacturing. However, ongoing uncertainty could see businesses further delay spending.

CAPEX: by industry by asset

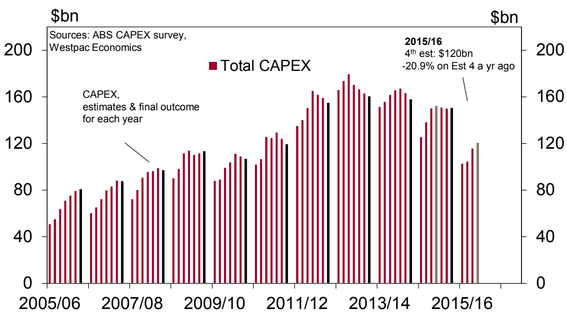


Aus private capex expectations, AUDbn

Feb 25, 2015/16, Est 4: 120

- Recall that Estimate 4 for 2015/16 capex was $120bn, some 21% below Est 4 for 2014/15. By industry: mining, $56bn, –34%; services, $56bn, –4%; and manufacturing, $8bn, –4%.
- If Estimate 5 were to print at $120bn, that would be 20.5% below the corresponding estimate of a year ago.
- We also receive Estimate 1 of 2016/17 capex. We expect another weak number, dragged lower by mining, potentially around $87bn, 15% below Est 1 of a year ago. Est 1 on Est 1 for the past three years have been: -9%, -17% and -18%.
- The December survey, conducted during January and early February, occurs as business conditions in the service sectors have slipped a little but remain above levels of a year ago, boosted by a lower dollar, but as concerns around China's growth outlook remain.

Total CAPEX: estimates & actuals



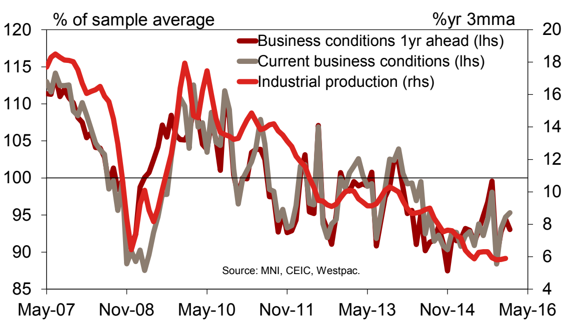
The week ahead

Chn Feb Westpac–MNI Consumer Sentiment

Feb 24, Last: 114.9

- The Westpac MNI China Consumer Sentiment Indicator lifted slightly in January rising 1.1pts to be up 2.5% on a year ago and marginally above the average over the last 18 months but still 4½% below its long run average.
- This was the 3rd straight gain after a steep fall in October and came despite the re-emergence of financial market turmoil in the month – China's equity markets fell 18% in the survey period alone. Equity market developments again appear to have only a minor bearing on the Chinese consumer's mood.
- Key to the growth outlook, we are yet to see a strong vote of confidence in favour of housing: consumers' perceptions of the sector are mixed; and broader risk aversion has also risen. Further improvement on both fronts would be very welcome, given continued weak growth in the sector.

Chinese IP & household views of business

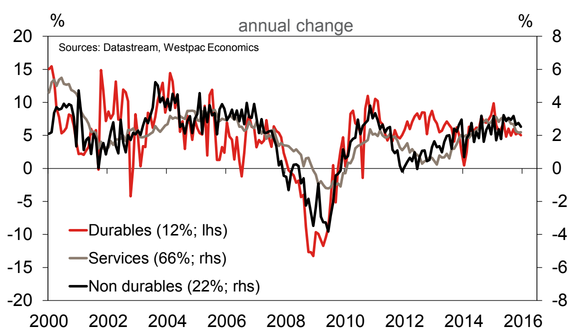


US January personal income, spending and deflator

Personal income Feb 26, Last: 0.3%, WBC f/c: 0.3%
Personal spending Feb 26, Last: 0.0%, WBC f/c: 0.3%
PCE deflator Feb 26, Last: –0.1%, WBC f/c: 0.0%

- In recent months, a modestly strengthening trend has become apparent in key nominal income measures. For the PCE measure, another solid gain is expected in January, circa 0.3%. Added to nominal wage growth, the trend decline in energy prices has further boosted real income growth.
- Consistent with this observation, the latest retail sales report came in above expectations, and also included upward revisions to history. Together with gains for services consumption, this renewed (but still subdued momentum) should result in a 0.3% gain for PCE spending in January. While we have seen progress made for wages and are seeing an improvement in spending, the inflation pulse remains soft on a headline basis; another flat result is anticipated.

