Weekly Commentary

25 July 2016

Upping the ante

Softer CPI data and the announcement of further macroprudential measures likely to cool the housing market a little have left us in no doubt that the RBNZ will cut the OCR to 2% in August. Indeed the RBNZ is also likely to signal it's willing to go even lower if the exchange rate remains strong.

The key development last week was the announcement of tighter mortgage lending restrictions by the Reserve Bank. Once again property investors were firmly in the RBNZ's sights, with the Bank effectively capping lending to investors at a maximum of 60% loan-to-value ratio (LVR) nationwide (previously there had only been restrictions on lending to Auckland investors). The nationwide speed limit for owner occupied lending was also lowered. No more than 10% of new lending is now permitted to have an LVR greater than 80% (previously, the limit was 15% of new lending outside Auckland).

The RBNZ announced said the new policy is effective from 1 September, but it also said that it expected the banks to "observe the spirit of the new restrictions in the lead-up to the new policy taking effect". Clearly the banks were listening, with the new restrictions already being enforced by all four major banks.

Potentially that's not the end of the road yet when it comes to restrictions on mortgage lending. In Tuesday's announcement, the RBNZ reiterated that restrictions on debt-to-income ratios are under development and could be introduced next year.

The new restrictions are expected to result in house price inflation and credit growth that are 2-5% lower than would have otherwise been the case. That's a pretty small effect given the backdrop of house price inflation currently tracking at 15%. But controlling house price inflation is not the objective of the policy. Instead, the RBNZ's financial stability mandate requires them to ensure the soundness and efficiency of the New Zealand financial system. And it's in this regard they hope the LVR restrictions will have an impact. LVR restrictions provide a greater buffer for banks in a housing downturn. They may also leave banks less inclined to turn off the credit taps during a downturn, potentially reducing the severity of the event (relative to one where credit conditions were significantly tighter).

Tighter macroprudential policy has been on the cards for some time as the RBNZ targets its financial stability mandates. But for monetary policy keeping inflation within the 1-3% target band remains the primary focus. Inflation has been persistently below target, and the sharp rise in the NZ dollar recently threatens to put that target out of reach for even longer.

The weak inflation outlook was highlighted by June quarter CPI data. Once again inflation undershot expectations, rising 0.4% in the June quarter (below market expectations of a 0.5% rise and RBNZ's prediction of a 0.6% lift). The surprise was largely down to weaker tradables inflation where it looks like the boost provided by last year's fall in the New Zealand dollar has petered out.

Also concerning for the Reserve Bank are signs that domestic inflation pressures are still largely confined to the

Upping the ante continued

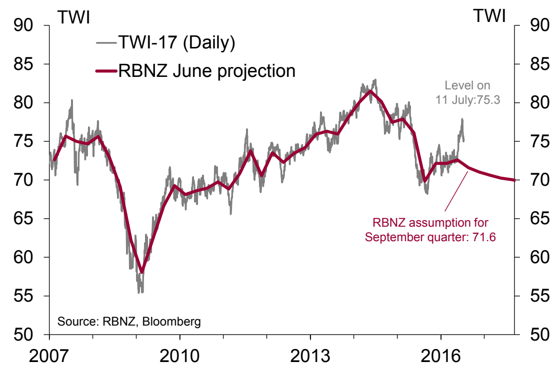
housing and construction sector. Beyond this, there's still little sign of significant upward pressure on prices.

Indeed the RBNZ made no bones about the deteriorating inflation outlook in their hurriedly scheduled Economic Update released on Thursday. The one page statement comes just 3 weeks ahead of the August monetary policy statement, but fills a gap that emerged because of a change in OCR decision schedule by the RBNZ. It bluntly stated that the "outlook for inflation has weakened since the June Statement." The softer inflation outlook is largely due to the TWI which remains well above its June level, which is making it "difficult for the Bank to meet its inflation objective".

Consequently, the RBNZ sounded even more dovish about the path for interest rates over the year ahead than they back in June, commenting that "it seems likely that further policy easing will be required". The RBNZ didn't mince its words when it said a "decline in the exchange rate is needed".

