Weekly Commentary

23 May 2016

Moments in time

Last week we released our latest *Quarterly Economic Overview*[1]. It highlights the shift in New Zealand's economic cycle that has occurred, and the continuing changes that are on the cards over the coming years.

The past few years saw solid GDP growth as the economy exited recession and activity was boosted by both strength in dairy prices and reconstruction following the devastating Canterbury earthquakes. However, during that time households maintained a degree of caution, with the ghosts of the financial crisis still fresh in people's minds. That phase of the economic cycle is now well and truly over.

Over the next 2 years, we continue to expect reasonable economic growth of 2.7% in 2016 and 2.6% in 2017. However, the drivers underlying growth have evolved.

Incomes in the economy are facing a serious hit, with the strength in dairy prices that previously boosted the terms of trade and GDP growth now a thing of the past. And subdued demand in some key markets, combined with increases in global supply, signals that a third sub-$5 payout season is on the cards for 2016/17. These conditions will weigh on incomes and spending in dairy regions over the coming years, and will also pass through the economy more widely. In response, we've already seen many farmers taking on debt to ensure the availability of working capital.

More generally, we're still facing a mixed global outlook, with muted demand in some of our key trading partner economies.

But despite these headwinds, overall activity in the economy is expected to hold up. A key reason for this is the current very low level of interest rates, which has seen much of the earlier caution in the household sector dissipating. Low interest rates have made it cheaper for households to fund spending using debt. At the same time, record low fixed mortgage rates have given housing markets nationwide a powerful shot in the arm. And as house prices have risen, home owners have felt wealthier and have spent more. However, the re-emergence of this borrow-to-spend dynamic has pushed debt-to-income levels above the peaks seen prior to the financial crisis.

GDP growth and employment are also being bolstered by the large pipeline of both residential and non-residential construction work planned over the coming years. Much of this work relates to Auckland's smouldering hot housing market, but building consent numbers have also been rising in areas such as the Bay of Plenty and Otago. On top of this, there is a large amount of infrastructure spending planned nationwide. Strength in these areas is helping to offset the levelling off of reconstruction spending in Canterbury. While rebuild related activity will remain strong for some time, it is no longer proving the strong boost to spending and employment growth that it did in recent years, and over time it will become a drag on economic growth.

Supporting the aforementioned positive factors has been strong growth in the economy's demand base on the shoulders of net migration. Net migration rose to 68,000 in the year to April, supported by new arrivals (including international students) and increases in the number of

1 Available here: http://www.westpac.co.nz/assets/Business/Economic-Updates/2016/Bulletins-2016/Westpac-QEO-May-2016_EMAIL.pdf

Moments in time continued

New Zealanders who have chosen to stay on shore or come back from overseas.

Putting it all together leaves us with a firm overall outlook for the New Zealand economy over the next year or two. However, as discussed in our recent *Regional Roundup*[2], conditions in regions that are closely linked to the dairy sector are likely to be softer than elsewhere.

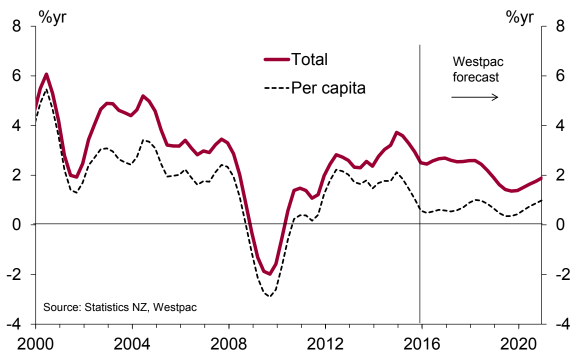
Looking to the latter part of the decade, the current phase of the economic cycle is set to give way to a period of slower economic growth and increases in unemployment. By that point the Canterbury rebuild will be very far advanced, and the associated spending and employment will have naturally started to taper off. This will dampen GDP growth, and given the sheer magnitude of rebuild spending, the resulting drag is likely to be sizeable and will continue for some time. Furthermore, as with the earlier boost to growth, the effects of the eventual slowdown in spending won't be limited to Canterbury or the construction sector.