Consumer offseting investment & global uncertainty



Data calendar

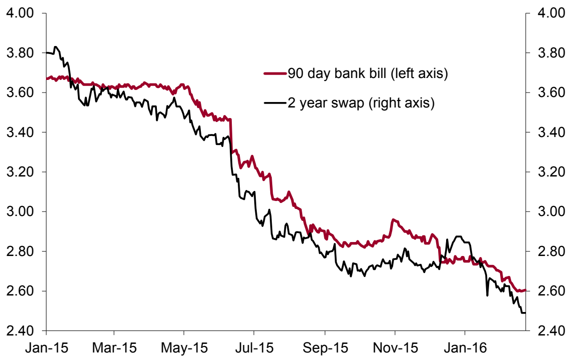
		Last	Market median	Westpac forecast	Risk/Comment
Mon 22					
Aus	RBA Assist Governor Financial Markets	–	–		Guy Debelle speaking, KangaNews summit, Sydney, 9.10am.
Chn	Feb MNI Business Indicator	–	–	–	External sector and heavy industry continue to weigh.
Eur	Feb Markit manufacturing PMI (provisional)	52.3	52.0	–	Domestic demand is solid but not strong...
	Feb Markit services PMI (provisional)	53.6	53.6	–	... services receiving more benefit than manufacturing.
Ger	Feb Markit manufacturing PMI (provisional)	52.3	52.0	–	Global economy a persistent pressure...
	Feb Markit services PMI (provisional)	55.0	55.0	–	... but domestic demand clearly supportive of growth.
US	Nov Chicago Fed national activity index	–0.22	–	–	Points to moderate growth.
	Feb Markit manufacturing PMI (provisional)	52.4	52.5	–	More positive than ISM, but still subdued.
	Fedspeak	–	–	–	Potter speaks in New York.
Tue 23					
Ger	Feb IFO business climate	107.3	107.0	–	For markets, its volatility versus Draghi.
US	Dec S&P/C-S 20 city house prices	0.9%	0.8%	–	Price growth maintaining solid pace over year at 5.8%.
	Feb consumer confidence	98.1	97.5	–	Conference Board measure. Around long-run average.
	Feb Richmond Fed manufacturing index	2	2	–	Has remained moderate despite external headwinds.
	Jan existing home sales	14.7%	–1.1%	–2.5%	Downside risk clear given Dec strength.
Wed 24					
Aus	Q4 wage price index	0.6%	0.6%	0.6%	Wages growth stuck at 0.6%qtr, yet to respond to stronger employment.
	Q4 construction work done	–3.6%	–2.0%	–2.0%	Mining downturn outweighing gain in housing & public works.
Chn	Feb Westpac-MNI Consumer Sentiment	114.9	–	–	Jan saw another modest rise despite equity market weakness.
US	Feb Markit services PMI	53.2	53.6	–	Momentum in the services sector has moderated of late.
	Jan new home sales	10.8%	–3.5%	–5.0%	Flattening positive trend amid all the volatility.
	Fedspeak	–	–	–	Kaplan speaks in Dallas.
Thu 25					
NZ	Jan net migration	5510	–	5730	Still extremely strong as fewer kiwis leave and students arrive.
Aus	Q4 private new capital expenditure	-9.2%	–3.0%	–4.0%	Mining downturn major negative. Equipment spend hit by uncertainty.
	Private capex expectations, AUDbn	120	–	–	2015/16 weak at -21%. Est 1 for 2016/17 also likely to be weak.
Eur	Jan CPI	0.4%	0.4%	–	Final estimate; 6-mth annualised rate much weaker at –1.0% in flash.
UK	Q4 GDP (provisional)	0.5%	–	0.5%	Domestic demand and services firm; manufacturing soft.
US	Initial jobless claims	262k	–	–	Claims remain in a tight range.
	Jan durable goods orders	–5.0%	2.3%	1.5%	Hope to see momentum build, but will likely take time.
	Dec FHFA house prices	0.5%	0.5%	–	House price growth momentum persists.
	Feb Kansas City Fed manufacturing activity	–9	–	–	Conditions in the manufacturing sector remain subdued.
	Fedspeak	–	–	–	Bullard speaks in New York; Lockhart gives opening remarks.
Fri 26					
NZ	Jan trade balance, $mn	–53	–225	–150	Dairy and meat exports passing their seasonal peak.
Chn	Jan property prices	–	–	–	Yet to see transfer of strength in Tier 1 to 2 and 3.
Eur	Jan economic confidence	105.0	104.7	–	Draghi has a very necessary objective to support confidence...
	Jan consumer confidence	–6.3	–	–	... encouraging marginal incomes gains to be spent by households...
	Jan business climate indicator	0.29	0.29	–	... and to see the fledgeling investment trend become robust.
Ger	Feb CPI, %yr	0.4%	0.4%	–	As for continent overall, inflation pressures minimal.
UK	Feb GFK consumer sentiment	4	3	–	The strengthening labour market is boosting consumer sentiment.
US	Q4 GDP, 2nd est.	0.7%	0.5%	0.6%	Very small downward revision coming in second estimate.
	Jan personal income	0.3%	0.4%	0.3%	Wages continue to pick up slowly...
	Jan personal spending	0.0%	0.2%	0.3%	... lower fuel price supports spending on services at margin...
	Jan PCE deflator	–0.1%	0.0%	0.0%	... but keeps weight on inflation.
	Feb consumer sentiment (final)	90.7	91.0	–	Uni of Michigan measure. Around long-run average.
	Fedspeak	–	–	–	Williams speaks in New York.