With such unequivocal guidance, it's unsurprising that markets have reacted to the past week's developments equally decisively. An August rate cut is now fully priced, with another 25 basis point OCR cut priced in by February. We concur that the risks are now skewed to a sub-2% OCR, though much will depend on the NZ dollar. Last week, the New Zealand dollar fell sharply, from above 71 cents against the USD on Monday, to around 69.9 cents currently. But it will need to fall further yet before the RBNZ can view the inflation outlook with a degree of comfort.

NZ dollar TWI



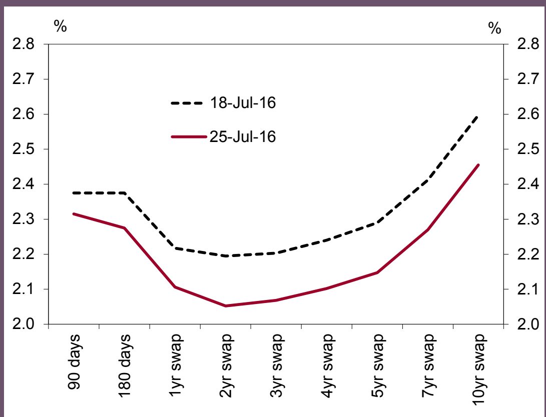
Fixed vs Floating for mortgages

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 June building consents

July 29, Last: -0.9%, Westpac f/c: 2.0%

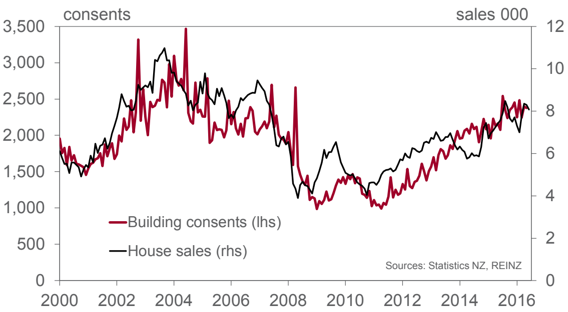
- Last month's overall change was disappointing from the perspective of the housing shortage, particularly for Auckland.
- Meanwhile, Canterbury's residential work remained surprisingly strong on the back of multi-unit consents.
- We expect growth in Auckland consents may remain subdued as developers wait for the outcome of the Unitary Plan deliberations, due mid August.
- Yet other parts of the country like Hamilton and Tauranga are likely to see continued strength in activity.

NZ July business confidence

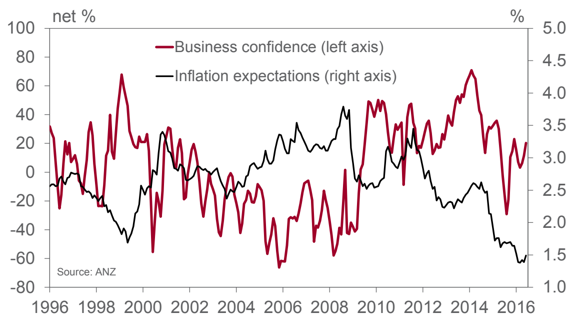
July 29, Last: 20.2

- Business confidence picked up across sectors in June, pointing to continued moderate rates of growth; meanwhile, indicators of inflation remained low. Firms in the construction and services sectors were the most upbeat, while those in the agricultural sector remain the most pessimistic.
- This month's survey provides the first read of how business confidence fared in the wake of the Brexit result, which received much media attention early in the month. We will also be paying close attention to the inflation gauges to see whether price setting behaviour by firms is beginning to respond to reported increases in capacity utilisation. So far, inflation pressures outside of housing and construction have been muted, creating challenges for the RBNZ in returning CPI inflation to 2.0%yr.

