

Weekly Commentary

22 August 2016



A strong performance

A 19% lift in whole milk powder prices in the most recent GDT auction was welcome news for New Zealand dairy farmers. There was also good (if somewhat muddled) news on the labour market front, with the unemployment rate ticking down to 5.1%.

Dairy prices put in a gold medal winning performance in last week's GlobalDairyTrade auction, with whole milk powder prices up a whopping 18.9%. Combine that with a solid outturn in the previous auction and whole milk powder prices have now risen almost 30% in the last month, and prices are back at levels last seen in October last year.

This improvement is certainly a welcome development for the dairy sector, but we'd continue to sound a note of caution. In August/September last year we saw a similar sharp lift in prices, only for this to be followed by a partial retracement through October and November. But while we'd continue to tread cautiously, the fundamentals certainly appear to finally be shifting in favour of dairy producers.

We have long been anticipating a drop in global supply in response to very low prices. And in recent months this has been starting to happen. After storming ahead following the abolition of milk production quotas in Europe in April 2015, European milk production has slowed noticeably of late. Combine this with expectations of New Zealand production declining this season on Fonterra's estimates by about 3% (on the back of a smaller national herd), and Australian milk production also expected to contract by 1% (following a 2% decline last season) and there won't be nearly as much milk sloshing around globally over the next year as we've seen over the last.

But perhaps more importantly, there are some signs that slower growth in global supply is coinciding with improved demand, particularly out of China. If sustained, this would clearly be a positive development for New Zealand exporters.

So even with a relatively cautious interpretation of the lift in dairy prices over the last month, prices to date have been stronger than expected. Consequently, we have revised up our milk price forecast for this season from \$4.60 to \$5. We will be watching forthcoming GlobalDairyTrade auctions closely, and are conscious of upside risk to this forecast if there is no retracement in prices from current levels over the coming months.

The other major data out last week was the June quarter HLFS survey. With the release date delayed by two weeks from its usual schedule (other data on wages and employment was released on time a fortnight ago), there was speculation that the HLFS survey could contain some wild numbers. This proved to be the case with a whopping 2.4% growth in employment reported in the June quarter.

Although last week's release was the first using Statistics New Zealand's updated methodology (which means those only looking at job adverts on the internet no longer count as actively seeking work) this wasn't directly responsible for the leap in employment. Instead, it was a change in the survey questionnaire which has led to a sharp lift in the

A strong performance continued

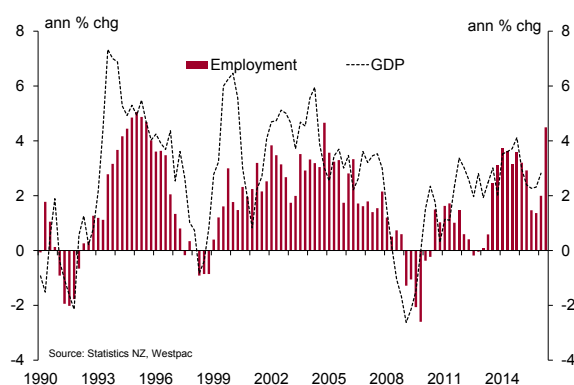
number of people counted as self-employed who were previously not counted in the labour force. In addition, the HLFS survey now includes people employed in the armed forces (living in private dwellings) who previously weren't captured by the survey. While statisticians are confident this is now a more accurate picture of employment in the economy, they haven't been able to put a finger on how much the changes have contributed to measured employment growth this quarter.

Looking across a broader range of labour market indicators we would conclude that we probably had pretty solid employment growth in the March quarter. And in this sense the fall in the unemployment rate from 5.2% to 5.1% feels about right. The bigger picture is that the labour market is continuing to gradually strengthen as the economy maintains a solid pace of growth.

Yet despite an improving labour market over the last year or two, firms reporting a lift in hiring intentions and increasing difficulty finding labour, wage inflation has been missing in action. The private sector labour cost index rose 0.4% in the June quarter, to be up just 1.6% on the year.

There are two key factors which have been keeping a lid on wage inflation. The first is the subdued inflation backdrop with annual inflation running at just 0.4%. While this means real growth in wages isn't looking nearly as tepid as the nominal headline, it also means there's little for employees to lean on when negotiating cost of living increases. The other factor keeping wage pressures contained is strong growth in working age population on the back of record net migration inflows. This was emphasised again by July

Employment and GDP



net migration data, which showed a monthly net inflow of migrants into New Zealand of 5,600 in the month.

But there were also hints in July's data that the tide is starting to turn. Annual net migration eased a smidgeon in July – bringing to an end a record setting run in net migration which has lasted almost two years. Arrivals of foreigners have been tracking lower for much of this year, and we expect departures will also start to lift as people who have arrived on temporary work or student visas over the past three years start to depart. In addition, an improving Australian labour market is expected to once again entice New Zealanders across the Tasman. Combined, this should see annual net migration slow further from here with a consequent impact on growth. That said, given the record starting point, net migration will remain relatively elevated for some time yet.