New Zealand forecasts

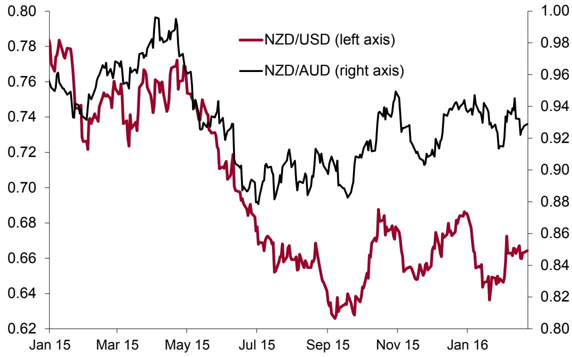
Economic Growth Forecasts	March years				Calendar years			
% change	2014	2015	2016f	2017f	2014	2015e	2016f	2017f
GDP (Production) ann avg	2.7	3.6	2.2	2.2	3.7	2.4	2.0	2.9
Employment	3.8	3.2	1.1	2.4	3.6	1.2	2.1	2.1
Unemployment Rate % s.a.	6.0	5.8	5.8	5.2	5.7	5.3	5.3	5.3
CPI	1.5	0.3	0.3	1.3	0.8	0.1	0.8	2.1
Current Account Balance % of GDP	-2.5	-3.4	-3.3	-2.7	-3.1	-3.3	-2.9	-3.0

Financial Forecasts	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Cash	2.50	2.25	2.00	2.00	2.00	2.00
90 Day bill	2.60	2.30	2.10	2.10	2.10	2.10
2 Year Swap	2.60	2.40	2.20	2.20	2.20	2.20
5 Year Swap	2.90	2.90	3.00	3.00	3.10	3.10
10 Year Bond	3.10	3.30	3.50	3.70	3.70	3.70
NZD/USD	0.65	0.63	0.61	0.61	0.62	0.62
NZD/AUD	0.93	0.93	0.92	0.91	0.90	0.89
NZD/JPY	79.5	77.7	75.9	76.5	75.9	75.9
NZD/EUR	0.61	0.61	0.59	0.58	0.57	0.57
NZD/GBP	0.44	0.44	0.43	0.42	0.41	0.40
TWI	71.1	70.1	68.4	68.0	67.7	67.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 22 February 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.50%	2.50%
30 Days	2.54%	2.56%	2.58%
60 Days	2.57%	2.60%	2.65%
90 Days	2.61%	2.64%	2.73%
2 Year Swap	2.49%	2.57%	2.67%
5 Year Swap	2.75%	2.84%	3.01%

NZ foreign currency mid-rates as at Monday 22 February 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6643	0.6622	0.6491
NZD/EUR	0.5972	0.5916	0.6011
NZD/GBP	0.4660	0.4588	0.4550
NZD/JPY	74.71	76.68	77.00
NZD/AUD	0.9289	0.9348	0.9266
TWI	72.25	72.34	71.58

International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015f	2016f	2017f
Australia						
Real GDP % yr	3.5	2.0	2.6	2.3	2.8	2.8
CPI inflation % annual	2.2	2.7	1.7	1.7	1.9	3.1
Unemployment %	5.3	5.8	6.2	5.8	6.1	5.9
Current Account % GDP	-4.4	-3.4	-3.0	-4.4	-5.0	-4.6
United States						
Real GDP %yr	2.2	1.5	2.4	2.4	2.4	2.1
Consumer Prices %yr	2.1	1.5	1.6	0.1	1.7	1.8
Unemployment Rate %	8.1	7.4	6.2	5.3	4.7	4.4
Current Account %GDP	-2.9	-2.3	-2.2	-2.3	-2.3	-2.3
Japan						
Real GDP %yr	1.7	1.6	-0.1	0.6	1.3	0.7
Euroland						
Real GDP %yr	-0.8	-0.3	0.9	1.5	1.3	1.4
United Kingdom						
Real GDP %yr	0.7	1.7	3.0	2.5	2.5	2.0
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	3.9	4.3
World						
Real GDP %yr	3.4	3.3	3.4	3.0	3.4	3.5
Forecasts finalised 12 Feb 2016						

Interest Rate Forecasts	Latest	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Australia						
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.28	2.20	2.20	2.20	2.20	2.20
10 Year Bond	2.44	2.50	2.70	2.90	3.30	3.55
International						
Fed Funds	0.375	0.375	0.625	0.875	1.125	1.375
US 10 Year Bond	1.72	1.80	2.20	2.60	3.00	3.25
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
AUD/USD	0.7130	0.70	0.68	0.66	0.67	0.69
USD/JPY	112.90	117	119	121	123	125
EUR/USD	1.1120	1.11	1.10	1.08	1.05	1.03
AUD/NZD	1.0765	1.08	1.08	1.08	1.10	1.12

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