NZ housing activity



NZ business confidence and inflation expectations



Aus Q2 Consumer Price Index %qtr

Jul 27 Last: –0.2%, WBC f/c: 0.5%
Mkt f/c: 0.4%, Range: 0.3% to 0.8%

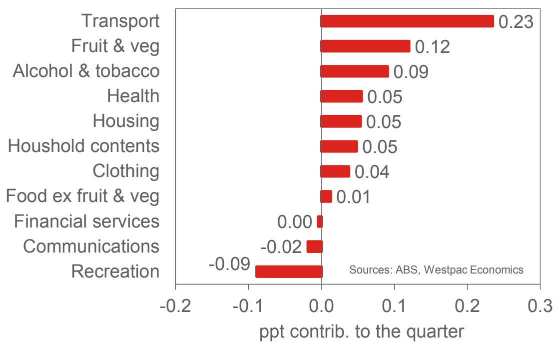
- The headline CPI surprised in Q1, falling 0.2% compared to Westpac's forecast of +0.4%. The market median was +0.2%. The annual rate is now just 1.3%yr compared to 1.7%yr in Q4. The core measures rose 0.2% versus the market's expectation of a 0.5% rise. The annual pace of the average of the core inflation measures is now 1.5%, moderating from 2.0% in Q4 – the lowest print we have yet seen for this measure.
- Westpac is forecasting a 0.5%qtr rise (1.2%yr) in the headline CPI for the June quarter. Auto fuel prices and a seasonal rise in fresh fruit & vegetables are helping to boost the CPI; but outside of car prices, the impact of the weaker AUD has been very modest to date. Core inflation is forecast to print 0.3%qtr (0.35% at two decimal places), which will see annual core inflation fall to a new record low of 1.4%yr.

Aus Q2 import price index

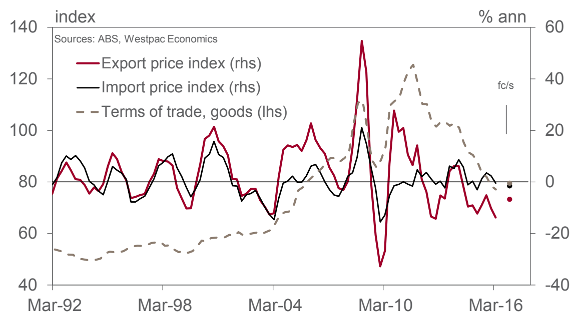
Jul 28, Last: –3.0%, WBC f/c: 0.4%
Mkt f/c: 1.5%, Range: –1.0% to 5.0%

- For June, we expect a small rise in the import price index, +0.4%qtr, –1.5%yr, anticipating that a bounce in oil prices outweighs the impact of a higher Australian dollar.
- Oil prices, having tumbled over the past two years, managed to bounce off their lows in the June quarter. The Singapore gasoline price increased by 17% in the period, but was still 30% lower than a year ago, and more than 50% below the levels prevailing in early 2013.
- The currency was firmer in the June quarter, thereby placing downward pressure on import prices. The AUD rose to 62.7 on a TWI basis, up 1.5% in the quarter to be 2.5% below the level of a year ago.

Contributions 2016Q2 CPI forecast



Import & export prices (excluding services)



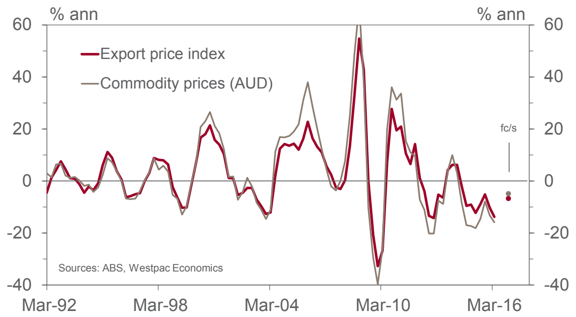
The week ahead

Aus Q2 export price index

Jul 28, Last: –4.7%, WBC f/c: 3.5%
Mkt f/c: 3.0%, Range: 0.0% to 7.0%

- Export prices recovered a little in the June quarter, breaking the downward trend of the past two years. The export price index is expected to rise by 3.5% in the June quarter following a 15% fall in the year to March 2015, and a further 15% decline in the year to March 2016. In June, commodity prices bounced 8% in US dollar terms, with iron ore, oil and other key commodities lifting from their recent lows. However, a stronger currency in the period, up 3.4% against the US dollar to 74.5¢, dampened export prices.
- The terms of trade for goods, on these estimates, increases by 3% in the period – following 9 consecutive quarterly declines.
- Note, the export price deflator (BoP) – to be published on September 6 – can diverge from export price index movements.