It's also likely that the migration cycle will turn over the coming years. Australia's labour market is strengthening, and over time increasing numbers of New Zealanders are likely to look at making the jump over the Tasman. In addition, the flow of international students into the country has levelled off, while many of those who arrived in recent years will soon depart as they complete their studies.

Finally, the run-up in household and farm debt will challenge growth over the coming years. Although low interest rates mean that debt is serviceable for now, increases in debt can't boost growth indefinitely. Debt eventually needs to be repaid, and larger increases now will require sharper reductions in the future. In addition, higher debt levels mean that households are more vulnerable to unfavourable changes in economic conditions. That's a particular concern given the other factors that will dampen growth over the coming years.

With inflation currently subdued and the NZ dollar holding up, we expect that the RBNZ will cut the OCR again in June. However, after this a pause in the interest rate cycle is likely as firm GDP growth and a lift in oil prices drive some pick-up in inflation over 2017. But as the late-in-decade slowdown in economic activity comes into sharper focus, inflation will drop back again. This could bring reductions in the OCR back on to the table from 2018.

Total and per-capita annual GDP growth



2 Available here: http://www.westpac.co.nz/assets/Business/Economic-Updates/2016/Bulletins-2016/Regional-Roundup-May-2016.pdf

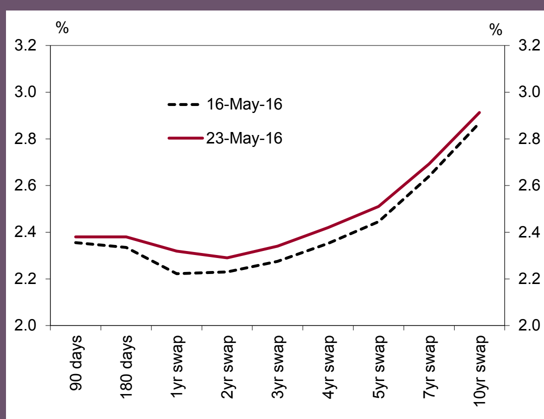
Fixed vs Floating for mortgages

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



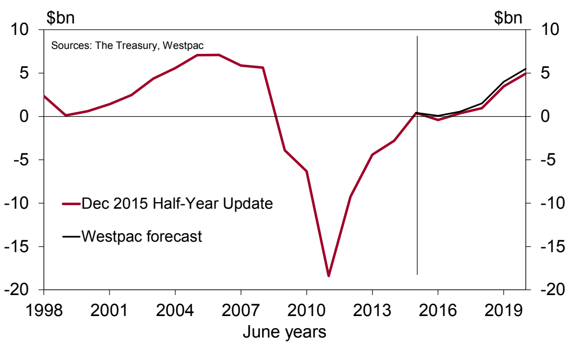
The week ahead

NZ Budget 2016

May 26, 2015/16 balance Last: –401mn

- The 2016 Budget is likely to be a relatively low key event, with a renewed focus on keeping debt in check.
- Finance Minister Bill English has signalled that while the Budget will bring forward some spending into the current year, it will also include cuts to the operational and spending allowances totalling around $1.2bn over the next 5 years.
- Treasury's growth forecasts are likely to continue to be more optimistic than our own in the latter part of the 5 year forecasting horizon – a period where we think the wind-down of the Canterbury rebuild will be a significant drag on growth. Consequently, we are sceptical that the large future surpluses Treasury are expecting by the end of the decade will eventuate.