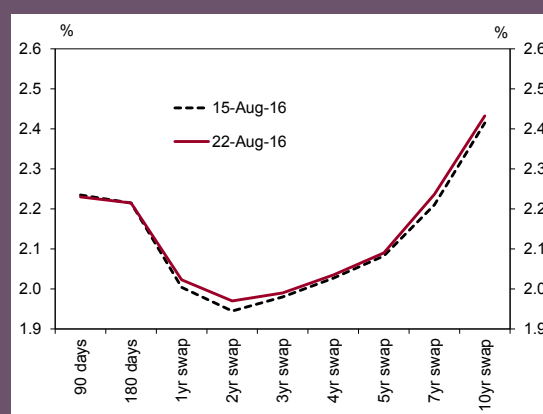
Fixed vs Floating for mortgages

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

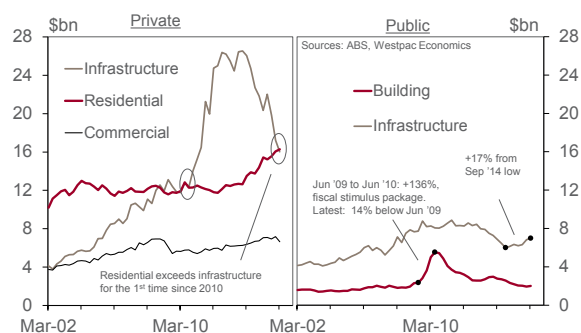
Aus Q2 construction work

Aug 24, Last: -2.6%, WBC f/c: -2.0%

Mkt f/c: -2.0%, Range: -5.3% to +2.0%

- Construction activity is trending lower, down from the historic highs of 2012, as work on mining projects is completed. Total work fell in each of the past three years: -1%, -8% and -4%.
- For Q2, we expect construction activity to decline by 2.0%, following a fall of 2.6% in Q1. Excluding private infrastructure, activity is to increase by a forecast 1% in the quarter.
- Private construction activity is forecast to fall by -2.8%qtr, -14.5%yr, with infrastructure down -8%qtr, -33%yr. New home building activity, having surged 31% over 2014 and 2015, is likely to make a more modest gain, f/c +1.5% after 1.5% in Q1.
- Public activity, accounting for 19% of total work in this survey, is expected to advance for a fourth consecutive quarter, +1.4%qtr, +10%yr, led higher by infrastructure projects.

Construction work: divergent trends



Data calendar

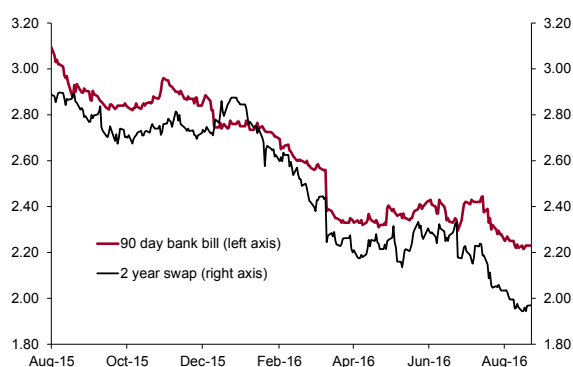
		Last	Market median	Westpac forecast	Risk/Comment
Mon 22					
US	Jul Chicago Fed activity index	0.16	-		Points to around trend growth in manufacturing.
Tue 23					
Eur	Aug Markit manufacturing PMI	52.0	52.0	-	Manufacturing and service PMI point to further moderate growth...
	Aug Markit services PMI	52.9	53.0	-	... but outcomes vary considerably by country.
	Aug consumer confidence	-7.9	-7.7	-	Households benefitting from ECB and market rally.
Ger	Aug Markit manufacturing PMI	53.8	53.7	-	Given soft global growth, moderate gains reported a good result...
	Aug Markit services PMI	54.4	54.3	-	... strength of labour market could give services greater momentum.
US	Aug Richmond Fed index	10	6	-	Has been volatile, points to firm manufacturing activity.
	Jul new home sales	3.5%	-2.9%	-	Continues to trend higher; interest rates very accommodative.
Wed 24					
NZ	Jul trade balance, \$mn	127	-300	-400	Seasonal drop in primary exports to drive sizeable monthly deficit.
Aus	Q2 construction work done	-2.6%	-2.0%	-2.0%	Mining downturn to outweigh gains in housing & public infrastructure.
US	Jun FHFA house prices	0.2%	0.3%	-	Solid price gains continuing.
	Aug Markit manufacturing PMI	52.9	53.0	-	Output, employment and new orders all improved in July.
	Jul existing home sales	1.1%	-0.4%	-	Evidence of renewed uptrend in recent months.
Thu 25					
Ger	Aug IFO business climate survey	108.3	108.5	-	Conditions remain robust; but views on outlook much less certain.
US	Initial jobless claims	262k	-	-	Claims remain at very low levels.
	Jul durable goods orders	-3.9%	3.5%	4.0%	A bounce expected, but underlying trend very poor.
	Aug Kansas City Fed index	-6	-2	-	Rebound likely after a particular weak July.
Fri 26					
Eur	Jul M3 money supply %yr	5.0%	5.0%		Credit data also due.
UK	Q2 GDP, 2nd est.	0.6%	0.6%	0.6%	Early estimate surprised to upside; momentum has eased through Q2.
US	Q2 GDP, 2nd est.	1.2%	1.1%	1.1%	Revisions expected to be minimal.
	Aug Markt service PMI	51.4	52.1	-	On the improve, but well below year-ago levels.
	Aug Uni. of Michigan sentiment	90.4	90.6	-	Sentiment remains above average.
	Fed Chair Yellen.	-	-	-	Speaking at annual Jackson Hole symposium; will be closely watched.
Sat 27					
Chn	Jul industrial profits %yr	5.1%	-	-	Pricing power very limited. Weaker CNY helps at margin.