Commodity prices & export price index

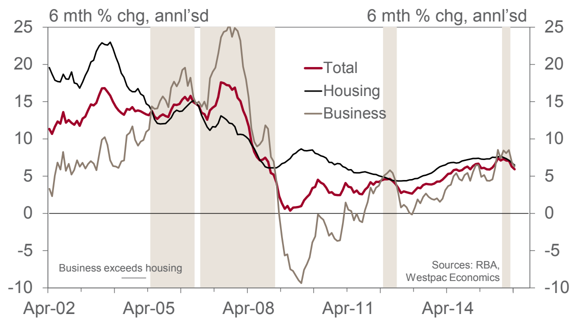


Aus Jun private sector credit

Jul 29, Last: 0.4%, WBC f/c: 0.4%
Mkt f/c: 0.5%, Range: 0.4% to 0.6%

- Credit to the private sector lost momentum ahead of any impact from the RBA's May rate cut. We expect this softer tone to still be evident in the month of June.
- In May, credit grew by 0.4% to be 6.5% higher than a year ago. However, over the past three months, annualised growth slowed to 5.3%. Key has been the impact of tighter lending conditions in the housing market. For June, we expect monthly credit growth to hold at 0.4%.
- Housing credit grew by 0.5%, 6.9%yr in May, with 3 month annualised growth at 5.8%. Any May rate cut boost will likely take a couple of months to be apparent. As to business credit, while up a solid 3.4% over the past half year, it managed only a modest 0.3% gain in May. Recent softer commercial finance data points to the risk of another modest result.

Credit momentum

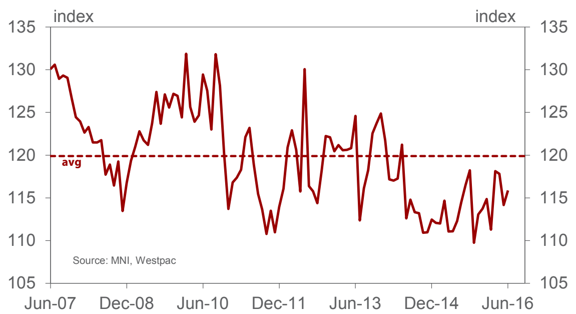


Chn Jul Westpac–MNI Consumer Sentiment

Jul 27, Last: 115.9

- The **Westpac MNI China Consumer Sentiment Indicator** rose 1.5% to 115.9 in June from 114.2 in May. Most components posted solid improvements, with downgraded views on the medium term outlook the one offsetting drag. The indicator remains below its 10yr average of 120.
- The July survey was in the field in the first half of the month and hence may be impacted by global financial volatility following the UK's 'Brexit' vote. However, these sorts of developments are not typically strong drivers of sentiment in China. The domestic data flow has been a touch better in recent months, but a decisive lift in activity remains elusive, particularly for the key industrial sectors. Activity also remains very uneven across geographies.

Westpac MNI China CSI

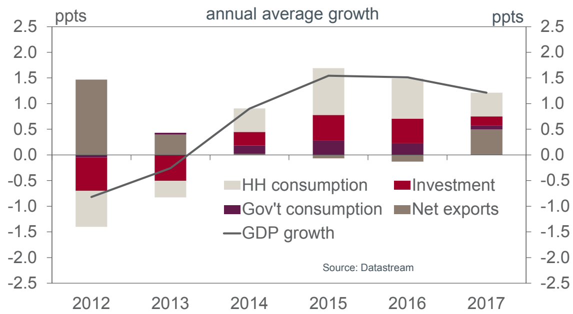


Q2 Euro Area GDP

Jul 29, Last: 0.6%, WBC 0.4%

- Euro Area GDP surprised to the upside in Q1, rising by 0.6%. That is the strongest outcome since Q1 2015, and compares to an average quarterly gain for 2015 as a whole of 0.4%. Annual growth was unchanged at 1.6%yr in Q1.
- Spain again led the way, with growth of 0.8% (3.4%yr). However, Germany and France also saw robust growth in Q1, respectively 0.7% (1.6%yr) and 0.6% (1.3%yr). Italy continues to lag, with growth of 0.3%, 1.0%yr.
- Conditions are mixed: investment is robust in some jurisdictions; consumption in others. Spain is the only nation to be experiencing momentum in both key sectors. Come Q2, another solid gain is expected, albeit a little more modest than in Q1. In that regard, a repeat of 2015 seems likely. For consumption, the labour market and confidence grant upside risk; but for investment, the outlook is clouded.