Operating balance (excluding gains and losses)

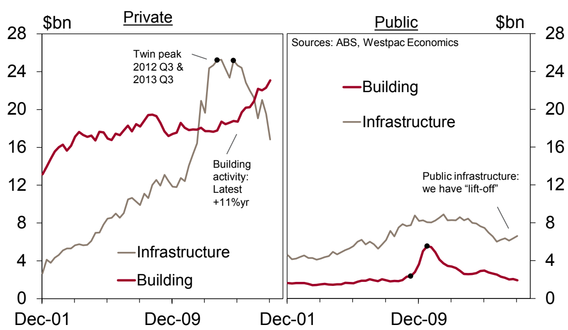


Aus Q1 construction work done

May 25, Last: –3.6%, WBC f/c: –2.2%
Mkt f/c: –1.5%, Range: –3.1% to 1.5%

- 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: –2%, –6% and –4%.
- For Q1, we anticipate a decline in activity of –2.2%qtr, –4.8%yr. In dollar terms, work falls $1.05bn in the quarter, centred on a $1.2bn drop in private infrastructure.
- Private construction activity is forecast to fall by –3%qtr, –6%yr, with infrastructure down –7%qtr, –18%yr. New home building activity, having surged 30% over the past two years, including a 3.6% rise in Q4, is expected to consolidate, +0.5%qtr.
- Public activity, accounting for 18% of total work in this survey, is expected to advance for a third consecutive quarter, +1.4%qr, +1.1%yr, led higher by infrastructure projects.

Construction work: divergent trends

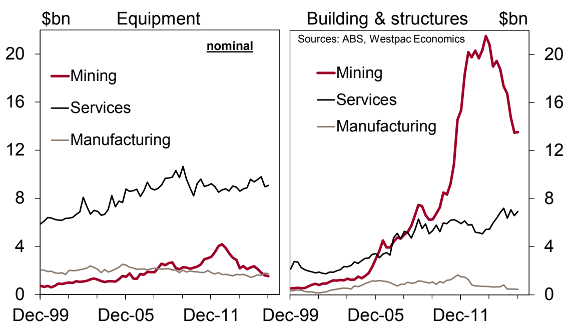


Aus Q1 private business capex

May 26, Total capex Last: 0.8%, WBC f/c: –4.0%
Mkt f/c: –3.5%, Range: –9.0% to 2.5%
Equipment capex: Last: 0.1%, WBC f/c: flat

- Private business capex fell in each of the past three years: -5%, -3% and -16%, led lower by Building & Structures as the downturn in mining investment dominates.
- In Q4, there was a rare rise, +0.8%qtr, reflecting noise in the data rather than anything of substance.
- For Q1, the slide will resume, with a forecast -4%qtr, -15%yr in total capex. Building & structures will remain the source of weakness, a forecast -6%qtr, -17.5%yr.
- Equipment spending, accounting for almost 40% of capex in this survey, is expected to be flat in Q1, as it was in Q4. This would be the balance of a lift in services (which accounts for 75% of such spending) and the downturn in mining.

CAPEX: by industry by asset

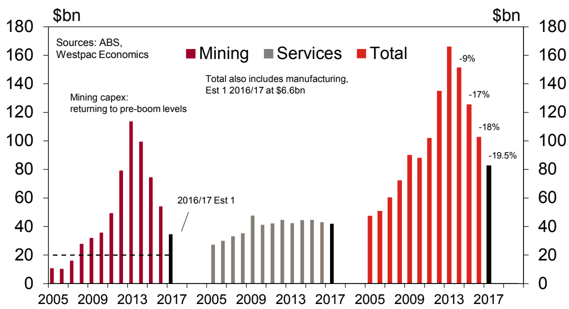


Aus private capex expectations, AUDbn

May 26, Last: 2015/16, Est 5: 124, –17.8%
Last: 2016/17, Est 1: 83, –19.5%

- Business investment plans are understandably weak as mining capex deflates following the boom - a trend that is locked in - and with the services sector yet to commit to a sustained lift in spending. For 2016/17, Estimate 1 of planned capex is $83bn, -19.5% below Est 1 a year ago (-$20bn). Mining is down $19.5bn, -36%. The services sector plans to invest $41.7bn in 2016/17, $1bn below Est 1 a year ago, -2.5%.
- The March survey, conducted in April and early May, will provide Est 2 for 2016/17 capex. Improved business conditions, including in the capex intense transport industry, are supportive of an emerging lift in service sector equipment investment. However, offsetting this is weakness in commercial building. Negatives weighing on investment intentions are: uncertainty leading into the Federal Budget and during the Federal Election campaign, and the recent jump in the AUD.