New Zealand forecasts

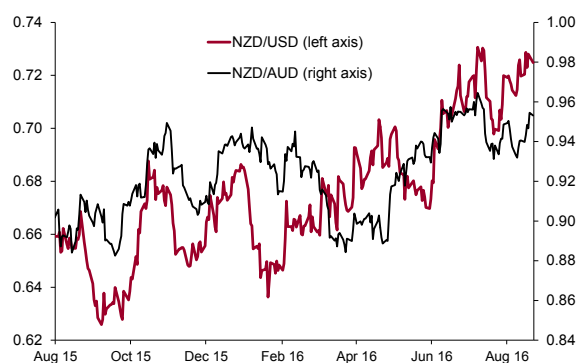
Economic Growth Forecasts	March years				Calendar years			
	% change	2015	2016	2017f	2018f	2014	2015	2016f
GDP (Production) ann avg	3.6	2.4	3.3	2.7	3.7	2.5	3.2	2.9
Employment	3.2	2.0	2.6	1.7	3.6	1.4	3.1	2.2
Unemployment Rate % s.a.	5.4	5.2	4.9	4.6	5.5	5.0	5.1	4.6
CPI	0.3	0.4	1.3	1.8	0.8	0.1	1.0	1.7
Current Account Balance % of GDP	-3.4	-3.0	-3.3	-3.6	-3.1	-3.2	-3.0	-3.7

Financial Forecasts	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
Cash	2.00	1.75	1.75	1.75	1.75	1.75
90 Day bill	2.00	1.90	1.90	1.90	1.90	1.90
2 Year Swap	2.00	1.90	2.00	2.00	2.00	2.00
5 Year Swap	2.10	2.10	2.20	2.30	2.40	2.50
10 Year Bond	2.10	2.20	2.30	2.50	2.60	2.70
NZD/USD	0.72	0.69	0.67	0.65	0.63	0.63
NZD/AUD	0.94	0.93	0.92	0.92	0.91	0.91
NZD/JPY	73.4	71.1	68.3	65.7	64.3	65.0
NZD/EUR	0.65	0.64	0.63	0.62	0.59	0.58
NZD/GBP	0.55	0.54	0.53	0.51	0.49	0.48
TWI	76.9	74.8	73.3	71.7	69.9	68.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



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

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.00%	2.25%	2.25%
30 Days	2.09%	2.15%	2.30%
60 Days	2.16%	2.20%	2.30%
90 Days	2.23%	2.25%	2.32%
2 Year Swap	1.97%	2.00%	2.05%
5 Year Swap	2.09%	2.09%	2.15%

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

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7248	0.7138	0.6993
NZD/EUR	0.6409	0.6369	0.6369
NZD/GBP	0.5555	0.5457	0.5321
NZD/JPY	73.09	72.82	74.26
NZD/AUD	0.9531	0.9369	0.9368
TWI	77.03	76.03	75.26

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	1.2	2.0
Unemployment %	5.3	5.8	6.2	5.8	5.7	5.6
Current Account % GDP	-4.4	-3.4	-3.0	-4.8	-4.6	-4.6
United States						
Real GDP %yr	2.2	1.5	2.4	2.4	1.6	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	4.8	4.6
Current Account %GDP	-2.9	-2.3	-2.3	-2.4	-2.3	-2.3
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	1.6	0.6
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 12 August 2016

Interest Rate Forecasts	Latest	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
Australia						
Cash	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
10 Year Bond	1.87	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	1.54	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	0.7680	0.77	0.74	0.73	0.71	0.69
USD/JPY	100.15	103	102	101	101	102
EUR/USD	1.1345	1.10	1.08	1.07	1.05	1.06
AUD/NZD	1.0545	1.07	1.07	1.09	1.09	1.10

Contact the Westpac economics team

Michael Gordon, Acting Chief 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

Sarah Drought, Economist +64 9 336 5696

Any questions email: economics@westpac.co.nz

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