Euro Area moderate growth continues



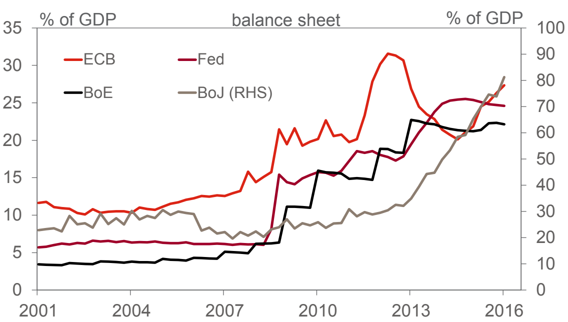
The week ahead

July FOMC meeting

Jul 26–27, Last: 0.375%, WBC 0.375%

- The past few months have proved particularly challenging for the FOMC, with soft nonfarm payrolls employment growth affecting market rate expectations ahead of the July meeting, and the Brexit vote stoking volatility thereafter. A month on, the Brexit vote's immediate impact on equity markets looks to have subsided, with the S&P500 rallying back to trade at fresh highs.
- Concerns over the US labour market have also eased, thanks to the upside surprise reported for June, which has helped annual employment gains remain well ahead of growth in the population. The current level of the unemployment rate signals full employment (of available labour resources) is at hand.
- A change in the policy stance in July is highly unlikely. But, if job gains persist, look for a move by the FOMC to stoke market rate expectations in coming months before a December hike.

Central bank balance sheets

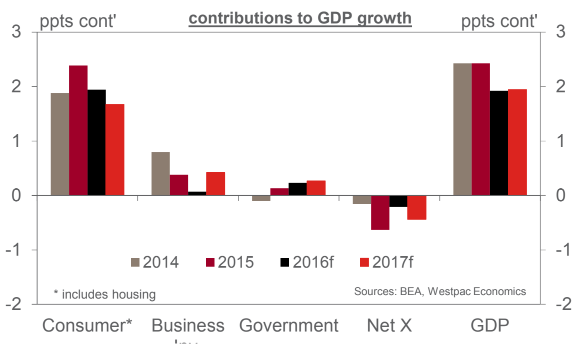


Q2 US GDP

Jul 29, Last: 1.1%, WBC 2.4%

- Initially reported at just 0.5% annualised, Q1 GDP came as a real disappointment to the market and the FOMC, raising questions over consumers' and firms' willingness to spend. Concern abated somewhat as growth was revised up to 1.1%; however, 6 month annualised growth is still soft at 1.2%.
- Following the experience of 2015, a significant improvement in the growth impulse is anticipated in Q2.
- While the quarter started with robust consumer momentum, subsequent readings have been solid but not strong. At the same time, business investment has remained weak. Residential construction should support in Q2, so too government spending and inventories. All told, quarterly annualised growth should accelerate to 2.4%, and the 6-month average to 1.8%. However, annual growth will slow, as 2015 Q2's 3.9% gain drops out.

US growth depends on consumer

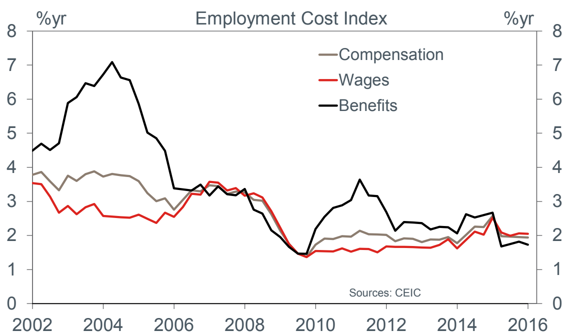


Q2 US Employment Cost Index

Jul 29, Last: 0.6%, WBC 0.6%

- In Q1, total compensation rose 0.6% to be 1.9% higher over the year. The annual result was weighed down by Q2 2015's 0.2%, which is soon to drop out of the calculations. Abstracting from this weak quarter, annualised compensation growth over the 9 months to March 2016 was a more healthy 2.4%. Over that period, growth in wages has clearly been stronger than for benefits, 2.4% versus 2.0% annualised – the latter restricted by private-sector firms taking a hard line on benefit inflation so as to mitigate total cost increases.
- Come Q2 2016, it is likely that we will see a continuation of the recent trend: wages outpacing benefits and the private sector remaining focused on costs. Another 0.6% gain for total compensation is expected overall. For the FOMC, this will signal robust health in the labour market, albeit without any evidence of unwanted inflationary concerns.