Capex plans, by industry: Estimate 1



The week ahead

Chn May Westpac–MNI Consumer Sentiment

May 25, Last: 118.1

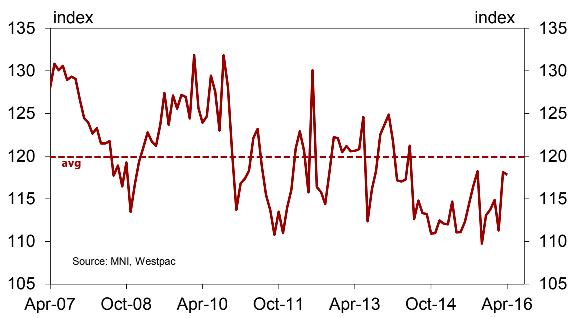
- The **Westpac MNI China Consumer Sentiment Indicator** edged 0.3pts lower to 117.8 in April from 118.1 in March. Sentiment held on to most of the previous month's 6.1% surge but was still 1.7% below the index's 9yr average of 120.
- The May survey – in the field May 1-15 – follows another period of relative calm for markets but with a mixed tone on the Chinese economy with the Q1 batch of data mostly undershooting expectations but the upturn in China's housing markets gaining more momentum (albeit with performances continuing to range widely across regions).

US April durable goods orders

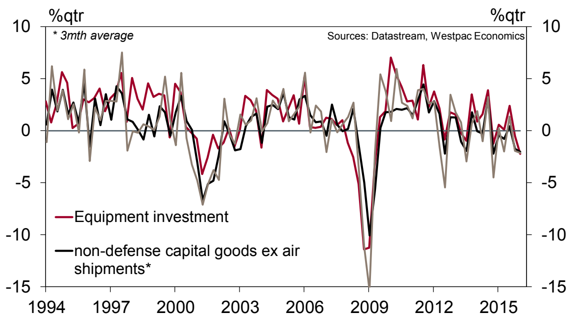
May 26, Last: 0.8%, WBC 0.5%

- Durable goods shipments and orders have been a consistent disappointment over the past year, with the weak oil price and stronger USD resulting in increasingly broad-based weakness in investment across major industries.
- In March, this downtrend abated somewhat, total durable orders rising 0.8% as transport and defence activity improved.
- However, core orders were broadly unchanged in the month, rising just 0.1%.
- Come April, a more modest gain in total orders is anticipated, circa 0.5%. The impact of transport and defence sector activity is expected to be marginal and largely offsetting. As such, growth in core orders should come in at a similar rate. Risks surrounding these forecasts are (at the margin) to the downside.

Westpac MNI China CSI



US durable goods underlying trend weak



Data calendar

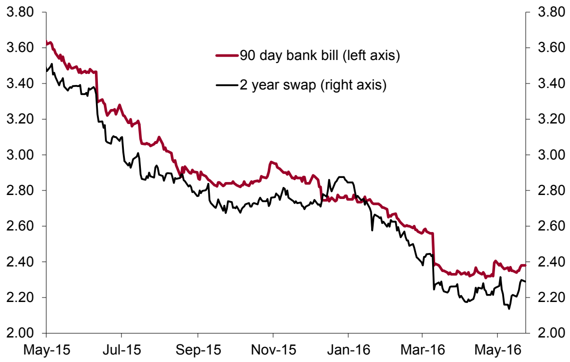
		Last	Market median	Westpac forecast	Risk/Comment
Mon 23					
Eur	May Markit manufacturing PMI	51.7	51.9	–	Manufacturing soggy of late….
	May Markit services PMI	53.1	53.2	-	… services continue to show more momentum.
Ger	May Markit manufacturing PMI	51.8	52	-	As for rest of region, so for German manufacturing…
	May Markit services PMI	54.5	54.5	-	… but strength in labour market aiding services.
US	Fedspeak	–	–	-	Bullard Speaks in Beijing; Williams in NY as well.
	May Markit manufacturing PMI	50.8	51.0	-	Broadly static outlook for US manufacturing.
Tue 24					
Aus	RBA Governor Stevens	–	–	–	Speech, Trans–Tasman Business Circle, Sydney 1:05pm.
Eur	May ZEW survey of expectations	11.2	12.0	–	A FOMC induced weaker EUR would be helpful for profits.
UK	Apr public sector borrowing £bn	4.2	–	–	The UK government will face an uphill battle to achieve its surplus aims.
US	Fedspeak	–	–	–	Harker Speaks on Economic Outlook in Philadelphia.
	May Richmond Fed index	14	10	–	At firm levels. Manufacturing gauges have been softening recently.
	Apr new home sales	–1.5%	1.8%	3.0%	Momentum slowing, but level of activity should hold.
Wed 25					
NZ	Apr trade balance $mn	117	80	60	Mar exports and imports may have been depressed by Easter timing.
Aus	Q1 construction work done	–3.6%	–1.5%	–2.2%	Construction activity led lower by private infrastructure.
Chn	May Westpac–MNI China Consumer Sent'	117.8	–	–	Decent rally in March mostly carried into April, but still below 9yr avg.
Ger	May IFO business climate survey	106.6	106.8	–	Current conditions are strong, but outlook uninspiring.
US	Mar FHFA house prices	0.4%	0.5%	–	Momentum solid albeit not spectacular.
	May Markt service PMI	52.8	53.2	–	Moderate growth continuing.
	Fedspeak	–	–	–	Harker, Kashkari and Kaplan.
Can	Bank of Canada policy decision	0.5%	0.5%	0.5%	Fiscal support aiding expectations of outlook.
Thu 26					
NZ	Budget 2016	–	–	-	FinMin has signalled a focus on debt reduction for this Budget.
Aus	Q1 private new capital expenditure	0.8%	–3.5%	–4.0%	Q4 rise an aberration. Weakness to resume in Q1, centred on Building &
	Q1 equipment spending	0.1%	–	0.0%	Structures (mining). Equipment spend flat, supported by services.
	2016/17 capex expectations	–19.5%	–	–	Est 1 –19.5% vs Est 1 yr ago, mining investment downturn.
	RBA Assist Governor (Financial Markets)	–	–	-	Guy Debelle, speech at Forex conference, New York, 11:00pm AEST.
UK	Q1 GDP	0.4%	0.4%	0.4%	Manufacturing a drag; signs service sector is losing momentum.
US	Fedspeak	–	–	-	Bullard Speaks in Singapore.
	Initial jobless claims	278k	–	–	Remains at historically low levels.
	Apr durable goods orders	0.8%	0.3%	0.5%	Another (marginally) positive outcome expected; weak trend persists.
	Apr pending home sales MoM	1.4%	0.6%	1.0%	Sales momentum is moderating.
	May Kansas City Fed index	–4	–4	–	Has picked up but continues to point to softness in activity.
	Fedspeak				Bullard in Singapore; Powell on economy.
Fri 27					
Aus	RBA Assist Governor (Financial Markets)	–	–	-	Guy Debelle, on panel, event on BIS FX code, New York, 8:30am AEST.
Chn	Apr industrial profits %yr	11.1%	–		Improving, though strength not broad based.
UK	May GfK consumer confidence	–3	–5	–	The upcoming Brexit vote could weigh on confidence.
US	Q1 GDP, 2nd est.	0.7%	0.7%	0.8%	A marginal upward revision anticipated; growth still weak.
	May Uni. of Michigan sentiment	95.8	95.8	–	Household confidence robust.
	Fed Chair Yellen	–	–	-	Receives Radcliffe medal; Q&A on "groundbreaking achievements".