Total nominal wage growth



Data calendar

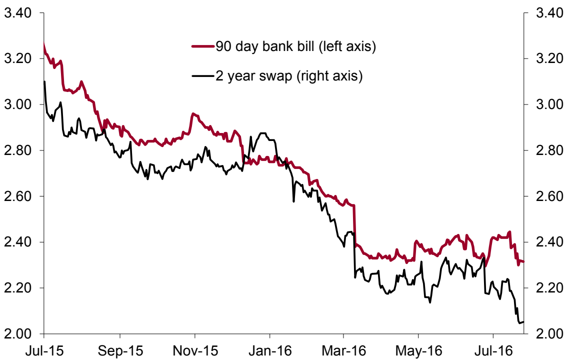
		Last	Market median	Westpac forecast	Risk/Comment
Mon 25					
Ger	Jul IFO business climate	108.7	107.5	–	Current conditions strong; expectations soft.
US	Jul Dallas Fed manufacturing activity	–18.3	–10.0	–	Manufacturing activity remains subdued.
Tue 26					
NZ	Jun trade balance $m	358	–	300	Strong volumes of dairy exports expected, although prices remain low.
US	May S&P/C-S 20 city house prices	5.4%	5.6%	–	Continues to maintain robust pace.
	Jul Markit services PMI (provisional)	51.4	–	–	Signals soft growth in the services sector; disagrees with ISM.
	Jul consumer confidence index	98.0	95.5	–	Conference Board measure.
	Jul Richmond Fed manufacturing survey	–7	–4	–	At modest levels; some recovery after recent falls expected.
	Jun new home sales	–6.0%	1.6%	–	Uptrend continues, supported by confidence and low interest rates.
Wed 27					
Aus	Q2 CPI	–0.2%	0.4%	0.5%	Rising auto fuel and fresh fruit & vegetables, but little impact from AUD.
	Q2 avg core CPI	0.2%	0.4%	0.35%	Moderation in housing costs is helping to hold down core inflation.
Chn	Jun industrial profits %yr	3.7%	–	–	Weak conditions continues to limit firms' pricing power.
	Jul Westpac-MNI China Consumer Sent'	115.9	–	–	Improving but still below 10yr avg of 120.
Eur	Jun M3 money supply %yr	4.9%	5.0%	–	Latest credit data also due.
UK	Q2 GDP	0.5%	0.4%	0.4%	Business conditions softened in the run up to the Brexit vote.
US	Jun durable goods orders (provisional)	–2.3%	–1.0%	–	Investment is weak and likely to remain that way.
	Jun pending home sales	–3.7%	1.8%	–	Lead for existing home sales; uptrend intact.
	FOMC policy decision, midpoint	0.375%	0.375%	0.375%	Will we see the FOMC start to stoke rate expectations for late-2016?
Thu 28					
Aus	Q2 import price index	–3.0%	1.5%	0.4%	On balance a small rise, higher oil prices outweigh impact of higher AUD.
	Q2 export price index	–4.7%	3.0%	3.5%	Up on a bounce in commodity prices, up from recent lows.
Eur	Jun economic confidence	104.4	103.6	–	Overall confidence looks well supported for now…
	Jun consumer confidence (final)	–7.9	–7.9	–	… the consumer remaining optimistic over the outlook…
	Jun business climate indicator	0.22	0.10	–	… while business conditions are robust, although outlook questionable.
Ger	Jul CPI %yr (provisional)	0.2%	0.3%	–	Contrast between inflation and labour market stark.
UK	Jul Nationwide house prices	0.2%	0.1%	–	Heightened uncertainty and policy changes dampening house prices.
US	Initial jobless claims	253k	–		Remain low historically.
Fri 29					
NZ	Jun building permits	–0.9%	–	2.0%	Uncertainty weighing on Auckland, firming activity elsewhere.
	NZ business confidence	20.2	–	–	Confidence points to steady growth, but limited price pressures.
Aus	June private sector credit	0.4%	0.5%	0.4%	A loss of momentum ahead of any impact from RBA May rate cut.
	Q2 PPI	–0.2%	–		
Eur	Jun unemployment rate	10.1%	10.1%	–	(Very) slowly improving.
	Jul CPI %yr (provisional)	0.1%	0.2%	–	A long way to go before an inflation uptrend is secured.
	Q2 GDP	0.6%	0.3%	0.4%	Pull back in Q2 likely after strong start, as per 2015.
UK	Jul GfK consumer confidence	–1	–7	–	Signs that household nervousness has risen since the referendum.
US	Q2 employment cost index	0.6%	0.6%	0.6%	Annual growth rate to rise to around 2.4% as weak Q2 2015 drops out.
	Q2 GDP	1.1%	2.6%	2.4%	Improvement in Q2 wont be anywhere near as strong as in 2015.
	Jul Chicago PMI	56.8	53.0	–	Has picked up, though the employment component remains subdued.
	Jul Uni of Michigan sentiment (final)	89.5	90.5	–	Confidence robust, a little above long-run average.
	Fedspeak	–	–	–	Williams discusses policy toolkit in Boston.
	Fedspeak	–	–	–	Kaplan speaks at Q&A in Albuquerque.