New Zealand forecasts

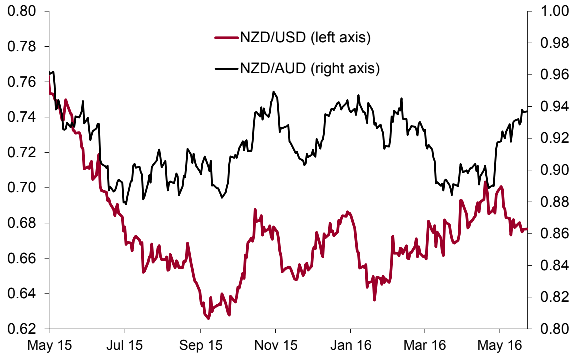
Economic Growth Forecasts	March years				Calendar years			
% change	2014	2015	2016f	2017f	2014	2015	2016f	2017f
GDP (Production) ann avg	2.7	3.6	2.4	2.6	3.7	2.5	2.7	2.6
Employment	3.8	3.2	2.0	2.5	3.6	1.4	2.9	2.4
Unemployment Rate % s.a.	6.0	5.8	5.7	5.4	5.8	5.4	5.7	5.0
CPI	1.5	0.3	0.4	1.1	0.8	0.1	1.1	1.8
Current Account Balance % of GDP	-2.5	-3.4	-3.0	-3.4	-3.1	-3.1	-3.2	-3.6

Financial Forecasts	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day bill	2.10	2.10	2.10	2.10	2.10	2.10
2 Year Swap	2.10	2.10	2.10	2.20	2.20	2.20
5 Year Swap	2.50	2.70	2.80	2.90	3.00	3.10
10 Year Bond	2.80	2.90	3.00	3.20	3.40	3.50
NZD/USD	0.67	0.66	0.64	0.63	0.62	0.62
NZD/AUD	0.92	0.92	0.91	0.90	0.89	0.87
NZD/JPY	73.7	73.9	73.6	73.7	74.4	74.4
NZD/EUR	0.60	0.61	0.59	0.59	0.58	0.58
NZD/GBP	0.48	0.48	0.47	0.46	0.46	0.44
TWI	71.1	70.9	69.4	68.9	68.2	67.5

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 23 May 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.25%	2.25%	2.25%
30 Days	2.27%	2.29%	2.26%
60 Days	2.31%	2.34%	2.31%
90 Days	2.38%	2.40%	2.32%
2 Year Swap	2.29%	2.18%	2.22%
5 Year Swap	2.51%	2.40%	2.49%

NZ foreign currency mid-rates as at Monday 23 May 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6766	0.6823	0.6855
NZD/EUR	0.6038	0.5987	0.6084
NZD/GBP	0.4666	0.4729	0.4733
NZD/JPY	74.55	73.10	76.25
NZD/AUD	0.9369	0.9274	0.8886
TWI	73.06	72.81	72.48

International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015f	2016f	2017f
Australia						
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
United States						
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
Japan						
Real GDP %yr	1.7	1.4	0.0	0.5	0.7	0.7
Euroland						
Real GDP %yr	-0.9	-0.3	0.9	1.6	1.4	1.3
United Kingdom						
Real GDP %yr	1.2	2.2	2.9	2.2	1.9	2.1
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	4.1
World						
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
Australia						
Cash	1.75	1.75	1.50	1.50	1.50	1.50
90 Day Bill	1.99	2.05	1.80	1.80	1.80	1.80
10 Year Bond	229	2.60	2.65	2.65	2.75	2.75
International						
Fed Funds	0.375	0.375	0.625	0.625	0.875	0.875
US 10 Year Bond	1.84	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	0.7230	0.73	0.72	0.70	0.70	0.70
USD/JPY	110.00	110	112	115	117	120
EUR/USD	1.1200	1.14	1.10	1.08	1.06	1.06
AUD/NZD	1.0680	1.09	1.09	1.09	1.11	1.13

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