New Zealand forecasts

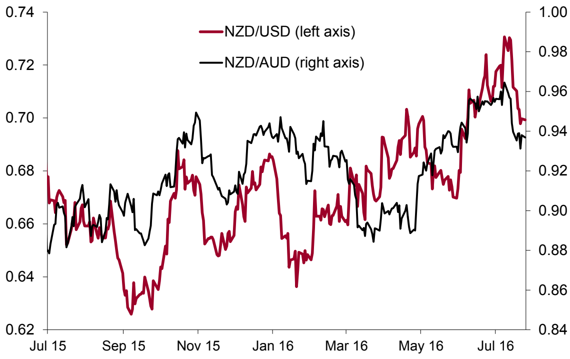
Economic Growth Forecasts	March years				Calendar years			
% change	2014	2015	2016	2017f	2014	2015	2016f	2017f
GDP (Production) ann avg	2.7	3.6	2.4	2.9	3.7	2.5	2.9	2.7
Employment	3.8	3.2	2.0	2.5	3.6	1.4	2.9	2.4
Unemployment Rate % s.a.	6.0	5.8	5.7	5.4	5.8	5.4	5.7	5.0
CPI	1.5	0.3	0.4	1.3	0.8	0.1	1.1	2.1
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	2.00	2.10	2.20	2.20	2.20	2.20
5 Year Swap	2.20	2.30	2.40	2.50	2.60	2.60
10 Year Bond	2.20	2.30	2.40	2.60	2.70	2.80
NZD/USD	0.68	0.66	0.63	0.63	0.62	0.62
NZD/AUD	0.93	0.93	0.93	0.93	0.90	0.89
NZD/JPY	70.0	67.3	63.6	63.6	63.2	64.5
NZD/EUR	0.62	0.61	0.59	0.60	0.58	0.58
NZD/GBP	0.52	0.52	0.50	0.49	0.48	0.48
TWI	73.6	72.2	69.9	70.1	68.7	68.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 25 July 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.25%	2.25%	2.25%
30 Days	2.30%	2.37%	2.31%
60 Days	2.30%	2.40%	2.33%
90 Days	2.32%	2.42%	2.32%
2 Year Swap	2.05%	2.23%	2.21%
5 Year Swap	2.15%	2.25%	2.33%

NZ foreign currency mid-rates as at Monday 25 July 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6993	0.7296	0.7074
NZD/EUR	0.6369	0.6602	0.6421
NZD/GBP	0.5321	0.5634	0.5267
NZD/JPY	74.26	73.42	71.82
NZD/AUD	0.9368	0.9642	0.9537
TWI	75.26	78.05	75.92

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	1.90	1.80	1.80	1.80	1.80	1.80
10 Year Bond	1.89	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	1.55	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	0.7474	0.73	0.71	0.68	0.68	0.69
USD/JPY	105.85	103	102	101	101	102
EUR/USD	1.1027	1.10	1.08	1.07	1.05	1.06
AUD/NZD	1.0683	1.07	1.08	1.08	1.08	1.11

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